Memo to: Oaktree Clients

From: Howard Marks

Re: The Impact of Debt

My partner Bruce Karsh recently supplied me with a newspaper article about chess that inspired me to write a brief memo called *The Indispensability of Risk*. The response to the memo was favorable, hopefully because people found the content valuable, but quite possibly because it was only three pages long versus the usual ten to twelve. Thus encouraged, I'm following up with another short memo.

One of my more interesting sources for readings on practical philosophy – including investment philosophy – is the blog from the Collaborative Fund to which Morgan Housel, a fund partner, is a regular contributor. As I read Housel's musings, I often find myself saying, "that's right in line with what I think." And at other times, I say, as I hope others say after reading my memos, "I never thought of it that way."

I found Housel's April 30 article, entitled "How I Think About Debt," particularly interesting. The subject is the impact of debt on longevity, and it really boils down to a discussion of risk, one of my favorite topics.

Housel starts by discussing the 140 businesses in Japan that are still operating more than 500 years after they were founded and the few that are purportedly more than 1,000 years old.

> It's astounding to think what these businesses have endured – dozens of wars, emperors, catastrophic earthquakes, tsunamis, depressions, on and on, endlessly. And yet they keep selling, generation after generation.
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> These ultra-durable businesses are called "shinise," and studies of them show they tend to share a common characteristic: they hold tons of cash, and no debt. That's part of how they endure centuries of constant calamities.

Clearly, all else being equal, people and companies that are indebted are more likely to run into trouble than those that aren't. And it goes without saying that a home or car that hasn't been used as collateral for a loan can't be foreclosed on or repossessed. It's the presence of debt that creates the possibility of default, foreclosure, and bankruptcy.

Does that mean debt is a bad thing and should be avoided? Absolutely not. Rather, it's a matter of whether the amount of debt is appropriate relative to (a) the size of the overall enterprise and (b) the potential for fluctuations in the enterprise's profitability and asset value.

Housel frames the issue by introducing the idea of potential volatility over one's lifetime: "Not just market volatility, but . . . world and life volatility: recessions, wars, divorces, illness, moves, floods, changes of heart, etc." With no debt, he postulates, we're likely to survive all but the most infrequent, most volatile events. But in a succession of illustrations, Housel shows that as the level of one's indebtedness increases, the range of volatility one can withstand narrows, until at a very high level of debt, only the tamest of environments are survivable. As Housel puts it, "**as debt increases, you narrow the range of outcomes you can endure in life.**"

Housel's approach to thinking about debt – and especially his illustrations – reminded me of my December 2008 memo, *Volatility + Leverage = Dynamite*. (Unless otherwise indicated, this memo is the source of the quotations that follow; in all cases, emphasis is in the original.) In that memo, I used a series of simple graphics to show that the lower a company's debt load is, the greater the decline in fortune it could survive. And I made the following observation about the root cause of the Global Financial Crisis, which was in full force at the time of the memo:

> **. . . the amount of borrowed money – leverage – that it's prudent to use is purely a function of the riskiness and volatility of the assets it's used to purchase.** The more stable the assets, the more leverage it's safe to use. Riskier assets, less leverage. It's that simple.
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> **One of the main reasons for the problem today at financial institutions is that they underestimated the risk inherent in assets such as home mortgages and, as a result, bought too much mortgage-backed paper with too much borrowed money.**

Portfolios, Leverage, and Volatility

The reason for taking on debt – i.e., using what investors call "leverage" – is simple: to increase so-called capital efficiency. Debt capital is usually cheap relative to the expected returns that motivate equity investments and thus relative to the imputed cost of equity capital. Thus, it's efficient to use it in lieu of equity. **In casinos, I've heard the pit boss say, "The more you bet, the more you win when you win." Likewise, for a given amount of equity capital, (a) the more debt capital you use, the more assets you can own and (b) the more assets you own, the greater your profits will be . . . when things go well.**

But few people talk about the downside. The pit boss never says, ". . . and the more you lose when you lose." Likewise, when your assets decline in value, the more leverage you've employed, the more equity loss you'll suffer.

The magnification of gains and losses stemming from leverage is typically symmetrical: a given amount of leverage amplifies gains and losses similarly. But levered portfolios face a downside risk to which there isn't a corresponding upside: the risk of ruin. **The most important adage regarding leverage reminds us to "never forget the six-foot-tall person who drowned crossing the stream that was five feet deep on average."** To survive, you have to get through the low points, and the more leverage you carry (everything else being equal), the less likely you are to do so.

> . . . it's important to recognize the role of volatility. Even if losses aren't permanent, a downward fluctuation can bring risk of ruin if a portfolio is highly leveraged and (a) the lenders can cut off credit, (b) investors can be frightened into withdrawing their equity, or (c) the violation of regulatory or contractual standards can trigger forced selling.

Obviously, the greatest leverage-related losses occur when the potential for downward fluctuations has been underestimated for a meaningful period of time and thus the use of leverage has become excessive. Generally speaking, "normal levels of volatility" – those seen on a regular basis and documented through historical statistics – are used in investors' calculations and reflected in the amounts of leverage they employ. It's the isolated "tail events" that saddle levered investors with the greatest losses:

The problem is that extreme volatility and loss surface only infrequently. And as time passes without that happening, it appears more and more likely that it'll never happen – that assumptions regarding risk were too conservative. Thus, it becomes tempting to relax rules and increase leverage. And often this is done just before the risk finally rears its head. As Nassim Nicholas Taleb wrote in *Fooled by Randomness*:

> Reality is far more vicious than Russian roulette. First, it delivers the fatal bullet rather infrequently, like a revolver that would have hundreds, even thousands of chambers instead of six. After a few dozen tries, one forgets about the existence of a bullet, under a numbing false sense of security . . . Second, unlike a well-defined precise game like Russian roulette, where the risks are visible to anyone capable of multiplying and dividing by six, one does not observe the barrel of reality. . . . One is thus capable of unwittingly playing Russian roulette – and calling it by some alternative "low risk" name.

. . . **In all aspects of our lives, we base our decisions on what we think probably will happen. And, in turn, we base that to a great extent on what usually happened in the past.** We expect results to be close to the norm most of the time, but we know it's not unusual to see outcomes that are better or worse. Although we should bear in mind that, once in a while, a result will be outside the usual range, we tend to forget about the potential for outliers. And importantly, as illustrated by recent events, we rarely consider outcomes that have happened only once a century . . . or never.

Cycles in the Use of Leverage

In my second book, *Mastering the Market Cycle: Getting the Odds on Your Side*, one of the longest chapters, and probably the most important, is one I hadn't planned when I first sat down to write: "The Cycle in Attitudes Toward Risk." Investor psychology has a dominant influence on the market in the short run, and the attitudes that motivate investment decisions are often cyclical in nature, driving markets to irrational extremes and then correcting in the opposite direction . . . to the opposite extreme.

Attitudes that govern the use of debt capital are examples of this cyclical process. When things have been going well for a while – asset prices have been rising, investment returns have been positive, and the use of leverage has paid off in the form of higher returns – investors view leverage as benign. As a result:

- the favorable aspects of leverage become well-recognized,
- the negative potential is overlooked,
- investors become interested in employing more,
- lenders become willing to provide more, and
- regulations and mores governing the use of leverage tend to become more permissive.

But when events turn negative, this process goes into reverse. Leverage is penalized, not rewarded. Thus, its use declines. And importantly, lenders provide less and try to demand repayment of outstanding leverage if they can, leading to negative consequences for borrowers. In this way, as we so frequently see, psychology often strays from the "happy medium" and moves toward extreme highs that presage painful losses when extreme lows are reached.

The source of losses from excessive use of leverage might be best understood through an adaptation of my favorite new quote, from Edward Chancellor's book *The Price of Time*, which I cited in this past

January's memo *Easy Money*:

> The Manchester Banker John Mills commented perceptively [in 1865] that "as a rule, panics do not destroy capital; they merely reveal the extent to which it has previously been destroyed by [the taking on of excessive leverage in good times]."

Using Debt Prudently

As with so many aspects of investing, determining the proper amount of leverage has to be a function of *optimizing, not maximizing*. Given that leverage magnifies gains when there are gains and that investors only invest when they expect there to be gains, it can be tempting to think the right amount of leverage is "all you can get." But if you bear in mind (a) leverage's potential to magnify losses when there are losses and (b) the risk of ruin under extreme negative circumstances, investors should usually use less than the maximum available. Successful investments, perhaps enhanced by the moderate use of leverage, should usually provide a good-enough return – something few people think about in good times.

Here's how I summed it up in *Volatility + Leverage = Dynamite*:

> Clearly, it's difficult to always use the right amount of leverage, because it's difficult to be sure you're allowing sufficiently for risk. Leverage should only be used on the basis of demonstrably cautious assumptions. And it should be noted that **if you're doing something novel, unproven, risky, volatile, or potentially life-threatening, you shouldn't seek to maximize returns. Instead, err on the side of caution. The key to survival lies in what Warren Buffett constantly harps on: margin of safety.** Using 100% of the leverage one's assets might justify is often incompatible with assuring survival when adverse outcomes materialize. . . .
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> **The riskier the underlying assets, the less leverage should be used to buy them.** Conservative assumptions on this subject will keep you from maximizing gains but possibly save your financial life in bad times.

The right way to think about debt may be best captured by one of the oldest maxims: "There are old investors, and there are bold investors, but there aren't many old bold investors." Using a moderate amount of borrowed capital balances the desire for enhanced gains against the awareness of the potential negative consequences. It's only in this way that one can hope to attain the longevity of Morgan Housel's 500-year-old success stories.

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