

Memo to: Oaktree Clients
From: Howard Marks
Re: I'd Rather Be Wrong

Just a few weeks ago, I published “Tell Me I’m Wrong,” my latest list of things in the investment environment that I find worth worrying about. I’m going to devote a few pages here – I promise this’ll be the shortest memo in years – to a point I touched on in “What Worries Me” (August 28, 2008) but omitted from the more recent piece.

This memo will be about one of the inarguably most depressing topics of our time: the seeming inability of governments and politicians to solve – or even tackle – the financial problems we face. Here’s the situation in Washington:

- Many of our most sweeping financial problems, such as deficits, national debt, healthcare costs, Social Security and Medicare, are long-term problems.
- It’s important that we tackle them early, since limiting their further growth can reduce the eventual cost and difficulty of fixing them.
- But the process of solving them will be unpleasant in the short term, entailing bad-tasting medicine, while the benefits will only be seen in the long term, when today’s politicians will have left the stage.
- Finally, most politicians’ main concern seems to be getting themselves and other members of their party elected. Voting for short-term pain in order to solve long-term problems is generally viewed as the wrong way to go about that.

This memo is inspired by two excellent newspaper articles that appeared within the last month: “Party Gridlock Feeds New Fear of a Debt Crisis,” by Jackie Calmes (*The New York Times*, February 17)^{*} and “Perils of the California Model” by David Wessel (*The Wall Street Journal*, March 4).[†] Indicating their importance, *The Times* piece ran in the upper right-hand corner of the front page, always the place for the top story of the day, and the *Journal* story was carried on page A2. I’ve included links below in the hope they’ll increase your likelihood of reading them. As Calmes wrote in *The Times* (in both cases below, emphasis added):

After decades of warnings that budget profligacy, escalating health care costs and an aging population would lead to a day of fiscal reckoning, economists and the nation’s foreign creditors say that moment is approaching faster than expected, hastened by a deep recession that cost trillions of dollars in foregone tax revenues and higher spending for safety-net programs.

Yet rarely has the political system seemed more polarized and less able to solve big problems that involve trust, tough choices and little or no short-

^{*} <http://www.nytimes.com/2010/02/17/business/economy/17gridlock.html>

[†] <http://online.wsj.com/article/SB20001424052748704541304575099371249822654.html>

term gain. The main urgency for both parties seems to be about pinning blame on the other, before November's elections, for budget deficits now averaging \$1 trillion a year, the largest since World War II relative to the size of the economy.

Two weeks later, Wessel put it this way in *The Journal*:

The stalemate over health-care legislation, despite widespread acknowledgment that the status quo is unsustainable, underscores the inability of the political system to cope with complex, long-term fiscal issues. . . .

Today, the deficits projected are bigger than ever, baby boomers are beginning to retire, health-care costs keep rising and, surely, we're closer to the day when Asian governments grow reluctant to lend ever-greater sums to the U.S. Treasury at low interest rates.

The Congressional Budget Office projects current policies would take the deficit from today's 10% of gross domestic product to over 20% by 2020 and over 40% by 2080. **Yet today's politics appear more toxic, and the ranks of congressional leaders with the skill and desire to fashion compromises instead of talking points are depleted.**

Here we have remarkably similar themes voiced in what some would call "a Democrat newspaper" and in a stalwart of the pro-business Republican establishment. Both articles complain that the current trends in politics reduce the likelihood that major problems will be tackled and solved . . . a rare example of agreement across the aisle.

That brings me to the subject of one of today's greatest stumbling blocks, the absence of that elusive ideal: bipartisanship. Let's discuss this issue in principle. It's likely that the "ins" always think the fact that voters gave them control means they should mostly get their way, and that "bipartisanship" consists of the "outs" going along with them. The outs, on the other hand, don't take the election results to mean the minority has no rights, and they feel perfectly within their rights to use Congress's rules and processes to fight for their point of view (which, on us-versus-them issues, equates to thwarting the efforts of the ins).

The Times article points out ironically that when control of government is divided between the two parties, they both feel some responsibility for solving problems, while today, with full control seemingly in the hands of the Democrats, the Republicans are free to view their only role as dissenting and obstructing. And as the party in control, the Democrats evidently feel no obligation to yield on their positions.

Frankly, I wouldn't be so unhappy if I were sure today's battles were being fought over principles. What worries me most is the appearance that, instead, they're being fought for personal and political advantage and to win elections.

Today I think few legislators from either party will vote for anything that would let members of the other party claim to have accomplished something. That may be an exaggeration, but I think it's more true than false. And I think that's behind the recent decisions by a number of senior legislators not to run for re-election. I've had the privilege of getting to know Byron

Dorgan, the senator from North Dakota, and I have no trouble believing that was behind his decision. We've spoken about his frustration with the contentious environment in Washington. More recently, Evan Bayh of Indiana also said he wouldn't seek another term in the Senate because it's impossible to get anything done in dysfunctional Washington. Here's how he put it in a February 21 Op-Ed piece in *The Times*:

There are many causes for the dysfunction: strident partisanship, unyielding ideology, a corrosive system of campaign financing, gerrymandering of House districts, endless filibusters, holds on executive appointees in the Senate, dwindling social interaction between senators of opposing parties and a caucus system that promotes party unity at the expense of bipartisan consensus.

Today's positions seem unusually unyielding. The Republicans' conservative base demands adherence to the no-tax pledge, while liberal Democrats demand that their representatives prevent cuts in spending for domestic programs. These hardened (and polar) positions greatly narrow the possible grounds for problem-solving.

When the seller says "I won't accept any price below \$20" and the buyer says "I'll never pay more than \$18," no deal can be struck, whereas in more flexible times they might meet at \$19. Maybe one party or the other (or both) is right and should stand on principle. But when we need them to find common ground on which to solve critical problems, refusal to reach agreement isn't to our advantage.

- Everyone wants to see the deficit narrowed, but today's circumstances seem to prohibit both expenditure reduction and revenue increases. Everything else is on the table (as the kids say, lol).
- We know Social Security has to be fixed in order to prevent its inevitable insolvency, since there are fewer and fewer working people paying into the system per retiree. However, some people find it unacceptable to raise tax rates or the limit on taxed income, and others resist reducing or delaying benefits. Thus no one in Washington seems to prefer tackling the problem over sweeping it under the rug (Congress's version of "extend and pretend").
- On the state and local level, there's massive underfunding of pensions, but few officials consider it possible to either reduce benefits or increase employee/employer contributions. Thus only two possibilities remain: ignore the problem or hide it by increasing the assumed return on assets (from today's already-challenging levels of 8% or more).

In the old days, the Lyndon Johnsons in Congress would sit down for a drink with the other side, swap a "yes" vote on this for something else, and get things done. For any of a million reasons, this seems impossible today. Calmes quotes G. William Hoagland, a former fiscal policy adviser to Senate Republicans, as follows:

I used to think it would take a global fiscal crisis to get both parties to the table, but we just had one. These days I wonder if this country is even governable.

I hasten to state that I don't view this as a question of one side being right and the other wrong. At this moment, with the Democrats in control of the White House and both houses of Congress, the Republican minority seems to be hell-bent on frustrating the Democrats' plans (and capable of doing so). But my criticism isn't reserved for today's minority party. I have absolutely no doubt that unless something changes, the next time the Republicans are in power, the roles will be reversed and the Democrats will be the obstructionists.

You can think the things President Obama wants to do are either right or wrong, but you can't deny the fact that, even with majorities in both houses of Congress, he can't do them. This truly is gridlock.

Some people think gridlock is a good thing. They think either (a) government should do less rather than more or (b) government is incapable of doing anything right (or both). In my opinion, you have to hold attitudes like those in order to be optimistic about the situation in Washington. However, there are some things only government can do. **Even the founding fathers, as leery of government as some were, created one. Many of today's problems are government-created, so government will have to solve them.**

I believe most Americans want to see the problems solved. Of course, they disagree on how best to do so. But our leaders should work together to find solutions and explain to the voters why compromise is necessary. **That's an important part of leadership . . . perhaps more important than simply resisting the other party's suggestions.**

The people in Washington may be of good will; certainly most of those I've met seem to be. They probably believe the positions they hold are the right ones. But they have to let go of their obsessions with re-election, personal preferences and politics as a contact sport. We need them to take up and solve the important problems, and I see no movement in that direction.

In fact, I see additions to the arsenal of delay and frustration. When I was a boy, filibusters – weeks-long orations – were employed on rare occasions to hamper legislative action. Now filibusters can be virtual, meaning no talking is required; you just say, "I filibuster." It takes 60 votes in the Senate to bring something to the floor over an objection. Thus, with filibusters more frequent, 60 votes have replaced 51 as the threshold for forward motion. (Since I'm from California, where it takes two-thirds of the legislature to approve a budget, I can assure you that supermajorities don't result in better decisions, just inaction.)

When I see tactics like this in use – and this brand of partisan warfare, where it's all about winning and losing – I tend to agree with Will Rogers: **"The more you observe politics, the more you've got to admit that each party is worse than the other."**

I don't think any elected official who puts re-election above all else can do the right thing when it comes to hard choices. If the decisions were easy and the remedies palatable to the electorate, they would have been implemented by now. Instead, the answers to today's problems will be painful and displease some voters (if not all). Here's how Wessel puts it:

Imagine this plausible scenario: Public confidence in government continues to decline. Unemployment remains high. Americans demand more government services, more benefits and lower taxes.

Politicians, seeking re-election, go along. Exhibit A: John McCain, the Arizona Republican who called for cutting Medicare as a presidential candidate last year and now, fighting for reelection to the Senate, proposes to erect new parliamentary obstacles to Medicare cuts.

In this scenario, even deficit-fearing politicians avoid taking on the long-term deficit. [Syracuse University's Leonard Burman] imagines a White House political adviser saying: "Mr. President, if you raise taxes or cut popular programs, you or your party will be defeated in the polls and the bad guys will take over. The bad guys do not share your priorities and they do not care about the deficit. Therefore, you cannot effectively deal with the deficit."

Unusually for me, I have a remedy in mind. **Let's tell our elected officials we want solutions, not warfare; compromise, not intransigence. And let's try to elect moderates in both parties, not extremists.** I don't know if it'll work, but I don't see many alternatives.

I'll move toward my conclusion with a quote (per *The Times*) from former Republican Senate leader Alan Simpson, who has been selected to co-chair the commission on the deficit:

There isn't a single sitting member of Congress – not one – that doesn't know exactly where we're headed. And to use the politics of fear and division and hate on each other – **we are at a point right now where it doesn't make a damn whether you're a Democrat or a Republican if you've forgotten you're an American.** (emphasis added)

And where is it that every single member knows we're headed? At a reception I was fortunate to attend earlier this month, Hank Paulson described the situation roughly as follows (I paraphrase):

At the family level, we try very hard to leave the next generation better off than we are. But at the national level, we're living in the present and ignoring massive problems with which the next generation will be saddled.

Wessel ends with a quote from President Ronald Reagan, and I'll go along with him. In 1982, Reagan had to sell a package of spending cuts and tax increases. In other words, there was something for everyone to dislike. But Reagan didn't shrink from such things. Here's what he said:

Do we tell . . . Americans to give up hope, that their ship of state lies dead in the water because those entrusted with manning that ship can't agree on which sail to raise? We're within sight of the safe port of economic recovery. Do we make port or go aground on the shoals of selfishness, partisanship, and just plain bullheadedness?

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