Memo to: Oaktree Clients

From: Howard Marks

Re: Irrational Exuberance

Recent years have witnessed great excesses in the stock market. The postmortems have begun to be written, and I'm determined not to lag. Thus I will attempt below to combine a number of ideas and bits of empirical data I've stored up over recent weeks in a memo which expresses my views and hopefully is of value to you. My ideas are disjointed, but I hope to be able to fashion a common thread.

Postmortem? Do I mean to say the market's rise is over? You know I don't make predictions of that sort. **I am not ringing the bell on stock prices, but hopefully on a style of investing without reason.**

The stock market's record-breaking rise through March 10 was driven by the tech stocks. The tech stocks, in turn, were driven by optimistic, get-rich-quick buying that was totally lacking in skepticism and caution. What I think may (and should) be on the wane is the belief that it is perfectly reasonable:

- to borrow in order to buy stocks that have already risen 500% and are selling at infinite P/E ratios,

- to rely exclusively on advice from friends, **CNBC** and Internet bulletin boards when investing in companies whose business you know nothing about, and

- for companies valued at billions of dollars to lose tens of millions per year, because investors can be counted on to give them more.

These attitudes have certainly signaled **irrational exuberance.**

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On December 5, 1996, with the Dow at **6,437,** Alan Greenspan coined that phrase, of which we're unlikely to have heard the last. Acting in the classic role of a central banker trying to jawbone against trends inimical to economic health, he asked:

> How do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions?

Did Greenspan want to stop people from having fun and making money? No. He wanted to keep stocks from running too far too fast and thus avoid an excessive wealth effect.

"Wealth effect" is the term used to describe the impact on the economy of major increases in the prices of stocks or other assets. When asset prices rise, people feel richer and spend more. When the resulting demand outstrips supply, inflation heats up. Further, when the upward trend of asset prices inevitably turns down, the wealth effect works in reverse, putting a damper on economic growth (although Greenspan is more likely to have been worried about inflation than economic softness).

Prior to expressing his concern about exuberance, Greenspan was credited with the power and wisdom needed to keep the economy rising forever. So how did investors react to his remark? In the first half-hour of trading the next day, they took the Dow down by 145 points (which used to be considered a big move). But the exuberance of which he had warned soon reasserted itself, with the Dow closing the year virtually unchanged from its pre-critique level and moving 1000 points higher over the next six months.

If it was irrational exuberance that had taken the Dow to 6,437 in late 1996, what would describe the rise to 7,437, and eventually to 11,497, in relatively short order? And what accounts for Greenspan's two subsequent years of silence on the subject? My guess is that he was feeling pressure from people – perhaps with a political stake in the continuing rise of the stock market-who castigated him for being a wet blanket.

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At any rate, Greenspan's warning receded into memory without meaningfully slowing the market's rise, and his place in the pantheon of popular heroes appeared diminished. After all, a record 49% of Americans now had a stake in the stock market, and their heroes were people who helped them make money, not scolds warning about excess and pushing prices lower. Having voiced concerns and diminished confidence, Greenspan was no longer the day trader's pin-up.

When Greenspan began to raise rates on June 30, 1999, no one seemed to care. The Nasdaq Composite rose practically unabated from 2,686 at the time of the first of five rate increases to 5,049 just 8½ months later. Thus Greenspan joined the roster of those whose genius was downgraded in recent times - almost comically, I think (unless you're one of the people so affected).

Another prime example is Julian Robertson, who compiled an incredible record through mid-1998, with a return averaging 31.7% a year for 18 years. Then losses and capital withdrawals knocked his Tiger Fund from $22.8 billion to $5.2 billion over the next 18 months. Every day the stock market was ridiculing both value investors like Robertson and the Old Economy companies they specialized in. Robertson announced a few weeks ago that he was closing up shop, saying, "we are in a market where reason does not prevail" and "there is no point in subjecting our investors to risk in a market which I frankly do not understand."

In a supreme irony, the April week in which Robertson announced his departure turned out to be one of the best of his career, but the damage had already been done. I often think about the corrosive effect of being on the wrong side of a market judgment for prolonged periods, and the phenomenon through which those who resist trends the longest can finally capitulate at just the wrong time. Robertson, 67, had an approach that failed to work for two painful years and enough wealth to allow him to say "why put up with this?" The pressure to quit obviously hit its apex just as his timing in quitting was at its worst.

Last week saw a pullback from risk on the part of George Soros, head of the remarkable Quantum Fund (up 32%/year after fees for 30 years), and the resignation of Stanley Druckenmiller, its portfolio manager since 1989. Why? Druckenmiller had resisted tech stocks until mid-1999, but then he invested and made a bundle in the second half. When he held on to most of them in 2000, they brought him heavy losses. The New York Times reported, "... he had known by December that the explosion in technology stock prices had gone beyond reason. But he expected it would go longer than it did ... 'We thought it was the eighth inning, but it was the ninth.'" Or as Soros admitted, "Maybe I don't understand the market. Maybe the music has stopped but people are still dancing."

An analyst who dealt with both Robertson and Soros summed up aptly for the Times:

> **The moral of this story is that irrational markets can kill you.** Julian said, "This is irrational and I won't play," and they carried him out feet first. Druckenmiller said "This is irrational and I will play," and they carried him out feet first. (Emphasis added)

And what about Gary Brinson, another top value stock investor? After he sold his firm to Swiss Bank Corp. and SBC merged with Union Bank of Switzerland, the combined firms had $920 billion under management and Brinson appeared well on his way to becoming the world's first trillion-dollar money manager. But either Brinson or his constituents lacked the resolve needed to hang in when his approach was out of fashion, and he announced his resignation on March 2. It was probably one more case of a wealthy man who saw no good reason to continue subjecting himself to the market's insults. Brinson became yet one more stellar investor who was kept from going out on top.

By the mid-1990s, Warren Buffett had become a household name and a role model for millions of American investors. He is absolutely unique in that he became one of the world's richest men by investing in common stocks. All it took was a return averaging 25% a year for 30 years. But his portfolio was flat in the raging bull market of 1999, and the stock price of his Berkshire Hathaway lost 49% from its 1998 high to its 2000 low. Buffett certainly has been treated with less awe in the last couple of years.

Jeremy Siegel also came to be ignored. Who's Siegel? This Wharton professor was voted the best in the country, and his book "Stocks for the Long Run" contributed greatly to the bull market's middle years. He reported that there had been very few long periods of time in which stocks had lost money or underperformed bonds or cash, and this greatly buttressed investor confidence. But when his article “Big-Cap Tech Stocks Are a Sucker Bet” ran in the Wall Street Journal on March 14, 2000, it seemed to have no immediate effect on stock prices – the Nasdaq Composite was 5% higher ten days later.

If these genuine geniuses have been dissed of late, who was elevated? Take the case of James Glassman and Kevin Hassett, **the** authors of “Dow 36,000.” Utilizing Siegel's research, they concluded that because stocks are so low in risk, they should not provide a premium return versus bonds; thus, their return in the past was far higher than it should have been. In order for stocks to offer a prospective return that is appropriately low - say 6% - their current price should be higher. The broad market's P/E ratio should be 100, and the Dow should be at 36,000 **now**. Glassman and Hassett got a lot of ink in the Wall Street Journal in 1999, but I couldn't get past one question: Who's going to buy stocks to make 6% a year?

And lastly, what about Frank P. Slattery, V, age 27, who entered the investment business in 1996. His smallish PBHG New Opportunities Fund was up 533% in 1999 and another 96% in the first 70 days of 2000. Now that's genius! (However, in the new market environment, the fund was down 57% between March 10 and April 14, wiping out all of 2000' s gain and more. Slattery has resigned to pursue other opportunities.)

In the choice of who should be canonized and who downgraded, the late 1990s were certainly a time when reason was turned upside down.

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Speaking of the 1990s, I was recently asked to compare the 1980s' “Decade of Greed” with the latest iteration. In the 1980s, a few financially astute leveraged buyout operators attained prominence while trying to take over some of America's leading companies without much capital of their own. In the 1990s, in contrast, it seemed everyone in America tried to get rich quickly by jumping on a perpetual motion machine.

One of the greatest irrationalities of the last few years has been the declining role of reason and fundamental business analysis in the setting of stock prices.

First, a look at trading volume convinces me that the retail investor - acting either directly or through mutual funds - increasingly became the marginal transactor setting stock prices. I doubt institutional trading could have increased enough to account for 1.5 billion shares a day on the NYSE and 2.0 billion shares a day on Nasdaq. (Circa 1980, when I bought Oppenheimer junk bonds whose interest was indexed to NYSE volume, the benchmark was the then-current average of 49 million shares a day.)

Second, with the enormous popularization of stocks in the '90s, rank amateurs were pulled in, diluting the expertise of even the retail investment community. Many of these new investors were ignorant of the process through which stock prices historically have been based on earnings and dividends. They knew only that stocks went up and tech stocks went up faster. Valuation didn't matter: if you bought a stock with a good enough "story," someone else would pay you more for it.

Third, the role of the brokerage house analyst changed. When I started doing equity research 31 years ago, the sell-side analyst tried to serve investors so as to attract trading and generate commissions. In the 1990s, with commission rates so low and the big money being made in investment banking, it became the sell-side analyst's job to generate capital market deal flow. The analyst tried to become influential with investors in order to endear himself to company management. Serious valuation work dwindled and "sell" recommendations became even more scarce: why antagonize a company whose investment banking business you're trying to attract? A recent Wall Street Journal quote from Morgan Stanley's Cisco analyst is emblematic of the analyst's new dog-chasing-its-own-tail role:

> We have to accept the facts of life. If investors want to buy these high growth companies, we are just trying to take what they are willing to pay and translate it into a target price and therefore a stock recommendation.

In other words, it wasn't the analyst's job to throw cold water on the investor's party by pointing out that the target price had been reached or the price was too high. He just moved the target price up. And investment newcomers, unaware of how superficial this all was, actually attached some importance to the target prices assigned by analysts.

Fourth, with reason lacking, the retail investor's approach came to be based on extremely simplistic thought processes.

- When momentum investing was working, the mantra was "buy stocks that have done well - they'll keep going up."

- When the inevitable pause in the rise swept the market - as it did in August **1998**, when Long-Term Capital and the emerging markets stumbled - the cry of "buy the dips" took hold, and it worked every time.

- On bad days recently, with the confidence behind the rise deflated (and with no reserve of reason there to back it up), I think it's been "sell before it goes down more."

Investors with no knowledge of (or concern for) profits, dividends, valuation or the conduct of business simply cannot possess the resolve needed to do the right thing at the right time. With everyone around them buying and making money, they can't know when a stock is too high and therefore resist joining in. And with a market in free fall, they can't possibly have the confidence needed to hold or buy at severely reduced prices.

And that brings me back to one of my favorite quotations from Warren Buffett:

> The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs.

Unless reversed, the damage of the last few weeks clearly demonstrates the extent to which the risky behavior of others can create peril for you. **If it has taught another generation that stock ownership is not a riskless one-way street, that's a healthy development that should render such imprudent behavior less likely to reappear.**

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While on the subject of investors' analytical capabilities, I want to take a look at stocks' failure for so long to respond to the Fed's rate increases. In earlier times, the market would decline as soon as a rate increase was hinted at, no less implemented. This time around, the Fed raised rates five times and Chairman Greenspan essentially came out and said the market was too high and he would bring it down. How can we explain the fact that there was no reaction (until recently, if that in fact did contribute to the correction)? I attribute this, also, to failings on the part of those setting stock prices.

There are two main reasons why stocks fall when rates rise. I'll discuss them below and offer my explanation for their failure to gain traction this time:

First, stocks dip because higher interest rates mean stiffer competition from fixed income investments. No one cared in 1999, however, because 6½% wasn't any more tempting than 6¼% to someone expecting a sure 20% from stocks.

Second, higher rates make it more expensive for consumers to buy houses and cars and for businesses to hold inventories, invest in machinery and build buildings. This puts a crimp in the pace of business and can lead to recession. But if the investors setting stock prices don't know (or care) how the economy and business cycle work, policy increases can be slow to impact the equity market.

Rate increases depress stocks in the short run when people understand how they work and anticipate the longer-term effects described above. That is, they work because people agree they will work. If this requirement isn't met, then rate rises deserve the description that First Boston's Al Wojnilower ("Dr. Doom") applied in the 1970s to manipulating the money supply: "turning on and off a light switch to which no wires are attached."

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Why did stocks rise so rapidly in 1999? Because people were rabid to buy and no one wanted to sell to them. The result was explosive appreciation. Those gains actually signaled great illiquidity (which is measured as the percentage price change that results from buying or selling a certain dollar value of stock). However, an imbalance of buyers over sellers is never <u>called</u> illiquidity; it's called profit and doesn't worry anyone.

In the last six weeks, however, the imbalance has been on the sell side. This time, investors' inability to find others willing to trade with them has forced prices down drastically, and they are calling it illiquidity. In other words, radical upward movement was greeted warmly, but radical downward movement is being attributed somewhat to a failing on the part of the market.

Certainly the behavior of stocks in 1999 was viewed more benignly than it should have been. Momentum investors irrationally planned to get out when the music stopped, but the market wasn't able to accommodate all of them.

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I want to turn now to the subject of market efficiency, something that's very important to us at Oaktree and that I have been looking for a chance to discuss.

In recent weeks I've heard good things about a new book, fittingly titled "Irrational Exuberance." Its author, Robert J. Shiller, a Yale economist, has taken on the theory that the stock market is efficient, saying stocks' swings are too violent to suggest that they are always accurately valued. On that famous Tuesday four weeks ago, the Nasdaq Composite traded at both 3,649 and 4,138 within seventy minutes. It's certainly hard to believe the underlying stocks were fairly valued at both levels. No, says Shiller, the stock market is not efficient; stock prices are set irrationally. Or as George Gilder recently wrote in the Wall Street Journal:

> Stock markets are world-wide webs of information. So why half the time do they behave like members of some candy mountain mystical sect, torn between dreams of eternal wealth and horror of a bottomless pit?

In response, I want to give my view of market efficiency. I want to say up front that academics don't share my view and theory says I'm wrong. But my approach works for me, and I want to share it with you.

In my opinion, the market for many stocks is highly efficient. That's what I was taught at the University of Chicago in the mid-'60s, when capital market theory was being developed. And in 1978, when I left equity research, I told Citibank I'd do anything but "spend the rest of my life choosing between Merck and Lilly." I believed in market efficiency then and I believe in it now. But what does that mean?

When I say efficient, I mean "**speedy**," not "right." My formulation is that analysts and investors work hard to evaluate all of the available information such that:

- the price of a stock immediately incorporates that information and reflects the consensus view of its significance, and

- thus, it is unlikely that anyone can regularly outguess the consensus and predict a stock's movement.

That is, the market may often misvalue stocks, but it's not easy for anyone person - working with the same information as everyone else and subject to the same psychological influences - to consistently know when and in which direction. That's what makes the mainstream stock market awfully hard to beat - even if it isn't always right.

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Lastly, I want to share what I told the board of a charity whose Investment Committee I chair. I listed some of the elements that have been at the foundation of prudent investing during my time in the business and more:

- pursuing both appreciation and income,
- balancing growth and value investments,
- balancing the desire for gain and the fear of loss,
- buying companies with a history of profitability,
- caring about valuation parameters,
- emphasizing cheap stocks,
- taking profits and reallocating capital,
- rotating industries, groups and themes,
- diversifying,
- hedging,
- owning some bonds, and
- holding some cash.

How did this list do in 1999? **It was a recipe for disaster!** Every one of these elements would have caused you to underperform. What should you have done? Just two things:

- bought growth and technology stocks that had already appreciated, and
- held them as they rose further, refusing to sell at any price.

Thus in one more way, wisdom was turned on its ear in this period.

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Robertson, Soros, Druckenmiller, Brinson and Buffett succeeded for decades because the markets they worked in (1) were driven by both fear and greed, (2) responded eventually to reason, and (3) rewarded disciplined analysis more than they did naked aggressiveness. That's the kind of climate we at Oaktree prefer. In the late 1990s, markets were propelled (and the big money was made) by people who, in my opinion, substituted optimism, risk tolerance and love of a good story for reason, caution and skepticism. If investors have been chastened by the events of the last few weeks, I think we'll see more of the latter in the future.

May 1, 2000

P.S.: I've learned the hard way that it's not easy to be right about the future, as I've been complaining about market excesses for far too long. That being the case, I'm not going to miss the opportunity to celebrate the correctness to date of my last memo, “bubble. com.” The table below lists the stocks mentioned in that memo and their declines from its publication at year end, and from the highs reached since then, to the April trough.

Company	**Ticker**	**12/31/99**	**2000 high**	**4/14/00**	**%Chg 12/31/99 to 4/14/00**	**% Chg 2000 high to 4/14/00**
Akamai Tech.	AKAM	$328	$321	**$ 65**	-80%	-80%
Amazon.com	AMZN	76	89	47	-38	-48
America Online	AOL	76	83	**55**	-28	-34
Charles Schwab	SCH	38	65	41	6	**-38**
CMGI	CMGI	138	163	52	-62	-68
E*Trade	EGRP	26	33	19	-27	-41
Egreetings Network	EGRT	10	12	3	-68	-74
Etoys	ETYS	26	26	5	-82	-81
Priceline.com	PCLN	47	96	59	24	**-39**
Red Hat	RHAT	106	141	24	-77	**-83**
theglobe.com	TGLO	**8**	9	3	-64	-67
VA Linux Sys	LNUX	207	193	29	-86	**-85**
Webvan	WBVN	17	18	6	-66	-69
Yahoo!	YHOO	216	238	116	-46	**-51**
Average					-50%	-61%

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