

Memo to: Oaktree Clients

From: Howard Marks

Re: Open and Shut

Mark Twain is described as having said, “History doesn’t repeat itself, but it does rhyme.” Thanks to the tendency of investors to forget lessons and repeat behavior, it sometimes seems there’s no longer a need for me to come up with new ideas for these memos. Rather, all I have to do is recycle components from previous memos, like a builder reusing elements from old houses. I’m willing to try an experiment along those lines for this memo. Here are my building blocks:

From “First Quarter Performance,” April 11, 1991:

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. . . . 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 the “happy medium.”

From “The Happy Medium,” July 21, 2004:

The capital market oscillates between wide open and slammed shut. It creates the potential for eventual bargain investments when it provides capital to companies that shouldn’t get it, and it turns that potential into reality when it pulls the rug out from under those companies by refusing them further financing. It always has, and it always will.

From “You Can’t Predict. You Can Prepare.” November 20, 2001:

Overpermissive providers of capital frequently aid and abet financial bubbles. . . . In *Field of Dreams*, Kevin Costner was told, “if you build it, they will come.” In the financial world, if you offer cheap money, they will borrow, buy and build – often without discipline, and with very negative consequences.

From “Genius Isn’t Enough,” October 9, 1998:

Look around the next time there’s a crisis; you’ll probably find a lender.

The above citations provide the themes for this memo. I’ll just update them, put them into the current context and discuss the ramifications for investing today. We’ll see how

it goes. If it works well this time, readers may conclude that in the future they can fashion their own memos from bits and pieces of my old ones.

The Credit Cycle at Work

Consider this: the ups and downs of economies are usually blamed for fluctuations in corporate profits, and fluctuations in profits for the rise and fall of securities markets. However, in recessions and recoveries, economic growth usually deviates from its trendline rate by only a few percentage points. Why, then, do corporate profits increase and decrease so much more? The answer lies in things like financial leverage and operating leverage, which magnify the impact on profits of rising and falling revenues.

And if profits fluctuate this way – more than GDP, but still relatively moderately – why is it that securities markets soar and collapse so dramatically? I attribute this to fluctuations in psychology and, in particular, to the profound influence of psychology on the availability of capital.

In short, whereas economies fluctuate a little and profits a fair bit, the credit window opens wide and then slams shut . . . thus the title of this memo. I believe the credit cycle is the most volatile of the cycles and has the greatest impact. Thus it deserves a great deal of attention.

In “The Happy Medium,” I discussed the workings of the credit cycle in creating market extremes:

Looking for the cause of a market extreme usually requires rewinding the videotape of the credit cycle a few months or years. Most raging bull markets are abetted by an upsurge in the willingness to provide capital, usually imprudently. Likewise, most collapses are preceded by a wholesale refusal to finance certain companies, industries, or the entire gamut of would-be borrowers.

Then, in “You Can’t Predict. You Can Prepare.” I described this expand-and-contract process in detail, along with its ramifications:

- 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 share by lowering demanded returns (e.g., cutting interest rates), lowering credit standards, providing more capital for a given transaction, and easing covenants.

When this point is reached, the up-leg described above is reversed.

- Losses cause lenders to become discouraged and shy away.
- Risk averseness rises, and with it, interest rates, credit restrictions and covenant requirements.
- Less capital is made available – and at the trough of the cycle, only to the most qualified of borrowers, if anyone.
- Companies become starved for capital. Borrowers are unable to roll over their debts, leading to defaults and bankruptcies.
- This process contributes to and reinforces the economic contraction.

Of course, at the extreme the process is ready to be reversed again. Because the competition to make loans or investments is low, high returns can be demanded along with high creditworthiness. Contrarians who commit capital at this point have a shot at high returns, and those tempting potential returns begin to draw in capital. In this way, a recovery begins to be fueled. . . .

Prosperity brings expanded lending, which leads to unwise lending, which produces large losses, which makes lenders stop lending, which ends prosperity, and on and on.

The bottom line is that the willingness of potential providers of capital to make it available on any given day fluctuates violently, with a profound impact on the economy and the markets. There's no doubt that the recent credit crisis was as bad as it was because the credit markets froze up and capital became unavailable other than from governments.

Impact of the Credit Cycle

The section above describes how the capital cycle functions. My goal below is to describe its effect.

From time to time, providers of capital simply turn the spigot on or off – as in so many things, to excess. There are times when anyone can get any amount of capital for any purpose, and times when even the most deserving borrowers can't access reasonable amounts for worthwhile projects. The behavior of the capital markets is a great indicator of where we stand in terms of psychology and a great contributor to the supply of investment bargains. (“The Happy Medium”)

An uptight capital market usually stems from, leads to or connotes things like these:

- Fear of losing money.
- Heightened risk aversion and skepticism.
- Unwillingness to lend and invest regardless of merit.
- Shortages of capital everywhere.
- Economic contraction and difficulty refinancing debt.
- Defaults, bankruptcies and restructurings.
- Low asset prices, high potential returns, low risk and excessive risk premiums.

On the other hand, a generous capital market is usually associated with the following:

- Fear of missing out on profitable opportunities.
- Reduced risk aversion and skepticism (and, accordingly, reduced due diligence).
- Too much money chasing too few deals.
- Willingness to buy securities in increased quantity.
- Willingness to buy securities of reduced quality.
- High asset prices, low prospective returns, high risk and skimpy risk premiums.

The point about the quality of new issue securities in a wide-open capital market deserves particular attention. A decrease in risk aversion and skepticism – and increased focus on making sure opportunities aren't missed rather than on avoiding losses – makes investors open to a greater quantity of issuance. The same factors make investors willing to buy issues of lower quality.

When the credit cycle is in its expansion phase, the statistics on new issuance make clear that investors are buying new issues in greater amounts. But the acceptance of securities of lower quality is a bit more subtle. While there are credit ratings and covenants to look at, it can take effort and inference to understand the significance of these things. In feeding frenzies caused by excess availability of funds, recognizing and resisting this trend seems to be beyond the majority of market participants. This is one of the many reasons why the aftermath of an overly generous capital market includes losses, economic contraction and a subsequent unwillingness to lend.

The bottom line of all of the above is that generous credit markets usually are associated with elevated asset prices and subsequent losses, while credit crunches produce bargain-basement prices and great profit opportunities.

The Events of the Past Decade

The last several years have provided a typical example of the credit cycle at work – typical in its pattern, that is, but unique in its extent and impact.

The highs in risk tolerance, credulity, financial innovation and leverage seen between 2004 and early 2007 gave rise to a credit crunch in late 2007 and 2008 – the

greatest of our lifetimes – and to vast capital destruction. Structured and levered investment vehicles melted down, bringing unprecedented losses to those who had provided their capital, and forcing the sale of holdings regardless of price. Financial institutions flirted with potential insolvency, requiring their capital to be rebuilt via government programs. Money market funds and commercial paper had to be buoyed as well. Lehman Brothers went under. General Motors and Chrysler went bankrupt and required bailouts, and companies such as Fannie Mae, Freddie Mac, Merrill Lynch and Bear Stearns had to be supported or absorbed. All of this stemmed in large part from the too-easy availability of capital and from market participants' irresponsible behavior in the middle of the decade. The result was a massive flight to quality and widespread refusal to take risk.

In 2009, miraculously in my opinion, the responses of governments caused investor psychology to turn positive, and the pursuit of return caused risk tolerance to be restored. Risk capital became available again, enabling financial institutions to raise equity capital and highly indebted companies to access the capital markets, extending maturities and capturing the discounts on their debt. As a result – thanks to the rise in risk appetites – many markets showed their greatest gains ever.

This year, even though economic and geopolitical fundamentals are still shaky and new things to worry about arise from time to time, the credit markets are generally wide open for companies deemed to have critical mass. In “Warning Flags” in May, I observed that certain types of deals could be completed that exemplified behavior in the most heated pre-crisis days but had become impossible in late 2007 and 2008. These included issuance of CCC-rated, covenant-lite and payment-in-kind bonds; dividend recap transactions; and the organization of structured entities for investing in debt.

Recently there have been additions to that list:

- The issuance of 100-year bonds.
- The issuance of 50-year bonds callable in five years (if interest rates go up, the buyer will be stuck with a low-rate bond, but if interest rates go down, the issuer can quickly replace the bond with one bearing a lower rate).
- The issuance of inflation-adjusted Treasury Inflation-Protected Securities (TIPS) that will return minus 0.55% plus the rate of inflation (if there's no inflation, the return will be negative, and if the rate of inflation is positive, the yield on the TIPS will be below that rate).
- The issuance of bonds through so-called “drive-by deals.” When a deal is announced in the afternoon and priced the next morning, investors have little time to study its creditworthiness and covenants.

Each of these things is indicative of the following on the part of investors:

- **rising confidence and declining risk aversion,**
- **emphasis on potential return rather than risk, and**
- **willingness to buy securities of declining quality.**

Why These Developments?

As with any economic event, there are numerous explanations for these things. But the one I want to concentrate on is government stimulus.

In the depths of the credit crisis, governments around the world took steps to deal with the liquidity contraction, economic slowdown and banks' depleted capital accounts. These included reductions of interest rates to record lows. The motivations and effects are many and varied.

First, everyone knows it's the primary goal of rate cuts to stimulate economic activity by making it cheaper and thus more attractive for businesses to borrow money with which to invest in factories, capital good and inventories. Retail credit should be cheaper, too, encouraging consumers to borrow and buy.

Second, providing low cost borrowings is a way to rebuild the health of financial institutions. If a bank can borrow \$100 million from the central bank at 1% and lend it out at 6%, it's as though the government gave it \$5 million per year (assuming the loans turn out to be money-good). Thus, in addition to enhancing banks' profitability and equity, in principle this should lead to increased lending.

To date, the results in these areas have been mixed. Economic activity is still muted and lending is slow. But another by-product has become particularly pronounced: encouragement to take risk.

So third, Treasury bill rates near zero – and note yields of 1 or 2 percent (depending on which country we're talking about) – **have the effect of driving investors toward riskier investments.** Especially when fear and risk aversion recede, returns like these on Treasuries become unacceptable. Thus some money that otherwise would have been invested in the safe part of the fixed income market is forced to more aggressive places.

Whatever fundamental doubt – and resulting reticence – might exist is in part offset by the unacceptably low returns on the safest of investments. Thus, for example, people who wouldn't buy high yield bonds in the past at their traditional 12% yields, or at 20% in 2008, will buy them today at 7% primarily because they can't stomach Treasuries at 2%. In the same way, alternative investment categories that fared poorly in the crisis can attract equity capital again (albeit in smaller amounts and to be paired with less leverage).

The fourth impact is that interest rate declines cause asset appreciation. This restores wealth – household and otherwise – and with it the bullish feelings that give rise to increased willingness to spend money and bear risk.

Fifth, quantitative easing (QE) puts cash in investors' hands in exchange for the securities the Fed buys. This, too, should add to investors' appetite for investing.

However, a program such as QE that increases liquidity has additional consequences. For example, other countries are complaining that (a) excess capital from the low-rate U.S. will flood their markets, inflating asset and commodity prices, and (b) increasing the supply of money in the U.S. will weaken the dollar, unfairly strengthening the appeal of U.S. exports and reducing U.S. demand for imports.

The Ramifications

In 2003, my memo “What’s Going On?” included a tortured metaphor called “The Cat, the Tree, the Carrot and the Stick.” In low-return environments, I said, investors are forced to move further out on the risk curve because of the paltry returns available on safe investments, and lured to riskier investments by the higher returns promised there. Conscious risk bearing can be done responsibly and perhaps even profitably. **But low-return environments often lead investors to unconsciously reach for return, with results that are painful. One of our greatest imperatives is to be alert to the emergence of such behavior.**

A final reference to past memos: you might want to look back to 2004’s “Risk and Return Today.” It describes an investment environment in which rates on short-term Treasuries, reduced by the Fed, had brought down returns in the safe part of the capital market. As a result, I said, the capital market line was “low and flat,” with inflated asset prices, low returns, skimpy risk premiums and high risk. I went on to urge caution when investing in such a low-return environment. It was early, but it turned out to have been in order.

There are differences today. Yield spreads on non-investment grade debt are above average. Leverage is only available in more moderate amounts. With investors chastened by cash squeezes in 2008, the flow of capital to private strategies is limited. Equity p/e ratios are below the historic average. And investors seem to be conscious of the economic and geopolitical uncertainties.

But there are also direct similarities, primarily in the fact that inadequate yields on Treasuries are driving bond investors elsewhere to apply their rekindled risk-taking, and thus absolute yields are low on all fixed income instruments.

On November 12, *The New York Times* reported on comments by Martin Feldstein, former president of the National Bureau of Economic Research and chairman of the Council of Economic Advisers under Ronald Reagan:

Anticipation of QE2, he wrote in the *Financial Times*, caused prices of commodities and common stocks to rise.

“Like all bubbles, these exaggerated increases can rapidly reverse when interest rates return to normal levels,” he said. “The greatest danger will then be to leveraged investors, including individuals who bought these assets with borrowed money and banks that hold long-term securities.

These risks should be clear after the recent crisis driven by the bursting of asset price bubbles. **Although the specific asset prices that are now rising are different from last time, the possibility of damaging declines when bubbles burst is worryingly similar.**” (Emphasis added)

In 2006-07, the most appreciated assets were real estate, mortgages and buyout companies. This year they're Treasury securities around the world, gold, commodities, currencies (versus the U.S. dollar), and real estate and stocks in emerging markets. Buyout companies could return to the list due to the combination of cheap debt, equity capital needing investing, and strong competition to put it to work.

The bottom line is that for whatever the reason, some asset prices have risen again, risk bearing has returned, and the risky transactions of 2004-07 are once again doable. Thus it strikes me that it's time to dust off the ultimate piece of advice from Warren Buffett:

The less prudence with which others conduct their affairs, the greater prudence with which we must conduct our own affairs.

Investors who engaged in aggressive behavior just a few years ago experienced significant pain as a result. Perhaps the punishment was too brief, and perhaps it was reversed too soon. Thus some are acting aggressively once again. It's possible that such behavior won't be punished again the second time around, but prudent investors shouldn't take the risk.

At the depths of the markets in the fourth quarter of 2008, after Lehman Brothers' bankruptcy filing and other events had unnerved the world, great assets were on sale at irrationally low prices. The result – as always in crashes – was that high prospective returns were available with low attendant risk. Just two ingredients were required in order to take advantage: capital and the nerve to invest it.

Today some assets are fairly priced and others are high, but there are no bargains like those of 2008. Capital and nerve can't hold the answers in such an environment. We're no longer in a high-return, low-risk market, especially in light of the inability to know how today's many macro uncertainties will be resolved. **Instead of capital and nerve, then, the indispensable elements are now risk control, selectivity, discernment, discipline and patience.**

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