

Bill Miller Commentary

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On the 20th anniversary of the Crash of '87, the US stock market took a drubbing, falling 2.56%. In a curious parallel, the woes that are besetting the market are the result of a crash in the credit markets every bit as severe as that which hit equities back then, but which threatens to have more impact on the US and the global economy.

The stock market can close down for a while and it really doesn't matter all that much. The primary function of the stock market is not to finance company operations, it is to price assets. Companies go public once, and most come to the equity market for capital sporadically, and then typically to finance long-lived projects or acquisitions.

Credit markets are different. They are the source of liquidity to fund operations. If they are not functioning, the economy is threatened. That is why the problems that began in US subprime but which have spread to encompass a wide swath of the mortgage market, as well as the commercial paper market, are so serious and have galvanized central banks and government financial authorities to move swiftly to try to restore those markets to normalcy.

They have only been partially successful. The new \$80 billion or so fund being put together to provide liquidity to Structured Investment Vehicles (SIVs) has been viewed skeptically by Warren Buffett, Alan Greenspan, and Bill Gross—not an auspicious beginning—and markets appear to be beginning to worry that a return to normalcy might not be the most likely outcome. I share that concern.

The difference between what is unfolding now and the Crash of '87, or the problems with Long-Term Capital Management in 1998, is that they were confined to Wall Street, whereas this issue extends to Main Street and to the value of the biggest asset of most consumers, their house.

When the Federal Reserve (Fed) cut rates all the way to 1% to try to ameliorate the effects of the technology bust, it accomplished something seen only once before: although we had the first recession since 1990, we had only the second recession ever that did not involve housing, which boomed. Now housing is in a severe slump, and we will be lucky to avoid its dragging down the rest of the economy. Although nearly all recessions have involved a housing decline, there have been two prior housing declines that did not involve recession: 1951 and 1967. Both of those times large increases in military spending offset the effects of housing on consumption.

The best forecaster of whether the problems of housing will lead to recession in 2008, the prediction market at Intrade, pegs the odds at around 45%. This is down substantially from odds of over 50% as late as mid-October, but up from odds of about 33% a week ago.

The issue for the stock market and for the global economy is the extent to which the slowdown in US consumption will spill over into a decline in global production next year.

The US has been the marginal consumer to the world, and our current account deficit reflects that. Fueled by low interest rates and people withdrawing equity from their homes to finance spending, consumption as a percent of GDP rose from 66% in the late 1990s to over 70% today. That is a record and the most likely direction from here is not up, with housing prices falling and job growth slowing.

Our current account deficit has already begun to decline, and with the dollar deeply undervalued against the euro and the pound, and trading at 40-year lows on a trade-weighted basis, that trend should continue. It comes with a price. When our current account deficit is expanding, we are providing liquidity to the rest of the world by

buying their goods with our dollars. When it is contracting, we are withdrawing liquidity.

It was the withdrawal of liquidity as the Fed removed the monetary accommodation provided by very low interest rates that led to the subprime collapse, as people could not make the increased payments on their homes when adjustable rate loans reset. The tripling of subprime loans from 2001 to 2005 was fueled by very low introductory teaser rates.

Our central bank was the first to stop tightening; the British and the European Central Bank (ECB) were continuing until very recently, as were the Chinese, though to little effect as real rates in China are still negative. The ECB just last week was hinting that there may be more tightening to come.

It was only in 2002 that the world was worried about deflation. The forces that gave rise to those fears—high debt, excess global labor, falling real prices for technology, and a global savings glut—have not disappeared. The locking up of large parts of the credit market does not help.

When the Fed took the unprecedented step on August 17th of cutting the discount rate between meetings, and changing its policy statement between meetings, having only 10 days before affirmed its views that the risks it was most concerned about were those of inflation and growth, it signaled just how rapidly things had changed. The 50 basis point cut at the September meeting was consistent with that.

Stocks rallied and bonds sold off when the Fed took action in mid-August and September, as markets felt relief that the problems in the credit arena would be dealt with, that those markets would gradually return to normal, and that the liquidity provided would give an additional fillip to growth.

The stock market rally has been led by the same groups that have led for 5 years: energy, materials, industrials, and technology. The same laggards, lagged: consumer, financials, and healthcare. Growth stocks continued to shine and traditional value stocks did not.

This market has been remarkably serially correlated. In plain talk, what has gone up keeps going up, and what

has not, does not. Valuation has not mattered at all. What has mattered is price momentum. This is very similar to what we saw with tech, telecom, and internet names in 1999. It is not yet that extreme, but it is pretty extreme.

The best quintile of stocks based on traditional valuation factors such as price to earnings, price to book, price to sales, and dividend yield, has underperformed the market by over 1000 basis points this year. The best quintile on price momentum alone, using 3 and 9 month price trends, has outperformed by 1400 basis points. Coming at it somewhat differently, if you took the 50 best-performing stocks for the 3 year period ended December 31, 2006, and made that your portfolio for 2007, you would have returns over double that of the S&P 500 this year.

What has worked for the past 5 years continues to work, and what has worked is the high beta trade on global synchronized recovery. When everyone was panicked about deflation in 2002, the right thing to do was to bet on reflation. The winners have been commodities, especially energy, materials, industrials, non-US, non-dollar, and emerging markets.

What seems to have escaped notice is that all those winners bottomed with the peaking of junk bond spreads in the summer of 2002, and have risen concomitantly with the consistent narrowing of credit spreads that began to end in March of this year. If that was not just a spurious correlation, and I do not think it was, then there is trouble ahead for those crowded into all the popular favorites.

The first warning sign came with the sell-off in China that began in late February and briefly convulsed the equity markets. They bottomed in mid-March and began to rise, with China beginning its stunning advance. Then came the subprime problems, which began to be felt in March and got steadily worse. Credit markets began to take notice.

By mid-August the mortgage markets were in complete chaos and the Fed took action. That again provided some relief. Now the SIV problem is front and center. Treasuries are rallying strongly, junk spreads are widening, and the Treasury Inflation-Protected Securities spread is back to its lows.

The equity sell-off on October 19 was precipitated by the market's reaction to the earnings of two stalwarts of the commodities cabal, Caterpillar and Schlumberger, both of which surprised their fans by issuing less than stellar guidance. Cat went so far as to opine that the US might be in recession already; its earnings gains were solely due to non-US growth.

If credit is becoming harder to come by, if spreads are widening, if growth is slowing, then it seems to me the leadership is about to change. The same strategies that led when the global economy was emerging from fears of deflation and entering a period of accelerating growth and synchronized recovery are very low probability bets to lead if the global economy is peaking, the US is slowing appreciably, and credit spreads are widening, not narrowing.

Where will the new leadership come from? The same place it usually does: the old laggards. I think the new leadership will be US, large-cap, dollar-based, and grow to encompass what no one wants to own today, especially financials and consumer. I also think so-called growth stocks will continue to do fine. When growth becomes scarcer and the discount rate becomes lower, growth becomes more valuable.

More particularly, just as the right thing to do in 2002 was to buy what everyone was panicked about, I think the greatest gains over the next 5 years will be made in those securities people are panicked about today. For specific names, consult the 52-week new low list.

VALUE EQUITY COMMENTS

One of the enduring features of the findings in behavioral psychology as it applies to finance, a subject I have discussed many times over the years, is the almost complete inability of those who are aware of them to actually apply them. You can attend Richard Zeckhauser's seminars at Harvard, read lots of articles and case studies, be reminded of how recency bias, or anchoring, or the representative fallacy, or myopic loss aversion impair clear thinking and skew decision making, and still fall prey to them and others of their ilk the moment you are confronted with real world situations.

The recent precipitous decline in financial stocks, especially those related to housing, which sent Countrywide Financial (CFC) to \$12 last week, and led to 20 to 30% drops in financial guarantors in a day or so—after they

had already dropped between 25 and 50% this year—is a case in point. After falling 20% in only a few days on no news, and this after being down 50% for the year, CFC rallied over 30% in one day once they reported their results and indicated they would be profitable for the 4th quarter and expect to earn a reasonable return on equity of 10-15% for all of 2008. The price action on both sides was driven by emotion – first fear, then relief – and was hardly the result of a careful analysis of Countrywide's long term business value. That, by the way, we think is in the \$40's compared to its current price of about \$14-15.

This is not unusual. Warren Buffett has often noted how any knowledgeable analyst would have pegged the value of the Washington Post at about 5x what it traded at in the 1974 bear market, yet no one wanted it at that price. The 2002 bear market saw some similarly amazing prices. AES traded under \$1. It will generate over \$1 of free cash flow this year and is up 20 times from the lows of 2002. Yet fear set its price, as it did those of Nextel, Tyco, Corning, Amazon, and a host of other companies at that time.

Today fear dominates the pricing of housing stocks, of mortgage related securities, of financials, and of many consumer stocks. Confidence and optimism underlay the pricing of energy, materials, industrials, and non-US stocks, especially those of emerging markets, and China in particular.

I am reminded once again of the quote that sits in the front of Ben Graham's Security Analysis, from Horace's *Ars Poetica*: "Many shall be restored that now are fallen and many shall fall that now are in honor." (The quote does not say "all" by the way, just "many").

In Value Equity, we have been taking advantage of the market's current turmoil to make adjustments as the market misprices some securities in relation to others. Here is what you can expect: the Value Equity portfolios will become more of what they already are, large capitalization US, as we systematically reduce our mid-cap names in favor of those with larger market values. As I noted elsewhere, I think large-cap US is the cheapest part of the equity market and so we will have more of those names. We will also extend exposure into some sectors from which we were previously absent. Inter industry valuations are pretty homogeneous and so concentration pays less than it used to. In other words, we will own more stocks, and in new industries. We will still be quite concentrated compared to the average portfolios, just less than we have been previously.

We will likely reduce the weightings of many of our top 10 holdings. They will still be among our largest holdings, we will just have less of them. This is being done to reduce risk in the over-all Value Equity portfolios, and to fund some of the new names we are buying.

This is the first time since 1990 we have had two calendar years behind the S&P 500. Perhaps not surprisingly, that was also a time of panic due to a housing market recession, soaring oil prices, banks and financials collapsing. We were able to take advantage of the values then offered to begin a pretty good period of excess returns.

While the past may not repeat itself, it does often rhyme, as Mark Twain once said. The chapters to come may be different, but the verses are likely to sound the same.

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