

Memo to: Oaktree Clients
From: Howard Marks
Re: Taking the Temperature

In preparation for my interview for “Lunch with the FT” last fall, I sent the reporter, Harriet Agnew, five memos I had written between 2000 and 2020 that contained market calls. How were they chosen? First, I felt the memos accurately conveyed my thinking at the key turning points in that 20-year period. And second, my calls turned out to be right.

Five Calls

I’ve written before about the time in 2017 when I was working on my book *Mastering the Market Cycle* and batting ideas back and forth with my son Andrew. I said, “You know, looking back, I think my market calls have been about right.” **His response was dead on target as usual: “Yeah, Dad, that’s because you did it five times in 50 years.” It struck me like an epiphany: He was 100% correct.** In those five instances – around the publication of the respective memos – the markets were either crazily elevated or massively depressed, and as a result, I was able to recommend becoming more defensive or more aggressive with a good chance of being right. (Before I go further, let me make it clear that while hindsight shows that the logic behind those calls was correct, that doesn’t mean I made them without great trepidation.)

To illustrate how one might approach making market calls, I’m going to briefly summarize what led me to make those five calls. (I’m not going to go into detail, since the contemporaneous memos I cite in each section will supply more than enough for those who’re interested.) As you read the description of each event, look closely at how the forces that contributed to – and resulted from – each episode led to the next one. You’ll be able to appreciate why I’ve long stressed the role of causality in market cycles.

January 2000

In the fall of 1999, against the backdrop of the massive gains being achieved in tech, media, and telecom stocks, I read Edward Chancellor’s excellent book *Devil Take the Hindmost*. I was struck by the similarities between the TMT boom and the historical bubbles that are the subject of that book. The lure of easy profits, the willingness to leave one’s day job to cash in, the ability to invest blithely in money-losing companies whose business models one can’t explain – all these felt like themes that had rhymed over the course of financial history, leading to bubbles and their painful bursting. And all of them were visible in investor behavior as 1999 came to an end.

While I wasn’t involved directly in equities and Oaktree’s investments had little if any exposure to technology at the time, I observed many market narratives that I thought were too good to be true. Thus, I said so in the memo [bubble.com](#), which was published as 2000 began. The memo described how tech investors were buying the stocks of young companies at astronomical prices set in many cases as a multiple of current revenues, as the companies often had no profits. In fact, many had no revenues, in which case the price was based on little more than a concept and hope. I define a bubble as an irrationally

elevated opinion of an asset or sector, and the TMT craze of the late 1990s exemplified this definition. Thus, I wrote as follows:

In short, I find the evidence of an overheated, speculative market in technology, Internet and telecommunications stocks overwhelming, as are the similarities to past manias. . . .

To say technology, Internet and telecommunications stocks are too high and about to decline is comparable today to standing in front of a freight train. To say they have benefited from a boom of colossal proportions and should be examined very skeptically is something I feel I owe you.

In my opinion, the TMT bubble burst in early 2000 for no reason other than that stock prices had become unsustainably high. The Standard & Poor's 500 Index fell by 46% from its 2000 high to the low in 2002, and the tech-heavy NASDAQ Composite declined by 80% during this period. Many tech stocks lost much more, and many young companies in fields such as e-commerce ended up becoming worthless. And the word "bubble" became part of everyday speech for a new generation of investors.

Late 2004 to Mid-2007

The aftermath of the TMT bubble led to an environment in the mid-aughts that felt to me like a slow-developing trainwreck, with an emphasis on "slow-developing." I started complaining too soon . . . or maybe my timing was reasonable but the negative consequences just took longer to develop than they should have.

In summary, the Federal Reserve was engaging in accommodative monetary policy – taking the fed funds rate to new lows – to battle the potential ramifications of the TMT bubble's bursting. Thus, in my memo [Risk and Return Today](#) from late 2004, I observed that (a) prospective returns on most asset classes were unusually low and (b) risk-seeking on the part of investors looking to improve on those low returns had led them to embrace higher-risk and "alternative" investments.

I identified some of these alternatives in the memo [There They Go Again](#) (May 2005), spending most of my time discussing residential real estate, as that was where investors were embracing the most glaring fallacy: **the belief that home prices only go up**. I also discussed the tendency of investors to (a) ignore the lessons of past cycles, (b) fall for new developments, and (c) pile into risky investments, guided by time-honored platitudes such as "it's different this time," "higher risk means higher returns," or "if it stops working, I'll just get out." Many of these logical errors were being committed by investors in the housing market.

The driving force behind Oaktree's behavior in that period wasn't any of the above. Rather, it was the fact that my Oaktree co-founder Bruce Karsh and I were spending much of each day trudging to each other's offices to complain about the crazy deals – characterized by low returns, high risk for investors, and a lot of optionality for issuers – that were easily being brought to market. **"If deals like this can get done," we agreed, "there's something wrong with the market."** Few people, we thought, were demonstrating prudence, discipline, value consciousness, or the ability to resist the fear of missing out. Investors are supposed to act as disciplinarians, preventing undeserving securities from being issued, but in those days, they weren't performing that function. This signaled a worrisome state of affairs.

These observations – along with an awareness of the generally high prices and low prospective returns that prevailed at the time – convinced us to dramatically increase our usual emphasis on defensiveness. In

response, we sold off large amounts of assets, liquidated large funds, organized small funds (or none at all in certain strategies), and significantly raised the bar against which potential new investments would be evaluated.

In July 2007, I published the memo [*It's All Good*](#), in which I was more emphatic (and had better timing):

Where do we stand in the cycle? In my opinion, there's little mystery. I see low levels of skepticism, fear and risk aversion. Most people are willing to undertake risky investments, often because the promised returns from traditional, safe investments seem so meager. This is true even though the lack of interest in safe investments and the acceptance of risky investments have rendered the slope of the risk/return line quite flat. Risk premiums are generally the skimpiest I've ever seen, but few people are responding by refusing to accept incremental risk. . . .

Eight months after I wrote *It's All Good*, Bear Stearns melted down under the weight of funds that had invested in subprime mortgages. Then, in mid-September we saw – in rapid succession – the rescue of Merrill Lynch by Bank of America, the bankruptcy of Lehman Brothers, and the bailout of AIG. The S&P 500 Index fell to a low of 735 in February 2009, down 53% from its high of 1,549 reached in 2007 (and down 39% from its level around the time I put out the way-too-early *Risk and Return Today*).

Importantly, Oaktree had essentially no involvement with subprime mortgages or mortgage-backed securities. Moreover, those assets were traded in a relatively remote corner of the investment world, and we had little appreciation for what was taking place there. **In other words, our cautious conclusions weren't reached on the basis of subject-matter expertise but rather on an unusually good example of what I call "taking the temperature of the market"** (see pages 9-10).

Late 2008

The world seemed relatively tranquil as September 2008 began, but then Lehman Brothers' bankruptcy filing, mentioned above, took place mid-month. The markets promptly fell apart, based on an apocalyptic view that Lehman's failure was part of a logical progression that had started when Bear Stearns ceased to exist as an independent entity and could eventually lead to a meltdown of the worldwide financial system. Complacency gave way to panic, and the Global Financial Crisis – in capital letters – was upon us.

Anticipating that the reckless behavior we were witnessing (see the previous section) would ultimately create significant buying opportunities for our distressed debt strategy, Oaktree organized an \$11 billion "reserve fund" for distressed debt between January 2007 and March 2008. The fund was created to give us capital to invest if things reached crisis proportions, which by mid-2008, they had not. Because its predecessor fund had only just become fully invested, we started to slowly invest the reserve fund prior to Lehman's bankruptcy. In the market panic that followed Lehman's collapse, our first job was to figure out how best to proceed. Should we continue to invest the fund's capital or hold it in reserve? Or should we step on the gas? Was this the bottom? How could we determine what lay ahead? There was no history of financial sector meltdowns to rely on and no informed way to approach these questions given the uniqueness of the circumstances and the many unknowns. With the future unknowable, we applied the only analytical framework we could think of (simplistic though it was):

I think the outlook has to be viewed as binary: will the world end or won't it? If you can't say yes, you have to say no and act accordingly. In particular, saying it will end would lead to inaction, while saying it's not going to will permit us to do the things that always have worked in the past.

We will invest on the assumption that it will go on, that companies will make money, that they'll have value, and that buying claims on them at low prices will work in the long run. What alternative is there? . . .

No one seems able to imagine how the current vicious circle will be interrupted. But I think we must assume it will be.

It must be noted that, just like two years ago, people are accepting as true something that has never held true before. Then, it was the proposition that massively levered balance sheets had been rendered safe by the miracle of financial engineering. Today, it's the non-viability of the essential financial sector and its greatest institutions. . . . ([Nobody Knows](#), September 19, 2008)

The above reasoning led us to conclude that if we invested and the financial world melted down, it wouldn't matter what we had done. But if we didn't invest and it didn't melt down, we wouldn't have done our job. So, we made the unsupportable assumption that the financial world would continue to exist and concluded that this meant we should invest aggressively. Bruce Karsh's team plunged in, investing an average of \$400 million a week from September 18, 2008 through year-end – a total of \$6 billion in, essentially, a single quarter. Purchases by the rest of Oaktree brought the total invested over that period to \$7.5 billion.

We ran into very few people outside Oaktree who were putting money to work or willing to grant that we might be doing the right thing. I told a reporter friend we were buying, and he said – incredulously – “You are!?!”

Around the same time, I met with the CIO of a client institution as part of our efforts to raise equity to delever a fund that was perilously close to receiving a margin call, and **although I had good responses to all the increasingly negative scenarios she posited, we never got to a point where she would grant that “it can't be that bad.”** This demonstration of unbridled pessimism – which appeared to be widespread at the time – convinced me that little optimism was embodied in the prices of the assets we were buying and thus that there was little chance of losing money. Here's how I put it in a memo I wrote that day:

Skepticism and pessimism aren't synonymous. Skepticism calls for pessimism when optimism is excessive. But it also calls for optimism when pessimism is excessive. . . .

In the third stage of a bear market . . . everyone agrees things can only get worse. The risk in that – in terms of opportunity costs, or forgone profits – is equally clear. **There's no doubt in my mind that the bear market reached the third stage last week. That doesn't mean it can't decline further, or that a bull market's about to start. But it does mean the negatives are on the table, optimism is thoroughly lacking, and the greater long-term risk probably lies in not investing.**

The excesses, mistakes and foolishness of the 2003-2007 upward leg of the cycle were the greatest I've ever witnessed. So has been the resulting panic. The damage that's been done to security prices may be enough to correct for those excesses – or too much or too little. But certainly it's a good time to pick among the rubble. ([The Limits to Negativism](#), October 15, 2008)

Importantly, our confidence in investing the reserve fund's capital was enhanced by the fact that (a) we were buying the senior-most debt of high-quality companies that had been the subject of recent buyouts and (b) we were buying at prices so low that our debt holdings would do fine even if the companies ended up being worth only one-quarter or one-third of what the buyout funds had just paid for them.

Episodes like the visit with the apprehensive CIO told me the post-Lehman temperature of the market was too low. There was too much fear and too little greed, too much pessimism and too little optimism, and too much risk aversion and too little risk tolerance. Negative possibilities were being accepted as fact. **When these things are true, it stands to reason that (a) investor expectations are low; (b) asset prices probably aren't excessive; (c) there's little possibility of investors being disappointed; and (d) thus there's little likelihood of lasting loss and a good chance prices will work their way higher. In other words, this was the epitome of a buying opportunity.**

March 2012

After the TMT bubble burst in mid-2000, the S&P 500 dropped in 2000, 2001, and 2002, the first three-year stretch of negative returns since 1939. These declines caused many investors to lose interest in equities. Just a few years earlier, there had been widespread faith that stocks could never perform poorly for a meaningful period. Now, all of a sudden, such a time seemed to be at hand. Stocks delivered disillusionment, which can be one of the strongest forces in markets, and investors turned against them.

During the first few years of the aughts, the lack of appetite for equities – and for bonds, given how low the Fed had driven yields – caused many investors to conclude they couldn't earn their targeted returns through traditional asset classes. This, in turn, caused capital to flow to alternative investments, first hedge funds and then private equity. Soon investors were confronted by the Global Financial Crisis and the fear of financial-sector meltdown described above, which added to their negativity. These developments weighed heavily on investor psychology, and as a result, the S&P 500 was essentially flat from 2000 through 2011, returning an average of only 0.55% a year for the 12 years.

This is how things stood in March 2012, when I wrote the memo [*Déjà Vu All Over Again*](#). My inspiration arrived when, sleepless while on a business trip in Chile, I reached into my Oaktree bag for something to read and came up with an old article I had wanted to revisit because I was sensing parallels between the current environment and the one the article described. It was "The Death of Equities," one of the most important magazine articles on investing of all time. It had appeared in *Businessweek* on August 13, 1979, following years of raging inflation, dreary economic news, and poor stock market performance.

In short, the article's theme was that no one would ever invest in stocks again because they had done so badly for so long. Here are a few of the article's observations:

Whatever caused it, the institutionalization of inflation – along with structural changes in communications and psychology – have killed the U.S. equity market for millions of investors. . . .

For investors . . . low stock prices remain a disincentive to buy. . . .

For better or for worse, then, the U.S. economy probably has to regard the death of equities as a near-permanent condition – reversible some day, but not soon. . . .

It would take a sustained bull market for a couple of years to attract broad-based investor interest and restore confidence.

In other words, poor performance had led to investor disinterest, and disinterest had perpetuated the poor performance, creating one of the supposedly unstoppable vicious cycles we see in the markets from time to time. In the author's view, this negative state was likely to prevail for years.

Like many arguments in the world of investing, the assertions in "The Death of Equities" may have seemed sensible on the surface. **But if you drilled down a bit – and, in particular, if you thought like a contrarian – the logical flaws became readily apparent. What if the lows in optimism and enthusiasm for equities meant things couldn't get any worse? Wouldn't that mean they could only get better? And in that case, wouldn't it be reasonable to assume that low stock prices presaged future gains, not continued stagnation?**

The above paragraph captures in brief the difference between the thinking of the average investor and what I call "second-level thinking." The latter doesn't rely on first impressions; rather, it's deeper, more complex, and more nuanced. In particular, second-level thinkers understand that the convictions of the masses shape the market, but if those convictions are based on emotion instead of sober analysis, they should often be bet against, not backed. Here's how I put it in *Déjà Vu All Over Again*:

The negative factors are clear to the average investor. And from there he draws negative conclusions. But the person who applies logic and insight, rather than superficial views and emotion, sees something very different.

Thus, it would not have come as a surprise to the more sophisticated investor that "The Death of Equities" – perhaps the most sweepingly dour article ever written about the stock market – preceded one of (if not the) most positive periods in market history. In the 21 years from 1979 (when the article was written) through 1999 (just before the TMT bubble burst), the S&P 500's average annual return was 17.9%. That was nearly double its long-term average and **enough to turn \$1 in 1979 into \$32 in 1999!!** Once more from *Déjà Vu All Over Again*:

Importantly, the stage had been set for this rise in 1979 by the accumulation and excessively pessimistic discounting of negatives. . . . **The extrapolator threw in the towel on stocks, just as the time was right for the contrarian to turn optimistic. And it will always be so. . . .**

The great irony here is that the extrapolator actually thinks he's being respectful of history: he's assuming continuation of a trend that has been underway. But the history that deserves his attention isn't the recent rise or fall of an asset's price, but rather the fact that most things eventually prove to be cyclical and tend to swing back from the extreme toward the mean.

Rereading "The Death of Equities" in 2012 allowed me to immediately see parallels between the then-present day and the environment in which that article was written. Recent events had been highly negative, performance had been poor, and investor sentiment was depressed. That was enough to allow me – benefiting from the lessons of history – to adopt a positive stance:

The story [in 2012] isn't as hopeless as it was in 1979, but it is uniformly negative. Thus, while I don't expect an equity rally anything like what followed on the heels of "The Death of Equities," I don't find it hard to conjure up positive scenarios.

The result: From 2012 – the year of *Déjà Vu All Over Again* – through 2021, the S&P 500 returned 16.5% a year. Once again, excessively negative sentiment had resulted in major gains. It's as simple as that.

March 2020

The last of the five calls – recent enough for readers to recall the context – came in the early days of the Covid-19 pandemic. The disease began to enter most people’s consciousness in February 2020, and from mid-February to mid-March, the S&P 500 fell by approximately one-third.

In *Nobody Knows II* (March 2020), my first memo during the pandemic, I cited Harvard epidemiologist Marc Lipsitch, who said on a podcast that when trying to understand the disease, there were (a) facts, (b) informed extrapolations from analogies to other viruses, and (c) opinion or speculation. But it was clear to me at the time that there were no “facts” regarding the pandemic’s future course and no “history of other viruses” of comparable magnitude to extrapolate from. Thus, we were left with “opinion or speculation.”

The bottom line of the above – simply put – is that we didn’t know anything about what the future held. But whereas some people think ignorance regarding the future means they mustn’t take any action, **someone who thinks the matter through logically and unemotionally should recognize that ignorance doesn’t mean the position they’re in is necessarily the position they should remain in.** (This is very much along the lines of Oaktree’s post-Lehman thinking.)

Two weeks later, on March 19, 2020, I ended my client-only memo *Weekly Update* in a similar vein:

I’ll sum up my views simply – since there’s nothing sophisticated to say:

- “The bottom” is the day before the recovery begins. Thus it’s absolutely impossible to know when the bottom has been reached . . . ever. Oaktree explicitly rejects the notion of waiting for the bottom; we buy when we can access value cheap.
- Even though there’s no way to say the bottom is at hand, the conditions that make bargains available certainly are materializing.
- Given the price drops and selling we’ve seen so far, I believe this is a good time to invest, although of course it may prove not to have been the best time.
- **No one can argue that you should spend all your money today . . . but equally, no one can argue that you shouldn’t spend any.** (Emphasis added)

Whereas some of the market calls described earlier relied on knowledge of history and/or logical analysis, this recommendation was based primarily on acknowledgment of ignorance. All we knew for sure was that (a) there was a pandemic underway and (b) the U.S. stock market was down one-third. Doesn’t it stand to reason, though, that however much money long-term investors had in stocks when the S&P 500 peaked at 3,386 in February, they should have considered adding to their positions when it hit 2,237 roughly a month later? That was the essence of my reasoning. Here’s how I built up to the conclusion cited above:

It’s easy to say that something approaching panic is present in the markets. We’ve seen record percentage declines several times within the last month (exceeded since 1940 only by Black Monday – October 19, 1987 – when the S&P 500 declined by 20.4% in a day). This week and last included down days as follows: -7.6%, -9.5%, -12.0%, and -5.2% yesterday. These are enormous losses. . . .

. . . there has been a rush to cash. Both long positions and short positions have been closed out – a sure sign of chaos and uncertainty. Cash in money market funds has

increased substantially. This doesn't tell us anything about fundamentals, but the outlook for eventual market performance is improved:

- the more people have sold,
- the less they have left to sell, and
- the more cash they have with which to buy when they turn less pessimistic. . . .

[In the words of Justin Quaglia, one of our traders,] after two days of a basically stalled but stressed [bond] market, we “finally had the rubber band snap.” Forced sellers (needing to sell for immediate cash flow needs) brought the market lower in a hurry. We opened 3-5 points lower, and the Street was again hesitant to take risk. . . .

We're never happy to have the events that bring on chaos, and especially not the ones that are underway today. But it's sentiment like Justin describes above that fuels the emotional selling that allows us to access the greatest bargains. (*Weekly Update*, emphasis added)

While neither a historical foundation nor rigorous quantitative analysis was achievable, the above paragraphs indicate that one could still logically determine an appropriate course of action. As I wrote in that same memo:

What do we know? Not much other than the fact that asset prices are well down, asset holders' ability to hold coolly is evaporating, and motivated selling is picking up.

But that was enough. Paralysis wasn't called for, but rather steps that could help us take advantage of most investors' panic and the resulting dramatic price declines. Sometimes it's as simple as that. When the knee-jerk reaction of most investors is to stand pat or sell, a contrarian decision to buy might well be called for. Doing so is never easy, though, and mid-March 2020 was one of the most challenging environments I've ever worked through. But the key, as Rudyard Kipling wrote in the poem “If,” is to “keep your head when all about you are losing theirs. . . .”

How Can You Do It?

I spent the preceding pages describing these five calls not for purposes of self-congratulation but rather to lay the groundwork for a discussion of how one can make useful observations regarding the status of the markets. **Hopefully we learn from our experiences as we go through life. But to really learn from them, we have to step back on occasion, look at an entire string of events, and figure out the following: (a) what happened, (b) is there a pattern that has repeated, and (c) what are the lessons to be learned from the pattern?**

Once in a while – once or twice a decade, perhaps – markets go so high or so low that the argument for action is compelling and the probability of being right is high. As my son helped me to recognize, I had identified five of those, and they paid off. But what if I'd tried to make 50 market calls in my 50 years . . . or 500? By definition, I would have been making judgments about markets that were closer to the middle ground – perhaps a little high or a little low, but not so extreme as to permit dependable conclusions. Investors' records of success with calls in markets like these are poor, since even if they're right about asset prices being out of line, it's very easy for something that's a little overpriced to go on to become demonstrably more so, and then to turn into a raging bubble, and vice versa. In fact, if we could rely on small mispricings to always correct promptly, they would never grow into the manias, bubbles, and crashes we see from time to time.

So, one key is to avoid making macro calls too often. I wouldn't want to try to make a living predicting the outcome of coin tosses or figuring out whether the favorite will cover the point spread in every football game over the course of a season. You have to pick your spots – as Warren Buffett puts it, wait for a fat pitch. Most of the time, you have nothing to lose by abstaining from trying to adroitly get in and out of the markets: you merely participate in their long-term trends, and those have been very favorable.

My readers know I don't think consistently profitable market calls can be manufactured out of macroeconomic forecasts. Nor do I believe you can beat the market simply by analyzing company reports. On both subjects, as Andrew puts it (see my memo [Something of Value](#), January 2021), “readily available quantitative data regarding the past and present” can't hold the secret to superior performance since it's available to everyone.

When markets are at extreme highs or lows, the essential requirement for achieving a superior view of their future performance lies in understanding what's responsible for the current conditions.

Everyone can study economics, finance, and accounting and learn how the markets are supposed to work. But superior investment results come from exploiting the differences between how things are supposed to work and how they actually do work in the real world. To do that, the essential inputs aren't economic data or financial statement analysis. The key lies in understanding prevailing investor psychology.

For me, the things one must do fall under the general heading of “taking the temperature of the market.” I'll itemize the most essential components here:

- **Engage in pattern recognition.** Study market history in order to better understand the implications of today's events. Ironically, when viewed over the long term, investor psychology and thus market cycles – which seem flighty and unpredictable – fluctuate in ways that approach dependability (if you're willing to overlook their highly variable causality, timing, and amplitude).
- **Understand that cycles stem from what I call “excesses and corrections”** and that a strong movement in one direction is more likely to be followed – sooner or later – by a correction in the opposite direction than by a trend that “grows to the sky.”
- **Watch for moments when most people are so optimistic that they think things can only get better**, an expression that usually serves to justify the dangerous view that “there's no price too high.” Likewise, recognize when people are so depressed that they conclude things can only get worse, as this often means they think a sale at any price is a good sale. When the herd's thinking is either Pollyannaish or apocalyptic, the odds increase that the current price level and direction are unsustainable.
- **Remember that in extreme times, because of the above, the secret to making money lies in contrarianism, not conformity.** When emotional investors take an extreme view of an asset's future and, as a result, take the price to unjustified levels, the “easy money” is usually made by doing the opposite. **This is, however, very different from simply diverging from the consensus all the time.** Indeed, most of the time, the consensus is as close to right as most individuals can get. So to be successful at contrarianism, you have to understand (a) what the herd is doing, (b) why it's doing it, (c) what's wrong with it, and (d) what should be done instead and why.
- **Bear in mind that much of what happens in economies and markets doesn't result from a mechanical process, but from the to and fro of investors' emotions.** Take note of the swings and capitalize whenever possible.
- **Resist your own emotionality.** Stand apart from the crowd and its psychology; don't join in!

- **Be on the lookout for illogical propositions** (such as “stocks have fallen so far that no one will be interested in them”). When you come across a widely accepted proposition that doesn’t make sense or one you find too good to be true (or too bad to be true), take appropriate action. See something; do something.

Obviously, there’s a lot to grapple with when taking the temperature of the market. In my opinion, it has more to do with clear-eyed observations and assessments of the implications of what you see than with computers, financial data, or calculations.

I’ll go into additional depth on a couple of points:

On pattern recognition: You may have noticed that the first of the five calls described above was made in 2000, when I had already been working in the investment industry for more than 30 years. Does this mean there were no highs and lows to remark on in those earlier years? No, I think it means it took me that long to gain the insight and experience needed to detect the market’s excesses.

Most notably, whereas I spent two pages above describing the profound error in “The Death of Equities,” you may have noticed that I didn’t say anything about my having called out the article when it appeared in *Businessweek* in 1979. The reason is simple: I didn’t. I had only been in this business for about a decade at that point, so (a) I didn’t have the experience needed to recognize the article’s error and (b) I had yet to develop the unemotional stance and contrarian approach needed to depart from the herd and rebel against its thesis. **The best I can say is that my eventual development of those attributes enabled me to catch the same error when it arose again 33 years later.** Pattern recognition is an important part of what we do, but it seems to require time in the field – and some scars – rather than just book learning.

On cycles: In my book *Mastering the Market Cycle*, I defined cycles not as a series of up and down movements, each of which regularly **precedes** the next – which I believe is the usual definition – but as a series of events, each of which **causes** the next. This causality holds the key to understanding cycles. In particular, I think economies, investor psychology, and thus markets eventually go too far in one direction or another – they become too positive or too negative – and afterward they eventually swing back toward moderation (and then usually toward excess in the opposite direction). **Thus, in my opinion, these cycles are best understood as stemming from “excesses and corrections.”** Overlooking the details of the individual episodes, it’s clear from the descriptions of these five calls that the greatest opportunities for bargain purchases result from overly negative prevailing psychology and the greatest opportunities to sell at too-high prices arise from excessive optimism.

Macro Calls and the Oaktree Culture

While on the subject of market calls, I want to touch on two questions I’ve received repeatedly since the publication of my memo [The Illusion of Knowledge](#) (September 2022), which discussed why I believe creating helpful macro forecasts is so challenging. How does making these market calls fit within Oaktree’s investment approach? And how can we make “micro forecasts” concerning companies, industries, and securities without predicting the macro context?

In 1995, when my four Oaktree co-founders and I decided to form a new firm, we’d already been working together for nine years on average. To come up with an investment philosophy that would guide the new entity, we only had to reflect on what had worked for us up to that point and what we believed in. This led us to write down the six tenets that describe how we invest, and we haven’t changed a word in 28 years.

Of the six tenets, two raise questions regarding how macro calls fit within Oaktree’s investment approach:

- Number five: “We don’t base our investment decisions on macro forecasts.”
- Number six: “We’re not market timers.”

How about the first of those? It’s easy to say you don’t invest on the basis of macro forecasts, and I’ve been saying this for decades. **But the truth is, if you’re a bottom-up investor, you make estimates regarding future earnings and/or asset values, and those estimates have to be predicated on assumptions regarding the macro environment.** Certainly, you can’t predict a business’s results in a given period without considering what’ll be going on in the economy at that point. So, then, what does avoiding macro forecasting mean to us? My answer is as follows:

- We generally assume the macro environment of the future will resemble past norms.
- We then make allowance for the possibility that things will be worse than normal. Ensuring our investments have a generous “margin of safety” makes it more likely they’ll do okay even if future macro developments disappoint somewhat.
- **What we never do is project that the macro environment will be distinctly better than normal** in some way, making winners out of particular investments. Doing so can lead to profits if one is right, but it’s hard to consistently make such forecasts correctly. Further, investments reliant on favorable macro developments can expose investors to the possibility of disappointment, leading to loss. **It’s our goal to construct portfolios where the surprises will be on the upside. Relying on optimistic underlying assumptions is rarely part of such a process. We prefer to make assumptions I would describe as “neutral.”**

So we do base our modeling on macro assumptions – by necessity – but rarely are those assumptions boldly idiosyncratic or optimistic. We never base our investment decisions on the mistaken belief that we (or anyone else) can predict the future. Thus, we recognize that the above average results we seek must arise from our ground-up insights and not from our ability to do a superior job of forecasting unusual macro events.

You might ask here, “What about the memo [Sea Change](#) and its assertion that we may be seeing a shift toward a wholly different environment?” My answer is that I feel good about this memo because (a) it’s mostly a review of recent history and (b) the important observations surround the unusual nature of the 2009-21 period, its effect on investment outcomes, and the improbability of it repeating. (I’m particularly comfortable saying interest rates aren’t going to decline by another 2,000 basis points from here.) While it’s important to stick to guiding principles, it’s also essential to recognize and respond to real change when it happens. Thus, I stand by *Sea Change* (my only expression of an opinion of this kind in my entire working life) as an acceptable deviation from my standard practice. For me, the case for a sea change has more to do with **observing and inferring** than it does with **predicting**.

And what about market timing? As I’ve written numerous times since developing my risk-posture framework a few years ago, every investor should operate most of the time in the context of their normal risk posture, by which I mean the balance between aggressiveness and defensiveness that’s right for them. It makes perfect sense to try to vary that balance when circumstances dictate compellingly that you should do so and your judgments have a high probability of being correct, like in the case of the five calls I’ve discussed. But such occasions are rare.

So, we stay in our normal balance – which in Oaktree’s case implies a bias toward defensiveness – unless compelled to do otherwise. But we are willing to make changes in our balance between

aggressiveness and defensiveness, and we have done so successfully in the past. In fact, I consider one of my principal responsibilities to be thinking about the proper balance for Oaktree at any given time.

If we're happy to vary our risk posture, then what does it mean when we say, "we're not market timers"? For me, it means the following:

- **We don't sell things we consider attractive long-term holdings to raise cash in expectation of a market decline.** We usually sell because (a) a holding has reached our target price, (b) the investment case has deteriorated, or (c) we've found something better. Our open-end portfolios are almost always fully invested; that way we avoid the risk of missing out on positive returns. It also means buying usually necessitates some selling.
- **We don't say, "It's cheap today, but it'll be cheaper in six months, so we'll wait."** If it's cheap, we buy. If it gets cheaper and we conclude the thesis is still intact, we buy more. We're much more afraid of missing a bargain-priced opportunity than we are of starting to buy a good thing too early. No one really knows whether something will get cheaper in the days and weeks ahead – that's a matter of predicting investor psychology, which is somewhere between challenging and impossible. We feel we're much more likely to correctly gauge the value of individual assets.

While on the subject of buying too soon, I want to spend a minute on an interesting question: Which is worse, buying at the top or selling at the bottom? For me the answer is easy: the latter. If you buy at what later turns out to have been a market top, you'll suffer a downward fluctuation. But that isn't cause for concern if the long-term thesis remains intact. And, anyway, the next top is usually higher than the last top, meaning you're likely to be ahead eventually. But if you sell at a market bottom, you render that downward fluctuation permanent, and, even more importantly, you get off the escalator of a rising economy and rising markets that has made so many long-term investors rich. This is why I describe selling at the bottom as the cardinal sin in investing.

* * *

Thinking about the macro environment and how it influences our proper risk posture falls squarely within our responsibilities as investment managers. But the bottom line is that, at Oaktree, we approach these things with great humility, diverging from our neutral assumptions and normal behavior only when circumstances leave us no other choice. "Five times in 50 years" gives you an idea about our level of interest in being market timers. The fact is, we do so hesitantly.

July 10, 2023

Legal Information and Disclosures

This memorandum expresses the views of the author as of the date indicated and such views are subject to change without notice. Oaktree has no duty or obligation to update the information contained herein. Further, Oaktree makes no representation, and it should not be assumed, that past investment performance is an indication of future results. Moreover, wherever there is the potential for profit there is also the possibility of loss.

This memorandum is being made available for educational purposes only and should not be used for any other purpose. The information contained herein does not constitute and should not be construed as an offering of advisory services or an offer to sell or solicitation to buy any securities or related financial instruments in any jurisdiction. Certain information contained herein concerning economic trends and performance is based on or derived from information provided by independent third-party sources. Oaktree Capital Management, L.P. (“Oaktree”) believes that the sources from which such information has been obtained are reliable; however, it cannot guarantee the accuracy of such information and has not independently verified the accuracy or completeness of such information or the assumptions on which such information is based.

This memorandum, including the information contained herein, may not be copied, reproduced, republished, or posted in whole or in part, in any form without the prior written consent of Oaktree.

© 2023 OAKTREE CAPITAL MANAGEMENT, L.P.
ALL RIGHTS RESERVED