

# Bill Miller Commentary

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This commentary will be short and to the point: We had a bad 2007, which followed a bad 2006.

Over this two-year span, we underperformed the S&P 500 by around 2000 basis points, our worst showing since the two-year period 1989 and 1990, where we underperformed by 2500 basis points.

In the 25 years since we started the Value Equity mandate in 1982, we have had six calendar years of underperformance. Despite that 19-6 record against the market, all the losses are painful. They are also unavoidable and unpredictable. It would be great if we could figure out how to never underperform. No one has been able to do that, but that does not make it any less painful.

I will talk a bit about what caused the results of the last couple of years, and a bit about how I see the current investment environment. I will conclude by discussing the situation with Countrywide Financial, which has been at the epicenter of the present housing turmoil, and offer some thoughts on Microsoft's bid for Yahoo, one of our substantial holdings.

About the only advantage of being old in this business is that you have seen a lot of markets, and sometimes market patterns recur that you believe you have seen before. It is not an accident that our last period of poor performance was 1989 and 1990. The past two years are a lot like 1989 and 1990, and I think there is a reasonable probability the next few years will look like what followed those years.

The late 1980s saw a merger boom similar to what we have experienced the past few years and a housing boom as well. In 1989, though, the merger boom came to a halt with the failure of the buyout of United Airlines to be completed. The buyout boom had been fueled by financial innovation. Then it was so-called junk bonds, which had been purchased by many savings and loans in an attempt

to earn higher returns. Now it is subprime loans repackaged into structured financial products. The Fed had been tightening credit to guard against rising inflation, which began to impact housing. By 1990, housing was in freefall, the savings and loans were going bankrupt (as the mortgage companies did in 2007), financial stocks were collapsing, oil prices were soaring in 1990 due to a war in the Middle East, the economy tipped over into recession, and the government had to create the Resolution Trust Corporation to stop the hemorrhaging in the real estate finance markets. Eerily similar to today, the situation began to stabilize when Citibank got financing from investors from the Middle East.

Although the overall market was down only 3% in 1990, we got trounced, falling almost 17%, the result of our large holdings in financials and other stocks dubbed "early cycle," and which tend to perform poorly as the economy is slowing or when it sinks into recession.

If it were possible to forecast with any degree of accuracy, one might be able to descry a slowing economy from an examination of economic data, and perhaps adjust portfolios accordingly. But unfortunately, as I have often remarked, if it's in the newspapers, it's in the price. The process works the other way: stocks are a leading indicator, so first they go down and then the data comes in.

In 2007, financial stocks began to decline in early February, before the market corrected in March. They then rallied into May, began a slow decline that culminated in an intermediate bottom in August when the Fed lowered the discount rate, rallied into early October, and then began the precipitous fall that appears to have made a bottom around the third week of January. The decline in financials reflected the freezing up of credit markets that began in August and which still persists, and was followed by a steep drop in consumer stocks in November that also may have

seen their worst days now that the Fed has begun to aggressively cut rates.

All of this was accompanied by the decline in the housing stocks, which fell almost continuously throughout 2007, ending with a loss of almost 60% on average.

The financial panic got going in earnest as we entered 2008, with global markets all dropping in the double digits or close to it as of this writing. The so-called decoupling thesis, which maintained that non-US and emerging markets and economies would be unaffected by a US slowdown, while not dead (yet), is severely wounded.

The monetary and fiscal authorities have now begun to move with alacrity, with the Fed cutting the funds rate to 3.0% (with likely more to come), and the administration and Congress coming up with a fiscal stimulus package estimated at around \$150 billion dollars.

Will it be successful? Yes. More precisely, if these measures aren't enough to free up credit and stimulate spending sufficient to set the economy on a growth path, then additional measures will be taken until that is accomplished. The important point is that the monetary and fiscal policy makers are focused and engaged, and will do what is necessary to stabilize the markets and restore confidence. This does not mean that the recovery will be swift, or seamless, or without additional trauma. But there will be a recovery, and I think the market abounds with good value. Those values may get even better if the markets get more gloomy, but they are good enough now for us to be fully invested.

I think the market is in for a period of what the Greeks refer to as enantiodromia, the tendency of things to swing to the other side. This is not a forecast, but rather a reflection on valuation.

All of the poorest performing parts of the market, housing, financials, and the consumer sector—with the exception of consumer staples—are at valuation levels last seen in late 1990 and early 1991, an exceptionally propitious time to have bought them. The rest of the market is not expensive, but valuations cannot compare to those in these depressed sectors.

Bonds, on the other hand, specifically government bonds, which have performed so wonderfully as the traditional safe haven during times of turmoil, are very expensive. (In bond land, the only values are in the so-called spread product, and there are some quite good values there.) The 10-year Treasury trades at almost 30x earnings<sup>1</sup>, compared to about 14 times for the S&P 500. The two-year Treasury yields under 2%, and is thus valued at over 50x earnings!

The valuation disparity between Treasuries and stocks is as great today in favor of stocks as it was in favor of Treasuries 20 years ago. Just prior to the Crash of 1987, stocks yielded about 2% (same as today), but traded at over 20x earnings. The 10-year Treasury yielded over 10%, vs. 3.6% today. The two-year Treasury now has a lower yield than the S&P 500, and that is before share repurchases, meaning you can get a greater yield in an index fund than you can in the two-year, and a free long-term call option on growth. Even more compelling are financials, where you can get dividend yields about double that of Treasuries, which only adds to their allure, with them trading at price-to-book value ratios last seen at the last big bottom in financials.

I think enantiodromia has already begun. What took us into this malaise will be what takes us out. Housing stocks peaked in the summer of 2005 and were the first group to start down. Now housing stocks are one of the few areas in the market that are up for the year. They were among the best performing groups in 1991, and could repeat that this year. Financials appear to have bottomed, and the consumer space will get relief from lower interest rates. Oil prices have come down, and oil and oil service stocks are underperforming in the early going.

Investors seem to be obsessed just now over the question of whether we will go into recession or not, a particularly pointless inquiry. The stocks that perform poorly entering a recession are already trading at recession levels. If we go into recession, we will come out of it. In any case, we have had only two recessions in the past 25 years, and they totaled 17 months. As long-term investors, we position portfolios for the 95% of the time the economy is growing, not the unforecastable 5% when it is not.

I believe equity valuations in general are attractive now, and I believe they are compelling in those areas of the market that have performed poorly over the past few years. Traders and those with short attention spans may still be fearful, but long-term investors should be well rewarded by taking advantage of the opportunities in today's stock market.

## *A Note on Countrywide Financial*

Legg Mason Capital Management (LMCM) is the largest shareholder of Countrywide Financial (CFC), holding about 11.8% of the company's shares outstanding as of December 31, 2007. CFC is the nation's largest mortgage originator and servicer. Early in January, CFC announced it had agreed to be acquired by Bank of America (BAC), with CFC shareholders receiving 0.1822 shares of BAC for each share of CFC. CFC shares traded over \$40 per share a year ago. This offer values them at under \$8. CFC shares have plunged in the past 12 months, battered by losses relating to the turmoil in the mortgage markets.

We were quite surprised by the decision to sell the company at close to a seven-year low in the stock price, and agreeing to a bid that amounts to only 30% of book value and under 3x consensus earnings for 2009. What makes the decision puzzling is that the company was seeing solid deposit growth, has no apparent capital problems, was not forced by the regulators to seek a merger partner, and is in sufficiently sound condition to have declared its regular quarterly dividend at the end of January. Subsequent to the decision to sell, the Federal Reserve cut interest rates sharply. The reduction in rates is quite beneficial to CFC by reducing its costs of deposits, and by setting off a wave of refinancings that should significantly increase its loan production.

We petitioned the Office of Thrift Supervision for permission to increase our holdings in CFC to up to 25% of the shares outstanding. That permission was granted on January 18, and we (LMCM) have increased our holdings to about 86 million shares, representing 14.9% of the company's shares outstanding.

CFC has a so called "poison pill" in place that makes it potentially prohibitive for us to go over its 15% triggering threshold. Poison pills are common anti-takeover devices designed to prevent a potential acquirer from taking control of a company at an artificially low price. Their intent is to force a potential acquirer to negotiate with the target company's Board.

We have asked CFC's Board to eliminate the poison pill (or at the least provide us with an exemption from it) as it plainly is unnecessary since the company has already agreed to be acquired by BAC. Eliminating it would allow us to acquire additional shares, should we decide to do so.

We have asked other companies to allow us to exceed pill thresholds, and those requests have been routinely granted, as we are long-term patient shareholders, not activists or acquirers. We fully expect CFC's Board to do the same.

Since the deal has been announced, an activist hedge fund called SRM has emerged owning over 5% of CFC. They've indicated they will oppose the deal (which requires shareholder approval) and hope to convince other shareholders to do the same.

CFC has not yet published its proxy containing additional information about the deal, so we are unable at this point to decide whether we will vote in favor of the deal or not. We continue to study the situation carefully, and look forward to the additional information that will be forthcoming.

It is important to understand that CFC's Board has effectively negotiated a put option contract with BAC. Shareholders now have the right to put the company to BAC for 0.1822 shares of that company. They may elect not to do so, in which case the company will remain independent.

Given the turmoil in the mortgage and credit markets, and the failure of hundreds of mortgage originators, some of whom were public, this provides protection to CFC owners from a worst-case outcome should the housing, mortgage, and economic situation worsen dramatically. On the other hand, should the actions of the Federal Reserve and the economic stimulus package lead to a gradually improving situation, CFC owners can turn down the deal, should they believe that is in their best interests.

Since the cut in rates, many companies closely tied to the housing and mortgage markets have seen their shares rise sharply. Washington Mutual, the nation's largest thrift, is up over 30% this year. IndyMac, a smaller version of CFC, is likewise up over 30% this year. CFC shares, on the other hand, are down 25% as share price appreciation has been truncated by the deal with BAC.

We will support the deal if we believe it is in the best interests of shareholders to sell to BAC, and we will vote against it if we believe greater value can be achieved by having CFC remain independent.

## **Yahoo**

On January 31, Microsoft (MSFT) made an unsolicited offer to acquire Yahoo (YHOO) at a price that represented over a 60% premium to where YHOO's shares were trading. LMCM is YHOO's second-largest shareholder, owning over 80 million shares. Subsequent to the deal being announced, we have met with Steve Ballmer, MSFT's CEO, and spoken with Jerry Yang, CEO of YHOO.

YHOO's Board has pledged to give the offer careful consideration and to do what they believe will deliver the most long-term value to YHOO owners. That is the right message, and we are waiting to hear their views as they develop. That said, we think it will be hard for YHOO to come up with alternatives that deliver more value than MSFT will ultimately be willing to pay.

We think this deal is a strategic imperative for MSFT, and that YHOO is in a tough spot if it wishes to remain independent. It has been reported that MSFT has been discussing a combination with YHOO for well over a year, and that it had been prepared to pay over \$40 per share previously. We have no way of knowing whether those reports are accurate or not.

Our own valuation work puts the value of YHOO in the range of those reported numbers, though, and we think MSFT will need to enhance its offer if it wants to complete a deal. YHOO shares were recently trading at a four-year low, and the stock averaged above the current offer price for all of 2004.

YHOO is a uniquely valuable asset, and we expect MSFT will do what it takes to acquire it.

One last point: the 60% premium MSFT offered for YHOO highlights what we believe are the significant opportunities present in our portfolios. Clients are understandably disappointed when the performance of their portfolio does not keep pace with the broader market. But the price of a publicly traded security is one thing, and its value is something else. Price is a function of short-term supply and demand characteristics, which are heavily influenced by the most recent news and results. Value is the present value of the future cash flows of the business, and that is what we focus on.

We believe the values in the market today are as attractive as they have been in the past five years, and patient long-term investors should be well rewarded for putting money to work right in here.

Bill Miller, CFA

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