

WEALTH & INVESTING



INSIGHTS FROM  
CFA SOCIETY SINGAPORE

By Mark Fortune

## A sea change: Howard Marks on the end of easy money

The beginning of a new era in financial markets will force investors to rethink how they approach investing

THE financial markets are experiencing a sea change marking the end of a long period of accommodative central bank monetary policy, and there is little hope of ultra-low interest rates returning anytime soon, legendary investor Howard Marks explained in a virtual conversation with Margaret Franklin, president and chief executive officer of CFA Institute, at the Asset and Risk Allocation Conference in May 2023.

Marks believes this represents the beginning of a new era in the financial markets that will force many investors to rethink how they approach investing, use different risk/reward assumptions and adjust to more difficult conditions that many practitioners are seeing for the first time in their careers.

"I'm not saying interest rates are going to go back up. I just think they're done coming down," Marks said. "One of the basic tenets of my thesis is that in the next five to 10 years, interest rates will not be constantly coming down or constantly ultra-low. And if that's true, I think we're in a different environment, and that's a sea change."

As co-chair and co-founder of Oaktree Capital Management, an investment firm with more than US\$170 billion in assets under management (AUM), Marks has earned a reputation as one of the world's most prominent value investors.

As he sees it, this sea change—the third he has witnessed in his 54-year career—does not necessarily spell a "financial cataclysm... but financing, avoiding default, making money will not be as easy, and borrowing will not be as cheap," he said.

The market has rotated from a period that was bad for lenders and great for borrowers to one now that is better for lenders and less positive for borrowers, according to Marks. "So, this is a great time to be investing in credit. It's better than it has been for a long time," he said. "Might it get better? Yes; interest rates could go higher, in which case the fixed-income investor could have a chance later to invest at even higher rates. But this is a good time. I think the most powerful statement I can make is that today you can get equity-like returns from fixed income or credit."

### Previous market sea changes

The first sea change Marks experienced was the arrival of non-investment-grade bonds in the primary markets in the 1970s. "Michael Milken and others made it possible for companies to issue non-investment grade bonds, and for investors to invest in them prudently if the bonds offered



Howard Marks, co-chair and co-founder of Oaktree Capital Management, has earned a reputation as one of the world's most prominent value investors. PHOTO: BANK OF SINGAPORE

20 per cent in 1980, to extinguish inflationary pressures, as inflation receded to 3.2 per cent by the end of 1983.

Marks said Volcker's success in bringing inflation under control allowed the Fed to reduce the federal funds rate to the high single digits and keep it there throughout the 1980s, before dropping it to the mid-single digits in the 1990s. "Volcker's actions ushered in a declining interest rate environment that prevailed for four decades," he said. "I consider this the second sea change in my career."

### Contributors to the current sea change

Several events have contributed to the current sea change, which has caused investor pessimism to balance optimism in the financial markets, according to Marks. Stocks that seemed fairly priced in a low interest rate environment have in recent months fallen to somewhat lower price-to-earnings ratios that are more commensurate with higher interest rates. Likewise, he said, the massive increase in interest rates has had a depressing effect on bond prices. Amid declining stock and bond prices, the fear of missing out (Fomo) has dried up and fear of loss has replaced it.

Because the tighter monetary policies last year were designed to slow the economy, investors focused on the difficulty the Fed faces in achieving a soft landing and thus the strong potential of a recession. The anticipated effect of a recession on earnings dampened investors' spirits. Thus, the S&P 500's decline over the first nine months of 2022 rivalled the greatest full-year declines of the last century, Marks said. (Markets have since recovered considerably.)

### Risk and return outlook

Franklin asked Marks about his expectations regarding risk and return and interest rates as well as the more granular risks and opportunities the current market presents. One of Marks's hallmarks is his deep research and analysis seeking outsized returns, paying close attention to the risk characteristics. "So maybe you could provide some perspective on those two levers or dimensions as well?" Franklin asked.

"We had the tech bubble burst in 2000 and the



Today, investors can earn high-single-digit returns in high-yield bonds and leveraged loans that provide liquidity, says Marks. PHOTO: AFP

stock market continued to decline in 2001 and 2002," Marks said. "And that was the first three-year decline since 1939. People lost interest in the stock market, which did nothing for the next 10 years. And since the Fed cut interest rates to bolster the economy, investors also lost interest in bonds. People said to themselves, 'I can't get the returns I need from stocks and bonds. What can I do?' And the answer was 'alternatives'."

Investors allocated capital to hedge funds, which had come through the 2000 to 2002 period quite well. "But then hedge funds that used to be US\$100 million were suddenly US\$2 billion or more, and they couldn't do such a great job anymore," Marks said. "Hedge funds were all the rage for the mid-2000s. But you don't hear much talk about hedge funds anymore."

Investors next turned to private equity, pouring large amounts of capital into the asset class. For years they benefited from rising asset prices and declining cost of capital that lower interest rates brought. Private equity managers were able to ride those broad-based trends to good returns. But if the sea change means those trends are basically over, private equity managers will have to buy bargain-priced assets and add value if they want to make strong returns—that is what is called alpha. Those are skills that not everyone has, but they are essential for high returns in private equity if managers do not have declining interest rates to rely on, said Marks.

The latest asset class to benefit in the low interest rate environment has been private credit. When the global financial crisis (GFC) and the resulting regulation caused banks to lend less, non-bank lenders stepped in to fill the gap. Private lending became a major asset class, growing to the current level of about US\$1.5 trillion.

Does Marks see a bubble in private credit, or in certain parts of the asset class? Franklin asked.

He acknowledged an onrush of new firms and money into the class. "Is it a bubble?" he asked. "Bubble is a term, in my opinion, for irrational behaviour and psychology. So, is the behaviour irrational? Is psychology excessively optimistic? I don't know how much risk they're taking. I don't know if they're making wise or unwise credit decisions, so I can't give you an answer on that. But Warren Buffett says it's only when the tide goes out that you find out who's been swimming naked, and the tide hasn't yet gone out on private credit. We'll find out one of these days."

As for what else he is watching, Ukraine and Russia; the dysfunction in Washington, DC; income inequality; and significant social problems are all factors that concern Marks, though he does not know how they will impact financial markets or how to factor them into investment decisions. "My answer on the subject is a short one, because I really have nothing intelligent to say," he said.

What will private credit managers need to do to succeed in a higher interest rate and inflation environment?

Investors in credit must constantly demand a margin of safety such that, even if expectations are not fulfilled, they will get paid anyway, Marks said, and ascertaining it is a key skill. "It's not as if equities require genius and fixed income is like plumbing," he said. "You need skill in order to know when the action is too heated and the loans that are being made don't allow adequate margin of safety, in which case you have to abstain."

If we see more restrictive credit conditions and banks lend less, what are the implications for private and direct lending? Is it an increased opportunity? Franklin enquired.

"Yes, it very much is. The law of supply and demand has not been rescinded, and in every asset class, the more people who want to get into it, the

worse it is. The fewer people who want to get into it, the better it is," Marks said.

"And so, when everybody's eager to make loans, the resulting loans are likely to provide inadequate safety and inadequate yields. But when people retreat, and fewer people are willing to lend, then yields go up and lenders can demand covenants and other forms of safety. So that's a very, very positive development... I made my career doing things other people didn't want to do: high yield bonds in '78, distressed debt in '88, emerging market equities in '98. When they're out of favour and people won't buy them, by definition there's no demand, and there's no optimism in the price—what a great time to invest!"

### Retail investors

Today, investors can earn high-single-digit returns in high-yield bonds and leveraged loans that provide liquidity, Marks said. And private credit products, which are harder for retail investors to access, can generate double-digit returns. "So, one way to say it is, 'What do you need stocks for?'" Marks said. "And if you go into credit investing to pursue the kinds of returns I'm talking about, your probability of getting them is high. Of course, since it's fixed income, you don't have potential for big ups. But if you competently select the borrowers, you also don't have the risk of big downs."

Franklin told Marks that with such a large audience watching, he had an opportunity to impart some words of wisdom. "These are the people who are putting integrity into the system, want to do a great job and want to deliver for investors and their clients," she said.

"When the markets are performing well, investors forget to be worriers," Marks responded. "We had 10-plus years of positive markets, and people started to say, 'Well, I guess there's no risk; there's nothing to worry about. It looks like the Fed will engineer prosperity forever. The dance will continue for an extended period. I don't have to worry about losing money. But I do have to worry about being under-represented.'"

Those moments are exactly the wrong time to take a risk-on approach, Marks said. The recent market correction has reminded investors that it is easy to lose money.

"People have been reminded that Fomo isn't the most important fear," he said, "and that suggests we're going into a healthier environment. An environment where everything's easy isn't a healthy environment, because it encourages risky behaviour and bad habits. I always say the riskiest thing in the world is the belief that there's no risk. I believe that's over, and I believe we're heading into a more normal period, where nothing's as easy as it has been for the last several years. But it's a healthier environment, because people will be applying an appropriate amount of risk aversion, as they should."

The writer has more than 30 years of experience as a financial writer and editor

WEALTH & INVESTING