

Memo to: Oaktree Clients
From: Howard Marks
Re: What Does the Market Know?

My buddy Sandy was an airline pilot. When asked to describe his job, he always answers, “hours of boredom punctuated by moments of terror.” The same can be true for investment managers, for whom the last few weeks have been an example of the latter. We’ve seen bad news and prices cascading downward. Investors who thought stocks were priced right 20% ago and oil \$70 ago now wonder if they aren’t risky at their new reduced prices.

In Thursday’s memo, “[On the Couch](#),” I mentioned the two questions I’d been getting most often: “What are the implications for the U.S. and the rest of the world of China’s weakness, and are we moving toward a new crisis of the magnitude of what we saw in 2008?” Bloomberg invited me on the air Friday morning to discuss the memo, and the anchors mostly asked one version or another of a third question: “does the market’s decline worry you?” That prompted this memo in response.

The answer lies in a question: “what does the market know?” Is the market smart, meaning you should take your lead from it? Or is it dumb, meaning you should ignore it? Here’s what I wrote in “It’s Not Easy” in September and included in “[On the Couch](#)”:

Especially during downdrafts, many investors impute intelligence to the market and look to it to tell them what’s going on and what to do about it. This is one of the biggest mistakes you can make. **As Ben Graham pointed out, the day-to-day market isn’t a fundamental analyst; it’s a barometer of investor sentiment. You just can’t take it too seriously.** Market participants have limited insight into what’s really happening in terms of fundamentals, and any intelligence that could be behind their buys and sells is obscured by their emotional swings. It would be wrong to interpret the recent worldwide drop as meaning the market “knows” tough times lay ahead.

The rest of this memo will be about fleshing out this theme (meaning you can stop reading here if you’ve had enough or are short on time).

The Nature of Consensus Opinion

I based the above reference to Ben Graham on his famous observation that in the long run the market’s a weighing machine, but in the short run it’s a voting machine. In other words, in the long term the consensus of investors figures out what things are really worth and moves the price there. But in the short term, the market merely reflects consensus opinion regarding an asset’s future popularity, something that’s highly susceptible to the ups and downs of psychology.

So, what does the market know? **First it’s important to understand for this purpose that there really isn’t such a thing as “the market.” There’s just a bunch of people who participate in a market.** The market isn’t more than the sum of the participants, and it doesn’t “know” any more than their collective knowledge.

This is a very important point. If you believe the market has some special insight that exceeds the collective insight of its participants, then you and I have a fundamental disagreement. The thinking of the crowd isn't synergistic. In my view, the investment IQ of the market isn't any higher than the average IQ of the participants. And everyone who transacts gets a volume-weighted vote in setting an asset's price at a given point in time.

People of all different levels of ability act together to set the price. They vary all over the lot in terms of knowledge, experience, insight and emotionalism. The market doesn't give the ones who are superior in these regards any more influence than the others, especially in the short run. **My bottom line on this subject is that the market price merely reflects the average insight of the market participants.** That's point number one.

If anything, I think it's emotion that's synergistic. It builds into herd behavior or mass hysteria. When 10,000 people panic, the emotion seems to snowball. People influence each other, and their emotions compound, so that the overall level of panic in the market can be higher than the panic of any participant in isolation. That's something I'll return to later.

Now let's think about the first goal of investing: to buy low. We want to buy things whose price underestimates the value of the underlying assets or earnings (value investing) or the future potential (growth investing). **In either case, we're looking for instances when the market is wrong.** If we thought the market was always right – the efficient market hypothesis – we wouldn't spend our lives as active investors. Since we do, we'd better believe we know more than the consensus. **So by definition we must not think the market – that is, the sum of all other investors – knows everything, or knows more than we do, or is always right.** That's point number two.

And that leads logically to point number three: why take instruction from a group of people who know less than you do? In "[On the Couch](#)," I wrote that it all seems obvious: investors rarely maintain objective, rational, neutral and stable positions. Do you agree with that or not? Is the market a clinical and rational fundamental analyst, or a barometer of investor sentiment? Does the market's behavior these days look like something a mature adult should emulate?

It seems clear to me: the market does not have above average insight, but it often is above average in emotionality. Thus we shouldn't follow its dictates. In fact, contrarianism is built on the premise that we generally should do the opposite of what the crowd is doing, especially at the extremes, and I prefer it.

A Case in Point – The Crash of 2008

The year 2008 culminated in the greatest panic I've ever seen. The events that built up to it included:

- massive subprime mortgage defaults and the failure of mortgage backed vehicles,
- meltdowns at funds that had invested in those vehicles, notably two Bear Stearns funds,
- the collapse of Bear Stearns, necessitating its purchase by JPMorgan for almost no consideration,
- rescues of Merrill Lynch by Bank of America; Wachovia by Wells Fargo; and Washington Mutual by JPMorgan (after it was first seized by the Office of Thrift Supervision),
- decisions on the part of BofA and Barclays not to acquire Lehman Brothers, and on the part of the U.S. Treasury not to bail it out, leading to Lehman's bankruptcy filing,
- the appearance that Morgan Stanley would be next if it couldn't secure additional capital, and
- widespread speculation regarding other firms that might follow.

A massive downward spiral ensued. Among the contributing factors were:

- precipitous declines in the prices of bank stocks,
- large-scale short selling of the stocks (the “uptick rule” previously mandated that a stock could only be sold short at a price above the last trade, meaning short selling couldn’t force the price down. But the rule was repealed in 2007, so there ceased to be limits on when stocks could be shorted. Thus short sellers could force stock prices down – whether intentionally, in what in the 1920s were called “bear raids,” or just because they thought the stocks were right to sell),
- dramatic increases in the cost to insure the debt of banks through credit default swaps.

In the environment described above, the downward spiral in bank stocks was intensified by the following factors (whether they were intentionally manipulated, I can’t say for sure):

- It was easy to bet against the banks by buying credit default swaps (CDS) on their debt.
- It was easy to depress bank stocks by selling them short.
- The declining stock prices were taken as a sign that the banks were weakening, causing the cost of buying CDS protection to rise.
- The rising cost of CDS protection was taken as an additional negative sign, causing the stocks to fall further.

I can tell you, it had the feel of an unstoppable vicious circle. Some compared it to the “China Syndrome”: a 1979 movie with Jane Fonda and Michael Douglas in which an out-of-control nuclear reaction threatens to propel reactor components through the earth’s core, from the U.S. to China. Thus the stock of panic-ridden Morgan Stanley (for example) fell 82%, to less than \$10.

But it’s important to note that the negative feedback loop described above was able to continue without reference to – and not necessarily in reasonable relationship to – actual developments at the banks or changes in their intrinsic value. Eventually, however, the Treasury restricted short selling in the stocks of 19 financial institutions deemed “systemically important.” Morgan Stanley secured a \$9 billion injection of convertible equity from Mitsubishi UFJ Financial Group. The panic subsided. The economy and capital markets recovered. And Morgan Stanley’s stock traded at \$33 a year later.

Do you wish you had taken the market’s instruction in 2008 and sold bank stocks? Or do you wish you had rejected its advice and bought instead? In short, did the market know anything?

There are three possible answers:

- The market was flat wrong in 2008 when it took Morgan Stanley’s stock so low.
- The market was right; it properly reflected the possibility of a meltdown that could have happened but didn’t.
- The market was wrong in the case of Morgan Stanley in 2008, but most of the time it isn’t.

I like the first, and the second is appealing as well. But while a meltdown certainly was possible, the below-\$10 price probably assigned it too high a likelihood. And, of course, I’m not persuaded by the third.

A Case in Point – Senior Loans in the Financial Crisis

While on the subject of 2008, I want to review the performance of senior loans. In the old days, banks made corporate loans, sometimes sharing part with a syndicate of a few friendly banks but retaining the rest. More recently the custom changed, with banks syndicating their loans widely to buyers of all types and retaining rather little. This process has more in common with investment banks' underwriting of securities than with the commercial banks' prior lending process.

Senior loans became a significant area of activity for credit investors like us. They're typically their issuers' senior-most debt, so they're perceived to carry little credit risk. And since they pay interest at floating rates, there is no interest rate risk. (Of course, with so little risk, they offer low yields.) They're the highest-quality instruments I've ever dealt in.

Because they were considered so safe, loans were widely deemed appropriate for levered investment, and prior to the financial crisis large numbers of highly levered Collateralized Loan Obligations, or CLOs, were formed to hold them. Borrowing at low floating rates to buy senior debt paying high floating rates was very enticing, and the CLO business mushroomed.

Senior loans were affected dramatically by the events of 2008. Since senior loans had been used to fund buyouts with purchase prices at high multiples of cash flow, investors became concerned about the issuers' ability to service them, and especially to refinance them when they came due (since the capital markets had slammed shut). Loan prices fell to levels never seen before in the absence of a default; whereas non-distressed senior loans had rarely sold below 95 in the past, now they fell to the 80s, and then to the 60s. Because of the collapsing prices, "market-value" CLOs received margin calls they couldn't meet, and banks seized portfolios and liquidated them in overnight BWIC (bid-wanted-in-competition) transactions. The indiscriminate selling put further pressure on prices, leading to more margin calls and more BWICs: another prototypical negative feedback loop.

The senior loan index was down 29% in 2008. That exceeded the 25% decline of the high yield bond index. Why would senior debt fall more during a crisis than junior debt? The answer is that senior loans had been ground zero for buying with leverage (and thus for margin calls and forced selling) whereas high yield bonds had not.

The key questions were rarely asked while things melted down: what were the loans worth, and would they pay? That depended on the outlook for defaults, but in late 2008 few people felt they could assess it or could take the time required to do so. **And neither did they question the extent to which the price collapses had been caused by margin calls and forced selling, rather than investment fundamentals.** They just succumbed to negativity and sold.

When 2008 ended, and with it the cycle of selling, price declines, margin calls, more selling and more price declines, the prices of loans stopped going down. And then they went up. The senior loan index rose 45% in 2009, meaning someone who invested on December 31, 2007 and didn't sell was up 3% overall by December 31, 2009. What if you had taken the market's advice in the post-Lehman meltdown and sold in response to the negative signal? You'd have a valid complaint, but whom would you blame? The market . . . or yourself?

What Does a Falling Market Say About Value?

What do big price declines mean? They mean market participants sense fundamental deterioration. But what price declines say is reflective, not predictive. They tell you about the events that have occurred, and how investors have reacted to them. They don't tell you anything that the average investor doesn't know about future events. And, again, I'm firmly convinced (a) the average investor doesn't know much, and (b) following average opinion won't help you attain above average results.

Most of my readers want to perform better than the average investor. As I've set out in "Dare to Be Great II" (April 2014) and in the discussion of "second level thinking" in my book *The Most Important Thing*, to accomplish that, you have to invest differently than the average investor. To do that, you have to think differently than the average investor. And to do that, you have to consider different inputs than the average investor, or consider inputs differently. You simply can't follow the signals their behavior provides.

It's a matter of logic: if price movements reflect average opinion, following their supposed advice can't help you perform above average.

Now let's think about the question of whether to sell. Here are some possible reasons to do so:

- Belief that the price is high relative to the fundamentals.
- Belief that while the current price may not be high relative to the current fundamentals, the fundamentals will deteriorate in ways that aren't anticipated by the price. (In other words, the price is high relative to how the fundamentals will come to be viewed.)
- Belief that the price will fall regardless of the fundamentals, meaning that by selling today you can avert a loss and/or position yourself to profit by buying lower later.

Do you agree that these are the main reasons to sell? Are there others? Are these all legitimate?

For me the first two are compelling. This is what the skilled investor thinks about. Both of these decisions are made relative to something called "intrinsic value." **There's only one intelligent form of investing: figure out what something's worth and see if you can buy it at or below that price.** It's all about value.

But note that the third reason to sell shown above has nothing to do with value. The price may be high, low or fair relative to the fundamentals today or what they're expected to be tomorrow. You just sell because you think the price will fall.

First, does it make sense to sell something if the price is low relative to the fundamentals, just because you fear it may fall in the short run? A long-term value investor holds or buys when price is low relative to value. Low price relative to value is his dream. Why sell a low-priced asset just because you think it's going to fall for a while? Most people understand the challenge in dealing with "two-decision stocks": you sell because you think the price may fall (even though it may be something you'd like to hold for the long term), and then you have to figure out when to buy it back. Last year Charlie Munger complained to me that they're really "three-decision stocks": you sell it because you think the price is full, you have to figure out when to buy it back, and in the meantime you have to come up with something else to do with your money. **In my experience, most people who are lucky enough to sell something before it goes down get so busy patting themselves on the back that they forget to buy it back.**

All other things being equal, as something falls in price, you should want to own it more, not less. The buy-and-hold value investor is stalwart, ignoring price fluctuations. Even better, the contrarian moves opposite to the market, buying when the price falls and selling when it rises.

Second, if not on the basis of fundamentals, how does one make the decision to sell for the third reason listed above? Essentially, two things give rise to changes in asset prices: changes in the outlook (macro or asset-specific) and changes in attitudes toward the asset. In other words, fundamentals and valuation. Fundamentals are dealt with above. If you're going to try to benefit from changes in price that are unrelated to changes in fundamentals, you're left having to predict investor psychology. If "[On the Couch](#)" wasn't successful in convincing you this isn't possible, this memo probably won't be, either.

My bottom line is that markets don't assess intrinsic value from day to day, and certainly they don't do a good job during crises. Thus market price movements don't say much about fundamentals. **Even in the best of times, when investors are driven by fundamentals rather than psychology, markets show what the participants think value is, rather than what value really is.** Value is something the market doesn't know any more about than the average investor. **And advice from the average investor obviously can't help you be an above average investor.**

What Does a Falling Market Say About Psychology?

Fundamentals – the outlook for an economy, company or asset – don't change much from day to day. **As a result, daily price changes are mostly about (a) changes in market psychology and thus (b) changes in who wants to own something or un-own something.** These two statements become increasingly valid the more daily prices fluctuate. Big fluctuations show that psychology is changing radically.

And, I said on page two, emotional fluctuations – swings in market sentiment or psychology – do seem to be synergistic. That is, in crowd psychology, $2 + 2 = 5$. **While I don't think the price of an asset reflects more wisdom than is possessed by the average of its market's members, I do believe mass psychology will make a group swing to reach greater emotional extremes than its members would separately.** In short, people make each other crazy. And when times are bad – like now – they depress each other. That was a factor in the edge enjoyed by our distressed debt team in 2008: they were able to buy at the market's lows because they weren't in New York, where everyone was trading scary stories and getting each other down.

Again, we can gain insight through logic. **We all know we want to buy (not sell) at the lows, and sell (not buy) at the highs. So then how can it be right to sell because of a decline or buy because of a rise?** Advocates of this latter approach must think (a) declines and rises tend to continue more than they reverse and/or (b) they can tell which declines mean "buy" and which mean "sell." Some savants may have that latter ability, but not many. In general, I think it's ridiculous to sell something because it's down (just as it is to buy because it's up).

As prices fall, there are some very genuine reasons to sell:

- Some people feel rising fear and have to lighten their positions in order to retain their composure.
- Some, having lost a lot of money, sell to be sure they won't experience losses they can't survive.
- Some have to sell to repay demanding creditors or satisfy investor withdrawals.

These reasons are not "invalid." It's just that none of them has anything to do with making money.

Most mature investors know intellectually that short-term price fluctuations are low in fundamental significance, and that the best results will be achieved if they hold on to their positions and ride out the volatility. But sometimes people sell anyway, perhaps for the above reasons. **Doing so has the potential to convert a short-term fluctuation into a permanent loss by causing any subsequent recovery to be missed. I consider this the cardinal sin in investing.**

What Do the Media Know?

I'm usually able to find something in the print or broadcast media that helps me make my point. Here's how *The New York Times* led the business section on Saturday:

Concern Grows That Market Sell-off is an Early Warning of a U.S. Slowdown

It may be time for everyone to take the markets seriously again.

As stock prices started tumbling in the first trading days of the year, many Wall Street professionals were tempted to describe the declines as the sort of adjustment that the market has gone through in recent years before moving higher.

But that opinion evaporated this week as the selling intensified. Concerns are now growing that the markets are signaling that the United States economy, despite its recent bright spots, is on the verge of a slowdown.

The fear is that economic problems in China have set off negative reactions around the world that could ultimately weigh on American households and corporations.

So the bottom-line question is simple: does the market reflect what people know, or should people base their actions on what the market knows? And if the latter, where does "the market" get its information, other than from people? For me it's simple: if people follow the market's dictates, they're taking advice from . . . themselves!

I set a trap at the beginning of this memo, and I want to spring it now. In the first paragraph, I wrote, "We've seen bad news and prices cascading downward." You probably glossed over it. But is it true? Leaving aside China and the markets' gyrations, have we really been seeing negative news on balance? Isn't it just that people are fixating on bad news, ignoring good news, and tending to interpret things negatively?

There are ways in which psychology can become "real," feeding back to influence fundamentals. One is that declining asset prices produce a negative "wealth effect," making people feel poorer and causing them to spend and invest less. And there are others. But despite the feedback influences of the market declines, I still would say U.S. and European economic fundamentals aren't negative on balance.

On Friday, in the midst of the declines, I participated in a small lunch attended by investment professionals and current and former senior government economic and financial leaders. I'll spare you the details: **there was a lot of "on one hand" and "on the other hand," but no one thought there would be a recession this year.** So then who are the people creating price signals to which others should accord significance?

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I want to end by making one thing completely clear. I'm not saying the market is never right when prices go down (or up). I'm merely saying the market has no special insight and conveys no consistently helpful message. **It's not that it's always wrong; it's that there's no reason to presume it's right.**

It is the goal of some investors to sell on declines when the subsequent movements will be down, but "buy the dips" when the subsequent movements will be up. If you think you can tell which is which from watching the market movements themselves, then we – again – have a fundamental disagreement. Future price movements can only be predicted on the basis of the relationship between price and fundamentals. And, given the market's short-term volatility and irrationality, this can only be done in the long-term sense. **The market has nothing useful to contribute on this subject.**

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