Strategy Thoughts

May 2014

Beware the correlation and causation delusions

The seventh Minor Zurich Axiom

Introduction

I began last month's Strategy thoughts with the major Zurich axiom illustrating the difference between confidence and optimism in investing. It continues to be the case that understanding and appreciating that difference is essential for all investors, but it is also the case that the behaviour highlighted by the seventh minor axiom, mistaking correlation for causation, has, and continues to be, one of the primary drivers of the high levels of optimism that continues to be present in many equity markets.

Over the last month markets for most assets, from gold to copper through to global equities, have traded in a broad sideways manner with the only minor exception being longer term interest rates falling slightly. None of this has done anything to dampen my level of concern, I continue to fear that the next important cyclical move across most markets will be a bear market that will do far more damage than the 10% 'healthy correction' that the majority of commentators seem to fear as being the 'worst case scenario'.

In this month's Strategy Thoughts I review the current manifestation of the seventh minor Zurich axiom, revisit (again) the San Juan Hill Theory as it relates to the growing divergence in the US equity market, compare the NASDAQ currently to the broader US market seven years ago and highlight again the danger of deflation.

Correlation /causation – economic surprise!

Reuters recently reported, after the Dow had notched up a new all-time high, that expectations were continuing to improve due to the level of earnings that were being reported;

> Also supportive: most S&P 500 companies are beating earnings forecasts, albeit on lowered expectations, he said.

The already lowered expectations did not appear to matter in the discussion that followed as of equal importance was the improving economic outlook;

> Data suggested the economy continued to gain momentum after the winter lull. U.S. consumer confidence dipped in April but remained near a six-year high, while home prices rose in February.

All this failed to recognise just what was cause and what was effect. I have frequently described, often at some length, how the equity market is an instant barometer of aggregate social mood whereas economic reports are always lagging (often by six months or more) reflections of the same. This is why historically the stock market has been a far better forecaster of the economy than the reverse and why the stock market is included as one of the measures that make up the Index of **Leading** Economic indicators. The reason the US market has been rising since the 2012 low has been in anticipation of better economic and earnings news ahead. Now that earnings etc. and the market have risen so too have expectations, as a result the real danger now is that the risk of disappointment has

increased markedly. In the same vein I was reading commentary over the weekend that was justifying why the US market should continue to rise, the primary reason that was given was that no cyclical peak in the market had ever been seen without an accompanying economic slowdown and apparently there is no slowdown currently on the horizon. Whilst the former comment may be true the problem lies in the lagging nature of the dating of economic slowdowns and the inability of forecasters to predict them.

A review of the last few economic peaks illustrates the futility of relying on economic releases for a market view.

The National Bureau of Economic Research is the body responsible for determining when a slowdown began and then releasing the news to the world. Their website shows that they believe the last economic slowdown in the US began in December 2007. This was only two months after the US equity market began its last cyclical decline, however, unfortunately for investors awaiting news of a slowdown the NBER did not make their determination as to when the slowdown began until December 1st 2008. By this time the market had been falling for fourteen months, was only three months away from an important bottom and was down 43% from its peak.

Working back the next peak dated by the NBER was in March 2001, this was fifteen months after the market had peaked and they did not publicly announce that the peak had occurred until November 26th 2002, sadly this was a month and a half **after** the Dow had recorded its bear market trough. There is no need to go through the entire history of recessions and the stock market to illustrate just how misplaced any comfort is that so many find in commentary such as I described a couple of paragraphs earlier, but one more is worthwhile. The next earlier recession was the one that began in July 1990, this declaration almost perfectly coincided with the pre Gulf War stock market peak, however, the date was not determined until April 25th 1991 by which time all that had been lost in the bear market had been fully recovered.

Comfort should not be taken because a recession is not apparently on the horizon, they never are until long after they have well and truly begun and the market has already fallen substantially. At the end of 2007, after the US recession, and what would become known as the Global Financial Crisis, had begun consensus economic forecasts were for some slow down but no recession.

Just as comfort at a peak should not be taken from economic forecasts, neither should they be taken from the general market commentary. In May of 2008, with equities entrenched in a bear market I wrote a Thoughts and Observations piece warning against the danger of taking comfort from the soothing words coming out from so many quarters. I illustrated this danger by quoting from a small book titled "Oh Yeah" published close to the end of the Great Depression.

> Towards the end of 1932 a small book titled "Oh Yeah?" was published. It was a compilation of commentary from prominent businessmen, investors, politicians and economists through the last days of the great bull market of the twenties and the first two years of the devastating bear market that followed. By the time of its publication the US market had already fallen eighty percent from its high and the depression had barely reached its half-way point. In the seven months after the book was published the market fell in half again, ultimately falling about 90% from its high.
>
> The following are just a selection of some of the prominent commentary that accompanied the peak and the ensuing decline;

October 16, 1929. "Stocks have reached what looks like a permanently high plateau" Irving Fisher, economist.

January 1930. "Happily, we have turned our backs upon the events of this unfortunate episode" Paul Warburg, Federal Reserve Board

March 8 1930. "President Hoover predicted today that the worst effect of the crash upon unemployment will have been passed during the next sixty days." Washington Dispatch.

May 21, 1930. "Business is gradually but unmistakably coming out of the depression." Dr Julius Klein, assistant secretary of commerce.

June 28 1930. "The worst is over without a doubt, and it has been a disciplinary and in some ways constructive experience. People have learned once again that only work produces wealth." James J Davis, secretary of agriculture.

September 18, 1930. "We have hit bottom and are on an upswing." James Davis

October 2, 1930. "Judged by historic precedence, we have now reached a low ebb." Resolution of American Bankers association.

December 6 1930. "We have already weathered the worst of the storm and signs of stability and recovery are already appearing." Robert Lamont, secretary of commerce.

February 1931. "The bottom has now been reached." Roy Young, Federal Reserve Bank of Boston.

March 1931. "The long decline has been halted." Dr Julius Klein.

April 1931. "Business has turned the corner." Roger Babson.

The market ultimately hit bottom in July of 1932 and the depression didn't end until early the next year. The mood at the end of the depression was understandably incredibly bleak and fear was undoubtedly the prevalent mood, the result was a full blown banking crisis in early 1933 with many banks closing their doors. By then it certainly didn't feel like it, but the worst had in fact passed.

I recently stumbled across a similar compilation of comments that were made ahead of and during the cyclical bear market in the early 2000's;

March 1999: Harry S. Dent, author of "The Roaring 2000s." "There has been a paradigm shift." The New Economy arrived, this time really is different.

October 1999: James Glassman, author, "Dow 36,000." "What is dangerous is for Americans not to be in the market. We're going to reach a point where stocks are correctly priced … it's not a bubble ... The stock market is undervalued."

August 1999: Charles Kadlec, author, "Dow 100,000." "The DJIA will reach 100,000 in 2020 after "two decades of above-average economic growth with price stability."

December 1999: Joseph Battipaglia, market analyst. "Some fear a burst Internet bubble, but our analysis shows that Internet companies ... carry expected long-term growth rates twice other rapidly growing segments within tech."

December 1999: Larry Wachtel, Prudential. “Most of these stocks are reasonably priced. There’s no reason for them to correct violently in the year 2000.” NASDAQ lost over 50%.

December 1999: Ralph Acampora, Prudential Securities. “I’m not saying this is a straight line up. ... I’m saying any kind of declines, buy them!”

February 2000: Larry Kudlow, CNBC host. “This correction will run its course until the middle of the year. Then things will pick up again, because not even Greenspan can stop the Internet economy.” He’s still hosting his own cable show.

April 2000: Myron Kandel, CNN. “The bottom line is in, before the end of the year, the Nasdaq and Dow will be at new record highs.”

September 2000: Jim Cramer, host of “Mad Money.” Sun Microsystems “has the best near-term outlook of any company I know.” It fell from $60 to below $3 in two years.

November 2000: Louis Rukeyser on CNN. “Over the next year or two the market will be higher, and I know over the next five to 10 years it will be higher.”

December 2000: Jeffrey Applegate, Lehman strategist. “The bulk of the correction is behind us, so now is the time to be offensive, not defensive.” Another sucker’s rally.

December 2000: Alan Greenspan. “The three- to five-year earnings projections of more than a thousand analysts ... have generally held firm. Such expectations, should they persist, bode well for continued capital deepening and sustained growth.”

January 2001: Suze Orman, financial guru. “The QQQ, they’re a buy. They may go down, but if you dollar-cost average, where you put money every single month into them, I think, in the long run, it’s the way to play the Nasdaq.” The QQQ fell 60% further.

March 2001: Maria Bartiromo, CNBC anchor. “The individual out there is actually not throwing money at things that they do not understand, and is actually using the news and using the information out there to make smart decisions.”

April 2001: Abby Joseph Cohen, Goldman Sachs. “The time to be nervous was a year ago. The S&P was overvalued, it’s now undervalued.” Markets fell 18 more months.

August 2001: Lou Dobbs, CNN. “Let me make it very clear. I’m a bull, on the market, on the economy. And let me repeat, I am a bull.”

June 2002: Larry Kudlow, CNBC host. “The shock therapy of a decisive war will elevate the stock market by a couple thousand points.” He also predicted the Dow would hit 35,000 by 2010.

Ultimately that bear market bottomed in October 2002.

As humans we do like to find comfort amid uncertainty, and the future path of any stock market is obviously uncertain, unfortunately history has repeatedly shown that any comfort found in economic forecasts and general market commentary is misplaced. Markets have always already reflected changes that will eventually manifest themselves in economic numbers, it is not the release of numbers that drives markets it is the level of surprise or disappointment that they deliver that moves

markets and it is sadly the case that the more comfortable and optimistic investors become the greater the risk of disappointment becomes.

The San Juan Hill Theory

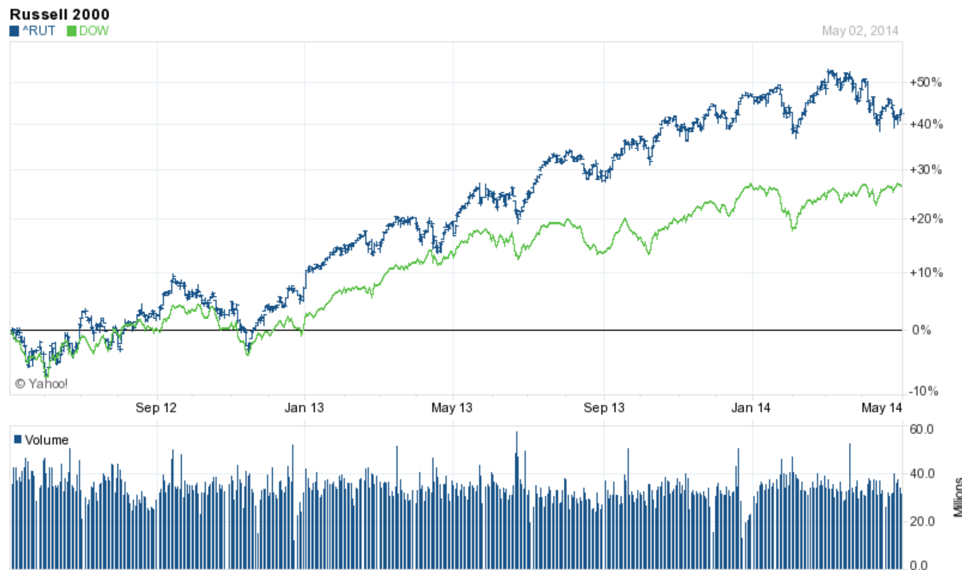
About fifteen years ago I read John Rothchild's book 'The BEAR book, survive and profit in ferocious markets', in it he referred to an 'early warning system' for the onset of a bear market; the 'San Juan Hill Theory';

> *"Hong Kong pundit Marc Faber says stocks reach the top when the generals (large stocks) are charging up the hill while the troops (small stocks) lag behind. It is not uncommon, says Faber, for the generals to plant the flag nine months after the troops have retreated."*

A year and a half ago I discussed the San Juan Hill Theory in relation to global markets;

> Over the last couple of cyclical bull market peaks I have extended this analogy of the 'generals'. Rather than just focussing upon the largest companies in an individual market it has also proved of value to study the breadth of the global market. Prior to both the 2007 peak and the peak in 2011 a deterioration in global breadth was apparent, this continues to be the case despite the much heralded recovery highs recorded by the major US indices.

Since then many markets have continued to struggle while the 'general' that is the US market has obviously continued on to new all-time highs. What is most interesting now is that the San Juan Hill Theory, in its original usage, is flashing a warning signal for the US market as a whole.



The chart above shows the Dow Jones Industrial Average over the last two years compared to the small capitalization Russell 2000 index. Over that period the two indices have moved in virtual lock step with all the major zigs and zags coinciding. The only real difference has been that the small cap index has risen at a faster rate, at least for most of the history shown. This relationship appears to have broken down over the last couple of months. The Russell index peaked on March 4th and since then has been trending down falling as much as ten percent at one point, over the same period the Dow has continued to struggle on to slightly higher highs. This is an almost perfect depiction of Marc Faber's San Juan Hill Theory, the generals (the Dow) are now approaching or at a peak while the troops (small stocks) have been in retreat for a couple of months. It is naturally possible that this relationship

could continue for some time, perhaps even the nine months that Faber originally said it could last, but investors must appreciate that such a situation would be increasingly unhealthy despite the glowing commentary that further rises from the 'generals' would naturally spawn.

It has not only been the small cap stocks that have given way to the generals recently, it is also of concern that the previously high flying technology stocks, the NASDAQ, have rolled over while the Dow has continued higher.

The chart below shows the NASDAQ over the last six months, its weakness since early March is obvious as the index fell ten percent in the six weeks after that peak.

Underperformance of the previous leadership sector is common at market peaks, a similar situation was seen in mid to late 2007 when the previously high flying financials rolled over some time ahead of the market as a whole. It is also worrying that the NASDAQ performance over the last six months has been eerily reminiscent of the market as a whole in 2007. Back then the overall market suffered its most severe setback in more than a year, just as the NASDAQ did in late January, before rallying to a new high. This rapid recovery confirmed to investors that they should stay invested for the long term and that all setbacks or corrections are buying opportunities, they are 'healthy corrections'. From that peak in 2007 markets then fell to a slightly lower level than the previous 'correction' but soon bounced. The rally that followed did not prove to be so 'healthy', it did not get back to the old high and soon rolled over into an even more severe swoon. It will be interesting to watch how both the NASDAQ and the Russell 2000 behave over the coming weeks.

Deflation

Over the last few years I have strongly recommended readers take the time to study Gary Shilling's 'The Age of Deleveraging' and that recommendation still stands. It is an incredibly thorough study of the causes and implications of deflation. His long standing forecast for deflation is still a long way from becoming widely accepted, although fears of pernicious deflation did emerge at the depths of the GFC. The widespread dismissal of deflationary risks is a little surprising given the increasing evidence of deflation emerging.

The Daily telegraph recently ran the headline;

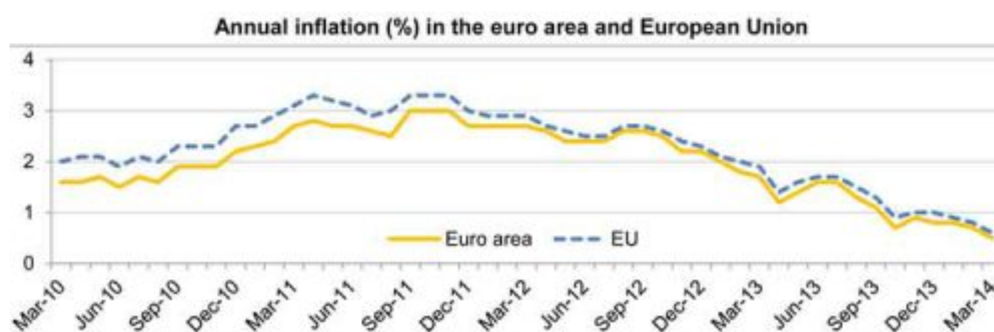
Eight EU states in deflation as calls grow for QE in Sweden

Sweden's Riksbank admitted in its latest monetary report that something unexpected had gone wrong

The article concluded;

> The IMF says there is a 20pc risk of deflation in the eurozone. It also warns that chronic "lowflation" of 0.5pc is also corrosive, making it harder for Italy, Portugal and others to claw back competitiveness without suffering a further rise in their debt ratios. Each year of lowflation pushes southern Europe closer to the limits of debt sustainability.

The two charts below clearly highlight that a strongly disinflationary trend has been in place for a number of years but don't expect the IMF to increase their assessment of the risk of outright deflation until there clearly is outright deflation!



Relative versus absolute performance (active share revisited)

Last week I saw a television advertisement encouraging retail investor to become their own fund managers. The institution behind the ad was urging investors to utilise their large suite of thirty or so funds to build their portfolio. In and of itself this is a great idea but I wondered what the costs would be. I was not surprised to find that in addition to the entry fee on all but cash funds of 0.75% the annual fee was in the range of 1% to 1.85% for equity funds. These are large charges, particularly when the majority of fund managers hug their benchmark and passive alternatives are available in virtually every market of the world with far lower fees.

Benchmark hugging may be understandable but does little to serve the retail investor; nonetheless, it is a problem that has only grown over the last few decades. A few years ago I wrote about the frustration Warren Buffett's mentor, Ben Graham, felt about this behaviour;

> At a conference, after hearing a fund manager state that *"if the market collapses and my funds collapse less that's ok with me. I've done my job."* Graham responded;
>
> *"I was shocked by what I heard at this meeting. I could not comprehend how the management of money by institutions had degenerated from the standpoint of sound investment to this rat race of trying to get the highest possible return in the shortest period of time. Those men gave me the impression of being prisoners to their operations rather than controlling them."*

Things have not improved in the years since Graham's lament at the state of the investment industry, except that very low fee alternatives do now exist so that an individual can become their own fund manager. Another improvement is that there are now tools available so that investors can establish whether or not their managers are benchmark huggers who should charge low fees or active managers striving for real long term returns. One of those measures is 'Active Share' a technique I described at some length in the December 2012 edition of Strategy Thoughts. Active Share looks inside a fund to establish how similar or different its holdings are to the benchmark that it is measured against. Naturally an active share measure showing a fund not to be hugging the index does not mean it will outperform, however, it does mean that it has the chance to outperform whereas that chance does not exist when indices are hugged.

Getting back to the advertisement I described earlier, what appealed to me was that perhaps the institution was encouraging retail investors to have something other than a 'balanced' fund as this is where I continue to believe real value is added over the very long term. This wasn't the case and it is probably understandable that they did not attempt to add such real value.

Establishing secular views and weighting assets for the long term based upon those views is the only way to meaningfully outperform over the very long term. It requires a long term understanding of value and the discipline to avoid the comfort of herding. I would recommend readers examine the following link;

http://www.safehaven.com/article/33519/spx-topping-valuations-3

It contains a study by Adan Hamilton of Safe Haven and provides a great description of secular bull and bear markets and the cyclical moves that build them.

I would also recommend that readers study the memo by Howard Marks to his investors at Oaktree that I have attached to the end of this month's Strategy Thoughts. It was distributed by John Mauldin recently and the title 'Dare To Be Great' captures the essence of what is required to be a successful investor. That is successful in Ben Graham's view not the currently held conventional view of investment success.

Conclusion

As the Zurich axiom in this month's title makes clear, correlation is not the same thing as causation, especially in investment markets. Whatever the prevailing economic situation maybe it is not the driver of markets, markets will have already discounted the current state. Attempting to forecast what a market is going to do based upon an economic forecast is a clear case of putting the cart before the horse, it is futile unless your proprietary view is markedly different from the consensus, is right and

would deliver a major surprise or disappointment. Looking for where there is the greatest risk of disappointment or chance of surprise is far more constructive and rewarding for investors than building an economic view. Currently the risk of disappointment continues to grow as evidenced by the complacent comfort that abounds across the investment media. When the risk of a ten percent 'healthy correction' is supposedly the worst case scenario there is plenty of room for disappointment.

Jeremy Grantham of GMO was interviewed in Fortune last month, he said;

> "We do think the market is going to go higher because the Fed hasn't ended its game, and it won't stop playing until we are in old-fashioned bubble territory and it bursts, which usually happens at two standard deviations from the market's mean. That would take us to 2,350 on the S&P 500, or roughly 25% from where we are now. But to invest our clients' money on the basis of speculation being driven by the Fed's misguided policies doesn't seem like the best thing to do with our clients' money.
>
> We invest our clients' money based on our seven-year prediction. And over the next seven years, we think the market will have negative returns. The next bust will be unlike any other, because the Fed and other central banks around the world have taken on all this leverage that was out there and put it on their balance sheets. We have never had this before. Assets are overpriced generally. They will be cheap again. That's how we will pay for this. It's going to be very painful for investors."

This quote captures the dilemma that all investors face. Currently even bearish commentators, who may share many of my concerns, are tempted to chase potential profits even though they don't believe they should be available. They are merely playing the now very old game of not fighting the FED! As Grantham so eloquently pointed out the eventual unwinding will be very painful. A cautious investment strategy focused upon capital preservation rather than chasing central bank leverage driven returns continues to be my strong recommendation.

Kevin Armstrong

6th May 2014

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Memo to: **Oaktree Clients**

From: **Howard Marks**

Re: **Dare to Be Great II**

In September 2006, I wrote a memo entitled *Dare to Be Great,* with suggestions on how institutional investors might approach the goal of achieving superior investment results. I've had some additional thoughts on the matter since then, meaning it's time to return to it. Since fewer people were reading my memos in those days, I'm going to start off repeating a bit of its content and go on from there.

About a year ago, a sovereign wealth fund that's an Oaktree client asked me to speak to their leadership group on the subject of what makes for a superior investing organization. I welcomed the opportunity. The first thing you have to do, I told them, is formulate an explicit investing creed. What do you believe in? What principles will underpin your process? The investing team and the people who review their performance have to be in agreement on questions like these:

- Is the efficient market hypothesis relevant? Do efficient markets exist? Is it possible to "beat the market"? Which markets? To what extent?
- Will you emphasize risk control or return maximization as the primary route to success (or do you think it's possible to achieve both simultaneously)?
- Will you put your faith in macro forecasts and adjust your portfolio based on what they say?
- How do you think about risk? Is it volatility or the probability of permanent loss? Can it be predicted and quantified *a priori?* What's the best way to manage it?
- How reliably do you believe a disciplined process will produce the desired results? That is, how do you view the question of determinism versus randomness?
- **Most importantly for the purposes of this memo, how will you define success, and what risks will you take to achieve it? In short, in trying to be right, are you willing to bear the inescapable risk of being wrong?**

Passive investors, benchmark huggers and herd followers have a high probability of achieving average performance and little risk of falling far short. But in exchange for safety from being much below average, they surrender their chance of being much above average. All investors have to decide whether that's okay. And, if not, what they'll do about it.

The more I think about it, the more angles I see in the title *Dare to Be Great.* Who wouldn't dare to be great? No one. Everyone would love to have outstanding performance. **The real question is whether you dare to do the things that are necessary in order to be great. Are you willing to be different, and are you willing to be wrong? In order to have a chance at great results, you have to be open to being both.**

Dare to Be Different

Here's a line from *Dare to Be Great:* **"This just in: you can't take the same actions as everyone else and expect to outperform."** Simple, but still appropriate.

For years I've posed the following riddle: Suppose I hire you as a portfolio manager and we agree you will get no compensation next year if your return is in the bottom nine deciles of the investor universe but $10 million if you're in the top decile. **What's the first thing you have to do – the absolute prerequisite – in order to have a chance at the big money?** No one has ever answered it right.

The answer may not be obvious, but it's imperative: you have to assemble a portfolio that's different from those held by most other investors. If your portfolio looks like everyone else's, you may do well, or you may do poorly, *but you can't do different.* And being different is absolutely essential if you want a chance at being superior. In order to get into the top of the performance distribution, you have to escape from the crowd. There are many ways to try. They include being active in unusual market niches; buying things others haven't found, don't like or consider too risky to

touch; avoiding market darlings that the crowd thinks can't lose; engaging in contrarian cycle timing; and concentrating heavily in a small number of things you think will deliver exceptional performance.

Dare to Be Great included the two-by-two matrix and paragraph below. Several people told me the matrix was helpful.

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

> Of course it's not that easy and clear-cut, but I think that's the general situation. If your behavior and that of your managers is conventional, you're likely to get conventional results – either good or bad. **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.**

For those who define investment success as being "average or better," three of the four cells of the matrix represent satisfactory outcomes. But if you define success strictly as being superior, only one of the four will do, and it requires unconventional behavior. More from the 2006 memo:

> The bottom line on striving for superior performance has a lot to do with daring to be great. **Especially in terms of asset allocation, "can't lose" usually goes hand-in-hand with "can't win."** One of the investor's or the committee's first and most fundamental decisions has to be on the question of how far out the portfolio will venture. **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?**

In the memo I mentioned my favorite fortune cookie: "the cautious seldom err or write great poetry." Like the title *Dare to Be Great,* I find the fortune cookie thought-provoking. It can be taken as urging caution, since it reduces the likelihood of error. Or it can be taken as saying you should avoid caution, since it can keep you from doing great things. Or both. No right or wrong answer, but a choice. . . and hopefully a conscious one.

<u>It Isn't Easy Being Different</u>

In the 2006 memo, I borrowed two quotes from *Pioneering Portfolio Management* by David Swensen of Yale. They're my absolute favorites on the subject of institutional behavior. Here's the first:

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

"Uncomfortably idiosyncratic" is a terrific phrase. There's a great deal of wisdom in those two words. What's idiosyncratic is rarely comfortable. . . and in order for something to be comfortable, it usually has to be conventional. The road to above average performance runs through unconventional, uncomfortable investing. Here's how I put it in 2006:

> Non-consensus ideas have to be lonely. **By definition, non-consensus ideas that are popular, widely held or intuitively obvious are an oxymoron.** Thus such ideas are uncomfortable; non-conformists don't enjoy the warmth that comes with being at the center of the herd. Further, unconventional ideas often appear imprudent. The popular definition of "prudent" – especially in the investment world – is often twisted into "what everyone does."

Most great investments begin in discomfort. The things most people feel good about – investments where the underlying premise is widely accepted, the recent performance has been positive and the outlook is rosy – are unlikely to be available at bargain prices. Rather, bargains are usually found among things that are controversial, that people are pessimistic about, and that have been performing badly of late.

But it isn't easy to do things that entail discomfort. It's no coincidence that distressed debt has been the source of many successful investments for Oaktree; there's no such thing as a distressed company that everyone reveres. In 1988, when Bruce Karsh and I organized our first fund to invest in the debt of companies seemingly at death's door, the very idea made it hard to raise money, and investing required conviction – on the clients' part and our own – that our analysis and approach would mitigate the risk. The same discomfort, however, is what caused distressed debt to be priced cheaper than it should have been, and thus the returns to be consistently high.

<u>Dare to Be Wrong</u>

"You have to give yourself a chance to fail." That's what Kenny "The Jet" Smith said on TV the other night during the NCAA college basketball tournament, talking about a star player who started out cold and as a result attempted too few shots in a game his team lost. It's a great way to make the point. Failure isn't anyone's goal, of course, but rather an inescapable potential consequence of trying to do really well.

Any attempt to compile superior investment results has to entail acceptance of the possibility of being wrong. The matrix on page two shows that since conventional behavior is sure to produce average performance, people who want to be above average can't expect to get there by engaging in conventional behavior. Their behavior has to be different. **And in the course of trying to be different and better, they have to bear the risk of being different and worse.** That truth is simply unarguable. There is no way to strive for the former that doesn't require bearing the risk of the latter.

The truth is, almost everything about superior investing is a two-edged sword:

- If you invest, you will lose money if the market declines.
- If you don't invest, you will miss out on gains if the market rises.

- Market timing will add value if it can be done right.

- Buy-and-hold will produce better results if timing can't be done right.

- Aggressiveness will help when the market rises but hurt when it falls.
- Defensiveness will help when the market falls but hurt when it rises.

- If you concentrate your portfolio, your mistakes will kill you.
- If you diversify, the payoff from your successes will be diminished.

- If you employ leverage, your successes will be magnified.
- If you employ leverage, your mistakes will be magnified.

Each of these pairings indicates symmetry. None of the tactics listed will add value if it's right but not subtract if it's wrong. Thus none of these tactics, in and of itself, can hold the secret to dependably above average investment performance.

There's only one thing in the investment world that isn't two-edged, and that's "alpha": superior insight or skill. Skill can help in both up markets and down markets. And by making it more likely that your decisions are right, superior skill can increase the expected benefit from concentration and leverage. But that kind of superior skill by definition is rare and elusive.

The goal in investing is asymmetry: to expose yourself to return in a way that doesn't expose you commensurately to risk, and to participate in gains when the market rises to a greater extent than you participate in losses when it falls. But that doesn't mean the avoidance of all losses is a reasonable objective. Take another look at the goal of asymmetry set out above: **it talks about achieving a preponderance of gain over loss, not avoiding all chance of loss.**

To succeed at any activity involving the pursuit of gain, we have to be able to withstand the possibility of loss. A goal of avoiding all losses can render success unachievable almost as readily as can the occurrence of too many losses. Here are three examples of "loss prevention strategies" that can lead to failure:

- I play tennis. But if when I start a match I promise myself that I won't commit a single double fault, I'll never be able to put enough "mustard" on my second serve to keep it from being easy for my opponent to put away.
- Likewise, coming out ahead at poker requires that I win a lot on my winning hands and lose less on my losers. But insisting that I'll never play anything but "the nuts" – the hand that can't possibly be beat – will keep me from playing lots of hands that have a good chance to win but aren't sure things.
- For a real-life example, Oaktree has always emphasized default avoidance as the route to outperformance in high yield bonds. Thus our default rate has consistently averaged just 1/3 of the universe default rate, and our risk-adjusted return has beaten the indices. But if we had insisted on – and designed compensation to demand – zero defaults, I'm sure we would have been too risk averse and our performance wouldn't have been as good. As my partner Sheldon Stone puts it, "If you don't have any defaults, you're taking too little risk."

When I first went to work at Citibank in 1968, they had a slogan that "scared money never wins." **It's important to play judiciously, to have more successes than failures, and to make more on your successes than you lose on your failures. But it's crippling to have to avoid all failures, and insisting on doing so can't be a winning strategy. It may guarantee you against losses, but it's likely to guarantee you against gains as well.** Here's some helpful wisdom on the subject from Wayne Gretzky, considered by many to be the greatest hockey player who ever lived: **"You miss 100% of the shots you don't take."**

There is no formulaic approach to investing that can be depended on to produce superior risk-adjusted returns. There can't be. In a relatively fair or "efficient" market – and the concerted efforts of investors to find underpriced assets tend to make most markets quite fair – asymmetry is reduced, and a formula that everyone can access can't possibly work.

As John Kenneth Galbraith said, "There is nothing reliable to be learned about makingmoney. If there were, study would be intense and everyone with a positive IQ would be rich." If merely applying a formula that's available to everyone could be counted on to provide easy profits, where would those profits come from? Who would be the losers in those transactions? Why wouldn't those people study and apply the formula also?

Or as Charlie Munger told me, "It's not supposed to be easy. Anyone who finds it easy is stupid." In other words, anyone who thinks it can be easy to succeed at investing is being simplistic and superficial, and ignoring investing's complex and competitive nature.

Why should superior profits be available to the novice, the untutored or the lazy? Why should people be able to make above average returns without hard work and above average skill, and without knowing something most others don't know? And yet many individuals invest based on the belief that they can. (If they didn't believe that, wouldn't they index or, at a minimum, turn over the task to others?)

No, the solution can't lie in rigid tactics, publicly available formulas or loss-eliminating rules . . . or on complete risk avoidance. **Superior investment results can only stem from a better-than-average ability to figure out when risk-taking will lead to gain and when it will end in loss.** There is no alternative.

<u>Dare to Look Wrong</u>

This is really the bottom-line: not whether you dare to be different or to be wrong, but whether you dare to look wrong.

Most people understand and accept that in their effort to make correct investment decisions, they have to accept the risk of making mistakes. Few people expect to find a lot of sure things or achieve a perfect batting average.

While they accept the intellectual proposition that attempting to be a superior investor has to entail the risk of loss, many institutional investors – and especially those operating in a political or public arena – can find it unacceptable to look significantly wrong. Compensation cuts and even job loss can befall the institutional employee who's associated with too many mistakes.

As *Pensions & Investments* said on March 17 regarding a big West Coast bond manager currently in the news, whom I'll leave nameless:

> . . . asset owners are concerned that doing business with the firm could bring unwanted attention, possibly creating headline risk and/or job risk for them. . . .
>
> One [executive] at a large public pension fund said his fund recently allocated $100 million for emerging markets, its first allocation to the firm. He said he wouldn't do that today, given the current situation, because it could lead to second-guessing by his board and the local press.
>
> "If it doesn't work out, it looks like you don't know what you are doing," he said.

As an aside, let me say I find it perfectly logical that people should feel this way. Most "agents" – those who invest the money of others – will benefit little from bold decisions that work but will suffer greatly from bold decisions that fail. The possibility of receiving an "attaboy" for a few winners can't balance out the risk of being fired after a string of losers. Only someone who's irrational would conclude that the incentives favor boldness under these circumstances. Similarly, members of a non-profit organization's investment committee can reasonably conclude that bearing the risk of embarrassment in front of their peers that accompanies bold but unsuccessful decisions is unwarranted given their volunteer positions.

I'm convinced that for many institutional investment organizations the operative rule – intentional or unconscious – is this: "We would never buy so much of something that if it doesn't work, we'll look bad." For many agents and their organizations, the realities of life mandate such a rule. But people who follow this rule must understand that by definition it will keep them from buying enough of something that works for it to make much of a difference for the better.

In 1936, the economist John Maynard Keynes wrote in *The General Theory of Employment, Interest and Money,* "Worldly wisdom teaches that it is better *for reputation* to fail conventionally than to succeed unconventionally" [italics added]. For people who measure success in terms of dollars and cents, risk taking can pay off when gains on winners are netted out against losses on losers. **But if reputation or job retention is what counts, losers may be all that matter, since winners may be incapable of outweighing them. In that case, success may hinge entirely on the avoidance of unconventional behavior that's unsuccessful.**

Often the best way to choose between alternative courses of action is by figuring out which has the highest "expected value": the total value arrived at by multiplying each possible outcome by its probability of occurring and summing the results. As I learned from my first textbook at Wharton fifty years ago *(Decisions Under Uncertainty* by C. Jackson Grayson, Jr.), if one act has a higher expected value than another and ". . . if the decision maker is willing to regard the consequences of each act-event in purely *monetary* terms, then this would be the logical act to choose. Keeping in mind, however, that *only one event and its consequence will occur* (not the weighted average consequence)," agents may not be able to choose on the basis of expected value or the weighted average of all possible consequences. **If a given action has potential bad consequences that are**

absolutely unacceptable, the expected value of all of its consequences – both good and bad – can be irrelevant.

Given the typical agent's asymmetrical payoff table, the rule for institutional investors underlined above is far from nonsensical. But if it is adopted, this should be done with awareness of the likely result: over-diversification. This goes all the way back to the beginning of this memo, and each organization's need to establish its creed. In this case, the following questions must be answered:

- In trying to achieve superior investment results, to what extent will we concentrate on investments, strategies and managers we think are outstanding? Will we do this despite the potential of our decisions to be wrong and bring embarrassment?
- Or will fear of error, embarrassment, criticism and unpleasant headlines make us diversify highly, emulate the benchmark portfolio and trade boldness for safety? Will we opt for low-cost, low-aspiration passive strategies?

In the course of the presentation described at the beginning of this memo, I pointed out to the sovereign wealth fund's managers that they had allocated close to a billion dollars to Oaktree's management over the preceding 15 years. Although that sounds like a lot of money, it actually amounts to only a few tenths of a percent of what the world guesses their assets to be. And given our funds' cycle of investing and divesting, that means they didn't have even a few tenths of a percent of their capital with us at any one time. Thus, despite our good performance, I think it's safe to say Oaktree couldn't have had a meaningful impact on the fund's overall results. Certainly one would associate this behavior with an extreme lack of risk tolerance and a high aversion to headline risk. I urged them to consider whether this reflects their real preference.

Lou Brock of the St. Louis Cardinals was one of baseball's best base stealers between 1966 and 1974. He's the source of a great quote: **"Show me a guy who's afraid to look bad, and I'll show you a guy you can beat every time."** What he meant (with apologies to readers who don't understand baseball) is that in order to prevent a great runner from stealing a base, a pitcher may have to throw over to the bag ten times in a row to hold him close, rather than pitch to the batter. But after a few such throws, a pitcher can look like a scaredy-cat and be booed. Pitchers who were afraid of those things were easy pickings for Lou Brock. Fear of looking bad ensured their failure.

<u>Looking Right Can Be Harder Than Being Right</u>

Fear of looking bad can be particularly debilitating to an investor, client or manager. This is because of how hard it is to consistently make correct investment decisions. Some of this comes from my last memo, on the role of luck.

- First, it's hard to consistently make decisions that correctly factor in all of the relevant facts and considerations (i.e., it's hard to be right).
- Second, it's far from certain that even "right" decisions will be successful, since every decision requires assumptions about what the future will look like, and even reasonable assumptions can be thwarted by the world's randomness. Thus many correct decisions will result in failure (i.e., it's hard to <u>look</u> right).

- Third, even well-founded decisions that eventually turn out to be right are unlikely to do so promptly. This is because not only are future events uncertain, their timing is particularly variable (i.e., it's impossible to look right on time).

This brings me to one of my three favorite adages: **"Being too far ahead of your time is indistinguishable from being wrong."** The fact that something's cheap doesn't mean it's going to appreciate tomorrow; it can languish in the bargain basement. And the fact that something's overpriced certainly doesn't mean it'll fall right away; bull markets can go on for years. As Lord Keynes observed, "the market can remain irrational longer than you can remain solvent."

Alan Greenspan warned of "irrational exuberance" in December 1996, but the stock market continued upward for more than three years. A brilliant manager I know who turned bearish around the same time had to wait until 2000 to be proved correct. . . during which time his investors withdrew much of their capital. He wasn't "wrong," just early. But that didn't make his experience any less painful.

Likewise, John Paulson made the most profitable trade in history by shorting mortgage securities in 2006. Many others entered into the same transactions, but too early. When the bets failed to work at first, the appearance of being on the wrong track ate into the investors' ability to stick with their decision, and they were forced to close out positions that would have been extremely profitable.

In order to be a superior investor, you need the strength to diverge from the herd, stand by your convictions, and maintain positions until events prove them right. Investors operating under harsh scrutiny and unstable working conditions can have a harder time doing this than others.

That brings me to the second quote I promised from Yale's David Swensen:

> . . . active management strategies demand uninstitutional behavior from institutions, creating a paradox that few can unravel.

Charlie Munger was right about it not being easy. **I'm convinced that everything that's important in investing is counterintuitive, and everything that's obvious is wrong.** Staying with counterintuitive, idiosyncratic positions can be extremely difficult for anyone, especially if they look wrong at first. So-called "institutional considerations" can make it doubly hard.

Investors who aspire to superior performance have to live with this reality. **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.** Thus each person has to assess whether he's temperamentally equipped to do these things and whether his circumstances – in terms of employers, clients and the impact of other people's opinions – will allow it ... when the chips are down and the early going makes him look wrong, as it invariably will. Not everyone can answer these questions in the affirmative. It's those who believe they can that should take a chance on being great.

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