CHAPTER 1

BILL MILLER: THE GO-TO GUY FOR NEW ECONOMY VALUE INVESTING

You got to be very careful if you don't know where you're going, because you might not get there.

Yogi Berra

The telephone rings. A young woman hurriedly announces that Bill Miller will be on the line in a second. Is this a good time for the interview? Actually, my computer is down for a couple of hours with my carefully crafted questions inside. But we've tried to arrange this telephone tête-à-tête for weeks. Miller is traveling. I am traveling. Okay, let's go for it. I warn him that I'm taking notes by hand, juggling the telephone and a legal pad, working from memory. Fine. He blasts off like a verbal rocket ship, firing out big concepts, spewing multisyllabic words, responding to questions as if his afterburners are in full tilt.

Whew! William H. Miller III, America's new money master, is a man in a hurry, but he's not showing off, brushing off, or short shrifting. By nature a high-energy, intellectualizing type (what else can you say about a man who uses the word *enantiodromia*—i.e., to proceed by way of opposites, or to swing the other way—in an annual report), Miller has earned celebrity status among investors and his peers by taking a classic concept—value investing—and catapulting it into the twenty-first century.

Michael Mauboussin, an investment strategist at Credit Suisse First Boston who also teaches an investment class at Columbia Business School, considers Miller the best mutual fund manager in America. "He's had a couple of things that land-mined this year (2001). But the guy made more money than God in AOL and Dell."[1] (By 1999, Miller had a 3,500 percent gain in Dell. At that time, he began trimming down his position.)

Fifty-two-year-old Miller runs the Baltimore-based Legg Mason Funds and is manager of the $11.8 billion Value Trust, the only diversified fund to beat the Standard & Poor's 500 for 11 years in a row. He was named Morningstar's Domestic Equity Fund Manager of the Year in 1998 and was his fellow analysts' choice for Morningstar's 1999 Investment Portfolio Manager of the Decade category. For the life of Value Trust, it has given an 18.24 percent annual return, and since 1991 Miller has achieved an annual total return of 18.16 percent, putting him laps ahead of most value-oriented money managers. In his eighth year of outperforming the S&P, he seized the record from former Fidelity Magellan legend Peter Lynch.

Furthermore, Miller achieved these records in a market that was decidedly hostile to value fund managers. For 30 years, from the mid-1960s to the mid-1990s, value was the front-running performance style, but since 1995 value funds have taken second place to growth funds. Some growth managers grouse that Miller only achieved stellar results throughout the 1990s because he abandoned value principles by switching from the old-economy blue-chip companies to a new-economy high-tech mode.

In fact, Miller does, from time to time and for significant parts of his portfolio, journey into the world of contemporary technologies. Yet he says this in no way diminishes his love affair with the fundamental value concepts. It does indicate, however, that Miller sees the future and knows that at some point value investing concepts and the world of high-technology business must meet, greet, and enter into a relationship.

THE RACE FOR THE BETTER BRAIN

Computer scientist Ray Kurzweil, author of *The Age of Spiritual Machines: When Computers Exceed Human Intelligence*, predicts that by the year 2018 computers costing just $1,000 will have roughly the same intelligence as the human brain. They will be able to talk with humans, recognize us, and keep us company when we're lonely. Short of an opposable thumb and a few other features, they'll have everything humans have. And within 10 years more, a $1,000 computer brain will have the power of a thousand human minds. The brilliant machines will start claiming consciousness—the digital equivalent of "I think, therefore I am." Kurzweil writes that "The specter is not yet here." But, he adds, "The emergence in the early 21st century of a new form of intelligence on earth that can compare with, and ultimately exceed that of human intelligence, will be a development of greater import than any of the events that have shaped human history."[2]

Given the potential impact of advances in electronic communication and computerization, can the revolution this implies be ignored by the investment world? Change is coming on galloping hooves, and indeed, investors have been overtaken by change before. But the canniest among them rode with the herd, embracing the onslaught as Bill Miller has done, rather than resisting it.

In their book *Information Rules,* Carl Shapiro, former chief economist to the Justice Department, and Hal R. Varian, dean of the School of Information Management and Systems at University of California–Berkeley, point out that a hundred years ago the way people lived and worked was turned upside down by two early network industries: the electricity grid and the telephone system. The rate of adoption may have been slower than the adoption of the Internet and it took longer for unifying standards to be established, but just as the impact of the Internet is huge, so were electricity and the telephone. Some experts claim that computers and the Internet are nothing more than the next evolutionary stage of these seminal technologies. Whatever the case, one thing is clear: Information technology is no longer something that nerds manipulate for kicks; it has become big business. Those who avoid it risk being left behind.

CAUGHT IN THE CORRECTION

Yet, as everyone discovered as the millennium dawned, high-kicking high tech is as risky as the old fuddy-duddies warned. And despite his innovative meshing of high tech and value, Miller to some extent got caught in the correction. Like all investors, he has chosen dynamite and duds, held both losers and winners too long, and simply missed the message on some superior companies. Like Warren Buffett and other longtime survivors in the investment world, Miller has occasional down ticks. During the late 1980s, Value Trust underperformed 4 out of 5 years, and ratings from Morningstar and other ratings services were an embarrassment. Although Miller turned that around and continued to outperform the S&P 500 through the end of the twentieth century and into the twenty-first, the returns on his funds were sometimes in negative percentages. Fortunately, the S&P's negatives were greater than Value Trust's. But Miller says these occasional slumps don't matter. Ten good years in a row "cuts you a lot of slack. I can underperform this year, next, for the next 3 years really."

All this said, those irritating, tenacious, value-oriented questions remain: When information technology stocks have such limited histories, how can an investor be certain that revenues will grow, free cash flow will be strong, and other fundamentals will materialize? With the wispy information that is usually available, how can anyone figure out whether a company's price is too much or too little? Miller admits he doesn't always know for sure. And his critics have expressed doubts at times that he is sure of what he's doing.

In fact, that's not even the way Miller thinks about his investments. He is acutely aware that in the investment world, there is no such thing as certainty. It's all about probability—how probable is it that a stock will achieve an expected return over time? Miller fully expects to be wrong a certain number of times, but he expects to be so spectacularly right enough times that he will achieve a high level of performance. For example, explains one of his analysts, Mark Niemann, if Miller is investing in four companies, three of them might go to zero. But if the fourth went to 6 times its current price, Miller could end up with a 50 percent return, or a total return on his portfolio that would beat the market. In fact, an analysis of Miller's portfolio performance would show that he sometimes has a lower frequency of correct picks than other managers do, although his return remains high.

"I USED TO BE SNOW WHITE, BUT I DRIFTED"—MAE WEST

Imagine the uproar in the mid-1990s when Bill Miller, a conservative-type money manager from Baltimore, started nosing around tech stocks, then made the big leap—God forbid—to telecommunications and Internet issues.

To a whole crowd of observers, old-line Legg Mason Wood Walker Inc.'s Value Trust, which eventually had 20 percent of its assets in stocks such as America Online, Amazon.com, and Dell Computers, was a travesty. To many, Value Trust, always a blend of value and growth, had crossed the line to become a growth fund. After all, it now quacked and waddled and flapped its wings like a growth fund. So a growth fund it must be.

"Lots of value managers, like William Miller at Legg Mason Value, are no longer buying what we consider value stocks," wrote mutual fund columnist Mary Rowland. "Miller's record is great, with annual returns of more than 43 percent over the last three years. But is it value, when your top holdings including America Online, Dell Computer, and MCI WorldCom? I don't think so."[3]

Even more critical was a column published in July 1998 on the financial web site theStreet.com. The site's founder, James J. Cramer, wrote, "value in this world has simply become a masquerade, a mean spirited marketing tactic that lures people in the door who would otherwise have no desire to own such nosebleed stocks."

WAS VALUE INVESTING DEAD, OR JUST OUT COLD?

The implications were abundantly clear. Bill Miller had become a poseur, a pretender—no longer a crew-cut, establishment-value guy. What's more, if a man smart enough to beat the S&P 500 year in and year out was jumping ship, then clearly value was dead. Journalists were among those who shouted the loudest that Miller had sold his very soul, especially those writers who pinned their analysis on highly simplified investment definitions.

Most of the pooh-poohing of Miller as a value investor came in the late 1990s, when respectable publications were happily and confidently chiseling headstones for the value approach. In an article typical of the times, *Businessweek* reported that despite the new-millennium revival of the classic approach, "the current rally could also be the last hurrah for old-style value investing. Such investing produces its best results in a traditional business cycle. Value stocks typically achieve most of their gains from the bottom of a recession to the top of the expansion as the rising economic tide lifts revenues and profits. Growth stocks—those with more reliable earnings streams—then outperform value stocks in the down phase of the business cycle.

"In a period of declining profits, the market prizes the companies whose earnings can continue to grow. But now, thanks to technology, globalization, and a savvier monetary policy, the business cycle has been dampened and elongated. From 1945 to 1991, the U.S. economy went through nine recessions. The current expansion is eight years old [this was in 1999], with no recession in sight. With fewer recessions, there are fewer opportunities for typical value stocks to shine. Low inflation also works against value investing."[4]

THE VETERAN SLUGGERS

Could the furor surrounding value have occurred because a generation raised on instant gratification couldn't deal with value-specific time frames? In fact, over extended periods of 20 years or more, value invariably beats growth. From 1946 to 2000, according to the research firm Ibbotson, value stocks bested growth stocks 15.4 percent to 11.5 percent. Put another way, $100 invested in value stocks in 1946 would have been worth $266,544 by 2001, compared to only $39,681 for growth stocks. Yet go back only 5 years, to 1996, and growth and value dash forward in a dead heat, with a 15.3 percent annualized increase for growth and a 15.1 percent rise in value securities. It only takes 10 years for value to overtake growth; by then, value has a 15.4 percent annual increase and growth stocks have slipped to 14.6 percent.[5]

Those who accused Miller of changing his stripes seemed insufficiently aware that the mission, the aspiration, the dream of value investors is to buy stocks that show the promise of growth. Clearly, all investors share this goal—to buy something now that will be worth more later. But value investors only want these stocks when they can be snatched up at a price comfortably beneath their intrinsic, or true, value. Given some of his choices, it was difficult for cynical observers to imagine Miller in the company of other great, revered, enduring value investors such as the late Columbia University professor and author Benjamin Graham, Warren Buffett of Berkshire Hathaway, William Ruane of the Sequoia Fund, Sir John Templeton of the Templeton Funds, or John Neff, retired from Windsor Funds. And, in fact, Miller doesn't exactly fit that mold. The difference between the various value practitioners—then and now—is how they make their choices and how long they're willing to wait for rewards.

Money manager and author, Robert Hagstrom, says that among investment gurus Miller has much in common with Buffett's curmudgeonly partner, Charlie Munger, who spent his early investment years combing every possible investment situation, shopping for bargains and overlooked possibilities. Later, Munger changed his approach. He decided deep value purchases took too much time to come to fruition, caused too much psychic pain. Better to pay a little more for solid value and sleep well at night without fears that your big investment might flip belly up.

GROWTH VERSUS VALUE

Even writers who should have known better were befuddled by Miller's approach because while they admired his accomplishments, they felt they couldn't find an easy niche for him. *Barron's* described Miller as an investment manager to whom "the investment muse speaks in a mysterious fashion, and one that has led him both to excellent results and a style that resists categorization."[6]

Nevertheless, perhaps due to his years of studying philosophy, Miller is sanguine about being misunderstood.

"I attribute it to the inability of people to understand long-term investing. 'Growth' and 'value' are labels that people use to try to categorize things," he said. "If you look at Morningstar's investment-style grid, we have migrated through the whole spectrum. Yet this fund has invested the same way for 15 years."[7]

From its inception in 1982 to 2001, Legg Mason Value Trust has had an average annual total return of 18.24 percent. Originally Miller managed the fund under the tutelage of respected veteran money manager Ernie Kiehne. Even with its admirable return, Value Trust had underperformed the market 4 out of 5 years in the late 1980s. This included two separate 2-year periods. "Those were years of greater economic volatility than we have experienced recently, as the more cyclical parts of the economy swung from periods of strength to weakness and investor behavior alternated between euphoria (1986 to mid-1987) and panic (late 1987 and 1990). During that period, the world was rocked by the collapse of oil prices in 1986, the dollar's weakness and the federal reserve's raising of interest rates in 1987, the fall of communism in 1989, the savings and loan banking crisis in 1989 and 1990, and the invasion of Kuwait in 1990, which sent oil prices spiraling up."[8]

Then in 1990 Miller took charge. Luckily, that year Wall Street was entering into its most remarkable growth phase ever. But even on top of that, Miller, as we shall see, supercharged the fund's performance. Between 1991 and 2001, the fund gave investors an average annual return of 21.05 percent.

Despite the fact that Value Trust outpaced the S&P 500 for 10 years in a row, Miller went through a frighteningly difficult streak in 2000. His fund trailed the S&P that January and February, due mainly to weakness in one of his core holdings, AOL. Investors began fleeing the fund at a clip of $20 million a day. Nevertheless, Miller managed that year again to best the S&P 500. We'll examine his record and review the lessons learned later in this chapter.

What has enabled Miller to weather so many financial storms? The *New York Times* asserted in early 2001 that it's his consistency that has made him "the reluctant, rumpled star of the investment world."[9] Despite his willingness to dive into the technology sector, Miller's personal style resembles that of the stodgy value crowd rather than the cocky, high-energy, reactive managers so often associated with tech funds.[10]

MILLER'S DEFINITION OF VALUE

And what *is* the style of the nation's mutual fund champion? Miller explains:

> *"We try to buy companies that trade at large discounts to intrinsic value. What's different is we will look for that value anywhere we can. We don't rule out technology as an area to look for value."*[11]

Then Miller drives his main point home:

"Our definition of value *comes directly from the finance textbooks, which define value for any investment as the present value of the future free cash flows of that investment. You will not find value defined in terms of low P/E [price-to-earnings] or low price–to–cash flow in the finance literature. What you find is that practicing investors use those metrics as a proxy for potential bargain-priced stocks. Sometimes they are and sometimes they aren't."*[12]

What, finally and decisively, earns for Miller the crown of a value investor, even though he sometimes seems to break all the traditional rules by buying short-history stocks with extremely high price-to-equity ratios?

- Like the purist Graham, Miller ignores the fickle moods of the infamous Mr. Market. "I don't have a strong view of the overall market," says Miller. "There is very little value added trying to predict where the market is going or guessing whether it's overpriced or underpriced," he says.[13]
- Like value icon Buffett, Miller looks for franchise value. This is one of the characteristics he likes about Amazon.com.
- Like John Burr Williams, Miller is willing to forecast when he runs the numbers. At the same time, he believes that numbers aren't enough to tell you everything you need to know before dialing up your brokerage firm and placing an order to buy a stock.
- Like Charlie Munger, Miller looks for investment ideas everywhere.

- Like all value investors, when making stock purchases, Miller works a margin of safety into his calculations. There is room for error. "Our methods are designed to try and capture companies very early on in their potential return stage, meaning they've been beaten down," he explains.[14]
- Like Sequoia Fund's William Ruane, Miller is not a frequent trader. He buys and holds; he invests for the long term.[15] "I'll easily trade no rate of return in the near term for higher confidence that the stock will outperform in the long term," he says.[16]

BUCKING THE TREND

To be sure, Miller took the majority of his criticism when the value approach to investing was in one of its most difficult phases. Value always suffers at the top of a bull market, but the situation looked especially bad in the summer of 2000. That year, Mark Coffelt, whose Texas Capital Value & Growth Fund had one of the lowest P/Es in its class, said, "Value has had what is the equivalent of a 200-year flood."[17]

Although Coffelt conceded that the last 2 years of the century were the worst in nearly 50 years for pilgrims in search of low-P/E stocks, he promised that value investing was due for a comeback and should do better than the so-called growth stocks over the first 5 years of the new millennium. "We don't think the laws of physics have changed," Coffelt said.[18]

In the enigmatic way of Wall Street, while the death knell was still ringing for value investing, certain value investors—Miller among them—were knocking down the blocks. In early 2000 Mohnish Pabrai, founder of the Pabrai Investment Fund I (PIFI), was beating more than 99 percent of mutual funds and professional fund managers. His PIFI, which is modeled after Warren Buffett's first partnership (which was formed in the late 1950s and disbanded in the early 1970s), had a 62.5 percent return (before fees and expenses) and outperformed all three market indices: the Dow Jones Industrial Average by 68.7 percent, the S&P 500 by 57.8 percent, and the NASDAQ Composite by 15.2 percent. Pabrai is an ardent value disciple and yet certainly managed his affairs differently from Miller. "Our performance is very compelling for the year because it was achieved by buying very mundane stuff," Pabrai said. "We have made very little in terms of pure technology bets. I'm only interested in investing in companies where I can project at least 5 to 10 years forward—by definition this is virtually impossible with most technology companies."[19]

Miller admitted the following year that his style might be open to criticism, but still, it got the job done:

> *"Over the long term [LM Value Trust] has provided shareholders with very attractive returns. However, along the way to this long-term outperformance, the fund has seen numerous quarters of under performance. Performance history suggests that periods of market weakness can be excellent opportunities for investment."*[20]

As might be expected, when tech's winning streak ended, value stocks again became the champions. The rush back to value, with its reputation for safety, began, and mutual fund investors were swift to move. Bill Nygren's Oakmark Select Fund, which had $3.1 billion in assets, gained significantly in the first 4 months of 2001. Nygren was so alarmed by the sudden $700 million in hot money that he stopped accepting new investors early in May. He feared that size would make it impossible to stick to the successful strategy of owning only 20 stocks and investing in midsized companies. Additionally, "There's a concern that many of our new investors are performance chasers who could be disruptive to the fund," Nygren explained.[21] Because investors perceived Value Trust as a tech-heavy fund, however, just the opposite happened to Miller. Investors withdrew.

Nevertheless, the resurgence in investor confidence was encouraging to those who stubbornly called themselves value investors. "Market action over the past year confirms that valuation does matter," said Miller.[22]

DO WHAT THE ALL-STARS DO

All the great enduring investors have been value investors. Joining Graham, Buffett, Templeton, and Neff on the value honor roll are Mario J. Gabelli of the Gabelli Funds; Bill Nygren, mentioned earlier, of Oakmark Select Fund; Mason Hawkins, founder of Longleaf Partners; and Larry Sondike of Mutual Shares. Table 1.1 below shows the performance of each of these managers over the past year and since the funds' creation.

Although these investors share a fundamental philosophy, each of them has created his own interpretation of classical value. Early on, Gabelli began valuing companies for the cash they generate rather than their assets or earnings. That concept became the tool used by corporate raiders during the leveraged-buyout boom of the 1980s.

Table 1.1

Fund Manager	1 year %	10 years %	Since Inception (annualized) (%)	Since Inception (cumulative) (%)
Legg Mason Value Trust/Miller	–13.68	18.49	18.17	2488.78
Oakmark Select/Nygren	33.73	NA	29.04	252.46
Longleaf Partners/Hawkins	–2.77	16.80	14.73	633.84
Gabelli Value Fund/Gabelli	–5.83	16.42	14.05	386.46
Mutual Shares Fund/Sondike	–4.16	NA	13.08	232.45

Investors came up with the term *private market value* to designate the price a savvy investor would pay for the entire company. Deal makers bought heavily into companies they saw as undervalued and then used the company's own cash to pay down the money borrowed to finance the purchase. Or at least that was the stated goal. All too often, however, the debt was left unpaid, a dragging anchor on the acquired unit's performance.[23]

As for Buffett, leveraged buyouts have never been his game, but he also stretched the traditional value style when in 1988 Berkshire Hathaway Inc. grabbed a $600 million stake in Coca-Cola, and in 1989 a $600 million position in Gillette Co. (in 1989, Buffett increased his Coca-Cola position to $1.2 billion). At the time, neither company was viewed as value stock, and the price seemed unnaturally high for Buffett. But he'd learned from his partner and vice chairman, Charlie Munger, that the old "cigar butt" style of value investing had risks of its own. Often, these deep value buys were badly battered operations. It took time, and sometimes additional cash, to coax these deep/cheap stocks back up to sell for full value. How much more pleasant to pay a higher price, get an appreciated global franchise, and enjoy the long and relatively easy ride up. By 2001, Berkshire's Coca-Cola stake was worth $9.4 billion and its Gillette shares were worth $2.8 billion.

THE MAN WHO COACHED MILLER

Miller had been introduced to value investing concepts in college, but it was Ernie Kiehne, a lively octogenarian and the cofounder of Value Trust, who really indoctrinated Miller into the value way. Miller, Chip Mason, and Kiehne share a love of baseball, each of them having played for their school teams in their youths. Kiehne, a natty dresser from the old school, has long favored the traditional value stocks such as banks, General Motors, and Citicorp (now Citigroup). Miller says he still manages money in a way very similar to that of his mentor, except that Kiehne—who incidentally still serves on Miller's investment team—is more traditional. In what way? "I rely a little more on modern portfolio theory," says Miller. "And we've become much more sophisticated in our valuation methods."[24] (We focus on these advanced valuation methods in future chapters.)

Miller's formation was far from the B-school track. A native of Florida, he graduated with honors from Washington and Lee University in Lexington, Virginia, in 1972, earning an undergraduate degree in European history and economics. After a stint as an Army intelligence officer, Miller pursued a doctorate in philosophy—more specifically, legal and political ethics—at Johns Hopkins University. "So I have not been infected by business school misinformation," he says with a wry grin. "I have my own proprietary source of misinformation."[25]

Miller considered teaching philosophy at one point, but took his professors seriously when they forewarned his class that there were no teaching jobs out there to be had. If the students had no fundamental fascination with the discipline, they might as well study something else. Miller stuck with philosophy through the end of the course work, but stopped short of writing a doctoral dissertation.

This was largely because he'd become increasingly fascinated with financial matters. Michael Hooker, who taught philosophy at Johns Hopkins when Miller studied there, recalls arriving for work each morning: "I was the first faculty member to get to work, and when I would arrive, Bill would be sitting in the faculty library reading The *Wall Street Journal.*" Hooker encouraged Miller to give up philosophy and try his hand at finance instead.

This led to a job in the mid-1970s as a financial officer and later treasurer at the manufacturing company J.E.Baker Co.[26] The York, Pennsylvania–based company operates quarries from which it produces dolomite products, to be used primarily in the production of steel and cement. Miller was overseer of some of J.E. Baker's investment portfolios, and discovered it was the part of the job he enjoyed the most.

During his stint at Baker, Miller's wife, Leslie, who he met and married in 1974 when he was in the Army, was working at Legg Mason as a broker and assistant to the financial house's star broker, Harry Ford. Miller would come by in the afternoon to pick her up from work, and while waiting, start digging through the company's research reports. Raymond "Chip" Mason, Legg Mason's chairman, recalls that Miller would show up about 4:30, and at 6:30 when his wife was ready to leave, he would be so immersed in research reports that Leslie would have to prod him to go.

Leslie Miller introduced her husband to Kiehne, then the firm's head of research. As luck would have it, Kiehne and Mason had launched a search for a person to replace Kiehne as he planned for his eventual retirement. It was somewhat of a surprise to Kiehne to realize he'd met the best possible candidate standing by the water cooler, but with fewer than 500 employees Legg Mason was a relatively small organization and Miller's fascination with research had attracted attention. Miller was hired at the century-old firm in 1981 and a few years later became Kiehne's successor.

Legg Mason remains a relatively small firm, although it has become highly regarded and is quickly strengthening as a global player. With approximately $175 billion under management, it ranks as the 25th largest money manager in the United States.

THE WINNING TEAM

As chief executive officer of Legg Mason Funds Management, Inc., Miller is responsible for five investment mutual funds valued at about $23 billion, including individually managed accounts and large institutional accounts. He also manages two funds at Legg Mason: the Value Trust and the Opportunity Trust. Additionally, he's one of the elite, outside team managers of Master Select Equity Fund, an experimental fund in which mutual fund newsletter publisher Ken Gregory is trying out out some of his ideas.

Until 2001, Miller had managed the Special Investment Trust as well, but that year it was taken over by Lisa Rapuano, age 36, one of the brain trust babies on Miller's 12-member research team and three traders. The Special Investment Trust follows the same investment strategy as Value Trust, but mostly operates in a different market segment—small-and mid-sized companies. About 25 percent of the fund is invested in special situations or corporate turnarounds. Under Miller's guidance, the Special Investment Trust had a solidly good record, outperforming its benchmark, the Russell 2000, by 960 basis points over the 5-year period ending December 31, 1999. Over its full 16-year life, the trust has had a 14.4 percent average annual total return. With this $2 billion fund, Miller invested principally in common stocks of smaller, out-of-favor companies involved in restructurings or other special situations. While these companies have the alluring growth potential of deep value buys, they also carry extra risk, not to mention the possibility of extremely long workout periods. With 42 percent of its assets in technology (at the peak in March), the fund limped through 2000 with a negative 17.74 percent return. The only consolation for shareholders was that the Special Investment Trust did better than its benchmark S&P 400 index, a minus 21.6 between March 2000 and March 2001. By that time the fund had outperformed its benchmark six consecutive years.

But Miller's blazing star remains Value Trust, which seeks growth of capital by purchasing securities that appear to be undervalued in relation to the earning power or asset value of the company. As the prospectus coyly states, "the fund is marketed to investors who seek capital growth in an effort to combat inflation." At the end of 2000, Nancy Dennin, who has worked with Miller for more than a decade, became assistant portfolio manager of Value Trust. Although her record has been excellent overall, Dennin for a time managed Legg Mason Total Return, which was not one of the company's stellar funds and since has been folded into another fund.

PLAY BY PLAY

Value Trust was established on April 23, 1982, with a beginning net asset value of $10 per share. It was a nerve-wracking time to launch a new fund, with double-digit interest rates that severely impacted the stock market. The Dow Jones Industrial Average stood at 825, off 19 percent from its April 1981 bull market high of 1,024. Two months after it started, the fund had 331 shareholders with net assets of $1.1 million and a net asset value of $10.25 per share.

In the first 10 years of Value Trust's history, Miller and Kiehne were comanagers of the fund. Even though the 1980s were generally good for value stocks, Value Trust generated mixed results. Kiehne was a classicist with affection for blue-chip low-P/E stocks. He expressed a liking for bank stocks, but initially at least, only 40 percent of the fund's total assets were in stocks. Stocks were a relatively small part of the portfolio at first because Kiehne and Miller were building their positions slowly over time, a process known at Legg Mason as "munching." Professional investors like to munch at a stock so as not to influence its market price. A sudden, large block purchase could drive the price unnaturally higher. Among the holdings were American Cyanamid, American Telephone and Telegraph, Norfolk Southern Companies, and Westinghouse Electric Corporation. The fund surged in the first few years after its inception. It then lagged for a few years, and when the market tumbled in 1990, bank stocks were among the biggest losers.[27] (For a full list of the fund's holdings at that time, see page 167.)

In 1990, with Value Trust facing a 17 percent decline, Kiehne turned the reins over to Miller. Despite difficult times and lackluster performance since 1986, there were well over 2,000 shareholders in the fund and net asset value per share had increased to $26.76. Even before he saw what was happening to the fund's cache of bank stocks, Miller was shifting toward a more flexible definition of value, relying on future cash flow, return on equity, and other measures that Buffett and other individualistic value investors were already pioneering.[28]

Within the year, Value Trust was beating the S&P 500, 35 percent to 30 percent, but not without an ironic twist: The fund got its greatest boost from Kiehne's reviving bank stocks, as well as other traditional plays such as Fannie Mae, Philip Morris, and the insurer, Orion Capital.[29] "I made a lot of mistakes," reflects Kiehne, "but some of them turned out all right anyway."[30]

Miller did well, but he told shareholders in his 1993 annual report that someone else did better, or at least would have if he was managing investments. "The first quarter belonged to Bill Clinton, who undoubtedly would have been the best performing money manager in America if only those pesky conflict of interest rules were not around. The stocks he likes: autos, airlines, energy, and especially natural gas, did wonderfully; but the ones he did not like: profiteering health care companies, the sinful alcoholic beverage and tobacco stocks, the gluttonous foods, were horrid. Bonds, which he loves, soared and carried stocks with them."[31]

What sounded like praise for Clinton turned the opposite direction at the end of that same report. "Bonds rose sharply in the first quarter and the administration was too quick to conclude the markets were ratifying its policies or, more accurately, proposals," Miller wrote, then added, "Despite the administration's glee at them, rising bond prices are not portents of prosperity. Bond holders are happiest during depressions."[32]

That same year, Miller met with John Reed, chief executive officer of Citicorp, which led him to establish a new position in the stock. Citicorp, America's largest bank, had a dreadful long-term history, and was selling for less than it had in 1929. But, explained Miller, in the course of their conversations it became apparent that Reed "had finally embraced cost control and the idea that the bank is in business to earn a return for its owners. It has an unparalleled global franchise and we expect earnings to approach $4 per share next year."[33]

Near the end of 1993, Miller's race with the S&P was running neck and neck. Value Trust trailed behind the S&P 500 right into the final weeks of the year. Miller remained anxiously hopeful that the fund would be "the horse that comes from the back to win by a nose," and his wish was granted. The last-minute burst of speed came from late gains by RJR Nabisco Holdings and Humana.[34]

The rising interest rates in 1994 again beleaguered the fund's bank stocks. To make the picture even darker, an out-of-the-blue devaluation of the Mexican peso battered the Mexican stocks in Value Trust—Grupo Financiero Serfin and Teléfonos de Mexico. "Judging by the market's action in the past two months, investors began the first quarter unaware of two things they were fully cognizant of by the quarter's end: stocks do not react well to rapidly rising interest rates and Mexico is not the fifty-first state,"[35] Miller wrote. But again, the portfolio got an unexpected, last-minute push when Caesar's World leaped 20 percent as the result of an acquisition bid by ITT Corp. Value Trust finished the year seven-hundredths of a percentage point ahead of the S&P 500.[36]

THE MENTAL GAME OF INVESTING

The most impressive advances to the fund came in 1996, about the time Miller discovered a source of inspiration at the cerebral Santa Fe Institute. Under the influence of economists and scientists meeting in the "city different," as Santa Fe calls itself, Miller experienced an intellectual awakening. (The nature and impact of Santa Fe's new-age theoretics is discussed in Chapter 2.) He considered investing in depressed paper companies, as certain other value investors were doing, or buying Dell, which was cheap because of worries over a cyclical downturn in PC sales. Because of some of the business leaders he talked to Miller concluded that the PC industry would, in time, become a commodity business with a few large players dominating. He figured Dell, a low-cost producer, would be among the leaders. The stock skyrocketed almost immediately after he bought Dell, which helped Value Trust whomp the S&P 500 by 15 percentage points that year.[37]

Based on similar reasoning, Miller started acquiring shares in the Internet access provider, America Online. In 1997, AOL shares rose 172 percent and Dell climbed 216 percent, driving Value Trust 37 percent higher. Although their prices were soaring, Miller did not cut back on those stocks as he might have in the past. He stuck with a winning hand. The holdings continued to multiply many times over and ballooned into a large portion of Value Trust's portfolio.[38]

About this same time, Miller became concerned that the stock market was overheated. As he put it in his 1997 *Legg Mason Annual*

Report, "We believe that the period of extraordinary stock returns that began in 1982 ended in 1996. Valuations are too high and future growth rates too low for stocks to average more than 9 or 10 percent per year."[39] He reached this conclusion because although corporate earnings growth was solid, pricing power had evaporated, unemployment was low—putting pressure on wages—and corporate profit margins were high by historical standards. Miller said the best possible rate an investor should expect, long term, was between 9 and 10 percent. "Sensitive investors will be prepared for periods, perhaps extended, where returns are well below those levels, or even negative."[40] Because his thinking was in fact premature, Miller picked up the entire passage from his 1997 report and repeated it word for word in the 1998 missive.

THE STANDARD & POOR'S HIDDEN MAP

At the close of 1999, the *Wall Street Journal* claimed that Miller was taking cues from the S&P 500 index itself. The index, overseen by McGraw-Hill Co.'s Standard & Poor's unit, said the *Wall Street Journal* "occasionally replaces lackluster businesses with better ones but mostly lets its winners ride." That is an inexact description of what Miller was thinking, especially since the purpose of any index is to reflect the reality of a particular market, not to outpace it. However, since the S&P—the broadest of all indices—was beating such a hot path, it made sense to pay attention to those stocks that were stoking the S&P fire. (More about the S&P strategy in Chapter 4.) Suffice it to say that Miller eventually let AOL shares rise to 19 percent of his portfolio and technology stocks to increase to a total of 41 percent of assets. He trimmed his AOL position only slightly in early 1999, even though he then considered the stock overvalued.[41]

In the summer of 1999, AOL and other Internet stocks tumbled head-over-heels. Value Trust's lead over its benchmark eroded from more than 15 percentage points in April to less than 1 percentage point in September. The pain eased at the end of the year, however, when the tech sector recovered. That year, Value Trust again scored big with AOL. Miller also triumphed with the help of holdings in cell-phone manufacturer Nokia, computer maker Gateway, and global advertising giant WPP Group.

In late 1999, Miller invested in Amazon.com, which the *Wall Street Journal* described as his most audacious move thus far. The Internet retailer had suffered a series of financial losses, to which the market overreacted. By the end of 1999, the stock was trading at about 22 times its expected 1999 sales. Yet Miller believed Amazon had achieved a virtually unassailable lead in its own business sector. It would be able to grow enormously, even without massive capital infusions and the debt or dilution of shares that often attends growth.

RETURN TO A TRADITIONAL STRATEGY

Despite the promise of many of his high-tech acquisitions, Miller attempted to bring balance to his holdings by buying Waste Management, Kroger supermarkets, and the toy maker, Mattel. (A detailed account of the Waste Management acquisition is in Chapter 7.)

But again, in mid-December 2000, Miller seemed to have fallen into a slump. "It's a very hostile investing environment out there," Miller observed. "Last year, over 127 funds were up over 100 percent. So investors ask: What are you guys doing? You are in the wrong stuff. You are missing the easy money."[42]

At an analyst's presentaton at New York's "21" Club in late 2000, Miller projected a Calvin & Hobbes cartoon strip showing 6-year-old Calvin saying, "How can something seem so plausible at the time and so idiotic in retrospect?" as a water balloon explodes in his hands.

"That's the way I feel with a lot of stocks we bought this year," said Miller. "The three names we bought last year all collapsed; the ones we bought this year collapsed." So, he joked, "I think we'll buy none next year."[43]

TAKING FLIGHT

Investors began fleeing Value Trust even before it paid out $7.82 a share in taxable gain on December 22, 2000. Some of them did so with Miller's blessing. A month before, Miller warned the fund's directors that all shareholders who had been in the fund less than a year should sell out. That way, most of them could take the losses on their income tax returns and avoid receiving the gain, which would be taxable. The gains were earned by selling stock, but the benefits had accrued to earlier investors in the fund. By that mid-December, money was gushing out at as much as $20 million a day, and the fund's assets had diminished by $1.5 billion from its peak of $13.7 billion.

At that moment, with less than 3 weeks left in the year, Value Trust was running dead even with the S&P 500. Value Trust had fallen far behind the market earlier in 2000, as dot.coms and other technology stocks were rocketing. Miller was able to regain an edge over the S&P when he sold chunks of AOL and some other winners, and reverting to Kiehne's old favorites, again purchased lagging financial stocks, Citigroup and Fannie Mae. Another pleasant surprise was Waste Management, which gained nearly 60 percent for the year.

It was only in the last weeks of 2000 that Miller began to gain a slight lead on the S&P 500. Miller celebrated Christmas in Santa Fe with his family, but checked on progress regularly. With only 3 trading days left in the year, Value Trust was down 8.1 percent compared to a 9.5 decline in the S&P. The following day, December 28, Value Trust had a strong day, and the lead seemed secure. The final score: Value Trust lost only 7.14 percent, beating the S&P 500 by 2 percentage points. Miller returned to his office after the first of the year to find it decorated with banners. The investment team celebrated with a catered lunch of sushi, followed by cake and champagne. But, Miller wryly noted that people were being strangely appreciative, considering that the fund lost money for the year.

It was the tenth year that Miller bested the benchmark. His fund's return would have been 10 to 20 percentage points worse than that of the market had he not taken the portfolio actions that he did.[44] By the end of 2001 Miller pulled another rabbit out of the hat and outperformed the S&P 500 eleven years in a row.

TECHNOLOGY TIPS THE SCALES

Miller later reported to shareholders:

> *"Investment success in both 1999 and 2000 was determined almost exclusively by how heavily weighted one was in technology. In 1999, the tech-heavy NASDAQ rose 85 percent, the largest single increase of any broad-based market index in U.S. history. In 2000, that index fell 39 percent, its worst showing ever. Managers who were overweight in the TMT area (tech, media, and telecom) had a great 1999 and a terrible 2000."*[45]

OPPORTUNITY TRUST

Miller launched his brainchild, the Opportunity Trust, in December 1999—an inauspicious time. Miller's plan for the fund was to invest in selected companies using the valuation tool he developed in his other funds, multifactor valuation analysis. Miller analyzes a company's share price using a range of value measures, then looks at the distribution of the results. The distribution gives him a clearer idea of the appropriate valuation. This "go-anywhere" portfolio would hold stocks that had been identified as priced at a significant discount to their intrinsic values, be they large or small, domestic or foreign. The fund, said Jennifer Murphy, chief operating officer for Legg Mason Fund Management, is "not intended to be guided by any investment style." Miller cautioned that the fund has been designed for investors comfortable with the risk inherent in an aggressively managed fund, and that turnover in the portfolio could be extremely high. As it turns out, this has been a fund for patient people with patient money. Opportunity Trust outperformed its benchmark index initially, then spent months and months under water before rising to the surface. Since its revival in 2000, it has achieved a 10.25 percent average annual return, measured from the fund's inception. For the first half of 2001, Opportunity had a return of 18.36 percent.

One of the drawbacks to the fund is its annual expense ratio, a rather hefty 1.98 percent. On an average, actively managed diversified funds have an expense ratio of 1.47 percent.[46] Value Trust's expense ratio of 1.69 percent is also more expensive than most other mutual funds.

MASTERS' SELECT EQUITY FUND

In addition to handling his Legg Mason funds, Miller is one of the team managers of Ken Gregory's Masters' Select Equity Fund.

Gregory, who runs the advisory firm of Littman/Gregory and publishes the *No-Load Fund Analyst* newsletter, went public with the innovative concept behind Masters' Select in December 1996. Six top managers were chosen, representing the spectrum from growth to value to large-cap stocks to small-cap stocks. The idea was to create a core equity portfolio built to outperform through the rolling waves of market cycles. From the start it was recognized that Masters' Select Equity might never be the number 1 performer in any given year. It would be judged in terms of a longer, more encouraging and forgiving time frame.

The original Masters' managers were Christopher Davis of Davis

Select Advisers, Foster Friess of Friess Associations, Mason Hawkins of Longleaf Partners, Sig Segalas of Harbor Capital, Dick Weiss of Strong Funds, and deep value manager Robert Sanborn. In 2000, Bill Miller replaced Sanborn.

These are worthy partners for Miller. During the 19 years ending December 31, 1998, for example, Mason Hawkins's Longleaf posted a compound return of 19.5 percent per year versus 17.7 percent per year for the S&P 500 and 14.8 percent per year for the Ibbotson Small Company Index during the same period. For the first 6 months of 2001, the fund had a return of 10.9 percent.

Despite the lineup, this is not team management in the way you might imagine. The managers do not cooperate together in the usual sense. They do not act as a board, getting together, planning strategy, and making investment decisions by consensus—nothing even close to the town council or the school board. Instead, the fund's assets are apportioned among the six "talents," and each is asked to select only his or her top picks.

Each manager contributes 8 to 15 of his best ideas. These can include small-cap stocks because of the fund's relatively small $56 million asset base per manager. Each of these men handle much larger funds on their own. Masters' Select Equity started slowly in late 2000, but gained momentum. It suffered in 2000, partly because of Miller's sizable losses in personal computer–related stocks such as Gateway. The fund's fortunes improved in 2001, but the main contributor to that was not an original Miller pick, but Toys "R" Us, which gained 43 percent in the first 3 months of the year. (More about this valuable holding in Chapter 7.) In time, Miller did, however, invest Legg Mason Funds in Toys "R" Us. The company became a favorite with many value managers.

Masters' Select stock pickers can easily be described as price conscious, and indeed in the year 2000, the $450 million fund outpaced the relevant indexes and most stock funds, a year when the large indexes deflated like a punctured balloon. Though the fund's returns have been positive, at 10.19 percent average annual return the last 3 years of the 20th century, performance has not made the investor's hearts race.

STEP ASIDE, ROCK STARS

Thanks to his wisdom as a stock picker, Miller has become a hero within his own company. "He is our go-to guy," says John Gallagher, a senior Legg Mason broker. "I mean, I used to go to [Rolling] Stones concerts all the time in my younger days, but I will tell you this: I'd rather spend a few minutes with Bill Miller than Mick Jagger."[47]

All this reverence comes at a price. Miller admits he is obsessive about his work. He puts in 7 days a week at the job. His 22nd-floor office looks down on Baltimore Harbor, but even with the sweeping view, the operation has a tight-knit, insular atmosphere. Aside from his wife, two teenage sons, season tickets for a seat behind home plate to the Baltimore Orioles, and his involvement at the Santa Fe Institute, Miller has few interests outside of reading and his work. He is an avid reader and is always recommending books to his coworkers. His briefcase might hold a biography of an obscure philosopher or a paperback edition of *Lives of the Poets*, a 992-page history of English-language poetry, or *At Home in the Universe*, by theoretical biologist Stuart Kauffman. "I don't have any hobbies, like building model airplanes or things like that," admits Miller. Single-minded, he sometimes even reads research reports between innings at Orioles games.[48]

Miller enjoys the perks of success. He drives a Mercedes S500, owns three homes including an 80-acre waterfront estate in Maine, and enjoys the use of a seven-seater Lear 60 jet that costs $2,500 per hour of flying time. And yet the Silicon Valley economist Brian Arthur, a leading Santa Fe Institute theorist and personal friend of Miller, describes him as an unassuming guy. "His main characteristic is curiosity. He just exudes the impression that he is a very decent guy. He will walk into a room and just stand there quietly observing the people. He's interested in everything, everybody."

Arthur says that he's wondered why Miller, with his academic tendencies, devotes hours each day to investment questions, but it is Arthur's opinion that Miller doesn't do it solely to make money. He does it as an intellectual excercise, enjoying it as a challenging mental puzzle. He says that Miller sees the whole picture, understands the basic economics, and won't be sold a bill of goods of any type.[49]

Arthur once asked Miller why he earned his living as a mutual fund manager despite his doctoral studies in philosophy. Miller replied that he wasn't an investor despite his grounding in philosophy; he was intrigued with money management precisely because of his exposure to the discipline of thought. Thanks to that training, says Miller, "I can smell a bad argument miles away."