Memo to: Oaktree Clients

From: Howard Marks

Re: So Much That's False and Nutty

As reported in *The New York Times* of May 5, Warren Buffett told the crowd at this year's Berkshire Hathaway annual meeting:

> There is so much that's false and nutty in modern investing practice and modern investment banking. If you just reduced the nonsense, that's a goal you should reasonably hope for.

As we look back at the causes of the crisis approaching its second anniversary – and ahead to how investors might conduct themselves better in the future – Buffett's simple, homespun advice holds the key, as usual. I agree that investing practice went off the rails in several fundamental ways. Perhaps this memo can help get it back on.

© Oaktree Capital Management, L.P. All Rights Reserved.

The Lead-up: Progress and Missteps

Memory dims with the passage of time, but when I think back to the investment arena I entered forty-plus years ago, it seems very different from that of 2003-07. Institutional investing was done mainly by bank investment departments (like the one I was part of), insurance companies and investment counselors – a pretty dull bunch. And as I like to point out when I speak to business school classes, "famous investor" was an oxymoron – few investment managers were well known, chosen for magazine covers or listed among the top earners.

There were no swaps, index futures or listed options. Leverage wasn't part of most institutional investors' arsenal . . . or vocabulary. Private equity was unknown, and hedge funds were too few and outré to matter. Innovations like quantitative investing and structured products had yet to arrive, and few people had ever heard of "alpha."

Return aspirations were modest. Part of this likely was attributable to the narrow range of available options: for the most part stocks and bonds. Stocks would average 9-10% per year, it was held, but we might put together a portfolio that would do a little better. And the admissible bonds were all investment grade, yielding moderate single digits.

We wanted to earn a good return, limit the risks, beat the Dow and our competitors, and retain our clients. But I don't remember any talk of "maximization," or anyone trying to "shoot the lights out." And by the way, no one had ever heard of performance fees. Quite a different world from that of today. Perhaps it would constitute a service if I pulled together a list of some of the developments since then:

- In the mid-1960s, **growth investing** was invented, along with the belief that if you bought the stocks of the "nifty-fifty" fastest-growing companies, you didn't have to worry about paying the right price.
- The first of the **investment boutiques** was created in 1969, as I recall, when highly respected portfolio managers from a number of traditional firms joined together to form Jennison Associates. For the first time, institutional investing was sexy.
- We started to hear more about **investment personalities**. There were the "Oscars" (Schafer and Tang) and the "Freds" (Carr, Mates and Alger) – big personalities with big performance, often working outside the institutional mainstream.
- In the early 1970s, **modern portfolio theory** began to seep from the University of Chicago to Wall Street. With it came indexation, risk-adjusted returns, efficient frontiers and risk/return optimization.
- Around 1973, put and call **options** escaped from obscurity and began to trade on exchanges like the Chicago Board Options Exchange.
- Given options' widely varying time frames, strike prices and underlying stocks, a tool for valuing them was required, and the **Black-Scholes model** filled the bill.
- A small number of **leveraged buyouts** took place starting in the mid-1970s, but they attracted little attention.
- 1977-79 saw the birth of the **high yield bond market**. Up to that time, bonds rated below investment grade couldn't be issued. That changed with the spread of the argument – associated primarily with Michael Milken – that incremental credit risk could responsibly be borne if offset by more-than-commensurate yield spreads.
- Around 1980, **debt securitization** began to occur, with packages of mortgages sliced into securities of varying risk and return, with the highest-priority tranche carrying the lowest yield, and so forth. This process was an example of disintermediation, in which the making of loans moved out of the banks; 25 years later, this would be called the **shadow banking system.**
- One of the first "quant" miracles came along in the 1980s: **portfolio insurance**. Under this automated strategy, investors could ride stocks up but avoid losses by entering stop-loss orders if they fell. It looked good on paper, but it failed on Black Monday in 1987 when brokers didn't answer their phones.
- In the mid- to late 1980s, the ability to borrow large amounts of money through high yield bond offerings made it possible for minor players to effect buyouts of large, iconic companies, and "**leverage**" became part of investors' everyday vocabulary.
- When many of those buyouts proved too highly levered to get through the 1990 recession and went bust, investing in **distressed debt** gained currency.
- Real estate had boomed because of excessive tax incentives and the admission of real estate to the portfolios of S&Ls, but it collapsed in 1991-92. When the Resolution Trust Corporation took failed properties from S&Ls and sold them off, **"opportunistic" real estate** investing was born.
- Mainstream investment managers made the big time, with Peter Lynch and Warren Buffett becoming famous for consistently beating the equity indices.
- In the 1990s, **emerging market investing** became the hot new thing, wowing people until it took its knocks in the mid- to late 1990s due to the Mexican peso devaluation, Asian financial crisis and Russian debt disavowal.

© Oaktree Capital Management, L.P.
All Rights Reserved.

- **Quant investing** arrived, too, achieving its first real fame with the success of Long-Term Capital Management. This Nobel Prize-laden firm used computer models to identify fixed income arbitrage opportunities. Like most other investment miracles, it worked until it didn't. Thanks to its use of enormous leverage, LTCM melted down spectacularly in 1998.
- Investors' real interest in the last half of the '90s was in **common stocks,** with the frenzy accelerating but narrowing to **tech-media-telecom stocks** around 1997 and narrowing further to **Internet stocks** in 1999. The "limitless potential" of these instruments was debunked in 2000, and the equity market went into its first three-year decline since the Great Crash of '29.
- **Venture capital funds**, blessed with triple-digit returns thanks to the fevered appetite for tech stocks, soared in the late 1990s and crashed soon thereafter.
- After their three-year slump, the loss of faith in common stocks caused investors to shift their hopes to **hedge funds** – "absolute return" vehicles expected to make money regardless of what went on in the world.
- With the bifurcation of strategies and managers into "beta-based" (market-driven) and "alpha-based" (skill-driven), investors concluded they could identify managers capable of **alpha investing**, emphasize it, perhaps synthesize it, and "port" or carry it to their portfolios in additive combinations.
- **Private equity** – sporting a new label free from the unpleasant history of "leveraged buyouts" – became another popular alternative to traditional stocks and bonds, and funds of $20 billion and more were raised at the apex in 2006-07.
- Wall Street came forward with a plan to package prosaic, reliable home mortgages into **collateralized debt obligations** – the next high-return, low-risk free lunch – with help from tranching, securitization and selling onward.
- The key to the purported success of this latest miracle lay in **computer modeling**. It quantified the risk, assuming that mortgage defaults would remain uncorrelated and benign as historically had been the case. But because careless mortgage lending practices unknowingly had altered the probabilities, the default experience turned out to be much worse than the models suggested or the modelers thought possible.
- Issuers of **collateralized loan obligations** bought corporate loans using the same processes that had been applied to CDOs. Their buying facilitated vast issuance of syndicated bank loans carrying low interest rates and few protective covenants, now called **leveraged loans** because the lending banks promptly sold off the majority.
- Options were joined by futures and swaps under a new heading: **derivatives**. Heralded for their ability to de-risk the financial system by shifting risk to those best able to bear it, derivatives led to vast losses and something new: counterparty risk.
- The common thread running through hedge funds, private equity funds and many other of these investment innovations was **incentive compensation**. Expected to align the interests of investment managers and their clients, in many cases it encouraged excessive risk taking.
- Computer modeling was further harnessed to create **"value at risk"** and other risk management tools designed to quantify how much would be lost if the investment environment soured. This fooled people into thinking risk was under control – a belief that, if acted on, has the potential to vastly increase risk.

© Oaktree Capital Management, L.P. All Rights Reserved.

At the end of this progression we find an institutional investing world that bears little resemblance to the quaint cottage industry with which the chronology began more than forty years ago. Many of the developments served to increase risk or had other negative implications, for investors individually and for the economy overall. In the remainder of this memo, I'll discuss these trends and their ramifications.

Something for Everyone

One thing that caused a lot of people to lose money in the crisis was the popularization of investing. Over the last few decades, as I described in "The Long View" (January 2009), investing became widespread. "Less than 10% of adults owned stocks in the 1950s, in contrast to 40% today." (*Economics and Portfolio Strategy*, June 1, 2009). Star investors became household names and were venerated. "How-to" books were big sellers, and investors graced the covers of magazines. Television networks were created to cover investing 24/7, and Jim Cramer and the "Money Honey" became celebrities in their own right.

It's interesting to consider whether this "democratization" of investing represented progress, because in things requiring special skill, it's not necessarily a plus when people conclude they can do them unaided. The popularization – with a big push from brokerage firms looking for business and media hungry for customers – was based on success stories, and it convinced people that "anyone can do it." **Not only did this overstate the ease of investing, but it also vastly understated the danger**. ("Risk" has become such an everyday word that it sounds harmless – as in "the risk of underperformance" and "risk-adjusted performance." Maybe we should switch to "danger" to remind people what's really involved.)

To illustrate, I tend to pick on Wharton Professor Jeremy Siegel and his popular book "Stocks for the Long Run." Siegel's research was encyclopedic and supported some dramatic conclusions, perhaps foremost among them his showing that there's never been a 30-year period in which stocks didn't outperform cash, bonds and inflation. This convinced a lot of people to invest heavily in stocks. But even if his long-term premise eventually holds true, anyone who invested in the S&P 500 ten years ago – and is now down 20% – has learned that 30 years can be a long time to wait.

The point is that not everyone is suited to manage his or her own investments, and not everyone should take on uncertain investments. The success of Bernard Madoff's Ponzi scheme shows that even people who are wealthy and presumed sophisticated can overlook risks. Might that be borne in mind the next time around?

At Ease with Risk

Risk is something every investor should think about constantly. We know we can't expect to make money without taking chances. The reason's simple: if there was a risk-

© Oaktree Capital Management, L.P. All Rights Reserved

free way to make good money – that is, a path to profit free from downside – everyone would pursue it without hesitation. That would bid up the price, bring down the return and introduce the risk that accompanies elevated prices.

So yes, it's true that investors can't expect to make much money without taking risk. But that's not the same as saying risk taking is sure to make you money. As I said in "Risk" (January 2006), if risky investments always produced high returns, they wouldn't be risky.

The extra return we hope to earn for holding stocks rather than bonds is called an equity risk premium. The additional promised yield on high yield bonds relative to Treasurys is called a credit risk premium. All along the upward-sloping capital market line, the increase in potential return represents compensation for bearing incremental risk. Except for those people who can generate "alpha" or access alpha managers, investors shouldn't plan on getting added return without bearing incremental risk. And for doing so, they should demand risk premiums.

But at some point in the swing of the pendulum, people usually forget that truth and embrace risk taking to excess. In short, in bull markets – usually when things have been going well for a while – people tend to say, "Risk is my friend. The more risk I take, the greater my return will be. I'd like more risk, please."

The truth is, risk tolerance is antithetical to successful investing. When people aren't afraid of risk, they'll accept risk without being compensated for doing so . . . and risk compensation will disappear. This is a simple and inevitable relationship. When investors are unworried and risk-tolerant, they buy stocks at high p/e ratios and private companies at high EBITDA multiples, and they pile into bonds despite narrow yield spreads and into real estate at minimal "cap rates."

In the years leading up to the current crisis, it was "as plain as the nose on your face" that prospective returns were low and risk was high. In simple terms, there was too much money looking for a home, and too little risk aversion. Valuation parameters rose and prospective returns fell, and yet the amount of money available to managers grew steadily. Investors were attracted to risky deals, complex structures, innovative transactions and leveraged instruments. In each case, they seemed to accept the upside potential and ignore the downside.

There are few things as risky as the widespread belief that there's no risk, because it's only when investors are suitably risk-averse that prospective returns will incorporate appropriate risk premiums. Hopefully in the future (a) investors will remember to fear risk and demand risk premiums and (b) we'll continue to be alert for times when they don't.

© Oaktree Capital Management, L.P.
All Rights Reserved

Embracing Illiquidity

Among the risks faced by the holder of an investment is the chance that if liquidity has dried up at a time when it has to be sold, he'll end up getting paid less than it's worth. **Illiquidity is nothing but another source of risk, and it should be treated no differently**:

- All else being equal, investors should prefer liquid investments and dislike illiquidity.
- Thus, before making illiquid investments, investors should ascertain that they're being rewarded for bearing that risk with a sufficient return premium.
- Finally, out of basic prudence, investors should limit the proportion of their portfolios committed to illiquid investments. There are some risks investors shouldn't take regardless of the return offered.

But just as people can think of risk as a plus, so can they be attracted to illiquidity, and for basically the same reason. There is something called an illiquidity premium. It's the return increment investors should receive in exchange for accepting illiquidity. But it'll only exist if investors prefer liquidity. If they're indifferent, the premium won't be there.

Part of the accepted wisdom of the pre-crisis years was that long-term institutional investors should load up on illiquid investments, capitalizing on their ability to be patient by garnering illiquidity premiums. In 2003-07, so many investors adopted this approach that illiquidity premiums became endangered. For example, as of the middle of 2008, the average $1 billion-plus endowment is said to have had investments in and undrawn commitments to the main illiquid asset classes (private equity, real estate and natural resources) equal to half its net worth. Some had close to 90%.

The willingness to invest in locked-up private investment funds is based on a number of "shoulds." Illiquid investments should deliver correspondingly higher returns. Closed-end investment funds should call down capital gradually. Cash distributions should be forthcoming from some funds, enabling investors to meet capital calls from others. And a secondary market should facilitate the sale of positions in illiquid funds, if needed, at moderate discounts from their fair value. But things that should happen often fail to happen. That's why investors should view potential premium returns skeptically and limit the risk they bear, including illiquidity.

Comfortable with Complexity

Investors' desire to earn money makes them willing to do things they haven't done before, especially if those things seem modern and sophisticated. Technological complexity and higher math can be seductive in and of themselves. And good times and rising markets encourage experimentation and erase skepticism. These factors allow Wall Street to sell innovative products in bull markets (and only in bull markets). But these innovations can be tested only in bear markets . . . and invariably they are.

© Oaktree Capital Management, L.P. All Rights Reserved.

Many of the investment techniques that were embraced in 2003-07 represented quantitative innovations, and people seemed to think of that as an advantage rather than a source of potential risk. Investors were attracted to black-box quant funds, highly levered mortgage securities critically dependent on computer models, alchemical portable alpha, and risk management based on sketchy historical data. The dependability of these things was shaky, but the risks were glossed over. As Alan Greenspan wrote in *The Wall Street Journal* of March 11:

> It is now very clear that the levels of complexity to which market practitioners at the height of their euphoria tried to push risk-management techniques and products were too much for even the most sophisticated market players to handle properly and prudently.

Warren Buffett put it in simpler terms at this year's Berkshire meeting. "**If you need a computer or a calculator to make the calculation, you shouldn't buy it**." And Charlie Munger added his own slant: "Some of the worst business decisions I've ever seen are those with future projections and discounts back. It seems like the higher mathematics with more false precision should help you, but it doesn't. They teach that in business schools because, well, they've got to do something."

To close on this subject, I want to share a quote I recently came across from Albert Einstein. I've often argued that the key to successful investing lies in subjective judgments made by experienced, insightful professionals, not machinable processes, decision rules and algorithms. I love the way Einstein put it:

> **Not everything that can be counted counts, and not everything that counts can be counted.**

<u>Relying on Ratings</u>

My memos on the reasons for the crisis, like "Whodunit" (February 2008), show that there's more than enough blame to go around and lots of causes to cite. **But if you boil it down, there was one indispensable ingredient in the process that led to trillions of dollars of losses: misplaced trust in credit ratings.** The explanation is simple:

- Competitive pressure for profits caused financial institutions to try to keep up with the leaders. As is normal in good times, the profit leaders were those who used the most leverage.
- Thus institutions sought to maximize their leverage, but the rules required that the greatest leverage be used only with investments rated triple-A.
- A handful of credit rating agencies had been designated by the government as Nationally Recognized Statistical Rating Organizations, despite their highly imperfect track records.
- The people who guard the financial henhouse often have a tough time keeping up with the foxes' innovations. Whereas traditional bond analysis was a relatively

© Oaktree Capital Management, L.P. All Rights Reserved

simple matter, derivatives and tiered securitizations were much more complex. This allowed rating agency employees to be manipulated by the investment banks' quantitatively sophisticated and highly compensated financial engineers.

- The rating agencies proved too naïve, inept and/or venal to handle their assigned task.
- Nevertheless, **financial institutions took the ratings at face value, enabling them to pursue the promise of highly superior returns from supposedly riskless, levered-up mortgage instruments. This deal clearly was too good to be true, but the institutions leapt in anyway.**

It all started with those triple-A ratings. For his graduation from college this year, Andrew Marks wrote an insightful thesis on the behavior that gave rise to the credit crisis. I was pleased that he borrowed an idea from "Whodunit": "if it's possible to start with 100 pounds of hamburger and end up selling ten pounds of dog food, 40 pounds of sirloin and 50 pounds of filet mignon, the truth-in-labeling rules can't be working." That's exactly what happened when mortgage-related securities were rated.

Investment banks took piles of residential mortgages – many of them subprime – and turned them into residential mortgage-backed securities (RMBS). The fact that other tranches were subordinated and would lose first allowed the rating agencies to be cajoled into rating a lot of RMBS investment grade. Then RMBS were assembled into collateralized debt obligations, with the same process repeated. In the end, heaps of mortgages – each of which was risky – were turned into CDO debt, more than 90% of which was rated triple-A, meaning it was supposed to be almost risk-free.

John Maynard Keynes said ". . . a speculator is one who runs risks of which he is aware and an investor is one who runs risks of which he is unaware." Speculators who bought the low end of the CDO barrel with their eyes open to the risk suffered total losses on a small part of their capital. But the highly levered, esteemed investing institutions that accepted the higher ratings without questioning the mortgage alchemy lost large amounts of capital, because of the ease with which they'd been able to lever holdings of triple-A and "super-senior" CDOs. Ronald Reagan said of arms treaties, "Trust, then verify." If only financial institutions had done the same.

The rating agencies were diverted from their mission by a business model that made them dependent on security issuers for their revenues. This eliminated their objectivity and co-opted them into the rating-maximization process. Regardless of that happening, however, it's clear that the stability of our financial institutions never should have been allowed to rely so heavily on the competence of a few for-profit (and far-from-perfect) rating agencies. **In the future, when people reviewing the crisis say, "If only they had . . . ," the subject will often be credit ratings. Bottom line: investors must never again abdicate the essential task of assessing risk. It's their number-one job to perform thorough, skeptical analysis.**

© Oaktree Capital Management, L.P.
All Rights Reserved

The More You Bet . . .

If I had to choose a single phrase to sum up investor attitudes in 2003-07, it would be the old Las Vegas motto: "The more you bet, the more you win when you win." Casino profits ride on getting people to bet more. In the financial markets just before the crisis, players needed no such encouragement. They wanted to bet more, and the availability of leverage helped them do so.

One of the major trends embedded in the chronology on pages two and three was toward increasing the availability of leverage. Now, I've never heard of any of Oaktree's institutional clients buying on margin or taking out a loan to make investments. It might not be considered "normal" for fiduciaries, and tax-exempt investors would have to worry about Unrelated Business Taxable Income.

None of us go out and buy Intel chips, but we've all seen commercials designed to get us to buy products with "Intel inside." In the same way, **investors became increasingly able to buy investment products with leverage inside . . . that is, to participate in levered strategies rather than borrow explicitly to make investments**. Think about these elements from my earlier list of investment developments:

- Investors who would never buy stocks on margin were able to invest in private equity funds that would buy companies on leverage of four times or more.
- The delayed and irregular nature of drawdowns caused people who had earmarked $100 for private investment funds to make commitments totaling $140.
- Options, swaps and futures – in fact, many derivatives – are nothing but ways for investors to access the return on large amounts of assets with little money down.
- Many hedge funds used borrowings or derivatives to access the returns on more assets than their capital would allow them to buy.
- When people wanted to invest $100 in markets with skill-derived return bolted on, "portable alpha" had them invest $90 in hedge funds with perceived alpha and the rest in futures covering $100 worth of the passive market index. This gave them a stake in the performance of $190 of assets for every $100 of capital.

Clearly, each of these techniques exposed investors to the gains or losses on increased amounts of assets. If that's not leverage, what is? In fact, an article entitled "Harvard Endowment Chief Is Earning Degree in Crisis Management" in *The New York Times* of February 21 said of Harvard, "The endowment was squeezed partly because **it had invested more than its assets** . . ." (emphasis added). I find this statement quite remarkable, and yet no one has remarked on it to me.

It shouldn't be surprising that people engaging in these levered strategies made more than others when the market rose. But 2008 showed the flip side of that equation in action. **In the future, investors should consider whether they really want to lever their capital or just invest the amount they have**.

© Oaktree Capital Management, L.P. All Rights Reserved

Sharing the Wealth

Apart from the increasing use of leverage, another trend that characterized the five years before the crisis was the widespread imposition of incentive fees.

In the 1960s, at the start of my chronology, only hedge funds commanded incentive fees, and there were too few for most people to know or care about. But fee arrangements that can be simplified as "two-and-twenty" flowered with private equity in the 1980s, distressed debt, opportunistic real estate and venture capital funds in the 1990s, and hedge funds in the 2000s. Soon they were everyplace.

Here are my basic thoughts on this sort of arrangement. (Oaktree receives incentive compensation on roughly half its assets; my objection isn't with regard to the fees themselves, but rather the way they've been applied.)

- **It seems obvious that incentive fees should go only to managers with the skill needed to add enough to returns to more than offset the fees – other than through the mere assumption of incremental risk.** For example, after a high yield bond manager's .50% fee, a 12% gross return becomes 11.5% net. A credit hedge fund charging a 2% management fee and 20% of the profits would have to earn a 16.375% gross return to net 11.5%. That's 36% more return. **How many managers in a given asset class can generate this incremental 36% other than through an increase in risk? A few? Perhaps. The majority? Never.**

- **Thus, incentive fee arrangements should be exceptional, but they're not**. These fees didn't go to just the proven managers (or the ones whose returns came from skill rather than beta); they went to everyone. If you raised your hand in 2003-07 and said "I'm a hedge fund manager," you got a few billion to manage at two-and-twenty, even if you didn't have a record of successfully managing money over periods that included tough times.

- The run-of-the-mill manager's ease of obtaining incentive fees was enhanced each time a top manager capped a fund. As I wrote in "Safety First . . . But Where?" (April 2001), "When the best are closed, the rest will get funded."

- In fact, whereas two-and-twenty was unheard-of in the old days, it became the norm in 2003-07. This enabled a handful of managers with truly outstanding records to demand profit shares ranging up to 50%.

- Clients erred in using the term "alignment of interests" to describe the effect of incentive compensation on their relationships with managers. Allowing managers to share in the upside can bring forth best efforts, but it can also encourage risk bearing instead of risk consciousness. Most managers just don't have enough money to invest in their funds such that loss of it could fully balance their potential fees and upside participation. **Instead of alignment, then, incentive compensation must be viewed**

© Oaktree Capital Management, L.P.
All Rights Reserved

largely as a "heads we win; tails you lose" arrangement. Clearly, it must be accorded only to the few managers who can be trusted with it.

- **Finally, the responsibility for overpaying doesn't lie with the person who asks for excessive compensation, but rather with the one who pays it.** How many potential LPs ever said, "He may be a great manager, but he's not worth that fee." I think most applied little price discipline, as they were driven by the need to fill asset class allocations and/or the fear that if they said no, they might miss out on a good thing (more on this subject later).

I'm asked all the time nowadays what I expect to happen with investment manager compensation. First, I remind people that what should happen and what will happen are two different things. Then I make my main point: there should be much more differentiation. **Whereas in past years everyone's fees were generous and pretty much the same, the post-2007 period is providing an acid test that will show who helped their clients and who didn't.** Appropriate compensation adjustments should follow.

Managers who actually helped their clients before and during this difficult period – few in number, I think – will deserve to be very well compensated, and their services could be in strong demand. The rest should receive smaller fees or be denied incentive arrangements, and some might turn to other lines of work. Oaktree hopes to be among the former group. We'll see.

© Oaktree Capital Management, L.P.
All Rights Reserved

Ducking Responsibility

The inputs used by a business to make its products are its costs. The money it receives for its output are its revenues. The difference between revenues and costs are its profits. At the University of Chicago, I was taught that by maximizing profits – that is, maximizing the excess of output over input – a company maximizes its contribution to society. This is among the notions that have been dispelled, exposing the imperfections of the free-market system. (Hold on; I'm not saying it's a bad system, just not perfect.)

When profit maximization is exalted to excess, ethics and responsibility can go into decline, a phenomenon that played a substantial role in getting us where we are. The pursuit of short-term profit can lead to actions that are counterproductive for others, for society and for the long run. For example:

- A money manager's desire to add to assets under management, and thus profits, can lead him to take in all the money he can. But when asset prices and risks are high and prospective returns are low, this clearly isn't good for his clients.
- Selling financial products to anyone who'll buy them, as opposed to those for whom they're right, can put investors at unnecessary risk.
- And cajoling rating agencies into assigning the highest rating to debt backed by questionable collateral can put whole economies in jeopardy, as we've seen.

One of the concepts that governed my early years, but about which I've heard little in recent years, is "fiduciary duty." Fiduciary duty is the obligation to look out for the welfare of others, as opposed to maximizing for yourself. It can be driven by ethics or by fear of legal consequences; either way, it tends to cause caution to be emphasized.

When considering a course of action, we should ask, "Is it right?" Not necessarily the cleverest practice or the most profitable, but the right thing? The people I think of perverting the mortgage securitization process never wondered whether they were getting an appropriate rating, but whether it was the highest possible. Not whether they were doing the right thing for clients or society, but whether they were wringing maximum proceeds out of a pile of mortgage collateral and thus maximizing profits for their employers and bonuses for themselves.

A lot of misdeeds have been blamed on excessive emphasis on short-term results in setting compensation. The more compensation stresses the long run, the more it creates big-picture benefits. Long-term profits do more good – for companies, for business overall and for society – than does short-term self-interest.

<u>Focusing on the Wrong Risk</u>

The more I've thought about it over the last few months, the more I've concluded that investors face two main risks: (1) the risk of losing money and (2) the risk of missing opportunity. Investors can eliminate one or the other, but not both. More commonly, they must consider how to balance the two. How they do so will have a great impact on their results. This is the old dilemma – fear or greed? – that people talk about so much. It's part of the choice between offense and defense that I often stress (see, for example, "What's Your Game Plan?" September 2003).

The problem is that investors often fail to strike an appropriate balance between the two risks. In a pattern that exemplifies the swing of the pendulum from optimistic to pessimistic and back, investors regularly oscillate between extremes at which they consider one to the exclusion of the other, not a mixture of the two.

One of the ways I try to get a sense for what's going on is by imagining the conversations investors are having with each other . . . or with themselves. In 2003-07, with most investors worried only about achieving returns, I think the conversation went like this: "I'd better not make less than my peers. Am I behaving as aggressively as I should? Am I using as much leverage as my competitor? Have I shifted enough from stocks and bonds to alternatives, or am I being an old fogey? If my commitments to private equity are 140% of the amount I actually want to invest, is that enough, or should I do more?"

Few people seemed to worry about losses. Or if they were worried, they played anyway, fearing that if they didn't, they'd be left behind. That must be what drove Citigroup's Chuck Prince when he said, "as long as the music's playing, you've got to get up and

© Oaktree Capital Management, L.P.
All Rights Reserved

dance. We're still dancing." **The implication's clear: No worries; high prices. No risk aversion; no risk premiums**. Certainly that describes the markets in 2003-07.

In the fourth quarter of 2008, when asset prices were collapsing, I imagined a very different conversation from that of 2003-07, with most investors saying, "I don't care if I never make another dollar in the market; I just don't want to lose any more. Get me out!" Attitudes toward the two risks were still unbalanced, but in the opposite direction.

Just as risk premiums disappear when risk is ignored, so can prospective returns soar when risk aversion is excessive. In late 2008, economic fundamentals were terrible; technical conditions consisted of forced selling and an absence of buyers; and market psychology melted down. Risk aversion predominated, and fear of missing out disappeared. These are the conditions under which assets are most likely to be available for purchase at prices way below their fair value. They're also the conditions in which most people go on buying strikes.

In the future, investors should do a better job of balancing the fear of losing money and the fear of missing out. My response is simple: Good luck with that.

Pursuing Maximization

When markets are rising and investors are obsessed with the fear of missing out, the desire is for maximum returns. Here's the inner conversation I imagine: "I need a return of 8% a year. But I'd rather have 10%. 14% would be great, and the possibility of 16% warrants adding to my risk. It's worth using leverage for a shot at 20%, and with twice as much leverage, I might get 24%."

In other words, more is better. And of course it is . . . except that to pursue higher returns, you have to give up something. That something is safety. But in hot times, no one worries about losing money, just missing out. So they try to maximize.

There should be a point at which investors say, "I need 8%, and it would be great if I could get 16%. But to try, I would have to do things that expose me to excessive loss. I'll settle for a safer 10% instead." **I've labeled this concept "good-enough returns**." **It's based on the belief that the possibility of more isn't always better. There should be a point at which investors decline to take more risk in the pursuit of more return, because they're satisfied with the return they expect and would rather achieve that with high confidence than try for more at the risk of falling short (or losing money).**

Most investors will probably say that in 2003-07, they didn't blindly pursue maximization; it was the other guys. But someone did it, and we're living with the consequences. **I like it better when society balances risk and return rather than trying to maximize. Less gain, perhaps, but also less pain.**

© Oaktree Capital Management, L.P.
All Rights Reserved

*　　　*　　　*

"Apropos of nothing," as my mother used to say, I'm going to use the opportunity provided by this memo to discuss market conditions and the outlook. On the plus side:

- We've heard a lot recently about "green shoots": mostly cases where things have stopped getting worse or the rate of decline is slowing. A few areas have shown actual improvement, such as consumer confidence and durable goods orders. It's important when you consider these improvements, however, to bear in mind that when you get deep into a recession, the comparisons are against depressed periods, and thus easier.
- It's heartening to see the capital markets open again, such that banks can recapitalize and borrowers can extend maturities and delever. Noteworthily, Michael Milken and Jonathan Simons wrote in *The Wall Street Journal* of June 20 that, "Global corporations have raised nearly $2 trillion in public and private markets this year . . ."
- Investor opinion regarding markets and the government's actions has grown more positive, and as Bruce Karsh says, "Armageddon is off the table." (He and I both felt 6-9 months ago that a financial system meltdown absolutely couldn't be ruled out.)

These positives are significant, but there also are many unresolved negatives:

- Business is still terrible. Sales trends are poor. Where profits are up, it's often due to cost-cutting, not growth. (Remember, one man's economy measure is another's job loss – not always a plus for the overall picture.)
- Unemployment is still rising, and with incomes shrinking, savings rising as a percentage of shrinking incomes, and credit scarcer, it's hard to see whose spending will power a recovery.
- The outlook for residential and, particularly, commercial real estate remains poor, with implications for further write-offs on the part of the banks. Ditto for credit card receivables.
- Many companies are likely to experience debt refinancing challenges, defaults, bankruptcies and restructurings.
- Developments such as rising interest rates and rising oil prices have the power to impede a recovery.
- Finally, no one can say with confidence what will be the big-picture ramifications of trillions of dollars of federal deficit spending, or the states' fiscal crises.

I'm not predicting that these things will turn out badly, merely citing potential negatives that may not be fully reflected in today's higher asset prices. My greatest concern surrounds the fact that we're in the middle of an unprecedented crisis, brought on by never-seen-before financial behavior, against which novel remedies are being attempted. And yet many people seem confident that a business-as-usual recovery lies ahead. They're applying normal lag times and extrapolating normal decline/recovery relationships. **The words of the late Amos Tversky aptly represent my view: "It's frightening to think that you might not know something, but more frightening to**

© Oaktree Capital Management, L.P.
All Rights Reserved

think that, by and large, the world is run by people who have faith that they know exactly what's going on."

Peter Bernstein, a towering intellect who sadly passed away a month ago, made some important contributions to the way I think about investing. Perhaps foremost among them was his trenchant observation that, "Risk means more things can happen than will happen." **Investors today may think they know what lies ahead, but they should at least acknowledge that risk is high, the range of possibilities is wider than it was ever thought to be, and there are a few that could be particularly unpleasant.**

Unlike 2003-07 when no one worried about risk, or late 2008 when few investors cared about opportunity, the two seem to be in better balance given the revival of risk taking this year. Thus the markets have recovered, with most of them up 30% or more from their bottoms (debt in December and stocks in March).

If you and I had spoken six months ago, we might have reflected on the significant stock market rallies that occurred during the decade-long Great Depression, including a 67% gain in the Dow in 1933. How uncalled-for those rallies appear in retrospect. But now we've had one of our own.

Clearly, improved psychology and risk tolerance have played a big part in the recent rally. These things have strengthened even as economic fundamentals haven't, and that could be worrisome. (On June 23, talking about general resilience – not investor attitudes – President Obama said the American people ". . .are still more optimistic than the facts alone would justify.") On the other hand, there's good reason to believe that at their lows, security prices had understated the merits. So are prices ahead of fundamentals today, or have they merely recovered from "too low" to "in balance"? There's no way to know for sure.

Unlike the fourth quarter of last year – when assets were depressed by terrible fundamentals, technicals and psychology – they're no longer at giveaway prices. Neither are they clearly overvalued. Maybe we should say "closer to fair."

With price and value in reasonable balance, the course of security prices will largely be determined by future economic developments that defy prediction. Thus I find it hard to be highly opinionated at this juncture. Few things are compelling sells here, but I wouldn't be a pedal-to-the-metal buyer either. On balance, I think better buying opportunities lie ahead.

July 8, 2009

© Oaktree Capital Management, L.P.
All Rights Reserved

Legal Information and Disclosures

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.

© Oaktree Capital Management, L.P.
All Rights Reserved