Behind the Memo – The Indispensability of Risk with Howard Marks, Bruce Karsh, and Maurice Ashley

Anna Szymanski

Hello, and welcome to *Behind the Memo by Howard Marks*. I'm Anna Szymanski, Oaktree's senior financial writer. And today, Howard and I are very excited to be joined by two very special guests, Bruce Karsh, Oaktree's CIO and co-chairman, and Maurice Ashley, a chess grandmaster and author of the new book, *Move By Move: Life Lessons on and off the Chessboard*.

As our listeners may know, Howard's recent memo, *The Indispensability of Risk*, was inspired by an article that Maurice wrote for *The Wall Street Journal* entitled *Chess Teaches the Power of Sacrifice*. So today, we're going to be discussing sacrifice, other lessons that investors can learn from chess, and how everyone can better understand risk.

Maurice, Bruce, Howard, thanks so much for joining me.

Howard Marks

Great to be here, Anna.

Bruce Karsh

Thank you.

Maurice Ashley

Thank you indeed. Thanks for being here.

Anna

So Maurice, I am going to start with you. As I mentioned, Howard's recent memo was based on an article that you wrote, which was adapted from a section of your new book. I was hoping that you could briefly discuss some of the key arguments from this essay and also why this was the main point that you wanted to highlight from your book.

Maurice

Well, thanks for that. In chess, we have a very important concept called sacrifice. And many people, even if you don't understand chess, you can easily and intuitively understand what a sacrifice is. But in chess, it is actually taking a piece of value and giving it away. And actually, everything in chess is of value. So you've got pawns, which are the least important units on the board, so to speak, and then you have the bigger pieces that are more mobile. They can move down the board quickly. And so they're considered more important, mainly because they're just so aggressive.

But in chess sometimes, you give away one of these units, and to give it away in a chess game is not a casual thing because if you give even a tiny pawn to a grandmaster, your odds of losing rise dramatically because being down in any way in chess is significant. We call it being down material, and giving away material in chess is just quite dangerous. So you don't do that lightly.

So when we do it, we do it because we have compelling reasons. We do it because we're going to get something for it. Sometimes it's concrete, sometimes you can calculate that you'll get back a piece, even more important piece from your opponent. So you don't care that you give this kind of sacrifice. We call that a sham sacrifice. It's not a real sacrifice if I can see to the very end that I'm going to get stuff back.

But a real sacrifice is when you can't see to the very end, when it's still nebulous, when you get what we call compensation, where you think it'll be a good position. It looks like you have great chances. Your odds of winning seem to you like they've risen, but you don't know. And that uncertainty is what makes a sacrifice compelling.

Anna

Howard, what about these ideas that Maurice was talking about really resonated with you and made you want to devote a memo to this topic?

Howard

Well, Bruce sent me the article on a weekend, and it was one of those aha moments. And as you know, Anna, it inspired me to write a memo uncharacteristically three pages, versus the norm of 10 or 12. Basically about one thing, what Maurice calls sacrifice. It has a direct parallel in the investment business, except that we call it risk-bearing. You do something which has the potential to diminish your position. That is to say you could lose money, but you think it's going to pay off. It doesn't have to pay off. You can't be assured that it's going to pay off. It's all a matter of probability. The risk-bearing is definite. The possibility of reward is uncertain.

And as I read Maurice's article, I just got more and more excited about the parallel. In fact, at one point he talks about the fact that his mother made the difficult decision to leave him and his siblings in Jamaica and traveled to the US in search of a better life for herself and for them. And of course it turned out great. And Maurice is chess master and his two siblings are similarly accomplished in very different fields. But he says, quote, " It did not have to turn out that way." Skip a little. "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."

And that's investing. You do something. Everything we do, we do because we think it'll work. There are very few things we can do that are guaranteed to work. They're all a matter of probability. We think we can assess the probability, and by multiplying the probability of success times the magnitude of success, and subtracting the cost of participating, we can figure out whether something has a positive or negative expectation. But there are no guarantees. Just like Maurice says, you sacrifice a piece, the addition to your probability of winning is not for certain, but you do it because of the positive expectation. So I just love the parallel in what we do. And that was the occasion for the memo.

Anna

Now Bruce, what about the article made you forward it to Howard?

Bruce

Well, I know Howard loves games, and I thought the concept of a real sacrifice versus a sham one would interest him. And he'd probably see parallels to investing in that. I knew Maurice's discussion of risk would resonate with him. And finally, I sensed that Howard would find this chess grandmaster's life story fascinating and compelling.

Anna

And now we'll unpack some of those ideas that, Maurice, that you introduced in your first answer. So one of the things that you really highlight in your article is the risk of not taking enough risk, and that's something Howard has written about quite a bit. I was hoping that you could speak more about this and why you think this is such a key concept in chess and in life in general.

Maurice

Yes. And by the way, listen to these answers, especially Howard breaking it down so well and with so many parallels to investing. It is just really mind-blowing. But not taking enough risks, Magnus Carlsen, the former world champion, maybe the greatest player of all time, some will argue it was Bobby Fischer or Garry Kasparov, but just know that he's on the Mount Rushmore of chess, he said this quote, "It's risky to not take enough risk." Sometimes you play too close to the vest. And what happens in a competitive environment is that the margins are so small, it's so close, the abilities of top players, that if you try to play it safe, if you try to be incrementalist about it, those guys will stop that in a second.

Whatever you're trying, it's like, "Come on, what is that? That's some weak stuff you bring in here." You have to take some level of chance, some degree of risk, something that will scare the other person. Whoa, whoa, whoa. What is this? Why are they giving this up? And intuitively they'll know that you're giving away something, but at the same time they'll know that you're getting something back. You're getting chances, you're getting opportunities. You are not just giving away because you feel like you're gambling. No, you've assessed the situation critically. You've looked at all your opportunities, your options, and you think, "This way, even though I cannot divine it all the way to the end, is the way to go."

And that's where your chances lie. So if you don't take enough of those chances against a really good player, and it sounds almost like it's bluffing in a way, almost like it's poker. It's similar, but it's not because it's so well, not just calculated, but intuitive based on years of experience, based on seeing similar patterns before, based on this gut feeling, like this will potentially pay off in this situation. And those taking of chances that give players the real opportunity to win games.

Bruce

Maurice, when you were reciting that answer, I thought about Howard and what he often talks about, which is investing in a company that's widely known, understood, and universally loved, or security that's complex, largely ignored or shunned and universally avoided. The former feels like not taking enough risk. And the latter feels like the kind of risk where you could probably do quite well.

Howard

Yeah. Well, Bruce, as long as you add the last three words, "If you're right." You can invest in the safe stuff and get a modest return pretty reliably, but probably lose the great investor sweepstakes. Or you can do things that are uncertain, under a cloud, disrespected, where other people's expectations are low. That's where you can score the real gains if you're right. I love the way Maurice put it in the article. He said, "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."

So we think we have a good position, we pursue it, patiently, doggedly, slowly, safely, and then a skilled opponent will eat you for lunch. You have to take a risk. You have to do something surprising. You might even have to do something where the opponent can't figure out what you're doing and then maybe you have a chance of beating a skilled opponent. It's the same for us. The things that are clearly going to pay off because of their safety will, if they work, deliver a low return. We have to do some things where the outcome is uncertain if we want to come out with superior returns or at the top of the league tables.

Maurice

If I may, I would like to point out that there are certain psychological traits one has to have, in order to take these chances? You have to be bold. You have to be an outlier. You have to be the kind of person that doesn't follow the crowd necessarily. You also have to develop your counter intuition versus your intuition. "My intuition says this." Normally maybe you'll be a safe person, living in a safe space because your intuition tells you, "If I do that, I'm going to fail or potentially fail."

But the counter intuition says, "This direction may be different from the crowd or run counter to the normal trend, but this looks to me like something that could work out." And that's a fine art. That is not easy at all. A lot of us could come up with what we would call interesting ideas that others may say are cockamamie ideas, but because we just have developed this fine sense of guessing, divining, what goes against the crowd but may pay off, that's where the sweet spot of success is.

And the reality is, in investing, as we know, you can fail a number of times and still come out way ahead because all you need to do is succeed two or three times in a massive way and you're golden. If a company goes 10x, 100x, then all those other bets you made won't matter because these two or three that you landed will pay off. Chess is a little bit different. I can't lose 97 games and win only three and still make the Grand Master title, but in investing, you definitely can do so.

Howard

I want to point out, Maurice, however that there are in investing more ways than one to win and the one you described is only one. In the summer of '23, I wrote a memo called *Fewer Losers, or More Winners?* And in our business you can win by having some good winners and fewer detractors than other people. Or you can win by swinging for the fences and occasionally hitting it out of the park. Of course, it would be great if you could do both. It's hard because it requires different skill sets and different personalities, but not all winning is a function of the grand gesture.

Maurice

And I would agree with that for chess as well, because it happens in chess. There are those who do play that game close to the vest and they end up still being really good players, sometimes even great players. We have what styles we call positional versus tactical. The tactical players are the ones who are ready to sacrifice in a heartbeat. Their personality just flows like swashbucklers, but then you have the others who say, "Hold on a second." And then there's that middle ground. Sometimes you do it, sometimes you don't. You just have to, again, develop that internal skill set that allows you to know just when to make that judgment.

Howard

Well, we say it exactly the same. You can be an aggressive player with superior skill or you can be a defensive player with superior skill. You can win either way. The necessary condition is the superior skill. Mere aggressiveness or mere defensiveness is not enough. And I think that's what you're saying in your article when you're saying that a skilled opponent can rob you of your advantage.

Maurice

Absolutely.

Howard

Really, if you're not doing some things that are adventurous with superior skill, that's the equivalent of when I said to Bruce, "As long as you're right."

Bruce

I loved what Maurice said about the need to be a contrarian, because that's certainly the case in investing, and also what I would say is second level thinking, which is what he talked about in terms of going beyond just the first blush analysis. But what I love most about the article, I have to say, or what really resonated with me was in discussing the need to take risks, Maurice writes that you have to be at peace with yourself and accept that even a negative outcome doesn't necessarily invalidate the decision to assume the risk in the first place. And it's something that we talk a lot about, Howard, in investing.

Howard

It's beautiful, Bruce, the way you said that. You have to be willing to do things that are not sure to work. You and I have worked together now 37 years, and when you plunged into the market right after the Lehman bankruptcy, in which I supported you, that was not guaranteed to work. Nobody could prove that the financial system was not going to melt down, but you did what you thought was right, and even though it wasn't guaranteed to work, it did work because you were right. You made a judgment that others didn't make. And because it was a contrarian judgment, that is to say you were willing to go aggressive at a time when almost nobody else was, the payoff for doing so was unusually high, and I think that's exactly what Maurice is talking about.

Bruce

There was also, I would argue, a genuine sacrifice associated with that decision to invest because as you'll recall, Howard, I guess we were 15 weeks after the Lehman bankruptcy in September until the end of the year, and we were investing at the clip of five, $600 million a week, knowing that probably the next week and maybe the next and the next, prices were going to go lower and lower, but having the conviction that we were making excellent purchases and one day, we didn't know when, our judgment would be validated.

Howard

Well, that's right. And Bruce, if you keep making observations like that, we're going to include you in this program more often. But there are multiple sacrifices entailed in every investment decision. Everybody knows, one, that's the possibility that it'll be a loser and you'll lose money. Another sacrifice is by investing today, you give up the opportunity to invest that money a month from now, but if you instead say, "No, I have to get this decision exactly right. I'm only going to do things that I'm a hundred percent sure will work," then you'll be frozen into inaction, trying to achieve certainty in an uncertain arena.

And I think that's a lot of what this is about. I keep quoting from Maurice's great article, but one of the things he said when he was describing sacrifices, he talked about giving away a piece offers gains that are neither immediate nor tangible, and so do we. So the fact that you're not going to get your gains right away, they're not tangible at this point in time, and they're certainly not certain, but you do it anyway because you believe you're right. That's the absolute path to success. What? "If you're right."

Maurice

And you have to also be comfortable with losing because... I talk about it in another chapter in my book, you will lose. I mean, that's going to happen from time to time. You will lose. You definitely want to win more than you lose, but losing is part of any great success story. That's just the way it is. Nobody, I don't care who you are. Michael Jordan did not have a perfect record. Neither did Djokovic, Serena Williams. You can name the sport. These great players are able to handle loss, face loss, are willing to embrace it. And the ones who don't like to lose... We don't like to lose, but who are not willing to face the possibility of losing, and then even losing from time to time, they never become great. Just don't. Not the greatest of the greats. You have no story when somebody says, "yeah, I won at every level all the time." It's ridiculous.

That journey through those difficult times, through loss, taking your chance, falling on your face, learning from that, that develops the internal and intestinal fortitude and it also develops that intuition and counter-intuition that allows you to, the next time, say, "wait a minute, I've seen this story before or been here before, or I'm ready to continue down this path," as Bruce described his path, when everybody else is looking at you and saying, "are you crazy?" Which is another sacrifice. Additional sacrifice potentially of your reputation, of how people see you and are willing to back you, when they're like, "no, this guy is nuts." You're sacrificing all of that when you go through this process. But boy, when it works out, it's so sweet.

Howard

Maurice, Dave Swensen ran the endowment at Yale for 35 years, from '85 until '20, and in a game of inches, he was miles ahead. He had terrific performance. And he wrote a book in the mid-90s called Pioneering Portfolio Management with the two greatest words I ever heard. He said that "investment management," by which he meant successful investment management "requires the adoption of uncomfortably idiosyncratic positions."

You have to depart from the crowd. That is to say, you have to do something which is less than obviously sure to work, less than safe, if you want to win. But if you do something that departs from the crowd, in a way, if you're not a little uncomfortable, there's something wrong with you. But we do it anyway because we do a calculation based on our intuition and we conclude that it'll work.

One of the great conundrums of investing is that everything we do, we do because we think it'll work. But we must know that some will not. And we have to have the maturity to live with a batting average of, less than what they call in baseball, for some reason, batting 1000, I would call it batting 100, but as you say, you're never going to get them all right and anybody who thinks they will is a fool, and anybody who claims they do is a liar.

Anna

And Howard, this makes me think of a quote that you have in the Indispensability of risk that actually was also in More Winners or Fewer Losers, which is "human nature makes it hard to accept the idea that the willingness to live with some losses is an essential ingredient in investment success."

Howard

Right. You're going to have some losses. You shouldn't celebrate, but you have to be okay with it. And if you can have a high batting average, and better than anybody else's, that's good enough. You don't have to bat 1000.

Bruce

Roger Federer, in a graduation speech at Dartmouth a couple weeks ago, said it best. He looked back at his career and counted the percent of points that he won throughout his career, and it was striking to me it was only 54% of all the points. One of the greatest tennis player of all times only won 54% of his points. Now, obviously, he won the big points because he won about 80% of his matches, but he makes the point that it's only a point and you've got to forget about it because you're going to lose a lot of them, and he lost 46% of his.

Anna

Now, one topic that I think all of you have been touching on a little bit is this idea of decision quality, of the idea of being able to separate the quality of a decision from the outcome. You end your piece by writing, "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." I was hoping that you could just unpack this statement and explain why you say that people should take these risks almost reflexively.

Maurice

Yes, I love the way you put that, in terms of decision quality. Many people are outcome driven. They see a result and they say, "that means what you did must have been a bad decision, that your analysis was unsound." But the world tells us that we cannot control all outcomes. There's no way you even bother to try. You cannot control the outcomes. You can only control your effort. You can control your analysis. You can control what you look at and see in front of you, and then make decisions based on what are either logical or creative or intuitive reasons, but you cannot control the outcome and you shouldn't even bother to try.

Now, there's some things that you do want to control the outcome. If a plane goes up in the sky, you want to make sure it comes down, so you're going to design that plane really well, you're going to make sure the mechanics... Took a good look before you went up. But even, you could be spotless in everything you did and a flock of birds decides to fly by and bump into your engine, and what did you do? You just could not predict that that was going to happen.

That means don't fly? No. It means that you can't control every single eventuality, so you have to just have a strategy. You know what it is, you go in knowing that the opportunities are there, that your decisions have been soundly thought through, and you go for it. And then the rest, perhaps not sleeping well at night because you might lose, if you're in that position, you shouldn't be in the game. Period.

Howard

I can't miss an opportunity to tell the listeners a story, that the first book I read when I got to Wharton, 61 years ago, in September of '63, was *Decision-Making Under Uncertainty in the Oil and Gas Industry*. And the lesson that I most prominently remember from reading that book is that you can't tell the quality of a decision from the outcome. There's so much randomness.

Now, I don't think there's too much randomness in chess, Maurice. There's no dice to roll and there's no wind to blow or sun to get in your eyes. But in most of life, there's so much randomness that good decisions fail to work and bad decisions work out pretty often. The idea that you can't tell the quality of a decision from the outcome is kind of counterintuitive and probably eludes most people, just like the fact that you have to take a bunch of actions, even though you know they're not all going to work. Both in chess and in investing.

Maurice

And chess is complex enough, I will tell you, that randomness creeps in much more often than you think because there are too many possibilities. After the first four moves in chess, there are over three billion possibilities. Three billion. No human is sitting there calculating those possibilities. A lot of what we do is based, again, on our insights, our experience, our understanding of the positions, the history of an opening that you might be studying, the tendencies that your opponent might have.

And so, you'll have calculated something, you think you know sort of the direction the wind is going to blow, and suddenly appears on the board a move that your opponent thought of, and you say, "wait a second, I didn't even see that coming." That happens much more often than you think, even to the best players. But if your position is already sound, even those surprising, so-called random possibilities that creep up that you may not have seen, you'll be able to handle as well because you started off from a position of solidity and those little twists and turns that pop up, you're ready for. And that's what you train for, to be ready for the peaks and the valleys as they come in every position.

Anna

Now, Bruce, in Howard's memo, he mentions that you are a chess player, which is something that I had not known previously. What are some other lessons outside of what we've already talked about that an investor can learn from the game of chess?

Bruce

I started playing when I was quite young, I think even younger than Maurice, I was probably eight or nine years old when I started. My dad taught me. He and I played chess virtually every night. He loved it, so did I, for probably seven or eight years. And it really teaches patience, focus, especially the need to think several moves ahead. That is key. And I would say those are the same things that really help an investor. Patience, focus, and think many, many moves ahead.

Maurice

If I may. That's great and what a great story, and everybody always remembers where they learn chess for some reason, was it my dad, my mom, a grandparent, a friend. It's always a beautiful origin story. For some reason, this game, it's something mystifying at the moment that you learn. Even if you don't stay with the game, it's just something about just that moment you learn. I learned from my brother playing with his friends. Something else I'd like to point out though, I think it's really important what Bruce said about thinking ahead.

But again, I mentioned the idea of complexity being so vast in chess that actually one very, very important quality that chess players have to have is the ability... What I'll call situational awareness. It's extremely important to see ahead yes, but it's so critical to be present, to see what's happening right now. A lot of times you start looking ahead and you miss what's right in front of your face. And that's something we try to master, being extremely present. Because if I'm making good decisions now, then two moves from now, I should still be okay.

And if I can just consistently make the proper decisions based on the factors that I see in front of me, then I don't have to look 10 moves ahead. And if you ever watch chess players play with a clock, blitz chess or even bullet chess, which is one minute for the entire game. I know people go crazy when they hear that. We go on speed runs where the entire game, I have 60 seconds, my opponent has 60 seconds, and if my time runs out, I lose. If their 60 seconds run out, they lose. And I don't have any time to look ahead.

All I can go on is just my intuition and my trust and confidence that I'll be able to handle whatever happens and I just have to make decisions in the moment, spot on, next, next, next and go. And that is being incredibly situationally aware and that is a craft, something we truly hone when we play chess. And I think that applies very clearly to investing.

Bruce

Quite definitely.

Anna

Maurice, you end your article by saying the courage to take risks becomes a worthwhile end in itself. So I wanted to maybe our discussion today by first letting you explain what you meant by that point.

Maurice

Well that point, and many of the other points I talk about in the book really encapsulate one philosophy that I have about success. And it's that success is not really about arriving at a destination, but that in fact the journey is what gives value to the destination. We are empowered by the valleys that we have to cross, by the challenges that we face, by the trials and tribulations, the difficulties of life that teach us so much about whatever craft we've tried to master, but most importantly teach us so much about ourselves, our tenacity, our ability to be resilient, our stick-to-itiveness, determination, stamina. All these abilities to tolerate loss, failure, ability to be graceful while being successful. All those qualities you get when you go on any great journey. And so anyone who wants a quick tip of how to be successful, just toss that out the window.

Because if you get success and that's all that you're after, you get nothing of the growth that you could have along the way. So that's why I talk about this in the same way with sacrifice and risk is you yourself are growing so much when you learn how to just do it. Just do it. Just act on it. Don't worry about the consequences. Go to sleep. How much can you gain, how much you will gain from being that type of person? That's going to be much more important than that actual success that you have. And I'm not saying you shouldn't have that success because that's the whole point. We're trying to get that great degree of success and wealth that we all covet, but it's that journey that makes it so special. It's that journey that gives value to that destination.

Howard

And I would say the same thing Maurice about investing and that's why it's so rewarding. In both fields, we do something that's competitive, we tackle challenges, we go up against opponents, we depend on our own personal characteristics, both intellectual and emotional. And it's the process that's very valuable. Having said that, of course it's better if your returns are high rather than low.

Anna

Well, I just want to thank you all so much for coming on. This was a wonderful conversation.

Howard

Thank you, Maurice, for joining Bruce and me. You've contributed to what's sure to be one of our most popular podcasts. And it's an honor to have you with us.

Maurice

It was really my pleasure to be here.

Anna

Thanks so much.

Bruce

Thank you. Thanks, Howard. Thanks, Maurice. Thanks, Anna.