Bill Miller Commentary November 2010

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THE 70% SOLUTION

"…we have involved ourselves in a colossal muddle, having blundered in the control of a delicate machine, the working of which we do not understand."
J.M Keynes, "The Great Slump of 1930"

"…if we consistently act on the optimistic hypothesis, this hypothesis will tend to be realised; whilst by acting on the pessimistic hypothesis we can keep ourselves for ever in the pit of want."
J.M Keynes, "Essays in Persuasion"

The differing approaches being taken to the economic problems arising from the financial crisis of 2008, and the debates between those favoring greater stimulus and those advocating austerity, show that Keynes' words are as true today as they were 80 years ago. Britain is slashing government spending while the Federal Reserve Board is about to embark on another round of unconventional stimuli via asset purchases. Both policies have engendered vigorous debate about their effectiveness and their consequences, and the advocates and their opposites are equally adamant that they are right. "Certitude is not the test of certainty. We have been cocksure of many things that were not so," as Justice Holmes wisely noted.

We all may have views on what the government should do, but as investors we are better served by focusing on what they will or are likely to do, and how those actions may affect the capital markets. This is no easy task, as the markets are continuously revising asset prices as new information arrives or probabilities change.

Just now, as the Fed embarks on a second round of quantitative easing, there's a lot of noise and uncertainty about whether the announced $600 billion is enough, how big the asset purchases might ultimately become, whether the program is already discounted in prices, whether it will engender too much inflation, and so on. Lots of questions.

The answer is, nobody knows. This is an experiment being performed on a tightly coupled, highly interdependent, complex adaptive system, "a delicate machine the working of which we do not understand." If we did understand it, we would not now be in the present predicament. So, as with most things involving markets, a good deal of humility is called for, but not much is in evidence.

I think it's helpful to recall what is prompting QE2. The Fed employs monetary policy in pursuit of a dual mandate: full employment and price stability, neither of which is currently being achieved. The normal tool for this, the federal funds rate, can't go lower, so they are driven to try other methods, in this case asset purchases. The important point is that they will continue to purchase assets, inject liquidity into the system, and grow their balance sheet until they are convinced their objectives are on the way to being met. QE2 will last as long and be as big as necessary to do that.

The transmission mechanism, the way this is supposed to work, is through higher asset prices, particularly stock prices. The Fed wants the stock market to go up, and they will do

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what's necessary to get it to whatever level it takes for the wealth effect of higher stock prices to stimulate growth, hiring, and inflation expectations of around 2%. When Chairman Bernanke signaled this in late August, it took the market a few days to digest it, then stocks began a rally that took us up around 10% going into the election and the FOMC meeting. After the election and the President's signaling a willingness to extend the Bush tax cuts for everyone, and once the Fed made clear what the QE2 policy was, we've had another spurt higher. In an editorial in the Washington Post, Chairman Bernanke wrote explicitly of the desire to get asset prices, both stocks and bonds, higher. There is a lot more to go in the next twelve months, in my opinion, in stocks if not in bonds. That's 12 months, not 12 days or 12 weeks. I think the market can be up another 15% in the next year, and perhaps more, depending on how the economy does.

Stock prices today have just recovered to where they were two weeks after Lehman collapsed, when the world was falling apart. As the table below shows, most measures of financial health have returned to levels prevailing before the demise of Lehman, but not stocks. The economy is expanding, liquidity is ample, inflation is under control, profits are growing rapidly and are set to pass their all time high, nominal GDP is at its all time high and real GDP will have fully recovered to its all time high within a quarter - two at the most, profit margins are at record levels, and corporate balance sheets are the best they've ever been, yet stocks languish below where they were in late August 2008, and that was hardly a bull market.

	Pre-Lehman August 29, 2008	**Peak of credit spreads November 28, 2008**	**Stock market bottom March 9, 2009**	**Now November 12, 2010**
S&P 500	1,283	896	677	1,199
Credit Spreads (bps)				
High-yield	794	1,833	1,684	561
Investment grade	304	607	542	164
LIBOR-OIS	78	178	105	11
Dollar Index	77	87	89	78
VIX	21	55	50	21

One of the most remarkable things about the investing world is how (correctly) venerated Warren Buffett is and how completely people ignore his investing advice. Since Mr. Buffett has made more money than anyone in the history of the planet solely through investing, one would think that when he says quite clearly what to invest in, people would pay attention. I guess they do pay attention, they just do the opposite. In 1974, near the bottom of the market, he said stocks were so cheap he felt like an over-sexed guy in a harem. In 1999, near the top, he opined that stocks would see returns way below those experienced in the bull market up to that time. From the time of his comments in November 1999 to the end of October 2008, stocks fell over 2% per year. In October 2008, again near the bottom, Buffett published an op-ed in the New York Times entitled, "Buy American. I Am." telling people to buy American stocks. They promptly accelerated their selling. On October 5th of this year, he said the following: "It is quite clear stocks are cheaper than bonds. I can't imagine anybody having bonds in their portfolio when they can own equities." The result: people pour their money into bond funds in record amounts, and sell their holdings in funds that invest in U.S. stocks. Why investors persist in doing the opposite of what the greatest investor of all time does, is a greater mystery than the problem of consciousness, or the origin of life, or free will and determinism. Those at least are hard problems.

What will bring the public back to stocks? The same thing that always does: higher prices. People like bonds not because they have carefully considered the risks and rewards of owning them, but because they have gone up so much over the past several decades. Stocks are the long duration asset, and their level reflects people's optimism about the future and their attitude toward risk. The objective of QE2 is to raise asset values, increase confidence, and stimulate spending and hiring. It will work, because they will continue it, or its successors, until it does. This is not an endorsement of the policy, just a statement that I think the Fed has the tools to change the aggregate portfolio preferences toward riskier assets, and that it intends to use them.

What might go wrong? Several things, but the most likely in my opinion is that the additional liquidity provided by QE2 raises commodity prices, particularly oil and other industrial and agricultural commodities sufficiently to blunt or even sterilize the effects of the asset purchases. Rising oil and commodity prices act as a tax on consumers and companies that use them. If they rise sufficiently they can slow economic growth and undermine the effect of QE2.

It is useful to remember that the great bond bull market that began nearly 30 years ago was preceded by a 30 plus year bond bear market that took long term treasury yields from 3% to nearly 15%. The devastating losses people suffered were such that my friend Lee Cooperman dubbed bonds, "certificates of guaranteed confiscation," when he was overseeing the Goldman Sachs research and strategy effort.

A common feature of that 30 year bond bear market was the bond swap. Almost every year, investors who owned bonds lost principal value as yields rose, so they sold their bonds in December and took a tax loss, replacing the bonds with others of similar maturity and quality. This continued year after year, inexorably. Finally, in 1982, yields started to fall. One elderly relative of mine had been taking her tax losses year after year, for over 30 years. When she asked me to look at her portfolio in late 1982, I told her there were some things I thought she needed to do. She said, "Oh yes, it's time for my bond swap." I told her that was not necessary as she now had gains in her bonds. She looked startled, and asked, "Is it legal to have gains in bonds?" I suspect that question may again be asked in the next 30 years.

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The Fed's job would be a lot easier, the economy would be a lot better, and investors would be a lot wealthier, if corporate boards and CEOs would allocate capital to the benefit of their owners, preferably through dramatically higher payout ratios of free cash flow, instead of hoarding it at zero rate of return on the balance sheet. Cash in excess of that necessary to provide ample liquidity in times of stress destroys value. Cash on balance sheets earns effectively nothing, yet it is equity and has a cost, a very high cost today, compared to the cost of debt.

Technology companies have the greatest opportunity to create shareholder value by intelligent capital deployment. Microsoft, Hewlett Packard, Cisco, and Intel among others have free cash flow yields of around 8-11% on the next 12 months estimated free cash flows. All have strong balance sheets, are highly profitable, and all remained so and generated excess cash through the crisis. Yet all have paltry payout ratios, the most generous of which are under 40%. All are mature companies with strong market position that will generate large amounts of cash for the foreseeable future. They all could EASILY pay out 70% of their free cash flows as dividends and still build cash on the balance sheet. If they did so, it is hard (nay, impossible) to believe their stocks would not move dramatically higher. My guess is that at worst they would trade at between a 4% and a 5% dividend yield, about where much slower growing utilities trade, providing an immediate gain of over 30% to their owners.

Why don't they do it? The reasons range from inertia, to what Buffett calls the institutional imperative - do what the others are doing and don't be an outlier - to excessive conservatism, to a belief that "growth companies" don't do that, to a misplaced preference for buybacks over dividends, to uncertainty over future tax rates on dividends. I could go on but the point is they have ample excuses to trot out about why they need to retain all their current cash and build it besides.

Some companies do it right and are rewarded for doing so: IBM and Texas Instruments are two. Time Warner is another. So is McDonald's. IBM has a disciplined, rational capital allocation policy and is highly transparent about its expectations for and uses of free cash flow on a multi year basis. It now trades at a higher P/E than Microsoft, Intel, or Hewlett. Texas Instruments is a leader in capital deployment. Unlike almost all of its peers, it pays the tax on its overseas cash and repatriates it, so the cash on the balance sheet really is all available for enhancing return for owners, and is not trapped overseas. McDonald's has moved its payout ratio from 32% in 2005 to over 50% today, growing the dividend over 30% annually and also shrinking the shares outstanding on average 3% per year.

Many companies prefer to buy back shares with excess cash instead of growing the dividend. There are two significant problems with this: first, they tend to buy back shares at high prices and suspend the buybacks at low prices. When prices are high, the outlook is good, and companies feel comfortable "returning cash to shareholders" via buybacks. When prices are low, things are "uncertain" and they too often suspend the buybacks until the stock is considerably higher. Few companies have the discipline to buy low, and so end up making poor capital allocation decisions with buybacks. Second, because dividends are transparent and public while buybacks are much more opaque, there is a much greater reluctance to cut or suspend dividends than to reduce or delay buybacks, which is why the market is much more willing to capitalize dividends into share prices than buybacks. And companies are not returning cash to shareholders via buybacks. They are giving cash to people who don't want to be shareholders, or who are reducing their investment in the company. Non selling shareholders are not getting any cash.

The buyback versus dividend debate is a good example of the divide between theory and practice. Theoretically, shareholders in aggregate are going to earn the market rate of return on dividends. Shares bought back below intrinsic value earn a greater than market return. The problem is that empirically most companies buy back above intrinsic value, so more value is created by dividends than via buybacks, in the aggregate.

In a low nominal return environment, yield is scarce and investors are hungry for it. That is why the most expensive sector in the market is the capital intensive, slow growing telecom sector: the yields are high. Property REITs have been spectacular performers this year, and commercial and residential property are not exactly booming. The reason is there is not uncertainty about capital deployment: they pay out almost all of their eligible income as dividends and come to the market for equity when they need it.

I believe companies will come under increasing pressure from shareholders to increase payout ratios and stop hoarding cash. An aging population will want more current income and will want to rely less on capital gains, and so demographics also supports higher dividends.

The market today has a free cash flow yield of about 7%, among the highest in history. About a fifth of non-financial companies in the S&P 500 have free cash flow yields of 10%. Balance sheets have never been better. The 70% solution to what ails the market is a 70% payout ratio of free cash flow. If the market were to yield the same as the 10 year treasury as a result, it would be at a new all time high.

A market at a new high would be one where the wealth effects of those prices would be visible in greater spending, confidence, and hiring. The "pessimistic hypothesis" Keynes referred to would have given way to the optimistic one and the Fed could dispense with unconventional and controversial policies.

This will not happen, though it should. Even a 50% payout ratio would be a big improvement. What companies such as the tech companies already mentioned should, and could, do is adopt the IBM way: be transparent about your expectations for revenue and earnings growth over the next three to five years, about expected margins, about sources and uses of cash, about returns on invested capital. Most importantly, have a policy on capital allocation that lets shareholders know how much cash is necessary for liquidity and business optionality, and why. What is the policy on dividends and buybacks, and what is the justification for it?

If all companies adopted the IBM way of communicating, there would be greater transparency, less confusion, less uncertainty, less speculation, less volatility, and more value creation.

I still prefer the 70% solution for what ails the market, though its adoption is admittedly a long way off.

Sherlock Holmes, in addition to his unparalleled powers of analysis, regularly injected himself with a 7% solution of cocaine, as we are told in The Sign of Four (1890). The duller and much more conservative Dr. Watson thought this quite risky, and in this he was right. No doubt conservative corporate boards would likewise find a 70% payout ratio quite risky, not because it is, but because it's just not done. If they were to adopt such a policy, then shareholders would find themselves reacting the same way Holmes did when he received his solution: he "sank back into the velvet-lined arm-chair with a long sigh of satisfaction."

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November 12, 2010
S&P 500: 1199