# Howard Marks on Luck and Skill in Investing

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## by Justin Kermond



When Howard Marks graduated from the Booth School of Business of the University of Chicago, he was turned down for the one job he really wanted. That, he said, was the luckiest moment of his career. The firm that turned him down was Lehman Brothers.

Marks is the co-chairman and founder of Oaktree Capital Management. He spoke to an audience of investment professionals and MBA students at the annual MIT Sloan Investment conferencein Cambridge on February 20th.

His talk was moderated by Randy Cohen, a senior lecturer at the Sloan School. Marks and Cohen discussed a range of topics, including his luck and skill in career choices, the lack of efficacy in forecasting, the importance of second-level thinking, investing in the current interest rate environment and the ingredients for investment success.

### On luck and skill in career choices

Marks said he was not the kid who started reading prospectuses at nine years old and then invested his bar mitzvah money. Before deciding on a career in finance, he considered being a history professor, an architect, an advertising man and an accountant. Before graduating from the University of Chicago, he interviewed for jobs in corporate treasury, banking, investment management, investment banking, accounting and consulting.

But he got lucky when he was turned down for the one job he was sure he wanted. Marks recounted that the recruiter had decided to hire Marks, but the partner in charge of making the final hire came in to work hung over that morning. He offered the job to the wrong guy. If it wasn't for that piece of bad luck, he said, he could have spent the first 30 years of his career at Lehman Brothers, ultimately ending up with nothing for whatever equity stake he might have earned.

Luck is very important, according to Marks, and he advised the future MBAs to "put themselves in the way of good luck" as opportunities only come around once in a while and you have to take them.

### On the lack of efficacy in forecasting

Forecasters have been very poor and consistently so, Marks said. In the summer of 2013, forecasters unanimously predicted that rates would go up after Federal Reserve Chairman Bernanke started talking about tapering. This was the most important decision in 2013 and most forecasters got it wrong as rates went down. He credited Jeffrey Gundlach at DoubleLine for being one of the

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few who got this decision right.

The most important decision of 2014 was the price of oil; very few forecasters got that right either. Marks advised giving up on the forecasting game and taking a more humble approach to fore knowledge. When he is asked what is going to happen to the price of oil, he said, the only correct answer is, “I don’t know.” Oil is an asset that does not produce cash flow, and it has not sold at a free market price. Since it is an administered price, he knows it will be unpredictable.

While Marks warned about forecasting, he said that you can’t invest without making some judgments about the future. Marks said that Oaktree invests in the areas that are under pressure. In the last four months those areas have been oil and oil-servicing companies. “Value investors proudly invest in assets based on the discounted price of future cash flows,” he said.

Do not invest in companies where their future is heavily dependent on the price of oil, Marks warned, because it is so unpredictable. Instead, he advised investing in companies that “can survive in a broader range of outcomes because the [oil] environment is so bizarrely uncertain.”

In periods when the markets do not change dramatically, most investors get it right most of the time but it does not make them any money. It is very valuable to forecast radical changes, as in the case of oil prices, but most people don’t get this right and this makes forecasting so unavailing. When something radical happens, someone gets it right, but Marks asks himself did this person get anything else right before or after, or do they just take extreme positions?

Marks quoted Mark Twain, “It’s not what you don’t know that gets you in trouble but what you know for certain that just ain’t true.”

## On the importance of second-level thinking

Eight years ago, Marks’ son advised him to invest in Ford because they were coming out with great new products. “Who doesn’t know that!” Marks said in response. He was not trying to denigrate his son’s enthusiasm for Ford, but to challenge him to think on a second level. The things everyone knows will not bring you an edge.

If you think the same as everybody else, you will act the same as everybody else. If you act the same as everybody else, you will perform the same as everybody else. If you want to outperform, then you have to think differently and act differently with higher level thinking.

With first-level thinking, an investor thinks that a company is great and buys the stock. With second-level thinking the investor thinks that the company is great but not as great as everyone thinks and therefore sells the stock. Marks described first-, second- and third-level thinking in the context of Maynard Keynes’ observations in predicting winners in newspaper beauty contests in London in the 1920s. With first-level thinking, you pick the winner based on your opinion. However to win the contest you need to have at least second-level thinking and pick the girl who you think will get the most votes.

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Ben Hunt provided further details on Keynes' observations of third-level thinking on his *Epsilon Theory* blog. Hunt stated that to win the contest you have to make a third-level decision and pick "who will get the most votes when all the voters are basing their votes on who they think will get the most votes".

Successful investing comes from "variant perception," Marks said, where the consensus view is incorporated into the price of the asset and you have a different view from the consensus. If your variant view is correct, then eventually the consensus comes to agree with you and the price moves favorably in your direction. Marks said if you think investing is easy and you do not see the complexities, you will not be successful.

## On investing in the current interest rate environment

Since the 2008 financial crisis, you cannot get paid for safety and liquidity, according to Marks. He described himself as a "conservative guy who likes liquidity and safety." Prior to the financial crisis of 2008 all of his money that wasn't in Oaktree or its funds was in laddered portfolios of Treasury bonds that produced a return of 6.5%.

After the crisis, Marks asked himself why one should be able to invest money with absolute safety and liquidity and be well paid for it. Marks said that when people are "freaked out" they will pay to have their money stored safely even if they lose a little as in the current negative interest rate environment. Investors now can get safety and liquidity but they don't get paid for it.

Although he thinks that free markets do the best possible job of allocating resources, Marks said that we are not in a free market environment and "the cost of money today is no less controlled than the cost of oil a year ago." He does not believe that market conditions have changed enough to warrant the interest rate reduction on the 10-year government bond from 6% eight years ago to 2% today. He said the interest rate is artificially low due to the Federal Reserve intervention, but he does not believe that conditions are bad enough or that inflation is low enough to warrant the current 2% rate. This is an artificial rate, and Marks said it is difficult to predict what the natural rate should be if it were left alone or whether it will be left alone.

## On the ingredients for investment success

In the short term, Marks said the ingredients for success are aggressiveness, timing and skill. He mused that if you have enough aggressiveness at the right time, you don't need any skill.

The person who successfully predicts the decline of the price of oil or gets the highest return in a given year is lionized by *The Wall Street Journal.* In the short term, it is impossible to know whether this success was due to luck or skill, but it will come out in the long term because it is hard to be lucky for 20 years.

Marks went into further detail on luck and skill in describing the 2006 collapse of the hedge fund Amaranth. Marks said that Amaranth lost 90% of its assets not due to poor bets in 2006 but

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because of their success in 2005 when they were up 100%. He offered that “losing 100% is only the flip side of making 100% if there is no skill.” Marks said Amaranth made some “wild ass” bets in 2005 and got lucky and then made similar bets in 2006 and got unlucky.

Marks said he has been successful by not taking bets that could lose dramatically, by mitigating loss, and by being consistent rather than having brilliant successes outweighed by dismal failures. He said, “If we avoid the losers, the winners take care of themselves.” He stressed the importance of matching your investment strategy with your personality and offered that his conservative nature supported his success in the bond market. A venture capital fund would fail if he ran it because he is “not a dreamer, a futurist or a congenital optimist.” What he tries to do is “take ten dollars and turn it into eleven, and have it become eleven before it becomes nine.”

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