Memo to: Oaktree Clients

From: Howard Marks

Re: You Can't Predict. You Can Prepare.

Those who have been readers of my memos for any meaningful period of time know there are a few things I dismiss and a few I believe in thoroughly. The former include economic forecasts, which I think don't add value, and the list of the latter starts with cycles and the need to prepare for them.

"Hey," you might say, "that's contradictory. The best way to prepare for cycles is to predict them, and you just said it can't be done." That's absolutely true, but in my opinion by no means debilitating. All of investing consists of dealing with the future, as I've written before, and the future is something we can't know much about. But the limits on our foreknowledge needn't doom us to failure as long as we acknowledge them and act accordingly.

In my opinion, the key to dealing with the future lies in knowing where you are, even if you can't know precisely where you're going. **Knowing where you are in a cycle and what that implies for the future is very different from predicting the timing, extent and shape of the next cyclical move**. And so we'd better understand all we can about cycles and their behavior.

Cycles in General

I think several things about cycles are worth bearing in mind:

- Cycles are inevitable. Every once in a while, an up-or down-leg goes on for a long time and/or to a great extreme and people start to say "this time it's different." They cite the changes in geopolitics, institutions, technology or behavior that have rendered the "old rules" obsolete. They make investment decisions that extrapolate the recent trend. And then it turns out that the old rules do still apply, and the cycle resumes. In the end, trees don't grow to the sky, and few things go to zero. Rather, most phenomena turn out to be cyclical.

- Cycles' clout is heightened by the inability of investors to remember the past. As John Kenneth Galbraith says, "extreme brevity of the financial memory" keeps market participants from recognizing the recurring nature of these patterns, and thus their inevitability:

  > . . . when the same or closely similar circumstances occur again, sometimes in only a few years, they are hailed by a new, often youthful, and always supremely self-confident generation as a brilliantly innovative discovery in the financial and

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For the title of this memo I've borrowed the tagline from Mass Mutual's advertising campaign.

larger economic world. There can be few fields of human endeavor in which history counts for so little as in the world of finance. Past experience, to the extent that it is part of memory at all, is dismissed as the primitive refuge of those who do not have the insight to appreciate the incredible wonders of the present.

- Cycles are self-correcting, and their reversal is not necessarily dependent on exogenous events. The reason they reverse (rather than going on forever) is that trends create the reasons for their own reversal. Thus I like to say **success carries within itself the seeds of failure, and failure the seeds of success.**

- Seen through the lens of human perception, cycles are often viewed as less symmetrical than they are. Negative price fluctuations are called "volatility," while positive price fluctuations are called "profit." Collapsing markets are called "selling panics," while surges receive more benign descriptions (but I think they may best be seen as "buying panics"; see tech stocks in 1999, for example). Commentators talk about "investor capitulation" at the bottom of market cycles, while I also see capitulation at tops, when previously-prudent investors throw in the towel and buy.

I have views on how these general observations and others apply to specific kinds of cycles, which I will set forth below.

The Economic Cycle

Few things are the subject of more study than the economy. There's a whole profession built around doing so. Academics try to understand the economy, and professionals try to predict its course. Personally, I'd stick to the former. I think we can gain a good grasp of how the economy works, but I do not think we can predict its fluctuations.

I have written *ad nauseam* on this subject, but I will repeat a few of the observations I consider relevant:

- There are hundreds, or more likely thousands, of people out there trying to predict the movements of the economy, but no one has a record much better than anyone else. Certainly no one who was consistently capable of accurately predicting the economy's movements would be among those distributing their forecasts gratis.

- The markets already incorporate the views of the consensus of economists, and thus holding a consensus view can't help you make above-average returns (even if it's right).

- Non-consensus views can make money for you, but to do so they must be right. Because the consensus reflects the efforts of a large number of intelligent and informed people, however, it's usually the closest we can get to right. In other words, I doubt there's anyone out there with non-consensus views that are right routinely.

- Most of the time, the consensus forecast extrapolates current observations. Most predictions for growth, inflation and interest rates bear a strong resemblance to the levels prevailing at the time they're made. Thus they're close to right when nothing changes radically, which is the case most of the time, but no prediction can be counted on to foretell the important sea changes. And it's in predicting radical changes that extraordinary profit potential exists. In other words, **it's the <u>surprises</u> that have profound market impact (and thus profound profit potential), but there's a good reason why they're called surprises: it's hard to see them coming**!

- Each time there's a radical change, there's an economist who predicted it, and that person gets to enjoy his fifteen minutes of fame. Usually, however, he wasn't right because of a superior ability to see the future, but rather because he tends to hold extreme positions (or perhaps he's a dart thrower) and this time the phenomenon went his way. Rarely if ever is that economist right twice in a row.

So forecasts are unlikely to help us foresee the movements of the economic cycle. Nevertheless, we must be aware that it exists and repeats. The greatest mistakes with regard to the economic cycle result from a willingness to believe that it will not recur. But it always does – and those gullible enough to believe it won't tend to lose money.

When we marketed our first distressed debt fund in 1988, most of the resistance came from people who said, "maybe there won't be a recession, and thus nothing for you to buy." Of course, we were deep into a recession within two years, and our 1988-92 distressed debt funds found lots to buy and produced excellent returns.

Eminent observers concluded again in the 1990s that the cycle had been eliminated and there would be no recession. In 1996, the Wall Street Journal wrote:

> From boardrooms to living rooms and from government offices to trading floors, a new consensus is emerging: The big, bad business cycle has been tamed.

Top business leaders were quoted as saying "There is no natural law that says we have to have a recession" and "I don't see what could happen to make a cyclical downturn." (These quotes are reminiscent of – and look no less silly than – some of my favorites from 1928: "There will be no interruption of our present prosperity" and "I cannot help but raise a dissenting voice to the statements that . . . prosperity in this country must necessarily diminish and recede in the future.")

Those quoted in 1996 might insist they weren't saying there would never be another recession, but rather that the tendency toward cyclical fluctuation had been dampened and there wouldn't be a recession soon. And they might say they were right in 1996, because there wasn't one until 2001. If managers had feared a recession in 1996, they might have pulled in their horns and missed some of the profits of the late 1990s. But they also might have avoided over-expanding and participating fully in the recession of 2001.

The important thing is to recognize that cycles reverse, and to allow for it. I described in my last memo, "What Lies Ahead?," the manner in which a recession continues until, at the margin, a few participants stop cutting back and decide instead to act in anticipation of better times. I believe this process, and the reverse process that eventually causes growth to stall out, will go on forever. No one knows when the turn will occur, or how far the correcting leg will go, but the odds are against anyone who says, "the business cycle is dead."

How can non-forecasters like Oaktree best cope with the ups and downs of the economic cycle? I think the answer lies in knowing where we are and leaning against the wind. For example, when the economy has fallen substantially, observers are depressed, capacity expansion has ceased and there begin to be signs of recovery, we are willing to invest in companies in cyclical industries. When growth is strong, capacity is being brought on stream to keep up with soaring demand and the market forgets these are cyclical companies whose peak earnings deserve trough valuations, we trim our holdings aggressively. We certainly might do so too early, but that beats the heck out of doing it too late.

The Credit Cycle

The longer I'm involved in investing, the more impressed I am by the power of the credit cycle. It takes only a small fluctuation in the economy to produce a large fluctuation in the availability of credit, with great impact on asset prices and back on the economy itself.

The process is simple:

- The economy moves into a period of prosperity.
- Providers of capital thrive, increasing their capital base.
- Because bad news is scarce, the risks entailed in lending and investing seem to have shrunk.
- Risk averseness disappears.
- Financial institutions move to expand their businesses – that is, to provide more capital.
- They compete for market share by lowering demanded returns (e.g., cutting interest rates), lowering credit standards, providing more capital for a given transaction, and easing covenants.

At the extreme, providers of capital finance borrowers and projects that aren't worthy of being financed. As The Economist said earlier this year, "the worst loans are made at the best of times." This leads to capital destruction – that is, to investment of capital in projects where the cost of capital exceeds the return <u>on</u> capital, and eventually to cases where there is no return <u>of</u> capital.

When this point is reached, the up-leg described above is reversed.

- Losses cause lenders to become discouraged and shy away.
- Risk averseness rises, and along with it, interest rates, credit restrictions and covenant requirements.
- Less capital is made available – and at the trough of the cycle, only to the most qualified of borrowers.
- Companies become starved for capital. Borrowers are unable to roll over their debts, leading to defaults and bankruptcies.
- This process contributes to and reinforces the economic contraction.

Of course, at the extreme the process is ready to be reversed again. Because the competition to make loans or investments is low, high returns can be demanded along with high creditworthiness. Contrarians who commit capital at this point have a shot at high returns, and those tempting potential returns begin to draw in capital. In this way, a recovery begins to be fueled.

I stated earlier that cycles are self-correcting. The credit cycle corrects itself through the processes described above, and it represents one of the factors driving the fluctuations of the economic cycle. **Prosperity brings expanded lending, which leads to unwise lending, which produces large losses, which makes lenders stop lending, which ends prosperity, and on and on**.

In "Genius Isn't Enough" on the subject of Long-Term Capital Management, I wrote "Look around the next time there's a crisis; you'll probably find a lender." **Overpermissive providers of capital frequently aid and abet financial bubbles**. There have been numerous recent examples where loose credit contributed to booms that were followed by famous collapses: real estate in 1989-92; emerging markets in 1994-98; Long-Term Capital in 1998; the movie exhibition industry in 1999-2000; venture capital funds and telecommunications companies in 2000-01. In each case, lenders and investors provided too much cheap money and the result was over-expansion and dramatic losses. In "Fields of Dreams" Kevin Costner was told, "if you build it, they will come." **In the financial world, if you offer cheap money, they will borrow, buy and build – often without discipline, and with very negative consequences.**

The credit cycle contributed tremendously to the tech bubble. Money from venture capital funds caused far too many companies to be created, often with little in terms of business justification or profit prospects. Wild demand for IPOs caused their hot stocks to rise meteorically, enabling venture funds to report triple-digit returns and attract still more capital requiring speedy deployment. The generosity of the capital markets let companies sign on for huge capital projects that were only partially financed, secure in the knowledge that more financing would be available later, at higher p/e's and lower interest rates as the projects were further along. This ease caused far more capacity to be built than was needed, a lot of which is sitting idle. Much of the investment that went into it may never be recovered. Once again, easy money has led to capital destruction.

In making investments, it has become my habit to worry less about the economic future – which I'm sure I can't know much about – than I do about the supply/demand picture relating to capital. Being positioned to make investments in an uncrowded arena conveys vast advantages. Participating in a field that everyone's throwing money at is a formula for disaster.

We have lived through a long period in which cash acted like ballast, retarding your progress. **Now I think we're going into an environment where cash will be king**. If you went to a leading venture capital fund in 1999 and said, "I'd like to invest $10 million with you," they'd say, "Lots of people want to give us their cash. What else can you offer? Do you have contacts? Strategic insights?" I think the answer today would be different.

One of the critical elements in business or investment success is staying power. I often speak of the six-foot-tall man who drowned crossing the stream that was five feet deep on average. Companies have to be able to get through the tough times, and cash is one of the things that can make the difference. Thus all of the investments we're making today assume we'll be going into the difficult part of the credit cycle, and we're looking for companies that will be able to stay the course.

The Corporate Life Cycle

As indicated above, business firms have to live through ups and downs. They're organic entities, and they have life cycles of their own.

Most companies are born in an entrepreneurial mode, starting with dreams, limited capital and the need to be frugal. `Success comes to some. They enjoy profitability, growth and expanded resources, but they also must cope with increasing bureaucracy and managerial challenges. The lucky few become world-class organizations, but eventually most are confronted with challenges relating to hubris; extreme size; the difficulty of controlling far-flung operations; and perhaps ossification and an unwillingness to innovate and take risks. Some stagnate in maturity, and some fail under aging products or excessive debt loads and move into distress and bankruptcy. The reason I say failure carries within itself the seeds of success is that bankruptcy then permits some of them to shed debt and onerous contracts and emerge with a reborn emphasis on frugality and profitability. And the cycle resumes . . . as ever.

The biggest mistakes I have witnessed in my investing career came when people ignored the limitations imposed by the corporate life cycle. In short, investors did assume trees could grow to the sky. In 1999, just as in 1969, investors accepted that ultra-high profit growth could go on forever. They also concluded that for the stocks of companies capable of such growth, no p/e ratio was too high. People extrapolated earnings growth of 20%-plus and paid p/e ratios of 50-plus. Of course, when neither the growth nor the valuations turned out to be sustainable, losses of 90%-plus became the rule. As always, the folly of projecting limitless growth became obvious in retrospect.

The exigencies of the corporate life cycle usually render ultra-high growth rates unsustainable. Regardless of the improbability, however, investors indulge in "the willing suspension of disbelief" (which I always bring to the movies but check at the door when I come to work). They assume that successful companies will be able to attract enough talent, develop enough new products, access enough new markets, fend off competition while protecting high profit margins, and correctly make the strategic adaptations needed to keep growing . . . but it rarely works that way.

In February an article in Fortune magazine, covering 1960-80, 1970-90 and 1980-99, showed that out of 150 candidates among large companies, only four or five in each period were able to grow earnings per share at 15% per year on average. Only one, Philip Morris, grew at that rate for all three periods. The key for Philip Morris wasn't a technological miracle or a fabulous new growth product; it was solid blocking and tackling in areas of stable consumer demand. So the latest "wonder-company" with a unique product rarely possesses the secret of rapid growth forever. I think it's safer to expect a company's growth rate to regress toward the mean than it is to expect perpetual motion.

Business Fads and Fancies

We all laugh about hemlines, which fluctuate from year to year and add nothing to society but cost. The truth is, there's no place for them to go but up and down . . . and so they do. Likewise, there are business trends that have nowhere to go but back and forth . . . and so they do.

Take corporate diversification, for example. As a new equity analyst in 1970, one of my first assignments was to study conglomerates, starting with Litton, ITT, Whittaker, Teledyne and City Investing. It was widely held that their diversification and synergies (along with the magic of acquisition accounting and high p/e "funny money") could produce rapid growth forever. They pursued large numbers of acquisitions (ITT made 52 one year) and were rewarded with very high p/e ratios (which enabled them to prolong their growth for a while through further anti-dilutive acquisitions).

It wasn't long, however, before their dependence on sky-high multiples was recognized and difficulties surfaced in connection with the management of their diverse organizations. Their managers switched to stressing the benefits of specialization (as opposed to diversification), and the head of Whittaker wrote a paper extolling the virtues of a process he called "distillation of the product centroid." Units began to be sold off and the companies deconglomerated. It's interesting to note that none of those five companies exists today.

Diversification or specialization? Centralization or decentralization? Savings through just-in-time inventories or protection from stockpiles and redundancy? Tough goal-oriented management or warm-and-fuzzy work environments? Leverage on the upside through maximum debt or the safety that comes from a large equity cushion? The pendulum in each of these continua can do nothing but swing back and forth, and so it does. The answer is that there is no perfect answer. Companies move toward one extreme as it becomes more popular. Then the drawbacks surface and they move back toward the other. There's no place else for companies to move with regard to each of these questions, and so they cycle from one extreme to the other.

Likewise, there are cyclical fluctuations in how business phenomena are viewed. People move *en masse* toward one view, and when it turns out that no view can hold the answer, they move away from it.

For example, in the 1990s, information technology was thought to hold the answer to increased corporate efficiency. A great deal of the decade's bull market was fed by gains in productivity, which contributed greatly to both earnings and the p/e ratios investors applied to them. Technology-derived gains in productivity were embraced as having fundamentally altered the growth potential of companies and the economy. In testimony to the House of Representatives on February 23, 2000, Alan Greenspan said:

> . . . there are few signs to date of slowing in the pace of innovation and the spread of our newer technologies that, as I have indicated in previous testimonies, have been at the root of our extraordinary productivity improvement. Indeed, some analysts conjecture that we still may be in the earlier stages of the rapid adoption of new technologies and not yet in sight of the stage when this wave of innovation will crest.

Well, I know what did crest within 30 days: the stock market. And on October 24, 2001, just twenty months later, a less expansive Mr. Greenspan was quoted in the Wall Street Journal as saying:

> What the events of September 11 did was to introduce a whole new set of uncertainties which information technology is not going to improve our insight into. And so it is a reversal of some of the forces that engendered the productivity acceleration of the last five years.

In other words, what had been thought to be a fundamental and durable change has proved to be one more development whose ability to wax and wane has to be acknowledged and watched. The gains from productivity are proving to be cyclical, and the cycle shorter than had been expected.

The Market Cycle

At the University of Chicago, I was taught that the value of an asset is the discounted present value of its future cash flows. If this is true, we should expect the prices of assets to change in line with changes in the outlook for their cash flows. But we know that asset prices often rise and fall without regard for cash flows, and certainly by amounts that are entirely disproportionate to the changes in cash flows.

Finance professors would say that these fluctuations reflect changes in the discount rate being applied to the cash flows or, in other words, changes in valuation parameters. Practitioners would agree that changes in p/e ratios are responsible, and we all know that p/e ratios fluctuate much more radically than do company fundamentals.

The market has a mind of its own, and its changes in valuation parameters, caused primarily by changes in investor psychology (not changes in fundamentals), that account for most short-term changes in security prices. This psychology, too, moves in a highly cyclical manner.

For decades – literally – I've been lugging around what I thought was a particularly apt enumeration of the three stages of a bull market:

- **the first, when a few forward-looking people begin to believe things will get better,**
- **the second, when most investors realize improvement is actually underway, and**
- **the third, when everyone concludes everything will get better forever.**

Why would anyone waste time trying for a better description? This one says it all.

Stocks are cheapest when everything looks grim. The depressing outlook keeps them there, and only a few astute and daring bargain hunters are willing to take new positions. Maybe their buying attracts some attention, or maybe the outlook turns a little less depressing, but for one reason or another, the market starts moving up.

After a while, the outlook seems a little less poor. People begin to appreciate that improvement is taking place, and it requires less imagination to be a buyer. Of course, with the economy and market off the critical list, they pay prices that are more reflective of stocks' fair values.

And eventually, giddiness sets in. Cheered by the improvement in economic and corporate results, people become willing to extrapolate it. The masses become excited (and envious) about the profits made by investors who were early, and they want in. And they ignore the cyclical nature of things and conclude that the gains will go on forever. That's why I love the old adage "What the wise man does in the beginning, the fool does in the end." Most importantly, in the late stages of the great bull markets, people become willing to pay prices for stocks that assume the good times will go on *ad infinitum*.

But they cannot. When the tech bubble was roaring ahead in late 1999, no one could think of any development that might be capable of bringing it to an end. Technology was certain to revolutionize everyday life, creating a new investment paradigm. Revenue growth (or at least the growth in "eye-balls") was strong. Capital was freely available, enabling expansion to continue and new, innovative companies to be formed. Cash flows into mutual funds and 401(k)s guaranteed steady demand for the stocks. Each time another tech stock was added to an index, a whole new group of forced buyers was created among index funds and the active managers benchmarked against that index. No portfolio manager could take the risk of under-owning these stocks; **they had to buy them regardless of price**! Eureka! There was no way they could stop going up. The perpetual motion machine had been built.

But somehow, the stocks did stop going up. And then they started going down. I don't think anyone can say just what it was that caused the tech bubble to burst. Certainly I can't think of any one thing – even in hindsight, which is usually 20:20. Maybe the groundwork was laid for declines when it was shown merely that the rise could slow. Maybe a few smart people, to paraphrase the third of the three stages, concluded that everything wouldn't get better forever. The best explanation probably is that the prices just collapsed under their own weight.

Anyway, the market proved – once again – that it can't move in one direction forever. **It has to be appreciated in cyclical terms, with increases followed by decreases, and in fact with increases causing decreases**.

In April 1991 , in just my second general memo to clients, I described the market as follows:

> The mood swings of the securities markets resemble the movement of a pendulum. Although the midpoint of its arc best describes the position of a pendulum "on average," it actually spends very little of its time there. Instead, it is almost always swinging toward or away from the extremes of its arc. But whenever the pendulum is near either extreme, it is inevitable that it will move back toward the midpoint sooner or later. In fact, it is the movement toward an extreme itself that supplies the energy for the swing back.
>
> Investment markets make the same pendulum-like swing:
>
> - between euphoria and depression,
> - between celebrating positive developments and obsessing over negatives, and thus
> - between overpriced and underpriced.

The swing of the pendulum? The oscillation of the cycle? Either way's fine – just don't tell me it'll be a straight line.

In 1999, the Wall Street Journal ran a number of OpEd pieces by James Glassman and Kevin Hassett trumpeting the theory behind the book "Dow 36,000." I couldn't think of anything that made less sense. By last month, it seemed the Journal's story had changed:

> With economic conditions turning downward so quickly, pushed along by the events of Sept. 11, a lot of business books have been rendered irrelevant, even silly. Anyone remember "Dow 36,000"?

How quickly views change, and how quickly the logical-sounding rationale for lofty or depressed prices is shown in retrospect to have been "silly."

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The risks entailed in ignoring the inherently cyclical nature of things are manifold, and the various cycles interact, often in ways that surprise the optimists. On October 26 the beautifully written (but inaptly-titled) "Grant's Interest Rate Observer" described the situation at a fallen telecommunications giant as follows:

> In the New Economy, the front office seemed persuaded, there would be no recession (let alone a global recession) and no bear market (especially one concentrated in technology). There would be no pause in the growth of the demand for broadband, no collapse in the price of broadband access and no credit contraction. What we are looking at . . . is compressed cash flow at the trough in a cyclical business so new that its proponents have yet to discover that it is, in fact, cyclical.

This example represents a four-bagger. It seems the company's management ignored the cyclicality of (l) the economy, (2) the stock market, (3) the availability of credit, and (4) the demand and price for its product. As in this case, the failure to prepare for cycles usually leads to what later are perceived as obvious, easily-avoided mistakes.

Cycles and How To Live With Them

No one knew when the tech bubble would burst, and no one knew what the extent of the correction could be or how long it would last. But it wasn't impossible to get a sense that the market was euphoric and investors were behaving in an unquestioning, giddy manner. That was all it would have taken to avoid a great deal of the carnage.

Having said that, I want to point out emphatically that many of those who complained about the excessive market valuations – including me – started to do so years too soon. And for a long time, another of my old standards was proved true: "being too far ahead of your time is indistinguishable from being wrong." Some of the cautious investors ran out of staying power, losing their jobs or their clients because of having missed the gains. Some capitulated and, having missed the gains, jumped in just in time to participate in the losses.

So I'm not trying to give the impression that coping with cycles is easy. But I do think it's a necessary effort. We may never know where we're going, or when the tide will turn, but we had better have a good idea where we are.

November 20, 2001

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