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What it Takes…

For many years we have looked for ways to communicate both timeless and topical investment issues in this essay. On April 8th, 2014 Howard Marks, the CEO of Oaktree Capital, wrote a letter to their investors that highlighted many of the tenets of value investing that we have embraced at KLCM in practice and in these essays for the past 21 years. Though Oaktree's specialty is in high yield bonds, distressed debt and other credit related areas, they have relied on a bottom-up, contrarian investment style that exposes them to many of the stresses and rewards of value-style equity investing. We hope that you find the excerpts of his letter*****, titled "Dare to be Great II," included in italics below to be as insightful and refreshing as we have. Very simply, Howard Marks provides another perspective on **what it takes** to provide superior returns over time and some of the realities of adhering to a disciplined approach that make it impractical for many to practice. Our comments follow in green.

The goal in investing is asymmetry: to expose yourself to return in a way that doesn't expose you commensurately to risk*, and to participate in gains when the market rises to a greater extent than you participate in losses when it falls. But that doesn't mean the avoidance of all losses is a reasonable objective. Take another look at the goal of asymmetry set out above: it talks about achieving a preponderance of gain over loss, not avoiding all chance of loss. To succeed at any activity involving the pursuit of gain, we have to be able to withstand the possibility of loss. A goal of avoiding all losses can render success unachievable almost as readily as can the occurrence of too many losses… But it's crippling to have to avoid all failures, and insisting on doing so can't be a winning strategy. It may guarantee you against losses, but it's likely to guarantee you against gains as well… Scared money never wins…* [Or as stated by] *Wayne Gretzky, considered by many to be the greatest hockey player who ever lived: "You miss 100% of the shots you don't take."*

Asymmetry is the true goal of value investors; to limit downside risk while enhancing upside potential with each purchase and to reduce risk with each sale when the positive asymmetry has dissipated.

Most great investments begin in discomfort. *The things most people feel good about – investments where the underlying premise is widely accepted, the recent performance has been positive and the outlook is rosy – are unlikely to be available at bargain prices. Rather,* ***bargains are usually found among things that are controversial, that people are pessimistic about, and that have been performing badly of late.***

If we can enter a stock when we believe that most of the risk has been wrung out of it, we are comfortable waiting for the eventual payoff.

But ***it isn't easy to do things that entail discomfort.*** *While they accept the intellectual proposition that attempting to be a superior investor has to entail the risk of loss, many institutional investors – and especially those operating in a political or public arena – can find it unacceptable to look significantly wrong. Compensation cuts and even job loss can befall the institutional employee who's associated with too many mistakes.*

This gets at the realities of investing as a big business or in an institutional setting. For many the objective is not to win, but to track a benchmark, to stay employed or to continue earning fees. Enter the consultant model of over-diversification by design,

where no single investment choice will make or break returns relative to the benchmark. Expenses and unproductive asset classes will generally weigh on returns. Occasionally, a fund/manager is sold or fired for a period of underperformance. Most importantly, by not losing materially or unconventionally, those working with clients or on the investment committee will continue in their roles.

Passive investors, benchmark huggers and herd followers *have a high probability of achieving average performance and little risk of falling far short. But in exchange for safety from being much below average, they* ***surrender their chance of being much above average****… The real question is whether you dare to do the things that are necessary in order to be great. Are you willing to be different, and are you willing to be wrong? In order to have a chance at great results, you have to be open to both.*

Passive investors can sensibly utilize a reasonable asset allocation and low-cost index funds to match their risk and return objectives. On the other hand, multi-manager, multi-asset class approaches may be highly complex and generate little or no incremental returns after expenses. In both cases, index investors may find themselves over-weighted to the most popular and risky parts of the markets just when the cycle turns down.

In order to be a superior investor, you need the strength to diverge from the herd, stand by your convictions, and maintain positions until events prove them right. *Investors operating under harsh scrutiny and unstable working conditions can have a harder time doing this than others… "Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally (John Maynard Keynes)."*

We know that we will go through multiple year periods where we will look less than bright and, at times, we will be just plain wrong on individual positions. We are fortunate to be a part of a stable enterprise with clients that understand that the market can be irrational at times and that the longer term rewards from adhering to a disciplined approach are well worth waiting for. Intuitively, they understand that portfolio risk is ultimately reduced by not overpaying for financial assets.

You can't take the same actions as everyone else and expect to outperform…Unconventional behavior is the only road to superior investment results, but it isn't for everyone. In addition to superior skill, ***successful investing requires the ability to look wrong for a while and survive some mistakes.*** *Thus, each person has to assess whether he's temperamentally equipped to… take a chance on being great. Or as Charlie Munger told me, "It's not supposed to be easy. Anyone who finds it easy is stupid." In other words, anyone who thinks it can be easy to succeed at investing is being simplistic and superficial, and ignoring investing's complex and competitive nature. Why should superior profits be available to the novice, the untutored or the lazy? Why should people be able to make above average returns without hard work and above average skill, and without knowing something most others don't know? Superior investment results can only stem from a better-than-average ability to figure out when risk-taking will lead to gain and when it will end in loss. There is no alternative.*

Fortunately, our approach is not complicated: buy understandable businesses that are neglected or out of favor when we see a catalyst that will improve earnings, don't overpay and wait patiently while the story unfolds. The long-term rewards have been exceptional, but we always know that the next test is coming!

Happy summer!

*****The complete text of Howard Marks' letter is available online in PDF form by searching for "Dare to be Great II."