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OAK - Q2 2016 Oaktree Capital Group LLC Earnings Call

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PRESENTATION

Operator

Welcome, and thank you for joining the Oaktree Capital Group's second quarter 2016 conference call. Today's conference call is being recorded. At this time, all participants are in a listen-only mode, but will be prompted for a question-and-answer session following the prepared remarks.

Now I would like to introduce Andrea Williams, Oaktree's Head of Corporate Communications and Investor Relations, who will host today's conference call. Ms. Williams, you may begin.

Andrea Williams - *Oaktree Capital Group, LLC - Managing Director, Head of Corporate Communications and IR*

Thank you, Laura. Welcome to all of you who have joined us for today's call to discuss Oaktree's second quarter 2016 financial results. Our earnings release issued this morning detailing these results may be accessed through the Unitholders section of our website.

Our speakers today are Oaktree's Chief Executive Officer, Jay Wintrob; Co-Chairman and Chief Investment Officer, Bruce Karsh; and Chief Financial Officer, David Kirchheimer. Howard Marks, our Co-Chairman, has also joined us and will participate in the question-and-answer segment of the call following the prepared remarks.

Before we begin, I want to remind you that our comments today will include forward-looking statements reflecting our current views with respect to, among other things, our operations and financial performance. Important factors could cause actual results to differ, possibly materially, from those indicated in these statements. Please refer to our SEC filings for a discussion of these factors. We undertake no duty to update or revise any forward-looking statements.

I'd also like to remind you that nothing on this call constitutes an offer to sell or a solicitation of an offer to purchase any interest in any Oaktree funds. Investors and others should note that Oaktree uses the Unitholders section of its corporate website to announce material information. Accordingly, Oaktree encourages investors, the media and others, to review the information that it shares on its corporate website at ir.oaktreecapital.com.

During our call today, we will be making reference to certain non-GAAP financial measures. For a reconciliation of each non-GAAP financial measure to its most directly comparable GAAP financial measure, please refer to our earnings press release, which was furnished to the SEC today on Form 8-K, and may be accessed through the Unitholders section of our website, also at ir.oaktreecapital.com.

Today we announced a quarterly distribution of $0.58 per Class A unit, payable on August 12, to holders of record as of the close of business on August 8. Finally, we plan to issue our second quarter 10-Q at the end of next week.

With that, I'll now turn the call over to Jay.

Jay Wintrob - *Oaktree Capital Group, LLC - CEO*

Thank you, Andrea, and good morning to everyone. Shrugging off concerns over Brexit and a lackluster global economy, the stock and fixed income markets staged surprisingly strong rallies in the second quarter. US high yield bonds ranked as one of the top performing asset categories returning 5.9%, their best quarterly performance in 4.5 years.

Equities didn't keep pace with fixed income in this environment, although the S&P 500 still managed to post a respectable 2.5% return on its way to a new record high. Despite the end-of-the-quarter volatility due to Brexit, Oaktree posted solid second quarter financial results, highlighted by year-over-year growth in all earnings metrics -- fee-related earnings, adjusted net income, and distributable earnings.

We deployed $2.4 billion of capital in the quarter, the most in the last five quarters. Gross capital raised was $3 billion for the second quarter and $10 billion for the last 12 months. In terms of closed-end fundraising, in the second quarter, we closed on additional capital commitments for Opps Xa and Opps Xb, bringing their total commitments to $11.2 billion.

We raised additional capital for Real Estate Opportunities Fund VII, bringing its total committed capital to $2.4 billion. European Principal Fund IV had its first close at EUR840 million, and European Capital Solutions had an interim close that brought its total commitments to approximately EUR300 million.

Over the balance of this year, we expect additional closes for Opps Xb, Real Estate Opportunities Fund VII, European Principal Fund IV, and European Capital Solutions. We also anticipate first closes for Infrastructure Fund I, Real Estate Debt Fund II, and one or more separate accounts for our new Real Estate Value-Add strategy.

Finally, later this year, we'll begin to raise capital for a commingled Emerging Markets Debt Total Return fund, a strategy where we've been amassing a solid track record over the last year and a half. We also remained quite active fundraising for our open-end funds, even though the net flow environment has been challenging in strategies, such as convertibles and senior loans, given the market headwinds for these asset classes.

Moving on to investment performance, our closed-end funds had a blended gross return in the second quarter of 1.4%, bringing the year-to-date return to 3.4%. Distressed debt had a 2% gross return in the quarter and a 4% return year-to-date, reflecting mixed performance in private assets, and strength in some public equities and energy-related debt securities.

Our strongest quarterly gross returns were in Real Estate Debt at 14%, Global Principal at 6%, European Private Debt at 5%, and Emerging Markets Opportunities and Mezzanine Finance, both at 3%. Given the impact of Brexit on both valuations and currencies at June 30, it's not surprising that our European Principal funds had a negative 3% return in the quarter.

Low interest rates, ample liquidity, and a search for yield, continue to sustain the credit markets and buoy equity markets, creating a somewhat challenging investment environment for our counter-cyclical investment strategies. That being said, the overall deployment environment has been decent, and we're finding opportunities in both developed and emerging markets, and across private and publicly-traded asset classes. Bruce will elaborate in just a few minutes.

At Oaktree, we consider these opportunities without attempting to tie markets; instead, focusing our efforts on bottom-up analysis. The past year validated this approach, as short-term market durations triggered by China growth concerns, energy and commodity prices, Brexit, and easy monetary policies of central banks -- including negative interest rates -- confounded forecasters. While it's impossible to know what the future will bring in any of these regards, it appears we are back to an environment that should reward credit selection and risk management rather than aggressive behavior.

And with that, I'll hand it over to Bruce to cover the investment landscape.

Bruce Karsh - *Oaktree Capital Group, LLC - Co-Chairman and Chief Investment Officer*

Thanks, Jay, and hello, everyone. The second quarter began with a continuation of the first quarter market rally that was driven by commodity prices stabilizing and subsiding investor concern over global slowdown. As anxiety about the global economy waned, investors again began to focus on the search for yield.

The biggest news of the second quarter came in its final week -- the surprising Brexit vote led initially to a sharp repricing of risk across financial markets. The British pound fell to a 31-year low against the US dollar, and European equity markets tumbled. However, the reaction of the credit markets was relatively muted.

In the European leveraged loan market, the spreads widened in the immediate aftermath of the vote, but then quickly stabilized, as buyers stepped in. Defaults continued to track at historical lows in Europe and remain a rare occurrence, not least because QE is supporting credit fundamentals and providing cheap funding to the region's banks.

At quarter-end, while we did take some mark-to-market losses related to our UK exposure, which is about 8% firmwide, we believe our investments in the UK will perform well over the medium to long term, given the sovereign state's full control of its monetary and fiscal policy.

While the US credit market showed some weakness immediately after the Brexit vote, it rebounded rapidly in the last few days of the quarter as Treasury yields declined. The rally was particularly pronounced in CCC-rated and commodity-related bonds, including those in the energy, metals and mining industries.

Brexit did not generate the buying opportunity we thought it might for our distress-related strategies, but it is relatively early in this less positive part of the credit cycle. We still see European non-performing loan pools as an important part of the opportunity set, and we continue to be active purchasers as banks look to rebuild their balance sheets. The recovery from February's lows has tempered buying opportunities in the public debt markets, but we are pleased to see multiple continental European bank sale processes ongoing.

In our view, given the strong recovery, it's only natural that the pace of capital deployment may slow as the market goes higher. We believe patience will generally be rewarded in this environment, and that our approach of splitting distressed debt funds between an A and B structure is the right one. While we are closing in on being 60% committed in Opps Fund Xa, and have several deals in the works that could take us above that number, we believe the current environment suggests we may not begin investing Opps Xb until 2017.

On the realization front, we've recently been quite productive, particularly with respect to real estate and principal investment. I'd like to share details on one realization. Earlier this month, in the face of post-Brexit market volatility, our Global Principal Group achieved a very successful initial public offering for AdvancePierre Foods Holdings, a leading US producer and distributor of ready-to-eat sandwiches, entrees and snacks.

Consistent with our mandate, the legacy company Pierre Foods was a classic distress-for-control situation. Our roughly $100 million investment was initiated in 2008 when we bought the bank debt and bonds in contemplation of the company going into bankruptcy and restructuring -- which, of course, occurred.

Fast-forward through several acquisitions, and extensive management and operational improvements, all directed by our team, and by the time of its IPO, the company had nearly tripled revenues and grown EBITDA eight-fold. At its IPO price, AdvancePierre had an enterprise value of over $2.7 billion compared to our effective purchase price of around $170 million in 2008.

Including multiple dividends over the period of our ownership, our Global Principal Fund has already received, in cash, over five times its initial investment. More impressively, the residual value of our holdings stood at over $1.1 billion at the end of its first trading day, implying an IRR of 92% and nearly 17 times our invested capital. We're excited about the further potential for this investment due to our still owning a majority of the public equity following the IPO.

AdvancePierre has the hallmarks of some of our most successful investments. First, the ability to identify and capitalize on distress-for-control opportunities at attractive entry multiples, and create highly asymmetric risk/return potential.

Second, the ability to add value to the portfolio company through hands-on financial and operational expertise while attracting a best-in-class management team through our deep industry networks.

And third, the ability to access the capital markets by opportunistically tapping debt for low-cost acquisition financing, refinancings and distributions. While the profitability of this particular investment makes it extraordinary, in our experience, the process and approach we used -- or the Global Principal Group used -- are typical, and serve as an excellent example of how our distress-oriented investment teams do their work.

I look forward to answering your questions, but now I'm delighted to turn the call over to David.

David Kirchheimer - *Oaktree Capital Group, LLC - CFO*

Thanks, Bruce. And hello, everyone. The second quarter produced solid income and cash flow, with both adjusted net income and distributable earnings posting strong gains on a year-over-year basis. Adjusted net income rose to $143 million, up 67% over the year-ago quarter due to growth in all three income categories -- fee-related earnings, incentive income, and investment income.

ENI per Class A unit increased to $0.79 in this year's second quarter from $0.44 last year. Distributable earnings rose 15% to $128 million. The second quarter's distribution followed suit, rising 16% to $0.58 per Class A unit. On a year-over-year basis, fee-related earnings grew $12 million, or 22%, to $64.6 million in the second quarter. For the first half, FRE rose $24 million, or 24%, to $127 million.

A big portion of our record $23 billion in uncalled capital commitments is not yet generating management fees. That subset is commonly referred to as Shadow AUM. As of June 30, Shadow AUM stood at about $13 billion with a blended annual fee rate of slightly over 1.3%. AUM already generating management fees stood at $80 billion with a blended fee rate of just under 1%.

Future closes for funds in marketing will, of course, add more capital commitments. Given those and other relevant items, I want to share my current expectation for the near-term trajectory of management fees.

To start, I want to highlight that, of the $13 billion in Shadow AUM, Opps Xb represents nearly $8 billion. Our best guess is that we will begin earning management fees from Opps Xb based on its total committed capital -- as opposed to the amount that has been drawn -- in late 2017.

In the current environment, we expect the remaining $5 billion of Shadow AUM, as well as some of the upcoming capital raises, to transfer into fee-generating AUM only gradually. Thus, for the third quarter, I expect management fees to remain roughly flat compared to the second quarter. Looking further out, and subject to all the usual caveats about the future, I wouldn't be surprised if quarterly management fees remained roughly around current levels until we begin earning full management fees from Opps Xb.

At Oaktree, investment income proceeds are a reliable generator of cash, thanks to distributions from among our large number of closed-end funds as well as our 20% equity stake in DoubleLine Capital. Indeed, the second quarter was the 18th consecutive quarter for which the trailing 12-month investment income proceeds topped $100 million.

Speaking of DoubleLine, growth continues at that asset manager, and thus, its FRE-type income and cash flow. DoubleLine's AUM grew to $102 billion as of June 30, up 34% from a year earlier and almost double the level of just two years ago. Growth also occurred in our accrued incentives, despite the second quarter's solid incentive income and headwinds from Brexit-effected valuations.

The quarter's gross incentive income of $88 million arose from five funds in four strategies. New gross incentives created were almost twice as large at $171 million. Thus, our net accrued incentives balance grew 3% to $771 million as of June 30.

And finally, with respect to the current third quarter, currently known incentive income, net of compensation expense, and fund-related investment income proceeds, are estimated to be about $30 million and $3 million, respectively.

With that, we are delighted to take your questions. So, Laura, please open up the lines.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Michael Carrier, BofA Merrill Lynch.

Michael Carrier - *BofA Merrill Lynch - Analyst*

Hey, David, maybe just a few questions on the financials. One is, it looks like on the core compensation expenses, things look pretty low relative to where they have been running. And also, the incentive comp ratio was lower. I know you guys mentioned mix on products, but maybe just shed a little light on that.

And then the last one is on the tax rate that also came in. And just, given the lower tax rate for the year, just what's driving that?

David Kirchheimer - *Oaktree Capital Group, LLC - CFO*

Sure. Thanks, Mike. Take them in order. So, for compensation -- you're right. Year-over-year, headcount grew just by five or six people, and so that's why you see that main compensation line leveling off. There's always some noise, as explained in the earnings release.

For example, we had a favorable swing in this phantom equity expense of something like $2.5 million. So, yes, you should be looking at an approximate run rate. But you're right about that amount -- that line item roughly leveling off.

Moving on to incentive income compensation expense -- again, you're absolutely right about the mix. We had a fund, Opportunities Fund VI, that was a significant contributor to the incentive income in the quarter. And that is an older fund, and therefore, has a lower compensation rate.

So, this quarter's approximate compensation percentage is not representative. Instead, as always, I would guide you to looking at the balance of net accrued incentives, where, as you can see, it's running around 50% as the blended compensation rate.

Third, the tax rate -- as we go through the year, the full-year rate becomes more representative each year as we start in the first quarter, given how tax rates are determined -- which, in the interest of time, I will spare you; happy to talk about it off-line -- that it can vary significantly from the full-year rate. And so, as we get deeper into the year, we have a more representative full-year rate.

And so, this quarter, we had a true-down effect. So, as always, Mike, I would guide you and others to look at the full-year rates for ANI and FRE, and not extrapolate from the current quarter's rate, where it can bounce around as we have these true-ups or downs, as we go through the year.

Michael Carrier - *BofA Merrill Lynch - Analyst*

Okay. Thanks a lot.

David Kirchheimer - *Oaktree Capital Group, LLC - CFO*

Thank you.

Operator

Michael Cyprys, Morgan Stanley.

Michael Cyprys - *Morgan Stanley - Analyst*

Thanks for taking the question. So I just wanted to follow up on the deployment -- certainly a strong quarter -- $2.4 billion, I think that was that you'd deployed. I'm just curious if you could just flesh out a bit more in terms of -- so where that's being put to work geographically -- sectors, opportunities?

And then if you could also touch upon some of the areas that you're most excited about as you look out over the next 12 months, in terms of putting capital to work. And maybe overlay that with what's happening from a geopolitical perspective as well, if that makes you less excited about Europe in some respects?

Bruce Karsh - *Oaktree Capital Group, LLC - Co-Chairman and Chief Investment Officer*

Okay. I'll take a crack at that, Michael. The areas that we are deploying are largely energy-related opportunities we've been seeing -- power. And then I mentioned the European NPL opportunity. And we continue to see those -- real estate also is seeing some interesting opportunities. And also on the emerging market debt side, there's some interesting things.

Across all our strategies, there's some decent levels of deployment. It's not an Oaktree-type market, rife with opportunities everywhere, but we are seeing selected pockets and sectors that look interesting.

As to Europe, we have invested in Europe, and we'll keep doing so. We understand the risks that Brexit gives rise to, in terms of the EU, but we're going to plow ahead. We haven't seen immediate great opportunities in the aftermath of Brexit, as I mentioned earlier, but it's early days and I think we will start to see some that will be more and more interesting. And we won't hesitate to continue to commit capital to the UK and/or Europe.

Michael Cyprys - *Morgan Stanley - Analyst*

Okay. Great. And if I could just dig in a little bit on infrastructure -- I know you're raising a fund there. If you could just remind us perhaps of the fee rate of returns that you're targeting? I think it's maybe 1.5 and 20, but just curious how you think about getting to the returns that can match those fees? Maybe if you could talk a little bit about the investment opportunities within infrastructure and how big that is relative to the market there?

Jay Wintrob - *Oaktree Capital Group, LLC - CEO*

I'll make a couple of comments on that, Michael. First of all, in terms of the opportunity set, we are believers in the infrastructure investing opportunity set really for the long-term. And, in fact, the deal flow there is good.

At this point, as you know, our main focus is the fundraising of Oaktree Infrastructure Fund I. The final Highstar Fund, IV, is basically fully committed. Our Infrastructure Fund I fundraise is taking a little bit longer than we initially expected. In retrospect, we probably came to market a little bit early.

We found that prospective clients had wanted to see more performance emerge from the $2 billion Highstar Fund IV -- their last fund prior to joining Oaktree. And fortunately, that performance has steadily improved over the last year, as we moved through the J curve. And we believe we'll have our first Oaktree Infrastructure Fund I closed this quarter or next. And I think the mandate for the Infrastructure Fund Group is as it was when they joined Oaktree; they're looking across several different sectors and geographies also.

Howard Marks - *Oaktree Capital Group, LLC - Co-Chairman*

Yes. The only thing I'd like to add -- this is Howard -- is that our infrastructure is not a purchase of commoditized, plain-vanilla assets and then levering them up, but rather it's entrepreneurial and creative. And a good example of that is that we've got a contract for the expansion of the Puerto Rico Airport, and modernization, which is completed and looks good, and that's in the Highstar Fund, but now we have a contract more recently to do the same thing in the Boston Airport.

And if you fly around this country much, as I do, you see that our airports are sorely in need. And we are unique in having the license as a private organization to do these things and so that's just one example of the areas in which we think we can do this. And it is probably more akin to private equity in many ways than it is to the traditional view of plain-vanilla infrastructure, which is something we had no interest in doing.

Bruce Karsh - *Oaktree Capital Group, LLC - Co-Chairman and Chief Investment Officer*

To expand on that just a little bit further, our Infrastructure Group had an excellent quarter in terms of deployment, committing over $300 million in the second quarter of this year, and in precisely the kinds of opportunities that Howard described. They happened to be in the energy and power sector, but unusual, off-the-beaten-track kind of opportunities. So we are optimistic that that group will achieve the target of returns.

Howard Marks - *Oaktree Capital Group, LLC - Co-Chairman*

And justify their fees.

Bruce Karsh - *Oaktree Capital Group, LLC - Co-Chairman and Chief Investment Officer*

Correct.

Michael Cyprys - *Morgan Stanley - Analyst*

Great. Thank you.

David Kirchheimer - *Oaktree Capital Group, LLC - CFO*

Thanks, Mike.

Operator

(Operator Instructions) Ann Dai, KBW.

Ann Dai - *Keefe, Bruyette & Woods, Inc. - Analyst*

Thanks for taking my question. Just had a question for you around direct lending. So, it's been a bit of a hot topic, in the light of banks pulling back on their lending activities, and a number of your peers have come out with dedicated funds or are doing more in the space.

So it hadn't really come up too much in the context of your business -- I was just wondering if you could give some color on your thoughts around the strategy, and whether that's something you would be interested in doing more of?

Jay Wintrob - *Oaktree Capital Group, LLC - CEO*

Yes. Thanks, Ann, for the question. It is something we're interested in doing more of. And we believe there's an opportunity there for the reasons that most people do, which is the banks not being as aggressive or as involved in the small and middle-market space.

And, in fact, direct lending at Oaktree is really nothing new. Basically the way to think about us is, in lieu of having a separate dedicated direct lending fund, we actually engage in that through a number of our current strategies -- certainly Strategic Credit looking lower down in the capital structure, and also higher up in our middle-market sponsor-driven Mezzanine strategy, would be the two biggest.

Then in Europe, we have our initial European Dislocation Fund, which was a middle-market direct-lending fund. And, as I mentioned during my comments, we're in the process of raising European Capital Solutions. Although the name is different, it's really our second generation fund dedicated to direct lending in Europe.

And so we will continue to engage there. We'll continue to look at whether there are other, more focused ways to engage in direct lending. But it is an area we're interested in and engaged in. But historically and currently, we do it through our existing strategies, as mentioned.

Bruce Karsh - *Oaktree Capital Group, LLC - Co-Chairman and Chief Investment Officer*

Jay mentioned Strategic Credit -- that's a $3 billion pool of capital that, increasingly, is focused and is emphasizing direct lending. It's done it historically from inception, but given the attractiveness -- as you and Jay point out, we're seeing more and more emphasis and focus out of Strategic Credit -- and more interest on the part of clients, as well.

Ann Dai - *Keefe, Bruyette & Woods, Inc. - Analyst*

Great. I appreciate the color. Is there any way to size across strategies about what you're doing in direct lending?

Jay Wintrob - *Oaktree Capital Group, LLC - CEO*

I guess the answer is probably if we had enough time and wanted to walk through it, but that's not something -- I don't think that's something we're prepared to do here, and there would be a lot of judgment calls about where direct lending ends, and something that you would consider other than direct lending, begins. But it is a significant activity at Oaktree; not an immaterial activity.

Ann Dai - *Keefe, Bruyette & Woods, Inc. - Analyst*

Okay. Understood. Thank you.

Jay Wintrob - *Oaktree Capital Group, LLC - CEO*

Thank you.

Operator

Chris Harris, Wells Fargo.

Chris Harris - *Wells Fargo Securities, LLC - Analyst*

We've got, as you guys know, negative interest rates across much of the globe. Rates in the US seem to be or are continuing to get lower and lower. And I know we're hoping for some kind of dislocation in the markets. But if the situation stays like it is, how big of a headwind are these low rates as it relates to your future returns? And what we're just thinking about is, if the rates stay down where they are, is it that much harder for you guys to hit your hurdle rates?

Howard Marks - *Oaktree Capital Group, LLC - Co-Chairman*

Well, I think that, clearly, when the central banks take the risk free rate to zero, all other rates kind of emanate from that in a capital markets line kind of phenomenon. So, it's all a function of that.

Now we have adjusted downward our clients' expectations, and our own expectations, as to what our strategies can provide. As I recall, Bruce, when we started off in 1998, we said we thought distressed could do 25% to 30%. And then we've had occasions since then when we said 30% or more. And we're not saying 30% any more or 25% or 20%. But we're hoping, for example, to get 15%. And we're targeting 15% in the investment decisions we make. And we still believe we can make 15%. And we may fall a little short of that, but that's a goal. It's what we're underwriting to.

Our hurdle is 8%. We still think we'll clear the hurdles. And it would be perfectly logical to go to the clients and say, look, 10 years ago, the five-year yield's at 6%, today it yields 1%; the hurdle should be lower. But we don't want to have that conversation. The clients still need the levels of return in excess of our hurdles, and that's what they come to us for. And we still think we can get it.

But, of course, as the capital market line comes down, the achievement of any given return gets harder. And that's the world we live in, but I don't want to go in there saying, well, how about if we start getting incentives at 5% on distressed debt and so forth? And I don't think that's a necessary conversation. We just haven't ever had the desire or felt the need to have that conversation.

Chris Harris - *Wells Fargo Securities, LLC - Analyst*

The follow-up question -- thank you that was very helpful -- is the situation causing you guys to consider a look at investment opportunities that you wouldn't have in prior cycles?

Howard Marks - *Oaktree Capital Group, LLC - Co-Chairman*

Well, I mean, by definition, we'll buy at 15% and in prior cycles, we wouldn't buy at 20%. So, back 15 or 18 years ago, I wrote a memo called ?It is what it is? in which I said the investment environment is what it is; it's a given, we can't change it and we can't order up a new one. We have to work within it.

And this investment environment offers us low, lower prospects than ever, but, of course, makes our products more important than ever to our clients. And I dare say that most people have given up on getting the 7.5% that they require from mainstream stocks and high grade bonds. Well, what does that leave? I think it leaves us in a pretty good position.

Plus we have adjusted to the change in the environment over the last -- I would say roughly six or seven years -- by continuing to bring out and increase our suite of products designed to produce returns around 10%, which 10, 15 years ago, 10% looked like a modest accomplishment, and now it looks like nirvana.

And we have a number of products ranging from Strategic Credit, which Bruce mentioned, and Direct Lending, to European Credit Solutions to Mezzanine to Enhanced Income to Real Estate Debt, all of which we think will produce high-single digits or 10% or so, if things break right. And as I said before, now people say, "Oh my God, 9%, wouldn't that be great" Believe me nobody stood up and cheered for 9% 30 years ago, but that's the way things are today. It is what it is.

Bruce Karsh - *Oaktree Capital Group, LLC - Co-Chairman and Chief Investment Officer*

Let me just expand a little further on this. Our LPs fully understand that Oaktree is not about to lower our quality standards, our credit standards, and incrementally take on a whole lot more risk in order to achieve returns that are very difficult in this environment. And, as Howard says, it is what it is; our clients understand how we feel about it. And it's most important to them that we control and manage risk as opposed to going way out on the risk curve in order to try to achieve returns that are very difficult.

Howard Marks - *Oaktree Capital Group, LLC - Co-Chairman*

Yes. And so we adjust our activities. Remember that Fund VIIb was $11 billion and Fund VIII was $5.5 billion, and Fund X is $3 billion and change. So, we've raised our standards. And to have high standards in a low-return world, you have to be modest about your expected returns and modest about the amounts you can manage. The one thing you can't do is say, "Well, the capital market line is lower but I want the same returns I used to get with the same risk on the same amount of money".

Chris Harris - *Wells Fargo Securities, LLC - Analyst*

Understood. Thank you very much.

David Kirchheimer - *Oaktree Capital Group, LLC - CFO*

Sure. Thanks, Chris.

Operator

Alexander Blostein, Goldman Sachs.

Alexander Blostein - *Goldman Sachs - Analyst*

So I wanted to follow up on the discussion with regards to LP allocations generally for the alternative asset class. There's obviously been a lot of pressure and discussions around redemptions from hedge funds. And I'm just curious when you sit down in front of your LPs, how are they thinking about their relative allocation to hedge fund strategies relative to other forms of alternatives? And I guess where does Oaktree fit in, in that backdrop?

Howard Marks - *Oaktree Capital Group, LLC - Co-Chairman*

Well, you know that very little of our capital is in the hedge fund form, and we certainly are not considered primarily as a hedge fund manager. And so, I think that people have grown appropriately skeptical about -- well, I mean, look, there was never anything about the term hedge fund that produced instant magic, you know. Hedge fund is just a form of delivery and maybe a form of compensation.

But all investment accomplishments still go back to superior judgments. You may not know, Alex, that I wrote a memo on hedge funds in 2004. And what I said then is that when I first learned about hedge funds -- which was probably in the 1970's -- there for 10 hedge funds run by 10

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geniuses. And in 2004 I said, today there are 5,000 hedge funds and I don't think they are run by 5,000 geniuses. And today we're up probably to 10,000.

And the performance of the greatest hedge funds are run by geniuses, and their closing created a huge umbrella over this industry which permitted the other 9,990 hedge fund managers to start hedge funds and command hedge fund fees. But I dare say that the average hedge fund performance, since I wrote that memo, has not warranted the average hedge fund compensation. I think it's fair to say that.

And by the way, I said in that memo that I thought that the average hedge fund would make about 5% or 6% in the coming years, and then eventually people would give up on paying 2% and 20% to get 5% or 6%. Barron's did a report on the 10th anniversary of that memo saying that the average return had been 5.2%. But at that time, assets were still screaming upward. And now people have caught up to the reality, I think.

And so at the margin, the appetite for hedge funds has been correcting. That has no impact on us. And in fact, if you can't do it in stocks and bonds, and you think less of hedge funds, I think that bodes well for the kinds of things that we and our peers do.

Alexander Blostein - *Goldman Sachs - Analyst*

Right. That's kind of where I was going. I was just curious whether you were seeing any shift from hedge funds in the form of alternatives into less liquid formal alternatives, such as your locked-up closed-end strategies.

Howard Marks - *Oaktree Capital Group, LLC - Co-Chairman*

Well, I think it's happening in a small way at the margin. I don't think -- it's not a groundswell yet.

Jay Wintrob - *Oaktree Capital Group, LLC - CEO*

Yes, I just would add, to directly respond to your question -- the other side of that coin is we're not experiencing any clients who are more reticent to invest in our types of funds, or longer-term locked-up structures of our type of investment strategies, citing the challenges in the hedge fund industry.

Howard Marks - *Oaktree Capital Group, LLC - Co-Chairman*

Yes. And I think that, given some recent experiences like the obvious decline in risk asset liquidity and the meltdown of Third Avenue and things like that, I think what they show is that when you engage with risky assets, you should do it in a closed-end form.

And the fact that we fell on the closed-end form when we started up Bruce's activity 28 years ago, has been one of our greatest advantages. Because we can do the right thing when the market is greater, and the clients, who are in for the long run, don't have to worry about other clients withdrawing and screwing up the cash flow and the managers' buying ability.

You know when we raised Fund VIIb, which was $11 billion, everybody said, well, we have a lot of faith in Oaktree and we believe in distressed debt, but when the bargains become available, won't the hedge funds run in and scoop them all up? And guess what? When the bargains appeared, the hedge funds were having redemptions and they were sellers, not buyers, adding to our opportunity, not competing against us.

So we are very strong believers in the closed-end form. And I think that clients -- if you want to get high returns in a low return environment, you have to take some risk. And the risk comes on a menu. And you can take beta risk, you can take liquidity risk, you can take manager risk, you can take quality risk -- there are many forms of risk to take.

And I think that clients are feeling better and better that if they had to take risk, they are willing to take it on the liquidity side. Coming out of 2008 and the crisis, everybody said, "That's it, I'm never going into another illiquid fund". I think that they are smiling on illiquidity at the present time. And the hope is that they don't do it to excess.

Alexander Blostein - *Goldman Sachs - Analyst*

Right. Makes sense. Thanks for the insight, guys.

David Kirchheimer - *Oaktree Capital Group, LLC - CFO*

Thanks, Alex.

Operator

This concludes our question-and-answer session. I would like to turn the conference back over to Andrea Williams for any closing remarks.

Andrea Williams - *Oaktree Capital Group, LLC - Managing Director, Head of Corporate Communications and IR*

Thank you. Busy earnings day. Thanks, everyone, for joining us for our second quarter 2016 earnings conference call. A replay of this conference call will be available for 30 days on Oaktree's website in the Unitholders section, or by dialing 877-344-7529 in the US, or 1-412-317-0088 outside of the US. That will begin approximately one hour after this broadcast.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.
