Memo to: Oaktree Clients Only

From: Howard Marks

Re: 2020 in Review

The opening lines of Charles Dickens's *A Tale of Two Cities* offer a fitting coda to 2020:

> It was the best of times, it was the worst of times . . . it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair.

We're left to contemplate the jaw-dropping list of extremes compiled during this turbulent year:

- The coronavirus brought on the worst global pandemic in over a century.
- In the U.S., more than 340,000 people died from Covid-19 – 85% of the number who died in battle in the four years of World War II.
- In the second quarter, the U.S. experienced the worst quarterly drop in real GDP in 74 years of recorded quarterly history, an annualized decline of 32.9%.
- But in the third quarter, it saw the biggest annualized gain in history: 33.4%.
- Initial unemployment claims jumped from 251,000 to almost 3 million in a single week in March, crested at 6.2 million two weeks later, and remained above the pre-pandemic record of 695,000 every week for the remainder of the year.
- Through bond buying, the Federal Reserve grew its portfolio by $2.7 trillion, or roughly 55%, and the U.S. Treasury funded roughly $4 trillion in grants and loans.
- After the S&P 500 Index reached an all-time high of 3,386 on February 19, it fell 33.9% in just 32 days to 2,237 on March 23.
- But from that low, the index regained the previous high in less than five months on August 18 (an increase of 51.5%). It ended 2020 up 67.9% from the low and up 18.4% overall for the year.
- Unlike the credit crunches that accompanied many past crises, capital flowed like water. High yield bond issuance for the year was $450 billion, up 57% from 2019 and well above the prior record set in 2013. Investment grade debt issuance totaled $1.9 trillion, up a similar 58% from 2019 and also ahead of the previous record, set in 2017.
- After the Fed cut its federal funds rate target to between zero and 0.25%, bond prices rose as bond yields fell in parallel. At year-end, the average A-rated bond yielded just 1.52%, and the average yield on high yield bonds (ex. energy) was just below 4%.

So we had a health emergency, an ailing economy, the most generous capital market of all time, and strong stock and bond markets. The seemingly anomalous relationship between the pandemic and recession on one hand and the strong capital and stock markets on the other can be explained by the Fed's and the U.S. Treasury's aggressive actions.

As suggested by the above catalog of events, the buying opportunity in 2020 turned out to be very brief, especially with regard to public securities and companies with the ability to access the capital markets. Defaults affected a large dollar amount of high yield debt securities, but default rates came nowhere near the highs that had been predicted and soon began to recede. Highly motivated selling was short-lived – essentially limited to the month of March – and we never saw the full-throated panic (accompanied by margin calls, meltdowns and forced selling) witnessed in prior crises. In just a few months:

- investors grew confident about the inevitability of an economic recovery;
- optimism developed regarding the outlook for a Covid-19 vaccine;
- the near-zero fed funds rate brought down prospective returns all along the capital market line;
- risk tolerance returned, and fear of missing out took over from fear of losing money;
- asset prices rose, and the markets bounced back; and
- the exceptional buying opportunity came to what for our purposes was a premature end.

Oaktree Performance

Last year's extreme, rapid-fire developments – and especially their origin in an exogenous and unforeseeable event, the virus outbreak – created great challenges for investors. To have taken maximum advantage, one would have had to have gone into late February prepared for a significant shock and then turned bullish a month later. Obviously, few investors did both.

While we never radically shift our portfolios, I think Oaktree did a very good job under these circumstances. For years we had been leery of the markets, because of our view that they were characterized by a great deal of uncertainty, full-to-high asset prices, the lowest prospective returns in history, and pro-risk behavior on the part of investors trying for high returns in a low-return world. With our mantra in that period of "move forward, but with caution," our portfolios were as fully invested as we could make them while maintaining the highest possible standards within the context of the market realities.

When the markets fell sharply in March, our prior caution allowed 10 of our 14 open-end strategies to avoid part of their benchmarks' declines (before fees). This enabled us to remain calm under fire, hold onto positions that warranted doing so, and increase aggressiveness at the margin where appropriate. Of course, these were the right things to do.

A year ago, in my 2019 review, I included a table showing how little of our closed-end funds' capital we had invested, taking pride in our portfolio managers' discipline, and writing:

> Investors' aggressive pursuit of return – and the strong resulting cash flows into alternative and private investments – has made it challenging to put money to work in these fields. . . . In each case, our insistence on good value and controlled risk resulted in a moderate pace of investment that was somewhat below our historic norms.

In 2020, in contrast, many of our closed-end strategies turned highly aggressive, starting in the worst of the March declines. This allowed them to make great progress. For example:

- Our Opportunities group bought public debt and negotiated private rescues in quantities sufficient to complete the deployment of Opportunities Fund Xb by investing over $7 billion and then put over $4 billion to work for its successor, Opps XI.
- The same was true of our Real Estate group, which finished investing Real Estate Opportunities Fund VII and moved on to ROF VIII.
- The investments made by our Special Situations group took the invested or committed percentage of its Special Situations Fund II from 19% to 82%.
- Overall, Oaktree's closed-end funds deployed nearly $17 billion, making 2020 our best year ever in that regard.

Given our insistence on risk control, Oaktree's open-end strategies don't always keep up with their benchmarks in highly bullish times. The fourth quarter of 2020 presented a potential challenge in that regard, as the market rally (and the low interest rates) encouraged risk-taking and caused the riskiest assets to soar. Thus, we're happy to report that 10 of the 14 strategies exceeded their benchmarks in the fourth quarter, allowing 9 of them to do so for the full year (all references to returns are before fees). Further, the ups and downs of our quarterly returns suggest we earned our returns with less volatility than the benchmarks. Overall, we're quite pleased with Oaktree's investment performance for the year.

To reiterate what you already know, none of this was predicated on forecasts. We never tried to predict when the markets would begin to recover from their Covid-19-induced declines. We didn't know better than anyone else that the new signs of life in the markets in late March were the beginnings of a rally that would take them to all-time highs. We simply favored defensiveness when we considered the markets vulnerable and then turned aggressive when price declines rendered defensiveness no longer appropriate.

<u>A Look at the Long Run</u>

At the end of the most turbulent year in my five-plus decades of experience, I'm going to devote my usual section on the long run to an Oaktree strategy that really would make you think 2020 was the best of times: our Power Opportunities funds. I'll start with the interesting history of these funds.

Just a year after Oaktree's founding, a friend brought us an unusual opportunity. Three long-term corporate-employees-turned-energy-consultants had left Arthur Andersen in 1995 to form an investment boutique, GFI Energy Ventures (with "GFI" standing for "Go For It"). Larry Gilson, Richard Landers and Ian Schapiro had developed an investment thesis based on their knowledge advantage regarding the deficiencies of the U.S. power infrastructure, the need for remediation and expansion, and what the incumbents would spend money on in the process. They were a sponsor without a fund, passing the hat among a small circle of investors whenever they found an attractive investment candidate. But, in 1996, they found an opportunity too large to finance using that approach, and they were referred to us.

We were very interested in that first investment, as well as the general thesis and its application, and we entered into a deal with GFI under which we would pay their overhead, get a right of first refusal on their deal flow, and jointly manage the investments made. And, if we continued to like what we saw, in three years we would organize a fund dedicated exclusively to their power infrastructure investments, which would also be run jointly. All went well during the period in question, and so the first Oaktree/GFI Power Opportunities Fund was formed in 1999.

While we tried to get the people of GFI to join Oaktree, Larry and Richard resisted our entreaties. But when they retired in 2009, Ian and his team jumped aboard, and we've had a great ride ever since. We're now in the process of investing Oaktree Power Opportunities Fund V.

A few specific things stand out to me about the last 25 years:

- When Bruce and I first met Larry, Richard and Ian, we were immediately struck by the strength of their thesis. Everyone knew the U.S. power grid was old and hadn't kept up with the country's progress. The frequent blackouts, among other things, told us it needed extensive (and expensive) remediation and investment.
- Interestingly, GFI didn't invest in power generation or transmission infrastructure, but rather in successful companies that sold products, services and software to firms involved "downstream" in the distribution, monitoring and consumption of power. In the words we used at the time,

"they won't try to predict which miners will find gold; they'll sell picks and shovels to all of them."

- When GFI gave us their drafts of the marketing materials for that first 1999 fund, there was extensive discussion, in a very Oaktree-like fashion, of the many types of risk they wouldn't take, such as technological risk and commodity risk. And they've stuck with that discipline.
- Larry, Richard and Ian also laid out the specific strategies that they would pursue based on the expected industry trends and company behavior. Those strategies are still guiding the Power funds to great success a quarter-century later. The GFI founders were remarkably prescient.
- Finally, it's worth observing that the Power Opportunities group has increased its capital under management only gradually. There can be little doubt that discipline in fundraising has had a favorable impact on investment results. It's simply an oxymoron to say, "I've found an incredible niche where great returns can be earned consistently and with little risk, and it's infinitely scalable." That just doesn't make sense. So, when the $1 billion Power Fund II compiled its net IRR of 59% – without its portfolio companies employing high leverage – I asked the group leaders how much capital they wanted for their next fund. The answer was simple: $1 billion. Certainly, the typical GP would have used the success of Fund II to raise far more for subsequent funds, perhaps bringing their record of exceptional performance to an end.

Lastly, I'm proud to report that the aggregate 2020 return of the Power Opportunities Funds was 131.1% net of fees, incentive allocation and expenses, and to present the lifetime performance of the constituent funds through December 31, 2020:

Power Opps Fund	Year Formed	Committed Capital	Net IRR	Multiple of Cost
I	2000	$ 453.8	13.1%	1.5x
II	2004	1,020.6	58.9	3.1
III	2010	1,062.1	13.4	1.6
IV	2016	1,105.7	29.9	2.5
V	2018	1,400.0	4.4	1.0
Total			26.5%	2.0x

It's easy to see why we're so proud of the Power Opportunities group. Not only is the average IRR for these funds very high, but individually they've always been good, sometimes astronomical, but never poor (in fact, never a mature fund with a net IRR below the low teens). Every Power fund has had a very high batting average and a very low incidence of loss. Power Fund IV's gross return of 200% in 2020 is the best we've ever had, and we believe it will turn out to be the highest returning fund of its size in U.S. private equity history in terms of MOIC, without highly leveraging its holdings. Until now, Power Fund II has held the #2 spot; it'll be bumped down to #3. **You can see why we feel the group's track record, with the surprises clearly on the upside, represents the Oaktree ideal to the fullest**.

The leadership of the Power Opportunities group has evolved and transitioned over these 25 years, but the talent keeps being regenerated and the returns roll on. Larry and Richard retired in 2009, as I said, and Ian took over. In 2016, Ian promoted Michael Cardito and Jason Lee to be his co-portfolio managers. Jason will be leaving us in the next few months to devote his energies to activities such as teaching, and while we're sorry to see him go, we're delighted to know he'll remain an informal advisor. At the same time, Ian is stepping back from managerial responsibilities and has passed the day-to-day reins to Michael. Since Michael has been responsible for much of the success of our most recent Power funds and

Ian will be fully involved in the investment process, we know the strategy continues to be in excellent hands. We thank the members of the Power Opportunities group for their long-term achievement. We're confident they'll continue to adhere to the Oaktree ideals of risk control and consistency, hopefully with further great success.

Oaktree Developments

Assets Under Management – Oaktree's assets under management changed little in the years leading up to 2020, only rising from $91 billion at year-end 2014 to $95 billion at year-end 2019 (in both cases excluding our share of DoubleLine's AUM). Given the market conditions, we opted to limit asset accumulation in order to maximize our ability to be selective. Further, Oaktree's overall ability to increase AUM largely depends on the state of the market for distressed debt, the focus of our largest funds, and supply there was very modest in those years. Consequently, our fundraising for that area – and thus for Oaktree overall – was quite restrained.

In contrast, 2020, with its many difficulties (including weak markets), seemed the perfect time to raise capital for our distressed debt strategy, and we brought forward the formation of Opportunities Fund XI from its planned date in 2021. In anticipation of a pronounced increase in the supply of candidates for investment, Opps XI became, we believe, the largest distressed debt fund ever formed, with capital commitments of $14.5 billion thus far.

In addition to Opps XI, in 2020, we went out for incremental capital for several of our strategies, including ongoing open-end and evergreen efforts and closed-end funds already in the market. The response was very favorable, permitting us to raise a total of $29.4 billion in 2020, the best year for total fundraising in Oaktree's history, as well as the best for strategies other than Opps. That lifted Oaktree's year-end AUM to $121 billion ex. DoubleLine ($148 billion overall). Importantly, we're confident this total – spread over more than two dozen strategies – allows us to remain selective and flexible.

Operations During the Pandemic – My first indication of the severity of the coronavirus came on February 26, when I was at the airport waiting to fly to see a state pension fund client. I received a call telling me that the client had to cancel my appointment, as they had established a no-visitors policy (along with a no-travel policy for their staff). That decision – which soon became so common – seemed jarringly serious at the time. (However, it permitted me to curtail my trip and attend Grandparents Day at Rosie's school – a real silver lining.)

On March 5, we made the decision to cancel the in-person version of Oaktree's biennial LP conference, scheduled for the 11th, and to livestream it instead. Nancy and I flew from New York to Los Angeles for the session, little knowing that we would be there for several months. I left the Beverly Hilton after the livestreaming sessions and, like many of you, haven't been back to the office since. As those who've read my memo *Something of Value* know, my son Andrew and his family moved in with us on March 13 for a period of months, and investment discussions with him added greatly to my productivity in 2020.

Oaktree employees soon reported our first two cases of Covid-19, and to date we've had 40+ cases among our roughly 1,000 staff members around the world. Fortunately, everyone recovered nicely. We closed all of our offices in early March, and the attendance picture since then has varied from office to office. We thank both those who've been coming in and those who've worked from home.

Oaktree's people made great efforts in 2020 and were extremely effective. And clearly, we're pleased with the results. Our systems operated without a hitch, and our people worked under difficult circumstances to help us seamlessly acquit our responsibility to our clients. I don't think we skipped a beat. And we all mastered the phrase that best symbolizes 2020: "you're on mute."

Ensuring Opportunity – One of the signal events of 2020 was the death of George Floyd at the hands of a Minneapolis policeman, a tipping point that ignited protests across the country. **Many American individuals and corporations were moved to recognize the racial inequalities and injustices that exist and to do something about them. We at Oaktree are very much part of that group.**

Since 2016, Oaktree has had a highly organized effort to improve the diversity and inclusiveness of our organization, led by separate leadership councils for women, people of color (Black, Hispanic/Latino and multi-racial) and LGBTQ employees. The councils have significant responsibility and influence with regard to recruiting, training, mentoring and retention, and they are charged with making sure these key functions are carried out well and bias is avoided. They serve as key advisers to Oaktree's senior management on these subjects. The councils are also mentoring college students from communities that have traditionally had limited access to opportunities in investment management and making great efforts to hire from those communities. We look forward to reporting on progress as it occurs.

As part of our response to the situation, we further ramped up our efforts to increase the presence of under-represented group members at the highest levels. Thus, we sought and found the ideal person to become Oaktree's first board member of color. **As previously announced, we were privileged last month to be able to attract Depelsha McGruder to join our board**. Howard University, Harvard MBA, 17 years as an executive at Viacom and presently COO and Treasurer of the Ford Foundation – this is an ideal background, especially given her role at Ford in managing global operations and vetting investment strategies to preserve and grow the $14+ billion endowment. We are excited to welcome Depelsha to our board and look forward to her contributions.

Environmental, Social and Governance – One of the biggest changes we've seen in the investment community in recent years is the increased attention to environmental, social and governance (ESG) considerations. Each year, more and more investors are increasing their emphasis on these matters and doing more about them by requiring investment managers to demonstrate their commitment. This has very much been reflected in the evolution of Oaktree's processes.

While we've long taken ESG considerations into account as part of our investment process, a decade ago we made little effort to document our ESG assessments. Moreover, each of our investment teams had its own ESG approach. In the last few years we formed an ESG Governance Committee to help improve and harmonize the ESG practices of our strategies globally. While we've made tremendous advances in ESG, to date we've done so without any dedicated resources. Given how fast the landscape is evolving, and because we've decided to redouble our commitment, we've created the position of full-time Head of ESG, reporting to our CIO and my co-chairman, Bruce Karsh.

I am pleased to report that we recently announced the appointment of Priya Prasad Bowe to that position. Priya, who joined Oaktree in 2019 to work on our credit businesses, has been integrally involved in the design and implementation of the ESG framework for our Global Credit strategy, including authoring the beginnings of its climate-change-management strategy. Going forward, Priya will work with all Oaktree investment teams to make certain we're fully aware and educated regarding emerging ESG risks and opportunities, and she will assist us in bolstering our ESG integration, documentation and engagement practices globally.

In addition to Priya, we're fortunate to have a deep bench of industry experts to provide guidance in this area, including our partners at Brookfield Asset Management. One such expert is Mark Carney, Brookfield's Vice Chairman and newly appointed head of ESG and Impact Fund Investing. Mark is the former Governor of the Bank of England and Bank of Canada and serves as a United Nations Special Envoy for Climate Action and Finance. Our investment personnel have begun to work with Mark to evolve their thinking on climate change. We expect over time to have much to report to you on ESG.

Oaktree Babies – It's one of my great pleasures each year to report on the progress of the Oaktree baby count. In that connection, 55 children were born to employees in 2020, bringing our since-inception performance to 831. I always take our employees' decision to bring a new person into this world as a show of their positive attitudes and faith in the future. **I'm particularly eager to see what 2021 brings in this regard, following the work-from-home stretch that began just over nine months ago**.

Positioning for 2021

Because the market is at a possibly critical juncture and its direction is much debated these days, I'm going to spend an unusual amount of time discussing positioning going forward. Thus, you might end up feeling this memo should have been titled *Preview of 2021* rather than *2020 in Review.*

Investors often imagine there are two distinct macro environments: times when the future is clear and times when it isn't. In reality, though, these periods are all pretty much the same, since perceived clarity regarding the future often turns out to have been illusory. Most macro forecasting consists of extrapolating current levels and recent trends with minor tinkering. While predictions of "no change" are often right – as continuation is the general rule – they give rise to little in terms of profit. Only forecasts of major deviation from trend can be highly profitable. But to be so, they also must be correct, and they rarely are. That's why profitable macro forecasts (and successful forecasters) are few and far between. This negative view on forecasting is a major theme running through Oaktree's culture and the reason we don't base our investments on macro forecasts.

Most investors felt that the beginning of 2020 was a time of clarity: the economy and the stock market were both expected to continue advancing. While everyone knew they wouldn't do so forever, nothing seemed poised to make them stop. And then came the strongest exogenous shock we've ever seen – the novel coronavirus – proving once again that we never know what's going to happen (and that even though we can't predict, we should prepare – more on this later). Today's environment, in contrast, seems to be characterized by a lack of clarity. Experts are expressing highly divergent opinions regarding the outlook for U.S. markets, with strong arguments both bullish and bearish.

Most important on the positive side of the ledger, we seem highly likely to have a healthy economy for a good while, and the Fed has telegraphed its plan for years of accommodative monetary policy to keep it that way. The economy continues to reopen and recover from the pandemic, and this process should speed up as the vaccine rollout accelerates. President Biden's administration wants to provide unprecedented levels of financial support and stimulus, and the Democrats probably have enough control of the two houses of Congress to do so.

I'm particularly impressed by the potential for well above average consumer spending. Think about all the things you didn't spend money on in the last 12 months, such as vacations, dinners out, concerts and shows, and clothing for special occasions, and about the millions of Americans of whom the same is true. Now consider the households that made more money last year than they did the year before – starting with those who received support checks but didn't suffer job losses. This caused real personal income to grow at the fastest rate in 20 years. **Harvard economist Jason Furman estimates that the combination of above-trend income and below-trend spending has created roughly $1.8 trillion of extra disposable personal income since the beginning of the pandemic**. Finally, add in the very positive wealth effect from last year's multi-trillion dollar appreciation on stocks and still more on homes.

The combination of this extra disposable income with the ending of a prolonged period of isolation and release of pent-up demand has the potential to add substantially to short-term economic growth. Many economists expect U.S. GDP to rise at a well above average rate this year, and with the early months likely to be slow, that implies big gains later in the year. Morgan Stanley, to pick one source, predicts that 4Q2021 annualized GDP will be 7.6% above 4Q2020. While the lockdown-related recession was painful, it set the stage for some very positive year-over-year comparisons in the period immediately ahead.

The strong economy will be abetted by a Fed that has promised to keep interest rates low for years and to continue buying bonds. The Fed will make every effort to keep monetary policy accommodative to support economic growth and job creation. It clearly demonstrated in the last year that its tools are varied and powerful, at least in the short run.

A related positive to consider is that market tops usually occur with the economy several years into the up-leg of the cycle and vulnerable to recession. This time, however, we have strong markets at the beginning of what may prove to be a long economic recovery. **The fact that we already see full asset prices so early in the recovery is a source of risk. But on the other hand, the fact that the economy is likely to grow for several years is very encouraging.**

Finally among the positives, I believe U.S. political uncertainty has declined somewhat, truncating the extreme tails of the distribution of possible events. With a center-left president and tiny Democratic majorities in both houses of Congress, I believe radical legislation is unlikely to be enacted.

Arrayed against the optimistic outlook regarding the two most important things, the economy and the fight against the pandemic, are a number of concerns. The shortest-term risk is the possibility of unimpressive first quarter GDP data. The latest severe wave of the virus, which took daily cases in the U.S. to record levels, may have slowed current economic activity (so far, the economic data are very mixed). But everyone knows this, and investors have been willing to "look across the valley" for the past eleven months and are unlikely to stop now, when strong growth is right around the corner.

The biggest risk of all is the possibility of rising interest rates. Rates have declined quite steadily for the last 40 years. This has been a huge tailwind for investors, since a declining-rate environment lowers the demanded returns on assets, making for higher asset prices. The linkage between falling interest rates and rising asset valuations is a good part of the reason why p/e ratios on stocks are above average and bond yields are the lowest we've ever seen (which is the same as saying bond prices are the highest).

But the downtrend in rates is over (if we can believe the Fed's assurance that it won't take nominal rates into negative territory). **Thus, while interest rates can rise from here – implying higher demanded returns on everything and thus lower asset prices – they can't decline. This creates a negatively asymmetrical proposition.**

So today's high asset prices may be justified at today's interest rates, but that's clearly a source of vulnerability if rates were to rise. (Note that today's 1.40% yield on the 10-year Treasury note is up from 0.52% at the low in August 2020 and from 0.93% in just the last seven weeks.)

The Fed says rates will be low for years to come, but are there limitations on its ability to make that happen? Can the Fed keep rates artificially low forever? On longer-maturity bonds? **And what about inflation? Can the 10-year Treasury note still yield 1.40% if inflation reaches 3%?** Will people buy it at a negative real yield? Or will the price fall so that it yields more? Where could inflation come from?

The price of goods may not rise in dollar terms, but reduced respect for the dollar (or increased quantities of dollars in circulation) could cause it to depreciate relative to the price of goods: same result.

On TV on February 7, Treasury Secretary Janet Yellen responded to a question about inflation risk posed by the proposed Covid-19 relief package with a long discourse on the importance of delivering relief to Americans who are suffering. Few would argue with that premise. She also made clear that she believes it's better to provide too much relief than too little. True as well. **But that doesn't mean (a) the more relief the better or (b) there aren't risks attached.** Experts from both sides of the political aisle have questioned whether the $1.9 trillion relief package under discussion is too much and/or misdirected; Larry Summers, a progressive economist, wrote to that effect in *The Washington Post* on February 4:

> . . . a comparison of the 2009 stimulus and what is now being proposed is instructive. In 2009, the gap between actual and estimated potential output was about $80 billion a month and increasing. The 2009 stimulus measures provided an incremental $30 billion to $40 billion a month during 2009 — an amount equal to about half the output shortfall.
>
> In contrast, recent Congressional Budget Office estimates suggest that with the already enacted $900 billion package — but without any new stimulus — the gap between actual and potential output will decline from about $50 billion a month at the beginning of the year to $20 billion a month at its end. The proposed stimulus will total in the neighborhood of $150 billion a month, even before consideration of any follow-on measures. That is at least three times the size of the output shortfall.
>
> In other words, whereas the Obama stimulus was about half as large as the output shortfall, the proposed Biden stimulus is three times as large as the projected shortfall. **Relative to the size of the gap being addressed, it is six times as large. . . .**
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> Another [way of assessing the scale of a fiscal program] is to look at family income losses and compare them to benefit increases and tax credits. Wage and salary incomes are now running about $30 billion a month below pre-Covid-19 forecasts, and this gap will likely decline during 2021. Yet increased benefit payments and tax credits in 2021 with proposed stimulus measures would total about $150 billion — a ratio of 5 to 1. The ratio is likely even greater for low-income individuals and families, given the targeting of stimulus measures. . . .
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> . . . while there are enormous uncertainties, **there is a chance that macroeconomic stimulus on a scale closer to World War II levels than normal recession levels will set off inflationary pressures of a kind we have not seen in a generation, with consequences for the value of the dollar and financial stability**. (Emphasis added)

Normally one would expect such a flood of additional liquidity into the economy to cause inflation to accelerate, but the Fed says no. Of course, although central banks might like to see inflation increase (as it makes it cheaper to repay debt), they have to discourage such talk for fear of fueling inflationary expectations. On the other hand, we've had substantial deficits and accommodative monetary policy ever since 2008 and no serious inflation. We've seen a 50-year-low in the unemployment rate and yet not the inflation the Phillips Curve would have predicted. And Japan and Europe have been trying for 2% inflation for years without success. Is inflation a threat anytime soon? The answer's clear: who knows?

In addition to these major risks, there are others that – although perhaps smaller, less consequential or less imminent – should nevertheless be considered:

- Optimism regarding the economy is based on positive assumptions about vaccines being efficacious, getting into arms, and holding up over time and against new variants. My own guess is that the U.S. will reach herd immunity in the third quarter, with life thereafter moving back in the direction of pre-pandemic norms. Disappointment regarding the speed or efficacy of vaccinations could delay and complicate the rekindling of economic growth.
- The actions of the Fed and U.S. Treasury may be leading investors to aggressively pursue high returns in today's low-return world, replacing risk aversion with risk tolerance. Signs that in the past indicated excessive optimism and complacency in stock and bond markets are present today:

    - the strong performance of speculative securities and "meme" stocks;
    - heavy retail buying of stocks, options buying, and buying on margin;
    - heated bidding for bond deals, low bond yields and weak contractual protections;
    - the Buffett Indicator (the ratio of total equity market capitalization to GDP) far above its previous high; and
    - large numbers of IPOs, including IPOs by unprofitable companies, and first-day share price jumps of tens or hundreds of percent.

- Since many investors have concluded over the last 20 years that they can't achieve the returns they want or need in traditional stocks and bonds, capital has flooded into alternative assets, complicating life for investors there, too.
- The unemployment rate may not soon fall to pre-Covid-19 levels, and the secular growth of the economy could remain unimpressive.
- U.S. relations with China are likely to continue to be thorny, flaring up from time to time, and globalization – with its economic benefits for the world overall – may be weaker than in the past.
- America's social and political divides are unlikely to close anytime soon, and the country may not easily resolve questions of unequal opportunity and treatment.

The above list omits two long-term worries that may seem theoretical and far off but I think are potentially significant:

- Can the Fed really increase its balance sheet by trillions of dollars and the U.S. run annual deficits in the trillions – in 2020 and in coming years – without negative consequences, like a decline in the dollar's value? If the dollar performs poorly, will it remain the world's reserve currency and leave unchanged the U.S.'s ability to borrow unlimited amounts of money to cover deficits? And what happens if the answer to that last question proves to be "no"?
- How will we find jobs for all the people who are displaced by technology and automation and lack the skills required to participate in the information economy? What happens to parts of the country that are left out of the new economy?

Finally, much of the worry about whether we're in a bubble relates to valuations. For the S&P 500, for example, the current ratio of price to projected 2021 earnings is roughly 22 (depending on which earnings estimates you use). This seems expensive compared to the historic average in the range of 15-16. But knee-jerk judgments based on the relationship between current valuations and historic averages are too simplistic to be dispositive. Before making a judgment about today's valuation of the S&P 500, one must consider (a) the context in terms of interest rates, (b) the shift in its composition in favor of rapidly growing technology companies, with their higher valuations, (c) the valuations of the index's individual components, including those tech companies, and (d) the outlook for the economy. **With these factors in mind, I don't think most of today's asset valuations are crazy**. Of course, a big correction in speculative stocks could have a negative impact on today's bullish investor psychology.

In particular, as to item (a) above, we can look at the relationship between today's 4.5% earnings yield* on the S&P 500 and the yield on the 10-year Treasury note of 1.4%. The implied "equity risk premium" of 310 basis points is very much in line with the average of 300 bp over the last 20 years. Valuations can also be viewed relative to short-term interest rates. The current p/e ratio on the S&P 500 of 22 is slightly below the reading of 24 in March 2000 (the height of the tech bubble), and the fed funds rate is around zero today versus 6.5% back then. Thus, in 2000, the earning yield on the S&P 500 was 4.2%, or 230 basis points below the fed funds rate, while today it's 450 bp above. In other words, the S&P 500 is much cheaper today relative to short-term rates than it was 21 years ago.

The story is similar in the credit market. For example, the yield spread on high yield bonds versus Treasurys is below the historic range, although probably still more than adequate to offset likely credit losses. Thus, as with most other assets today, the price of high yield bonds is high in the absolute, fair-ish in relative terms, and highly reliant on interest rates staying low.

So where does that leave us? In many ways, we're back to the investment environment we faced in the years immediately prior to 2020: an uncertain world, offering the lowest prospective returns we've ever seen, with asset prices that are at least full to high, and with people engaging in pro-risk behavior in search of better returns. This suggests we should return to Oaktree's pre-Covid-19 mantra: move forward, but with caution. But a year or two ago, we were in an economic recovery that was a decade old – the longest in history. Instead, it now appears we're at the beginning of an economic up-cycle that's likely to run for years.

Over the course of my career, there have been a handful of times when I felt the logic for calling a top (or bottom) was compelling and the probability of success was high. This isn't one of them. There's increasing mention of a possible bubble based on concerns about valuations, federal government spending, inflation and interest rates, but I see too many positives for the answer to be black-or-white.

In the interest of moving toward a conclusion, I'm going to briefly recap the pros, cons and counter-arguments:

- The **economic outlook** is positive, although Chairman Powell warns that the recovery remains "uneven and far from complete," with inadequate job creation.
- Thus he says the Fed will keep **interest rates** low for years. But with fiscal and monetary policy extremely accommodative, rates are already on the move up and vulnerable to increased inflation.
- **Inflation** stayed low in the 2010s despite records being set in terms of duration of the economic recovery, deficits and low unemployment. However, inflation's ability to remain so is uncertain.
- The **temperature of the market** is elevated, and there are signs of euphoria and risky behavior.
- **Valuations** are high relative to history, as security prices have run ahead of economic gains. High multiples are justified by today's low interest rates but dependent on continued low rates.
- **Risk compensation** is skimpy, as seen in the premium valuations of favored companies and in historically narrow yield spreads on credit.
- **Washington** poses a risk because of one party's control and the anti-capitalist policies of its most progressive members. My hope is that the narrow majorities render radical legislation less likely.
- As to **exogenous risks**, President Biden will pursue greater harmony, but tension with China and Iran and the racial and social divisions at home continue to cloud the outlook.

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* -- The earnings yield on a stock or stock index is the ratio of its earnings to its price. Thus it's the e/p ratio: the inverse of the p/e ratio, or 1 divided by the p/e ratio. A forward-looking p/e ratio of 22 equates to an earnings yield of 1 ÷ 22, or 4.5%.

With arguments on both sides, I feel the prices of most assets are in a gray area – certainly not low, mostly on the high side of fair, but not so high as to be unreasonable.

The bottom line is this: given current conditions, should investors be at their usual risk position, more defensive or more aggressive? **While the risk-adjusted returns of most asset classes seem to be at rough equilibrium relative to each other, all absolute returns are ultra-low, commensurate with today's equally low interest rates.** On balance, I think it's appropriate to be in one's normal stance, perhaps with a modest bias toward defense. Since the rewards for moving further out on the risk curve – such as yield spreads – aren't lavish, I have trouble seeing this as a time to aggressively chase high returns. **Moreover, the surer one is that rates will soon rise meaningfully, the more cautious one should be today.**

Because the primary risk lies in the possibility of rising inflation and the higher interest rates that would bring, I think portfolios have to make allowances: even though we can't predict, we should prepare. This possibility means (a) bonds with maturities much above ten years are obvious candidates for underweighting and (b) inflation beneficiaries should be considered for overweighting, including floating-rate debt, real estate capable of seeing rent increases, and the stocks of companies with the power to pass on price increases and/or the potential for rapid earnings growth.

When it comes to finding decent returns in this environment, the options are slim. Investors have plowed capital into the mainstream public "beta" markets. As a result, prospective returns have come down – fully reflecting the reduction in interest rates – and markets have become quite efficient. In most cases, price has converged with – if not run ahead of – intrinsic value. That means it's harder than ever to outperform, other than by taking on additional risk and being lucky enough to do so in an environment where such action is rewarded.

Although no markets are starved for capital these days, there may be alternative "alpha" markets where investment skill can add to returns, hopefully without a commensurate increase in overall risk. Some of this additional return is simply a premium for bearing illiquidity, and the pain suffered by some institutions during the 2008-09 crisis shows how important it is to correctly assess one's ability to live with illiquidity. And some of the return increment will come from employing managers with alpha, or the ability to add to return without a corresponding increase in risk. However, relying on positive alpha exposes investors to manager risk, or the possibility of hiring managers who turn out to have negative alpha.

This past year challenged many preconceived notions about the economy, markets and policy – and even changed the way we live. But the inescapable truth of investing remains unchanged: there is no magic answer, no solution (other than superior skill) that will enable an investor to earn a high return safely and dependably. And that's especially true in today's low-return world.

* * *

I wish you all the very best in 2021, and everyone at Oaktree looks forward to continuing our work together.

March 4, 2021

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The U.S. High Yield Bond – Broad Composite ("Composite") includes all actual, fully discretionary, fee-paying accounts that focus exclusively on the debt of solvent U.S. and Canadian corporations with an emphasis on senior, cash paying securities rated BB+ to CCC- and are benchmarked to the BB+/CCC- index.

The Oaktree Emerging Markets Equities performance results displayed herein represent the investment performance record for a composite of emerging markets long-only accounts managed by Oaktree. The Composite includes all fully discretionary accounts invested in the Emerging Markets Equity strategy.

The performance information set forth herein contains valuations of investments in companies that have not been fully realized as of December 31, 2020, or as otherwise noted. Oaktree values its investments in accordance with U.S. GAAP. Information regarding the valuation procedures and policies for each Oaktree fund, account or strategy mentioned herein is available upon request. There can be no assurance that any of these valuations will be attained as actual realized returns will depend upon, among other factors, future operating results, the value of the assets and market conditions at the time of disposition, any related transaction costs and the timing and manner of sale, all of which may differ from the assumptions upon which the valuations contained herein are based. Consequently, the actual realized returns may differ materially from the current returns indicated in this communication. Nothing contained herein should be deemed to be a prediction or projection of future performance. For more information or a description of the benchmark presented, please contact your Oaktree representative.

In addition, as noted herein, certain (but not all) of Oaktree's funds have utilized credit facilities (subscription lines), which has the effect of making fund, aggregate fund and composite level gross and net returns higher than the gross and net returns that would have been presented had drawdowns from partners been initially used to acquire the investment(s). There can be no assurance that future funds and strategies will be able to obtain comparable leverage on commercially reasonable terms.

Oaktree Performance

Important information about the statements: "When the markets fell sharply in March, our prior caution allowed 9 of our 14 open-end strategies to avoid part of their benchmarks' declines (before fees)." and "we're happy to report that 10 of the 14 strategies exceeded their benchmarks in the fourth quarter, allowing 9 of them to do so for the full year (all references to returns are before fees)."

The annual performance of the open-end strategies presented below is for the period of 1/1/2020 – 12/31/2020.

As of 12/31/20	Annual Gross Return		Annual Net Return	
Description	**Composite**	**vs. Benchmark**	**Composite**	**vs. Benchmark**
Global High Yield Bond (USD Hedged) Composite.	6.32%	0.76%	5.79%	0.23%
ICE BofA Non-Financial Developed Markets High Yield Constrained (USD Hedged)(1)	5.56		5.56	
Expanded High Yield Bond Composite	7.37	1.77	6.84	1.24
FTSE High-Yield Cash-Pay Capped (Local)(1)	5.60		5.60	
U.S. High Yield Bond - BB-B Composite	7.00	1.88	6.47	1.35
FTSE High-Yield Cash-Pay Capped, All BB/B - rated (Local)	5.12		5.12	
U.S. High Yield Bond - Broad Composite	7.39	1.79	6.85	1.25
FTSE High-Yield Cash-Pay Capped (Local)(1)	5.60		5.60	
European High Yield Bond (EUR Hedged) Composite	3.01	0.76	2.50	0.25
ICE BofA Global Non-Financial HY European Issuers Excluding Russia (EUR Hedged)	2.26		2.26	
U.S. Convertible Securities Composite	35.04	(11.18)	34.38	(11.84)
ICE BofA US Convertible Index (Local)(1)	46.22		46.22	
High Income Convertible Securities Composite	3.87	(2.42)	3.28	(3.01)
FTSE High-Yield Market (Local)	6.29		6.29	
Non-U.S. Convertible Securities (USD Hedged) Composite	15.23	5.89	14.66	5.32
Thomson Reuters Global Focus ex US Convertible Index (USD Hedged)(1)	9.34		9.34	
Global Convertible Securities (USD Hedged) Composite	24.81	1.97	24.20	1.36
Thomson Reuters Global Focus Convertible Index (USD Hedged)	22.84		22.84	
U.S. Senior Loan Composite	1.93	(0.85)	1.42	(1.36)
Credit Suisse Leveraged Loan (Local)	2.78		2.78	
European Senior Loan (EUR Hedged) All-Currency Composite	2.54	0.16	2.02	(0.35)
Credit Suisse Western European Leveraged Loan (EUR Hedged)	2.38		2.38	
Global Credit Composite	3.91	(0.38)	3.24	(1.05)
CUST-GLOBALCREDIT(1)	4.29		4.29	
Emerging Markets Equity (MSCI) Composite	16.56	(1.75)	15.64	(2.67)
MSCI Daily TR Net Emerging (USD Unhedged)	18.31		18.31	
Global Credit Fund-OAR	6.16	5.49	5.74	5.07
ICE BofA 3-Month U.S. Treasury Bill	0.67		0.67	
	Out Performed	**9**	**Out Performed**	**8**
	Total Count	**14**	**Total Count**	**14**

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The performance of the open-end strategies presented below is for the period of 10/1/2020 – 12/31/2020.

As of 12/31/20	Annual Gross Return		Annual Net Return	
Description	**Composite**	**vs. Benchmark**	**Composite**	**vs. Benchmark**
Global High Yield Bond (USD Hedged) Composite.	6.40%	0.13%	6.27%	0.00%
ICE BofA Non-Financial Developed Markets High Yield Constrained (USD Hedged)(1)	6.28		6.28	
Expanded High Yield Bond Composite	6.54	0.27	6.41	0.14
FTSE High-Yield Cash-Pay Capped (Local)(1)	6.27		6.27	
U.S. High Yield Bond - BB-B Composite	5.84	0.21	5.71	0.08
FTSE High-Yield Cash-Pay Capped, All BB/B - rated (Local)	5.63		5.63	
U.S. High Yield Bond - Broad Composite	6.29	0.02	6.16	(0.11)
FTSE High-Yield Cash-Pay Capped (Local)(1)	6.27		6.27	
European High Yield Bond (EUR Hedged) Composite	4.94	(0.36)	4.81	(0.49)
ICE BofA Global Non-Financial HY European Issuers Excluding Russia (EUR Hedged)	5.30		5.30	
U.S. Convertible Securities Composite	15.92	(3.75)	15.78	(3.89)
ICE BofA US Convertible Index (Local)(1)	19.67		19.67	
High Income Convertible Securities Composite	7.10	0.65	6.95	0.50
FTSE High-Yield Market (Local)	6.45		6.45	
Non-U.S. Convertible Securities (USD Hedged) Composite	9.69	2.75	9.56	2.61
Thomson Reuters Global Focus ex US Convertible Index (USD Hedged)(1)	6.95		6.95	
Global Convertible Securities (USD Hedged) Composite	12.86	2.14	12.73	2.00
Thomson Reuters Global Focus Convertible Index (USD Hedged)	10.72		10.72	
U.S. Senior Loan Composite	3.38	(0.26)	3.25	(0.39)
Credit Suisse Leveraged Loan (Local)	3.64		3.64	
European Senior Loan (EUR Hedged) All-Currency Composite	3.44	(0.10)	3.31	(0.23)
Credit Suisse Western European Leveraged Loan (EUR Hedged)	3.54		3.54	
Global Credit Composite	5.91	0.94	5.74	0.77
CUST-GLOBALCREDIT(1)	4.98		4.98	
Emerging Markets Equity (MSCI) Composite	24.67	4.97	24.43	4.74
MSCI Daily TR Net Emerging (USD Unhedged)	19.70		19.70	
Global Credit Fund-OAR	0.88	0.85	0.78	0.75
ICE BofA 3-Month U.S. Treasury Bill	0.03		0.03	
	Out Performed	**10**	**Out Performed**	**8**
	Total Count	**14**	**Total Count**	**14**

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Oaktree Power Opportunities Fund IV – Preqin Record
Important information about the statement: "we believe Power Fund IV's performance makes it the highest returning fund of its size in U.S. private equity history"

The source for this information originates from Preqin, an independent alternative assets data collection and reporting service. Their 12/31/2020 report includes data and return information on Preqin's U.S. Private Equity fund universe starting from 1985 of 126 funds in the $1billion to $1.3billion fund size.

The representative metric is based on the funds' Multiple on Invested Capital ("MOIC")

Fund and Vintage Year	*Net IRR*	*MOIC*	*Date Reported*
*Oaktree Power Opportunities Fund IV (2016)**	*8.12*	*1.32*	*6-30-2020*
- *Fund IV (Source: Oaktree)*	*56*	*4.6*	*1-31-2021*
*OCM/GFI Power Opportunities Fund II (2005)**	*58.80*	*3.66*	*12-31-2020*
*Other Private Equity fund (1987)**	*28.85*	*4.49*	*12-31-2020*

** Source: Preqin 12/31/20 Private Equity Fund Report.*

The 12/31/20 Preqin report does not reflect the current performance data of Power Fund IV. However, based on Oaktree's current data, Power Fund IV's MOIC is 4.6 as of January 31, 2021, reflecting its position as the highest performing U.S. private equity fund based on MOIC.

Further, please note we understand that you appreciate that such performance comparisons are difficult to prepare fairly. Meaningful comparisons require access to accurate data and appropriate consideration of strategy, vintage and leverage (in addition to myriad other factors). Unfortunately, we don't always have access to all of the requisite data of our competitors. Thus, while we are sharing this data that we rely upon internally, we want to be sure you understand the limits of our analysis.

As the Preqin database purports to report accurate performance data (though we are obviously not in a position to verify the data they report). The analysis provided herein is derived from that data. Needless to say, our analysis is inherently subjective. Among other things, you might question whether we have appropriately selected our competitors. Due to the limitations of the data we cannot guarantee that the competitive analysis or the investment universe provided herein is fully comparable. Moreover, we are subject to the limitations of the underlying data, which does not always include IRR or other information that might be meaningful to a competitive assessment. In addition, the information presented also does not disclose the investment objectives, risks, fees, or tax features of the peer funds included in the comparison universe, all of which is relevant information for a full comparison. Nevertheless, it is our best attempt to compare our performance and we make it available to you in that spirit and in the hope that you will find it helpful.

Calculation of Assets Under Management
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