

# The Human Side of Investing

6<sup>th</sup> Annual Value Investing Congress West  
May 3, 2011

Howard Marks, Chairman  
Oaktree Capital Management, L.P.

# The Human Side of Investing or The Difference Between Theory and Practice

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*“In theory, there’s no difference between theory and practice.  
In practice, there is.”*

– Yogi Berra

## The Human Side of Investing

Textbooks and professors will tell you about the dependable workings of the market. They'll describe the simple roadmap to investment success, as in "if you do a and b, then you'll make money." But this assumes there's an underlying process that can be counted on to work, and that anyone can learn to apply it. That's the theory. Nothing could be further from the truth.

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Practice: Markets are made up of people, with their emotions, insecurities, excesses and foibles. Thus they often make mistakes and swing to erroneous extremes.

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Practice: Riskier assets usually appear to promise higher returns, but that doesn't mean those returns will arrive.

If riskier assets always provided higher returns, they wouldn't be riskier.

## The Human Side of Investing

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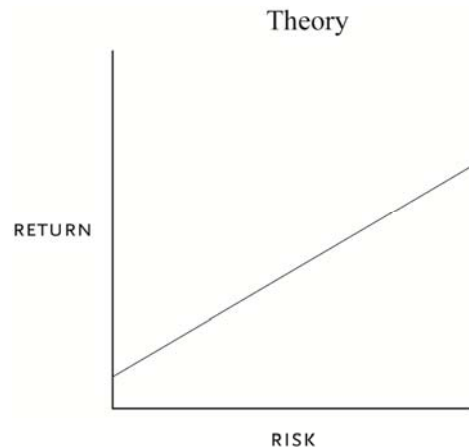
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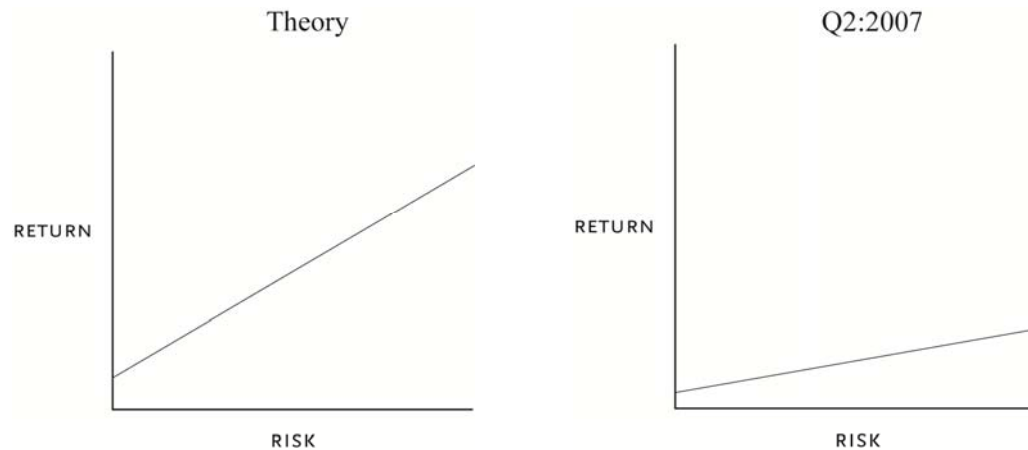
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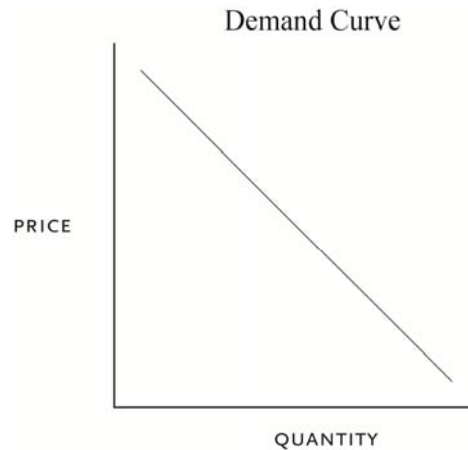
Practice: Buying without discernment at the market price will give you returns that are all over the lot.

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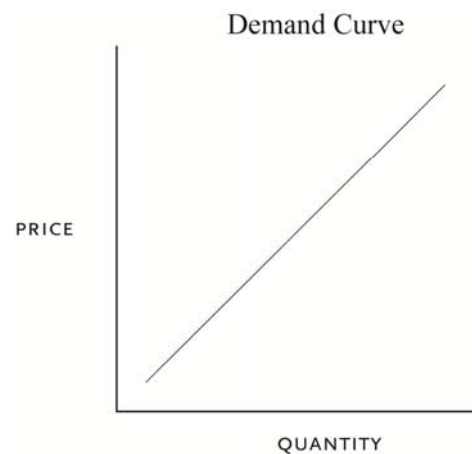
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Investors fluctuate between:

Optimism and pessimism

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Risk tolerance and risk aversion

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Instead, there are frequent excesses – the errors of herd behavior

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The three stages of a bull market:

- When a few people begin to feel things will get better
- When most people recognize that improvement is underway
- When everyone thinks things will get better forever

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The three stages of a bull market:

- When a few people begin to feel things will get better
- When most people recognize that improvement is underway
- When everyone thinks things will get better forever

The three stages of a bear market:

- When a few people realize that things are overpriced and riding for a fall
- When most people see that a decline is taking place
- When people think things will get worse forever

# The Human Side of Investing

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*“Establishing and maintaining an unconventional investment profile requires acceptance of uncomfortably idiosyncratic portfolios, which frequently appear downright imprudent in the eyes of conventional wisdom.”*

– David Swensen

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Memory – and the result, prudence – always come out the loser when pitted against greed

*“What the wise man does in the beginning, the fool does in the end.”*

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Buy high; sell low

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*“It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so.”*

– Mark Twain

# The Human Side of Investing

- The “I know” school versus the “I don’t know” school

I know: confidence in foreknowledge;

I don’t know: skeptical regarding foreknowledge

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Invest for one outcome

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I don’t know:

Hedge against uncertainty

Diversify

Avoid or limit leverage

Emphasize avoidance of losses

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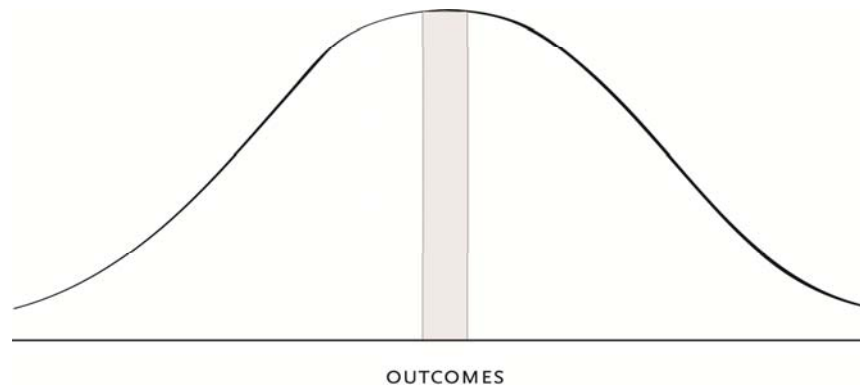
*“Never forget the six-foot tall man who drowned crossing the stream that was five feet deep on average.”*

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- In particular, most investors ignore the possibility of extreme outcomes – so-called “Black Swans”

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*“Risk means more things can happen than will happen.”*

– Elroy Dimson

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- The twin impostors – short-term outperformance and short-term underperformance

Investors are right (and wrong) all the time for the “wrong reason.”

The correctness of a decision can't be judged from the outcome.

Randomness alone can produce just about any outcome in the short run.

– lessons from “Fooled by Randomness” by Nassim Nicholas Taleb

## The Human Side of Investing

- Non-appreciation of “alternative histories” – the difficulty of seeing past events as a range of possible things that could have happened, and thus the reduced significance of what actually did happen

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*“Markets can remain irrational longer than you can remain solvent.”*

– John Maynard Keynes

It’s hard to do the right thing

It’s impossible to do the right thing at the right time

*“Being too far ahead of your time is indistinguishable from being wrong.”*

# The Human Side of Investing

- The pitfalls of investment bureaucracy

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*“ . . . active management strategies demand uninstitutional behavior from institutions, creating a paradox that few can unravel.”*

– David Swensen

## The Human Side of Investing

- Most institutional investors expend extraordinary effort and often make decisions for the purpose of avoiding embarrassment. In particular, they often over-diversify.

*“It is better to fail conventionally than to succeed unconventionally.”*

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The ultimate conundrum: in order to do enough of something to make a positive difference for your portfolio if it's right, you have to do enough so that it could make a negative difference if it's wrong.

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Investing in things that are easily understood

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All of these things imply elevated prices, limited return potential, and substantial risk.

At most points in time, the real bargains are found in doing things others won't do, not the things described above. Those are the things that appeal to the herd.

## The Human Side of Investing

- Smart investing doesn't consist of buying good things, but rather of buying things well. Price is what matters most for investment success. Only disciplined, objective, unemotional, expert investors can know the right price.

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- To sum up...

The Efficient Market Hypothesis tells us the market operates smoothly to incorporate information into prices, so that no individual can consistently do much better.

In fact, “inefficiencies” – the investing crowd’s mistakes – arise all the time and are the superior investor’s *raison d’être*.

At the extremes, when the actions of the crowd create bubbles and crises, the mistakes of others create opportunities for us to make or lose vast sums.

# The Human Side of Investing

Oaktree's investment philosophy was designed to overcome the impediments on the human side of investing:

- Dedication to understanding and controlling risk
- Insistence on consistency
- Involvement in less-efficient markets only
- High degree of investment specialization
- No reliance on macro-economic projections
- No raising of cash for purposes of market timing

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