The Knowledge Project

Howard Marks:

Luck, Risk, & Avoiding Losers

EPISODE #53

fs

Shane Parrish: On the show today is Howard Marks, the co-chairman and cofounder of Oaktree Capital Management. He has authored two books, The Most Important Thing: Uncommon Sense for the Thoughtful Investor and Mastering the Market Cycle: Getting the Odds On Your Side.

The most famous investor ever, Warren Buffet, said of Howard, "When I see memos from Howard Marks in my mail, they're the first thing I open and read. I always learn something." And you're going to learn something too in this conversation. While it's wide-ranging, covering how to think better, how to position yourself to get the odds on your side, a little bit of investing in market cycles—but there's so much more to this. It's time to listen and learn.

Howard, I'm so happy to get the chance to speak with you. I've read your memos for years and this is exciting.

Howard Marks: Great. Thank you very much, Shane. It's a pleasure to be here.

Shane: Can you take me back to the financial crisis a little bit and explain, or at least illuminate for me, how it is that we had this series of events unfold, and you were able to have this "aha" moment and take advantage of it. What happened?

Howard: Crises are complicated, and it's hard to give a linear description of their formation. But in general, as we'll discuss later about the book, cycles are all about excesses and their correction. And so, the financial crisis grew out of excesses, which were then corrected painfully. And the excesses were basically a willing suspension of disbelief, an excess of credulousness, and there was too much faith in mortgages and mortgage-backed securities. And they were invested too heavily and too riskily by essential financial institutions, which then became precarious.

And you had Bear Stearns and Merrill Lynch and Wachovia Bank and Washington Mutual all disappear, or require rescues. And it culminated in the bankruptcy of Lehman Brothers on September 15, 2008. And now—I said in one of my memos, that in the real world, things fluctuate between pretty good and not so hot. But in the investment world, investors go from perfect to no chance of survival in their psychology.

And so, after the Lehman bankruptcy, people were talking about the end of the world, the end of the financial world, the meltdown of the financial cycle. And the truth is that it appeared to be—if you ever saw the Jane Fonda movie China Syndrome—it looked like a vicious circle that would absolutely go nonstop and go through the center of the Earth to Beijing.

And so, the question was, do we invest or not? First, does the financial system melt down? Now, this is something that could not be analyzed or proved or disproved or anything. It was not subject to intellectualization.

Shane: It wasn't knowable.

Howard: No. That's right. And so I took the stance that it's hard to predict the meltdown of the financial system; that if you think it's going to melt down, it's impossible to know what to do; that anything you might do to prepare for the meltdown of the financial system would be a disaster under any other circumstances. And most of the time, the financial world doesn't end. That was the extent of my analysis. And so I said, "Well, we can't plan on the end of the financial crisis."

Number two, do we invest or not? If we invest and the financial world melts down, it doesn't matter what we did. But if we don't invest and it doesn't melt down, then we abdicated our responsibility. We were hired by our clients to invest. If there's a crisis that does not culminate in the meltdown of the financial system, then that was the best of all possible environments to invest and we didn't invest. As the English say, full stop.

In other words, we had no choice. We had to invest. And so, we started to invest, and sometimes we thought we were going too fast and sometimes we thought we were going too slow. But for the last 15 weeks of '08, we invested an average of $650 million a week for a total of $10 billion. And the financial world did not melt down.

Shane: Isn't Wall Street full of people with this same sort of logic, who identified an opportunity? But what was the difference? Because one of the things that I'm so impressed with is, not only did you recognize it, but you actually took action on it. So a lot of people seemed to purport to understand what was happening, but they had an inability to act. Where did that come from?

Howard: Our emotions conspire at every turn to make us do the wrong thing. Maybe it comes from the fight or flight mentality, which is so deeply ingrained in us. But, as the economy does wel,l and companies report good earnings, and the media reports turn positive and the stock prices rise and people become more enthusiastic, it becomes very hard not to buy. In other words, emotion causes people to buy more, the higher prices go.

Now, in most walks of life, people buy more when the prices go down during sales. On Wall Street, they buy more when the prices rise. And then, let's say eventually things reach a top which is not maintained, now the economy turns down and the company is reporting decreasing earnings, or maybe losses, and the media put out scare stories. And the prices cascade down, now people get depressed. And when they approach the bottom, they say, "I just don't want to lose anymore. Get me out. I'm terrified. I don't know what to do. I feel so terrible about all the things I've owned, and so stupid." So in other words, emotion tends to get people to sell at the bottom just as they bought at the top.

Shane: And this applies to professional managers, as well.

Howard: Of course. Well, it only applies to people who have feelings. I quote in the book Richard Feynman, the physicist, who said that physics would be much harder if electrons had feelings. Markets—by the way, there's no such thing as a market. There's only a bunch of people who trade.

Shane: Talk to me about that. Why do we conceptualize it as a market then?

Howard: Because if you think of a market, most people flash to a photo of the New York Stock Exchange, a building, just as if most people...well, in my day, if you talked about a stock, people would think about a stock certificate. But the building is not the market and the stock certificate is not ownership of a company. These things are only signifiers. But, a market consists of a group of people who implement their views on value by transacting.

And so, that's all there is, is people. And people have feelings.

And so the emotions tend to get people to buy, buy, buy at the top, until the last potential buyer has bought and spent all his money—at which point the top is reached and the second derivative goes negative—and sell, sell, sell at the bottom, until the last person who's going to panic out does so.

And so, number one, it's very difficult to take these contrarian actions in the face of sentiment. And I don't know...I'm sure we're not the only person who did it. I don't know who else did it. Most people don't report their transactions, and most investors don't write the memos like I do. So I don't know who was thinking what at the time. I think we were exceptional.

Shane: Yeah, I mean, there's thousands of people who sort of manage money. And very few, I think, have been able to act on that in the moment.

Howard: Yeah, right.

Shane: And that's really interesting to me for a couple of reasons, right? One, you sort of overcame your evolutionary emotional programming. But two, I'm curious about how you test for that beforehand. How do you test how people will respond in a crisis before you actually have a crisis?

Howard: We had lived through some lesser crises. My partner, Bruce Karsh and I, who—Bruce runs our distressed debt funds, which is where most of this activity is centered. We lived through a severe market downturn in '90, '91, and another one in '01, '02. So, we had rehearsed. At the time of the financial crisis, I had been working 40 years already. I've seen some of these things. And so, hopefully we learn from experience. Hopefully at some point, our intellect, aided by dispassionate observation of our experience, can overcome our emotion. That's number one.

Number two, maybe Bruce and I are more unemotional than most. Number three, our very activity of investing in distressed debt is inherently contrarian. People say, "Well, how can you invest in companies that are bankrupt or destined to become so?" And at that point, we'd been doing that for 20 years. And if we succumbed to the normal view of distressed companies, we wouldn't be able to conduct that activity.

And finally, I think we are unusually supportive of each other. And we've been partners for 31 years. Neither of us has ever said to the other one, "Boy, that worked out badly. You did a stupid thing." This is not an activity where you can bat a thousand. And hopefully it's better than baseball, where the greatest bat 30% or 40%. Hopefully we can do 60% or 70%. But we can't bat 100%. And if you have a partner or an organization which second-guesses your mistakes, then you become mistake-averse. And we don't do that, so...and in this case, we worked together and supported each other. And we have a lot of respect for each other, and that permits it. And I think that that sets the tone for the organization, because it is not a blame- or finger-pointing organization. I think all these things help.

Shane: Can we geek out on this for a second? So, you have this thing where you're necessarily fallible. You're not going to bat a thousand, or 100%. And so, there's times when you're going to be wrong. How do you distinguish between being wrong and it just being a function of probabilities, or it being lucky and right? And how do you learn from those in a culture that—and I like the fact that you don't sort of assign blame, but how do you learn from that, how do you surface that?

Howard: I think for many of the things we're discussing today, I can't give you a recipe.

Shane: Oh, of course. Yeah.

Howard: I mean, I think that we have an above-average ability to detect risk and make investments that have upside potential with the risks under control. I think we have this ability you described, to understand the difference between bad decisions and bad outcomes, and this hesitation to point fingers when we get a bad outcome. And I think that all of these things start with a mindset. And rather than have a recipe or a roadmap, I think we have a mindset to do these things.

One of the reasons we're so good at controlling risk is that we put risk control first. We have a motto. If we avoid the losers, the winners take care of themselves. And that was fine when we invested in high-yield bonds, where a high-yield bond, if you buy it at par, the best you're going to get is interest plus par back. But there are lots of worse outcomes. So, we've concluded that if we secure against the worst outcomes, we'll get our interest and our money back.

So, those securities have no upside aspiration. Then we moved into areas like distressed debt, real estate, infrastructure, and power investments and private equity and so forth, where we do have aspirations, where we're trying to make a lot of money. And we have a record in distressed debt of, I think, 16% or 17% a year for 30 years, without using any leverage.

Clearly, we have high aspirations. Securing against losses is not enough. You actually have to find some winners. But we have retained our motto. Clearly, "if we avoid the losers, winners take care of themselves" is not enough in an aspirational strategy, like distressed debt. We have retained it because it signifies front-of-mind consciousness of risk control.

Well, look, I started Wharton 55 years ago last month. And the first thing I remember learning there is that you can't tell the quality of a decision from the outcome. And that pervades my thinking. And I think it's very important. And then I played backgammon with my good friend Bruce Newburg, out in Los Angeles, and you need some crazy number to win, and you get it. That doesn't mean you're a good player. It means you were lucky. And he always says that improbable things happen all the time and probable things fail to happen all the time, because the world is an uncertain place. If the things that were probable happened all the time, in theory, there would be no risk.

So, we understand that we're going to make decisions that aren't going to work, and the people we work with are going to make decisions that aren't going to work, especially in the short run. They may work in the long run, but in the short run, a good decision that didn't work can look an awful lot like a bad decision. But we have a mentality which recognizes that, doesn't criticize people every time something goes wrong, and we try to hire people who are not terribly emotional, egotistical, don't have a lot of hubris or testosterone. And I think we try to have a mellow organization, which is very helpful in all these regards.

Shane: How do you test for that when you're hiring?

Howard: Just talking. We don't run psychological tests or anything like...but you know, the first step toward solving a personnel or managerial problem is acknowledging it. So, if you put a high priority on hiring the kind of person I have described, you have a better chance of doing so. And we do.

Shane: I want to talk a little bit about cycles, which is what the book is about. What are sort of examples of the most important cycles? And maybe we can do a deep dive on the economic cycle, and including the role of governments and central banks.

Howard: Well, it's funny you should say that, because literally in the car coming here this morning, I was reading an article about—timely article—about the need for Fed independence and the—Paul Volcker is a great example of Fed independence, and some examples of Feds that were not independent and failed.

Shane: Volcker was the 80's—

Howard: Was the bull work.

Shane: Just for people listening, can we give context to....

Howard: Well, in the 70's, we had runaway inflation in America. Not like some African nation that had 1000% a year, but we had 16% a year, I think it was at the peak. And makes it very hard to live, and securities collapse and people have trouble keeping up with the cost of living and commodity prices get out of hand and so forth. And of course, short-term rates go up, which makes it hard to finance business and so forth.

So the main point about inflation is that I think it's very mysterious. It's hard to say what starts it, it's hard to say what stops it. Deflation they have in some countries like Japan, it's hard to know what starts or stops that. But obviously, it has a great impact on the economic cycle. And if you think about the economy, US economy grows, let's say for rounding purposes, on average 2% a year. Why doesn't it grow 2% a year? Why sometimes three and sometimes one and sometimes four and sometimes negative? And I think that—and unfortunately the book is already printed, and as you keep thinking about things and talking about them, your thoughts come into better focus. So I would summarize it as saying that cycles happen because people—not electrons, but people—commit excesses to the upside, usually out of enthusiasm, which then have to be corrected and those corrections overshoot to the downside. And—

Shane: And that's the investor psychology.

Howard: Yes, exactly. But it's the way the world works. I mean, you take a company. We're in a recession, we're coming out of the recession, the management sits around the table, says, "We're going to be in a recovery. There's going to be an increase in demand for our product and we want to get our share of the demand, of the increase in demand. So, we're going to build another factory, hire a thousand workers, and build inventories." And all the companies in the industry do the same thing at the same time, they all build factories, workforce, and inventories. That makes that an above average year in the economy.

Shane: Yeah.

Howard: But then it turns out that collectively, they built much more factories and workforce and inventories than they need to take advantage of the gain in demand in the recovery. And so they falter, and the next year they don't build those things. And that makes that a below average year in the economy. I'm oversimplifying, of course—

Shane: Success is sowing the seeds of its own destruction, in a way.

Howard: Exactly, yeah. And that's another description of cyclical behavior. It's interesting to look at the US economy. We're in the 10th year of a recovery. There's never been a recovery of more than 10 years. So, somebody was an absolutist would say, "Well, then that means that in...let's see, October...in nine months, the economy will stop going up." But of course, there are no rules. And Twain said, "History does not repeat." And that's one of the ways in which is does not repeat.

These limitations are not hard and fast. This has also been the slowest recovery since World War II, and that's a good thing, because that slow recovery—you see, one of the things that your listeners should note is that in the financial or investment world, where psychology is so important and there are no absolute laws of nature at work, everything has two sides. Every development has a positive side and a negative side. So the negative side of a slow recovery is that it's been slow. The positive side is that it hasn't been marked by excesses. And if it hasn't been marked by excesses, then that means we don't have to have a correction to the downside, which is called the recession, any time soon. So, my guess is that this recovery will set a record for the longest recovery in history, because of the slowness and the absence of excesses.

Now, in December, the government passed a tax bill, which is highly stimulative, because it cut the rates on corporations, not from 35 to 25 as most people have thought generous, but to 21.

Shane: Yeah.

Howard: And I would say that was over-stimulative. That tax bill will cut government revenues. And most people think that that will lead to an increase in the deficit and in the national debt. And that it was...I would say it was over-stimulative. And my reaction at the time was, and still is, that doctors do not give adrenaline to healthy patients. They give it to people who are having heart attacks. And we had a healthy economy. That tax bill stimulated it, I would say overstimulated it, unnecessarily. That will lead to excesses, which will then have to be corrected.

One of the way we correct excesses in the economy, preferably and hopefully less painfully, is through interest rate increases, because interest rate cuts are stimulative, increases are restrictive. And that will tend to diminish the growth in the economy and hopefully prevent types of inflation from taking hold.

So, it's Kabuki dance to try to get that balance right. And given that the tax bill was over-stimulative, it will probably need higher interest rates than we otherwise would have, which will increase the possibility of lapsing into recession.

Shane: What's the government's role in the economic cycle?

Howard: The most direct is the actions of the Fed, and of course that's...in theory, that is independent of government. But the Fed--central banks, which is what the Fed is, have for more than 100 years, basically been charged with controlling inflation. That is the number one job. Keep the economy on an even keel so that it grows, but not overheats causing inflation that has to be reined in.

In the more recent years, maybe 30, 40 years ago, the Fed was given another responsibility, which is to support employment. Now, this is problematic, because employment growth comes from economic growth. That's good. Too much economic growth, you get rising inflation. That's bad. So, they have two goals which are in opposition. And of course, that requires particularly a joint management, which is by definition not so easy.

And so, sometimes the Fed is too positive and you might get inflation, or you might get—I think that in some ways, the Fed contributed to the global financial crisis by being too accommodating. And I think that Greenspan was so accommodating of the need of the economy to grow, that—and kind of a cheerleader—that he permitted the perception of something called the Greenspan Put, which is any time the economy looks like it might have a problem, the Fed will squirt in some extra liquidity, and cut rates maybe, and that'll prevent the problem.

So, i.e., there will never be a problem. There will never be a slowdown. We don't have to worry about negative scenarios in doing our planning. It'll always be okay. And that's dangerous. Because if you eschew planning for tough times, then your planning will be overly biased to the upside, and when the tough times come, you're by definition not ready.

Shane: Outside of the Fed, does the government play a wealth sort of redistribution role? And how does that affect the economic cycle? I mean, we talked about the tax cuts.

Howard: Yeah. Well, of course. What people have to understand, maybe more than anything else is that governments don't make anything. All they do is redistribute. All they do. We have these millions of people working in Washington and all these Senators and Congress, all they really do is they collect money and they spend it. They don't make it. They don't have businesses which add value to our society.

And so, they make spending decisions and collecting decisions. These are policies. Taxation. How much from the rich, how much from the poor? How much from interest and dividends, and how much from salaries? And I've seen fluctuations in these things over the years, but this is policy. And then there are people who say we have too much inequality and it should be fixed, and there are people who say that they way to fix it is to get the rich to pay their share. Now I kind of bridle at that, because it seems like a religious or philosophical statement. It's not an economic statement. There is no such thing as a fair share, and the only question is, who determines the fair share? And my feeling is that the fair share is, by definition, when people say we're trying to get the rich to pay their fair share, what they mean is we're trying to get them to pay more than they pay now. But how do you define a fair share?

Shane: Right.

Howard: Right now, people we might call the rich, or certainly the people in the upper part of the income distribution, pay almost all the taxes, so this question of fair share is problematic. And then, how do you distribute it? Do you have welfare? Do you have guaranteed universal income? Do you have federally guaranteed jobs, et cetera? These are all redistribution questions. And A, no easy answers. And B, this is the main grists for politics, are the differences of opinion on this subject, one of the very most important.

Shane: I want to come back to get your opinion on universal basic income in a second, but before we sort of move on out of the economic cycle and the role of the government and the Fed and investor psychology...when I think about that intuitively, I think about it as a nation, a state. But we also operate in this global economy, where tax rates on businesses make it more competitive for one country over another, where interest rates make investment in one country more prone than another.

Howard: Yeah.

Shane: How do you think about that? Not only from the individual United States point of view, but then in the global sort of world that we live in?

Howard: First of all let me say, Oaktree is not what we call a macro-investor. We do not invest in broad themes of economic growth and movements and currencies and interest rates. But we are a micro-investor. We invest in individual companies and situations and properties and so forth. So, I don't do this for a living, but I am out in the world and I do tend to have opinions on these things.

Back in May of 2016, I wrote a memo entitled "Economic Reality." And basically what I said—our presidential campaign was going on at the time. In campaigns people always say things which do not comport with economic reality. In real life if we have $10, we can't have two $10 hamburgers. In politics, during campaigns, people say, "I'll give you two $10 hamburgers and it won't cost you anything and you don't have to choose between having two hamburgers and putting money in the bank," or what have you.

And so, yes, economic realities define the playing field and the rules. So for example, a nation cannot, or shouldn't, set its tax rates without reference to the tax rates in the rest of the world. One of the reasons we had to reduce our corporate tax rate is that our corporate tax rate was high relative to the rest of the world, which gave businesses an incentive to establish themselves elsewhere or move elsewhere to escape US taxation. And they can do that. And in "Economic Reality," I talked about the fact that there was an article in the paper that the highest tax-, the biggest taxpayer in New Jersey moved away—I happen to know him—and people can move if they want to. So, down in Venezuela they were running...oh, toilet paper was becoming too expensive, so they controlled the price of toilet paper and the price of toilet paper couldn't go up. Guess what? You can't make people produce toilet paper. And they said, "If we can't raise our price to reflect the cost of making toilet paper, we're going to cut production." And now, it's even harder to get toilet paper.

So, this is economic reality. And if we say, "Well, are we going to balance the budget by taxing the rich?" Raise tax rates on the rich, they move away. We saw this in France, I think it was Hollande—put a 75% tax rate on the wealthiest Frenchmen and they move away. This is economic reality in action. And—

Shane: Presumably, the rich are also the...I mean, it's easy for them to move away, too, right?

Howard: Exactly. That's right. Look, in the new tax bill, they changed the tax deductibility of state and local taxes and mortgage interest. And as to the state and local taxes, there are seven states in America that have no state taxes. So, you have a lot of incentive to move from New York and California and New Jersey and Connecticut and Illinois, to Florida, Texas, and Nevada. And as you say, the working man may not be able to do that. But the person who lives off his investment portfolio can do that in a heartbeat.

Shane: Yeah.

Howard: And since I moved to New York five and a half years ago, I've run into a lot of people and I'll say, "How do you like living in New York?" "Oh, I don't live in New York. I live in Florida."

Shane: Right.

Howard: I only come to New York 181 days a year.

Shane: Because that's the maximum permissible before you—

Howard: Right. And government can't undo by fiat, in the long run, the things that economic reality requires. It's very interesting, I think.

Shane: But the same thing is playing out with countries, not just people. And that's impacting where companies locate, it's impacting where tax dollars go. How do you think about that on...even if you come up with a global agreement, the cost of defection is a huge advantage, and probably very little sort of disadvantage if you're caught.

Howard: Well, and when you say "if you're caught"—nations will cheat.

Shane: Right.

Howard: And every time—

Shane: It's incentive.

Howard: Every time we have commercial treaties, you get a little cheating around the edges and the cheaters get away with it for a while. And this will always be the case.

Shane: How would you do things differently if you were sort of in charge of, not only the US government and the economic cycle, but broadly, how would you conceptualize how the world would best be maximized? How do we unleash that potential across the globe?

Howard: Well, that raises a real interesting question, Shane. And you used the term maximize. And the greatest contributor to global economic maximization is globalization. I mean, let's say you have two countries, mine and yours.

Shane: Yep.

Howard: And we're really good at raising sheep, and you're really good at turning leather into shoes. And so, we raise the sheep and when they're ready, we send the hides to you, and you make the leather into shoes. And this system produces 100 pairs of shoes a year. And then, some politician erects a wall. No more trade in sheep, leather, or shoes. Now, I'm good at raising sheep, but I have to try to learn how to make shoes. And you are good at making shoes, but you have to learn how to raise sheep to get the leather.

Shane: Yeah.

Howard: And so, in this new world, I can only produce 40 pairs of shoes and you can only produce 40 pairs of shoes, because we're not doing what we're good at. We have to do what we're bad at also. And in this new system, there's only 80 pairs of shoes. In the old system, which was humming, there were 100. And that's called the benefits of specialization. And globalization is in opposition especially to negating the benefits of specialization.

And so, the administration in this country says we run a big $800-billion trade deficit with China, or whatever the number is, and that shows that A, they're winning and we're losing, and B, they must be cheating. They're taking advantage of us and we're going to stop that. And this is a total ignoring of economic reality.

When you go to the barbershop, you get a haircut, you pay the guy $20. You run a trade deficit with him.

Shane: Yeah.

Howard: He's taking in $20 from you, you're not taking in anything from him. So in those terms, he's killing you, trade-wise. But you're not unhappy. He gets the money, you get the haircut. So, when we run a trade deficit with China, most people weren't unhappy. Why? And so, let's say the number is $800 billion. I don't remember. If we run an $800-billion trade deficit with China, what does it mean? It means we bought $800 billion more of Chinese goods than they bought of American goods. That's what a trade deficit is.

Why do we have a trade deficit? Because we would rather buy their goods, which are some combination of better and cheaper, and they're not very motivated to buy our goods because number one, we don't manufacture that much and what we manufacture, by their standards, isn't better and cheaper.

So, we get cheap goods. And if we say we're going to stop the trade deficit, what it means is we're not going to have access to the cheap goods. Now, I saw the president on TV the other day. And he said, "You just don't understand. We've taken billions, we've collected billions from the Chinese in tariffs." Well, not economic reality. Chinese don't pay tariffs. Tariffs are paid by consumers of goods. We have collected billions in tariffs from US consumers of Chinese goods.

Shane: Paying higher prices.

Howard: Paying higher prices. I don't know if they're happy. Everything at Walmart just went up. Is that good or bad? Now presumably, there would be two reasons for the imposition of these tariffs. Well, maybe three. One is, I would say, some machismo. Another is that China is cheating in some ways on trade and we want to punish them until they stop...and everybody tells me there's some truth in that. And then the third thing is that we want to protect US jobs. And it clearly can be a combination of all three.

And we've lost...I think the estimate is that we've lost three million jobs to China over the last, let's say 15 years. So, let's say the tariffs reverse that process, we get those three million jobs back. That's a good thing. And to do so, we impose tariffs which require 100 million Americans to pay higher prices for the things they buy every day. That's a bad thing. Is that justified? Is that good for America or bad? And those are the kind of decisions that Washington makes in their judgment.

Shane: It's really interesting to hear you say that, because that's not the type of conversation we hear around that. We hear the sound bites, the bullet points, right?

Howard: Right, sure.

Shane: The jobs are good.

Howard: Okay, so May 2016, "Economic Reality." August 2016, I wrote a memo called "Political Reality."

Shane: Yeah.

Howard: I said political reality is totally different from economic reality. The politician says, "I can get you everything you want without any sacrifice."

Shane: It's not going to cost you anything.

Howard: "Vote for me. And you can have it all, you don't have to choose." Economics, if you think about it, is really the science of choices. And clearly it's not true, but people can say anything on the stump they want, and you can't sue a politician for making a promise that he didn't come through with. And they do. But we have to make choices.

Shane: How is the reasonable sort of person to make choices in a world where they have to elect officials, but the tone and the quality of that conversation is just ... I don't know, to me it seems absurd on a lot of levels.

Howard: Well, the tone and quality is ridiculous. I mean, it has lapsed into just vilification of the other side. Tribalization of opinions. Great article this week by David Brooks in The New York Times on the differences in thinking between the extreme left and the extreme right, and the difference of opinions on things like the level of racism in this country and that kind of thing. They just think totally differently. And as a consequence, they can't communicate at all. And part of the reason is that I have a position, which is different from yours. And I tell you the good things about my position and you tell me the good things about your position. I never admit to the bad things about my position, or vice versa. And we don't have a respectful, honest discussion. We just try to fight for our side.

Part of it is, what percent of, let's say Americans, understand economics? I mean, economics is really convoluted. And what percentage of people—all right, now we have tariffs. There have been tariffs in the headlines for the last six, nine months. How many people understand what a tariff is? How many people understand that the Chinese don't pay the tariffs, Americans pay the tariffs? And pretty soon, when the events surrounding my new book die down, I'm going to write my next memo and I'm probably going to touch on tariffs and all the things that nobody understands about tariffs. And there are so many.

You know, you put a tariff on imports of steel and aluminum to protect American manufacturers of steel and aluminum. But that means that American manufacturers of motorcycles who use foreign steel are at a disadvantage relative to American manufacturers of motorcycles who use domestic steel. Do you want to disadvantage some American companies relative to others? And they're at a disadvantage relative to foreign motorcycle manufacturers. Do you want to disadvantage American companies relative to foreign? It's not easy.

And why? Because a tariff is an attempt to regulate the economy by rule in contravention of economic reality. You have somebody who can produce steel cheaper than you. You put a tariff on to fix that, but it has all these ramifications, all of which are, shall we say, unnatural.

Shane: What do you think personally is a better option?

Howard: Oh, so let me ... There's one thing I have to interject that I left out. So globalization leads to global maximization. And world economic product is maximized by globalization. It's a winning strategy. However, at the individual level, there are winners and losers.

Shane: Right.

Howard: Because in my example, all the people who used to make shoes in America were forced out of business because they didn't do it well. And all the people who used to raise sheep in Canada are forced out of business because they didn't do it well. And then you get into the question of whether the American advantage in raising sheep is the result of government subsidies, et cetera, and then you pass a rule against subsidies, et cetera.

So, I have to confess, Shane, I've never thought I had the answers on these things. But I think that I could help participate in an honest and open discussion of the issues—

Shane: I think that's where it starts, right?

Howard: Yes. And hopefully, thoughtful, honest objective, not highly partisan, people could come to a decision which maximizes the welfare for the most people. But still of course, there will be losers. And then one of the differences between the two political parties in this country is, what do you do for the losers?

Shane: We don't want anybody to lose, right? I mean, that's part of the issue, is—

Howard: Well, we don't—no. Some don't want anybody to lose. I had a stepmother who thought everybody should get a vacation in Las Vegas and color TV.

Shane: Yeah.

Howard: Or I would rather say, we don't want anybody to...any of the losers, and of course it's hard to use that word—but losers in this process—to suffer.

Shane: Right.

Howard: You have to have winners and losers. And I used to say to my stepmother, "Well, why don't we pass a law that says that when people go to the casinos in Vegas, they can't lose. There can be people who win and people who break even, but nobody can lose." Well—

Shane: I want to go to that casino.

Howard: Right, me too. But it would only be open for an hour and then they'd figure out that they should close it. And so, you...again, you're trying to contravene. You have to have losers and winners in the free enterprise system. If you don't want winners and losers, switch to the socialist system or communist system, in which they were only losers.

Shane: I think personally, I mean for me, I think of it as people trying to have equal opportunity, but outcomes should not necessarily be equal. And part of that is work ethic, part of it is luck. There's a whole bunch of factors that go into that. But ideally, I mean, I would love to live in a world where everybody had equal opportunity to flourish.

Howard: Well, of course you can't produce that, because we are born with advantages of birth, of where we're born, of which schools we go to.

Shane: Yes.

Howard: And I wrote a memo in January of 2014, which happens to be the memo that got the most response, and it was called "Getting Lucky." And it was on the importance of luck, the roll of luck. And I talked in there about a dozen ways in which I feel I've been lucky. I think I've been the luckiest person on the planet. And I think it was to that that people were responding. But I get into arguments with people and a lot of people say, "Oh—!" Well, what started the article is, I read a piece that quoted some Silicon Valley guy who says, "Success is never accidental. You make your own luck." And I don't agree. I think luck is a real thing and it's important and it's inherently unfair, but that's life.

And so, I get into the arguments with people and I say to them, "Okay, how about your IQ. What did you do to deserve, develop, or nurture your IQ? You were born with a brain that works better than others." That's luck.

Shane: Yeah.

Howard: And it's totally—it's not merit.

Shane: We convince ourselves that we did something to foster that or improve it, but—

Howard: Well, I don't. I was just born lucky.

Shane: Yeah, me too.

Howard: And Buffet talks about the ovarian lottery.

Shane: I think that's a great concept that people really misunderstand.

Howard: Yeah. Well, they really do. And let's say we get over the hurdle of agreeing that there is such a thing as luck and then we say that some people get it and some people don't, and that's inherently unfair. I think the next step is some people might say...I mean, it's conceivable to imagine somebody saying, "I'm kind of down, because I realize that my success came from luck and that depresses me." But me, I think my success comes from luck and am ecstatic about it.

Shane: It's great, yeah.

Howard: Because I feel I've always been lucky, and why shouldn't I keep being lucky? And it's great to go through life with a positive attitude and I think that my good fortune in the past contributes to my positive attitude with regards to the future. Now, that's probably illogical, because lucky events, in theory, may be independent. But I think that I will continue to benefit from my good luck. And the philosopher Cicero said something beautiful. He said, "The thankful heart is not only the greatest of all the virtues, but it is the parent of all the other virtues." And I think what that means is that people who are lucky should thank their luck, acknowledge it and revel in it. I think it will also make them want to share the fruits of their luck with others.

Shane: That's a great segue into—so, we talked about sort of unequal outcomes, but equal opportunity. And when people don't have equal outcomes, one of the things that's come up is sort of a universal basic income. How do you think about that?

Howard: On the one hand, we don't want anybody to starve. And we feel terrible about children who grow up in the unlucky circumstances, and don't have exposure to a good education and good nutrition and things that help them stay out of trouble and develop a positive self-image. And so, that tends to drive on, shall we say, the Left, which is more concerned about the unequal outcomes and wants to fix them. And I do not want to see the unfortunate among us suffer, live in extreme poverty. And we've been doing quite well as a world, in terms of fighting extreme poverty.

Shane: Do you view that nationally or globally? When you say that comment, is this—

Howard: Well, I think globally. I was reading the book Factfulness, and it says that if you ask people what percentage of the world's population lives in extreme poverty, most people would say a much higher number than is true.

Shane: Yeah.

Howard: And I think that the number has been coming down. And the other thing is that I think that people who live in what we describe as poverty, poverty today might be even better than most people lived 200 years ago, in terms of quality of life. But the problem is that we get a lot more from our work than just our income. And—

Shane: Because we feel like we're part of something, or contributing?

Howard: Yeah. Well, we feel part of something, we get self-satisfaction, we understand that we are able to do things, we understand that we are producing our own subsistence. And we have colleagues, we have a team effort, we work together with others on things and we accomplish them. And there's so many benefits to work. Now, the truth is that the work I do and the work that people who do manual labor is not too much the same. They may not love their work the way I love mine.

One of John Kenneth Galbraith's last books was...he had an essay, maybe I would call it a rant, on a subject that...it's ridiculous that we use the same word to describe what a CEO does and what a road worker does. We say work. But clearly it's not very much in common. But the truth is, we get great benefits from work. And universal basic income will not give those benefits. It'll only feed the physical needs.

And so, number one, there was a big debate under Clinton about welfare and we reduced welfare, because we thought it gave bad incentives and it got people into bad habits. And I think that's probably right. And universal basic income probably would do so.

And so, I think that the universal basic income idea would go some way to keeping people from starving to death, which of course is important, and children from being malnourished and mal-clothed, but it's not going to solve the problems of society. And I don't know what is, because I think that automation and the elimination of jobs is one of the biggest problems we face in the long run, and it may exacerbate the need for universal basic income, or—some progressive candidates now say—guaranteed jobs from the government.

Shane: Talk to me about that sort of change with the, we'll call it technology and automation and AI and machine learning. How is that similar to other sort of, I want to use the term revolutions, but.... And how is it dissimilar in your mind?

Howard: Yeah, I was invited down to Tulane University. They had a speaker's program, and I think I was the first speaker at the business school after the school was repaired after the terrible hurricane they had down there. And my hosts took me to dinner in Basin Street, and one of the things they told me about was that New Orleans and the environs were a thriving metropolis, economically thriving metropolis, in the days of agriculture. And of course, millions of people had jobs in agriculture. And then agriculture became automated, those people lost their jobs in agriculture, and they moved to the upper Midwest to make cars and appliances. And then that was...they thrived and the people who worked in those industries, who really maybe only had a strong back as their main asset, did very well. They had unions, they had strong unions, the unions gave great packages for them and they did very well.

But then of course, we globalized and the manufacturing of cars and appliances moved overseas, and since then, the unions have been in decline on the private sector side. And now, what do you do if your only asset is a strong back? I think President Obama on the stump said, "Well, we'll give more laptops." But not everybody can work a laptop enough to make a living. And number two, in the information age, by definition, we need fewer people to produce GDP than we did in the days of physical labor. So, it's a big problem.

Now, I was talking about the fact that China took three million jobs from us. I believe I'm accurate in saying that from '79, roughly, to today, our manufacturing output in this country has doubled.

Shane: Okay.

Howard: We don't think ourselves as being great manufacturers, but I think that we sell, measured in dollar terms, which is of course the only way you can measure it, we sell twice as much today as we did 40 years ago. And 40 years ago, we had I think about 19 million people working in manufacturing. Today, we have 12. So, we have twice the outcome, output, with a third less workers. Which means that the output per worker has tripled. If the output per worker hadn't tripled, we'd have three times as many workers.

Shane: Right.

Howard: Making the same amount of goods. Rather than 12, we'd have 36 million employed in manufacturing. And so, I wrote in...I think this was in "Economic Reality." I wrote if you want to solve the problem, all you have to do is bans gains in productivity. But of course, that would be silly and that would not be economic reality, because somebody else would implement those gains in productivity and eat our lunch.

But the point is that we have probably lost 24 million jobs to increasing productivity over the last 40 years, compared to three million that went to China. And that shows you the scope of the problem and the location of the problem. And the problem is not China. And—

Shane: And knocking on the door is self-driving cars. And I think driving is the single largest job category in the—

Howard: That's right. And self-driving cars are going to be a big issue. They're going to—by the way, not only will they put—I mean, this is a utopian world that may be decades away, but not only will they put all the taxi drivers, bus drivers, truck drivers, limo drivers out of business, but think about the body shops. Because self-driven cars won't have any accidents and the paint shops, and the—

Shane: Steel, because they're require less sort of....

Howard: That's right. And the insurance companies, because you won't need insurance adjusters since there won't be any accidents to inspect. And then take it further down, people won't want cars. They'll do with cars what they do today with bicycles. In New York, you'll have a supply of cars, you'll pick one up, drive it for a few hours and drop it off and somebody else will pick it up. So, the average car, take a guess. The average car in America, and I can't even...it's hard to think about all of America, but how many hours a day is it used? Two?

Shane: Yeah.

Howard: Well, that means if we could increase the utilization of cars by having them drive themselves, you punch into your number where you need a car, it comes to you, picks you up and takes you where you want to go, that we would only need 1/12 the number of cars. So think of all the number of people who'd lose their jobs in the auto industry. And because the auto industry contracts, then the steel industry and so forth. So, where do those people get jobs? It's hard to imagine.

Shane: And yet, we've faced this before, haven't we?

Howard: That's what people say to me, "We've faced this before." And that's why I went through recitation about people moving from agriculture to appliances and cars. And so, the optimist says we've faced it before and jobs don't go away, they just move around. I don't have a good enough imagination to picture that world.

Shane: You're not optimistic on this?

Howard: I'm not optimistic. And I try to be an optimist, but I try not to be a stupid optimist. And what do they do? If they don't drive cars, do insurance adjusting, fix cars, build cars, or make steel, what do they do?

Shane: So, what's different about this one that causes you to be less optimistic?

Howard: It's the march of technology.

Shane: Is it the sheer volume of number of people displaced?

Howard: Well, it's the volume of people displaced and the fact that their jobs will not be done by other people. They'll be done by machines. And—

Shane: Who are doing them at an equivalent or better level than they were.

Howard: And much faster.

Shane: Reduced variability.

Howard: Yeah, there's a joke, Shane, about the factory of the future. Do you know about that? It'll have one man and one dog. The dog's job will keep the man from touching the machinery, and the man's job will be to feed the dog.

Shane: Sounds like the Amazon Go store I was in, in Seattle last week, where you just.... Literally, there's one person standing at the front explaining how you download the app and swipe in, and then you just go in and grab stuff and walk out.

Howard: Right. And so, there's one. There used to be 10 people working in the bookstore.

Shane: Yeah.

Howard: What are the other nine doing? Are there new jobs to.... You see, when people stopped working in agriculture, there were the new industries of autos and appliances. Will there be new labor-intensive industries to give jobs to the nine people who lost them in the bookstore?

Shane: What do you think that'll do for wages of blue-collar sort of jobs?

Howard: Well, you're seeing it already. In this rising income inequality, the people who have capital or technical education skills are doing very well. And the people who don't have those things are doing very badly. Don't you think that'll just continue? The people who can develop the personless bookstore or the robot will be in great demand, and people who can create artificial intelligence will be in great demand, and very valuable, and they'll all live in a small community just south of San Francisco. And the people who can't do any of that stuff and get displaced from their jobs will do very poorly. And this is dystopian and I hate myself for thinking that way, but I'm not optimistic about a solution.

And by the way, let's be generous and say that there's a possibility that government could solve this or help. Not this government. This government—by which I mean the current state of affairs in Washington. I'm not talking about a person or a political party. This government can't solve any problems, because they can't agree on anything. I think if there were a solution to this problem, it would be a big solution. It would be a national solution and revolutionary, and would require bipartisan support for something pretty radical. Hard to believe.

Shane: And that seems to be getting increasingly difficult, not only here, but around the globe from...I mean, what I'm exposed to.

Howard: Sure. The tribalization of views, exacerbated by the polarization of the media.

Shane: But is this part of a natural cycle? Like, we become more extreme and then we come back together? Or am I just trying to be optimistic about it?

Howard: Oh, I'd like to hope so.

Shane: Yeah.

Howard: I'd like to hope so. I'd like to hope that eventually you have experiences which are so bad that you say, "We can't run that way anymore." But things probably have to get pretty bad for it to happen. My greatest interest at the present time, in the political world, is in bipartisanship. And I'm supporting an organization which exists, no labels, to support bipartisanship.

Shane: Yeah.

Howard: And we're hopeful. But most people say it quixotic.

Shane: I want to go back to the days where both sides of the aisle used to go to social engagements with each other and talk and try to find reasonable solutions, instead of avoid each other and—

Howard: Me, too.

Shane: —polarize everything.

Howard: Right.

Shane: I want to come back a little bit just to investing. One thing we didn't talk about that I really want to get your thoughts on is, what is risk? How do you define risk? Not only in investing, but risk in general.

Howard: Well, risk in general, what is it? It's the probability of bad outcomes. In academic investment theory, they say it's volatility, the volatility of prices, the volatility of returns. Now, I believe—and that was a view basically developed in the new theory of investing, and I would say basically at the University of Chicago in the early 60's. And I was very fort—I talked before about my luck. One of the things I was lucky about is, I went to Chicago in '67 and I was among the new classes taught the new theory. And any time you're at the front of the line, it's an advantage. And that put me at the front of the line.

But in the new theory, there are all these processes and equations which concern risk and return, and how you optimize return relative to risk. And you have a formula, you need to plug something in for risk. And they plugged in volatility. Now, I don't think volatility is risk. I think risk is the probability of bad outcomes, but why did they use volatility? Because it exists. You can say, "How volatile was this asset or asset class in the past?" and we'll extrapolate that to the future. And if you don't use volatility, there's no other number available, because there is no number that you can observe historically for the probability of bad outcomes at various points in time. But I think that risk is the probability of bad outcomes.

Now my thinking, fortunately, is always evolving. And I wrote my last memo on risk in 2015. It was called "Risk Revisited Again." And I talked about risk as being the probability of loss. And for most investors, loss is the bad outcome they're concerned with. But, the truth is, we really should talk—if it's the probability of bad outcomes, there are really at least two risks that we should think about. One is the probability of loss and the other is the probability of gains that you miss out on.

Now given the way people are wired, we care more about losses than we do about gains foregone. And an investor who works for somebody else is more likely to get fired for losing money than for missing out on opportunities.

Shane: Right.

Howard: But the point is, I go through this only to say that they're bad outcomes and we should think of risk in terms of both.

Shane: Does that imply we know the range of outcomes that are possible? I mean, what about uncertainty?

Howard: So, in this memo...which anybody who's interested in risk, I strongly recommend they read it. By the way, all the memos that I've been talking about, all the memos I've written in the last 29 years are available at www.oaktreecapital.com, under the heading of "Insights." Hopefully there is some insight there. And they're all free, and anybody can go on and read them and download them and sign up for a service that will notify you the next time one comes out and you can download that. And I hope people will.

Shane: We'll include a link on the page.

Howard: Thank you very much. That's great. But there was a great economic philosopher, investment philosopher is how I describe him, named Peter Bernstein. He died about 10 years ago. And I quote him extensively. The reason that "Risk Revisited" was revisited again, and thus the title "Risk Revisited Again," is because I found a memo from Bernstein from '07 on my desk in 2015. My desk can be messy. And I incorporated a lot of what he wrote. And he said, "Risk exists because the future is a range of possibilities."

There was a professor at the London Business School, Elroy Dimson, who said, "Risk means more things can happen than will happen," which is a brilliant summation. But risk exists because the future is uncertain. "There's a range of possibilities," Bernstein says. Sometimes we don't even know what's in the range, in answer to your question. And sometimes we think we do, and sometimes we're right about that and sometimes we're wrong. But I think clearly the upside is that in order to manage risk, you have to have a view of what the probability distribution of future events looks like, what's most likely, what's least likely, and what's in between. And you can only make your decisions on the basis of that probability of distribution.

Now, the first key is that you have to do it right. If you start from the wrong probability distribution, you're unlikely to find success. But number two, it's essential—and this returns to a theme you and I discussed an hour ago—it's essential to bear in mind that even if you know the probability of distribution exactly right, you still don't know what's going to happen.

Shane: Right.

Howard: The difference between probability and outcome, as Bruce Newburg says. And—

Shane: It's like a roulette table at the casino.

Howard: Well, I use the example of a craps table.

Shane: Sure, yeah.

Howard: And Bruce and I play backgammon all the time. Backgammon is run by dice. So, you throw two dice and there are 36 possible outcomes. Each die has six sides, six times six, 36. And we know with 100% certainty what's possible.

Shane: You're going to get one of those outcomes.

Howard: We're going to get one of those outcomes. And we know that of the 36 outcomes, six of them are seven. Six-one, one-six, five-two, two-five, four-three, three-four. So, there are six combinations that give seven. It is the most likely outcome.

Shane: Right.

Howard: There are five combinations that give six and five that give eight, and from there on the probabilities recede. So we know which numbers are most likely, somewhat likely, unlikely. We still don't know what's going to happen.

Shane: Right.

Howard: It's only what the tendency would be on a given roll, and probably if you do enough experiments in the long run, that's what you'll get. If you roll 1,000 dice 1,000 times, 366 of the outcomes will be seven.

Shane: Yeah.

Howard: But in one roll, anything—

Shane: You have no idea.

Howard: And that's the difference between probability and outcome. And that's where the uncertainty comes in, the risk. And in economics, we make decisions based on what's called the expected value, which is you enumerate the possibilities, you assign probabilities, you figure out which course of action has the highest probability weighted value. But some—maybe the action which has the higher expected value includes some possible outcomes which are unsurvivable.

Probably the activity which could produce the highest expected level of elation for me might be cliff diving. I don't like the bad outcomes, so I'm not going to engage in cliff diving. And similarly, the highest-returning investment activity might be venture capital investing, and somewhere in the probability distribution for any venture capital fund investment is the possibility that all the investments turn out to be valueless.

So, if I'm a conservative investor, I'm not going to do that. And so, we can't just invest on the basis of the probability distribution and the expected value. We also have to take our own tolerances and predilections into account.

Shane: I like expected value as sort of like a model or a lens into making better decisions. One of the other ones that you've talked about is sort of second-order thinking.

Howard: Yes.

Shane: Can you explain a little bit about that? And then what would be really interesting is to go into other sort of mental models you commonly use to conceptualize problems and think about them.

Howard: Well, what I call second-level thinking says this**:** The goal in investing—investing is a funny activity. It's really incredibly easy to be average. And average is usually not too bad. And if you're willing to settle for average, you can do it with very little risk and very little...excuse me. Very little risk of being below average, and very little cost. You buy what's called an index fund. If you say, "I will be"—that the S&P 500 stock index represents average stock market performance—"I'll be happy with the return of the S&P 500." You invest in an index fund, which invests in all the stocks in the S&P 500 in a certain weighting. The cost is very low, because there's nobody making any decisions.

Shane: And you're not investing time either, right?

Howard: No time.

Shane: There's not any time cost.

Howard: And you're absolutely guaranteed against falling short at the expense of not being able to exceed. So, it's really easy to be average. Those of us who work in the investment business, clearly we shouldn't be well paid for producing average results, and certainly not below average results. But there should be, there can be generous rewards for being above average. That's our goal, that's my goal, to be above average.

Now, next paragraph. If you think the same as everybody else, you'll take the same actions as everybody else. If you take the same actions as everybody else, you'll have the same performance of everybody else. And that by definition cannot result in above average results. So, you can't think the same as everybody else. You have to diverge from the thinking of the herd at some point in time. And if you do and you're right, then you will probably do things which are different from that the herd does and you'll have above average performance.

There's problems with that, however. Which is that there's a concept developed at the University of Chicago in 1964 called the Efficient Market Hypothesis, which says that the market does a good job—I'm going to take off some of the absoluteness of the hypothesis—that the market, that is the consensus of all investors, does a good job of incorporating the available information at a point in time. Which is to say that most of the time, the consensus opinion is close to the truth and can't be improved upon.

Now, that creates a problem, vis-à-vis the desire for second level thinking. Because to be an outperformer, you have to think different from the crowd. But most of the time, the crowd is about as close to being right as you can get.

Shane: Right.

Howard: Most of the time, shall we say idiosyncratic thinking is not right.

Shane: Right.

Howard: Ergo, the problem. So, to be an above average investor, number one you have to think different from the crowd. But number two, you have to be right. So, second-level thinking is thinking which is different and better. And by definition, if you think about it, very few people can do it. My mother used to say it's the exception that proves the rule. And exceptional people think different from the crowd, and better than the crowd. But by definition, they're exceptional. This isn't Lake Wobegon, the fictional Lake Wobegon, where all the children are above average.

And—I mean, my last book was called The Most Important Thing, and it has 21 chapters and each one says, "The most important thing is," and then it's a different thing. Because in investing, there is no one important thing or one clearly most important thing. And there are 21 things, all of which are essential. They're like bricks in the wall. You can't remove one, in my opinion.

And I've devoted the first chapter to this concept of second-level thinking. And the way you make...most people have no idea how to be a successful investor. I mean, intellectually, they don't—they have no conception of the process. The way you become a superior investor is you look at things. You see things other people don't see. Most people make mistakes concerning a given company, they get too excited and price too high. They get too depressed and toss away its stock at a price which is too low. You have to see the mistakes that others are making, understand what they're doing, understand why it's wrong, hold a different point of view, and be proved right. That's a difficult recipe. But, that's what you have to do to be a second-level thinker.

So, in the chapter I give some examples. The first-level—and this is the simplest and the clearest. The first-level thinker says, "This is a great company. We should buy the stock." The second-level thinker says, "It's a great company, but it's not as great as everybody thinks. The opinions which are incorporated in the price are too optimistic. And when it turns out that they are too optimistic and when the truth comes out, those hopes are going to be dashed, the prices are going to fall. So, we should sell the stock."

Now clearly, the first-level thinker is simplistic. Good company, buy the stock. The second-level thinking requires a more convoluted discussion. Many more words, more time. A lot of the concepts of second-level thinking are by definition counterintuitive, which by definition elude most people. That's the definition of counterintuitive. So, it's not easy, but it is a necessary condition for being superior.

Shane: But you can sort of train yourself to think in that way.

Howard: Well, can you or can't you? Some people are naturally born contrarian and some people don't get contrarian thinking. And one of the things I say, Shane, is that everything that's important in investing is counterintuitive.

Shane: Right.

Howard: And everything that's obvious is wrong. So you go up to 100 people on the street and you say, "Here's a company that—tech company—and everybody's buying it and the stock has tripled in the last month. And we should buy it." A large percentage of the people will say, "Yeah, that makes perfect sense." Some small percentage will say, "No, if it's tripled in the last month, it's probably some kind of a boom, which means that it has become unjustifiably popular. And if everybody's buying it, we should sell it." That's contrarian thinking.

Shane: Right.

Howard: That's second-level thinking. And I think that that...a lot of people.... Look, I've thought about this a long time. I've made my money in asset classes that, when I got there, were unpopular, like high yield bonds in 1978. And I thought to myself, if you went up to a bunch of people in the straight world, the straight investing world, and you said, "You should buy this because nobody else is," most of them will say, "What are you, crazy?" If they're not buying it, by definition, it has no merit. And we can't do that. And anyway, we don't want to do something which is different from what everybody else is doing, because if it turns out to be a mistake we'll look stupid.

Shane: How important is that ability to look stupid, in terms of outperformance?

Howard: It's essential. It is one of the most essential ingredients. And again, I wrote a memo. Back in, well, in '06 I think it was, I wrote one called "Dare To Be Great." And I said, "In order to be great, you have to dare to be great." And then in '14, I updated it, "Dare To Be Great II." And I said, "Everybody dares to be great. The question is not, do you dare to be great? The question is, do you dare to be different?" Because clearly by--to diverge from the pack is required if you're going to be a superior in anything.

And number two, do you dare to be wrong? Number three, do you dare to look wrong? Because even things which are going to be right in the long run, maybe look wrong in the short run. So, you have to be willing to live with all those three things, different, wrong, and looking wrong, in order to be able to take the risk required and engage in the idiosyncratic behavior required for success.

Shane: I want to come back to something you said about thinking the same as everybody else. How does that change the information that you consume? And how do you go about the opportunity cost? I mean, you have a lot of things on your desk, there's a lot of books to read. How do you think about that?

Howard: At some point in the process, and it's probably a different point for everybody, you have to think about, again, this idea of counterintuitive. I think what most people think, who think about investing, is that if good things happen, you'll make money. Not necessarily so. It all depends on expectations. If the expectations are too high, then you could have a favorable event and it could disappoint people.

So people think, last year the company made $1 per share, next year they think they're going to make $2 a share, earnings doubling, that's exciting, they bid the stock up, and the earnings come out at $1.75. Now earnings going from $1 to $1.75 is certainly a good accomplishment, but most people are disappointed and the stock falls.

And so, I think at some point...look, the people who work here spend all their time trying to figure out what is. And they try to know what is, that is to say what is this company about, what will it be worth down the road, what will it accomplish, and so forth? And they try to know those things better than others.

Shane: Right.

Howard: But I think an important element in the process is, you have to stop at some time and say, "What do other people think? Why do they think it? Why do they diverge from me? What makes me think I'm right and they're wrong?" You have to plumb those differences. The term you might use, that I like to use sometimes, is variant perception. If you think about everything the same way everybody else does, you can't have an exceptional return. If you think differently and it turns out better, you have an exceptional return. If you think differently and it turns out worse, you have a horrible return. But clearly you can't distinguish yourself if you think the same.

And so, you know my son. And when he was training as a young investor when he was in university and starting to think about a career in investing, he would come to me and he would say, "Well, we should buy the stock with Ford, because they're bringing out this new Mustang and it's going to be terrific." And I always, for pedagogical purposes answered him the same way**:** "Who doesn't know that?"

See, let's say Ford is going to bring out a Mustang and it's going to be fabulous. But if everybody knows it, then the expectation of the success of that car is already reflected in the price of that stock, and the event will not be a profitable one. It'll be favorable for Ford, but it will not be profitable for investors.

So, it all comes from seeing things that others don't see. Another way to say that is, it comes from taking advantage of the mistakes that others are making, which results in thinking which is different, which is right. That's the laundry list.

Shane: And does that change the information you consume?

Howard: I think it just adds a second level to the information, because the information is—that you want—basically is what's going to happen. Our people sit around and think about what's going to happen. If they're in the distressed debt area, how is the restructuring going to go? If it's in the real estate area, how can that building be optimized and so forth? But I think it's just another layer of information you need and thinking you have to do, which is, "What do other people think, and how am I different from them, and how are they wrong and how am I right?"

Shane: Is that one of the reasons that you read broadly across subjects?

Howard: I do that mainly—I mean, my reading is not so purposeful.

Shane: Okay.

Howard: I mean, I'm not reading at this point to become a better investor. I'm not making that many investment decisions around here. I'm really just trying to lead the organization and the people and the culture, and relate to the clients, and write and speak and that kind of thing. I'm not making investment decisions. And I'm just trying to get smarter and know more and always challenge my thinking. And as I said about risk, I now have a slightly different way of explaining risk than I did three years ago.

Shane: Always refining and reflecting.

Howard: Yes, right. And I hope to be smarter when we next speak.

Shane: Final question, because I know you gotta run. What other parenting sort of ways did you teach your kids about money, that other people can use or borrow from?

Howard: First of all, we always talked about money. Not in some...not like it's the altar of money on which we have to lay ourselves down, but we talked about responsible financial decision and if you have—if my kids had money, "Do you want to spend it on this or that, or save it?" And if I have money and my wife has money, how do we think we should spend it? And you should not insulate your kids from the discussion of money. Money is a very real thing, and it's essential to develop good attitudes toward it early, number one.

Number two, of course I think you have to keep money in its proper place. And it should not be the be-all end-all, and if you're at the dinner table, you should try to avoid saying, "Oh, that guy's a millionaire, so he must be a good guy," or, "That person is poor, so they must not have any merit." And that's really so important.

I think one of the most important things to have kids who function well around money is for them to have a feeling of finiteness. And this goes back really to "Economic Reality," the memo. They should understand that money is finite. No matter how much money you have, you can get in trouble if you spend too much of it. And since it's finite, you shouldn't waste it. You should make good decisions.

When our daughter went off to college, we said, "Here's your credit card. We're going to put money in your checking account every month, and when the bill comes in, you pay the credit card bill." And she said, "Well, I want a credit card like my friend has." I said, "What's that?" She says, "Oh, she doesn't get bills." You're not helping your kids if they don't get bills. And by the way, her friend may not have thought of where the money comes from to pay that credit card. That's a bad habit.

And we love our children, and we love them so much. And some of us grew up without and we want to give our kids, we want to give them what we didn't have, we want to give them what their friends have, we want them to feel good. And there's this temptation to feel that if they have what their friends have, they'll feel good, and if they don't have what their friends have, they'll feel bad. And so, we give them everything we can. And some people think that a good parent gives all they can.

But it's bad to have the...what the kid who has the most, it's bad to let that kid set the tone for what your kid should have. And it builds character to have some...to say, "No, in our family we don't do that," or, "In our family we don't spend our money that way," or, "Our family decided to take a trip to Paris rather than buy one of those." These are good, letting kids make responsible decisions and choices and stuff like that. And insulating kids from choices is not doing them a favor.

Shane: What are the other sort of moral lessons that you would start with, "In our family we...?"

Howard: We respect others and we care for others, and we want good for others. In our family, it's not about getting to the front of the line and it's not about succeeding at the expense of others. We want to be part of a team effort, be it in the house, in the community, in the country, in the company, in the school. We want to be part of a team effort which brings success to everybody. And it's not about getting ahead of the others. And if you go out and do a great job, you'll be successful. And kindness. And the Golden Rule, "Do unto others as you would have them do unto you," is very relevant. And the importance of being good people and being liked for good reasons, and respected.

And when you get to be my age, you.... Eric Ericson, the psychologist wrote about the stages of man. And you think in terms of how are you thought of? It's very important to you. But when you get to be my age, it's too late to change how you're thought of. And then ultimately, how do you think of yourself? And when I think of people who get close to the end and are unhappy with how they led their lives, I think it's a terrible tragedy.

And then the other thing is, I would advise young parents, if there is a choice to be made and the two choices, let's say, are both nonlethal, let the child make the choice. Our daughter got into two schools for high school. We wanted her to go to one, but we never said a word. She chose the other one. She went, she did fine. And number one, maybe the child can make a good decision. And number two, experience in making decisions is important. And number three, having your parents tell you, "We trust you to make that decision," is really very positive for a child's development.

And the other thing is, your kids will make mistakes, hopefully not lethal ones. And insulating them from making mistakes is not doing them a favor. Because if they make their first mistake at five and they improve their decisionmaking process, and they learn that mistakes don't kill you, that's a good thing. And if they make their first mistake at 35 and it crushes them because they're not prepared for that, then that's a bad outcome.

And to close on this subject, I'd like to read you a paragraph from the book, if I may.

Shane: Yeah, of course.

Howard: I'm going to go get it. It has become, for now, my favorite paragraph in the book. It's also the next to last.

'As Peter Bernstein said, "The future is not ours to know, but it helps to know that being wrong is inevitable and normal. Not some terrible tragedy. Not some awful failing in reasoning. Not even bad luck in most instances. Being wrong comes with the franchise of an activity whose outcome depends on an unknown future."'

No baseball player expects to bat a thousand. Investors shouldn't. Which means they shouldn't get down on themselves if they make a mistake, as long as they reexamine their process and it was good. And you shouldn't castigate your staff members for making a mistake, or your children.

Shane: Thank you, Howard. That's a great place to end this phenomenal conversation.

Howard: Great. Thank you, Shane. I'm glad to have been part of it.