Memo to: Oaktree Clients

From: Howard Marks

Re: Something of Value

If asked about possible silver linings to this pandemic, I would list first the chance to spend more time with family. Our son Andrew and his wife and son moved in with Nancy and me in Los Angeles at the beginning of the pandemic, as they were renovating their house when Covid-19 hit, and we lived together for the next ten weeks. There's nothing like getting to spend months at a time building relationships with grandchildren, something we were privileged to do in 2020. I'm sure the impact will literally last lifetimes.

As I've previously reported, Andrew is a professional investor who focuses on making long-term investments in what the world calls "growth companies," and especially technology companies. He's had a great 2020, and it's hard to argue with success. Our living together led me to talk with him and think a great deal about subjects on which I hadn't previously spent much time, contributing a lot to what I'll cover in this memo.

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I've written before about how the questions I'm asked give me a good sense for what's really on people's minds. These days, one I frequently field is about the outlook for "value" investing. "Growth" stocks have meaningfully outperformed "value" for the last 13 years – so long that people are asking me whether it's going to be a permanent condition. My extensive discussions with Andrew led me to conclude that the focus on value versus growth doesn't serve investors well in the fast-changing world in which we live. I'll start by describing value investing and how investors might think about value in 2021.

<u>What is Value Investing?</u>

Value investing is one of the key disciplines in the world of investing. It consists of quantifying what something is worth intrinsically, based primarily on its fundamental, cash flow-generating capabilities, and buying it if its price represents a meaningful discount from that value. Cash flows are estimated as far into the future as possible and discounted back to their present value using a discount rate made up of the prevailing risk-free rate (usually the yield on U.S. Treasurys) plus a premium to compensate for their uncertain nature. There are a lot of common valuation metrics, like the ratio of price to sales, or to earnings, but they're largely subsumed by the discounted cash flow, or DCF, method.

Now, determining this value in practice is quite challenging, and the key to success lies not in the ability to perform a mathematical calculation, but rather in making superior judgments regarding the relevant inputs. Simply put, the DCF method is the main tool of all value investors in their effort to make investment decisions based on companies' long-term fundamentals.

Importantly, value investors recognize that the securities they buy are not just pieces of paper, but rather ownership stakes in (or, in the case of credit, claims on) actual businesses. These financial instruments have a fundamental worth, and it can be quite different from the price quoted in the market, which is based on the manic-depressive ups and downs of a character Benjamin Graham called "Mr. Market." On any given day, Mr. Market can be exuberant or despondent, and he quotes prices for securities based on how he feels. The value investor understands that – rather than informing us as to what a given asset's value is – Mr. Market is there to serve us by offering up securities at prices, which can be meaningfully disconnected from the actual value of a stake or claim in the underlying business. In doing so, he sometimes gives us the opportunity to snatch up shares or bonds at a meaningful discount from their intrinsic value. This activity requires independent thought and a temperament that resists the emotional pull of the market cycle, making for decisions based solely on value.

Thus, to me the essential underlying principles of value investing are these:

- the understanding of securities as stakes in actual businesses,
- the focus on true worth as opposed to price,
- the use of fundamentals to calculate intrinsic value,
- the recognition that attractive investments come when there is a wide divergence between the price at which something is offered in the market and the actual fundamental worth you've determined, and
- the emotional discipline to act when such an opportunity is presented and not otherwise.

Value vs. Growth

Over the last 80-90 years, two important developments occurred with regard to investing style. The first was the establishment of value investing, as described above. Next came "growth investing," targeting a new breed of companies that were expected to grow rapidly and were accorded high valuation metrics in recognition of their exceptional long-term potential.

It seems likely that the label "value" was applied to the value school because one of its greatest early popularizers, Ben Graham, practiced a low-valuation style. Deemed "cigar butt" investing by his protégé Warren Buffett, Graham's style emphasized the search for pedestrian companies whose shares were selling at discounts from liquidation value based on the assets on their balance sheets, which Buffett likened to searching the street for used cigar butts that had one last puff left in them. It is this style that Graham preached in his Columbia Business School classes and his books, *Security Analysis* and *The Intelligent Investor*, which are considered the bibles of value investing. His investment style relied on fixed formulas to arrive at measures of statistical cheapness. Graham went on to achieve enviable investment performance although, funnily enough, he would later admit that he earned more on one long-term investment in a growth company, GEICO, than in all his other investments *combined*.

Buffett, the patron saint of value investors, also practiced cigar butt investing with great success in the first decades of his career, until his partner, Charlie Munger, convinced him to broaden his definition of "value" and shift his focus to "great businesses at fair prices," in particular because doing so would enable him to deploy much more capital at high returns. This led Buffett to invest in growing companies – such as Coca-Cola, GEICO and the Washington Post – that he could purchase at valuations that were not particularly low in the absolute, but that he found attractive given his understanding of their competitive advantages and future earnings potential. While Buffett has long understood that a company's prospects are an enormous component of its value, his general avoidance of technology stocks throughout his career may have unintentionally caused most value investors to boycott those stocks. Intriguingly, Buffett allows that his recent investment in Apple has been one of his most successful.

Over time, a subset of value investors adopted a harder-line approach, with a pronounced emphasis on low valuation metrics. Graham and Buffett's cigar butts had featured low valuation metrics, and this no doubt caused some value investors to elevate this characteristic to be the core consideration in their investment process. It's interesting to note that the methodology for populating the S&P 500 Value Index relies solely on finding the one-third of the S&P 500's market capitalization with the highest ratio of Value Rank (based on the lowest average multiple of earnings, sales and book value) to Growth Rank (based on the highest three-year growth in sales and earnings and 12-month price change). In other words, the stocks in the Value Index are those that are most characterized by "low-valuation parameters" and least characterized by "growth." **But "carrying low valuation parameters" is far from synonymous with "underpriced."** It's easy to be seduced by the former, but a stock with a low p/e ratio, for example, is likely to be a bargain only if its current earnings and recent earnings growth are indicative of the future. Just pursuing low valuation metrics can lead you to so-called "value traps": things that look cheap on the numbers but aren't, because they have operating weaknesses or because the sales and earnings creating those valuations can't be replicated in the future.

The growth investing camp, on the other hand, came into existence during the "go-go" early years of the 1960s, the decade in which I started my career in the equity research department at First National City Bank. Investor interest in rapid growth led to anointment of the so-called Nifty Fifty stocks, which became the investment focus of many of the money-center banks (including my employer), which were the leading institutional investors of the day. This group comprised the fifty companies believed to be the best and fastest-growing in America: companies that were considered so good that "nothing bad could happen to them" and "there was no price too high" for their shares. Like the objects of most manias, the Nifty Fifty stocks showed phenomenal performance for years as the companies' earnings grew and their valuations rose to nosebleed levels, before declining precipitously between 1972 and 1974. Thanks to that crash, they showed negative holding-period returns for many years. Their dismal performance cost me my job as director of equity research (and led to my being assigned to start funds for investment in high yield and convertible bonds – my lucky break). It's worth noting, however, that the truly durable growth companies among the Nifty Fifty – about half of them – compiled respectable returns for 25 years, even when measured from their pre-crash highs, suggesting that very high valuations can be fundamentally justified in the long term for the rare breed of company.

The two approaches – value and growth – have divided the investment world for the last fifty years. They've become not only schools of investing thought, but also labels used to differentiate products, managers and organizations. Based on this distinction, a persistent scoreboard is maintained measuring the performance of one camp against the other. Today it shows that the performance of value investing lagged that of growth investing over the past decade-plus (and massively so in 2020), leading some to declare value investing permanently dead while others assert that its great resurgence is just around the corner. My belief, especially after some deep reflection over the past year – prompted by my conversations with Andrew – is that **the two should never have been viewed as mutually exclusive to begin with**. We'll get to that shortly.

<u>Vantage Points</u>

An interesting aspect of my discussions with Andrew has been our joint recognition of the fact that we come from very different backgrounds, and perhaps for that reason we look at investing from considerably different vantage points.

I began to form my investment philosophy in the 1960s. Investment thought was much less developed at that time, and what did exist was heavily dominated by the philosophy espoused by Ben Graham. Buffett was still searching for his last puff of "cigar butts" and had yet to coin the term "moat" in reference to the lasting competitive advantages that sustain high-quality businesses. My philosophy was informed by the fact that I started working in 1969, during the "Nifty Fifty" bubble, which I watched crash around me.

It was further shaped by my transition in 1978 from equities to fixed income investments in the form of convertible and high yield bonds. Importantly, Graham and his less famous co-author, David Dodd, characterized bond management as a "negative art." What did they mean? In general, bond investors' return is capped at a yield that stems from the promised interest payments and payoff at par upon maturity; that's why it's called "fixed income." The upshot is that all bonds bought at a 6% yield will return 6% when held to maturity if they pay. Bonds that don't pay, on the other hand, will produce losses of varying magnitudes. Thus, oversimplifying, you improve your performance in bonds not through which paying bonds you buy (since all 6% bonds that pay will have the same return), but through what you exclude (that is, whether you're able to avoid the ones that don't pay). Clearly, this is very different from equities, where your upside is theoretically unlimited, requiring that investors intelligently balance downside risk and upside potential.

To be a good equity investor, I think you have to be an optimist; certainly, it's no activity for doomsayers. On the other hand, the term "optimistic bond investor" is practically an oxymoron. Since bonds generally lack potential for long-term returns in excess of their promised yields, bond investing mostly requires skepticism and attention to the downside. One of the reasons I did well in fixed income is that it played to my natural conservatism. And since tech companies issue relatively few bonds, it also accommodated my lack of focus on technology, which has never been of particular interest to me and has always felt a bit "over my head." I'm certainly not an "early adopter," nor do I have a history of recognizing emerging technological trends in their infancy.

Lastly, as a child of parents who were born in the early 1900s and thus were adults during the Great Depression, my thought process was shaped by the deprivation and fear they had experienced. Because they had been made so painfully aware of the value of a dollar and how quickly things could change for the worse, they considered the future and the possibility of loss things to worry about. Adages like "don't put all your eggs in one basket" and "save for a rainy day" were watchwords I grew up with. This is very different from the experience of those whose parents were born a decade or two later than mine, never lived with deprivation, and may never have heard those words. These influences and experiences led me to adopt a value approach and the persona of a "bargain hunter," which has served me well in my chosen field, which now has come to be called "credit."

Andrew has a considerably different mindset. Clearly, his early experience was very different from mine, not marked by anything like the Depression. He was bitten by the investment bug early, and from a young age investing dominated our conversations. While he deeply appreciates some elements of my philosophy – such as the importance of understanding investor psychology, focusing on fundamentals, and contrarianism – he has forged his own path and ended up in a very different place. His first phase was spent as a "Buffett nerd," consuming everything written by the Oracle and adhering strongly to his philosophy. But over time, he has developed his own perspective and transitioned to investing primarily in technology and other growth-oriented companies. He spends the vast majority of his time managing a venture firm called TQ Ventures with his two partners, but he also steers our family's "upside-oriented investments" with great results. (I, fittingly, handle our more conservative investments).

This contrast of viewpoints, particularly in 2020, has created extraordinary opportunities for discussion and learning. **From this point on, most of what I write will consist of what Andrew has caused me to appreciate in my 75th year.**

The False Dichotomy of Value and Growth

At some point, the camps of value and growth developed nearly the same fervent adherence as rival political factions. You pledged allegiance to one or the other, and so went your future investing actions. You believed your way was the only way and looked down on practitioners of the other. I think investors – perhaps based on their emotional makeup, intellectual orientation and understanding of things like technological innovation – naturally gravitated toward one side of the stylistic divide or the other. And there are notable differences:

- Value stocks, anchored by today's cash flows and asset values, should *theoretically* be "safer" and more protected, albeit less likely to earn the great returns delivered by companies that aspire to rapidly grow sales and earnings into the distant future.
- Growth investing often entails belief in unproven business models that can suffer serious setbacks from time to time, requiring investors to have deep conviction so as to be able to hang on.
- When they're rising, growth stocks typically incorporate a level of optimism that can evaporate during corrections, testing even the most steeled investor. And because growth stocks depend for most of their value on cash flows in the distant future that are heavily discounted in a DCF analysis, a given change in interest rates can have meaningfully greater impact on their valuations than it will on companies whose value comes mainly from near-term cash flows.

Despite these points, I don't believe the famous value investors who so influenced the field intended for there to be such a sharp delineation between value investing, with its focus on the present day, low price and predictability, and growth investing, with its emphasis on rapidly growing companies, even when selling at high valuations. Nor is the distinction essential, natural or helpful, especially in the complex world in which we find ourselves today. Both Graham and Buffett achieved success across a variety of styles and, more importantly, viewed value investing as consisting of adherence to fundamental business analysis, divorced from the study of market price action. As Buffett put it, "We don't consider ourselves to be value investors. . . . Discounted cash proceeds is the appropriate way to value any business. . . . There is no such thing in our minds as value and growth investing." It just so happened that considerable opportunity existed for them in the cigar butt arena at the time they operated – especially considering that both started with relatively small amounts of money with which to invest – so that's what they emphasized. But as the world evolved, the landscape of opportunities has changed significantly.

There's a saying that "to the man with a hammer, everything looks like a nail." The widely discussed distinction between value and growth made some people believe they only had hammers, when in fact they potentially had access to a whole toolbox. **Now we live in a complex world where a range of tools is required for success.**

A More Efficient World

As mentioned earlier, the investment world back when Buffett and Graham were first practicing their version of value investing was considerably different from the current one. First, the level of competition was much lower, almost unrecognizable when compared to today. Investment management wasn't a hot field in which many people aspired to spend their careers. It was instead a cottage industry, with a small number of outfits practicing quite traditional activities. Second, information was extremely hard to come by and process. There were no computers, spreadsheets or databases. Before researching a stock, you first had to find it in either the back of the newspaper (if it was a mainstream issue) or large books put together by firms like Moody's and Value Line (if it was more thinly traded). Then you had to either send a request to the company for the annual report or go to the library hoping to find a copy of the report or a broader publication that included the company's financial statements. And third, with the industry so small, nascent and unpopular, the investment thought process wasn't something broadly developed or disseminated. The key analytical frameworks were not yet codified, and folks like Graham and Buffett had a huge edge simply because they knew how to process the data they found. In short, there were few people searching; the search process was quite difficult; and few people knew how to turn the data they did find into profitable investment conclusions. In this environment, bargains could literally be hiding in plain sight for anyone with the willingness to look and the capacity to analyze.

When Buffett was applying his cigar butt approach to running his early investment partnership – which racked up a tremendous record – he famously used to sit in his back room in Omaha, flipping through the thousands of pages of *Moody's Manual*, and he would buy shares in small companies that were trading at enormous discounts from liquidation value for the simple reason that no one else paid attention to them. In one case, that of National American Fire Insurance, Buffett was able to buy the stock at 1x earnings by driving around to farmers who had decades earlier been stuffed by promoters with stock they'd since forgotten about, and handing them cash on their front porch. Thus, the Grahamian value framework was created at a time when things could be stupidly cheap based on clearly observable facts, simply because the search process was very difficult and opaque.

As time went on, the diligent analyst's information advantage began to slowly dissipate, but it still existed for a good while. Prior to the broad adoption of the Internet and the explosion of the investment industry in the early years of this century, information and analytical methods were still hard to come by. One still had to mail away for annual reports as recently as the 1990s, and while more people may have known how to find pure balance sheet arbitrages like Graham practiced in the 1950s and '60s, seemingly basic analytical concepts like return on invested capital, competitive moats and the importance of free cash flow (rather than GAAP earnings) were not widely appreciated. And certainly, most people didn't understand the dynamics around what are called "special situations," which become available when complex corporate actions create investment opportunities by giving rise to significant mispricings. There was still the opportunity to find bargains in plain sight, albeit perhaps with an extra level of sophistication required.

Fast forward to today, and everything has changed. The investment industry is wildly competitive, with tens of thousands of funds managing trillions of dollars. Investment management is one of the most desirable careers, prompting complaints about "brain drain" as intellectual prodigies eschew careers as world-changing scientists or inventors in exchange for jobs on Wall Street. Warren Buffett has evolved from a man buying cheap stocks in his home office to an international celebrity, with 50,000 investors from around the world making the pilgrimage to Omaha each year for the Berkshire Hathaway annual meeting. Information is incredibly ubiquitous, with seemingly endless amounts of data – not to mention books, articles, blogs and podcasts about investment methodologies and specific stock research – available on your mobile phone in seconds. And, not only is information broadly available and easily accessed, but billions of dollars are spent annually on specialized data and computer systems designed to suss out and act on any discernable dislocation in the marketplace. All this is largely motivated by the fact that many of the greatest fortunes made in the last forty years belong to people in the investment profession. In contrast, when I entered the business in the late 1960s, few investors were "household names," investment industry incomes were in line with those in other professions, and only a handful of investors had a "carried interest" in their clients' profits.

In the past, bargains could be available for the picking, based on readily observable data and basic analysis. Today it seems foolish to think that such things could be found with any level of frequency. If something about a company can be easily read in an annual report, or readily discovered by a mathematically competent analyst or a computer, it stands to reason that, in most cases, this should already be appreciated by the marketplace and thus incorporated in the prices of the company's securities. That's the essence of the Efficient Market Hypothesis. Thus, in the world we live in today, investing on the basis of rote formulas and readily available fundamental, quantitative metrics should not be particularly profitable. (This is not necessarily true during market downturns and panics, when selling pressure can cause prices to decouple from fundamentals.) **It also stands to reason that in a time when readily discernable quantitative data is unlikely to produce high-profit opportunities:**

- **if something carries a low valuation, there's probably a good reason, and**
- **successful investing has to be more about superior judgments concerning (a) qualitative, non-computable factors and (b) how things are likely to unfold in the future.**

Not Your Grandfather's Market

Not only are the traditional staples of classic value investing (readily discernable quantitative measures of cheapness in the here-and-now) no longer likely to produce a sustainable edge on their own, but the world has gotten more complex, with many more dynamics that can drive a decoupling of near-term metrics from valuation, both to the positive and negative.

Back in the old days, Warren Buffett could find businesses that clearly were likely to remain dominant for long periods of time and perform relatively straightforward analysis to assess their valuation. For instance, he could look at something like the Washington Post, which essentially became the monopoly newspaper in a major city, and invest on the basis of reasonable, consistent assumptions regarding a few variables like circulation, subscription prices and ad rates. It was a foregone conclusion that the paper would remain dominant because of its strong moat, and thus that the past would look very much like the future. In contrast today:

- Because markets are global in nature, and the Internet and software have vastly increased their ultimate profit potential, technology firms or technologically aided businesses can grow to be much more valuable than we previously could have imagined.
- Innovation and technical adoption are happening at a much more rapid pace than ever before.
- It has never been easier to start a company, and there has never been more capital available to fund entrepreneurship.
- There have also never been as many highly capable people focused on starting and building companies.
- Since many of these companies are selling products primarily made with code, their costs and capital requirements are extremely low and their profitability – especially on incremental sales – is unusually high. Thus, the economics of winners have never been more attractive, with very high profit margins and minimal capital requirements.

- Because the friction and marginal cost of scaling over the Internet can be so low, businesses can grow much more rapidly than ever before.
- It has never been more acceptable for public companies to lose money in the pursuit of a large prize down the road. This in turn leads to obfuscation of the real potential economics of winners and makes differentiating between winners and losers difficult without great, insightful effort to peel back the onion.
- As developing and scaling new products is much easier in the digital world (often requiring little more than engineers and code), it's never been more possible for companies to develop completely new avenues of growth, further extending their runways (Amazon's AWS and Square's Cash App are two notable examples). This gives real value to intangibles such as exceptional management, engineering talent and strategic positioning with customers.
- The moats protecting today's winners have never been stronger, and as Brian Arthur pointed out in "Increasing Returns and the New World of Business," his amazing piece of almost 25 years ago, the winners often get stronger and more effective as they get bigger, rather than bloated and inefficient.
- Conversely, the onslaught of startups with readily available capital and minimal barriers to scaling means that the durability of legacy businesses has never been more vulnerable or uncertain.
- At the same time, however, it's important to recognize that the leading tech firms face threats from trustbusters who believe these companies have developed excessive market power.

To summarize, businesses are both more vulnerable and more dominant in today's world, with much greater opportunities for dramatic changes in fortune, both positive and negative. On the positive side, successful businesses have much more potential for long runways of high growth, superior economics, and significant durability, creating a huge pot of gold at the end of the rainbow and seemingly justifying valuations for the potentially deserving that are off-puttingly high by historical standards. On the negative side, it also creates immense temptation for investors to overvalue undeserving companies. And companies with here-and-now cash flows and seeming stability can see those evaporate as soon as a bunch of Stanford computer science students get funding and traction for their new idea.

When I consider this new world, I think fundamental investors need to be willing to thoroughly examine situations – including those with heavy dependency on intangible assets and growth into the distant future – with the goal of achieving real insight. However, this is, to an extent, antithetical to the value investor's mentality. Part of what makes up the value investor's mindset is insistence on observable value in the here-and-now and an aversion to things that seem ephemeral or uncertain. **Many of the great bonanzas for value investors have come in periods of panic following the bursting of bubbles, and this fact has probably led value investors to be very skeptical of market exuberance, especially when concerning companies whose assets are intangible.** Skepticism is important for any investor; it's always essential to challenge assumptions, avoid herd mentality and think independently. Skepticism keeps investors safe and helps them avoid things that are "too good to be true."

But I also think skepticism can lead to knee-jerk dismissiveness. While it's important not to lose your skepticism, it's also very important in this new world to be curious, look deeply into things and seek to truly understand them from the bottom up, rather than dismissing them out of hand. I worry that value investing can lead to the rote application of formulas and that, in times of great change, applying formulas that are based on past experience and models of the prior world can lead to massive error. John Templeton warned about the risk that's created when people say, "it's different this time," but he also allowed that 20 percent of the time they're right. Given the rising impact of technology in the 21st century, I'd bet that percentage is a lot higher today.

It's also worth noting with regard to truly dominant companies that are able to achieve rapid, durable and highly profitable growth that it is very, very hard to overprice them based on near-term multiples. The basic equations of finance were not built to handle high-double-digit growth as far as the eye can see, making the valuation of rapid growers a complicated matter. As John Malone famously said, if your long-term growth rate exceeds your cost of capital, your present value is infinite. **However, this is only true for truly special companies, which are few and far between and certainly not as ubiquitous as is generally implied by the market in times of ebullience.** It's important to note, that when markets are at extreme levels of optimism, as we saw in both the Nifty Fifty and Dot Com bubbles, (a) every company in the affected field is treated as a long-term winner, (b) if bought in times of significant optimism and extreme valuations for growth, the stocks of even the greatest companies are likely to produce outcomes that are mediocre at best, and (c) in the crashes that follow most bubbles, enormous interim markdowns can befall good companies as well as bad, requiring sharp analysis to differentiate between them, and high conviction and an iron stomach to hold on.

I want to make very clear that I do not intend this to imply an opinion about growth stocks' valuations today. I've heard a variety of views, and while I have my own, I don't want to make it the subject of this memo. In the spirit of seeking to understand this new world, market commentators (including me) would be well served to understand the fundamentals underpinning the small number of companies that currently drive a huge percentage of the market, instead of basing top-down conclusions on purely historical valuation comparisons. And it seems imprudent to opine on the level of the overall market without being fully informed regarding the tech companies that now account for so much of equity indices like the S&P 500. As Andrew repeatedly reminds me, it's hard to make a convincing case that today's market is too high if you can't explain why its tech leaders are overvalued.

But by far the most important intention of this memo is to explore the mindset that I think will prove most successful for value investors over the coming decades, regardless of what the market does in the years just ahead. It's important to note that (a) the potential range of outcomes for many of today's companies is very wide and (b) there are considerations with enormous implications for the ultimate value of many companies that do not show up in readily available quantitative metrics. They include superior technology, competitive advantage, latent earning power, the value of human capital as opposed to capital equipment, and the potential option value of future growth opportunities. In other words, determining the appropriateness of the market price of companies today requires deep micro-understanding, and that makes it virtually impossible to opine on the valuation of a rapidly growing company from 30,000 feet or by applying traditional value parameters to superficial projections. **Some of today's lofty valuations are probably more than justified by future prospects, while others are laughable – just as certain companies that carry low valuations can be facing imminent demise, while others are just momentarily impaired.** The key, as always, is to understand how today's market price relates to the company's broadly defined intrinsic value, including its prospects.

<u>The Heart of the Problem</u>

Consider two companies. Company A is a respected long-term competitor selling a widely consumed, fairly prosaic product. It has built a decades-long record that shows modest but steady sales growth and healthy profit margins. It manufactures its product using heavy machinery located on its own premises. Its stock sells at a modest multiple of earnings per share.

Company B, on the other hand, was formed a few years ago with the goal of disrupting a legacy industry. It has a brief but impressive record of sales growth, albeit at modest absolute dollar levels and with limited profitability. It plans to accelerate its sales growth and build market share over the next several years, overtake its more traditional prey, and then expand its profit margins by tapering spending on R&D and customer acquisition, raising prices, and scaling into its largely fixed cost structure. Its products are constantly evolving and innovating, and they emerge not from factories, but rather the minds of engineers doing coding. It has no current earnings, but because of its potential, sells at a lofty multiple of sales.

Value investors are likely to consider it easy to predict and value Company A, with its time-tested product, stable revenues, well-established profit margins and valuable production facilities. The process requires only a few simple assumptions: that something that has been successful will remain so; that next year's sales will be equal to this year sales plus some modest growth; and that the profit margin will remain where it has been for years. **It seems intuitively obvious that chugging along as in the past is more predictable and reliable than rapid and durable growth, and thus that industrial stalwarts are more capable than innovators of being valued with precision.**

Company B, on the other hand, is at an early stage in its development, its profit margins are far from maximized, and its greatest assets go home every night rather than residing on the balance sheet. Valuing it requires guesses about the ultimate success of its products; its ability to come up with new ones; the response from competitors and the targeted industry; its growth runway; and the extent to which it will be able to increase profitability once doing so becomes its focus. Company B seems more conceptual in nature and more dependent on developments in the distant future that are subject to significant uncertainty, so valuing it might have to be done on the basis of broad ranges for future sales and profitability rather than reliable point estimates. Assessing its value also requires conversance with a technologically complex field. For all these reasons, value investors are likely to consider Company B hard to value, "speculative" and thus not investable under the canon.

Certainly, the range of potential outcomes – both good and bad – appears greater with respect to Company B than Company A, and thus Company B seems less predictable. But Company A's track record may suggest stability that could ultimately prove fleeting. And even if one can't exactly predict the future of Company B, British philosopher and logician Carveth Read reminds us that we'd rather be vaguely right than exactly wrong. The ability to formulate precise forecasts does not necessarily make something a better or even a safer investment.

- **First, the apparent ease of predicting traditional Company A's future can be quite deceptive** – for example, considerable uncertainty can exist regarding its risk of being disrupted by technology or seeing its products innovated out of existence. On the other hand, while Company B is more nascent, its products' strength and traction in the marketplace may make success highly likely.
- **Second, as noted earlier, if conclusions regarding Company A's potential can easily be reached by a finance student with a laptop, how valuable can such conclusions be?** Shouldn't a deep understanding of a company's qualitative dynamics and future potential be a greater source of advantage in making correct forecasts than data which is readily available to all?

Value investing is thought of as trying to put a precise value on the low-priced securities of possibly mundane companies and buying if their price is lower. And growth investing is thought of as buying on the basis of blue-sky estimates regarding the potential of highly promising companies and paying high valuations as the price of their potential. **Rather than being defined as one side of this artificial**

dichotomy, value investing should instead consist of buying whatever represents a better value proposition, taking all factors into account.

Dealing with Winners

A couple of times this past year, I've committed the sin of asking Andrew how he felt about selling part of some highly appreciated holdings and "taking some money off the table." The results haven't been pretty; he has made plain my error, as described below.

Much of value investing is based on the assumption of "reversion to the mean." In other words, "what goes up must come down" (and what comes down must go up). Value investors often look for bargains among the things that have come down. Their goal, of course, is to buy underpriced assets and capture the discounts. But then, by definition, their potential gain is largely limited to the amount of the discount. Once they've benefitted from the closing of the valuation gap, "the juice is out of the orange," so they should sell and move on to the next situation.

In Graham's day, cigar butts could be found in good supply, valued precisely, bought very cheaply with confidence, and then sold once the price had risen to converge with the value. But Andrew argues that this isn't the right way to think about today's truly world-class companies, with their vast but unquantifiable long-term potential. Rather, if an investor has studied a company, reached a deep understanding of it and concluded that it possesses great potential for growth and profitability, he'll probably recognize that it's impossible to accurately quantify that potential and know when it has been realized. He also may realize that ultimate potential is a moving target, as the company's strengths may allow it to develop additional avenues of growth. **Thus he might have to accept that the correct approach is to (a) hope he has the direction and quantum approximately right, (b) buy and (c) hold on as long as the evidence suggests the thesis is right and the trend is upward – in other words, as long as there's still juice in the orange.**

My 2015 memo *Liquidity* included some observations from Andrew regarding point "c":

> When you find an investment with the potential to compound over a long period of time, one of the hardest things is to be patient and maintain your position as long as doing so is warranted on the basis of the prospective return and risk. Investors can easily be moved to sell by news, emotion, the fact that they've made a lot of money to date, or the excitement of a new, seemingly more promising idea. **When you look at the chart for something that's gone up and to the right for 20 years, think about all the times a holder would have had to convince himself not to sell.**

He hasn't changed his tune one bit over the last five years. **Andrew insists that when you're talking about today's great growth companies, the approach of "buy in cheap, set a target price, sell as it rises, and exit fully when it reaches the target" is dead wrong.** A dispassionate look at history makes clear that taking profits in a rapidly growing company with durable competitive advantages has often been a mistake. Given the properties of today's leading companies, it can be even more wrong now. **Instead, as he says, you have to talk yourself out of selling.**

I think winners are sold for four primary reasons: (a) the investor concludes that the investment has accomplished everything it's capable of, (b) she thinks it has appreciated to the point that its prospective return is only modestly attractive, (c) she realizes something in her investment thesis was incorrect or has changed for the worse or (d) she fears that the gains to date might be proved unwarranted and thus evaporate; in particular, she's afraid she'll end up kicking herself for not having taken profits while they were there. But fear of making a mistake is a terrible reason to sell something of value.

Here's how Andrew puts it today:

> It's important to understand the paramount importance of compounding, and how rare and special long-term compounders are. This is antithetical to the "it's up, so sell" mentality but, in my opinion, critical to long-term investment success. As Charlie Munger says, "the first rule of compounding is to never interrupt it unnecessarily."
>
> In other words, if you have a compounding machine with the potential to do so for decades, you basically shouldn't think about selling it (unless, of course, your thesis becomes less probable). Compounding at high rates over an investment career is very hard, but doing it by finding something that doubles, then moving on to another thing that doubles, and so on and so on is, in my opinion, nearly impossible. It requires that you develop correct insights about a large number of investment situations over a long period of time. It also requires that you execute well on both the buy and the sell each time. When you multiply together the probabilities of succeeding at a large number of challenging tasks, the probability of doing them all correctly becomes very low. It's much more feasible to have great insights about a small number of potentially huge winners, recognize how truly rare such insights and winners are, and not counteract them up by selling prematurely.

As I was working on this memo, I came across a very helpful article from the Santa Fe Institute:

> When it comes to investing and businesses, the mental models in our head help us answer the question, '*what does the future hold?*'. . . [But] applying the mental model of '*mean reversion*' for a '*fade-defying*' business model will lead to an erroneous conclusion. (*Investment Master Class*, December 21, 2020)

The last sentence struck a very responsive chord in me. **It suggested to me that my background had biased me toward assuming "mean reversion" and thus sometimes caused me not to fully grasp the potential of "fade-defying business models."** This bias caused me to conclude that one should "scale out" of things as they rose and "take some money off the table." I even formulated a saying on the subject: "If you sell half, you can't be all wrong." But I now see that this high-sounding verbiage can lead to premature selling, and that cutting back a holding with great potential can be a life-altering mistake. Note that, according to Charlie Munger, he's made almost all his money from three or four big winners. What if he had scaled out early?

Fortunately, (a) Oaktree's business consists mostly of garnering valuation discrepancies; (b) because of their nature, our asset classes offer up relatively few opportunities to err by prematurely selling off potential mega-multiple winners; (c) Oaktree's decentralized structure insulates our portfolio managers from the extremes of my caution; and (d) my colleagues do a better job of letting their winners run than I might have. We might have done more if I didn't have my limitations. Maybe I could have remained in equities, or even become a venture capitalist and seeded Amazon. But I can't complain – things couldn't have turned out better.

The Value Mentality in Action

Back in 2017, my memo *There They Go Again . . . Again* included a section on cryptocurrencies in which I expressed a high level of skepticism. This view has been a source of much discussion for me and Andrew, who is quite positive on Bitcoin and several others and thankfully owns a meaningful amount for our family. While the story is far from fully written, the least I can say is that my skeptical view has not borne out to date. This brings up what Andrew considers a very important point about the value investor's mentality and what is required for success as an investor in today's world.

As I said before, the natural state for the value investor is one of skepticism. Our default reaction is to be deeply dubious when we hear "this time it's different," and we point to a history of speculative manias and financial innovations that left behind significant carnage. It's this skepticism that reduces the value investor's probability of losing money.

However, in a world where so much innovation is happening at such a rapid pace, this mindset should be paired with a deep curiosity, openness to new ideas, and willingness to learn before forming a view. The nature of innovation generally is such that, in the beginning, only a few believe in something that seems absurd when compared to the deeply entrenched status quo. When innovations work, it's only later that what first seemed crazy becomes consensus. **Without attaining real knowledge of what's going on and attempting to fully understand the positive case, it's impossible to have a sufficiently informed view to warrant the dismissiveness that many of us exhibit in the face of innovation.**

In the case of cryptocurrencies, I probably allowed my pattern recognition around financial innovation and speculative market behavior – along with my natural conservatism – to produce my skeptical position. These things have kept Oaktree and me out of trouble many times, but they probably don't help me think through innovation. Thus, I've concluded (with Andrew's help) that I'm not yet informed enough to form a firm view on cryptocurrencies. In the spirit of open-mindedness, I'm striving to learn. Until I do, I'll be referring all requests for comments on the subject to Andrew (although I'm sure he'll decline).

Back to the Original Question

I'll move toward ending this memo by turning to the question I mentioned at the outset: Is the recent underperformance of value investing a temporary phenomenon? Will value stocks ever again have their day in the sun?

First, I think the stocks of the tech leaders are clearly being aided by a virtuous circle created by the combination of their preeminence as companies, their recent eye-popping performance, their huge market capitalizations, and the strategic considerations of the fund business. The companies' preeminence and price momentum make them essential cornerstone holdings in many ETFs, and their enormous scale places them among the largest holdings. They also dominate equity indices such as the S&P 500. Those two things mean that as long as money flows disproportionately into ETFs and index funds and the four factors enumerated above don't change, the leading tech stocks will continue to attract more than their fair share of capital and perform better than stocks not as well represented in the indices and ETFs.

However, this is one of those trends that will continue until it stops. To the extent investors' expectations for these companies' rapid growth are realized, they can continue to be great performers. But at some point, if they keep appreciating faster than the rest of the stock market, there should come a time when even their superior growth rates are fully reflected in their stock prices and their performance should subside: their stock prices may grow "only" in line with their earnings or even slower. And other stocks may come into favor and perhaps outperform. But importantly, there's no reason why this has to happen anytime soon.

There are many similarities between today and past periods of optimism. There's immense excitement about investing in high-growth stocks, fueling continued rapid appreciation. There's very easy monetary policy, which adds fuel to the fire in any bull market. There are pockets of extreme behavior, with 30-40x sales multiples not uncommon for software businesses, and with high-priced IPOs doubling on their first trading day. But there are real differences as well. We've rarely had businesses as dominant as the tech leaders, with the growth runways they have and the profit margins and capital efficiency they enjoy making them more dominant with each passing day. We've never seen businesses with the ability to scale as rapidly and frictionlessly. We've never had such a catalyst for technology adoption as we've had in the coronavirus pandemic. We've had a boom of new public companies coming to market, both through IPOs and SPACs, reversing the long trend of a shrinkage in the number of public companies. We've never had interest rates as low as they are and as likely to stay low for as long as has been telegraphed. The Internet has permeated the world and changed it, and business models have evolved in a way that makes today's situation incomparable to the Nifty Fifty or the Dot Com Bubble of the late '90s (for example, in 1998 there were 150 million Internet users globally; today there are more than that in Indonesia alone).

I believe most types of investment are likely to go through periods of both outperformance and underperformance. There are reasons to believe (with ample counterarguments) that as the tide turns on monetary policy (if it ever does), rising interest rates will disproportionately hurt growth stocks, just as they've been disproportionately helped during this period of easy money. More importantly, it has long been true that when something works, people follow the herd, chase the gains, and bid it up to the point where prospective returns are paltry, thus positioning investments that have been out of favor to become the new outperformers. **But, as I said earlier, broad observations about historic valuations are not a sufficient foundation for market opinions today.** I also believe, as outlined earlier, that certain types of value opportunities have largely evaporated and, save for times of market panic when things become dislocated, are unlikely to deliver the returns they did in the past.

In short, there are arguments for a resurgence in value investing and arguments for its permanent impairment. But, I think this debate gives rise to a false and unhelpful narrative. The value investor of today should dig in with an open mind and a desire to deeply understand things, knowing that in the world we live in, there's likely more to the story than what appears on the Bloomberg screen. **The search for value in low-priced securities that are worth much more should be just one of many important tools in a toolbox, not a hammer constantly in search of a nail. It doesn't make sense for value investors to bar investments simply because (a) they involve high-tech companies that are widely considered to have unusually bright futures, (b) their futures are distant and hard to quantify, and (c) their potential causes their securities to be assigned valuations that are high relative to the historic averages. The goal at the end of the day should be to figure out what all kinds of things are worth and buy them when they're available for a lot less.**

* * *

To end, I'll pull together what I consider the key conclusions:

- Value investing doesn't have to be about low valuation metrics. Value can be found in many forms. The fact that a company grows rapidly, relies on intangibles such as technology for its success and/or has a high p/e ratio shouldn't mean it can't be invested in on the basis of intrinsic value.
- Many sources of potential value can't be reduced to a number. As Albert Einstein purportedly said, "Not everything that counts can be counted, and not everything that can be counted counts." The fact that something can't be predicted with precision doesn't mean it isn't real.
- Since quantitative information regarding the present is so readily available, success in the highly competitive field of investing is more likely to be the result of superior judgments about qualitative factors and future events.
- The fact that a company is expected to grow rapidly doesn't mean it's unpredictable, and the fact that another has a history of steady growth doesn't mean it can't run into trouble.
- The fact that a security carries high valuation metrics doesn't mean it's overpriced, and the fact that another has low valuation metrics doesn't mean it's a bargain.
- Not all companies that are expected to grow rapidly will do so. But it's very hard to fully appreciate and fully value the ones that will.
- If you find a company with the proverbial license to print money, don't start selling its shares simply because they've shown some appreciation. You won't find many such winners in your lifetime, and you should get the most out of those you do find.

I once asked a well-known value investor how he could hold the stocks of fast-growing companies like Amazon – not today, when they're acknowledged winners, but rather two decades ago. His answer was simple: "They looked like value to me." **I guess the answer is "value is where you find it."**

My conversations with Andrew over the ten months of the pandemic have represented a "voyage of discovery" and culminated in this memo. I think we came to some important realizations regarding the question of value versus growth investing, and in the process, I learned a lot about myself.

I don't mean to suggest that anything I've written here pertains to all value or all growth investors. There's a lot of generalizing, and we know how imperfect generalizations can be. I also don't insist that it's correct. It's just the current state of my thinking. Not only do I not insist that my version is the only one possible, but I expect it to evolve further as the world changes and I continue to learn. I hope you'll find this memo interesting and helpful, and I wish you all the best in 2021.

January 11, 2021

Appendix: Dealing with Winners in Practice

The conclusions described above regarding how to deal with winners shouldn't be taken to mean it was easy for Andrew and me to reach agreement on this subject. The discussion here was our most spirited, and we returned to it many times. Our talks usually went something like this:

Howard: Hey, I see XYZ is up xx% this year and selling at a p/e ratio of xx. Are you tempted to take some profits?

Andrew: Dad, I've told you I'm not a seller. Why would I sell?

H: Well, you might sell some here because (a) you're up so much, (b) you want to put some of the gain "in the books" to make sure you don't give it all back and (c) at that valuation, it might be overvalued and precarious. And, of course, (d) no one ever went broke taking a profit.

A: Yeah, but on the other hand, (a) I'm a long-term investor, and I don't think of shares as pieces of paper to trade, but as part ownership in a business, (b) the company still has enormous potential, and (c) I can live with a short-term downward fluctuation, the threat of which is part of what creates opportunities in stocks to begin with. Ultimately, it's only the long term that matters. (There's a lot of a-b-c in our house. I wonder where Andrew got that.)

H: But if it's potentially overvalued in the short term, shouldn't you trim your holding and pocket some of the gain? Then if it goes down, (a) you've limited your regret and (b) you can buy in lower.

A: If I owned a stake in a private company with enormous potential, strong momentum and great management, I would never sell part of it just because someone offered me a full price. Great compounders are extremely hard to find, so it's usually a mistake to let them go. Also, I think it's much more straightforward to predict the long-term outcome for a company than short-term price movements, and it doesn't make sense to trade off a decision in an area of high conviction for one about which you're limited to low conviction.

H: Well for one thing, the p/e ratio is awfully high.

A: The p/e ratio is just a very quick heuristic that doesn't necessarily tell you much about the company. You can't say a stock is overvalued just because its p/e ratio is high relative to historic average p/e's for the market. All that matters is thinking about how much cash flow the company can produce over a long period of time, discounting that at a reasonable discount rate, and comparing the resultant present value against the current price. There are lots of things – about both the company's present condition and its future potential – that don't get picked up in a p/e ratio, so a high multiple alone shouldn't scare you off.

H: Aha! That's just what they said during the Nifty Fifty bubble around the time I started working. "No price too high," was a widespread mantra. Coca-Cola reached 46x earnings at the height of the bubble in mid-1972 – 2.4x the p/e on the S&P 500. From there it fell 65% over the next year and a half.

A: First, saying a high p/e alone shouldn't stop you from owning something doesn't mean there's no price too high. It simply means that no single metric can hold the key to investment decisions, and the price of something should be weighed against its fundamental potential. Coke may have been overvalued in 1972 at its p/e of 46. In particular, since it dealt in a physical product and required incremental capital to grow, it didn't have potential for exponential growth. But note that Coke holders did earn a compound return of 16% percent a year for 26 years even if they bought at the 1972 pre-crash high. So, even without the growth prospects of today's best businesses, companies that can compound earnings at high rates can merit very high p/e ratios.

H: Aren't you concerned that if the leading stocks of today go out of style, you could see XYZ down a third or more?

A: Stocks can go in and out of style, causing their prices to fluctuate wildly. And when a group is in vogue, it may be more likely to experience a reversal. But, at the end of the day, all I care about is this specific company and its long-term potential which, even when using conservative assumptions, I find to be immense relative to its current price. Seeing it fall wouldn't be fun, but I think selling here and missing out on part of that future would be far worse. Some years XYZ may do well, and some years it may do poorly (even perhaps very poorly). But if I'm right, I think it has a great long-term future ahead of it. The only way to be sure we participate in that future is to hold on throughout. And, by the way, if you don't sell, you get to compound without paying capital gains taxes until the end.

H: You run a concentrated portfolio. XYZ was a big position when you invested, and it's even bigger today, given the appreciation. Intelligent investors concentrate portfolios and hold on to take advantage of what they know, but they diversify holdings and sell as things rise to limit the potential damage from what they don't know. Hasn't the growth in this position put our portfolio out of whack in that regard?

A: Perhaps that's true, depending on your goals. But trimming would mean selling something I feel immense comfort with based on my bottoms-up assessment and moving into something I feel less good about or know less well (or cash). To me, it's far better to own a small number of things about which I feel strongly. I'll only have a few good insights over my lifetime, so I have to maximize the few I have.

H: Isn't there any point where you'd begin to sell?

A: In theory there is, but it largely depends on (a) whether the fundamentals are playing out as I hope and (b) how this opportunity compares to the others that are available, taking into account my high level of comfort with this one.

H: If there's a point at which you'd start to sell, what it is? Isn't setting a target price based on intrinsic value an important part of value investing?

A: This company can't be valued with a single number – and it's not a mature company with a fixed value I'm trying to capture – so I can't tell you where I'd start to sell. There are a lot of moving parts; most importantly, it has very strong management that I believe will continue to leverage the company's strong position in the marketplace to develop new avenues of growth. I can't say what those will be, or how they'll be valued, but I'm confident the team will continue to add value. Amazon is the classic example; it created a completely new business out of nothing, AWS, that today accounts for a large percentage of the company's total market value. Selling should be a function of watching how the future develops relative to your expectations and weighing the opportunity as it stands at any point in time against whatever else is out there.

H: Okay. I'm convinced. I hope you hold on!

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