# Behind the Memo – The Impact of Debt with Howard Marks and Morgan Housel

### Anna Szymanski

Hello and welcome to *Behind the Memo by Howard Marks*. I am Anna Szymanski, Oaktree's Senior Financial Writer, and today Howard and I are very excited to be joined by a special guest, Morgan Housel.

Morgan is the bestselling author of *The Psychology of Money* and *Same As Ever*, and he's a partner at the Collaborative Fund. Howard's recent memo, *The Impact of Debt*, is based on a Collaborative Fund blog post that Morgan wrote, entitled *How I Think About Debt*. So today, we are going to be exploring exactly that, how to think about debt, and specifically, how debt impacts an investor's longevity.

So Morgan, Howard, thanks so much for joining me.

### Morgan Housel

Thank you for having me.

### Howard Marks

Great to be here, Anna.

### Anna

So Morgan, I'm going to start with you. As I mentioned, Howard's recent memo is based on a blog post that you wrote for the Collaborative Fund. So to begin, I'd like you to let our listeners know exactly what the Collaborative Fund is, maybe what the Collaborative Fund blog is, and then if you could explain the main argument that you're making in this article.

### Morgan

Yeah, so the firm is a private investing firm that does everything from venture capital to public markets investing. It's always been a home for my blog. I've been a financial writer for 17 years now, and it's been where I publish my public blog post, contrasting that with the books that I publish. So this post that I wrote several weeks ago was a very basic idea. This is almost kindergarten 101 finance of just how to think about debt from a philosophical level. And debt, I think more than equities, tend to be viewed as a mathematical investment. It's just you find the value in the spreadsheet.

But I think there is almost a philosophical way to think about debt that is outside of the cost of capital and just what the interest rate is. And to me it was the more debt you have, the narrower the range of volatile outcomes you can endure in life. All investments, you get paid for two things in investing. One is mispricing, the other is the endurance of volatility. And when you view debt as a narrowing of the outcomes that you can endure, it really takes on a new level of significance.

### Anna

So Howard, what were some of the ideas from this piece by Morgan that really jumped out at you and made you want to devote a memo to this?

### Howard

Well, Anna, the idea that Morgan just described is incredibly basic, but often forgotten, especially cyclically, and I'm sure you'll return to that later. But anytime you read about somebody getting into financial trouble, a hedge fund melts down, whatever it might be, it's invariably related to debt. Basically, you can't melt down and you can't be foreclosed, and you can't be forced into bankruptcy if you don't have debt outstanding, if you haven't used debt in your financial affairs.

Now, that doesn't mean to say that if you take on a dollar of debt, it tips you over into the dangerous category. But, each financial actor has a certain amount of money, what we call equity, they're worth. And with that money, you can go out and buy some assets, or you can borrow some money and buy more assets, and then enjoy the upside, the appreciation, on more assets.

If you have $10,000 of equity, you can borrow another $10,000 and enjoy the appreciation on $20,000 of assets. And that looks like a good idea. And in the memo I wrote, The Impact of Debt, I mentioned the pit boss in Las Vegas who comes around and says, "Now remember, the more you bet, the more you win when you win." This is one of my favorite sayings because it's inarguable. It's obvious that the more you bet on your winning hands, the more you're going to win. But it leaves out the fact that the more you bet on your losing hands, the more you're going to lose. And if you've done it with borrowed money, you can be forced into bankruptcy. So this is a really important concept.

And then this idea that Morgan had, that the more debt you have, the narrower the range of bad outcomes you can survive. This is really important, and it reminded me when I read it. Morgan's notes come on a Saturday morning, they're one of the first things I read, and I was reading it and, well, I hope this is a good thing Morgan, but I rarely find myself saying, "Boy, this guy thinks a lot like I do." And in this case, it reminded me of a memo I wrote late in 2008, in the heat of the global financial crisis post Lehman meltdown, called *Volatility + Leverage = Dynamite*.

And basically what it says is, if you put on leverage, the more leverage you have, the more you get in trouble. The more volatile the assets you buy with the leverage funds, the more you get in trouble. And the combination of two in the right circumstances can really be fatal. I show in the memo through a series of little cartoons, that a highly leveraged capital structure cannot coexist with highly volatile assets. If you want to buy volatile assets, your capital structure should be conservative. If you want to use a lot of leverage, you should buy conservative assets. But aggressive capital structure plus aggressive assets will get you carried out once in a while. So those are the two main thoughts that resonated for me.

### Morgan

One thing I'd add here is that so many investors, virtually every investor, says, "I'm a long-term investor." At least they aspire to be a long-term investor. That's like a core for the vast majority of investors. But what that really means you have to do is be willing to forego shorter term gains. And that is much more difficult to do. It's easy to say, "I'm in it for the long-term." It's much harder to say, "I'm going to go the next one or five years below my potential." And I think that's where so many people get tripped up, is that you have to be willing to say, "I could be leveraged up here and earn more over the next one year, over the next five years, but it's going to make me less durable. But if I can stick around for the next 30 years, the returns that compound to that are going to be absolutely extraordinary."

And there's this great saying from PIMCO that I used to love, I don't know if they use this phrase anymore, but back in the early days of PIMCO, they had a phrase called strategic mediocrity, which meant that in any given one year period, they were rarely going to be in the top half ranked against their peers. But in every 10 year period, they would always be in the top 10%, maybe top 5%. And that I think is really important.

One of the most fascinating investing stories that I think is so overlooked, because it's so fascinating, is a guy named Rick Guerin, who was an absolutely lovely gentleman, passed away not too long ago. If you go back to the 1960s in Omaha, there were three investors who made all of their investments together. That was Warren Buffett, Charlie Munger, and Rick Guerin. They were a trio in what became the duo of Warren and Charlie that we all know.

And so several years ago, a hedge fund manager named Mohnish Pabrai had dinner with Buffett. And Mohnish said, "What happened to Rick Guerin? He was all over the early history of Berkshire, and now he's not. What happened to this guy?" And Warren told a story, which was that Warren, Charlie, and Rick made all the same investments together. Rick did one thing different, which was that he invested very heavily on margin. And in the, I think it was the 1974 bear market, he got clobbered. Warren had a saying that stopped me in my tracks. I thought it was so fascinating. He said, "Rick was just as smart as us, but he was in a hurry." And that is amazing.

And I don't think it's an exaggeration to say Warren and Charlie have gone through their entire life intentionally at 70% of their potential. They could have been levered. They could have gone into debt and earned higher returns, but they willingly operated below their potential because they were more focused on endurance. And the fact that Buffett's been compounding for 80 years now or whatever it is, is the sole reason that he has the net worth and has accumulated the assets that he has. And so much easier to say, "I'm in it for the long term," than it is to willingly operate below your potential in the short term.

### Howard

Well, Morgan, a great observation. It's one I hadn't heard from you before, including the story of Rick Guerin. But, every investor has to make a choice at some point in time, between optimizing and maximizing. Optimizing means, you try to do well, but you also try to set up your fares so that you'll be able to last for the long term as Morgan describes. Maximizing is just trying to get the most you can, the soonest you can. And that's the essence of what Morgan just went through. And this whole thing brings me back to one of my three favorite adages that in total, I think sum up the whole, well, 90% of what you have to know in the financial world. But, never forget the person who was six feet tall, who drowned crossing the stream that was five feet deep on average. The concept of surviving on average is meaningless.

You've got to survive every day. And that means you have to importantly survive on the bad days. And if you have set up your affairs to maximize every step you take to maximize beyond an optimal point, reduces your probability of survival. And when you take on debt to own bigger positions, to amplify your winnings when you win, it's like putting rocks in a knapsack and you're trying to cross that stream. And the more rocks you have in the knapsack, the less likely you are to get across the stream when you hit a low point. And everybody makes investments for one reason. They think they're going to win. Nobody buys investments and says "Well, I want to have a diversified portfolio, so I should have some winners and some losers." Every investment that everybody makes, they think they're winners, but at the same time, they're not all going to be winners. And you have to be prepared for when things go against you. And that means optimizing, taking a reasonable approach in terms of the sum of your aggressive capital structure and your aggressive investments rather than maximizing.

### Morgan

I think so much of investing history too is people claiming that an event, they say nobody could have seen this coming, who knew this was going to happen? And invariably, the event is something that has occurred regularly every decade for the last 500 years. So I hope to be an investor for the next 30 to 50 years, let's say. What are the odds that during that period I'm going to experience a 50% bear market and unemployment at 10% and inflation over 10%? What are the odds I'm going to experience those? 100%. The odds are 100% that I'll experience those things. So when you come across somebody that has a portfolio that cannot endure anything close to that, basically what they're saying is, "Well, I will unwind this portfolio before that happens." And the odds of that happening round to zero as well. And that's why going through this endeavor at below your potential is actually the way to maximize wealth over the long term.

### Howard

Anna, you're not going to get a chance to get a word in edgewise.

### Morgan

Let's let her in.

### Anna

You're making my job too easy.

### Howard

But what Morgan says is extremely important. I love the book that I read in the middle '90s called *A Short History of Financial Euphoria* by John Kenneth Galbraith. He says in there that one of the two outstanding characteristics of the investment universe is shortness of memory. When people have lived through a good time, they project that it will go on forever.

And that the extreme negative occurrences that Morgan describes, which are a part of history, are soon forgotten. And anybody who has memory of those negative events and harps on them is dismissed as an old foggy out of step with the modern times, unable to appreciate the wonders of the new industry, the new financial mechanisms, whatever they might be. This is so important.

### Anna

What you've both talked about so much here is investor psychology, of investors not understanding how much risk they're actually taking, and that really being one of the riskiest things.

### Howard

Well, the riskiest thing in the world is the belief that there's no risk. Because when people believe that the environment is safe, they will amp up the riskiness of the things they do to make sure that there's lots of risk. So real risk is self-reinforcing, if you will. On the heels of good times, people invariably tend to forget the possibility of negative outcomes, and we know the result. This is a good contributor to the cyclicality in our world, is this forgetfulness of past lessons. It's very simple. When greed and prudence do battle, greed wins. It's very simple. So you have to be quite mature and adult in your approach to make sure that you assert some prudence to balance the greed.

### Morgan

I would say too, that at the high level, there are two forms of investing risk. One, I guess you could call it macro risk, which is, what is the market going to do to me? What's the economy going to do to me? And the other is psychological risk, which is, how am I going to respond to that? Both of those are easy to forget and easy to understate because for macro risk, I think we tend to look back at the Great Depression, the inflation of the '70s, and say, "Well, that happened then, but it couldn't happen anymore. We've learned our lesson," which might be true for those specific events. What's easy to overlook is that we're not going to have another Great Depression that played out exactly like the one did in the 1930s, but we can have other things that have equally terrible consequences. The early months of COVID, by some metrics, were worse than the early days of the Great Depression. So it's true that we're not going to have that again. We're not going to have that war again. We'll have other new wars that we are underestimating today.

And then for psychological risk, people tend to think that they have learn their lessons in the past. So you have an investor who says, "I panicked in October of 2008, but I learned my lesson, I'm not going to do it again." And most of the evidence in behavioral finance is, yes, you will. That is an ingrained part of your personality, that is your brain chemistry that caused you to panic then, and you will probably panic again in the future. The solution to that is just embrace that that's who you are and have an asset allocation that understands that.

What's really important here is that when things are going well in the economy, in the market, if you were to ask someone, how would you feel if the market fell 30%, let's say? And when things are going well, people imagine a world in which everything is the same as it is today except stock prices are 30% cheaper. And in that world, people are like, "Oh, that would be great. That'd be an opportunity. I would love it." What you overlook is that the reason the market might fall 30% is because there's a terrorist attack or a war or a recession or a pandemic. And in that context, if I said, "How would you feel if the market fell 30% because there's a virus that shuts down the global economy and might kill you and your family?" in that context, people are like, "I don't know. I might actually panic, sell myself in that situation." So it's very difficult to understand how you will respond psychologically in the trenches, in the heat of the moment.

### Anna

Howard, obviously that speaks to something that you've already been talking about a little bit today, this cycle of attitudes in relation to leverage. So could you just explicitly say what you mean by that, which is something you talk about also in this memo?

### Howard

Well, as Morgan describes, there's nothing more volatile than attitudes. Reality, or what we call in the investment business, fundamentals, change modestly. The economy grows 2% to 3% a year, in a really good year, 4%, and a really bad, 1%. Obviously, the changes are not that radical.

Company profits rise and fall more because companies have leverage, they have operating leverage and financial leverage, and so company profits are much more volatile than is the economy. But stock prices, for example, vary like crazy. They fluctuate up and down. If you see a chart of stock prices relative to company earnings, what you're seeing is the radical volatility of psychology relative to reality.

When things go well, as Morgan and I have been describing, and people feel strong and they feel encouraged and they feel that they'll prudently take advantage of the potential of the future by amping up their portfolio, they take a very positive attitude toward the future, toward the use of leverage, toward the purchase of risky assets. At the same time, the financial institutions are feeling equally good about it, so they become willing to lend more to a given investor for a given purpose. So the leverage and portfolios goes up. As the good times roll on, the leverage is rewarded through magnified profits, and that causes the investor to do even more of it. And as stock prices rise, the investor buys more, and with more and more borrowed money, increasing the riskiness of the portfolio as the times become riskier.

Then eventually, something turns down, the companies don't do as well, the market sags, stock prices decline. The investor now starts to take magnified losses. He might get a margin call or he might just liquidate and get out on his own, and uses less and less leverage and sells stocks at lower and lower prices because they can't stand the pressure. They had overestimated their ability to live with risk, and their attitude towards leverage becomes more harsh at the same time that the banks become unwilling to provide leverage and in fact try to recall some of the leverage they put out in the past.

So everything goes swimmingly on the way up and people take on more and more risk and people get depressed and things go terribly when things swing down until at the bottom. Portfolios tend to be less levered and to hold fewer assets even though they have become much cheaper. So it's a highly cyclical process, but it follows the pattern of most other things, especially in the financial world and especially when human nature is involved.

### Morgan

I think to add on to what Howard just said, it's so important to realize how inevitable these cycles are, that whenever you have a boom-bust cycle, it doesn't mean that people have lost their minds. It doesn't mean that we've all gone crazy. It doesn't even necessarily mean that regulators and politicians have made mistakes. They're completely inevitable.

There was a great economist named Hyman Minsky, and he came up with this idea called the financial instability hypothesis. To grossly simplify it, basically what he said was, "When there are no recessions, people get optimistic. When they get optimistic, they go into debt. When they go into debt, the economy is fragile. And when the economy is fragile, you have a recession." And inherent in that was, a lack of recessions plants the seeds for the next recession, and that's why you're always going to have recessions.

The same thing applies to the stock market, any asset class, that a lack of volatility is what plants the seeds for future volatility. In the stock market, if there was no volatility, people would very rationally bid valuations up. When valuations go up, they become fragile. When you become fragile, you get volatility. It's completely inevitable. And I think that's important because this is what causes people to underestimate volatility. I think at least intuitively, they think, "Well, there will be a recession when people go crazy or when politicians screw up," whatever it might be. It's like, no, you don't need any of that. You don't need people to screw up. You can just have natural volatility in all asset classes based off of what Hyman Minsky figured out 50 years ago. So that's why these things are completely inevitable. They don't require a car crash, so to speak, in the economy. It's just the natural tendency of what markets do.

### Howard

What Morgan just illustrated so eloquently is the cause and effect nature of cyclical events. I wrote a book a few years ago called *Mastering the Market Cycle*, and I said in there that people might think that a cycle consists of a series of events which typically follow in a given progression. So you have A, and then B happens, and then after a while C happens, and sometimes D happens, and then it goes on to E, and that's followed by F. No, A happens. It causes B. B causes C. C causes D. And if you replay Morgan's description of the process through which the occurrence of a recession is ensured, you see this causality and you make a big mistake if you think about cycles without thinking about causality.

I think that the great example is the boom in mortgages, especially subprime mortgages, that led to the Global Financial Crisis. Basically, to put it short, people looked at history, they said there's never been a nationwide wave of mortgage defaults, and so they engaged in practices that guaranteed there would be a nationwide wave of mortgage defaults. It's that simple.

### Morgan

I think it's important too, there's an interesting thing here that's a great thing for the overall world, and there's lots of theories for why this is the case, but we have far fewer recessions today than we used to. If you go back and look at the economic history of the late 19th century, early 20th century, we would consistently have recessions every 18 months, and they tended to be pretty shallow, but it was every 18 months you would have a recession, things were very volatile. One explanation for why this has occurred is because central bankers have become better at managing the business cycle. Some people disagree with that. But one thing that's happened that is inarguable is that we have far fewer recessions now than we used to. It's not uncommon now to go five or ten years in between recessions, which is great from a social perspective.

It makes it much harder as an investor, I think, because it makes it easier to forget what happened. You have investors who have been in the market for 10 years who have never experienced a major fall, and that makes it very difficult. There's this great quote from Keynes where he says, "A speculator is one who takes risks for which he is aware. An investor is one who takes risks for which he is unaware." A lot of investors really don't understand how volatile the asset or the economy that they're investing into really is, because the time between these big events can be so long.

### Anna

This makes me think of something that Howard has written about quite a bit recently in his sea change memos, which is this idea that many investors working today many of them have never lived through a period in which interest rates are really going up, they've gotten so used to money being so cheap, and now we may be shifting into this new environment. So in light of everything we've been discussing here, what do you think just thinking of some of the ramifications of shifting into this new era?

### Howard

Well, you're right Anna, you really had to be working in the 70s to have seen interest rates that were anything other than either declining or ultra-low. That's 45 years ago, most people have retired before they reach 45 years on the job, so there are very few people who are working today who remember the 70s. And, in fact, it was very hard to get a job in our industry in the 70s because times were so terrible, so you probably had to get your job in the 60s, like I did, and there are even fewer of us around today, but people have lived through this period and they think that's normal. But the impact of declining interest rates over the 40-year period from 1980 to 2020 was gradual, slow, but pervasive, it made assets worth more, it reduced carrying costs on levered positions, it stimulated the economy, it made companies more profitable, it made it easier to avoid bankruptcy and default, all things that made the environment easy.

But this was not a normal environment, this was a highly salutary benign environment, and if people assemble their portfolios and select their level of leverage on the assumption that the environment will always be as benign as it was on average over that period, they're likely eventually to run into one of the negative environments that Morgan described, or even an environment which is simply less helpful. The owners of assets, using borrowed money, when they run into interest rates that are stable at higher levels, they're going to see less appreciation in the assets they own the cost of capital is not going to decline, so leveraged investment strategies will be less successful than they were. I think that's axiomatic.

### Morgan

Two things I would add to what Howard just said. The first, I've joked that the three most important investing skills are patience, diversification, and having your peak investing years align perfectly with a 40-year decline in interest rates. Those are the three things you need to need do well over time. One thing I would add to this topic that I think is really important is that it becomes dangerous to use history as a perfect guide of the future.

History, by and large, is the study of surprises, and the irony that people use the study of surprises to try to gain a map of the future causes a lot of disappointment. So it's common for people who have not experienced a rising interest rate environment to say, "Well, what happened in the 1970s, the last time this occurred?" And they go back and say, "Oh, what did well? Gold did well, small caps did well," whatever it was. And they say, "Great, well, we should do that now."

And that's just not how the world works. Things adapt. It's an utterly different economy today than it was back then. Very different social, investing ideas, whatnot. So I think a lot of people, they stumble into problems when they just look back and say, "Well, what worked last time?" And like back test it from there. The world adapts in a way that doesn't allow you to do that. My solution to this is just going back historically and saying, "How do people psychologically act during these events?" That tends to be repeatable, the behaviors tend to be repeatable, even if the specific investing ideas are by and large not.

### Howard

This is what Mark Twain had in mind when he said, if in fact he said it, "That history does not repeat, but it does rhyme." In other words, the events of history, the facts of history, the investments that benefited from declining interest rates, those things will not repeat, but the themes of history and certainly, as Morgan says, human behavior, will rhyme from cycle to cycle. So if you were a strict student of history and you believe that it could be extrapolated, you might go out and buy the railroad stocks, which were great beneficiaries in the 1860s and 70s, but I dare say you should say, "What is the environment going to look like in the years ahead? How will investors react to that environment in the years ahead? What new investments should I be looking to take advantage of it?" Certainly not the ones that did well 150 years ago.

### Morgan

My favorite quote here is from Voltaire who says, "History never repeats itself, but man always does." I think that's a great summary of investing history. The events never repeat, but the behaviors always do.

### Anna

I think this is so interesting to keep in mind right now because it does seem like we're at a time when it may be that some fundamental things in the economy could be shifting. We have AI, obviously we do have this new potential interest rate environment, you also have all of these geopolitical changes, and when people think about how much debt they can take on, how much risk they can take on, on the one hand it seems like, "Okay, if everything's changing, how can anyone use anything from history to figure out how to move forward?" But as you're saying, as both of you're saying, maybe there are these behavioral cycles, these behavioral shifts that people can look to.

### Morgan

I think at the high level you can say, "I have no idea what's going to cause the next recession or when it'll occur, but I have a very good idea of how people will respond to it, because that's really never changed," the same with bear markets and whatnot. I think the vast majority of attention in the financial world is put towards forecasting when these things are going to occur, and the track record of that is very poor. I think it's just much better to have a good idea of what happens whenever they do occur, because that is something that we can learn from history. And you know that these behaviors have been happening for hundreds of years. Go back and look at how people are responding to bear markets in the 1800s and recessions in the 1800s, it's no different than it is today.

I've talked about this example many times, but there's an incredible investing book called *The Great Depression: A Diary*, it was written by this Ohio bankruptcy attorney named Benjamin Roth, who kept a very elaborate diary during the Great Depression in the 1930s. And if you read that diary, it will instantly occur to you that exactly what he's describing in 1932, 1933 is what happened in 2008, how people were responding to it, the behaviors were no different. And then Benjamin Roth himself has a diary entry where he says, "What is so astounding about 1932 is that it seems like exactly what people were experiencing in 1894," whenever the previous Great Depression was. And so these things are just keep repeating over and over again, even if the events that caused them are very different.

### Anna

So we've been talking a lot about people taking on too much risk, taking on too much debt, underestimating risk, but I'm also thinking about the other side of it, which is the risk of not taking enough risk, so I'd like you both to speak about that.

### Howard

Well, the memo before last was entitled *The Indispensability of Risk*. And the point is that risk avoidance usually results in return avoidance. Risk is the element that fuels gains. You make money as an investor by taking risk and having your decisions validated. And, as I say, it's risk management, not risk avoidance. In that memo, I said, "Most people understand this intellectually, but human nature makes it hard for many to accept the idea that the willingness to live with some losses is an essential ingredient in investment success." Now, this sounds like an oxymoron. How can losses be part of success? And it's not that we crave to lose money, but we have to understand that exposing yourself to the possibility of losses is an essential part in an investment plan designed to produce success. And if you bear the risk of losses, once in a while you're going to have some losses.

So it shouldn't come as a shock when you have some investments that turn out to be unsuccessful. And it doesn't mean you did a bad job. The question is how many, what ratio to the winners, how big were the losers? How big were the winners? Warren Buffett lately has been attributing the bulk of his success, I think he says 12 ideas. Charlie Munger used to say four ideas, and he would tell you what they were. But the point is you make a lot of investments, it's like throwing bread on the waters. And some of them succeed as you hoped, some of them will surprise you, others will disappoint and produce losses. But if you do a good job on average, that's what successful investing is all about.

### Morgan

One thing I'd add here is just the definition of risk in general. If you live in Florida, then getting caught in a thunderstorm is not a risk; it's inevitable. It's going to happen. There's no question about it. And I think if you are an investor, then dealing with a 10 or 20% decline in the S&P 500 is not a risk, it's an inevitability. It's going to happen. Maybe you don't know when or how long it's going to last, but it's going to happen. And so that's just a definition of risk. In your own personal life, getting in a fatal car accident is a risk because it's not going to happen to 99.9% of people. So that really is a risk. But if you are an investor and your definition of risk is something that is guaranteed to happen to you, you have a faulty definition of risk. What you're dealing with is just run-of-the-mill volatility.

And back to what I said earlier, you get paid for two things in investing. One is mispricing, the other is the endurance of volatility. For the vast majority of investors, professional or otherwise, what you're going to be paid for over the long term is the endurance of volatility. So when you experience a decline, if you say, "This is a risk, I didn't see this coming. Somebody screwed up. I made a mistake." You're viewing it all wrong. What you are experiencing is the cost of admission over time, and your ability to put up with it is what you get paid for over the long run.

### Howard

Anna, one of the stories I love to tell is that I started to manage high yield bonds for Citibank in 1978 and I was interviewed on one of the first cable shows, the Financial News Network, I think was called, around '81. And the interviewer said, "How can you invest in high yield bonds when you know some are going to default?" And for some reason, the perfect answer popped into my head. I said, "How can the life insurance companies, which are the most conservative companies in America, ensure people's lives when they know they're all going to die?" And this goes back to what Morgan said a bit ago. The question is, are you taking risks you're aware of or risks you're unaware of?

The life insurance company knows everybody's going to die. They can analyze their health individually, they can diversify their portfolios; but most importantly, they charge a rate for the insurance, which assumes that the deaths will occur and still produce a profit. That's exactly what I saw the high yield bond investing as. We take credit risk, we diversify our portfolios, we study our borrowers, and we invest only when we think the extra yield we get, called the yield spread, is sufficiently compensatory for the risk we're taking. I call that the intelligent bearing of risk for profit. And that is what you have to do. But to say, my job is to avoid risk, my job is to have no risk in my portfolio, that's really folly.

### Anna

So I think, just bringing it back to what we were talking about at the beginning of today's episode, it's really trying to put oneself in a position where one can endure the inevitable risk. And that goes back to the idea of optimizing levels of debt, not maximizing levels of debt.

### Morgan

I think it's different for everyone. I've talked about this for my own personal finance where the level of debt I have in my household finances is zero, not on the house, not on anything. And to me, there's two reasons for that. One is maybe just psychology. I have two young kids and it makes me feel good they have that level of stability. But the other that I think is tactical is, as I mentioned a million times before, I just want to maximize for endurance because I know that if I can be an average investor for an above average period of time, it's going to lead to extraordinary returns. It's just pick the variable that you want to maximize for. The vast majority of investors want to maximize for returns. That's the knee-jerk reaction of like, of course that's what you should do. I want to earn the highest returns. I actually don't think that's the case for most investors.

What you want are the best returns that you can sustain for the longest period of time. That's what you want. I heard the story recently, and this is a secondhand story that I'm paraphrasing, so if I get some of these details wrong, don't sue me. I think it was in 2002, the dot-com wreckage, and there were lots of bonds that were trading at huge discounts. And Amazon had a couple of bonds, I'm making these numbers up, but let's say Amazon had a ten-year bond that was yielding 12% and a five-year bond that was yielding 15%, let's say.

That shouldn't exist. You shouldn't have a longer-term bond that yields less because there's a higher chance that the company can go bankrupt for the longer duration. But there was one big investor who was scooping up the longer dated bonds at a lower interest rate, and it turned out that that investor was Warren Buffett. And asked why that was the case, he said because earning 12% for 10 years is a much better opportunity than earning 15% for two years. And so when you're maximizing for endurance in time, a lot of these investing questions that trip people up in the short term become much clearer.

### Anna

So before we end this discussion today, any final thoughts from either of you about everything we've been talking about today?

### Morgan

I'll jump in. One that sticks out to me, Howard mentioned this early on at the start of the conversation, and I did as well. These topics that we're discussing today are literally kindergarten finance 101 topics, but they are the easiest to forget. And I think a lot of times in the financial industry where you can make a lot of money, it is a magnet for people who have very high IQs and have PhDs and are very analytically skilled. And those people tend to be the ones who are the most likely to forget the basics that matter most.

Maybe it's similar to medicine where you have a lot of people who are studying mRNA and the most advanced topics, but so much of what matters in medicine is eat your vegetables, don't smoke, and get eight hours of sleep. And the people who have the biggest brains are the ones who are most likely to ignore that because it's not intellectually stimulating. And so a lot of times in investing, I think Howard has been the master of this over the decades; the people who are the most successful are the ones who are smart enough to get it right, but also humble enough to pay attention to the basics that so many people ignore.

### Howard

Well, Churchill said he was a humble man and he had a lot to be humble about. But the truth is, and showing why this is a complicated process, is because when the good times are rolling and everybody's making a ton of money and all the events are positive, it's really easy to forget the lessons we've been talking about today. And in the bad times, people fixate on them and conclude that there will never be a good time again. And they fail. They depart from the fray.

So it’s all about balance, risk versus safety, prudence versus greed, using maybe some leverage, but only an amount you can endure financially and emotionally. I thought this was a great conversation. I’m really a thrill to have Morgan on, I think even more that we think very similarly. And I want to thank him for participating in our podcast.

**Morgan**

Well, thank you, Howard. It’s been an honor to do this. Hopefully we can do it again. And thank you for everything I’ve learned from you over the years.

**Howard**

Before we close, I want to inform our listeners that we’ll be losing Anna’s services. She’s wrapping up her career at Oaktree as our Senior Financial Writer and moving onto an exciting new job at Reuters. And I want to wish her all the best of luck and thank her for the success she’s created for these podcasts.

**Anna**

Oh, Howard, thank you so much. That means a lot. And Morgan, also, again, thank you so much for coming on the show today. This was a really, really wonderful discussion.

**Morgan**

Thank you.