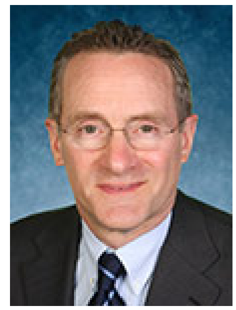
Howard Marks: Equities are Under-owned and Un-loved

By Robert Huebscher
November 19, 2013

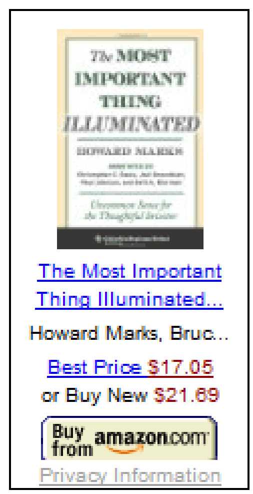


Howard Marks is the founder and chairman of Oaktree Capital Management, a Los Angeles-based firm with approximately $80 billion of primarily fixed-income and distressed assets under management. The "illuminated" edition of his, book, The Most Important Thing, was recently released. It contains comments from notable investors, including Christopher Davis, Joel Greenblatt, Paul Johnson and Seth Klarman.

I spoke with Mr. Marks on November 15 at the University of Virginia Investment Conference in Charlottesville, VA.

In your book you make the following observations about cycles: "Rule number one, most things will prove to be cyclical. Rule number two, some of the greatest opportunities for gains and loss come when people forget rule number one." At this time, are people forgetting rule number one in either the equity or the bond market? Tied into that, in your last memo in August, The Role of Confidence, you wrote that we were in the middle ground of the valuation cycle. What has changed since then?

That is still true. Markets go up and down, and at the bottom they're cheap, and then they rise to fair and then rich. We are in the middle range with regard to U.S. stocks. They have come a long way from the lower range a year and half ago. They are probably up 45% on the S&P from there. I thought they were very cheap at that time, and now they are at fair to full value. Full does not mean over-priced. I think they're somewhere in the upper part of the fair territory.



All bonds are expensive since interest rates are being held artificially low by the Fed's bond-buying program. One of these days, I hope, the government will stop holding interest rates down and rates will go up a moderate amount. If the 10-year today is 2.7%, my guess is it is going to go to 3.5% to 4%, but not to 6% right away. Bonds in general are rich. Credit spreads within the bond universe look okay.

You are a proponent of second-level thinking. Can you give a short explanation of what that means for the benefit of our readers?

It mainly means that you have to understand how securities are valued and how money is made. If you take a simplistic approach you can't succeed. Second-level thinking says that you have to think different from and better than the crowd. If you think the same as the crowd you'll have average results.

How is money made? If corporate profits grow 6% a year, it'll be easy to make 6% a year in stock market. But to make more, or to outperform others, you have to think different and better. Money is made when the crowd's expectation of the future turns out to have been too low, when reality exceeds perception.

Obviously, if you are going to make money to an above average extent, you have to see when the crowd's thinking is off. By definition, if you think like the crowd you can't know when the crowd is off.

As I say in the book, the first-level thinker says, "This is a good company, you should buy the stock." The second-level thinker says, "This is a good company, but not that good. You should sell it because it is up on expectations."

Let me give you examples, to see your second-level thoughts on some topics. We will start with high-frequency trading.

There are a lot of things that I think can't work, and yet somebody makes money with most of them. Maybe not enough people make money to refute the belief that these things are random, but somebody makes money. Can you hire a computer to tap into the flow of trading information and make a superior return? You should not be able to, because that should be capable of being arbitraged away, but I understand some people do. They probably make it by finding some tiny abnormality and leveraging it up. If we are talking about a tiny abnormality, then it should not have a profound effect on the market itself. So I don't worry about it, but then again I am not in equities.

Fracking and the so-called energy revolution?

I don't follow it. I don't have any primary information. A lot of smart people think it is going to move us into the direction of energy sufficiency for a while, and importantly increase our efficiency in manufacturing, and give us an edge. I am not willing to bet the ranch on this producing a brand-new era, but it sounds like a positive. It would be a plus for the stocks that are affected – if it is not already in the price.

The first-level thinker says, "When we reach energy sufficiency, stocks are going to go up." The second-level thinker says, "Since we are going to be better off in the future than we are, I will buy some stocks today." That bids stocks up and that is how future events are discounted today.

Quantitative easing?

I may be in the minority on that, because I don't think it is a big deal, in a sense. There was an article in the papers within the last week talking about fears of quantitative easing. My question is: What are you afraid of?

People are concerned that tapering quantitative easing will have two effects. Number one, they are concerned that the economy will slow if we stop simulating it, and number two, they are afraid that interest rates will go up.

On the first, I believe a Yellen-led Fed will be a dovish Fed, which is interested in producing growth. I don't think they are going to remove the patient from the breathing machine until they're sure he can breathe for himself. If the fear is that growth will slow, the Fed is going to do everything it can to make sure that in the environment in which they remove QE, the economy will grow on its own.

Number two, if people are afraid interest rates will go up, my answer would be, “Yes that is right; get used to it, because today’s interest rates are artificially low.” Herb Stein, the great economist said, “If something cannot continue it will stop.” Artificially low interest rates cannot continue forever. They will stop. Rates will probably rise.

If you agree with that, and I think it is all true, then it means that you have to accept that it is going to happen. What is the difference when it happens? People say it will happen in December or March. What is the difference between the two if it is going to happen? I am never very fixated on timing of events.

When I was an equity analyst you would get reports and they would say things such as, “I like it for the long term not the short term, or I like it for the short term not the long term.” How do you know? If you think something’s going to go up, how do you know whether it is going to happen in the short term or the long term? Either you like it or you don’t, it seems to me.

If you think interest rates are going to go up, what does it matter whether they go up in December or March? If you think they are going to go up in March, wouldn’t it be stupid to plan on holding bonds from now until February in the expectation that you are smart enough to avoid the effect in March? Number one, it may happen in February instead and surprise you. And number two, if it happens in March it may be anticipated in February, bringing markdowns while you’re holding.

So I just don’t see the big deal.

Do you have any second-level thoughts on Japan with respect to Abenomics?

Abenomics are the right policies. Growth has been very slow over there and this is their best chance to get out of the rut. Prime Minister Abe has enumerated the right policies, and the key question is will they work? Because the fact that that they are the right policies is different from saying they are going to work. What he is trying to do is change the dynamism of a whole country.

At a media briefing in Shanghai earlier this month, you stated that Chinese equities were tremendous bargains.

I was misquoted. What I said is that the guy who runs our emerging-market portfolios thinks that Chinese and emerging-market equities are outstanding bargains. So the truth differed in a few degrees from what they printed.

What is the bull case for owning China in those emerging markets at this time?

China has superior growth potential and its stocks are way down. Three to four years ago everybody thought the developed world was in the soup, but the emerging markets would do great. Now, everybody thinks the opposite. There has been a swing of confidence, and I think it has gone to an extreme. I am not an expert in this area, but I am told that the stocks are at historic low valuations from which, if you bought them in the past, you made a lot of money.

Over the last two years you have invested in nonperforming mortgages on single-family homes. What have you learned from that experience?

It's going well. We actually did most of it two to three-plus years ago and we made numerous investments related to residential housing. We bought them when confidence was at an extreme, exaggerated low. Everybody acted like there would never be another house built in America again. If you can buy an asset when there is no optimism in its price, it is usually a good thing. Now you read about housing booms and shortages, so it has worked very well.

You indicated in a recent interview that you have capital to invest in real estate. Are you looking now at commercial or residential, U.S. or overseas? What part of the capital structure?

All parts of the capital structure. The main thing is that we are not prime real estate buyers. Prime real estate sells on yield and gives a little spread over high grades. That is not interesting to us. We are buyers of B and C buildings in secondary cities, where you can still get some value, and real estate debt. We are buyers in the States but our activity has been rising faster in Europe.

In a memo you wrote in February of this year, you noted that the average spread over Treasury bonds on your U.S. high-yield portfolio is about 490 basis points – toward the high end of the normal range over the last three decades. Do the low absolute yield and the resulting longer duration in those kinds of bonds have implications now for high-yield investing?

Like I said before, all bonds are in a bubble. I have been involved in high-yield bonds for over three decades, and for most of that time they yielded double digits. Now they yield mid-single digits, which is disappointing. But a lot of things offer less today than they normally do, and less than we would like, because interest rates are artificially low.

If you buy a bond at 6% and you are right on the credit, guess what? You will make 6%. So the question is, is that enough? If 6% is not enough, you shouldn't buy them. If 6% is the yield, you shouldn't expect 12% because they are called "fixed income" for reason – the maximum return is fixed.

You can say, "Well, I would like to get that bond at a 12% yield," but that is not available today. Your option is to buy it or not. If you don't buy it, what are you going to buy? Sid Cottle, who was the editor of the later editions of Graham and Dodd's *Security Analysis*, told me that, "investing is the discipline of relative selection." So if not A, then what?

Everything is somewhat elevated. The good news about a 6% bond is if you buy it and it pays, you are going to make 6%; you are going to get your money back with interest. If interest rates go higher, you will have the ability to reinvest those cash flows at a higher interest rate.

Does that argue for owning individual bonds over bond funds?

Probably, because the bond fund never pays off. On the other hand, it is very hard for individuals to make those choices. It is very hard to know enough about enough bonds to have an intelligently diversified portfolio. We have approximately 140 names in our portfolios; that is a lot safer than going out and buying 10. The people picking those 140 bonds are experts, and that is a lot safer than some novice buying the 10. If you combine the lack of diversification in individually bought bonds with the lack of expertise, then you really get in trouble if you try it yourself. An emphasis on investing in a diversified portfolio has always been at the heart of prudent investing in high bonds.

Earlier this year, *Forbes* magazine quoted you as saying you were "quite comfortable imagining a few years of equity performance that provide a pleasant surprise relative to what I think is the prevailing expectation of 6% or so per year." Other well-known value investors, including Seth Klarman, Bob Rodriguez, Rob Arnott and Jeremy Grantham, are much less sanguine. What is different about your practice of value investing that makes you so optimistic?

I wrote a memo February or March called the Outlook for Equities and I enumerated the pros and cons. I found roughly six pros and eight cons. The trouble is that you cannot put them on a scale and figure out how to weight them. You have to decide which factors you consider more important. Just like so many other things in this interview we have been talking about, the confidence in equities had swung to the negative. In 2000 everybody would have said equities would give you 11%; they would have been unanimous in that. Now everybody says 6% or 7%.

What changed? The only thing that changed is that the companies doubled their earnings and the P/E ratio went in half.

To put it simply, I still think equities are under-owned institutionally and under-loved, and I like to buy assets like that.

I expected that with bonds offering so little, the affection would flow to stocks, and it seems it has. I started saying this in March 2012, when I put out a memo called "Déjà Vu All Over Again." That is when I first said "un-loved and under-owned." Obviously it is a little less true today, but money has to go someplace. Where is it going to go? I don't think it is going to go into bonds. You can only put so much into real estate, private equity, or hedge funds. If you put it in hedge funds, they will buy stocks anyway. So it bodes well for the stock market.

But, now the stock market is back to fully or fairly priced, at a P/E ratio of 16 or 17. They are not giving them away. But, I keep going back to what would you rather buy? I am not shilling for stocks because we are not in the equity business. But with bonds at these artificially low interest rates, stocks are less bad. Note that I did not say "good."

What sources of information do you find most useful in terms of gaining perspective into the macro environment or in terms of gaining investment insights?

I read a lot of newspapers – the *Wall Street Journal*, the *New York Times*, and the *Financial Times*. When I was a kid in the 1960s, there was something called, I think, the Johnson Inference Service. They read the papers and they did not summarize the headlines; they tried to say what the headlines meant. That is what I try to do. I try to figure out what the headlines mean. I think the headlines can tell you where that pendulum is that I keep talking about: its position between too optimistic and too pessimistic, too confident and too worried, too greedy and too fearful. The most important thing that any of us can know in terms of performing in the short run is where we stand on the pendulum, and that is what the papers can tell you.

www.advisorperspectives.com

For a free subscription to the Advisor Perspectives newsletter, visit:
http://www.advisorperspectives.com/subscribers/subscribe.php