

Bill Miller Commentary

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Our returns this year compared to the market's are primarily due to our exposure to housing and housing-related securities, and our lack of exposure to energy. A few thoughts on both are in order.

Owning housing stocks in the midst of the worst housing market in at least 15 years, and one where the problems may linger until 2009, may prompt a reaction similar to that one client had when we bought a company in the midst of a scandal: don't you read the papers? At LMCM we actually try to buy low and sell high, and you don't buy low when everything is great and the headlines reflect it. Usually (but not always), when you read about some industry or company having the worst time since some period of years, or even decades, ago, you will find that buying that industry or company when it was going through those difficulties proved quite profitable if your time horizon wasn't measured in days or months. The headlines today are all about this being the worst housing market since the early 1990's. Had you bought housing stocks during that previous period of duress, you would have made many times your money and handily outperformed the market over the subsequent decade.

We were clearly too early in buying these stocks in late 2005 and 2006—and if you are early enough, that is indistinguishable from being wrong—thinking that the US housing experience would be similar to that in the UK and Australia, a correction from inflated levels that would be over in less than 2 years, that is, just about now. The very poor housing fundamentals, now exacerbated by a subprime loan collapse and the continuing upward repricing of adjustable-rate mortgages made in the past few years, show no signs of improvement. But the market looks forward, and by the time those signs are tangible and evident, the stocks will likely be a lot higher. If we did not own housing or housing-related stocks (such as Countrywide Financial) we would be buying them now, amidst the panic selling currently underway. That said, just

because we own them does not mean we won't sell them if we think we can improve the portfolio's long-term risk/reward profile by doing so.

Energy and energy-related stocks continue to be among the market's best performers and we don't own them. That sector was the strongest performer in the month of June, in the second calendar quarter of 2007, in the six months ending June 30, and in the three and five year periods ending June 30. Only in the 12 months ending June 30 did other sectors perform better. It is said the only thing worse than being wrong is staying wrong. The question for us now is have we experienced a long cycle in energy, or is this a secular change where energy prices will not decline in real terms, as has been the historic norm, but will be stable or maybe even increase after adjusting for inflation?

That question should be answerable shortly. We are at or near the high prices for oil that were reached last summer. Most other commodities prices have peaked and have now declined from the highs achieved either last year or earlier this year, including nickel, once thought to be in a secular shortage situation, and corn, whose price has been boosted by government-mandated ethanol programs. If oil retreats from these or modestly higher levels over the next six months, it is likely that we are nearing the end of a long cycle. If it breaks out to new highs and stays there, then the secular story may carry the day. Interestingly, prices for natural gas, which is both environmentally friendly and long-term substitutable for oil, are not only less than half the levels reached post Katrina, they are also below the average price of the past year or so. Finally, speculative interest in oil futures on the commodities exchanges is at record levels, while oil companies and others in the industry are net short the commodity, believing the price will decline. Stay tuned.

I am constantly asked for my market outlook, so I will give one, not because I know but because I am asked.

The market last week had its worst week since the fall of 2002, which was a pretty good time to buy stocks. Other things equal, lower stock prices mean values are better and future rates of return higher. This latest sell off to 1458 on the S&P 500—from a high of 1553 reached only a few weeks ago—puts us still above the 1449 level of February 26, which preceded the sell-off in early March that occasioned much angst but, of course, should have been bought. We are now trading just about the same level after this sell-off that marked the high before that sell-off.

The proximate cause of this sell-off is a reappraisal of risk in the credit markets, starting first at subprime but now having spread to the riskier parts of corporate credit, namely high-yield bonds and loans to finance buy-outs. Many high-profile deals are being delayed, and banks have been unable or unwilling to sell bridge loans into the secondary market, raising fears about future credit problems. While all this is understandably unnerving, there was a lot of sloppy underwriting in subprime, and risk premia in deals were too low, in my opinion. The current problems in the credit markets are a prelude to sounder lending in the future.

Stocks are lower in the claim chain on corporate assets than bonds, so when bondholders demand better returns, stocks suffer in the short run. In the intermediate or long run, stock returns depend on valuation relative to fundamentals such as growth rates and return on capital.

According to data compiled by Bloomberg, stocks are now the cheapest they have been in 16 years. The S&P 500 is valued at 15.4x estimated earnings, the lowest since January 1991. Again, a pretty good time to be a buyer of stocks!

Even after this decline in the stock market, over the past 12 months the market is up 17% with dividends reinvested, which is well above the long-term average.

I began the year quite bullish and remain so.

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