MASTERING THE MARKET CYCLE

GETTING THE ODDS ON YOUR SIDE

HOWARD MARKS

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Howard Marks

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Contents

Title Page
Contents
Copyright
Dedication
Memos from Howard Marks
Introduction
Why Study Cycles?
The Nature of Cycles
The Regularity of Cycles
The Economic Cycle
Government Involvement with the Economic Cycle
The Cycle in Profits
The Pendulum of Investor Psychology
The Cycle in Attitudes toward Risk
The Credit Cycle
The Distressed Debt Cycle
The Real Estate Cycle
Putting It All Together—The Market Cycle
How to Cope with Market Cycles
Cycle Positioning
Limits on Coping
The Cycle in Success
The Future of Cycles
The Essence of Cycles
Index
About the Author
Connect with HMH

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With All My Love
to Nancy
Jane, Justin, Rosie and Sam
Andrew and Rachel

“When I see memos from Howard Marks in my mail, they’re the first thing I open and read. I always learn something.”

—Warren Buffett

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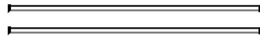
INTRODUCTION



Seven years ago I wrote a book called *The Most Important Thing: Uncommon Sense for the Thoughtful Investor,* regarding where investors should direct their greatest attention. In it I said "the most important thing is being attentive to cycles." The truth, however, is that I applied the label "the most important thing" to nineteen other things as well. There is no single most important thing in investing. Every one of the twenty elements I discussed in *The Most Important Thing* is absolutely essential for anyone who wishes to be a successful investor.

Vince Lombardi, the legendary coach of the Green Bay Packers, is famous for having said, "winning isn't everything, it's the only thing." I've never been able to figure out what Lombardi actually meant by that statement, but there's no doubt he considered winning the most important thing. Likewise, I can't say an understanding of cycles is everything in investing, or the only thing, but for me it's certainly right near the top of the list.

Most of the great investors I've known over the years have had an exceptional sense for how cycles work in general and where we stand in the current one. That sense permits them to do a superior job of positioning portfolios for what lies ahead. Good cycle timing—combined with an effective investment approach and the involvement of exceptional people—has accounted for the vast bulk of the success of my firm, Oaktree Capital Management.

It's for that reason—and because I find something particularly intriguing about the fluctuations of cycles—and because where we stand in the cycle is one of the things my clients ask about most—and finally because so little has been written about the essential nature of cycles—that I decided to follow *The Most Important Thing* with a book devoted entirely to an exploration of cycles. I hope you'll find it of use.

Some patterns and events recur regularly in our environment, influencing our behavior and our lives. The winter is colder and snowier than the summer, and the daytime is lighter than the night. Thus we plan ski trips for the winter and sailing trips for the summer, and our work and recreation for the daytime and our sleeping at night. We turn on the lights as evening draws nigh and turn them off when we go to bed. We unpack our warm coats as the winter approaches and our bathing suits for the summer. While some people swim in the ocean in winter for exhilaration and some elect to work the night shift to free up their days, the vast majority of us follow the normal circadian patterns, making everyday life easier.

We humans use our ability to recognize and understand patterns to make our decisions easier, increase benefits and avoid pain. Importantly, we depend on our knowledge of recurring patterns so we won't have to reconsider every decision from scratch. We know hurricanes are more likely in September, so we avoid the Caribbean at that time of year. We New Yorkers schedule our visits to Miami and Phoenix for the winter months, when the temperature differential is a

positive, not a negative. And we don't have to wake each day in January and decide anew whether to dress for warmth or cold.

Economies, companies and markets also operate pursuant to patterns. Some of these patterns are commonly called cycles. They arise from naturally occurring phenomena but, importantly, also from the ups and downs of human psychology and from the resultant human behavior. Because human psychology and behavior play such a big part in creating them, these cycles aren't as regular as the cycles of clock and calendar, but they still give rise to better and worse times for certain actions. And they can profoundly affect investors. If we pay attention to cycles, we can come out ahead. If we study past cycles, understand their origins and import, and keep alert for the next one, we don't have to reinvent the wheel in order to understand every investment environment anew. And we have less of a chance of being blindsided by events. We can master these recurring patterns for our betterment.

It's my primary message that we should pay attention to cycles; perhaps I should say "listen to them." Dictionary.com supplies two closely related but distinct definitions for the word "listen." The first is "to attend closely for the purpose of hearing." The second is "to heed." Both definitions are relevant to what I'm writing about.

In order to properly position a portfolio for what's going on in the environment—and for what that implies regarding the future of the markets—the investor has to maintain a high level of attention. Events happen equally to everyone who is operating in a given environment. But not everyone listens to them equally in the sense of paying attention, being aware of them, and thus potentially figuring out their import.

And certainly not everyone heeds equally. By "heed" I mean "obey, bear in mind, be guided by or take to heart." Or, in other words, "to absorb a lesson and follow its dictates." Perhaps I can better convey this "heeding" sense for listening by listing its antonyms: ignore, disregard, discount, reject, overlook, neglect, shun, flout, disobey, tune out, turn a deaf ear to, or be inattentive to. Invariably, investors who disregard where they stand in cycles are bound to suffer serious consequences.

In order to get the most out of this book—and do the best job of dealing with cycles—an investor has to learn to recognize cycles, assess them, look for the instructions they imply, and do what they tell him to do. (See the author's note below regarding my use of male pronouns.) If an investor listens in this sense, he will be able to convert cycles from a wild, uncontrollable force that wreaks havoc, into a phenomenon that can be understood and taken advantage of: a vein that can be mined for significant outperformance.

A winning investment philosophy can be created only through the combination of a number of essential elements:

- A technical education in accounting, finance and economics provides the foundation: necessary but far from sufficient.
- A view on how markets work is important—you should have one before you set out to invest, but it must be added to, questioned, refined and reshaped as you proceed.
- Some of your initial views will come from what you've read, so reading is an essential building block. Continuing to read will enable you to increase the efficacy of your approach—both embracing those ideas you find appealing and discarding those you don't.

Importantly, it’s great to read outside the strict boundaries of investing. Legendary investor Charlie Munger often points to the benefits of reading broadly; history and processes in other fields can add greatly to effective investment approaches and decisions.

- Exchanging ideas with fellow investors can be an invaluable source of growth. Given the non-scientific nature of investing, there’s no such thing as being finished with your learning, and no individual has a monopoly on insight. Investing can be solitary, but I think those who practice it in solitude are missing a lot, both intellectually and interpersonally.
- Finally, there really is no substitute for experience. Every year I have come to view investing differently, and every cycle I’ve lived through has taught me something about how to cope with the next one. I recommend a long career and see no reason to stop any time soon.

Writing my books has given me a wonderful vehicle for acknowledging the people who have contributed to my investment insight and the texture of my working life.

- I’ve gained a great deal from reading the work of Peter Bernstein, John Kenneth Galbraith, Nassim Nicholas Taleb and Charlie Ellis.
- I’ve continued to pick up pointers from the people I cited in *The Most Important Thing* and others, including Seth Klarman, Charlie Munger, Warren Buffett, Bruce Newberg, Michael Milken, Jacob Rothschild, Todd Combs, Roger Altman, Joel Greenblatt, Peter Kaufman and Doug Kass. And since Nancy and I moved to New York in 2013 to follow our kids, I’ve been fortunate to add Oscar Schafer, Jim Tisch and Ajit Jain to this circle. Each of these people’s way of looking at things has added to mine.
- Finally I want to return to the most important collaborators, my Oaktree co-founders: Bruce Karsh, Sheldon Stone, Richard Masson and Larry Keele. They honored me by adopting my philosophy as the foundation for Oaktree’s investment approach; applied it skillfully (and thus gained recognition for it); and helped me add to it over the thirty-plus years we’ve been associated. As indicated in what follows, Bruce and I have exchanged ideas and backed each other up almost daily over that period, and my give-and-take with him—especially in the most difficult of times—has played a particularly indispensable part in the development of the approach to cycles on which this book is based.

I also want to thank the people who played important parts in this book’s creation: my talented editor at HMH, Rick Wolff; my resourceful agent, Jim Levine, who brought me to Rick; my great friend Karen Mack Goldsmith, who pushed me at every turn to make the book more appealing; and my highly supportive long-time assistant, Caroline Heald. I particularly want to cite Prof. Randy Kroszner of the University of Chicago’s Booth School, who helped out by reviewing the chapters on the economic cycle and government intervention with it.

Since knowledge is cumulative but we never know it all, I look forward to learning more in the years ahead. In investing, there is nothing that always works, since the environment is always changing, and investors’ efforts to respond to the environment cause it to change further. Thus I hope to know things in the future that I don’t know now, and I look forward to sharing them in memos and books yet to come.

Author’s notes:

1. As I did in *The Most Important Thing,* I want to issue up front a blanket apology for my consistent use of male pronouns. It can be force of habit for someone who started to write more than sixty years ago. I find it much easier and more attractive to write “he” than “he/she.” Alternating between “he” and “she” seems forced. And I dislike the use of “they” when the subject is a single person. The exceptional women I’ve been privileged to work with over the course of my career know I absolutely think every bit as much of them as professionals and investors as I do their male counterparts.
2. Also as in *The Most Important Thing*, in order to make my points here I will borrow from time to time from the client memos I’ve written over the years starting in 1990. I will also borrow from my first book. I could go to the trouble of reinventing the wheel and writing on these subjects anew, but I won’t. Instead, I’ll lift key passages from my book and memos that I think make their point clearly. I hope my doing so won’t make those who buy this book feel they’ve received less than their money’s worth.
   In order to advance the purposes of this book, I will occasionally add a few words to or delete a few from the passages I cite, or present paragraphs in an order different from that in which they appeared in the original. Since they’re my passages, I think it’s okay to do so without noting it in every case. But I do it only to increase their helpfulness, not to alter their meaning or make them more correct with the benefit of hindsight.
3. And finally as in *The Most Important Thing,* I’ll be dealing here with a topic that—like investing in general—is complex and involves elements that overlap and can’t be neatly segregated into discrete chapters. Since some of those elements are touched on in multiple places, you’ll likewise find some instances of repetition where I include noteworthy quotations from others or citations from my book and memos that I can’t resist using more than once.
4. Please note that when I talk about “investing,” I’ll assume the investor is buying, holding or, as we say, “being long” in the expectation that certain assets will appreciate. This is as opposed to selling short securities that one doesn’t own in the hope they’ll decline. Investors aren’t always “long” rather than “short,” but most of the time they are. The number of people who sell stocks short or ever get “net short”—that is, whose short positions have a total value exceeding that of the stocks they own—is tiny relative to those who don’t. Thus, in this book I’m going to speak exclusively about investing in things because they’re expected to rise, not selling assets short in the hope they’ll fall.
5. Lastly, whereas I first conceived of this book as being just about cycles, as I wrote I came up with ideas on lots of other topics, such as asset selection and “catching falling knives.” Rather than discard them, I’ve included them, too. I hope you’ll be glad they’re here: providing a bonus rather than straying from the mission.

I

WHY STUDY CYCLES?

> The odds change as our position in the cycles changes. If we don't change our investment stance as these things change, we're being passive regarding cycles; in other words, we're ignoring the chance to tilt the odds in our favor. But if we apply some insight regarding cycles, we can increase our bets and place them on more aggressive investments when the odds are in our favor, and we can take money off the table and increase our defensiveness when the odds are against us.

Investing is a matter of preparing for the financial future. It's simple to define the task: we assemble portfolios today that we hope will benefit from the events that unfold in the years ahead.

For professional investors, success consists of doing this better than the average investor, or outperforming an assigned market benchmark (the performance of which is determined by the actions of all the other investors). But achieving that kind of success is no small challenge: although it's very easy to generate average investment performance, it's quite hard to perform above average.

One of the most important foundational elements of my investment philosophy is my conviction that we can't know what the "macro future" has in store for us in terms of things like economies, markets or geopolitics. Or, to put it more precisely, few people are able on balance to know more about the macro future than others. And it's only if we know more than others (whether that consists of having better data; doing a superior job of interpreting the data we have; knowing what actions to take on the basis of or our interpretation; or having the emotional fortitude required to take those actions) that our forecasts will lead to outperformance.

In short, if we have the same information as others, analyze it the same way, reach the same conclusions and implement them the same way, we shouldn't expect that process to result in outperformance. And it's very difficult to be consistently superior in those regards as relates to the macro.

So, in my view, trying to predict what the macro future holds is unlikely to help investors achieve superior investment performance. Very few investors are known for having outperformed through macro forecasting.

Warren Buffett once told me about his two criteria for a desirable piece of information: it has to be important, and it has to be knowable. Although "everyone knows" that macro developments play a dominant role in determining the performance of markets these days, "macro investors" as a whole have shown rather unimpressive results. It's not that the macro doesn't matter, but rather that very few people can master it. For most, it's just not knowable (or not knowable well enough and consistently enough for it to lead to outperformance).

Thus I dismiss macro prediction as something that will bring investment success for the vast majority of investors, and I certainly include myself in that group. If that's so, what's left? While there are lots of details and nuances, I think we can most gainfully spend our time in three general areas:

- trying to know more than others about what I call "the knowable": the fundamentals of industries, companies and securities,
- being disciplined as to the appropriate price to pay for a participation in those fundamentals, and
- understanding the investment environment we're in and deciding how to strategically position our portfolios for it.

A great deal has been written on the first two topics. Together, these constitute the key ingredients in "security analysis" and "value investing": judgments regarding what an asset can produce in the future—usually in terms of earnings or cash flow—and what those prospects make the asset worth today.

What do value investors do? They strive to take advantage of discrepancies between "price" and "value." In order to do that successfully, they have to (a) quantify an asset's intrinsic value and how it's likely to change over time and (b) assess how the current market price compares with the asset's intrinsic value, past prices for the asset, the prices of other assets, and "theoretically fair" prices for assets in general.

Then they use that information to assemble portfolios. Most of the time, it's their immediate goal to hold investments offering the best available value propositions: the assets with the greatest upside potential and/or the best ratio of upside potential to downside risk. You might argue that assembling a portfolio should consist of nothing more than identifying the assets with the highest value and the ones whose prices most understate their value. That may be true in general and in the long term, but I think another element can profitably enter into the process: properly positioning a portfolio for what's likely to happen in the market in the years immediately ahead.

In my view, the greatest way to optimize the positioning of a portfolio at a given point in time is through deciding what balance it should strike between aggressiveness and defensiveness. And I believe the aggressiveness/defensiveness balance should be adjusted over time in response to changes in the state of the investment environment and where a number of elements stand in their cycles.

> The key word is "calibrate." The amount you have invested, your allocation of capital among the various possibilities, and the riskiness of the things you own all should be calibrated along a continuum that runs from aggressive to defensive. . . . When we're getting value cheap, we should be aggressive; when we're getting value expensive, we should pull back. ("Yet Again?," September 2017)

Calibrating one's portfolio position is what this book is mostly about.

One of the key words required if one is to understand the reasons for studying cycles is "tendencies."

If the factors that influence investing were regular and predictable—for example, if macro forecasting worked—we would be able to talk about what "will happen." Yet the fact that that's not the case doesn't mean we're helpless in contemplating the future. Rather, we can talk about the things that might happen or should happen, and how likely they are to happen. Those things are what I call "tendencies."

In the investment world, we talk about risk all the time, but there's no universal agreement about what risk is or what it should imply for investors' behavior. Some people think risk is the likelihood of losing money, and others (including many finance academics) think risk is the volatility of asset prices or returns. And there are many other kinds of risk—too many to cover here.

I lean heavily toward the first definition: in my view, risk is primarily the likelihood of permanent capital loss. But there's also such a thing as opportunity risk: the likelihood of missing out on potential gains. Put the two together and we see that risk is the possibility of things not going the way we want.

What is the origin of risk? One of my favorite investment philosophers, the late Peter Bernstein, said in an issue of his *Economics and Portfolio Strategy* newsletter titled "Can We Measure Risk with a Number?" (June 2007):

> Essentially risk says we don't know what's going to happen. . . . We walk every moment into the unknown. There's a range of outcomes, and we don't know where [the actual outcome is] going to fall within the range. Often we don't know what the range is.

You'll find below a few ideas (summarized very briefly from the full treatment provided in my memo "Risk Revisited Again" of June 2015) that I think follow directly from the starting point provided by Bernstein. They might help you understand and cope with risk.

As retired London Business School professor Elroy Dimson said, "Risk means more things can happen than will happen." For each event in economics, business and markets (among other things), if only one thing could happen—if there could be only one outcome—and if it was predictable, there would, of course, be no uncertainty or risk. And with no uncertainty regarding what was going to happen, in theory we could know exactly how to position our portfolios to avoid loss and garner maximum gains. But in life and in investing, since there can be many different outcomes, uncertainty and risk are inescapable.

As a consequence of the above, the future should be viewed not as a single fixed outcome that's destined to happen and capable of being predicted, but as a range of possibilities and—hopefully on the basis of insight into their respective likelihoods—as a probability distribution. Probability distributions reflect one's view of tendencies.

Investors—or anyone hoping to deal successfully with the future—have to form probability distributions, either explicitly or informally. If it's done well, those probabilities will be helpful in determining one's proper course of action. But it's still essential to bear in mind that even if we know the probabilities, that doesn't mean we know what's going to happen.

Outcomes regarding a given matter may be governed by a probability distribution in the long run, but with regard to the outcome of a single event there can be great uncertainty. Any of the outcomes included in a distribution can occur, albeit with varying probabilities, since the process through which the outcome is chosen will be affected not only by the merits, but also by randomness. To invert Dimson's statement, even though many things can happen, only one will.

We may know what to expect "on average," but that may have no connection with what actually will happen.

In my way of thinking about it, investment success is like the choosing of a lottery winner. Both are determined by one ticket (the outcome) being pulled from a bowlful (the full range of possible outcomes). In each case, one outcome is chosen from among the many possibilities.

Superior investors are people who have a better sense for what tickets are in the bowl, and thus for whether it's worth participating in the lottery. In other words, while superior investors—like everyone else—don't know exactly what the future holds, they do have an above-average understanding of future tendencies.

As an aside, I want to add a thought here. Most people think the way to deal with the future is by formulating an opinion as to what's going to happen, perhaps via a probability distribution. I think there are actually two requirements, not one. In addition to an opinion regarding what's going to happen, people should have a view on the likelihood that their opinion will prove correct. Some events can be predicted with substantial confidence (e.g., will a given investment grade bond pay the interest it promises?), some are uncertain (will Amazon still be the leader in online retailing in ten years?) and some are entirely unpredictable (will the stock market go up or down next month?) It's my point here that not all predictions should be treated as equally likely to be correct, and thus they shouldn't be relied on equally. I don't think most people are as aware of this as they should be.

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A good way to think about the superior investor described above is as someone whose insight into tendencies permits him to tilt the odds in his favor.

Let's say there are 100 balls in a jar, some black and some white. Which color should you bet will come up?

- If you don't know anything about the contents of the jar, betting would be just a matter of guessing: uninformed speculation. The situation is similar if you know there are 50 black and 50 white. You can just as wisely bet on black as white, but doing either wouldn't give you more than a 50:50 chance of being right. Thus betting would be dumb unless you're offered odds that are at least even—and unless you're able to avoid paying an admission charge (in investing, a commission or bid-asked spread) to play. Betting on black or white at even odds wouldn't very profitable other than if you got lucky, and luck isn't something you can count on. Betting in the absence of a knowledge edge regarding the contents of the jar wouldn't be dependably profitable.
- But what if you do have special insight regarding the contents of the jar? Let's say you know there are 70 black balls and 30 white. That could allow you to win more often than you lose. If you can bet $10 on black against someone who gives you even odds, you'll win $10 70% of the time and lose $10 only 30% of the time, for an expected profit of $40 per 10 picks. (Note: these will be the outcomes on average over a large number of trials, but they are subject to significant variation in the short run due to randomness.)
- Of course, your betting partner will only give you even odds on a bet on black (a) if he doesn't know the balls are 70% black and 30% white and (b) if he doesn't know that you do know. If he knew as much as you do about the contents of the jar, he would give you only 30:70 odds on a bet on black, and the bet would be back to being profitless.
- In other words, in order to win at this game more often than you lose, you have to have a knowledge advantage. That's what the superior investor has: he knows more than others

about the future tendencies.

- Yet it's important to remember what I said earlier: even if you know the probabilities—that is, even if you do have superior insight regarding the tendencies—you still don't know what's going to happen. Even if the ratio of balls in the jar is 70 black to 30 white, you still don't know what color the next one picked will be. Yes, it's more likely to be black than white, but it'll still be white 30% of the time. When there are white balls as well as black in the jar, and especially when random and exogenous forces are at work when the next ball is chosen, there can be no certainty regarding the outcome.
- But all this being said, there doesn't have to be certainty in order for the game to be worth playing. A knowledge advantage regarding the tendencies is enough to create success in the long run.

And that brings us to the payoff from understanding cycles. The average investor doesn't know much about it:

- He doesn't fully understand the nature and importance of cycles.
- He hasn't been around long enough to have lived through many cycles.
- He hasn't read financial history and thus learned the lessons of past cycles.
- He sees the environment primarily in terms of isolated events, rather than taking note of recurring patterns and the reasons behind them.
- Most important, he doesn't understand the significance of cycles and what they can tell him about how to act.

The superior investor is attentive to cycles. He takes note of whether past patterns seem to be repeating, gains a sense for where we stand in the various cycles that matter, and knows those things have implications for his actions. This allows him to make helpful judgments about cycles and where we stand in them. Specifically:

- Are we close to the beginning of an upswing, or in the late stages?
- If a particular cycle has been rising for a while, has it gone so far that we're now in dangerous territory?
- Does investors' behavior suggest they're being driven by greed or by fear?
- Do they seem appropriately risk-averse or foolishly risk-tolerant?
- Is the market overheated (and overpriced), or is it frigid (and thus cheap) because of what's been going on cyclically?
- Taken together, does our current position in the cycle imply that we should emphasize defensiveness or aggressiveness?

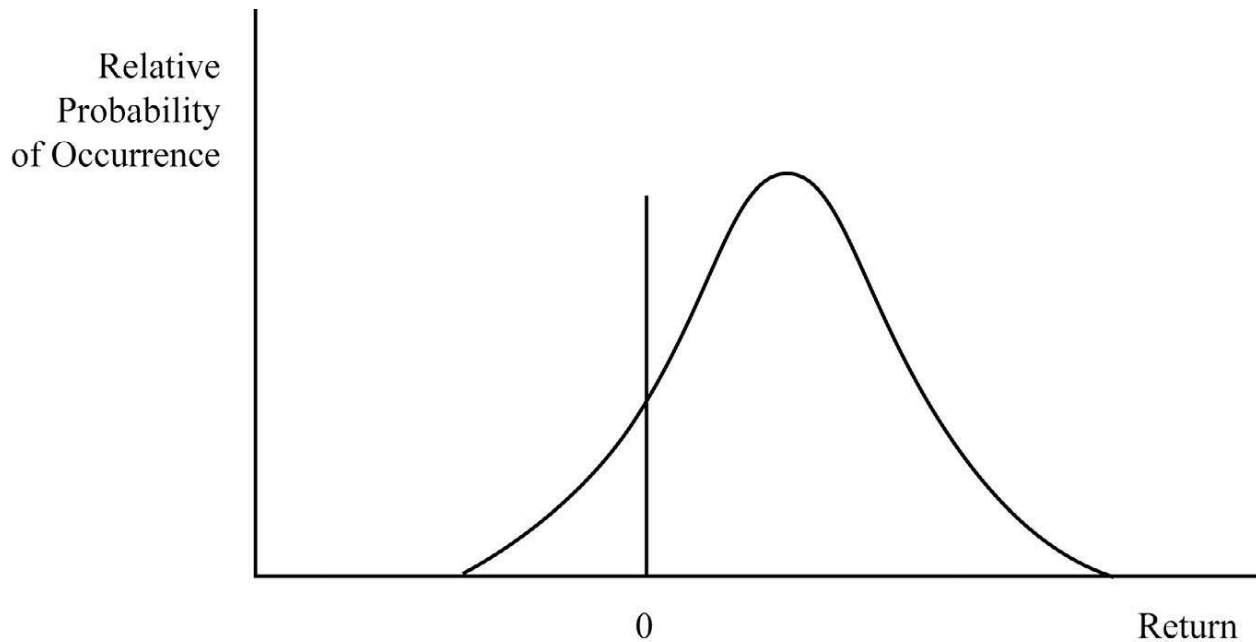
Attention to these elements gives the superior investor an edge that allows him to win more often than he loses. He understands the tendencies or odds; thus he knows something that others don't about the color of the balls in the jar. He has a sense for whether the chances of winning exceed the chances of losing; thus he is able to invest more when they are favorable and less when they aren't. Importantly, all these things can be assessed on the basis of observations regarding current conditions. As we'll see in later chapters, they can tell us how to prepare for the future without requiring that we be able to predict the future.

Remember, where we stand in the various cycles has a strong influence on the odds. For example, as we'll see in later chapters, opportunities for investment gains improve when:

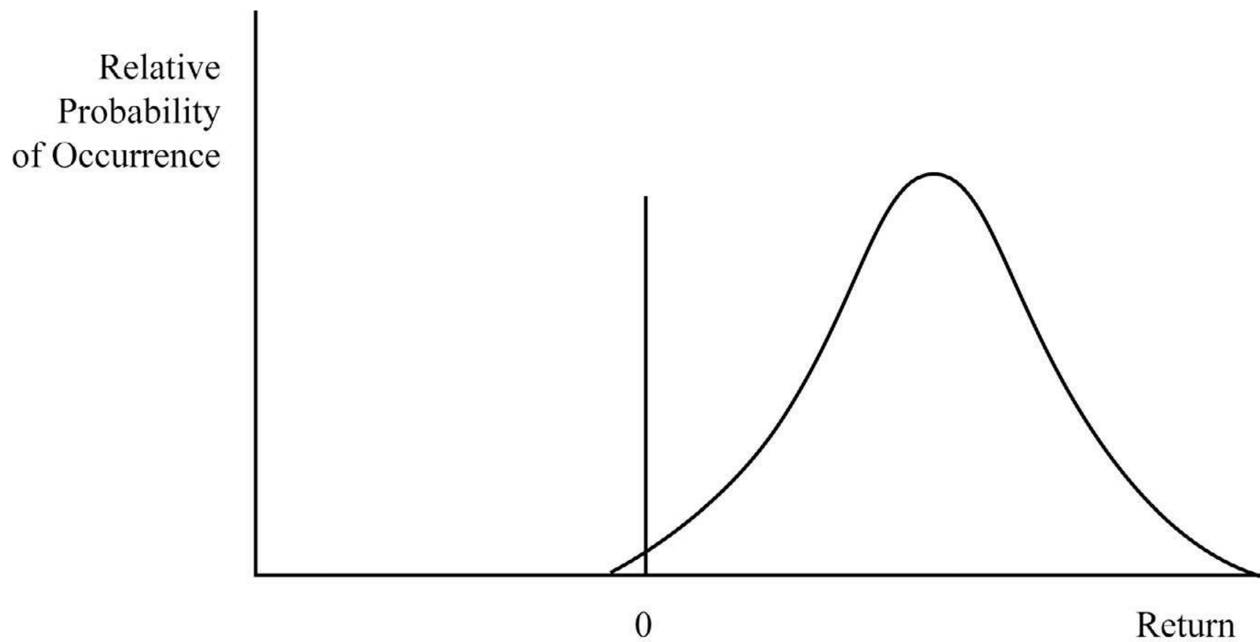
- the economy and company profits are more likely to swing upward than down,
- investor psychology is sober rather than buoyant,
- investors are conscious of risk or—even better—overly concerned about risk, and
- market prices haven't moved too high.

There are cycles in all these things (and more), and knowing where we stand within them can help us tilt the odds in our favor. In short, the movement through the cycle repositions the probability distribution governing future events. Perhaps I should illustrate with regard to investment returns:

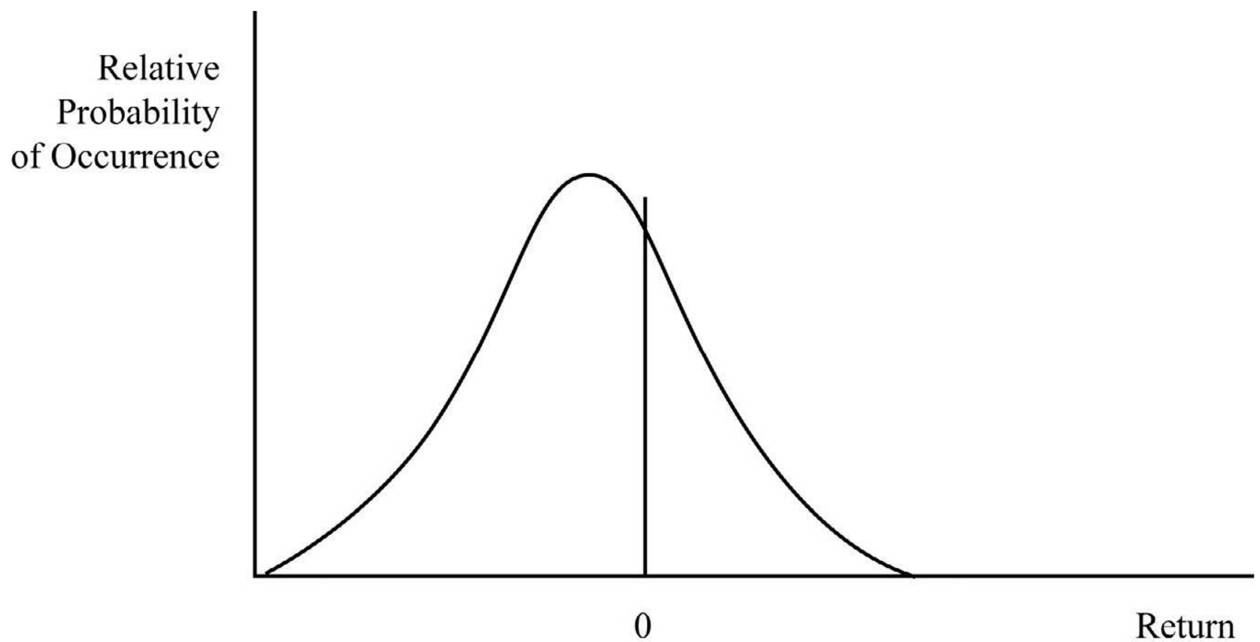
When our position in the various cycles is neutral, the outlook for returns is "normal."



When the cycles are positioned propitiously, the probability distribution shifts to the right, such that the outlook for returns is now tilted in our favor. Our favorable position in the cycles makes gains more likely and losses less so.



But when the cycles are at dangerous extremes, the odds are against us, meaning the likelihoods are less good. There's less chance of gain and more chance of loss.



The same is true when our position changes in only a single cycle. For example, regardless of what's going on with regard to the economy and company profits (that is, as the academics say, *ceteris paribus* or "all other things being equal"), the outlook for returns will be better when investors are depressed and fearful (and thus allow asset prices to fall) and worse when they're euphoric and greedy (and drive prices upward).

The odds change as our position in the cycles changes. If we don't change our investment stance as these things change, we're being passive regarding cycles; in other words, we're

ignoring the chance to tilt the odds in our favor. But if we apply some insight regarding cycles, we can increase our bets and place them on more aggressive investments when the odds are in our favor, and we can take money off the table and increase our defensiveness when the odds are against us.

The student of cycles doesn’t know for a fact what’s going to happen next—any more than someone with insight regarding the balls in the jar knows what color ball will come out next. But both have a knowledge advantage regarding what’s likely. The student’s knowledge of cycles and appreciation for where we stand at a point in time can make a big contribution to the edge that must be present in order for an investor to achieve superior results. The ball-chooser who knows the ratio is 70:30 has an advantage. So does the investor who knows better than others where we stand in the cycle. It’s the purpose of this book to help you become that person.

In that interest, I’ll describe a number of cyclical processes that I watched take place in real time. The oscillations might seem extreme, and in fact they may be, since they’re chosen from the experience of a half-century to prove a point. And they may give the impression that the events under discussion were compressed in time, whereas in truth they took months and years to develop. But these examples are real, and I hope they’ll make my message clear.

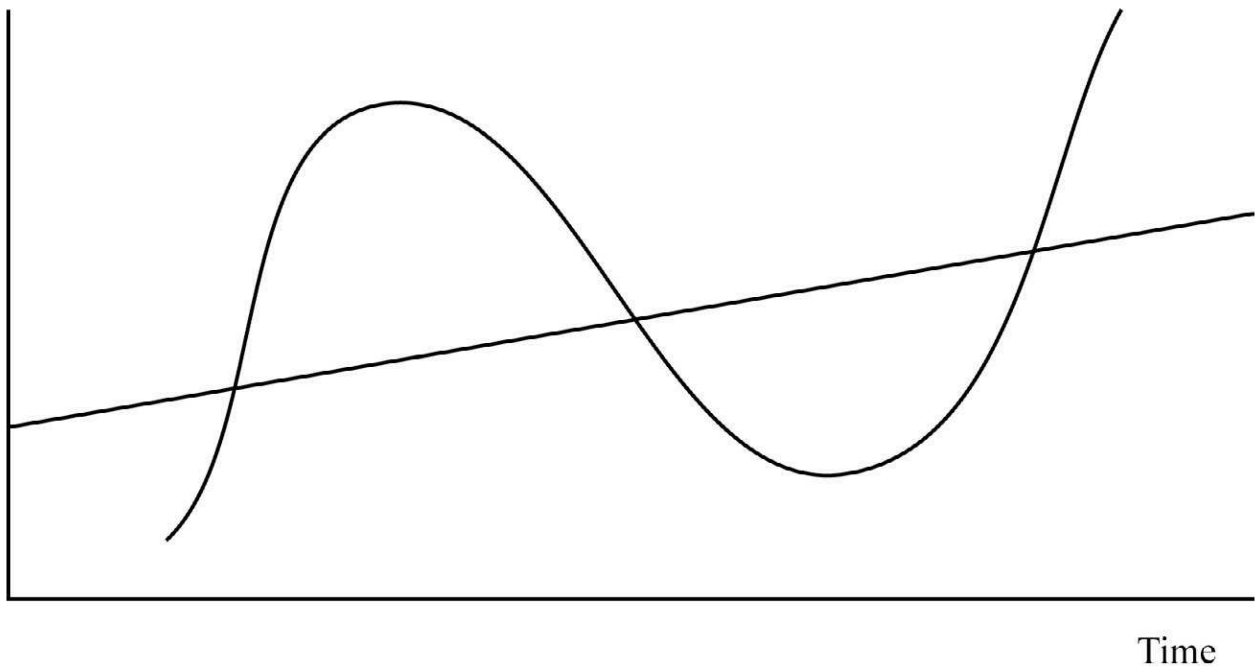
II

THE NATURE OF CYCLES

Most people think of cycles in terms of a series of events. And most people understand that these events regularly follow each other in a usual sequence: upswings are followed by downswings, and then eventually by new upswings. But to have a full understanding of cycles, that's not enough. The events in the life of a cycle shouldn't be viewed merely as each being followed by the next, but—much more importantly—as each *causing* the next.

When I meet with Oaktree clients, they almost always ask me to help them make sense of what's going on in the world or in the market. They usually want to know about one particular cycle or another and where we stand in it. I invariably pull out a sheet of paper and make a drawing to aid the discussion.

There's usually a line that stretches from lower left to upper right. Another line fluctuates up and down around it. Together they look like this.



When I started to organize for the task of writing this book, I went through my Oaktree bag and found a large number of such drawings. I had drawn them in the course of describing several

different phenomena, and they were annotated differently. But each one related to a cycle worthy of discussion. The chapters in this book will generally be devoted to those cyclical phenomena.

Before moving ahead with my discussion of cycles, I want to return to something I mentioned in *The Most Important Thing*. I confess that I alternate between discussing the ups and downs of cycles and the side-to-side oscillations of pendulums, applying the cycle label to some phenomena and (as seen in chapter VII) the pendulum label to others (usually those connected to psychology). Sometimes I'll talk about a given phenomenon as a cycle, and sometimes as a pendulum. But when pressed, I find it hard to distinguish between the two or to say why one gets one label and not the other.

I tend to think about things visually, so perhaps I can use an image to describe the connection between cycles and pendulums. As I will describe at length later, cycles oscillate around a midpoint (or a secular trend). Similarly, pendulums hang over a midpoint (or norm) and swing back and forth from there. But if you take the hang-point of the pendulum, turn it on its side and drag it from left to right as it oscillates, what do you get? A cycle.

There really is no fundamental difference. I'll even admit that a pendulum is little more than a special case of a cycle, or perhaps just a different way to make reference to particular cycles. My reasons for referring to some things as cycles and others as pendulums are clear to me. I hope they will become clear to you as well. Or, at minimum, I hope my use of the two terms won't detract from what you take from this book.

The bottom line is that, in the world investors inhabit, cycles rise and fall, and pendulums swing back and forth. Cycles and pendulum swings come in many forms and relate to a wide variety of phenomena, but the underlying reasons for them—and the patterns they produce—have a lot in common, and they tend to be somewhat consistent over time. Or as Mark Twain is reputed to have said (although there's no evidence he actually said it), "History doesn't repeat itself, but it does rhyme."

Whether Twain said it or not, that sentence sums up a lot of what this book is about. Cycles vary in terms of reasons and details, and timing and extent, but the ups and downs (and the reasons for them) will occur forever, producing changes in the investment environment—and thus in the behavior that's called for.

The central line in my drawings constitutes a midpoint around which the cycle oscillates. It sometimes has an underlying direction or secular trend ("secular" as in "of or relating to a long term of indefinite duration" per *Webster's New Collegiate Dictionary*), and that's usually upward. So, over time and in the long run, economies tend to grow, companies' profits tend to increase and (largely because of those things) markets tend to rise. And if these developments were scientific or wholly natural, physical processes, economies, companies and markets might progress in a straight line and at a constant rate (at least for a while). But of course, they're not, so they don't.

The fact is that the performance of these things is heavily influenced in the short run by, among other things, the involvement of people, and people are far from steady. Rather they fluctuate from time to time, often because of things we can lump under the broad heading of "psychology." Thus people's behavior varies . . . certainly as the environment varies, but sometimes in the absence of changes in the environment, too.

It's the oscillation of things around the midpoint or secular trend that this book is largely about. The oscillation bedevils people who don't understand it, are surprised by it or, even worse, partake in and contribute to it. But as I've said before, it often presents profit opportunities for those who understand, recognize and take advantage of cyclical phenomena.