Memo to: Oaktree Clients

From: Howard Marks

Re: It's All Good

---

Readers of my memos know that one thing I believe in most strongly – and harp on most frequently – is the inevitability of cycles. They're something we can depend on absolutely.

Several of my memos have dealt with cycles, starting from the very beginning: "First Quarter Performance" (April 11, 1991), "Will It Be Different This Time?" (November 25, 1996), "You Can't Predict. You Can Prepare." (November 20, 2001) and "The Happy Medium" (July 21, 2004). I've said in the past that I consider "You Can't Predict," a primer on cycles, to have been one of my best¸ and also that it evoked the least response of any memo in this decade. Thus I'm offering it as a twofer with this memo; copies are available on request at no additional cost.

**I always say that while we can't know where we're going, we ought to know where we are** (in cyclical terms). Understanding our environment can help us decide what tactics to employ, how aggressive to be, and which potential mistakes we should try hardest to avoid. Being conscious of cycles can be extremely helpful, even if we can't see the future.

Thus I'm going to devote this memo to the cycle that's been underway for the last few years. **In terms of amplitude, breadth and potential ramifications, I consider it the strongest, most heated upswing I've witnessed. A lot of this is because people seem to think everything's good and likely to stay that way.**



Cycles in the World of Investing

The basics of cycles are simple. The economic cycle gives rise to recessions and recoveries, creating the business environment. This produces a business cycle marked by rising and falling sales and profits. The credit cycle swings more radically, such that capital market conditions alternate between irrationally generous and unfairly restrictive. Likewise, market cycles fluctuate much more than do the more "fundamental" economic and business cycles, due largely to the volatile cycle in investor psychology.

In this latter regard, I'll reprint a few paragraphs from "First Quarter Performance," the 1991 memo cited above. I think they capture investors' pattern of behavior.

> The mood swings of the securities markets resemble the movement of a pendulum. Although the midpoint of its arc best describes the location of the 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 the 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.

This oscillation is one of the most dependable features of the investment world, and investor psychology seems to spend much more time at the extremes than it does at the "happy medium."

Polar Opposites

My 2004 memo, "The Happy Medium," took its title from this last phrase and went beyond the three listed above to discuss additional pairs of opposites between which the investment pendulum oscillates:

- between greed and fear,
- between optimism and pessimism,
- between risk tolerance and risk aversion,
- between credence and skepticism,
- between faith in value in the future and insistence of concrete value in the present, and
- between urgency to buy and panic to sell.

I find particularly interesting the degree to which the polarities listed above are interrelated. When a market has been rising strongly for a while, we invariably see all nine of the elements listed first. And when the market's been declining, we see all nine of the elements listed second. Rarely do we see a blend of the two sets, given that the components in each are causally related, with one giving rise to the next.

Usually, when either set of polar extremes is in the ascendancy, that fact is readily observable, and thus the implications for investors should be obvious to objective observers. **But of course, the swing of the market pendulum to one set of extremes or the other occurs for the simple reason that the psyches of most market participants are moving in the same direction in a herd-like fashion.** Few of the people involved actually are objective. To continue a thread from my last memo, "Everyone Knows," **expecting widespread clinical observation during a market mania makes about as much sense as saying "everyone knows the market has gone too far." If many people recognized that it had gone too far, it wouldn't be there.**

**Between the two sets of cyclical extremes, I have no doubt that the environment of the last few years has been marked by the elements listed first above, not second: euphoria, greed, optimism, risk tolerance and credence; not depression, fear, pessimism, risk aversion and skepticism. Certainly it's been the recent consensus of investors that, "It's all good."**

Unusual Breadth

In the past we've seen bull markets in equities, commodities and real estate. And we've seen bull markets in the U.S., Japan and the emerging markets. But this time around, we've been seeing a near-global bull market, where the participating sectors vastly outnumber those left out.

In his April letter to investors, entitled "The First Truly Global Bubble," Jeremy Grantham summed up the worldwide nature of the good times.

> Never before have all emerging countries outperformed the U.S. in GDP growth over a 12-month period until now, and this when the U.S. has been doing well. Not a single country anywhere – emerging or developed – out of the 42 listed by *The Economist* grew its GDP by less than Switzerland's 2.2%! Amazingly uniform strength, and yet another sign of how globalized and correlated fundamentals have become, as well as the financial markets that reflect them.
>
> Bubbles, of course, are based on human behavior, and the mechanism is surprisingly simple: perfect conditions create very strong "animal spirits," reflected statistically in a low risk premium. Widely available cheap credit offers investors the opportunity to act on their optimism. Sustained strong fundamentals and sustained easy credit go one better; they allow for continued reinforcement: the more leverage you take, the better you do; the better you do, the more leverage you take.
>
> A critical part of the bubble is the reinforcement you get for your optimistic view from those around you. And of course, as often mentioned, this is helped along by the finance industry, broadly defined, that makes more money when optimism and activity are high. . . . To say the least, there has never ever been anything like the uniformity of this reinforcement.

The March issue of Marc Faber's Gloom, Boom & Doom Report described the pervasiveness of the positive effect on markets. He listed four "bubbles of epic proportions" that he has witnessed: metals, mining and energy in the 1970s; Japanese equities and real estate and Taiwanese equities in the late 1980s; emerging markets in the 1990s; and TMT at the end of the 1990s. In contrast to the present experience, he pointed out,

> . . . all had one common feature: they were concentrated in just one or very few sectors of the economic or investment universe and were accompanied by a poor performance in some other asset classes. . . . Currently, looking at the five most important asset classes – real estate, equities, bonds, commodities, and art (including collectibles) – I am not aware of any asset class that has declined in value since 2002! Admittedly some assets have performed better than others, but in general every sort of asset has risen in price, and this is true everywhere in the world.

It's interesting not only to see just about everything rise at the same time, but also to see people act as if this is likely to continue for a prolonged period. Usually that just doesn't happen.

It's Different This Time

My memos are full of quotations, adages and old saws. I'm attached to a few and tend to use them over and over. Why reinvent the wheel, especially if the old one can't be improved upon? Hopefully the things I borrow contain enough wisdom to make them worth repeating.

Equally worth repeating are the statements I cite as investor mistakes. They, too, are highly instructive . . . in the sense that they're heard often and must be recognized for how potentially toxic they are. **None is as dangerous as "it's different this time." Those four little words are always heard when the market swings to dangerously high levels. Like so many of the polar opposites enumerated above, it's not just the sign of an absurd condition. It's a prerequisite.**

I first came across the phrase in what for me was a seminal article, "Why This Market Cycle Isn't Any Different," by Anise C. Wallace (New York Times, October 11, 1987). The stock market's rapid ascent at the time was being attributed to (or excused by), among other things, (1) the outlook for continued economic growth, given that the economy had learned how to correct itself painlessly, (2) the likelihood of continued buying of U.S. stocks by foreign investors piling up dollars with no better place to go, and (3) the fact that stocks weren't overvalued compared to other assets, which had also appreciated.

But Ms. Wallace countered as follows: "No matter what brokers or money managers say, bull markets do not last forever. In general, investment professionals say, cycles and markets differ only by degree." **And of course, in the next eight days the Dow fell 30%.**

It wasn't just 1987. People also came to believe the business cycle had been tamed in 1928 and in the late 1990s. And wouldn't you know, I'm hearing it again today:

- The Fed's skillfully walking the tightrope between stimulus and restrictiveness. (A few years ago people felt Greenspan was indispensable; now there's suddenly faith in Bernanke.)
- A service economy is less volatile than a manufacturing-based economy.
- As the Chinese and Indians get rich, their purchases from us will buoy our economy.

**The truth is, we couldn't have great cyclical extremes if people didn't occasionally fall for a justification that's never held true before. How else might investors rationalize holding or buying despite highly elevated valuation parameters, low prospective returns and just-plain-wacky security structures?** I still believe what I wrote in "The Happy Medium":

> 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.

I'm hearing again – as often in the past – that we're in a Goldilocks economy. It's not so hot that there's risk of inflation accelerating, which would require restrictive measures on the part of the Fed.

Or so cold that business will slow, with a depressing effect on profits. No, it's just right. Of course, this condition has never held for long in the past.

Earlier this year, Kenneth Lewis, chairman of Bank of America, summed it up candidly and simply: "We are close to a time when we'll look back and say we did some stupid things . . . We need a little more sanity in a period in which everyone feels invincible and thinks this is different."

**And while I'm on the subject, I want to offer an important observation. No matter how favorable and steady fundamentals may be, the markets will always be subject to substantial cyclical fluctuation. <u>The reason is simple: even ideal conditions can become overrated and therefore overpriced.</u> And having reached too-high levels, prices will correct, bringing capital losses despite the idealness of the environment (see tech stocks in 2000). So don't fall into the trap of thinking that good fundamentals = positive market outlook (and especially not forever). As I said in "Everyone Knows," profit potential is all a matter of the relationship between intrinsic value and price. There is no level of fundamentals that can't become overpriced.**

<u>Willing Suspension of Disbelief</u>

One of the key requisites for enjoying a trip to the movies is a willingness to suspend disbelief. If they wanted to, moviegoers invariably could find plot glitches, technological impossibilities or historical inaccuracies. But they tend to overlook them in the interest of having a good time.

**Similarly, investors' recurring acceptance that it's different this time – or that cycles are no more – is exemplary of a willing suspension of disbelief that springs from glee over how well things are going (on the part of people who're in the market) or rationalization of the reasons to throw off caution and get on board (from those who've been watching from the sidelines as prices moved higher and others made money).**

The fact is, the higher asset prices go, the more people think assets are worth, and the more eager they become to buy them. A rip-roaring rally fuels buying appetites rather than make people think the appreciation may have moved prices to precarious levels. In the same way, price collapses cause people to worry rather than start combing the market for bargains.

**In this way, the bullish swing of the investment cycle tends to cause skepticism and risk tolerance to evaporate. Faith, credence and open-mindedness all tend to move up – at just the time that skepticism, discrimination and circumspection become the qualities that are most needed.**

<u>Financial Innovation</u>

Another element that I notice tends to rise and fall with the cycles is the level of financial innovation. Again, this is a cycle that's easily understood.

**Wall Street exists to develop and sell new products, no less so than toothpaste manufacturers and movie studios. So why is it that some periods are rife with innovation and other periods totally lacking? It's because it's only in bullish times that investors accept financial inventions.** When the market's in an up-swing, people tend to say, "Sure, I'll give it a chance" or "Good, I've been looking for new ways to make money." But when the market has been moving down and people are tallying their losses, they tend to be much less open to new ideas. **In the financial world, the mother of invention isn't necessity, its salability.**

In the roaring 1960s we saw Nifty-Fifty investing, dual shares from mutual funds and discounted shares issued through unregistered private placements without any mechanism for subsequent liquidity. In the '80s we saw portfolio insurance – a surefire way to enjoy the appreciation potential that comes with large commitments to equities, but with much less risk. And in the '90s, no one could think of a reason why every dot-com, e-tailer, media aggregation and venture capital fund wouldn't be successful. Of course, all of these things failed to function as promised and either disappeared forever or experienced severe corrections.

And what have we seen in the last few years? CDOs, CLOs, CPDOs, SPACs and securitizations of every type. In the current environment – marked by decent returns; disinterest in conventional, safe assets; and openness to risky investments – few people seem to dwell on the reasons why something new might not work. No one asks why, if a $2 billion fund was successful, a $20 billion fund shouldn't be as well.

Derivatives deserve particular attention in this regard. On July 8 The Wall Street Journal noted that,

> Over the last six years, global futures trading on exchanges has grown nearly 30% a year. The total derivatives market is valued at about $500 trillion, four times the value of all publicly traded stock and bonds. . . . The four biggest futures exchanges have launched more than 300 new derivatives products in just the last few years . . .

Particularly intriguing, it seems the value of outstanding credit default swaps – insurance against defaults among corporate debt instruments – exceeds the value of the instruments insured. How will this work if a wave of defaults occurs? How well are the provisions of these insurance contracts documented? How readily will the writers of the insurance pay up? What will be the effect if conditions are chaotic? No one knows the answers to these questions. **Inventions originate in up markets, but they're tested in down markets. Rarely do they work entirely as hoped.**

**In down markets, people see potential risks that can't be argued away. But in markets like this one, they see opportunities they must seize to avoid being left behind. Thus, like the other things I'm discussing, a high level of financial innovation is symptomatic of a market that's been rising for a good while and may be behaving in an overconfident manner.**



<u>What, Me Worry?</u>

Two recent innovations deserve particular attention here: structured entities and what the British call "selling onward." **Both embody an impractical expectation: that financial engineering can eliminate risk. Combined, they're particularly dangerous.**

In creating structured entities such as CDOs, managers bring together investors with different risk/return appetites. To satisfy those varying appetites, the investors are sold claims with different priorities with regard to the entity's portfolio and cashflows, and with projected returns that are proportional. The managers use the investors' capital to assemble a portfolio of assets. And each investor receives a security with risk and return tailored to its needs.

It should work . . . in theory. My biggest knocks on structuring are these: First, many of the people who develop the structured entities and rate their securities know more about probabilities than they do about the specific assets in the portfolio, something that's particularly dangerous when portfolios are highly leveraged. And second, there seems to be a belief that this process – at Oaktree we call it "slicing and dicing" – can reduce the overall risk in the system.

If risk is reduced, I'd like to know where the eliminated part goes. If ten people each hold a share of ten highly correlated risky assets, I don't think the overall system is much less risky than if each of the ten people held one entire risky asset. At the extreme, however, it may be true that risk sharing reduces the likelihood that a spate of failures will precipitate a generalized credit crunch.

Selling onward is the process through which the originating of assets and the owning of assets are separated. In the old days, banks made loans and mostly held on to them, syndicating a bit to build relationships and limit risk. Nowadays, banks originate loans largely to generate loan and syndication fees, and actually living with the loans is much less prevalent. After they're originated, assets such as corporate loans, mortgages, auto paper and credit card receivables are often packaged and sold, sometimes in the form of securities. There's a belief that this process, too, makes the world less risky.

I fail to see net benefits here as well. Instead, I think this process introduces great moral hazard. When the people making loans aren't going to remain dependent on the borrowers they give money to, they have little incentive to actively police risk. Thus I have grave doubts about a lot of the credit decisions being made.

For an extreme example, take a look at the subprime mortgage brokers. Were they motivated to make prudent credit decisions? No; they were motivated to create a lot of paper. **There's something wrong when it's in someone's best interests to lend money to unqualified borrowers, but this was the case in subprime mortgages.** Obviously this occurred because mortgage brokers weren't risking their own money. With selling onward so prevalent, an originator just had to hope the borrower would make the first few payments, so that delinquencies wouldn't surface before the originator's repurchase obligation expired and the loans became the buyer's problem. How could buyers have been silly enough to purchase loans made by brokers operating under this set of incentives?

Now, let's combine structuring and selling onward. Here's how I see it working:

- A mortgage broker makes a bunch of loans without knowing much about creditworthiness (think about so-called "liar loans") or caring much about creditworthiness (because he intends to sell them momentarily).
- An investment banker buys a few hundred of these loans, also without knowing much about them (because of their sheer numbers), in order to package them into residential mortgage-backed securities (RMBS) and sell them onward.
- An investment manager buys a few dozen RMBS, about which he doesn't know much (also the numbers) or care much (because the fees and potential profits incentivize him to put a lot of money to work fast). They become part of the portfolio of a CDO, against which debt is issued.
- A rating agency analyst assigns ratings to the CDO debt, about which he can't know much (lack of specialized expertise; vast number of underlying assets; structural complexity and the newness

- A hedge fund manager buys CDO debt about which he doesn't know much (with thousands of underlying mortgages having been sliced and diced) or worry much (given the high debt ratings).

Concoctions like this are tolerated only in heady times. Clearly the results can be incendiary. We're waiting to see the final outcome – and perhaps to pick among the ashes.

One last thought: **Let's say slicing, dicing and selling onward do have the potential to reduce the overall level of risk in the system, all other things being equal. Even if that were true, the other things wouldn't remain equal; market participants would adjust their behavior to the new reality and in so doing return risk to its old level.** On May 23, the Financial Times said this about trying to reduce risk by selling onward and by obtaining credit insurance via derivatives:

> This makes banks less vulnerable to individual defaults. **But it could also be making them feel so comfortable about lending risks that they are making more risky loans.** Outside investors such as hedge funds are gobbling them up, either because they also think they are protected with credit derivatives or because they are desperate to find somewhere to place their cash. This has triggered a collapse in the standards used to conduct and fund deals. (Emphasis added)

Again, no matter how good fundamentals may be, humans exercising their greed and propensity to err have the ability to screw things up. **Perhaps Myron Scholes put it most succinctly (The Wall Street Journal, March 6): "My belief is that because the system is now more stable, we'll make it less stable through more leverage, more risk taking."**

<u>The L Word</u>

Some of the most glaring innovation this time around has taken place in the area of leverage. It's not that leverage hasn't been available and been used before: In the late 1980s, companies like RJR were the subject of leveraged buyouts in which 95% of the purchase price was borrowed. Nowadays, debt rarely constitutes much more than 80% of buyout capital structures, but the terms of the debt and the ease of obtaining it are startlingly accommodating.

Unlike the historic norm, it's routine today to issue CCC-rated bonds. It's easy to borrow money for the express purpose of distributing cash to equity holders, magnifying the company's leverage. It's so easy to issue bonds with little or no creditor protection in the indenture that a label has been coined for them: "covenant-lite." And it's possible to issue bonds whose interest payments can be paid in more bonds at the option of the borrower.

**The first requirement for an elevated opportunity in distressed debt is the unwise extension of credit, which I define as the making of loans which borrowers will be unable to service if things get a little worse. This happens when lenders fail to require a sufficient margin of safety.**

Here the interrelatedness of cycles is quite evident. Good economic times bring rising profits. Rising profits cause the default rate to subside. And the low default experience erases lenders' reticence. Among other things, they become willing to lend money so that troubled companies can stay afloat and hopefully outgrow their problems. Today that's called "rescue finance"; in less rosy times it might be called "throwing good money after bad."

**The default rate in the high yield bond universe is at a 25-year low on a rolling-twelve-month basis. Under such circumstances, how could the average supplier of capital be expected to maintain a high level of risk aversion and prudence, especially when doing so means ceding all the loan making to others? It's not for nothing that they say "The worst of loans are made in the best of times."**

## The Downside of Leverage

If lenders are acting in an imprudent fashion, what's the effect on the borrowing companies? If loans are available too readily, is it right or wrong to borrow? These are among the most interesting questions of the day.

Lots of good things have been said about leverage. In the late 1980s, when venerable American companies were being bought in leveraged buyouts structured with debt/equity ratios of 25-to-one, we were told that an underleveraged balance sheet is indicative of a sub-optimal capital structure and excessive use of high-cost equity, and that significant leverage sharpens management's focus on cash flow and leads to better expense control.

The only thing omitted was the reminder that equity – which doesn't require the periodic payment of interest or the repayment of principal at maturity – represents a company's margin of safety. It's the capital layer that absorbs the first blow in tough times without occasioning an event of default. **While leverage may magnify gains in good times, it's a healthy layer of equity that gets companies through the bad times.**

**It's inescapable that, all other things equal, greater leverage increases a company's likelihood of experiencing financial distress. Thus, with lenders enjoying a carefree recent experience and consequently financing some unwise deals – and with borrowers eager for the enhanced upside potential that comes with leverage – it seems clear that we'll see rising rates of default and bankruptcy a few years down the pike.** This is especially true if, as has often been the case recently, debt is incurred not just to leverage the company's equity, but to finance payouts to equity holders that reduce or eliminate the equity.

So then, are private equity funds – raising much more equity capital than ever, and doing the biggest deals in history at a rapid-fire pace, at rising transaction prices and rising leverage ratios – doing a smart thing or making a mistake? It all depends on how you look at things. The funds seem to be looking in terms of optionality.

## Ketchup, Easy Money and Optionality

I was a picky eater when I was a kid, but I loved ketchup, and my pickiness could be overcome with ketchup. I would eat hamburgers, frankfurters, veal cutlets, filet of sole and frozen fish sticks, but as far as I was concerned, they were all just vehicles for ketchup. The ketchup of today is easy borrowing, and private equity managers are entering into a large number of transactions to access it.

Let me illustrate what I consider to be the thought process: If you were offered the chance to buy companies with 100% debt financing and no money of your own, how many would you buy? The smart answer is, "All of them." Not just the well-run ones? Or the growing ones? Or the profitable ones? No; all of them. Some would produce positive cash flow and/or appreciation, which you'd welcome. The others would be unsuccessful, but with none of your own money invested, you'd just walk away. That's optionality.

**Optionality is a new-age finance term for the ability to cheaply obtain a call on asset appreciation, creating the possibility of profits out of proportion to potential losses.** That's the way it is in venture capital: all you can lose is your investment, but you can multiply it hundreds of times simply by finding the next Google. Even though venture capital investing produces only occasional success, it's justified by the occasional outsized payoff.

I think that's the deal today in mega-private equity. In their highly successful first decade of 1975-85, LBO funds invested in small, underpriced industrial concerns or orphaned corporate spinoffs. They paid low prices for stable companies, financed their purchases with moderate amounts of debt, and put a lot of energy into improving the companies' operations. Both their batting averages and their overall rates of return were attractive.

But I'm not sure that's the model today. Few companies are languishing on the bargain counter, and everyone knows that if buyout funds bid for a company, the shareholders had better take a good look at what they're giving up. Likewise, buyout funds are buying well into a period of economic expansion, and the scope for improvement in operations may be limited.

No, the model today seems different: pay premiums to open-market prices for prominent, multi-billion dollar companies, sometimes after the boards, shareholders or other bidders have forced prices higher. Borrow large sums to finance the deals. Generate whatever fundamental improvement you can. Hope the market will provide a highly leveraged payoff. And, given the enormity of the scale, get rich off management fees, ancillary fees and the profits from the ones that work.

In other words, it seems that, relative to the past, the thought process in mega-private equity is based on the combination of (1) ultra-cheap financing, (2) high fees, (3) quick withdrawal of equity capital and (4) a lower batting average but big payouts on the winners. The optionality is certainly on the GPs' side. Let's hope it works for the LPs as well.

<u>If the Lender's a Sap, Is the Borrower a Genius?</u>

I have a lot of experience looking at leveraged transactions from the standpoint of the lender, but less experience as a borrower. Thus I found it novel – even surprising – to read a January memo on this subject from Carlyle founder William Conway to his colleagues, with thoughts echoing mine:

> As you all know (I hope), the fabulous profits that we have been able to generate for our limited partners are not solely a function of our investment genius, but have resulted in large part from a great market and the availability of enormous amounts of cheap debt. This cheap debt has been available for almost all maturities, most industries, infrastructure, real estate, and at all levels of the capital structure. Frankly, there is so much liquidity in the world financial system, that lenders (even "our" lenders) are making very risky credit decisions. . . .

> I know that this liquidity environment cannot go on forever. I know that the longer it lasts the more money our investors (and we) will make. I know that the longer it lasts, the greater the pressures will be on all of us to take advantage of this liquidity. And I know that the longer it lasts, the worse it will be when it ends. And of course when it ends the buying opportunity will be a once in a lifetime chance. But, I do not know when it will end. . . .
>
> Last year, I asked you to be humble, ethical and optimistic. This year I am asking you to be careful as well.

In 1990-91, our distressed debt funds made a fortune buying the obligations of companies that had been loaded up with too much debt in LBOs in the late ’80s. Chastened by that experience, lenders in the ’90s didn’t provide enough leverage to make buyout companies much of a factor in the debt collapse of 2002. But with the memory of having 1990-91 faded, leverage became freely available in the last few years, and thus we have little doubt we’ll be buying a great deal of distressed LBO debt the next time around.

When all the above is taken together, it seems likely that a few years out, we’ll see a landscape littered with companies that were crippled with excessive debt loads and lenders who weren’t repaid. What happens to private equity funds and their investors will depend on the outcome of a game of hot potato: will they get their capital – and their gains – out of the over-leveraged companies before they go sour? We’ll see.



<u>But Don’t the Borrowers Have a Free Pass?</u>

Much is being made of the possibility that today’s debt is default-proof. “Toggle bonds” give borrowers the option of paying interest in the form of more bonds for a while. And covenant-lite indentures mean the likelihood of an interim technical default has been reduced. Do these developments reduce the overall risk?

This, too, goes back to the concept of optionality. The value of an option is greater the longer it has to run, and options that can’t be extinguished early are worth more than those that can.

Think of someone who issues ten-year bonds to raise the money with which to buy a company. On the surface, it seems he has ten years for his purchase to work out profitably, at the end of which period he has to repay his lenders. In other words, he has a ten-year option on the company’s appreciation potential. But what if the company gets in a bind in the early years and misses an interest payment? Or if an economic slowdown causes a technical breach of a covenant? In past downturns, these things have forced borrowers to pay lenders for extensions or forbearance, and they have led to defaults. Those things may be somewhat less likely nowadays.

It is true that payment-in-kind and covenant-lite loans reduce the likelihood of interim defaults. But does that mean the credit landscape is risk-free and lenders can breathe easy? Sooner or later, debt has to be repaid or refinanced, and the credit market may not be accommodating at that moment; this is especially true if the company’s fortunes have deteriorated. Not enough of a company’s debt may be default-proof to make it invulnerable. The price of the debt may decline with the fundamentals, even if default isn't an immediate threat. And the free pass in the interim may just delay – but also worsen – the eventual outcome.

Under a traditional structure, a company might default in the third year of a bond's life, by which time 20% of its value may have evaporated. But with these new wrinkles, it might not happen until year five . . . when 60% of the value is gone. **Yes, lenders are giving borrowers more rope. But will it prove to be a lifeline for the company or a hangman's noose?** A lot will depend on how things go while the postponed default is in abeyance.

This is yet another area where up-cycle faith that risk has been reduced can convince people to add back the risk. As The Wall Street Journal said of standby revolvers on May 11, "Thanks to debt arrangements like this, some private-equity buyers say they are doing deals they would otherwise not do."

<u>What Could Cause This Upward Cycle to Falter?</u>

Since I insist that the good times can't roll on forever, I'm often asked what might make them stop. I don't have any inside information on this subject, but I can enumerate the possibilities:

1. economic slowdown,
2. reduced willingness to lend or insistence on higher interest rates, perhaps due to increased worry about credit risk,
3. systemic problems like a crisis in derivatives or a cluster of hedge fund meltdowns,
4. exogenous factors such as $100 oil, a dollar crisis, terrorist acts, and
5. the things I haven't thought of.

First, I want to point out that these things are not unrelated. A reduction in lenders' willingness to lend may stem from an economic slowdown. An economic slowdown could be brought on by an exogenous event. It's when there's a confluence of these things that the debt market gets into real trouble, as was the case in 1990 and 2002.

Second, these things are often unpredictable. I like to remind people that the best buying opportunity we ever had in distressed debt arose in the summer of 2002, when recession, credit crunch, 9/11, Afghanistan, telecom meltdown and the scandals at Enron et al. occurred all at once. Few if any of these were predictable twelve months earlier.

And third, the one we should worry about most is number five. Investors can cope with the things they can anticipate, analyze and discount. They have more trouble with the rest. I love hearing people from the "I know" school say, "I'm not anticipating any surprises." Those are the developments that can knock a market into a cocked hat. As Martin Wolf wrote in the Financial Times on May 2, "The most obvious reason for taking today's euphoria with a barrel of salt is that nobody ever expects shocks. That is what makes them shocks."

Where do we stand in the cycle? In my opinion, there's little mystery. I see low levels of skepticism, fear and risk aversion. Most people are willing to undertake risky investments, often because the promised returns from traditional, safe investments seem so meager. This is true even though the lack of interest in safe investments and the acceptance of risky investments have rendered the slope of the risk/return line quite flat. Risk premiums are generally the skimpiest I've ever seen, but few people are responding by refusing to accept incremental risk.

Peter Bernstein put it this way in the February 15 issue of Economics and Portfolio Strategy:

> I hear over and over that we live in an era of low expected returns. The rational response to low expected returns is to withdraw and wait until expected returns are higher. That response to low expected returns appears to have gone out of fashion. Today's response is to seek higher returns from higher risks in a low-risk environment – or, worse, to underestimate the risks taken. [Of course, I am less certain than Peter that we are in a low-risk environment.]

Markets have tended recently to move up on positive developments and to recover easily from negatives. I see few assets that people are eager to get rid of, and few forced sellers; instead, most assets are strongly bid for. As a result, I'm not aware of any broad markets that I would describe as under-priced or uncrowded. I will say, however, that some of the excess confidence that usually accompanies booms may be missing. Some of the people making risky investments today seem to be doing so with their fingers crossed. And even though they're optimistic enough to make these prosperity-oriented investments, they're also wary enough to want to hedge their bets by participating in distressed debt as well.

**It is what it is. We've been living in optimistic times. The cycle has been swinging strongly upward. Prices are elevated and risk premiums are slender. Trust has replaced skepticism, and eagerness has replaced reticence. Do you agree or disagree? That's the key question. Answer it first, and the implications for investing become clear.**

In the first quarter of this year, significant delinquencies occurred in subprime mortgages. Those directly involved lost a lot of money, and onlookers worried about contagion to other parts of the economy and other markets. In the second quarter, the impact reached CDOs that had invested in subprime mortgage portfolios and hedge funds that had bought CDO debt, including two Bear Stearns funds. Those who had to liquidate assets were forced – as usual – to sell what they could sell, not what they wanted to sell, and not just the offending subprime-linked assets. We began to read about ratings downgrades, margin calls and fire-sales, the usual fuel for capital market meltdowns. And in the last few weeks we've begun to see investor reticence on the rise, with new low-grade debt issues repriced, postponed or pulled, leaving bridge loans un-refinanced.

**It is in this way that awareness of the inevitability of cycles is reawakened, and it is for reasons like these that the pendulum starts to swing back from one extreme toward the center of its arc . . . and then the other extreme. We never know whether a little jiggle is the start of the swing back and, if so, how far it will go. But we always should be aware that reversion will occur.**

The last 4½ years have been carefree, halcyon times for investors. That doesn't mean it'll stay that way. I'll give Warren Buffett the last word, as I often do: "It's only when the tide goes out that you find out who's been swimming naked." **Pollyannas take note: the tide cannot come in forever. Time, tide and cycles wait for no man.**

July 16, 2007

*This memorandum expresses the views of the author as of the date indicated and such views are subject to change without notice. Oaktree has no duty or obligation to update the information contained herein. Further, Oaktree makes no representation, and it should not be assumed, that past investment performance is an indication of future results. Moreover, wherever there is the potential for profit there is also the possibility of loss.*

*This memorandum is being made available for educational purposes only and should not be used for any other purpose. The information contained herein does not constitute and should not be construed as an offering of advisory services or an offer to sell or solicitation to buy any securities or related financial instruments in any jurisdiction. Certain information contained herein concerning economic trends and performance is based on or derived from information provided by independent third-party sources. Oaktree Capital Management, L.P. ("Oaktree") believes that the sources from which such information has been obtained are reliable; however, it cannot guarantee the accuracy of such information and has not independently verified the accuracy or completeness of such information or the assumptions on which such information is based.*

*This memorandum, including the information contained herein, may not be copied, reproduced, republished, or posted in whole or in part, in any form without the prior written consent of Oaktree.*