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Capturing Inefficiencies: The Rare Insight of Howard Marks, CFA®

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CAPTURING INEFFICIENCIES

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Howard Marks, MBA, CFA®

Investor and writer Howard Marks is a co-founder and co-chairman of Oaktree Capital Management, the world's largest distressed debt investor.[1] Recognized in the investment community for his memos to Oaktree clients, Marks uses these missives to inform clients about his investment strategies, his opinions about market opportunities and risks, and his insights about the economy. He is also the author of a 2011 book, The Most Important Thing: Uncommon Sense for the Thoughtful Investor.[2]

Marks began his career at Citicorp Investment Management, where he was an equity research analyst, the company's director of research, and, eventually, vice president and senior portfolio manager in charge of convertible and high yield securities. He joined TCW Group in 1985, where he held responsibility for investments in high yield bonds, convertible securities, and distressed debt. He left TCW in 1995 to become one of the founders of Oaktree. As of September 30, 2015, Oaktree managed assets of $100 billion for institutional clients, endowments and foundations, insurance companies, wealthy individuals, and mutual funds.[3] As co-chairman of Oaktree, Marks divides his time between Los Angeles, New York, and London, dispatching his memos to Oaktree's 1,800 clients worldwide.

Marks grew up in Queens, New York, the son of an accountant and a homemaker.[4] He earned a B.S.Ec. *from The Wharton School, University of Pennsylvania, graduating* cum laude *with a major in finance. Marks earned an MBA in accounting and marketing from the University of Chicago Booth School of Business. Marks is a member of the investment committees of the Metropolitan Museum of Art and the Edmond J. Safra Foundation, a trustee of the Metropolitan Museum, chair of the board of trustees of the Royal Drawing School in London, and an emeritus trustee of the University of Pennsylvania.*

In November 2015, Marks spoke with members of the Journal of Investment Consulting *Editorial Advisory Board about his investment philosophy and Oaktree's corporate culture. Taking part in the discussion were Margaret M. Towle, PhD, CAIA®, CIMA®, CPWA®, editor-in-chief of the* Journal*; Edward Baker, The Cambridge Strategy; Ludwig Chincarini, PhD, University of San Francisco and United States Commodity Funds; Michael T. Dieschbourg, CIMA®, Federated Investors; Geoffrey Gerber, PhD, TWIN Capital Management; and Meir Statman, PhD, Santa Clara University.*

This interview is the seventeenth in the Journal's *Masters Series, which is devoted to topical discussions with experts and visionaries in finance, economics, and investments.*

Margaret Towle: In your book, *The Most Important Thing*, you write about the positive influences your academic career, both at the University of Pennsylvania and the University of Chicago, had in shaping your investment philosophy and professional achievements. You also talk about the role of luck, which ironically is a theme throughout our Masters interviews. In addition to these two factors, what other factors, either professional or personal, helped carry you to where you are today?

Howard Marks: My philosophy of investing was built primarily on experiences but also on things I read: John Kenneth Galbraith's ideas about cycles, the importance of contrarianism and being countercyclical, and the importance of not being a forecaster, and Charlie Ellis's article on "The Loser's Game"—the desirability of just keeping the ball in play rather than trying to hit home runs.[5] Concepts like these were very important to me.

The pivotal event in my career happened in 1978 when, after ten years in equity research, I switched to portfolio management and was assigned to Citicorp's fixed income department to manage a convertible securities portfolio. Then a few months later, a client said, "I'd like to have a high yield bond portfolio." The bosses said, "Well, give it to Marks." If not for that, I wouldn't be where I am today, and I wouldn't have had the experiences that have shaped my career. Peter Vermilye at Citicorp permitting me to move to California in 1980 was also extremely important.[6]

Margaret Towle: What would you consider your major achievement so far—either as part of your career or in your personal life?

Howard Marks: Well, of course, having a warm family and two kids who are in good shape, and now a son-in-law and a granddaughter—these are the most important things in life. Aside from that, leading a firm to a record of pretty consistent success in the absence of glaring failures is very satisfying, although that's not my achievement alone. In addition, building a major firm, while sticking to the high road in terms of integrity and treatment of people, is also very important to me.

Finally, my writing—sharing my investment philosophy with other people through my memos and my book, and having others say they like to read what I write—is very satisfying. The act of writing itself is a great pleasure for me.

Margaret Towle: There's no question that your written works have influenced a number of people—contrary to a statement you made in an interview that when you first started publishing your memos, when you jokingly said you weren't sure if people were reading them because you never got any comments.

Howard Marks: I wasn't joking. For the first ten years, I never had a response.

Margaret Towle: Conversely, what do you consider your greatest challenge or disappointment?

Howard Marks: The main challenge is just doing well in the competitive world we live in. Nobody bats 1,000 in investing, but our firm has never had a fund that lost money, and very few big losers or terrible years.

My greatest challenge on a personal level is dealing with people. When you hire, you get it right only a certain percentage of the time. And then of the people you hire who are good performers, a certain percentage will either leave or turn out to be difficult to work with. Managing the people side of a business and keeping an organization together is a great challenge, especially when a firm reaches the size of ours.

Margaret Towle: You've stated in the past that your success is based on an effective investment philosophy and implementing that philosophy with highly skilled individuals who share a culture and values. Would you please tell us how you've managed to foster a strong culture and shared values at Oaktree in the past, and now, given the organization's size, how you and your senior management team plan to foster a strong culture and shared values going forward?

Howard Marks: My early experiences were in large organizations. Citicorp was huge and highly political, and though TCW was a lot smaller, it was still a good-sized organization. TCW was not political, but given the way it was organized, it lacked glue. It wasn't designed to have glue. It was designed to just bring in smart people and give them a lot of incentive and turn them loose.

Over the years I gained an appreciation for the desirability of having people work closely together. I like working closely with others, and I think a team of people working closely can do better than one individual. I also developed the feeling that I'd rather work in an organization that is not political and not hierarchical.

Maybe that feeling began the day I started work at Citicorp in 1968. My dad took me aside and said: "Look, when you deal with these people, remember they're people just like you. You're not inferior. You're starting off lower on the totem pole, but everybody should treat everyone else as equals." That's always been my inclination. Some of us have higher IQs, are better at our jobs, or have bigger jobs, but we're all important as people, and we all deserve respect.

The other thing is that my partners and I have always reinforced one another's integrity. We all want a firm that operates on the high road. So there's a thread among our company's leaders that reinforces the principle that we won't cut any corners to increase success or make more money.

I wrote a memo back in 2003 called "The Most Important Thing," which is where the idea for the book came from.[7] In that memo, I said one of the twenty most important things was shared values and complementary skills. There are a lot of different possible cultures, and just like in a marriage, it's great to have partners whose outlook on life is the same as yours. I've been lucky in that regard.

There are organizations that consist of the cowboys and the chickens, the clergy and the killers, however you want to describe them. We just have a group of people who are attracted to the idea of teamwork. We don't have an individual-centered culture. It's not a bureaucracy in which everybody who has the same amount of experience has to make the same amount of money. I think it's a meritocracy.

Our firm doesn't worship short-term results, or just this year's numbers, or "What did you do for me lately?" It respects teamwork, long-term potential, and contributions other than short-term, quantitative gains. I'm proud of our organization's culture, and I consider myself the person with the greatest responsibility for perpetuating it. This is an important part of my job description. We meet a lot. We talk a lot. My memos are directed at maintaining a certain culture.

Margaret Towle: Oaktree has thrived under your leadership, so your values, the firm's culture, and your leadership style seem to be working. What is your process for handling organizational problems, and why do you think it has been effective?

Howard Marks: It's always been consultative. When we started, Bruce Karsh and I were the two senior-most partners. I was chairman; he was president. We had the same amount of ownership. I think we devoted the most time to operation of the company. The other partners—Sheldon Stone, Larry Keele, and Richard Masson—pretty much restricted themselves to doing their investment jobs, although if an important decision was needed, Bruce and I would hash out a conclusion and then consult with Sheldon, Larry, and Richard. The five of us were the principals. Later we admitted a few new principals, who sometimes joined us in making those decisions. But Bruce and I handled a lot of it. We had the strongest inclination to do that kind of thing.

In 2006, I believe, we elevated John Frank, who was our general counsel and we thought had very good judgment, to the position of managing principal. Over time, he oversaw all the noninvestment functions, and he would make those decisions, consulting with us when appropriate. Then in 2007, we went on the Goldman Sachs platform for unregistered equities and at that point took on some outside directors.

We went public in 2012 with a full board, which included Jay Wintrob, whom Bruce and I have known for decades and who had a great career at AIG (American International Group). Then in November 2015, we made Jay our chief executive officer (CEO), our first experienced corporate top executive. We concluded that the firm had become large enough, diverse enough, and complex enough that it needed somebody who had run a large firm. Jay had had a huge job as CEO of AIG Retirement and Life, and he came in to help us make the big decisions.

The spirit at Oaktree is collaborative and consultative. Nobody says, "That's my job," or "That's not your job," or that kind of thing. I'd like to think that we don't have fiefdoms and that people are open. The other thing I like to believe is that people come to me when they need my advice, but I don't require them to come to me about everything. Bruce Karsh feels the same. He and I are still very much involved in management, but Jay is the full-time guy.

I also consider our firm a low-ego place. People don't fight to preserve their areas of responsibility by excluding others in order to protect their egos. I think this leads people to ask for help when it's appropriate.

Edward Baker: I recently heard a talk by Noreena Hertz, who has spent a lot of time studying corporate cultures and has concluded that diversity and disagreement are elements that contribute to a company's long-term success.[8] Would you agree with that, and, if so, how do you balance that with the need for stability and uniformity?

Howard Marks: Well, diversity and disagreement are two different things, and both are desirable. You don't want people drinking the Kool-Aid and blindly following a bunch of pronouncements carved on the wall. You want thinking to take place. But on the other hand, you want people pulling together, not separately, and how you accomplish that is art, not science. There are no rules for it.

I believe it's fair to say that Oaktree is not hierarchical. Another thing my dad said on that day in 1968 was: "Don't call anybody 'mister.' We're all just people." I don't think anybody at Oaktree says, "Mr. this" or "Ms. that." I believe anybody at Oaktree would call me or Bruce or Jay if they had an idea to present, and I think that's valuable.

As for disagreement, I hope a junior person has no hesitation about saying, "Look, that doesn't sound right to me." If the person has reasons and isn't afraid of getting into trouble just for disagreeing, you're on the right track.

I wrote a memo in 2006 called "Dare to Be Great," in which I talked about committees.[9] I'm not crazy about committees. We don't have many committees at Oaktree. What I said in that memo was: "If you have a committee, what you need is sparks. You need disagreement, because if everybody's polite and goes along to get along, what are you accomplishing? If everybody speaks as one, then one could probably have done the job." So I support disagreement so long as it is courteous and friendly.

Meir Statman: I wonder if you might connect your work with your background at Chicago and Wharton. Both institutions, but especially Chicago, are known for emphasizing market efficiency. Your work seems to be, if not diametrically opposed, at least different from that. How would you put those approaches side by side?

Howard Marks: My attendance at Wharton preceded its adoption of the efficient market hypothesis. And my approach is very much informed by what I learned at Chicago. As I said, I spent ten years in equities, and when they asked, "What do you want to do next?" I said, "I'll do anything except spend the rest of my life choosing between Merck and Lilly." It seemed to me that that's the kind of thing you can't do profitably often, and that's because of market efficiency.

I consider market efficiency extremely relevant to my work. I wrote a memo in 2001 called "What's It All About, Alpha?"[10] In this memo, I talked about how to juxtapose the pragmatic education I had at Wharton with the theoretical one I had at Chicago. I believe it's important to do that, and I think going to both schools was invaluable. Either would have been fine, but both meant two plus two equals seven.

What that has meant for me is an emphasis on finding markets where mistakes are being made. That's my definition of inefficiency. You shouldn't presume this is true of all markets, and you shouldn't presume you can just walk into any market and pick off the mistakes. I wrote a memo in January 2014 called "Getting Lucky," in which I said that among my luckiest breaks consisted of being assigned to what turned out to be inefficient markets in the early stages of their existence.[11] I guess I was prepared enough to understand that they were inefficient markets and what made them that way.

Ludwig Chincarini: Although you've argued that no market is completely efficient or inefficient, you've claimed that a market characterized by mistakes and mispricing can be beaten by people with rare insight. Can you provide some examples of how you deal with more-efficient markets and how you identify inefficiencies?

Howard Marks: Consider high yield bonds, for example. When I met Mike Milken[12] in 1978, he said to me, "You know, if you buy single-B bonds[13] and they survive, all of the surprises will be on the upside." What that told me was that I should try to hold only bonds that survive and weed out the defaults—that I shouldn't look for upgrades, take-overs, or serendipitous benefits. Just weed out the losers. We continue to do that in high yield bonds, and I think that's still the right strategy.

Our long-term experience at Oaktree consists of having only a third of the defaults that the average has. I believe there is such a thing as a superior credit analyst. This is the approach we've taken over the years, and I believe it will still work in the future.

However, there have been almost no defaults over the past five years, so this has recently been a hard way for us or anybody else to excel. I think defaults will resume and we'll see if we continue to avoid most of them, but I still believe that's an example of understanding the task.

In that January 2014 memo "Getting Lucky," I said there are fewer markets, if any, today, that I would consider structurally inefficient. The high yield bond market was structurally inefficient when I entered it in 1978. People said, "It's not right, it's not proper, we have a rule against it, we would never do it, it's risky, it's junk." When 90 percent of investment organizations have a rule against owning single-B bonds, then there's a chance that single-B bonds will be cheaper than other bonds, and they were. Nobody has that rule anymore, so it gets harder over time to outperform the market, because the market is intelligent. The market doesn't know everything, but it doesn't know nothing, and knowledge is cumulative. The market knows stuff now that it didn't know forty years ago, so it's harder to outperform. The margin of outperformance should be expected to narrow, but I believe it will still be possible to outperform. We'll see.

Ludwig Chincarini: Given your basic assumptions about the efficient market hypothesis, what do you think of smart beta exchange-traded funds (ETFs) and the proliferation of smart strategies?

Howard Marks: I don't think ETFs claim to be smart, but I don't know about all of them. Most of them are passive proxies, as I understand it.

What does smart beta mean? I think it means tilts. I think it means taking a passive vehicle and tilting it toward small, toward risk, toward quality, whatever. The answer to your question is there's nothing that always works. Let's say I want an ETF, and there's one that invests in the S&P (Standard & Poor's 500 Index). If you say, I'll give you an S&P fund that's tilted toward quality, I'm sure you can do that, but the point is it will work sometimes, it won't work other times, so what's smart about that? Smart strategies are smart only if they put you more into holdings that have a superior risk-invested return. If a client wants a quality index fund, a quality tilt, and you provide it, that's not necessarily smart—I mean it shouldn't be expected to outperform the index all of the time.

Geoffrey Gerber: Are you saying what you do can't necessarily be packaged? For example, I can't package what you do because of the human element?

Howard Marks: I don't think you can. And yes, that's because of the human element. I believe the market accurately reflects not the truth, which is what the efficient market hypothesis says, but it accurately and efficiently reflects everybody's opinion as to what's true. To outperform it, you have to see the truth better than the consensus of everybody else. I like to say there's no such thing as superior investing without superior judgment. Now, it happens, for example, that Jim Simons's Renaissance Fund has had a highly superior record.[14] It's run by machines, as I understand it, although it's quite a black box and we don't know exactly how it works. But if it succeeds because of its black box, then I think someone with superior insight designed that black box. When people say, "We'll give you better results through a system that does not require judgment," this seems to me to be an oxymoron.

Michael Dieschbourg: I'm sensing that you consider it more important to minimize losses through your investment process than trying to maximize gain, because you'll get the market return if you're invested in the market, but you want to avoid big losses.

Howard Marks: What you're describing is what Graham and Dodd called a "negative art" in their book *Security Analysis*.[15] They said fixed income investing—they called it fixed-interest investing—is a negative art, which means you improve the performance of your portfolio not by what you put in but by what you take out, by taking out the ones that do badly.

Now, that's true for straight fixed income investments. In other words, if you buy a hundred 7-percent bonds, all of the ones that pay are going to pay 7 percent. The only way to improve the return is by excluding the ones that don't pay, because it doesn't matter which of the ones that pay you hold. But when you get away from straight fixed income investments, simply avoiding the losers is not enough. You also have to find some winners. We have a lot of strategies that are not really fixed income strategies—convertibles, distressed debt, real estate, private equity, power infrastructure. In the area of distressed debt, we have achieved a gross return of about 23 percent a year for twenty-seven years without using any leverage. You can't do that without finding winners.

Oaktree's motto is, "If we avoid the losers, the winners take care of themselves." That's a mindset; it's not a roadmap. Whenever we consider an investment, we think just as much or more about what can go wrong as about what can go right, and we put the avoidance of losses on a high pedestal. That's not the only thing we consider, but we put it first.

Michael Dieschbourg: So you want to stay in the market no matter what—buy and hold. You're basically saying avoid losses first and then focus on winners. It's a two-step process.

Howard Marks: I think it's fair to say that. It's not always step one, step two; sometimes you do them at the same time. But the point is to consider risk control, loss avoidance, at least as important as return.

Geoffrey Gerber: You like to quote Warren Buffet when discussing the concept of the perversity of risk. As you mentioned, that's the counterintuitive notion that a crowd's perception of high risk can bring safety and a crowd's perception of abundant safety can bring risk. You've attributed this phenomenon in part to the fact that most investors fail to distinguish between fundamental risk and investment risk. Would you elaborate on that and give us some examples?

Howard Marks: When you want to understand the perversity of risk, it's important to recognize that the riskiness of investing comes only partly from the things you invest in. A lot of the risk comes from the behavior of the participants. Almost any asset can be risky or safe, depending on how other investors treat it.

You asked earlier about the formative influences on me. Entering the equity business in 1968 at an institution that practiced nifty-fifty investing was a formative influence because over the next five years or so, we lost 80 or 90 percent of our clients' money while investing in the best companies in America.[16] That was a pretty good object lesson that the safety or risk in investing doesn't come from the securities you buy or the companies whose securities they are. Safety and risk come from how the investments are priced. We lost that money because we bought those stocks at price/earnings ratios of 80 and 90, as I recall.

I said in my book that there's no asset so good that it can't be overpriced and become a bad investment, and very few assets are so bad that they can't be underpriced and be a good investment. People just don't understand this. They say things like, "This is a great company, and you should buy the stock." If it's a great company, maybe you should buy the stock—but only at a good price.

More things matter than price. Chapter three of the book says the most important thing is value, and chapter four says the most important thing is the relationship between price and value. You have to buy an asset at a price that is attractive and reasonable for its value.

Edward Baker: Another element of this is the macro-economic framework—another source of risk that one needs to be sensitive to, as well as perhaps a source of opportunity. In the modern world, of course, central-bank policy seems to be a dominant feature. How has your thinking worked out in this area, or do you think it's all much ado about nothing?

Howard Marks: Well, it's not about nothing. The macro economy has certainly been the dominant consideration for the past ten years at least, if not more, and the Fed's actions are very influential. But my goal is not to be an average investor; my goal is to be a superior investor. Whatever your forecasts are, they're not going to contribute to your being a superior investor unless they are superior. I've listened to a lot of economic briefings, and I've had a lot of visits from economists, and I've never encountered one who was right consistently. In fact, I've heard it said that an economist is a portfolio manager who never marks to market. Everybody knows my record and Oaktree's record, but the economists don't publish their records.

Did you ever hear an economist say, "I think we're going to have gross domestic product growth of 2.4 percent, and over the past forty quarters, on average, I predicted XYZ, and, on average, the result was ABC"? Where are the economists who are right consistently? Consistently doesn't mean all of the time, but it means more often than not in meaningful ways.

Extrapolation is usually right, but not valuable, and predictions of deviation from trends are potentially profitable but rarely right. So for me, macro-economic forecasting doesn't represent the path to superior investments.

Meir Statman: Of course, it is not possible that all investors are going to be superior. The finding is that, in general, money-management companies make money for their managers, but investors are left behind. From this comes the recommendation that regular investors choose broadly diversified index funds—no cost, no beta tilts, just plain index funds. How do you counter that?

Howard Marks: I don't counter that. I agree.

Meir Statman: So why should someone choose active managers when their costs are higher and it's not at all clear that they provide superior returns to their investors?

Howard Marks: Don't ask me. Ask the managers. Ask the clients.

Meir Statman: Well, the managers don't tell me about the average returns, and the clients—I don't want to besmirch them, but frankly I think too many of them are perfectly ignorant. They have no idea of what they are getting, and they are likely influenced by what you talked about, for example, not knowing the difference between a company that is good and an investment that is good.

Howard Marks: Well, sadly, I agree with you. First of all, Oaktree is not active in efficient markets, and your comments really apply to efficient markets and mostly to the large stock market. On average, the average large-stock manager produces average returns before fees and below-average returns after fees. So compared with after-fee returns, an index fund is superior.

Very few people have beaten that argument. People invest with certain managers because they get four stars instead of three. Maybe a four-star manager doesn't beat the S&P—I don't know—but I'm convinced that in efficient markets, you shouldn't charge a large management fee for choosing between Merck and Lilly. I also believe, however, that there are inefficient markets in which you can outperform the indexes.

Meir Statman: Even in efficient markets, if some managers are producing above-average returns, there must be some who are producing below-average returns. Who are they, and why is it that they don't get the point and are still trying to beat the market if they don't know how?

Howard Marks: I think the key here is an intelligent customer. You remember that guy who sold suits on TV, Sy Syms?[17] He said an intelligent and educated consumer is our best customer. I think retail investors are not educated. First of all, they have no idea about risk-adjusted performance, and risk-adjusted performance is not easy to calculate. Then, they're sold a bill of goods, and they want to get rich easily. Investing is a hard area for most people to figure out what to do.

The big idea nowadays with people in their twenties and thirties, maybe teens, is disrupt—Uber disrupts the taxi industry, Airbnb disrupts the hotel industry, and Amazon disrupts the book stores. What is the key? Information. Today, you can easily find the cheapest price for a given book, and this kind of information generates educated consumers. But information about our industry is scant. It's hard to go to any website and find out everybody's risk-adjusted performance. In this respect, our industry is prehistoric by current standards.

Ludwig Chincarini: You mentioned that the key to successful investing is distinguishing between price and value. I think a lot of people agree with that, but they have a hard time figuring out value relative to price. What are your thoughts on this?

Howard Marks: Galbraith said, "There's nothing intelligent to be learned about making money, because if there were, study would be intense and everybody with a positive IQ would be rich." If the discernment of value could be reduced to an algorithm and taught, then everybody would be Warren Buffet. The answer is it's a matter of judgment. What's good about the company, what's bad about the company, how defensible is its position, how good are its products, at what rate will it grow, its revenues, and the outlook for its profit margins. These things have to be assessed by experts. A lot of people out there are trying, but not everybody gets it right, so it all comes down to superior judgment.

What makes investing interesting is that it can't be reduced to an algorithm. I think superior judgment always will produce a payoff, although it might conceivably be a declining payoff. I mentioned this in my 2014 memo "Getting Lucky." More people are investing in high yield bonds than ever before. Of course, with the risk-free rate at zero, people were forced to buy high yield bonds at 5 or 6 percent to get the kind of return they wanted or, in some cases, to be able to live.

Ludwig Chincarini: Some investors today are talking about the market for high yield or corporate debt instruments as a crowded space, with too many people making similar investments. Do you believe this, and, if so, what should an investor do?

Howard Marks: One of the questions I often get these days is, "Is there a high yield bond bubble?" The thing that argues against that proposition is that high yield bonds still have a yield spread over Treasury bills and high-grade bonds, which I consider more than fair relative to history and more than fair relative to actual risk. If you think Treasuries have no risk and high yield bonds have risk, the yield spread is there to compensate for the bearing of that incremental risk. The question is whether it is adequate.

In our experience at Oaktree, I don't think there's ever been a year in which the default losses consumed the yield spread, and my colleagues and I have been doing this for thirty-seven years. I think you were asking whether, on average, the yield spread has been enough. I think it's been enough every year—sometimes enough and sometimes extremely generous—and that's the definition of a superior investment. And it still is. So I don't think high yield bonds are priced incorrectly relative to other bonds.

Geoffrey Gerber: A few years ago you published your thoughts on regulation, postulating that attitudes toward regulation follow the same pendulum-like swing as most other aspects of market behavior. Fortunately for Oaktree's investors, the pendulum swung in the firm's favor during the 2008 financial crisis. You raised the largest distressed fund in history, and investors were paid off nicely. Given the changes in financial regulation since 2008, the fact that more investors are playing, and the advent of new investors, will there ever again be that kind of opportunity in the distressed debt market?

Howard Marks: Sure. Well, maybe not for eighty years, because the crisis was a weird, aberrant experience. It wasn't like the typical ups and downs of the market; it resulted from a confluence of events. First of all, there was this idea that everybody in America should have a house and that poor people should have houses as nice as those of rich people. Then there were the mortgage companies trying to make that happen by creating a lot of mortgages. And a lot of people were willing to buy structured mortgage securities, because mortgages had a good record in the past—there had never been a nationwide wave of defaults. So the confluence of these things caused mortgage standards to decline to a level that, along with rising housing prices, guaranteed that a nationwide wave of defaults would occur. That's number one.

Then Wall Street took all those crummy mortgages and structured them into highly leveraged, tranched, structured entities. That's number two.

Number three: The banks were permitted to leverage up thirty-two times, and many of them bought the riskiest parts of the mortgage entities for their own accounts. So highly leveraged institutions were buying the bottom tranche of highly leveraged structures. I wrote a memo once called "Leverage + Volatility = Dynamite," and that's what happened.[18] There's no reason to think we're going to have a replay of that any time soon. Now the banks are less leveraged, and nothing that is the analog of those subprime mortgages exists. We'll have ups and downs, but I think the regulations would have to retreat much further for those risk conditions to be recreated.

Edward Baker: I have a question about the institutional framework of our business. When you started out, investing was quite a different business than it is now. The current regulatory framework is difficult. Clients are much more cautious and afraid to take on smaller firms. Do you think this is just a temporary shift, or do you think it's a permanent shift toward investors favoring bigger firms?

Howard Marks: I would say that everything in life is temporary, including life. But when things go badly, people become cautious. Then their caution causes things to go well, and when things go well, they become incautious. I think that's a forever cycle. The reason everybody is favoring big investment managers now is that some small managers didn't survive the crisis. More important, an agent who invests with a big institution rather than a boutique is much less likely to be subject to criticism. If we see twenty years of good performance, good times are rolling again, and people who take risks are rewarded again without punishment, then risk tolerance will increase, and that's an important phenomenon in the marketplace. When risk tolerance returns, people say: "Why not give some money to a startup hedge fund? The manager could be great." I think all these things are cyclical, perhaps attitudes toward risk more than anything else.

Margaret Towle: We've talked about the asset-management industry in terms of active versus passive management and the need to educate retail clients. The primary readership of this publication, the *Journal of Investment Consulting*, is investment advisors in the consulting community. Given our discussion, what do you consider an appropriate role for investment consultants, and has that role changed over time?

Howard Marks: No, I don't think it's changed. Most people need help because their knowledge is limited. I think they need help with three main objectives: to find viable asset classes, to find good managers, and to set the right balance in a portfolio between offense and defense.

We talked about macro forecasting, and I said, "I'm not into it." But at Oaktree, we do spend time, and I spend a great deal of my personal time, trying to figure out one thing, which is, at a given point in time, how should you balance aggressiveness and defensiveness in your portfolio? If you get that right, the other stuff will be fine, and if you get that wrong, the other stuff won't help, especially at the extremes.

Achieving this balance is not easy. I wrote a memo in September 2015 called "It's Not Easy," and this is one of many things that are not easy.[19] Not too many people get it right, but there's a great role for a consultant who can get it right.

Margaret Towle: Is there anything that you would like to add that we haven't asked you? Your writing covers so much, and we have that wealth of information.

Howard Marks: Well, I won't think of it until I hang up, Margaret. This has been pretty wide-reaching.

Margaret Towle: It has. We appreciate you taking the time to talk with us, and I want to thank the committee for their participation as well.

Howard Marks: Thanks for the good questions.

Endnotes

1. See *Forbes* 400, 2015 Ranking, http://www.forbes.com/profile/howard-marks/; and Gillian Wee, "Biggest Distressed Debt Investor Marks Europe With 19% Gains," Bloomberg.com (June 16, 2011), http://www.bloomberg.com/news/articles/2011-06-17/biggest-distressed-debt-investor-marks-europe-after-22-years-of-19-return.
2. Howard Marks, *The Most Important Thing: Uncommon Sense for the Thoughtful Investor*, New York: Columbia University Press (2011).
3. *Forbes*, cited above.
4. Wee, cited above.
5. Charles Ellis, "The Loser's Game," *Financial Analysts Journal* 51, no. 1 (January–February 1995): 95–100.
6. Peter H. Vermilye (1920–2009) was global chief investment officer at Citicorp from 1977 to 1984.
7. Howard Marks, "The Most Important Thing" (July 1, 2003), https://www.oaktreecapital.com/docs/default-source/memos/2003-07-01-the-most-important-thing.pdf.
8. Noreena Hertz (1967–) is an author, strategist, and commentator who combines traditional economic analysis with foreign policy trends, psychology, behavioral economics, anthropology, history, and sociology to look at global culture. In *The Debt Threat*, she predicted the 2008 financial crisis, and in *The Silent Takeover*, she anticipated that unregulated markets and massive financial institutions would have serious global repercussions. Her latest book is *Eyes Wide Open: How to Make Smart Decisions in a Confusing World*. She is the Duisenberg Professor of Globalization, Sustainability, and Finance at the Duisenberg School of Finance in Amsterdam. She is also affiliated with RSM International, Erasmus University in Rotterdam, and the University of Cambridge and is a Fellow of University College London (http://www.noreena.com/).
9. Howard Marks, "Dare to Be Great" (September 7, 2006), https://www.oaktreecapital.com/docs/default-source/memos/2006-09-07-dare-to-be-great.pdf?sfvrsn=2.
10. Howard Marks, "What's It All About, Alpha?" (July 11, 2001), https://www.oaktreecapital.com/docs/default-source/memos/2001-07-11-whats-it-all-about-alpha.pdf?sfvrsn=2.
11. Howard Marks, "Getting Lucky" (January 16, 2014), https://www.oaktreecapital.com/docs/default-source/memos/2014-01-16-getting-lucky.pdf?sfvrsn=2.
12. Michael Robert Milken (1946–) is an American former financier and philanthropist. He is noted for his role in developing the market for high yield bonds ("junk bonds"), for his conviction following a guilty plea on felony charges for violating U.S. securities laws, and for his charitable giving (www.wikipedia.com).
13. A grade indicating the credit quality of a bond. Private independent rating services such as Standard & Poor's, Moody's, and Fitch provide these evaluations of a bond issuer's financial strength or its ability to pay a bond's principal and interest in a timely fashion. Bond ratings are expressed as letters ranging from "AAA," which is the highest grade, to "C" ("junk"), which is the lowest grade. Different rating services use the same letter grades but use various combinations of upper- and lower-case letters to differentiate themselves from other rating services.
   To illustrate the bond ratings and their meaning, using the Standard & Poor's format:
   - AAA and AA: High credit-quality investment
   - AA and BBB: Medium credit-quality investment
   - BB, B, CCC, CC, C: Low credit-quality (noninvestment grade) or "junk bonds"
   - D: Bonds in default for nonpayment of principal and/or interest

   (www.investopedia.com).
14. James Harris "Jim" Simons (1938–) is an American mathematician, hedge fund manager, and philanthropist. He is a code breaker and studies pattern recognition. Simons was a professor of mathematics at Stony Brook University, where he also was the former chair of the mathematics department. In 1982, Simons founded Renaissance Technologies, a private hedge fund investment company based in New York with more than $25 billion under management (www.wikipedia.com).
15. Benjamin Graham and David Dodd, *Security Analysis,* New York: The McGraw-Hill Companies, Inc. (1934).
16. The fifty stocks that were most favored by institutional investors in the 1960s and 1970s. Companies in this group were usually characterized by consistent earnings growth and high price-to-earnings ratios (www.investopedia.com).
17. Sy Syms (1926–2009) was an American businessman, entrepreneur, and philanthropist, who founded the SYMS off-price clothing chain in New York City in 1959 (www.wikipedia.com).
18. Howard Marks, "Leverage + Volatility = Dynamite" (December 17, 2008), https://www.oaktreecapital.com/docs/default-source/memos/2008-12-17-volatility-leverage-dynamite.pdf?sfvrsn=2.
19. Howard Marks, "It's Not Easy" (September 9, 2015), https://www.oaktreecapital.com/docs/default-source/memos/2015-09-09-its-not-easy.pdf?sfvrsn=2.

INVESTMENTS & WEALTH INSTITUTE®
formerly IMCA

5619 DTC Parkway, Suite 500
Greenwood Village, CO 80111
Phone: +1 303-770-3377
Fax: +1 303-770-1812
www.investmentsandwealth.org