

Bill Miller Commentary



Bill Miller, CFA
Chairman & Chief Investment Officer
Legg Mason Capital Management

In my colleague Michael Mauboussin's terrific new book, *Think Twice*, the opening chapter tells the story of Big Brown, the super looking colt who'd won such impressive victories in the Kentucky Derby and the Preakness, the first two legs of racing's Triple Crown. This is a story with a lesson that directly relates to investing, and to understanding the kind of recovery that appears to be getting underway in the U.S. economy.

After winning all 5 of his starts by a combined total of almost 40 lengths, Big Brown was a 3-10 favorite to win the Belmont Stakes and become the first horse in 30 years to win the Triple Crown. Those odds indicated the "wisdom of crowds" putting a 77% probability on Big Brown's winning the race and making horse racing history. Part of that was right: he did make horse racing history — by being the only horse to win the first two legs of the Triple Crown and finish last in the Belmont.

That so many were so sure of Big Brown's success was due to a common analytical error that manifests itself in investing as well as horse racing. That error is the neglect of base rates. Psychologists call it the "inside" view, in contrast to the "outside" view. As Michael explains in his book:

The inside view considers a problem by focusing on the specific task and by using information that is close at hand. The outside view...asks if there are similar situations that can provide a statistical basis for making a decision. The outside view wants to know if others have faced comparable problems, and if so, what happened. It's an unnatural way to think because it forces people to set aside the information they have gathered.

In the case of Big Brown, taking the outside view would be to see how many horses in the past had won the first two legs of the Triple Crown and then went on to win the third. The inside view focused on Big Brown, his history, the competition he faced, the tracks he ran on and their condition, his time between races, and so on.

The outside view revealed that 29 horses had won the first two races of the Triple Crown in the 130 years it had been run, with 11 of those horses going on to win the third race. Parsing the data a little more finely showed a remarkable divergence in winning percentages. Before 1950, 8 of the 9 horses that had a shot at the Triple Crown won it. After 1950, only 3 of 20 were successful. Moreover, when Big Brown's speed ratings were compared to the most recent 6 Triple Crown contenders (and not just to his competition in the race), he was the slowest by a wide margin. If those who were betting on the Belmont had used the outside view instead of the inside view, no one would have believed what everyone did believe, that Big Brown had a nearly 80% chance to win the Belmont.

Investors are faced with these sorts of problems constantly: if I put my money in bonds now, what rate of return should I expect over the next 5 or 10 years? What is the outlook for stocks over the next 12 months? What are the chances of a significant rise in inflation over the next few years? What kind of economic recovery will we have? Should I fire my active money manager and replace him with a passive index product? What are the chances we have a "double-dip" recession? And on and on.

Faced with these sorts of questions, most people default to the inside view, and then augment its flaws with the usual assortment of behavioral biases long known to psychologists: they anchor on the most recent experience, they assume instances are representative of deeper patterns, they give more weight to vivid examples or dramatic outcomes, they place twice the weight on a dollar lost as on a dollar gained, etc.

The financial crisis that is now abating has created a near perfect environment for the admixture of all of the above, and that is perhaps why what Nobel winning economist Ken Arrow called the “clouds of vagueness” seem particularly thick and forbidding just now. Taking the outside view on some of the issues facing investors won’t make an inherently unknowable future predictable, but it can improve the odds of getting things right, or getting fewer things wrong.

The difference between the inside and the outside view is well on display in the different and in some cases strongly held views about what kind of recovery is now unfolding in the U.S. PIMCO’s Mohamed El-Erian is the most prominent advocate of the “new normal”, a term he coined to describe a recovery with real growth of 1-2%, persistently high unemployment, and much greater government involvement in the economy. He has recently warned of a big letdown from the “sugar high” we are now experiencing in the market and the economy as the effects of the abatement of the credit crisis and massive government stimuli, both fiscal and monetary, begin to wear off.

He may be the most prominent, but he is not alone. In fact, it looks like he is the leader of a not so silent majority. The current consensus growth rate for the U.S. economy in 2010 is 2.4%. This is way below “normal” for the first year of a recovery, yet even it is well above what most thought only 6 months ago. In April the IMF projected negative growth in world output of 1.3% this year, and only 1.9% growth in 2010. That included a projection of zero growth in 2010 for developed countries.

Projections such as these follow the classic inside view pattern: they look at current conditions, current trends, anchor on the most recent data, and adjust from there. Since the economy bottomed in March, almost all time series forecasts of economic improvement have been adjusted higher as the year wore on. They are still well below “normal.”

A recent Bloomberg story noted how in the second quarter of 2009 almost 75% of companies in the S&P 500 beat consensus expectations, which were then revised upward. Now, the consensus is for profits growth in 2010 to be up about 25% from 2009. Yet economic growth is expected to be only 2.4%, a ratio of profits growth to GDP growth of about 11. The outside view would show that the ratio has historically been around 6x, indicating either profits expectations are way too high, or

growth expectations way too low. The outside view would favor the latter, as both time series have been steadily revised higher, and the early indications are that third quarter earnings are also coming in better than expected.

What does the outside view say about what we should expect? In an article in *The Wall Street Journal* (“From Bear to Bull,” Sept 19, 2009) Jim Grant quotes economist Michael Darda as follows: “The most important determinant of the strength of an economic recovery is the depth of the downturn that preceded it. There are no exceptions to this rule, including the 1929-1939 period.” In the first year of the recovery from the bottom of the Depression, the economy expanded 17.3%. If one adjusts for the drop in output in this recession, the outside view would put 2010’s expected growth rate at around 8%.

Is the ‘new normal’ wrong? No one knows, yet. The core of the argument in its favor is an inside view: the consumer is over-leveraged, savings rates have risen from negative to positive and may stay elevated or go higher, balance sheets have been shocked by home price declines and the stock market collapse and need to be rebuilt. A mountain of corporate debt has to be refinanced, banks are not disposed to lend and capital requirements are going higher, and corporations will be cautious about hiring or expanding due to pervasive uncertainty.

A variant of the argument has it that with consumption elevated at 70% of GDP and the consumer retrenching, growth must be sluggish, profits will disappoint, and it will be hard for the stock market to make any headway. The outside view helps here too. In 1933, consumption as per cent of GDP was even higher than today, at 83%, and the savings rate was negative. The consumer deleveraged aggressively, pushing consumption as a percent to 73%, while the savings rate rose. Yet unemployment fell sharply, output grew rapidly, and the stock market went up over 100% from 1933-1937. There have been 8 times the consumer has deleveraged, and the market rose in 6 of those periods, with an average gain of 39%.

Since the bottom in March, the S&P 500 is up over 60%, and year to date returns exceed 20%, yet skepticism (if not downright pessimism) remains high. This judgment is not based on sentiment readings, or surveys. As market veteran John Mendelson often points out, it is not what people say that matters, it is

what they do. And what they are doing is buying bonds and selling stocks. Through the first 9 months of this year, domestic equity funds had net outflows of \$8 billion. During the first week of October, another \$5 billion was redeemed. Bond funds, in contrast, had inflows of nearly \$300 billion in the first 9 months of this year. Of the top 10 selling funds in America this year, 9 are bond funds and only one is a stock fund, and that one is the Vanguard 500 index fund.

Stocks are pretty unpopular, despite having had a decent year so far, and why not? “Riskless” Treasuries have trounced stocks over this decade, having risen 85%, while if you’d bought the S&P 500 at the end of 1999 and held it through Sept 30 of this year, you’d have lost 14% over the same period. No profits at all for a 10-year period of investing in the biggest US stocks! Buy and hold is dead is a common refrain. Who wants to own a risky asset that does not go up, and one denominated in a currency that will surely go down? (We “know” the dollar will go down because it is on the front pages of the financial papers and magazines that it will do so. Everyone knows that—the only question is how far and how fast and will it collapse?)

That is the inside view, anyway. The outside view provides a different perspective. According to data compiled by Jeremy Siegel at the University of Pennsylvania, stocks have provided average annual real returns (after inflation) of 6.66% for all 10-year periods going back to 1871. (It is a curious coincidence that stocks bottomed on March 6, at 666 on the S&P 500). There have been 14 10-year periods where stock returns have been negative, including this one. In every one of the previous 13, the subsequent 10-year returns have exceeded 10% real, about 50% more than average, and more than double the return of government bonds. So every time stocks have performed poorly for 10 years, they have performed better than average for the next 10 years, and they have beaten bonds every time by an average of 2 to 1, yet investors can’t put money fast enough into bond funds, and continue to redeem equity funds.

As we sit at our desks pondering the myriad questions we’re faced with as investors, questions of great complexity, and ones of undeniable importance to our future well-being, it probably makes sense to get up and go outside, where the view is likely to be different, and clearer, and better.

Bill Miller

October 17, 2009

Investment Risks: All investments are subject to risk, including possible loss of principal. Because our Value Equity investment style expects to hold a concentrated portfolio of a limited number of securities, a decline in the value of these investments would cause the portfolio’s overall value to decline to a greater degree than a less concentrated portfolio. The Value Equity investment style may focus its investments in certain regions or industries, thereby increasing the potential vulnerability to market volatility.

The views expressed in this commentary reflect those of the portfolio manager and Legg Mason Capital Management, Inc. (LMCM) as of the date of the commentary. Any views are subject to change at any time based on market or other conditions, and LMCM disclaims any responsibility to update such views. These views may differ from those of portfolio managers and investment personnel for LMCM’s affiliates and are not intended to be a forecast of future events, a guarantee of future results or investment advice. Because investment decisions are based on numerous factors, these views may not be relied upon as an indication of trading intent on behalf of any portfolio. The information contained herein has been prepared from sources believed to be reliable, but is not guaranteed by LMCM as to its accuracy or completeness.

References to particular securities are intended only to explain the rationale for the portfolio manager’s action with respect to such securities. Such references do not include all material information about such securities, including risks, and are not intended to be recommendations to take any action with respect to such securities.