

Advice for Investing Institutions

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Suggestions for Institutional Investors

- **Expectations and Goals**
- Creed
- Process
- Organization and Environment
- Inescapable Truths

Start from Reasonable Expectations

In investing, it's extremely easy to achieve average results and extremely difficult to consistently be above average.

It's important to decide whether you will:

- strive to be above average – which costs money, is far from sure to work, and can result in your being below average, or
- accept average performance – avoiding those costs but being forced to look on as the winners occasionally report mouth-watering successes.

A decision to strive for superior results should be based on conviction that (a) assets are often mispriced and (b) your organization is capable of exploiting those mistakes (or finding managers who are).

Make Your Goals Explicit

Every coherent investment program has to proceed from an explicit return goal.

The goal is likely to be expressed in absolute terms. How will it be reconciled with relative performance considerations?

Keeping up with – or beating – the market when it rises usually requires market-sized helpings of beta, risk and correlation. If you have those things, what will happen when the market falls?

The time frame has to be explicit, too:

- The goal doesn't have to be achieved every year, and it probably can't be.
- The only thing that matters is achieving it on average over the long term.
- Full market cycles present a reasonable time frame for the purposes of assessment.

Make Sure Your Goals are Realistic and Achievable

Your goals should reflect and accommodate to the investment environment. For example:

- Today the risk-free rate is near zero, Treasuries pay 1-2%, and the consensus thinks stocks will return 5-6%.
- In that case, maintaining a return of goal 7% or more will require holding a risky portfolio and accepting the possibility of meaningful drawdowns and perhaps permanent loss.

In addition, your expectations should reflect the realities of your situation:

- Are you small enough to benefit from selectivity, contrarianism and active management?
- Does your financial condition mandate conservatism or permit a more aggressive approach?
- Given that achieving superior performance requires heightened risk-taking, should it be your goal?
- Will your institutional setting permit you to attract and retain people who are above average?
- **Will your realities permit you to focus on the long term and ignore short-term noise?**
- Given how hard it is to perform above average, do you have reason to think you can?

The market is not an accommodating machine. It will not go where you want it to just because you need it to.

– Peter Bernstein

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Adopt an Investment Creed That Is Clear to All

What do you believe in? What core values will guide your organization?

- Is the efficient market hypothesis relevant?
- Will you put faith in macro forecasts? Will you attempt to predict and profit from the market's ups and downs?
- How do you think about risk? Can it be predicted and quantified *a priori*? Can it be controlled through a methodical process? Will bearing more increase your returns?
- Will you emphasize risk control or return maximization?
- How will you balance science and art, process and judgment?
- **How will you define success, and what risks will you take to achieve it?**

Understand the Notion of Market Efficiency

- There are lots of investors. Many are intelligent, numerate, computer-literate, able to access data, clinical and objective, and highly motivated.
- They work hard to find mispriced assets, buying those they think are underpriced and selling those that are overpriced.
- These actions cause the available information to be reflected in asset prices so that they converge with intrinsic value. In other words, prices become “fair,” meaning no assets will be obviously overpriced or underpriced. There will be no “inefficiencies” – mispricings – to be found.
- If you buy an asset at a fair price you should expect to earn a return that is fair relative to the risk involved, but no more. Thus (a) no market will offer a better risk/return proposition than any other, and (b) no investor can beat the market he or she operates in.

These are the assertions of the efficient market hypothesis. I don't believe they all hold true, but I do believe prices tend to reflect the consensus opinion regarding the significance of the available information.

My bottom line: while assets may be priced right or wrong, some markets are so efficient in incorporating the available information that few individuals can regularly find and benefit from mispricings. Where efficiency is present, it's hard to beat the market.

Take a Position Regarding Market Efficiency

Do you think investors can beat the market?

- Do “inefficiencies” exist – instances when assets are mispriced?
- Are there people with enough “alpha” (personal skill) to find them?
- Can they do so consistently?
- Can they do so with a lot of money under management?
- Can you identify these people, retain them on your staff and hire them as outside managers?
- At moments when their efforts fail, what will the reaction be?
- What are the implications for your approach of the answers to these questions?

Understand Where Superior Returns Come From

The “base” long-term return enjoyed by the average investor comes from participating in companies’ earnings by owning their securities. One of the routes to outperformance is superior asset selections: overweighting the securities that will do better than average and underweighting those that will do worse.

Often, securities do better because their companies’ fundamentals had been under-appreciated:

- The price of each security reflects the consensus view regarding its company’s earning potential
- Perhaps you hold a view of one company that is more favorable than the consensus – a “variant perception” – so you overweight its security in your portfolio
- When the company delivers a favorable surprise, others see that they weren’t optimistic enough – and thus didn’t hold enough of its security – so they buy to increase its representation in their portfolios
- Their buying causes the security to outperform those of companies that only perform as expected or worse. Because you held more of it than the average investor, you outperform

Thus above average gains usually come from pleasant surprises

You can only hope to perform better than others if you see things differently than others and better, enabling you to be better prepared for the events that surprise others

Decide Whether You Will Bet on Macro Forecasts as the Route to Outperformance

Can macro forecasting contribute to superior performance?

- Consistently correct macro forecasts could be a great help in investing.
- They're easily achieved when trends roll on and extrapolation succeeds.
- But extrapolation isn't very helpful . . . or profitable. Everyone gets it right, but correct forecasts that everyone has are no help toward outperformance.
- Correct forecasts of deviations from trend are potentially very valuable.
- But they're rarely made correctly.
- Thus forecasts are not useful on balance.

We have two kinds of forecasters: the ones who don't know, and the ones who don't know they don't know.

– John Kenneth Galbraith

- Even worse, bold and idiosyncratic forecasts that lead to bold bets can be highly injurious if they turn out to be wrong.

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

Will You Bet on Macro Forecasting? (cont'd)

The macro future isn't knowable with confidence.

The future must be viewed as a probability distribution, not a single, knowable outcome.

Only investors with unusual insight can regularly divine the probability distribution that governs future events and sense when the potential returns compensate for the risks that lurk in the distribution's negative left-hand tail.

– “The Most Important Thing,” 2011

It's essential to realize that you may know what's likely — you may even know the probabilities precisely — but you still don't know what's going to happen. That's where risk comes in.

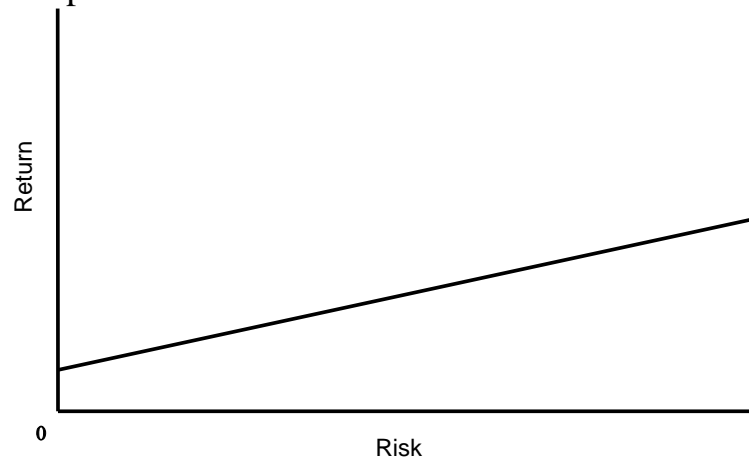
Risk means more things can happen than will happen.

– Elroy Dimson, London Business School

Clarify How You Think about Risk

How are risk and return connected?

Most people have come to think about the relationship between risk and return as follows: as risk increases, the expected return increases.



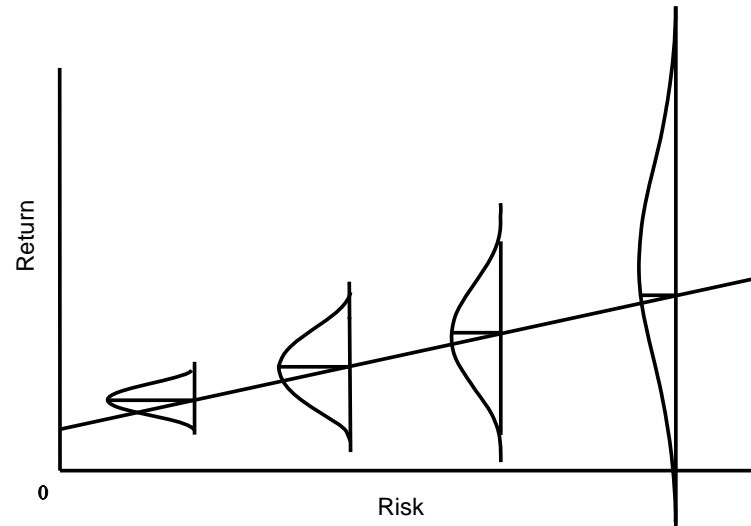
Given this relationship, how much risk will you take?

The upward slope and linearity of the line give the impression that bearing risk can be counted on to deliver higher returns. Most people take this to mean “riskier assets produce higher returns” and “the way to achieve higher returns is to take more risk.”

But that can't be right: If riskier assets could be counted on to produce higher returns, they wouldn't be riskier.

Clarify How You Think about Risk (cont'd)

I think this graphic is much more helpful.



Viewed this way, as risk increases:

- the expected return increases (as in the traditional graphic),
- the range of possible outcomes becomes wider, and
- the less-good outcomes become worse.

That's the essence of risk.

Now how much will you take?!?!

Consider Risk, But Don't Think You've Mastered It

Risk isn't volatility, but rather the possibility of unfavorable outcomes, including permanent loss.

Like other things in the future, this possibility can be estimated, but it can't be measured.

- We don't know whether negative events will occur, or when.
- We don't know what losses negative events will produce – the linkages are unpredictable.

Thus losses can't be predicted with precision, quantified, or limited to a given quantum. We can't know with certainty how bad things can get.

Accept that It's Hard to Have Both Superior Returns and a High Degree of Safety

There is no simple roadmap to superior returns.

For example:

For superior results, you have to do something other than chase assets with obvious appeal and managers with good records.

You can't ensure success by going with things that are "obviously good" regardless of how they're priced. Oftentimes others will have bid up the price of a good asset to the point where it's a bad investment, or will have given a previously-superior manager enough money to blunt his or her effectiveness.

But in order to depart from things with obvious appeal and managers with good records, you have to make a leap of faith. This is unlikely to work all the time.

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Make Clear How Participants Can Add Value

How can the participants in the process add value?

The main thing we can't consistently do is see the macro future better than others.

What might we be able to do?

- Identify potentially profitable asset classes, strategies and approaches
- Inform the capital allocation process by assessing the attractiveness of asset classes
- Strive to know more than others about companies, industries and securities
- Attempt to find bargains and avoid overpriced securities
- Try to limit risk to a tolerable level
- Set an appropriate balance between offense and defense; alter it as appropriate
- Practice contrarianism and counter-cyclical
- Control ego and emotion
- Assess managers in terms of intelligence, process, philosophical agreement and trustworthiness

These are the things the team should be charged with and paid for achieving.

Establish an Asset Allocation Framework That Will Help You Toward Your Goals

Asset categories should be meaningful and functional.

For example, consider the University of Pennsylvania's former framework –

- Developed world equities – for participation in economic growth and the performance of the corporate sector
- Developed world bonds – for safety, stability and liquidity
- Diversifying assets – for returns similar to those from developed world equities, but with low correlation to them (e.g., high yield bonds, convertibles, low-beta hedge funds, infrastructure)
- Return-enhancing assets – for returns above those on developed world equities, albeit with higher risk and volatility (e.g., emerging market equities, private equity, venture capital, opportunistic real estate, distressed debt, aggressive hedge funds).

This way there's an explicit reason for including every category (and every asset class or strategy within it).

Employ Benchmarks That Measure (and Motivate) the Things That Matter to You

There are many possible benchmarks. They include indices for individual strategies; the portfolio-weighted average of the strategy indices; passive proxies like 60% equities/40% bonds; and the performance of peer organizations.

Each can accomplish certain things.

- The overall efficacy of your investment process can be measured by comparing your return against a passive benchmark such as 60% MSCI Equities and 40% Barclay's Aggregate.
- Your U.S. large-cap stock manager can be evaluated by comparing returns against the S&P 500.
- The portfolio-weighted average of your strategies will tell you if your managers collectively did a superior job.

But each also has pitfalls.

- Beating the weighted average of the strategy indices doesn't tell the whole story. How will you assess the efficacy of the decisions regarding weightings?
- **Since all benchmarks are imperfect, they can be a cinch to beat some of the time and impossible at others.**
- And what happens when performance is good relative to all the benchmarks listed above but the portfolio fails to meet its absolute return goal? Or it meets its absolute goal but lags behind the market and the peers?

Formulate an Opinion Regarding Cycle Positioning

The goal in cycle positioning is to have more risk when the markets rise and less when they fall.

It has to be based on the belief that opportunities to benefit exist and can be recognized and taken advantage of.

The keys in this regard lie in awareness of where the market stands, contrarianism, counter-cyclical behavior and the pursuit of relative value.

But it isn't easy: Today's valuations already reflect everyone else's effort to do the same. Can you do a superior job? If not, your efforts will be in vain at best and costly at worst.

Understand the Essential Nature of Contrarianism

The investing herd is usually wrong at the extremes.

- The herd becomes more optimistic and euphoric as positive events occur and asset prices rise. Its buying creates the markets' highs.
- Likewise, the herd becomes more pessimistic and depressed as negative events occur and prices decline, and its selling brings on the lows.

Thus contrarianism – doing the opposite of the herd – is an essential element in superior investing.

It's important to assess the state of the environment and take advantage of investors' biases and foibles:

- Be fearful when others are greedy
- Be greedy when others are fearful

But contrarianism isn't easy. This is true particularly because most investors are subject to the same environmental and emotional influences as the herd.

And remember, even the best contrarian decisions often fail to work immediately and thus can look wrong for long periods of time.

Work to Combat Envy, FOMO and Other Destructive Emotions

One of the strongest and most destructive aspects of human nature is the discomfort that comes from watching while others make money. Envy lies behind much of the worst investment behavior.

“Overpriced” is far from synonymous with “sure to go down tomorrow.” An investment mania or bubble won’t correct as soon as you conclude it should. In fact, it’s likely to go considerably further.

The market can remain irrational longer than you can remain solvent.

– John Maynard Keynes

It’s particularly unpleasant to not hold something that’s popular and appreciating. Thus the higher it goes, people who resisted at lower prices become increasingly likely to capitulate and jump on board. This is prime among the forces that cause bubbles to proceed beyond reason.

In order to avoid being victimized when bubbles pop, you have to refuse to participate in them. And given the impossibility of beginning to do so at the exact right time, you have to refuse well before they pop. That means there’s sure to be a period when you look dumb and feel dumb.

Likewise, to be early in buying something that everyone will clamor for in the future, you have to commit before its merit becomes obvious and hold until its price begins to rise. This, too, can take a good while and introduce considerable discomfort.

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

Decide How Reliable You'll Expect Your Process to Be

There is nothing reliable to be learned about making money. If there were, study would be intense and everyone with a positive IQ would be rich.

– John Kenneth Galbraith

. . . not only am I unaware of any formula that alone will lead to above average investment performance, but I'm convinced such a formula cannot exist.

– “Dare to Be Great,” September 2006

“Process” alone will not suffice. Even a well-designed process, operated in an average way, will lead to average results.

Superior judgment is the essential ingredient in investment success.

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Create an Organization and Environment That Are Conducive to Achieving Your Goals

You won't get the behavior you want if your environment doesn't encourage it.

For example,

- pursuing superior returns requires risk taking;
- risk taking means some actions will result in losses;
- when losses arise, staff decisions will look wrong;
- if staff will be penalized for errors, risk taking will be discouraged. People don't do what you tell them to do – they do what you pay them to do.

Accept the Fallibility of Even the Best Investment Organization

- Randomness plays a substantial role in determining investment outcomes. Random developments have the ability to render even well-reasoned decisions unsuccessful.
- Even the best investors make lots of mistakes and experience significant rough periods.

If you accept these things, you should focus on batting average rather than individual decisions, and the long term, not the short.

Insist on Long-Term Focus

- It's hard to consistently do the right thing.
- It's impossible to consistently do the right thing at the right time.
- Thus no one and no organization can consistently achieve short-term goals.
- **Anyway, only long-term performance matters.**
- Short-termism is one of the greatest weaknesses in investing today.

If you agree with the above, you should de-emphasize the short run.

Given that no one can be right consistently, penalizing short-term underperformance – which we agreed doesn't matter – will discourage constructive, long-term creativity.

An easy way for an organization to distinguish itself today is by focusing on the long run, not the short run. But you have to walk the walk:

- Make clear to all that you only want long-term decisions.
- Deemphasize reporting on short-term results.
- Base compensation on long-term performance, not short-term. (But then how will you decide on pay in the early years?)

Ensure an Appropriate Allocation of Roles

Board or Investment Committee:

- Select and review the Chief Investment Officer
- Set goals, creed, allocation framework and long-term allocation ranges
- “Advise and consent”
- Get out of the way

CIO and staff:

- Propose changes to goals, creed, allocation framework and long-term allocation ranges
- Move capital within long-term allocation ranges and among managers. (If they have the requisite skill, why not let them? If they don't, why employ them?)
- Hire managers and choose funds (with the Board in the loop)

Should the Board interview and decide on new managers?

- Do they know more than the staff? If not, what can they add?
- Do they ever say no to staff recommendations?
 - If not, isn't their involvement a waste of everyone's time?
 - If so, isn't it dispiriting?

Pay Strict Attention to Fees

The only sure thing in investing is management fees

However, fees are not unmanageable. They can be reduced, for example, through passive investing

High fees should be paid only if they increase the expected net return

Incentive fees, in particular, have gone from being rare to common. **Only exceptional managers deserve to receive the return on a portion of your capital. By definition they are the exception, not the rule.**

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The Ultimate Issue: Decide Whether Your Organization Will Dare to Be Great

Will you dare to behave unconventionally?

Will you bear the associated uncertainties?

Will you accept the risk of being wrong?

How will you define success, and what risks will you take to achieve it?

How much emphasis should be put on diversifying, avoiding risk and ensuring against below-pack performance, and how much on sacrificing these things in the hope of doing better?

– “Dare to Be Great II,” 2014

Will You Dare to Be Different?

	Conventional Behavior	Unconventional Behavior
Favorable Outcomes	Average good results	Above-average results
Unfavorable Outcomes	Average bad results	Below-average results

Unusual success cannot lie in doing the obvious. The investing herd pursues the obvious. Conventional behavior will, by definition, lead to conventional results.

Only if your behavior is unconventional is your performance likely to be unconventional . . . and only if your judgments are superior is your performance likely to be above average.

– “Dare to Be Great,” 2006

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

Will You Dare to Be Wrong?

Every attempt at above average performance will expose you to the possibility of experiencing below average performance.

- Most institutions invest a lot of capital, effort and opportunity costs to avoid the embarrassment that results from being wrong.
- Consider, for example, the ultimate conundrum. For most bureaucracies, the unspoken rule is this: “We would never buy so much of something that if it didn’t work, it would make us look bad.” But if that’s true, how can you do enough of it so that if it works it will move the needle on performance?
- **Trying to do better than average means accepting the possibility of doing worse, and the associated headline risk.** In particular, think hard about the possible consequences of high-profile deals and large commitments.

Will Your Environment Encourage Trying to Be Great?

Bureaucracy and great investment results tend to be mutually exclusive.

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

– David Swensen

This is largely because unconventional behavior is inconsistent with bureaucratic oversight.

Bureaucracies are unlikely to coalesce around idiosyncratic decisions.

Worldly wisdom teaches us that it is better for reputation to fail conventionally than to succeed unconventionally.

– John Maynard Keynes

What will be your response?

- Will your organization be permitted – and enabled – to act unconventionally?
- Will you try to reduce bureaucracy, or will you give up on achieving great results? There is no third option.

Will You Dare to Look Wrong?

Remember, in investing, it's hard to do the right thing and impossible to consistently do the right thing at the right time.

That means even “correct” actions may take a while to work, and in the meantime they'll look like mistakes.

The penalties institutional investors face for below average results can far exceed the potential rewards for above average results.

Unconventional behavior is the only road to superior investment results, but it isn't for everyone. In addition to superior skill, successful investing requires the ability to look wrong for a while and survive some mistakes.

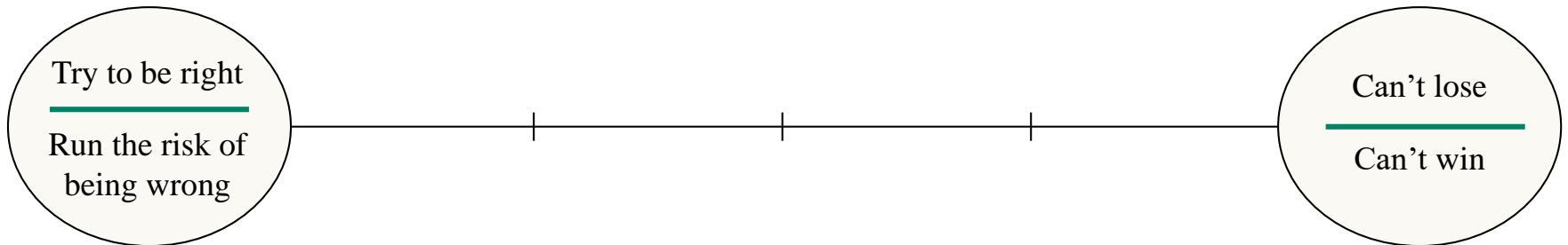
– “Dare to Be Great II,” 2014

You should consider whether your organization's goals are consistent with the realities of its environment. Can you endure long enough for the wisdom of your correct actions to become apparent?

Grapple with the Great Conundrum

- **You can't try to be superior without running the risk of being inferior**
- **Most loss-minimization strategies eliminate the possibility of substantial gains**

These two pairings represent the opposite ends of a spectrum of behavior



How will you position your effort on that spectrum?

Never Forget the Inescapable Truths

Investing is a challenging, messy and imprecise activity that has to be engaged in on the basis of estimates, intuition and subjective judgment, not accurate forecasts, scientific laws and dependable processes.

Nothing is sure to work every time. The best you can hope for is asymmetry: that you'll be right more often than you're wrong, and that your successful decisions will add more than your mistakes subtract.

Nothing will lead to superior results in the absence of superior judgment. But even superior investors are far from perfect.

The environment doesn't remain static. The actions of the participants alter the environment, and thus the things you must do for success. The quest for gain causes easy answers to be driven out. Yesterday's right answer can be today's wrong answer.

Everything that's important is counterintuitive, and everything that's obvious is wrong.

Ego, emotion and human nature are dangerous enemies.

On average, the average investor produces average results before fees and below average results after fees. Very few can be consistently above average – especially in more-efficient markets.

If you can't understand and accept these things, you're in the wrong job.

It's not supposed to be easy. Anyone who finds it easy is stupid. – Charlie Munger

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