

35 Years of Memos

Harry Whitelaw

Hello and welcome to a special Oaktree podcast. We're delighted to once again take you inside the Oaktree office, this time live from New York for a fireside chat with Howard Marks, moderated by me, Harry Whitelaw, in celebration of the 35th anniversary of his famous memos. We hope you enjoy listening in.

We'll welcome everyone, both here in New York and around the world, for this very special fireside chat with Howard Marks, a man whose accomplishments make him difficult to introduce adequately. We know Howard as a legendary credit investor, an Endeavor in which he has a few peers, not many, but a few. We know him as the co-founder of a leading alternative asset manager. Again, an Endeavor with a few peers out there. Not many, but a few. We also know him as the writer of an extraordinary body of literature that has transcended our industry, The Memos. In this Endeavor, he has no peers at all. No comparables. He stands in a group of one.

The Memos are an institution read by everyone from budding finance students to the most erudite practitioners in our industry, including one Mr. Warren Buffett. They chart the most impactful financial events of our lives, but perhaps more importantly, they chart Howard's investment philosophy. This October, we celebrate 35 years of them. To mark the occasion, we'll be releasing a complete digital anthology of all Howard's memos and a special greatest hits edition. Painstakingly, whittled down by Howard and I over the last few weeks.

Howard, great to be with you today.

Howard Marks

Thank you, Harry. Great to be here. Thank you for doing this.

Harry

Well, we better start in 1990, the year of the first memo. What were you doing at the time and why put finger to typewriter for the first time?

Howard

Well, I guess I was roughly half my age and still working at TCW. The memos did not come from some grand plan or decision to have a series of memos, but rather just from an interesting event or the juxtaposition of two interesting events that occurred in 1990 and that I thought illuminated our approach and the clients would like to know about.

Harry

So design for clients, but an early decision to focus on clarity rather than the jargon and numbers perhaps commonplace with most financial literature.

Howard

Well, that was never a conscious decision on my part. I never thought of the alternative. I always try to write the way I speak, and that's all I did, I just wrote it down. And I think things are more readable if they're casual, casual rather than intimidating or erudite. To me that's important. And the greatest notes I get from readers, and I'm happy to say a theme, is they say, "You made something complex simple." And when they say that, I feel like mission accomplished because that's what I'd like to do.

Harry

Clarity at the forefront. If you've ever had your work marked by Howard, the best response is very clear, HM. Nothing else.

Howard

You ever get that?

Harry

Not yet. Not yet. Not yet. And this might come as a surprise, right? You did not get a response for quite a long time from that first memo.

Howard

10 years. Of course, this was in the days before electronic communications. So we would print them out, fold them up, put them in an envelope, put an address on, put a stamp on, throw them in the mailbox. And for people to respond, first of all, it went to small numbers. If it started in 1990 with our actual clients, it might've been 100, or probably less. But even then, for people to actually respond, they would have to either actively pick up the phone or actively write out a note and went through that process of addressing and stamping and mailing.

And so I never had a response. Not only did nobody ever say it was good, but nobody even said, "I got it." But yet I kept doing it. Obviously, I think I was doing it because I enjoyed it, and I've always found it a creative outlet, almost an artistic outlet, and I just love the process. And I'd do my first draft, and then I'd refine it, and I just, I love the process.

Harry

We iterate. We always do.

Howard

Right.

Harry

And it was Bubble.com that broke the Deadlock, right?

Howard

Yeah.

Harry

That was written in January 2000.

Howard

Yeah.

Harry

I'll read your closing remark. "To say technology, internet and telecommunication stocks are too high, and about decline is comparable today to standing in front of a freight train. To say they've benefited from a boom of colossal proportions and should be examined very skeptically is something I feel I owe you."

Two months later, the bubble began to deflate, one of the biggest wealth destruction events in history. Take us back to experience of writing that memo and going against a market that was pure exuberance at the time, right?

Howard

Well, the idea came in the fall of '99 when I was reading a book called Devil Take the Hindmost: A History of Financial Speculation by Edward Chancellor. And it talked about past bubbles, and it talked about, in particular about the South Sea bubble in which the British government granted an exclusive license to something called the South Sea Company for trade with what I think turned out to be South America. And sounding familiar to today, the government had a deficit and they had trouble meeting the deficit and funding it. And so they figured they'd make a lot of money if they created the South Sea Company. And people thought it was a get-rich- quick scheme, and so they jumped on board and they traded it.

But as I read the book, I saw things going on and I said, "This is what's happening today." People were leaving their jobs to trade in the stock of the South Sea Company and so forth, and people were quitting their jobs in '99 to day trade in the tech stocks. It felt exactly the same. So I turned a skeptical eye toward what was going on, what was called the TMT bubble, tech, media, telecom, but it was really the internet bubble and the e-commerce bubble. And everybody said, "Well, the Internet's going to change the world, and as a consequence, any internet stock is worth infinity." we looked today and we see that the internet certainly has changed the world, we can't imagine a world without the internet, and yet I think the vast majority of the stocks from that time are worthless. So it's a cautionary tale.

But anyway, that caused me to write the memo. And as the last paragraph, which you read, indicates I make these statements with considerable trepidation. As I said, standing in front of a freight train, and the market's roaring ahead and you say it's irrational and it's not going to last. If you don't have some fear when you do that, there's something wrong with you.

Harry

We have to accept being wrong for a few months, a few years perhaps.

Howard

Yeah, but that doesn't mean you have to be happy with the idea. There's an old saying that, I think the first of the greatest sayings that I learned in the early seventies was that being too far ahead of your time is indistinguishable from being wrong. If you say something's going, doesn't happen for three or four years, you're wrong. Now, it may happen after six or eight years, and if anybody's still alive or if you're alive, they may say, "Well, yes, I guess he was right." But you have to be willing to be wrong and to look wrong for a long time.

Harry

Well, this one got attention because it was proved right pretty quickly. But also, I think it's your definition of a bubble, one based on investor psychology rather than spreads, p/e numbers, I mean, for most people out there, a p/e ratio of 50 means nothing, a spread of 200 means nothing. But you say, instead, "Look around, you spot the sentiment," and that's something that resonates with everyone.

Howard

And as you have mentioned, Harry, that emphasis on investor psychology is one of the primary threads that has run through the memos in the last 35 years. Because I think it's the thing that the layman has the hardest time understanding the role of psychology. They think it's about numbers and dollars and financial statements and things. But in the shortest run, it's not. Ben Graham, who was Warren Buffett's teacher, said that in the long run, the market is a weighing machine, it figures out what things are worth. But in the short run, it's a voting machine and it just reaches the conclusion about what's popular.

Harry

So bubble.com put the memos on the map, the next big crisis, seven or eight years later, the global financial crisis, again, I'll read an excerpt from quite a timely memo Race to the Bottom, written in February 2007. When I was reading back through this, I realized it's actually Valentine's Day 2007.

Howard

Well, that's what Nancy got for Valentine's.

Harry

Yeah. So this is February the 14th, 2007. Investors are readily accepting significant risk in the form of heightened leverage, untested derivatives, and weak deal structures. Five, six months later, we know what happened next. You're warning in the years up to the crash, but actually what's interesting is when the crash happens, you say, "Actually, maybe we're too negative now. Maybe now we go out and buy." Your memos flip in turn, and that was your message at Oaktree as well. Maybe this is a buying opportunity now.

Howard

Well, if one of the most important common threads in the markets is that people make mistakes at the extremes, they get too excited when things go well and too depressed, when things go poorly, then it's very important to be a contrarian at the extremes. And I think somehow or other it comes naturally to me. Somehow it just seems to me, I kind of tend to think of investing as jujitsu, where you use the force of your enemy against it. And if the enemy, which is to say the rest of investors are applying excessive force, optimistically, then we let that happen. And we sell them things at prices they shouldn't pay, but that we're happy to receive, and so forth. So I think this contra aspect is a very important component of dealing with the psychology.

Harry

And what was your message internally at Oaktree at the time?

Howard

Well, I think it was the same. Actually, I recently came across, on Monday, I came across a treasure trove of internal memos from that period. And I basically sent one out in '08, after the bankruptcy of Lehman where when people were predicting that meltdown of the financial sector saying, "We're okay, don't worry. It's scary, but we're in better shape than most."

Harry

And your punchline was, if it really is as bad as everybody thinks, the world is over anyway and it doesn't matter. And well, why not buy then?

Howard

But if the world doesn't end and we didn't buy, then we missed the chance.

Harry

We'd regret it.

Howard

We didn't do our job.

Harry

So these crises naturally punctuate your writings, but if there's one concept that underpins most is risk. Did you set out thinking, "Every memo should focus on risk, I should be the expert?" Or is it just natural the way it comes?

Howard

No, I think, Harry, that the themes, common threads that have developed, were never an intention to, "Let's mention risk in every third memo," or something like that. It's just that I think risk is the most important thing. In my book, *The Most Important Thing*, there are three chapters out of 20 dedicated to risk. The most important thing is understanding risk, recognizing risk, and managing risk.

And I think that it's the ability to manage risk that separates the excellent investor from the rest. It's not hard to make money, that's especially true when the market goes up and the market goes up seven or eight years out of every 10 or more. So making money isn't a challenge. Making it with the risks under control so that when the bad times come, you don't get carried out, that's an accomplishment. And so we've always had an emphasis on that. It's always been tenet number one in Oaktree's investment philosophy. It still is something that I think distinguishes us.

Harry

You're proud of the way we've embodied that over the last 30 years.

Howard

Yeah. And I would say that we're not risk mongers, and so we don't really shoot the lights out in boom times. But I think our best relative performance, compared to our competitors and the markets has come in the bad times. And lastly, let me say, you can't maintain a certain posture and then, in a timely manner, switch to a defensive posture and just be right when the stuff hits the fan. You have to have defense embodied in everything you do, and to be able to embody defense at the same time you're trying to make money if things go well. That to me is the accomplishment.

Harry

So following the financial crisis, we had this fairly odd period where debt was cheap, defaults were low, a frustrating period for Oaktree in many ways. Did that make it harder to write?

Howard

And we largely take advantage of other people's mistakes. People, they do buyouts and they pile a company on with more debt than it can support in a bad period. And so the debt crashes and we're contrarian enough to buy it up when it gets cheap enough and make money. It's all being contrarian, but of course being contrarian is not enough. You have to be right. You have to do it at the right time with regard to the right things, and that's what we're all about, and the memos are all about talking about those opportunities.

When the economy's doing well and the market is rising and everybody's sanguine and nobody's distressed and nobody feels any urgency to unload their positions and everybody thinks that if they just hold it another week, they'll make some more money, then how is the opportunist supposed to get a great bargain? The answer is, you can't. And there are times when we can't excel, and sometimes they'll last a long time, like from 2010 to 2019. You know, the economy rose gradually, but for a long time. The markets rose gradually, but for a long time. Financing was readily available. Troubled companies weren't tested. Over levered companies weren't tested. And so we had relatively little to do. And you have to be able to sit on your hands. And, as Buffett says, you got to be able to stand at the plate with the bat in your hands and not swing until you get a good pitch. And sometimes you have to wait a long time for a good pitch.

Harry

We waited, and then Covid happened. And this was the ultimate illustration of uncertainty, which you've written so much about. I have a quote from Uncertainty I, not Uncertainty II for anybody who might get them confused. This is May 2020. And you wrote, "A much needed reminder amid the chaos of the pandemic. To put it simply, intellectual humility means saying, I'm not sure the other person could be right, or even I might be wrong. I think it's an essential trait for investors. I know it is. And the people I like to associate with." Intellectual humility.

Howard

Well, I mean, again, look, people who are a hundred percent sure that they're right are not that much fun to be around. And I think they're often wrong. You know? And one of my favorite quotes is from Mark Twain who said, "It ain't what you don't know that gets you into trouble. It's what you know for certain that just ain't true." And if you have a strongly held belief and you bet heavily on it and it turns out to be wrong, that's how you get into trouble. No sentence that starts with, I could be wrong, but, or I don't know, but, ever got anybody into big trouble. So I think that intellectual humility is a very important thing.

And no one is diminished by saying, I don't know. I think that when you are in an important meeting and you say, I don't know, I think people think more highly of you, not less. And they know that your ego is in check and your mentality is strong, and maybe you'll come to right answers. There are certain threads that run through them. One is humility with regard to knowledge of the future. And I wrote a memo 25 years ago, plus or minus, called Us and Them talking about there are two schools of thought. The I Know School and the I Don't Know School, and which one do you want to be a member of? And the I Know School certainly sounds more self-assured and is more likely to take bold action, which if blessed with good luck ends up on the front page. But those actions, if bold enough and poorly timed enough, will get you carried out and you don't hear from those people again.

And that leads to another of my sayings. "Never forget the person who was six foot tall who drowned crossing the stream that was five feet deep on average." And, you know, if you say, I'm six feet tall, the streams five feet deep, fine. And you go about crossing it cavalierly. If you get to a low spot, you might drown. And if companies lever up and take on too much debt because using debt magnifies their profitability in the good times, they might get to a spot in the stream where they can't get through with all those rocks in their backpack, all that debt, and they get carried out.

Harry

Is there a surefire way for the, I Don't Know school to generate alpha? They need skill and efficiency. It's not easy. Right?

Howard

No. It's not, there's no surefire way of anything, because I can tell you, you have to do this and this and this and this and this, and you can do those things, but there's no substitute for the fact that you have to do them well. You have to do them better than anybody else. If you do things and everybody else does them equally well, you're not going to outperform. That's obvious. And so you can approach these decisions with a good framework for thought, but in the end you have to execute them with superior insight.

So when Columbia asked me for the first chapter of my book, The Most Important Thing, for some reason, I sat down and wrote out a chapter I had never thought about, which is called Second Level Thinking, which says that if you're going to outperform others, you have to outthink others, it's pretty obvious that if you're going to outperform them, you can't think the same. You have to think different. But just thinking different isn't enough. You have to think different and better. And since we practice intellectual humility, we know that the people we're competing against aren't stupid. So the task of thinking different and better is a daunting task, but it's the only thing you can do if you want to be superior in your performance. So you have to take on that task, or as Taleb would say, become a dentist.

Harry

I think it's confounded as well, particularly in judging performance by one of your other big beliefs that you can't judge the quality of a decision from its outcome. What might look like a great performance result, you have to ask, how did you get there? And that makes it tricky, I guess, from the allocator side, from people trying to judge different managers trying to see if they really did have alpha. You can't necessarily trust that outcome. You need to look at the process.

Howard

Well, part of intellectual humility is awareness of the role of luck. You see? And you might get very excited because you've recently made five decisions properly, but you might. Then you should say, well, just a minute. I was right, but did I make the decision for reasons that turned out to be right? Or did I make it for wrong reasons and get lucky? Or was it a random event that nobody could have figured out in advance and it just happened to go my way? So the person who is not intellectually humble takes full credit for all of his successes and finds it very easy to dismiss all the failures.

Well, that was just bad luck. It wasn't my fault. You know, I didn't make a bad decision. I just got hit with the unlucky stick. But you have to understand the limits on intellect, the limits on foreknowledge, how hard it is to really be smarter than others. And yet, if we're not, in some way, it's an oversimplified term, but in some way, if we're not smarter than others, we're not going to outperform because we buy the things they want to sell us. And we have to be the ones who are right in buying. They have to be the ones who are wrong in selling. If it's the other way around, we're in trouble.

Harry

It's a zero-sum game. Somebody has to make a mistake.

Howard

Right. It's zero mistake sum game. But so in the long run, we have to think better. And, you know, this hearkens to the book, Fooled by Randomness, which is an important one by Taleb, who I mentioned it a couple of minutes ago. You have to understand the role of luck. You have to understand the illegitimacy of short-term performance records because anything can happen in the short run in fields that are affected by randomness like we are.

Harry

And you're quite open. You've done pretty well. Would you say luck has played a role in it?

Howard

Oh. Absolutely. Sure. I mean, I was just talking with somebody earlier this week about my, I was going to say career decisions, but my first few career steps were not the result of decisions on my part. Somebody else made decisions that affected me, and they worked out well.

Harry

Go and see what high yield bonds are.

Howard

Go and see what, if you can figure out what a high yield bond is. Yeah. Or the fact that I applied for a job, which probably would've been a bad job, but I didn't get it because the partner in charge of the firm called my apartment, but gave the job to my roommate. I thought that was bad luck at the time, but it turns out to have been good luck.

Harry

Did the roommate do okay?

Howard

Okay.

Harry

Okay. Well, that's something then. The 2020 pandemic year was your most productive year, writing away. How was that experience for you?

Howard

Well, number one, we didn't have anything else to do, couldn't go out of the house, couldn't go to the movies, couldn't go out to a restaurant. Number two, things were coming out at fast and furious. And if you have your, as my mother used to say, if you have your thinking cap turned on, what could be more stimulating than to go through an experience which is unprecedented?

You know, there was no precedent in our lifetimes in over 100 years for the pandemic, and there was one in 1917, but everything was different then. There was no electronic this or the mechanical that. So there was no communication, transportation, and certainly no investing as we know it. So figuring out what the developments in the world meant and what we should do about them was fascinating and figuring out what we knew and what we didn't know.

Harry

I was going to say, the discourse at the time must have been quite annoying for you. There was an awful lot of speculation based on not much evidence. It was people forecasting with variables. The variables probably weren't even right they were putting into their models to forecast.

Howard

Right. Well, and not only was the data wrong, but they probably were asking about the wrong parameters. But in my first memo in the pandemic in very early March of '20, I was fortunate to quote a epidemiologist from Harvard named Lipsitch who said that normally when we make decisions, we have three things. We have past data. We have analogous past experiences. And we have supposition. But in that case, we didn't have any data, and we didn't have any analogous prior experiences. All we had was supposition. This epitomized the decision-making challenge because you have to make decisions, but you have little to base them on.

So you have to figure out, if I do this, could it go well? Could it do poorly? If it goes well, what could I make? If it goes poorly, what could I lose? Those kinds of things. And we make our decisions by extrapolating past patterns, there was no past pattern in this case, and assigning probabilities to the outcomes. We had no basis on which to do that, but we had to do something. So I think that the key is to not be among the people who exaggerate the situation and panic. Well, you have to assert reason even if there's limit basis on which to do so, rather than let your emotions take over.

Harry

So as we left the pandemic, we met an old enemy, inflation, and we had the interest rate increases we've been waiting for a while. You set the tone with Sea Change, which was huge a few years ago. I will read an analogy of the moving walkway, which I'm sure you remember. You wrote that, "Investors over the last 40 years were on a moving walkway carried along by declining interest rates. The results have been great, but I doubt many people fully understand where they came from. It seems to me that a significant portion of all the money investors made over this period resulted from the tailwind generated by the massive drop in interest rates. I consider it nearly impossible to overstate the influence of declining rates over the last four decades." You wrote that a few years ago, but it's fair to say we're still adjusting to that paradigm.

Howard

Yeah. Basically what I said is that if you came into this business after 1980, which is almost everybody today, and all you've seen is either declining interest rates or ultra-low interest rates or both. And when people, human nature is that when you live through a period, people tend to think that's normal and extrapolate it into the future. And all I said in December of '22 was that the Fed had taken the fed funds rate from zero to five and a quarter, five and a half, and that we weren't going back to zero or to a half or to one.

And that that's not normal. And normal is rates are stable-ish with variation in the mid-single digits. Now that's a simple statement, but so different from the prevailing history. Declining interest rates are good for asset values, declining interest rates reduce the cost of capital. So people who use borrowed money to buy assets got a double bonanza, strategies like private equity were invented during that period. So it shouldn't come as a surprise that they worked very well. But if the environment's going to be different, maybe different things will work better. I've been thinking lately about what is the decision, what is the error that investors commit the most often and in the biggest way with the most detrimental effect? And I think the answer is they believe that the things that are going on will always go on and they extrapolate to infinity as opposed to expecting regression toward the mean.

Harry

You just change your posture for a different environment.

Howard

Yeah. Well, Einstein said, "The definition of insanity is doing the same thing over and over again and expecting a different result." But I said that another definition of insanity is doing the same thing in a new environment and expecting the same result. And one thing we should know as investor is that the environment in which you act will determine the success of your actions. That's a fancy way of saying that if you buy when prices are low, you'll probably make money. But if you buy when prices are high, you will have a more difficult time doing so. You have to understand, and I wrote a memo once called, "It is what it is." And the one thing we have to do as investors and as people is we have to accept the world we're living in as a given. And the investor can't say, "I don't like today's environment because everybody is sanguine, which means there are no bargains. I want bargains." Well, you can't demand a different environment. It is what it is.

Harry

You just take more risk would be your option.

Howard

Well, you could take more risk, but if taking more risk in a sanguine environment when prospective returns are low, I don't recommend.

Harry

So post-sea change environment, credit more of a role in the portfolio than it was for that 2009 to '21?

Howard

Yeah. Well, at the beginning of '09, the Fed took the fed funds rate to zero to battle the global financial crisis. And at the end of '21, they gave up on inflation being transitory and started to raise the rate in '22. And from the beginning of '09 to the end of '21, 13 year period, the Fed funds rate was zero most of the time and averaged about a half a percent. And it was a very tough time for lenders and Oaktree, that's what we do. We're basically lenders. And so if you go back three and a half years to the beginning of '22, high yield bonds yielded four. And that's not a very big number. So our strategies were not that helpful to them. And we went through a very quiet period. And the other thing we do is we take advantage of other people's unease when they want to get out of their positions.

Nobody was uneasy. Everybody was comfortable in sanguine and confident that if they held they would make money. So for 7, 8, 9 years, I would title my regular speech, "Investing in a Low Return World." We were in a low return world, how do you make good returns in a low return world? And the answer is it can't be easy. And one of your choices is to do what you suggested, which is raise your risk. But everything is offering very low returns, even risky things. They may be higher than the safe things, but their perspective returns are anemic. That's not the time to do those things. You have to sit on your hands, you have to be patient.

Harry

Bring us up to the present day, your most recent memo, Calculus of Value, new thinking on the relationship between price and value and the magnetic influence we see over time. Relevant perhaps as we look at equity valuations today, which are pretty frothy.

Howard

Well, I'd say they seem pretty frothy. But I mean we look at valuations and we use numbers and we look at the main valuation in the equity businesses, the p/e ratio, the ratio of the price of a stock to the earnings of the company, which are attributable to each share of the stock. You take all the earnings divided by the number shares, you get the earnings per share. You look at the price as a multiple of that, and you say whether that stock is cheap, priced high or low relative to history, relative to peers and so forth. And right now the p/e ratio on the S&P is probably 24. And the p/e ratio historically has been about two-thirds of that.

So you'd have to say, "Looks expensive. Is it really expensive? Well, have the companies improved? Are the companies better? If the companies are better, then maybe 24 isn't too high." But the trouble is that in frothy times people always say the companies are better. Every bubble, if we want to use that word, is created when people say, "This time it's different. This time the companies are better." And so the old value, yes, it looks like they're selling at high valuations, but the history is irrelevant because the companies are so much better now.

Harry

This time it's different.

Howard

This time it's different. It's a great way to get into trouble.

Harry

What response did you hope to elicit with the memos as we look back at 35 years of them?

Howard

I guess if I can be perfectly honest, what I want people to say is, “Hey, that guy’s pretty smart.” And I want them to say, “You know, I never thought of it that way.” If I can get people to say that they looked at something differently and maybe my way of looking at it holds water than I’ve been successful.

Harry

Do you have a final remark before we finish for today?

Howard

I’ll just say that I’m going to keep writing and if people will continue to read and continue to give me the benefit of their responses, I’ll keep going.

Harry

Great place to end. Thank you very much, Howard.