


Bill Miller Dishes On His Streak and His Strategy

**With a Fourth-Quarter Surge,
Legg Mason Value Trust Beats
The S&P for 14th-Straight Year**

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After a furious finish last year, Bill Miller's streak lives.

With a late-December surge for his \$11.9 billion Legg Mason Value Trust, Mr. Miller edged out the Standard & Poor's 500-stock index for the 14th-consecutive year. The next longest streak in the mutual-fund world is half as long, according to investment researcher Morningstar Inc.

THE JOURNAL REPORT



¹ See the complete [Mutual Funds Quarterly Review](#).²

Mr. Miller's streak is the product of an eclectic investment approach. Rather than focus on stocks with a particular label -- value or growth, large or small -- he and his colleagues at Baltimore-based Legg Mason Funds cast a wider net than most in his role as portfolio manager of Value Trust. Their goal: Sift through the market for businesses whose competitive advantages

will lead to vast profits down the road, then make big, long-term bets at prices that seem reasonable given the growth potential.

The veteran value investor buys traditional "value" fare like financial stocks, but also "growth" stocks prone to nosebleed valuations and jarring volatility like Nextel Communications, Amazon.com Inc., IAC/InterActiveCorp, eBay Inc. and, most recently, Google Inc. These picks occasionally have drawn critics, but they were also key drivers of a more than 15% jump for the fund in the fourth quarter.

Mr. Miller, 54 years old, plays down the importance of his much-ballyhooed streak. The former philosophy student and government intelligence officer who has worked at Legg Mason Inc. since 1981 notes that calendar-year returns are an arbitrary yardstick. In fact, when looking at rolling monthly returns, there were more than 30 12-month periods where he trailed the index during the streak, according to Morningstar.



Bill Miller

Still, there is no ignoring that Value Trust has posted a more than 830% cumulative return over the past 14 years, more than double that of its average peer and the index, by Morningstar's tally. Mr. Miller chatted with the Journal about his record, his strategy and today's markets. Excerpts follow.

WSJ: *First things first, how did you celebrate?*

Mr. Miller: By delaying the start of my much-needed diet for one day. We had a celebration at a club in our building Monday for our investment team and other people in the organization. There were about 75 or 80 people there and some fund-board members. It was a little after-work champagne. It was nice.

WSJ: *What's the bigger surprise -- that you've built this streak or that no one else has matched it?*

Mr. Miller: The evidence is pretty compelling that the market is pretty efficient and will beat most

people most of the time. ... When I took over the fund in late 1990 ... one of the things that became clear to me was that the way people typically constructed portfolios had some flaws.

People reacted to information as opposed to anticipating it. More importantly, they tended to spend too much time thinking about businesses via simple-minded, short-term factors like current earnings acceleration or deceleration, or today's P/E [stock price-to-earnings] or P/B [stock price-to-book value] multiple. That's why some people sold Microsoft and Wal-Mart years ago because they seemed expensive at the time. ... Portfolio turnover is over 100% for the average mutual fund, implying a 10- or 11-month holding period even though the short term is pretty well reflected in stock prices.

The biggest opportunity for investors is really thinking out longer term. ... So, we tried to adjust the construction of our portfolio to reflect the neglect that analysts and portfolio managers have given to those factors. Our turnover rate has dropped significantly as we've tried to lengthen our time horizon. I think that has contributed to the consistency of our results.

As for the so-called streak, that's an accident of the calendar. If the year ended on different months it wouldn't be there and at some point those mathematics will hit us. We've been lucky. Well, maybe it's not 100% luck. Maybe 95% luck.

WSJ: *To illustrate your approach, walk us through your thesis and current valuation estimates for one "growth" stock you own that's been controversial -- Amazon.com?*

Mr. Miller: People focus on Amazon, InterActive, eBay and Google because they overemphasize near-term valuations and don't think about businesses' long-term dynamics. What ties all this stuff together is that we're trying to estimate long-term business value.

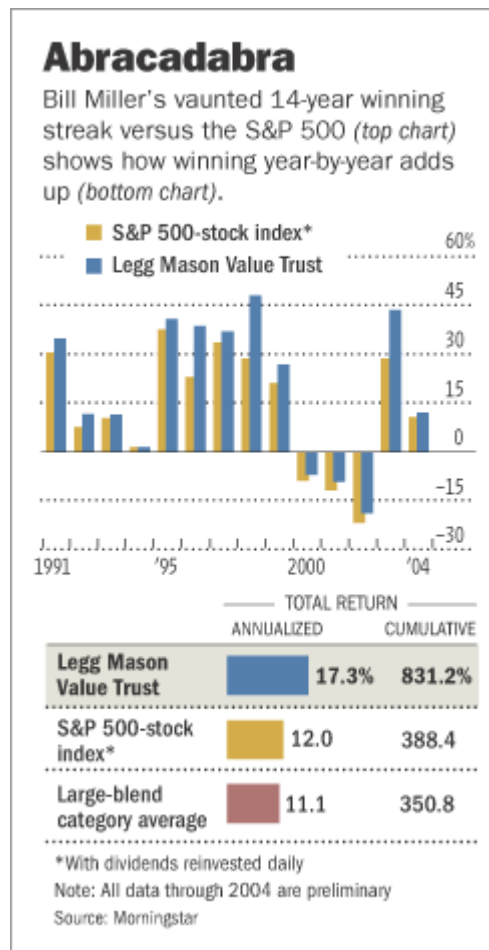
We think Amazon is conservatively worth in the mid-\$50s. For some reason, people love to hate Amazon and love to love eBay. There's never a bad word said about eBay, which is fine since we're shareholders of eBay, but you wonder how they can worry so much about Amazon when the company is doing so well.

Amazon generates huge amounts of free cash flow. They continue to successfully enter into new product categories and geographies.

When you look at Amazon you're looking at the low-cost provider of these services that also has the highest customer-satisfaction ratings.

People think about Amazon as a retailer because it does in fact sell products like a retailer. What they don't understand is that retail is the business they're in, but it's not their business model. They're in the retail business with a model similar to Dell -- both are direct-to-customer purveyors of goods. ... You can look at Dell to gauge the trajectory Amazon is on. We think Amazon will have sales growth of 25% or higher in the near term and that over the longer term 15% revenue growth isn't an egregious estimate for a company in this early stage of its life cycle.

If you assume the company traces roughly the same growth as Dell and you look at its current valuation, it should outperform



the market by a factor of at least two.

WSJ: *What about one of your holdings that's traditional for value-fund managers but has become controversial due to accounting questions -- Fannie Mae?*

Mr. Miller: We've owned Fannie Mae for years because it has a sustainable competitive advantage. They can earn above their cost of capital even if that cost rises. ... The issue with Fannie is not the economic reality of their business, but how it was portrayed [by its accounting]. ... I think all of that is noise obscuring the important facts that the stock has a low valuation and a significant competitive advantage. ... There's a whole coterie of people shorting Fannie Mae and worried about it. That's typical when you have controversy and uncertainty like you have today. Whenever you find something that's very cheap, people will line up to tell you why you shouldn't own it. Our success is always defined by how many of those calls we get right.

WSJ: *Many strategists say shares of the biggest U.S. companies look cheap. Where do you see value today?*

Mr. Miller: One of the unusual things about this market is that there are no real obvious valuation anomalies where broad swaths of the market are deeply mispriced. Even in 1999 and 2000, when the market was dominated by technology stocks, most of the nontechnology names were quite cheap. This market is more like the markets of the late 1980s. It's not like 1987 when everything was overpriced, but it's like 1987 in that there's a lot of equilibrium in the overall market. The good news is that today's equilibrium is at a level that's modestly below what a lot of companies are worth. On the whole, the market is pretty attractive.

I don't disagree that some of the biggest stocks are moderately underpriced relative to the rest of the market. A lot of the common valuation metrics indicate there's value there and we don't dispute that. Names like Fannie Mae, Citigroup and J.P. Morgan are examples.

WSJ: *Is it harder to find bargains than it was a year or two ago and is that partly because of your fund's growing asset base?*

Mr. Miller: Prior to March 2003, when the market took off, everything was cheap. Companies where people were concerned about scandal, bad balance sheets and questionable management were really cheap. Those companies were being virtually given away. In summer of 2002, Nextel was trading at one times what it would earn two years later. You don't see that very often.

Now people look at the market and are concerned about valuation, but we aren't. Why would you expect things to be cheap when the economy is good, cash flows are strong, balance sheets are strong and companies' returns on equity are at record levels? To expect things to be visibly cheap when everything is going well just doesn't make sense.

WSJ: *You own shares of three hedge funds in your \$3 billion Legg Mason Opportunity Trust and recently expanded the parameters of other stock funds to allow them to do the same. Would you invest in hedge funds in Value Trust, and with these investments are you trying to boost returns or outsource some research efforts?*

Mr. Miller: Both. We're talking about a relatively small amount of money, totaling less than 5% of the [Opportunity Trust's] assets. I think of the [hedge] funds as an investment position that will and has added to the [Opportunity Trust] fund's returns.

Secondarily, the [hedge funds] are ways to amplify and augment our research by talking to managers and

analysts at those three firms. I doubt if we'd [own hedge funds] in Value Trust because the fund is so large that it would take a large investment to make a difference in Value Trust's returns. We have a unified research effort, so the research benefits accruing to shareholders of the Opportunity Trust are accruing to shareholders of Value Trust, too.

WSJ: *Many strategists have predicted muted, below-average stock returns in coming years. Do you buy that idea and what's your best guess for the market's direction in 2005?*

Mr. Miller: My reaction is to ask, below average compared to what? If you compare future returns to those of the last five years, when the market went almost nowhere, I'd say no. If we're talking about returns being more muted than they were in the bull market from 1982 to 1999, I'd say absolutely. The way we calculate implied returns in the market is by adding the historical equity risk premium of about 3.5% to the yield on 10-year Treasurys. That gives you about a 7% to 8% return in the broader market. If inflation stays low, that gives you a real return that's about in line with historic averages.

I think returns will be a bit higher than that this year. Last year there was a lot of uncertainty and the market went nowhere for nine months. This year I think the economy will be fine, cash flows will be great, dividends will be good and mergers and acquisitions will be extremely strong. So, investor, business and consumer confidence will remain robust. That should lead to a good market.

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