Memo to: Oaktree Clients

From: Howard Marks

Re: How Quickly They Forget

In January 2004 I received a letter from Warren Buffett (how’s that for name dropping?) in which he wrote, “I’ve commented about junk bonds that last year’s weeds have become this year’s flowers. I liked them better when they were weeds.”

Warren’s phrasings are always the clearest, catchiest and most on-target, and I thought this Buffettism captured the thought particularly well. Thus for Oaktree’s 2004 investor conference we used the phrase “Yesterday’s Weeds . . . Today’s Flowers” as the title of a slide depicting the snapback of high yield bonds. It showed the 45% average yield at which a sample of ten bonds could have been bought during the Enron-plus-telecom meltdown of 2002 and the 6% average yield at which they could have been sold in 2003; **on average, the yields had fallen by 87% in just thirteen months.** The idea went full-circle in 2005, when Warren used our slide at the Berkshire Hathaway annual meeting to illustrate how rapidly things can change in the world of investing.

And that’s the point of this memo. Asset prices fluctuate much more than fundamentals. This happens because, rather than applying moderation and balancing greed against fear, euphoria against depression, and risk tolerance against risk aversion, investors tend to oscillate wildly between the extremes. They apply optimism when things are going well in the world (elevating prices beyond reason) and pessimism when things are going poorly (depressing prices unreasonably). Shortness of memory plays a major part in abetting these swings. If investors remembered past bubbles and busts and their causes, and learned from them, the swings would moderate. But, in short, they don’t. And they may be forgetting again.

**High yield bonds and many other investment media have once again gone from being weeds to flowers – from pariahs to market darlings – and it happened in a startlingly short period of time.** As is so often the case, things that investors wouldn’t touch in the depths of the crisis in late 2008 now strike them as good buys at twice the price. The swing of this pendulum recurs regularly and creates some of the greatest opportunities to lose or gain. Thus we must always be mindful.

The Importance – and Shortcomings – of Investment Memory

A number of my favorite quotations are on the subject of history and memory, and I’ve used them all in past memos. Humorist and author Mark Twain talked about the relevance of the past:
History doesn’t repeat itself, but it does rhyme.

The philosopher Santayana stressed the penalty for failing to attach sufficient importance to history:

Those who cannot remember the past are condemned to repeat it.

And economist John Kenneth Galbraith described the shabby way investors treat history and those who consider it important:

Contributing to . . . euphoria are two further factors little noted in our time or in past times. The first is the extreme brevity of the financial memory. In consequence, financial disaster is quickly forgotten. In further consequence, when the same or closely similar circumstances occur again, sometimes in only a few years, they are hailed by a new, often youthful, and always supremely self-confident generation as a brilliantly innovative discovery in the financial and larger economic world. There can be few fields of human endeavor in which history counts for so little as in the world of finance. Past experience, to the extent that it is part of memory at all, is dismissed as the primitive refuge of those who do not have the insight to appreciate the incredible wonders of the present.

String together these three pearls of wisdom and you get a pretty accurate picture of investment reality. Past patterns tend to recur. If you ignore that fact, you’re likely to fall prey to those patterns rather than benefit from them. But when markets get cooking, the lessons of the past are readily dismissed. These are nothing short of eternal verities, and their collective message is indispensible.

Why Does Investment Memory Fail?

Think back to the emotions you felt so strongly during the recent financial crisis, and the terrifying events that brought them on. You swore at the time that you’d never forget, and yet their memory has receded and nowadays has relatively little influence on your decisions. Why does the collective memory of investment experiences – and especially the unpleasant ones – fade so thoroughly? There are a number of reasons.

- First, there’s investor demographics. When the stock market declined for three straight years in 2000-02, for example, it had been almost seventy years since that had last happened in the Great Depression. Clearly, very few investors who were old enough to experience the first such episode were around for the second.

For another example, I believe a prime contributor to the powerful equity bull market of the 1990s and its culmination in the tech bubble of 1999 was the fact that in the quarter century from 1975 through 1999, the S&P 500 saw only three minor annual
declines: 6.4% in 1977, 4.2% in 1981, and 2.8% in 1990. In order to have experienced a bear market, an investor had to have been in the industry by 1974, when the index lost 24.3%, but the vast majority of 1999’s investment professionals doubtless had less than the requisite 26 years of experience and thus had never seen stocks suffer a decline of real consequence.

- **Second, the human mind seems to be very good at suppressing unpleasant memories.** This is unfortunate, because unpleasant experiences are the source of the most important lessons. When I was in army basic training, I was sure the memories would remain vivid and provide material for a great book. Two months later they had disappeared. After the fact, we may remember intellectually but not emotionally: that is, the facts but not their impact.

- **Finally, the important lessons of the past have to fight an uphill battle against human nature, and especially greed.** Memories of crises tell us to apply prudence, patience, moderation and conservatism. But these things seem decidedly outdated when the market’s in a bull phase and risk bearing is paying off, and if practiced they appear to yield nothing but opportunity costs.

  Charlie Munger contributed a great quote to my recent book, from Demosthenes: “Nothing is easier than self-deceit. For what each man wishes, that he also believes to be true.” In other words, there’s a powerful tendency to believe that which could make one rich if it were true.

I’ve tried to spend the last 42 years with my eyes open and my memory engaged. As a result, a lot of what I write is based on recognition of past patterns. It’s time to put my recollections to work, because I’m definitely seeing a trend in the direction of Galbraith’s “same or closely similar circumstances.”

**The Not-So-Distant Past**

It seems it was impossible – unless you were John Paulson – to escape entirely unscathed from the financial crisis of 2007-08. Most investors could only hope to have turned cautious in the run-up to the crisis, sold assets, increased the defensiveness of their remaining holdings, reduced or eschewed leverage, and secured capital with which to buy at the bottom in order to benefit from the subsequent recovery.

What might have prompted investors to do these things in advance of the mid-2007 onset of the crisis? Almost no one fully foresaw the impending subprime meltdown, and few macro-forecasts and market analyses were sufficiently pessimistic. Rather, I think investors would have been most likely to take the appropriate actions if they were aware of the pro-risk behavior taking place around them.
One of the most important things we can do is take note of other investors’ attitudes and behavior regarding risk. Fear, worry, skepticism and risk aversion are the things that keep the market at equilibrium and prospective returns fair. When investors fear loss appropriately, too-risky deals can’t get done, and risky investments are required to offer high prospective returns and generous risk premiums. (And when fear reaches extreme levels during crises, the capital markets turn too stingy, asset prices sink too low, and potential returns become excessive.)

But when investors don’t fear sufficiently – when they’re risk tolerant rather than risk averse – they let down their guard, surrender their discipline, accept rosy projections, enter into unwise deals, and settle for too little in the way of prospective returns and risk premiums.

The years immediately preceding the onset of the crisis in mid-2007 constituted nothing short of a “silly season.” It seemed the financial world had gone crazy, with deals getting done that were beyond reason. Investors acted as if risk had been banished. They believed that the markets had been rendered safe by the combination of (a) an omniscient, omnipotent Fed providing a “Greenspan put,” (b) the wonders of securitization, tranching and selling onward and (c) the “wall of liquidity” coming toward our markets, composed of excess reserves being recycled by China and the oil-producing nations. They accepted the alchemy under which financial engineering could turn sub-prime mortgages into triple-A debt. And they viewed leverage as sure to have a salutary effect on returns.

There’s nothing more risky than a widespread belief that there’s no risk . . . but that’s what characterized the investment world. It was possible to conclude in 2005-07 that investors were applying insufficient risk aversion and thus engaging in risky behavior, elevating asset prices, reducing prospective returns, and raising risk levels. What were the signs?

- The issuance of non-investment grade debt was at record levels.
- An unusually high percentage of the issuance was rated triple-C, something that’s not possible when attitudes toward risk are sober.
- “Dividend recaps” went unquestioned, with buyout companies borrowing money with which to pay dividends, vastly increasing their leverage and reducing their ability to get through tough times.
- Credit instruments were increasingly marked by few or no covenants to protect lenders from managements’ machinations, and by interest payments that could be made with debt rather than cash at the companies’ discretion.
- Collateralized loan and debt obligations were accepted as being respectable instruments – with the risk made to vanish – despite the questionable underlying assets.
- Buyouts of larger and larger companies were done at increasing valuation multiples, with rising debt ratios and shrinking equity contributions, and despite the fact that the target companies were increasingly cyclical.
Despite all of these indications of falling credit standards and rising riskiness, the yield spread between high yield bonds and Treasury notes shrunk to record lows. The generous capital market conditions and low cost of capital for borrowers caused buyout fund managers to describe the period as “the golden age of private equity.” Conversely, then, for lenders it was the pits.

In 2005-07, investors suspended skepticism and disbelief, ignored the risk of loss, and obsessed instead about avoiding the risk of missing opportunities. This caused them to buy securities at low implied returns; employ vast amounts of low-cost debt to lever up those returns; loosen the terms on debt they would provide; and participate in black-box vehicles on the basis of investment banks’ recommendations, the nontransparent machinations of financial engineers, and the imprimatur of far-from-perfect rating agencies.

In short, investors were oblivious to risk and thus failed to demand adequate risk premiums. The environment could only be described as euphoric. Here’s how I put it in “It Is What It Is” (March 2006):

The skinniness of today’s risk premiums can be observed most clearly in the high yield bond market, where prospective returns can be calculated with precision and yield spreads are in the vicinity of historic lows, and in certain real estate markets, where actual cash returns are similarly low. But the difficulty of quantifying prospective returns in public and private equity doesn’t mean the offerings there are any less paltry. And, as Alan Greenspan said, “… history has not dealt kindly with the aftermath of protracted periods of low risk premiums.”

Market Conditions Today

In May 2005, I wrote a memo entitled “There They Go Again,” complaining that investors were taking excessive comfort from mindless platitude of the type that accompany and abet the creation of every bubble. These are accepted as a substitute for putting rational intrinsic valuations on the assets that are the subject of the bubble, and despite repeated evidence that trees can’t grow to the sky. I touched on the mania for real estate, as well as the growing popularity of hedge funds and private equity. I went on to assert that this behavior – and the supportive underlying capital market trends – had turned the markets into a “low-return world.”

I recite all of this because I have no doubt that investors are making substantial movement back in the same direction. To illustrate, here’s an account of capital market conditions in 2011 (Bridgewater Daily Observations, February 15):

Consistent with the pickup in credit creation that we have seen elsewhere, LBO activity and the credit pipes that are supporting it have recently improved. Since the first quarter of 2010 we have seen a steady rise in LBO activity, starting from a very
low base. The rate of activity is now roughly similar to the average level of activity since 1985, excluding the boom and bust period of 2006 to 2009. . . . today’s deals are similar in size but the number of deals has risen by more than the dollar value of deals. We also see that the leverage in the deals is increasing. For example, so far this year the average deal was financed with 30% equity, down from last year’s 38%, though still up from the most leveraged period of 2005 to 2009 when deals were financed with an average of 25% equity. The leveraged loan market has also picked up and an increasing percentage of leveraged loans are going toward LBOs. A few new CLOs and mutual funds have been created that are concentrated on the leveraged loan market, indicative of renewed demand. Investor demand has pushed prices back up to par and allowed a decline in the average credit quality of the loans, with increasing indications of “covenant light” loans getting done.

In other words, in most regards the capital markets – and investors’ tolerance of risk – are retracing their steps back in the direction of the bubble-ish pre-crisis years. Low yields, declining yield spreads, rising leverage ratios, payment-in-kind bonds, covenant-lite debt, increasing levels of LBO activity and the beginnings of the return of levered, structured vehicles . . . all of these are available for the eye to see.

For a case in point, let me recap a note I received from one of our veteran high yield bond analysts regarding a deal that recently had come to market:

- PIK/toggle bonds: the company can elect to pay interest in debt rather than cash
- Holdco obligation: debt of a holding company, removed from the moneymaking assets
- Use of proceeds: to pay a dividend to the equity sponsor, returning half of the equity it put into the company just a few months earlier
- The sponsor’s purchase price for the company in 2010 was 1.45 times what the seller had bought it for in 2008
- The company operates in a commodity industry where annual sales are shrinking and costs are variable and unpredictable
- Negative earnings comparisons are expected, since the environment makes it hard to pass on rising raw material costs
- EBITDA coverage of interest expense plus capital expenditures is modestly above 1x
- The company is incorporated in Luxembourg, an uncertain bankruptcy environment
- The assessment of Oaktree’s Sheldon Stone: “I know they don’t ring a bell at the top, but they should on this deal!”
It’s easy to gauge bond investors’ attitudes. Here are the yield to maturity and yield spread versus Treasuries on the average high yield bond at a few points in the recent past and today:

<table>
<thead>
<tr>
<th>Maturity</th>
<th>Yield to Maturity</th>
<th>Spread vs. Treasurys</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bubble peak – June 30, 2007</td>
<td>7.6</td>
<td>242</td>
</tr>
<tr>
<td>Panic trough – December 31, 2008</td>
<td>19.6</td>
<td>1,773</td>
</tr>
<tr>
<td>Recovered – March 31, 2010</td>
<td>9.0</td>
<td>666</td>
</tr>
<tr>
<td>Shrinking again – April 30, 2011</td>
<td>7.5</td>
<td>492</td>
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The yield spread on the average high yield bond is still on the generous side relative to the 30-year norm of 350-550 basis points, a range of spreads that has given rise to excellent relative returns over that period. On the other hand, (a) spreads have fallen back to the normal range from the crisis-induced stratosphere and (b) the lowness of today’s interest rates means that reasonable spreads translate into promised returns that are low in the absolute. The story’s the same for many asset classes.

I don’t mean to pick on high yield bonds. I use them here as my prime example only because of my familiarity with them and because their fixed-income status facilitates quantification of attitudes toward risk. In fact, high yield bonds still deliver above average risk compensation, and they remain the highest returning contractual instruments and excellent diversifiers versus high grade bonds.

If you refer back to a memo called “Risk and Return Today” (November 2004), you’ll see that today’s expected returns and risk premiums – especially on the left-hand side of the risk/return spectrum – are eerily similar to those prevailing in late 2004: money market at 1%; 5-year Treasurys at 3%; high grade bonds at 5%; high yield bonds at 7%; stocks expected to return 6-7%. I said at the time that low base interest rates and moderate demanded risk premiums had combined to render the risk/return curve “low and flat.” In other words, absolute prospective returns were at modest levels, as were the return increments that could be expected for taking on incremental risk. I described that environment as “a low-return world.” I think we’re largely back there.

(Please note that late 2004 was nowhere near the cyclical peak. Security prices continued to rise and prospective returns to fall for two and a half years thereafter. In particular, in the 30 months following the publication of that memo, high yield bonds went on to return a total of 19.7%. So similarities to 2004 don’t constitute a sign of impending doom, but perhaps a foreshadowing of a potential move into bubble territory.)

I want to state very clearly that I do not believe security prices have returned to the 2006-07 peaks. It doesn’t feel like the silly season is back in full. Investors aren’t euphoric. Rather they seem like what my late father-in-law used to call “handcuff
volunteers” – people who do things because they have no choice. They’re also not oblivious to the risks that exist. I imagine the typical investor as saying, “I’m not happy, but I have to buy it.” Finally, the leverage used at the peak of risk-prone pursuit of return in 2005-07 isn’t nearly as prevalent today, perhaps because investors are chastened, but more likely because it’s not available in the same amounts.

There may be corners of the market where elevated popularity and enthusiastic buying have caused prices to move beyond reason: high-tech stocks, social networks, emerging markets from time to time, perhaps gold and other commodities (what’s the reasonable price for a non-cash-flow-producing asset?) But for the most part, I think investors are taking the least risk they can while assembling portfolios that they think can achieve their needed returns or actuarial assumptions.

In general, I would describe most security prices as falling somewhere between fair and full. Not necessarily bubbly, but also not cheap.

Especially since the publication of my book, people have been asking me for the secret to risk control. “Okay, I’ll read the 180 pages. But what’s really the most important thing?” If I had to identify a single key to consistently successful investing, I’d say it’s “cheapness.” Buying at low prices relative to intrinsic value (rigorously and conservatively derived) holds the key to earning dependably high returns, limiting risk and minimizing losses. It’s not the only thing that matters – obviously – but it’s something for which there is no substitute. Without doing the above, “investing” moves closer to “speculating,” a much less dependable activity. When investors are serene or even euphoric, rather than discomforted, prices rise and we become less likely to find the bargains we want.

So if you could ask just one question regarding an individual security, asset class or market, it should be “is it cheap?” Oaktree’s investment professionals try to ask it, in different ways, every day.

And what makes for cheapness? In sum, the attitudes and behavior of others.

I try to get away from it, but I can’t. The quote I return to most often in these memos, even 17 years after the first time, is another from Warren Buffett: “The less prudence with which others conduct their affairs, the greater prudence with which we should conduct our own affairs.” When others are paralyzed by fear, we can be aggressive. But when others are unafraid, we should tread with the utmost caution. Other people’s fearlessness invariably translates into inflated prices, depressed potential returns and elevated risk.

Today, pension funds and endowments simply can’t achieve their goal of nominal returns in the vicinity of eight percent if they keep much money in Treasurys or high grade bonds, and they may not even expect public equities to be much help. They’ve moved into high yield bonds, private equity and hedge funds . . . not because they want to, but
because they feel they have to. They just can’t settle for the returns available on more traditional investments. Thus their risk taking is in large part involuntary and perhaps unenthusiastic.

So where do we stand today?

- General interest rates are some of the lowest in history.
- Yield spreads are about normal.
- Returns on low-risk assets are reasonable in relative terms but skimpy in the absolute.
- Investors are forced toward pro-risk behavior because of the lowness of returns in the safer, low-risk portion of the risk/return curve.
- Thus investors are jettisoning the conservatism they adopted at the depths of the financial crisis, in many cases not out of choice.
- Investors are once again engaging in risky behavior, albeit not at peak levels of riskiness.

Those of us who calibrate our behavior based on what others are doing should increase watchfulness and, as Buffett suggests, apply rising amounts of prudence.

How Did Things Get This Way?

Just two and a half years ago, in the depths of the financial crisis, I was convinced that pro-risk psychology had undergone lasting damage. With investment banks, rating agencies and financial engineers defrocked, no-lose investments collapsing, account balances decimated and investors disillusioned, it seemed it might be years before market psychology recovered. And yet markets began a dramatic recovery in early 2009, investors have returned to bearing risk, and many indices are back in the vicinity of their pre-crisis peaks. What’s behind this turn of events?

In 2007 and 2008, governments around the world rushed to support financial institutions and stimulate economies. They did this by making liquidity readily available and cutting interest rates to near zero.

Everyone knew the rate cuts would stimulate the economy by encouraging borrowing and reducing the cost of doing business, and that they would increase the profit margin in lending, buttressing financial institutions. But I don’t think anyone fully appreciated the impact they would have on reviving pro-risk behavior.

In short, the rate cuts made it unrewarding to hold cash, T-bills and high grade bonds. Investors looking for returns in line with their needs – or income on which to live – were literally forced to move into riskier asset classes in pursuit of returns in excess of a few percent.
Much of the money that normally would be invested in the giant Treasury market simply couldn’t stay there because the yields were so low. Thus large amounts flowed toward smaller markets where they were quite capable of lifting prices. Nothing can reduce returns, worsen terms or raise risk faster than “too much money chasing too few deals.”

It’s disproportionate flows of capital into a market that give rise to the disastrous race to the bottom such as we saw in 2005-07. Greater sums are provided to weaker borrowers at lower interest rates and with looser terms. Higher prices are paid for assets: first less of a discount from intrinsic value, then the full intrinsic value, and eventually premiums above intrinsic value. These processes account for many of the trends decried here.

In addition, I would point out that the pain of the crisis was surprisingly short-lived. The real panic began on September 15, 2008, the day Lehman Brothers filed for bankruptcy. Until then, the world seemed to be coping and investors retained their equanimity. But Lehman, Fannie Mae, Freddie Mac, Merrill Lynch, Washington Mutual and AIG fell like dominoes in short order, and in the last fifteen weeks of 2008 people were paralyzed by fear of a global financial meltdown.

And then things turned in the first quarter of 2009, primarily, I think, because people were coerced to move further out on the risk curve as described above. Since then the markets have risen dramatically from their lows.

In distressed debt, for example, the post-Lehman days and weeks were characterized by terror, uncertainty, forced selling, illiquidity and huge mark-to-market losses. But if you look back, you see that the panic and pain – and thus the greatest buying opportunity – really lasted only fifteen weeks, through the end of 2008. Prices continued downward in the first quarter of 2009, but without the deluge of supply brought on by the previous quarter’s forced selling. By April prices were headed up. So the lesson was painful but short-lived and, apparently, easily forgotten.

As usual, the cyclical upswing is circular and self-reinforcing. It takes on the appearance of a virtuous cycle that will proceed non-stop, and it does so . . . until it fails. Here’s an example of the process at work:

- The pursuit of return caused people to move from Treasurys to high yield bonds.
- The revival of demand enabled companies to raise money.
- The reopening of the capital markets made it possible for companies to do bond exchanges and refinancings: extending maturities, extinguishing covenants and capturing bond discounts, converting them into reduced amounts of debt outstanding. In some cases equity could be issued to delever balance sheets.
- These remedial actions improved companies’ creditworthiness and brought down the default rate on high yield bonds from 10.8% in 2009 to a startling 1.1% in 2010, the greatest one-year decline in history.
• The resulting price appreciation produced profits for those who’d bought, turning investor psychology more rosy and producing envy – and thus a rush to join in – among those who had been slow to invest.
• And the combination of these things convinced people that conditions had improved, making them still more willing to take on increased risk.

I thought the lessons of 2007-08 had been etched into people’s psyches, and that the return to pro-risk behavior would therefore be slow. But clearly that hasn’t been the case.

Prudent Behavior in a Low-Return World

The 2005 memo I mentioned earlier, “There They Go Again,” proceeded from the discussion of the low and flat risk/return curve contained in “Risk and Return Today” to ponder what investors might do in times of low prospective returns and risk premiums. The possibilities fell into just a few categories:

• Go to cash – not a real alternative for most investors.
• Ignore the lowness of absolute returns and pursue the best relative returns.
• Forget that elevated prices might imply a correction, and buy for the long run.
• Reach for return, going out further on the risk curve in pursuit of returns that used to be available with greater safety.
• Concentrate investments in “special niches and special people”; by this I meant emphasizing strategies offering exceptional bargains and managers with enough skill to wring value-added returns from assets of moderate riskiness.

Of all of these, I consider reaching for return to be the most flawed, especially if it’s done without being fully conscious (which is often the case when return becomes hard to come by). I’ve described this approach as “insisting on achieving high returns in a low-return world” and reminded people of Peter Bernstein’s admonition: “The market’s not a very accommodating machine; it won’t provide high returns just because you need them.”

Here’s what I wrote in May 2005:

Given today’s paucity of prospective return at the low-risk end of the spectrum and the solutions being ballyhooed at the high-risk end, many investors are moving capital to riskier (or at least less traditional) investments. But (a) they’re making those riskier investments just when the prospective returns on those investments are the lowest they’ve ever been; (b) they’re accepting return increments for stepping up in risk that are as slim as they’ve ever been; and (c) they’re signing up today for things they turned down (or did less of) in the past, when the prospective returns were much higher. This may be exactly the wrong time to add to risk in pursuit of more return. You want to take risk when others are fleeing from it, not when they’re competing with you to do so.
Even six years later, I can’t think of any responses to a low-return world beyond those enumerated above. Limit risk, sacrificing return. Accept risk in pursuit of return, and pray the consequences will be tolerable. Or strive to find ways to augment returns through means other than risk bearing.

None of these possible solutions is perfect and without pitfalls. In fact, each brings its own form of risk. Staying safe entails the risk of inadequate return. Reaching for return increases the risk of financial loss. And the search for “alpha” managers introduces the risk of choosing the wrong ones. But, as they say, “it is what it is.” When it’s a low-return world, there are no easy solutions devoid of downside.

The Right Approach for Today

One of the things that makes investing interesting is the ever-changing nature of the route to profit, the pitfalls that are present, and the tools and approaches that should be employed. Conscious decisions regarding these things should underlie all efforts to manage capital, and they must be revisited constantly as circumstances and asset prices change. What’s right today?

**First, should you prepare for prosperity or not?** By prosperity I mean a return to the happy days of the 1980s and ’90s, when reported economic growth was strong and consumers were eager to spend. My answer is that we’re not likely to see anything like that, in large part because in those decades the gap between stagnant incomes and vigorous consumption growth was bridged through buying on credit. Instead, in the years ahead I think (a) growth in employment and incomes will be sluggish, (b) consumers should be restrained in their borrowing as a result of having experienced the crisis, (c) consumer credit shouldn’t be available as readily, and (d) borrowing against home equity will be much less of a factor, especially because home equity is so scarce.

**Second, should you worry more about losing money or about missing opportunities?** This one’s easy for me. First, the macro uncertainties tell me we won’t be seeing a highly effervescent economy or market environment. Second, other people’s increasingly aggressive behavior tells me to seek cover. And third, since I don’t see many compellingly cheap assets, I doubt there will be gains big enough to make us kick ourselves for having invested too cautiously.

**And that brings me to my third question: what tools should you employ?** In late 2008 and early 2009, you needed just two things to achieve big profits: money to commit and the nerve to commit it. If you had caution, conservatism, risk control, discipline and selectivity, you probably achieved lower returns than otherwise (although having factored those things into your analysis might have given you the confidence needed to implement favorable conclusions in that terrible environment). The short answer was simple: money and nerve.
But what if you had money and nerve in 2006 or early 2007? The results would have been disastrous. In those times you needed caution, conservatism, risk control, discipline and selectivity to stay out of trouble. **In short, when the market is defaulting on its job of being a disciplinarian, discernment becomes our individual responsibility.**

So then, which is the right set of equipment for today? I think we’re back to needing the cautious attributes, not the aggressive. An unusually large number of thorny macro issues are outstanding, including:

- the so-so U.S. recovery;
- the U.S.’s deficit, debt ceiling impasse and dysfunctional political process;
- the economic impact of deleveraging and austerity;
- the over-indebtedness of peripheral eurozone countries;
- the possibility of rekindled inflation and rising interest rates;
- the uncertain outlook for the dollar, euro and sterling; and
- the instability in the Middle East and resulting uncertainty over the price of oil.

With all of these, plus prices that are fair to full and investor behavior that has increased in aggressiveness, I would rather gird for the things that can go wrong than ensure maximum participation if things go right. (Of course that’s not an unfamiliar refrain from me.)

The other day, the investment committee of a non-profit on which I sit decided to take the first steps toward marshaling resources and managers so as to be ready to buy into beaten-down assets after the next round of bubble and bust. And it wasn’t even my idea!

**We can never be sure what will happen – and certainly not when – but it’s important to be prepared for what’s likely to lie ahead. And understanding the inevitable pendulum swing in the way investments are viewed – from weeds to flowers and back – is an essential ingredient in being able to do so.**

May 25, 2011

P.s.: I hope you’ll consider rereading “Risk and Return Today” (November 2004) and “There They Go Again” (May 2005) (see [http://www.oaktreecapital.com](http://www.oaktreecapital.com)). Hopefully they’ll strengthen the case for reflecting on past patterns and help you think through the current conditions. You might also take a look at “The Cat, the Tree, the Carrot and the Stick” in “What’s Going On” (May 2003) for a metaphorical look at the process of risk acceptance. Today’s echoes of those past times are worth noting.
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