

Memo to: Oaktree Clients Only

From: Howard Marks

Re: An Update

Oaktree's biennial client conferences, scheduled for this week in Los Angeles and next week in London, were cancelled last week. While we regret having to cancel – as well as the factors that required us to do so – we were glad to do what we could to communicate by livestreaming the most important content to clients. We had 900 registrants for the livestream, as opposed to the total of 500 who had signed up for the two in-person sessions.

A few weeks ago, I had a slide presentation all ready to go for the conference. It described a complacent, risky, low-return world (again) and urged caution (again). In the last three weeks, its relevance went straight out the window. Thus last weekend I roughed out some new remarks for the conference. I went through them at the livestreamed session on Wednesday, and I want to share them with you now.

Since I had to create these remarks on the fly, I used as a foundation my memo of last Tuesday, "[Nobody Knows II](#)." Thus I repeat some of that memo's content, meaning if you read this, you'll find a lot you already know. Still, I hope you'll find the new material helpful and the old not unduly repetitive.

* * *

Here's how I opened the agenda:

Coronavirus isn't the only thing in the world, but right now it's certainly monopolizing attention.

The title of my memo last week was "Nobody Knows," and it noted that the "the veteran will just have a better guess." Both those points are no less true today. Anything I say will be a guess, and, with respect to coronavirus, I think that holds true for all non-scientists.

Here are the many areas of uncertainty:

- How many people will contract it?
 - Epidemiologists' estimates range up to 40-70% of the world's adult population.
 - There are over 100,000 confirmed cases in the world.
 - There are more than 1,000 diagnosed cases in the U.S. (On Wednesday, as we were livestreaming, the World Health Organization declared this a pandemic.)
 - **One reason for the low number in the U.S. is the lack of testing to identify cases. Thus going forward we should expect both (a) exponential spread and (b) a strong rise in reported cases as a result of increased testing.**

- **The keys to slowing the rate of spread lie in (a) testing to find out who's sick and (b) discouraging social interaction.**
 - The good news is that fear of the disease causes people to avoid contact, and thus it's the key to limiting the spread. Yesterday I listened to a podcast explaining exponential spread. It said, "If people are sufficiently worried, there's a lot less to worry about. But if no one is worried, that's when you should worry." That's a lot like what I say about investment risk: "The riskiest thing in the world is the belief that there's no risk." Fortunately few people believe that today.
 - The level of alarm among investors is high: on the bad days, I might say "panic," although that word connotes irrationality, which I can't say is the case. Perhaps investors fear, for example, that there will be 100,000 U.S. cases. That's nearly as many as there are currently in the whole world, and it sounds like a big number versus today's 1,000-plus.
 - But the U.S. certainly hasn't taken extreme measures to contain it like China did. And we certainly can't say we're above average in preparedness. Thus the market reflects a high level of alarm, but I wouldn't say it's a "worst-case" scenario.
- Will it recede?
 - According to the reported data, new cases in China have declined substantially, from 9 out of 13 days in the first half of February with more than 3,000 new cases a day, to 8 out of 9 days with less than 500 new cases a day at the end of the month.
 - How much of this is a function of China's restriction of people's movement? If that's been a very important component, we're unlikely to emulate it.
 - A view has been expressed that the virus will dry up when the weather turns warm, as happens with other flus. That obviously is the best case and the best source of short-term optimism. In that event the market would be likely to spring back. Certainly nobody knows. Note, however, that the virus has taken hold in countries where it's currently summer.
 - What will the effect of the virus be?
 - To date, only 20% of those contracting the virus have experienced more than something that feels like a cold or regular flu.
 - The bad outcomes are clustered among the elderly and compromised. Women appear to do better than men.
 - The fatality rate has been about 3% of those infected.
 - Given the availability of good treatment in the U.S., our fatality rate might be lower, but most observers believe that even our health system will become overburdened.
 - There is no cure for the disease. We can only treat the symptoms and nurse people back to health.
 - Obviously, the development of a vaccine would be an incredible boon, but it's said to be 12-18 months off.
 - **Overall, I think the news about the disease seems certain to get worse. The key questions are how the news will compare against the expectations factored into security prices, and whether and when we'll get the virus under control.**

- What will be the effect on the U.S. economy?
 - Less shopping, travel, hotel stays, restaurant meals, attendance at events.
 - Supply chain disruption.
 - Reduced productivity from workers who stay home.
 - Negative wealth effect and downcast “animal spirits,” leading to self-fulfilling pessimism.
 - Difficulty borrowing money and issuing securities.
 - I’ve seen projections that “GDP growth will be halved.” That sounds Draconian, but it still suggests that 2020 will be better than 2019 – right now that seems like an optimistic expectation.
 - Impact on other countries’ economies: they’re in worse shape than ours.
- How will the market react? – **Since the market’s reaction ultimately will be a function of both economics and emotion, it’s impossible to quantify how far it’ll go.**
- Finally, the oil price decline has been described as “another problem,” adding to the panic. But is it? I view oil price changes as something of a zero-sum game. Clearly it’ll hurt oil companies and producing countries, and it may bring losses to banks and investors who backed drillers. But it’ll be a boon to consumers, oil-consuming industries and oil-importing countries.

Certainly the 29% decline of the S&P 500 thus far is very powerful. It may well have further to go – especially on the back of bad news. But 50-60% or so is the rough range of what we’ve seen in most past busts – and many of those were from highly inflated bubbles, which I don’t think was the case before the virus struck. The decline thus far suggests that the stock market may have gone a good part of the way – perhaps halfway – toward past crashes. **Or perhaps this bust will exceed what we’ve seen in the past.**

Bigger-Picture Observations

As I observed in my recent memo, in the real world, things generally fluctuate between “pretty good” and “not so hot,” but in the world of investing, perception often swings from “flawless” to “hopeless.” That certainly has happened now. I can’t say the swing is unjustified or excessive, but I believe I can say optimism is gone and pessimism is everywhere.

The recent events call to mind a memo of mine from 2001 called “[You Can’t Predict. You Can Prepare.](#)” The bottom line is that just because you can’t predict the future doesn’t mean you can’t do something about it. This may sound illogical, but it’s not.

In my July 2007 memo “[It’s All Good](#),” on the doorstep of the Global Financial Crisis, I asked “what could cause this upward cycle to falter?” I can tell you, the list didn’t include sub-prime mortgages. But importantly, the fifth and final item on the list was “the things I haven’t thought of.”

That’s the point. Just because you can’t pinpoint a potential catalyst doesn’t mean you don’t have to worry about one.

- First, the catalyst for a recession or correction isn't always foreseeable.
- Second, it can seemingly appear out of thin air, as this virus did.
- And third, the negative effect of a catalyst is greater when it collides with a market that reflects so much optimism that it's "priced for perfection."

So, often we can't tell when a catalyst will arrive. But you can tell:

- when things have gone well for a long time;
- when economic expansions and bull markets are advanced;
- when valuations are full or excessive;
- when risk taking is prevalent;
- when risk aversion and prudence are scarce;
- when standards for security issuance and lending have declined;
- when people are more afraid of missing out than they are of losing money; and
- when there's too much money chasing too few deals.

Taking note of these things can allow you to prepare for a possible catalyst, even if we can't predict what it will be and when it will hit.

Three, five, ten, and even 18 months ago, everybody said: "Things are looking great, the U.S. economy is the best in the world, and people have no alternative but to invest in risk assets because they can't buy safe investments with their paltry returns." Most people thought the macro outlook was uniformly favorable, and they had trouble thinking of a possible negative catalyst with a serious likelihood of materializing.

When the market is optimistic, we never know where it's going to go. It could become more optimistic, or it could become less optimistic. But we might suspect that the possibility of gains from further increases in optimism doesn't justify the potential risk of the market swinging from optimistic to pessimistic. If sentiment swings from optimistic to pessimistic, you get declines like the one we've had in the last three weeks. (Today it might seem impossible, but of course the opposite can be true when sentiment swings from pessimistic to optimistic.)

In recent years, we at Oaktree thought the cons in the environment, combined with elevated asset prices and a prolonged bull market, meant one should emphasize defense over offense. Thus, in recent years, Oaktree's mantra has been "move forward, but with caution." We believed things weren't high enough or crazy enough to call for disinvesting, but they did call for more caution than usual.

We'll find out if it helped. Just like greed on the upside, fear and panic on the downside prevent investors from making fine distinctions between individual securities: they paint with a broad brush and "throw the baby out with the bathwater." There's an old saying, "In times of panic, all correlations go to one." Thus it may take a while for our portfolio management to be rewarded. We'll see.

Now it happens this catalyst is one we know particularly little about. We have no idea what will happen in terms of the virus or its effect on the economy or the market.

Two possibilities constitute the extremes. Number one: We bounce back and everything goes back to normal, in which case most stocks will do okay. The point is that there can be good news, and there can be a rebound. Maybe the disease has a natural decline curve, as we've seen in China; maybe it'll be the arrival of warm weather; maybe our measures to prevent contagion will be successful; or maybe an effective vaccine will be created.

It's also possible that, tangible events aside, the bad news is well understood, universally embraced and on the way to being appropriately reflected in market prices. Relaxation of the adverse reaction could thus lead to market improvement. That's all possible good news.

Or, number two: The world is fundamentally and permanently changed, and people alter their behavior, meaning we don't go back to business as usual. There's almost certain to be bad news ahead about the increase in cases. No one knows how the numbers will grow, how long it will go on, or what the ultimate impact on investors' psychology will be.

And then there's the middle case: things are significantly disrupted for a while – presumably at least some weeks or months – and then things go back more or less to normal. But in the meantime, any number of businesses will have suffered serious losses – creating investment opportunities – to say nothing of the human impacts that may occur (both due to illness and economic disruption). In other words, this could go on for a while and be significantly impactful, even if it doesn't permanently change life as we know it.

A few things to remember:

In "Nobody Knows II," I listed an "elite group of stress episodes," ranging from LTCM (1998), to the World Trade Center attack (2001), to the accounting scandals at places like Enron (2002), to the Global Financial Crisis in (2008-2009) to some more recent, smaller ones. Every one of them was gut-wrenching. But all were followed by recoveries that produced significant gains for stalwart investors.

You will read a lot about past events that are possible models for this one. Just the other day, I came across an account suggesting that one particular past episode is comparable to today's developments. **But whereas we all look for patterns and analogies to help us get a handle on our environment, it's essential to remember that (a) history doesn't repeat, meaning past events are of limited relevance, and (b) a sample of one from the past is of almost no help.**

The market drop following 9/11 has been nominated as analogous. But that was a one-day event; we feared more, but it didn't materialize. The bear market that accompanied the Global Financial Crisis may be a better model, since the downward spiral lasted a good while. But no historic event tells you what this one will do: neither of those events threatened life to the extent this one does.

The Fed

The Fed's 50-basis-point rate cut last week may or may not be enough to stem the tide. But investors probably infer from Powell's "we will use our tools and act as appropriate" language that the Fed will "do what it takes." And while the Fed will work on countering the effects of the virus, I worry about what it does after that.

The normal program of rate cuts covers roughly 500 basis points. That's not a very encouraging notion when we consider the fact that the short-term rate now stands at 100 basis points. So the one thing we know is that the Fed doesn't have room for a normal regime of rate-cutting (there's uniform insistence that it won't cut into negative territory). Stimulus is a good idea today, but most of it will have to come from something other than rate cuts.

The Fed/government's tools for fighting the economic impact of coronavirus are very limited. Thus I believe it's undesirable to be highly sanguine about their powers at this juncture.

And, importantly, financial actions can only try to ameliorate the economic ramifications. This is a healthcare crisis, not a financial crisis. The solution will have to come from successful actions in the arena of public health.

What to Do?

These days, people have been asking me whether this is *the time* to buy. My answer is more nuanced: it's probably *a time* to buy. There can be no unique time to buy that we can identify. The only thing we can be sure of today is that stock prices, for example, are a lot lower in the absolute than they were two weeks ago.

Will asset prices decline in the coming days, weeks and months? This is the wrong question to ask . . . primarily because it's entirely unanswerable. Since we don't have answers to the questions I asked at the beginning of this memo, there's no way to decide intelligently what the markets will do. We know the stock market has declined by 29% in 15 trading days. There can be absolutely no basis on which to conclude that it won't lose another 29% in the weeks ahead – or that it will – since the answer will be determined by unpredictable events and swings in psychology.

Instead, intelligent investing has to be based – as always – on the relationship between price and value. In other words, not “will the collapse go further?” But rather “has the collapse to date caused securities to be priced right; or are they overpriced given the fundamentals; or have they become cheap?”

I still believe investing on the basis of value is the most reliable way to invest for the long term.

On the other hand, it's the thrust of this whole discussion that nothing provides a reliable handle on the short-term future.

After we've learned more about the coronavirus and developed a vaccine, it seems to me that it's unlikely to fundamentally and permanently change life, make the world of the future unrecognizable, decimate all businesses or make valuing them impossible. (Yes, this is a guess: we have to make some of them.)

Buy, sell or hold? I think it's okay to do some buying, because things are cheaper. But there's no logical argument for spending all of your cash, given that we have no idea how negative future events will be.

I'm not saying we're at the bottom. No one can tell you that asset prices aren't going to go down – now or ever. But I think the opportunity to buy at today's reduced prices compensates

somewhat for the risk of further declines. I can assure you we'll be putting money to work when we find assets we like that are selling at suitably low prices. It's our job to judge when that is.

As I said in "Nobody Knows II," if you spend some of your cash now, stocks may turn around and head north, and you'll be glad you bought some. Or they may continue down, in which case you'll have money left (and hopefully the nerve) to buy more. That's life for people who accept that they don't know what the future holds.

The strong likelihood of further bad news regarding the spread of the virus might make buying now seem foolhardy. But that negative outlook is already out there and already affecting people's behavior as they set asset prices. Thus there's no reason to assume today's prices ignore that possibility. That may make some buying at today's lower prices a good idea.

Time for a Commercial

For years the combination of a sanguine economy and super-generous capital markets has made it hard for companies to get into trouble. Thus there's been precious little to do in the area of distressed debt, and investing in the area has gone slowly.

Now, however, as you can imagine, it's more likely that business will suffer and less likely that companies will be able to finance their way out of difficulty. Thus I think it's time for you to start preparing to invest to take advantage of the next bout of distress . . . whenever it arises.

For years, that idea seemed irrelevant. Today it does not. We'd be happy, of course, to help you.

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As has been my practice since 1990, after the conference presentations concluded, I came back on stage to share a few observations regarding what I'd heard. Here they are, in no particular order:

- In the last three weeks, we've seen yields on Treasuries decline substantially. Usually, lower interest rates mean higher bonds prices. But in this case, high yield bond prices have fallen, increasing their yields. Thus, with Treasury yields lower and high yield bond yields higher, spreads have expanded rapidly, reaching 700 basis points, a level from which purchases in the past eventually have proven profitable.
- There's nothing in a name. Our panelists discussed the fact that nowadays capital structures contain a higher percentage of senior or first lien debt. On the surface, this sounds like a source of protection for lenders. But my usual reaction is to ask, "Senior to what?" Seniority is only protective if there's substantial cushion from junior securities. In other words, senior creditors are only protected if there's a lot of debt and equity below them. An all-senior capital structure merely means all the senior lenders lose money together.
- So far, there hasn't been much "price discovery." That means not many assets have changed hands, especially private assets. This is normal in collapses, as buyers want to see

pronounced bargain prices before they'll buy, and holders start off unwilling to sell at those prices and accept the resulting losses. This means the price declines thus far in private assets likely are understated. Additional reasons why prices may be unrealistic include the fact that private holdings aren't consistently marked to market (and when they are marked, it's to reflect economic fundamentals, not investors psychology), and the fact that today's senior loans rarely include the covenants that in the past could bring on defaults just because a business weakens.

- We've tried for years to increase the caution in our portfolios. It may take a while for the benefits of that caution to become clear, however, since as I mentioned above, markets tend not to make fine distinctions amid chaos. For example, our high yield bond team is invested only in what it believes are the better energy companies, but right now investors are treating all energy companies as hopeless.
- On the subject of energy companies, it's worth noting that "the cure for low prices is low prices." That is, low prices for a commodity like oil tend to reduce supply and encourage demand, eventually resulting in higher prices.
- As always, it's important to be conscious of the investment environment and behave like a contrarian. For years, investors thought conditions were good, and we at Oaktree believed that consequently, prices were high and markets were characterized by risky behavior. That's what made us cautious. Now the "flawless decade" is certainly over, and asset prices have been cut. The great contrarian, Warren Buffett is famous for saying he likes hamburgers, and when hamburgers go on sale, he eats more hamburgers.
- My roughly quarterly memos pale when compared to the output of Doug Kass, who writes at least daily. His March 11 note had a terrific title: "When the Time Comes to Buy, You Won't Want To." The best time to buy generally comes when nobody else will; other people's unwillingness to buy tends to make securities cheap. But the factors that render others averse to buying will affect you, too. The contrarian may push through those feelings and buy anyway, even though it's not easy. **As I put it, "All great investments begin in discomfort." One thing we know is that there's great discomfort today.**

I hope you'll find this memo useful, and I look forward to being in touch again soon.

March 12, 2020

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