

Memo to: Oaktree Clients
From: Howard Marks
Re: Dare to Be Great

In one of the most colorful vignettes of the early 1970s, Glenn Turner, the head of Koscot Interplanetary, would fly into a small Midwestern town in his Learjet (when that was a huge deal). Two dwarfs would hop out and unroll a red carpet. Turner would emerge under a banner reading “Dare to Be Great” and vacuum up money through a pyramid marketing scheme based on selling motivational tapes containing the secret of getting rich. **Turner’s long gone from the scene, but daring to be great still deserves our consideration, even in the absence of a surefire recipe for success.**

This memo stems from an accumulation of thoughts on the subject of how investment management clients might best pursue superior results. Typically my thoughts pile up, and then something prompts me to turn them into a memo. In this case, the impetus came while I read “Hedgehogging” by Barton Biggs. I’ll come back to it later.

How Can We Achieve Superior Investment Results?

The answer is simple: 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. According to one of my favorite sources of inspiration, the late John Kenneth Galbraith:

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.

Of course there can’t be a roadmap to investment success. First, the collective actions of those following the map would alter the landscape, rendering it ineffective. And second, everyone following it would achieve the same results, and people would still look longingly at the top quartile . . . the route to which would have to be found through other means.

I’ll make a few suggestions below on what investors should and shouldn’t do. In the end, though, the things I suggest will be of little help without highly skilled implementation, and the results will depend almost entirely on that implementation and rather little on my suggestions.

First, Get Out of Lake Wobegon

Nori Gerardo Lietz of Pension Consulting Alliance, in a paper on the performance of real estate opportunity funds, was the latest to remind me about Garrison Keillor’s fictional Lake Wobegon, where all the children are above average. **Investing, likewise, is a world where it seems everyone claims to be terrific and can back it up with performance data.** Especially in

alternative investing areas such as real estate and private equity, the managers make it sound like they've done great. But the long-term average returns in most such areas have been lackluster, and many managers' records are inconsistent. One of my favorite quotes came from "Dandy Don" Meredith while announcing on Monday Night Football: "They don't make 'em anymore the way they used to," he said, "but then again they never did." Rarely are the real records as good as the ones people (and especially the managers who created them) fondly remember.

Take a look at the performance over time in venture capital, buyouts and real estate and you'll see results for the median manager that are far from exciting. Professor Steven Kaplan, head of the entrepreneurial studies department at the University of Chicago's Graduate School of Business, authored a paper showing that a dollar invested in the totality of buyout funds between 1980 and 1997 did no better than a dollar invested in the S&P 500. And that was despite the fact that the buyout funds were leveraged in a rising equity market and the S&P wasn't.

The eye-popping results of the funds at the top of the performance range draw money magnetically to alternative investment areas, while the average return usually deserves a big yawn. **For superior results, it's absolutely essential to invest with superior managers.**

My old boss at Citibank, Peter Vermilye, is famous for saying that only 5% of analysts add value. That's probably true as well of portfolio managers, consultants and investment committees and their members. (Of course you and I are in that 5%, but I have my doubts about the others.)

The consensus opinion of market participants is baked into market prices. Thus, if investors lack insight that is superior to the average of the people who make up the consensus, they should expect average risk-adjusted performance. Few people are able to consistently identify cases where the market price is wrong and act on them to their advantage. "But how about Peter Lynch?" people respond. That's just the point. His singular reputation is proof how rare the Peter Lynches are. As my mother used to say, it's the exception that proves the rule.

So, the first job in trying to access superior performance consists of getting in with the best funds and managers. Everyone wants above-average results, but far from everyone can achieve them. (Of course, the chore is complicated by the fact that the investment capacity of superior investment vehicles is limited, and the inrush of money can itself render them less superior, since the cost of investing will be pushed up as the money arrives.)

Escape From the Crowd

This just in: you can't take the same actions as everyone else and expect to outperform. The search for superior results has to lead to the unusual, perhaps the idiosyncratic. Take manager selection.

Above-average managers aren't easy to find. When you choose on the basis of a manager's track record, it's the same record that everyone else sees. In order to make superior choices, clients have to do in-depth analysis; get to know more than the record, reputation and printed word; fully understand managers' approaches; make judgment calls based on that knowledge;

and take chances. Especially as to that last point, **unusual success cannot lie in doing the obvious**. Two specific examples:

- New managers – Someone has to fund them (or else they'll never become established managers). But clearly that decision can't be based on reams of data. It involves making a bet on people and their investment approaches. Hiring new managers can pay off very well . . . when it's done right.
- Underperforming managers – Retain or fire . . . or add money? That's the real question. Good investors hold fast to their approach and discipline. But every approach goes out of favor from time to time, and the manager who adheres most firmly can do the worst. (Page 217 of the book "Hedgehogging" provides fascinating data on some great managers' terrible times.) A lagging year or two doesn't make a manager a bad one . . . maybe just one whose market niche has been in the process of getting cheap. But how often are managers given more money when they're in a slump (as opposed to being fired)?

Buck the Trend

As in manager selection, bucking the trend is a key element in all aspects of the pursuit of superior investment results. First, going along with the crowd will, by definition, lead to average performance. Second, the crowd is usually in broad agreement – and wrong – at the extremes. That's what creates the extremes (and the highly profitable recoveries therefrom). But going against the crowd isn't easy. As Yale's David Swensen puts it,

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

Non-consensus ideas have to be lonely. **By definition, non-consensus ideas that are popular, widely held or intuitively obvious are an oxymoron**. Thus such ideas are uncomfortable; non-conformists don't enjoy the warmth that comes with being at the center of the herd.

Further, unconventional ideas often appear imprudent. The popular definition of "prudent" – especially in the investment world – is often twisted into "what everyone does." When courts interpret Prudent Man laws, they take them to mean "what most intelligent, careful people would do under those circumstances." **But many of the things that have worked out best over the years – betting on start-ups, buying the debt of bankrupt companies, shorting the stocks of world-altering tech companies – looked downright imprudent to the masses at the time. (If they weren't so out of favor, they couldn't have been implemented at such advantageous prices and produced such huge returns.)**

Bucking the trend does not have to be synonymous with taking a lot of investment risk. In fact, it's following the crowd that's risky, since the crowd's actions take security prices to such extremes.

Staying away from tech stocks in the late 1990s meant refusing to pay ridiculously high prices. It wasn't risky in fundamental terms, but in that it required daring to be different. Those who moved to underweight tech stocks when they first became overpriced were on the hot seat for a long time. I don't think any other stock group in history has done as well as the techs in the late 1990s, and the 1999 divergence between growth stock returns and value stock returns was the greatest ever. In the years leading up to March 2000, lots of managers were fired for having underweighted tech stocks. That didn't make them wrong – just too early. While it wasn't easy for them to stick to their guns – or for their clients to stay with them – it sure paid off.

Unconventionality

Unconventionality is required for superior investment results, especially in asset allocation. As I mentioned above, you can't do the same things others do and expect to outperform.

Unconventionality shouldn't be a goal in itself, but rather a way of thinking. In order to distinguish yourself from others, it helps to have ideas that are different and to process those ideas differently. I conceptualize the situation as a simple 2-by-2 matrix:

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

Of course it's not easy and clear-cut, but I think that's the general situation. If your behavior and that of your managers is conventional, you're likely to get conventional results – either good or bad. **Only if the behavior is unconventional is your performance likely to be unconventional . . . and only if the judgments are superior is your performance likely to be above average.**

Contrarian investing, which is akin to unconventional investing, has been behind many of the greatest successes. But that's not the same as saying all contrarian decisions are successful. As is the case with unconventionality, you should not aim for contrarianism for its own sake, but only when the reasons are good and the actions of the crowd look particularly foolish. If your actions aren't founded on solid logic, (a) they're unlikely to work consistently, and (b) when the going gets tough, you might find it hard to hold on through the lows. David Swensen puts it well in his book, "Pioneering Portfolio Management":

Contrarian, long-term investing poses extraordinary challenges under the best of circumstances. . . . Unfortunately, overcoming the tendency to follow the crowd, while necessary, proves insufficient to guarantee investment success. . . . While courage to take a different path enhances chances for success, investors face likely failure unless a thoughtful set of investment principles undergirds the courage.

I like to say Oaktree buys when people say “no way” and sells when they say “no sweat.” We bought Tumi in 2002, when people believed that because of 9/11, nobody would ever travel again (or need luggage), and we sold it in 2004 when no one remembered having felt that way. We gained control of Regal, Loews, Edwards and Landmark when people thought overexpansion had sounded the death knell for the movie exhibition industry, and we began to sell when industry capacity was rationalized and profitability rebounded. We bought land in Chicago when everyone was sure there would never be another skyscraper built in the Loop, and we sold it when they decided more were in fact needed. These transactions were highly profitable.

When someone says, “I wouldn’t buy that at any price,” it’s as illogical as, “I’ll take it regardless of price.” The latter can get you killed (see Nifty-Fifty growth stocks in 1969 and tech stocks in 1999), and the former can make you miss an opportunity. When everyone’s eager to buy the same thing, it’s probably overpriced. And when no one is willing to buy something, it’s equally likely to be underpriced.

Be a Pioneer

In my experience, many of the most successful investments have entailed being early. **That’s half the reason why I consider the greatest of all investment adages to be: “What the wise man does in the beginning, the fool does in the end.”**

While there’s no surefire route to investment success, I do believe one of the easiest ways to make money is by buying things whose merits others haven’t yet discovered. You ask, “When do you get that chance?” Not often, (and certainly not easily today), but not never.

In 1978, Bache asked Citibank to manage a new mutual fund for it. Citibank turned the job over to me: “There’s some guy named Milken or something who works for a small brokerage firm in California, issuing and trading high yield bonds. Can you find out what that means?”

Few people had ever heard of high yield bonds. There wasn’t much historic performance data, and what little there was came from a few obscure mutual funds. Buying bonds with a meaningful probability of default certainly seemed imprudent. Most institutional portfolios had an inviolate minimum credit rating for bonds of single-A or triple-B. Corporate CEOs said, “My buddy’s company was just threatened by a corporate raider backed by junk bonds; our pension fund will never own any!” And no public or union pension trustee wanted the headline risk associated with bankruptcy. **In other words, the perfect buying opportunity.**

Thus, our high yield bond portfolios have outperformed high grade bonds for two decades-plus, by more than enough to compensate for their defaults, volatility and illiquidity. It’s been a long-term free lunch, and **the earliest investors got the biggest helping.**

Everyone craves market inefficiency, but most people are vague on what it means or where it comes from. I’ve always thought a likely source can be a market niche that most people don’t know about, don’t understand and don’t feel comfortable with. That certainly describes high yield bonds in 1978. It helps to be a pioneer.

Likewise, we were fortunate to turn to distressed debt in 1988. There weren't any distressed debt funds from mainstream financial institutions, and the area was a little-known backwater. What could be more unseemly – and less intuitively attractive – than investing in the debt of companies that are bankrupt or sure to become so? Actually, what else could have been as profitable? Distressed debt buyers have reaped high returns while enjoying the relative safety that comes with paying low prices, investing in asset-rich companies and deleveraging their capital structures.

To take early advantage of areas like these, you have to put your faith in concepts and people, based on logical arguments and analyses but without the benefit of historic performance data. That's how you make the big bucks.

(Today, of course, everyone is willing to do anything to make money. Moreover, everyone assumes that the more *outré* the concept, the more likely it is to produce high returns. Thus, today (a) few if any free lunches are available, and (b) risk-taking is likely to generate sub-par rewards. **That brings me to the second half of my favorite adage, regarding that which “the fool does in the end.”**)

Up Against the Institution

Large investment management firms, pension funds, endowments, investment committees; they're all institutions. As such, they tend to engage in what is described as “institutional behavior” – an oft-heard phrase that's rarely intended as a compliment. We all know what's implied: shared decision making, diffused responsibility, personal risk minimization, and go-along-to-get-along interaction. All of these things work to discourage unconventionality, and thus to render superior investment results elusive.

David Swensen takes direct aim at institutional behavior. In fact, he makes repeated use of the word “institution,” as if invoking a negative mantra.

. . . active management strategies demand uninstitutional behavior from institutions, creating a paradox that few can unravel. (my personal favorite, emphasis added)

By operating in the institutional mainstream of short-horizon, uncontroversial opportunities, committee members and staff ensure unspectacular results, while missing potentially rewarding longer-term contrarian plays.

Creating a governance process that encourages long-term, independent, contrarian investing poses an enormous challenge to endowed institutions.

Whether the connotation has to be negative is unclear. **But certainly it is true that “idiosyncratic” and “unconventional” seem to go with “unusual investment results,” but probably not with “institutional” and “bureaucratic.”** I encourage everyone to examine the

sorts of behavior that characterize their organizations and see if anything can be changed to increase the likelihood of success.

Committees

I don't like being on committees. I was on five of them at Citibank (before moving downward in the organization from Director of Research to just-plain portfolio manager in 1978), and thus I had eleven hours of meetings scheduled per week before I walked in the door each Monday morning. I've always felt that committee meetings tend to last as long as the person who wants them to last the longest wants them to last. Since that's never me, they make me impatient (unless they're doing really interesting stuff). Oaktree generally doesn't have committees, but it's a matter of local option; our Principal Group works through investment committees that everyone seems happy with and that have produced great results.

In "Hedgehogging," under the heading "Groupthink Stinks," Barton Biggs lists a number of the shortcomings of committees, borrowing from Yale psychologist Irving Janis. He says these structures encourage:

- collective rationalization of shared illusions generally believed,
- negative stereotypes of out-of-favor groups, techniques and individuals,
- unwarranted confidence in chosen approaches,
- unanimity, suppression of doubts and pressure on dissenters,
- docility on the part of individual members,
- free-floating conversations during meetings, and
- non-adherence to standardized methodologies.

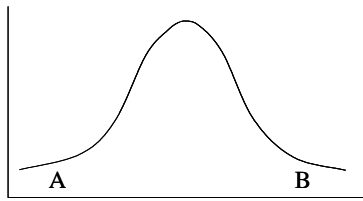
It's easy to believe that these elements are fostered in decision making groups. And certainly they are undesirable and must be guarded against. As Barton Biggs puts it,

. . . groups of intelligent people have so many inherent liabilities that a lone individual has a far better chance of making good decisions. The collective intelligence of the group is surely less than the sum of its parts, and the more people on a committee, the less chance it has to be wise and crisp in its decision making.

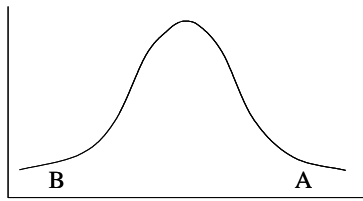
I'd rather say, "The collective intelligence of the group often is less than the intelligence of its one or two smartest members." By that I mean committees rarely aggregate the insights of their members; rather they tend to reflect the average insightfulness of their members.

At Citibank in the mid-1970s, the senior-most panel, the Investment Policy Committee, would go off-site for semi-annual retreats. The high point consisted of voting on which industries' stocks would perform best over the coming year.

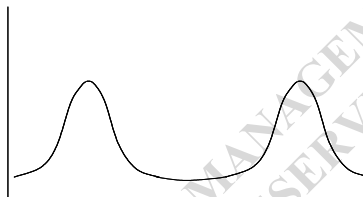
For some people, the result was a bell-shaped curve.



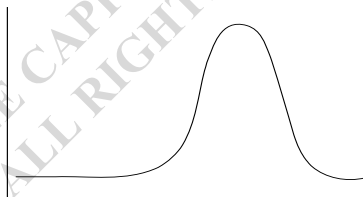
For others it was also bell-shaped, but with the placement of the industries reversed.



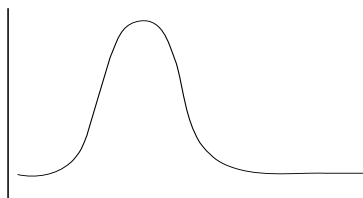
Some saw only big winners and big losers.



The bulls thought most would do average or better.



The bears thought most would do average or worse.



And the agnostics thought they'd all do about the same.



It was my sense that if you added up the members' individual distributions of expected performance, you'd get a summary distribution that was pretty close to what would have been generated randomly, and one largely devoid of valuable information. Certainly any unique insight that a member of the committee might have would be lost in such an aggregation process.

Committees rarely take high-risk positions for which the members can be criticized. They rarely embrace idiosyncratic opinions. They rarely capture the most insightful member's uniqueness, as expressed in a lone non-conformist viewpoint. And thus they rarely produce highly superior investment results. It's not impossible, just against the odds. Barton Biggs says the chances of its happening can be improved if one or two members seize more-than-equal power. It'll also help if it's the right ones who do so.

I think the key to successful committee efforts lies in "sparks." There should be intellectual friction capable of generating heat and light: spirited discussion leading to unique insight. Professor Janis urges the leader to create an atmosphere that fosters "intellectual suspicion amidst personal trust." Barton Biggs suggests praising those who disagree with the trend; designating devil's advocates; and holding second-chance meetings where members can take another, skeptical look at decisions the group has made. He says, **"harmonious, happy meetings may be a warning of groupthink and complacency, whereas agitation, passionate arguments and some stress are good signs."** While these latter things are no guarantee of correct, unconventional decisions, such decisions may prove elusive without them.

Agency Risk

Why don't investing institutions strive for unconventionality as often as they should? When they don't dare to be great, why is that the case? One reason is the limitations inherent in institutional behavior and committee decision making, as described above. Another is agency risk.

I first read about agency risk in 1983, in an article by Dean LeBaron of Batterymarch. It's risk that arises when agents are hired to do a job in lieu of their principals, and it arises because the agents' motivations may diverge from those of the principals. **When you manage your own money, the decisions are made according to your view of what's best for you. When other people manage your money, the decisions may also be influenced by what's best for them.** How many times have you heard a hired hand say, "It's not worth my while to take that risk"?

The most basic agency issue arises because staff and investment committee members may gain relatively little if their decisions are successful but can lose a lot (like their jobs and reputations) if the decisions are unsuccessful. All else being equal, this can lead them to care more about limiting risk than about achieving gains. (On the other hand, because hedge fund managers participate in profits but not losses, this can make them care more about achieving gains than about limiting risk.)

The litany of agency risks goes on, per David Swensen, "from trustees seeking to make an impact during their term on the investment committee, to portfolio managers pursuing steady fee

income at the expense of investment excellence, to corporate managers diverting assets for personal gain.”

Whenever parties other than the owners are engaged in a process, there’s a chance that they will act (wittingly or unwittingly) in their own interests in addition to (or instead of) the interests of the owners. This is inescapable, but not unmanageable.

The best way to deal with an issue is usually to put it on the table. Sunlight is a great disinfectant. All decision-making processes should recognize and take into consideration the factors influencing the decision makers. Candid discussion is usually the first step.

Another way to address the issue is through incentives, to which creative principals should pay a lot of attention. An experienced director told Forbes in the early 1990s, “I’ve given up on trying to get people to do what I tell them to do; they do what I pay them to do.” To the extent possible, people involved in the investment process should be able to look forward to rewards for attempts at nonconformity, not just penalties for decisions that don’t work. That might be the best response to John Maynard Keynes’s observation: **“Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.”**

Insist on Using Consultants Constructively

Consultants are what you make of them. They can bring expertise and data that only the largest of institutional investors can build internally. They can introduce ideas they’re seeing in use elsewhere. They can support investors’ efforts to innovate while making sure they don’t go so far as to endanger the corpus. Because few institutions can afford to home-grow all of the resources that a good consultant has, consultants truly can be additive.

Or, they can just be used as a source of cover. Their stamp of approval can be sought as protection against potential criticism. They can be used to ensure that the portfolio is never different enough from the herd to stand out. They can be hired – and motivated – to preclude innovation. Frighteningly, a consultant once told me, “I never initiate; if I did, I could be criticized for being wrong. I just opine when asked.”

By supplying new ideas and needed data in support of an effort to be great, consultants clearly can add value. But left in bureaucratic mode, it is possible for them to contribute nothing other than protection. The choice – of consultant and *modus operandi* – is up to the client.

Recognize That All Investors Aren’t Created Equal

Wouldn’t it be great if the rules in Las Vegas were changed so there would be winners but no losers? Can’t capitalism allow some businesses to thrive without requiring that some fail? Can’t we have survival of the fittest without the demise of the less fit? Wouldn’t it be nice?

And wouldn’t it be nice if everyone could make an equally positive contribution to investment results? But they can’t.

Investment committee decisions can't be improved by members possessing below average skill, experience and expertise. The bottom 50% of the universe may help by giving the top participants a manager median they can beat, but they do not contribute to the pursuit of superior results for themselves or those who employ them.

Some investment organizations are egalitarian and democratic. Participation in the investment process is broad and diffuse. Everyone gets a little money to manage, or everyone gets a vote. This approach doesn't appeal to me, because of my conviction that investment skill isn't distributed evenly.

Every team includes some members who are more skilled than others. It is they who should have greater influence in the decision making process. It's nice to see the junior members developed as professionals and given valuable experience, but bringing more people into the process doesn't necessarily enhance performance in the short run.

I've watched an investment organization at work where the portfolio was divided up among several professionals, each of whom ran his portion separately. It seemed to me that each one engaged in individual stock-picking; no one was responsible for considering the portfolio's overall diversification and risk; and, in fact, each person relied (without justification) on the others to balance out the extremeness of his actions. The resulting portfolios represented little more than a bunch of concentrated bets on personal favorites thought to have home run potential.

Systems do exist in which responsibility for portfolio management is apportioned, and they can work. But they have to incorporate rigorous coordination and overall risk management. They can achieve camaraderie, personnel development and results that are mostly down the middle of the fairway with contributions from several minds – all good things. But I don't believe that broadly sharing or dispersing portfolio management responsibility is likely to lead to highly superior returns.

We get a lot of questionnaires asking, "Which portfolio manager will be assigned to our account? What assurance do we have that our manager won't deviate from your standards?" Our answer is simple: all the portfolios in each Oaktree strategy are managed by a single individual or team. I don't believe in broadly dispersed portfolio management responsibility, and I don't think you should, either.

Avoid Common Mistakes

Lastly, I want to mention some of what I believe are mistakes I've seen made by investors and investment committees. Hopefully this will help stamp out some of them.

- Over-diversifying – It's common for portfolios to have rules stating that they can't invest more than x% per manager or per fund. However, it's probably only on rare occasions that they approach those limits. In my opinion, most portfolios are spread too thin. **While it's true that only large positions can get you into trouble, it's equally true that only large positions can make a big contribution. (This is one of the great dilemmas in investing.)**

When I see 1% or ½% of portfolio capital invested with a trusted (and diversified) fund or manager, it strikes me as too little. A manager who has earned his clients' confidence should be entrusted with enough money to make a difference in overall portfolio results. One pension plan was bold enough to let Oaktree manage 70% of its alternatives portfolio, and this led to a relationship that was wildly successful for both sides. How many investors would have taken that chance?

- Limiting the percentage of a manager's AUM – As a counterpoint to the above, I've heard committees say, "We don't want to represent more than x% of the manager's assets under management, or of the fund's total capital." But why not? **Is the goal better performance, or is it safety in numbers?** If you're considering investing \$10 million with a manager, why does it matter how much money she manages? Why is investing \$10 million safe if she manages \$1 billion but risky if she manages \$50 million? If a manager is unusually skillful, aren't you better off as her client (all else equal) if she manages less money rather than more? And if a manager was really good, wouldn't you prefer that she managed only your money? Wouldn't that be a great way to differentiate your performance (assuming you're right)? The pension client referred to above committed 40% of the capital for the initial fund in a new Oaktree strategy. Mistake? Not with an after-fee gain of 118% over the next three years.
- Moderating – Committees often prefer to take baby steps, go slow, and invest less than the maximum possible. **But in the pursuit of superior investment results, moderation is not a virtue in and of itself.** When you look at the portfolios that do better than others over time, like the Yale and Harvard endowments, you usually see very substantial commitments to individual strategies, managers and funds. In fact, you invariably see commitments that could have gotten the decision makers into trouble if they'd gone wrong.
- Managing toward peer allocations – Finally, I often see investors make reference to their peers' portfolios when setting allocations. It's unlikely that they're looking for the "right" allocation, but rather one ensuring that performance won't be far below the pack. **But if you've mirrored the pack enough to be sure you can't underperform, then it's also likely that you won't outperform.** Like everything else in the investing world (other than "alpha," or genuine personal skill), emulating the pack cuts both ways.

My most specific and most heartfelt advice is this: The surest way to achieve superior performance is by investing significant amounts with individuals and firms that can be depended on for investment skill, risk control, and fair treatment of clients.

When you're dealing with investments where reliable probabilities can't be assigned to the possible outcomes, or which entail the possibility of significant risk to the corpus (make-it-or-break-it-type risks), failing to diversify can be a big mistake. But when you know of managers and strategies that appear to offer high returns with bearable, controlled risks, and when reasonable judgments can be made about the probable outcomes, it's failing to concentrate that can be the big mistake.

In short, if you can get money to work with people that your experience shows you can rely on, load up!

* * *

The bottom line on striving for superior performance has a lot to do with daring to be great. **Especially in terms of asset allocation, “can’t lose” usually goes hand-in-hand with “can’t win.”** One of the investor’s or the committee’s first and most fundamental decisions has to be on the question of how far out the portfolio will venture. **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?**

I learned a lot from my favorite fortune cookie: **The cautious seldom err or write great poetry.** It cuts two ways, which makes it thought-provoking. Caution can help us avoid mistakes, but it can also keep us from great accomplishments.

Personally, I like caution in money managers. I believe that in many cases, the avoidance of losses and terrible years is more easily achieved than repeated greatness, and thus risk control is more likely to create a solid foundation for a superior long-term track record. Investing scared, requiring good value and a substantial margin for error, and being conscious of what you don’t know and can’t control are hallmarks of the best investors I know.

But in assembling a portfolio of managers and strategies, there has to be an element of boldness if you hope to enjoy superior returns. Too large a dose of caution in asset allocation can keep portfolios from outperforming the norm.

Two additional factors bear on the integration of risk management in asset allocation, with its pivotal role in portfolio construction:

- First, as Professor William Sharpe demonstrated, adding a risky strategy to a portfolio with which it is uncorrelated can reduce the overall riskiness of the portfolio.
- Second, it should be borne in mind that when one portfolio places a greater emphasis than another on managers who lean toward risk control, that portfolio can allocate more of its capital to risky strategies without having a higher overall quantum of risk. Thus, while restricting your total risk to your targeted level, **would you rather allocate more money to the aggressive asset classes via risk-controlling managers, or less money with free-wheeling managers?**

* * *

I hope this memo won’t come across as preachy. The things discussed here are challenging, and I don’t claim to be much better at them than anyone else. I’ve sat on the investor’s side of the table. I’ve been a member of several investment committees. I know it’s a tough job. Committee and staff members have to act in what they consider to be the best interests of the beneficiaries, trying for superior returns but avoiding unacceptable losses. They also have to

choose investment managers, separating the ones that sound good and are from the ones that sound good and aren't. (The ones that don't sound good usually aren't let out on the road.) All we can do is our best.

The right approach to portfolio construction has to combine discipline and hard work; skillful, intelligent risk bearing; and insight, flair and talent. In that regard, I'll cite the last three words of Barton Biggs's chapter on groupthink: "It's not easy."

September 7, 2006

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