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Our friends at 13D Research, led by Kiril Sokoloff, recently hosted a meeting of portfolio managers to discuss their current thinking on the market. The question posed was, what are you thinking about that no one else is thinking about? The 10 or so investors gathered, a mix of well-known hedge fund or mutual fund managers, quickly disposed of that formulation, noting that it would be astonishing if any of us were actually capable of such a feat. What we were capable of was offering some views that we thought had not been adequately discounted by the market, and which, if right, might offer some opportunities for excess return.

The most important question in markets is always, what is discounted? What does the market expect, as reflected in prices, and how do my expectations differ? All expectations incorporate a time horizon, and it is necessary to have that reflected in one's judgments.

Today those time horizons appear to be quite short, creating a just-in-time market, or a data point driven market, one that extrapolates each new number as if it were the beginning of a new trend. Wasn't it only a couple of months ago that oil was \$20 per barrel higher? And who thought in April when it was up 15% year over year that by October the Reuters/Jeffries Commodity Research Bureau index would be down 5% year over year?

A different way of looking at it is that the markets have become more informationally efficient, quickly incorporating new information into prices so fast that one has almost no ability to effectively trade in response to what comes over the tape. By the time one has been able to read a company's earnings release, the "wisdom of crowds" has usually adjusted the price to reflect whatever new information is contained therein, and those changes are usually pretty good, at least in the short run.

Adding value involves forecasting changes in what Keynes called the state of long-term expectation.

We do that by trying to narrow the cone of uncertainty that inevitably widens as one extends time horizons. Market prices reflect the weighted average expectations of a security's future returns, and those expectations must encompass even low probability events, especially if they might have a high impact—e.g. Iran's reacting to an Israeli attack on its nuclear facilities by blocking the Strait of Hormuz (I realize some do not consider this a low probability event).

Since more things can happen than will happen, if we can identify where our expectations differ materially from those embedded in market prices, we can construct portfolios that we believe will earn higher risk-adjusted rates of return over time than could be earned by a passive investment program.

This involves always keeping in mind a basic business principle: only compete where you have a competitive advantage. Warren Buffett refers to staying within your circle of competence. Social psychologists tell us, though, that we are prone to overconfidence when it comes to assessing our abilities, so even when we think we have an advantage, we may well be mistaken.

In markets, competitive advantages are three: informational, analytical, or behavioral. Informational advantage is when you know something material that someone else doesn't. It is the easiest to exploit and the hardest to find. The securities regulators make it their business to see to that by mandating public release of all material information, by regulations like FD, and stiff penalties for acting on inside information.

Analytical advantages come from taking publicly available information and processing or weighting it differently from the others. The market appears to be pricing Amazon.com as though its current operating margins in the low single digits are a permanent feature of its business model, as they are of bookseller Barnes & Noble. We think that

is wrong and that Amazon's margins will soon begin a steady climb toward and perhaps into double digits. If our analysis is right, we stand to make an excess return from our holdings in Amazon.com.

Behavioral advantages are the most interesting because they are the most durable. The field of behavioral finance is still in its infancy yet has already yielded results that can be incorporated profitably into a sound investment process. The best part is that such results are likely to be systematically exploitable and not able to be arbitrated away as they become more widely known. That is because they represent broad findings about how large groups of people are likely to behave under well-defined circumstances. Until large numbers of people are able to alter their psychology (don't hold your breath), there is money to be made from prospect theory, support theory, cognitive psychology, and neuroscience. Until *Institutional Investor* magazine starts rating analysts on their coverage of the Social Psychology Network ([www.socialpsychology.org](http://www.socialpsychology.org)), there is still time.

This brings me back to the beginning, to the meeting Kiril organized on what no one was thinking about. I offered that there was something no one was thinking about, which was how we think about things. More specifically, we all come to our tasks with all kinds of beliefs, but we spend very little time thinking about beliefs: why do we have them, how did we get them, are they right, what is the evidence for them, how do they relate to our other beliefs, what does it take for us to change them, and so on.

Belief is an area that has not been well studied, and is just now beginning to garner renewed attention. I say "renewed" because in the late 19<sup>th</sup> century there was a lively interest in and debate about belief. This was due to the upheaval in belief systems caused in part by Darwin. British mathematician W. K. Clifford wrote what became a famous essay called "The Ethics of Belief," where he argued it was "wrong always, everywhere, and for anyone, to believe anything on insufficient evidence." He was countered by philosopher William James, in "The Will to Believe," who argued that there were areas where sufficient evidence was lacking but belief was justified (remember The Little Engine that Could?).

There is a renewed interest in beliefs as we have had to confront the implications of how the beliefs of radical Muslims affect our security after 9/11, or how beliefs about the presence of WMD in Iraq contributed to the

decision to take military action. Authors such as Sam Harris, Dan Dennett, and Richard Dawkins have renewed the moral debate about belief raised by Clifford in the 1870's.

The beliefs that we bring to investing determine our actions. Are profit margins mean-reverting? Are we at or approaching Hubbert's Peak? Is the consumer over-leveraged? Is the current account deficit a problem? Has the Fed tightened too much? Not enough?

Beliefs are not created equal. Philosopher Willard Van Orman Quine noted that our belief systems are like a series of concentric circles, some are central to who we are and some are on the periphery and subject to change relatively quickly. Those that are central we may hold even when there is abundant evidence they are false, because it is too difficult to give them up. Many beliefs are impervious to evidence, and our dispositions to believe some kinds of things may be hard-wired, as British biologist Lewis Wolpert suggests in his new book *Six Impossible Things Before Breakfast: The Evolutionary Origins of Belief*.

In *Pragmatism*, William James emphasized the role temperament plays in our beliefs. If you are bearish by nature, you will read the data differently than if you have a bullish bent. A famous investor at the meeting last week noted that he had made most of his money from instability, so that colored how he looked at things, and when he saw stability he naturally looked for how things could go awry. I suspect one of the reasons he is such a good investor is he is introspective enough to understand how his temperament may load the dice.

Ken Leech, Chief Investment Officer of our sister company Western Asset Management, once quipped that I alternate between being bullish on stocks, and being very bullish on stocks. It was a good line, and while not entirely true, does reflect something I believe, and with sufficient evidence: people are too risk averse and therefore systematically misprice risky assets more often than not. The work of Dick Thaler at the University of Chicago on myopic loss aversion makes this clear.

Loss is painful, on average twice as painful as gain is pleasurable in matters financial. That is, people on average need about a 2 to 1 payoff on an even odds bet

gains over time, which is why casinos make so much money.

People get more bullish as prices go up, and more bearish as they go down. They overweight recent trends relative to their long-term significance, and their emotions give greater weight to events the more dramatic they are, often out of all proportion to the probability of their occurrence. All of these features of how our beliefs affect our behavior are actionable if they are systematically incorporated into an investment process.

We are, of course, not immune to what Charlie Munger calls the psychology of misjudgment, but we are aware of it and try to compensate for it. We make plenty of mistakes; we just hope they are mostly new ones.

The prevailing beliefs in the stock market today have been affected by the recent rally and the press surrounding Dow 12000, a new all-time high for that index. As with all news driven judgments, they are subject to change. A 5% pullback would likely quickly bring on the gloom. Emotions are fickle.

Warranted beliefs are more stable and more reliable than emotions. US economic fundamentals are solid and notable excesses are absent. Earnings growth continues apace, as does merger and acquisition activity, and record corporate buybacks. Managements continue to be disciplined in capital spending without being miserly. Balance sheets are strong. Interest rates and inflation remain subdued, and the recent pullback in oil prices removes a source of inflationary pressure. The Fed is vigilant but not hostile. Most importantly, valuations are not demanding and the US stock market remains undervalued in my opinion.

Count me somewhere between bullish and very bullish.

Bill Miller

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