Memo to: Oaktree Clients

From: Howard Marks

Re: Touchstones

In the two-plus years since the onset of the financial crisis, it's been a regular theme of mine that we should look back, identify the causes and learn from them. I've tackled this assignment in a number of memos and a variety of ways. Now, despite the fact that you've heard much of this from me before, I'm going to try to pull it all together, using the quotations, adages and images that I feel best capture the essence of what we've been through. When I think back, these are the ones that stand out.

"Greed Is Good"

There's no debating which line from the film *Wall Street* is the most memorable. It's hard to forget the image of slicked-back takeover artist Gordon Gekko urging on his troops, invoking the positive power of self-interest. What he meant by "greed is good," of course, was that greed – or self-interest, or the profit motive – is what drives people and companies operating in a free-market setting to strive for more and better, and thus to work hard and optimally allocate resources. It's the force that motivates Adam Smith's "invisible hand" and carries economies to increased output and higher standards of living.

Among the many pendulum-like phenomena we occasionally witness is the swing in people's willingness to rely on the free market. First they trust the market to come up with solutions. Then the shortcomings of those solutions are laid bare and there's a call for regulation. Then the folly of government involvement becomes evident and people want the free market back, and so forth. Because neither extreme is perfect, the oscillation between them goes on. Governments can't run economies or companies. But it's equally true that in a free market, the rules will occasionally be stretched and participants harmed.

In a free market, things will inevitably go past the optimal to the extreme. When they swing back, the retreat can be painful. **Thus, if we're going to rely on the market to settle things, we have to be willing to accept the consequences.**

In the pre-crisis years, the free market was revered and deferred to, and regulation was thought of as little more than a potential impediment to the market's processes. (An article I can't locate in my pile of clippings beautifully explained the dearth of government action: "That's the kind of regulation you get from an administration that doesn't believe in regulation.") That attitude permitted financial institutions to take actions and bear risks that turned out to be unwise, unprofitable and unsustainable. Their strategies took them to the brink of disaster in 2008.

In a truly free market, Bear Stearns, Merrill Lynch, Citibank, AIG, Fannie Mae, Freddie Mac and others likely would have gone bankrupt. Those bankruptcies would have been quite instructive, but also quite painful. If the world is unwilling to live with such lessons from time to time – and if some institutions are considered to be "too big to fail" for society's purposes – then free markets and self-interest have to be restrained. **Greed may be good, but it can be permitted to run free only up to a point.**

Nothing's More Risky Than a Widespread Belief That There's No Risk

The recent crisis came about primarily because investors partook of novel, complex and dangerous things, in greater amounts than ever before. They took on too much leverage and committed too much capital to illiquid investments. **Why did they do these things? It all happened because investors believed too much, worried too little, and thus took too much risk. In short, they believed they were living in a low-risk world.**

In 2006 and early 2007, for instance, we heard a lot about the "wall of liquidity" that was coming toward us from China and the oil producing countries, a flow that could be counted on to provide capital and raise asset prices non-stop. Likewise, we were told (a) the Fed had tamed the business cycle through its adroit management, (b) securitization, tranching and disintermediation had reduced risk by putting it where it could best be handled, and (c) the "Greenspan put" could always be counted on to bail out investors who made mistakes. These and other things were said to have lowered the risk level worldwide.

Belief that risk has been banished is a key element in allowing people to engage in practices they would otherwise view as risky, and in permitting assets to be bid up to prices that would clearly be too high in a world perceived to involve risk.

> . . . former Fed Chairman Paul A. Volcker noted that one of the causes of the financial crisis "was the ultimately explosive combination of compensation practices that provided enormous incentives to take risks" just as new financial innovations "seemed to offer assurance – falsely, as it turned out – that those risks had been diffused." (*The Wall Street Journal*, September 18, 2009)

Worry and its relatives, distrust, skepticism and risk aversion, are essential ingredients in a safe financial system. To paraphrase a saying about the usefulness of bankruptcy, fear of loss is to capitalism as fear of hell is to Catholicism. Worry keeps risky loans from being made, companies from taking on more debt than they can service, portfolios from becoming overly concentrated, and unproven schemes from turning into popular manias. When worry and risk aversion are present as they should be, investors will question, investigate and act prudently. Risky investments either won't be undertaken or will be required to provide adequate compensation in terms of anticipated return.

But only when investors are sufficiently risk averse will markets offer adequate risk premiums. When worry is in short supply, risky borrowers and questionable schemes will have easy access to capital, and the financial system will become precarious. Too much money will chase the risky and the new, driving up asset prices and driving down prospective returns and safety.

> For a market to function, those who invest and lend in that market must believe that their money is actually at risk. (President Obama, September 14, 2009)

Clearly, in the months and years leading up to the crisis, few participants worried as much as they're supposed to.

<u>Soros's Theory of Reflexivity</u>

Some of the biggest problems arise because market participants think of their environment as a static arena in which they act. What they miss – to their frequent detriment – is that their actions alter the environment, causing the results to differ from their expectations.

George Soros has written and spoken most articulately about the ability of investors' actions to change the environment. He calls this process "reflexivity."

> The generally accepted theory is that financial markets tend towards equilibrium, and on the whole, discount the future correctly. I operate using a different theory, according to which financial markets cannot possibly discount the future correctly because they do not merely discount the future; they help to shape it. In certain circumstances, financial markets can affect the so-called fundamentals which they are supposed to reflect. When that happens, markets enter into a state of dynamic disequilibrium and behave quite differently from what would be considered normal by the theory of efficient markets. Such boom/bust sequences do not arise very often, but when they do, they can be very disruptive, exactly because they affect the fundamentals of the economy. . . . (George Soros, MIT Department of Economics World Economy Laboratory Conference, Washington, D.C., April 26, 1994)

My son Andrew, now starting his investment career, has provided an illustration of reflexivity at work that's clear and topical. For several years prior to the crisis, the desire for high returns with low risk (what else is new?) created strong demand for mortgage-based investment products such as RMBS and CDOs. Underpinning it all was the fact that there had never been a nationwide decline in home prices, and thus participants were confident that geographic diversification would render levered mortgage pools safe, warranting triple-A ratings for most of the resulting securities. Rising demand for these products required an increasing volume of underlying mortgages. This need caused lending standards to be weakened and loans to be provided to home buyers with dubious creditworthiness. Easy financing allowed buyers to bid up home prices to levels that exceeded the homes' realistic values and made it tough for borrowers to make their mortgage payments. When the perpetual-motion machine of house appreciation ground to a halt in 2007, the combination of too-high prices and record mortgage defaults resulted in the first nationwide decline in home prices. **Thus, in the end, the belief that an asset was safe led to investor behavior that made it unsafe. That's reflexivity.**

In 2003-07, as described above, investors considered the world a low-risk place. Thus they rushed to buy assets they found attractive, borrowing in order to buy more when their own capital was exhausted. They expected purchases made with cheap leverage to produce high

profits with low risk. But their buying drove up both the cost of the assets and the riskiness of the environment, transforming their "low-risk" strategies into high-risk ones. The consequences have become clear.

<u>Greenspan and Bubbles</u>

One of the most obvious ways in which investors change the environment is through the creation of asset bubbles, like the one that popped in the summer of 2007. In a process that invariably looks silly after the fact, they reach the conclusion that an investment is a sure winner, usually on the basis of simplistic platitudes that simply can't hold up under scrutiny. These include "Internet stocks must rise because these companies are going to change the world," "real estate (or gold) is a good hedge against inflation," "home prices can never decline nationwide," "oil will appreciate because it's being consumed faster than it's being found," and "alternative investments (or hedge funds or private equity funds) hold the key to meeting investment goals."

Because of the strength attributed to these platitudes, investors go on to conclude that the investments they support will be profitable regardless of the price at which they're undertaken. How can this be right? **It's not possible that something can be a good investment regardless of the price paid. But when a logical-seeming platitude is adopted by the stampeding herd, that belief is the result.** That's how we get bubbles.

Bubble thinking is irrational, given that it's built on a belief that there's no price too high. This goes on to manifest itself in a variety of ways. In the 1970s, when hyper-inflation was rampant and interest rates were astronomical, people concluded that no matter the interest rate paid, borrowing to buy "inflation protected" assets like real estate would be profitable. That's bubble thinking.

In my forty-year career, I've seen bubbles in growth stocks, small stocks, oil stocks, emerging market stocks and tech stocks, as well as such surefire winners as silver, homes and buyouts. In each instance, there was a logical underlying rationale for the desirability of the subject assets, but people overlooked the possibility that bubble thinking had raised prices to dangerous levels.

Alan Greenspan greatly influenced economic and market developments during his term as Fed Chairman from 1987 to 2006, and his record on the subject of bubbles was poor. He set the world on its ear in 1996 by railing against "irrational exuberance" as the Dow Jones Index soared past the 6,000 level, but he was quiet thereafter, rationalizing appreciation well beyond 10,000 based on gains in productivity. Here's his position on bubbles:

> . . . bubbles generally are perceptible only after the fact. To spot a bubble in advance requires a judgment that hundreds of thousands of informed investors have it all wrong. While bubbles that burst are scarcely benign, the consequences need not be catastrophic for the economy. (June 17, 1999)
>
> . . . it was far from obvious that bubbles, even if identified early, could be preempted short of the central bank inducing a substantial contraction in economic

activity – the very outcome we would be seeking to avoid. Prolonged periods of expansion promote a greater rational willingness to take risks, a pattern very difficult to avert by a modest tightening of monetary policy . . . we recognized that, despite our suspicions, it was very difficult to definitively identify a bubble until after the fact. . . . the idea that the collapse of a bubble can be softened by pricking it in advance is almost surely an illusion. (August 30, 2002)

Thus it was his view that (a) bubbles can only be detected in retrospect, not as they occur, (b) even if detected, bubbles are hard to deflate benignly, (c) rather than deflate them, bubbles can be managed, and (d) deflating bubbles isn't the job of the Fed. This relaxed position on bubbles can easily be seen as having abetted their growth. For example:

> . . . testimony before Congress last week refutes, once and for all, the existence of an alleged housing market "bubble," said chief economists of the National Association of Home Builders. . . . "The time has come to put this issue to rest," said NAHB Chief Economist David Seiders. "The nation's home builders have said it, the Realtors have said it, and **now Alan Greenspan has said it once again, in no uncertain terms: there is no such thing as a current or impending house price bubble**."
>
> Asked about the issue during his testimony, Greenspan said, "We've looked at the bubble question and we've concluded that it is most unlikely." He attributed recent "sizeable gains" in home prices to "the effects on demand of low mortgage rates, immigration and shortages of buildable land." (*Business Wire*, July 22, 2002, emphasis added)

Ignoring bubbles is a special case of ignoring risk in general. The philosopher George Santayana is famous for having said, "Those who cannot remember the past are condemned to repeat it." Likewise, **those who fail to learn from past bubbles are bound to suffer in the bursting of new ones.**

<u>The More You Bet, the More You Win When You Win</u>

In the years just prior to the crash, obliviousness to risk encouraged numerous forms of risky behavior. One of the greatest was the use of leverage to increase returns, a phenomenon that became widespread.

People make investments on the basis of positive expected returns. When the cost of borrowing is below the expected return, using leverage appears certain to magnify the gain. Thus the Las Vegas maxim that heads this section comes into play, and it's that kind of thinking that gives leverage its seductive power.

But there's so much more to leverage than that, and unfortunately the rest is learned only when things go badly. Leverage doesn't make an investment better; it merely magnifies the gains and losses. Leverage is what James Grant of *Grant's Interest Rate Observer* calls "money of the mind," meaning it can vanish if the lender is able to take his money back. And any combination of fundamental difficulty, falling asset prices, reduced market liquidity, collateral value tests and margin calls can be the ruination of investors employing leverage. That's what befell many in the fourth quarter of 2008.

In 2003-07, interest rates brought low by the Fed, modest demands for risk premiums on the part of unworried investors, and financial institutions' competition to lend conspired to make low-cost leverage readily available. That cheap financing (a) convinced people that high leverage was the route to increased returns (even from low-yielding underlying investments), (b) armed all parties for a bidding war for assets, and (c) made people rush to borrow and buy before the river of financing ran dry. The result was a buying spree of massive proportions, the bill for which – in terms of debt maturities, often unpayable – will come due in the next few years.

Like just about everything else in investing, leverage is neither good nor bad per se. Used at the right time, in judicious amounts, to purchase low-priced assets, it's a good thing. But that's not the story of the pre-crisis years. And that's a big reason for the trouble we've had since.

<u>"Risk Means More Things Can Happen Than Will Happen"</u>

The above quote from Elroy Dimson of the London Business School helps bring risk into focus. Risk has been the subject of excessive complication and sophistication, but Dimson's simple formulation makes clear what it's all about.

Investing consists entirely of dealing with the future. To do that, people must form opinions about what lies ahead. But few things are more potentially harmful than projections. I've collected a lot of quotations on this subject. Here are my two favorites, but I have a million more:

> We have two classes of forecasters: Those who don't know – and those who don't know they don't know.
>
> John Kenneth Galbraith

> It's frightening to think that you might not know something, but more frightening to think that, by and large, the world is run by people who have faith that they know exactly what's going on.
>
> Amos Tversky

One of the errors committed in 2003-07 – forming a cornerstone of the crisis – consisted of believing too much in the ability to predict the future. Investors, risk managers, financial institution executives, rating agencies and regulators trusted forecasts, extrapolations and computer models. **This made them comfortable with risk, always a dangerous arrangement.**

The "I know" school of investing has received frequent mention in my memos (e.g., "Us and Them," May 7, 2004). Its members – money managers, Wall Street strategists and media pundits – believe that there's a single future, it is knowable in advance, and they're among the people who know it. They're eager to tell you what the future holds, and equally willing to overlook the inaccuracy of their past predictions. **What they repeatedly ignore is the fact that (a) the future possibilities cover a broad range, (b) some of them – the "black swans" – can't even be imagined in advance, and (c) even if it's possible to know which one outcome is the most likely, the others have a substantial combined probability of occurring instead.**

Thus one key question each investor has to answer is whether he views the future as knowable or unknowable. An investor who feels he knows what the future holds will act assertively: making directional bets, concentrating positions, levering holdings and counting on future growth – in other words, doing things that in the absence of foreknowledge would increase risk. On the other hand, someone who feels he doesn't know what the future holds will act quite differently: diversifying, hedging, levering less (or not at all), emphasizing value today over growth tomorrow, staying high in the capital structure, and generally girding for a variety of possible outcomes.

The first group of investors did much better in the years leading up to the crash. But the second group was better prepared when the crash unfolded, and they had more capital available (and more-intact psyches) with which to profit from purchases made at its nadir.

<u>Never Forget the 6'-Tall Man Who Drowned Crossing the Stream That Was 5' Deep on Average</u>

The range of possibilities – the environments with which we must deal – invariably will include some bad ones. We must prepare for them, and the unavoidable prerequisite for doing so is being aware of them. Following from the section above, **the key is to view the future as a range of possibilities, not a reliable point estimate**.

How does the successful investor prepare for the uncertain future? By building in what Warren Buffett calls "margin for error" or "margin of safety." It's having this margin that enables us to do okay even when things don't go our way.

If an investor prepares for a single future and attempts to maximize under the assumption that his view will prove right, he'll be in big trouble if it doesn't. The investor who backs off from the maximizing position is likely to do better when negative surprises occur. Thus it's essential to realize a few things:

- It's not sufficient to think about surviving "on average" – investment survival has to be achieved every day, under all circumstances.
- The ability to survive under adverse conditions comes from a portfolio's margin for error.
- **Ensuring sufficient margin for error and attempting to maximize returns are incompatible**.

The use of leverage illustrates a special case of the above. Leverage increases the gains if you succeed and the losses if you fail. Thus leverage increases the probability of maximizing under favorable outcomes and reduces your margin of safety under unfavorable ones. In 2008, leveraged loans that ultimately proved to be money-good declined in price for psychological and technical reasons. **Loan investors who were able to hold on recovered, but many who had bought with leverage couldn't do so. They drowned in the deep part of the stream.**

Chuck Prince on Dancing

A quotation from the former CEO of Citigroup contains just 30 words, but it could serve as a case study regarding the events leading up to the crash:

> When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing. (Charles Prince, July 9, 2007)

I suspected in mid-2007 that this quotation would end up being emblematic of the cycle. It's been replayed many times, but usually without the first dozen words. Prince seems to have been more aware of what was going on than people give him credit for. He may have sensed the bank was on thin ice in lending and levering, like the rest. The problem wasn't that he overlooked the danger; the problem was that he felt he had to participate anyway.

One of the dilemmas faced by businesses is that they can conclude that they have no choice but to take part in dangerous behavior. Usually this is because they're unwilling to cede market share. On October 5, Leo Strine, Vice Chancellor of the Delaware Court of Chancery, wrote as follows in *The New York Times Dealbook*:

> . . . the ability of any particular firm to resist imitating the overly risky, but law-compliant behavior of competitors will be compromised to the extent that managers face criticism or even removal for not keeping up with so-called industry leaders whose high, short-term returns have pleased a stock market filled with short-term investors looking for alpha.

In "The Race to the Bottom" (February 14, 2007), I described the dangerous behavior that providers of capital engage in when the competition becomes heated. The formula is one of the simplest: **when there's too much money chasing too few deals, asset prices are driven up, prospective returns are driven down, and risk rises**.

Those seven little words – too much money chasing too few deals – represent an absolute death knell for the availability of good returns earned with safety. It should be possible to know when this is the case, as Prince did, but people tend to join in nevertheless. Often this is true because, even if they recognize the danger, they're also aware that "being too far ahead of your time is indistinguishable from being wrong," and they don't want to be out of step.

The way I see it, investors face two main risks: the risk of losing money and the risk of missing out. Although investors should balance the two, in reality this is yet another of those arcs along which the pendulum swings regularly between extremes.

The disposition of a market – the position of the pendulum – can be inferred from the behavior of participants regarding these two risks. In the years just before the crash, encouraged by the purported risk-reducers described on page 2 above, investors generally ignored the risk of loss. In those heady times, they feared only missing opportunities, looking too conservative, and losing business. This combination spurred them to employ aggressive strategies, innovative products, leverage and illiquidity. **When most people think the worst imaginable outcome is failing to participate fully in gains, the result is risky behavior. They're inevitably reminded that there's worse, but it can take a long time to happen.**

<u>"It's Only When the Tide Goes Out That You Find Out Who's Been Swimming Naked"</u>

When I came across the above quotation from Warren Buffett, I borrowed it for "It's All Good" (July 16, 2007) and later devoted an entire memo to it ("The Tide Goes Out," March 18, 2008). Buffett's way of saying things combines brevity, humor and pinpoint accuracy, and this is a great example.

Financial innovation was a major component in building the base for the crisis. As I've said before, **popularization of new investment products is possible only in rising markets, with their suspension of skepticism, easy access to money, and dearth of trying moments. On the other hand, innovations are only tested in falling markets, and few pass the ultimate test.** Californians' homes may contain construction flaws, but we only learn about them during earthquakes. Likewise, a fatally flawed investment product can easily survive until it's tested in a bear market.

The extensive investment innovation of 2003-07 was driven by the poor performance of stocks in 2000-02 and the low yields available on high grade bonds. A large number of new products and strategies emerged, increasing in popularity in a salutary environment. Few investors were troubled by the products' dependence on high leverage or suddenly commonplace triple-A ratings, or by the fact that they hadn't been tested in tough times.

It's not surprising that bull market developments were defrocked in the tougher times of 2007-08, but it's somewhat shocking how many examples there are. It turned out that:

- losses on investments involving leverage, illiquidity or risky assets could be much worse than the "worst case" that had been predicted,
- beta had been confused for alpha, just as leverage had for value added,
- there was nothing absolute about "absolute return," and "market neutral" strategies were correlated with the market,
- the "golden age of private equity" had been a function of easy money, not bargain purchases,
- sharing the upside with investment managers isn't sufficient to align their interests with those of their clients, and
- things that "should happen" often don't.

While an extreme case, the story of Bernie Madoff presents an apt example of this phenomenon. Madoff's fictitious returns weren't very high, but they were remarkably steady; thus his clients thought of his fund as a high-yielding T-bill. This made it easy for the skilled Ponzi schemer to satisfy the few withdrawal requests with cash from eager new investors. This could have continued *ad infinitum* if not for the market collapse in 2008. Madoff's investors had complete confidence in him, but they couldn't get money they needed from other funds that had put up gates, or they didn't want to sell other investments that, unlike Bernie's, were showing big losses. So Madoff received requests for $7 billion of withdrawals, an amount he simply couldn't raise from new suckers, and his nakedness became apparent.

The Madoff story exemplifies the ability of ill-founded investments to prosper in bull markets, and the role of bear markets in exposing them. **Now that the tide has gone out, many pre-crisis miracles have been exposed as non-value based, overly dependent on prosperity and easy money, pro-cyclical, over-hyped or just plain flawed. Hopefully next time, investors will give more thought to how their bull-market dalliances will fare when the tide goes out.**

The Opposite of a Bubble

On the heels of the lessons regarding the run-up to the crash, the latter part of 2008 provided several lessons about behavior in times of crisis. With the fundamental outlook terrible, psychology depressed and technical conditions featuring a great deal of forced selling, that period represented one of the greatest buying opportunities I've ever seen.

I expressed my view that, having been too optimistic before the crash, people were now taking things too far on the downside. It's not easy to resist emotional excesses at highs and lows, but it's by doing so that the best investment decisions can be made:

> . . . it's improbable events that brought on the credit crisis. Lots of bad things happened that had been considered unlikely (if not impossible), and they happened at the same time, to investors who'd taken on significant leverage. So the easy explanation is that the people who were hurt in the credit crisis hadn't been skeptical – or pessimistic – enough. But that [realization] triggered an epiphany: **Skepticism and pessimism aren't synonymous. Skepticism calls for pessimism when optimism is excessive. But it also calls for optimism when pessimism is excessive.** ("The Limits to Negativism," October 15, 2008)

The swing of the pendulum to one extreme or another is a constant in the investment world: from optimism to pessimism, from credulous to skeptical, from sanguine to panicked, from wide-open capital markets to windows slammed shut, from more buyers than sellers to more sellers than buyers and, consequently, from overpriced to underpriced. Thus I was thrilled when an article by my friend James Grant provided a quotation that beautifully sums up the end result of this process:

> To the English economist Arthur C. Pigou is credited a bon mot that exactly frames the issue. **"The error of optimism dies in the crisis, but in dying it gives birth to an error of pessimism. This new error is born not an infant, but a giant."** (*The Wall Street Journal*, September 19, 2009, emphasis added)

Optimism thrives in bubbles. That's what they're built on, with optimism and rising prices reinforcing each other. Likewise, crises are brought on by an extreme turn toward pessimism. Falling prices and pessimism contribute to each other on the way down.

In the years just before the crash, no view was considered too optimistic. There were few skeptics around to point out that a notion might be too good to be true. And then, as Pigou says, the opposite became true post-Lehman Brothers. There was no scenario of which someone wouldn't suggest, "But what if it's worse than that?" Now no idea was considered too negative to be true.

The error is clear. The herd applies optimism at the top and pessimism at the bottom. Thus, to benefit, we must be skeptical of the optimism that thrives at the top, and skeptical of the pessimism that prevails at the bottom.

Pigou makes an excellent additional point. Bubbles usually build gradually over time, the result of a steady accretion of logical basis, favorable developments, high returns being achieved, platitudes taken to extremes, willing suspension of disbelief, rising optimism and the recruitment of new buyers. But when the bubble's faulty underpinnings are exposed, it tends to collapse in a rush. The excess of pessimism does arrive quickly, "born a giant." Or as my partner Sheldon Stone puts it, "the air goes out of the balloon a lot faster than it went in."

A recent report by Ian Kennedy and Richard Riedel of Cambridge Associates, entitled "Behavioral Risk," provides an excellent explanation for this process and describes its effect:

> [During good times,] we suffer from what James Montier characterizes as "the illusion of control: the belief that if things go wrong, we will be able to sort them out." When that illusion is shattered during a selling panic, we don't know where to turn or what to think. . . .
>
> What happens when we humans (and, indeed, other animals) are slammed by shock? Unless trained otherwise, our instincts tell us to retreat, conserve, seek the comparative safety of groups, and search for a path out of danger. These are ancient survival instincts, hard-wired. Slammed by *financial* shock, the same instincts result in heightened risk aversion (gimme cash!), a dramatic foreshortening of our normal investment time horizon, an overwhelming impulse to flee with the herd, a tendency to extrapolate current trends all the way to Armageddon . . .
>
> In times of crisis, when risk aversion spikes, panicked investors tend to stampede for the exits. The temptation to join them is well-nigh irresistible because the whole financial edifice seems to be collapsing. Carefully wrought models are rendered irrelevant overnight, as correlations converge on 1.0, and "fat tail" risk wags the dog. . . .
>
> **When markets are falling, we instinctively feel that risk is rising, and when markets are rising, that risk is ebbing. In the short term, this instinct may be right since markets often run on momentum in the short run. But for long-term investors it is dead wrong**. . . . **As equity markets plummet, investors' risk aversion rises even as the fundamental risk is in fact declining**. (emphasis added)

In other words, our instincts and emotions conspire to make us do the wrong thing at the wrong time: to trust at the top and worry at the bottom, and to think something's riskier at $10 than it was at $100, as if the emotion-fed price decline is correct in suggesting that something's wrong.

Buy Low, Sell High

Of all the adages that bear on the events of this extreme cycle we're living through, the simple one just above – probably the first one any of us learned – is still the most important.

In my early years in this business, people who spent all their time on security selection were told that asset allocation can be more important. I'd like to nominate a third candidate for primacy: countercyclical behavior. Consider any intermediate-term period of 3-5 years or so in which the market pendulum makes a significant swing (and that's about all of them). The period 2004-08 presents a good example. Individual security selection had limited impact on the return from a diversified portfolio. Asset allocation mattered much more, but primarily because it determined your posture with regard to the market's swing. **By far the most pivotal thing is whether your investing was anti-cyclical or pro-cyclical. Did you buy more at the bottom or more at the top? Did you invest defensively at the top and aggressively at the bottom, or vice versa? In other words, did you buy low and sell high, or buy high and sell low?**

The Cambridge study describes the importance of resisting the cycle and acting counter to it. It also outlines the difficulty of doing so, and some of the reasons. But it is the most important thing. Did you participate in the errors of 2004-08 or resist? That's the key.

Resisting – and thereby achieving success as a contrarian – isn't easy. Things combine to make it difficult, including natural herd tendencies and the pain imposed by being out of step, since momentum invariably makes pro-cyclical actions look correct for a while. (That's why it's essential to remember that "being too far ahead of your time is indistinguishable from being wrong.") Given the uncertain nature of the future, and thus the difficulty of being confident your position is the right one – especially as price moves against you – it's challenging to be a lonely contrarian.

A few things that can help, however. First, after even a little time spent in the investment business, everyone should know that the herd is usually wrong at the extremes and pays dearly for its error. Second, some contrarians have records that are very impressive. And third, **an accurate reading of investor mood and behavior – perceptive inference of danger or opportunity based on what others are doing in the market – can give investors a good leg up toward being effective contrarians.**

I say we never know where we're going, but we sure as heck ought to know where we are. The cycle isn't unknowable or unbeatable. Touchstones like those enumerated above are there for everyone to see, but few people take full advantage. The key is to be among those who do.

*   *   *

The philosopher Hannah Arendt wrote:

> . . . no matter how much we may be capable of learning from the past, it will not enable us to know the future. (*The Origins of Totalitarianism*, 1951)

We cannot know what the future holds, and history cannot tell us. But awareness of that limitation is a key lesson in itself. Mastering it increases our likelihood of investment success.

November 10, 2009

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.