Memo to: Oaktree Clients

From: Howard Marks

Re: What's Your Game Plan?

As the summer ends, my thoughts turn to the tennis game I've been hoping to improve, the baseball season that's moving toward a conclusion, and the football season that's just getting started. It's enough to remind me of the role sports play in our lives . . . and in our thoughts about investing.

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How Oaktree Plays the Game

Sometimes I feel I should apologize for the frequency with which I use sports metaphors to express my views on investing. And I worry that they'll fall flat in Europe and Asia. But that doesn't seem to stop me.

"The key to investment success isn't hitting home runs; it's avoiding strikeouts and inning-ending double plays." I say this over and over . . . and over . . . as you've no doubt experienced. But I truly believe it.

Investing is a testosterone-laden world where too many people think about how good they are and how much they'll make if they swing for the fences and connect. Ask some I-know-school investors to tell you what makes them good, and you'll hear a lot about home runs they've hit in the past and the home runs-in-the-making that reside in their current portfolio. How many talk about consistency, or the fact that their worst year wasn't too bad?

One of the most striking things I've noted over the last 35 years is how brief most outstanding investment careers are. Not as short as the careers of professional athletes, but shorter than they should be in a physically non-destructive vocation.

Where are the leading competitors from the days when I first managed high yield bonds 25 or 20 years ago? Almost none of them are around anymore. And astoundingly, not one of our prominent distressed debt competitors from the early days 15 or even 10 years ago remains a leader today.

Where'd they go? Many disappeared because organizational flaws rendered their game plans unsustainable. And the rest are gone because they swung for the fences but struck out instead.

That brings up something that I consider a great paradox: I don't think many investment managers' careers end because they fail to hit home runs. Rather, **they end up out of the**

game because they strike out too often – not because they don't have enough winners, but because they have too many losers. And yet, lots of managers keep swinging for the fences.

- They bet too much when they think they have a winning idea or a correct view of the future, concentrating their portfolios rather than diversifying.
- They incur excessive transaction costs by changing their holdings too often or attempting to time the market.
- And they position their portfolios for favorable scenarios and hoped-for outcomes, rather than ensuring that they'll be able to survive the inevitable miscalculation or stroke of bad luck.

At Oaktree, on the other hand, we believe firmly that "if we avoid the losers, the winners will take care of themselves." That's been our motto since the beginning, and it always will be. We go for batting average, not home runs. We know others will get the headlines for their big victories and spectacular seasons. But we expect to be around at the finish because of consistent good performance that produces satisfied clients.

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For Me, It Started With Tennis

In July, Larry Keele and I met with the Directors of the Vanguard Convertible Securities Fund to report on Oaktree's performance as the fund's manager. I was extremely pleased to see Charles Ellis of Greenwich Associates, one of the great thinkers in the investment field, whom I hadn't come across in many years. I was especially pleased to have a chance to tell him about the seminal part his 1975 article, "The Loser's Game," had played in the development of my thinking. The article employed a metaphor that was simple but profound.

Charley's article described the perceptive analysis of tennis contained in "Extraordinary Tennis for the Ordinary Tennis Player" by Dr. Simon Ramo, the "R" in TRW. Ramo pointed out that professional tennis is a "winner's game," in which the match goes to the player who's able to hit the most winners: fast-paced, well-placed shots that his opponent can't return. But the tennis the rest of us play is a "loser's game," with the match going to the player who hits the fewest losers. The winner just keeps the ball in play until the loser hits it into the net or off the court. **In other words, in amateur tennis, points aren't won; they're lost.** I recognized in Ramo's loss-avoidance strategy the version of tennis I try to play.

Charley took Ramo's idea a step further, applying it to investments. His views on market efficiency and the high cost of trading led him to conclude that the pursuit of winners is unlikely to pay off. Instead, you should try to avoid hitting losers. I found this view of investing absolutely compelling. I can't remember saying, "Eureka; that's the approach for me," but the developments over the last three decades certainly suggest his article was an important source of my inspiration.

Because of his conviction that markets are efficient, Charley recommended passive investing as the best way to end up the winner – let others try the tough shots and fail. Oaktree's view is a little different. Although we believe in the existence of inefficient markets as well as efficient ones, we still view the avoidance of losers as a wonderful foundation for investment success. Thus we diversify our portfolios, limit the fundamental risk we'll take, try to buy things that provide downside protection, and emphasize senior securities. **We, too, try to win by not losing.**

Which Team Do You Want Out There?

I recently came up with a new sports metaphor that handily illustrates a crucial choice each investor has to make. It goes like this:

Think about a football game. The offense has the ball. They have four tries to make ten yards. If they don't, the referee blows the whistle. Off the field goes the offense and on comes the defense, whose job it is to stop the other team from advancing the ball.

Is football a good metaphor for your view of investing? **Well I'll tell you, it isn't for mine.** In investing there's no one there to blow the whistle; you rarely know when to switch from offense to defense; and there aren't any time-outs during which to do it.

No, I think investing is more like the "football" that's played outside the U.S. – soccer. In soccer, the same eleven players are on the field for essentially the whole game. There isn't an offensive squad and a defensive squad. The same people have to play both ways . . . have to be able to deal with all eventualities. Collectively, those eleven players must have the potential to score goals and stop the opposition from scoring more.

A soccer coach has to decide whether to field a team that emphasizes offense (in order to score a lot of goals and somehow hold the other team to fewer) or defense (hoping to shut out the other team and find the net once), or one that's balanced. **Because the coach knows he won't have many opportunities to switch between offensive and defensive personnel during the game, he has to come up with a winning lineup and stick with it.**

That's my view of investing. Few people (if any) have the ability to switch tactics to match market conditions on a timely basis. So investors should commit to an approach – hopefully one that will serve them through a variety of scenarios. They can be aggressive, hoping they'll make a lot on the winners and not give it back on the losers. They can emphasize defense, hoping to keep up in good times and excel in bad times. Or they can attempt to balance offense and defense, giving up on tactical timing but aiming to win through superior security selection in both up and down markets.

Oaktree's preference for defense is clear. In good times, we feel it's okay if we just keep up with the indices (and in the best of times we may even lag a bit). But even average investors make a lot of money in good times, and I doubt many managers get fired for

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being average in up markets. Oaktree portfolios are set up to outperform in bad times, and that's when we think outperformance is essential. Clearly, if we can keep up in good times and outperform in bad times, we'll have above average results over full cycles with below average volatility, and our clients will enjoy outperformance when others are suffering. We think that's a winning long-term combination.

Our game plan is built around defense. But that's not enough. We still need players with superior skills.

Finding Your Role Model

An article in the Wall Street Journal of August 8, entitled "Greatness in Our Midst," supplied the immediate impetus for this memo. It attempted to determine "who's the greatest living baseball player?" I'm no expert on baseball, but I liked the Journal's analytical approach and loved its conclusions.

Of the five players discussed, Barry Bonds came in fifth. "If you're looking for a peak-value player – a guy to play one season as well as anyone ever has – this is your guy. His past two campaigns have been other-worldly . . ." Bonds has a ton of ability, but he has yet to prove that he's "the greatest." Lots of fence-swinging investors have had otherworldly years, but few have completed outstanding careers.

Stan Musial placed fourth: outstanding at the plate, but below average on defense according to the Journal. It's tough to be the best without strong defense.

The #3 pick was Willie Mays. He ended his career with excellent stats in many offensive categories and he was an outstanding fielder, having made what has to be the most famous catch in baseball history. **Surprisingly, however, "in a career full of milestones, such as 3,000 hits and 600 homers, Mr. Mays doesn't own a single significant major-league record."** Records aren't what it's about; I think its competence, consistency, and an absence of weaknesses.

I like the way Ricky Henderson made it to runner-up. "Walks aren't sexy and steals aren't trendy," but Henderson holds the career record in both, and they positioned him to score. "And no one's done this more often than Mr. Henderson." It's kind of like being a steady performer in an unfashionable niche like convertibles, underdeveloped real estate or power infrastructure.

The Journal's pick for greatest living player: Henry Aaron. Unlike Willie Mays, the Journal says, "Hammerin' Hank holds more important records than any player in history: home runs, runs batted in, total bases, extra-base hits and Aggregate Bases," (which it defines as the sum of hits, extra bases, walks and steals). And I love the way he did it: **"Mr. Aaron's best seasons don't compare with those of Messrs. Bonds, Mays or Musial, but he played at a high level longer than any player in the history of the game."** In my book, that's the definition of #1.

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Few people, in any field, can hope to have talents and abilities like these men. But each of us can try to apply the same work ethic, and we can select our role models and decide how to conduct ourselves professionally. I want an Oaktree that's like Willie and Hank. **An exceptional career, even if it doesn't result in entries in the record books. Or a number of records, but for a lifetime, not a single great year**.

"Steady Eddie" Murray was inducted into the Baseball Hall of Fame just six weeks ago. He drove in at least 75 runs a year for a major league-record 20 consecutive seasons. **I'd like Oaktree's play to be described as "Steady Eddie."**

Sandy Koufax was pretty steady, too. In the six years 1961-66, he was named an All-Star six times and led the league in earned run average five times, in strikeouts per inning five times, in hits allowed per inning five times, in hits and walks allowed per inning four times, in shutouts three times, in innings pitched twice, in won-lost percentage twice, and in complete games twice. He pitched a no-hit game every year from 1962 to 1965, and the last of those was a perfect game. Over that period, he essentially had no weaknesses.

And, of course, I can't fail to mention Cal Ripken, Jr. He played all of his 21 seasons with the Orioles, a great oddity in a time when there's little constancy. And speaking of constancy, Cal is well known for his record of playing in 2,632 consecutive games, spanning a 15-year period. He also played 8,243 innings without missing one. Always there for his teammates and fans, he was chosen to start at shortstop in 17 consecutive All-Star games.

These are my baseball heroes. They personify my aspirations for Oaktree.

<u>Playing Within Yourself</u>

An expression from the broadcasting booth that's relevant to investing relates to the need to avoid pushing too hard. "Playing within yourself," they call it. **It means not trying to do things you're not capable of, or things that can't be accomplished within the environment as it exists.**

When the defenders drop back to cover the deep receivers, the intelligent quarterback throws short passes until they move up. That opens up the downfield routes, enabling him to complete the long bomb. **"He's taking what they give him," the commentators say, approvingly. It's what we all must remember to do.**

We simply cannot create investment opportunities when they're not there. In its first year, our newest distressed debt fund produced a 64% net IRR that's eye-popping . . . and impossible to replicate any time soon. So what should we do now? Rather than take profits and distribute the proceeds, should we prolong our holding periods or try to repeat our gains in new positions? And would it be smart to raise a big new fund? None of these, if the prospective returns on our holdings are inadequate and new investment

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opportunities are limited.

The dumbest thing we could do is to insist on perpetuating our high returns – and give back our profits in the process. If it's not there, hoping won't make it so. **All we ever can do is take what they give us.**

What's Better, Investing or Sports?

When people ask me what I like so much about investing, I usually go to the well for more comparisons to sports.

- It's competitive – some succeed and some fail, and the distinction is clear.
- It's quantitative – you can see the results in black and white.
- It's a meritocracy – in the long term, the better returns go to the superior investors.
- It's team-oriented – an effective group can accomplish more than one person.
- It's satisfying and enjoyable – but much more so when you win.

Many of the things that make sports fun to watch and participate in are the same things that make investing a great area in which to work. However, Warren Buffett came up with one way in which the investor has it better than the athlete.

In Berkshire Hathaway's 1997 Annual Report, Buffett talked about Ted Williams – the "Splendid Splinter" – one of the greatest hitters in history. A factor that contributed to his success was his intensive study of his own game. By breaking down the strike zone into 77 baseball-sized "cells" and charting his results at the plate, he learned that his batting average was much better when he only went after pitches in his "sweet spot." Of course, even with that knowledge, he couldn't wait all day for the perfect pitch; if he let three strikes go by without swinging, he'd be called out.

Way back in the November 1, 1974, issue of Forbes, Buffett pointed out that investors have an advantage in that regard, if they'll just take advantage of it. Because they can't strike out looking, investors needn't feel pressured to act. They can pass up lots of opportunities until they see one that's terrific.

> Investing is the greatest business in the world because you never have to swing. You stand at the plate; the pitcher throws you General Motors at 47! U.S. Steel at 39! And nobody calls a strike on you. There's no penalty except opportunity. All day you wait for the pitch you like; then, when the fielders are asleep, you step up and hit it.

Buffett's approach, like that of Williams, rewards patience, selectivity and a superior understanding of the underlying process. These are some of the things Oaktree likes to emphasize.

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Back to Tennis for the Wrap-up

Just as this memo was going into the home stretch, the Wall Street Journal's Allan Barra greeted the start of the U.S. Open tennis tournament with an article about Pete Sampras. For me, it provided the ultimate investment/sports metaphor.

> Mr. Sampras will need no future historians to make his case as the greatest tennis player of our time. His career credentials – the 14 Grand Slam singles championships; the 63-7 record in Wimbledon and seven Wimbledon titles in eight years; the 71-9 record at the U.S. Open with 87 consecutive service games won there; the six straight seasons of being ranked No. 1 – do that admirably.
>
> . . . Sampras the player wasn't always exciting. Mr. Sampras's outstanding quality was always his uncanny consistency. Was there an athlete of the past 10 to 12 years whose greatness has been harder to capture in highlights? **His highlights were hard to distinguish from his lowlights**. As I wrote in the Wall Street Journal a few years ago: "The definitive book on the man would have to be titled 'Pete Sampras: The Dullness of Excellence.' But who would buy it?" (August 26, 2003; emphasis added)

The sentence I've bolded struck me as particularly thought provoking. You could read it as saying "his best moments weren't much better than his worst moments" – not a very stirring thought. **Alternatively, you could read it as "his worst moments were almost as good as his best." In my view, that would describe a terrific money management career. We hope people will say it about Oaktree.**

* * *

I'm always careful to point out that there are many game plans capable of leading to success. Offense or defense. Home runs or batting average. Go for the long bomb, or pick them apart with short passes. Battle from the baseline or rush the net. There are as many choices as there are sports metaphors. But the best game plan will only take you as far as the starting line or the first pitch. Once the game is underway, it comes down to skillful execution. **The best strategy in the world won't pay off without skillful blocking and tackling.**

And having a talented, disciplined team that stays together – a rarity in sports or investing – doesn't hurt.

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