Memo to: Oaktree Clients

From: Howard Marks

Re: Calibrating

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I set a personal record by writing four memos in the month of March, responding to the rapidly unfolding coronavirus crisis. The task was made easier by the dearth of available data, meaning I was able to proceed without doing much research, mostly providing personal views.

In the first of the four memos, *Nobody Knows II*, I described the distinction made by Harvard epidemiologist Marc Lipsitch. He said there are (a) facts, (b) informed extrapolations from analogies to other viruses and (c) opinion or speculation. At that point, I thought the scientists were trying to make informed inferences, and there wasn't enough data regarding the novel coronavirus to enable them to turn those inferences into facts. I also noted that anything a non-scientist said was highly likely to be a guess. In that vein, I wrote the following to an Oaktree colleague last week: **"These days everyone has the same data regarding the present and the same ignorance regarding the future."** That pretty much sums up the state of affairs.

Most of what we have today is opinion, and much of it tilts either optimistic or pessimistic. The gulf in between is massive: if you read just the optimistic pieces, you'd think the virus will soon be eradicated and the economy brought back to health, and if you read just the negative ones, you'd think we're all done for.

In my opinion, the difference between most people's positive and negative views is likely to stem largely from their innate biases, and thus the data points they choose to overweight. Future scenarios comprise a large number of variables: today even more than usual. It's relatively easy to build a spreadsheet listing the many things that will contribute to the future and rate them as likely to turn out well or poorly. **But merely toting up the plusses and minuses won't tell you whether the future will be favorable or unfavorable. The essential element is figuring out which ones will be most influential. That's often where optimistic or pessimistic biases come in.** The optimist takes cheer from the favorable outlook for the positive data points, and the pessimist is depressed by the unpleasant possibilities for the negative ones . . . even if they're both working from the same underlying spreadsheet in terms of elements and ratings.

There's rarely such a thing as "knowing the future." But usually the future will be mostly like the past. This time, I think we can agree that the near-term future isn't likely to look much like it did a year ago. As I wrote last week in *Which Way Now?*, **we have to consider our situation "in the context of unprecedented uncertainty and the total absence of guidance from analogies to the past."**

Whereas the future is always uncertain, today the uncertainty is much greater than usual: the probability distribution governing future events is much wider and the tails much fatter. In fact, there are potential negatives (and perhaps positives) that few living people have faced before. Most of what we have is subjective opinion and interpretation.

I don’t think I’m likely to have superior knowledge regarding the outlook for the virus, its impact on the economy, the success of Fed/government actions or the direction of oil prices. I organized and discussed the possibilities for each of these things in the March memos, but I’m unlikely to be a better predictor than anyone else.

**I do, however, hope to help by discussing how you might think about your behavior in the current context.** That’s my subject today. But before I end with the conclusion I’ve reached, I want to summarize the relevant statements from the March memos. (As you’ll see, I wrote two memos in mid-March that only went to Oaktree clients, although one was made available on our website a few days later.) Here we go (emphasis in the originals):

### ***Nobody Knows II*** **– March 3**

We were still early in the crisis at this time, with just a handful of cases of the disease reported in North America. We were also early in the process of economic decline and market reaction. In fact, the S&P 500 was only down 13% from its level on February 19. In this first memo of the crisis, I struck a number of themes I would return to in the following weeks:

> These days, people have been asking me whether this is *the time* to buy. My answer is more nuanced: it’s probably *a time* to buy. There can be no unique time to buy that we can identify. The only thing we can be sure of today is that stock prices, for example, are a lot lower in the absolute than they were two weeks ago.
>
> Buy, sell or hold? I think it’s okay to do some buying, because things are cheaper. But there’s no logical argument for spending all your cash, given that we have no idea how negative future events will be. What I would do is figure out how much you’ll want to have invested by the time the bottom is reached – whenever that is – and spend part of it today. **Stocks may turn around and head north, and you’ll be glad you bought some. Or they may continue down, in which case you’ll have money left (and hopefully the nerve) to buy more. That’s life for people who accept that they don’t know what the future holds.**
>
> But no one can tell you this is *the* time to buy. Nobody knows.

### ***An Update*** **– March 12 (to Oaktree clients only)**

A week and a half later, after we cancelled the Oaktree client conference and livestreamed instead, after Nancy and I had begun the social distancing that is still going on full-bore, and with the S&P 500 down 29%, I emphasized a contrarian theme, concluding that the damage done had created pronounced opportunities.

> As always, it’s important to be conscious of the investment environment and behave like a contrarian. For years, investors thought conditions were good, and we at Oaktree believed that consequently, prices were high and markets were characterized by risky behavior. That’s what made us cautious. Now the “flawless decade” is certainly over, and asset prices have been cut. The great contrarian, Warren Buffett is

famous for saying he likes hamburgers, and when hamburgers go on sale, he eats more hamburgers.

My roughly quarterly memos pale when compared to the output of Doug Kass, who writes at least daily. His March 11 note had a terrific title: "When the Time Comes to Buy, You Won't Want To." The best time to buy generally comes when nobody else will; other people's unwillingness to buy tends to make securities cheap. But the factors that render others averse to buying will affect you, too. The contrarian may push through those feelings and buy anyway, even though it's not easy. **As I put it, "All great investments begin in discomfort." One thing we know is that there's great discomfort today.**

**[*Latest Update*]() – to clients March 19, on website March 24**

This memo was issued with the S&P 500 down 29% and within a few days of the low (down 34%) that would be reached on March 23. The panic we were observing, and the great purchases we made that week, convinced me to take a firmer tone in arguing for buying. I took the position that it would be a mistake to wait for an ascertainable bottom before doing so.

What do we know? Not much other than the fact that asset prices are well down, asset holders' ability to hold coolly is evaporating, and motivated selling is picking up. I'll sum up my views simply – since there's nothing sophisticated to say:

- "The bottom" is the day before the recovery begins. Thus it's absolutely impossible to know when the bottom has been reached . . . ever. Oaktree explicitly rejects the notion of waiting for the bottom; we buy when we can access value cheap.
- Even though there's no way to say the bottom is at hand, the conditions that make bargains available certainly are materializing.
- Given the price drops and selling we've seen so far, I believe this is a good time to invest, although of course it may prove not to have been the best time.
- No one can argue that you should spend all your money today . . . but equally, no one can argue that you shouldn't spend any.
- The more you want to garner potential gains and don't mind mark-to-market losses, the more you should invest here. On the other hand, the more you care about protecting against interim markdowns and are able to live with missing opportunities for profit, the less you should invest.

But is there really an argument for not investing at all? In my opinion, the fact that we're not necessarily at "the bottom" isn't such an argument.

**[*Which Way Now?*]() – March 31**

Word of the Fed/Treasury response to the economic difficulty emerged on March 24 and was immediately accepted as likely to succeed. By the time the program was enacted, the stock market had experienced a rally on March 24-26 that delivered the best three-day gain since the 1930s, leaving the S&P 500 down just 24%.

> . . . the market prices of assets have responded to the events and outlook (in a very micro sense, I feel last week's bounce reflected too much optimism, but that's me). I would say assets were priced fairly on Friday [March 27] for the optimistic case but didn't give enough scope for the possibility of worsening news. Thus my reaction to all the above is to expect asset prices to decline. **You may or may not feel there's still time to increase defensiveness ahead of potentially negative developments. But the most important thing is to be ready to respond to and take advantage of declines.**

My message wasn't uniform across the four memos, but there were some common threads.

- My observations waxed and waned, in particular as security prices did.
- I never urged selling, as I thought a fair bit of the damage had been done. In other words, it was probably too late to make portfolios less risky.
- I talked about the reasonableness of buying – to varying degrees – primarily in response to the extent securities had cheapened.
- I never said it was *the* time to buy (or that it wasn't). I urged an incremental approach, not all-in or all-out.
- **The most consistent observation was probably that not buying anything at the new low prices would be a mistake.**

The vagueness and variation of the message summarized above make it less than concrete and perhaps less than satisfying for someone who's looking for unequivocal advice. **In my opinion, however, there's simply no room for certainty in investing, and today more so than usual.**



Portfolio Positioning

One of the benefits I derive from writing my memos is that the more I work on a memo about something, the more it comes into focus. Thus the four March memos gave me a great opportunity to ponder what the events imply for investment behavior. I'm glad to say I've reached a conclusion on that subject. I feel strongly that it's right . . . and I fully expect to amend it in the future. (To set the scene, the next few paragraphs will be repeat things I've said in the past.)

In recent years I've become more and more convinced that the fund manager's most important job for the intermediate term isn't to decide the allocation of capital between stocks versus bonds; U.S. versus foreign; developed markets versus emerging; large-cap versus small-cap; high-quality versus low-quality; or growth versus value. And it isn't choosing among strategies, funds and managers. **The most important job is to strike the appropriate balance between offense and defense.** Those other things won't help much if you get offense/defense wrong. And if you get offense/ defense right, those other things will take care of themselves.

**One way to think about the balance between offense and defense is to consider the "twin risks" investors face every day: the risk of losing money and the risk of missing opportunity.** At least in theory, you can eliminate either one but not both. Moreover, eliminating one exposes you entirely to the other. Thus we tend to compromise or balance the two risks, and every individual investor or institution should develop a view as to what their normal balance between the two should be.

Next, investors might consider trying to calibrate their balance over time in response to conditions in the environment – thus the title of this memo:

- The more propitious the environment – the more prudently other investors are behaving, the better the outlook for earnings, and the lower security prices are relative to intrinsic value or "fundamentals" – the more an investor might want toward shift offense.
- On the other hand, the more precarious the environment – the more others are embracing risk, the more headwinds to profits there are, and the higher valuations are – the more an investor might choose to emphasize defense.

In recent years, it's been my view that the investment world was marked by the following characteristics:

- more uncertainty than usual,
- extremely low prospective returns,
- full to high asset prices, and
- pro-risk behavior on the part of investors reaching for higher returns.

**These things told me the world was a risky, low-return place, and for that reason Oaktree's mantra has been "move forward, but with caution."** We've generally been fully invested, but with even more than our usual caution. We made a decision to overweight defense, and there were years in which higher risk produced higher returns, and we paid a price for being cautious. We had no idea what the catalyst would be that turned the risk into loss, and there were no obvious candidates. But we felt the world was a risky place, exposed to negative developments. Now we know the catalyst, and now portfolio risk has produced loss. That's the background.

As described above, I felt the uncertain, low-return environment called for defense to be over-weighted relative to offense. Now, however, as opposed to the conditions of 2, 6, 12 or 24 months ago:

- the risks in the environment are recognized and largely understood,
- prospective returns have turned from paltry to attractive (for example, the average yield on high yield bonds ex. energy has gone from 3½% to almost 9%),
- security prices have declined, and
- investors have been chastened, causing risk-taking to dry up.

**Given these new conditions, I no longer feel defense should be favored.** Yes, the fundamentals have deteriorated and may deteriorate further, and the disease makes for risk (remember, I'm the one who leans toward the negative case). **But there's a big difference between a market where no one can find a flaw and one where people have given up on risk-taking. And there's a big difference between one that's priced for perfection and one that allows for bad outcomes.**

Cautious positioning in recent years has served its purpose. Investors who favored defense over offense have experienced smaller losses this year, have the satisfaction that comes from relative outperformance, and are able to spend more of their time looking for bargains than dealing with legacy problems. **Thus, I feel it's a time when previously cautious investors can reduce their overemphasis on defense and begin to move toward a more neutral position or even toward offense** (depending on how sure they want to be of grasping early opportunities).

**I'm not saying the outlook is positive. I'm saying conditions have changed such that caution is no longer as imperative.** With part of the crisis-related losses having already taken place, I'm somewhat less worried about losing money and somewhat more interested in making sure our clients participate in gains. **My 2018 book, *Mastering the Market Cycle*, carries the subtitle *Getting the Odds on Your Side.* In that vein, I now feel the odds are more in investors' favor or, at a minimum, somewhat less against them. Portfolios should be calibrated accordingly.**



Looking for the Bottom

Before I close, just a word on market bottoms. Some of the most interesting questions in investing are especially appropriate today: **"Since you expect more bad news and feel the markets may fall further, isn't it premature to do any buying? Shouldn't you wait for the bottom?"**

To me, the answer clearly is "no." As mentioned earlier, we never know when we're at the bottom. A bottom can only be recognized in retrospect: it was the day before the market started to go up. **By definition, we can't know today whether it's been reached, since that's a function of what will happen tomorrow. Thus, "I'm going to wait for the bottom" is an irrational statement.**

If you want, you might choose to say, "I'm going to wait until the bottom has been passed and the market has started upward." That's more rational. However, number one, you're saying you're willing to miss the bottom. And number two, one of the reasons for a market to start to rise is that the sellers' sense of urgency has abated, and along with it the selling pressure. That, in turn, means (a) the supply for sale shrinks and (b) the buyers' very buying forces the market upward, as it's now they who are highly motivated. These are the things that make markets rise. **So if investors want to buy, they should buy on the way down. That's when the sellers are feeling the most urgency and the buyers' buying won't arrest the downward cascade of security prices.**

Back in 2008, on the heels of Lehman Brothers' September 15 bankruptcy filing, Bruce Karsh and his team embarked on an unprecedented program to buy the debt of companies in distress. They invested an average of roughly $450 million per week over the last 15 weeks of the year, for a total of nearly $7 billion. Debt prices collapsed throughout that period, and they continued to fall in the first quarter of 2009 (along with the stock market). But because the hedge funds facing withdrawals had been gated – and because the leveraged, securitized vehicles that would melt down had all been liquidated – large amounts ceased to be for sale after year-end. In short, if we hadn't bought in the fourth quarter, we would have missed our chance.

The old saying goes, "The perfect is the enemy of the good." Likewise, waiting for the bottom can keep investors from making good purchases. **The investor's goal should be to make a large number of good buys, not just a few perfect ones.** Think about your normal behavior. Before every purchase, do you insist on being sure the thing in question will never be available lower? That is, that you're buying at the bottom? I doubt it. You probably buy because you think you're getting a good asset at an attractive price. Isn't that enough? And I trust you sell because you think the selling price is adequate or more, not because you're convinced the price can never go higher. **To insist on buying only at bottoms and selling only at tops would be paralyzing.**

On the contrary, I gave this memo the title *Calibrating* because of my view that a portfolio's positioning should change over time in response to what's going on in the environment. As the environment becomes more precarious, (with prices high, risk aversion low and fear lacking), a portfolio's defensiveness should be increased. And as the environment becomes more propitious (with prices low, risk aversion high and fear prevalent), its aggressiveness should be ramped up. **Clearly, this process is one of gradual readjustment, not a matter of all-or-nothing. It shouldn't be the goal to do this only at bottoms and tops.**

So it's my view that waiting for the bottom is folly. What, then, should be the investor's criteria? **The answer's simple: if something's cheap – based on the relationship between price and intrinsic value – you should buy, and if it cheapens further, you should buy more.**

I don't want to give the impression that it's easy to buy while prices are tumbling. It isn't, and in 2008, Bruce and I spent a lot of time supporting each other and debating whether we were buying too fast (or too slow). The news was terrible, and for a good while it seemed as if the vicious circle of financial institution meltdowns would continue unchecked. **Terrible news makes it hard to buy and causes many people to say, "I'm not going to try to catch a falling knife." But it's also what pushes prices to absurdly low levels.** That's why I so like the headline from Doug Kass that I referred to above: "When the Time Comes to Buy, You Won't Want To." **It's not easy to buy when the news is terrible, prices are collapsing and it's impossible to have an idea where the bottom lies. But doing so should be the investor's greatest aspiration.**



As for the current episode, here's some data from Gavekal Research's Monthly Strategy piece for April, bearing on the question of whether the bottom was passed in March:

> . . . markets rarely clear after one massive decline. In 15 bear markets since 1950, only one did not see the initial major low tested within three months . . . In all other cases, the bottom has been tested once or twice. Since news-flow in this crisis will likely worsen before it improves, a repeat seems likely.

And here's some data from my son Andrew regarding the movements of the S&P 500 index around the time of the last two big crises. The first and second declines were followed by substantial rallies . . . which then gave way to even bigger declines:

| | |
|---|---|
| 9/1/00 - 4/4/01 | -27% |
| 4/4/01 - 5/21/01 | +19% |
| 5/21/01 - 9/21/01 | -26% |
| 9/21/01 - 3/19/02 | +22% |
| 3/19/02 - 10/9/02 | -33% |

| | |
|---|---|
| 10/9/07 - 3/10/08 | -18% |
| 3/10/08 - 5/19/08 | +12% |
| 5/19/08 - 11/20/08 | -47% |
| 11/20/08 - 1/6/09 | +25% |
| 1/6/09 - 3/9/09 | -27% |

Gavekal's and Andrew's data tell us markets rarely rally in a straight line. Rather, their movements represent a continuous tug-of-war between the bulls and the bears, and the result rarely goes in just one direction. After the optimistic buyers of the initial dips have responded to the low prices and bought, the pessimists find the new, higher prices unsustainable and engage in another round of selling. And so it goes for a while. Thus, as Oaktree's Wayne Dahl points out, it took until mid-May 2007, or almost seven years, for the stock market to regain the September 2000 highs, and it took until mid-March 2013, or five and a half years, to regain the highs of October 2007.

**The bottom line for me is that I'm not at all troubled saying (a) markets may well be considerably lower sometime in the coming months and (b) we're buying today when we find good value. I don't find these statements inconsistent.**

April 6, 2020

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