Memo to: Oaktree Clients

From: Howard Marks

Re: Hemlines and Investment Styles

While the details change, the pendulum-like fluctuation of investment styles is a constant. Fear versus greed, pursuit of safety versus aggressiveness, stocks versus bonds, and growth versus value are just a few examples of the areas in which we see this take place. In this way, the investment world proves the wisdom of Mark Twain's observation that, "History doesn't repeat itself, but it does rhyme."

The limits of the pendulum's swing are fixed, and it tends to move back and forth over the territory between them. This occurs because (a) people tend to take trends to extremes, (b) neither extreme of the pendulum's arc represents a perfect or permanent solution, and (c) there's no place else to go in these regards. **Thus the best way to view investment trends may be through an analogy to hemlines: all they can do is go up and down, and so they do**. The style mavens call for short skirts, and people fall into line, raising hemlines until they're as high as they can go. And then they drop (and so forth).

The reasons behind the rise and fall of investment fashions rarely repeat exactly, in that the details, timing and effects vary from instance to instance. But the underlying process is a recurring one. For example:

- An idea is born when an undervalued asset is discovered.
- Its undervaluation attracts attention, as do pioneering investors' early gains.
- Its popularity rises, attracting more and more adherents, even as undervaluation moves to fully valued.
- It turns into a mania or "bubble," and price becomes immaterial.
- Eventually, the last potential buyer becomes convinced and comes on board.
- With no one else left to convert to the trend, the bubble of overvaluation is ripe for bursting.
- When followers experience the first price declines, disillusionment sets in.
- One-time devotees flee en masse, and the bubble turns into a crash.

This cycle of discovery, mania and crash is best summed up by the most useful of all investment adages: **"What the wise man does in the beginning, the fool does in the end."** This memo will be about recurring patterns, the history of stocks and bonds as I know it, and the adage's applicability to that history.

A Brief History of Stocks

A significant milestone occurred in October 2008, attracting a lot of attention. For the first time in almost fifty years, it was reported, the dividend yield on the Standard and Poor's 500 stock index was equal to the yield to maturity on the U.S. 10-year Treasury Note. People knew this meant stocks had cheapened, but it took an understanding of history to grasp the real significance. **The truth is that stocks, like other investment media, tend to go in and out of style, and this was just one more example of the latter.**

Prior to the 1950s, common stocks were viewed as a speculative, inferior (i.e., junior) asset class. For that reason, stocks had to pay higher yields than bonds in order to attract buyers; of course a riskier asset should yield more. In fact, most states had laws restricting holdings of stocks in fiduciary portfolios. This attitude toward stocks largely traced from the speculative stock bubble in the 1920s – featuring high-margin buying, bucket shops and shoe shine boys sharing stock tips – which collapsed in the Crash of '29. Poor economic and market performance stretching from 1929 to the end of World War II further contributed to the skepticism toward stocks.

It was only after WW II that economic performance began to support optimism. Brokerage firms led by Merrill, Lynch, Pierce, Fenner and Smith trumpeted the merits of stocks. Equity investing became widespread, and "customers' men" in local brokerage offices delivered stock investing to a great many households: I remember my mother buying 10 shares of Columbia Gas and 15 shares of Chock Full of Nuts around 1959.

I also remember a brochure on "growth stock investing" that Merrill put out in the mid-1960s, touting the desirability of rapid earnings growth and the strength of companies like IBM, Xerox, Avon, Coke, Texas Instruments and Johnson & Johnson. This idea grew into "nifty-fifty" investing, a true mania adopted by many of the large banks, among others. Ballyhoo took over from logic – excitement from value-consciousness – and these growth stocks' prices reached 80 and 90 times earnings.

The nifty-fifty stocks were tested – and found wanting – when the tide went out in the 1970s. Prosperity shifted to recession. The Arab oil embargo, a period of strong cost-push, and self-reinforcing cost-of-living adjustments created hyperinflation to which few people saw a chance for an end. Those growth stock p/e ratios went from 80 or 90 to 8 or 9. And stocks, Wall Street and the general economy went through a truly dreary decade, culminating in a *BusinessWeek* cover story entitled "The Death of Equities," in August 1979. For evidence of the cyclicality of attitudes toward stocks, consider its final paragraph:

> Today, the old attitude of buying stocks as a cornerstone for one's life savings and retirement has simply disappeared. Says a young U.S. executive: "Have you been to an American stockholders meeting lately? They're all old fogies. The stock market is just not where the action is."

In the investment world, lows in sentiment usually coincide with lows in price, and the late Seventies were no exception. Because of the dreadful environment, you could buy an existing company in the stock market for less than it would cost to start one. I was fortunate to become a portfolio manager in mid-1978, and thus to benefit from the subsequent recovery of investor psychology from its nadir.

In general (albeit with some prominent exceptions), the last half of the twentieth century was marked by the rise of a cult of equities, and the last quarter century was probably the best ever. From 1979 through 1990, the S&P 500 averaged an annual return of 15.4% and showed losses in only two years (4.8% in 1981 and 3.1% in 1990). Economic prosperity, rising corporate profits, a trend among consumers toward borrowing to spend, and the subsidence of inflation and interest rates all made for a most hospitable environment.

When the stock market's performance improved even further in 1991-99, with an average return of 20.6% and no down years, the fawning kicked up a notch. From the low of 7 reached in 1980, the p/e ratio on the S&P 500 eventually exceeded 33 in 1999. The market's dramatic

performance led to steady increases in the capital allocated to equities, and eventually to the tech stock bubble. It culminated in books such as the fact-based *Stocks for the Long Run* and the more fanciful *Dow 36,000*. If you asked institutional investors what return they expected from stocks going forward, I think just about all would have said 11%.

An aside: investors consistently seize upon above average returns as an encouraging sign and extrapolate them, and the 17.6% compound return on the S&P 500 from 1979 through 1999 was certainly a case in point. But rarely do they ask what gave rise to those good returns, or what it implies for the future. In essence, stock ownership conveys the benefits of owning a corporation, and stock appreciation should be powered by increases in profits. Thus long-run returns should reflect corporate growth. But as Warren Buffett has pointed out, ". . . people get into trouble when they forget that in the long run, stocks won't appreciate faster than the growth in corporate profits." Although that growth is the underlying source of equity profits, it is often overshadowed and obscured in the short run by trends in valuation. People took that 17.6% gain as an encouraging sign, overlooking the fact that it stemmed primarily from the rise of p/e ratios described above and thus was unlikely to continue unabated. Rather than healthy performance that could be extrapolated, this swollen return should have come as a warning that valuations were unsustainable and likely to regress toward the mean. **But investors consistently fail to recognize that past above average returns don't imply future above average returns; rather they've probably borrowed from the future and thus imply below average returns ahead, or even losses.** The tendency on the part of investors toward gullibility rather than skepticism is an important reason why styles go to extremes.

Wharton's Professor Jeremy Siegel, the author of *Stocks for the Long Run*, used historical data (a) to demonstrate that there had never been a long period when stocks didn't outperform cash, bonds and inflation, and thus (b) to argue that most people of average risk tolerance should have roughly 100% of their capital in the stock market. But Siegel, like many laymen, failed to pursue the most critical line of inquiry. **The right question to ask in the late 1990s wasn't, "What has been the normal performance of stocks?" but rather "What has been the normal performance of stocks if purchased when the average p/e ratio is 33?"**

Many investors were seduced by the performance of stocks in the late 1990s by the promise of wealth and a secure retirement, and by the meshing of equity participation with the allure of the technology, media and telecom industries. The results are well known: the first three-year decline for stocks since the Great Depression; a peak-to-trough decline of 51% for the S&P 500; massive losses for tech investors; shrunken 401-k accounts; and general disillusionment with stocks.

Basically, I think equity investors had their hearts broken, as happens from time to time in the investment world. The promise of easy money turned out to be empty – as usual – and investors who had adopted overblown expectations promised "never again." A good economy, low interest rates and resurgent general psychology brought stocks back between 2002 and 2007, but just to their 2000 peak. Versus the 11% prospective return they were sure of in 1999, by 2003 many investors expected only 6-7% from stocks (despite the fact that they were now much cheaper). With the bloom off the rose, people looked elsewhere – to private equity, real estate, hedge funds and mortgage backed securities, for example – for the next solution. I didn't hear any investors say, "We don't have enough stocks." Their glory truly had faded.

But having recovered to their previous high, stocks were buffeted again in the credit crisis. They fell 58% from their 2007 peak to their 2009 trough. Stocks weren't singled out for punishment; non-government bonds, real estate, mortgage securities and private equity all shared the pain as panic and loss of confidence were everywhere.

With the panic now gone, stocks have recovered, but only about half their 2007-09 losses. The S&P 500 stands at a level that was first reached in 1998, meaning over the last twelve years, the average stockholder's paltry return of less than a percent a year came entirely from dividends. People talk about the "lost decade in equities," and still no one seems to feel he owns too few stocks.

A Brief History of Bonds

The recent history of bonds requires less telling. Bonds were the bedrock of investment portfolios in the first half of the last century. Along with Treasurys, utilities and corporates, business was brisk in railroad and streetcar bonds. Graham and Dodd's classic, *Security Analysis*, devoted more than 200 pages to "fixed-value investments" including preferred stock, of which next to nothing is heard today.

The story of bonds in the last sixty years is the mirror opposite of what happened to stocks. First bonds wilted as stocks monopolized the spotlight in the 1950s and '60s, and at the end of 1969, First National City Bank's weekly summary of bond data died with the heading "The Last Issue" boxed in black. Bonds were decimated in the high-interest-rate environment of the '70s, and even though interest rates declined steadily during the '80s and '90s, bonds didn't have a prayer of standing up to equities' dramatic gains.

By the time the late 1990s rolled around, any investment in bonds rather than stocks felt like an anchor restraining performance. I chaired the investment committee of a charity and watched as a sister organization in another city – which had suffered for years with an 80:20 bond/stock mix – shifted its allocation to 0:100. I imagined a typical institutional investor saying the following:

> We have a little money in bonds. I can't tell you why. It's an historical accident. My predecessor created it, but his reasons are lost in the past. Now our fixed income allocation is under review for reduction.

Even though interest in stocks remained low in the current decade, little money flowed to high grade bonds. The continued decline in bonds' popularity was fed, among other things, by the decision on the part of the Greenspan Fed to keep interest rates low to stimulate the economy and combat exogenous shocks (like the Y2K scare). With Treasurys and high grade bonds yielding 3-4%, they didn't do much for institutional investors trying for 8%.

As a result of a process I consider quite standard, bond allocations reached all-time lows at just the time they became needed. Other than cash and gold, Treasurys were the only asset that performed well in 2008. In fact, they benefited from a massive flight to quality. Corporate high grade and high yield bonds suffered along with everything else in 2008, but less than stocks, and they've enjoyed a comparable recovery. Thus bonds have performed much better than stocks since the onset of the crisis in July 2007, as shown on the next page.

	June 30 to June 30			
	2007-08	2008-09	2009-10	three years
10-year Treasury bond	12.6%	7.3%	8.3%	30.8%
Barclay's Govt/Credit	7.2	5.3	9.7	23.8
Citi High Yield Index	-0.5	-4.2	24.7	18.8
S&P 500	-13.1	-26.2	14.4	-26.6
MS EAFE Index	-22.5	-26.1	7.1	-38.7
MS Emerging Markets	2.6	-30.0	20.6	-13.4

Clearly, the recent performance edge of bonds over stocks has been dramatic.

What's Going On Today?

Now, suddenly, investors seem to have awakened to bonds' attractions. This after failing to do so in time for the crisis, when holding bonds would have been of great value. Is this just another case of investors driving while looking in the rearview mirror? And are they shifting from stocks to bonds at just the wrong time?

The headlines are dramatic and the facts are clear. In just the last few weeks, we've seen newspaper stories like these: "Investors Fleeing Stocks with Cash Flow Lure JP Morgan" (Bloomberg, August 16), "Treasury Bears Cave as Bond Yields Keep Tumbling" (*The Wall Street Journal*, August 16), and "Growing Concern over Bond Bubble" (*Financial Times*, August 21). Bloomberg reported as follows:

> About $33 billion flowed out of funds owning U.S. shares this year . . . About $185 billion was sent to bond funds through July 31, the most on record, according to the Investment Company Institute.

These statistics relate to mutual funds and their retail investors. While not necessarily the same for institutions, they are indicative of trends in investor psychology. In other words, the disaffection with stocks is continuing, and the withdrawn capital and much more is flowing to bonds. (It must be noted, however, as Tom Petruno of the *Los Angeles Times* pointed out on August 21, that gross inflows to equity mutual funds are still very substantial – and larger than those into bond funds – although exceeded in this period by outflows.)

The first question I want to tackle is "why these trends?" The answer with regard to stocks is simple. They were over-hyped in the 1990s; they disappointed in the 2000s; and investors are extrapolating the poor performance (even at lower prices) just like they previously extrapolated good performance (at higher prices). **This tendency to expect trends to continue is typical of investor behavior, especially with regard to phenomena that should instead be expected to regress toward the mean.**

In the late 1990s, when stocks were performing so well and universally expected to far exceed most investors' return needs, no one saw a reason to hold fixed income instruments with their modest yields. Now stocks have performed poorly for a decade and expectations have been cut back. Equities are no longer considered the sure thing they were. The other day *The New York Times* ran an article entitled "In Striking Shift, Investors Flee Stock Market":

> Renewed economic uncertainty is testing American's generation-long love affair with the stock market. . . . Small investors are "losing their appetite for risk." . . . "Like everyone else, I lost" during the recent market declines [an individual investor] said. I needed to have a more conservative allocation." . . . Investors pulled $19.1 billion from domestic equity funds in May, the largest outflow since the height of the financial crisis in October 2008. (August 22, 2010)

Turning conservative after a crisis smacks of closing the barn door after the horse has left, but it's a regular feature of investor psychology.

Of course, there has to be a fundamental rationale for investor behavior, and the current low opinion of stocks is based on the spreading belief that the recovery will be anemic and there could be a double dip. Also behind it may be the expectation that tax rates on dividends and long-term capital gains will rise relative to the rates on ordinary income.

And why is so much capital flowing to bonds? The analogy to hemlines serves well in this regard. Take a long-established style, stir in changed circumstances, and add a significant swing in psychology. **Bonds became passé over a long period of time, and stocks caught everyone's attention. When these trends had gone as far as they could, and the error of the fashion extreme ultimately was exposed, bonds came back into style.**

Bonds used to constitute the majority of portfolios; then a 70:30 equity/bond mix became the norm; and then bonds went further out of style. And then, when bond allocations got as small as they could, the style mavens began to call for more, instead. Of course it helped that bonds outperformed during and after the crisis.

So few people held bonds going into the crisis, and in such small amounts, that the attractions of bonds must seem like a sudden revelation: They're senior in the capitalization to equities, of course, so they're less subject to fundamental risk. Then there's what I call the "power of the coupon." In addition to redemption at maturity, most bonds provide an interest check every six months. Not only are these cash flows spendable and investable, but they also serve to stabilize bond prices, restraining volatility. Sounds like a great deal. So why, people now wonder, did we hold so few? **Take historically small allocations, add in newly discovered merits, and you get a buying trend and rising prices.**

The fundamental underpinnings for the buying trend in bonds are the converse of those compelling equity reductions: concern about economic sluggishness, the chance for a double dip, and even the distant possibility of deflation. Under any of these circumstances, companies are likely to do poorly, so you'd rather own senior securities (debt) with the promise of positive returns if held to maturity, rather than junior ones (equities), to which just about anything can happen.

And if inflation is declining – taking interest rates with it – you'd rather secure a fixed rate of return with a bond than hold a totally variable instrument like a stock. With inflation at zero or negative, the thinking goes, locking in today's interest rates will prove to have been a godsend.

Finally, if we get back into another crisis, wouldn't we rather hold bonds? Look how well they did during the last one.

At What Price?

That question – at what price? – isn't just the right question to ask about bonds versus stocks today. It's the right question regarding every investment at every point in time.

I try every chance I get to convince people that in investing, there's no such thing as a good idea . . . or a bad idea. Anything can be a good idea at one price and time, and a bad one at another. Here's how I've put it in the past:

> It has been demonstrated time and time again that no asset is so good that it can't become a bad investment if bought at too high a price. And there are few assets so bad that they can't be a good investment when bought cheap enough. . . No asset class or investment has the birthright of a high return. It's only attractive if it's priced right. ("The Most Important Thing," July 1, 2003)
>
> Investment success doesn't come primarily from "buying good things," but rather from "buying things well" (and the difference isn't just grammatical). ("The Realist's Creed," May 31, 2002)

The thing to think about isn't whether you'd rather have junior or senior securities in a recession, or fixed rate securities versus variable ones in deflation. The question is which securities are priced right for the future possibilities: which ones are priced to give good returns if things work out as expected and not lose a lot if they don't? You mustn't fixate on a security's intrinsic merits, but rather on how it's priced relative to those merits.

So, for example, it's not enough to say "We want fixed rate securities in deflationary times." You'll be glad to be holding 2½% ten-year Treasurys if deflation materializes, but how will you feel if it doesn't? And what's the probability of each outcome?

If bonds are ideal for deflation and stocks will bear the brunt of the associated economic weakness, is that all that matters? Would you rather buy overpriced bonds than underpriced stocks? Is there an objective standard for overpriced and underpriced? And, for example, if the ten-year note will pay 2½% regardless of the environment, and stocks will return 15% if deflation is avoided and lose 10% if it's not, doesn't deflation have to have a likelihood exceeding 50% for bonds to be preferred? (Check the math.)

My point here is that simplistic blanket statements are no help at all in making investment decisions. How have investors gotten killed in the past? By falling for statements like these:

- High-growth stocks are a good thing (1970).
- Bonds rated below triple-B aren't appropriate for investment (1977).
- No one will ever buy equities again (1979).
- There can never be too many disc-drive manufacturers (1988).
- The Internet and optical fiber will change the world (1999).
- Home prices can only go up, and there can't be a nationwide surge in mortgage defaults (2006).
- High yield bonds are unattractive given the risk of Armageddon (2008).

<u>Most of today's positive articles about bonds are totally devoid of discussion of prices and probabilities. But it's only by assessing those things that attractiveness can be determined.</u>

What To Do Now?

Ever since the financial crisis started in mid-2007, I've been saying any recovery would be lackluster and investors shouldn't be planning on prosperity. To me that called for investing in solid, stable, non-cyclical companies; avoiding levered companies and strategies; emphasizing risk-controlled strategies and managers; and, perhaps foremost, holding more bonds and fewer stocks. These were general principles: my own blanket statements, if you will. But now that stock prices have drifted lower and bond prices have continued to surge, I find I must reconsider the emphasis on bonds.

How are bonds priced today? What returns can we expect? Let's consider that 2½% ten-year note. With regard to Treasury securities, where it still seems safe to say there's no credit risk, there are three possible states of nature.

- If we buy at a yield to maturity of 2½% and interest rates don't change, we'll enjoy an annual return of 2½% per year for the next ten years. (With interest rates unchanged, there'll be no change in price other than from accretion to par at maturity, and we'll be able to reinvest the interest payments at the yields available at the time of purchase, an assumption implicit in the yield-to-maturity calculation.)

- If interest rates fall in response to economic weakness or deflation, we're likely to see interim appreciation. And if we sell at the appreciated prices, our holding-period return will exceed the yield to maturity at which we bought. Even if we just hold, our 2½% notes will be desirable museum pieces, as in, "Do you remember the good old days, when you could get 2½% on Treasurys?" (In truth, though, how much lower can yields go from here?).

- Finally, if the economy, inflation and interest rates surprise on the upside relative to today's low expectations, having locked in a yield of 2½% won't turn out to have been a good thing. From 2½%, it's clear that rates have much further to go up than down. Any substantial increase in bond yields would bring meaningful interim price declines. It must be borne in mind that holders of the bonds of creditworthy issuers don't have to worry about permanent capital losses (unless they're frightened into selling when things are down). A bond that's money-good will outlive any negative interim fluctuations, pay par at maturity and deliver the yield at which it was bought. So the real risk for people who invest in these bonds is that their returns turn out to be sub-par under the circumstances. If inflation turns out to be normal, investors in the 2½% note may end up with no more purchasing power down the road than they have today – that is, a real return of zero. Thus, if there are positive surprises in the environment, bond holders are likely to wish they had stocks instead.

Portfolio construction is supposed to strike an appropriate balance between safety and certainty on one hand and aggressiveness and gains-seeking on the other. The key question is whether today's bond buyers are leaning too heavily toward the former and forgetting too much about the latter. Are they too pessimistic and thus honoring uncertainty to excess?

An article by Richard Thaler of the University of Chicago, in *The New York Times* of August 22, makes an important point. He wrote about CFOs, but I think it's largely the same for investors:

> . . . the confidence limits [of their forecasts] widen after bear markets, mostly because estimates at the lower bound become more pessimistic. This puts a new light on the recent comment by Ben S. Bernanke . . . that the economic outlook was "unusually uncertain." . . . Yes, things *feel* more uncertain after bad times,

> but severe market downturns tend to occur after long bull markets when we are feeling least uncertain.

In other words, investors become so accustomed to good times that bad times seem unsettling in comparison. **That could explain excessive appetites for the safety of bonds and thus why, according to Deutsche Bank, "the top 10 lowest-yielding U.S. corporate new issues in history have been sold in the last 14 months"** (Bloomberg, August 16).

And what about sellers of stocks? I'm no longer an "equity guy" by profession, and Oaktree manages far more bonds than stocks, so this isn't a commercial. But I feel investors may be overlooking some substantial merits on the part of stocks today (data from Bloomberg, August 16, except as noted):

- Having made their organizations lean and benefited from declining floating-rate interest costs, cheaper labor or staff downsizing, companies are doing a good job of making money despite today's lackluster economic environment. "Earnings for S&P 500 companies may rise 36% in 2010 and 16% in 2011, the largest two-year advance since 1994-5."

- Rather than spend that money on expansion or acquisitions, most companies are piling it up. "The Federal Reserve reported in June that nonfinancial companies were holding cash totaling more than $1.8 trillion, having built up their hoards at a rate unmatched in more than 50 years" (*LA Times*, August 25). This pile of cash adds greatly to companies' financial security and to the potential for dividend increases or stock buybacks in the future.

- Finally, those selling or shunning stocks today seem to be overlooking some very attractive valuation parameters.

  - Price/earnings ratios are lower than usual. "The S&P 500 trades at 14.4 times annual earnings, compared with an average of 16.5, according to data . . . that goes back to 1954." Not giveaway levels, but 13% below the post-war average.

  - Annual free cash flow for American companies excluding banks is running at 6.8% of their market value. This "cash flow yield" is roughly capable of being compared against the yield on bonds. Although (unlike dividends or interest) the cash flow isn't necessarily received by investors as it's earned, it should contribute to stocks' value one way or another.

The bottom line is that, as bond prices rise (reducing yields) and p/e ratios fall, the chances increase that stocks will outperform bonds. Thus the benefits high grade bond investors feel they're gaining through **what they're buying** can be undone by **what they're paying**. I'll say it another way: **the attractiveness of one investment relative to another doesn't come from what it's called or how it's positioned in the capital structure, but largely from how it's priced relative to the other.**

I'm impressed today by the ability to assemble a portfolio of iconic, high quality, large-cap U.S. growth stocks that will provide appreciation in a strong environment, a measure of protection in a weak environment, and a meaningful dividend yield regardless. To me, and given my standard view that we don't know what the macro future holds, these stocks' potential over a range of possible scenarios is more attractive than bonds which will do well in periods of economic weakness or deflation but poorly in strength or inflation.

Compared to stocks, I feel Treasurys and high grade bonds currently reflect all of the environmental factors in their favor and perhaps more and are priced rich relative to stocks. For them to do well from here, with yields so low, everything has to work out as the bond bulls hope.

My friend, hedge fund manager Doug Kass, publishes a daily note to investors. (Given that I average a memo every couple of months, I find the very idea daunting.) I usually like what he writes, which is another way of saying we think a lot alike. Doug's August 18 note carried a catchy headline, "Setting Up For the Trade of the Decade." His nominee for that sobriquet: shorting the U.S. bond market.

What about high yield bonds, one of Oaktree's flagship asset classes? They're selling at yield spreads over Treasurys that are well above the historic norms, and their promised yields to maturity (before credit losses) should help institutional investors toward their return goals. On the other hand, it must be said that if interest rates rise, high yield bonds will see interim markdowns (albeit cushioned by their modest durations and the "gravitational pull" of price toward par at maturity). In all, given today's yield spreads, we believe high yield bonds will outperform high grade bonds in most foreseeable long-term environments.

Leveraged loans may deserve consideration as well. The yields on these loans are low in the absolute, like other fixed income instruments, but relatively attractive at 5½-6%. The loans are senior-most in the capital structure, meaning they should provide some protection in a sluggish economy, and the fact that their interest rates float with LIBOR should insulate them against interest rate increases.

Oaktree manages half a dozen large "multi-strategy fixed income" accounts, in which we are responsible for allocating capital to our various marketable securities strategies. Recently, in recognition of the developments described above, we made a modest initial shift away from high yield bonds and into convertibles, with their sensitivity to equity market trends. Here's what I wrote to our multi-strategy clients a month ago:

> Certainly by the onset of 2000, people believed too much in stocks and thought too little of bonds. Now, a decade later, these things are reversing. As we enjoy our portfolios' performance, we should be alert for a day when bonds will have become too popular and stocks' outcast status will have rendered them too cheap. We can pat ourselves on the back for being in the right asset classes today, but we shouldn't fail to consider what these diverging performance trends can do to tomorrow's returns.

Since few investment trends continue forever, it's usually smarter to expect ultimate regression to the mean rather than growth to the sky. No one should view the great popularity of bonds relative to stocks without reservation.

September 10, 2010

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