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Miller's Tale

Legg Mason's revered fund steward talks about value, metrics and his optimism

By SANDRA WARD

An Interview With Bill Miller ~ Not since Peter Lynch of Fidelity Magellan fame has an investor so captured the imagination of the stock-buying public and won the admiration of his stock-picking peers as has Legg Mason's Miller. He confounds and infuriates those who would buy stocks at a discount in his willingness to expand the boundaries of conventional metrics to determine the true worth of a company and its businesses. Yet he is revered because he is, so often, right. But he's merely mortal as well, and that has meant Miller hasn't escaped the misery of the markets during the past few years. Although his vaunted Legg Mason Value Trust lost 18% last year, the fund rose 5%, on average, under his stewardship over the five-year period and advanced 14.5% over the 10 years he's been at its helm. His newer Legg Mason Opportunity Trust has lost, on average, 5.5% a year since its start in early 2000. Market-beating returns, all. For his views on the market and how and why he's positioned some of the \$20 billion in assets under his care, please read on.

Barron's: *You were fairly bullish coming into the new year. Has your outlook changed in the past few weeks?*

Miller: I think about the market probabilistically, and so while nothing is impossible in the capital markets, four down years in a row has happened only once in the last century. Markets are discounting mechanisms, and in order to have them keep going down you have to have new and undiscounted bad things happening. After three down years -- in October, the decline was just about 50% from the high -- the valuations have reached a level that provides pretty good support.

One thing fueling my more optimistic stance is that the character of the rally since Oct. 9 is very different from the character of the rallies that we saw during the bear market.

Q: *How is that?*

A: In the bear market when we had brief rallies, people used them to reduce risk because they recognized that the path of least resistance was down. They sold higher-beta names and bought perceived safer and lower-volatility names. Since Oct. 9, it's been different. People got caught short and they are still trying to catch up. I think we've had a trend reversal.

Q: *So the bear market is over?*

A: Yes. It ended Oct. 9.



Nicholas McIntosh

"At one point, we had almost 20% of the portfolio in AOL, and fortunately we were able to sell large swaths of it in 2000. We have about a 3% position now."

Q: *When we last talked it was the spring of 2001, and you were much more optimistic about the way that year would play out. In hindsight, what did you miss?*

A: We got progressively more bullish in 2001 as the summer wore on because the market went down. Then Sept. 11 happened. That's what derailed the market. I thought Sept. 21 was the low, and that would have been correct had we not had the corporate scandals. When Enron happened in the fourth quarter, it was seen as an aberration and the market rallied right through it. When it later became clear that it wasn't an aberration, when we had issues with Adelphia and Tyco and WorldCom, that caused a huge crisis of confidence in the equity market and there was a huge negative feedback loop from the bond market.

Previously, Enron, WorldCom and Tyco had been investment-grade credits. When those companies collapsed, the corporate-bond market fell out of bed, and that filtered back through equity valuations. If the equity market is going to do well, the corporate-bond market has to be healthy

and spreads have to come in. Since Oct. 9, there has been a big rally in both the lowest grade of investment-grade credits as well as in junk bonds. But that's got to keep happening. That can't be short-circuited. A good sign was that during the big decline on Jan. 24, the high-yield market didn't budge at all.

Q: *What about valuations? Some maintain the market is still very much overvalued.*

A: The way we look at it, the market is a little under 16 times 2003 earnings.

Q: *How do you get there?*

A: Well, by adding all the bottom-up numbers of all the companies in the Standard & Poor's 500 and dividing by the total market capitalization. In any case, the market's valuation isn't terribly demanding. It is still demanding relative to high yield and to corporates.

Q: *What do you mean by "demanding"?*

A: Ten-year Treasury notes are yielding less than 4%, while **Eastman Kodak** is yielding a secure 6% and **J.P. Morgan** is yielding nearly 6%. In other words, with those two stocks I can get greater income than from a government bond as well as a free call option on a stock. Alternatively, the yield on the S&P 500 right now is higher than the yield in money-market funds by a decent margin. That rarely happens.

Q: *What gives you confidence that the Kodak and J.P. Morgan dividends are so secure?*

A: An analysis of the companies' fundamentals and trying to also understand the psychology of

management and the board with respect to dividends. Putting it differently, if the dividends aren't secure, then they should be secure. By that paradoxical statement, I mean that if the companies aren't earning enough to cover their dividend, that's a very good reason why they shouldn't cut the dividend. If management can't earn a return on their underlying capital sufficient to pay those dividends, then they are earning too low a return to be entrusted with any more capital. So the payout ratio should rise. Put another way, cutting dividends is usually a very bad strategy, because it penalizes the shareholders for management's failures.

Q: *Are you paying a lot more attention to dividends these days? Are you looking for more total return?*

A: We're paying more attention to dividends because we are in a low-nominal-rate-of-return world. When you can get a significant part of the return up front in cash, that's good. Managements are going to need to raise payout ratios because there's plenty of capacity, and retaining capital isn't going to do the shareholders much good. Companies pay interest to banks for the use of capital, and dividends are the rent managements should pay for this use of owner capital. Also, good and growing dividends will be a sign of future capital gains.

Q: *We've focused on the market; what do you think of the economy?*

A: You only have to look at the market. If the market doesn't do well, the economy isn't going to do well. The wealth effect and the problems of a declining market will overwhelm whatever nascent strength there is. The consumer has been holding the economy together, but consumer spending isn't going to accelerate. Savings rates are going up as the wealth effect is hitting the consumer. It's very rare, and I'm not sure it has ever happened before, but savings rates have risen as the Federal Reserve has been cutting interest rates dramatically. Business capital spending needs to improve, and it isn't going to improve if stock prices keep going down. But I am reasonably optimistic about the market, because for the first time since the peak in 2000, all of the mechanisms by which monetary policy operates to get the economy going are now working.

Q: *Such as?*

A: Interest rates are low. The dollar until this fall was stubbornly high, but it has fallen more than 15% and that improves the competitiveness of our goods in foreign markets. Furthermore, the market rallied 8% in the fourth quarter and began the year with a rally. Assuming the market does better, even though it's declined recently because of the Iraq situation, all of that should lead to a decent economy.

Q: *Are you concerned at all about deflation or inflation?*

A: A big risk to the overall global economy is deflationary pressures brought about by high debt and overcapacity and sluggish demand and high productivity. That's why we have interest rates where they are, and it's also why I think liquidity will be supplied by the Fed and why the weaker dollar will also put a lot of pressure on overseas governments to cut their rates. As far as inflation goes, monetary policy has undergone a very dramatic change, from one that was pre-emptive in terms of fighting inflation to one that's reactive in the sense there's going to have to be a lot of upward price pressure before the Fed is likely to start raising rates.

I saw on the tape recently that apparently two-thirds of surveyed firms believe the Fed will be raising rates by the end of this year. If the Fed does raise rates by the end of the year, that would be very bullish.

Q: *Do you expect rates to rise this year?*

A: No, I would be surprised.

Q: *You mentioned Kodak earlier. Is it still a big holding of yours?*

A: We're the largest shareholder of Kodak. It worked out well last year, when it was the best-performing stock in the Dow. We're quite optimistic about Kodak, especially at these prices. We think Kodak is worth about \$50 a share, so at 40 we aren't really a buyer but back here in the 30 level we like it a lot. Wall Street was disappointed with the first-quarter projections Kodak came out with when they reported results recently, even though I think the projections are quite conservative.

Q: *Why do you think it's worth 50?*

A: Kodak generated \$5 a share of free cash flow last year, an astonishing number. This year, even on the lower numbers and with less working capital in its favor, they'll make about \$3.70 of free cash flow, assuming they make the consensus earnings number of about \$2.50 a share. One of the most important metrics we focus on is free cash flow -- the ability to generate it and what it yields: that is, free cash flow per

share divided by the stock price. Kodak at 30 and an expected \$3.70 of free cash flow this year is yielding 12% on free cash flow. If that's right and sustainable, and we think it is, then that's going to easily outperform the market, which we believe has a long-term upward path of about 6% to 8%. Also at Kodak, you've got a 6% dividend yield, which alone gets you almost the expected market rate of return.

The company has several growth engines that most people aren't properly focused on. Kodak's digital business, which was losing \$150 million a year ago, is going to break even this year and will be profitable next year. That's a big swing factor. That business is also far less capital-intensive than the film business. Film is a business that is slowly declining, but it's still going to provide huge amounts of cash flow to Kodak over the next 10 years. But in addition to the digital business, Kodak also has the OLED, or organic-light-emitting-diode, business, which has zero revenue right now. They've got something like 80 patents on this technology, and we expect they'll announce a contract in the next 30 days or so for the first commercial use.

Q: *What is it?*

A: It's a flat-screen technology that enables sharper images that are viewable from any angle, at a

MILLER'S PICKS

Company	Ticker	Recent Price
Eastman Kodak	EK	\$29.90
AOL Time Warner	AOL	12.02
UnitedHealth Group	UNH	85.70
Home Depot	HD	20.72

fraction of the depth of the current flat screen. It could be used in cellphones, television sets, computers -- anywhere there's a screen. There is no current revenue, but Kodak estimates this will be a \$500 million business for them within five years. Sanyo is its manufacturing partner in a joint venture to develop OLED.

Q: *You have bought this all the way down. Can you talk about that strategy?*

A: Lowest average cost wins. It's rare for us to pay up for anything, and it's common for us that if the stock goes lower after we buy it -- and it always does -- we will buy more of it. If we're not buying more of it, then we'll be selling it, because it doesn't make any sense to hold onto a declining position without putting more money into it or changing the weighting in the portfolio.

Q: *eBay seems to be a new name for you.*

A: I've known Pierre Omidyar, the founder, for some time. We're both on the board of the Sante Fe Institute. As you know, we are the largest holder of **Amazon.com**, and we owned AOL in its infancy. So it was sort of embarrassing not to own **eBay**, especially knowing the economics of it and knowing Pierre and finally after spending time with Meg Whitman, the chief executive, over the summer and fall. We decided to take a moderate position in it in the 50s and it's now in the 70s. It's been great, but I wish we'd bought more of it. It isn't a big position for us, but it's a wonderful company.

Q: *What were your earlier reservations?*

A: Our historical reservations were based on valuation, but then we decided there was some valuation illusion going on and so we bought it. Unfortunately, it ran up, and it's got to be almost the Second Coming before we'll pay up for something.

Q: *What do you mean by valuation illusion?*

A: I'll give you two historical valuation illusions: **Wal-Mart Stores** and **Microsoft**. From the day they came public, they looked expensive. Nonetheless, if you bought Wal-Mart when it went public at an expensive-looking 20 plus times earnings, you would have made returns of many thousand percent on that. The same goes for Microsoft. Until a couple of years ago, Microsoft went up an average 1% every week it was public, despite the fact that it looked expensive. Had we known the growth that was in front of it, we would have known it was actually a bargain.

Q: *How does this apply to eBay?*

A: eBay seemed expensive, but when we examined it, we found it was nowhere near as expensive as it looked. Most people were looking at eBay and focusing on whether they could keep growing at 40%, which is a legitimate question. We discovered, however, that although it looked expensive, it didn't have a lot of the risk associated with other companies. There is no balance-sheet risk, because they have a huge amount of cash and no debt. There is no technology risk, because they are a user of technology and simply provide a platform. There is no visible competitive threat, because nobody has anything approaching their business. There is no inventory risk, because they don't take any inventory. There is no receivables risk, because they don't hold receivables.

Q: *What do you make of AOL Time Warner at this point?*

A: We like **AOL** at these levels and have started buying it again. At one point, we had almost 20% of the portfolio in AOL and we were fortunate enough to sell large swaths of it in 2000. We have about a 3% position now. The strategy is right. I like what Dick Parsons is doing.

Q: *What is the strategy?*

A: The critical issue with AOL Time Warner isn't the Time Warner side of the business, except for the music business, which is bad. People are hung up about the AOL side and its broadband transition, its growth and the cultural differences that exist between the two camps. What we see is that AOL is actually going back to the strategy Steve Case outlined when we first got into the company in the mid-'Nineties, and that strategy is based on adding more value to the customer as opposed to extracting rents from anybody that accesses its service. They still have a 50% share of the consumer market and have roughly 35 million subscribers. Either it can grow or it can't. If it grows, there is no issue because it already generates great profit margins and is a major contributor of cash. If it can't grow, then it turns into a subscription-based service similar to the New York Times or the Washington Post or Time Magazine, with valuable assets. The most important issue is whether they make a successful transition to broadband without losing their customer base. If they can, it becomes a home run; and if they can't, it becomes a slowly declining asset that can still be monetized.

Q: *What's your case for UnitedHealth Group?*

A: This is an unusual name for us because it's a very high-quality company with great management and a great record. There's no controversy, but it trades at a ridiculous valuation. It is a great value at 85 to 86. It's a company that has increased earnings 35% a year for the past five years. It has taken its return on equity from 15% to 35%. It routinely raises earnings guidance and did it again recently with a forecast for about \$5.15 a share this year. We think the earnings will be higher than that. We estimate it will generate over \$7 of free cash flow this year. It's a gigantic company, the largest health-care provider in the country, with a \$25 billion market cap, and it trades at 13 times next year's earnings and about 15 times this year's. The stock price has grown 50% a year for the last five years, and it was a wonderful performer last year.

Q: *When did you get interested?*

A: We bought it when it collapsed in 1998 when they missed a number. It is our largest position. The company is buying back its stock aggressively at current levels. The shares are shrinking, which you don't find in many big companies.

Q: *So why are the shares depressed?*

A: One of the concerns people have is that health-care premium growth, which has been double-digit for many of these companies, is going to slow. Of course it's going to slow. Yet **UnitedHealth's** total top line isn't growing 15%, it is growing mid-to-high single digits. But their margins are growing significantly, and their return on capital is growing because they are using technology to take costs out. We think it is worth at least \$125 a share.

Q: *How about another, newer stock?*

A: A new name for us is **Home Depot**. People are talking about its problems -- slowing growth, cannibalization and low morale -- but all these problems are getting fixed. This is a company that didn't have any perpetual inventory, didn't have any point-of-sales terminals, didn't have pay scales for their employees, and didn't have any centralized purchasing. It was remarkable what they didn't have, which tells you how powerful the economics of the business were -- that they could do so well for so long without basically having any of the processes that a \$50 billion-revenue company ought to consider routine. We just started buying this in the mid-20s and aggressively down here at 20 or so where it's making new lows. Home Depot earns 17% on total invested capital, and we think it stays at that level. It has \$4 billion cash on the balance sheet. We think they have good capital discipline. It's a very low-risk name.

Q: *I would assume all the stocks you own have compensation structures you feel comfortable with?*

A: You should assume if we don't like the compensation structures we are talking to the managements about them, and we will vote our proxies in our shareholders' interest. We don't have any substantial issues with **Nextel**, UnitedHealth or Kodak. We think there are better compensation schemes, but we don't find theirs egregious. Actually, as *Barron's* reported, Amazon has changed their compensation so that restricted stock is the primary vehicle for equity-linked compensation, and we find that far preferable to options.

Q: *Thanks a lot, Bill.*

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