OAKTREE

Mastering the Market Cycle: Getting the Odds on Your Side

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What is a cycle?

A pattern of up-and-down oscillation over time around a midpoint.

Why are there cycles?

Why don’t things just grow every year at their long-term growth rates?

For example, if GDP grows at 2% on average, why doesn’t it just grow 2% every year? Why sometimes 1% and sometimes 5%? And why sometimes negative?

And the return on the S&P 500 averages about 10% per year. Why not 10% every year? In fact, why so rarely between 8% and 12%?

The answer is simple, but key:

Most positive trends eventually are carried to excess, and those excesses eventually correct on their own or are corrected

Rather than ups and downs, it might be helpful to think in terms of excesses and corrections

Why do trends go to excess?

Because of the involvement of people

Physicist Richard Feynman said “Physics would be much harder if electrons had feelings”

To oversimplify, economies, markets and companies are made up of people, and people have feelings

Why do trends go to excess?

- Positive emotions can contribute to management decisions that result in the over-expansion of factories, workforces and inventories

  Periods of over-expansion are marked by above average economic growth

- Positive investor psychology causes asset prices to incorporate increasing optimism and thus grow faster than the assets' underlying fundamentals are growing

  Periods of excessive appreciation are marked by above average returns but usually lead to precarious valuations

What happens when excesses are corrected?

- Rapid expansion can bring manufacturing capacity to a level at which it is excessive. When demand falls short of the expectations on which the expansion was conditioned, factories may be shuttered, workers laid off and inventories wound down. These things contribute to below average growth . . . or recession.

- Given enough appreciation, the prices of assets – even desirable assets – eventually reach levels that are extreme and unsustainable. Thus, after a period in which they rise faster than fundamentals, asset prices are brought back into line with underlying value through a period in which they rise slower than fundamentals . . . or they decline.

Are cycles dependable?

The key to understanding cycles lies in a quotation widely attributed to Mark Twain:

"History doesn't repeat itself, but it does rhyme"

- The details of cycles vary – their amplitude, speed, power and duration
- So do their causes and effects

But certain underlying themes do recur

What are the recurring themes behind most market excesses on the upside?

- too much optimism
- too little risk aversion
- too much capital availability

The role of optimism

The idealized decision-maker that economic theory is based on is always objective and unemotional, like Feynman's dependable electrons.

But investors are human, and as such they tend to swing wildly in terms of psychology or emotion: between optimism and pessimism, fear and greed, and credulousness and skepticism, for example.

An asset's price is a function of reality (its fundamentals) and how that reality is perceived (filtered through emotion, psychology, popularity). Excessively-positive perception causes prices to over-rate the fundamentals and become excessive.

In theory, investors are objective and rational and their psychology sticks to the "happy medium," avoiding extremes. In reality it rarely does.

The role of optimism

In particular, market booms tend to be characterized by tales of unending prosperity and limitless potential that push asset valuations to levels above past norms. But in booms, investors eager to participate in these miracles rationalize their aggressive behavior with four particularly dangerous words:

“It’s different this time”

In other words, rules and limits that applied in the past have been suspended, this tree will grow to the sky, and this current miracle is worthy of valuations that generally have ended in tears in the past

It’s essential that investors keep an eye out for excessive optimism that leads to peak valuations (as well as for excessive negativism that produces bargains)

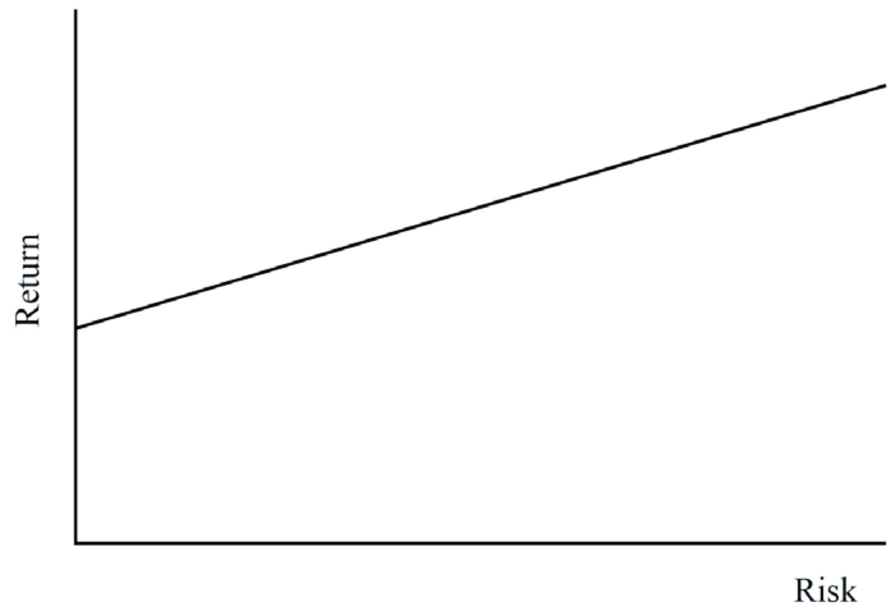
The importance of risk aversion

People are usually risk averse . . . as they should be

People should insist on the possibility of incremental returns (a “risk premium”) if they’re to accept investments that seem incrementally risky

If they don’t, something’s wrong!

Thus investors usually face a “capital market line” that slopes up and to the right – that is, assets that appear riskier must appear to offer higher potential returns, or else no one will buy them



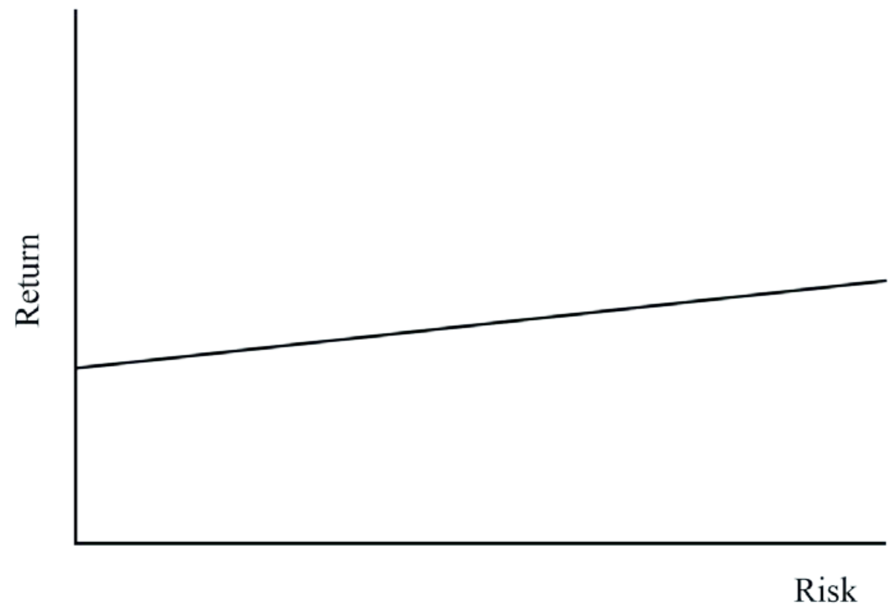
The importance of risk aversion

Sometimes when enthusiasm is high, recent results have been good and the economic sky seems cloudless, investors drop their risk aversion

Since they're less concerned about risk, they fail to insist on adequate risk premiums, allowing the prices of risk assets to go too high

And when they don't insist on adequate risk premiums, they generally won't get them

When risk compensation is skimpy, investors should cut their risk



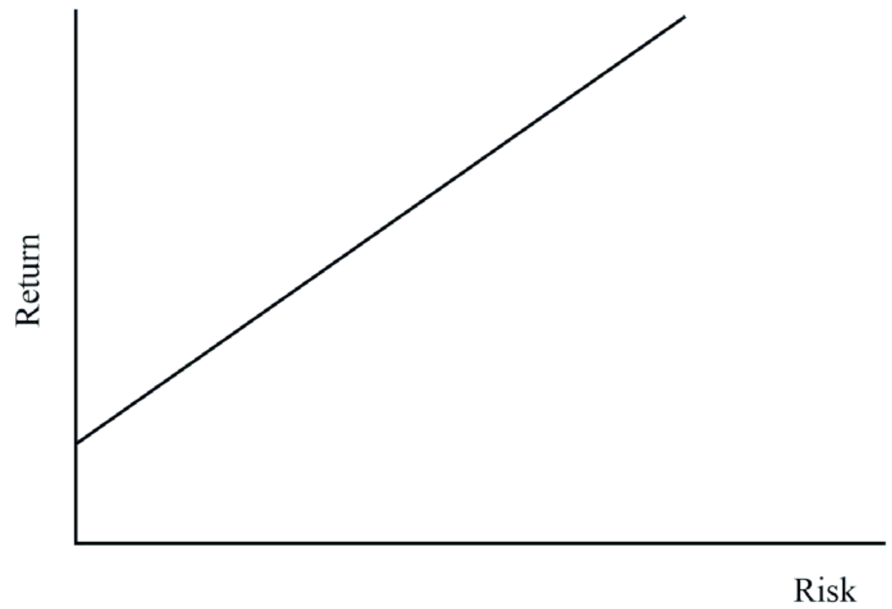
The importance of risk aversion

And sometimes, when investors are depressed, recent results have been poor and trouble seems to loom everywhere, investors' risk aversion becomes exaggerated

When risk aversion is excessive, that negativity causes the level of risk compensation to likewise become excessive, and the prices of risk assets to be too low

In such times, most investors boycott the markets . . . despite the lavish potential reward for risk-bearing

When risk compensation is generous, investors should increase their risk



The importance of risk aversion

Feynman's electrons – free from emotion – act as they should every time. If investors acted that way, they would demand a high risk compensation when risk is high, and vice versa.

But people, with their emotions, get excited when things are going well, buy avidly, and push up asset prices. At the resulting highs of the market cycle, they buy at the high prevailing prices, forget to demand adequate risk compensation as a condition for buying, and fail to sell if compensation is insufficient

And when things are going poorly, they smart from declines, become depressed, sell with urgency, and push prices down. At the cyclical market lows that result, they tend to find even swollen risk compensation inadequate, and thus they rarely buy

The impact of capital availability

The volatile cycles in investor psychology and attitudes toward risk cause the “credit window” – the availability of capital – to open wide in good times and slam shut in bad. This cycle fluctuates wildly and is highly influential

When things are going well, capital is available in vast amounts. Suppliers of capital make generous assumptions in their analysis, give borrowers and issuers the benefit of the doubt, see little risk, and thus forget to demand much in the way of return or safety

Since many investors do this at the same time, the competition to make investments or supply capital becomes fierce

The impact of capital availability

The conditions caused by a high level of investor ardor are summed up by the seven worst words in the world:

“Too much money chasing too few deals”

Heated bidding in the auction for opportunities to invest and lend causes prices to rise, prospective returns to fall, security structures to become weak, and risk to rise

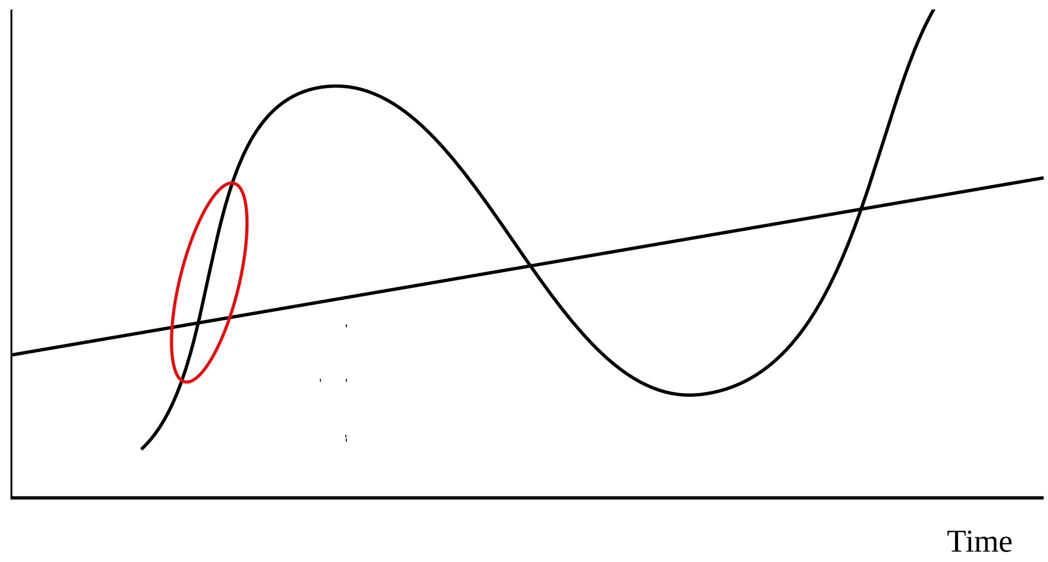
In such an environment, capital is available in large amounts, even for companies or deals of questionable worthiness. Thus any deal can get done, including risky ones, and undeserving companies can get financing and roll over their debts

Thus easy capital availability is a warning sign

To sum up, how do typical market cycles unfold?

On the way up –

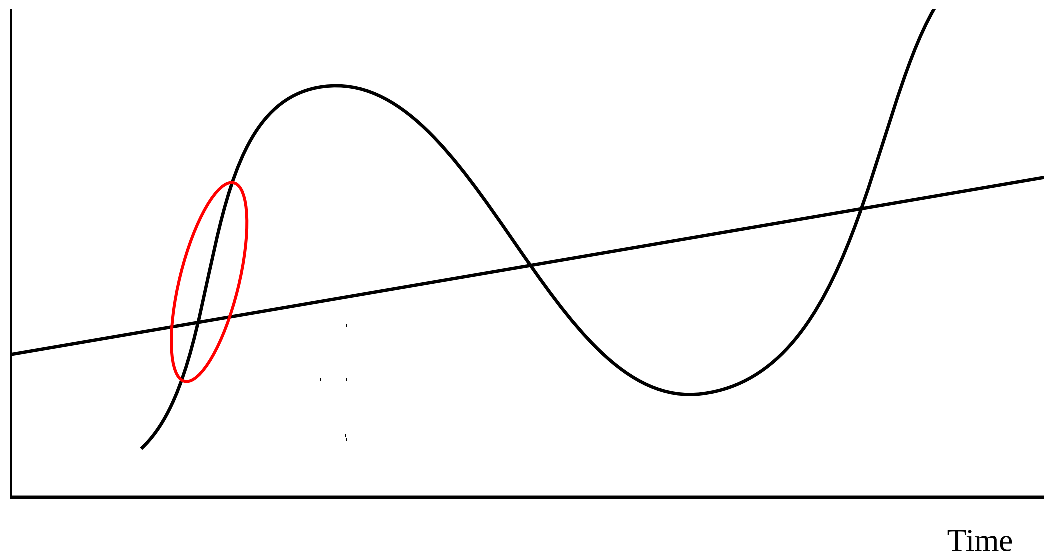
- economic fundamentals improve
- earnings increase and beat expectations
- the media report only good news



To sum up, how do typical market cycles unfold?

As a result:

- expectations rise
- psychology strengthens
- people perceive only favorable developments
- capital is readily available
- asset prices rise
- holders are happy and buy more
- non-holders capitulate and start to buy
- risk aversion evaporates; people embrace risk, saying “the more risk you take, the more money you make”



How do typical market cycles unfold?

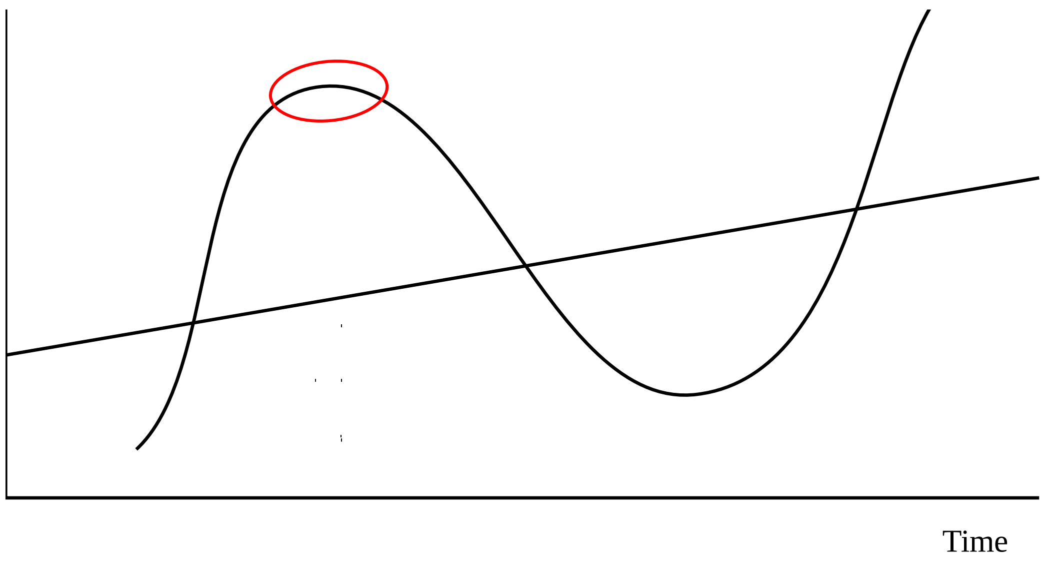
At the top –

- asset prices are high
- prospective returns are low
- risk is high

This is the time for caution!

But most people are euphoric, since the top in prices by definition coincides with peak psychology

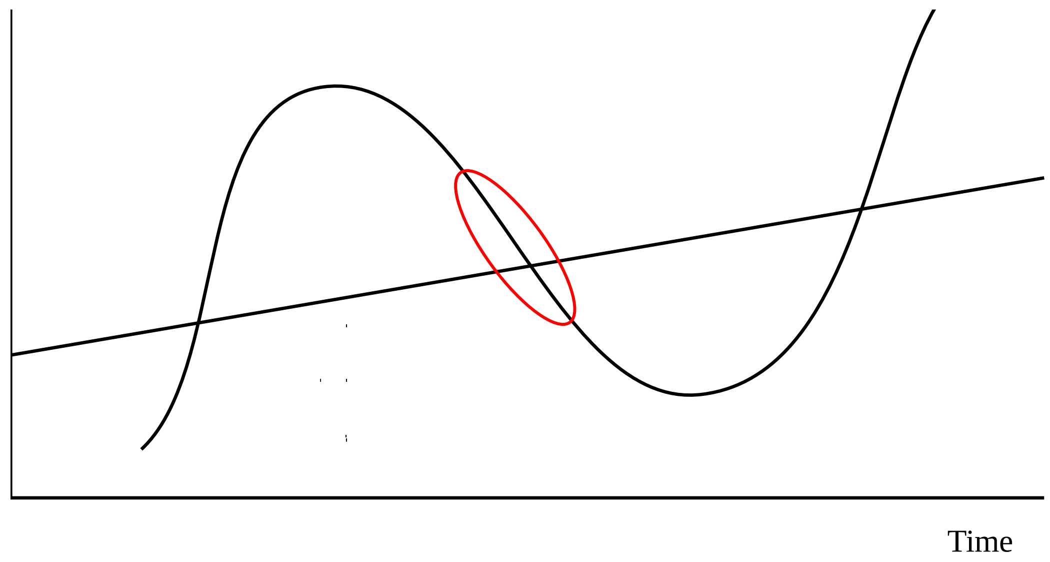
No one's willing to bear the risk of missing out on further gains



How do typical market cycles unfold?

On the way down –

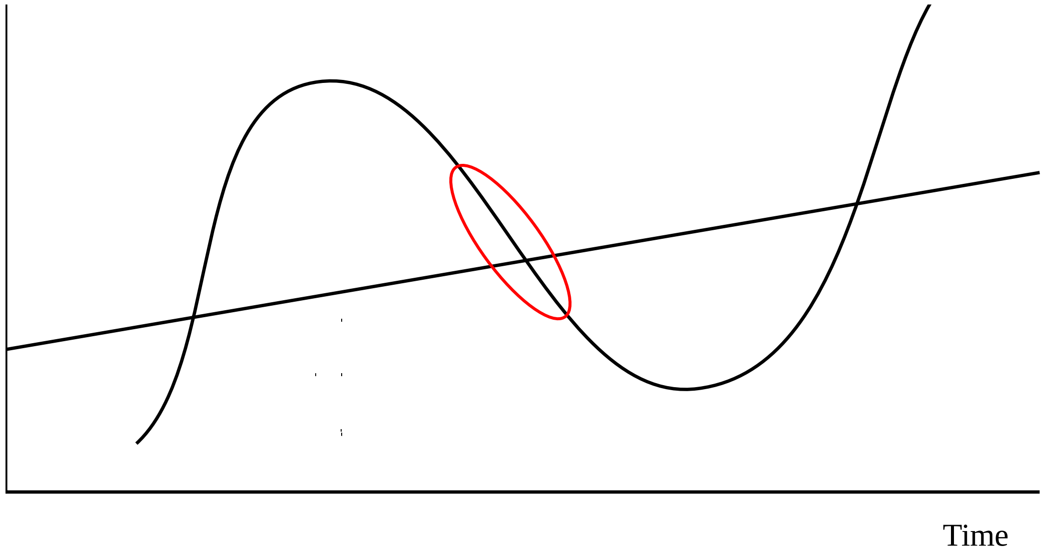
- economic fundamentals deteriorate
- earnings decline and fall short of expectations
- the media report only bad news



How do typical market cycles unfold?

As a result:

- expectations decline
- psychology weakens
- people see only undesirable developments
- asset prices fall
- holders are chagrined and sell
- non-holders celebrate and stand pat
- risk aversion grows; investors flee from risk, saying “bearing risk is just a way to lose money”



How do typical market cycles unfold?

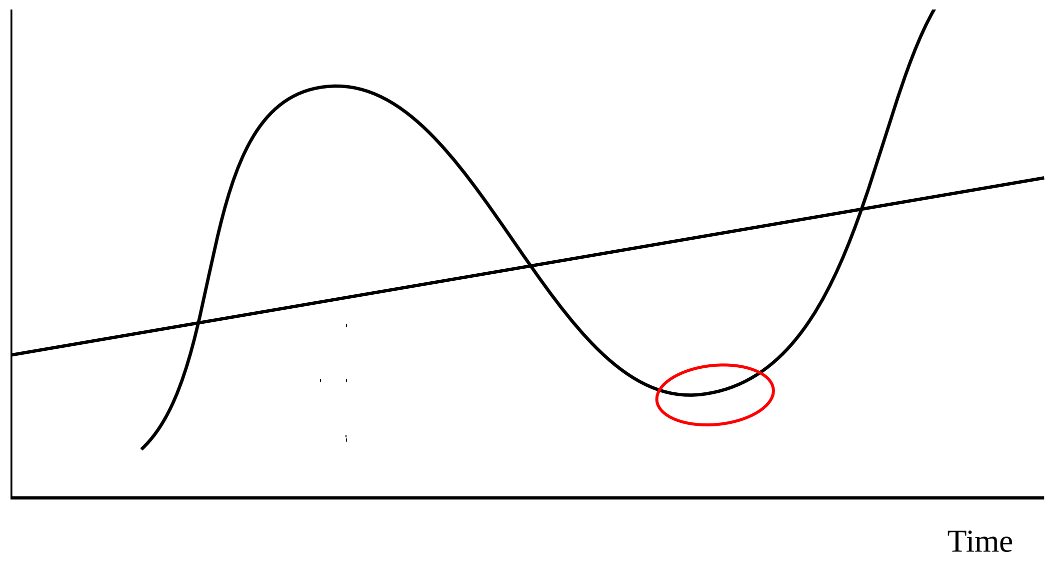
At the bottom –

- asset prices are low
- prospective returns are high
- risk is low

This is the time for aggressiveness!

But most people are scared stiff

No-one wants to commit capital under these conditions, since prices reach bottom at just the time when people are most depressed and cautious



Getting the odds on your side

The market is like a lottery, and investment performance is like one lottery ticket (the actual outcome) drawn from a bowlful of tickets (the full range of possible outcomes)

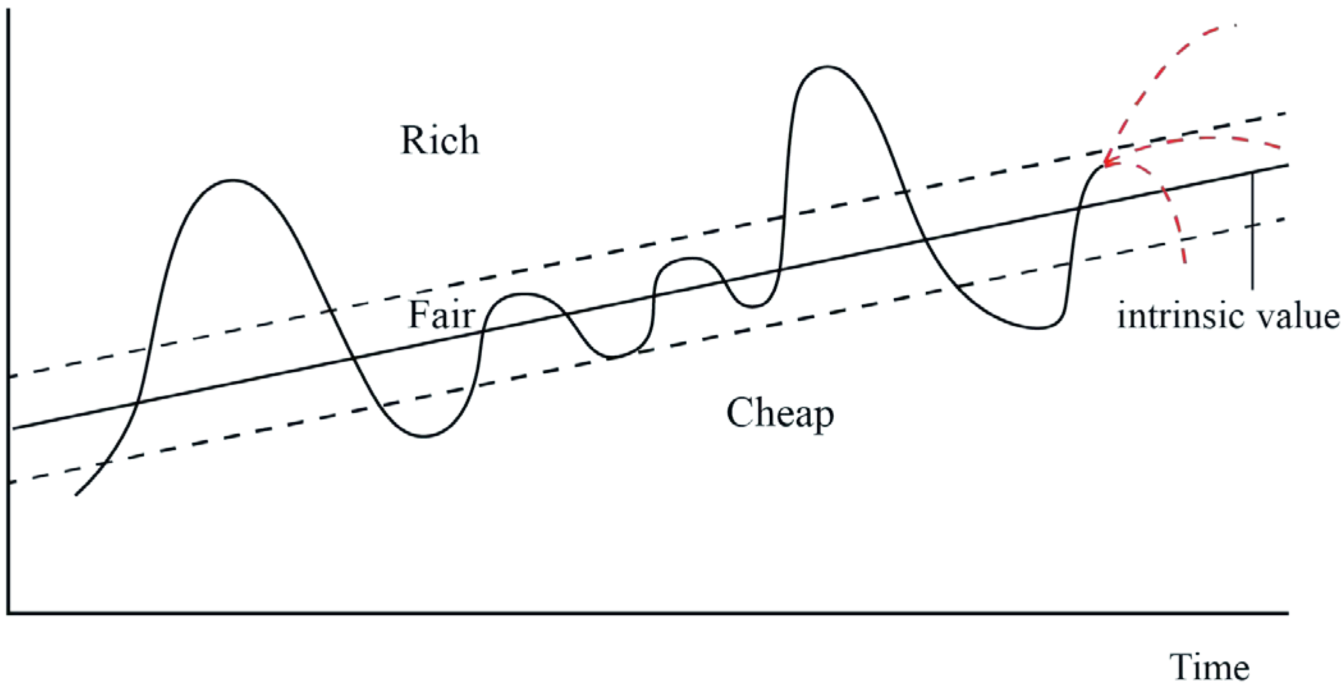
Assets that are priced below their intrinsic value are more likely to turn out to be winners, and assets priced above intrinsic value are likely to be losers

Which ticket is chosen – which outcome occurs – is influenced by the merits, but also to a large extent by swings in emotion and random events. We never know enough about the future to be sure what the outcome will be – which ticket will be drawn – but we can have a sense for when the tickets in the bowl tilt the odds in our favor, or when they're against us

What determines the mix of tickets in the bowl, and thus the odds of investment success?

In large part, the position of the market in its cycle

The Cycle in Action



Advice for Investing Institutions

Howard Marks, Chairman

Oaktree Capital Management, L.P.

Start from Reasonable Expectations

In investing, it's extremely easy to achieve average results and extremely difficult to consistently be above average.

It's important to decide whether you will:

- strive to be above average, which costs money and is far from sure to work, or
- accept average performance, avoiding those costs but being forced to look on as the winners occasionally report mouth-watering successes.

A decision to strive for superior results should be based on conviction that (a) assets are often mispriced and (b) your organization is capable of exploiting those mistakes (or of finding managers who are).

Make Your Goals Explicit

Every coherent investment program has to proceed from an explicit return goal.

The goal is likely to be expressed in absolute terms. How will it be reconciled with relative performance considerations?

Keeping up with the market when it rises usually requires market-sized helpings of beta, risk and correlation. If you have those things, what will happen when the market falls?

The time frame has to be explicit, too:

- The goal doesn't have to be achieved every year, and it probably can't be.
- The only thing that matters is achieving it on average over the long term.
- Full market cycles present a reasonable time frame for the purposes of assessment.

Make Sure Your Goals are Realistic and Achievable

Your goals should reflect and accommodate to the investment environment. For example:

- Today the risk-free rate is zero, Treasurys pay 1-3%, and the consensus thinks stocks will return 5-6%.
- In that case, maintaining a return of goal 7-8% will require holding a risky portfolio and accepting the possibility of meaningful drawdowns and perhaps permanent loss.

In addition, your expectations should reflect the realities or your situation:

- Are you small enough to benefit from selectivity, contrarianism and active management?
- Does your financial condition mandate conservatism or permit a more aggressive approach?
- Given that achieving superior returns requires heightened risk-taking, should they be your goal?
- Will your institutional setting permit you to attract and retain people who are above average?
- **Will your realities permit you to focus on the long term and ignore short-term noise?**
- Given how hard it is to perform above average, do you have reason to think you can?

> The market is not an accommodating machine. It will not go where you want it to just because you need it to.
>
> – Peter Bernstein

Formulate an Opinion Regarding Cycle Positioning

The goal in cycle positioning is to hold more of something when it's cheap and less when it's dear, and to increase aggressiveness and defensiveness at appropriate times.

It has to be based on the belief that opportunities to benefit exist and can be recognized and taken advantage of.

The keys in this regard lie in awareness of where the market stands, contrarianism, counter-cyclical behavior and the pursuit of relative value.

But it isn't easy: Today's valuations already reflect everyone else's effort to do the same. Can you do a superior job? If not, your efforts will be in vain at best and costly at worst.

Understand the Essential Nature of Contrarianism

The investing herd is usually wrong at the extremes.

- The herd becomes more optimistic and euphoric as positive events occur and asset prices rise. Thus its buying creates the markets' highs.
- Likewise, the herd becomes more pessimistic and depressed as negative events occur and prices decline, and its selling brings on the lows.

Thus contrarianism – doing the opposite of the herd – is an essential element in superior investing.

It's important to assess the state of the environment and take advantage of investors' biases and foibles:

- Be fearful when others are greedy
- Be greedy when others are fearful

But contrarianism isn't easy. This is true particularly because most investors are subject to the same environmental and emotional influences as the herd.

And remember, even the best contrarian decisions often fail to work immediately and thus look wrong for long periods of time.

Decide How Reliable You'll Expect Your Process to Be

There is nothing reliable to be learned about making money. If there were, study would be intense and everyone with a positive IQ would be rich.

– John Kenneth Galbraith

. . . not only am I unaware of any formula that alone will lead to above average investment performance, but I'm convinced such a formula cannot exist.

– Dare to Be Great, September 2006

"Process" alone will not suffice. An average process operated in an average way will lead to average results.

Superior judgment is the essential ingredient.

Insist on Long-Term Focus

- It's hard for an investor to consistently do the right thing.
- It's impossible to consistently do the right thing at the right time.
- Thus no one and no organization can consistently achieve short-term goals.
- **Anyway, only long-term performance matters.**
- Short-termism is one of the greatest weaknesses in investing today.

If you agree with the above, you should de-emphasize the short run.

Given that no one can be right consistently, penalizing short-term underperformance – which we agreed doesn't matter – will discourage constructive, long-term creativity.

An easy way for an organization to distinguish itself today is by focusing on the long run, not the short run. But you have to walk the walk:

- Make clear to all that you only want long-term decisions.
- Deemphasize reporting on short-term results.
- Base compensation on long-term performance, not short-term. (But then how will you decide on pay in the early years?)

The Ultimate Issue: Decide Whether Your Organization Will Dare to Be Great

Will you dare to behave unconventionally?

Will you bear the associated uncertainties?

Will you accept the risk of being wrong?

How will you define success, and what risks will you take to achieve it?

> How much emphasis should be put on diversifying, avoiding risk and ensuring against below-pack performance, and how much on sacrificing these things in the hope of doing better?
>
> – Dare to Be Great

Will You Dare to Be Different?

	Conventional Behavior	Unconventional Behavior
Favorable Outcomes	Average good results	Above-average results
Unfavorable Outcomes	Average bad results	Below-average results

Unusual success cannot lie in doing the obvious. The investing herd pursues the obvious. Conventional behavior will, by definition, lead to conventional results.

> Only if your behavior is unconventional is your performance likely to be unconventional . . . and only if your judgments are superior is your performance likely to be above average.
>
> – Dare to Be Great

> Establishing and maintaining an unconventional investment profile requires acceptance of uncomfortably idiosyncratic portfolios, which frequently appear downright imprudent in the eyes of conventional wisdom.
>
> – David Swensen

Will You Dare to Be Wrong?

Every attempt at above average performance will expose you to the possibility of experiencing below average performance.

- Most institutions invest a lot of capital, effort and opportunity costs to avoid the embarrassment that results from being wrong.

- Consider, for example, the ultimate conundrum. For most bureaucracies, the unspoken rule is this: "We would never buy so much of something that if it didn't work, it would make us look bad." But if that's true, how can you do enough of it so that if it works it will move the needle on performance?

- **Trying to do better than average means accepting the possibility of doing worse, and the associated headline risk**. In particular, think hard about the possible consequences of high-profile deals and large commitments.

Will Your Environment Encourage Trying to Be Great?

Bureaucracy and great investment results tend to be mutually exclusive.

> … active management strategies demand uninstitutional behavior from institutions, creating a paradox few can unravel.
>
> – David Swensen

This is largely because unconventional behavior is inconsistent with bureaucratic oversight.

Bureaucracies are unlikely to coalesce around idiosyncratic decisions.

> Worldly wisdom teaches us that it is better for reputation to fail conventionally than to succeed unconventionally.
>
> – John Maynard Keynes

What will be your response?

- Will your organization be permitted – and enabled – to act unconventionally?
- **Will you try to reduce bureaucracy, or will you give up on achieving great results? There is no third option.**

Will You Dare to Look Wrong?

Remember, in investing, it's hard to do the right thing and impossible to consistently do the right thing at the right time.

That means even "correct" actions may take a while to work, and in the meantime they'll look like mistakes.

The penalties institutional investors face for below average results can far exceed the potential rewards for above average results.

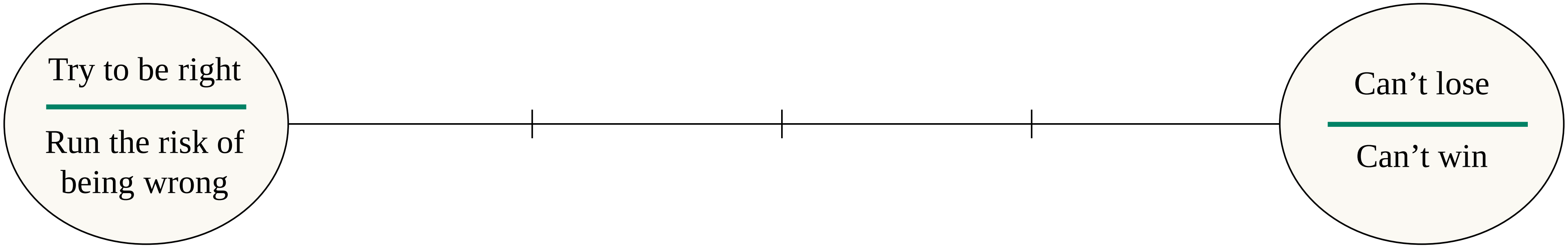
> Unconventional behavior is the only road to superior investment results, but it isn't for everyone. In addition to superior skill, successful investing requires the ability to look wrong for a while and survive some mistakes.
>
> – Dare to Be Great II, 2014

You should consider whether your organization's goals are consistent with the realities of its environment. Can you endure long enough for the wisdom of your correct actions to become apparent?

Grapple with the Great Conundrum

- **You can't try to be superior without running the risk of being inferior**
- **Most loss-minimization strategies eliminate the possibility of substantial gains**

These two pairings represent the opposite ends of a spectrum of behavior



How will you position your effort on that spectrum?

Never Forget the Inescapable Truths

Investing is a challenging, messy and imprecise activity that has to be engaged in on the basis of estimates, intuition and subjective judgment, not accurate forecasts, scientific laws and dependable processes.

Nothing is sure to work every time. The best you can hope for is that you will be right more often than you're wrong, and that your successful decisions will add more than your mistakes subtract.

Nothing will lead to superior results in the absence of superior implementation. But even superior investors are far from perfect.

The environment doesn't remain static. The actions of the participants alter the environment, and thus the things you must do for success. The quest for gain causes easy answers to be driven out. Yesterday's right answer can be today's wrong answer.

Everything that's important is counterintuitive, and everything that's obvious is wrong.

Ego, emotion and human nature are dangerous enemies.

On average, the average investor produces average results before fees and below average results after fees. Very few can be consistently above average – especially in more-efficient markets.

It's not supposed to be easy. Anyone who finds it easy is stupid. – Charlie Munger

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