

Memo to: Oaktree Clients  
From: Howard Marks  
Re: The New Paradigm

---

When I was a kid, no one ate kiwi fruit or heirloom tomatoes – or had ever heard of them, for that matter. And then, all of a sudden, they were everywhere. The same is true for the word “paradigm”: no one had heard the word, and then one day it was part of everyday speech, especially that of management consultants and other savants.

“Paradigm” seems to invariably be used along with the word “new.” No one ever talks about the old paradigm. Just as there’s newness to the word, there’s usually newness to the subject it describes. And there’s usually a connotation that the new paradigm represents progress.

I believe a new paradigm has taken hold in the investment world, bringing with it vast changes – and not necessarily for the better. The situation today is very different from that of just five or six years ago, and the implications for the future are nothing short of profound. But I haven’t seen this overall subject given much attention.

### The Good Old Days

In the old days – meaning prior to the current millennium – the investment world was different from that of today in a number of important ways:

- **Risk capital was in limited supply.**
- **Risk aversion was reasonably present, such that in order for risky investments to be undertaken, that risk aversion had to be overcome by high promised returns.** The reluctance to make risky investments also meant that they had to be supported by research and analysis performed by skeptical experts.
- **There was a particular aversion to new, unproven and “alternative” forms of investment.** Fiduciary caution was an overarching consideration. With the returns from U.S. equities expected to handily exceed the overall return needs of pension funds and endowments, alternative investments were something of an exotic luxury: tempting but also non-essential and somewhat forbidding.
- Because the amounts of capital pursuing alternative investments were limited, **investors had negotiating power** and were able to insist on, among other things, an incentive system that aligned their interests with those of their money managers, in which fixed fees merely covered managers’ expenses and incentive fees offered managers the hoped-for brass ring.

## The Great New Days

In my view, all of the elements listed above have changed drastically in the last few years. (You've seen some of this from me before, but not all in one place.)

- **The stock market's losses in 2000-02 substantially cooled investors' ardor for equities.** Instead of 9-11%, U.S. stocks now are universally expected to return just 5-7%. **Thus pension funds and endowments that need 8% or more are looking elsewhere for return.** That "elsewhere" means non-traditional market niches such as buyouts, venture capital, hedge funds, real estate and emerging market equities and debt.
- **This stretch for return has overcome innate caution.** Any aversion to the risks entailed in these markets has been wiped away by the combination of (1) the perceived paucity of return in traditional stocks and bonds, (2) the high returns achieved recently in the alternate markets, and (3) the failure of risk to turn into loss in the last few years. Recent successes have erased from the collective consciousness any reluctance to undertake the new, unproven or risky.
- **As a result, large amounts of money are demanding access to the alternative markets.** However, these markets are much smaller than the traditional stock and bond markets that now seem uninteresting. (The Financial Times reported on September 11 that according to JPMorgan, the alternative investment world amounts to \$3 trillion, while the size of the mainstream bond and equity world is estimated at \$60 trillion.) Thus the amounts people are trying to invest can overwhelm these markets. **For this reason, investors may attach more importance to the ability to put large sums to work than to being able to attain historic returns and risk premiums, clear high due diligence hurdles, or structure fee arrangements that channel managers' energies for the benefit of clients.**
- **For now, the high level of liquidity is creating a "virtuous cycle."** The inflows have (1) given rise to asset appreciation, high returns and further demand, and (2) made it easy for weak companies to finance their way out of trouble, thus contributing to the impression that the level of risk is low.
- **The business model for managers in these areas has been completely altered by these developments.** Because the amounts under management are so large (and the ability to charge high management fees is so great), managers can get rich off management fees and deal fees alone. **For managers, then, high returns may be a nice-to-have, not a need-to-have, and avoiding endangering the fee machine can become a greater preoccupation.**

It is my view that, in combination, these developments have had a number of undesirable effects on the investment environment such that:

- Willingness to bear risk is up.
- Insistence on high risk premiums is down.
- Skepticism is down, and there's widespread willingness to suspend disbelief.
- Demand for t-crossing and i-dotting is in retreat.
- Quantity can replace quality as the *sine qua non* for portfolio construction.

I'll provide a few examples below to illustrate what I think is going on in the alternative markets.

### Buyouts: Where's the Magic?

A startling revolution has taken place among buyout funds in the last year or so. Let's take a look at how we got here.

So many of the big-name, highly leveraged buyouts of the late 1980s went bankrupt in 1990 – Macy's, Federated, National Gypsum, etc., etc. – that the industry had to recreate itself, dropping the discredited word “leveraged” and the previously ubiquitous acronym LBO. Instead, the industry began to call what it does “buyouts” or “private equity.” It switched its model from loading massive leverage on venerable, multi-billion dollar companies to the mantras of “platform and buildup” and “consolidate the industry.”

In the 1990s, the low levels of leverage permitted by chastened lenders kept the buyout boys from closing any landmark acquisitions, but also from loading on enough debt to render their companies vulnerable to distress. In order to lose huge amounts of capital, buyout funds had to venture into the tech and telecom arenas, and relatively few rose to the occasion. Thus buyout funds got through the 2002 debt debacle largely unscathed. The buyouts of the 1990s did not give rise to a high level of bankruptcies, but neither were the returns spectacular, even with leveraged equity in a rising stock market.

The pioneers of the buyout business – like KKR, Warburg Pincus and Apax Partners – enjoyed the spectacular success that can come with early entry and good execution. But as a result of the trends since the mid-1980s, results for most buyout funds have been anything but spectacular. As I mentioned in “Dare to be Great,” from 1980 to 1997 the typical fund performed just in line with the unleveraged S&P 500. So what's happened since then?

- The stock market declined for three consecutive years for the first time since the 1930s.
- Buyout funds did okay.
- Expectations for returns from stocks have been almost halved.
- Financial engineering (in an extremely benign capital market) has enabled buyout funds formed in the last few years to report sky-high internal rates of return on their early winners.

As a result of the above, the demand for funds in the buyout field – and especially “big buyout” – is absolutely booming. I believe that in 2000, KKR couldn't get \$10 billion for its Millennium Fund and closed at \$6+ billion instead. Their current fund is at \$15 billion, and that on top of \$5 billion they raised through a public offering in Amsterdam earlier this year. Several funds have

been raised with capital in eleven figures, and \$15 billion has become the new \$5 billion. \$6 billion is considered a mid-sized fund, and \$2-3 billion feels like small-fry.

What's behind the boom? As elsewhere in the investment business, the buyout managers talk a great game, and the best have produced excellent results over the years – although perhaps not always as good as they intimate. In 1999, I explained distressed debt investing to a state pension fund and said I thought we could make 20% before fees. “Buyout fund x was just in here,” they said, “and they think they can make 30%.” I'm confident that most 1999 vintage buyout funds didn't make 30%.

But in the last couple of years, cheap money made available by avid lenders – willing even to lend money that would be paid out immediately to stockholders, increasing indebtedness but not adding to assets, revenues or profits – has enabled buyout funds to shrink their equity investments and supercharge their IRRs. Not always larger dollar profits or higher ratios of terminal value to committed capital, but higher reported rates of return – probably in many cases on small amounts of equity for brief periods of time (See “You Can't Eat IRR”). But people are turned on by high percentage returns, and the dollars have followed.

I believe the largest pools of investment capital have given up on getting the returns they need from now-debased equities and have turned to buyouts and the like for help. I imagine a thought process that goes like this: “Historically, good buyout funds have had returns in the high teens net of fees. Even though the environment isn't what it used to be, it should be a lay-up for them to reach the low teens. I'd even be happy with 10%; it would certainly help me with my 8% required return. And I can put a billion to work in one phone call.”

Well, I'm not sure many buyout firms have produced historic average returns in the high teens. (According to Bloomberg, “U.S. buyout funds produced returns of 13.3% during the past two decades.”) And even if the best did, that doesn't mean earning even low teens will be easy in the environment ahead. Finally, I'm not convinced that returns in the low teens are enough to make it worth bearing the risk that comes with leverage, illiquidity and competition for deals. But the money flowing into buyout funds makes it clear that I'm in the minority.

### The Outlook for Buyout Returns

Investors – in any field – can make money in four broad ways: buy cheap, add value, apply financial engineering and sell dear. Let's examine each one as it applies to buyouts.

Buying cheap – The golden age of buyouts lasted from approximately the mid-1970s to the mid-1980s. What was the environment like as that period began?

- The stock market was in a terrible slump, with Business Week heralding “The Death of Equities.”
- Companies could be bought cheaper through the stock market than they could be built for.
- Historically, before the age of leverage, one company could buy another only if the would-be acquirer was larger than the target. Thus the competition to acquire was limited.

- As the LBO era dawned, only a few organizations had the inclination and know-how required to buy companies bigger than themselves.
- Buyout funds were tiny, and their *modus operandi* consisted of paying bargain prices for small, little-known companies or orphaned divisions of larger companies with stable cash flows.

Today's environment bears little resemblance to that one. As I mentioned in a memo earlier this year, I'd heard a buyout mogul say, "It's our job to buy good companies at fair prices and make them better." I doubt he was content with fair-priced purchases thirty years ago.

- Listed companies are cheaper today than they were in 1999, but not nearly as cheap as in 1976. The P/E ratio on the S&P 500 is 17.5 today versus 10.3 at the inception of the LBO movement three decades ago.
- To deploy unspent capital that in August was estimated by The Financial Times at \$297 billion, buyout funds will have to acquire companies worth roughly \$1.5 trillion in the years ahead. That's a few percent of all of the world's stock markets.
- The buyout funds are competing with each other to spend their capital, and they also have to compete against strategic corporate buyers that have enjoyed strong profitability and are cash-rich. (Nevertheless, buyout funds often outbid strategic buyers, who in theory should be able to pay more because they can combine the acquiree's operations with their own and garner efficiencies.)
- In some cases, activist shareholders and cash-swollen hedge funds are pushing managements (and boards under increased scrutiny) to demand higher prices before turning over their companies to buyout funds, and escalating purchase prices are frequently the result.

Under this combination of circumstances, are there still bargains to be found? Here's the big question that's nagging at me: **Everyone is convinced that investing in listed U.S. equities at today's prices will produce gross returns of 5-7% in the years ahead. If that's true, then how can buyout funds go into that same market, pay substantial control premiums over their target companies' stock prices, and generate double-digit annual returns after deducting 2-4% per year in management fees, deal fees and incentive fees? Will there be enough "value added" and financial engineering to bridge that gap?**

Adding value – The buyout funds claim that they'll be able to create gains by making companies better. But many companies have been working hard for years to improve their efficiency and profitability. There's always room for improvement, but it's a lot harder to make money this way than by buying something cheap and selling it at a fair price. **As in everything else, the best managers will add substantial value, but if it was easy enough for everyone to do it, it probably would have been done already.**

Financial engineering – Between the two, I'd rather bet on fundamental improvement than smoke and mirrors. Withdrawing equity in order to leverage up the IRR doesn't add any value. It couldn't be done in the stingier debt market of five years ago, and it may not be doable five years from now if a business slowdown shows lenders its folly. Rising interest rates would be a negative, and factoring in a more restrictive capital market would ring the bell on radical financial engineering for a while.

Selling dear – Of course, you can always hope to sell at valuation multiples higher than you paid, but it's not reasonable to count on being able to do so all the time. Purchase multiples below the historic norms could buttress such an expectation, but we're not there now. Today's valuation multiples are being supported by low interest rates (prices of financial instruments rise as demanded yields decline, and vice versa), and higher interest rates would be expected to reduce sale prices for companies. And as the subject companies get bigger and bigger, the number of possible buyers shrinks. For the \$30 billion companies that are being talked about today, the stock market may be the only exit, and that's something that can't be counted on year-in and year-out.

So in contrast to the description of the golden days of buyouts on the previous page, today we have:

- A buyout phenomenon that everyone's aware of and eager to play.
- A stock market that can't be described as cheap.
- Heavy competition to buy target companies.
- Dependence on financial engineering based on low interest rates and generous capital markets that may not stay that way forever.

We also see companies being sold from one buyout fund to another. What does that imply? In most transactions, one party's right and the other's wrong. Generally, the buyer can't be getting a bargain unless the seller is accepting less than he should. And shouldn't the seller know the company best (and be expected to have made the available improvements)? So are the selling buyout funds being generous? Are buyers overpaying? Or are the transactions motivated by a desire to lock in incentive fees and generate further deal fees? If there is a free lunch, where's it coming from? I'll leave those questions to you.

Buyout prices have been rising as a multiple of company earnings, and companies are being bought with greater proportions of debt in an attempt to squeeze out higher returns on the buyout firms' equity. As companies become more highly geared, the outcomes become more dependent on a favorable environment. As they say in Las Vegas, "The more you bet, the more you win when you win." **But, simply put, when you increase leverage, the probability of getting into a jam increases and the consequences of that jam worsen.** Certainly this is not a cautious, capital-starved environment for buyouts in which people have girded for tough times.

I have to admit it: if I could push the fast-forward button and see how a movie ends, it would be this one. Like most "silver bullets," I think buyouts will fail to live up to the highest expectations of those who're making it the darling of the investment world today.

I find the outlook for funds in the "big buyout" category particularly intriguing. Certainly the managers spin a convincing tale: Because there are so few buyers capable of tackling the biggest transactions, the competition to buy will be limited and transaction prices will be kept low. The few big funds will tend to join forces in "club deals," further precluding bidding wars. And, based on the supposed correlation between corporate bigness and inefficiency, it's claimed that vast gains will be wrought from streamlining the acquired companies. We'll see.

## How About Real Estate?

The other day, I was privileged to hike with a friend who I consider one of the very best value-added real estate investors, Dean Adler of Lubert-Adler. I thought I was listening to a tape of my worrisome self. Dean told a tale that I found scary – even though I don't stand to lose a penny if his warnings hold true. Here's what he says is going on in the real estate arena:

As in other parts of the world of investment and finance, the ability to borrow is what's keeping the wheels turning. And the ability to borrow for real estate investments is under the control of a group of people called appraisers.

Dean's firm spends months performing in-depth analysis on the properties it owns and wants to finance, and on those it wishes to buy. Then it takes the data to lenders . . . who don't care. All that matters, they say, is what the appraiser thinks. If the appraiser says your property is worth 100, you can borrow 80. But if he says it's worth 50, you can only borrow 40.

Interestingly, the data generated by Lubert-Adler through months of analysis is dismissed by the lender, but the opinion of the appraiser – who spends perhaps a week or two looking at the property – is accepted unquestioningly. But – I have to say it – if the appraiser was as good as Dean at putting values on property, wouldn't he be a leading real estate investor rather than an appraiser?

The real estate story has other negative aspects. The first is that whereas I posit being able to borrow 80% of appraised value, it has become possible to borrow more than 100%, as lenders will finance not just the purchase price, but development and other expenses as well. In "Field of Dreams," they said "If you build it, they will come." In real estate, it's more like, "If you'll lend them money, they will buy or build." Just imagine what goes through the heads of real estate dreamers when the capital markets allow them to take risks with other people's money.

Lastly, Dean pointed to construction loans. These short-term (and, in today's market, low-rate) loans bear the substantial risks associated with delays, cost overruns and the like. And yet they are being made by hedge funds that lack real estate expertise, experience and infrastructure.

**If having a sense for the behavior going on around us can be highly instructive, as I feel it can, then these observations from the real estate industry should be cautionary. As I often quote Warren Buffett as saying, "The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs." Dean Adler's description of the state of affairs in real estate doesn't suggest there's a lot of prudence out there, meaning it's time for us to apply our own.**

## Give Me Structure

Ten years ago, we would raise \$100 from a client and use it to buy \$100 worth of high yield bonds. We still do it that way, but in many quarters, that \$100 is used as the equity for a structured investment vehicle, such as a CDO, CBO or CLO, in which it supports the purchase of \$1,000 worth of (management fee-generating) bonds.

Collateralized Debt Obligations, Bond Obligations and Loan Obligations are entities that collect capital from investors and lenders with which to construct portfolios of the relevant instruments. The capital structure of the entity is tiered, so that the providers of capital have varying priorities in terms of being repaid and participating in losses.

The senior-most lender enjoys security from the entire portfolio, and because his loan is thus heavily over-secured and highly rated, he demands only a low rate of return. The second-most-senior loan is a bit less well secured and less highly rated, and thus the rate demanded on his debt is a bit higher, and so forth. Because the interest rates promised to the senior lenders are below the average coupon on the portfolio, there should be a lot of cash left over for the junior lenders and the equity investors – if things go well. But the equity is also in the first-loss position, so it's truly a make-it-or-break-it proposition.

Vast sums have been raised for this “silver-bullet” solution to the problems of allocating risk, leveraging returns and putting money to work. Clearly, the key to seeing all this work out lies in enough credit expertise being present for risks to be controlled and defaults minimized. But today the necessary ingredient for the establishment of these structured vehicles isn't credit expertise, but the ability to structure the entity so as to win high-enough ratings on the senior tranches to attract capital and permit a lot of leverage. This distinction is highly significant. In a clear analogue to real estate appraisers, the people controlling the all-important credit spigot are the financial structurers assembling the entities and the CDO analysts at the credit rating agencies.

In a June 2 article entitled “Structured Complacency,” the often-brilliant “Grant's Interest Rate Observer” went into great (and, as usual, critical) detail on this phenomenon. As to the popularity of structured vehicles, it wrote, **“Credit markets are sanguine. Structured credit is proliferating. Could the first fact be related to the second?”** And as a key part of this trend, it says, **“Financial engineering is displacing credit analysis.”** What's the difference? **“Financial engineering is the science of structuring cash flows; credit analysis is the art of getting paid.”**

Why the declining interest in credit analysis? Grant's advances the thesis that it is linked to disintermediation, in which many lenders no longer hold on to the loans they make, but more often syndicate or sell them onward to other providers of capital. Holding the keys in this process are the risk manager who structures the entity based on statistical likelihoods and the rating agency that applies the stamp of approval for buyers lacking direct knowledge of the underlying instruments and the ability to understand the structure. Grant's quotes the IMF's 2006 Global Financial Stability Report:

Not surprisingly, the development of structured credit markets has coincided with the increasing involvement of people with advanced financial engineering skills required to measure and manage these often complex risks. In fact, for many market participants, the application of such skills may have become more important than fundamental credit analysis. . . .



Discussions with market participants raised questions as to whether the increased focus on structuring skills, relative to “credit” analysis, may itself present a concern.

The structurers are “risk managers.” They assemble mathematical models that extrapolate historic default rates and recovery rates (which may or may not have relevance in today’s environment). They look at probabilities, expected values and correlations. But they count heavily on the statistical properties of the universe as it has been and may know rather little about the actual assets contained in the portfolios. **Of course, this sort of reliance on statistically derived expectations was behind the undoing of Long Term Capital Management in 1998 – of which so little seems to be remembered.**

Grant’s describes an interview with a junior analyst at a rating agency whose job it is to monitor the health of a large number of CDOs each day, plugging numbers into an Excel spreadsheet. According to Grant’s, “he doubts that many people really understand what these structures own, how their assets are correlated, or what might happen to them in the liquidation portion of a credit cycle.” To wrap up, Grant’s quotes Michael Lewitt of Harch Capital Manager, a manager of bank loans:

. . . having a credit market priced on a non-credit basis – meaning priced off quantitative and arbitrage bases, and not on credit fundamentals – is not a healthy thing.

Interestingly in this connection, Wachovia Structured Products reports that as of April, of the 47 Collateralized Loan Obligations that had gone full cycle, 30 generated positive returns for their equity. Put the other way around 17, or 36%, had lost money. I doubt that was the expectation on which they were sold. And that in relatively good times.

**My favorite investment adage warns about the things “the fool does in the end.” Clearly, turning over the administration of credit to appraisers, raters and structurers who know relatively little about the underlying assets they’re dealing with – and who are hired hands without their own capital at risk – signals a dangerous late stage of the inevitable cycle.**

### It’s Time to Hedge

**Given the laxness, euphoria and credulousness that I detect in the market for money today, it’s time for caution. Where better to find it than in funds that hedge?**

**Well, of course, today the term “hedge fund” has nothing to do with hedging and everything to do with incentive fees. In no way does that label connote risk control.** And whereas the shortcomings of the structured entities described above go along with the activities fitting their charter, most hedge funds have unlimited charters and can roam free in search of return. Here are a few recent trends:

- Hedge funds are making “second lien loans” in large numbers. In some cases, however, there are no assets left (after the claims of first lien loans) to have a lien against. They may

or may not be made by people who have previously been lenders. Those people may or may not possess workout experience. And it's an open question how hedge funds holding large portfolios of small loans will behave when companies get into financial hot water. Lately I've heard mention that hedge funds might be making these loans to gain control of companies that default. But it isn't clear to me how appreciation will routinely be wrung from loans that are made at par and subsequently become non-performing.

- Since I moved to Los Angeles in 1980, my friends in "The Industry" have been unanimous in one piece of advice: never invest in movies. Yet The Wall Street Journal of April 29 carried a story headlined, "Defying the Odds, Hedge Funds Bet Billions on Movies."

For decades, movie studios have gladly accepted millions of dollars from a group of investors collectively dismissed as "dumb money": deep-pocketed dentists, oil tycoons and other wealthy individuals eager for a piece of the glamorous but high-risk game of film production. But the biggest influx of money in Hollywood these days is coming from sharks, not suckers: hedge funds, private equity funds and investment banks.

Take the example of "Poseidon," which was co-financed by hedge fund-backed Virtual Studios. It has brought in gross revenues of \$180 million worldwide since May against its production budget of \$160 million, meaning that after the deduction of at least half the revenues for distribution charges, advertising costs and exhibitors' fees, it's still a big loser.

- If there's one thing I've never claimed to understand, it's how you put a price on a highly improbable disaster. Thus I have a lot of respect for anyone who can do a consistently superior job of underwriting catastrophe insurance against earthquakes, hurricanes and terrorist events. Is the right premium for insuring a Caribbean hotel against hurricanes \$1 million or \$5 million, given that the loss may be zero or \$100 million? The difficulty of setting these premiums isn't keeping hedge funds from filling the gap in the "cat insurance" market.
- Along similar lines as catastrophe insurance, hedge funds are among the leading writers of Credit Default Swaps, the equivalent of issuing insurance against bond defaults. Hedge funds find it attractive to write this coverage for multi-year periods, perhaps in part because the premiums are taken into earnings each year, adding to returns and giving rise to incentive fees, while the defaults are likely to come later. **As in any form of risk transfer, the ultimate profitability of this proposition will depend on how well the insurers know the risks and on what they're able to charge in terms of premiums.** When lots of hedge funds are eager to sell CDS, however, premiums are driven down, and they can easily prove inadequate when defaults occur down the road.
- In recent months we've seen hedge funds take major losses (sometimes prompting them to close their doors) in natural gas trading and unhedged emerging market equities. I've read of hedge funds that trade in carbon dioxide emissions and one backing a fledgling fashion designer. And hedge funds are making the construction loans that Dean Adler discussed.

**None of these activities is imprudent in and of itself. But they all involve substantial risk and should be undertaken only by people possessing the essential edge: sufficient expertise in the relevant field to be able to know when the opportunities are truly attractive.**

### Why This Appetite for Risk?

In my memo on hedge funds of two years ago, I cited an insightful piece from Byron Wien of Morgan Stanley called “In Praise of Hedge Fund Volatility.” In it, he observed that many hedge funds have become asset gatherers for whom the retention of assets and the receipt of management fees have become more important than the achievement of high returns and the earning of incentive fees. Thus low volatility has supplanted high return in the pantheon of virtues.

In my view, this trend has reached beyond hedge funds to additional corners of the alternative investing world. The concept of management fees sufficient to “pay the light bill” seems obsolete. For example, even at just 1¼% per annum, a \$15 billion buyout fund can generate more than \$1 billion of management fees over its lifetime. Add to that the “deal fees” and “monitoring fees” commonly charged and it’s easy to picture managers becoming wealthy irrespective of performance. Indeed, the ancillary fees can be so massive that even where some or all of them must be applied to offset management fees, managers can receive total fees that far exceed the stated management fee percentage.

Of course, if a fund can generate \$1 billion or more in fees, you as its manager would love to perpetuate that flow. While you don’t need high returns in order to get rich, it would be nice to be able to repeat this process, so returns should be good enough to permit further funds to be raised. **But the notion of managers who are entirely dependent on high returns for the achievement of their financial dreams may to some extent have become a thing of the past.**

**So what’s the new paradigm?**

- **First, raise a lot of money.**
- **Second, try for a rate of return that clients will find acceptable.**
- **Third, don’t take enough risk to possibly preclude an encore.**
- **Fourth, invest as fast as is prudently possible, so that another fund can be raised while the market remains accommodating.**

**I believe this last point may be part of the reason for managers’ ever-growing willingness to invest in large transactions and afield from the tried-and-true.** In view of today’s incentive structure for managers, speed and size can count for more than investment excellence. Some managers will sell out knowingly, even proactively. Others may be influenced more insidiously. And some will be egged on by clients emphasizing their desire to invest large amounts of money with low volatility and downplaying the need for high returns. Managers who do not want to be so affected (and their clients) must strongly resist this trend. Recognizing it is the first step in doing so.

\* \* \*

It doesn't give me pleasure to talk about an environment in which risk aversion is in short supply, risk premiums are skimpy and danger lurks. Or in which there's a new paradigm capable of contributing to a misalignment of interests between investors and their managers.

But it is what it is. Take a look at the lists of elements on pages 2, 3 (top), 6 and 11 and tell me which ones you think aren't described accurately. **If you agree that the investment world of today is captured in those lists, then the prescription is unambiguous: it's time for caution and risk control.**

**The workings of free capital markets require that in order to overcome investors' innate aversion to risk, seemingly riskier investments must offer the possibility of higher returns providing "risk premiums." But when risk aversion is at cyclical lows, risk premiums needn't be generous; people will invest anyway.** Too many people trying to dine at the buffet simultaneously can lead to a disorderly process and skimpy portions. I recommend that you look twice at the cost of admission and – if you do decide to partake – proceed carefully.

For the last few years, my mantra has been "special niches, special people." By the "special people" part I mean it's important to find managers who possess the skills required to safely pursue return in high-priced markets. It's at least as important in the current environment, however, that they also can be counted on to resist the conditions described above in the interest of serving their clients.

October 19, 2006

© Oaktree Capital Management, LP  
All Rights Reserved

## ***Legal Information and Disclosures***

---

*This memorandum expresses the views of the author as of the date indicated and such views are subject to change without notice. Oaktree has no duty or obligation to update the information contained herein. Further, Oaktree makes no representation, and it should not be assumed, that past investment performance is an indication of future results. Moreover, wherever there is the potential for profit there is also the possibility of loss.*

*This memorandum is being made available for educational purposes only and should not be used for any other purpose. The information contained herein does not constitute and should not be construed as an offering of advisory services or an offer to sell or solicitation to buy any securities or related financial instruments in any jurisdiction. Certain information contained herein concerning economic trends and performance is based on or derived from information provided by independent third-party sources. Oaktree Capital Management, L.P. (“Oaktree”) believes that the sources from which such information has been obtained are reliable; however, it cannot guarantee the accuracy of such information and has not independently verified the accuracy or completeness of such information or the assumptions on which such information is based.*

*This memorandum, including the information contained herein, may not be copied, reproduced, republished, or posted in whole or in part, in any form without the prior written consent of Oaktree.*

© Oaktree Capital Management, L.P.  
All Rights Reserved