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KAIZEN INTERVIEWS

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HOWARD MARKS INTERVIEW – 2017

Howard Marks co-founded Oaktree Capital Management in 1995 and it has grown into one of the world's largest distressed-debt investors and manages over $100bn in alternative investments. We have found Howard's "Oaktree memos" to clients over the years, and his excellent books, a source of thoughtful ideas that often challenge conventional wisdom. At Kaizen we are always looking for insight, from successful investors, into 'how to think' rather than focusing solely on a single idea or concept. "The most important thing: Uncommon sense for the thoughtful investor' is one of our favourite books and you can find the memos at Oaktree at https://www.oaktreecapital.com/insights/howard-marks-memos

CG: It is a pleasure to introduce Howard Marks (HM) today. Welcome and thank you for your time. If you started out again, knowing that you love markets and investing, how would you begin your journey, with the benefit of hindsight?

HM: Thank you Connor. It's a good idea to get a good education. I was lucky to get a qualitative education at Wharton and then a quantitative education at Chicago. The combination of the two was great, and it was very advantageous to get an education at Chicago at a time that it was just starting to teach its theory of finance. That worked out very well.

I think it's good to start off in equities -- because they are the foundational element of investing -- and see if you enjoy it and have a nose for it. Then I think it's interesting to branch out into a speciality, like some form of alternative investing or some-such. But then some people like the stock market and studying companies, so maybe that's just me. But the point is that if you do something that interests you and that you like, there's a better chance you'll be good at it.

CG: Do you think if you started again you would have ended up in distressed debt? Or was that just a quirk of history and interaction with Milken?

HM: That was a quirk of history at the time, and it was a lucky quirk. I don't know, if I came out of school this year, what I'd do, I might look at emerging markets or private credit or something like that. High yield bonds are kind of mainstream now. I think for the better opportunities one has to look outside the mainstream.

CG: We find the patterns of history interesting and were introduced to this idea, in financial markets, by Jim Rogers. There are patterns that rhyme, but they don't necessarily repeat to quote Twain. Looking at the big picture, why and where do sectors and companies become inefficiently priced? Do you see patterns?

HM: Right, well, in the old days things were inefficient because they were unknown, un-followed, not understood, not the subject of infrastructure and information, not openly priced, that kind of thing.

Another reason is if there is a law which mandates, for example, that pension funds can only invest in bonds rated A or better and not in bonds rated below A, chances are that bonds rated A or better will be fully priced and bonds rated below that will be cheaper. I ran into – and benefitted from -- those kinds of legal or organizational prohibitions when I started.

Another reason might be a great degree of complexity. If something is extremely complex, only 'x' percent of the population (1) will go to the trouble and (2) has the intelligence to understand it. So, that's the third reason why you get structural inefficiency.

Of course, today most people will do anything to make a buck, there aren't any rules, everyone has a computer, people are smarter, quantitatively, than they were 50 years ago, so it is correspondingly harder today to find what I call structural inefficiencies. You mentioned a minute ago that things will still get cheap from time to time, that's what I call that cyclical inefficiency. That will go on as long as there are people involved in the investment process. Often that's the best we can do. At the moment nothing looks pronouncedly cheap.

CG: We'd observe that as the investment banks have been forced to cut back on trading proprietary capital, the number of analysts doing pure non-deal research has dropped. That could create sell-side inefficiency. Then on the buy-side, the rise of ETFs and skew of active management to the biggest indices means that the career risk to portfolio managers of buying off-index or meaningful positions is creating buy-side inefficiency around the world. We are finding quite a few big stocks that are off the radar for these reasons: they have no coverage and won't be covered anytime soon. So there is a structural inefficiency – things are cheap there. But it's not the S&P 500 where everything is very well covered.

HM: Right

CG: How do you think about 'shocks'?. When you see a 'shock', like oil falling rapidly 18 months ago, do you say to yourself 'there's going to be some carnage', 'are there any companies with debt' – let's take a look? Is there a simple process or logic that says 'we should look over here'?

HM: No, no, it can't be simple. Look, if there's a train crash then it's usually pretty prominent and then we know to look. But deciding whether to do it can't be simple. I wrote a memo a few years ago called 'It's Not Easy'. Investing cannot be easy. https://www.oaktreecapital.com/docs/default-source/memos/2015-09-09-its-not-easy.pdf?sfvrsn=2 But negative headlines can give you a place to start.

CG: Yes, that is a great memo. Perhaps we can use an example to highlight the logic. Since '08/'09, you've had the rise of the 'quality stocks', U.S. large caps, they are easy to screen for, have high ROE's, ROICs, are great businesses, run by great management and are well-covered. Yet fund managers around the world that have bought these have delivered the best returns, particularly adjusted for risk, which we'll come onto. Trending stocks tend to compress in volatility so they look even better as time goes on. But, as you said, it's not that easy – it can't be that easy in the long-term.

Can you talk about your first and second level thinking analysis as it would relate to an example like this; i.e., these are great companies but everyone knows it?

HM: If they're great quality companies and everyone knows it, chances are that it's all priced in. It can't be much of a bargain. Back when I started, most of the banks invested in the Nifty 50 -- the best, fastest-growing companies in America, at 80-90x PEs (price/earnings ratios) -- and people lost a fortune. The point is that you have to be able to reach the conclusion that you are buying at a reasonable valuation. Buffett's willing to buy great companies at good prices, but you shouldn't buy good companies at the prices of great companies. You have to make that kind of judgment. It all depends on how happy you are riding corporate coat-tails or how important it is to you to get a bargain. It's all subjective.

CG: Do you think there is a bubble in the 'quality stocks'?

HM: I don't spend my time looking at them, so I don't know them so well. I just know there's been a lot of money that's flowed into the dependable companies, and especially the consumer stocks. They're great companies, but the question, just like in '68 and '69, is how high should the PE be? These are not easy questions. If you have two companies, and one is better than the other, how much higher a PE ratio would you pay for it? It's not easy.

CG: In a lot of your writing you talk about probability distributions. As a child, everything is black and white, but as an adult there are shades of grey. I like the way you always explain things with a probability distribution. Do you try and frame every decision with a curve? Do you try and put that into your head?

HM: No, not formally. My approach was never to develop a formal probability distribution, but it's important, even if it is informal, to have an idea what the possible outcomes are, which are the most likely, and what are their relative probabilities. That's the only way to make intelligent decisions.

CG: And in terms of position sizing, did you have any rules around that probability analysis?

HM: No, I'm not a believer in rules, it's all judgment. This whole thing – investing -- is a matter of judgment, it can't be reduced to rules. John Kenneth Galbraith said "There's nothing intelligent to be learned about making money. Because if there was, study would be intense and everyone with a positive IQ would be rich." It can't be reduced to rules, because every situation has subjective, qualitative factors that can't be expressed in terms of numbers. If you could reduce a company's safety to a number and its future potential to a number -- and let's assume that's all there is -- then you could get to a number for the price you should pay. But I don't think you can. I think the best analysts and investors make superior, subjective judgment calls.

CG: When you were starting out and you had those conversations with institutional allocators of capital, that are used to being given a formulaic answer, did you find that many rejected your views? How did you deal with that?

HM: When I started in portfolio management in '78 (after nine years in equity research), I was working mostly with high yield bonds, and I found that fixed income investing can largely be reduced to numbers. I was able to make very convincing numerical presentations based on the yield, yield spread, default rates and loss experience and that kind of thing. Fixed income investing can more readily be reduced to number: ou know the promised return, and the question is its adequacy given the credit risk. The wild card was the probability of default for each company, and that can only be a matter of judgment. It's harder when it's equities: there's nowhere to look on the page to see a number for the promised return.

CG: On risk: I've read your memos and your book. What is risk and how should we think about it?

HM: Risk is the degree of uncertainty in future outcomes and, in particular, the probability of bad ones. Most of that is about losing money. It's also about missing out on opportunities, there's the risk of something doing well and your not owning it, but most people see that – opportunity cost -- as less of a risk. If you miss too many opportunities, though, you'll lose your job or your clients.

It goes back to probability distributions: the range of possible outcomes. As Peter Bernstein wrote, sometimes we don't know where the outcome will fall within the range, and sometimes we don't even know what the range is. It's uncertainty and variability that produces the risk in investing; if we knew what was going to happen, then we wouldn't have the risk.

CG: You also use 'permanent loss of capital' as a measure of risk.

HM: Yes, if you read the memo "Risk Revisited Again", I listed 24 types of risk, so it's not like there's just one or two. But the risk of losing money is certainly the most important risk.
https://www.oaktreecapital.com/docs/default-source/memos/2014-09-03-risk-revisited.pdf?sfvrsn=2

CG: There's also mark-to-market risk.

HM: I turn up my nose to mark-to-market. If it's temporary, then you should learn to ignore it. Of course you have to get your clients to ignore it too, rather than fire you. As Buffett says, I'd rather have a lumpy 15% per annum than a smooth 10%. But some clients want smooth. You have to have the right clients for our style. It happens that in Oaktree's businesses, we are one of the low risk managers in some adventurous asset classes. Clients like it that way; that's been a big part of our success.

CG: So how do they measure that you're the low risk investor?

HM: Well there are lots of ways, depending on which strategy. First there's the Sharpe ratio, which is the ratio of excess return (return in excess of the T-bill rate) to a measure of volatility, like standard deviation. I don't think variability is risk, but it's the only statistic we have. If you're considering a high yield bond manager, you can look at his default ratio and see how many defaults he's had versus other managers. In distressed debt, my partner Bruce Karsh tracks what he calls his batting average: of the total outcomes -- gains and losses -- what percentage are gains and what percentage are losses? Bruce's batting average has been extremely high for 28 years. That tells me he has some combination of high skill and a controlled-risk approach. I was looking at our mezzanine strategy today, and a very small percentage of the outcomes has consisted of losses . You can have someone with a huge overall rate of return and 40% of his outcomes are losses – he has some investments that make 10X his money and some where he loses all his money. That can tell you something about his style and riskiness. This is a matter of personal preference, but all these things have to be dealt with via interpretation.

CG: The problem with the Sharpe ratio is that it is based on volatility, which is stated as the standard deviation of the price.

HM: Right, but what else does one have? There are no other quantitative measures of risk.

CG: That's the hard bit. It's like democracy – it's flawed, but it's the best thing we have.

HM: Winston Churchill said it's the worst system, except for all the others.

CG: And that's the paradox. Private Equity managers will buy a company and operationally gear it with debt, so the risk should go up because if things go bad, they may not be able to service it and they go bankrupt.

HM: But on the other hand they don't fully mark to market. There's no organized market for the companies they own, so there's no price reporting. They estimate what something "is worth," but not what a manic/depressive – "Mr. Market" – would pay for it at the highs and lows.

CG: Yes, that's my point.

HM: So in their reported returns, volatility may understate the risk relative to the public markets. And then people say "I like private equity, because it's low in risk". It's not low in risk, it's low in volatility: reported risk. The actual risk may be quite a bit higher. So then you have to get philosophical and think about the tree falling in the forest. I believe that if the tree falls in the forest, it does make noise. I believe that if private equity companies run into trouble, they'll turn out to be risky even if they didn't mark to market.

CG: They then sell their companies onto the stock market where, if they miss a quarter, the stock is down 40-50%. Yet, if it was held as a private equity investment and the quarterly earnings were light, it wouldn't be marked down anywhere near that. Same company, but the reported risk, as you say, has somehow changed. We now see increased allocations going into private equity for those reasons. In many ways you stand alone in terms of having a very different view on risk/reward and private equity. Before you became so successful and credible, and considering your unconventional thinking, you must have had moments in your career that were contradictory to many.

HM: I always quote from David Swenson, who runs the endowment at Yale, who says something like 'successful investing requires the adoption of comfortably idiosyncratic portfolios which, at a given point in time, fly in the face of conventional wisdom'. Obviously, if you're doing the same thing as everybody else, and buying all the things that everyone likes, it's hard to be a superior performer.

CG: Exactly, it's almost impossible.

HM: It's just a math thing. If you take the same actions, you're not going to get different results.

CG: You will be the average.

HM: And the average may be pretty bad, because the things that everybody likes may be recognized and appreciated, meaning the price has already gone up before you buy it.

CG: You recently made an observation that as you've travelled around the world, you've noted that the U.S. is still a market that understands risk and likes what entrepreneurs and mavericks do, whereas elsewhere the risk appetite is less. Can you perhaps elaborate?

HM: Let's take, for example, contrarianism. Contrarianism is a complex thing. It's counter-intuitive by definition and not everyone gets it. To most American professional investors, at this point, it's not so foreign. But 50 years ago, if you said to someone "you should do this because no one else will," they might not have understood it. In those days, 50 years ago, good investing was conventional investing and investing in high quality companies, stocks and bonds. If you did something unusual or contrarian, that was suspect. Today everyone understands the essence of contrarianism in the U.S., but not necessarily in other countries. I always thought that if you went out in Japan and said "you should do this because no one else is," they would say you're nutty. So it's a cultural thing, this idea that it's desirable to do that which is counterintuitive and unpopular.

CG: Just in relation to the allocators, you mentioned Yale, they have this issue where they have so much capital now and it's difficult to deploy that into different strategies.

HM: Success can be its own enemy.

CG: In the U.S, are the big universities, their funds, the most forward thinking?

HM: No, just a few of them. Not all of them: Yale set the bar, then Duke, Harvard – at a time. It's interesting if you look at Harvard. Things went too well at Harvard. They brought in great guys and gave them significant financial incentives for performance. Those guys did extremely well for the university. But they made a great deal of money personally, and the onlookers said 'that's not okay, we don't want people making $30m a year who run the Harvard endowment, so fire all those people'. So they fired them all and performance went dead. Now for the last 5 to 8 years, Harvard's had real performance problems. They got rid of $100m in compensation expense, but I would guess they have about $40bn in the endowment, so $100m is about a quarter percent and if you get rid of salaries equal to a quarter percent but it takes a few percent off your return, then its wasn't very smart. Everybody can read what those people were earning, not too many can figure out what they're contributing to the endowment. They look and they say 'I could have done that, you don't have to pay $30m to get someone to do that'. And that's how you get in trouble.

CG: Which books have been most influential in your thinking? I like this concept of you wanting to teach people how to think. Logic has the greatest longevity.

HM: Nassim Nicolas Taleb's 'Fooled by Randomness' was very important for me, and John Kenneth Galbraith's 'A Short History of Financial Euphoria'. 'The Intelligent Investor' is probably the best book ever written on investing. Those are the most important, and then something like 'Against the Gods: The Remarkable Story of Risk' by Peter Bernstein,' talking about probability.

CG: Can you talk about the role of randomness? You can make the right decision and lose, or the wrong decision and succeed, without knowing it. It is always difficult, as an investor, when you are wrong for the right reasons. I always try to remember that 'when man does well he parties, but when he struggles or does badly he ponders' and it's during the pondering that you learn.

HM: I don't think many do (ponder). When they go wrong, most people say 'I got screwed, it was just bad luck'. Most people don't ponder what they did wrong, that's the problem.

CG: That's interesting. Because it's in the pondering that you do the best learning.

HM: That's right. I always say 'experience is what you got when you didn't get what you wanted'.

CG: That's good; I like that.

HM: On books, I'd add Edward Chancellor's 'Devil Take the Hindmost; History of Financial Speculation." That was a good book. I was reading that book in 1999, about the South Sea Bubble, and I said 'Oh I see a lot of the tech bubble in here'. That was very important for me.

CG: I was reading "The Intelligent Investor" in 1999 on holiday from Credit Suisse, running into the tech bubble and there were also a lot of flags in that.

HM: And that book was written 50 years before the tech bubble. That goes back to your Mark Twain quote. History does rhyme, so it's enormously helpful to know history.

CG: It has been a pleasure to speak to you today and I look forward to reading many more of your memos in the future. I have one last, rather tangential question. You look so young, what's your secret?

HM: Good genes, good eating, no drugs, no smoking, little drinking, no coffee, and some exercise. But the most important is genes. Buffet says when he found out that the best predictor of how long you live is how long your parents lived, he got his mother an exercise bicycle! Of course he was kidding: it's hard to beat genetics.

CG: Thank you Howard Marks.

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