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Guru to the Stars

By JONATHAN R. LAING

Howard Marks has made a killing on distressed debt. So, what does he think of the bond bubble? It's in only the "fifth inning."

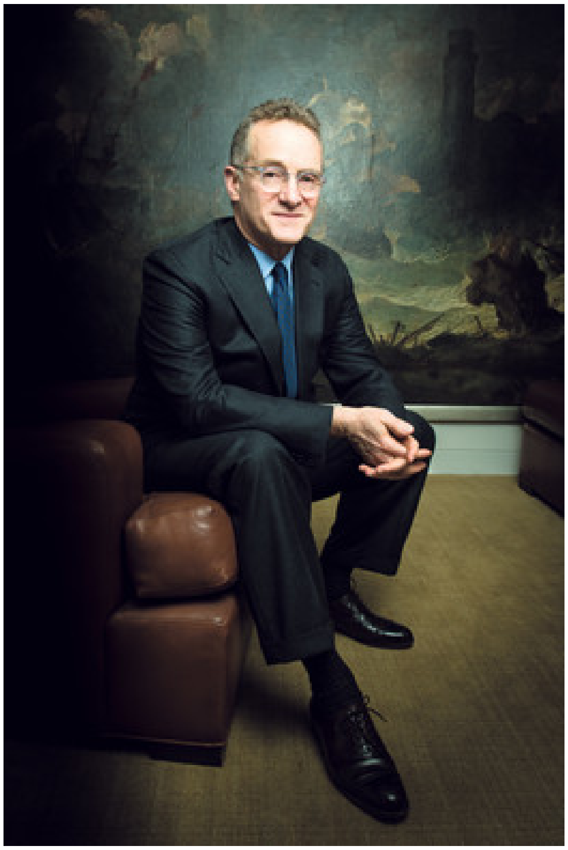
Howard Marks is a study in contrasts. On the one hand, he has the undeniable mien of an academic, with his clear horn-rim glasses, conservative dress, and close-cropped, spiked hairstyle. His manner during a long interview with *Barron's* is both diffident and didactic, though a certain intensity crackles just beneath the surface.

Yet, over his four decades on Wall Street, the trim 67-year-old co-founder and chairman of Oaktree Capital Management has acquired true star power -- partly because the size of his firm ($77 billion in investments), partly because of his returns (solidly into the double digits), and partly because of the hundreds of long memos he sends to clients and others; they're larded with astute commentary on financial markets and perceptive disquisitions on investor psychology.

One of his biggest fans is Warren Buffett, who encouraged him to gather his memos into a book, *The Most Important Thing*. Buffett's blurb says it all: "When I see memos from Howard Marks in my mail, they're the first thing I open and read. I always learn something."

Other admirers include Christopher Davis of Davis Funds, Seth Klarman of Baupost Group, and Joel Greenblatt of Gotham Capital -- all of whom offer commentary throughout a new, annotated version of the book, *The Most Important Thing Illuminated*, published in January. Though they quibble with him at times, this trio of giants mostly marvel at Marks' observations. "I love this thought," Greenblatt exclaims in the middle of a chapter about contrarianism. "This is extremely simple and extremely insightful," adds Davis. It's almost as if Marks is their guru.

MARKS FOCUSES on the rough-and-tumble



Peter Murphy for Barron's

Mark believes the growing credit bubble won't soon explode. The bond game is only in the "fifth inning," he says.

world of distressed corporate debt, and his memos provide a window into his real-time thinking during some of the most convulsive periods in financial history. By late 2007, for example, Marks became convinced that the unraveling of the subprime-mortgage sector was just a symptom of much greater malaise in U.S. credit markets. He pointed to private-equity buyouts of companies done at absurdly high prices and bloated levels of debt. Those deals would make sense "only if nothing untoward happened," he wrote. And that, he believed, was anything but a safe assumption.

In December of 2007 -- less than a year before the crisis hit -- he warned that banks were lending money promiscuously. Debt was being issued in veritable buckets with virtually none of the standard protections. And various "fairy tales," he observed, such as the claim that investment risk was a thing of the past, had wide currency. Many believed that central banks, through adroit management, had tamed the normal economic cycle.

The foreboding evinced in the memos was more than literary flourish. In 2007 and early 2008, Oaktree prepared for what it saw as an impending apocalypse by raising the largest distressed-debt fund ever, totaling $11 billion. Then, in the three months after Lehman Brothers collapsed in September 2008, Oaktree pounced. It spent more than $6 billion scooping up senior secured debt in overleveraged companies like the utility TXU, auto-parts maker Delphi and casino concern Harrah's, generally around 50 cents on the dollar.

It was his belief that governments and central banks would do everything possible to resolve the financial crisis by running their printing presses nonstop. As he put it in a memo of Oct. 15, 2008: "The sums being thrown around are the biggest ever: hundreds of billions of dollars, adding up to trillions. But there's no hesitation: Everything will be done. That doesn't mean it has to work, but it's likely to."

The World According to Marks

Here are some choice Howardisms, as Joel Greenblatt of Gotham Capital calls them. They're plucked from memos and other musing in Marks' book *The Most Important Thing Illuminated*.

"Experience is what you get when you didn't get what you wanted."

Most of the bonds paid off at par in a matter of months. It was a huge payday for Oaktree and its clients, which included many of the largest U.S. pension funds, a number of sovereign wealth funds (reportedly including the China Investment Fund), and a host of state pension funds, endowments, and foundations.

"Being right may be a necessary condition for investment success, but it won't be sufficient. You must be more right than others."

"Well bought is half sold."

"When things are going well and prices are high, investors rush to buy, forgetting all prudence. Then when there's chaos all around and assets are on the bargain counter, they lose all willingness to bear risk and rush to sell. And it will ever be so."

"Risk control is the best route to loss avoidance. Risk avoidance, on the other hand, is likely to lead to return avoidance as well."

There are old investors, and there are bold investors, but there are no old bold investors

"The truth is, much in investing is ruled by luck."

These days, Marks sees disquieting signs of another credit bubble, though it is just in "the fifth inning." Central banks are pumping money into economies with abandon. And rates have descended to levels that hardly compensate investors for the risks incurred.

The leveraged buyout market, too, is heating up again, with private-equity firms willing to pay price-to-cash-flow ratios at the elevated levels of 2006, if not the absurd ratios of 2007.

Debt issuance, particularly of high-yield bonds and leveraged loans, is soaring. Individuals and pension funds, though hardly complacent about risk after the trauma of the credit crisis, are, Marks says: "acting bullish, if not thinking bullish," by piling into high-yield and other riskier debt sectors in a desperate attempt to fund retirements or satisfy minimum return needs.

Does it all spell a disaster in the making? Probably not, he avers. The much-feared eventual rise in interest rates, which doomsday forecasters say could crush bonds, would likely result from an improvement in the economy, he reasons. That alone would mitigate against a smash-up in, say, the junk-bond market, as defaults would remain at minimal levels.

PROSPECTS ARE BETTER for the stock market, even after its recent rally, than for bonds because the former "remains less loved," says Marks. And Oaktree, despite its heavy concentration in debt markets, does have a clear interest in stocks: The company frequently ends up with large equity positions as a result of company restructurings. For example, it owns more than 20% of **Tribune** (ticker: TRBAA), along with substantial positions in **Clear Channel Outdoor Holdings** (CCO), **Charter Communications** (CHTR), **First BanCorp** (FBP) of Puerto Rico, and more. At the moment, Oaktree also holds some emerging-market shares as direct equity investments.

"I can tell you from talking to institutions that, after 13 years of having their hearts broken by the stock market, they still are still leery of stocks even with the recent rally," Marks says. "You can see that in their low stock allocations, compared with the period of 2000 and before. But imagine a couple of more years of good performance for stocks, which well could happen, and the love affair will really be rekindled."

Right now, Marks and his Oaktree cohorts are enamored of commercial real estate; they have over $5 billion committed directly to the sector and even more exposure indirectly in distressed-debt funds. They are employing a variety of tactics, including making loans on raw land, finishing projects, buying distressed properties, and proffering rescue financing and purchasing portfolios of troubled mortgages. But in characteristic fashion, Oaktree is concentrating its efforts on small- to medium-size markets, in which prices haven't recovered much from the bursting of the real-estate credit bubble.

Marks' investment philosophy was honed during a circuitous career that began when he joined Citicorp in 1969 as an equity analyst. He went on to Trust Co. of the West for a decade, from 1985 to 1995, before founding Oaktree. Along the way, he learned that to consistently beat the market, it was far better to concentrate on unloved, less-followed and therefore less-efficient sectors like distressed debt -- "good companies with too much debt." Oaktree also invests in convertible securities, high-yield bonds, senior corporate debt, and real estate.

These areas can be highly remunerative for investors willing to do some security analysis and ply the often-tortuous pathway of restructuring negotiations to convert debt to equity.

Success also requires the guts to buy during those periodic moments in the market cycle when investors ranging from mutual funds to hedge funds to overleveraged individuals dump holdings at fire-sale prices because of redemptions, margin calls, and plain naked fear. "These crises seem to come about every 10 years or so," Marks observes. "As one of my partners, Sheldon Stone, likes to say: 'The air goes out of the balloon much faster than it went in.' "

To extract full value from its debt investments, Oaktree frequently pushes for equity control positions following debt restructurings in bankruptcy. That's why its 720 employees include "corporate performance" experts and a cadre of outside industry specialists to buff up the operations of takeovers and other companies in which it has control positions; the idea is to exit through stock offerings or asset liquidations. The firm typically closes out its positions and returns money to its fundholders in three to five years.

Over the years, Oaktree has made multiples of its original debt investment in the likes of movie-theater concern **Regal Entertainment** (RGC), telecoms Qwest and Nortel, several airplane-leasing operations, and radio and other media companies. Following the marathon bankruptcy battle at Tribune, owner of the Los Angeles Times and Chicago Tribune newspapers, Oaktree emerged with two board seats and the company's chairmanship. The newspapers now are on the block.

All of these moves have resulted in superior performance going all the way back, in some cases, to the mid-1980s, when Marks and his key team members were at TCW. Over the past 24 years, funds employing Oaktree's primary strategy—distressed-debt investing—notched an average annual return of 17.5%, and that's after hedge-fund type management fees exceeding 1% and taking 20% of the profits.

MARKS' LIFE EXPERIENCE did much to shape his skeptical, contrarian world view. He grew up in middle-class circumstance in the Rego Park neighborhood of Queens, N.Y., the son of an accountant. He recalls his father as being a chronic pessimist and complainer. "He thought he was a realist, though that wasn't true," Marks says. "He lived to be 102, enjoying mostly good health. So, look at all the fun he missed out on."

Marks, a good student, had his card punched with a B.A. from Wharton and an M.B.A. from the University of Chicago. The lessons he learned at the two institutions went far beyond what he calls "the vocational stuff" of finance, accounting, and marketing. Required to take a humanities course at Wharton, Marks ended up almost as an afterthought signing up for Japanese studies. He ended up becoming fascinated by Japan's culture and earned a minor in the field.

Marks was particularly struck by the Buddhist concept of *mujo*, which holds that life and human affairs are a ceaseless process of transience and change to which the wise adjust. "Isn't this the essence of investing?" he asked in one of his memos.

Chicago was the bastion of efficient market theory by the time Marks arrived there in 1967. The theory posited the futility of trying to beat the market because asset prices at any time are correctly priced to reflect all the latest market information. Mark's takeaway: If you want to succeed as an investor, you must work harder than others and find more obscure corners of the investment world that might not be ruled by the same brutal efficiency as stocks.

This lesson was only reinforced when he joined Citicorp in 1969 as a stock analyst, eventually becoming head of his department in 1974. Citicorp was a Nifty Fifty shop, wedded to the notion that the then-premier growth companies like IBM, Xerox, Kodak, Hewlett-Packard, Motorola, and Coke could be safely purchased at virtually any price, since they would inevitably grow sufficiently to justify price-to-earnings ratios that had reached as high as 80 to 90.

"I found myself agonizing over silly things like whether to buy Lilly or Merck and spouting the two sentences of the conventional wisdom that I knew on a narrow subset of some 400 stocks. The model was just crazy," he recalls ruefully. The Nifty Fifty, of course, crashed in the early-1970s, some falling more than 90%, and failed to recover much during the rest of the decade. Hence, Marks was only too happy to get out of the stock research group in 1977 and start two new funds for Citicorp in convertible bonds and high-yield debt.

Neither sector was deemed respectable for most clients because of higher default risk. But he found that they were more than fairly priced to reflect that risk and therefore were generally far better plays than blue-chip stocks or triple-A bonds. Or as Marks likes to put it: If good life-insurance companies can make money knowing all their clients will eventually die, why, with sufficient diversification and higher yields, can't investors do well in junk bonds?

Perhaps most trenchant in Marks' investing philosophy is his insight into investor behavior. Investors, in his opinion, tend to be lazy and superficial in their investment decisions, embracing rosy scenarios when optimism reigns and end-of-the-world despond when markets sink. Classic manic-depression, in other words, and not the wisdom of crowds. These swings cause markets to move in a pendulum motion around fair value, rather than in the linear direction most observers assume. That means investors must be astute, both in determining fair value and judging the amplitude of each emotional wave.

For all his intellectuality, Marks hardly lives the life of an ascetic. Last year, he sold his Malibu estate for an eye-popping $75 million and a month later bought a fancy apartment on Park Avenue in New York for $52.5 million. He shows up on the most recent Forbes 400 list with a net worth of $1.4 billion.

He met his wife, Nancy, and got her telephone number during an eight-floor elevator ride in Manhattan in 1969, and he pursued her with characteristic determination. After she spurned his subsequent marriage proposal, both she and he married others.

Then, in the mid-80s, they were reunited by the chance intervention of a mutual friend after their respective marriages had ended. They have been together ever since, and have two grown children -- a daughter by Nancy's first marriage and a son by their union.

Clearly, tenacity has paid off for Marks in both markets and life.

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