Howard Marks, CFA, was the keynote speaker at the CFA Society of Washington annual dinner held at the Organization of American States on April 6, 2016. Below are our notes from Howard Marks' speech.

What makes markets work?

Fundamentals and psychology drive markets. "In order to be successful, an investor has to understand not just finance, accounting and economics, but also psychology." Fundamentals don't change daily but psychology does. How investors **feel** about fundamentals drives short-term market movements. As Ben Graham pointed out, "In the short-term, the market is a voting machine while in the long-term, the market is a weighing machine."

"One of the most notable traits among investors is their tendency to overlook the negatives or understate their significance for a while, and then eventually to capitulate and overreact to them on the downside."

Recent history confirms this adage. A litany of troubling macro fundamental risks existed in 2012 to 2014. Slow global economic growth, globalization which depressed wages in developed markets, troubles in the Eurozone, a dearth of leadership domestically and abroad, out-of-control entitlement spending in the U.S., a potential hard-landing in China and geopolitical hotspots flaring up across the world were among the fundamental risks. Yet, despite all the uncertainty around the world, the S&P 500 Index returned a cumulative 74%. Psychology (and thus prices) were high given the fundamentals. "Our world was marked by low prospective returns and plentiful problems, a troubling combination."

During the first half of 2015, the negatives began to build and worries accelerated with the tipping point triggered in August 2015. Despite little change in fundamentals, risk tolerance ruled through July 2015 and risk aversion was reawakened in August with the S&P 500 Index dropping 11% between August 17 and 25. Markets around the world dropped about the same amount. It's highly unlikely that these uniform declines were the result of objective, independent analysis of the fundamental events on each economy and company. Rather, Howard believes a worldwide psychological contagion caused the uniform market declines. Declining oil prices, terrorism, U.S. politics, and China all weighed on market psychology. Confidence is currently low as it has never fully recovered from the crisis. Low confidence becomes self-fulfilling. Fundamentals change slowly but psychology can change on a dime.

One of the biggest mistakes investors make is to interpret drops in the market as meaning the market "knows" tough times lay ahead. As Ben Graham noted, the day-to-day market isn't a fundamental analyst; it is a barometer of investor sentiment and you can't take it too seriously. Many mistakenly look to the market to tell them what's going on and what to do about it - especially during downturns.

"One of the most significant factors keeping investors from reaching appropriate conclusions is their tendency to assess the world with emotionalism rather than objectively. Their failings take two primary forms: selective perception and skewed interpretation." Perceptions and interpretations of fundamentals are rarely balanced and neutral. Sometimes investors focus only on the positive events while ignoring negative events, and sometimes the opposite is true. Sometimes events are viewed in a positive light, and sometimes it's negative.

One of the oldest cartoons in Howard's file shows a TV commentator saying, "Everything that was good for the market yesterday is no good for it today." Investor psychology rarely gives equal weight to both favorable and unfavorable events. Interpretation of events is typically influenced by investors' emotional reaction to events.

In another favorite cartoon, the TV commentator says, "On Wall Street today, news of lower interest rates sent the stock market up, but then the expectation that these rates would be inflationary sent the market down, until the realization that lower rates might stimulate the sluggish economy pushed the market up, before it ultimately went down on fears that an overheated economy would lead to a reimposition of higher interest rates."

Rarely are investors objective, rational, neutral and stable. They move from high levels of optimism, greed, risk tolerance and credulousness, causing:

- asset prices to rise
- potential returns to fall and
- risk to increase.

Then, after the arrival of the tipping point, investors move to pessimism, fear, risk aversion and skepticism, causing

- asset prices to fall
- potential returns to rise and
- risk to decrease.

In investing, psychology swings from everything being flawless to everything being hopeless. First denial, then capitulation. The pendulum swings from one extreme to the other, spending little time in the range of reasonableness.

"Emotion is one of the investor's greatest enemies." Fear makes it hard to remain optimistic about a stock when the price plummets. Envy makes it hard to refrain from buying appreciating popular stocks.

Do market declines worry you? Are you tempted to sell into declines? The market doesn't "know" anything. Markets sometimes make mistakes. The market is not smarter than every player, but it is more emotional. Herd behavior frequently drives market moves.

Howard Marks' Prescription for Coping with Market Irrationality

- First, understand the importance of psychology and its influence on markets.
- Second, control one's emotions. Warren Buffett is one of the most unemotional investors around which is why he has been so successful. It is important to keep optimism and fear in balance.

- Limit the impact of other people's emotions by structuring your environment to limit the impact of other's emotional swings. Educate clients so their emotions will not influence your investment decisions.
- Practice contrarianism thereby converting other investors' emotional swings from a menace into a tool. Become optimistic when others are fearful and vice versa.

Likelihood of another 2008-Style Crash?

Eighty years passed between the Great Depression and the Great Recession. Cataclysmic financial events are the exception. We haven't experienced a boom, in either the economy or the stock market, so a bust is unlikely, especially given that there is no powder keg similar to the subprime mortgage loan market. System-wide private sector leverage has declined substantially, particularly for banks. Before the crisis, debt was 30+ times equity. Today, debt to equity is in the low double-digits.

We live in an uncertain world. Asset prices are full but not "bubblicious." Future returns are low due to actions of central bankers bringing risk-free returns to zero. Invest with caution and a healthy dose of prudence. Understand value and its relation to price. Keep in mind that the market doesn't "know" anything. Inefficiencies do occur in markets. Investors should take advantage of market mistakes. The only intelligent form of investing is fundamental investing. Figure out what the value of an investment is worth and then seek to buy it at a discount to its intrinsic value.