

Memo to: Oaktree Clients

From: Howard Marks

Re: Yet Again?

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“[There They Go Again . . . Again](#)” of July 26 has generated the most response in the 28 years I’ve been writing memos, with comments coming from Oaktree clients, other readers, the print media and TV. I also understand my comments regarding digital currencies have been the subject of extensive – and critical – comments on social media, but my primitiveness in this regard has kept me from seeing them.

The responses and the time that has elapsed have given me the opportunity to listen, learn and think. Thus I’ve decided to share some of those reflections here.

### Media Reaction

The cable news shows and blogposts delivered a wide range of reactions – both positive and negative. The best of the former came from a manager who, when asked on TV what he thought of the memo, said, “I’d like to photocopy it and sign it and send it out as my quarterly letter.” Love that guy.

I haven’t spent my time reveling in the praise, but rather thinking about those who took issue. (My son Andrew always reminds me about Warren Buffett’s prescription: “praise by name, criticize by category.” Thus no names.) Here’s some of what they said:

1. “The story from Howard Marks is ‘it’s time to get out.’ ”
2. “He’s right in the concept but wrong to execute right now.”
3. “The market is a little expensive, but you should continue to ride it until there are a couple of big down days.”
4. “There are stocks that are past my sell points, and I’m letting them continue to burble higher.”
5. “I appreciate Howard Marks’s message but I think now is no more a time to be cautious than at any other time. We should *always* invest as if the best is yet to come but the worst could be right around the corner. This means durable portfolios, hedges, cash reserves . . . etc. There is no better or worse time for any of these things that we can foresee in advance.”

I take issue with all these statements, especially the last, and I want to respond – not just in the sense of “dispute,” but rather to clarify where I stand. In doing so, I’ll incorporate some of what I said during my appearances on TV following the memo’s publication.

**Numbers one and two are easy.** As I explained on CNBC, there are two things I would never say when referring to the market: “get out” and “it’s time.” I’m not that smart, and I’m never that sure. The media like to hear people say “get in” or “get out,” but most of the time the correct action is somewhere in between.

I told Bloomberg, “Investing is not black or white, in or out, risky or safe.” **The key word is “calibrate.” The amount you have invested, your allocation of capital among the various possibilities, and the riskiness of the things you own all should be calibrated along a continuum that runs from aggressive to defensive.**

And as I told CNBC, what matters is “the level that securities are trading at and the emotion that is embodied in prices.” Investors’ actions should be governed by the relationship between each asset’s price and its intrinsic value. **“It’s not what’s going on; it’s how it’s priced. . . . When we’re getting value cheap, we should be aggressive; when we’re getting value expensive, we should pull back.”**

Here’s how I summed up on Bloomberg:

It’s all about investors’ willingness to take risk as opposed to insisting on safety. And when people are highly willing to take risk, and not concerned about safety, that’s when I get worried.

If it’s true, as I believe, that (a) the easy money in this cycle has been made, (b) the world is a risky place, and (c) securities are priced high, then people should probably be taking less risk today than they did three, five or seven years ago. Not “out,” but “less risk” and “more caution.”

And from my visit to CNBC:

All I’m saying is that prices are elevated; prospective returns are low; risks are high; people are engaging in risky behavior. Now nobody disagrees with any of the four of those, and if not, then it seems to me that this is a time for increased caution. . . . It’s maybe “in, but maybe a little less than you used to be in.” Or maybe “in as much as you used to be in, but with less-risky securities.”

**Numbers three and four – arguing that it’s too early to sell even if the market is expensive or holdings are past their sell point – are interesting. They’re either (a) absolutely illogical or (b) signs of the investor error and lack of discipline that are typical in bull markets.**

- If the market is expensive, why wouldn’t you lighten up?
- Why would you prefer to sell after a few big down days, rather than today? (What if the big down days are the start of a slide so big that you can’t get out at anything close to fair value? What if there’s a big down day followed by a big up day that gets you right back where you started? Does the process re-set? And is it three big down days in a row, or four?)
- And if you continue to hold past your sell points, what does “sell point” mean?

Bottom line: I think these things translate into “I want to think of myself as disciplined and analytical, but even more I want to make sure I don’t miss out on further gains.” In other words, fear of missing out has taken over from value discipline, a development that is a sure sign of a bull market.

**The fifth and final comment – that one should exercise the same degree of care and risk aversion at all times – gives me a lot to talk about.** In working on my new book, I divided the things an investor can do to achieve above average performance into two general categories:

- selection: trying to hold more of the things that will do better and less of the things that will do worse, and
- cycle adjustment: trying to have more risk exposure when markets rise and less when they fall.

**Accepting that “there is no better or worse time” simply means giving up on the latter.** Whereas Buffett tells us to “be fearful when others are greedy and greedy when others are fearful” – and he’s got a pretty good track record – this commentator seems to be saying we should be equally greedy (and equally fearful) all the time.

I feel strongly that it's possible to improve investment results by adjusting your positioning to fit the market, and Oaktree was able to do so by turning highly cautious in 2005-06 and highly aggressive in 1990-91, 2001-02 and immediately after the Lehman bankruptcy filing in 2008. This was done on the basis of reasoned judgments concerning:

- how markets have been acting,
- the level of valuations,
- the ease of executing risky financings,
- the status of investor psychology and behavior,
- the presence of greed versus fear, and
- where the markets stand in their usual cycle.

Is this effort in conflict with the tenet of Oaktree's investment philosophy that says macro-forecasting isn't key to our investing? My answer is an emphatic "no." **Importantly, assessing these things only requires observations regarding the present, not a single forecast.**

**As I say regularly, "We may not know where we're going, but we sure as heck ought to know where we stand."** Observations regarding valuation and investor behavior can't tell you what'll happen tomorrow, but they say a lot about where we stand today, and thus about the odds that will govern the intermediate term. They can tell you whether to be more aggressive or more defensive; they just can't be expected to always be correct, and certainly not correct right away.

The person who said "there is no better or worse time" was on TV with me, giving me a chance to push back. What he meant, he said, was that the vast majority of people lack the ability to discern where we stand in this regard, so they might as well not try.

I agree that it's hard. **Up-and-down cycles are usually triggered by changes in fundamentals and pushed to their extremes by swings in emotion. Everyone is exposed to the same fundamental information and emotional influences, and if you respond to them in a typical fashion, your behavior will be typical: pro-cyclical and painfully wrong at the extremes. To do better – to succeed at being contrarian and anti-cyclical – you have to (a) have an understanding of cycles, which can be gained through either experience or studying history, and (b) be able to control your emotional reaction to external stimuli.** Clearly this isn't easy, and if average investors (i.e., the people who drive cycles to extremes) could do it, the extremes wouldn't be as high and low as they are. But investors should still try. If they can't be explicitly contrarian – doing the opposite at the extremes (which admittedly is hard) – how about just refusing to go along with the herd?

Here's what I wrote with respect to the difficulty of doing this in "[On the Couch](#)" (January 2016):

I want to make it abundantly clear that when I call for caution in 2006-07, or active buying in late 2008, or renewed caution in 2012, or a somewhat more aggressive stance here in early 2016, I do it with considerable uncertainty. My conclusions are the result of my reasoning, applied with the benefit of my experience (and collaboration with my Oaktree colleagues), but I never consider them 100% likely to be correct, or even 80%. **I think they're right, of course, but I always make my recommendations with trepidation.**

When widespread euphoria and optimism cause asset prices to meaningfully exceed intrinsic values and normal valuation metrics, at some point we must take note and increase caution. And yet, invariably, the market will continue to march upward for a while to even greater excesses, making us look wrong. **This is an inescapable consequence of trying to know where we stand and take appropriate action.** But

it's still worthwhile. Even though no one can ascertain when we're at the exact top or bottom, a key to successful investing lies in selling – or lightening up – when we're closer to the top, and buying – or, hopefully, loading up – when we're closer to the bottom.

## FAANGs

There's been a lot of discussion regarding my comments on the FAANGs – Facebook, Amazon, Apple, Netflix and Google – and whether they're a “sell.” Some of them are trading at p/e ratios that are just on the high side of average, while others, sporting triple-digit p/e's, are clearly being valued more on hoped-for growth than on their current performance.

But whether these stocks should be sold, held or bought was never my concern. As I said on Bloomberg:

My point about the FAANGs was not that they are bad investments individually, or that they are overvalued. It was that the anointment of one group of super-stocks is indicative of a bull market. **You can't have a group treated like the FAANGs have been treated in a cautious, pessimistic, sober market.** So that should not be read as a complaint about that group, but rather indicative [of the state of the market].

That's everything I have to say on the subject.

## Bitcoin

As I said earlier, there has been particularly spirited response to my comments on digital currencies. It prompted me to sit down with people ranging from some of my Oaktree colleagues to Steven Bregman and Murray Stahl of Horizon Kinetics (my July memo incorporated some of Steven's observations on ETFs), and I learned that I've been looking at Bitcoin the wrong way. In particular, I realized that the memo incorporated the wrong joke from my father; instead of “the half-million-dollar hamster,” it should have been this one:

Two friends meet in the street, and Jim tells Sue he has some great sardines for sale. The fish are pedigreed and pure-bred, with full papers and high IQs. They were individually de-boned by hand and packed in the purest virgin olive oil. And the label was painted by a world-renowned artist.

Sue says, “That sounds great. I could use a tin. How much are they?” and Jim tells her they're \$10,000. Sue responds, “That's crazy, who would eat \$10,000 sardines?” **“Oh,” says Jim, “these aren't eating sardines; these are trading sardines.”**

**I had been thinking about digital currencies like Bitcoin as investing sardines, and that may have been a mistake. Their fans tell me they're spending sardines, and while that may be the case, I think at the moment they're being treated largely as trading sardines. The question remains open as to whether Bitcoin is (a) a currency, (b) a payment mechanism, (c) an asset class, or (d) a medium for speculation.**

The main complaint expressed in my memo was as follows:

Serious investing consists of buying things because the price is attractive relative to intrinsic value. Speculation, on the other hand, occurs when people buy something without any consideration of its underlying value or the appropriateness of its price, solely because they think others will pay more for it in the future.

In the memo I talked about Bitcoin as an investment asset that should have a value that can be appraised. While its fans tell me this isn't the right way to view it, I note that in their February "Bitcoin Review," even Steven and Murray called it "a new asset class." I think this is the weakest claim being made about Bitcoin. As I said in the memo, "it's not real" – there is no intrinsic value behind it.

What Bitcoin partisans have told me subsequently is that Bitcoin should be thought of as a currency – a medium of exchange – not an investment asset. Given that the evolution of Bitcoin is so topical, I think further discussion is in order. To start, I'm going to present the case for it as a currency. What are the characteristics of a currency?

- **Most importantly, it's something that people agree can be used as legal tender** (to buy things and pay debts), used as a store of value, and exchanged for other currencies.
- Currencies generally are created by governments. However, there have been exceptions: banks issued their own currencies in our nation's first century, and it can be argued that the "Green Stamps" of my childhood, and airline miles today, have a lot in common with currencies.
- For a long time currencies were backed by (and exchangeable for) gold or silver, but that's no longer the case. The truth is, there's nothing behind currencies these days other than their issuing governments' "full faith and credit." But what do they promise? New currencies are sometimes created out of thin air (like the euro, which wasn't legal tender sixteen years ago), and sometimes they're devalued.
- Currencies change in value relative to each other, in theory based on differential purchasing power, and in practice based on changes in supply and demand (which can stem, among other things, from changes in purchasing power).

**Bitcoin fans argue that it qualifies as a currency under these criteria: most importantly, it's something that parties can agree to accept as legal tender and a store of value.** That actually seems right.

**When I first responded to comments on the memo – even before my recent enlightenment – I found myself admitting that much of the criticism I had leveled at Bitcoin is applicable to the dollar as well.** Whereas I said Bitcoin "isn't real" because it has no intrinsic or underlying value, that's certainly true of the dollar and other fiat currencies: there's nothing behind them either. You can no longer exchange them for gold (and what is gold, anyway? But that's another subject). In fact, government-issued fiat currencies are accorded value only because of a government edict. **Why, the fans of Bitcoin ask, is such an edict superior to an agreement among people to accept a non-government-issued currency? Fiat currencies have value simply because of faith in the governments that issue them. If enough people believe in it, why can't faith in Bitcoin suffice? If you consider the properties of fiat currencies, these are darn good questions.**

So my initial bottom line is that I see no reason why Bitcoin can't be a currency, since it shares the characteristics listed above, especially the fact that there are people (and businesses and even countries) that accept it as legal tender.

But that's not good enough for Bitcoin's fans. **It's not the same as the dollar, they say; it's better.** In all the following ways, they've told me, Bitcoin is superior to government-issued currency:

- All the relevant data regarding Bitcoin – number outstanding, number newly created, and transactions – are recorded in the “blockchain,” a sort of transparent electronic ledger of which everyone can have his or her own copy.
- Bitcoin can’t be debased by unlimited issuance, since the blockchain process has been set to permit only a gradual increase from today’s 16 million, to 21 million in 2140. In this sense Bitcoin is better than the dollar, of which a lot more can be issued at any time, diminishing its purchasing power through inflation. As Steven and Murray have written, “a purchase of Bitcoin is nothing other than a short sale of the currencies of the world. Merely by limiting the growth of supply, Bitcoin would become more valuable as other currencies devalue.”
- Since the blockchain exists on each person’s individual computer, rather than in a central location, it can’t be hacked, and thus Bitcoin can’t be stolen, counterfeited, or secretly created in amounts exceeding the authorized total. Likewise, Bitcoin isn’t subject to the currency controls on portability that are often imposed by failing governments. (But I wonder whether the technological claims made for the blockchain might be its Achilles’ heel. While I certainly don’t have the ability to assess these claims for myself, I wonder how many of Bitcoin’s advocates do either.)

Where will we go from here? The partisans claim the outlook for Bitcoin as a currency is bright:

- Since very few people own it today but millions more will want it in the future, demand is sure to rise faster than supply, meaning the price will rise.
- Specifically, the U.S. money supply is almost \$14 trillion, so if people and businesses decide to hold just one-third of their wealth in Bitcoin rather than dollars, (and who wouldn’t want to do so given all the advantages described above?), the value of the Bitcoin in circulation will rise to \$4.5 trillion, from today’s \$73 billion, for a gain of roughly 60x.
- There’s sure to be a network effect: the more people join the Bitcoin movement, the more it will be accepted as legal tender, the more useful it will be, and the more demand will increase.
- Ignoring Bitcoin’s utility as currency, many people will buy just because they believe someone else will pay them more for it. (This time-honored “greater-fool theory” lies at the heart of all speculative manias.) Likewise, people will buy it because of fear of missing out, another bull-market standard.

There’s absolutely no reason why Bitcoin – or anything else – can’t serve as a currency if enough people accept it as such. While I’d point out that no private currency has gained widespread use in a long, long time, there’s nothing to say it can’t happen.

**Being willing to agree that Bitcoin may become an accepted medium of exchange is not the same as saying you should buy it now to make money.** Think about the fact that the price of Bitcoin has risen more than 350% so far this year and 3,900% in the last three years. To the degree people argue that Bitcoin is a currency, then (a) why is it so volatile? and (b) is that desirable? You might want to consider whether a real currency can do that, or whether speculative buying is determining Bitcoin’s price. And whether what’s gone up can come down.

**The immediate issue of Bitcoin as a currency still comes down to the question of whether today’s price is right.** The price of a Bitcoin is around \$4,600 today. Can one Bitcoin buy the same amount of goods as 4,600 dollar bills? Or the much higher amounts that Bitcoin bulls think it will soon be worth? I don’t think we have enough information to know, but the question isn’t irrelevant. If it were, this would be another case of “there’s no price too high.”

The other purported use for Bitcoin, given its status as what Marc Andreessen calls a “digital bearer instrument,” is as a payment mechanism. Its advantages in this regard include the following:

- transactions in Bitcoin can be anonymous (I understand it is often used to pay for opioids),
- payments are made without fees like those charged on credit card transactions and wire transfers,
- there can't be fraud and merchant charge-backs like with credit cards, and
- it can be particularly useful in emerging nations lacking developed payment systems.

But I see two issues here:

- First, I expect there to be many competing transaction systems. Will the banks and other financial institutions cede this territory to Bitcoin? Wouldn't banks' systems be more likely to gain acceptance from people other than perhaps millennials? What would happen to Bitcoin's utility as a payment mechanism if Amazon announced its own? Would you rather transact in Bitcoin or Amazonians?
- Second, if Bitcoin were to become the leading non-governmental payment system, what would cause it to appreciate? If you want to pay me in Bitcoin and I'll accept it, what would cause its price to rise? Adherents would argue that the limited supply relative to the growing use will make the price rise. But that assumes there's no price so high for Bitcoin that transferees won't accept it in lieu of dollars. The “pro” side of the argument foresees limitless appreciation, but that doesn't make sense. Think of any other currency: isn't there a price at which you wouldn't accept it? Would you sell your house for euros that are said to be worth two or three times as much as the dollar?

Marc Andreessen wrote an excellent article in The New York Times' *Dealbook*, titled “Why Bitcoin Matters” (January 21, 2014). The article outlined Bitcoin's potential as a payment system and described many of the advantages listed above. But it didn't include one word about why these advantages give Bitcoin appreciation potential.

So what's my real bottom line?

- Advocates say if Bitcoin is accepted as described above, you'll make more than 50 times your money. Thus success doesn't have to be highly probable for buying Bitcoin to have a huge expected return. **This is called “lottery-ticket thinking,” under which it seems smart to bet on an improbable outcome that offers a huge potential payoff.** We saw it in full flower in the dot-com boom in 1999-2000, and I think we're seeing it in action again today with regard to Bitcoin. Nothing is as seductive as the possibility of vast wealth.
- Several of the “seeds for a boom” that I listed in [“There They Go Again . . . Again”](#) are at work in the Bitcoin surge: (a) there is a **grain of underlying truth** as set out above; (b) there's **the prospect of a virtuous circle**: widespread demand will lead to wider acceptance as legal tender, which will lead to widespread demand; and (c) thus **this tree may grow to the sky**, as there is no obvious limit to this logic. None of these things necessarily make Bitcoin a mistake. They merely say elements that contributed to past bubbles can be detected today with regard to Bitcoin.
- Finally, Bitcoin isn't alone. There are hundreds of digital currencies already – including eleven with market capitalizations over a billion dollars – and no limits on the creation of new ones. So even if digital currencies are here to stay, who knows which one will turn out to be the winner? Hundreds of e-commerce start-ups appreciated rapidly in the tech bubble based on the premise that “the Internet will change the world.” It did, but most of the companies ended up worthless.

Thanks to the people who took the time to educate me, I'm a little less of a dinosaur regarding Bitcoin than I was when I wrote my last memo. I think I understand what a digital currency is, how Bitcoin works, and some of the arguments for it. But I still don't feel like putting my money into it, because I consider it a speculative bubble. I'm willing to be proved wrong.

### Passive Investing

Passive investing can be thought of as a low-risk, low-cost and non-opinionated way to participate in “the market,” and that view is making it more and more popular. But I continue to think about the impact of passive investing on the market.

One of the most important things to always bear in mind is George Soros's “theory of reflexivity,” which I paraphrase as saying that the efforts of investors to master the market affect the market they're trying to master. **In other words, how would golf be if the course played back: if the efforts of golfers to put their shot in the right place caused the right place to become the wrong place? That's certainly the case with investing.**

It's tempting to think of the investment environment as an unchanging backdrop, that is, an independent variable. Then all you have to do is figure out the right course of action and take it. But what if the environment is a dependent variable? Does the behavior of investors alter the environment in which they work? Of course it does.

The early foundation for passive or index investing lay in the belief that the efforts of active investors cause stocks to be priced fairly, so that they offer a fair risk-adjusted return. This “efficiency” makes it hard for mispricings to exist and for investors to identify them. “The average investor does average before fees,” I was taught, “and thus below average after fees. You might as well throw darts.”

There's less talk of dart-throwing these days, but much more money is being invested passively. **If you want an index's performance and believe active managers can't deliver it (or beat it) after their high fees, why not just buy a little of every stock in the index? That way you'll invest in the stocks in the index in proportion to their representation, which is presumed to be “right” since it is set by investors assessing their fundamentals.** (Of course there's a contradiction in this. Active managers have been judged to be unable to beat the market but competent to set appropriate market weightings for the passive investors to rely on. But why quibble?)

The trend toward passive investing has made great strides. Roughly 35% of all U.S. equity investing is estimated to be done on a passive basis today, leaving 65% for active management. However, Raj Mahajan of Goldman Sachs estimates that already a substantial majority of daily trading is originated by quantitative and systematic strategies including passive vehicles, quantitative/algorithmic funds and electronic market makers. In other words, just a fraction of trades have what Raj calls “originating decision makers” that are human beings making fundamental value judgments regarding companies and their stocks, and performing “price discovery” (that is, implementing their views of what something's worth through discretionary purchases and sales).

What percentage of assets has to be actively managed by investors driven by fundamentals and value for stocks to be priced “right,” market weightings to be reasonable and passive investing to be sensible? I don't think there's a way to know, but people say it can be as little as 20%. If that's true, active, fundamentally driven investing will determine stock prices for a long time to come. But what if it takes more?



Passive investing is done in vehicles that make no judgments about the soundness of companies and the fairness of prices. More than \$1 billion is flowing daily to “passive managers” (there’s an oxymoron for you) who buy regardless of price. I’ve always viewed index funds as “freeloaders” who make use of the consensus decisions of active investors for free. **How comfortable can investors be these days, now that fewer and fewer active decisions are being made?**

Certainly the process described above can introduce distortions. At the simplest level, **if all equity capital flows into index funds for their dependability and low cost, then the stocks in the indices will be expensive relative to those outside them.** That will create widespread opportunities for active managers to find bargains among the latter. **Today, with the proliferation of ETFs and their emphasis on the scalable market leaders, the FAANGs are a good example of insiders that are flying high, at least partially on the strength of non-discretionary buying.**

I’m not saying the passive investing process is faulty, just that it deserves more scrutiny than it’s getting today.

### The State of the Market

There has been a lot of discussion about how elevated I think the market is. I’ve pushed back strongly against people who describe me as “super-bearish.” **In short, as I wrote in the memo, I believe the market is “not a nonsensical bubble – just high and therefore risky.”**

I wouldn’t use the word “bubble” to describe today’s general investment environment. It happens that our last two experiences were bubble-crash (1998-2002) and bubble-crash (2005-09). But that doesn’t mean every advance will become a bubble, or that by definition it will be followed by a crash.

- Current psychology cannot be described as “euphoric” or “over-the-moon.” Most people seem to be aware of the uncertainties that are present and of the fact that the good times won’t roll on forever.
- Since there hasn’t been an economic boom in this recovery, there doesn’t have to be a major bust.
- Leverage at the banks is a fraction of the levels reached in 2007, and it was those levels that gave rise to the meltdowns we witnessed.
- Importantly, sub-prime mortgages and sub-prime-based mortgage backed securities were the key ingredient whose failure directly caused the Global Financial Crisis, and I see no analog to them today, either in magnitude or degree of dubiousness.

**It’s time for caution, as I wrote in the memo, not a full-scale exodus.** There is absolutely no reason to expect a crash. There may be a painful correction, or in theory the markets could simply drift down to more reasonable levels – or stay flat as earnings increase – over a long period (although most of the time, as my partner Sheldon Stone says, “the air goes out of the balloon much faster than it went in”).

### Investing in a Low-Return World

A lot of the questions I’ve gotten on the memo are one form or another of “So what should I do?” Thus I’ve realized the memo was diagnostic but not sufficiently prescriptive. I should have spent more time on the subject of what behavior is right for the environment I think we’re in.

In the low-return world I described in the memo, the options are limited:

1. Invest as you always have and expect your historic returns.
2. Invest as you always have and settle for today's low returns.
3. Reduce risk to prepare for a correction and accept still-lower returns.
4. Go to cash at a near-zero return and wait for a better environment.
5. Increase risk in pursuit of higher returns.
6. Put more into special niches and special investment managers.

**It would be sheer folly to expect to earn traditional returns today from investing like you've done traditionally (#1).** With the risk-free rate of interest near zero and the returns on all other investments scaled based on that, I dare say few if any asset classes will return in the next few years what they've delivered historically.

Thus one of the sensible courses of action is to **invest as you did in the past but accept that returns will be lower.** Sensible, but not highly satisfactory. No one wants to make less than they used to, and the return needs of institutions such as pension funds and endowments are little changed. Thus #2 is difficult.

If you believe what I said in the memo about the presence of risk today, you might want to opt for #3. In the future people may demand higher prospective returns or increased prospective risk compensation, and the way investments would provide them would be through a correction that lowers their prices. **If you think a correction is coming, reducing your risk makes sense.** But what if it takes years for it to arrive? Since Treasuries currently offer 1-2% and high yield bonds offer 5-6%, for example, fleeing to the safety of Treasuries would cost you about 4% per year. What if it takes years to be proved right?

Going to cash (#4) is the extreme example of risk reduction. **Are you willing to accept a return of zero as the price for being assured of avoiding a possible correction?** Most investors can't or won't voluntarily sign on for zero returns.

All the above leads to #5: **increasing risk as the way to earn high returns in a low-return world.** But if the presence of elevated risk in the environment truly means a correction lies ahead at some point, risk should be increased only with care. As I said in the memo, every investment decision can be implemented in high-risk or low-risk ways, and in risk-conscious or risk-oblivious ways. High risk does not assure higher returns. It means accepting greater uncertainty with the goal of higher returns and the possibility of substantially lower (or negative) returns. I'm convinced that at this juncture it should be done with great care, if at all.

And that leaves #6. **"Special niches and special people,"** if they can be identified, can deliver higher returns without proportionally more risk. That's what "special" means to me, and it seems like the ideal solution. But it's not easy. Pursuing this tack has to be based on the belief that (a) there are inefficient markets and (b) you or your managers have the exceptional skill needed to exploit them. Simply put, this can't be done without risk, as one's choice of market or manager can easily backfire.

**As I mentioned above, none of these possibilities is attractive or a sure thing. But there are no others.** What would I do? For me the answer lies in a combination of numbers 2, 3 and 6.

Expecting normal returns from normal activities (#1) is out in my book, as are settling for zero in cash (#4) and amping up risk in the hope of draws from the favorable part of the probability distribution (#5) (our current position in the elevated part of the cycle decreases the likelihood that outcomes will be favorable).

Thus I would mostly do the things I always have done and accept that returns will be lower than they traditionally have been (#2). While doing the usual, I would increase the caution with which I do it (#3), even at the cost of a reduction in expected return. And I would emphasize “alpha markets” where hard work and skill might add to returns (#6), since there are no “beta markets” that offer generous returns today.

**These things are all embodied in our implementation of the mantra that has guided Oaktree in recent years: “move forward, but with caution.”**

Since the U.S. economy continues to bump along, growing moderately, there’s no reason to expect a recession anytime soon. As a consequence, it’s inappropriate to bet that a correction of high prices and pro-risk behavior will occur in the immediate future (but also, of course, that it won’t).

Thus Oaktree is investing today wherever good investment opportunities arise, and we’re not afraid to be fully invested where there are enough of them. But we are employing caution, and since we’re a firm that thinks of itself as always being cautious, that means more caution than usual.

This posture has served us extremely well in recent years. Our underlying conservatism has given us the confidence needed to be largely fully invested, and this has permitted us to participate when the markets performed better than expected, as they did in 2016 and several of the last six years. **Thus we’ll continue to follow our mantra, as we think it positions us well for the uncertain environment that lies ahead.**

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