Memo to: Oaktree Clients

From: Howard Marks

Re: Warning Flags

For about a year, I've been sharing my realization that there are two main risks in the investment world: the risk of losing money and the risk of missing opportunity. You can completely avoid one or the other, or you can compromise between the two, but you can't eliminate both. One of the prominent features of investor psychology is that few people are able to (a) always balance the two risks or (b) emphasize the right one at the right time. Rather, at the extremes they usually obsess about the wrong one . . . and in so doing make the other the one deserving attention.

During bull markets, when asset prices are elevated, there's great risk of losing money. And in bear markets, when everything's at rock bottom, the real risk consists of missing opportunity. Everyone knows these things. But bull markets develop for the simple reason that most people are buying – ignoring the risk of loss in order to keep from missing opportunity – just when elevated prices imply losses later. Likewise, markets reach their lows because most people are selling, trying to avoid further losses and ignoring the bargains that are everywhere.

<u>The Never-Ending Cycle</u>

Why do people buy when they should sell, and sell when they should buy? The answer's simple: emotion takes over. Price increases excite investors and encourage them to buy, and price declines scare them into selling.

When the economy and markets boom, people tend to assume more of the same is in the offing. They find little to worry about, other than the possibility that others will make more money than they will. Fear of loss recedes, and fear of opportunity costs takes over. Thus risk aversion evaporates and risk tolerance rises.

Risk aversion is absolutely essential in order for markets to function properly. When sufficient risk aversion is present, people shrink from riskier investments and prefer safer ones. Thus riskier investments have to appear to offer higher returns in order to attract capital. That's as it should be.

But when people get excited about the prospect of easy money – even if from assets or investment strategies that have become far too popular, turning into overpriced manias – they frequently drop their risk aversion and adopt risk tolerance instead. Thus they swarm into the investment *du jour* without concern for its elevated price and risk. This behavior should constitute an important warning flag for prudent investors.

In the same way that expanded risk tolerance accompanies appreciated asset prices and contributes to the risk of loss, so does risk aversion tend to rise in times of depressed prices, increasing the risk of missed opportunity. When people refuse to buy assets regardless of their low prices, they miss out on the best, lowest-risk returns of the cycle.

<u>Recent History – on the Upside</u>

Just as the recent market cycle was extreme, so was the swing in attitudes regarding the "twin risks." And thus so are the resultant learning opportunities.

Risk aversion was clearly inadequate in the years just before the onset of the crisis in mid-2007. In fact, I consider this the main cause of the crisis. (Last year, *DealBook*, the online business publication of *The New York Times*, asked me to write about what I thought had been behind the crisis. My article, entitled "Too Much Trust, Too Little Worry," was published on October 5, 2009. It offers more on this subject should you want it.) Here's the background regarding the early part of this decade:

Interest rates kept low by the Fed combined with the first three-year decline of stocks since the Depressionto reduce interest in traditional investments. As a result, investors shifted their focus to alternative and innovative investments such as buyouts, infrastructure, real estate, hedge funds and structured mortgage vehicles. In the low-return climate of the time, much of the appeal of these asset classes came from the fact that they promised higher returns thanks to their use of leverage, whether through borrowing, tranching or derivatives.

Given the high promised returns, investors forgot about (or chose to ignore) the ability of leverage to magnify losses as well as gains. Contributing to investors' rosy view of leverage's likely impact was their belief that risk had been banished by (a) the efficacy of the Fed and its "Greenspan put," (b) the combination of securitization, disintermediation, tranching, decoupling and financial engineering, and (c) the "wall of liquidity" coming toward us from China and the oil producing nations.

For these reasons, few market participants were afraid of losing money. Most just worried about missing opportunity. The unattractive outlook for stocks and bonds meant investors would have to be aggressive and innovative if they were going to earn significant returns in the low-return environment. Thus risk aversion (a) was unnecessary and (b) would be counter-productive. "You'd better invest in this new financial product," people were told. "If you don't, you'll miss out. And if you don't and your competitor does – and it works – you'll look out-of-step and fall behind." When contemplating a virtuous circle without end, investors usually think of only one word: "buy."

This describes the process through which fear of missed opportunity can overcome skepticism and prudence. And in this period, that's what happened. No one worried about losing money. Fear of missed opportunity drove most investors, and Citibank's Chuck Prince famously said, ". . . as long as the music is playing, you've got to get up and dance. We're still dancing." Although he worried about a possible decline in liquidity, he worried more about falling behind in the manic race to provide capital.

Recent History – on the Downside

The events from mid-2007 through late 2008 or early 2009 demonstrate the reverse in operation. The upward trend in home prices ground to a halt and subprime mortgages began to default in large numbers. Leveraged vehicles melted down. Credit became unavailable, and financial institutions needed rescuing. Recession caused spending to contract, and corporate profits declined. Bear Stearns, Merrill Lynch, AIG, Fannie Mae, Freddie Mac, Wachovia and Washington Mutual all required rescues. Bank capital, commercial paper and money market funds needed federal guarantees. After the bankruptcy of Lehman Brothers, people began to ponder the collapse of the financial system. As often happens in scary times, "possible" morphed into "probable," or at least something very much worth worrying about.

Now a vicious circle replaced the virtuous one of just a few months earlier. And with its arrival, the fear of losing money replaced the fear of missing opportunity. As I've said before, I imagine most investors' cry was, "I don't care if I ever make a penny in the market again; I just don't want to lose any more. Get me out!"

For most investors, no assumption was too negative to be true, and no potential return made the risk of loss worth bearing. High yield bonds at 19% yields. First lien leveraged loans at 18%. Investment grade bonds at 11%. None of these was sufficient to induce risk-taking.

As I wrote in "The Limits to Negativism" (October 15, 2008), "Skepticism calls for pessimism when optimism is excessive. But it also calls for optimism when pessimism is excessive." By the fourth quarter of 2008, risk aversion ruled and risk tolerance had disappeared. A skeptical view toward excessive pessimism was called for at a time of unprecedented low asset prices, but few people could muster it. The credit markets offered the highest returns in their history, but fear of losing money kept most investors from seizing the opportunity.

In the middle of this decade we saw a manic period in which losses were unimaginable. The resultant shortages of risk aversion and skepticism caused investors to buy at highs and assume unprecedented risks in order to avoid missing opportunity. This was followed – as usual – by a collapse in which no negative event could be ruled out and no return was high enough to induce buying, all because investors wanted nothing other than to avoid losing money.

This cycle produced a treacherous, low-return period in which it was very hard to find investments promising good returns earned with safety, and then a period of collapse in which there were bargains everywhere but few investors possessed the requisite "dry powder" and intestinal fortitude with which to buy. That's the background. Where do we stand today?

Signs of the Times

Optimism, adventurousness and unworried behavior characterized the pre-crisis period, and investor behavior reflected those attitudes. In my memo "It's All Good" (July 16, 2007), just before the onset of the crisis, I mentioned some of the warning signs in the credit markets:

> Unlike the historic norm, it's routine today to issue CCC-rated bonds. It's easy to borrow money for the express purpose of distributing cash to equity holders, magnifying the company's leverage. It's so easy to issue bonds with little or no creditor protection in the indenture that a label has been coined for them: "covenant-lite." And it's possible to issue bonds whose interest payments can be paid in more bonds at the option of the borrower.
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> The first requirement for an elevated opportunity in distressed debt is the unwise extension of credit, which I define as the making of loans which borrowers will be unable to service if things get a little worse. This happens when lenders fail to require a sufficient margin of safety. . . .
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> The default rate in the high yield bond universe is at a 25-year low on a rolling-twelve-month basis. Under such circumstances, how could the average supplier of capital be expected to maintain a high level of risk aversion and prudence, especially when doing so means ceding all the loan making to others? It's not for nothing that they say "The worst of loans are made in the best of times."

The inspiration for today's memo came as my pile of clippings began to swell with indications that pre-crisis behavior is coming back. Here are excerpts from a few, with emphasis added in each case:

On covenant-lite loans –

> **Are debt investors just stupid? That might help explain why they're buying covenant-lite loans again.** These deals, which carry few restrictions on borrowers, became a standard bearer for easy money. They may have helped some companies limp through the downturn – but they've left lenders saddled with lots of risk and little return.
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> It's easy to see why companies like covenant-lite loans. . . . But for owners of the debt, the attraction is far less clear beyond the familiar short-term reach for yield. . . .

Lyondell Chemical is paying [Libor plus 400 basis points] on its recent $500 million covenant-lite deal. And the energy refiner will emerge from bankruptcy with a much slimmer debt load than before it filed for Chapter 11.

Lyondell's terms are better than 2007's crop of covenant-lite loans, to be sure, but lenders still are essentially relinquishing their right to force companies into paying them more money, or exiting the loan entirely, should their creditworthiness tumble.

So why are lenders doing it again? Lyondell Chemical's answer: investor demand for higher yielding assets. This is a familiar mantra while official interest rates remain low. **But lenders should be mindful of loosening standards or risk finding themselves once again on the short end of the stick.** ("Don't call it a comeback," *breakingviews*, April 5)

On payment-in-kind loans and flexibility –

Clint Eastwood's Dirty Harry character famously held a gun to a suspect and asked: "Do you feel lucky?" Investors in credit markets seem to be saying yes, if Cerberus' refinancing of Freedom Group, maker of Remington firearms, is any indication.

A deflating gun bubble backfired on the private equity firm's plans last year for an initial public offering of Freedom. Now trigger-happy credit investors are taking off their safeties and letting Cerberus unload some of its stake.

The $225 million of notes are useful ammo for Cerberus. They allow Freedom to either pay the interest in cash or half in cash and half in additional notes at the company's discretion. The financing allows Cerberus to get cash back on its investment today by buying back preferred stock held by the private equity group ahead of an eventual IPO. . . .

The buyers of these notes, though, are taking their chances. Freedom doesn't look overleveraged according to its historic cash flow – the company's debt level is about three times "adjusted EBITDA" for 2009. But sales of rival gun-makers are continuing to fall. . . .

Moreover, these sorts of notes are notoriously difficult to price. The investor has to figure out the risk of the company encountering cash flow problems, whether the firm will actually pull the toggle trigger, and how much the PIK feature may reduce their potential recovery in the event of default. Indeed, many investors took drubbings on similar notes issued at the top of the credit boom. **Caution is warranted when investors remove their trigger locks.** ("Do you feel lucky?" *breakingviews*, March 31)

On initial public offerings –

> **It is springtime for IPOs. . . . KKR and Bain, two of the most aggressive private-equity firms during the buyout boom, are now as aggressively looking to cash out**. They are leading what is expected to be a season of IPOs as long as the markets continue to stabilize or climb. The IPOs would allow the firms to partially cash out their stakes and return money to investors. They also could use the proceeds to pay down the sizable debt used to finance the takeovers. ("Bain, KKR to Push New Crop of IPOs," *The Wall Street Journal*, April 9)

On leveraged loans –

> Even as worries escalate about the ability of highly rated countries to fund themselves, there is a buzz at the other end of the credit spectrum. **Leveraged loans, a source of funding for private-equity acquisitions, are drawing investor interest again after a long period in the doldrums.**
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> **In the U.S., there are signs of life in the collateralized-loan-obligation market, with the year's first deal not only refinancing an existing CLO but bringing in new money, too.** In Europe, HarbourVest Partners is launching a listed fund to invest in mid-market leveraged loans. Leveraged-finance bankers are more bullish, and new loans have started to flow. . . .
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> There are wider implications, too: **Cash moving into the loan market represents a greater willingness to hold more illiquid assets, an important development. . . .** ("A Pulse Finally Returns to the Leveraged-Loan Market," *The Wall Street Journal*, April 12)

On dividend recaps –

> **Blackstone Group LP and other private-equity firms are accelerating sales of junk bonds and leveraged loans to pay themselves dividends in a sign the market for the riskiest debt may be overheating.**
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> Apria Healthcare Group Inc., owned by Blackstone, is seeking consent from bondholders to sell notes to issue a dividend, following at least six similar offerings this year, according to data compiled by Bloomberg.

Including loans, companies have raised $10.8 billion in debt to fund payouts this year, compared with $1 billion in all of 2009 and $1.3 billion in the prior 12 months, according to Standard & Poor's LCD.

Private-equity firms are taking advantage of record high-yield, high-risk bond sales and a rally in loans to extract cash from companies they own, awaiting a rebound in leveraged buyouts and initial public offerings. So-called dividend deals, which permeated debt markets in 2006 and 2007 before the credit seizure, may signal investors are becoming too complacent, said William Quinn, chairman of American Beacon Advisors Inc.

"You start to be concerned that you're increasing leverage, which was one of the things that created these problems in 2008," said Quinn, who helps oversee $45 billion for the fund manager in Fort Worth, Texas. **"I understand why private-equity firms do it, but I would be concerned."** ("Dividend Deals Rebound as Blackstone Seeks Cash," *Bloomberg*, April 16)

Companies may increase borrowing to pay shareholder dividends in a record year for junk bonds, Standard & Poor's said. . . .

"We are starting to see the proceeds of high-yield issues being channeled to shareholders as dividends, something that is less-welcome from a credit perspective, reminiscent of the leveraged finance market back in 2007," analysts led by Taron Wade wrote . . . .

Companies owned by LBO firms in 2007 issued a record 6.1 billion euros of loans in the first half to pay dividends to shareholders, data compiled by Fitch Ratings show.

Private-equity firms "essentially decreased the risk of their portfolio equity investments, boosting their near-term equity returns at the expense of the credit quality of the companies themselves," according to S&P. ("Junk Bond Issuers Increase Dividend Deals, S&P Says," *Bloomberg*, April 20)

On collateralized loan obligations –

Citigroup is set to launch its second leveraged loan structured products transaction this year, this time for a large private equity client, as **debt managers and bankers look to revitalise the markets which drove the buyout boom. . . .**

> If the transaction goes ahead soon, it will be only the second CLO to be sold since the beginning of 2009. Last month Citigroup structured a $525m CLO managed by US fund manager Fraser Sullivan Investment Management. . . .
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> Leveraged finance bankers are hopeful the CLO market can take off again as it would provide greater availability of finance for leveraged loans, the engine of the private equity industry. The market for CLOs ground to a halt after the collapse of Lehman Brothers pushed credit markets into freefall. Even the most actively traded leveraged loans lost as much as a third of their face value in the depths of the crisis. ("Citigroup markets second CLO," *Financial News*, April 19)

On buyouts –

> **Private equity firms bear some resemblance to children at a fairground: they jump on a ride as dealmaking gathers pace, whizzing faster and faster, before jumping off as the cycle slows down. As the ride starts to gather pace again, buyout firms are back, with some eyeing the biggest rides.** (Emphasis in the original)
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> Mega-deals – transactions over $10 bn that were favoured in the boom years of 2006-2008 but have been crimped by the lack of debt – are making a comeback. Last week, Blackstone Group and other investors were in talks to acquire financial data processing company Fidelity National Information Services, according to The Wall Street Journal.
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> The acquisition of Fidelity, which has a market capitalisation approaching $10 bn and about $3 bn in debt, would be the largest leveraged buyout since the credit crisis struck. . . .
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> **Bankers and buyout executives said the resurrection of large buyouts was being driven by a booming high-yield bond market. With low interest rates in Europe and the US, investors are more willing to take the risk of weaker credits because it allows them to secure yields unavailable in other forms of lending.** ("Are dealmakers ready for another white-knuckle ride?" *Financial News*, May 10)

On investor psychology –

> **Irrational equanimity is back. Not only are developed market stocks back to pre-Lehman levels, but investors' comfort levels are in a zone not seen since the eve of the credit crisis in early 2007.** Apart from US stock indices, this shows up in the price investors will pay to insure

> against volatility, with the CBOE Vix index down to its lowest since the crisis eve of July 2007, and in sharp reductions in cash cushions held by institutions.
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> Merrill Lynch's widely followed survey of fund managers . . . finds that more now want companies to pay higher dividends or make more capital expenditures than see them pay down debts. . . .
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> Such equanimity is not totally irrational. Macroeconomic data in the past month have run ahead of expectations. When the herd trampling forward is this bullish, it is not a good idea to stand in its way. But it would be easier to feel comfortable with current share price levels if investors showed a little more unease. **Complacency on this scale suggests risk of a correction.** ("*Investor sentiment*," Financial Times, April 14)

Just as one returning swallow doesn't make a summer, anecdotal evidence of rising risk tolerance does not mean entire markets have returned to dangerous levels. But it's a fact that issuers and investment bankers can do things today that they couldn't do a year or two ago. **The door is open to transactions that wouldn't be possible if risk aversion were running high. The clear inference is that fear of loss has declined and fear of missed opportunity has come back to life. That's an important observation.**

<u>Where Did the Unease Go?</u>

Just a short while ago, I believed investors had been sufficiently traumatized that the willingness to bear risk would be absent for years. But it came back in just a matter of months. What explains that?

For one thing, the crisis – as painful as it was – was surprisingly brief. The worst of it began in the third quarter of 2008 with the disclosure of weakness at financial institutions. The onset of the most intense part of the crisis can be dated to Lehman Brothers' September 15 bankruptcy filing. Remarkably, high yield bonds began to recover just three months later, with most of the indices showing gains of roughly 5% for the month of December. So in the credit markets, the worst pain lasted only about three months and quickly gave way to recovery.

And what kicked off the recovery? Fear of missing opportunity was resurrected by the Fed and other central banks which forced interest rates on short-term government debt to near zero. It might have been the banks' intent, or it might have been an unintended consequence, **but those low rates pushed investors to engage in riskier behavior**. The returns on T-bills and money market funds went to a fraction of a percent, meaning investors had to crawl out on the limb in pursuit of returns they could live with.

Further, governments flooded the system with liquidity and produced the opposite of crowding out. When governments are big issuers of debt, it can be hard for nongovernment issuers to raise money. But when governments are big buyers of securities instead, the capital they inject into the markets can make it easy for others to issue securities.

> Investors flooded risky companies with money in March even as the government prepares to shut down a key engine driving one of the greatest corporate-bond rallies in history.
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> A total $31.5 billion in new high-yield debt, otherwise known as junk bonds, hit the market through Tuesday, exceeding the previous monthly record in November 2006. Partly propelling the activity: The Federal Reserve's massive mortgage-buying program, [which recently came to an end].
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> By buying $1.25 trillion of mortgage securities, the Fed absorbed a flood of assets that otherwise would have needed buyers. That kept money in the hands of investors, who went searching for something else to buy. The Fed's underpinning encouraged investors to seek riskier, higher-yielding securities. A natural choice: corporate bonds. ("Bonds Cap Epic Comeback," *The Wall Street Journal*, March 31)

One of the prime tasks investors must perform is to stay alert to extreme behavior and take hints as to what we should do from what we see taking place around us. This is best expressed in Warren Buffett's helpful reminder: "The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs."

Investor behavior between 2003 and mid-2007 was sending some very worrisome signals. It's obvious in retrospect that all one had to do was take heed and lean in the opposite direction. But observations regarding the past are no help for purposes other than education. For observations to be profitable, they must relate to the present and the future.

Investors have made a substantial move back in the direction of pre-crisis behavior. That behavior has to be recognized and monitored. The pendulum has moved away from the depression, panic, skepticism and excessive risk aversion we saw in the fourth quarter of 2008, and with the disappearance of those characteristics have gone the great bargain opportunities.

Uncertainty and fundamental weakness at the depth of the crisis were offset by irrationally low prices and the potential for a rebound in risk tolerance, making most assets a screaming buy. With most of the great bargains gone – along with excess risk aversion – macro uncertainties should no longer be overlooked. **Thus the caution, discipline, patience, selectivity and discernment that were so unnecessary in 2009 are absolutely essential today.**

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I started this memo in late April, but I didn't get it out before Greece's financial crisis burst into full bloom last week. This gives me an opportunity to discuss the significance of the recent developments (not the substance, however; that'll have to await another memo).

Investing defensively requires that when everything seems to be going well and investors are feeling positive, we must sense the implicit danger and prepare for negative developments.

In the mid-2000s, I began to warn that with asset prices full, investors optimistic and their behavior aggressive, it was important to worry about things that could come along to derail the markets. When asked what they might be, my list of possibilities would go like this:

- recession,
- credit crunch,
- $100 oil,
- collapse of the dollar,
- exogenous events such as terrorist attacks, or
- something else.

The most dangerous possibility, I pointed out, was the last one. Markets and market participants can adjust to things they see coming. What usually knocks them for a loop are things they don't anticipate. "We're not expecting any surprises" is one of my favorite oxymorons. By definition, surprises are things that aren't anticipated, and thus their arrival can be traumatizing.

Just a few months ago, I published a memo called "Tell Me I'm Wrong" (January 22), in which I listed a number of things that worried me. These included our reliance on government stimulus and artificially low interest rates; the uncertain outlook for consumer spending, jobs and state and municipal finances; and the risks pertaining to inflation, exchange rates and interest rates. Here's how I concluded:

> My goal in this memo isn't to express a forecast. I know no forecast – and certainly not mine – is likely to be correct. What I do want to do is caution that the considerable risks I see may be less than fully appreciated by those setting asset prices today. The greatest market risks lie in failure of the macro economy to live up to the expectations embodied in today's prices. . . .
>
> Most people view the future as likely to repeat past patterns, which it may or may not do. They tend to think of the future in terms of a single

scenario, whereas it really consists of a wide range of possibilities. (Remember Elroy Dimson's trenchant observation that "risk means more things can happen than will happen.") And to the extent they do consider a variety of possibilities, few people include ones that haven't been part of recent experience.

The uncertainties discussed above tell me today's distribution of possibilities has a substantial left-hand (i.e., negative) tail, probably greater than at most times in the past. The proper response should be to discount asset prices, allowing a substantial margin for error. Forecasts should be conservative, yield spreads should incorporate ample risk premiums, valuation parameters should be below the long-term norms, and investor behavior should be prudent.

Conspicuously missing from my list of worries was Greece (and all it entails); thus it falls firmly in the category of "something else." Last week it dominated the headlines and depressed markets worldwide. Thus in this short time I have proved two things: first, I know little more than others about what the future will bring and, second, when most investors turn optimistic, it becomes important to worry.

The issue of Greece and its debt has been on investors' radar screens for months, but few people seem to have understood its ramifications and the risks it presented to the markets. Then, in recent weeks, things began to be discussed daily in the media – such as Greece's profligacy and the risks involved in admitting it to the European Union; Europe's lack of an established mechanism for dealing with a problem of this nature; and its reliance on Germany to contribute voluntarily to a solution – that in hindsight it seems should have been obvious. This tells us a few important things about investing:

- Investors generally overestimate their ability to see the future, and the worst of them act as if they know exactly what lies ahead.
- It's important to worry about what's coming next. The fact that we don't know what it is shouldn't permit us to think there's nothing to worry about.
- Low asset prices allow us to invest aggressively, without much consideration given to worrisome fundamentals and the possibility of negative surprises. But as prices rise, so should our degree of concern over these things.

The bottom line is this: the fact that we don't know where trouble will come from shouldn't allow us to feel comfortable in times when prices are full. The higher prices are relative to intrinsic value, the more we should allow for the unknown.

The recovery of 2009 in the face of significant fundamental uncertainty meant that the markets were reincorporating optimism and thus vulnerable to surprise and disappointment. This in itself should be sufficient to induce caution.

May 12, 2010

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