

Bill Miller Commentary

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Bill Miller, CFA
Chairman, Chief Investment
Officer, Portfolio Manager

Two articles in the *New York Times* on Saturday (July 17th) encapsulated about all you need to know to understand this stock market. The first was the lead on the front page: “Wealthy Sector of Buying Public is Cutting Back.” The second was in the business section: “Wall Street Stumbles on Disappointing Bank Earnings.” With consumption at around 70% of GDP,¹ U.S. economic growth relies heavily on a consumer able and willing to spend.

Spending though, is highly skewed—the typical Wal-Mart shopper spends about all he or she earns, so their spending depends on having a job or getting a raise. But the top 5% of the population, those making more than \$210,000, account for about 33% of total spending. “That means the purchasing decisions of the rich have an outsize effect on economic data,” as the Times noted, and the direction of the stock market has an outsize effect on those purchasing decisions.

The rich sharply cut back on spending as stocks plunged during the financial crisis, pushing their savings rate to over 20% in the fall of 2008, compared to about 5% in the immediate pre-crisis period.² As the stock market recovered in 2009, their spending accelerated, the economy recovered, and their savings rate fell to negative. With the stock market faltering in the last few months, they have again curtailed consumption, and economic growth has decelerated.

The common view seems to be that the weak stock market reflects a weakening economy. More likely is this: the weak stock market is causing the economy to weaken. It is not a surprise that the consumer confidence numbers just released were so poor; with the stock market having fallen so sharply since late April, they could hardly be otherwise.

Using the outlook for the economy to predict the direction of the stock market, which most appear to do, has it exactly backward. The stock market’s behavior will predict the economy’s future behavior. The market’s decline since late April foreshadowed the soft economic numbers now being reported, just as the market’s rally beginning in the Spring of 2009 foretold the beginning of the recovery now underway.

Markets are all about expectations, and the critical question for investors is always, what is discounted? Are the expectations reflected in market prices too high, or too low?

One clue is to look at financial stocks, which is where the second article comes in. As I have often noted, financials tend to lead the market, both on the upside and the downside. They have been market leaders off the bottom in March 2009, and they peaked in 2007 well before the market. They peaked about two weeks before the market in April and have led it down in this correction. Their record is still intact, as the *New York Times* dutifully noted in the article cited above.

If financials begin to act better, the market should follow; and if they languish, or decline further, then the market is likely to do no better.

Financials in particular, and the market in general, have been plagued with a variety of worries since April, when concerns about the Greek financial situation led to a more generalized worry about sovereign debt. The oil spill, Goldman Sachs coming under fire from the SEC, gold's relentless rise, the ultimate shape of the financial reform bill, the specter of higher taxes as the Bush tax cuts expire, were all part of what weighed on the market during this swoon.

To say that they caused the market drop, though, is a stretch. "What will the stock market do, Mr. Morgan?" someone asked JP Morgan over a hundred years ago. "Fluctuate," he is said to have replied. That's what markets do, and in late April after 8 straight weeks higher, the string was broken. Now we have had a decline that's dropped the market to a loss of almost 5%, and led to significantly renewed pessimism about the outlook, for just about everybody with an outlook. As longtime market observer Bob Farrell recently reminded us, the news is always a mix of positive and negative. When markets decline, people point to the negative news; and when it increases, the positive news is emphasized.

This decline has led to elevated levels of bearish sentiment, and bearish activities, such as rising put call ratios, which is probably setting the stage for a rally, or so the best market technicians such as John Mendelson, are saying. I hope so. But hope is not a strategy, as the saying goes.

Having a long term strategy may seem a quaint idea in a market dominated by high frequency trading, the 24 hour news cycle, the ubiquitous and shrill blogosphere, flash crashes, and where it is repeated as though divinely given that buy and hold is dead.

The summer of 2010, though, when most global markets are down, pessimism about the future is high, and macro concerns predominate, is one of those rare periods where one can reliably adopt a long term strategy that promises (but of course cannot guarantee) returns superior to what just about everybody else is now doing.

The public's distaste for equities is palpable and understandable. Negative returns for 10 years in stocks while "riskless" treasuries³ have soared, and right after one of the best 6 months treasuries have had in the decade, is more than enough to convince folks that stocks are just not where you want to invest long term.

Then there is the really long term. Long term treasuries as measured by the Barclay's Capital Long Term Treasury Bond total return index have beaten equities as measured by the S&P 500 year to date, and in the 3-, 5-, 10-, 15-, and 20-year time frames. It's a tie at 25 years. Over 20 years of consistently superior returns over stocks in an asset guaranteed by the U.S. government seems to be sufficient to drive a stake through the heart of the idea that you want stocks for the long term. Gentlemen and ladies both prefer bonds. Who doesn't?

Well how about Bill Gross, who runs the biggest mutual fund in the history of the world (bonds naturally)? Bill is on the cover of the new Bloomberg magazine, and the story is about PIMCO's equity strategy. Bill has been right for about his whole career, and he is right again, in my opinion.

A few weeks ago I sent a little note to our staff about Exxon Mobil.⁴ It pointed out that Exxon Mobil was on the 52 week low list, and was actually lower than it was during the depths of the panic in the fall of 2008. It had (and still has) a yield greater than the 10 year treasury, trades at a multiple well below the market, has returns on capital above the market, has grown the dividend over 9% per year the past 5 years, and uses its prodigious free cash flow to shrink its shares outstanding by between 300 and 400 million shares per year. If it keeps this up for the next 15 years, it will be just about out of shares. Yet it languishes at 5 year lows. When it was last trading here in 2005 oil was \$50 a barrel. The math is fairly simple: a sum of the dividend yield, growth rate and share shrink could represent an attractive annual return even if the valuation stays the same, and the valuation is among the lowest the company has traded at in years. Cash returns zero, the 5 year treasury is now trading at one of the lowest yields in history, the 10 year yields 2.93% and that yield will not go up.

Yet what do people want: treasuries. What do they not want: Exxon Mobil and most other large capitalization U.S. stocks with similar characteristics.

Exxon Mobil is the largest company in the U.S. equity market, and one of the highest quality companies in the world, yet no one seems to care. When I mentioned this to a hedge fund manager a few weeks ago, he said that the oil stocks have underperformed this year, that the oil spill had cast a pall over all energy equities, that regulations on energy companies were going to increase, that subsidies may decrease as governments seek more revenue, and that the Congress is now going to take up a new energy bill, which is why Exxon Mobil is not attractive. Well the math is the math, no matter what the near term sentiment. I then asked him about Kimberly Clark, with a 4% yield, an 8% dividend growth rate, buys back shares, etc. So is Congress going after diapers and Kleenex next?

It is almost a tautology in capital markets that the best investments are those with the worst previous returns, where expectations are low, demand is down, and prospects appear at best highly uncertain. In 1980 bonds had been through a 30 year bear market relative to stocks, inflation was soaring, yields were at historic highs, yet expected to go higher, and a long bull market in bonds was at hand. The idea that U.S. interest rates would be near all time lows 30 years later would have been dismissed as ludicrous. The situation is now reversed, with stocks having underperformed bonds for decades.

The point here is simple: U.S. large capitalization stocks represent a once in a lifetime opportunity in my opinion to buy the best quality companies in the world at bargain prices. The last time they were this cheap relative to bonds was 1951. I was 1 year old then, but did not have then sufficient sentience or capital to invest.

I do now, and if you are reading this, so do you.

Bill Miller, CFA

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¹Gross Domestic Product ("GDP") is the market value of all final goods and services produced within a country in a given period of time.

²Source: New York Times, 7/17/10.

³U.S. Treasuries are backed by the full faith and credit of the United States Government and offer return of principal value if held to maturity. Prior to maturity U.S. Treasuries will fluctuate with market conditions, inflation and interest rate changes.

⁴As of 6/30/10 Legg Mason Capital Management held a position in Exxon Mobil, but not Kimberly Clark.

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