

# Bill Miller Commentary



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As you know only too well, the world is in the midst of a global financial crisis of epic proportions. Everyone invested in anything other than cash or U.S. Treasuries has suffered grievous losses. All of the major stock markets around the world are down 40% to 50% or more year-to-date. Previously hot markets such as China are down over 60%. There is some evidence that the crisis is beginning to abate, as credit spreads have begun to come in, and credit markets are beginning to function better. But the system is still very fragile and the economic news is likely to be pretty grim the next few months.

People have fled from anything that is perceived to have risk, driving prices of long-term investment securities to levels that appear to offer extraordinary value, yet few are interested, except Warren Buffett and a smattering of other hardy investors who have been stockpiling cash the past few years.

This period has been particularly difficult for us at Legg Mason Capital Management, as we have performed very poorly relative to both the market and our history. As investors in our funds, we share both the disappointment and the losses you have suffered. This is our first period of extended underperformance in 18 years, and its depth makes it especially painful to all of us who have invested in our products. The fact that all investors have gone through periods of substantial underperformance is of little consolation. We have not met your expectations or our own, and we apologize for that.

As we did 18 years ago when we last performed so poorly, we have intensively examined the investment environment of the past two and a half years, the decisions we made and our reasons for doing so. Now, as then, we have identified strategies at both the level of individual securities and portfolio construction that we believe will help us improve our relative performance if we encounter similar conditions again. It was our analysis of our only other previous period of sustained underperformance that we believe ushered in our

extended period of outperformance, which enabled us to largely avoid the problems so many value investors had in the mid and late 1990s. While of course there are no guarantees, I believe we will return to our previous history of providing shareholders and clients with long-term returns they are happy with.

We remain committed to our value-oriented investment philosophy and process. And we remain committed to doing our best to provide above-average investment returns to our shareholders in the years to come.

This letter will address our view of the current financial crisis, and some thoughts on the current investment environment. One feature of this crisis is that it has been moving so fast recently that something written one week is out of date the next. I had planned on writing about the third quarter, but the market collapse since then has rendered anything said about the third quarter obsolete.

## *The Current Crisis*

The current crisis is in its second year, and it is only in the past 30 days that effective policies to deal with it are finally being implemented. The policy response prior to this can only be described as disastrous, culminating in the decision to let Lehman Brothers go bankrupt, a decision widely and, we believe, correctly seen to have been a mistake of historic proportions. This decision created a whole new crisis in the global credit markets, which, combined with the existing housing-related crisis, brought the financial system to the point of collapse.

I think the Treasury, up until very recently, must have been operating under the motto of Boris Johnson, mayor of London, who said, "My friends, as I have discovered myself, there are no disasters, only opportunities. And, indeed, opportunities for fresh disasters."

That of course, applies to us as well. General Douglas MacArthur has famously remarked that every military disaster can be summed up in two words: "Too late."

That certainly applies to this crisis and to our response to it. The authorities and we were too late to recognize the scope and seriousness of the unfolding crisis, and too late to take the appropriate action. When Federal Reserve Board Chairman Ben Bernanke and others

repeatedly said the crisis was contained, we thought that the probabilities were that it was—they had far more information and far more resources than anyone in the private sector to make that judgment. We were both wrong.

This is not the venue for a complete analysis of policy failures, nor is it my desire to blame policymakers for their errors. I have made enough mistakes in this market of my own, chief among them was recognizing how disastrous the policies being followed were, yet not taking maximum defensive measures, believing that the policies would be reversed or at least followed by sensible ones before things got completely out of control. In this market, our long-term orientation and optimism about the future have not served us well.

I believe the present phase of the crisis was initiated by the politically popular but, in my judgment, economically disastrous decision to nationalize Fannie Mae and Freddie Mac (the GSEs)<sup>1</sup> on September 7. The best analysis of this, in my view, has been done by famed economist Anatole Kaletsky of GaveKal Research, whose two papers, “The Unintended Consequences of Mr. Paulson” and “The Financial Doomsday Machine” are required reading, in my opinion. Some of the more historically minded of you may recognize the title of the first as harking back to John Maynard Keynes’s 1925 work, “The Economic Consequences of Mr. Churchill.”

The stock market had been recovering from its July 15 low, with the S&P 500 Index rising nearly 100 points by the end of August. Even the GSE’s stocks had been rising. Then the seizure happened, and a bit over a week later Lehman went bankrupt, Merrill was sold to Bank of America, and AIG was “rescued,” again nearly wiping out shareholders. The day after the GSEs were seized, AIG stock was \$24. Eight days later it opened at \$1.85.

The GSE nationalization created what Karl Marx would have called a “contradiction” in the capitalist system. The contradiction was that the government repeatedly said financial institutions needed more capital, and that it wanted private capital to solve the problem. But the government also indicated that if it needed to provide additional assistance in the future, then shareholders who had provided capital should be completely or mostly wiped out. Private capital will not be forthcoming if it believes it is the policy of the government to wipe it out should intervention later be necessary. Still, prior to the seizure, there had been enough private capital around to put large amounts of money into Merrill Lynch, AIG, and Lehman. But when the government preemptively seized the GSEs, not because they needed capital and could not get it (Fannie Mae had \$14 billion in excess capital, and Freddie Mac several billion above regulatory requirements), but because the government believed they would run out in the future, then shareholders of every other institution that needed or was perceived to need capital did the only rational thing they could do—sell, in case the government decided to preemptively wipe them out as well.

This made it effectively impossible for any institution, except those who manifestly did not need it, to raise capital. John Thain at Merrill recognized this immediately and salvaged something for Merrill shareholders. The bankruptcy of Lehman, though, ushered in a whole new stage of the crisis.

Heretofore, when financial institutions failed or were seized, their creditors suffered no losses. Bear Stearns creditors were protected, as were those of the GSEs. Lehman, though it was twice the size of Bear Stearns, was allowed to go bankrupt. Creditors who had investment-grade paper on Friday had worthless paper on Monday, leading the oldest money market fund, the Reserve Fund, to “break the buck,” and precipitating a complete freezing up of all short-term credit markets as no one knew whose paper could be trusted.

As I noted earlier, this now seems to be recognized by many as a monumental policy error. (I think it is still widely held that the GSE seizure was good policy, though. If so, it is awfully difficult to account for the financial collapse of all those institutions so close on the heels of what was supposed to be a confidence-building policy decision.) This is not the place for further discussion of the aftermath of Lehman. The question for investors is, where are we now and what of the present policy?

The Troubled Asset Relief Program<sup>2</sup> (TARP), although hastily conceived and in its initial configuration designed to buy assets from financial institutions, was broad enough in its powers to allow it to be modified on the fly. It has now taken on a very sensible and positive form, in my opinion, and one that is likely to be part of a successful effort to restore some confidence and stability to the financial system.

The most important changes in the program were two: (1) putting capital into the banks directly, where it can be leveraged, and, (2) doing so on terms that are shareholder-friendly, which will encourage private capital to invest as well. \$250 billion of capital for financials at a typical leverage ratio of 10-to-1 means the system will have around \$2.5 trillion to invest in loans or securities. For some perspective, the entire market for mortgages on new and existing homes in the U.S. this year should be about \$1.5 trillion. Gross domestic product (GDP) is about \$12 trillion, so we are talking about an impact equal to 20% of GDP. This program may also be extended to include major insurance companies.

The most important part of the TARP program was not its size, but its terms. For the first time, the Treasury is injecting capital into financial institutions without requiring that shareholders be mostly wiped out. The interest rate on the preferred shares, combined with the effective cost of the warrants, provides capital on sufficiently attractive terms that most institutions will avail themselves of it. Most importantly, it signals that it is OK to invest in at least those financials eligible for the TARP, as partners instead of victims of the government.

This program, combined with the coordinated efforts of the Federal Reserve Board<sup>3</sup> (Fed) and other global authorities to guarantee bank deposits and bank debt, to buy commercial paper directly, along with many other efforts, are (finally) sensible policies and should begin to restore confidence to the system.

The goal of policy, indeed the reason we have institutions such as the Fed and the Treasury, is to promote stability and confidence in the financial system. The current crisis would not have reached anything approaching its current form if they had pursued policies that accomplished that.

The core of the problem is nicely captured by a story Berkshire Hathaway's Charlie Munger tells about a little boy who lived on a farm and was in school when the teacher posed the following problem: "If there are nine sheep in a pen and one runs out, how many sheep are left?" The class all responded "eight" except for the little boy who said, "No, zero." The teacher said, "I can see you don't know anything about arithmetic." To which the little boy replied, "I can see you don't know anything about sheep."

With the GSEs, the Treasury took them out of the pen and thought that all the other sheep would remain. But we sheep realized that if they killed the shareholders of the GSEs preemptively, they would also kill the shareholders of Lehman, AIG, and any other financial institution that needed or was even perceived to need money, and we all stampeded from the pen.

(As an aside, what would good policy have looked like in that case? Just like the TARP: senior preferred shares at some reasonable rate, warrants for some percentage of the equity amount of the preferred. Even better, to minimize risk to the taxpayer, let private capital invest alongside the government on the same terms. We proposed just such a policy with respect to the GSEs, but the Treasury ignored it, having apparently already decided to wipe shareholders out.)

I think the problem has been that the authorities have been trying to get the arithmetic right on such questions as: What should the spread between GSE debt and Treasuries be? What level of Fed funds provides enough liquidity without raising inflationary expectations? How much capital does the banking system need? And so on. All the while, they had been pursuing policies causing all the sheep to run out of the pen. What needs to be done is to pursue policies that get the sheep back into the pen, that get investors out of cash and into risk-based assets. The current policies are a start, but much more could be done.

We saw in the last week of October signs that the worst of the crisis may be over. If it persists, though, or gets worse, then more will need to be done.

Here are two suggestions: First, in order to get people out of cash and into stocks, corporate bonds, and real estate—into long-term assets—Congress could create a one-year window where any purchase of such assets, provided they were held for at least a year, would be free of capital gains taxes. If you buy a house, or a stock, or a bond, in the next year, and hold it for at least a year, it will be forever free of capital gains taxes. This would cause a flood of money to return to long-dated assets, restoring value to people's savings, 401(k) plans, etc. It would be temporary and short-lived, but enough to see us through the present crisis and help restore confidence. Given the scale of losses in the past years, capital gain receipts are going to be minimal compared to the past. A temporary program such as this would likely increase government revenues in the short run as people realize gains now in order to reinvest tax free. People would have an incentive to become truly long-term investors, since if they sell the asset after one year, the proceeds would have to be reinvested under whatever capital gains tax regime was then in effect. The only way to avoid future taxes would be to hold the asset as long as possible.

Second, in order to bring down mortgage rates sharply and greatly increase the demand for housing, the government could offer to swap GSE paper for Treasuries on a one-to-one basis. There is currently about a 200 basis point difference between the yields on the two, despite both being guaranteed by the government. The Treasury or the Fed could swap the expensive asset for the cheap one, creating an instant capital gain for holders of GSE paper, and spreads would collapse as buyers arbitrated away the difference. This would accelerate the stabilization of housing as mortgage rates dropped and refinancings increased.

This is a collateral-driven crisis, not a liquidity crisis. It was caused by the drop in housing prices, housing being the collateral for mortgages, the single largest pool of credit. Mortgages in turn are the collateral for mortgage backed securities, which in turn have been sliced into ever more complex instruments. Now no one has confidence in collateral values, which is why credit markets are frozen.

The continued sell-off in global equities is particularly ominous, as equity is the ultimate collateral underlying the system. As equity values erode, everyone from ratings agencies to the average person on the street begins to question whether there is enough equity to backstop the system's obligations. This leads to ratings downgrades and calls for more equity and for everyone from pension plans to hedge funds to mutual funds to insurance companies to convert long-term assets of uncertain value such as equities into short-term assets of certain value such as cash. Liquidity becomes king. But as Keynes so correctly noted over 70 years ago, there is no liquidity for the system as a whole.

It is imperative that collateral values be stabilized, including the value of equity. As equity is a residual, this ought to happen automatically once confidence begins to return to the system.

Left to its own devices, the market will find an equilibrium value, but again as Keynes noted and modern economics has shown, there are many places where the economy and markets might settle, and some of these are consistent with a world of poverty and misery, an outcome no one wants.

It is not the government's job to make stocks go up or to target any particular level of equity values. It is the government's job to promote stability and confidence and to break the cycle of fear and panic now gripping global markets, so that equities can find whatever value is reasonable. Few sensible people believe today's values represent anything approaching a reasonable approximation of the present value of the future free cash flows of long-dated assets.

#### *The Current Investment Environment*

What should one make of an investment environment where the major indices are down 40% to 50% or more, credit markets are completely disrupted, housing prices are falling for the first time in 70 years, bond spreads are at record highs, consumer confidence has plunged, and fear is palpable? If you have been hoarding cash waiting for the collapse, you feel vindicated, maybe even gleeful. If, like many of us, you have been carefully acquiring assets, building up capital, investing for the long term, trying to ignore market fluctuations, you feel sick, maybe even disillusioned, at the scale of the losses to date.

There is little dispute among knowledgeable investors that U.S. (and global) equities are extraordinarily attractive on a wide variety of measures based on historical standards. The worry is they may go a lot lower before they eventually recover, as the current crisis unfolds and as the economy undoubtedly gets worse. This worry is legitimate. After all, to most of us, stocks seemed quite cheap at the end of September, and now they are a whole lot cheaper. So what to do? The data indicate there is now a mountain of cash on the sidelines, enough in money market funds to buy about half the market capitalization of the S&P 500.

One of the most important bullish signs has been little remarked upon. The monetary base, which consists of cash in circulation or in banks, had been decelerating during the entire time the Fed had supposedly been injecting liquidity into the system since last August. Thus, the amount of what economist Milton Friedman called high-powered money to stimulate the economy was decelerating, and so was the economy as the crisis continued. Now, though, the base is exploding as the Fed has finally turned up the liquidity pump. Since just after the GSE seizure, the Fed began expanding the monetary base, so far by over \$300 billion, an unprecedented increase. It takes a while for all that liquidity to find its way into the system, but find it, it should, and the transmission mechanism is typically through capital markets first. As it does so, the odds are very good credit spreads will begin to decline sharply and equity prices rise.

It is an old cliché that they don't ring a bell at the tops and bottoms of markets, but it is not entirely true. Occasionally someone climbs up in the belfry and does just that, as a public service, but knowing that few are likely to heed the bell. That someone is Warren Buffett, and the reason he is one of the richest men in the world is that he understands asset values and human behavior as it relates to those values better than anyone. In 1974, which prior to now was the worst bear market since the 1930s and the best buying opportunity since then, he recognized that the values were compelling and advised that the time was right to start investing. In 1999, he warned that prices were very high and future rates of return likely to be far below normal. Sure enough, the trailing 10-year return on stocks is now negative, something seen only a few times in history, and an event that has historically heralded strong returns over the next 10 years. Mr. Buffett has returned to the belfry to ring the bell again, with his October 17 *New York Times* piece saying to buy American stocks, that the values are once again exceptional. His partner, Charlie Munger, has also recently remarked that we are setting the stage for a 10- or 15-year bull market. Once again, few are paying heed.

We are.

#### *Value Trust Portfolio Comments*

While visiting a client in Asia last month, I was describing the opportunities created by the dramatic drop in stock prices, and what I thought ought to be done to capitalize on it. The client said, "It sounds as if you think you know what to do." I replied that while I had been wrong to underestimate the crisis and wrong to be bullish too early, I thought the strategy was sound, even if the market went lower. The client answered that at least we had a plan; their other managers appeared shell shocked. I later called one of their other managers, whom I know, and asked him what he was doing. "I'm shell shocked," was the response.

Whenever there is a bear market, people typically go back to previous bear markets and look and see what did well coming out, and adjust their portfolios accordingly. I think that approach may be less effective this time, because I think the recovery will not be one that unfolds in the context of the kind of credit environment that existed in the post-war period. We reached the point of maximum systemic leverage over a year ago, and we will not go back to that for a generation or more, in my opinion, if ever. Credit will become much scarcer and credit growth will not exceed GDP growth, and will likely lag it.

Whatever happens to the market, it seems to me the following approach to stock selection will likely minimize future losses while preserving the opportunity for significant gains. In any investing environment, the scarce resource becomes more valuable relative to the abundant resource.

Debt has been growing for decades, and there is too much of it relative to equity. The scarce resource is equity, and companies that do well will be those that generate cash (equity) well in excess of their needs, and that have an abundance of it on their balance sheets. In addition to being cash generative and cash rich, the companies we think will do well will have the following characteristics: they are market leaders (No. 1 or No. 2), and should have bargaining power with suppliers and customers. In difficult times, you might stop doing business with No. 3 or 4 but will usually stay with the leaders. Ideally, dividend yield should be competitive with or even above the 10-year Treasury. Even if the market goes nowhere for years, the dividend will provide a source of return. The stock price should be at a five-year low or lower, so you are not paying for any of the gains of the previous bull market. Finally, valuation (using traditional metrics such as price-to-cash flow, price-to-book, price-to-earnings, and free cash flow yield) should also be at a five-year low or more.

The combination of market leadership, financial strength, current dividend yield, low stock price and low valuation, especially if buttressed by a solid share repurchase program, ought to provide a significant margin of safety in turbulent times, while preserving the opportunity for capital gains as confidence returns. Our portfolio contains a large number of just such companies, and has more since the quarter ended.

It has been well and correctly remarked that the only things that go up in credit crisis and financial panic are correlations and volatility. Put differently, almost everything has dropped in price dramatically, quite apart from its fundamentals, outlook, or value.

This presents investors with an opportunity to separate those businesses whose competitive position, financial strength and management quality should allow them to weather the current difficulties well and recover soon from those that will become increasingly challenged by the economic environment.

Our team is fully engaged in that effort.

We appreciate your support during these very difficult times and, as always, welcome your comments.

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DJIA: 8,282.66

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<sup>1</sup>GSEs, or government sponsored entities, are private corporations with public purposes created by the U.S. Congress to reduce the cost of capital for certain borrowing sectors of the economy. Members of these sectors include students, farmers and homeowners.

<sup>2</sup>A government program created for the establishment and management of a Treasury fund, in an attempt to curb the ongoing financial crisis of 2007-2008. The fund was created by a bill that was made law on the 3rd of October 2008 with the passage of H.R. 1424 enacting the Emergency Economic Stabilization Act of 2008.

<sup>3</sup>The governing body of the Federal Reserve System charged with, among other things, managing the nation's monetary policy by influencing the monetary and credit conditions in the economy in pursuit of maximum employment, stable prices, and moderate long-term interest rates.

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