Behind the Memo: Fewer Losers, or More Winners?

Anna Szymanski

Hello, and welcome to *Behind the Memo* with Howard Marks. Today, we're going to be discussing Howard's latest memo titled, *Fewer Losers, or More Winners?* Howard, as always, thanks so much for joining me.

Howard Marks

Well thank you, Anna, it's a pleasure to be with you, and I'm especially looking forward to discussing this memo, which is a topic close to my heart.

Anna

You begin this memo by discussing your first memo, *The Route to Performance*, which was published in 1990. And, in particular, you focus on one phrase that people at Oaktree are very familiar with. The phrase, "If we avoid the losers, the winners will take care of themselves." So, I'd like you to explain the significance of this phrase, and how it relates to the main idea of this memo.

Howard

As the memo says, back in 1990, I had two interesting experiences, in short order. A certain value investment firm had a really terrible year. They were heavy in the banks, which were deep value, and the banks did terribly. And so, the head of the firm comes out and he says, "Well, if you want to be in the top 5% of money managers, you have to be willing to be in the bottom 5%." My reaction was, "I don't care if I'm in the top 5% in any given individual year, and my clients certainly are not willing to have me be in the bottom 5%, and neither am I."

Well, around the same time, I had dinner with one of my clients, Dave VanBenschoten, who ran the pension fund at General Mills. And he told me that he'd been doing it for 14 years, and in the 14 years, the General Mills equities had never been above the 27th percentile of the pension universe or below the 47th percentile. So, 27th to 47th, solidly in the second quartile every year for 14 years in a row. Where did that place them for the whole 14 years? Were they in the 27th or the 47th or maybe average it and maybe the 37th? No, they were in the 4th percentile. So how can a firm that's never been out of the second quartile be up in the 4th percentile for the whole period? And the answer is, most people eventually shoot themselves in the foot. And, one or more terrible years can ruin a record for the long term.

So I said, "Well, I like Dave's approach." When I started off in money management, '78, Citibank asked me to start convertible and high-yield bond portfolios, which I did. When you invest in straight bonds, non-convertible bonds, and you buy it on an 8 yield to maturity, what you're doing is you're expecting to get 8. You shouldn't buy 8% bonds hoping to get 10 or 12. And if you know what you're doing, you're not going to get 6 or 4, you're going to get 8.

So, the point is that if you are running a high-yield bond portfolio, the real goal is not to find the future winners, because in straight bond world there aren't many winners, but to avoid the losers. Avoid the ones that default. And, if you can put out a lot of money in a high-yield bond portfolio, highly-diversified, in which none of the holdings default. Then you'll get the promised yield to maturity, and taking more risks, investing in a different list, is unlikely to enhance your returns because straight bonds don't have much upside. They only have downside if they don't pay. So, if we avoid the ones that don't pay and hold a diversified portfolio of the ones that do pay, we feel some of them will give us exposure to favorable developments that occur, whether it's upgrades, or takeovers by stronger credits, or what have you. But, we always have eschewed hunting for those. We spend our time avoiding defaults. If we participate in favorable developments, that's an outgrowth of our investing, not the primary goal itself.

I was profiled in the Financial Times last fall in the Lunch with the FT column. And I took the reporter to my favorite restaurant, and I said, "Eating here is like investing at Oaktree. Always good, sometimes great, never terrible." But anyway, that's my approach. And I think that if you can go through a long investment career, and at the end if you can say, "Always good, sometimes great, never terrible," I think that's a real accomplishment. So that really became my mantra and Oaktree's mantra, and we adopted it as our motto when we formed Oaktree in 1995.

Anna

And in this memo, you're focusing on the idea that while there's definitely a risk of focusing too much on winners, there's also a risk associated with not taking enough risk. So I'd like you to explain that difference between risk control and risk avoidance.

Howard

Well, as I mentioned in the memo, investing is about, really, the intelligent bearing of risk-for-profit. Number one, you should do it intelligently. Number two, there should be an expectation of profit if you do it successfully. But number three, you have to bear risk. Investing is about the future. It's about positioning your capital for future events. Now, that's not easy. You have to position your portfolio for future events when you don't know what the future events are going to be. That's a dilemma right there.

But, as you say, there is the risk of not taking enough risk. The mere fact that you didn't have any defaults in a given year doesn't mean you did a great job because you can invest in Treasuries and have no defaults, and almost no yield. There's a reason why Treasuries yield less than everything else, which is just they have no credit risk. So you get no risk compensation.What you want to do to be an active investor is you want to get risk compensation, without bearing a lot of risk. You want to take risks that other people believe are risks that you don't believe are risks, and of course you want to be right. So, that's really what we try to do. You're paid for bearing risk. You want to bear risk intelligently. You don't want to avoid risk, because then you'll probably end up having avoided return as well.

Anna

And, as you say in the memo, people might somewhat understand or think, "I need to be able to accept some losses in order to have some gains," but it's ultimately really hard for people to accept that. And in the memo, you explain it through tennis. I wanted to shift into that part of the memo where you use tennis as a way to make this a little bit easier for people to understand.

Howard

Well, I've written a lot about comparing investing with sports, but also about comparing investing with games or gambling. And they're both very relevant, because in all three areas, gaming, sports, investing, you want to successfully play offense, but you also want to play defense at the same time. And you have to make a choice how much of your time should be spent on offense and how much should be spent on defense.

And that's where the title of the memo comes from. Fewer losers, that is more defense, or more winners, more offense. There's no answer. That's just the choice that each investor has, and each investor should make consciously. That's the point.

But first of all, when you're playing tennis, you try to hit good shots. You try to hit shots that your opponent won't absolutely slaughter. But at the same time, you want to make sure you get the ball back because if you don't get the ball back, you lose the point and you haven't given your opponent a chance to make you the winner. So clearly you have to balance offense and defense, but even the worst tennis player should not abandon all offense.

And in the memo, I cite an article which appeared in the Financial Analyst Journal, I believe was 1975 by Charlie Ellis. And this really had a profound impact on me. And Charlie talks about a book by Si Ramo, who was the R in TRW. And Si wrote a book about tennis. And in setting the stage for his lessons in the book, he explains that there are two different kinds of tennis games. There's the winners game and there's the losers game. And I've written a lot about this at length.

But the champion tennis player, they are so skillful and they are so in control of what they try to do, that they can go for winners, they can try to shot angles or speed or something that the opponent just can't do much with. They don't have to worry about, oh, the sun was in my eyes, or the wind was blowing, or that kind of stuff. So they should go for winners. And in fact, if you're a professional tennis player and you don't go for winners, you just keep the ball in play, you're going to be off the court as a loser in 15 minutes.

The professional tennis player wins by hitting winners shots that the opponent can't get. The amateur tennis player, like I am, the club tennis player, if you will, plays a loser's game. Not that he's a loser or she's a loser, but in the sense that you don't win points so much by hitting winners. You win points by not hitting losers. You keep the ball in play until your opponent makes a mistake, hits it in the net, hits it off the court, and then you win the point. You didn't have to hit a winner to win the point. It was sufficient to not hit any losers and wait until your opponent hits the loser.

Two different games. So of course, the key is to assess which category you fall in. And if you think you're a great tennis player and you go out to play a winners game, but you don't have the equipment, you're in big trouble. And in fact, as I have learned, seen, experienced, if you're playing a player who's better than you, you play your game, she plays her game, if she's a better player, she's going to beat you.

So if you want to have a chance of winning, you have to raise your game, which means you have to basically try shots that you don't have the ability to hit consistently. You have to go outside your comfort zone, take some risk. If you don't take any risk, if you take risk unsuccessfully, you may fail. If you don't take any risk, you're guaranteed to fail if you play a better player.

So investment is competitive and it's reactive. And if you want to be a superior investor, you have to try to add value in some way that the others haven't. And it may come from going more for winners, if you have that skill. It may be doing a better job of driving out losers if that's your skill. But you have to do something if you're going to win the match.

Anna

It makes me think about what you've written over the years in the *Dare To Be Different* memos, that if you want to be superior, you obviously have to be different. But as you've also often said, you also have to be right.

Howard

Yes, yes. To compete, you may have to raise your game.

Anna

And staying on the tennis theme a little bit, in this memo you speak about the recent Wimbledon quite a bit, and I was wondering if that was the spark for writing this memo.

Howard

Well, of course I wrote it over the summer, and if you look at the record of the memos, you'll see that there's almost always one published in September, which I wrote over the summer. There's usually one in January, which I wrote over Christmas, so I didn't have to just sit around the tree and sing songs. But Wimbledon was a big part of the inspiration why this memo got written. And in fact, there was a match between Daniil Medvedev, who's spent a lot of time in recent years just below the top three. The top three were Federer, Nadal, and Djokovic. And he played a guy named Christopher Eubanks. Eubanks was really unheard of pretty much outside of tennis circles, and he was unseated in the tournament. That means wasn't given a very high chance to win, but he ended up in the quarterfinals because he surprised a lot of people.

He's six foot seven, very fast, very athletic, and he surprised a lot of people with his aggressive game. And so he has to play Medvedev, who based on the record you would say is a better player. How's he going to beat a better player? The answer is he has to go for winners. So he goes all out and tries for a lot of winners. And guess what? He hit a lot of winners. I forget the exact numbers, but something like he had 74 winners and Medvedev had maybe 52, something like that.

Well, does that mean he won? No, because in pursuit of winners, he hit a lot of losers, and he had what we call unforced errors, which is an unsuccessful shot where your lack of success is not the fault of your opponent doing something great, it's just that you didn't do well. So he had three unforced errors for every four winners. Medvedev only had one unforced error for every four winners. So Eubanks had a few more winners than Medvedev, but he had a lot more losers than Medvedev. Medvedev won the match. Not because Eubanks didn't hit winners, he hit too many losers. And it's a great metaphor for investing, I think. And that really got me going. And that same observation, as you know, carried forward into the finals.

Anna

In the finals though, it was a little bit different. So can you explain what happened there?

Howard

Well, in the finals, a newcomer, a kid named Carlos Alcaraz from Spain, 20 years old, was playing against Djokovic, number one in the world, or probably the best player in the world over the last decade. In tennis, there are four grand slam events, Wimbledon, US Open, French Open, and Australian Open. And so there's four a year, there's 80 in 20 years. And Djokovic has won 23 of them. That's the most of any man in history. Nadal and Federer are not far behind with 22 and 20.

So he's playing Alcaraz, he's got 23 slams under his belt. Alcaraz has one. But Alcaraz is an incredible athlete, and very, very aggressive. So like Eubanks against Medvedev, Alcaraz went for winners. The main difference is he hit them, successfully. And so I think that in the end, Alcaraz had 66 winners and Djokovic only had 32. And Alcaraz won the match. And so the interesting thing is that if you think about it, Eubanks tried to hit winners. Medvedev won with the steadier game. Alcaraz went for winners and succeeded. He won the match by having more winners.

And in investing this question of whether you should go for more winners or whether you should try to eliminate more losers, it's a choice that everybody should make. It's a stylistic choice. It depends on your skill level, your return aspirations, and your ability to tolerate ups and downs. Because if you have an aggressive portfolio, you'll have a lot of ups and downs. And how's your intestinal fortitude? And how do you do with volatility? These are important questions.

Anna

The memo is focused primarily on Wimbledon, but I was curious if you had watched the recent U.S. Open, and if the final there sparked any thoughts in relation to the theme of this memo.

Howard

That's a great question, Anna. In the memo, I make the point that in tennis, when you play a player who's better than you, in order to have a chance of winning, you have to make shots you can't make consistently, but you have to try because if you don't try to hit those winning shots, you will readily lose to the better player.

Medvedev said something very similar after he beat Alcaraz in the semifinals and was facing the finals against Djokovic. He said, "I have to play better than myself." I think that's his way of saying exactly what I said. In other words, if he plays the Medvedev level and Djokovic plays the Djokovic level, Medvedev's going to lose. And to have a chance of beating Djokovic, he has to play at a different level, but it's not his level. He has to try things that he can't do consistently, and he has to get lucky and have an on day. Certainly not impossible.

What this reminds me of is the same question applied to investing. However, in this case, you're not playing against a better player. You're playing against the market and all the other investors on mass. So again, how are you going to turn out to be the winning player with superior investment returns? And if you say, I'm going to go for winners, how are you going to get those winners? You either have to figure out the macro future better than everybody else, which is hard. You have to time your ins and outs from the market better than everybody else, which is hard. You have to figure out the future of companies and thus their value better than everybody else, which is hard. Most investors don't have the ability to do these things. It's part of a game that they don't have. They can try, but when they falter, they make mistakes and fall behind. It's like playing a player who's better than you, really hard to win.

Anna

So when thinking about balancing having winners versus trying to avoid losers, in the memo, when you're talking about the winner side of it, you focus on something that you wrote about in 2022 in your memo, *Selling Out*, this idea that one of the reasons that a lot of active investors have lagged behind the indices is because they've sold too many of their winners. So can you elaborate a little bit on that?

Howard

Well of course, Apple is in the S&P500, and I forget exactly when it was admitted to the S&P500. But you look at Apple, back in 2003, on a strike split adjusted basis, Apple stock was 37 cents. And 10 years later it was $15. So it went up 40 times in 10 years. So the key question is, if you were lucky enough or smart enough to have Apple stock at the beginning, in '03, did you still have it in '13? Or had you lightened your position?

Now if Apple's weighting in the S&P was constant over that period, but you diminished yours, and Apple kept on performing well, then clearly you would begin to lag. And so as I said, it went from 37 cents to $15 in the first 10 years. In the second 10 years it went from $15 to $175, which is where it is today. And it's up, I think 485 times since '03. If you didn't continue to own all your Apple, it was very hard to keep up with the indices. And by the way, it's not just Apple. There are other stocks as well that fall into that category. So holding an index fund sounds like a passive activity, a low risk activity, et cetera. But clearly, you had to have as much risk as the index in order to keep up with the index. It's total logical.

But it's hard for people to keep all the risk of the index because they're afraid that the things that have gone up so much are going to turn around and go south, and they'll look stupid. What? You had a stock that was up 480 times? And you didn't take any profits? And now it's only up 300 times? What's wrong with you?

So human nature wise, it's very hard to hold your winners and just let them run. There was that memo that you're talking about, in which my son Andrew made a great contribution. He said, "If you have a chart of a stock that's been up for 20 years, and you look at the chart enviously, and you say, 'man, I wish I had that stock,' think of all the days you would've had to talk yourself out of selling."

20 years, that's 7,300 days. On any one of those 7,300 days, you could have gotten up and said, "Oh man, it's so high. I don't think it can keep going. I'm going to sell 10%, because that's the prudent thing to do." But if you did and it kept going, you lagged. So clearly there's a downside to not having a full complement of winners.

Anna

Yeah, that reminds me of something I believe you mentioned in that memo, was that idea that for most investors, just being invested and staying invested is really what's going to be the best over the long run.

Howard

Right, absolutely. That's what people lose track of. Everybody's, "Well, is it a buy or is it a sell? Should we get in? Should we get out? Should we increase risk, decrease? Risk on, risk off?" "What's going to happen with the economy? We going to have recession, more inflation?" "What will the Fed do?" All these questions are subsidiary.

The most important thing for most investors is that they have an investment portfolio, hopefully in the stock market, other things are also investible for the long run, and that they stay with it, and just don't screw it up. Don't try to mastermind it, just hold it.

S&Ps been up over 10% a year for a hundred years. And if you put a dollar in a hundred years ago, which most of us didn't have the opportunity to, that dollar is probably worth about $15,000 today. That's enough, right? You don't have to add to it by getting in, getting out, getting in, changing your weight, changing your allocation, changing your holdings. Just buy and hold a representative portfolio.

Anna

Yeah, and in a way, it makes me think of what you were saying, obviously earlier with tennis, that again, for most people, just not doing anything wrong is really going to be the best bet. And for those who want to potentially be a superior investor, it's not enough to have strategy, they also need to have the skill?

Howard

Yes. Well, Anna, it's like, so I go out to play tennis tomorrow. And I say, "You know what? I'm tired of just getting it back. It's kind of boring. It's not that exciting. So I think for now on I'm going to play like Djokovic. Every shot's a winner. Well, that match wouldn't last very long because I can't hit that many winners. So you have to play, as they say in football, you have to play within yourself. You have to do things you're capable of doing if you want to be a steady winner and you can try shots that you're not really capable of making steadily and get lucky and be a winner that way, but your life expectancy will not be that high. And Dave VanBenschoten, what he showed me was the root to having a great life expectancy.

Anna

I would be remiss if I didn't ask you about one section of the memo where you include a graph that you've had in a number of memos over the years. And I think it's a really excellent way for people to understand risk. So I was hoping that you could just describe this graph and then explain why it's been so key to a lot of your ideas about investing.

Howard

In 2006, I wrote the first memo devoted entirely to risk, and the title was *Risk*. I said in there that when I went to University of Chicago for grad school and they taught the new Chicago approach to investing, they showed a line which went from lower left to upper right, where the vertical axis is return, and the horizontal axis is risk. So if a line goes from the lower left to the upper right, we say it's positive correlation.

So my problem was that a lot of people look at that graph and they show that upper sloping line and they reach two conclusions. Number one, that riskier assets have higher returns. And number two, that if you want to make more money, the way to do it is to take more risk. And that was quite universal, but I was never happy with that because there's an implication that if you want to make more money, all you have to do is take more risk, that riskier assets will lead to success.

But my dilemma was that if riskier assets can be counted on to produce higher returns, then by definition they're not risky. So they can't be right. It can't be true that riskier assets can be depended on for high returns. So what I did is I took some little bell-shaped curves, turned them on their side and superimposed them on that capital market line. And they spread as you move from left to right. So now, rather than saying that as you take more risk, you get more return, now what you see is that as you take more risk, the expected return increases just the same, but at the same time, the range of possible outcomes becomes wider. There's more uncertainty, and the bad outcomes become worse. In other words, by going into a riskier asset, you may have a lower return or a negative return, you could lose money. Well, isn't that the definition of risk?

So this is a formulation that I'm extremely comfortable with. This is not an algorithm for making money, but it's a way to think, which is what I mostly try to write about. And I think this is really very useful because I think it gives you a feeling for the nature of risk, that riskier strategies have more uncertainty, the possibility of better outcomes and the possibility of worse outcomes. That's risk.

So it's the same with Djokovic and tennis. Djokovic plays a steady game, dependable, rarely makes an unforced error. And since that sounds like a small accomplishment, but most people can't do it. Alcaraz plays a more aggressive game. He goes for more winners. And I say in the memo, according to my tennis coach, if he has a good day, he can beat anybody. If he has a bad day, he may well lose because a lot of his attempts at hitting winners will be unsuccessful. So that's what you might call a high risk, high return strategy. And the important thing is neither of them is right or wrong. It's a choice that every investor has and we hope they'll make a good choice for themselves.

Anna

One of the other things you mentioned in the memo related to this chart is that what it doesn't show is the impact of alpha.

Howard

Well, that's right, because as I drew the curves, they're all bell-shaped. That is to say they're all symmetrical. You have an expected outcome and you have the same area to the left and to the right, the better and the worse. So your expectation is 10, you have some possibility of 15 and some possibility of five. And if those possibilities are equal, then you say it's symmetrical. That's the University of Chicago approach, which says that the market is efficient. You can't beat the market. I believe there are investors who can beat the market.

And so how do you beat the market? And the answer is you produce a probability distribution of outcomes, which is asymmetrical. Where if the market's up 10, you might be up 15 or you might be up eight. So your good ones are better than your bad ones or bad or you're, hold on one second. So I believe that exceptional investors are exceptional because they can produce asymmetrical outcomes because they can set themselves up so that if the market does well, they'll do much better than the market. But if the market does poorly, they'll do maybe a little worse. It's a favorable trade-off.

The trouble is most people don't have alpha, most people can't produce asymmetry, and they should have an index fund or some very safe investments in treasuries or high grade bonds and so forth. But if an amateur tries pro tennis, it's going to be a problem. If a person without alpha makes a bunch of bold bets in the hope of getting lucky, the expectation isn't that great. Anybody can get lucky anytime.

Anna

Right.

Howard

But luck is not much of a plan.

Anna

Luck's not a great strategy.

Howard

Right.

Anna

So as always, do you have any final thoughts about this memo?

Howard

Well, I think it presents a fundamental question. One of my arguments, Anna, is that a lot of people proceed to invest without asking themselves the fundamental questions. Do you have the ability to produce asymmetry? And if not, why try? Do you have the stomach for volatility? And if not, why try to hit winners? Is the return on the averages enough? And if 10% a year on average in the long run is enough, why try for winners? Why have a non-market portfolio? So the point is this question of should you try for fewer losers or should you try for more winners? As I say, there's no correct answer, but it is a fundamental question that every investor should ask, and I believe not many do.

Anna

Well, that's an excellent place to end. So as always, thanks so much for joining me.

Howard

Thanks for your good questions, Anna.