

Bill Miller Commentary



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The credit crisis that I wrote about last quarter culminated this quarter in the collapse and rescue of Bear Stearns, an event that I believe (though no one knows) ended the panic phase of the credit cycle. The economic consequences of curtailed credit, increased risk aversion, deleveraging, lost jobs, falling house prices, and negative equity returns remain, and are likely to take some time to play out. All of those issues have been front-page news for some time, and I believe they are well discounted by the market, which is why stocks have risen since Bear's collapse.

After an awful quarter in which Value Equity dropped approximately 19.7% compared to a loss of 9.4% for the benchmark S&P 500, we have begun to perform better. In the first few weeks of the quarter, the S&P 500 is up just over 5% and we are up a bit more. Our lead widens if you look back to the Monday the Bear Stearns rescue by JPMorgan was announced. While neither I nor anyone else knows if our period of underperformance is over, it ought to be, if valuation begins to matter more and momentum less in how the market behaves.

To put our results in some context, in our 26-year history, Value Equity has outperformed its benchmark 20 calendar years and underperformed 6 calendar years. Since I assumed sole responsibility for Value Equity, we have outperformed 15 years and underperformed 2 (the last 2 obviously). On a rolling 12-month basis, we have outperformed 60% of the time since inception, and 68% of the time since I took over. Our relative performance this past quarter was the worst in our history, as we trailed the market by just over 1000 basis points. We have had 3 previous quarters where we trailed by over

700 basis points, 2 of which were in the 1989-1990 period which I have previously likened to this in terms of the economic and market backdrop. We have had 3 worse quarters in absolute terms: the quarter the market crashed in 1987, the 9/11 quarter, and the third quarter of 1990.

The reason this past quarter was our worst relative quarter is that we had back-to-back months where we were more than 400 basis points behind the market. Prior to this, we had only had 7 such months in 17 years. From the standpoint of statistics, though, we were due. Without getting into the details of the math, given our historical returns and average volatility, we should have been expected to have 10 such months since 1990, instead of the 7 we had experienced.

Why does this matter? Because when you are doing poorly, the question always comes up: Is this normal and expected, or is something wrong and should changes be made to the portfolio or the investment process? Every investor goes through periods of poor relative results. Remember the Barron's cover story on whether Warren Buffett had lost it in the tech-driven market of the late 1990s? Statistically, our results, while disappointing—and few are more disappointed than the team here at LCM, as we are substantial investors in our products—are consistent with what one would expect given our process, style, and historic results.

That does not mean we are satisfied with those results, or complacent about our investment process. We are not. We are always looking to improve our research methodology, our analytic efforts, and our portfolio construction process. We systematically study the methods and the portfolios of investors with great long term records for insights, and we scour the academic literature in finance, psychology, economics, and decision theory to see if any new research results in those (and other) fields can be adapted in ways that may improve our results. We study our past decisions to see if mistakes were made that can be avoided in the future. We do this whether we are performing well, or poorly.

One of the more common issues clients have raised during this period is that of risk controls, given that we have had several companies suffer dramatic and highly publicized declines, such as Countrywide Financial and Bear Stearns. Are we taking more risk than usual, or is our research not as rigorous as it used to be? Some insight into this can be gleaned by looking at the 1998-2002 period. That period is instructive because it began and ended with financial panics, similar to the credit panic today. In 1998, Russia defaulted on its debt and the hedge fund Long-Term Capital Management collapsed. In 2002, high-yield bonds did likewise, and fears of deflation were rampant. During that period we had 12 stocks that declined more than 80%, including three bankruptcies. The difference between then and now is that we were outperforming then, and are not now. When you are doing poorly, the scrutiny is higher and the questions more pointed, as it should be.

What makes things difficult is that when you look at performance you are observing the results of price changes in the securities held in our portfolio. You are not observing the value of the businesses whose shares you own, merely how the market is pricing those shares at a point in time. Price and value are not only different, it is precisely that they can differ widely that creates the opportunities for value investors to earn excess returns. The greater the difference, the greater the potential return.

My friend Jeremy Hosking, who has delivered around 400 basis points per year of excess return over two decades at Marathon (in London), corrected me recently when I spoke about our underperformance. "You mean, your deferred outperformance," he said. I thought it a clever line, but it contains an important point. For investors who are trend followers, or theme driven, or who primarily build portfolios around forecasts, or who employ momentum strategies, price is dispositive. When they do badly, it is because prices moved in a direction different from what they thought. For value investors, price is one thing, and value is another. When prices move against us, it usually means that the gap between price and value is growing, and our future expected rates of return are higher.

This is especially the case in momentum-driven markets, such as we have been in for the past two years. In such markets, price trends persist, and wide gaps open up between price and value. That is why fertilizer stocks such as Potash can go from the \$20s to the \$200s in two years, and why Microsoft can bid over 60% more than where Yahoo! was trading and still be getting a great deal.

We looked at when momentum does well, and when valuation does well. Momentum strategies typically dominate when there is perceived distress, such as the past year or so in credit and financials and this year in equities globally (in the first quarter, not a single S&P sector was up), or there is euphoria, such as tech in the late 90s or commodities and materials today, or when valuation spreads between industries are narrow, as has been the case for most of the past two years. So it's been a great time for momentum and a lousy time for value. According to Birinyi Associates, the single worst strategy you could have followed in the first quarter would have been to buy the worst stocks of 2007. Momentum in action, just negative momentum.

I am often asked, how long do we have to wait before Value Equity starts to do better? The real answer here is the same as it is about most such forecasts: no one knows. I am reminded of the story Nobel Prize winner Ken Arrow tells about his experience trying to make long-range weather forecasts for the military during World War II. He told his superiors that his forecasts were so unreliable as to be useless. The word came back that the General knew his forecasts were useless, but needed them anyway for planning purposes.

For planning purposes, here is my forecast: I think we will do better from here on, and that by far the worst is behind us. I think the credit panic ended with the collapse of Bear Stearns, and credit spreads are already much improved since then. If spreads continue to come in, the write-offs at the big financials will end, and we may even have some write-ups in the second half instead of write-downs. Valuations are attractive, and valuation spreads are now about one standard deviation above normal, a point at which valuation-based strategies usually begin to work again, and momentum begins to fade (there is no evidence of the latter yet, as the old leaders continue to lead). Most housing stocks are up double digits this year despite dismal headlines, a sign the market had already priced in the current malaise. I think likewise we have seen the bottom in financials and consumer stocks, but not necessarily the bottom in headlines about the woes in those sectors. Although the economy is likely to struggle as it did in the early 1990s, the market can move higher, as it did back then.

The wild card is commodities. If commodities break, or even just stop their relentless rise, equity markets should do well. If they continue to move steadily higher, they have the potential to destabilize the global

economy. We are already seeing unrest in many countries due to the soaring prices of rice and other grains. Oil has rallied \$30 per barrel in the past 8 weeks on no fundamental news, save only the same stories about fears of supply disruptions. The typical fundamental drivers at the margin, such as global economic growth, miles driven, and seasonality, would all suggest prices similar to those that prevailed in early February. But none of that has mattered. I agree with George Soros that commodities are in a bubble, but it also appears he is right when he describes it as one that is still inflating, and we still have the summer driving and hurricane season with which to contend.

The weak dollar is another culprit in the commodity cycle. Oil began to rise in earnest when the dollar index broke down sharply in February. The Fed could help a lot by halting its interest rate cuts. Real short rates are now negative. It is not the price of credit that is the problem, it is its availability. If the Fed stopped cutting rates, that would help the dollar, which in turn ought to stall the commodity price rises, and thus also help the inflation picture. More technically, the Fed, in my opinion, needs to focus on the value of collateral and not on the price of credit. It appears they are beginning to do this, which is a very healthy sign. This is a topic for another letter, but anyone interested in it should consult the work of John Geanakoplos, a distinguished economics professor at Yale and an external faculty member at the Santa Fe Institute, who has written extensively on this issue, and presented to the Fed on it as well. He and Chairman Bernanke were grad students together at MIT.

Despite moving higher over the past month, the U.S. market and most others around the world are down for the year, and fear and risk aversion still predominate. Yet valuations in general are not demanding, interest rates are low, and corporate balance sheets, especially in the U.S., are in excellent shape. That sets the stage for what should be an improving environment for investors in stocks and in spread credit products, if not in government bonds where risks are high and opportunities low, in my opinion. With most investors being fearful, I think it makes sense to allocate some capital to the greedy side of that pendulum, and that means putting cash to work in equities.

Our portfolio, in my opinion, is in excellent shape, despite, or more accurately because of, its performance. Prices have declined substantially more than business values. On the Monday Bear Stearns opened for trading after its sale to JPMorgan, the stock of the latter

increased in value by the rough difference between the price agreed to (then \$2 per share) and the mark-to-market book value of Bear Stearns, about \$90 per share including the value of their building. While the price of Bear was around \$2, the market understood the tangible value was about \$90, all of which accrued to JPMorgan's shareholders. While the press focused on our ownership of Bear Stearns, our position in JPMorgan was nearly three times larger. Many of our top 10 holdings sell at less than half our assessment of their intrinsic business value (defined as the present value of their future free cash flows), an unusually wide discount.

It is this assessment that makes us confident our, and your, investment will deliver results more consistent with the past 26 years than with the past two.

As always, we appreciate your support and welcome your comments.

Bill Miller

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