Memo to:	Oaktree Clients
From:	Howard Marks
Re:	The Indispensability of Risk

Oftentimes, we're best able to understand something we're interested in through analogies that clarify the matter by establishing connections between it and other parts of life. That's why I've written a memo comparing investing to sports in each of the four decades I've been writing memos and one connecting investing and card playing in 2020.

The motivation for this memo comes from an article in *The Wall Street Journal* of April 12 that my partner Bruce Karsh sent me entitled "Chess Teaches the Power of Sacrifice" by Maurice Ashley, a chess grandmaster who has been inducted into the U.S. Chess Hall of Fame. Few people know that Bruce is a chess player, and I hadn't thought about this fact for years, but the article provided a good reminder and moved me to dash off this memo.

As is obvious from the article's title, the piece is mostly about the role of sacrifice. Ashley says, "Many positions cannot be won or saved without something of value being given away, from a lowly pawn all the way up to the mighty queen." Intentionally losing a piece as part of one's gameplan is the sacrifice that Ashley is referencing.

- He describes some sacrifices as "shams," (a term coined by chess master Rudolf Spielmann in his book *The Art of Sacrifice in Chess*) where ". . . one can easily see that the piece being given up will return concrete benefits that can be clearly calculated." In other words, I put a piece in clear jeopardy, but I do this so that I'll be able to take one of yours of greater value.
- Others are deemed "real" sacrifices, where ". . . giving away a piece offers gains that are neither immediate nor tangible. The return on investment might be controlling more space, creating an assailable weakness in the opponent's position, or having more pieces in the critical sector of attack."

The analogy to investing begins to become clear. Buying a 10-year U.S. Treasury note is a modest or "sham" sacrifice. You give up the use of your money for ten years, but that's only an opportunity cost, and accepting it brings the certainty of interest income. Most other investments involve real sacrifices, though, where the risk of loss is borne in pursuit of "gains that are neither immediate nor tangible."

Ashley goes on to speak of sacrifice in risk/return terms that are familiar to investors. He describes his mother's decision to leave him (at age two) and his two siblings in Jamaica and travel to the U.S. in search of a better life for herself and for them. She reached her goal a decade later and was able to bring her kids to the U.S., where they would find success in a variety of fields:

> **It did not have to turn out that way.** It did because she was willing to stomach the key aspect of making real sacrifices: **the willingness to take risks.** For a chess player, risk is as much intuited as it is calculated. Due to the inherent complexity of the game, it is virtually impossible to assess with certainty whether a risky move will pay off in the end. **It's up to the player to decide if sufficient conditions have been met to take the chance on a risky move. . . .**

> What we do know, however, is that the famous saying "No risk, no reward" is true in many cases. A skilled adversary is normally able to handle solid, conservative play and therefore able to rob us of opportunities that may be inherent in our position. As [five-time world chess champion] Magnus Carlsen put it, "Not being willing to take risks is an extremely risky strategy." (Emphasis added)

And there you have it: the indispensability of risk.

<u>The Risk of Not Taking Risk</u>

Because the future is inherently uncertain, we usually have to choose between (a) avoiding risk and having little or no return, (b) taking a modest risk and settling for a commensurately modest return, or (c) taking on a high degree of uncertainty in pursuit of substantial gain but accepting the possibility of substantial permanent loss. Everyone would love a shot at earning big gains with little risk, but the "efficiency" of the market – meaning the fact that the other participants in the market aren't dummies – usually precludes this possibility.

Most investors are capable of accomplishing "a" and most of "b." The challenge in investing lies in the pursuit of some version of "c." **Earning high returns – in absolute terms or relative to other investors in a market – requires that you bear meaningful risk – either the possibility of loss in the pursuit of absolute gain or the possibility of underperformance in the pursuit of outperformance. In each case, the two are inseparable.** As Ashley says, no risk, no reward. No pain, no gain.

The risk inherent in not taking enough risk is very real. Individual investors who eschew risk may end up with a return that is insufficient to support their cost of living. And professional investors who take too little risk may fail to keep up with their clients' expectations or their benchmarks.

Like chess (and most card games), backgammon requires the calculation of when to take risk and when to avoid it. In backgammon, two players move their checkers around the board based on throws of a pair of dice. One player moves clockwise and the other counterclockwise. When players' checkers come near each other, the player who's moving often has a choice between (a) landing on one of the other player's checkers, sending it back to the start (but at the risk of leaving the moving checker in a vulnerable position), and (b) avoiding doing so to play it safe. No one wants to be exposed and get hit. But most beginners play it too safe, and because they put so much emphasis on avoiding getting hit, they rarely win.

Relevant lessons from sports (included in past memos) are easily accessed and also very helpful:

- "You miss 100% of the shots you don't take." – Wayne Gretzky, NHL Hall of Famer
- "You have to give yourself a chance to fail." – Kenny "The Jet" Smith, two-time NBA champion

I'll sum up with a paragraph from my memo of last September, *Fewer Losers, or More Winners?* The final sentence says a great deal about sacrifice and risk:

> . . . not having any losers isn't a useful goal. The only sure way to achieve that is by not taking any risk. But … risk avoidance is likely to result in return avoidance. There's such a thing as the risk of taking too little risk. 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.**

How to Think About Risk-Taking

The paradox of risk-taking is inescapable. You have to take it to be successful in competitive, high-aspiration arenas. But taking it doesn't mean you'll be successful; that's why they call it risk.

Equally paradoxical, earning a high rate of return over a long time period doesn't have to – and usually doesn't – connote a record of consistent success. More often it results from having made a lot of well-reasoned investments, some subset of which worked out well. Here's how I described the basis for the success of Berkshire Hathaway in *Fewer Losers, or More Winners?*:

> I believe the ingredients of Warren [Buffett]'s and Charlie [Munger]'s great performance are simple: (a) a lot of investments in which they did decently, (b) a relatively small number of big winners that they invested in heavily and held for decades, and (c) relatively few big losers. No one should expect to have – or expect their money managers to have – all big winners and no losers.

Investors must accept that success is likely to stem from making a large number of investments, all of which you make because you expect them to succeed, but some portion of which you know won't. You have to put it all out there. You have to take a shot. Not every effort will be rewarded with high returns, but hopefully enough will do so to produce success over the long term. That success will ultimately be a function of the ratio of winners to losers, and of the magnitude of the losses relative to the gains. But refusal to take risk in this process is unlikely to get you where you want to go.

I'll conclude with another good paragraph from Ashley:

> Taking a chance doesn't mean there will be a successful outcome, nor does it require it. If the reasons are sound, the risk should be taken almost reflexively. The more often we trust our judgment, the more confidence we gain in our decision-making capacity. The courage to take risks becomes a worthwhile end in itself.

The bottom line on the quest for superior investment returns is clear: **You shouldn't expect to make money without bearing risk, but you shouldn't expect to make money just for taking risk. You have to sacrifice certainty, but it has to be done skillfully and intelligently, and with emotion under control.**

April 17, 2024

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