Memo to: Oaktree Clients

From: Howard Marks

Re: Nobody Knows

The title of this memo isn't a joke; I mean it. Nobody knows the real significance of the recent events in the financial world, or what the future holds. Everyone has an opinion – there's an off-color joke to that effect – but opinions are entirely different from knowledge. As usual, the bulls are optimistic, the bears are pessimistic, and the rest are uncertain.

This is a great time for my favorite quote from John Kenneth Galbraith: "There are two kinds of forecasters: those who don't know, and those who don't know they don't know." No one knows about the future, and that's more true now than ever . . . literally. Excesses were committed at financial institutions that we've never seen before in terms of their scale or their breadth, and many new inventions are in place that never existed before. So clearly no one can know how things will pan out.

My conviction that this is true frees me from having to methodically assess the strength and weakness of economies and institutions, and it permits me to limit my comments to what I consider strategic realities.

I'm flattered that people have asked for my opinion, and I will give it. But that's all it is: an opinion. In setting it down, I will repeat things I've written before. So if you find something that you think you're reading for the second time, you're probably right.

Boom-Bust

Those two words say it all. If you have a boom, eventually you'll have a bust. And the further the boom goes, the worse the bust is likely to be. If there's no boom, on the other hand, there needn't be a bust.

There was no great boom in the U.S. economy in 2003-07, and that's one of the reasons why it has held up reasonably well despite the recent turmoil.

But there was an incredible boom in the financial sector, and it has led to an incredible bust. (It remains to be seen whether its effects will slop over into the real economy. As you know, we think they will.)

Finally, there wasn't a boom in the U.S. stock market, and so it hasn't busted. (If you think your stocks have given you pain, realize that their decline isn't at all commensurate with the end-of-the-world thinking roiling the financial sector).

How Things Got This Way

Much of the current problem can be attributed to a decades-long bubble in the financial sector that made it the employer of obvious choice; attracted employees who were "the best and the brightest" (although often untrammeled by experience); contributed to greed and risk taking; drove out fear and skepticism; and carried institutions, behavior, expectations and asset prices to unsustainable levels.

What are the factors that got us in the current mess?

- Excess liquidity, which had to find a home.
- Interest rates that had been reduced to stimulate the economy.
- Dissatisfaction with the resulting prospective returns on low-risk investments.
- Inadequate risk aversion, and thus a willingness to step out on the risk curve in search of higher returns.
- A broad-scale willingness to try new things, such as structured products and derivatives, and to employ massive leverage.
- A desire on the part of financial institutions to supplement operating income with profits from proprietary risk taking – that is, to be "more like Goldman."
- A system of disintermediation, selling onward, and slicing and dicing that caused many participants to overlook risk in the belief that it had been engineered away.
- Excessive reliance on rating agencies which were far from competent to cope with the new instruments, and on black-box financial models that extrapolated recent history.
- Unquestioning acceptance of financial platitudes without wondering whether altered circumstances and elevated asset prices had rendered them irrelevant:
    - Houses and condos are good investments and can be counted on to appreciate.
    - Mortgages rarely go into default.
    - There can never be a nation-wide decline in home prices.
    - It's okay to grossly lever a balance sheet if you've hedged enough through derivatives.
    - It's safe to borrow and invest funds equal to a huge multiple of your equity capital if the probabilistic expected value is positive, because "disasters rarely happen."
- Individuals such as mortgage brokers and mortgage borrowers who were given incentives to do the wrong thing.
- Newly minted financial "masters of the universe" encouraged to maximize returns for themselves and their employers without concern for whether they were adding value to the financial system or endangering it.

In general, the above can be summed up as a shortage of adult supervision, common sense, skepticism, ethical concern and good old-fashioned prudence. As often happens in booms, the kids shouldered the adults aside or impressed them too much.

The list of errors can make you laugh . . . or cry. I mentioned in "Hindsight First, Please" how often financial people do things that look downright silly afterwards. But that never stops them from repeating the old mistakes or making new ones.

So now we find financial institutions that endangered themselves by using extensive short-term borrowings or deposits to make investments that turned out to be enormously risky when an unlikely disaster – a nationwide decline in home prices – occurred.

In many ways, changes in the environment contributed as well. They crept up one by one, unnoticed, but their combined effect is significant. For example,

- The Glass-Steagall Act was repealed, permitting banks and investment banks to combine. (It had been enacted in 1933 to outlaw such combinations because they were felt to have contributed to the Crash of '29. It's ironic – and certainly not irrelevant – that it was repealed in 1999, in time to contribute to the current credit crunch.)
- The rule limiting short sales to up-ticks was revoked in July 2007, enabling short selling to force stock prices down unabated.
- Derivatives were created whose prices were determined by the price of their "real" underlying securities; now we see that in an Alice-in-Wonderland way, they're able to influence the price of real securities (see below).
- And mark-to-market accounting exposed precariously leveraged institutions to the risk that technically-driven declines in asset values might leave them too weak to make it through to a better day.

It was during my working lifetime that the phrase "too big to fail" was coined. More recently, Citibank caused some people to observe that it had become too big to manage. In the current go-round, financial institutions have been described as too big to understand and, finally, too big to disentangle (given the proliferation of derivatives and swap transactions, a key element in assessing an institution's essentialness is the degree of counter-party risk it presents to others). There's no doubt that these developments are frightening. But heroes aren't people who're unafraid, but rather those who act bravely despite their fears. Investors mustn't let emotion control their actions.

Because of this combination of altered behavior, financial innovation and changes in the environment, I feel unable to tell you what lies ahead. But that doesn't mean I'm not going to suggest a course of action.

Does the Market Know?

For reasons both systematic and unsystematic, the market is in many cases taking its lead from . . . the market. Price declines cause fear, and thus further price declines.

In some cases, the signal for increased worry comes from increases in the price of credit default swaps, which provide insurance against debt defaults. Rising CDS prices imply that creditors have become more concerned. This can send down the prices of a company's stock and debt instruments and frighten customers and depositors into withdrawing funds, potentially leading to downgrading and failure. In other words, increases in prices for credit insurance can serve as self-fulfilling prophesies. This is the unintended consequence of one of the recent innovations.

I want to mention the potential for manipulation present in this situation. One strong bid for default protection in the thin market for CDS on a given company can massively depress the price of billions of dollars worth of stock and/or debt. Clearly, an unscrupulous short-seller can use this tactic to his advantage. No one knows the extent to which it is in play . . . or how to stop it.

In the end, people once again have to apply skepticism and their own judgment, this time to bad news. Is the market smart or dumb? Is it giving us a valid signal to get out or the buying opportunity of a lifetime? I seem to remember a useful quotation to the effect that "The market is an ass." Thus I think there's more money to be made by being a contrarian than a trend follower.

The End of the Financial System

We're seeing and hearing things today that we never imagined.

- The demise or bailout of Lehman Brothers, Bear Stearns, Freddie Mac, Fannie Mae and AIG.
- Concern about the viability of Goldman Sachs and Morgan Stanley, and huge declines in their stocks.
- Rising prices for CDS protection on U.S. Treasury securities.
- Rates on short-term T-bills close to zero because of an extreme flight to safety.
- Awareness for the first time, I think, that the U.S. government's financial resources are finite, and that there are limits on its ability to run the printing press and solve problems.

Will the financial system melt down, or is this merely the greatest down cycle we've ever seen? My answer is simple: we have no choice but to assume that this isn't the end, but just another cycle to take advantage of.

I must admit it: I say that primarily because it is the only viable position. Here are my reasons:

- It's impossible to assign a high enough probability to the meltdown scenario to justify acting on it.
- Even if you did, there isn't much you could do about it.*
- The things you might do if convinced of a meltdown would turn out to be disastrous if the meltdown didn't occur.

- Most of the time, the end of the world doesn't happen. The rumored collapses due to Black Monday in 1987 and Long-Term Capital Management in 1998 turned out to be just that.

* -- Money has to be someplace; where would you put yours? If you put it in T-bills, what purchasing power would be accorded the dollars in which they're denominated? If the government's finances collapsed, what good would your dollars be, anyway? What depository wouldn't be in danger? If you and many others decided to put billions into gold, what price would you have to pay for it? Where would you store it, and how would you pay for the truck to move it? How would you spend it to buy the things you need? What would people pay you for your gold, and what would they pay you with? And what if you bought credit insurance on all of your holdings: who would be able to make good on your claims?

No, I don't see any viable way to plan for the end of the world. I don't know any more than anyone else about its probability, but I see no use in panicking.

I think the outlook has to be viewed as binary: will the world end or won't it? If you can't say yes, you have to say no and act accordingly. In particular, saying it will end would lead to inaction, while saying it's not going to will permit us to do the things that always have worked in the past.

We will invest on the assumption that it will go on, that companies will make money, that they'll have value, and that buying claims on them at low prices will work in the long run. What alternative is there?

What Kind of Future Do We Face?

Of course, even assuming there will be a recovery, we have to think about what it will look like. As I wrote in "Doesn't Make Sense," we aren't counting on a "V." We will continue to emphasize companies that we feel serve basic economic functions and can do relatively well even in bad times. Many elements in the economy are being damaged, especially confidence, and they may take a relatively long time to recover. In particular, the mechanism for providing capital is in great disrepair, and less credit certainly means a slower recovery and less growth.

The financial institutions deserve a special mention. If there's ever been a sector that's down-and-out, this is probably it. Nevertheless, Oaktree generally demands more transparency in order to invest than most of them provide. It can seem almost impossible to ascertain their condition through due diligence, and absolutely impossible without access to their books. For example, possible buyers probably found the risks at Lehman Brothers to be unanalyzable. As *The Wall Street Journal* said on Tuesday,

> Even understanding Lehman's current trading positions was tough. Lehman's roster of interest-rate swaps (a type of derivative investment) ran about two million strong . . .

What kind of effort would it require to understand the significance of two million derivatives positions: are they thoroughly hedged, or bullish or bearish on balance? And what about Lehman's millions of other derivatives and complex securities? This opacity, combined with heavy leverage, reliance on short-term funds, liquidity and conscious risk taking, is the reason why a loss of confidence is conceivable at any financial institution in times of panic.

What will the Wall Street of the future look like? We read – and I don't doubt – that for at least a while it will be smaller, less leveraged, less profitable, and more highly regulated. But I also think it will be less competitive and less risky.

In the course of my career, Wall Street went from being (1) brokers handling riskless trades for commission to (2) dealers buying and selling inventory for a spread to (3) block traders purchasing large amounts of stock when market liquidity was inadequate to (4) proprietary traders risking their own capital in pursuit of profit for the house. Backing down this progression wouldn't be the worst thing in the world.

<u>What Will Start the Recovery?</u>

Eventually, someone will walk out of the crowd and take advantage of the lows. He may start an investment bank unburdened with a legacy of losing positions. Or a bond insurer like Warren Buffett did when MBIA and Ambac became impaired. **The cause of the recovery can't be predicted. There may not even be a visible one. Maybe things will just get so cheap that they can't stay down.** (In ancient history – November 2001 – I wrote "You Can't Predict; You Can Prepare," with a thorough description of how cycles happen, based on energy all their own. It might be worth digging up.)

I like to point out that, even in retrospect, no one can say what started the collapse of the tech stock bubble in 2000. But it did start . . . just, I think, because stock prices rose far too high. That works in reverse, too.

In March, in "The Tide Goes Out," I mentioned the three stages of a bull market, a notion I've been carrying around in my head for about 35 years:

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

As we all know, buying during the first stage can be highly profitable, while buying during the last euphoric stage usually leads to disaster.

Then I went on to create the converse of the above, the three stages of a bear market:

- the first, when just a few prudent investors recognize that, despite the prevailing bullishness, things won't always be rosy,
- the second, when most investors recognize things are deteriorating, and
- the third, when everyone's convinced things can only get worse.

In the final stage, you can buy assets at prices that reflect little or no optimism. There can be no doubt that we are in the third stage with regard to many financial institutions. Not necessarily at the bottom, but in a serious period of unremitting pessimism. **No one seems able to imagine how the current vicious circle will be interrupted. But I think we must assume it will be.**

It must be noted that, just like two years ago, people are accepting as true something that has never held true before. Then, it was the proposition that massively levered balance sheets had been rendered safe by the miracle of financial engineering. Today, it's the non-viability of the essential financial sector and its greatest institutions.

Everyone was happy to buy 18-24-36 months ago, when the horizon was cloudless and asset prices were sky-high. Now, with heretofore unimaginable risks on the table and priced in, it's appropriate to sniff around for bargains: the babies that are being thrown out with the bath water. We're on the case.

September 19, 2008

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