

Memo to: Oaktree Clients
From: Howard Marks
Re: The Seven Worst Words in the World

I have a new book coming out next week titled [Mastering the Market Cycle: Getting the Odds on Your Side](#). It's not a book about financial history or economics, and it isn't highly technical: there are almost no numbers in it. Rather, the goal of the book, as with my memos, is to share how I think, this time on the subject of cycles. As you know, it's my strong view that, while they may not know what lies ahead, investors can enhance their likelihood of success if they base their actions on a sense for where the market stands in its cycle.

The ideas that run through the book are best captured by an observation attributed to Mark Twain: "History doesn't repeat itself, but it does rhyme." While the details of market cycles (such as their timing, amplitude and speed of fluctuations) differ from one to the next, as do their particular causes and effects, there are certain themes that prove relevant in cycle after cycle. The following paragraph from the book serves to illustrate:

The themes that provide warning signals in every boom/bust are the general ones: that excessive optimism is a dangerous thing; that risk aversion is an essential ingredient for the market to be safe; and that overly generous capital markets ultimately lead to unwise financing, and thus to danger for participants.

An important ingredient in investment success consists of recognizing when the elements mentioned above make for unwise behavior on the part of market participants, elevated asset prices and high risk, and when the opposite is true. We should cut our risk when trends in these things render the market precarious, and we should turn more aggressive when the reverse is true.

One of the memos I'm happiest about having written is [The Race to the Bottom](#) from February 2007. It started with my view that investment markets are an auction house where the item that's up for sale goes to the person who bids the most (that is, who's willing to accept the least for his or her money). **In investing, the opportunity to buy an asset or make a loan goes to the person who's willing to pay the highest price, and that means accepting the lowest expected return and shouldering the most risk.**

- Like any other auction, when potential buyers are scarce and don't have much money or are reluctant to part with the money they have, the things on sale will go begging and the prices paid will be low.
- But when there are many would-be buyers and they have a lot of money and are eager to put it to work, the bidding will be heated and the prices paid will be high. When that's the case, buyers won't get much for their money: all else being equal, prospective returns will be low and risk will be high.

Thus the idea for this memo came from the seven worst words in the investment world: "too much money chasing too few deals."

In 2005-06, Oaktree adopted a highly defensive posture. We sold lots of assets; liquidated larger distressed debt funds and replaced them with smaller ones; avoided the high yield bonds of the most highly levered LBOs; and generally raised our standards for the investments we would make. Importantly, whereas the size of our distressed debt funds historically had ranged up to \$2 billion or so, in early 2007 we announced the formation of a fund to be held in reserve until a special buying opportunity materialized. Its committed capital eventually reached nearly \$11 billion.

What caused us to turn so negative on the environment? The economy was doing quite well. Stocks weren't particularly overpriced. And I can assure you we had no idea that sub-prime mortgages and sub-prime mortgage backed securities would go bad in huge numbers, bringing on the Global Financial Crisis. Rather, the reason was simple: with the Fed having cut interest rates in order to prevent problems, investors were too eager to deploy capital in risky but hopefully higher-returning assets. Thus almost every day we saw deals being done that we felt wouldn't be doable in a market marked by appropriate levels of caution, discipline, skepticism and risk aversion. As Warren Buffett says, "the less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs." **Thus the imprudent deals that were getting done in 2005-06 were reason enough for us to increase our caution.**

The Current Environment

What are the elements that have created the current investment environment? In my view, they're these:

- In order to counter the contractionary effects of the Crisis, the world's central banks flooded their economies with liquidity and made credit available at artificially low interest rates.
- This caused the yields on investments at the safer end of the risk/return continuum to range from historically low in the United States to negative (and near zero) in Europe and elsewhere. At least some of the money that in the past would have gone into low-risk investments, such as money market instruments, Treasuries and high grade bonds, turned elsewhere in search of more suitable returns. (In the U.S. today, most endowments and defined-benefit pension funds require annual returns in the range of 7½-8%. It's interesting to note that the notion of required returns is much less prevalent among investing institutions outside the U.S., and where they do exist, the targets are much lower.)
- Whereas I thought while it was raging that the pain of the Crisis would cause investors to remain highly risk-averse for years – and thus to refuse to provide risk capital – by injecting massive liquidity into the economy and lowering interest rates, the Fed limited the losses and forced the credit window back open, rekindling investors' willingness to bear risk.
- The combination of the need for return and the willingness to bear risk caused large amounts of capital to flow to the smaller niche markets for risk assets offering the possibility of high returns in a low-return world. And what are the effects of such flows? Higher prices, lower prospective returns, weaker security structures and increased risk.

In the current financial environment, the number "ten" has taken on particular significance:

- **This month marks the tenth anniversary of Lehman Brothers' bankruptcy filing on September 15, 2008**, and with it the arrival of the terminal melt-down phase of the Crisis.

- Thanks to the response of the Fed and the Treasury to the Crisis, **the U.S. has seen roughly ten years of artificially low interest rates, quantitative easing and other forms of stimulus.**
- **The resulting economic recovery in the U.S. has entered its tenth year** (and it's worth noting that the longest U.S. recovery on record lasted ten years).
- **The market's upswing from its low during the Crisis is in its tenth year.** Some people define a bull market as a period in which a market rises without experiencing a drop of 20%. On August 22, the S&P 500 passed the point at which it had done so for 3,453 days (113 months), making this the longest bull market in history. (Some quibble, since the market could be said to have risen for 4,494 days in 1987-2000 if you're willing to overlook a decline in 1990 of 19.92% – i.e., not quite 20%. I don't think the precise answer on this subject matters. What we can say for sure is that stocks have risen for a long time.)

What are the implications of these events? I think they're these:

- **Enough time has passed for the trauma of the Crisis to have worn off; memories of those terrible times to have grown dim; and the reasons for stringent credit standards to have receded into the past.** My friend Arthur Segel was head of TA Associates Realty and now teaches real estate at Harvard Business School. Here's how he recently put it: "I tell my students real estate has ten-year cycles, but luckily bankers have five-year memories."
- Investors have had plenty of time to get used to monetary stimulus and reliance on the Fed to inject liquidity to support economic activity.
- While there certainly is no hard-and-fast rule that limits economic recoveries to ten years, it seems reasonable to assume based on history that the odds are against a ten-year-old recovery continuing much longer. (On the other hand, since the current recovery has been the slowest since World War II, it's reasonable to believe there haven't been the usual excesses that require correcting, bringing the recovery to an end. And some observers feel that in the period ahead, a proactive or politicized Fed might well return to cutting interest rates – or at least stop raising them – if weakness materializes in the economy or the stock market.)
- **Finally, it's worth noting that nobody who entered the market in nearly ten years has experienced a bear market or even a really bad year, or seen dips that didn't correct quickly. Thus newly minted investment managers haven't had a chance to learn firsthand about the importance of risk aversion, and they haven't been tested in times of economic slowness, prolonged market declines, rising defaults or scarce capital.**

For the reasons described above, I feel the requirements have been fulfilled for a frothy market as set forth in the citation from my new book on this memo's first page.

- Investors may not feel optimistic, but because the returns available on low-risk investments are so low, they've been forced to undertake optimistic-type actions.
- Likewise, in order to achieve acceptable results in the low-return world described above, many investors have had to abandon their usual risk aversion and move out the risk curve.
- As a result of the above two factors, capital markets have become very accommodating.

Do you disagree with these conclusions? If so, you might not care to read further. But these are my conclusions, and they're the reason for this memo at this time.

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In memos and presentations over the last 14 months, I've made reference to some specific aspects of the investment environment. These have included:

- the FAANG companies (Facebook, Amazon, Apple, Netflix and Google/Alphabet), whose stock prices incorporated lofty expectations for future growth;
- corporate credit, where the amounts outstanding were increasing, debt ratios were rising, covenants were disappearing, and yield spreads were shrinking;
- emerging market debt, where yields were below those on U.S. high yield bonds for only the third time in history;
- SoftBank, which was organizing a \$100 billion fund for technology investment;
- private equity, which was able to raise more capital than at any other time in history; and
- cryptocurrencies led by Bitcoin, which appreciated by 1,400% in 2017.

I didn't cite these things to criticize them or to blow the whistle on something amiss. Rather I did so because phenomena like these tell me the market is being driven by:

- optimism,
- trust in the future,
- faith in investments and investment managers,
- a low level of skepticism, and
- risk tolerance, not risk aversion.

In short, attributes like these don't make for a positive climate for returns and safety.

Assuming you have the requisite capital and nerve, the big and relatively easy money in investing is made when prices are low, pessimism is widespread and investors are fleeing from risk. The above factors tell me this is not such a time.

A Case In Point: Direct Lending

In the years immediately following the Crisis, the banks – which remained traumatized and in many cases were marked by low capital ratios – were reluctant to do much lending. Thus a few bright credit investors began to organize funds to engage in “direct lending” or “private lending.” With the banks hamstrung by regulations and limited capital, non-bank entities could be selective in choosing their borrowers and could insist on high interest rates, low leverage ratios and strong asset protection.

Not all investors participated in the early days of 2010-11. But many more got with the program in later years, after private lending had caught on and more managers had organized direct-lending funds to accommodate them. As the *Wall Street Journal* wrote on August 13:

The influx of money has led to intense competition for borrowers. On bigger loans, that has driven rates closer to banks' and led to a loosening of credit terms. For smaller loans, “I don't think it could become any more borrower friendly than it is today,” said Kent Brown, who advises mid-sized companies on debt at investment bank Capstone Headwaters.

The market is poised to grow as behemoths and smaller outfits angle for more action. . . . Overall, firms completed fundraising on 322 funds dedicated to this type of lending between 2013 and 2017, **with 71 from firms that had never raised one before**, according to data-provider Preqin. That compares with 85 funds, including 19 first-timers, in the previous five years. (Emphasis added)

And what about the quality of the loans being made? The *Journal* goes on:

Companies often turn to direct lenders because they don't meet banks' criteria. A borrower may have a one-time blip in its cash flows, have a lot of debt or operate in an out-of-favor sector. . . .

Direct loans are typically floating-rate, meaning they earn more in a rising-rate environment. But borrowers accustomed to low rates may be unprepared for a jump in interest costs on what is often a big pile of debt. That risk, combined with the increasingly lenient terms and the relative inexperience of some direct lenders, could become a bigger issue in a downturn.

Observations like these tempt me to apply what I consider the #1 investment adage: “What the wise man does in the beginning, the fool does in the end.” It seems obvious that direct lending is taking place today in a more competitive environment. More people are lending more money today, and they're likely to compete for opportunities to lend by lowering their standards and easing their terms. That makes this form of lending less attractive than it used to be, all else being equal.

Has direct lending reached the point at which it's wrong to do? Nothing in the investment world is a good idea or a bad idea *per se*. **It all depends on when it's being done, and at what price and terms, and whether the person doing it has enough skill to take advantage of the mistakes of others, or so little skill that he or she is the one committing the mistakes.**

At the present time, the managers raising and investing large funds are showing the most growth. But in the eventual economic correction, they may be shown to have pursued asset growth and management fees over the ability to be selective regarding the credits they backed.

Lending standards and credit skills are seldom tested in positive times like we've been enjoying. That's what Warren Buffett had in mind when he said, “It's only when the tide goes out that you learn who has been swimming naked.” **Skillful, disciplined, careful lenders are likely to get through the next recession and credit crunch. Less-skilled managers may not.**

Signs of the Times

Unfortunately, there is no single reliable gauge that one can look to for an indication of whether market participants' behavior at a point in time is prudent or imprudent. All we can do is assemble anecdotal evidence and try to draw the correct inferences from it. Here are a few observations regarding the current environment (all relating to the U.S. unless stated otherwise):

Debt levels:

- “One remarkable feature of the past decade is that between 2007 and 2017, the ratio of global debt to GDP jumped from 179 per cent to 217 per cent, according to the Bank for International Settlements.” (*Financial Times*)
- “In the last year Congress has passed a gargantuan tax cut and spending increase that, according to Deutsche Bank, represents the largest stimulus to the economy outside of a recession since the 1960s. It sets the federal debt, already the highest relative to GDP since the 1940s, on an even steeper trajectory [and] stimulates an economy already at or above full employment which could fuel inflation . . .” (*Wall Street Journal*)
- “Debt levels crept up as central banks suppressed [interest rates], with the proportion of global highly-leveraged companies – those with a debt-to-earnings ratio of five times or greater – hitting 37 percent in 2017 compared with 32 percent in 2007, according to S&P Global Ratings.” (*Bloomberg*)
- The debt of U.S. non-financial corporations as a percent of GDP has returned to its Crisis level and is near a post-World War II high. (*New York Times*)
- Total leveraged debt outstanding (high yield bonds and leveraged loans) is now \$2.5 trillion, exactly double the amount in 2007. Leveraged loans have risen from \$500 billion in 2008 to almost \$1.1 trillion today. (*S&P Global Market Intelligence*)
- Most of this growth has been in levered loans, not high yield bonds. Whereas the amount of high yield bonds outstanding is roughly unchanged from the end of 2013, leveraged loans are up \$400 billion. In the process, we think the risk level has risen in loans while remaining stable in high yield bonds. These trends in loans are due in large part to strong demand from new Collateralized Loan Obligations and other investors seeking floating-rate returns.
- “Some \$104.6 billion of new [leveraged] loans were made in May, according to Moody’s Investors Service, topping a previous record of \$91.4 billion set in January 2017, and the pre-crisis high of \$81.8 billion in November 2007.” (*Barron’s*)
- BBB-rated bonds – the lowest investment grade category – now stand at \$1.4 trillion in the U.S. and constitute the largest component of the investment grade universe (roughly 47% in both the U.S. and Europe, up from 35% and 19%, respectively, ten years ago). (*IMF, NYT*)
- The amount of CCC-rated debt outstanding currently stands 65% above the record set in the last cycle. (It is, however, down 10% from the peak in 2015, thanks primarily to reduced issuance of CCCs; numerous defaults of energy-related CCCs; and strong demand – largely from CLOs ⊖ for first lien loans rated B-, which otherwise might have been unsecured CCC bonds.) (*Credit Suisse*)

Quality of debt:

- The average debt multiple of EBITDA on large corporate loans is just above the previous high set in 2007; the average multiple on large LBO loans is just below the 2007 high; and the average multiple on middle market loans is at a clear all-time high. (*S&P GMI*)
- \$375 billion of covenant-lite loans were issued in 2017 (75% of total leveraged loan issuance), up from \$97 billion (and 29% of total issuance) in 2007. (*S&P GMI*)
- BB-rated high yield bonds are now coming to market with the looser covenants common in investment grade bonds.
- More than 30% of LBO loans (and more than 50% of M&A loans) incorporate “EBITDA adjustments” these days, versus roughly 7% and 25%, respectively, ten years ago. A mid-

teens percentage of LBO loans include adjustments of more than 0.5x EBITDA, as opposed to a few percent ten years ago. (*S&P GMI*)

- Loans to raise money for stock buybacks or dividends to equity owners are back to pre-Crisis levels. (*S&P GMI*)
- The all-in yield spread on BB/BB- institutional loans is down to 200-250 basis points, as opposed to roughly 300-400 bps in late 2007/early 2008. Spreads on B+/B loans also have narrowed by 100-150 bps. (*S&P GMI*)

Other observations:

- At the beginning of 2018, 2,296 private equity funds were in fund-raising mode, seeking \$744 billion of equity capital. (*FT*) These are all-time highs.
- As of June, SoftBank had been able to raise \$93 billion of the \$100 billion it sought for its Vision Fund for technology investments, and it was trying to raise \$5 billion of the remainder from an incentive scheme for its employees. Lacking capital, the employee pool would borrow it from SoftBank, which in turn hoped to borrow it from Japanese banks. (*FT*)
- Challenged to bid for deals against SoftBank’s huge firepower, other venture capital funds are expanding in response. They’re seeking capital in much greater amounts than they invested in the past, and investors – attracted by the returns being reported by the best funds – are eager to supply it. Of course this onslaught of money is bound to have a deleterious impact on future returns.
- “According to Crunchbase, there have been 268 [venture capital] mega-rounds (\$100 million rounds), invested during the first seven months of this year, almost equal to a record of 273 mega-rounds for the entire year of 2017. And during the month of July alone, there were 50 financing deals totaling \$15 billion, which is a new monthly high.” (*The Robin Report*)
- From 2005 to 2015, the oil fracking industry increased its net debt by 300 percent, even though, according to Jim Chanos, from mid-2012 to mid-2017 the 60 biggest fracking firms had negative cash flow of \$9 billion per quarter. “Interest expenses increased at half the rate debt did because interest rates kept falling,” said a Columbia University fellow. (*NYT*)
- Student debt has more than doubled since the Crisis, to \$1.5 trillion, and the delinquency rate has risen from 7½% to 11%. (*NYT*)
- Personal loans are surging, too. The amount outstanding reached \$180 billion in the first quarter, up 18%. “Fintech companies originated 36% of total personal loans in 2017 compared with less than 1% in 2010, Chicago-based TransUnion said.” (*Bloomberg*)
- Emerging market countries have been able to issue vast amounts of debt, much of it repayable in dollars and euros to which they have only limited access. “According to the Bank for International Settlements, . . . the total amount of dollar-based loans [worldwide] has jumped from \$5.8 trillion in the first quarter of 2009 to \$11.4 trillion today. Of that, \$3.7 trillion has gone to emerging markets, more than doubling in that period.” (*NYT*)
- In a relatively minor but extreme example, yield-hungry Japanese investors poured several billion dollars into so-called “double-decker” funds that invested in Turkish assets and/or swapped into wrappers denominated in high-yielding (but depreciating) Turkish lira. (*FT*)

Moving on from the general to the specific, I’ve asked Oaktree’s investment professionals, as I did at the time of [The Race to the Bottom](#), for their nominees for imprudent deals they’ve seen. Here’s the evidence they provided of a heated capital market and a strong appetite for risk, with their commentary in quotes in a few cases. (Since my son Andrew often reminds me of Warren Buffett’s admonition, “praise by name, criticize by category,” I won’t identify the companies involved.)

- Capital equipment company A issued debt to finance its acquisition by a private equity fund. “While we thought the initial price talk was far too tight, the deal was oversubscribed and upsized, and the pricing was tightened by 25 bps. Final terms were highly aggressive with covenant-lite structure, uncapped adjustments to EBITDA, and a large debt incurrence capacity.” The company missed expectations in the first two quarters after issuance, in reaction to which the first lien loan traded down by as much as five points and the high yield bonds traded down by as much as 15.
- The European market isn’t insulated from the trend toward generosity. Company B is a good services company, albeit with exposure to cyclical end-markets; is smaller than its peers; has lower margins, higher leverage and limited cash-generation ability; and went through a restructuring a few years ago. Nevertheless, on the back of adjusted EBITDA equal to 150% of its reported figure, the company was able to issue seven-year bonds paying just over 5%.
- Energy product company C recently went public. Despite a retained deficit of \$2.4 billion and an S-1 stating “we have incurred significant losses in the past and do not expect to be profitable for the foreseeable future,” its shares were oversubscribed at the IPO price and are now selling 67% higher. One equity analyst says that’s a reasonable valuation, since it’s 5x estimated 2020 revenues. Another has a target price 25% below the current price, although to get to that valuation the analyst assumes the company will be able to expand its gross margin by 30% a year for the next 12 years and be valued at 6x EBITDA in 2030.
- Over the last two years, company D has spent an amount on buybacks equal to 85% of a year’s EBITDA. In part because of the buybacks, the company now has much more debt than it did two years ago. In contrast to the last two years, we estimate that in the seven preceding years, it spent only one-tenth as much on buybacks as in the last two years, at an average purchase price 85% below the more recent average.
- A buyout fund just bought company E, a terrific company, for 15x EBITDA, a very high “headline figure.” The price is based on adjusted EBITDA which is 125% of reported EBITDA; thus the transaction price equates to 19x reported EBITDA. Stated leverage is 7x adjusted EBITDA, meaning 9x reported EBITDA. “We aren’t saying this will wind up being a bad deal. Just saying that IF this ends up being a bad deal, no one will be surprised. Everyone will say, with the benefit of hindsight, ‘they paid way too much and put way too much debt on the balance sheet, and it was doomed out of the gate.’ ”
- Company F earns substantial EBITDA, but 60% comes from a single unreliable customer, and its growth is constrained by geography. We arrived at a price where we thought it would constitute a good investment for us. But the owners wanted twice as much . . . and they got it from a buyout fund. “We are generally seeing financial sponsors being very aggressive, pricing to perfection with very little room for error, on the back of very liberal lending practices by banks and non-traditional lenders. We all know how this will end.”
- A year ago, a buyout fund financed the acquisition of company G by one of its portfolio companies with 100% debt and took out a dividend for itself. The deal was marketed with an adjusted EBITDA figure that was 190% of the company’s reported EBITDA. Based on the adjusted figure, total leverage was more than 7x, and based on the reported figure it was 13.5x. The bonds are now trading above par, and the yield spread to worst on the first lien notes is below 250 bps.
- Company H is a good, growing company that we were ready to exit, and our bankers sent out 100 “teasers.” We received 35 indications of interest: three from strategic buyers and 32 from financial sponsors. “The strategic buyers offered the lowest valuations; it’s always a big warning sign when financial sponsors with no hope of synergies are offering prices much

higher than strategics.” We received four purchase offers from buyout funds, one with the price left blank. We ended up selling at 14x EBITDA, with total leverage of more than 7x.

- In 2017, investors bought over \$10 billion of debt from Argentine and Turkish local-currency-earning corporates that now trades, on average, 500 bps wider than at issuance (e.g., at an 11% yield today versus 6% at issue).
- The high point in emerging market debt (or was it the low point?) was Argentina’s ability in June 2017 to issue \$2.75 billion of oversubscribed 100-year bonds despite a financial history marked by crises in 1980, 1982, 1984, 1987, 1989 and 2001. The bond was priced at 90 for a yield of 7.92%. Now it’s trading at 75, implying a mark-down of 17% in 16 months.

Of particular note, David Rosenberg, Oaktree’s co-portfolio manager for U.S. high yield bonds, provides an example of post-Crisis restraints being loosened. The government’s Leverage Lending Guidelines, “introduced in 2013 to curb excessive risk-taking, capped leverage at 6x – subject to certain conditions – and contributed to less aggressive dealmaking [*sic*] among regulated banks. . . .” Now the head of the Office of the Comptroller of the Currency has indicated, “it’s up to the banks to decide what level of risk they are comfortable with in leveraged lending. . . .” Here’s what the OCC head said on the subject: “What we are telling banks is you have capital and expected loss models and so if you are reserving sufficient capital against expected losses, then you should be able to make that decision.” (The quotes above are from *Debtwire*.) And here’s my response: how did that work out last time?

David goes on: “Not surprisingly, bankers have told me they are now testing the waters with 7.5x levered LBOs. **A banker recently told me that for the first time since 2007, he has been in a credit review and heard the credit deputy rationalize approving a risky deal because it is a small part of a larger portfolio so they can afford for it to go wrong, and if they pass on the deal they will lose market share to their competitors.**” That sounds an awful lot like “if the music’s playing, you’ve gotta dance.” I repeat: how’d that work out last time?

The bottom-line question is simple: does the sum of the above evidence suggest today’s market participants are guarded or optimistic? Skeptical or accepting of easy solutions? Insisting on safety or afraid of missing out? Prudent or imprudent? Risk-averse or risk-tolerant? To me, the answer in each case favors the latter, meaning the implications are clear.

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Before closing, I want to share my view that equities are priced high but (other than a few specific groups, such as technology and social media) not extremely high – especially relative to other asset classes – and are unlikely to be the principal source of trouble for the financial markets. I find the position of equities today similar to that in 2005-06, from which they played little or no role in precipitating the Crisis. (Of course, that didn’t exempt equity investors from pain; they were hit nevertheless with declines of more than 50%.)

Instead of equities, the main building blocks for the Crisis of 2007-08 were sub-prime mortgage backed securities, other structured and levered investment products fashioned from debt, and derivatives, all examples of financial engineering. In other words, not securities and debt instruments themselves, but the uses to which they were put.

This time around, it's mainly public and private debt that's the subject of highly increased popularity, the hunt by investors for return without commensurate risk, and the aggressive behavior described above. Thus it appears to be debt instruments that will be found at ground zero when things next go wrong. As often, *Grant's Interest Rate Observer* puts it well:

Naturally, the lowest interest rates in 3,000 years have made their mark on the way people lend and borrow. Corporate credit, as [Wells Fargo Securities analyst David] Preston observes, is "lower-rated and higher-levered. This is true of investment-grade corporate debt. This is true in the loan market. This is true in private credit."

So corporate debt is a soft spot, perhaps *the* soft spot of the cycle. It is vulnerable not in spite of, but because of, resurgent prosperity. The greater the prosperity (and the lower the interest rates), the weaker the vigilance. It's the vigilance deficit that crystalizes the errors that lead to a crisis of confidence.

Conditions overall aren't nearly as bad as they were in 2007, when banks were levered 32-to-1; highly levered investment products were being invented (and swallowed) daily; and financial institutions were investing heavily in investment vehicles built out of sub-prime mortgages totally lacking in substance. **Thus I'm not describing a credit bubble or predicting a resulting crash.** But I do think this is the kind of environment – marked by too much money chasing too few deals – in which investors should emphasize caution over aggressiveness.

On the other hand – and in investing there's always another hand – there is little reason to think today's risky behavior will result in defaults and losses until we see serious economic weakness. And there's certainly no reason to think weakness will arrive anytime soon. The economy, growing but relatively free of excesses, feels right now like it could go on a good bit longer.

But on the third hand, the possible effects of economic overstimulation, increasing inflation, contractionary monetary policy, rising interest rates, rising corporate debt service burdens, soaring government deficits and escalating trade disputes do create uncertainty. And so it goes.

* * *

Being alert for the ability of others to issue flimsy securities and execute fly-by-night schemes is a big part of what I call "taking the temperature of the market." By also incorporating awareness of historically high valuations and euphoric investor attitudes, taking the temperature can give us a sense for whether a market is elevated in its cycle and it's time for increased defensiveness.

This process can give you a sense that the stage is being set for losses, although certainly not when or to what extent a downturn will occur. Remember that [*The Race to the Bottom*](#), which in retrospect seems to have been correct and timely, was written in February 2007, whereas the real pain of the Global Financial Crisis didn't set in until September 2008. Thus there were 19 months when, according to the old saying, "being too far ahead of one's time was indistinguishable from being wrong." In investing we may have a sense for what's going to happen, but we never know when.

Thus the best we can do is turn cautious when the situation becomes precarious. We never know for sure when – or even whether – “precarious” is going to turn into “collapse.”

To close, I’m going to recycle two of the final paragraphs of [The Race to the Bottom](#). Doing so permits me to provide an excellent example of history’s tendency to rhyme:

Today’s financial market conditions are easily summed up: There’s a global glut of liquidity, minimal interest in traditional investments, little apparent concern about risk, and skimpy prospective returns everywhere. Thus, as the price for accessing returns that are potentially adequate (but lower than those promised in the past), investors are readily accepting significant risk in the form of heightened leverage, untested derivatives and weak deal structures. . . .

This memo can be recapped simply: there’s a race to the bottom going on, reflecting a widespread reduction in the level of prudence on the part of investors and capital providers. No one can prove at this point that those who participate will be punished, or that their long-run performance won’t exceed that of the naysayers. But that is the usual pattern.

It’s now eleven years later, but I can’t improve on that.

I’m absolutely not saying people shouldn’t invest today, or shouldn’t invest in debt. Oaktree’s mantra recently has been, and continues to be, “move forward, but with caution.” The outlook is not so bad, and asset prices are not so high, that one should be in cash or near-cash. The penalty in terms of likely opportunity cost is just too great to justify being out of the markets.

But for me, the import of all the above is that investors should favor strategies, managers and approaches that emphasize limiting losses in declines above ensuring full participation in gains. You simply can’t have it both ways.

Just about everything in the investment world can be done either aggressively or defensively. In my view, market conditions make this a time for caution.

September 26, 2018

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