

Memo to: Oaktree Clients

From: Howard Marks

Re: The Aviary

Rather than dwell this time on a single subject, I want to cover a few. They may not seem related at first, but I believe they're birds of a feather.

A Dead Duck

While it's important that we have a sense for where we stand in terms of the market cycle, figuring that out can require some sophisticated inference. It's not often that we get crystal clear evidence of the pendulum's swing, or get it in short order. That's what makes the case I'll describe so distinctive.

"The Race to the Bottom" (February 2007) is one of my favorite memos. I think it presented clear evidence of the degree to which the pendulum of innovation and risk taking had swung to the undisciplined end of its arc. As I described, I was prompted to write it by an article in the Financial Times of November 1, 2006, which reported the following:

Abbey, the UK's second-largest home loans provider, has raised the standard amount it will lend homebuyers to five times either their single or joint salaries, eclipsing the traditional borrowing levels of around three and a half times salary. It followed last week's decision by Bank of Ireland Mortgages and Bristol and West to increase standard salary multiples from four to 4.5 times.

After quoting that paragraph, I went on to draw what I thought was the compelling conclusion:

Any way you slice it, standards for mortgage loans have dropped in recent years, and risk has increased. Logic-based? Perhaps. Cycle-induced (and exacerbated)? I'd say so. The FT quoted John Paul Crutchley, a banking analyst at Merrill Lynch, as saying "When Abbey are lending a multiple of five times salary, that could be perfectly sensible – or it could be tremendously risky." Certainly mortgage lending was made riskier. We'll see in a few years whether that was intelligent risk taking or excessive competitive ardor.

Auctions were taking place in the capital markets, and suppliers of capital were bidding against each other to make deals. In the case of UK home mortgages, the right to make loans would go to the institution willing to lend the highest multiple of annual salary . . . that is, willing to accept the most risk. In the last few years, there were many ways in which lenders and investors vied for deal flow on the basis of lowered return expectations and heightened risk. I considered Abbey's decision emblematic of this trend.

Thus, you can imagine my reaction upon reading the following in the Financial Times of April 8:

First-time buyers with no cash savings were shut out of the housing market yesterday after Abbey became the last mainstream lender to stop offering 100 per cent mortgages. Borrowers who a month ago had a choice of mortgages offering 100 per cent of a property's value, will now need a deposit of at least 5 per cent . . . More than 20 lenders . . . offered 100 per cent mortgages at the start of last month. These have been pulled out of the market one by one as banks and building societies have distanced themselves from riskier lending.

Eighteen months ago, Abbey was the **first** to take lending standards to a new low in terms of times-salary-loaned. Now, it's the **last** to raise them with regard to down payments. Can there be a clearer example of the credit cycle at work?

For now, high-risk, no-worries lending seems to be a dead duck, a casualty of the corrections in risk aversion and demanded returns that have accompanied – or are at the root of – the current credit crunch. At the highs of the credit cycle, anyone can get money for any purpose. At the lows, even deserving borrowers are shut out. The former is highly expansionary, and the latter depresses economic activity. It'll always be so.

The Canard of Free Market Infallibility

“*Canard*” is the French word for “duck.” In English, however, a “canard” is “a false or unfounded report or story.” That English meaning comes from the French phrase “*vendre des canards à moitié*”: to cheat, literally, to half-sell ducks.

A canard gained broad acceptance over the last decade or two, as faith in the ability of the free market to optimally allocate assets morphed into an irrational expectation that the free market would produce a continually rising tide, lifting all boats and bringing a better life for everyone. Here's my version of the saga.

One of the longest cycles I've witnessed has taken place in the area of government involvement in the financial industry. Prior to 1929 (I wasn't around for this part), there was little regulation. When much of the subsequent market collapse was attributed to improper conduct in investment banking and in investments generally, this led to significant new regulation.

For an interesting look at behavior in the 1920s, I'd recommend *Wall Street Under Oath*, written in 1939 by Ferdinand Pecora, who led the Senate investigation into the causes of the Great Crash and then became a New York State judge. It's a scathing indictment: imagine Wall Street operating in the 1920s unhampered by today's securities laws. Among other things, the Street's conduct led to the enactment of the Glass-Steagall Act of 1933 that mandated the divorce of commercial banks from investment banks, the Securities Act of 1933 and the Securities Exchange Act of 1934. Thus a strong regulatory regime prevailed – particularly under the

Democrats who controlled the White House for 28 of the 36 years from 1933 to 1969, and the Senate for 44 of the 48 years from 1933 to 1981. (In America, regulation is generally associated with Democrats and liberalism, and deregulation with Republicans and conservatism.)

The last 28 years have been very different, however, thanks primarily to Ronald Reagan and Margaret Thatcher, bolstered by centrist Clinton and Blair administrations, and helped along by Bush, Bush and Brown. For much of that time, the Fed was under the leadership of Alan Greenspan, who is philosophically indebted to Ayn Rand, a strong believer in free markets.

Free-market solutions were deemed certain to yield optimal economic decisions. Deregulation, privatization and market pricing went into full swing. Government involvement in policy making and control was disrespected. In short, it was assumed that the profit motive – Adam Smith’s “invisible hand” – would maximize capital efficiency and, therefore, societal welfare.

This trend reached its apogee in the last ten years. The Glass-Steagall Act was nullified; this allowed, for example, the combination of Citibank and Salomon Brothers. Other than lowering interest rates and providing liquidity to fend off weakness, the Fed employed a hands-off approach. Investment managers and investment bankers gained fame and huge fees for performance that showed which of them were the most talented. In every corner, the cry was “let the market decide.”

Clearly, however, the events of recent years attest to excesses prompted by the profit motive. More was better: more leverage, more innovation, higher ratings for a given security and more activity in areas like residential real estate. **Equally clearly, not all of the free-market decisions were salutary; the proof can be found in the fact that *laissez-faire* has landed us in a financial crisis that some observers consider the potentially most serious since the Depression.**

How can we reconcile theory and practice: the way free-market decisions are supposed to work and the way they do work? The answer lies, I think, in the difference between short term and long, and in the coexistence of beneficial general trends and harmful exceptions. **Free markets allocate resources efficiently in the long run. But they can’t make the tide rise continually, and while some boats rise, others will crash. Properly functioning free markets will give rise to times that set the stage for ruin, and then to times of ruin itself. They must create losers as well as winners, and capital destruction as well as capital creation.**

In pursuit of profit in a free market, people can engage in any behavior that’s not illegal. (Well, actually, they can do illegal things too, but hopefully not for long.) Ethical considerations constrain some but not all, and ethicality seems to wax and wane. There’s no doubt that profit pursuers sometimes push the envelope. Examples?

- The fees for appraising houses and rating securities went to those willing to assign the highest values. Did they let this affect their valuations?

- Thanks to disintermediation, financial institutions saw that they could earn fees for originating loans and selling them onward. Did the rewards for achieving volume displace the prudence they used to employ when putting their own capital at risk?
- Once financial engineers had built their new tranching products, they could sell them at lower yields (higher prices), sell more of them, and earn bigger fees if they could get them rated higher. For a given instrument, single-A was good, double-A was better and triple-A was best. The investment bankers marshaled the data and fed it into their models, tweaked to yield the best possible result. **I find it hard to believe they ever said, “Wait a minute; triple-A’s too high given the underlying collateral” or “It can’t be triple-A, because there are a few scenarios that, although unlikely, would yield terrible results.”**

I’m not suggesting these people engaged in illegal activity or consciously did the wrong thing. They were just trying to make more money for their employers and themselves. But I believe their economic self-interest caused them to go to extremes in an environment that allowed candor, skepticism and ethics to be forgotten in pursuit of revenue maximization.

A New Canard Takes Flight

Government involvement in the private sector is like hemlines: it goes up and down. But it does so in very long cycles. It takes decades for it to reach maximums and minimums, and it can take a long time for the error of the extremes to be exposed.

In the last couple of months, we’ve read a great deal about the need for increased regulation, and there’ll be more. There are several reasons for this:

- First, when there’s a crisis, people tend to look for easy explanations. Insufficient regulation can be a good candidate.
- Members of the out-of-power political party can always make hay by blaming the governing party and its philosophy.
- **The truth is, whichever philosophy is in the ascendancy will deserve some responsibility for crises . . . because no approach is perfect. Regulation will always produce red tape and some inefficient, non-market solutions, and deregulation will always permit a degree of cowboy behavior.**
- It’s easy to allege that the solution can be found in reversing the trend in regulation, and hard to disprove *a priori*.

So now the cry has been raised. People are jumping on the bandwagon, and those opposed are trying to head it off with promises of better behavior and self-regulation. As the Financial Times noted on April 10,

Now credit and consumer confidence are ebbing, to the likely detriment of company profits. State intervention, which free marketers have argued against for centuries, has been royally legitimized.

Paul Volcker put it this way in the FT of April 12: “The bright new financial system – for all its talented participants, for all its rich rewards – has failed the test of the marketplace.” Belief in free market omniscience has been laid to rest for a while.

The New York Times of April 15 described Bob Steel, Treasury Under Secretary for Domestic Finance, as being highly optimistic about a “superregulator” or “market stability regulator” that “would pass judgment on the capital levels, trading exposure and leverage of Wall Street’s most sophisticated institutions.” Yet within just the last two years, it says, “Mr. Steel has been co-chairman of one commission that claimed heavy-handed regulation was stanching financial innovation and another that argued that hedge funds could police themselves.” Times certainly do change.

And in a sign of the times, *breakingviews.com*, an online interpreter of financial news, put it this way on May 14:

The hands-off approach to financial markets now looks neglectful. . . . Greenspan’s laissez-faire attitude to asset prices went along with paying little attention to bank supervision and positively welcoming the growth of less regulated financial institutions. Trusting financial markets to self-correct now looks wrongheaded. . . . **The authorities need to relearn that financial markets are too important and too impulsive to be left to operate unconstrained.** They work better with careful, consistent supervision. (Emphasis added)

In place of market-based decisions, we’re likely to see more limits on free-market activity. I find it impossible to believe that the government will do a better job than the market of allocating assets and preventing excesses. But the current pain – when combined with regulation’s avowed goals of avoiding harm, limiting predatory conduct and protecting the little guy – will make the trend hard to resist. As Martin Wolf wrote in the FT of April 16,

More regulation is on its way. After frightening politicians and policy makers so badly, even the most optimistic banker must realize this. **The question is whether the additional regulation will do any good.** (Emphasis added)

Some specific actions have the potential to increase financial security, such as (a) increases in the capital reserves required against complex structured products and off-balance-sheet vehicles and (b) full and detailed disclosure of the latter. Some increase in regulation seems appropriate, especially with regard to off-balance-sheet entities, the source of most of the banks’ losses. It’s remarkable that just six years after Enron, where the worst abuses were hidden off balance sheet, another crisis was able to arise there. Banks benefit from deposit insurance (the government’s seal of approval) and access to cheap Fed funds. Thus it’s reasonable that, in exchange, **all of their entities** should be tightly regulated. This is especially true since it’s been made clear that non-bank activities won’t be permitted to sink our large banks.

But I think there are dozens of reasons why generally increased regulation won't work to the hoped-for extent. Here are my first twelve:

1. **It's far easier to find holes in regulations than to plug them.** Financial professionals innovate and expand. Regulators must try to catch up, often with outdated tools. By the time new rules are enacted, the financiers have moved on to invent new products and open new loopholes.
2. It's a simple fact that the regulated are more financially motivated to act than the regulators are to respond. It's not without effect that investment bankers work two or three times as many hours per week as the people who're counted on to police them.
3. The most skillful regulators often move eventually to work in regulated institutions, weakening the effectiveness of the regulatory process and spilling its secrets.
4. **Hedge funds and derivatives are behind many of the excesses, and it will be particularly hard to get them under control.** Today, one huge area of uncertainty is credit default swaps, particularly with regard to capital adequacy and counterparty risk. It's not a coincidence that CDS are derivatives with heavy hedge fund involvement. How might they be regulated?
5. **Derivatives are particularly hard to regulate because it's difficult to quantify the risk they entail.** Let's take the simplest example: you sell someone a "naked call" that gives him the right to buy from you for \$2 apiece 100 shares of a stock you don't own. If the stock goes to \$5, you lose \$300 (the difference between the \$2 you've been paid and the \$5 you now must pay to buy 100 shares to deliver). If it goes to \$10, you're down \$800. At \$100, you're down \$9,800. At \$1,000, you're down \$99,800. At \$10,000, it's \$999,800, and so on. With naked call writing (and its equivalent, naked short selling), the potential loss is theoretically unlimited. So what's the right amount of risk to show on your balance sheet? No one can say. Should it be the "worst case"? And what is that? Or how about a model-derived estimate of the likely outcome? The last few months certainly showed those to be useless.
6. **It's worth noting that banks, probably the most regulated of our financial institutions, are reporting the biggest losses. Regulation can be improved and tightened, but it's hard to believe that it actually can be counted on to prevent crises.** Similarly, the weaknesses in the mortgage loan generation process were huge, but no regulator spoke out against them.
7. It's been proposed that financial institutions should be required to stress-test their ability to cope in difficult times. But how bad an environment should they be able to survive? What is the worst case, and should banks have to prepare for it? **If banks always were required to be able to survive the conditions of February and March, for instance, they might never make a loan.**

8. **Regulatory proposals are also likely to include calls for more and better risk management.** But the risk management profession's exertions in the last ten years probably exceeded the sum of its efforts prior thereto. Those efforts certainly didn't head off the current crisis. In fact, it's highly likely that risk managers' blessings led to a false sense of security in recent years, and thus to more confident (and greater) risk taking.
9. Since many of the biggest recent errors occurred in the area of credit ratings, **it's appropriate to ask whether regulation could make ratings more accurate.** According to an article in the Herald Tribune of April 25,

Senator Chris Dodd . . . practically begged Christopher Cox, the SEC chairman, to ask for new authority. He suggested that perhaps it would be a good idea to leave credit ratings to some kind of non-profit agency that would not have conflicts of interest. Both he and [Senator] Shelby suggested that the SEC should revoke the operating license of a credit rating agency that was wrong too often.

Can you imagine anything along these lines working? **Would you like to see credit ratings being set by an agency lacking economic motivation?** Who would determine whether they'd been "wrong too often"? And would "wrong too often" include ratings that proved to be too low, or just too high? I've seen a lot of both in the last forty years.

10. Likewise, some of this cycle's greatest gaffes came from having people make loans who lacked an ongoing stake in their creditworthiness. So it's been suggested that lenders should be required to have money at risk in loans even after they've been securitized and sold onward. Could regulators possibly prevent a highly motivated lender from getting around this requirement? How, for instance, would they keep an institution from hedging its bets through offsetting positions in derivatives?
11. A number of the proposals I've read relate to financial executives' compensation. Bankers' bonuses should be related to performance that has been adjusted for the risks entailed. And they should be long-term in nature and subject to being clawed back if profits turn into losses later on. **Can government possibly regulate compensation in the private sector? And should it under our system?** I would say "no" to both.
12. **Finally, the main things that gave rise to the pain this time around were imprudence, insufficient skepticism and excessive faith in innovation.** The International Herald Tribune of March 29 said, "Democrats in Congress . . . are pushing for tougher restrictions on risky lending." And I read elsewhere a suggestion that mortgage lenders should have to act responsibly. How can these things be regulated? **How might a regulator require good judgment, and how would it be measured?**

I think Alan Greenspan did an excellent job of summing up the situation in an op-ed piece in the Financial Times of April 7,

Regulators, to be effective, have to be forward-looking to anticipate the next financial malfunction. This has not proved feasible. Regulators confronting real-

time uncertainty have rarely, if ever, been able to achieve the level of future clarity required to act pre-emptively. Most regulatory activity focuses on activities that precipitated previous crises.

Aside from far greater efforts to ferret out fraud (a long-time concern of mine), would a material tightening of regulation improve financial performance? I doubt it. **The problem is not the lack of regulation but unrealistic expectations about what regulators are able to prevent.** How can we otherwise explain how the UK's Financial Services Authority, whose effectiveness is held in such high regard, fumbled Northern Rock? Or in the US, our best examiners have repeatedly failed over the years. These are not aberrations.

The core of the subprime problem lies with the misjudgments of the investment community. . . . Even with full authority to intervene, it is not credible that regulators would have been able to prevent the subprime debacle. (Emphasis added)

Martin Wolf sized the challenge in the FT of April 16:

If regulation is to be effective, it must cover all relevant institutions and the entire balance sheet, in all significant countries; it must focus on capital, liquidity and transparency; and, not least, it must make finance less pro-cyclical.

That's a tall order. The results are unlikely to stack up well against the goals.

No, government intervention doesn't hold the key to a financial system existence free of extremes and crises . . . any more than *laissez-faire* does. But the trend is likely to be in the direction of regulation. The truth is that cycles, with their dangerous excesses, will cease to occur only when human emotion and the pursuit of profit no longer go to extremes. Neither government intervention nor the free market will ever produce that result.

The Black Swan

The best-known bird around today is *The Black Swan*, the second book from Nassim Nicolas Taleb. You may remember Taleb as the author of *Foiled by Randomness*, which I've described as an essential read (see "Returns and How They Get That Way," October 2002, and "Pigweed," December 2006). He's an ex-hedge fund manager and self-styled philosopher whose books are nearly impenetrable (I suspect intentionally). But they also contain some incredibly important ideas.

The main thrust of *Foiled by Randomness* was that while many of the forces that shape investment performance – or history in general – are random in nature, people often ignore that fact and give them meaning that would be warranted only if they weren't random. Thus the top performing investor in a given year may be the manager – in Taleb's terminology, the "lucky

idiot” – who took an extreme and unwise position and was bailed out by a highly improbable event that occurred by chance. For that reason, one year of outstanding performance says absolutely nothing about the likelihood of another.

The Black Swan continues in that vein, emphasizing the dangers of overestimating knowledge and predictive power. The book gets its name – and its theme – from some unusual Australian birds which, never having been seen before foreigners began to visit, were considered in Europe not to exist.

According to Taleb, there are three criteria for a “black swan.” The first two are that it should be “an outlier” and carry “an extreme impact.” **The fact that these “highly consequential events” are infrequently occurring and improbable often is taken to mean they’re nonexistent and impossible. The difference between the two may be small, but it’s highly significant.**

Taleb’s third criterion is that black swan phenomena have “retrospective (though not prospective) predictability.” **And because people are able to “concoct explanations” for them after the fact, they end up believing themselves capable of understanding the causes and predicting future occurrences.** In short, they underestimate the limits on foreknowledge with regard to these events – a regular theme of mine, as you know – and underrate the role of randomness. To simplify their world and render it subject to established statistical analysis, quants attribute standard properties – like the familiar bell-shaped curve – to events that are far less regular than they should be for this approach to be valid.

The publication of *The Black Swan* last year was extremely well timed, because many of the infamous recent events satisfy Taleb’s criteria.

- The greatest errors in mortgage securitization arose because “home prices have never declined nationally” was taken to mean “home prices can’t decline nationally.”
- Innovative financial products were modeled on the basis of common probability distributions that may have been inapplicable to the phenomena being studied. Thus the possibilities were oversimplified by recent business school graduates who’d never been out bird-watching in the real world.
- In the end, events that had been described as highly unlikely happened. But they shouldn’t have come as complete surprises and should have been anticipated. Models had led people to consider things with a 1% chance of loss as riskless. **Once in a while, however, people need a reminder that “unlikely” isn’t synonymous with “impossible.”** Black swans do occur.

Now, with the final bullet point above in mind, let’s talk about the black swan as a practical matter, not a topic for philosophic rumination. It’s easy to say black swans should be prepared for, and that the people who fell into the last few years’ traps ignored obvious risks. My December memo “No Different This Time” included the following among the key lessons of ‘07:

Investment survival has to be achieved in the short run, not on average over the long run. That’s why we must never forget the six-foot-tall man who

drowned crossing the stream that was five feet deep on average. **Investors have to make it through the low points.**

This statement makes obvious sense. Certainly investors must brace for untoward developments. There are lots of forms of financial activity that reasonably can be expected to work on average, but they might give you one bad day on which you melt down because of a precarious structure or excess leverage.

But is it really that simple? It's easy to say you should prepare for bad days. But how bad? What's the worst case, and must you be equipped to meet it every day?

Like everything else in investing, this isn't a matter of black and white. **The amount of risk you'll bear is a function of the extent to which you choose to pursue return. The amount of safety you build into your portfolio should be based on how much potential return you're willing to forgo.** There's no right answer, just trade-offs. That's why I went on from the above as follows:

Because ensuring the ability to [survive] under adverse circumstances is incompatible with maximizing returns in the good times, investors must choose between the two.

One of the most interesting questions I've pondered over the years is this: **How much should we spend – be it in the form of insurance premiums or forgone returns – to protect against the “improbable disaster” (my term for the black swan)?** But that's all it remains: a question. It's for each of us to answer in our own way.

Birds on a Wire

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. I see the events since last summer – and those that will stretch into the coming months and perhaps years – as a chain reaction:

- The **subprime crisis** resulted from trends that had been building during the preceding years: leverage, securitization and tranching, financial engineering, looser ratings, unregulated non-

bank lending, weaker loan standards and rising risk tolerance. The risk embodied in these things came home to roost in residential mortgages first because it's there that they were applied to the greatest extent and to the weakest underlying collateral. Too many triple-A securities were created from each pool of non-investment grade mortgages, and they collapsed as soon as default rates surpassed the models' assumptions.

- The **credit crunch** was an obvious next step. A number of more generalized developments resulted from the mess in residential mortgages:
 - rising risk aversion,
 - higher demanded risk premiums, and thus lower prices for risky assets,
 - the withdrawal of leverage and liquidity,
 - leveraged fund meltdowns and frightening headlines,
 - losses at banks and thus endangerment of their capital adequacy, and
 - hoarding of capital and the unavailability of new loans.
- This resulted in **problems at financial institutions**. Losses on highly leveraged investments were sure to lead to a crisis mentality, which could morph easily into a plain old crisis. What are the characteristics of financial institutions?
 - **high leverage**,
 - **near-total reliance on short-term deposits and borrowings** to fund illiquid, longer-term assets,
 - **risk bearing** – that's what their business consists of, and it's by doing so that they earn lending spreads (if they borrowed safe and lent safe, where would the spread come from?), and
 - **extremely low transparency**.

What greater recipe could there be for a drying up of confidence? If a financial institution loses the confidence of its customers, what's to prevent a run on the bank? Nothing, as the UK found out in September with Northern Rock and the US found out in March with Bear Stearns. And what can inject fear into an economy more than doubt about the safety of its financial institutions?

- The main shoe left to drop concerns **the impact on the broader economy**. Economies run on confidence. People spend on non-necessities because they expect the future to be good and their incomes to grow. Businesses expand plant, workforce and inventory because they expect sales to increase. Financial institutions lend because they expect to be repaid with interest. Investors provide capital because they expect the value of assets to increase. When doubt is shed on these expectations, the growth process stalls. When the economy contracts for two consecutive quarters, a recession is declared, and positive assumptions become further in doubt.

Already, businesses are reporting declining or disappointing earnings (even General Electric). Unemployment is on the rise. Higher prices for oil and food are likely to cut into consumers' ability to spend. And their psyches have been damaged by scary headlines they may or may not

understand. Consumer confidence is at low levels, and fewer Americans expect an improving future. Much of the growth in consumer spending has been abetted by the more widespread availability of credit. Now, less credit should mean less spending. These aren't the conditions for a vibrant economy.

There's a strong consensus that we'll see a recession – and a possibility we're in one already. GDP grew in the first quarter, but final sales were down and output increased only because businesses added to inventories. These additions likely were involuntary, and when stopped or reversed, GDP growth certainly could go negative.

Please note that a depressed economy isn't the end of the line. Slower consumer and industrial activity could feed back to the beginning of the process, causing further house price depreciation, further write-downs, a further credit contraction and so forth. And then, when levels get low enough, something mysteriously will cause the cycle to turn positive.

Things don't happen in isolation in economies and markets. Birds do flock together. The implications of past events will spread further.

Phoenix from the Ashes?

As always, there's a tug-of-war going on between the optimists and the pessimists. This time, however, the stakes are unusually high and the rhetoric proportional to the potentially momentous consequences.

Over the last few weeks, the markets rose based on statements to the effect that the worst had passed: "We're closer to the end than the beginning" (Lloyd Blankfein of Goldman Sachs). "Maybe 75 to 80 percent over. . ." (Jamie Dimon of JPMorgan Chase). The worst is "behind us" (Richard Fuld of Lehman Brothers). The subprime market in the U.S. has reached its eighth inning or maybe the "top of the ninth" (Morgan Stanley's John Mack).

On the other hand, John Thain of Merrill Lynch said, "I hope those who say we are at the end are correct. I am somewhat more skeptical." Dan Fuss of Loomis Sayles, a highly experienced bond manager with an excellent track record, said, "This is the most worrisome financial situation I've seen in my working lifetime" [which approximates fifty years]. And George Soros described this go-round as "much more serious than any other financial crisis since the end of World War II."

People are talking about March 17, the day JPMorgan Chase rescued Bear Stearns, as the bottom. Psychology was terrible in the weeks leading up to that event; things would have melted down much further in the absence of a rescue; and psychology and markets picked up substantially thereafter. **Certainly that day was "a bottom," but I'm not so sure it was "the bottom."**

The Bear Stearns rescue dealt with the credit crunch, investor attitudes and the possibility of a downward spiral among financial institutions. But it didn't mark the end of mortgage

defaults or economic weakness. Mortgages will continue to go unpaid, and the numbers may accelerate if interest rates take adjustable-rate loan payments higher and if house prices continue to fall. Further, nothing that was done in March will preclude economic slowdown, falling corporate profits or defaults on debt. Finally, it doesn't seem to have done much for the availability of credit. Several elements are likely to remain – or become – further depressants:

- **Bank write-downs will continue to be reported.** The majority of the banks' subprime-related losses may have surfaced **as relate to the current level of house price depreciation and mortgage default.** That doesn't mean these trends won't go further, and thus that the reservoir of unreported losses won't be refilled. The IMF has projected total mortgage-related losses of \$1 trillion. Certainly the write-downs announced to date haven't approached that figure. And there's a broad consensus that most holders haven't been as forthcoming on this subject as the U.S. banks.

Progress is being made toward breaking the logjam, but we're not done yet, and there continue to be additions to the backlog. As banks report large write-downs, I can't help but sense that the immediate reaction is, "I wonder how much more remains." Only when people stop thinking that way will real progress have been made toward easing the credit crunch.

- Similarly, sales of "hung" bridge loans are increasing, and clearly some investment banks are willing to take their medicine with regard to the extent to which loans bought in 2006 and 2007 are unsalable at par. Recently we have seen sales at 90, often with financing provided by the sellers. **But just as in the case of mortgage losses, it's quite possible that new obligations to lend will re-burden the financial institutions' balance sheets,** as companies draw against the excess credit lines that were arranged at the time they changed hands in buyouts.
- **The availability of credit is still a question mark,** although things seem to be getting better. Despite the Fed's low rates and all central banks' massive injections of liquidity, inter-bank interest rates still incorporate significant yield spreads and volumes are limited. On April 28, the Financial Times quoted John Maynard Keynes:

Whilst the weakening of credit is sufficient to bring about a collapse, its strengthening, though a necessary condition of recovery, is not a sufficient condition.

In other words, the FT said, "just because the banks are not going bust does not mean that they can lend as before – nor would they if they could."

- Commercial real estate prices, like home prices, are coming off irrational highs achieved because of the oversupply of investment capital in the last few years. **The coincidence of a broad real estate collapse with a significant recession has the potential to make this a painful episode.** But few prominent commercial defaults and failed refinancings have been reported to date.

- **The economic news, while not dire at the moment, isn't rosy.** Consumer spending, inflation, employment and business investment all remain exposed to negative future developments. Default rates among highly levered companies have just begun to rise.
- **Finally, the viability of derivatives such as credit default swaps has yet to be tested.** That means either (a) they're not going to cause trouble, or (b) they're going to cause trouble and have yet to do so. This is another case where potential negatives have yet to be dispelled.

The markets have seen substantial gains since the time of Bear Stearns's rescue. They give me the impression that people who refrained from trying to "catch a falling knife" may have concluded that they waited too long, and thus they rushed to buy out of fear that they'd look bad if they stayed uninvested. The FT of April 28 summed up in a way I thought was very much on target:

The awkward truth is that nobody knows for sure how severe an impact the credit crunch will prove to have on the global economy and on financial markets.

On fundamental grounds a wealth-preserving investor might well feel justified in being cautious until the extent of the downside becomes clearer. **The beauty contest approach** [in which, rather than bet on who's the prettiest contestant, people bet on who most people will judge to be the prettiest contestant], **however, suggests that many professional investors are taking the view that however bad their private fears, the majority of their counterparts are looking through the immediate fallout to a rosier future.**

Just as markets anticipate eight of the next five recessions, so too they can look forward to eight of the next five bull market recoveries. (Emphasis added)

I'm not saying the pessimists are right and the optimists are wrong, or that we truly face an ongoing crisis. Rather, I think the possibility is there and several more shoes remain capable of dropping. Importantly, while mortgage securities and leveraged loans have gone through the wringer and arguably might be cheap, most other assets are as yet unscathed or have rebounded. Stocks, in particular, do not seem to reflect the possibility that this economy's goose is cooked, having declined only slightly from 2007's all-time highs.

* * *

So you want to know, "Is it over?" Here's my bottom line:

- **There's been a significant correction of the excesses of a year ago.** Prices are down and risk premiums are up. Fear and risk aversion have been brought back into the equation; unbridled optimism is no longer the norm.

- **A good part of the losses have been recognized that relate to the fundamental deterioration – and especially the mortgage defaults – to date.**
- **Psychology, which reached “end-of-the-world” levels in the days leading up to the rescue of Bear Stearns, is back from the brink and on the upswing.** Although this could be a worrisome sign of inadequate caution, the risk that psychology will spur a massive downward spiral seems to be off the table for now.
- **However, the foreseeable future is not without significant risks, many of which are real, not psychological** (to the extent the two can be distinguished in economics). There could easily be further house price depreciation, causing more mortgage defaults and requiring additional write-downs. American consumers, buffeted by rising prices for energy and food and concerned about the future, could easily slow their spending and further weaken the economy. And we continue to believe that many high-priced, highly leveraged private equity deals will fail to survive an economic slowdown.

The outlook continues to call for prudence . . . although not as much or as urgently as a year or two ago. Then, people were investing at low returns in the belief that nothing could go wrong. Today, that optimism has been dispelled and prospective returns embody more generous risk premiums.

However, only when a great deal of caution has been built into the markets – and hopefully an excess of caution – is it time to turn highly aggressive. We’re not there yet, but there’s reason to believe we’re moving in that direction.

May 16, 2008

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