Memo to: Oaktree Clients

From: Howard Marks

Re: Doesn't Make Sense

Academics have their theories about market efficiency. Because market participants are well-informed and rational, they say, markets make correct decisions and smoothly assign the right price to each asset. It's for this reason that investors can't routinely find the mispricings they need in order to be able to beat the market.

But investors – and most of the people living on this planet, for that matter – are far from the unemotional computing machines the academics assume them to be. They make faulty decisions, fall for scams and swing from one irrational position to another all the time. **In fact, I marvel at how many things take place in the worlds of business, investments and politics that stem from irrationality and just don't make sense**. It's my purpose here to write about a few.

<u>Letting the Market Call the Tune</u>

In "Whodunit," I talked about Chuck Prince, the ex-CEO of Citigroup. Early in July of 2007, he astutely observed, "When the music stops, in terms of liquidity, things will get complicated." However, he went on to add, **"as long as the music is playing, you've got to get up and dance. We're still dancing."** Because Citigroup danced as much as the other banks or more – and lost as much or more on subprime-related write-downs – Prince lost his job in November 2007.

The portion of Prince's statement that I've highlighted seems emblematic of the attitudes that prevailed from early 2003 until the summer of 2007. People were doing risky things – often even though they recognized the attendant risk, as Prince seemed to do – because they saw no alternative if they wanted to remain competitive.

Upon hearing of Prince's departure, my immediate reaction was to think (a) when a firm fares so badly, the CEO may deserve to lose his job, and (b) to avoid that fate, Prince just had to cause Citi to avoid the risky behavior he identified. If he had done the latter, Citi would be among the big winners today instead of the losers; it wouldn't have to recapitalize by selling equity at depressed prices; and instead it would have funds with which to take advantage of today's better market environment. So in saying that if the music was playing, Citi had to dance – and thus letting the market call the tune – Prince's leadership was flawed.

Compulsory Short-Termism

But is it right to say Prince and Citi could have avoided trouble by refusing to go along? Let's do what some DVDs let you do nowadays: go back and consider an alternative ending. It's July 2005 instead of July 2007. Presciently, Chuck Prince says, "When the music stops, in terms of liquidity, things will get complicated. We're not going to get caught in that trap. As of today, we're adopting a conservative stance toward loans, mortgages, subprime, CDOs and SIVs. The others can dance all they want; we're sitting this one out."

What would've happened? Rather than lose his job in late 2007, he probably would have lost it sooner. Why? Because from whenever he made that statement until July 2007, Prince would have looked dumb. While other banks were gaining market share, Citi's share would have been shrinking. And while other banks were borrowing on the cheap to make mortgage-related investments at seemingly attractive spreads, Citi would have been on the sidelines, forgoing easy profits. Shareholders would have been yelling for Prince's scalp.

The bottom line is one of my three favorite adages: **Being too far ahead of your time is indistinguishable from being wrong.**

Of the two things I think are most wrong about American business, the worst is short-termism. (The other is the ability of executives to thrive while their companies do poorly.) **Companies are rewarded for short-term success and penalized for short-term failure, whereas few people ask about the long term**. The only thing that matters is "What have you done for me lately?" A lot of this emanates from stockholders.

In a memo several years ago, I listed a few phrases that have sunk into obscurity over the course of my career. They included "fiduciary duty," "preservation of capital" and "dividend yield." Another is "long-term investor."

Most investment managers are measured against a benchmark every quarter and expected to add value. Some clients have their fingers on the trigger, ready to axe a manager who underperforms for a year or two. For this reason, managers sit with their own fingers on the trigger, ready to dump a stock or bond whose short-term performance lags. And company CEOs whose securities are laggards are likewise on the hot-seat, with boards that rarely support executives who disappoint Wall Street.

Too many people think of the long run as nothing but a series of short runs. The way to have the best five-year investment record, they think, is by sequentially assembling the twenty portfolios that will produce the best performance in each of the next twenty quarters. No one wants to invest in a company that may lag until long-term investments pay off down the road. They'll just sell its stock today, assuming they'll be able to buy it back later.

Understanding this, companies face great pressure to emphasize short-term results. What might they do in response?

- Maximize revenues (perhaps by stuffing pipelines and offering discounts that accelerate future sales into the present).
- Minimize expenses in slow-to-bloom areas like research and development.
- Borrow to buy back stock, because debt capital is cheap and equity is expensive (despite the fact that equity provides safety and leverage amplifies risk).

Do you want your companies doing these things? Probably not. But do the collective external pressures force companies in these directions? Absolutely. **The things that maximize profits in the short run often serve to decrease profits and increase risk in the long run, but they can be mandatory these days.**

Investors are increasingly short-sighted, and none more so than some hedge funds, with their emphasis on year-by-year incentive fees. The average stock might deliver a return roughly in line with the growth in corporate profits, and the stocks of better companies should outperform in the long run, but hedge funds (and their investors) expect more. They're strongly motivated to hold a subset of stocks that will be the best near-term performers. One approach is to take positions and then pressure companies to "maximize shareholder value." With their focus on short-run performance and short-run compensation, many of the things they advocate – like spin-offs, stock buy-backs and oversized dividends – can be less than optimal for the long run. But that's not their concern.

This kind of behavior exemplifies the debate over *laissez-faire* described in "The Aviary" in May. **In the long run, it should be good for society to have capital in the hands of sophisticated, focused, bright managers who are free of guidelines and can go anywhere in pursuit of profit. In theory, it should be a positive that they're willing to bet against the herd, adopt unpopular positions and take on unresponsive managements. But in the short run, they can have a destabilizing effect, especially when several act in common**. Maybe it just proves that free-market solutions – like just about everything else – have both positive and negative aspects.

If Chuck Prince had taken Citigroup to the sidelines in 2005, it's highly likely that some hedge funds would have tried to force him out. And with Citi looking unduly conservative, the board might not have been in a position to resist. **So being right isn't always enough when you run a public company. You have to be right in the short run. And in choosing a course of action, the one that's right for the short run generally will be preferred over the one that's right for the long run. None of this seems ideal.**

Unreliable Ratings

Probably the group that had the most power and yet covered itself with the least distinction over the last few years – and has been outed to the greatest extent – are the credit rating agencies. The rating agencies were accorded quasi-official status as the policemen of the credit markets, and they failed miserably.

This is nothing new. I've always considered the rating agencies to be error-prone, and much of my career has consisted of taking advantage of their mistakes. They've often rated seemingly safe bonds too high and risky bonds too low. They've been slow to adjust ratings, but when finally they did change, they usually overshot. **The bottom line is that managing a bond portfolio according to ratings would be somewhere between unavailing and disastrous. Profits are more likely to be found in gaming against the ratings.**

Nevertheless, when the government felt Wall Street had to be policed and debt investors protected, they turned to the agencies. Before doing so, I doubt anyone checked to see how accurate ratings have been. Now we know. Thousands of ratings of structured mortgage securities turned out to be too high and were adjusted downward, often many notches at a time. The CDO tranche that didn't have to be downgraded is the exception, not the rule. In other words, the ratings were grossly wrong.

In my view, a triple-A rating shouldn't just imply a low probability of default, but a low probability of downgrading as well. The agencies may say they were blindsided by developments in residential defaults, but I think a triple-A rating should also imply a low probability of being blindsided. To follow on with the "black swan" thought process, something potentially subject to an "improbable disaster" shouldn't receive a triple-A rating. But clearly a lot did.

A Model Destined to Fail

The bottom line's simple: you can't get dependable results from a faulty process. Most people realize now that the rating process was highly flawed.

I've written before about the biggest weakness: the fact that rating agencies are hired and paid by the issuers whose debt they're rating. In "Now It's All Bad?" (September 2007), I compared this to a trial where the defendant picks and pays the judge. But I realize now that I overlooked an important element in the equation. **It's actually a trial where the defendant gets to ask a number of prospective judges what verdict they'd reach before choosing one**. Issuers can describe a proposed issue to multiple agencies, hear back as to what rating they're likely to assign, and then hire the one they want.

Think about an agency's incentives under this arrangement: the fee goes to the one willing to supply the highest rating. Go along and your profits grow; stand on principle and you're left behind.

When I came into this business in the 1960s, Moody's and Standard & Poor's made their money selling subscriptions to their publications. Thus their customers were investors, and they weren't beholden to the issuers. But when they began to derive most of their revenue from the issuers, the agencies understood who was buttering their bread.

There's a further problem: only above-average judgment can make you a superior investor. The consensus view of the future is incorporated in market prices. Only someone more astute than the consensus can help you do better than average.

Now let's turn to the rating process. **Anyone can compute current financial ratios and see how a company's doing today. And the future looks the same to the average person as it does to the consensus. Thus, for a helpful assessment of a company's prospects, you need someone who can foresee possibilities and risks better than most.** But if someone possesses above-average insight into bonds' prospects, will he assign credit ratings for a living, or will he get a job managing investments? Money isn't everything, but most people tend toward their highest and best use. **I think it's fair to say the rating agencies don't attract bond gurus.**

Since the ratings business is highly competitive and profit margins are slim, agency analysts tend to be paid for high ratings and "responsiveness," as opposed to unique insight. Principled, conservative decisions aren't rewarded, as is now plain to see.

Moody's disclosed in May that, because of a programming error, eleven European CPDOs (complex investment vehicles formed to write large amounts of credit insurance) had been incorrectly rated triple-A instead of double-A. Okay, everyone makes mistakes. But the plot thickens.

According to *The New York Times* of July 2, the law firm of Sullivan & Cromwell conducted an investigation for Moody's and found that the ratings hadn't been corrected even after the error came to light. Its report,

> . . . blamed employees in charge of monitoring and adjusting ratings for considering "factors inappropriate to the rating process" after the errors were discovered. . . . In a statement, Moody's said unidentified employees had violated a code that required analysts to consider only credit factors, not "the potential impact on Moody's, or an issuer, an investor or other market participant."

It's not exactly clear what happened, and I don't think anyone's trying to make it particularly clear. It seems, however, that Moody's employees overlooked the ratings errors that came to light for "business reasons."

According to an article on ratings in *The Wall Street Journal* of May 23, Moody's and Fitch,

> . . . acknowledged they have switched analysts assigned to rate bonds after receiving requests to do so from bond issuers or their bankers. Changes usually were made after a specific bond was rated, meaning the analyst wouldn't work on the bond issuer's next deal, according to current and former officials at the credit-rating firms. . . .
>
> At Moody's, at least one analyst in the group that rated collateralized debt obligations, or CDOs, was moved off a particular investment bank's deals within the past few years after bankers requested an analyst who raised fewer questions, according to people familiar with the matter.
>
> Another mortgage analyst at Moody's was moved to the firm's surveillance unit after a Moody's official agreed with an investment banker's opinion that the analyst was too fussy, a person familiar with the situation said. . . .
>
> "**We're a service business**," says John Bonfiglio, group managing director of structured finance at Fitch. [Emphasis added]

Lastly, on July 9, *The New York Times* provided these tidbits from internal rating agency emails, which were part of an SEC report on its investigation of the agencies:

> "We do not have the resources to support what we are doing now."
>
> "I am trying to ascertain whether we can determine at this point if we will suffer any loss of business because of our decision and if so, how much?"
>
> "We are meeting with your group this week to discuss adjusting criteria for rating C.D.O.'s of real estate assets this week because of the ongoing threat of losing deals."

It doesn't make sense for unregulated and sometimes unprofessional organizations, operating under the wrong incentives and performing tasks that are above their heads, to be appointed watchdogs of the capital markets. But that's what happened.

<u>When It's Good to Be Bad</u>

Only in an Alice-in-Wonderland world can there be benefits in having a weak credit rating. But today's complex, rules-based accounting system makes it possible.

On May 18, *The Wall Street Journal* published the story of Radian Group, a bond and mortgage insurer. Although its business was poor, an accounting gain enabled it to report a $195 million net profit for the first quarter, as opposed to the $215 million loss it would have reported otherwise. However, this was an unusual gain. It didn't arise because the value of Radian's assets went up, but rather because the value of its liabilities went down.

Here's how, according to the *Journal*:

> One of the basic rules of accounting says that a reduction in the value of a liability leads to a gain that usually boosts profit. Under the new [mark-to-market accounting] rule, companies have to take into account the market's view of their own financial health when considering the market value of some liabilities. In this case, a company's poor health can lead to a reduction in the liability's value. . . .

In other words, if you owe money and the probability you'll pay your debts declines, your financials strengthen. But shouldn't a declining ability to pay be associated with weakness, not strength? **Before enacting rules like this one, someone should ask if they make sense. It doesn't seem anyone did**.

Similarly, mark-to-market accounting can – in the extreme – require a company to value its assets at the prices that would be realized if they all had to be sold today. And those prices are likely to decline as more assets are assumed to need dumping. Liquidation values are far different from intrinsic values or going-concern values. Do we really want to value assets on the assumption that they're all going to be sold immediately? What purpose does that serve?

<u>Blame the Speculators</u>

The current debate over the role of speculators in oil pricing reminds me of Rep. Noah Sweat's classic answer when asked in 1952 what he thought about whiskey:

> If you mean whiskey, the devil's brew, the poison scourge, the bloody monster that defiles innocence, dethrones reason, destroys the home, creates misery and poverty, yea, literally takes the bread from the mouths of little children; if you mean that evil drink that topples Christian men and women from the pinnacles of righteous and gracious living into the bottomless pits of degradation, shame, despair, helplessness, and hopelessness, then, my friend, I am opposed to it with every fiber of my being.
>
> However, if by whiskey you mean the oil of conversation, the philosophic wine, the elixir of life, the ale that is consumed when good fellows get together, that puts a song in their hearts and the warm glow of contentment in their eyes; if you mean Christmas cheer, the stimulating sip that puts a little spring in the step of an elderly gentleman on a frosty morning; if you mean that drink that enables man to magnify his joy, and to forget life's great tragedies and heartbreaks and sorrow; if you mean that drink the sale of which pours into our treasuries untold millions of dollars each year, that provides tender care for our little crippled children, our blind, our deaf,

> our dumb, our pitifully aged and infirm, to build the finest highways, hospitals, universities, and community colleges in this nation, then my friend, I am absolutely, unequivocally in favor of it.
>
> This is my position, and as always, I refuse to be compromised on matters of principle.

I guess you could say Rep. Sweat found the merits of whiskey to be in the eye of the beholder. So, it seems, is the role of "speculators" in the escalation of oil prices.

Politicians don't seem eager to tell constituents the truth about oil:

- We use too much of it (perhaps because it's cheaper in the U.S. than elsewhere).
- Our cars are less efficient than they should be.
- A good bit of this year's increase in the dollar price of oil may be attributable to the fact that a dollar now buys considerably less goods (or other currencies) than it did in December.
- Oh yeah: and Washington completely dropped the ball in areas like fuel efficiency standards.

So it shouldn't come as a surprise that some politicians are blaming the price rise on other people: speculators. But what is a speculator? That'll bring an answer like Rep. Sweat's. Ask a lay person, and the answer will be a shiftless gambler who takes unwise chances in pursuit of unjustified profits.

In the commodities market, a distinction is made between "commercial" and "non-commercial" traders. A commercial trader may buy oil, for example, in the course of its main business (like an airline, utility or oil refiner) and thus have a reason to hedge against price rises. Or it may be an oil producer that wants to protect against falling prices by selling its future production at the current price. People making value judgments deem these to be "legitimate" reasons.

Speculators, on the other hand, are non-commercial traders – anyone without direct reliance on oil in its business. The current furor implies they don't have valid reasons for buying oil.

But what about the long-term investor who wants to own natural resources as part of a balanced portfolio? Or the individual seeking protection against inflation? Or the sovereign nation that wants to put part of its reserves into something other than depreciation-prone dollars? These motives aren't "illegitimate," and they don't deserve to be disparaged.

In particular, some have suggested that pension funds should be barred from trading in oil. This has to have more to do with scapegoating and short-term perception than it does with preventing improper behavior or solving our nation's energy problem.

Prices – for everything – are set by the interaction of supply and demand, and short-term swings in these things can swamp long-term fundamentals. Certainly, incremental demand from the kinds of buyers described above may have lifted the recent price of oil above what it otherwise would have been. But upward pressure doubtless came as well from (1) increased consumption (especially in developing countries like China and India), (2) rising international tensions, and (3) the simple fact that, **because a dollar now buys less than it used to, it's logical for sellers to demand more of them per barrel**. How much of the blame rightly falls on the speculators?

Thirty billion barrels of oil are consumed each year worldwide, worth over $4 trillion at today's prices. Can the buying of oil by investors – even speculators – really be responsible for much of this year's $1 trillion increase in the total cost of those thirty billion barrels? I don't think that explanation makes much sense.

When major problems arise in the economy or markets, politicians and the media often find it attractive to point fingers at alleged evil doers. That's a lot easier than admitting that regulation fell short, or that we face intractable problems. We're sure to see criticism and even prosecutions following the current economic episode. But any misdeeds are likely to be symptomatic of a lax environment, not causes of the problem, and punishing them is unlikely to be an effective part of the solution.

Eliminating the Fear of Loss

A couple of weeks ago, I had a great talk with Tom Petruno, an insightful business reporter for the *Los Angeles Times*. Calling on our shared experience as Californians, he presented what I consider a very apt analogy. It went like this:

We've all heard about the connection between the Fed's actions and moral hazard. There've been many incidents and scares over the last couple of decades: Black Monday, the meltdown of Long-Term Capital Management, Y2K, the bursting of the tech bubble, 9/11, and a recession here and there. Each time, the Fed rushed in with interest rate cuts and increases in liquidity designed to prevent or offset their depressing effects. A few times, it was said, these actions averted a collapse of the world financial system.

But the cost was moral hazard: a growing expectation that the Fed would bail out imprudent risk takers. By behaving in ways that cause people to think they'll always come to the rescue, authorities encourage risky behavior. And we all share the cost of rescuing the risk takers, whether we participated or not. In this way, the risk taking encouraged by the Fed's policy of protecting participants caused the risks to grow ever-higher. The result is a housing bubble and full-scale credit crunch that together have cost millions of people money and perhaps their homes, pushed financial institutions to the brink, and caused the government to expend a lot of its problem-solving resources.

Tom asked if I didn't see a parallel between the management of our financial system and the policy toward forest fires. The western states experience forest fires all the time, for any number or reasons: lightning, stray cigarettes, campfires that get out of control, even arson. While undesirable, these frequent fires have a good side: they get rid of the relatively small amount of dry brush created each year during our dry season.

But in recent years, the authorities promptly extinguished these fires to make sure they wouldn't get out of control. As a result, brush was permitted to accumulate from year to year. And this May, when a series of freak lightning storms started 2,000 fires, the built-up brush turned some of them into major conflagrations at a time when fire-fighting resources were stretched thin.

This past Sunday, the 27th, the *Los Angeles Times* kicked off a major series on forest fires. Here's part of what it said:

> The government's long campaign to tame wildfires has, perversely, made the problem worse. . . . By stamping out most wildland blazes as quickly as possible, the Forest Service has stymied nature's housekeeping – the frequent, well-behaved fires that once cleaned up the pine forests of the Sierra Nevada and the Southwest. Now, woodlands are tangled with thick growth and dead branches. When fires break out, they often explode.

Sound familiar? Clearly, the analogy between financial crises and forest fires is solid. And I told Tom that just as the Fed's growing tendency to solve every problem led people to take greater risks, the policy of fighting fires early also created moral hazard by encouraging people to build homes further into the forest. It fell to the community to keep those unwisely built structures safe, just as the government now feels it has to rescue subprime borrowers and financial institutions.

Capitalism can produce great results, but participants have to be allowed to both win and lose. If they aren't, they come to believe the only possible outcomes are winning or, at worst, breaking even. **Good business decisions can be made only if the hope for gain is balanced by the fear of loss. The latter must not be eliminated. The system must be allowed to work. Of course, this has to be balanced against the desire to prevent catastrophes, necessitating some very difficult choices.**

Counting on a "V"

Finally, I want to provide a word of caution regarding expectations for recovery. I hear predictions that things will come back next year. Earlier this month, for instance, an elevator news display cited a forecast that home prices will rise 4% in 2009, almost offsetting 2008's decline.

People have become conditioned to expect V-shaped declines and recoveries. We saw quick downs and ups in the markets or the economy in 1987, 1990, 1994, 1998 and 2002. But it doesn't have to be that way. Those of us who were in this business in the 1970s know different.

The ‘70s saw a 37% decline in the S&P 500 in 1973-74; huge losses in the “nifty-fifty” growth stocks; the Arab oil embargo in 1973; inflation in the high teens; short-term interest rates in the 20s; and an infamous *Business Week* cover story, “The Death of Equities.” Stagflation ruled, and there seemed to be no way out of the wage-price spiral. People wore buttons promoting President Ford’s WIN program (“Whip Inflation Now”), but neither the buttons nor the program did any good. New York stockbrokers were driving cabs, and it was extremely difficult to find employment in the investment industry. That means that in order to be part of the investment industry in the ‘70s, you pretty much had to have your job by 1969. And that in turn means you had to be at least 21 by 1969 . . . and sixty or older today. There aren’t many of us still working.

I can tell you, no one was talking about a “V” in the 1970s. We experienced financial malaise lasting almost a decade. The best we felt we could hope for was a “saucer-shaped” recovery, a far different story.

As I said in “The Tide Goes Out” in March, economies aren’t hard-wired, and no one knows in advance how things will go. Further, some of the ingredients this time never have been seen before. When taken together, I see problems that may not go away any time soon and the possibility of a sluggish period lasting more than months or quarters.

First, let’s consider financial institutions and the housing market. In recent years, as everyone knows, the former combined with the latter to create a bubble based on the combination of leverage, innovative structuring and heedless buying. Institutions and housing have been gravely hurt, and they’re likely to bring harm to additional sectors of the economy. For their downward spiral to be arrested, I see four things that have to happen:

- Home prices have to stop going down.
- Home mortgages have to be made available.
- Financial institutions have to stop experiencing incremental write-offs.
- Financial institutions have to be able to raise additional capital with which to rebuild their balance sheets.

The problem I see is that each of these four things is dependent on the occurrence of another – a classic chicken-or-the-egg problem. Write-offs won’t stop until home prices stop going down. Prices won’t stop going down until mortgages become available. Mortgages won’t become available until lenders can raise capital. And capital won’t be freely available until write-offs stop coming. Which will happen first, facilitating the others? What will cause it to happen? When?

These things will happen, of course. Maybe for reasons we can’t foresee. Maybe for no apparent reason. And maybe just because things got so bad they couldn’t get any worse. I go through this only to show why I don’t see an easy or quick solution. But then I’m rarely an unbridled optimist.

Second, consumer spending is a principal lynchpin of the economy, and there's no reason to think the near-term outlook here is positive:

- Employment, earnings, the wealth effect and consumer psychology in general are all likely to be negative, and thus to act as depressants on the economy.
- Higher energy costs and higher mortgage payments (driven up as inflation worries lift interest rates) both have the potential to hamper consumer spending.
- Consumers aren't likely to be able to borrow as easily as in the past. Credit cards may not be available as freely. Borrowing on home equity could be nearly impossible and, anyway, there isn't as much equity to borrow against.
- The American consumer hasn't saved in years and thus has very little in the bank to spend.
- The consumer may realize that savings are essential – at last. If so, in order to save, he'll have to spend less than he makes – at last. This, too, will depress spending.

The record over the last decade – and even the first half of 2008 – shows the American consumer to be incredibly resilient and unwilling to break the spending habit. **Thus it isn't impossible that spending will stay strong . . . just illogical.**

Basically, I think this economy has to hunker down. Financial institutions have to strengthen their balance sheets. Consumers should do so as well. There should be less risk tolerance and financial innovation. Regulation is destined to increase, and in exchange for its support of financial institutions, the Federal government is likely to demand that they carry less leverage and take less risk. Thus financing could be scarce.

But positives do exist. Dollar-denominated exports look very cheap to the rest of the world and will bolster the U.S. economy. And the Fed will do everything possible to help (but it can reduce rates only so far and has to remain vigilant regarding inflation).

The usual tug-of-war is taking place between the optimists and the pessimists. On July 18, the *Financial Times* quoted Deutsche Bank chief executive, Josef Ackermann, as saying, "We are seeing the beginning of the end of the crisis." But the very next day, *The New York Times* quoted Alan Blinder (ex-vice chairman of the Fed board of governors): "The financial system looks substantially worse now than it did a month ago."

On balance, I continue to think the odds favor economic sluggishness for a not-insubstantial period of time. **Given today's general dearth of beaten-down assets outside of residential real estate and financial institutions, investing gradually probably won't cause you to miss great opportunities. But it will keep you out of trouble and ensure that you have capital with which to take advantage of any bargains ahead. In my book, going slow here makes the most sense.**

July 31, 2008

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