Behind the Memo - On Bubble Watch

Harry Whitelaw

Hello, and welcome to *Behind the Memo with Howard Marks*. I'm Harry Whitelaw, and I'm delighted to welcome Howard to explore a recent memo that has received great reader interest, perhaps because it addresses something that is both enduring and topical, On Bubble Watch.

So Howard, when most of us conceptualize a market bubble, we probably picture a line on a chart displaying some kind of financial metric and rocketing upwards. But you argue that a bubble isn't best defined by numbers, but instead by investor psychology.

Howard Marks

Well, I think that's right, Harry. The line rocketing upward on the chart does indicate a bubble, but it doesn't give a sense for a bubble. And I think that you have to have both. I think that a bubble is both a time when prices for one asset or one asset class or a whole market are elevated, but to really understand it and be able to work with it, I think you have to grasp the emotional or psychological aspects. And a bubble is really a temporary mania, and it is the excessiveness of the psychology that creates the phenomenon and characterizes the phenomenon, and then of course creates its vulnerability.

Harry

You incorporate one aspect of investor psychology into this definition, which is FOMO. And again a quote by Kindleberger in the memo that I think probably made a lot of us chuckle is, "There's nothing so disturbing to well-being as to see a friend get rich."

Howard

Right. I think that if a bubble is a period when investors become unhinged, I think more than anything else, it is the fact that some people have been watching others get fabulously rich that unhinges them. And the element that keeps markets safe and sane is risk aversion. People don't like to lose money, and in particular, money lost counts more heavily for most people than money gained. Most people are ho-hum about making $100 but really pained to lose $100.

So that makes people biased toward risk aversion. Because they are risk averse, however, they perform a function, they police the market and they keep it safe and sane, as I say. They keep deals from being done that shouldn't be done. They keep borrowers from having access to money they shouldn't have, et cetera. The term is used sometimes vigilantism, and sometimes they forget to do that. Sometimes people become inadequately risk averse, overly risk tolerant. People take on risks that they aren't really fit to bear, and they set the stage for subsequent bad outcomes when times turn bad.

The fear of loss should be prominent. Buffett says, "The less prudence with which others conduct our affairs, the greater the prudence with which we must conduct our own affairs." When they're not performing the police function and keeping the market safe and sane, we have to redouble our efforts to do so independently. Sometimes FOMO, the fear of missing out, takes over from the fear of losing money. You can't elevate both simultaneously. And when people get crazy because they've been on the outside watching other people get rich, as Kindleberger says, they lose their ability to be rational and to say it's overpriced. It might've been a good idea two years ago when Joe bought it, but now he's made five times his money. It's probably not a good idea anymore. Or anyway, at minimum, it's a much less good idea.

And so, "I wish I'd been in on it, but I have to accept that I missed it." Well, that's a very mature sounding inner monologue. But that corrosive effect that Kindleberger cites as being injurious to your mental well-being, well, it's a very powerful force that moves people to create bubbles.

Harry

And sometimes that excitement is around something that's previously unknown: a new product, a new service, a new idea. You write how that can whip existing positive, broad sentiment into a real frenzy. Most things move in a historical range, but for something totally new, we have no map, nothing to chart the course of a new technology, for example.

Howard

And it follows then that it's very easy to get off course, isn't it, Harry? Bubbles are usually around something new, something that captures and fires the imagination. And as you say, there's no historical precedent to indicate when people are behaving irrationally about it. So we have, let's see, the tulip craze in Holland, 1630, I believe, the South Sea Bubble in England, 1720. We had several in the meantime. But of course, the one I remember best is the Nifty Fifty bubble of the '60s in which growth stock investing was just invented in the early '60s. So you had a new activity, and of course, people made a lot of money at it.

So everybody else says, "Well, I have to get in on that." The companies that were the subject of the Nifty Fifty, the best and fastest-growing companies in America. Companies that were so great that nothing bad could ever happen. These were idolized. And rather than being viewed individually as, "Oh, I love Xerox," or, "I love Polaroid," they were assembled into a group, if you will, and the group was given special recognition: IBM, Xerox, Kodak, Polaroid, Merck, Lilly, Hewlett-Packard, PerkinElmer, Texas Instruments, AIG, Coca-Cola, Avon Products, the list went on.

Harry

Even poor old Simplicity Pattern, Howard, which you often pick out.

Howard

My favorite. When stocks are highly valued, you pay a high multiple of their current profitability in the expectation that the profitability will continue and perhaps even grow. Thus, the high price is predicated on something I call persistence. And when you look at something called Simplicity Pattern, which everybody thought was a great idea at the time, there was an implicit assumption that Americans would continue to make their own clothes. And how did that work out? Did it really make sense to buy the earnings of that company decades into the future? Which is what people were doing.

Anyway, these companies were adored. Growth stock investing was adored when I walked into this business in September of 1969, the official dictum at First National City Bank where I worked and several of the other money center banks that engaged in that activity was that there was no price too high for such a great company, and that phrase to me is extremely important.

Harry

I was going to say if there's one facet of bubble attitude you'd take most opprobrium with, it's probably the idea that there's no price too high.

Howard

Well, I think that's right because what no price too high says is there's no reason that needs to be applied, no analysis needs to be performed. The value process of saying, "What can it do? What does that make it worth? How does the current price compare with its worth? That whole process goes out the window. So, to me, when I hear no price too high, either explicitly or implicitly, I take that as a major warning signal. In 1999, the internet was really flowering, and what people said is the internet will change the world. So, for an internet company or an e-commerce company, there's no price too high. And those sentences don't follow one from the other.

Yes, the internet will change the world, but maybe there is a price too high for web grocer or a company that has the idea of selling pet food virtually. Maybe you can say, how much can they sell? How much can they make on that? What does that stream of profit look like? And what's it worth? The merest fact that something's new and exciting should not cause people to surrender their reason. And when they do so, you get in trouble.

So, I came into this business 1969. People said that Nifty Fifty are great. There's no price too high. If you bought those stocks the day I got to work in September of '69, and you held them tenaciously for five years, you lost well over 90% of your money. Why? Because A, something had happened, deleterious to many of them. And B, the price had been too high and it came down to earth. It's as simple as that. And ignoring that potential really gets you into trouble. It made me conclude from that experience that there is no asset which is so good, that it can't become too high-priced and thus, dangerous. And that's one of the few absolute rules in this business, in my opinion.

Harry

Touching on that persistence point, Howard, often investors may justify paying up for a leading company because they're currently number one, but you make the really important point investors are sometimes paying with the assumption the leader will remain the leader forever, and yet history indicates it's extraordinarily hard for incumbents to remain in pole position. Most of them don't.

Howard

Well, that's right, and just think about the odds you're facing when you're a leader. Number one, will your industry continue to be a leader? Number two, will your particular technology continue to be the one that produces success or will it be supplanted by a new technology? Number three, will a competitor be able to do it better? Will the leading company become calcified, ossified, bureaucratic, stodgy, and stop being innovative? Will a hungrier, younger company be more successful at innovating? Will the newcomer disrupt the leader? And will patents expire?

Change is the rule, development is the rule, and things don't stay the way they are, including the fact that the leaders of a given industry don't always remain the leaders. It's very challenging, and yet when you buy a company at a price-earnings ratio, you're buying a share in the company which is actually a share in the profitability for years into the future, and the higher the price-earnings ratio, the longer you're buying the earnings for and the more reliant you are on the assumption that this company will continue to lead if it's a leader and will continue to exhibit rapid growth. And sometimes they do and sometimes they don't. But if you looked at the Nifty Fifty, the greatest companies in America in 1969, certainly half of them are no longer even in the Fortune 500. That is of the best 50, 25 of them from '69 are not in the top 500 in 2025. Now, some of them got merged or acquired, it's not that they all faltered, but many did and certainly Simplicity among them.

Harry

So you do provide us this interesting qualifier, the excitement around something new is often based on something very genuine. The power of the internet in the dot-com bubble, it did change all our lives, but sometimes the excitement gets dragged beyond its immediate commercial applicability.

Howard

Well, it's very challenging for something as powerful as a bubble to be created out of nothing, so I think there's invariably a grain of truth. Although look at the present time, people are having great success with a meme coin, and a meme coin is nothing but an idea. Nowadays in the virtual world, the non-physical world, people are paying a lot for virtual assets, which may not even have any physical aspects.

Harry

I guess AI is a good example, though, because we know AI is powerful but we don't necessarily know how to value it. We're guessing a little bit.

Howard

Well, exactly. AI is the new, new thing and it is assumed that it will change the world. I'm not so stodgy as to sit here and say it won't. It probably will, and everybody I hang out with engages in these parlor tricks. I gave an interview with a Korean media group a couple of months ago. They sent it back to me where I was speaking Korean, so the power of AI is unquestionable. How will it be used? What can it do better than prior efforts? At what cost? Will there be enough power?

I just don't know, but the point is great potential, no historical basis for imposing limits on enthusiasm. That's a great precursor for the kind of enthusiasm that sometimes leads to bubbles, and so that necessary condition is satisfied. The thrill of the new thing and the fear of missing out is an incredibly powerful combination. I've seen it at work many times and it'll never stop, in my opinion.

Harry

Well, we should also talk about the bursting of the bubble. At Oaktree, we're known as bargain hunters. But it's important to remember that to access the inevitable dislocation, you need to have remained cautious during the prior period where market sentiments been overly positive. And that can be quite difficult to maintain that discipline.

Howard

Absolutely. First of all, if you jump on the bandwagon the same as everybody else, you'll use all your money to buy at elevated prices. And then when the bubble pops, you won't have any money to scoop up the bargains. Number two, your psyche will be shot. Having participated in what then turns out to have been a mindless pursuit in the bubble, you won't have the resolve. You'll lose faith in yourself. And when you can buy the same asset for a fifth the price, you'll say, "But how do I know it's cheap enough?" Just as you couldn't recognize when it was too expensive, you won't be able to recognize and get motivated when it's too cheap.

And we pride ourselves on bargain purchases. We say we are in business to buy assets for less than they're worth. But that requires cooperation from somebody else who's willing to sell it to us for less than it's worth. Why would anybody do that? The reason they do it is because they bought it higher, they've seen deterioration of the economy, and the company, and the earnings and their own psyches. They've seen the price collapse. They've lost confidence. Whereas when you bought it at 90, you were sure it was going to go to 200. Now that it has fallen to 50, you're not so confident that it's not going to go to 10. So, you say, "Get me out at any price. I can't take it anymore." It's the reverse of FOMO. It's fear of continued irrational losses.

However, now, in order to have money left with which to buy up bargains when the bubble pops, you have to have had some in reserve. You have to have not been fully committed during the bubble. That's hard. Everybody else is making money. You don't want to miss out. It's hard to maintain high standards when everybody else around you is losing their standards and bidding for the new thing, even at prices that seem nutty. But you have to do that, or you can't be exceptional if you succumb to the influences that are dominating everyone.

Dave Swensen, who ran the endowment at Yale with incredible success from 1985 to 2020 when he passed away, said in his book, Pioneering Portfolio Management, that investment management requires the assumption of uncomfortably idiosyncratic positions. And I find uncomfortably idiosyncratic the two most beautiful words I ever heard, because let's take the example in a bubble, you must not succumb. You must not be an average participant in the bubble because the average participant gets eviscerated when the bubble collapses. Your behavior has to be idiosyncratic, which is to say you have to not participate or certainly not participate to the same extent of everybody else.

Idiosyncratic. Idiosyncratic, but by definition, uncomfortable. And if everybody else is doing something and making money at it, and you're not doing it because you believe it's overdone and it's an error, you're watching from the sidelines, they're getting rich. If you're not uncomfortable with that, there's probably something wrong with you. But to be a great investor or a great participant in any sphere of activity, you have to have the strength to avoid doing what others are doing when it is ill-founded.

Harry

So, the memo mainly addresses equity market bubbles. But recently you've written that perhaps market participants underestimate just how different ownership and lending assets are in kind. So, we should expect a credit bubble to look a little bit different to an equity bubble.

Howard

Well, that's right. I believe there are two main forms of investing, owning and lending. You want to start a business, Harry, I like you. I think you have a lot of potential. I want to be part of your success. So, I can put up half the money for your company and maybe I can own half of it, and I participate in your profits if there are profits, but I also share in the losses if there are losses. I'm not guaranteed anything, I just get my share of the outcome. The alternative is I'm not that comfortable with your likelihood of success. So, I say, I don't really want to be an owner, but I'll lend you money and I'll give you the money you need to get into business. And you promise me you'll pay me interest every six months. And then at the end of some term, seven years, 10 years, whatever it might be, you'll give me my money back. So I have a promise from you. I have a contract with you for interest and the repayment of principal, and that contract provides me with a contractual return. And those are the two forms of investing.

So ownership means stocks, companies, buildings, commodities. And lending is loans, bonds, notes, debt, whatever you want to call that. And they're very different in kind. So you're right. We've been talking mainly about bubbles in ownership. Bubbles in the stock market is where we see them most of the time.

The same excessive, undisciplined psychology occurs in the lending markets, but it takes a different form. And basically the form it takes is what I call the race to the bottom, is that when people have too much money and they're too eager to put it to work and too eager to make loans, they compete to be the one who gets to make the loan. And that competition takes the form of saying, "I'll do it for a lower rate of interest. I'll do it with less safety. I'll lend enough money to let you get levered up to the point where it might be dangerous. And I'll do it on the basis of weak documentation, the absence of what we call protective covenants. And I'll do it without security from collateral or assets."

So it's a somewhat more subtle form of bubble behavior because it's really in the terms, but it's people saying, "I want to do this business. I'll take more risk than my competitor and I'll settle for lower return than my competitor because I want the business."

Harry

I guess one thing that helps with the credit though is that nothing more than survival is really needed, whereas sustaining a high equity valuation means you do need to provide exceptional business performance continually. Credit you often write, if you buy a bond at an 8% yield, all you need is the company to survive and you get your 8%.

Howard

Right. So if you will, the channel of outcomes is much narrower in lending. If you get survival, you get the return you expected. You don't fall short because they pay you a hundred percent of what they promised. You also don't have a windfall gain because it's not going to double or triple. At best, it's going to give you the return you were promised. In equity, there's no promise. There's significant downside, there's lots of uncertainty as to what the outcome will be. But there's also the promise of a higher return, which induced you to take the ownership risk in the first place, and then the ever-present possibility of upside beyond that, a pleasant surprise from owning something that does better than expected or gets hot. So the shape of the probability distribution is incredibly different for ownership assets versus lending. And people should keep that in mind.

Harry

We should wrap up with talking, I think about asset allocation. Your guidance is for investors to first identify their own risk posture and then adjust accordingly based on the environment, where they are in the cycle. How should we think about that today? Is a bit more defensiveness warranted?

Howard

Yeah, I think it's really important, Harry, what you just said. I think I wrote in my first book, The Most Important Thing, that people say to me, "Do you know any good investments?" And that's like going to a doctor and saying, "Do you have any good medicines?" The real question that you have to ask first is, "What condition are you trying to treat?" So the choice of investment media should be dependent on what the person is trying to accomplish.

And if you say, “My goal is to make the very most money I possibly could,” well then you need all ownership assets and probably very aggressive ownership assets. If you say, “ My goal is to make a reasonable return with a high degree of confidence and not much downside potential,” then you probably don’t want many ownership assets. You certainly don’t want the aggressive ones. You probably want to engage in a lot of lending. So I think it’s very, very important to put that question first. What condition are you trying to treat? And so people should come up with the answer to that. They should maybe with help arrive at a portfolio composition that will permit them to accomplish it. Most of the time, they should probably have some combination of ownership assets and lending.

And then the other part of the equation is the one you mentioned, Harry. Some people may want to change their asset mix from time to time as conditions change. Now, you can either do it well or poorly. So the person who has a mix of ownership assets and lending might, as the market does better, better, better, better, want to ramp up their percentage in ownership assets. But that is what we call trend following. And you can’t gain participation in the profits that have already occurred by buying more of something, more ownership investments. And in fact, maybe you’re just jumping on the band-wagon too late. Maybe you’re just jumping on as it heads into bubble territory.

So it’s really important to not be a trend follower and to try to do this on the basis of values and analytically derived potential rather than emotion and trying to catch up with the people who’ve already made money. And it works in both directions by the way. When things go poorly and people say, “Well, now I want to get out of risky assets,” maybe it’s too late. And at that point, maybe reducing their ownership assets will be tantamount to locking in losses and selling at prices that are too low to bargain hunters like us. So it’s important to do these things analytically as opposed to under the dictates of emotion.

Harry

Thanks, Howard. I’m regretting that we can’t display your probability curves on the podcast format, but I’ll direct our listeners to Howard’s asset allocation memo to see them.

We hope you all enjoyed listening, and please do look out for future episodes on the Oaktree website or wherever you get your podcasts. And of course, all Howard’s memos, all 35 years of them, can be found on the *Insights* section of the Oaktree website.