

MARGIN for ERROR

**Howard Marks, CFA, a self-professed “worrier,”
explains why “girding for bad times ...
is more essential [to success] than preparing for good times”**

BY RHEA WESSEL

Howard Marks, CFA, cofounder and chairman of Los Angeles-based Oaktree Capital Management, brought his firm and its clients through the financial crisis relatively unscathed. The investor and his firm took some short-term losses in 2008, but Oaktree performed better than most of its competitors. While other firms suffered heavy declines, Oaktree’s assets under management went from US\$52 billion at the end of 2007 to US\$73 billion at the end of 2009.

Marks gives a lot of credit to the company’s investment culture, which is guided by the belief that the first job of an investor is to control risk. “If everybody had put risk control ahead of making money, we wouldn’t have had this crisis,” he says. In this exclusive CFA Magazine interview, he shares his views on the prospects of regulatory reform, leading and managing investment professionals, incentive structures, and the direction of the economy.

Do you think the discussion on regulation is moving in the right direction in the aftermath of the financial crisis? What needs to be done that’s not being done?

On the one hand, I’m a believer in regulation; on the other hand, my expectations regarding regulation aren’t without reservation.

Free markets are not the answer to everything in life—they produce ups and downs we have to be prepared to live with. On the other hand, regulated entities had some of the worst experiences in the crisis, so that doesn’t give me a lot of hope for regulation. The disclosures at Lehman Brothers this year about the use of Repo 105 and the way they put assets off balance sheet were shocking. And Lehman Brothers was highly regulated. They even had regulators on the premises.

We need regulation, but it’s a daunting prospect because the job of regulators is almost impossible to perform properly. It’s like having a police force on bicycles.

I wish I had the answer, but I don’t. I do think principles should be promulgated in addition to just rules. When you set a rule—“you can’t do this or you must do that”—it’s very easy to get around the rule. I think we need principles as well, such as a requirement that financial statements be clear, complete, transparent, and honest.

But that’s not going to protect us from people who don’t want to follow the rules. It’s very hard for auditors to know everything that is really going on in a company, and if the management doesn’t tell the auditors what’s really going on, then the auditors have little chance. To go back to the Lehman Brothers example, it looks like the management of Lehman Brothers did not want to be clear or honest about what was going on with their financial situation. They used a tactic designed to obfuscate. If the management doesn’t want to be transparent, I don’t think there’s much hope.

How do you make sure that this type of obfuscation doesn't take place in the companies you invest in?

As owners, we try very hard to know what's going on in each company, and we have systems in place to make the business as transparent as possible. In general, I think when you have private ownership, you have a better alignment of interests between the owner and the management than in public companies.

We're going to make money if we can sell the companies we own for more than we paid, and so will the management. So we have an alignment of interests. The trouble with public ownership is that the management can make money in the short run through an appreciation of the stock, or through options, without enhancing value for the owners in the long run. So I'm more confident of our alignment of interests. And, of course, we try hard to team up with managers we can trust.

Can you tell me about some of the important leadership lessons you learned over the years as the chairman and cofounder of Oaktree? Your letters to Oaktree clients are highly anticipated by the market, and people clearly see you as a role model. Tell me how you gained some of your insights?

We've been very fortunate. We haven't learned many lessons the hard way. I've learned a lot of important lessons by observing, maturing, and seeing other people do things well. But we haven't had a lot of things go badly so that we had object lessons.

I'd have to say that the biggest lesson I have learned in the last decade is about personnel. We started this place with a very tight staff and had almost no turnover for a long time. I think we tried too hard to have no turnover.

One day, a prospective investor came to see me. He had a checklist of things he looked for, and one of them was a "reasonable level of turnover." And that was kind of an epiphany. The point is that the level of turnover should be reasonable, and that doesn't mean zero. Zero turnover isn't necessarily a good thing.

What's the cost of low turnover?

I think sometimes you keep people who don't contribute positively to the culture. They may be grippers or malcontents. They should go their own way. That's better than having zero turnover and retaining those people.



As you pointed out, you haven't learned too many lessons the hard way. Your investment record shows you have some of the best people in the industry working for you. How do you evaluate your employees?

I think the important thing is that our people don't get paid primarily on the basis of their individual accomplishments.

We don't use numerical, quantitative evaluation systems to determine people's pay. We don't have a formula to use for calculating pay based on so many upgrades or so many downgrades, and we don't compute each analyst's P&L.

Of course, the people who work on funds that produce incentive fees for us, which is most of our business, get a share of the incentive fees. To distinguish us from other types of organizations, however, the important thing is that our managers don't get paid for what they contributed to the incentive fees. In other words, they don't get paid for the profits on their own deals. Everybody gets paid on the profits of the whole fund.

Let me say up front that no system is perfect. If you pay people on how the whole fund does, then if Bob screws up, Joe says: "I don't want to get paid on how the whole fund does. My part was successful. I want to get paid on my successes." I think every person should have the goal that the fund succeeds, and our system encourages teamwork. If they have that goal, they have a greater incentive to help their teammates do better.

You've had this type of incentive structure since you founded Oaktree. Have you lost recruits because there was no way for individual enrichment?

I don't really know if we've lost recruits due to our pay structure. But if we lost people for that reason, that's OK. I don't want the people who crave reward for individual accomplishments. I want the people who want reward for team accomplishments. That's why the people here are paid for how their fund or product does, for how Oaktree does, and based on our sense of their personal contribution and potential. That qualitative third part is important.

There's an ethic in parts of the hedge fund industry that "you eat what you kill." We don't have that. Ours is team oriented, and it's long-term oriented. We don't lure people here with higher upfront pay. But people who come here can make a lot of money through incentive-fee participation or participation in the overall success of the company. And they can enjoy having been part of a successful team.

It's common in the alternative investment area for people to get paid on how their fund does. But it's uncommon for people to get paid on how the company does. That's what distinguishes us.

Promoting concern for the long run is not a common characteristic of pay structures in the industry.

We've always had 20–25 percent of the employees own the company. We also dedicate a percentage of each year's profits to the firmwide bonus pool. I think that creates a very wholesome incentive system. People are concerned whether they do well, whether their teammates do well, *and* whether all the funds in the company do well. It also tends to make people concerned with the long run and not the short run.

Our company was started in 1995 by five people who owned 100 percent. At the end of 1995, we added 13 more owners. By 2007, we were up to 85. Today, I think we have 160. This is a great contributor, as having co-owners encourages the right kind of behavior. It also gives people something they can aspire to.

One of the important things about the ownership at Oaktree is that it is not limited to investment people. We have accountants, marketing people, and others who become owners, such as the head of compliance. That's very significant. Everybody should have the same incentives to pull together. And we don't want to give the impression that the only route to success around here is by being an investment person.

We try for a horizontal, meritocratic culture, although not egalitarian or socialistic—investment talent isn't evenly distributed. I don't believe there are better and worse people in the world. There are people who can

handle bigger jobs and do better jobs, but everybody is important. So we don't have a dining room for executives only, or a two-class culture.

Does the Oaktree culture work equally well in all regions?

Oaktree is expanding very rapidly in Europe, and London is now our second-largest office. I think it's important to deliver the culture personally, as opposed to expecting the culture to make its way across the pond through memos and phone calls. That's why I spend four months a year living in London. The culture is received very well in Europe.

Our culture is very explicit. Without trying to sound too self-satisfied, I'd say we've been very successful. Our investment results have been very good, and I think we played the crisis as well as anyone could. We tend to do particularly well with cycles. And I think everybody here sees how effective the culture is. So we don't have a schism. We don't have the pros and the cons, or what I call the cowboys and the chickens. There's no question around here about the contribution the culture has made to our success.

I once wrote a memo called "The Most Important Thing." I listed 19 things, each of which I thought was the most important thing. One of them was what I called "shared values and complementary skills." A company needs employees with shared values; I think we have a very broad buy-in on values here. That's a big reason for our effectiveness. At the same time, their skills have to be diverse in order to do the whole job.

You say your culture is explicit, meaning it's apparent, transparent, and easy to understand. Is that what you mean?

Our culture is not mysterious. Everybody knows what we stand for. And in fact, if you go to oaktreecapital.com, you can find a six-point explanation of our investment philosophy and a clear statement of our business philosophy regarding clients, employees, and so forth.

And you think this culture that you have so carefully cultivated led to some of the good decisions you made during the financial crisis?

Yes. Let me say that when I'm talking about the culture, I'm primarily talking about the investment culture. You and I have been discussing the organizational culture here. But the investment culture—the way we manage our portfolios—is what makes us successful.

We have six tenets to our investment philosophy. We wrote them out on the first day, and I don't think we've ever changed a word—and we turned 15 years old in April. You can find them on our website (www.oaktreecapital.com/about/investment-philosophy.aspx). The

first tenet says that the number-one job of the money manager is risk control. It's not making a lot of money. It's not beating the market or being in the top quartile. We have a fiduciary responsibility to our clients, and that's reckoned in terms of risk control, not return. I believe if everybody had put risk control ahead of making money, we wouldn't have had this crisis.

As I said in a recent letter to Oaktree clients, I'm a worrier. I always ask myself whether I'm being too cautious. I believe strongly that girding for bad times, and thereby ensuring margin for error, is more essential than preparing for good times. If you prepare for and count on good times, their failure to materialize can knock you out.

There's a downside to this, however. Having a margin for safety in your portfolio means you can't always maximize returns. The people who are sure what's going to happen and turn out to be right—due to skill or luck—are the ones who'll maximize. Those who aren't sure what is going to happen and build in a margin of safety are unlikely to maximize under any single scenario. As investors, we all have to choose whether we're going to play mostly offense or mostly defense.

The last several decades were marked by increasingly aggressive behavior, what I call "willingness." Then there was the trend toward leveraging up in order to do more than one's capital permits, or "expansiveness." Finally, we all observed the bullishness that produced rising asset prices.

These three trends reached a peak in 2007, and it's easily summed up in what I find to be the greatest investment adage: "What the wise man does in the beginning, the fool does in the end." I'm not saying leverage is a mistake, but it's a mistake when it's carried too far. There's nothing in the investment business—no asset class, no single investment, no strategy—that's a good idea or a bad idea. Everything is a good idea or a bad idea at a particular price and at a particular time. It's when people forget this that they get into trouble.

What are you doing right now in your investment strategy to control risk, and what risks do you see?

I think the main risk is that the markets have come back strongly and the economy has not. So we have to see whether the strong psychology will be borne out by strong fundamentals. That's the biggest short-term uncertainty

Before cofounding Oaktree, Marks spent 16 years with Citicorp Investment Management in equity research and portfolio management and then 10 years at Trust Company of the West. He holds a bachelor's degree in finance from Wharton and an MBA in accounting and marketing from the Graduate School of Business at the University of Chicago. Marks earned his CFA charter in 1975.



to me. The others are the heavy reliance on government stimulus and on artificially low interest rates, as well as the effect of deficits. These are all interrelated.

This economy is limping along. It's kind of like a motorcycle that somebody's trying to kick-start. We're waiting to see if it will catch, and I don't think it's caught yet. I am not an economist, but what I see is a weak recovery. I'd love to see the economy lift off, but I'm just not sure it has.

What kind of risk management strategies are you using in this scenario where the markets are back but the economy is not?

Well, it's rather easy in the debt world. You could go and buy a bond at 60 cents on the dollar a year and a

half ago, and if today it's 100 cents on the dollar, you know to sell it. So, it's kind of an automatic process. We're taking some profits in highly appreciated securities and going back into some that aren't as appreciated. At the same time, we don't want to reach for yield by taking on a lot more risk. And the other thing I would say, broadly speaking, is that we're not making too many investments today which presuppose buoyant prosperity. I think that's the main thing. For example, we're not going down in our companies' capital structures to more junior debt.

Last but not least, I'd like to talk about your CFA designation. Why did you pursue the CFA?

It's hard to remember why I did anything 40 years ago. But I just think it's very important to (1) have the education but also (2) have the credential as a professional analyst. I couldn't think of being in a profession that has a seal of approval and not trying to earn it.

From your perspective, what important work is CFA Institute doing?

I support any effort to set standards, for competence and also for behavior. CFA Institute can initiate and manage a dialogue about regulatory efforts and play a role in setting standards in the industry, especially regarding performance reporting. I think it's our best voice. Whenever there's a discussion of what standards of behavior should be, somebody has to speak for the profession—and that's CFA Institute. ▀

Rhea Wessel is a financial journalist based in Frankfurt.