The Human Side of Investing

or The Difference Between Theory and Practice

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Howard Marks, Chairman
Oaktree Capital Management, L.P.

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The Human Side of Investing

"In theory, there's no difference between theory and practice.
In practice, there is."

– Yogi Berra

The Human Side of Investing

Textbooks and professors will tell you exactly how the markets work. Some will describe a smooth-functioning world in which markets price assets right. Others will describe a simple roadmap to investment success, as in "if you do a and b, then you'll make money."

But both approaches assume there's an underlying process that can be counted on to work, and that anyone can learn to apply it. That's the theory. Nothing could be further from the truth.

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- Theory: Theory tells us markets are "efficient," objective and clinical, and thus that they price assets right.

  Practice: Markets are made up of people, with their emotions, insecurities, excesses and foibles. Thus they often make mistakes and swing to erroneous extremes.

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- Theory: People are risk averse, and for that reason, riskier assets must provide higher returns than safe assets in order to attract capital.

  Practice: Riskier assets usually appear to promise higher returns, but that doesn't mean those returns will arrive.

  If riskier assets always provided higher returns, they wouldn't be riskier.

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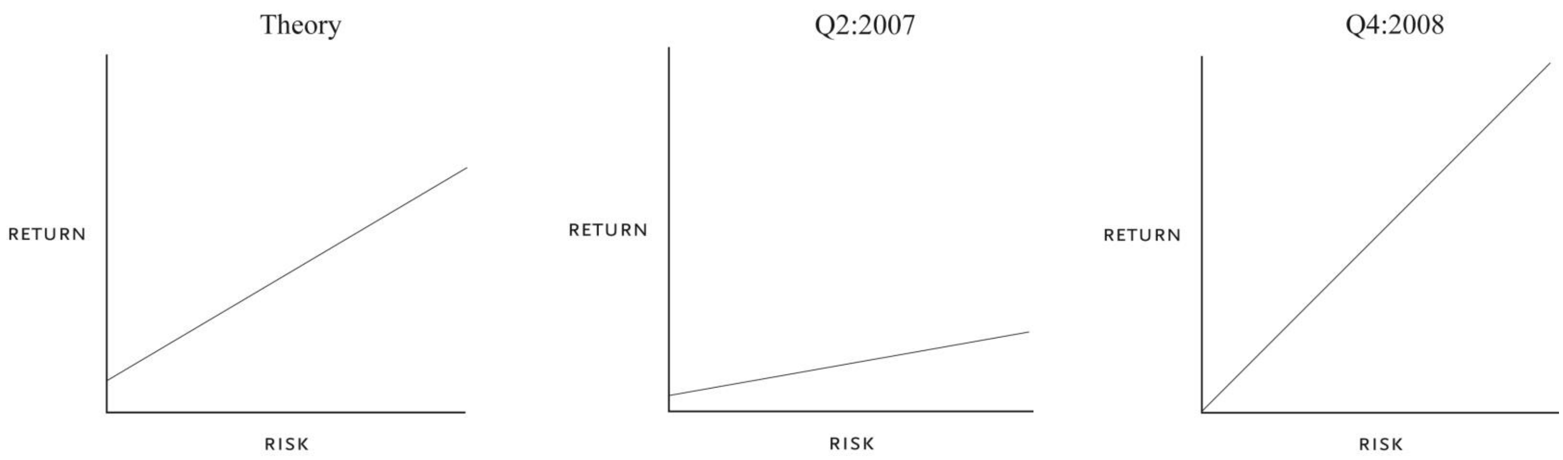
- Theory: An appropriate risk premium is incorporated into the promised returns on riskier assets.

  Practice: Sometimes the risk premium is appropriate, sometimes it is inadequate, and sometimes it is excessive.



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- Theory: Since markets price assets fairly, if you buy at market prices you can expect a "fair" risk-adjusted return.

  Practice: Buying without discernment at the market price will give you returns that are all over the lot.

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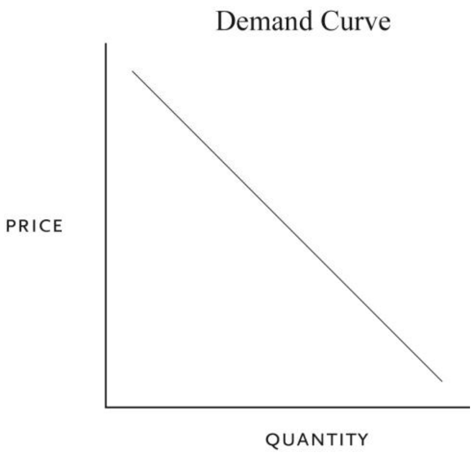
- Theory: People want more of something at lower prices and less of it at higher prices.



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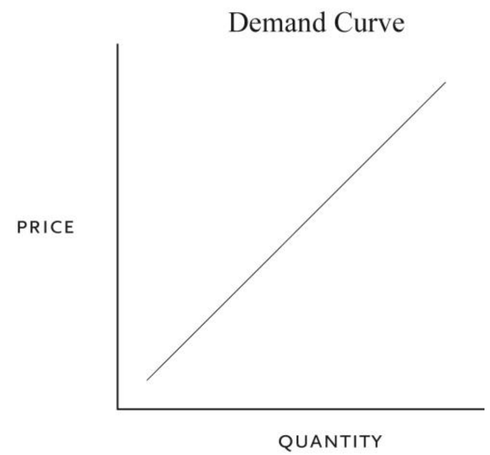
- Theory: People want more of something at lower prices and less of it at higher prices.

  Practice: People tend to warm to investments as they rise and shun them when they fall.



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Human Failings

The best way to conceptualize:

- The swing of the pendulum

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Human Failings

- The swing of the pendulum

  Investors fluctuate between:

  Optimism and pessimism

  Greed and fear

  Credulousness and skepticism

  Risk tolerance and risk aversion

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Human Failings

- The swing of the pendulum

  The happy medium is rarely seen

  Instead, there are frequent excesses – the errors of herd behavior

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Human Failings

- The swing of the pendulum

  The three stages of a bull market:

  - When a few people begin to feel things will get better
  - When most people recognize that improvement is underway
  - When everyone thinks things will get better forever

  The three stages of a bear market:

  - When a few people realize that things are overpriced and riding for a fall
  - When most people see that a decline is taking place
  - When people think things will get worse forever

"What the wise man does in the beginning, the fool does in the end."

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Human Failings

Few people are able to act in a contrarian fashion relative to these market cycles. But it is essential . . .

"Whenever you find yourself on the side of the majority, it's time to reform."

– Mark Twain

… and very difficult

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

– David Swensen

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Human Failings

Investor memory must fail in order for the extremes of bubbles and crashes to be reached

"Contributing to . . . euphoria are two further factors little noted in our time or in past times. The first is the extreme brevity of the financial memory."

– John Kenneth Galbraith

Memory – and the result, prudence – always come out the loser when pitted against greed

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Human Failings

Behaving pro-cyclically is one of the greatest, most frequent mistakes

For example, in advanced up-cycles:

- The economic indicators show gains;
- Companies report earnings increases;
- Assets appreciate;
- Investors enjoy good returns;
- Riskier approaches outperform;
- Leverage adds to gains, and
- The capital markets eagerly provide financing.

What is the effect on decision making?

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Human Failings

Overestimating what you know about the future introduces great risk

"We have two classes of forecasters: Those who don't know – and those who don't know they don't know."

– John Kenneth Galbraith

"It's frightening to think that you might not know something, but more frightening to think that, by and large, the world is run by people who have faith that they know exactly what's going on."

– Amos Tversky

"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."

– Mark Twain

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Human Failings

The “I know” school versus the “I don’t know” school

I know: confidence in foreknowledge;

I don’t know: skeptical regarding foreknowledge

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Human Failings

The "I know" school versus the "I don't know" school

I know:

- Invest for one outcome
- Concentrate
- Lever heavily
- Target maximum gains

I don't know:

- Hedge against uncertainty
- Diversify
- Avoid or limit leverage
- Emphasize avoidance of losses

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Most people think in terms of the average or the norm and ignore the outliers.

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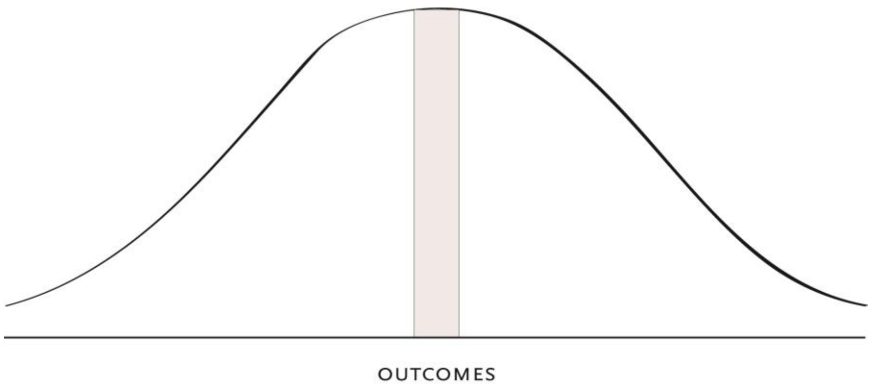
Human Failings

Single-scenario investing – the difficulty of seeing future events as a range of possibilities



"Risk means more things can happen than will happen."

– Elroy Dimson

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Human Failings

Most people think in terms of the average or the norm and ignore the outliers.

"Never forget the six-foot tall man who drowned crossing the stream that was five feet deep on average."

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In particular, most investors ignore the possibility of extreme outcomes – so called “Black Swans”

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Human Failings

The twin impostors – short-term outperformance and short-term underperformance

Investors are right (and wrong) all the time for the "wrong reason."

The correctness of a decision can't be judged from the outcome.

Randomness alone can produce just about any outcome in the short run.

– lessons from "Fooled by Randomness" by Nassim Nicholas Taleb

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The twin imposters

Non-appreciation of “alternative histories” – the difficulty of seeing past events as a range of possible things that could have happened, and thus the reduced significance of what actually did happen

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The difficulty of getting timing right – “should” isn’t the same as “will”

“Markets can remain irrational longer than you can remain solvent.”
– John Maynard Keynes

It’s hard to do the right thing

It’s impossible to do the right thing at the right time

“Being too far ahead of your time is indistinguishable from being wrong.”

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Human Failings

The pitfalls of investment bureaucracy

". . . active management strategies demand uninstitutional behavior from institutions, creating a paradox that few can unravel."

– David Swensen

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Human Failings

The pitfalls of investment bureaucracy

Most institutional investors expend extraordinary effort and often make decisions for the purpose of avoiding embarrassment. In particular, they often over-diversify.

"*It is better to fail conventionally than to succeed unconventionally.*"

– John Maynard Keynes

The ultimate conundrum: in order to do enough of something to make a positive difference for your portfolio if it's right, you have to do enough so that it could make a negative difference if it's wrong.

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Human Failings

In many ways, the forces that influence investors push them toward mistakes:

Investing in things with obvious appeal
Investing in things that are easily understood
Investing in things that are popular
Investing in things that have been doing well

Those are the things that appeal to the herd. They all imply elevated prices, limited return potential, and substantial risk.

At most points in time, the real bargains are found in doing things others won’t do, not the things described above.

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Smart investing doesn't consist of buying good things, but rather of buying things well. Price is what matters most for investment success. Only disciplined, objective, unemotional, expert investors can know the right price.

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To sum up…

The Efficient Market Hypothesis tells us the market operates smoothly to incorporate information into prices, so that no individual can consistently do much better.

In fact, “inefficiencies” – the investing crowd’s mistakes – arise all the time and are the superior investor’s *raison d’être*.

At the extremes, when the actions of the crowd create bubbles and crises, the mistakes of others create opportunities for us to make or lose vast sums.

The Human Side of Investing

Oaktree's investment philosophy was designed to overcome the impediments on the human side of investing:

- Dedication to understanding and controlling risk
- Insistence on consistency
- Involvement in less-efficient markets only
- High degree of investment specialization
- No reliance on macro-economic projections
- No raising of cash for purposes of market timing

The common thread running through the tenets of the philosophy is recognition of - and respect for - the limitations imposed by real-world considerations

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