Memo to: Oaktree Clients

From: Howard Marks

Re: Liquidity

My wife Nancy's accusations of repetitiveness notwithstanding, once in a while I think of something about which I haven't written much. Liquidity is one of those things. I'm not sure it's a profound topic, and perhaps my observations won't be either. But I think it's worth a memo.

Liquidity Defined

Sometimes people think of liquidity as the quality of something being readily saleable or marketable. For this, the key question is whether it's registered, publicly listed and legal for sale to the public. "Marketable securities" are liquid in this sense; you can buy or sell them in the public markets. "Non-marketable" securities include things like private placements and interests in private partnerships, whose salability is restricted and can require the qualification of buyers, documentation, and perhaps a time delay.

But the more important definition of liquidity is this one from *Investopedia*: "The degree to which an asset or security can be bought or sold in the market *without affecting the asset's price*." (Emphasis added) **Thus the key criterion isn't "can you sell it?" It's "can you sell it at a price equal or close to the last price?"** Most liquid assets are registered and/or listed; that can be a necessary but not sufficient condition. For them to be truly liquid in this latter sense, one has to be able to move them promptly and without the imposition of a material discount.

Liquidity Characterized

I often say many of the important things in investing are counter-intuitive. Liquidity is one of them. **In particular, it's probably more wrong than right to say without qualification that something is or isn't "liquid."**

If when people ask whether a given asset is liquid they mean "marketable" (in the sense of "listed" or "registered"), then that's an entirely appropriate question, and answering it is straightforward. Either something can be sold freely to the public or it can't.

But if what they want to know is how hard it will be to get rid of it if they change their mind or want to take a profit or avoid a possible loss – how long it will take to sell it, or how much of a markdown they'll have to take from the last price – that's probably not an entirely legitimate question.

It's often a mistake to say a particular asset is either liquid or illiquid. Usually an asset isn't "liquid" or "illiquid" by its nature. Liquidity is ephemeral: it can come and go. An asset's liquidity can increase or decrease with what's going on in the market. One day it can be easy to sell, and the next day hard. Or one day it can be easy to sell but hard to buy, and the next day easy to buy but hard to sell.

In other words, the liquidity of an asset often depends on which way you want to go . . . and which way everyone else wants to go. If you want to sell when everyone else wants to buy, you're likely to

find your position is highly liquid: you can sell it quickly, and at a price equal to or above the last transaction. But if you want to sell when everyone else wants to sell, you may find your position is totally illiquid: selling may take a long time, or require accepting a big discount, or both. **If that's the case – and I'm sure it is – then the asset can't be described as being either liquid or illiquid. It's entirely situational**.

There's usually plenty of liquidity for those who want to sell things that are rising in price or buy things that are falling. That's great news, since much of the time those are the right actions to take. But why is the liquidity plentiful? For the simple reason that most investors want to do just the opposite. The crowd takes great pleasure from buying things whose prices are rising, and they often become highly motivated to sell things that are falling . . . notwithstanding that those may be exactly the **wrong** things to do.

Further, the liquidity of an asset is very much a function of the quantity involved. At a given time, a stock may be liquid if you want to sell a thousand shares but highly illiquid if you want to sell a million. **If so, it can't be said categorically that the stock is either liquid or illiquid. But people do it all the time.**

Investment managers are often asked how long it would take to liquidate a given portfolio. The answer usually takes the form of a schedule that says: "We could sell off x% of the portfolio in a day, y% in a week, and z% in a month, etc."

But that's a terribly simplistic answer. It doesn't say anything about how the price received would compare with the last trade or the price at which the assets were carried on the previous valuation date. Or about how changing market conditions might make the answer different a month from now. Bottom line: to the statement "we could sell off z% in a month" one should add "but who knows what the price will be, or what effect changing market conditions might have on that percentage?" Anything else requires an assumption that the assets' liquidity is constant. That's often far from the case.

Usually, just as a holder's <u>desire</u> to sell an asset <u>increases</u> (because he has become afraid to hold it), his <u>ability</u> to sell it <u>decreases</u> (because everyone else has also become afraid to hold it). Thus (a) things tend to be liquid when you don't need liquidity, and (b) just when you need liquidity most, it tends not to be there. (In the 2014 Berkshire Hathaway Annual Letter, released early this month, Warren Buffett expresses his dislike for "substitutes for cash that are claimed to deliver liquidity and actually do so, *except* when it is truly needed.") The truth is, things often seem more liquid when you buy than when you go to sell.

The bottom line is that it can be wrong to assume it'll be easy and painless to get out of your holdings, and especially to exit a position after its price has begun to drop.

<u>Liquidity and Opportunities</u>

We watch TV, listen to radio or read newspapers. I'm always amused when the pundits say, "stocks went up today because several companies beat analysts' earnings forecasts" or "the market dropped because of increased uncertainty regarding the price of oil." How do they know? Where do buyers or sellers register their motivations, such that the media can discern them so definitively?

There's only one indisputable explanation for why the market went up on a given day: there were more buyers than sellers. When buyers have greater influence in the market than sellers – because would-be

buyers predominate relative to sellers; buyers feel more urgency than sellers; or buyers want to buy more shares than sellers want to sell – prices rise. Under those circumstances, sellers enjoy great liquidity, and buyers have to pay a premium over prior prices.

So there's the germ of a plan. Why not sell the things people are bidding for most strongly and buy the things they're eager to dump? That sounds like a good idea. It is, and that's why smart investors flock to it: **it's called contrarianism**.

One of the main reasons why opportunistic strategies like distressed debt investing can perform well is that investors are sometimes able to buy from sellers who outnumber them . . . who are in a hurry . . . who want to sell really badly . . . or who have to sell regardless of price. To achieve "immediacy" (a term for a quick exit coined by Richard Bookstaber), the sellers tend to sacrifice something else: price. And the price discount they accept makes an important contribution to the bargain hunter's excess return. (See *Investment Miscellany*, November 2000, for a thorough discussion of immediacy).

Random Thoughts on Liquidity

Here are a number of truths about liquidity. Some are important, but they don't fit into a coherent narrative.

- It's possible that liquidity can be relied on when sellers and buyers are balanced in number and degree of motivation. But more often, given the herd mentality in markets, "everyone" wants to either sell or buy at once.

  There's an old saying to the effect that "In times of crisis all correlations go to one." The prices of everything move in unison during crises because investors are driven by mob psychology, not fundamentals. Thus – and for the same reason – **in times of crisis liquidity often goes to zero**.

- Usually, as described above, it's either hard to buy but easy to sell, or hard to sell but easy to buy. **Sometimes, however, when everyone's confused and intimidated, the market freezes up and it can be hard to do both**.

  For example, after securities backed by sub-prime mortgages were thoroughly impugned in the crisis of 2007-08, there was a total lack of trading. The fact that the "last trade" occurred months ago made it hard for potential buyers and sellers to feel confident regarding what a fair price might be. I believe it was for this reason that the U.S. Treasury organized the Public Private Investment Partnership program, under which nine investment managers raised equity capital from clients for investment in mortgage backed securities, with the Treasury matching the equity and then supplying an equal amount of zero-cost leverage. The goal was to cause trading to occur, and with it "price discovery." After transactions resumed, buyers and sellers had a better idea what a fair price was, so trading and liquidity increased. This was one of the ways in which the government coaxed the capital markets to reopen. Yet this program is little known and its brilliance is unrecognized.

- It's one of my standing rules that **"No investment vehicle should promise greater liquidity than is afforded by its underlying assets."** If one were to do so, what would be the source of the increase in liquidity? Because there is no such source, the incremental liquidity is usually

illusory, fleeting and unreliable, and it works (like a Ponzi scheme) until markets freeze up and the promise of liquidity is tested in tough times.

Some hedge funds provided an example in the last crisis. They raised capital with which to buy assets of uncertain liquidity, sometimes using leverage, and they promised investors the ability to withdraw their money quarterly or annually. But when the end of 2008 rolled around, the desire of LPs for liquidity overwhelmed the capacity of the marketplace to absorb the assets that were for sale (or perhaps the GPs wisely refused to sell because a fair price couldn't be obtained). When that occurred, the funds told LPs they couldn't have the liquidity they'd been promised. Illiquid assets went into locked-up "side pockets," and "gates" came down delaying the effective dates of withdrawals. These little-known provisions gave LPs an unpleasant surprise, demonstrating that **in a crisis, the promise of withdrawal from a vehicle holding illiquid assets can easily turn out to be too good to be true.**

- People often think about liquidity constraints as relating to specific assets; they don't necessarily think about the knock-on effects of illiquidity from asset to asset and market to market. For example, in the crisis, institutional investors had to sell liquid assets at steep discounts and redeem from the most liquid hedge funds because of the heavy allocations to illiquid strategies and gated funds elsewhere in their portfolios. The resulting elevated supply of assets for sale from these funds reduced the liquidity for sellers in those markets and put downward pressure on assets that shouldn't have been so affected.

- Specific investor actions can have a dramatic impact in illiquid markets. For example, the price of an illiquid asset can rise simply because one buyer is buying, in which case selling the asset becomes very easy. When that buyer stops buying, however, the market can quickly reset to much lower levels in terms of both price and the liquidity enjoyed by sellers (and it can overshoot in the other direction if the buyer decides to sell what he's bought).

- In assessing an asset's liquidity, one should think about the other people who hold it. Are they all the same type of investor, and thus likely to react the same to a given story on *Bloomberg*? Do many of them own it in funds whose investors have the right to make quick withdrawals? And, in particular, are they highly levered and subject to potential margin calls? The more ownership is concentrated in the hands of investors who could become motivated to sell *en masse*, the faster liquidity can disappear.

- **Taking on large amounts of illiquidity is neither a winning nor a losing strategy *per se*.** Like any other form of risk, it's advantageous to bear illiquidity when the incremental return for doing so is high, but a bad idea when it's not. And, needless to say, the liquidity premium is neither always there nor always generous.

  In my view, some endowments emulated Yale to excess in the years before the crisis, taking on too much illiquidity in the belief that (a) as ultra-long-term investors they could bear it and (b) they were sure to be well paid for doing so. **But risk premiums arise from risk aversion, meaning they may not exist when investors are risk-tolerant.** The willing acceptance of illiquidity in the early to mid-2000s caused the premium for bearing it to be inadequate, and investors who did so were penalized, not rewarded.

- On the other hand, at the right time, investors can make tremendous amounts of money simply by being willing to supply liquidity (or accept illiquidity). When everyone else is selling in panic or

sitting frozen on the sideline, refusing to buy, cash can be king. Often when a crash follows a bubble-driven run-up, most people are short of cash (and/or the willingness to spend it).

But it may not be a good idea to always sit with a large amount of cash so as to be able to provide liquidity and scoop up bargains in a once-a-decade crash. This may equate to sub-optimizing. It would have paid off in 1990-91, 2001-02 and 2008-09, but what about the other 19 years in the last 25?

- **A high degree of concern over illiquidity can push investors to avoid it to excess.** For example, institutions whose realities could permit a long-term investment approach sometimes decide to invest only in things they can get out of quickly. Is this prudence, or merely sub-optimizing? Is it done in response to a threat that has a reasonable likelihood of materializing, or to a crisis while it is fresh in memory ("fighting the last war")? Is it realistic, or the result of an irrational desire to be able to turn the whole portfolio into cash in short order? Or is it done in order to always be able to comply with a sell order from the boss or the investment committee? **Liquidity is a good thing (everything else being equal). But is it smart to require that a portfolio be able to provide more liquidity than is ever likely to be called on? Let's remember that liquidity isn't free. There's usually a cost, and it comes in the form of return forgone.**

- I think the best way to deal with the issue of liquidity is to think of the portfolio in terms of layers ranging from highly liquid to totally illiquid. The appropriate size for each layer at a given point in time is a function of each investor's specific situation, as well as the position of the market in its cycle.

  In sizing those layers, it's clear that no investor should shoulder more illiquidity than its realities permit, as happened in 2008 with serious consequences for some endowments. Portfolios may be required to (a) meet their owners' needs for current cash with which to operate, (b) fund capital drawdowns at a time when lock-up funds aren't making distributions, or (c) enable the owners to avoid having to sell assets at depressed prices. Thus portfolio liquidity should be set so these needs can be met in bad times.

  But how bad is bad? Should the portfolio have to respond to the last bad year, the average of the last five bad years, the worst year ever . . . or something worse? These decisions require judgment.

- Finally, excessive liquidity can do more harm than good, and investors can be better off if they're able to trade less rather than more. **My son Andrew makes a number of excellent points on the theme that liquidity is a good thing, but not necessarily all good:**

  - The siren song of liquidity can convince investors to try their hand as traders. The result can be increases in (a) emphasis on short-term considerations relative to long-term ones, (b) transaction costs and taxes, and (c) exposure to negative surprises when the liquidity they've been enjoying and counting on disappears.

  - Liquidity can cause you to lower the bar for investments. If you're thinking about making an investment you know you won't be able to exit for years, you'll probably do thorough due diligence, make conservative assumptions and apply skepticism, etc. But when you have something that appears very liquid, you may take a position casually, with little work or

conviction, under the assumption that it would be easy and cheap to get out. Here's a great quote on the subject from Warren Buffett:

> If you aren't willing to own a stock for ten years, don't even think about owning it for ten minutes. Put together a portfolio of companies whose aggregate earnings march upward over the years, and so also will the portfolio's market value.

- Certainly owners of companies wouldn't (and couldn't) trade in and out of them every day. If you intend to invest in businesses based on their fundamentals – rather than trading based on short-term market dynamics – it's critical to think and act like a long-term owner.

- When you find an investment with the potential to compound over a long period of time, one of the hardest things is to be patient and maintain your position as long as doing so is warranted on the basis of the prospective return and risk. Investors can easily be moved to sell by news, emotion, the fact that they've made a lot of money to date, or the excitement of a new, seemingly more promising idea. **When you look at the chart for something that's gone up and to the right for 20 years, think about all the times a holder would have had to convince himself not to sell.** An abundance of liquidity can be a handicap in this regard. Here's some more good advice from Warren: "If you can enjoy Saturdays and Sundays without looking at stock prices, give it a try on weekdays." Looking less often would improve most investors' results.

I have particularly strong feelings about the insistence that 401(k) retirement accounts include only investment choices that provide daily pricing and liquidity. I've heard from Oaktree pension clients about employees who frequently trade their 401(k) accounts. It can't be a good thing for these portfolios to be constantly rejiggered. **It's hard enough to make an occasional well-reasoned long-term decision, but much harder to make a large number of correct short-term decisions.** Rather than ensuring daily liquidity, the people in charge could help plan participants by limiting them to annual changes at most.

So liquidity – like most other things in the investment world – is multi-faceted and complex, not simple. There are a lot of considerations to be taken into account, and certainly no simple formula for doing so. Like everything else in investing, there's no surefire way to manage the issue of liquidity in the absence of superior insight.

Influences on Liquidity Today

Many factors cause the availability of liquidity to change over time. The biggest factor lately in some of our credit markets has been the growth of demand through mutual funds and ETFs, or Exchange-Traded Funds. While there's been no real mania for stocks, the ultra-low level of interest rates has driven many retail investors (who in the past may have invested in Treasurys and money market funds) to credit vehicles instead.

Witness, for example, the fact that senior loan mutual funds saw net inflows of capital for 95 straight weeks leading up to April 2014. That's almost two solid years without a break. You might expect that to cause an imbalance of demand over supply, rendering buyers unable to get their fill. But Wall Street abhors a vacuum, and the banks were able to round up enough issuers to satisfy the buyers. **And with large numbers of retail buyers on one side and obliging issuers on the other, the market certainly**

looked liquid. But when mutual fund inflows turned into outflows in the second half of 2014, the supply of loans put up for sale to meet redemptions added to the supply of loans issued by companies seeking capital. Thus the total supply of loans for sale exceeded the demand, causing prices to decline and the market to become less liquid for holders.

Investors in mutual funds think of them as highly liquid. "You can get out any day," the ads say, "Just call the 800 number." But withdrawing from a mutual fund (if there isn't adequate cash in the fund to meet the redemption) is equivalent to requiring the portfolio manager to enter a "market held" order for some of the securities in the fund's portfolio: sell regardless of price. And the depressed price that results from the involuntary sale of securities is the same price that's paid to the redeeming fund investor.

That's because the mutual fund investor may enter his redemption order at 6:00 p.m. on Monday or 10:00 a.m. on Tuesday, but the price he gets will be determined in an NAV calculation after the close of trading Tuesday. He doesn't get the price that prevailed before the sell order occasioned by his redemption was entered. Thus a mutual fund may be "highly liquid," but that's not the same as "100% liquid," and **it's certainly not more liquid than the assets in its portfolio.**

The other source of increasing demand for securities of late has been ETFs. ETF-like vehicles, sometimes known as "tracking shares," began to appear in the early 1990s, and they proliferated significantly after 2000. According to Wikipedia, "As of January 2014, there were over 1,500 ETFs traded in the U.S., with over $1.7 trillion in assets." (Several years ago I cited Wikipedia in a memo, and Oaktree co-founder Richard Masson – a stickler for correctness – told me in no uncertain terms that it wasn't a respectable source. I think things have changed enough since then, Richard: I'm citing it!)

ETF's have become popular because they're generally believed to be "better than mutual funds," in that they're traded all day. Thus an ETF investor can get in or out anytime during trading hours, whereas with mutual funds he has to wait for a pricing at the close of business. "If you're considering investing," the pitch goes, "why do so through a vehicle that can require you to wait hours to cash out?" **But do the investors in ETFs wonder about the source of their liquidity?**

Here's what Wikipedia has to say about the liquidity of ETFs:

> An ETF combines the valuation feature of a mutual fund or unit investment trust, which can be bought or sold at the end of each trading day for its net asset value, with the tradability feature of a closed-end fund, which trades throughout the trading day at prices that may be more or less than its net asset value. . . .

Consider the possibility that many of the holders of an ETF become highly motivated to either buy or sell. Their actions theoretically could cause the trading price of the ETF to diverge from the value of the securities in the underlying portfolio. To minimize that risk, the creators of ETFs established a mechanism through which financial institutions can trade in wholesale quantities of "creation units" of the fund at NAV.

> The ability to purchase and redeem creation units gives ETFs an arbitrage mechanism intended to minimize the potential deviation between the market price and the net asset value of ETF shares. Existing ETFs have transparent portfolios, so institutional investors will know exactly what portfolio assets they must assemble if they wish to purchase a creation unit, and the exchange disseminates the updated net asset value of the shares throughout the trading day, typically at 15-second intervals.

> If there is strong investor demand for an ETF, its share price will temporarily rise above its net asset value per share, giving arbitrageurs an incentive to purchase additional creation units from the ETF and sell the component ETF shares in the open market. The additional supply of ETF shares reduces the market price per share, generally eliminating the premium over net asset value. A similar process applies when there is weak demand for an ETF: its shares trade at a discount from net asset value.

What would happen, for example, if a large number of holders decided to sell a high yield bond ETF all at once? In theory, the ETF can always be sold. Buyers may be scarce, but there should be some price at which one will materialize. Of course, the price that buyer will pay might represent a discount from the NAV of the underlying bonds. In that case, a bank should be willing to buy the creation units at that discount from NAV and short the underlying bonds at the prices used to calculate the NAV, earning an arbitrage profit and causing the gap to close. But then we're back to wondering about whether there will be a buyer for the bonds the bank wants to short, and at what price. **Thus we can't get away from depending on the liquidity of the underlying high yield bonds. The ETF can't be more liquid than the underlying, and we know the underlying can become highly illiquid.**

This whole discussion calls to mind a Wall Street Wonder called "auction rate securities." They were popular ten years ago, but today they're only a footnote to financial history. In brief, auction rate securities were developed to satisfy the desire of borrowers for long-term financing at the lower interest rates on short-term debt. The securities were described as safe and liquid because Dutch auctions would be held every week or month, resetting the yield on the securities to contemporary levels and thereby ensuring a price near par, as well as plentiful liquidity. Certainly there would always be **some** yield capable of enticing investors to buy at par. Thus the securities would be free from the risks associated with long-term debt. That's what **should** have happened. Here's what Wikipedia says did happen:

> Beginning on Thursday, February 7, 2008, auctions for these securities began to fail when investors declined to bid on the securities. The four largest investment banks who make a market in these securities (Citigroup, UBS AG, Morgan Stanley and Merrill Lynch) declined to act as bidders of last resort, as they had in the past. *This was a result of the scope and size of the market failure, combined with the firms' needs to protect their capital during the 2008 financial crisis.* (Emphasis added)
>
> On February 13, 2008, 80% of auctions failed. On February 20, 62% failed (395 out of 641 auctions) . . . .

When the auctions failed, auction rate securities became frozen. Holders saw large markdowns and for years were unable to obtain liquidity. Eventually, the investment banks that had issued the securities bought many of them back at par, under threat of investigation by U.S. attorneys general. And one more "miracle" disappeared from the scene.

Lastly on the subject of ETFs, a senior loan ETF can be sold for settlement in three days, whereas if there are tenders of creation units, sales of loans to raise the funds with which to pay for those units may require a week or considerably more to settle. What are the implications of such a mismatch?

So-called "liquid alternatives" or "liquid alts" are another recent innovation. They're supposed to deliver performance comparable to other alternative investments without the illiquidity they entail. To me it sounds like just one more promise of something for nothing. How many portfolio managers are smart enough, for example, to deliver the alpha of a well-managed hedge fund without accepting the illiquidity that the clever manager of that hedge fund feels he has no choice but to bear?

Financial innovations created in good times often fool people into thinking a silver bullet has been invented that offers a better deal than traditional investments. (By "traditional" I mean investments that are acknowledged to entail increased risk as the price for targeting increased return . . . not the "miracles" where increased return comes gratis.) Many recent innovations have promised high liquidity from low-liquidity assets. As I said on page three, however, no investment vehicle should promise more liquidity than is afforded by its underlying assets. Do these recent promises represent real improvements, or merely the seeds for subsequent disappointment?

Auction rate securities were a way to buy long-term debt securities without interest-rate risk and illiquidity. Likewise, ETFs offer a liquid way to invest in potentially illiquid markets. But these instruments rely for their desirable outcomes on the assumption that other parties will do what they "should" do. Over the course of my career I've seen many instances when market participants failed to do what they were supposed to do. The related financial innovations often remind me of my father's story about the habitual gambler who finally found a sure thing: a race with only one horse. He bet all his money, but halfway around the track the horse jumped over the fence and ran away. **Will ETFs prove liquid in the next crisis? And what impact will mass sales of ETFs have on the prices of underlying assets? We'll find out.**

Finally under the heading of recent developments, I want to mention the Volcker Rule, which arose from a suggestion from former Fed chairman Paul Volcker. The main reason for the 2008 government bailouts of systemically important banks was the losses the banks had suffered thanks to unsuccessful investments made with their proprietary capital in mortgage backed securities and other levered assets. When these collapsed, the banks lost a great deal of their capital, such that they required capital injections only the government could or would make.

In response to that experience, legislators decided to incorporate the Volcker Rule into the Dodd–Frank Wall Street Reform and Consumer Protection Act, the main piece of regulation to emerge after the crisis. Although there has been much back-and-forth regarding its modification and enactment, the main thrust of the Volcker Rule is to prevent banks from making speculative investments that aren't related to their activities on behalf of clients; in other words, to impose a general ban on proprietary trading**.**

Often during crises, investors take to the sidelines, such that there are no buyers for the assets that come up for sale. Liquidity dries up, and prices plummet. In the past, banks have stepped forward, risking their proprietary capital in pursuit of profit. Many times in our experience, banks have competed strongly against us to buy distressed debt, thereby supplying liquidity to the market. Although the eventual impact of the Volcker Rule is unknown, **any diminution of the banks' likelihood of engaging in proprietary buying during crises suggests a significant reduction in liquidity just when it may be needed most.**

For the last few years I've been expressing my view that (a) investors – driven by central bank-mandated interest rates near zero – have been moving into riskier investments in pursuit of higher returns and (b) in taking that step they've often ignored the need for caution or been ignorant as to how to achieve it. **I believe that as an important part of this behavior, those investors have extrapolated the high level of liquidity they've witnessed in the last five years, failing to understand its transitory nature.**

The impact on liquidity of ETFs, liquid alternatives and the Volcker Rule has yet to be tested in tough times. We'll see what happens in the next serious downturn.

* * *

The bottom line is unambiguous. Liquidity can be transient and paradoxical. It's plentiful when you don't care about it and scarce when you need it most. Given the way it waxes and wanes, it's dangerous to assume the liquidity that's available in good times will be there when the tide goes out.

What can an investor do about this unreliability? The best preparation for bouts of illiquidity is:

- **buying assets, hopefully at prices below durable intrinsic values, that can be held for a long time – in the case of debt, to its maturity – even if prices fall or price discovery ceases to take place, and**
- **making sure that investment vehicle structures, leverage arrangements (if any), manager/client relationships and performance expectations will permit a long-term approach to investing.**

These are the things we try to do.

And the worst defenses against illiquidity – or, better said, the approaches that make you most dependent on the availability of liquidity – are (a) employing trading strategies under which you buy things because of how you think they'll perform in the short run, not what they'll be worth in the long run, (b) being focused on what the market says your assets are worth, not what your analysis shows them to be worth, and (c) buying with leverage that exposes you to the risk of a margin call in a declining market.

One of the great advantages of investing in performing debt is that if our credit judgments are correct, the return will come from our contractual relationship with the issuers – from the interest and principal they've promised to pay us – not the operation of the market. **At Oaktree, trading is what we do to implement portfolio managers' long-term investment decisions. We generally consider it a cost of doing business, not something we engage in to make money.**

There are two benefits to this approach:

- we aren't highly reliant on liquidity for success, and
- rather than be weakened in times of illiquidity, we can profit from crises by investing more – at lower prices – when liquidity is scarce.

We're not immune to occasional periods of illiquidity; our holdings become just as hard to sell as anyone else's. But with the proper structure and approach, it's possible to turn such periods to our advantage rather than just endure them.

* * *

I started this memo by saying liquidity might not be a profound topic. But when I ran a draft by our CEO Jay Wintrob, who came to us in November from AIG, he took issue. I'll give him the last word:

> In September 2008, AIG experienced serious liquidity issues (despite its $1 trillion balance sheet) when it couldn't post $20-25 billion of liquid collateral related to credit default swap contracts written by one of its subsidiaries. The U.S. government stepped in

as a result, lending support that eventually reached $182.3 billion, massively diluting AIG shareholders in the process. **When you can't meet a margin call because you have insufficient liquidity, that's profound.**

March 25, 2015

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