Memo to: Oaktree Clients

From: Howard Marks

Re: Dare to Be Great II

In September 2006, I wrote a memo entitled *Dare to Be Great*, with suggestions on how institutional investors might approach the goal of achieving superior investment results. I've had some additional thoughts on the matter since then, meaning it's time to return to it. Since fewer people were reading my memos in those days, I'm going to start off repeating a bit of its content and go on from there.

About a year ago, a sovereign wealth fund that's an Oaktree client asked me to speak to their leadership group on the subject of what makes for a superior investing organization. I welcomed the opportunity. The first thing you have to do, I told them, is formulate an explicit investing creed. What do you believe in? What principles will underpin your process? The investing team and the people who review their performance have to be in agreement on questions like these:

- Is the efficient market hypothesis relevant? Do efficient markets exist? Is it possible to "beat the market"? Which markets? To what extent?
- Will you emphasize risk control or return maximization as the primary route to success (or do you think it's possible to achieve both simultaneously)?
- Will you put your faith in macro forecasts and adjust your portfolio based on what they say?
- How do you think about risk? Is it volatility or the probability of permanent loss? Can it be predicted and quantified *a priori*? What's the best way to manage it?
- How reliably do you believe a disciplined process will produce the desired results? That is, how do you view the question of determinism versus randomness?
- **Most importantly for the purposes of this memo, how will you define success, and what risks will you take to achieve it? In short, in trying to be right, are you willing to bear the inescapable risk of being wrong?**

Passive investors, benchmark huggers and herd followers have a high probability of achieving average performance and little risk of falling far short. But in exchange for safety from being much below average, they surrender their chance of being much above average. All investors have to decide whether that's okay. And, if not, what they'll do about it.

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.**

Dare to Be Different

Here's a line from *Dare to Be Great*: **"This just in: you can't take the same actions as everyone else and expect to outperform."** Simple, but still appropriate.

For years I've posed the following riddle: Suppose I hire you as a portfolio manager and we agree you will get no compensation next year if your return is in the bottom nine deciles of the investor universe but $10 million if you're in the top decile. **What's the first thing you have to do – the absolute prerequisite – in order to have a chance at the big money?** No one has ever answered it right.

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 thinks can't lose; engaging in contrarian cycle timing; and concentrating heavily in a small number of things you think will deliver exceptional performance.

Dare to Be Great included the two-by-two matrix and paragraph below. Several people told me the matrix was helpful.

	Conventional Behavior	Unconventional Behavior
Favorable Outcomes	Average good results	Above-average results
Unfavorable Outcomes	Average bad results	Below-average results

> Of course it's not that easy and clear-cut, but I think that's the general situation. If your behavior and that of your managers is conventional, you're likely to get conventional results – either good or bad. **Only if your behavior is unconventional is your performance likely to be unconventional . . . and only if your judgments are superior is your performance likely to be above average.**

For those who define investment success as being "average or better," three of the four cells of the matrix represent satisfactory outcomes. But if you define success strictly as being superior, only one of the four will do, and it requires unconventional behavior. More from the 2006 memo:

> The bottom line on striving for superior performance has a lot to do with daring to be great. **Especially in terms of asset allocation, "can't lose" usually goes hand-in-hand with "can't win."** One of the investor's or the committee's first and most fundamental decisions has to be on the question of how far out the

> portfolio will venture. **How much emphasis should be put on diversifying, avoiding risk and ensuring against below-pack performance, and how much on sacrificing these things in the hope of doing better?**

In the memo I mentioned my favorite fortune cookie: "the cautious seldom err or write great poetry." Like the title *Dare to Be Great*, I find the fortune cookie thought-provoking. It can be taken as urging caution, since it reduces the likelihood of error. Or it can be taken as saying you should avoid caution, since it can keep you from doing great things. Or both. No right or wrong answer, but a choice . . . and hopefully a conscious one.

It Isn't Easy Being Different

In the 2006 memo, I borrowed two quotes from *Pioneering Portfolio Management* by David Swensen of Yale. They're my absolute favorites on the subject of institutional behavior. Here's the first:

> Establishing and maintaining an unconventional investment profile requires acceptance of uncomfortably idiosyncratic portfolios, which frequently appear downright imprudent in the eyes of conventional wisdom.

"Uncomfortably idiosyncratic" is a terrific phrase. There's a great deal of wisdom in those two words. What's idiosyncratic is rarely comfortable . . . and in order for something to be comfortable, it usually has to be conventional. The road to above average performance runs through unconventional, uncomfortable investing. Here's how I put it in 2006:

> 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 does."

Most great investments begin in discomfort. The things most people feel good about – investments where the underlying premise is widely accepted, the recent performance has been positive and the outlook is rosy – are unlikely to be available at bargain prices. Rather, bargains are usually found among things that are controversial, that people are pessimistic about, and that have been performing badly of late.

But it isn't easy to do things that entail discomfort. It's no coincidence that distressed debt has been the source of many successful investments for Oaktree; there's no such thing as a distressed company that everyone reveres. In 1988, when Bruce Karsh and I organized our first fund to invest in the debt of companies seemingly at death's door, the very idea made it hard to raise money, and investing required conviction – on the clients' part and our own – that our analysis and approach would mitigate the risk. The same discomfort, however, is what caused distressed debt to be priced cheaper than it should have been, and thus the returns to be consistently high.

Dare to Be Wrong

"You have to give yourself a chance to fail." That's what Kenny "The Jet" Smith said on TV the other night during the NCAA college basketball tournament, talking about a star player who started out cold and as a result attempted too few shots in a game his team lost. It's a great way to make the point. Failure isn't anyone's goal, of course, but rather an inescapable potential consequence of trying to do really well.

Any attempt to compile superior investment results has to entail acceptance of the possibility of being wrong. The matrix on page two shows that since conventional behavior is sure to produce average performance, people who want to be above average can't expect to get there by engaging in conventional behavior. Their behavior has to be different. **And in the course of trying to be different and better, they have to bear the risk of being different and worse.** That truth is simply unarguable. There is no way to strive for the former that doesn't require bearing the risk of the latter.

The truth is, almost everything about superior investing is a two-edged sword:

- If you invest, you will lose money if the market declines.
- If you don't invest, you will miss out on gains if the market rises.

- Market timing will add value if it can be done right.
- Buy-and-hold will produce better results if timing can't be done right.

- Aggressiveness will help when the market rises but hurt when it falls.
- Defensiveness will help when the market falls but hurt when it rises.

- If you concentrate your portfolio, your mistakes will kill you.
- If you diversify, the payoff from your successes will be diminished.

- If you employ leverage, your successes will be magnified.
- If you employ leverage, your mistakes will be magnified.

Each of these pairings indicates symmetry. None of the tactics listed will add value if it's right but not subtract if it's wrong. Thus none of these tactics, in and of itself, can hold the secret to dependably above average investment performance.

There's only one thing in the investment world that isn't two-edged, and that's "alpha": superior insight or skill. Skill can help in both up markets and down markets. And by making it more likely that your decisions are right, superior skill can increase the expected benefit from concentration and leverage. But that kind of superior skill by definition is rare and elusive.

The goal in 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. Take another look at the goal of asymmetry set out above: **it talks about achieving a preponderance of gain over loss, not avoiding all chance of loss.**

To succeed at any activity involving the pursuit of gain, we have to be able to withstand the possibility of loss. A goal of avoiding all losses can render success unachievable almost as readily as can the occurrence of too many losses. Here are three examples of "loss prevention strategies" that can lead to failure:

- I play tennis. But if when I start a match I promise myself that I won't commit a single double fault, I'll never be able to put enough "mustard" on my second serve to keep it from being easy for my opponent to put away.

- Likewise, coming out ahead at poker requires that I win a lot on my winning hands and lose less on my losers. But insisting that I'll never play anything but "the nuts" – the hand that can't possibly be beat – will keep me from playing lots of hands that have a good chance to win but aren't sure things.

- For a real-life example, Oaktree has always emphasized default avoidance as the route to outperformance in high yield bonds. Thus our default rate has consistently averaged just 1/3 of the universe default rate, and our risk-adjusted return has beaten the indices. But if we had insisted on – and designed compensation to demand – zero defaults, I'm sure we would have been too risk averse and our performance wouldn't have been as good. As my partner Sheldon Stone puts it, "If you don't have any defaults, you're taking too little risk."

When I first went to work at Citibank in 1968, they had a slogan that "scared money never wins." **It's important to play judiciously, to have more successes than failures, and to make more on your successes than you lose on your failures. But it's crippling to have to avoid all failures, and insisting on doing so can't be a winning strategy. It may guarantee you against losses, but it's likely to guarantee you against gains as well.** Here's some helpful wisdom on the subject from Wayne Gretzky, considered by many to be the greatest hockey player who ever lived: **"You miss 100% of the shots you don't take."**

There is no formulaic approach to investing that can be depended on to produce superior risk-adjusted returns. There can't be. In a relatively fair or "efficient" market – and the concerted efforts of investors to find underpriced assets tend to make most markets quite fair – asymmetry is reduced, and a formula that everyone can access can't possibly work.

As John Kenneth Galbraith said, "There is nothing reliable to be learned about making money. If there were, study would be intense and everyone with a positive IQ would be rich." If merely applying a formula that's available to everyone could be counted on to provide easy profits, where would those profits come from? Who would be the losers in those transactions? Why wouldn't those people study and apply the formula also?

Or as Charlie Munger told me, "It's not supposed to be easy. Anyone who finds it easy is stupid." In other words, anyone who thinks it can be easy to succeed at investing is being simplistic and superficial, and ignoring investing's complex and competitive nature.

Why should superior profits be available to the novice, the untutored or the lazy? Why should people be able to make above average returns without hard work and above average skill, and without knowing something most others don't know? And yet many individuals invest based on the belief that they can. (If they didn't believe that, wouldn't they index or, at a minimum, turn over the task to others?)

No, the solution can't lie in rigid tactics, publicly available formulas or loss-eliminating rules . . . or on complete risk avoidance. **Superior investment results can only stem from a better-than-average ability to figure out when risk-taking will lead to gain and when it will end in loss.** There is no alternative.

Dare to Look Wrong

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

Most people understand and accept that in their effort to make correct investment decisions, they have to accept the risk of making mistakes. Few people expect to find a lot of sure things or achieve a perfect batting average.

While they accept the intellectual proposition that attempting to be a superior investor has to entail the risk of loss, many institutional investors – and especially those operating in a political or public arena – can find it unacceptable to look significantly wrong. Compensation cuts and even job loss can befall the institutional employee who's associated with too many mistakes.

As *Pensions & Investments* said on March 17 regarding a big West Coast bond manager currently in the news, whom I'll leave nameless:

> . . . asset owners are concerned that doing business with the firm could bring unwanted attention, possibly creating headline risk and/or job risk for them. . . .
>
> One [executive] at a large public pension fund said his fund recently allocated $100 million for emerging markets, its first allocation to the firm. He said he wouldn't do that today, given the current situation, because it could lead to second-guessing by his board and the local press.
>
> "If it doesn't work out, it looks like you don't know what you are doing," he said.

As an aside, let me say I find it perfectly logical that people should feel this way. Most "agents" – those who invest the money of others – will benefit little from bold decisions that work but will suffer greatly from bold decisions that fail. The possibility of receiving an "attaboy" for a few winners can't balance out the risk of being fired after a string of losers. Only someone who's irrational would conclude that the incentives favor boldness under these circumstances. Similarly, members of a non-profit organization's investment committee can reasonably conclude that bearing the risk of embarrassment in front of their peers that accompanies bold but unsuccessful decisions is unwarranted given their volunteer positions.

<u>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.</u>

In 1936, the economist John Maynard Keynes wrote in *The General Theory of Employment, Interest and Money*, "Worldly wisdom teaches that it is better *for reputation* to fail conventionally than to succeed unconventionally" [italics added]. For people who measure success in terms of dollars and cents, risk taking can pay off when gains on winners are netted out against losses on losers. **But if reputation or job retention is what counts, losers may be all that matter, since winners may be incapable of outweighing them. In that case, success may hinge entirely on the avoidance of unconventional behavior that's unsuccessful.**

Often the best way to choose between alternative courses of action is by figuring out which has the highest "expected value": the total value arrived at by multiplying each possible outcome by its probability of occurring and summing the results. As I learned from my first textbook at Wharton fifty years ago (*Decisions Under Uncertainty* by C. Jackson Grayson, Jr.), if one act has a higher expected value than another <u>and</u> ". . . if the decision maker is willing to regard the consequences of each act-event in purely *monetary* terms, then this would be the logical act to choose. Keeping in mind, however, that *only one event and its consequence will occur* (not the weighted average consequence)," agents may not be able to choose on the basis of expected value or the weighted average of all possible consequences. **If a given action has potential bad consequences that are absolutely unacceptable, the expected value of all of its consequences – both good and bad – can be irrelevant**.

Given the typical agent's asymmetrical payoff table, the rule for institutional investors underlined above is far from nonsensical. But if it is adopted, this should be done with awareness of the likely result: over-diversification. This goes all the way back to the beginning of this memo, and each organization's need to establish its creed. In this case, the following questions must be answered:

- In trying to achieve superior investment results, to what extent will we concentrate on investments, strategies and managers we think are outstanding? Will we do this despite the potential of our decisions to be wrong and bring embarrassment?

- Or will fear of error, embarrassment, criticism and unpleasant headlines make us diversify highly, emulate the benchmark portfolio and trade boldness for safety? Will we opt for low-cost, low-aspiration passive strategies?

In the course of the presentation described at the beginning of this memo, I pointed out to the sovereign wealth fund's managers that they had allocated close to a billion dollars to Oaktree's management over the preceding 15 years. Although that sounds like a lot of money, it actually amounts to only a few tenths of a percent of what the world guesses their assets to be. And given our funds' cycle of investing and divesting, that means they didn't have even a few tenths of a percent of their capital with us at any one time. Thus, despite our good performance, I think it's safe to say Oaktree couldn't have had a meaningful impact on the fund's overall results. Certainly one would associate this behavior with an extreme lack of risk tolerance and a high aversion to headline risk. I urged them to consider whether this reflects their real preference.

Lou Brock of the St. Louis Cardinals was one of baseball's best base stealers between 1966 and 1974. He's the source of a great quote: **"Show me a guy who's afraid to look bad, and I'll show you a guy you can beat every time."** What he meant (with apologies to readers who don't understand baseball) is that in order to prevent a great runner from stealing a base, a pitcher may have to throw over to the bag ten times in a row to hold him close, rather than pitch to the batter. But after a few such throws, a pitcher can look like a scaredy-cat and be booed. Pitchers who were afraid of those things were easy pickings for Lou Brock. Fear of looking bad ensured their failure.

<u>Looking Right Can Be Harder Than Being Right</u>

Fear of looking bad can be particularly debilitating to an investor, client or manager. This is because of how hard it is to consistently make correct investment decisions. Some of this comes from my last memo, on the role of luck.

- First, it's hard to consistently make decisions that correctly factor in all of the relevant facts and considerations (i.e., it's hard to <u>be</u> right).

- Second, it's far from certain that even "right" decisions will be successful, since every decision requires assumptions about what the future will look like, and even reasonable assumptions can be thwarted by the world's randomness. Thus many correct decisions will result in failure (i.e., it's hard to <u>look</u> right).

- Third, even well-founded decisions that eventually turn out to be right are unlikely to do so promptly. This is because not only are future events uncertain, their timing is particularly variable (i.e., it's impossible to look right <u>on time</u>).

This brings me to one of my three favorite adages: **"Being too far ahead of your time is indistinguishable from being wrong."** The fact that something's cheap doesn't mean it's going to appreciate tomorrow; it can languish in the bargain basement. And the fact that something's overpriced certainly doesn't mean it'll fall right away; bull markets can go on for years. As Lord Keynes observed, "the market can remain irrational longer than you can remain solvent."

Alan Greenspan warned of "irrational exuberance" in December 1996, but the stock market continued upward for more than three years. A brilliant manager I know who turned bearish around the same time had to wait until 2000 to be proved correct . . . during which time his investors withdrew much of their capital. He wasn't "wrong," just early. But that didn't make his experience any less painful.

Likewise, John Paulson made the most profitable trade in history by shorting mortgage securities in 2006. Many others entered into the same transactions, but too early. When the bets failed to work at first, the appearance of being on the wrong track ate into the investors' ability to stick with their decision, and they were forced to close out positions that would have been extremely profitable.

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.

That brings me to the second quote I promised from Yale's David Swensen:

> . . . active management strategies demand uninstitutional behavior from institutions, creating a paradox that few can unravel.

Charlie Munger was right about it not being easy. **I'm convinced that everything that's important in investing 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.

Investors who aspire to superior performance have to live with this reality. **Unconventional behavior is the only road to superior investment results, but it isn't for everyone. In addition to superior skill, successful investing requires the ability to look wrong for a while and survive some mistakes.** Thus each person has to assess whether he's temperamentally equipped to do these things and whether his circumstances – in terms of employers, clients and the impact of other people's opinions – will allow it . . . when the chips are down and the early going makes him look wrong, as it invariably will. Not everyone can answer these questions in the affirmative. It's those who believe they can that should take a chance on being great.

April 8, 2014

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