Memo to: Oaktree Clients

From: Howard Marks

Re: What's Going On?

In recent months, a few Oaktree clients have asked me to take part in give-and-take sessions with their investment staffs and other money managers. The discussions have revolved around changes in the investment environment and the implications for the future. The process of thinking about those subjects has given rise to this memo.

A Sweeping Change

In the last three years, there have been massive changes in markets, investment thinking, expectations and behavior. The term "paradigm shift" certainly is overused, but in this case I don't think it's off target.

During the 1990s and for many years prior, institutional investors such as pension funds and endowments targeted returns of 8-10 %. The task of appropriately allocating assets was made easy by the universal expectation (accompanied by sixty-plus years of supporting data) that stocks "normally" return 9-11 % per year. When the main engine of a portfolio's performance can be counted on for returns that exceed what's needed overall, asset allocation is a relatively easy task. Put a substantial majority of the portfolio in stocks, add a few bonds in a nod to conservatism and an allocation to private equity for spice, and the job's done.

The only question was what you wanted your return to be (within the range of 8-10%), and the solution was found in the magnitude of your equity allocation. Certainly, overall portfolio returns in the range of 8-10% were viewed as readily attainable.

But all of a sudden, no one thinks so anymore. Goals at that level (or even a little lower) now seem quite daunting. What has changed is the equity return people feel can be expected. History is out the window, and few people believe any longer in 9-11% from equities. Moderates talk about long-term returns between 4% and 8%, and the bear case is considerably lower (or negative). With high grade bond yields also in the low to mid-single digits, the two biggest asset categories are promising returns that fall short of the overall goal. Thus it's unclear how that goal can be achieved while holding any meaningful amount in stocks and/or high grade bonds – or whether it can be achieved at all.

We all know what happened to prospective bond returns: economic weakness and the Fed's stimulative actions combined to lower prevailing interest rates, and thus promised bond returns, to 40-year lows. But what happened to the prospective return on equities?

Simply put, people began to search for the elements that would lead to continued lofty equity returns, and they failed to find them. In the 1990s, few people pondered the fact that if corporate profits grow in single digits and "normal" equity performance is 9-11 %, two decades or so of returns almost twice that might be borrowing from the future. Now the future is here and that realization has set in. Those single digit profit increases (accompanied by low dividend yields) are expected to result in mid-single digit equity returns if P/E ratios are unchanged, and less if multiples shrink.

So the question has switched from "How much would you like to make and spend?" to "How much can you make safely, and what will that let you spend?"

Is There No Opportunity in Equities?

It is clear that (a) most people's expectations for equities now are in the mid single digits, and (b) equities are attracting as little interest as at any time in the last 25 years. There are, however, factors supportive of a more positive case:

- The most obvious is the fact that stock prices are off substantially since hitting record highs in early 2000.

- Another positive might be seen in the fact that the curtailing of expectations for equity returns coincided with the incurrence of substantial losses. Thus it's tempting to think that the moderation of expectations may have stemmed from the corrosive emotional effect of recent losses on investor psyches, not from new data or objective analysis.

- In fact, it's comforting to note a hopeful analogy. In August 1979, after a harsh correction in 1973-74 followed by several sluggish years, the cover of Business Week proclaimed "The Death of Equities" . . . just prior to the ignition of the historic bull market that lasted through 1999. As in that case, with attitudes toward equities beaten down so universally, the contrarian position today might be to bet heavily on them. Sentiment toward equities can hardly get worse and, unimaginable as it seems, it just could get better.

At the same time, there are negatives to be dealt with:

- Even though stock prices have come down substantially, the average P/E ratio remains high – in the upper teens or low twenties, depending on whom you ask. In the last major cycle, which bottomed in the 1970s, P/E ratios reached levels like today's at the high and fell to single digits when prices hit bottom. By that standard, today's valuations suggest a high, not a low.

- One reason today's P/E ratios are high in the absolute is that interest rates are so low. Low interest rates justify a high valuation of future cash flows. But what does that imply for P/E ratios (and stock prices) if interest rates were to rise from today's historic lows?

- Lastly, we have to wonder where the energy for a more bullish market will come from, and specifically whether a generation of investors who've been burned is lost from the stock market forever.

My own take is that even if the 9-11% historic long-term return on stocks remained relevant with regard to the future, (and certainly that's the best anyone could hope for), the above-average gains of the last two decades have borrowed from the future, and the high resulting P/E ratios imply an average return in single digits over the next few years.

At the same time, I think some good individual opportunities may be found among orphaned small and mid-cap stocks. Because investment banks are no longer supposed to recommend stocks just to get investment banking business, their coverage lists might contract. The financial pressures and resulting layoffs at the big research firms are leaving many companies without coverage. Many un-researched companies will likely emerge from financial restructurings and corporate spin-offs. Put it all together, and expert stock pickers probably will find some good opportunities in the newly less efficient market.

<u>The Market Cycle at Its Wildest</u>

In a memo on cycles entitled "You Can't Predict. You Can Prepare." I discussed the general progression of a market cycle:

- Favorable developments and positive investor psychology cause prices to rise.
- Reports of price appreciation attract momentum players, who shout, "We'd better get in; who knows how far this can go." Their purchases of already-appreciated assets move prices still higher on a trajectory that appears capable of rising forever.
- Eventually, prices get so high that they vastly exceed intrinsic values.
- A few value-conscious investors step into the crowd to sell. Prices turn down, sagging under their own weight or perhaps because fundamental developments begin to be less favorable.
- Less-favorable developments and less-favorable psychology combine to force prices below intrinsic values.
- The pain of losses becomes so great that investors flee and prices reach giveaway levels. This time it's, "We'd better get out; who knows how far this can go."
- The first iron-nerved contrarians recognize that good values are available and start to buy.
- Others soon follow, and eventually the number of new buyers exceeds the number of sellers. Prices stop falling . . . and begin to rise.

- Reports of rising prices and the bargains obtained by those astute pioneers attract the masses to the marketplace, who shout, "We'd better get in . . . ," and the cycle continues.

I've always known about this cycle. I've seen it at work for decades. **But I've never seen it function – in terms of the extent and swiftness of the fluctuations – as it did with regard to low-grade debt over the last year.** Because the performance of mainstream equities has little direct impact on Oaktree, we remain largely disinterested observers of stock market developments. But we are vitally interested in what happens in credit-related investments, and the change there has been mind-boggling.

<u>The Pricing of Credit Risk in 2002-03</u>

It's hard to believe, but the biggest cycle I've ever seen in distressed debt began just about a year ago.

- With investors softened up by economic sluggishness, depressing world events and the realization of just how wrong they'd been in the 1990s, conditions were ripe for a crisis of confidence. The catalyst came in the form of an incredible series of corporate scandals.

- At first, Enron was viewed as an isolated instance of corporate venality. But then Tyco, Adelphia and Global Crossing began to suggest a pattern. Arthur Andersen was convicted and had to shut down. The capper was the disclosure of massive fraud at WorldCom. Billions were lost, confidence was dashed, and investors – so certain just a year or two earlier – no longer felt they had a foundation on which to base any confidence.

- Bond fund managers who thought they had bought money-good securities found themselves holding distressed debt. Bonds they felt good about buying at prices of 90 or 100 turned scary at 20 or 30. High grade bond managers sold down-graded bonds (or bonds expected to be downgraded) as required or to dress up their statements, and everyone sold to reduce concentrations, raise cash to meet withdrawals, or cut risk.

- Because of this combination of events, we were able to invest more than $2 billion last summer in distressed debt priced very attractively. We put massive amounts into the public bonds of sizeable corporations – like Tyco, Qwest, Lucent, Nortel and Corning – that we thought might pay interest and principal as promised. In the past, we've always thought our distressed companies were 99% likely to default or go bankrupt. Now we were paying death's-door prices for bonds that we thought had a good chance of escaping that fate.

In this way, the downswing of the distressed debt market cycle gave us unusually good investment opportunities: significant companies that might survive, giveaway prices, potentially high prospective returns, in vast quantities. We were buying at yields well above 20%, and total returns that we thought would be far higher if our credit judgments were validated. We felt our purchases in June-September 2002 rivaled those of 1990, which had produced our highest returns to date.

But the most amazing thing is what happened next. The market turned on a dime, and in the next six months it became as strong as it had been weak.

What caused the turn? Maybe it was the fact that scandals stopped erupting. Maybe it was the first few successful sales of assets made to improve balance sheets. Maybe investors realized that distressed debt offered excellent investment opportunities. Maybe distressed debt fund managers regretted having missed a major opportunity to invest during the summer. Or maybe it was Warren Buffett's announcement that Berkshire Hathaway had increased its holdings of lower-rated debt by $6 billion in 2002. Whatever the reason, sentiment turned from negative to positive . . . with a vengeance.

Based on data for the OCM Opportunities Fund IVb, the distressed debt positions we bought in 2002 returned almost 20% in November alone, and 23% in the fourth quarter of the year. They took off again in early 2003, rising 15% in the first quarter and another 10% in April. For the six months from November through April, the total estimated gain has been more than 55% (and more than 41% net of fees and expenses).

This was yet another example of the schizophrenic swing of the investment pendulum: Trust replaced skepticism. Gain replaced loss. Greed replaced fear. And, incredibly, panic buying replaced panic selling. The cycle had swung from morosely negative to ebulliently positive in less than a year. **And thus the Tyco bonds we bought in May 2002 at a 24% yield became gilt-edge securities that could be sold in January 2003 – at yields of 4%-plus.**

We've seen the same cycle in high yield bonds. Last July, because investors had developed allergies to high yield bonds, the average bond had to provide more than 1,000 basis points more yield than a Treasury note of comparable maturity to induce investors to buy it. But now, investors have come to lust after high promised returns, and they are willing to buy the average high yield bond at a spread of just 600 basis points or so. The resulting estimated net return on our high yield bond portfolios: more than 15% for the 6 months November through April.

<u>But Why?</u>

Most observers are familiar with the returns reported above, and with the changed attitudes toward credit risk that lie behind them. But I think the behavior of distressed debt and high yield bonds should be viewed in a broader context, not in isolation. There are big-picture influences behind these trends.

What happens when people get excited about an asset class?

- capital floods in,
- prices rise,
- current returns soar, and
- prospective returns decline.

But don't forget the significant ramifications. Investors lose interest in other asset classes; thus their prices fall (at least in relative terms) and their prospective returns rise. In other words, the popular asset becomes more expensive and the rest get cheaper.

A powerful cult of equity believers held sway from 1978 – when I started to manage portfolios – through 1999, with only minor interruptions. The average return on the S&P 500 was over 17%. There wasn't a year in which the index declined more than 5%. Equity managers and analysts showed up on magazine covers and TV screens. Equities were fawned over in books ranging from "Stocks for the Long Run" (which explained that stocks could be counted on to beat bonds, cash and inflation in any period, providing it was long enough) to the self-explanatory "Dow 36,000." The man on the street accepted stocks as a sure thing.

What both the man on the street and the investment professional missed was that the appreciation that powered stocks' record returns had borrowed from the future and made them very expensive. And the view that stocks were all you needed also implied that other assets were superfluous. Thus bonds went out of favor, at least in relative terms. In the 1990s, few of the people I met could think of a convincing reason for their fixed income allocations. Maybe that made bond yields and yield spreads more generous than they should have been. **Stocks in favor and rich; bonds out of favor and cheap.**

And since the beginning of 2000? Stock prices are down. Confidence in stocks has been dashed. Equity return expectations have collapsed. Bonds and their contractual returns suddenly seem more attractive. Bond prices are up. Credit spreads have narrowed. The proof is seen in the performance described above.

The Power of Capital Flows

I want to discuss one last element that's been behind the powerful appreciation we've seen recently. I think the explanation's easy.

In the long run, investing is about value and the expectation that, eventually, price will catch up. But in the short run it's about psychology, emotion and popularity. The influence of those three factors comes through their effect on flows of capital, and **in the short run it's capital flows that have the most profound impact of all.**

The equity market is huge: $8.6 trillion in the U.S. alone. The high yield bond universe is about a tenth that size, and distressed debt is a fraction of that tenth. When a few billion dollars were withdrawn from stocks, the effect was moderate. But when those same refugee dollars sought deployment in our niche markets, the impact was dramatic.

In the last few months, what had been a buyers' market has become a sellers' market. Last year, especially in distressed debt, it was "the more money, the better." Now it's the opposite.
In the long run the return on an investment will follow the fundamentals, and in that sense I think of it as something approaching a fixed-sum proposition. But market fluctuations will render the receipt of that return highly uneven, as price moves above and then below intrinsic value. **Thus, everything else being equal, a higher return to date means a lower return in the future.** In this way the recent increase in bond prices implies lower bond returns in the future, and the narrowing of yield spreads implies lower relative returns for lower-rated bonds. A manager of lower-rated bonds hates to have to make these admissions, but refusing to make the admissions wouldn't make them any less true.

The Cat, the Tree, the Carrot and the Stick

I hope you'll forgive an incredible mixing of metaphors, but I can't resist using one to sum up on the subject of the current investment environment. As I think about situations like today's, (which, by the way, is not unprecedented), I visualize a cat in a tree. A carrot lures him out onto increasingly higher branches, and a stick prods him from behind.

In my analogy, the cat is an investor, whose job it is to cope with the investment environment, of which the tree is part. **The carrot – the incentive to accept increased risk – comes from the high returns seemingly available from riskier investments. And the stick – the motivation to forsake safety – comes from the modest level of prospective return being offered on safer investments.**

The carrot lures the cat to higher branches – riskier strategies – in pursuit of his dinner (his targeted return), and the stick prods the cat up the tree, because he can't get dinner while keeping his feet firmly on the ground. And that's a pretty good description of today's investment environment.

Today the greatest carrots are perceived to be available in the high yield bond and distressed debt markets. Not only do they make sense as ways to play the economic recovery that is presumed to loom ahead, but also they have provided the best recent results. **Of course, many cat-like investors fail to realize that excellent recent results don't add to an investment's prospective return; rather, they detract from it.** But the carrot of high recent results never fails to attract new followers to a strategy.

And, of course, the stick is extremely powerful today, because any substantial allocations to high grade bonds (with their promised returns of 4-6%) or to equities (whose prospective returns aren't perceived to be much higher) seem likely to ensure that a portfolio with a targeted return of 8-10% will fall short.

So investors consistently climb out on the limb of whatever strategy has performed best lately, without noticing their increasing distance from the ground. **Risk never looks like risk when it's generating a high return.**

Today that hungry cat is looking for a free lunch (oh no, not another metaphor!) in high yield bonds and distressed debt. **Those markets may offer the best way to be well-fed today, but they should be pursued only with eyes wide open concerning the altitude to which one is venturing.**

What else is there to do? It may sound like heresy, but what about concluding that (a) under what appear to be today's revised circumstances, pursuing that high-up dinner is just too risky, and (b) investors should content themselves with what's available, with safety, on limbs closer to the ground? Am I being too oblique? Let me stop trying to extend the metaphor and put it simply: investors may have to consider lowering their target returns.

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In recent times we've had several reminders regarding the inevitability of the market pendulum's swing, the propensity of investment popularity to wax and wane, the extremes of fluctuations, and the dramatic influence of cash flows. Some years, these transient influences will benefit us, as they have this year. Other years they're sure to hurt.

We can try to cope by understanding where the pendulum stands at a point in time and striving to anticipate its future swings. Or we can put our energy into emphasizing long-term value under the assumption that we'll be able to ride out the fluctuations if we're right about the values. To help us deal with the short-run developments, we've chosen to do some of each in the affected areas.

- We're being very candid about market conditions.
- We're limiting our assets under management.
- And if market conditions don't take a turn for the better, our clients should expect a reduced ability to profitably employ capital in our markets.

As to the long run, we're confident our adherence to value investing will continue to get us through.

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