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Reflections on Howard Marks' Book on the Market Cycle

Howard Marks has long been regarded as one of the great investment communicators; wise enough to understand how investment markets work and witty enough to explain it in an interesting way. His ad-hoc memos always receive broad coverage and are considered essential reading by many including Warren Buffett. Readers of his memos and those not familiar with them should both enjoy his recently released book "Mastering the Market Cycle" which combines new material with passages from some of his historical memos. The subtitle, "getting the odds on your side" explains the reason for the book and for regularly asking the question "where are we at in the market cycle"?

From the outset, Marks is explicit that no one can know the future, particularly regarding market timing. Those who are given credit for calling the top of one cycle almost never repeat that feat again. However, this doesn't mean investors shouldn't be planning and investing with the market position in mind. Whilst the probabilities are never certain, they are often slanted towards above or below average future returns. The pendulum of market cycles often swings well past the mid-point, creating opportunities for patient investors to buy assets cheaply and sell them richly.

Marks is pragmatic in his advice, noting that even if you could perfectly predict the peak or trough, for institutional investors it would be impossible to trade everything you want near that level given the relative illiquidity in investment markets for large portfolios. Marks notes how his firm Oaktree Capital was raising capital in 2007 and 2008, then started buying heavily in late 2008, all ahead of the market's nadir in March 2009. Had Oaktree waited until then, it simply would not have been able to deploy its capital in meaningful size before the bargains were grabbed by others.

Warren Buffet fans will enjoy the mutual admiration with Marks, as Marks often quotes Buffett in the book. Whilst Marks and Buffett differ in their specialties (credit and equities respectively) both are extremely unusual individuals in that their superb communication skills are matched by their firm's excellent track records. Long-term followers of both will note though that Oaktree and Berkshire Hathaway have struggled in more recent times to replicate the returns of the past as the enormous size of their capital at work has diluted their ability to profit from niche opportunities.

Structure of the book

Marks begins with an explanation of the characteristics of market cycles and the frequency with which they occur. Readers are then taken through chapters on the economic cycle and its impacts on the cycle of company profits. Chapters seven and eight delve into investment psychology, looking at how investor's mindsets and their attitude to risk change as the market cycle evolves. The book then flows onto an analysis of the credit cycle, distressed debt cycle and property cycle; three sectors that are thoroughly interlinked as the boom and bust of credit cycles creates the other two. Marks finishes off with chapters on coping and positioning for market cycles, and a reminder that market cycles will continue to exist because human behaviour isn't always rational.

Marks' book has the potential to either engage readers or frustrate them, over two types of repetition. First, reusing slabs of his memos could be seen positively as it creates a consistent narrative across his writing or negatively for repeating something many have already read. Second, the book has a steady progression, but often repeats points in some detail from previous chapters before leading onto the next point. I wasn't phased by either of these repetitions, but I've spoken to others who found them annoying. The last chapter is a 22 page summary of the book, so if you find the content long-winded just skip to this. It's also helpful as a quick review, particularly in the weeks before asset allocation meetings.

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Key takeaways

It’s often said that the three key components of investment returns are market timing, asset allocation and security selection. The book, as with almost all of Marks’ writing, doesn’t focus on security selection but spends a great deal of time on market timing and asset allocation. The eighth chapter is a great help for thinking about market timing and asset allocation, covering the cycle in risk tolerance, which flows into investor behaviour and expectations.

Evaluating what the crowd is doing is partly art and partly science. The art aspect is judging whether investors are seeing risk everywhere or ignoring risk everywhere, an ability enhanced by experience but never really definable. It often comes back to the anecdotes of stock tips from amateurs and people investing with expectations of rapid gains. The science aspect is more definable, for example P/E ratios for stocks and credit spreads on debt instruments. Marks notes that perceived risk dictates future long-term returns, in that when everyone is fearful long-term returns are likely to be above average and when optimism abounds below average returns lie ahead.

For those who aren’t fluent in the impact of credit on economic and market cycles, chapters nine to eleven are compulsory reading. Marks sums up the impact of bad lending with: “look around the next time there’s a crisis; you’ll probably find a lender”. Excessive risk taking in lending inflates asset prices, particularly in sectors like property and infrastructure that use large amounts of leverage. The widespread withdrawal of credit, as lenders switch from risk embracing to risk averse, leads to bankruptcies and fire sales of assets.

After reading through the mid-section of the book it becomes clear that market timing and asset allocation are highly interlinked. Your view on market timing isn’t as simple as increase cash and reduce risk assets or vice versa, it’s nuanced across and within asset classes. For instance, a late cycle view on credit points to owing higher rated securities and having lower credit duration across a portfolio. But it also has implications for bank equity, with the likelihood that credit losses will increase from their current low levels, reducing future bank profits.

For portfolio managers, Marks inclusion of an Oaktree crisis story on pages 129-134 is a standout. He details how Oaktree had started managing geared funds of leveraged (sub-investment grade) loans in the years before the crisis. As loan prices declined and margin calls were imminent Marks had to visit clients and plead with them to add more equity to their position in one fund. He couldn’t convince all investors to add to their positions but saved the fund by adding either his own or Oaktree’s capital and reaping a great return as a result. Marks uses the story as an illustration of an investor’s irrational risk avoidance, but there are far deeper lessons for portfolio managers which he leaves out.

First, Oaktree should never have been in a situation where it was facing margin calls on its funds. When leverage is used, it should be locked in for a long enough period for the underlying assets to materially paydown the debt from normal cashflows. Strategies that include borrowing short to lend long (e.g. structured investment vehicles in 2007/8) or giving lenders control via mark to market triggers (e.g. LTCM in 1998), have a long history of blowing portfolio managers out of their positions.

Second, using leverage creates the wrong conversation at the wrong time. Margin calls always occur at the most inconvenient time and will almost always be seen by clients as mismanagement on the part of the portfolio manager. Rather than pleading for more equity for a precariously placed fund, Oaktree should have been pointing to the good management on its existing funds and asking for additional capital for a new distressed debt fund.

Going beyond the book

Howard Marks sticks to high level commentary and strategy in his writing and interviews. This is understandable given his role as Chairman and face of Oaktree, which would involve far more time on marketing and client engagement than “on the tools” investment analysis. However, as I sit across both of those functions in my role, I like to take my writing a step further than Marks and give some detail on what I’m doing with the capital I’m entrusted with.

I’m in hearty agreement with Marks that we are late cycle but simply cannot know how long before there is a meaningful downturn. Sell-offs in late 2015 and late 2018 turned out to be blips rather than busts. Holding cash and hoping that the next major downturn will arrive soon is both unprofitable and unnecessary for credit investors.

I’m finding plenty of opportunities to invest in low risk, short duration securities. What I’m typically giving up is immediate liquidity, instead getting liquidity from a portfolio of securities that predominantly matures or amortises over the next 6-24 months. It’s a case of fishing in a different pond, rather than fighting with the crowd who are seeking higher returns from subordinated securities, by extending duration and by giving up covenants.

For my clients this delivers on almost all of what they are looking for. They have below average risk, they keep receiving good returns (often equivalent to the long-term average returns of listed equities) and they will have cash available when asset prices fall and the bargains are there for the taking. The portfolios have also been surprisingly stable month to month, experiencing very little of the losses seen through the sell-off late last year.

One final lesson I’ll add to Marks’ book is a quick calculation of the value of market timing. Using basic estimates of long-term returns, inflation and asset prices through the cycle, 15 years of alpha can be made in 5 years from buying crossover (BBB/BB) credit securities towards the bottom of the credit cycle. For deeply distressed securities the gains are even greater. This demonstrates the enormous optionality from having near-term maturities in a credit portfolio during buoyant times. Those implementing this strategy may see underperformance of 1-2% per year for 2-3 years before a downturn occurs, but this can be recouped many times over through buying bargain securities in the downturn.

Written by Jonathan Rochford for Narrow Road Capital on March 18, 2019. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

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