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At an investment conference in London in early February I said that not only was I bullish on the market for 2005, but that I was the most bullish person I know. I guess that means now I am the most bullish and wrong person I know.

Stocks have struggled in the first four months of this year, as they did for most of last year. This year, as last, it's all about oil. The market moved mostly sideways in 2004 as oil prices doubled, and only began to move higher after oil prices peaked just before the election. The fourth quarter rally coincided with an oil price decline, and this year's market decline has been closely correlated with the resumption of the rise in the price of the world's largest and most important commodity.

As longtime shareholders know, we have mostly avoided oil and other extractive industries for many years, believing that these sectors faced a combination of headwinds—slow unit growth, declining prices in real terms, capital intensity, environmental and political issues are some examples—that made long term investment problematic, despite the occasional opportunity for sharp cyclical moves upward.

We preferred, and still do, businesses that consistently earn above the cost of capital, have managements that understand shareholder value, are the beneficiaries of secular trends, and which, most importantly, are available at prices below our assessment of intrinsic business value.

Intrinsic business value is derived by estimating the future free cash flows available to owners and discounting those by a number that compensates for the fact that money in the future is worth less than money today, and for the estimation error that accompanies the difficult task of making reasonable estimates of future free cash flows.

There are, of course, other markers of value, and methods of arriving at value, including the usual array of accounting based metrics such as price to book value, or price earnings ratios, or comparing present market values to prices paid by reasonable buyers for similar assets. We employ all of them in order to estimate a central tendency of value for the companies we analyze so that we can construct portfolios for clients and shareholders that meet their objectives.

Our results have been penalized over the past twelve months, and especially this year, by not having any exposure to the oil and gas industries, or to basic materials, or for that matter, to utilities (except AES) and real estate, all of which have been strong performers recently.

We had a similar experience in the early 1980's and the early 1990's, other times when traditional cyclicals did well. For the past 20+ years, the economy has tended to peak around the end of the decade, a recession ensues and the market performs poorly as the new decade unfolds, and then a recovery commences, typically catalyzed by declining interest rates and tax cuts. As demand picks up, prices rise for basic materials, and commodity cyclicals do well.

The period of outperformance of the cyclicals during the early 80's and the 90's lasted about 2 ½ years or so, before succumbing to a shift in the supply curve in response to the increased demand for and price of whatever commodity or heavy asset is affected. Just like the economics textbooks say should happen.

This time is different, say the commodity bulls. It is almost too tiresome to note the irony that many of the same voices who heaped scorn on the new era pundits of the internet and telecom boom when they pro-

claimed how it was different that time, are now proclaiming their own new era of permanent prosperity for oil and gas and commodities generally.

My view is that it is different every time, and that the relevant analytical exercise is to figure out what the differences are, what the similarities with past periods are, and what it all means, so that one can make sensible investment decisions.

I think it would be naïve and dangerous to simply overlay the previous patterns of performance on the current state of affairs and declare the imminent end of the period of outperformance of commodity cyclicals. (It would be fun and very satisfying to do so, but only if it turned out to be right.) The market doesn't lack for analysts and commentators who mine the data for patterns and declare how the future will look based on how past patterns evolved. I wish it was that easy.

The crux of the bullish commodity argument is that poor pricing and returns since the last hard asset boom of the 1970's led to chronic underinvestment in capacity that will take many years to correct, and which will require high prices to persist, since if they don't the capacity will not be built, which will keep prices high. A considerable period of high prices will also be necessary to overcome the inherent skepticism about the sustainability of high prices arising from 20 years of the opposite experience.

The bulls also point out that the last time commodities and other hard assets performed well, during the decade of the 1970's, much of the world's population lived in command economies. Now, whatever the form of government, the economic systems of Eastern Europe, the former Soviet Union, and China are all market based, are growing rapidly, and are voracious users of commodities as they industrialize. Their demand will also serve to keep prices high.

These are good arguments, and are roughly right. The reason commodity prices are so volatile is that they are commodities, economically undistinguishable items except for price. The low cost producer has the advantage, and high prices lead to more capacity to take advantage of scale economics.

Nothing is more predictable than that new capacity will be built if it is believed prices will stay high enough to earn a return on that capacity. So skepticism

about the sustainability of price is a necessary condition for the delay of new supply. But that creates a game theoretic problem: if a management team believes its competitors in general are skeptical about prices remaining high, prices will remain high since new capacity will not be built. That means, though, that someone who adds capacity, just not too much, can gain a competitive advantage and earn excess returns. Indeed, the first mover in adding new capacity may thereby deter competitors from doing the same, as they fear adding too much, providing even greater incentive to add capacity quickly.

The important point behind all this is that prices rise because demand grows faster than supply in these kinds of markets, since it takes awhile for high prices to convince others they will be here long enough to justify investment, and, just as importantly, to provide sufficient profits and balance sheet strength to undertake new investment. High prices will call forth a supply response, and of course high prices act on their own to curb increasing demand. That demand from emerging high growth economies such as China is expected to be rapid will underpin the arguments of those who will want to increase supply to meet it.

The energy bulls have an additional argument they advance to bolster their case for a new era of permanently higher prices: that we will soon hit Hubbert's peak, the point of maximum oil production. Afterward, production begins to decline. This is due anywhere from now to about 2010, and if it occurs, would truly signal a new era for oil and gas, since prices would tend to rise in real terms, perhaps rapidly, which would remake economic relations across a broad expanse of the global economy.

I am intellectually agnostic about this claim, but emotionally skeptical. Production has peaked in the US, so it is not farfetched to believe it may be about to globally. But timing is everything here.

The market gets very twitchy when oil prices are \$55 or higher, signaling that much above that level and global demand may be impacted, and global economic growth curtailed. The Saudis appear to agree, having last week announced \$50 billion of spending to increase exploration, production, and refining capacity.

We have seen an increasing number of companies report adverse effects from rising commodity prices, indicating these prices are beginning to bite. These are all signs that market forces are at work to curtail demand and increase supply.

If the oil bulls are right, this may not be enough, and the new era may be upon us. Five thousand years of commodity price experience says otherwise, as does 150 years of oil price experience. If things really are different, and these prices portend secular, not just cyclical change, it will not be too late to adjust to things as events unfold. Interest rates peaked in 1981, but buying financials in 1984 proved pretty profitable for most of the next 15 or 20 years. Missing the first part of the move did not entail missing the entire move.

Being wrong is something anyone involved in capital markets has to get used to, though being used to it and being comfortable with it are two different things. There is a difference between conviction and stubbornness, and I promise to try and be sensitive to it.

The Fed has tightened seven times and looks set to do a bit more. The rise in oil and commodity prices also acts similarly to Fed tightening by curtailing demand and diverting capital from where it would otherwise go. The year over year change in commodities' prices has been falling and will soon be at zero, while MZM—money of zero maturity, essentially the tinder for economic activity—has also been falling sharply. There is not much impetus to economic activity from the wealth effect, since markets are down for the year and except for about 10 weeks last fall, have mostly meandered.

All of these things tend to work with a lag, and economic momentum appears to be slowing as we anniversary the commodity price increases and Fed tightenings. The impact of these is cumulative, so we will feel it more in the next few quarters.

Oil price momentum likewise appears to brake in the \$55 a barrel area. If economic activity is slowing, that should further curb prices. And if prices rise much more, that should slow economic activity. Either way, the economics should work.

It makes a difference to markets, though, which comes first. If oil continues to climb, I think the market will struggle to make any progress. If oil declines in conjunction with a moderating pace of economic growth,

then not only will that encourage investors, it will remove the inflationary impact of rising commodity prices from the economic equation, and may lead the Fed to take a more benign view of what constitutes neutrality than markets now expect.

The experience of the past five years, where the major stock indices have made no progress, has eliminated the exuberance arising from 17 years of 17% per year returns beginning in 1982. Investors have learned to be risk averse when it comes to equities, after being risk seeking for most the 1990's.

The safety and relative performance of bonds since early 2000 has led to a crowding in effect in that market, with very low real rates, low nominal rates, and low spreads. Investors appear to be suffering a bout of cognitive dissonance, becoming risk seeking in low return bonds, and risk averse in higher return stocks.

People always seem to buy today what they should have bought about 5 years earlier: they hated tech stocks in 1994 when prices were low and loved them in 1999 when prices were high, they hated bonds in 1999 when prices were low and love them now when prices are high, they hated oil in 1999 at \$12 a barrel but love it now at \$55. Plus ça change, as the French say.

Our views also remain the same. We like what is out of favor and unloved. We are bullish on the out of favor asset class: US equities.

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