

On Howard Marks' Memos

By Blas Moros



"SEVERAL THINGS GO TOGETHER FOR THOSE WHO VIEW THE WORLD AS AN UNCERTAIN PLACE: HEALTHY RESPECT FOR RISK; AWARENESS THAT WE DON'T KNOW WHAT THE FUTURE HOLDS; AN UNDERSTANDING THAT THE BEST WE CAN DO IS VIEW THE FUTURE AS A PROBABILITY DISTRIBUTION AND INVEST ACCORDINGLY; INSISTENCE ON DEFENSIVE INVESTING; AND EMPHASIS ON AVOIDING PITFALLS. TO ME THAT IS WHAT THOUGHTFUL INVESTING IS ALL ABOUT."

HOWARD MARKS

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¹ <http://tradingcomposure.com/howard-marks-quotes/>

Intro

The hope is that this “[teacher’s reference guide](#)” helps summarize and highlight what I think are the key points that [Howard Marks](#) makes in his insightful [memos](#).

Howard Marks is mainly known for co-founding [Oaktree Capital](#), an alternative asset management firm with over \$120B in AUM.

Howard and Oaktree are very well-respected in the field, having weathered and prospered in every imaginable cycle – and that, to me, is the definition of a successful investor. Oaktree employs a defensive mindset which admits that “*we don’t know*” and their investing process reflects that principle. Some of my main takeaways from reading these memos include:

- The pendulum of history and markets
- Forecasting is hard, especially about the future
- Having and sticking to your principles
- Everything that’s important is counterintuitive
- Honor biology’s #1 law – survival
- Everything is triple-A at the right price
- Ripple effects and second-order thinking

One of the key aspects which struck me after reading Marks’ memos was how often he repeated himself and his core ideas. This is not a slight whatsoever! I think he focuses on truly important ideas and he correctly focuses on those key ideas rather than trying to come up with something new just because it is new. That is part of the beauty of his writing and, similarly, of Buffett’s. Their deeply held beliefs are out there for all to read and copy, but most don’t. It is not the complexity of the ideas that makes these investing legends difficult to emulate, rather it is the psychological and behavioral discipline they have, over decades, which separates them – *simple but not easy*! Some recurring themes and quotes which stuck with me include:

- What the wise do in the beginning, fools do in the end. – Warren Buffett
- The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs. – Warren Buffett
- Forecasts usually tell us more of the forecaster than of the future. – Warren Buffett
- History doesn’t repeat, but it does rhyme. – Mark Twain
- As long as the music is playing, you’ve got to get up and dance. – Chuck Prince, CEO of Citigroup (just prior to the Great Recession...)

- Everything important in financial history has taken place outside of two standard deviations. – Ric Kayne
- . . . active management strategies demand uninstitutional behavior from institutions, creating a paradox that few can unravel. Establishing and maintaining an unconventional investment profile requires acceptance of uncomfortably idiosyncratic portfolios, which frequently appear downright imprudent in the eyes of conventional wisdom. – David Swensen

My favorite memos were those which were more universal and time-invariant – memos which weren't attached to a specific time, niche, or asset class. Of these, my favorites were:

- [How the Game Should Be Played](#)
- [Safety First...But Where?](#)
- [You Can't Predict. You Can Prepare.](#)
- [The Realist's Creed](#) (excellent overview of Marks' thinking)
- [Etorre's Wisdom](#)
- [Returns and How They Get That Way](#)
- [The Most Important Thing](#) (Precursor to his first book, [The Most Important Thing](#))
- [Risk](#)
- [Dare to Be Great](#)
- [The Long View](#)
- [What Can We Do For You?](#)
- [Ditto](#)
- [Dare to Be Great II](#)
- [There They Go Again...Again](#) (precursor to his newest book, [Mastering the Market Cycle](#))

The rest of the teacher's reference guide expands and is organized based on these ideas, rather than being organized chronologically by memo. These are Howard's words and I am not affiliated with Oaktree, I have simply tried to curate, organize, and distill them. Please note that this guide is something I plan to update as Howard and team release new memos – hopefully something that continues for a long time to come.

The pendulum of history and markets

[First Quarter Performance](#)

The mood swings of the securities markets resemble the movement of a pendulum. Although the midpoint of its arc best describes the location of the pendulum "on average," it actually spends very little of its time there. Instead, it is almost always swinging toward or away from the extremes of its arc. But whenever the pendulum is near either extreme, it is inevitable that it will move back toward the midpoint sooner or later. In fact, it is the movement toward an extreme itself that supplies the energy for the swing back. Investment markets make the same pendulum-like swing:

- between euphoria and depression,
- between celebrating positive developments and obsessing over negatives, and thus
- between overpriced and underpriced.

This oscillation is one of the most dependable features of the investment world, and investor psychology seems to spend much more time at the extremes than it does at a "happy medium."

“The farther backward you can look, the farther forward you can see.” – Winston Churchill

[Will It Be Different This Time?](#)

But I recoil any time I hear a prediction that trees will grow to the sky, or that centuries of history are irrelevant. When I hear people say the valuation measures of the past no longer matter, I think John Kenneth Galbraith put it well, stating that in a speculative episode, “Past experience, to the extent that it is part of memory at all, is dismissed as the primitive refuge of those who do not have the insight to appreciate the incredible wonders of the present.” ([A Short History of Financial Euphoria](#), Viking, 1990) And I feel cyclicity is one of the few constants in the economy and markets. Cycles are the result of human behavior, herd instinct and the tendency to psychological excesses, and these things are unlikely to evaporate. Galbraith cites "the extreme brevity of the financial memory" in explaining why markets are able to move to extremes of euphoria and panic. And few adages have been borne out as often as "What the wise man does in the beginning, the fool does in the end." It is rare for trends to be curtailed at a reasonable point before swinging to the excesses from which they invariably correct

[We're Not in 1999 Anymore, Toto](#)

Throughout my 30-plus years in the investment business, I have seen one localized boom after another. Each time, the end was marked by a Wall Street Journal table cataloging once-hot stocks that had fallen more than 90% from their highs. Conglomerates (late 1960s), computer software and services (1969-70), the Nifty-Fifty (1973-4), oil stocks (early '80s) and biotech (early '90s) – they've all been there, and I felt certain that TMT stocks would join them sooner or later. The only difference is that in 2000, the top ten losers on the NASDAQ all declined more than 99%!

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All of this is normal cyclical behavior. **Cycles are one of the few things we can rely on, as you have heard me say repeatedly, and this downswing is moving along familiar lines.** What surprised even me this time around is the rapidity and severity of these developments. Given the extreme nature of the ascent, though, I guess an equally extreme reversal is not unreasonable.

Respect cycles – There's little I'm certain of, but these things are true: Cycles always prevail eventually. Nothing goes in one direction forever. Trees don't grow to the sky. Few things go to zero. That was really the problem with the bubble. Investors were willing to pay prices that assumed success forever. They ignored the economic cycle, the credit cycle and, most importantly, the corporate life cycle. They forgot that profitability will bring imitation and competition, which will cut into – or eliminate – profitability. They overlooked the fact that the same powerful force that made their companies attractive, technological progress, could at some point render them obsolete.

Remember that, for the most part, things don't change – The five most dangerous words in our business aren't "The check's in the mail" but "This time it'll be different." Most bubbles proceed from the belief that something has changed permanently. It may be a technological advance, a shortage or a new fad, but what all three have in common is that they're usually short-lived. Most "new paradigms" turn out to be just a new twist on an old theme. No technological development is so significant that its companies' stocks can be bought regardless of price. Most shortages – whether of commodities or securities – ease when supply inevitably rises to meet demand. And no fad lasts forever.

At Oaktree, we're guided more by one principle than any other: **if we avoid the losers, the winners will take care of themselves**

[Safety First...But Where](#)

The bottom line is that risk of fluctuation is always present. Thus, stocks are risky unless your time frame truly allows you to live through the downs while awaiting the ups. Lord Keynes said, "markets can remain irrational longer than you can remain solvent," and being forced to sell at the bottom – by your emotions, your client or your need for money – can turn temporary volatility (the theoretical definition of risk) into very real permanent loss. **Your time frame does a lot to determine what fluctuations you can survive.**

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No rule is valid all the time. Buy growth; buy value. Buy large-cap; buy small-cap. Buy domestic; buy international. Buy developed; buy emerging. Buy momentum; buy weakness. Buy consumer; buy tech. I've seen them all. There is no perfect strategy. People flocked in droves to growth stock investing, real estate, portfolio insurance, Japanese stocks, emerging market stocks, tech stocks, dotcoms and venture capital. Each worked for a while and sucked in more and more investors. But in each case, success eventually pulled in enough money to guarantee failure.

[You Can't Predict. You Can Prepare.](#)

Cycles in General

I think several things about cycles are worth bearing in mind:

- Cycles are inevitable. Every once in a while, an up-or down-leg goes on for a long time and/or to a great extreme and people start to say, "this time it's different." They cite the changes in geopolitics, institutions, technology or behavior that have rendered the "old rules" obsolete. They make investment decisions that extrapolate the recent trend. And then it turns out that the old rules do still apply, and the cycle resumes. In the end, trees don't grow to the sky, and few things go to zero. Rather, most phenomena turn out to be cyclical.

- Cycles' clout is heightened by the inability of investors to remember the past. As John Kenneth Galbraith says, "extreme brevity of the financial memory" keeps many participants from recognizing the recurring nature of these patterns, and thus their inevitability:

... when the same or closely similar circumstances occur again, sometimes in only a few years, they are hailed by a new, often youthful, and always supremely self-confident generation as a brilliantly innovative discovery in the financial and larger economic world. There can be few fields of human endeavor in which history counts for so little as in the world of finance. Past experience, to the extent that it is part of memory at all, is dismissed as the primitive refuge of those who do not have the insight to appreciate the incredible wonders of the present.

- Cycles are self-correcting, and their reversal is not necessarily dependent on exogenous events. The reason they reverse (rather than going on forever) is that trends create the reasons for their own reversal. **Thus, I like to say success carries within itself the seeds of failure, and failure the seeds of success.**
- Seen through the lens of human perception, cycles are often viewed as less symmetrical than they are. Negative price fluctuations are called "volatility," while positive price fluctuations are called "profit." Collapsing markets are called "selling panics," while surges receive more benign descriptions (but I think they may best be seen as "buying panics"; see tech stocks in 1999, for example). Commentators talk about "investor capitulation" at the bottom of market cycles, while I also see capitulation at tops, when previously-prudent investors throw in the towel and buy. I have views on how these general observations and others apply to specific kinds of cycles, which I will set forth below

The Economic Cycle

Few things are the subject of more study than the economy. There's a whole profession built around doing so. Academics try to understand the economy, and professionals try to predict its course. Personally, I'd stick to the former. I think we can gain a good grasp of how the economy works, but I do not think we can predict its fluctuations

How can non-forecasters like Oaktree best cope with the ups and downs of the economic cycle? I think the answer lies in knowing where we are and leaning against the wind. For example, when the economy has fallen substantially, observers are depressed, capacity expansion has ceased and there begin to be signs of recovery, we are willing to invest in companies in cyclical industries. When growth is strong, capacity is being brought on stream to keep up with soaring demand and the market forgets these are cyclical companies whose peak earnings deserve trough valuations, we trim our holdings aggressively. We certainly might do so too early, but that beats the heck out of doing it too late.

The Credit Cycle

The longer I'm involved in investing, the more impressed I am by the power of the credit cycle. It takes only a small fluctuation in the economy to produce a large fluctuation in the availability of credit, with great impact on asset prices and back on the economy itself. The process is simple:

- The economy moves into a period of prosperity
- Providers of capital thrive, increasing their capital base.
- Because bad news is scarce, the risks entailed in lending and investing seem to have shrunk.
- Risk averseness disappears.
- Financial institutions move to expand their businesses – that is, to provide more capital.
- They compete for market share by lowering demanded returns (e.g., cutting interest rates), lowering credit standards, providing more capital for a given transaction, and easing covenants.

In making investments, it has become my habit to worry less about the economic future – which I'm sure I can't know much about – than I do about the supply/demand picture relating to capital. **Being positioned to make investments in an uncrowded arena conveys vast advantages. Participating in a field that everyone's throwing money at is a formula for disaster.** We have lived through a long period in which cash acted like ballast, retarding your progress. Now I think we're going into an environment where cash will be king. If you went to a leading venture capital fund in 1999 and said, "I'd like to invest \$10 million with you," they'd say, "Lots of people want to give us their cash. What else can you offer? Do you have contacts? Strategic insights?" I think the answer today would be different. One of the critical elements in business or investment success is

staying power. **I often speak of the six-foot-tall man who drowned crossing the stream that was five feet deep on average.** Companies have to be able to get through the tough times, and cash is one of the things that can make the difference. Thus, all of the investments we're making today assume we'll be going into the difficult part of the credit cycle, and we're looking for companies that will be able to stay the course.

The Corporate Life Cycle

As indicated above, business firms have to live through ups and downs. They're organic entities, and they have life cycles of their own. Most companies are born in an entrepreneurial mode, starting with dreams, limited capital and the need to be frugal. Success comes to some. They enjoy profitability, growth and expanded resources, but they also must cope with increasing bureaucracy and managerial challenges. The lucky few become world-class organizations, but eventually most are confronted with challenges relating to hubris; extreme size; the difficulty of controlling far-flung operations; and perhaps ossification and an unwillingness to innovate and take risks. Some stagnate in maturity, and some fail under aging products or excessive debt loads and move into distress and bankruptcy. The reason I say failure carries within itself the seeds of success is that bankruptcy then permits some of them to shed debt and onerous contracts and emerge with a reborn emphasis on frugality and profitability. And the cycle resumes . . . as ever

The Market Cycle

For decades – literally – I've been lugging around what I thought was a particularly apt enumeration of the three stages of a bull market:

- the first, when a few forward-looking people begin to believe things will get better,
- the second, when most investors realize improvement is actually underway, and
- the third, when everyone concludes everything will get better forever.

[The Happy Medium](#)

I continue to believe that cycles are inevitable, often profound, and the most reliable feature of the business and investment worlds. In November 2001 I wrote a memo on this subject entitled “You

Can't Predict. You Can Prepare." (It didn't generate any reader reaction, even though I thought its contents were important.) The memo discussed some of the cycles that affect the investor:

- The economic cycle evidences moderate fluctuations (although their impact can be profound). Viewed on a long-term graph, it looks like a gentle wave.
- The business cycle responds to developments in the economy with a more pronounced effect, rising and falling as consumers and businesses loosen and tighten their purse strings.
- The profits cycle reflects an exaggerated reaction to changes in the amount of business companies are doing, primarily because of the twin influences of operating leverage (such that operating profits change more than revenues) and financial leverage (such that net income changes more than operating profits).
- The credit cycle moves dramatically, usually oscillating between periods when the capital markets are wide open and periods when they're slammed shut.
- The market cycle reacts violently, as investor psychology magnifies all of the above. Security prices yo-yo in what can often be described as extreme over-reaction.

This cycle in investors' willingness to value the future is one of the most powerful that exists. A simple metaphor relating to real estate helped me to understand this phenomenon: What's an empty building worth? An empty building (a) has a replacement value, of course, but it (b) throws off no revenues and (c) costs money to own, in the form of taxes, insurance, minimum maintenance, interest payments, and opportunity costs. In other words, it's a cash drain. When investors are in a pessimistic mood and can't see more than a few years out, they can only think about the negative cash flows and are unable to imagine a time when the building will be rented and profitable. But when the mood turns up and interest in future potential runs high, investors envision it full of tenants, throwing off vast amounts of cash, and thus salable at a fancy price. Fluctuation in investors' willingness to ascribe value to possible future developments represents a variation on the full-or-empty cycle. Its swings are enormously powerful and mustn't be underestimated.

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Bookstaber says, "the principal reason for intraday price movement is the demand for liquidity... In place of the conventional academic perspective of the role of the market, in which the market is efficient and exists solely for informational purposes, this view is that the role of the market is

to provide immediacy for liquidity demanders...By accepting the notion that markets exist to satisfy liquidity demand and liquidity supply, the framework is in place for understanding what causes market crises, which are the times when liquidity and immediacy matter most.” **“Liquidity demanders are demanders of immediacy.”** I would describe them as holders of assets in due course, such as investors and hedgers, who from time to time have a strong need to adjust their positions. When there’s urgency, “the defining characteristic is that time is more important than price...they need to get the trade done immediately and are willing to pay to do so.”

[There They Go Again](#)

Investors truly do make the same mistakes over and over. It may be different people doing it each time, and usually they do it in new fields and in connection with new assets, but it is the same behavior. As Mark Twain said, “History doesn’t repeat itself, but it rhymes.” Rarely is the same error repeated in back-to-back years. Usually enough time passes for the repetitive pattern to go unnoticed and for the lessons to be forgotten. Often it’s a new generation repeating the errors of their forefathers. But the patterns are there, if you observe with the benefit of objectivity and a long-term view of history.

Why do the mistakes repeat? That’s a good question, but not much of a mystery. First, few investors have been around long enough to recognize reoccurrence of the errors of twenty or forty years ago. And second, the greed that argues for ignoring “the old rules” easily trumps caution; hope truly does spring eternal. That’s especially true when the good times are rolling. The tendency to ignore the rules invariably reaches its apex in periods when following them has cost people money. It is thus, as Galbraith points out, that those who harp on the lessons of the past are dismissed as old fogies.

What are some of the recurring mistakes investors make?

- **It’s Different This Time** – Trends in investing are carried to their greatest (and most punishing) extremes by the belief that something has changed – that rules that applied in the past have been rendered obsolete by new circumstances. (E.g., the traditional standards for reasonable valuations weren’t applicable to shares in tech companies whose products were likely to change the world.)
- **It Can’t Miss** – The fact is, anything can miss. There’s no asset so good or trend so strong that you can’t lose money betting on it. No investment technique is guaranteed to deliver high returns or keep risk low. Smoothly functioning markets don’t permit the combination

of high return and low risk to persist – good results bring in buyers who raise prices, lowering future returns and elevating risk. It'll never be otherwise.

- **The Explanation Couldn't Be Simpler** – By this I mean to poke some fun at investors' tendency to fall for stories that seem true on the surface but ignore the workings of markets. The stage was set for some of the greatest debacles by platitudes that were easy to swallow – but too simplistic and, in the end, just plain wrong. These include “For a company with good enough growth prospects, there's no such thing as too high a price” (1969 and 1999) and “Emerging markets are a sure thing because of the terrific potential for growth in per capita consumption” (1994).
- **This Tree Will Grow to the Sky** – The fact is, no trend will go on unabated forever. Most trends are limited by cycles, which are caused by people's reaction to developments. Buyers, sellers and competitors respond to trends, altering the current landscape and the future.
- **The Positives of Today Will Still Be Positives Tomorrow** – From time to time, some combination of optimism and greed convinces people that the favorable elements in the current environment – responsible for today's high asset prices – will stay that way. But (a) things usually turn less rosy, and (b) even before they do, investors take prices to levels that are too high even for today's positives.
- **Past Returns Are a Good Guide to Future Returns** – **The greatest bubbles stem from the belief that high returns in the past foretell high returns in the future. The most successful investors – the longest-term survivors – believe in just the opposite: regression to the mean.** The things that have appreciated the most will slow down (or decline), and those that lagged will catch up or move ahead. Instead of being encouraged by months or years of price appreciation, investors should be forewarned.
- **It'll Always Beat the Cost of Borrowing** – Speculative behavior usually features the belief that assets will always appreciate faster than the rate of interest paid on money borrowed to buy them with. We saw a lot of this in the inflationary 1970s. But for the most part, statements including the words “always” and “never” are usually a sign of trouble ahead.
- **The Supply/Demand Picture Doesn't Matter** – The relationship between supply and demand determines the price of everything. The higher the demand relative to the supply, the higher the price for a given asset or strategy. And, the higher the price, the lower the prospective return (all else being equal). Why can't investors remember these two absolute rules?

- **Higher Risk Means Higher Return** – There are times, especially when the prospective returns on low-risk investments appear inadequate, when people reach for more return by going out further on the risk curve. They forget that riskier investments don't necessarily bring higher returns, just higher projected returns. Forgetting the difference can be fatal
- **Anything's Better Than Cash** – Because it entails the least risk, the prospective return on cash invariably is lower than all other investments. But that doesn't mean it's the least desirable. There are times when the valuations on other investments are so high that they entail too much risk.
- **It May Be Too Good to Be True, But I Don't Want to Miss Out** – There've been lots of times in my career when people knew something was unlikely to keep working but jumped on the bandwagon anyway. Usually they did so because they thought there was a little bit more left in the trend, or because not being aboard – and watching from the sidelines while others got rich – had become too painful.
- **If It Stops Working, I'll Get Out** – When people invest despite obvious danger signs, they usually do so under the belief that they'll be able to get out when the market turns down. They rarely ask how it is that they'll know to sell before others do, or to whom they'll sell if everyone else figures it out simultaneously

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If you look back at the recurring mistakes listed at the beginning of this memo, you'll see some common threads. They all express wishful thinking, an inevitable part of human nature. They stem from an excessive proclivity to believe the positives – and disregard the negatives – prompted by the desire to make money. The key ingredients in being able to avoid these mistakes should be pillars in everyone's investment approach:

- awareness of history,
- belief in cycles rather than unabated, unidirectional trends,
- skepticism regarding the free lunch, and
- insistence on low purchase prices that provide lots of room for error.

Adherence to these things – all parts of the canon of defensive investing – invariably will cause you to miss the most exciting part of bull markets, when trends reach irrational extremes and prices go from fair to excessive. But they'll also make you a long-term survivor. I can't help thinking that's a prerequisite for investment success.

[Now It's All Bad?](#)

When will market cycles be banished or made more muted? That'll happen when greed, human failings and herd behavior are eliminated. Or, in other words, never. In "You Can't Predict. You Can Prepare." I wrote of cycles that success carries within itself the seeds of failure, and failure carries the seeds of success. It'll always be so.

[The Long View](#)

Recognizing times when historic data shouldn't be extrapolated is an important part of dealing prudently with the future.

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Central banks will try to stabilize economies, and company managers will strive for smooth earnings growth. But as long as human beings determine security prices, market cycles will be the rule, not the exception. The extremes of greed, fear and worry over missing out will never be banished.

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And that's why I think the investment decisions we make today must emphasize value, survivability and staying power. **I readily acknowledge that assuring survival in bad times is inconsistent with return maximization in good times. Insistence on these three things won't produce the greatest rewards if the economy and markets surprise on the upside, but that's not my main concern.**

[Hemlines](#)

But investors consistently fail to recognize that past above average returns don't imply future above average returns; rather they've probably borrowed from the future and thus imply below average returns ahead, or even losses. The tendency on the part of investors toward gullibility rather than skepticism is an important reason why styles go to extremes.

Forecasting is hard, especially about the future

[The Value of Predictions II](#)

There's no question about it: each consensus forecast represented a near-extrapolation of then-current levels. Like many forecasters, these economists were driving with their eyes firmly fixed on the rearview mirror.

In general, we can say with certainty that these forecasters were much better at telling us where things stood than where they were going. This bears out the old adage that "it's difficult to make accurate predictions, especially with regard to the future." The corollary is also true: predicting the past is a snap.

[Genius Isn't Enough](#)

"How Quickly They Forget." While it would be great (and very profitable) to be able to see the future, the truth is that few of us can. But you don't have to be prescient to be able to invest intelligently while avoiding the most dangerous hazards. Knowledge of the past will get you a good part of the way there. The relevance of the lessons of Long-Term has nothing to do with knowledge of the future. **Leverage is always dangerous. Something always goes wrong eventually. Those who see high returns often mistake risk bearing for genius.** The swings of the credit cycle can overwhelm all other factors. Every boom carries within itself the seeds of decline (just as every bust lays the groundwork for recovery). **Forget forecasting -- you'll be well ahead if you simply bear in mind the lessons of the past.**

[What Lies Ahead?](#)

The process of investing consists entirely of divining the future – in terms of profits and values – and translating that future into prices that should be paid today. Obviously, doing so requires a view of what the world will look like tomorrow and how businesses and their products will fare in that world.

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When I reflect on all of the mottoes I use, it seems half of them relate to how little we can know about what lies ahead.

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The longer I'm in this business, the less I believe in investor agility. Most people seem stuck in positions as bulls, bears or something in between. Most are always aggressive or always defensive. Most either always feel they can see the future or never feel they can see the future. Most always prefer value or always prefer growth. Few people's psyches are flexible enough to allow them to switch from one way of thinking to another, even if they theoretically possessed the needed perspicacity. Rather, most people have a largely fixed style and point of view, and the most they can hope for is skill in implementing it – and I don't exempt Oaktree and myself from that observation. But that's not so bad. It's my conclusion that if you wait at a bus stop long enough, you're sure to catch your bus, while if you keep wandering all over the bus route, you may miss them all. So, Oaktree will adhere steadfastly to its defensive, risk-conscious philosophy and try to implement it with skill and discipline. We think that's the key to successful long-term investing – especially in today's uncertain environment.

[The Realist's Creed](#)

First, I think investing must be based on a firmly held belief system. What do you believe in, and what do you reject? Put another way, what are the principles that will guide you? For me, the starting point consists of deciding which approach to take in dealing with the future. That decision primarily revolves around choosing between two polar opposites: what I call the "I know" school and the "I don't know" school. Most of the investment professionals I've met over my 33 years in the industry fall squarely into the "I know" school. These are people who believe they can discern what the future holds, and in their world investing is a simple matter:

- First you decide what the economy is going to do in the period under consideration.
- Then you figure out what the impact will be on interest rates.
- From this you infer how the securities markets will perform.
- You choose the industries that will do best in that environment.
- You make judgments about how the industries' companies will fare in terms of profits.

- Based on all of this information, you pick stocks that are bound to appreciate.

End of story. Of course, the usefulness of this approach depends entirely on people's ability to make these decisions correctly. What if you're wrong about the economy? What if you're right about the economy but wrong about its impact on a company's profits? Or what if you're right about profits but the valuation parameters contract, and thus the price? The bottom line is that the members of this school think these things are knowable. I know lots of people who are perpetually and constitutionally optimistic about both the long-term future for stocks and their ability to make these judgments correctly.

On the other hand, I and most of the investors with whom I feel an affinity belong to the "I don't know" school. In short, (1) we feel it's impossible for anyone to know much about a vast number of things, (2) we consider it especially difficult to outperform by guessing right about the direction of the economy and the markets, (3) we spend our time trying to know more than the next person about specific micro situations, and (4) we think more about what can go wrong than about what can go right. In contrast to the "I know" school, people in this group are more cautious and feel a strong need for downside protection. Sticking to this approach requires some solid building blocks. One of those is contrarianism. Basically, that means leaning away from the direction chosen by most others. Sell when they're euphoric and buy when they're afraid. Sell what they love and buy what they hate. In general, I think you'll find few bargains among the investments that everyone knows about, understands, feels comfortable with, is impressed by and is eager to own. Instead, the best bargains usually lie among the things people aren't aware of, don't fully understand, or consider arcane, unseemly or risky. Closely related to contrarianism is skepticism. It's a simple concept, but it has great potential for keeping investors out of trouble: If it sounds too good to be true, it probably is. That phrase is always heard after the losses have piled up – be it in portfolio insurance, "market neutral" funds, dot-coms, or Enron. My career in money management has been based on the conviction that free lunches do exist, but not for everyone, or where everyone's looking, or without hard work and superior skill. Skepticism needn't make you give up on superior risk-adjusted returns, but it should make you ask tough questions about the ease of accessing them.

Thus, I also advocate modest expectations. To shoot for top-quartile performance every year, you have to hold an idiosyncratic portfolio that exposes you to the risk of being outside the pack and dead wrong. It's behavior like that that leads to managers being carried off the field when things go poorly – and to clients losing lots of money. It's far more reasonable just to try for performance

that's consistently a little above average. Even that's not easy to achieve, but if accomplished for a long period it will result in an outstanding track record.

I think humility is essential, especially concerning the ability to know the future. Before acting on a forecast, we must ask whether there's good reason to think we're more right than the consensus view already embodied in prices. I think it's possible to get a knowledge advantage with regard to under-researched companies and securities, but only through hard work and skill.

Finally, I'm a strong believer in investing defensively. That means worrying about what one may not know, about what can go wrong, and about losing money. If you're worried, you'll tend to build in greater margin for error. Worriers gain less when everything goes right, but they also lose less – and stay in the game – when things return to earth. All of Oaktree's activities are guided more by one principle than any other: if we avoid the losers, the winners will take care of themselves. **We're much more concerned about participating in a loser than we are about letting a winner get away. In my experience, long-term investment success can be built much more reliably on the avoidance of significant losses than it can on the quest for outsized gains. A high batting average, not a swing-for-the-fences style, offers the most dependable route to success.**

Second, I'd advise you to approach the entire subject of forecasts and forecasters with extreme distrust. Reduced to the absolute minimum, investing consists of just one thing: Making judgments about the future. And the future is inherently uncertain. Everyone looks for help in dealing with this uncertainty, and their usual recourse is to put faith in forecasters. How could they not? Most forecasters are highly articulate, represent prestigious institutions, and exude total confidence in their knowledge of the future

Most of the time, the consensus forecast extrapolates current observations. Predictions for a given parameter usually bear a strong resemblance to the level of the parameter prevailing at the time they're made. Thus, predictions are often close to right when nothing changes radically, which is the case most of the time, but they can't be counted on to foretell the important sea changes. And as my friend Ric Kayne says, **"everything important in financial history has taken place outside of two standard deviations."** It's in predicting radical change that extraordinary profit potential exists. **In other words, it's the surprises that have profound market impact (and thus profound profit potential), but there's a good reason why they're called surprises: it's hard to see them coming!**

Third, I think it's essential to remember that just about everything is cyclical. There's little I'm certain of, but these things are true: Cycles always prevail eventually. Nothing goes in one

direction forever. Trees don't grow to the sky. Few things go to zero. And there's little that's as dangerous for investor health as insistence on extrapolating today's events into the future.

Fourth, investors should bear in mind the role played by timeframe. It seems obvious, but long-term trends need time in order to work out, and time can be limited. Or as John Maynard Keynes put it, "Markets can remain irrational longer than you can remain solvent." Whenever you're tempted to bet heavily on your conviction that a given phenomenon can be depended on in the long run, think about the six-foot tall man who drowned crossing the stream that was five feet deep on average.

Fifth, you must never forget the key role played by valuation. Investment success doesn't come primarily from "buying good things," but rather from "buying things well" (and the difference isn't just grammatical). It's easy for most people to tell the difference between a good company and a bad one, but much harder for them to understand the difference between a cheap stock and an expensive one. Some of the biggest losses occur when people buy the stocks of great companies at too-high prices. In contrast, investing in terrible companies can produce huge profits if it's done at the right price. Over time, investors may shift their focus from dividend yield to p/e ratio, and they may stop looking at book value, but that doesn't mean valuation can be considered irrelevant

Sixth, beware the quest for the simple solution. Two important forces drive the search for investment options: the urge to make money and the desire for help in negotiating the uncertain future. When a market, an individual or an investment technique produces impressive returns for a while, it generally attracts excessive (and unquestioning) devotion. I call this solution-du-jour the "silver bullet."

The main thing I've tried to indicate here is that investing isn't easy. Or better put, superior investing isn't easy. It's easy to do average. In fact, there are vehicles – index funds – that exist for the explicit purpose of delivering average performance at low cost, and they are completely capable of doing so. But most people want to do better than the average. They want higher returns and achieving higher returns without assuming commensurately higher risk is the hard part. It's easy to make guesses about the future but hard to be consistently more right in those guesses than your fellow investor, and thus hard to consistently outperform. **Doing the same thing others do exposes you to fluctuations that in part are exaggerated by their actions and your own. It's certainly undesirable to be part of the herd when it stampedes off the cliff, but it takes rare skill, insight and discipline to avoid it. The thing I'm surest of is that the solution doesn't lie in making guesses about**

the big picture future. Rather, it lies with investors who possess skill, insight and discipline. There are times when they'll underperform – times like 1998-99, when aggressiveness was rewarded far more than caution. But if you can find those people, you should stick with them. For me, the laundry list of their desired characteristics is clear:

- **adherence to the "I don't know" school of thought**
- **contrarianism, skepticism, modest expectations, humility and defensiveness**
- **eschewing of macro forecasts**
- **attention to the cyclical nature of things**
- **consciousness of timeframe**
- **concentration on valuation**
- **disdaining the hunt for the silver bullet**
- **awareness of prevailing investor psychology**

[Returns and How They Get That Way](#)

The Role of Luck To end this memo on returns, I want to spend a few pages discussing the part played by randomness (or luck or chance). A new book on this subject is being passed around the alpha manager world more than Playboy was passed around when I was in the ninth grade. It's "[Fooled By Randomness](#)" by Nassim Taleb, a Ph. D. hedge fund manager and self-described aesthete. My "Realist's Creed" list of required ingredients for intelligent investing started with membership in the "I don't know" school; progressed through contrarianism, humility and skepticism; and ended with awareness of prevailing investor psychology. **Taleb's book reminded me of one other essential: being conscious of the role of luck.** This book can be difficult to read. Here are just two examples: Popper believed that any idea of Utopia is necessarily closed in the fact that it chokes its own refutations...to be technical, these "randomizations" are frequently done during optimization problems, when one needs to perturbate a function.

Nevertheless, I found its contents profound. In "Investment Miscellany" I discussed an article by Richard Bookstaber of Moore Capital and stated that, "**What smart people do is put into logical words the thoughts we may have had but never formulated or expressed.**" Taleb is such an individual. As I did with Bookstaber's article, I will attempt below to communicate and explain some of his salient points, supported by excerpts from the book. Randomness (or luck) plays a huge part in life's results, and outcomes that hinge on random events should be viewed as different from those that do not

Every record should be considered in light of the other outcomes – Taleb calls them "alternative histories" – that could have occurred just as easily as the "visible histories" that did. Clearly my way of judging matters is probabilistic in nature; it relies on the notion of what could have probably happened. (p.29) If we have heard of [history's great generals and inventors], it is simply because they took considerable risks, along with thousands of others, and happened to win. They were intelligent, courageous, noble (at times), had the highest possible obtainable culture in their day – but so did thousands of others who live in the musty footnotes of history. (p. 35) Think about the aggressive backgammon player who can't win without a roll of double sixes. He accepts the cube – doubling the stakes – and then gets his "boxcars." It might have been an unwise bet, with its one-in-36 chance of success, but because it succeeded, everybody considers him brilliant. We should think about how probable it was that something other than double sixes would materialize, and thus how lucky the player was to have won. This says a lot about his likelihood of winning again. **As my friend Bruce Newberg says over our backgammon games, "there are probabilities, and then there are outcomes." The fact that something's improbable doesn't mean it won't happen. And the fact that something happened doesn't mean it wasn't improbable. (I can't stress this essential point enough.)** Every once in a while, someone makes a risky bet on an improbable or uncertain outcome and ends up looking like a genius. But we should recognize that it happened because of luck and boldness, not skill. In the short run, a great deal of investment success can result from just being in the right place at the right time. I always say the keys to profit are aggressiveness, timing and skill, and if you have enough aggressiveness at the right time, you don't need that much skill. My image is of a blindfolded dart thrower. He heaves it wildly just as someone knocks over the target. His dart finds the bulls-eye and he's proclaimed the champ...at a given time in the markets, the most profitable traders are likely to be those that are best fit to the latest cycle. This does not happen too often with dentists or pianists – because of the nature of randomness. (p.74)

Luck

Skill

Randomness
Probability
Belief, conjecture
Theory
Anecdote, coincidence
Survivorship bias
Lucky idiot

Determinism
Certainty
Knowledge, certitude
Reality
Causality, law
Market outperformance
Skilled investor

The correctness of a decision can't be judged from the outcome. Nevertheless, that's how people assess them. A good decision is one that's optimal at the time it's made, when the future is by definition unknown. Thus, correct decisions are often unsuccessful, and vice versa

[Hindsight First, Please](#)

Time after time when I read about trends being taken to excess – and later, when the painful consequences become clear – I find myself asking what they could have been thinking. The alpha that's so much in demand today is really the ability to see ahead to things others will see only afterwards, in the rearview mirror. The people of Oaktree spend a lot of their time figuring out what might be the next mistake and preparing for it. In other words, we try to anticipate – and avoid – pitfalls that others will rue after the fact.

...

Investors should demand return premiums, but they shouldn't count on them. They should try to figure out whether they're in prospect – and as "prospect" implies, that's done by looking forward, not backward. The fact that return was there in the past doesn't mean it'll be there in the future. And, in fact, if too much return was earned in the past, that implies not much may be left for the future.

...

The philosopher George Santayana is famous for having said, "Those who cannot remember the past are condemned to repeat it." (Most apropos of this memo, but less famously, he also said, "Skepticism is the chastity of the intellect, and it is shameful to surrender it too soon or to the first comer.") The value of hindsight lies in the fact that lessons learned in the past by others can enable subsequent generations to avoid having to learn them anew. And yet, it seems investors must learn

those lessons over and over – and often the hard way. The exact circumstances may not repeat, and the mistakes may not surround the same asset classes, but the general lessons of investing go on having to be learned. To avoid this, we have to improve on the brevity of memory that Galbraith complains about; refuse to surrender our skepticism; and learn to assess market behavior around us and extract the proper inferences for application to our own behavior. Readers of my memos know I feel awareness and understanding of cycles is an essential tool for investment survival. I always say about cycles, **“We may never know where we’re going, but we’d better have a good idea where we are.”** Hindsight is helpful in this regard, not because the future will be exactly like the past, but because by learning the time-honored lessons of the past we can better cope with the uncertain future. Recognizing past patterns permits us to increase our preparedness, the payoff from which can be considerable.

[The Limits of Negativism](#)

But in dealing with the future, we must think about two things: (a) what might happen and (b) the probability it will happen.

...

But now I want to talk about the flip side: When others conduct their affairs with excessive negativism, it’s worth being positive. When others love ‘em, we should hate ‘em. But when others hate ‘em, we can love ‘em.

[The Role of Confidence](#)

It’s easier to know what to do at the extremes that it is in the middle ground, where I believe we are today. As I wrote in my book, when there’s nothing clever to do, the mistake lies in trying to be clever. Today it seems the best we can do is invest prudently in the coming months, avoiding aggressiveness and remembering to apply caution.

[Dare to Be Great II](#)

How can investors deal with the limitations on their ability to know the future? The answer lies in the fact that not being able to know the future doesn't mean we can't deal with it. It's one thing to know what's going to happen and something very different to have a feeling for the range of possible outcomes and the likelihood of each one happening. Saying we can't do the former doesn't mean we can't do the latter. The information we're able to estimate – the list of events that might happen and how likely each one is – can be used to construct a probability distribution.

Key point number one in this memo is that the future should be viewed not as a fixed outcome that's destined to happen and capable of being predicted, but as a range of possibilities and, hopefully on the basis of insight into their respective likelihoods, as a probability distribution.

...

To move to the biggest of pictures, I want to make a few over-arching comments about risk

The first is that risk is counterintuitive

- The riskiest thing in the world is the widespread belief that there's no risk
- Fear that the market is risky (and the prudent investor behavior that results) can render it quite safe
- As an asset declines in price, making people view it as riskier, it becomes less risky (all else being equal)
- As an asset appreciates, causing people to think more highly of it, it becomes riskier
- Holding only "safe" assets of one type can render a portfolio under-diversified and make it vulnerable to a single shock
- Adding a few "risky" assets to a portfolio of safe assets can make it safer by increasing its diversification. Pointing this out was one of Professor William Sharpe's great contributions

The second is that risk aversion is the thing that keeps markets safe and sane. Simply put, risk is low when risk aversion and risk consciousness are high, and high when they're low

The third is that risk is often hidden and thus deceptive

The fourth is that risk is multi-faceted and hard to deal with. In this memo I've mentioned 24 types of risk: the risk of losing money, falling short, missing opportunities, FOMO, credit, illiquidity, concentration, leverage, funding, manager, over-diversification, volatility, basis, model, black swan, career, headline, event, fundamental, valuation, correlation, interest rate, purchasing power,

and upside. And I'm sure I've omitted some. Many times, these risks are overlapping, contrasting and hard to manage simultaneously.

The fifth is that the task of managing risk shouldn't be left to designated risk managers.

[Risk Revisited Again](#)

Peter Bernstein wrote the following in his November 2001 newsletter: **“We like to rely on history to justify our forecasts of the long run, but history tells us over and over again that the unexpected and unthinkable are the norm, not an anomaly. That is the real lesson of history.”**

Having and sticking to your principles

[Etorre's Wisdom](#)

While I was driving with Andrew he asked, as fifteen-year-olds are prone to, "Dad, why do you always have to drive in the slow lane? Why don't you switch to that one; it's moving faster?" As I wound up for a lengthy explanation, I recognized in his comment the greatest imaginable metaphor for investor behavior. What is it like to drive on our crowded highways?

- We often sit there, frustrated, watching cars whiz by in the adjacent lane.
- However, if we change to the faster lane, it slows down just as the one we left speeds up.
- Sometimes a lane-jumper shoots past us, but we know deep down that drivers who constantly shift from one lane to another are unlikely to reach a given point much before we do.

I think there are many ways in which the experience of drivers on a crowded highway is similar to that of investors. I'll touch on them below, and on what I see as the reasons (and the lessons).

Finding Your Way on an Efficient Highway – Some people find it difficult to understand the concept of efficient markets, and how efficiency makes it hard for investors to outperform. It's really for this that a crowded highway is the perfect metaphor.

Most drivers share the same goal: we want to get there as quickly as possible, with safety. A few people drive like slowpokes, sacrificing speed for excessive safety, and a few others are maniacs who keep the pedal down without a care. The vast majority of us, however, conduct ourselves reasonably but really would like to cut our travel time. As we drive along, we see from time to time that another lane is moving faster than ours. Just as obviously, however, we know that jumping to that lane is unlikely to bring much net improvement. And that's where the metaphor comes in. If I could switch to the faster lane while everything remained unchanged, doing so would cut my travel time. But everyone sees which lane is moving fastest, and if everyone switches into that lane, that will make it the slow lane. Thus, the collective actions of drivers alter the environment. In fact, they create the environment. In April 2001, I wrote the following in "Safety First . . ."

Over the years, performance has constantly improved in areas like golf. That's because while the participants develop new tools and techniques, the ball never adjusts, and the

course doesn't fight back. But investing is dynamic, and the playing field is changing all the time. The actions of other investors will affect the return on your strategy. Just as nature abhors a vacuum, markets act to eliminate an excessive return

What I meant is that, unless the Greens Committee changes the layout, a golf course is a static environment. The actions of golfers don't change the game. If I try a certain approach to a hole – or even if everyone does – that won't alter the effectiveness of the approach. In contrast, highways – like markets – are dynamic environments. What the other participants do on a given day goes a long way toward determining what will and will not work for us. When people flock to the fast lane, they slow it down. And with the lane they left suddenly less crowded, it speeds up. This is how the "efficient market" in travel acts to equalize the speed of the various lanes, and thus to render ineffective most attempts at lane-picking. Efficient securities markets work the same way to eliminate excess returns. Everyone knows what has worked well to date. Just as they know which lane has been moving fastest, they know which securities have been performing best. Most people also understand there is no guarantee that past performance will continue. What is a little less widely understood, however, is that past returns influence investor behavior, which in turn alters future performance? While investors have the option of switching into the securities that have been performing best, most know the outperformance isn't likely to last forever. It takes a little more insight, however, for them to comprehend that their switching will be, in itself, among the things that change performance. When people switch to the better-performing group, their buying bids up the prices of those securities. That bidding-up prolongs the outperformance somewhat, but it also reduces the prospective return and increases the probability of a correction. **(The higher the price you pay, the worse your prospects for profit. This seems like a simple concept, but it's forgotten once in a while – as it was in the tech bubble.)**

...

The Tactics Others Adopt – The fact that crowded highways are efficient allocators of space doesn't mean people don't try to beat them. How often do we see the guy in the souped-up '67 Mustang careen back and forth just in front of us, changing lanes every minute and cutting off half the cars on the road? But does he get there any faster? Should he expect to?

Of course, the analogy to investing holds beautifully. Knowing which lane to drive in has nothing to do with which lane has been going fastest. To chart the best course, one must know which one will go fastest. As usual, outperforming comes down to seeing the future better than others, which

few drivers on crowded highways can do. So, half the time the lane-jumper moves into a fast-moving lane that keeps going fast, and half the time into one that's just about to slow down. And the slow lane he leaves is as likely to speed up as it is to stay slow. Thus the "expected value" of his lane changing is close to zero. And he uses extra gas in his veering and accelerating, and he bears a higher risk of getting into an accident. Thus, the returns from lane changing appear modest and undependable – even more so in a risk-adjusted sense. There are lots of investors in our heavily populated markets who believe (erroneously, in my opinion) they can see the future, and thus that they can get ahead through market timing and short-term trading. Most markets prove to be efficient, however, and most of the time these machinations don't work. Still, investors keep guessing at which lane on the investment highway will go fastest. They are encouraged by the successes they recall and the gains they dream of. But their recollection tends to overstate their ability by exaggerating correct moves and ignoring mistakes. Or as Don Meredith once said on Monday Night Football, "they don't make them the way they used to, but then again they never did." So, most investors go on trying to time markets and pick stocks. When it works, they credit the efficacy of their strategy and their skill in executing it. When it doesn't, they blame exogenous variables and the foolishness of other market participants. And they keep on trying.

In the ultimate form of capital punishment, the hyper-tactician – on the road or in the market-stands a good chance of repeatedly jumping out of the thing that hasn't worked just as it's about to start working, and into the thing that has been working moments before it stops. This is why it's often the case that the performance of investors in a volatile fund is worse than the performance of the fund itself. On its face this seems illogical . . . until you think of the unlucky lane-jumper described just above. People often jump into a hot fund toward the end of a period of good performance, when overvaluation in the market niche (or hubris on the manager's part) has set the stage for a fall, and when the great results have brought in so much money that it's impossible to keep finding enough attractive investments. By the time a hot fund falls, it's usually much larger than it was when it rose, and thus a lot more money is lost on a 10% drop than used to be made on a 10% rise. It's in this way that the collective performance of a fund's investors can be worse than that of the fund. There are prominent examples of money managers who started small, made 25% a year for 25 years, got famous and grew huge, and then took a 50% loss on \$20 billion. I often wonder whether their investors enjoyed any cumulative profit over the funds' entire lives. **Just as lane-jumping is risky on the road, following the hot trend is risky in the investment world.**

Isn't There a Way to Make Good Time? – If crowded highways are truly efficient, and the fast lane is destined to slow down, is there no way to do better than others? My answer is predictable: find the inefficiencies. Go where others won't. Do the things others avoid? We all have our tricks on the road. We'll take the route with the hazards that scare away others – after we've made sure we know the way around them. Or we'll take the little-known back road. We'll go through the industrial area, leaving the beautified route to the masses. Or we'll drive at night, while others prefer the daylight. All of these things are analogous to the search for inefficiency in investment markets. At Oaktree we invest in things that others find frightening or unseemly – like junk bonds, bankruptcies and non-performing mortgages. We spend our time in market niches that others ignore – like busted and international convertibles, and distressed debt bought for the purpose of obtaining control over companies. We try to identify opportunities before others do – like European high yield bonds and power infrastructure. And we do things that others find perilous, but we approach them in ways that cut the risk – like investing in emerging markets without making sink-or-swim bets on the direction of individual countries' economies and stock markets.

I continue to believe there are ways to earn superior returns without commensurate risk, but they're usually found outside the mainstream. A shortcut that everyone knows about is an absolute oxymoron, as is one that's found where the roads are well marked and mapped. The route that's little known, unattractive or out of favor may not be the one that's most popular or least controversial. But it's the one that's most likely to help you come out ahead.

[What's Going On?](#)

In the long run, investing is about value and the expectation that, eventually, price will catch up. But in the short run it's about psychology, emotion and popularity. The influence of those three factors comes through their effect on flows of capital, and in the short run its capital flows that have the most profound impact of all.

[The Most Important Thing](#)

There is one of the few areas where there is a magic formula: be fair. Oaktree's founders always say it's our goal to own less and less of a firm that becomes worth more and more. We think sharing

ownership with key colleagues – rather than zealously holding onto it – is key in building a great firm.

So, the recipe's simple: shared values and complimentary skills; mutual respect and an appreciation for each other's contribution; and people with whom you enjoy associating

Everything that's important is counterintuitive

[The Value of Predictions, or Where'd All This Rain Come From?](#)

It has since been realized, however, that it's not earnings changes that cause stock price changes, but earnings changes which come as a surprise. Look in the newspaper. Some days, a company announces a doubling of earnings and its stock price jumps. Other earnings doublings don't even cause a ripple -- or they prompt a decline. The key question is not "What was the change?" but rather "Was it anticipated?" Was the change accurately predicted by the consensus and thus factored into the stock price? If so, the announcement should cause little reaction. If not, the announcement should cause the stock price to rise if the surprise is pleasant or fall if it is not. This raises an important Catch 22. **Everyone's forecasts are, on average, consensus forecasts. If your prediction is consensus too, it won't produce above-average performance even if it's right. Superior performance comes from accurate non-consensus forecasts. But because most forecasters aren't terrible, the actual results fall near the consensus most of the time -- and non-consensus forecasts are usually wrong. The payoff table in terms of performance looks like this:**

		Forecast	
		Consensus	Non-Consensus
Accurate?	Yes	Average	Above Average
	No	Average	Below Average

The problem is that extraordinary performance comes only from correct non-consensus forecasts, but non-consensus forecasts are hard to make, hard to make correctly and hard to act on.

In poker, "scared money never wins." In investing, it's hard to hold fast to an improbable, non-consensus forecast and do the right thing...especially if the clock is telling you the forecast is off base. As I was told years ago, "being too far ahead of your time is indistinguishable from being wrong."

For example, people hold equities because they find prospective long-term equity returns attractive. The average annual return on equities from 1926 to 1987 was 9.44%. But if you had gone to cash and missed the best 50 of those 744 months, you would have missed all of the return.

This tells me that attempts at market timing are a source of risk, not protection.

Groucho Marx said, "I wouldn't join any club that would have me as a member." Another formulation may be "I would never act on any forecast that someone would share with me." I'm not saying that no one has above-average forecasting ability. Rather, as one University of Chicago professor wrote in a paper years ago, such forecasters are more likely to be sunning themselves in Saint Tropez than going around entreating people to borrow their forecasts.

[Random Thoughts on the Identification of Investment Opportunities](#)

The bottom line is that it is best to act as a contrarian. An investment that "everyone" knows to be undervalued is an oxymoron. If everyone knows it's undervalued, why haven't they bought it and driven up its price? And if they have bought, how can the price still be low? Yogi Berra said, "nobody goes to that restaurant; it's too popular." The equally oxy-moronic investment version is "Everybody likes that security because it's so cheap."

Book the bet that no one else will.

If everyone likes the favorite in a football game and wants to bet on it, the point spread will grow so wide that the team -- as good as it is -- is unlikely to be able to cover the spread. Take the other side of the bet -- on the underdog. Likewise, if everyone is too scared of junk bonds to buy them, it will become possible for you to buy them at a yield spread which not only overcompensates for the actual credit risk but sets the stage for their being the best performing fixed income sector in the world. That was the case in late 1990. The bottom line is that one must try to be on the other side of the question from everyone else. If everyone likes it, sell; if no one likes it, buy.

As Warren Buffet said, "the less care with which others conduct their affairs, the more care with which you should conduct yours." When others are afraid, you needn't be; when others are unafraid, you'd better be. It is usually said that the market runs on fear and greed. I feel at any given point in time it runs on fear or greed. As 1991 began, everyone was petrified of high yield bonds. Only the very best bonds could be issued, and thus buyers at that time didn't have to do any credit analysis -- the market did it for them. Its collective fear caused high standards to be

imposed. But when investors are unafraid, they'll buy anything. Thus, the intelligent investor's workload is much increased.

Gresham's Law says, "bad money drives out good." When paper money appeared, gold disappeared. It works in investing too: bad investors drive out good. When undemanding investors appear, they'll buy anything. Underwriting standards fall, and it gets hard for demanding investors to find opportunities offering the return and risk balance they require, so they're forced to the sidelines. **Demanding investors must be willing to be inactive at times**

[Dare to Be Great II](#)

The more I think about it, the more angles I see in the title *Dare to Be Great*. **Who wouldn't dare to be great? No one. Everyone would love to have outstanding performance. The real question is whether you dare to do the things that are necessary in order to be great. Are you willing to be different, and are you willing to be wrong? In order to have a chance at great results, you have to be open to being both.**

...

The answer may not be obvious, but it's imperative: you have to assemble a portfolio that's different from those held by most other investors. **If your portfolio looks like everyone else's, you may do well, or you may do poorly, but you can't do different. And being different is absolutely essential if you want a chance at being superior. In order to get into the top of the performance distribution, you have to escape from the crowd.** There are many ways to try. They include being active in unusual market niches; buying things others haven't found, don't like, or consider too risky to touch; avoiding market darlings that the crowd things can't lose; engaging in contrarian cycle timing; and concentrating heavily in a small number of things you think will deliver exceptional performance

...

The goal to investing is asymmetry: to expose yourself to return in a way that doesn't expose you commensurately to risk, and to participate in gains when the market rises to a greater extent than you participate in losses when it falls. But that doesn't mean the avoidance of all losses is a reasonable objective.

...

This is really the bottom-line: not whether you dare to be different or to be wrong, but whether you dare to look wrong.

...

I'm convinced that for many institutional investment organizations the operative rule – intentional or unconscious – is this: “We would never buy so much of something that if it doesn't work, we'll look bad.” For many agents and their organizations, the realities of life mandate such a rule. But people who follow this rule must understand that by definition it will keep them from buying enough of something that works for it to make much of a difference for the better.

...

In order to be a superior investor, you need the strength to diverge from the herd, stand by your convictions, and maintain positions until events prove them right. Investors operating under harsh scrutiny and unstable working conditions can have a harder time doing this than others.

...

Charlie Munger was right about it not being easy. I'm convinced that everything that's important is counterintuitive, and everything that's obvious is wrong. Staying with counterintuitive, idiosyncratic positions can be extremely difficult for anyone, especially if they look wrong at first. So-called “institutional considerations” can make it doubly hard.

Honor biology's #1 law – survival

The Route to Performance:

I feel strongly that attempting to achieve a superior long-term record by stringing together a run of top-decile years is unlikely to succeed. Rather, striving to do a little better than average every year -- and through discipline to have highly superior relative results in bad times -- is:

- less likely to produce extreme volatility,
- less likely to produce huge losses which can't be recouped and, most importantly,
- more likely to work (given the fact that all of us are only human).

Simply put, what the pension fund's record tells me is that, in equities, if you can avoid losers (and losing years), the winners will take care of themselves. I believe most strongly that this holds true in my group's opportunistic niches as well -- that the best foundation for above-average long-term performance is an absence of disasters. It is for this reason that a quest for consistency and protection, not single-year greatness, is a common thread underlying all of

Random Thoughts on the Identification of Investment Opportunities

The discipline which is most important in investing is not accounting or economics, but psychology. The key is who likes the investment now and who doesn't. Future prices changes will be determined by whether it comes to be liked by more people or fewer people in the future. Investing is a popularity contest, and the most dangerous thing is to buy something at the peak of its popularity. At that point, all favorable facts and opinions are already factored into its price, and no new buyers are left to emerge. The safest and most potentially profitable thing is to buy something when no one likes it. Given time its popularity, and thus its price, can only go one way: up. Watch which asset classes they're holding conferences for and how many people are attending. Sold-out conferences are a danger sign. You want to participate in auctions where there are only one or two buyers, not hundreds or thousands. You want to buy things either before they've been discovered or after there's been a shake-out.

[How the Game Should Be Played](#)

One of the questions asked most often in connection with our leaving to form Oaktree - - perhaps second only to "where'd the name come from?" -- is "why did you do it?" The answer is that we concluded we had an opportunity to create our own investment management firm, all of which would run our way, according to our philosophies, beliefs and standards. But what do we mean when we say, "our way?" Well, an article about sports in the April 2 New York Times Sunday Magazine provided an excellent metaphor through which to illustrate the point. In it, the author wrote of Babe Ruth that he represented

. . . The Credo of the Home Run: A man can never be faulted, even if he's wrong, for the bold, aggressive action in pursuit of victory; a real man must be willing to strike out, to go down swinging

I believe this is the way much of the investment world thinks, but it's the opposite of what we believe in. In fact, I wrote a memo in 1990 to take issue with a money manager who justified his poor recent performance by saying **"If you want to be in the top 5% of money managers, you have to be willing to be in the bottom 5%, too."** "Our way" is never to tolerate poor performance, and certainly not to consider it an acceptable side-effect of swinging for the fences. While we strive to be somewhat above average each year, our philosophy mandates that we put the greatest emphasis on trying to avoid losing our clients' money. And that brings me to what I feel is a much more appealing sports metaphor, which I clipped from the Wall Street Journal in 1992 but never had occasion to cite until now: the story of golfer Tom Kite. **The article was about Kite's having won a major tournament, but the part that interested me dealt with his record up to that time: The bespectacled 42-year-old had won**

... over the past 20 seasons some \$7.2 million in official prize money, more than any other golfer -- ever. But [he had never before won] one of the sport's "majors" (the U.S. and British Opens, Masters and PGA Championship).

That's the way we think it should be done: by consistently finishing in the money, but with no need for headline-grabbing victories. What we think matters isn't whether you hit a home run or win the Masters on any given day, but rather what your long-term batting average is.

...

Our response on this subject is simple: (1) We accept that we're among the many who do not know what the big-picture future holds. (2) It is for this reason that we choose to work in inefficient markets where specialization, skill and hard work can add value and lead to above-average performance over time. (3) **Lastly, we feel that because we're not clairvoyant, it's important to acknowledge our limitations and put the highest priority on avoiding losses, not executing bold strategies.** I was raised on an adage which had good things to say for "he who knows and knows he knows" but warned about the danger of following "he who knows not but knows not he knows not." Or, as expressed in my favorite quotation, from Stanford behaviorist Amos Tversky, . . . It's frightening to think that you might not know something, but more frightening to think that, by and large, the world is run by people who have faith that they know exactly what's going on. We never forget how risky it is to join that group. Thus our "game plan" is directed at avoiding strikeouts and building a high batting average over time, not at hitting a home run each trip to the plate.

[Safety First...But Where](#)

To me, alpha is skill. It's the ability to profit from things other than the movements of the market, to add to return without adding proportionately to risk, and to be right more often than is called for by chance. **More important, alpha is differential advantage; it's skill that others don't possess.** That's why knowing something isn't alpha. If everyone else knows it, that bit of knowledge gives you no advantage. Lastly, alpha is entirely personal. It's an art form. It's superior insight; some people just "get it" better than others. Some of them are mechanistic quants; others are entirely intuitive. But all those I've met are extremely hard working.

[What's It All About, Alpha?](#)

That's because, in my view, alpha is best thought of as "differential advantage," or skill that others don't possess. **Alpha isn't knowing something, it's knowing something others don't know. If everyone else shares a bit of knowledge, it provides no advantage. It certainly won't help you beat the market, given that the market price embodies the consensus view of investors – who on average know what you know**

[Wha'dYa Know](#)

One of my favorite oxymorons is “common knowledge.” Knowledge just isn’t that common, and that which is common often contains little knowledge

The bottom line: there’s often no wisdom in the stuff that “everyone knows.” And nowhere is that more true than in investing.

[What’s Your Game Plan?](#)

“The key to investment success isn’t hitting home runs; it’s avoiding strikeouts and inning-ending double plays.” I say this over and over . . . and over . . . as you’ve no doubt experienced. But I truly believe it.

That brings up something that I consider a great paradox: I don’t think many investment managers’ careers end because they fail to hit home runs. Rather, they end up out of the game because they strike out too often – not because they don’t have enough winners, but because they have too many losers. And yet, lots of managers keep swinging for the fences.

- They bet too much when they think they have a winning idea or a correct view of the future, concentrating their portfolios rather than diversifying.
- They incur excessive transaction costs by changing their holdings too often or attempting to time the market.
- And they position their portfolios for favorable scenarios and hoped-for outcomes, rather than ensuring that they’ll be able to survive the inevitable miscalculation or stroke of bad luck. At Oaktree, on the other hand, we believe firmly that “if we avoid the losers, the winners will take care of themselves.” That’s been our motto since the beginning, and it always will be. We go for batting average, not home runs. We know others will get the headlines for their big victories and spectacular seasons. But we expect to be around at the finish because of consistent good performance that produces satisfied clients

For Me, It Started With Tennis

In July, Larry Keele and I met with the Directors of the Vanguard Convertible Securities Fund to report on Oaktree’s performance as the fund’s manager. I was extremely pleased to see Charles Ellis of Greenwich Associates, one of the great thinkers in the investment field, whom I hadn’t

come across in many years. I was especially pleased to have a chance to tell him about the seminal part his 1975 article, “The Loser’s Game,” had played in the development of my thinking. The article employed a metaphor that was simple but profound. Charley’s article described the perceptive analysis of tennis contained in “[Extraordinary Tennis for the Ordinary Tennis Player](#)” by Dr. Simon Ramo, the “R” in TRW. **Ramo pointed out that professional tennis is a “winner’s game,” in which the match goes to the player who’s able to hit the most winners: fast-paced, well-placed shots that his opponent can’t return. But the tennis the rest of us play is a “loser’s game,” with the match going to the player who hits the fewest losers. The winner just keeps the ball in play until the loser hits it into the net or off the court. In other words, in amateur tennis, points aren’t won; they’re lost. I recognized in Ramo’s loss-avoidance strategy the version of tennis I try to play.**

Charley took Ramo’s idea a step further, applying it to investments. His views on market efficiency and the high cost of trading led him to conclude that the pursuit of winners is unlikely to pay off. Instead, you should try to avoid hitting losers. I found this view of investing absolutely compelling. I can’t remember saying, “Eureka; that’s the approach for me,” but the developments over the last three decades certainly suggest his article was an important source of my inspiration

Finding Your Role Model – An article in the Wall Street Journal of August 8, entitled “Greatness in Our Midst,” supplied the immediate impetus for this memo. It attempted to determine “who’s the greatest living baseball player?” I’m no expert on baseball, but I liked the Journal’s analytical approach and loved its conclusions. **Of the five players discussed, Barry Bonds came in fifth. “If you’re looking for a peak value player – a guy to play one season as well as anyone ever has – this is your guy. His past two campaigns have been other-worldly . . .” Bonds has a ton of ability, but he has yet to prove that he’s “the greatest.”** Lots of fence-swinging investors have had otherworldly years, but few have completed outstanding careers. Stan Musial placed fourth: outstanding at the plate, but below average on defense according to the Journal. It’s tough to be the best without strong defense. The #3 pick was Willie Mays. He ended his career with excellent stats in many offensive categories and he was an outstanding fielder, having made what has to be the most famous catch in baseball history. Surprisingly, however, “in a career full of milestones, such as 3,000 hits and 600 homers, Mr. Mays doesn’t own a single significant major-league record.” Records aren’t what it’s about; I think its competence, consistency, and an absence of weaknesses. I like the way Ricky Henderson made it to runner-up. “Walks aren’t sexy, and steals aren’t trendy,” but Henderson holds the career record in both, and they positioned him to score. “And no one’s done this more often than Mr. Henderson.” It’s kind of like being a steady performer in an unfashionable niche like

convertibles, underdeveloped real estate or power infrastructure. The Journal's pick for greatest living player: Henry Aaron. Unlike Willie Mays, the Journal says, "Hammerin' Hank holds more important records than any player in history: home runs, runs batted in, total bases, extra-base hits and Aggregate Bases," (which it defines as the sum of hits, extra bases, walks and steals). And I love the way he did it: "Mr. Aaron's best seasons don't compare with those of Messrs. Bonds, Mays or Musial, but he played at a high level longer than any player in the history of the game." In my book, that's the definition of #1.

...

Playing Within Yourself

An expression from the broadcasting booth that's relevant to investing relates to the need to avoid pushing too hard. "Playing within yourself," they call it. It means not trying to do things you're not capable of, or things that can't be accomplished within the environment as it exists

...

Back to Tennis for the Wrap-up

Just as this memo was going into the home stretch, the Wall Street Journal's Allan Barra greeted the start of the U.S. Open tennis tournament with an article about Pete Sampras. For me, it provided the ultimate investment/sports metaphor. Mr. Sampras will need no future historians to make his case as the greatest tennis player of our time. His career credentials – the 14 Grand Slam singles championships; the 63-7 record in Wimbledon and seven Wimbledon titles in eight years; the 71-9 record at the U.S. Open with 87 consecutive service games won there; the six straight seasons of being ranked No. 1 – do that admirably... **Sampras the player wasn't always exciting. Mr. Sampras's outstanding quality was always his uncanny consistency. Was there an athlete of the past 10 to 12 years whose greatness has been harder to capture in highlights? His highlights were hard to distinguish from his lowlights. As I wrote in the Wall Street Journal a few years ago: "The definitive book on the man would have to be titled 'Pete Sampras: The Dullness of Excellence.' But who would buy it?"** (August 26, 2003; emphasis added)

The sentence I've bolded struck me as particularly thought provoking. You could read it as saying "his best moments weren't much better than his worst moments" – not a very stirring thought. Alternatively, you could read it as "his worst moments were almost as good as his best." In my

view, that would describe a terrific money management career. We hope people will say it about Oaktree.

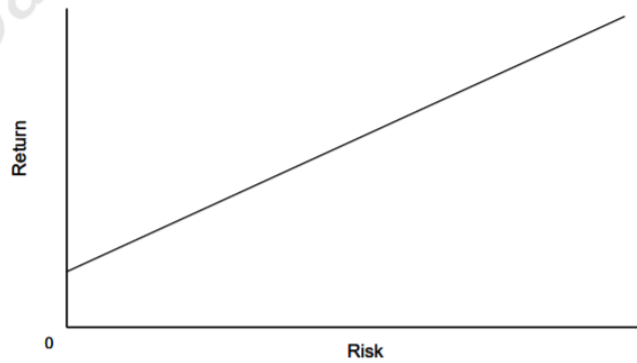
[Us and Them](#)

The best opportunities for investment returns aren't created by companies, exchanges or paper securities; they result from the mistakes other investors make. It's Oaktree's job to take advantage of them.

[Risk and Return Today](#)

Risk/Return Foundations

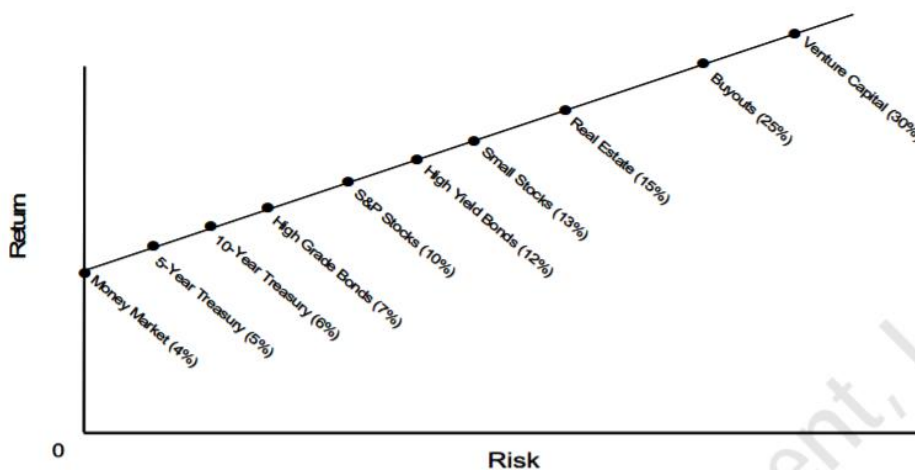
The most fundamental assumption underlying investment theory and practice today regards the universality of risk aversion. It is assumed that people dislike risk and prefer safety. The proof is simple: if a safe investment and risky investment – e.g., a 30-day U.S. Treasury bill and a start-up company's 30-year bond – both offer a 5% yield, virtually no one will choose the latter. Thus, if investors are going to bear risk, they must be induced to do so, with the incentive coming in the form of a higher expected return. In short then, the market must set prices such that investors will expect riskier investments to deliver higher returns. (I have said many times that those higher returns must not be viewed as dependable; if risky investments could be counted on to produce higher returns, they wouldn't be risky. Thus, their expected returns must appear to be higher in order to attract capital, but the higher expected return will always be accompanied by a range of possible outcomes that is wider and may include losses.) Because of the assumed correlation between perceived risk and perceived return potential, the following graphic has come into widespread use to depict the market's basic workings:



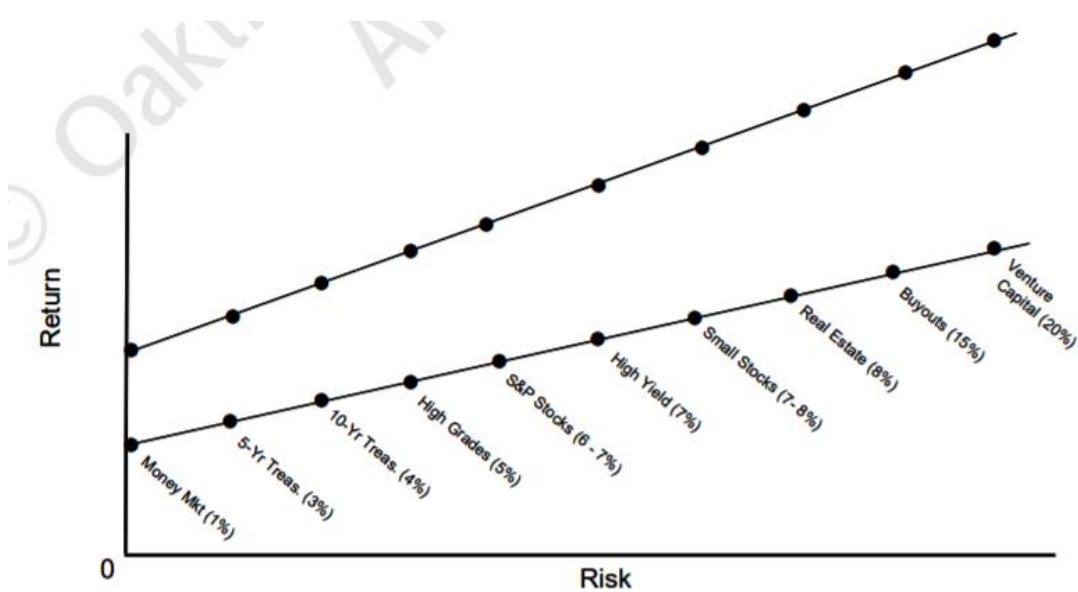
As the graphic suggests, there is a low return that can be earned on the riskless asset and, from there, prospective return will rise with prospective risk. Thus, we have a “capital market line” that, as the academics say, “is upward sloping to the right.” (The “riskless asset” is generally felt to be the shortest U.S. Treasury bill, with regard to which investors don’t worry about credit risk or the risk that inflation will erode the purchasing power of principal before it’s repaid upon maturity.)

...

“If I can get 10% from stocks, I need 15% to accept the illiquidity and uncertainty associated with real estate. And 25% if I’m going to invest in buyouts . . . and 30% to induce me to go for venture capital, with its low success ratio.” That’s the way it’s supposed to work, and in fact I think it generally does (although the requirements aren’t the same at all times). The result is a capital market line of the sort that has become familiar to many of us, as shown on the next page.



The Market at Work – 2004 Version A big problem for investment returns today stems from the starting point for this process: The riskless rate isn't 4%; it's closer to 1%. Interest rates reached multi-generational lows in 2004. The Fed kept short rates low for much of the year, although they've been inching up in recent months. This was done (a) to stimulate an economy that has been quite sluggish since the last recession and (b) to protect the economy against negative effects from exogenous shocks, most prominently the corporate scandals of 2001-02 and the terrorist attacks of 9/11 (and the possibility of more); in fact, the low rates have been described as "emergency rates." Our typical investor still wants more return if he's going to accept time risk, but with the starting point at 1+%, now 4% is the right rate for the 10-year (not 6%). He won't go into stocks unless he gets 6-7%. And junk bonds may not be worth it at yields below 7%. Real estate has to yield 8% or so. For buyouts to be attractive they have to appear to promise 15%, and so on. Thus, we now have a capital market line like the one shown below that is (a) at a much lower level and (b) much flatter



The lower level of the line is explained by the low interest rates, the starting point for which is the low riskless rate. After all, the investment thought process is a chain in which each investment sets the requirement for the next. Each investment has to compete with others for capital, but this year, due to the low interest rates, the bar for each successively riskier investment has been set lower than at any time in my career.

...

THEM

"I know"
Bullish by nature
Aggressive
Confident
Comfortable with risk
What might go right?
Worried about winners missed
Trend followers
Attracted to pretty flowers
Comfortable when part of the crowd
Growth/momentum investors
"Great things cost a lot"
Believers
"We're in a new era"
Cheered by appreciation
Enjoy averaging up
"Let it ride"
Relative return-oriented
Worried about underperforming
Pained by cash
Confident in their powers
Convinced that their good returns
are fully deserved
Impatient
Short term-fixated
Never worried by large amounts
of capital
Engrossed in watching the market
"The market's efficient"

Everything's okay:

Economic recovery underway
Corporate profit gains
Increases in productivity
Continuing foreign investment
Ability of weak dollar to bolster exports
Existence of job growth
Optimism implied by willingness to borrow
Strong military capability
Low level of interest rates
Today's security prices are justified
by low rates

US

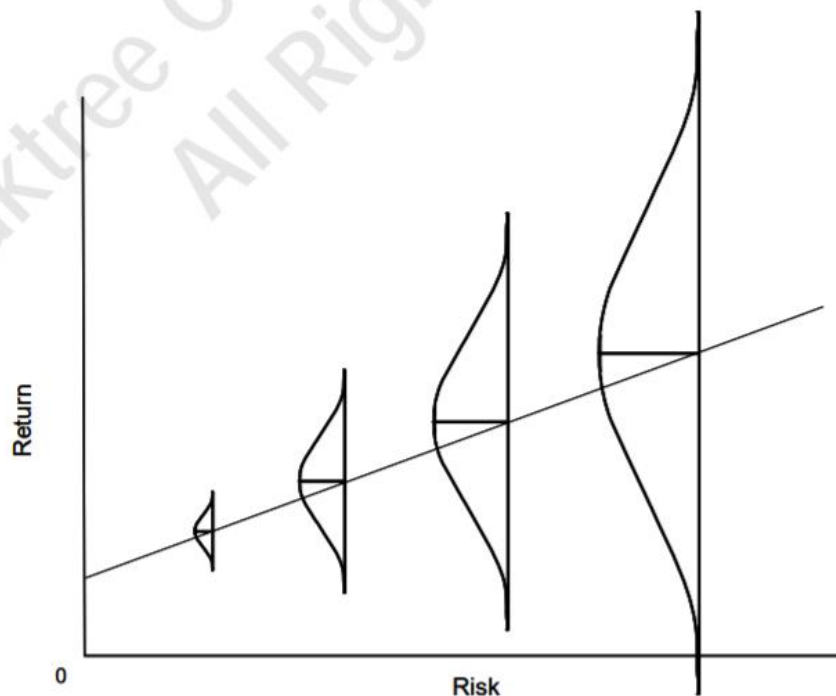
"I don't know"
Bearish by nature
Defensive
Guarded
Obsessed with risk
What might go wrong?
Worried about losers bought
Contrarians
Glad to search among the weeds
Happy when apart from the crowd
Value investors
Insistent on buying cheap
Skeptics
"Trees don't grow to the sky"
Frightened by excessive appreciation
Enjoy averaging down
Eager to take profits
Absolute return-oriented
Worried about losing money
Comfortable with cash
Aware that much is beyond their control
Highly conscious of the role
played by luck
Patient
Long term-oriented
Aware that it's possible to have
too much capital
Devoted to watching companies
"The market's an ass"

Worries abound:

Movement of jobs overseas
Gaping trade deficit
Growing budget deficit
Reliance on foreign capital
Threat to value of the dollar
Halting nature of job growth
Consumers' high debt/low savings
Risk of terrorism
Risk of interest rate rise
Today's security prices are reliant
on rates staying low

Risk

Before going further, I want to stop for a brief tirade. In my opinion, especially in good times, far too many people can be overheard saying, “Riskier investments provide higher returns. If you want to make more money, the answer is to take more risk.” But riskier investments absolutely cannot be counted on to deliver higher returns. Why not? It’s simple: if riskier investments reliably produced higher returns, they wouldn’t be riskier! The correct formulation is that in order to attract capital, riskier investments have to offer the prospect of higher returns, or higher promised returns, or higher expected returns. But there’s absolutely nothing to say those higher prospective returns have to materialize. The way I conceptualize the capital market line makes it easier for me to relate to the relationship underlying it all



...

There are many kinds of risk, and I’ll discuss some of them below. But volatility may be the least relevant of them all. Theory says investors demand more return from investments that are more volatile. But for the market to set the prices for investments such that more volatile investments will appear likely to produce higher returns, there have to be people demanding that relationship,

and I haven't met them yet. I've never heard anyone at Oaktree – or anywhere else, for that matter – say, “I won't buy it, because its price might show big fluctuations,” or “I won't buy it, because it might have a down quarter.” Thus, it's hard for me to believe volatility is the risk investors factor in when setting prices and prospective returns.

First, it clearly is nothing but a matter of opinion: hopefully an educated, skillful estimate about the future, but still just an estimate.

Second, the standard for quantification is nonexistent. With regard to a given investment, some people will think the risk is high and others will think it's low. Some will state it as the probability of not making money, and some as the probability of losing a given fraction of their money (and so forth). Some will think of it as the risk of losing money over one year, and some as the risk of losing money over the entire holding period. Clearly, even if all the investors involved met in a room and showed their cards, they'd never agree on a single number representing an investment's riskiness. And even if they could, that number wouldn't likely be capable of being compared against another number, set by another group of investors, for another investment.

Third, risk is deceptive. Conventional considerations are easy to factor in, like the likelihood that normally recurring events will recur. But freakish, once-in-a-lifetime events are impossible to quantify or prepare for. The fact that an investment is susceptible to a particularly serious risk that will occur infrequently if at all – what I call the “improbable disaster” – means it can seem safer than it really is. 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. The bottom line is that, looked at prospectively, much of risk is subjective, hidden and unquantifiable. But I think one of the most interesting aspects of risk – and one of the least appreciated – is the fact that it isn't quantifiable even in retrospect.

...

If you think about it, the response to these questions is simple: The fact that something happened doesn't mean it was likely, and the fact that something didn't happen doesn't mean it was improbable. Improbable things happen all the time, just as likely things often fail to occur.

...

For example, let's consider diversification versus concentration. Is concentration risky? Not if you know what the future holds. Diversification by definition implies a willingness to trade off return for safety, motivated by acceptance of the fact that knowledge of the future is imperfect. Most investors rank their stocks by potential return, formally or informally, but no one I know buys just the one they expect to deliver the highest return. Why? Because they know their rankings might be wrong and don't want to bet it all on black and see red come up. Concentration is risky for investors who can't see the future with much clarity, but it wouldn't be for one who can. For the latter, it's the way to maximize performance, and diversification can hold it back.

...

"Offsets" translate in the investment world into something very familiar: diversification. Intelligent diversification means not just investing in a bunch of different things, but in things that respond differently to the same factors. In a well-diversified portfolio, something that negatively influences investment A might have a positive and offsetting influence on investment B.

"Correlations" are somewhat the opposite. The term refers to the chance that a number of investments will respond in the same way to a given factor. Be alert, however, to the fact that when things in the environment turn really negative, seemingly unconnected investments can be similarly affected. "In times of panic," they say, "all correlations go to one."

...

Rick Funston performs a service by organizing risks into two categories: those that are suitable for probabilistic modeling and those that aren't. He includes among the elements that render a risk suitable for modeling (1) recurring situations, (2) processes that are subject to known rules, (3) conditions that can be counted on to remain stable, (4) controllable environments, (5) a limited range of outcomes, and (6) certainty that combinations of things will lead to known results. What could be less descriptive of investing? Given the non-recurring situations we face, the fact that many of the rules are unknown, and the largely unlimited range of outcomes (among other things), I would

argue strongly that models and modelers are of very limited utility in measuring investment risk at the extremes, where it really matters.

...

We've said for years that risky assets can make for good investments if they're cheap enough. The essential element is knowing when that's the case. That's it: the intelligent bearing of risk for profit, the best test for which is a record of repeated success over a long period of time

[It Is What It Is](#)

The Poor Man's Guide to Market Assessment

Here's a simple exercise: I have listed below a number of market characteristics. For each pair, check off the one you think is most descriptive of today. And if you find that most of your checkmarks are in the left-hand column, as I do, hold on to your wallet.

Economy:	Vibrant	Sluggish
Outlook:	Positive	Negative
Lenders:	Eager	Reticent
Capital markets:	Loose	Tight
Capital:	Plentiful	Scarce
Terms:	Easy	Restrictive
Interest Rates:	Low	High
Spreads:	Narrow	Wide
Investors:	Optimistic	Pessimistic
	Sanguine	Distressed
	Eager to buy	Uninterested in buying
Asset owners:	Happy to hold	Rushing for the exits
Sellers:	Few	Many
Markets:	Crowded	Starved for attention
Funds:	Hard to gain entry	Open to anyone
	New ones daily	Only the best can raise money
	GPs hold the cards on terms	LPs have bargaining power
Recent performance:	Strong	Weak
Asset prices:	High	Low
Prospective returns:	Low	High
Risk:	High	Low
Popular qualities:	Aggressiveness	Caution and discipline
	Broad reach	Selectivity
The right qualities:	Caution and discipline	Aggressiveness
	Selectivity	Broad reach
Available mistakes:	Buying too much	Buying too little
	Paying up	Walking away
	Taking too much risk	Taking too little risk

[Dare to Be Great](#)

This just in: you can't take the same actions as everyone else and expect to outperform. The search for superior results has to lead to the unusual, perhaps the idiosyncratic. Unusual success cannot lie in doing the obvious.

...

Non-consensus ideas have to be lonely. By definition, non-consensus ideas that are popular, widely held or intuitively obvious are an oxymoron. Thus, such ideas are uncomfortable; non-conformists don't enjoy the warmth that comes with being at the center of the herd.

Further, unconventional ideas often appear imprudent. The popular definition of "prudent" – especially in the investment world – is often twisted into "what everyone else does." When courts interpret Prudent Man laws, they take them to mean "what most intelligent, careful people would do under those circumstances." But many of the things that have worked out best over the years – betting on start-ups, buying the debt of bankrupt companies, shorting the stocks of world-altering tech companies – looked downright imprudent to the masses at the time. (If they weren't so out of favor, they couldn't have been implemented at such advantageous price and produced such huge returns).

...

Only if your behavior is unconventional is your performance likely to be unconventional...and only if the judgments are superior is your performance likely to be above average

[Pigweed](#)

Classic Investment Mistakes: Hemlines go up and down. Ties go from wide to narrow and back again. There are only so many ways in which things can vary. Likewise, there are only a few mistakes one can make in investing, and people repeat them over and over. It seems Amaranth made several.

- **Borrowing short to buy long (and illiquid). This cardinal sin is at the root of most great investment debacles. A fund's capital should be as long-lived as its commitments. And no fund should promise more liquidity than is provided by its underlying assets. You can successfully invest in volatile assets if you're sure of being able to ride out a storm. But**

if you lack that certainty and face the possibility of withdrawals or margin calls, a little volatility can mean the end. In the case of Amaranth, just as had been true of Long-Term Capital Management and the big junk bond holders that were forced to sell out at the 1990 lows, many of the losses would have turned back into profits if they had just been able to hold on through the crisis. That's why I always caution, "Never forget the six-foot-tall man who drowned crossing the stream that was five feet deep on average." It's not enough to be able to get through on average; you have to be able to survive life's low points.

- Confusing paper profits with real gains. The Wall Street Journal of September 20 points out that Hunter was encouraged by the positive marks to market showing up in his statements, so much so that he added further to his positions. But he seems not to have asked whether the gains were real and realizable. The Journal also points out that Hunter was such a big buyer in thin markets that his buying often supported prices and created the very profits he found so encouraging. But if the profits were the product of his buying, and thus dependent on it for their continued existence, he clearly had no way to realize them. My father used to tell a joke about the guy who insisted that his hamster was worth thousands more than he had paid for it. "Then you should sell it," his friend urged. "Yeah," he responded, "but to whom?"
- Being seduced by loss limitation. Hunter is said to have liked buying deep-out-of-the-money options, and everyone knows that one great thing about buying options is that in exchange for a small option premium you receive the right to benefit from price movements on lots of assets. You can only lose 100% of the amount you put up . . . and in deep-out-of-the-money options people do just that all the time.
- Misjudging liquidity. People often ask me whether a given market is liquid or not. My answer is usually, "that depends on which side you're on." Markets are usually liquid in one direction or the other but not necessarily both. When everyone is selling, a buyer's liquidity is great, but a seller will find the going difficult. When sellers' urgency increases, they're likely to have to give on price in order to achieve the "immediacy" they crave (see my memo "Investment Miscellany," November 16, 2000). If their desire for immediacy is extreme, the bids they see might be absurdly low. Thus, markets can't be counted on to accommodate a seller's need to realize fair value.
- Ignoring the impact of others. In small markets, everyone may know about your trades. That means they can copy them (making buying tough and adding to the crowd that will eventually jam the exits), and they can deny you fair prices if they know you have to sell.

Aggressive traders, especially at hedge funds, don't wear kid gloves. • Underestimating correlation. There's another old saying: "In times of crisis, all correlations go to one." It means that assets with no fundamental or economic connection can be caused by market conditions to move in lockstep. If a hedge fund experiences heavy withdrawals during a period of illiquidity, assets of various types may have to be dumped at once, and thus they can all decline together. Further, hidden fault lines in portfolios can produce unexpected co-movement. Let's say you're long sugar and gas, two unrelated commodities. Unusually warm weather can reduce the demand for gas for heating and also cause a record sugar crop (as happened this year). Thus, the prices of seemingly unrelated goods can decline together. Intelligent diversification doesn't mean just owning different things; it means owning things that will respond differently to a given set of environmental factors. Thus, it requires a thorough understanding of potential connections. The case of Amaranth is highly and painfully instructive, and it bears out another of my favorite expressions: Experience is what you got when you didn't get what you wanted

[Everyone Knows](#)

paradox n – a seemingly absurd or self-contradictory statement that is or may be true...an opinion that conflicts with common belief. (Collins English Dictionary)

I'm sometimes asked to speak about investing with the choice of topic wide open. I like to begin by saying the thing I find most interesting about investing is how paradoxical it is: how often the things that seem most obvious – on which everyone agrees – turn out not to be true. I'm not saying accepted investment wisdom is sometimes valid and sometimes not. The reality is simpler and much more systematic: What's clear to the broad consensus of investors is almost always wrong. First, most people don't understand the process through which something comes to have outstanding moneymaking potential. And second, the very coalescing of popular opinion behind an investment tends to eliminate its profit potential

I've been saving up ideas for a memo about how often the investing herd is wrong and accepted wisdom should be bet against. Then along came the March 1 issue of Mark Faber's "[Gloom, Boom and Doom Report](#)" and its lead quotation from William Stanley Jevons (1835-1882). Another chance for someone else to help me say it better, this time from 100-plus years ago: As a general rule, it is foolish to do just what other people are doing, because there are almost sure to be too

many people doing the same thing. “Common Sense” and Other Oxymorons Take, for example, the investment that “everyone” believes to be a great idea. In my view by definition it simply cannot be so.

- If everyone likes it, it’s probably because it has been doing well. Most people seem to think outstanding performance to date presages outstanding future performance. Actually, it’s more likely that outstanding performance to date has borrowed from the future and thus presages sub-par performance from here on out.
- If everyone likes it, it’s likely the price has risen to reflect a level of adulation from which relatively little further appreciation is likely. (Sure, it’s possible for something to move from “overvalued” to “more overvalued,” but I wouldn’t want to count on it happening.)
- If everyone likes it, it’s likely the area has been mined too thoroughly – and has seen too much capital flow in – for many bargains to remain.

...

In short, there are two primary elements in superior investing:

- **seeing some quality that others don’t see or appreciate (and that isn’t reflected in the price), and**
- **having it turn out to be true (or at least accepted by the market).**

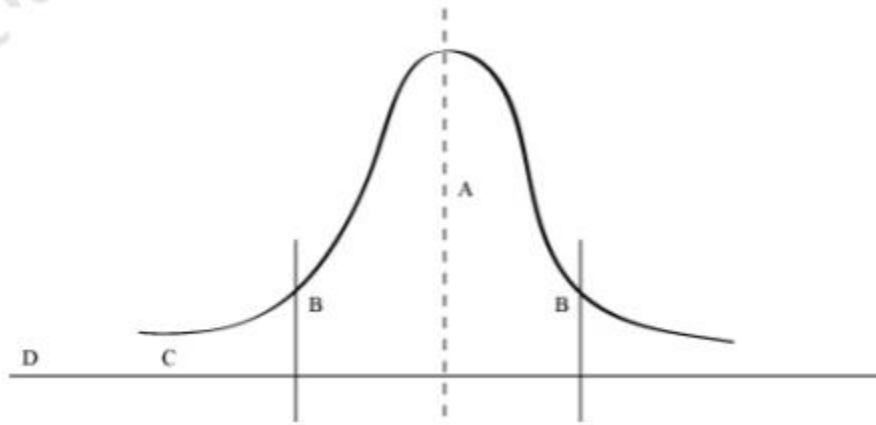
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This paradox exists because most investors think quality, as opposed to price, is the determinant of whether something’s risky. But high-quality assets can be risky, and low-quality assets can be safe. It’s just a matter of the price paid for them.

[Volatility + Leverage = Dynamite](#)

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 (A) most of the time, but we know it’s not unusual to see outcomes that are better or worse (B). Although we should bear in mind that, once in a while, a result will be outside the usual range (C), 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 (D).



Even if we realize that unusual, unlikely things can happen, in order to act we make reasoned decisions and knowingly accept that risk when well paid to do so. Once in a while, a “black swan” will materialize. But if in the future we always said, “We can’t do such-and-such, because we could see a repeat of 2007-08,” we’d be frozen in inaction. **So, in most things, you can’t prepare for the worst case. It should suffice to be prepared for once-in-a-generation events. But a generation isn’t forever, and there will be times when that standard is exceeded. What do you do about that? I’ve mused in the past about how much one should devote to preparing for the unlikely disaster. Among other things, the events of 2007-08 prove there’s no easy answer.**

[Déjà Vu All Over Again](#)

The bottom line here is simple, and I’m thoroughly convinced of it: common sense isn’t common. The crowd is invariably wrong at the extremes. In the investing world, everything that’s intuitively obvious is questionable and everything that’s important is counter-intuitive. And investors prove repeatedly that they can be less logical than Yogi.

...

If I were asked to name just one way to figure out whether something's a bargain or not, it would be through assessing how much optimism is incorporated in its price.

...

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

[Getting Lucky](#)

The second inspiration for this memo came from a report entitled [Alpha and the Paradox of Skill](#) by Michael Mauboussin of Credit Suisse. In it he talks about Jim Rutt, the CEO of Network Solutions. As a young man, Rutt wanted to become a better poker player, and to that end he worked hard to learn the odds regarding each hand and how to detect “tells” in other players that give away their position.

Here's the part that attracted my attention:

At that point, an uncle pulled him aside and doled out some advice. “Jim, I wouldn't spend my time getting better,” he advised, “I'd spend my time finding weak games.”

Success in investing has two aspects. The first is skill, which requires you to be technically proficient. Technical skills include the ability to find mispriced securities (based on capabilities in modeling, financial statement analysis, competitive strategy analysis, and valuation all while sidestepping behavioral biases) and a good framework for portfolio construction. The second aspect is the game in which you choose to compete.

Mauboussin goes on to talk primarily about changes in the relative importance of luck and skill. But for me, what his words keyed first and foremost were musings about market efficiency and inefficiency. What they highlighted is the easiest way to win at poker is by playing in easy games in which other players make mistakes. Likewise, the easiest way to win at investing is by sticking to inefficient markets.

...

Markets will be permanently efficient when investors are permanently objective and unemotional. In other words, never. Unless that unlikely day comes, skill and luck will both continue to play important roles.

[Risk Revisited](#)

Permanent loss is very different from volatility or fluctuation. A downward fluctuation – which by definition is temporary – doesn't present a big problem if the investor is able to hold on and come out the other side. A permanent loss – from which there won't be a rebound – can occur for either of two reasons: (a) an otherwise-temporary dip is locked in when an investor sells during a downswing – whether because of a loss of conviction; requirements stemming from his timeframe; financial exigency; or emotional pressures, or (b) the investment itself is unable to recover for fundamental reasons. We can ride out volatility, but we never get a chance to undo a permanent loss.

Everything is triple-A at the right price

[Microeconomics 101](#)

Two principal factors determine whether an investment will be successful. The first is the intrinsic quality of the underlying entity being invested in. In short, how good is the venture you are buying a piece of or lending money to? It's better to invest in a good company than a bad one, ceteris paribus, [Ceteris paribus is a favorite term of economists. It means “everything else being equal,” and yes, at a given price, it's smarter to invest in a better company than a worse one. Of course, “everything else” never is equal, and you're not likely to be asked to choose between two assets of obviously different quality at the same price.] The second factor determining whether something will be a good investment is price. Ceteris paribus, given two assets of similar quality, it's better to pay less than more... **In short, we feel “everything is triple-A at the right price”.**

[Random Thoughts on the Identification of Investment Opportunities](#)

What matters most is not what you invest in, but when and at what price. There is no such thing as a good or bad investment idea per se. For example, the selection of good companies is certainly not enough to assure good results -- see Xerox, Avon, Merck and the rest of the "nifty fifty" in 1974. Any investment can be good or bad depending on when it's made and what price is paid. It's been said that "any bond can be triple-A at a price." **There is no security that is so good that it can't be overpriced, or so bad that it can't be underpriced.**

[Risk in Today's Markets](#)

Warren Buffet said, in one of my favorite adages, "The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs." Another adage I'm fond of is, "What the wise man does in the beginning, the fool does in the end." No course of investment action is either wise or foolish in and of itself. It all depends on the point in time at which it is undertaken, the price that is paid, and how others are conducting themselves at that moment.

Safety First...But Where

Pursuing quality regardless of price is, in my opinion, one of the riskiest – rather than the safest – of investment approaches. Highly respected companies invariably fall to earth. When investors' hopes are dashed, the impact on price is severe. For example, if a high p/e ratio is attached to earnings that are expected to grow rapidly, an earnings shortfall will cause the p/e ratio to be reduced, bringing about a double-barreled price decline. Lord Keynes wrote "speculators accept risks of which they are aware; investors accept risks of which they are unaware." As Keynes's definition makes clear, investing in the stocks of great companies that "everyone" likes at prices fully reflective of greatness is enormously risky. We'd rather buy assets that people think little of; the surprises are much more likely to be favorable, and thus to produce gains. **No, great companies are not synonymous with great investments . . . or even safe ones.**

Ripple effects and second-order thinking

[The Aviary](#)

There's an old riddle about ten birds sitting on a telephone wire. A hunter shoots one. How many are left? The usual response is nine. But the correct answer is none; the rest are frightened by the gunshot and fly away. Maybe it's a joke, but it illustrates the ease with which ramifications – what my British friends call “knock-on effects” – are overlooked. In “It's All Good . . . Really?” I discussed the way people were describing the events of last summer as an isolated subprime crisis and ignoring the potential for contagion. Now most see that the “subprime crisis” was just the first act in what might be a long period of generalized economic difficulty and market weakness. The longer I think about economic and investment trends, the more I view every development as a reaction to something else. And you've probably noticed my inability to talk about current events without discussing their precursors.

[Touchstones](#)

Some of the biggest problems arise because market participants think of their environment as a static arena in which they act. What they miss – to their frequent detriment – is that their actions alter the environment, causing the results to differ from their expectations.

George Soros has written and spoken most articulately about the ability of investors' actions to change the environment. He calls this process “**reflexivity.**”

The generally accepted theory is that financial markets tend towards equilibrium, and on the whole, discount the future correctly. I operate using a different theory, according to which financial markets cannot possibly discount the future correctly because they do not merely discount the future; they help to shape it. In certain circumstances, financial markets can affect the so-called fundamentals which they are supposed to reflect. When that happens, markets enter into a state of dynamic disequilibrium and behave quite differently from what would be considered normal by the theory of efficient markets. Such boom/bust sequences do not arise very often, but when they do, they can be very disruptive, exactly because they affect

the fundamentals of the economy. (George Soros, MIT Department of Economics World Economy Laboratory Conference, Washington, D.C., April 26, 1994)

The Most Important Thing

First-level thinking says, “it’s a good company; let’s buy the stock.” Second-level thinking says, “It’s a good company, but everyone thinks it’s a great company, and it’s not. So, the stock’s overrated and overpriced; let’s sell.”

First-level thinking says, “The outlook calls for low growth and rising inflation. Let’s dump our stocks.” Second-level thinking says, “The outlook stinks, but everyone else is selling in a panic. Buy!”

The difference in workload between first-level and second-level thinking is clearly massive, and the number of people capable of the latter is tiny compared to the number capable of the former.

First-level thinkers look for simple formulas and easy answers. Second-level thinkers know that success in investing is the antithesis of simple.

First-level thinking is simplistic and superficial and just about everyone can do it. Second-level thinking is deep, complex and convoluted. The second-level thinker takes a great many things into account:

- What is the range of likely future outcomes?
- Which outcome do I think will occur?
- What’s the probability I’m right?
- What does the consensus think?
- How does my expectation differ from the consensus?

