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Humbler, After a Streak of Magic

By GERALDINE FABRIKANT

FOR 15 years through 2005, Bill Miller, one of the country's most closely watched and widely worshiped stockpickers, made investments that handily beat stock market averages. But for the last two years, the market has handily pulverized him.

As the chairman of Legg Mason Capital Management, Mr. Miller helps oversee a $35 billion portfolio and is directly responsible for managing its marquee mutual fund, the $12 billion Legg Mason Value Trust. He says his recent travails have been humbling.

"I have been through periods like this before," he says thoughtfully, during a lengthy interview at the Baltimore headquarters of Legg Mason Inc., the holding company for all the Legg Mason entities. "The difference is that we are a lot larger and more visible, and so there is a lot more client focus than there was then."

But, really, a period like this? After all, the federal government has just bailed out Wall Street, and the broader economy has been on tenterhooks for months as fears of a recession — or worse — loom on the horizon.

"This is the most serious financial problem since the Depression," says Mr. Miller, 58. "It is global, it is systemic, and it is unclear how the financial system is going to (a) be regulated, and (b) behave. So it is very difficult to assess right now."

Still, some investors have been able to produce top-notch returns despite the broader economic problems that surround them. Mr. Miller readily concedes this point as well.

"John Paulson got it right for the right reasons," Mr. Miller says of the hedge fund investor who reaped billions of dollars by betting correctly on the housing market collapse. "When enough people get it right, even if it is a small number, it tells me that unless there is something special that they have, we should have gotten it right, too."

Mr. Miller's corporate parent is also suffering. On Tuesday, Legg Mason posted a quarterly loss of $255 million, the first time it has lost money as a public company. Its stock closed at $55.09 on Friday, down 24.7 percent for the year.

While Legg Mason set aside almost $2 billion in the past six months as a buffer against losses in three of its money market funds, its downturn for the quarter was also attributable to $26.3 billion worth of investor withdrawals over the last year and poor performance at its funds, including Legg Mason Value Trust.

All of which has left investors questioning whether Mr. Miller — a hyperconfident corporate handicapper

who is famous for lugging annual reports to Baltimore Orioles games despite being an avid fan — has just hit a long-overdue rough patch or has lost his magic touch, or whether his fund has grown too large to produce the stellar returns it did in earlier years, when he was still relatively unknown.

SOME longtime market experts think that fund size is the most daunting challenge he faces. Regardless of periodic ups and downs, he may simply be managing too much money to continue to produce outsized gains, they say.

“The number of investment opportunities just shrinks radically” when a fund swells, says John C. Bogle, the founder of the Vanguard Group, the mutual fund powerhouse, who describes himself as a fan of Mr. Miller. “The bigger you get, the fewer the number of stocks you can hold with a meaningful position.”

Indeed, Mr. Miller holds a relatively concentrated portfolio, and the bad news has kept coming for some of his major picks. Last week, after Microsoft’s proposed buyout of Yahoo fell apart, Yahoo’s stock plunged 11.5 percent last week. Legg Mason holds a 6.7 percent stake in Yahoo. Countrywide Financial, another big holding, has been slammed by the mortgage crisis and errant lending. Its stock has fallen 87.9 percent over the last 12 months. And Mr. Miller amassed a sizable position in Bear Stearns, the investment bank gone to the grave.

Of course, Mr. Miller has also had inspired plays during his long and largely successful run. He made a controversial bet on Google when it went public in 2004, gobbling up 2.1 million shares at $85, and making a killing in the face of criticism that he was not a true value investor. (Google now trades at $573.20.) He has also raked in big paydays from Amazon.com, America Online and Dell.

An investor who put $10,000 into Legg Mason Value Trust in 1990 would have $67,317 today, even when considering the recent downturns, according to Morningstar. That compares with $58,274 for the same investment in the Standard & Poor’s 500-stock index.

The fund annually outperformed the index until 2006, when the fund’s value rose 5.9 percent but trailed the S.& P. by 9.9 percentage points. In 2007, it tumbled 6.7 percent. This year, it was down 16.35 percent for the year as of Thursday, trailing both the S.& P. and funds in its peer group.

Mr. Miller says that during his long run of beating the S.& P., people often asked him, “Won’t you be relieved when the streak is over because it puts so much pressure on you?” The question still stuns him. “Why would I be relieved?” he asks. “If it’s over, that means I am underperforming.”

Underperformance creates pressures of its own, from big investors, like pensions and endowments. “I have to travel more now for client stuff, but that is because we are underperforming,” he says. “The boards want to see me.” And he conceded, “It’s a drag.” At Legg Mason, Mr. Miller has been stress-testing his investment theses — the way he and his colleagues picks stocks — and is considering a move away from concentrating his bets on dozens rather than hundreds of stocks.

“The question we are asking ourselves is: Should we think more broadly now about probability, about high-impact events and protecting against them by having broader exposure to the market?” he says.

That would be a radical shift at Legg Mason, where the flagship fund has just 35 holdings. Today the five

largest investments in the portfolios overseen by Mr. Miller are Amazon, JPMorgan Chase, AES, Aetna and Yahoo. He largely buys and holds his stocks for years, even if they are pummeled at times.

“His success has come from a willingness to be long headline risk and short consensus thinking,” said Christopher C. Davis, chairman of Davis Selected Advisors, referring to Mr. Miller’s preference for counterintuitive bets.

Mr. Miller, a voluble man eager to share his thoughts on the market, says he has been preoccupied with his failure to invest in energy, materials and global cyclical stocks — areas that have prospered despite the current crisis.

He and his team are trying to determine whether there has been a secular change in the global economy because of pressure from the economic rise of China and India. If so, stocks that look expensive by traditional measures may still be relatively inexpensive, he says.

“I don’t know what the answer is, but we should find it out within very short order because the global economy is clearly slowing,” he says. “Usually that leads to a drop-off in demand for stuff: oil and stuff like that, so those prices should begin to come down.”

Still, broader diversification does not really appeal to him.

“I have never found it a useful policy because what it guarantees is that you will be in the worst sectors of the market as a matter of policy,” he said. “That is why so many managers are justly criticized as closet indexers because they don’t get too far away from the index because they are afraid to be wrong. My view is that being wrong is part of the business. You need to focus on making the best investments you can, instead of trying to smooth things out.”

IN the meantime, Mr. Miller is clear-eyed about some errors in judgment, particularly those that resulted in overexposure to the housing and financial sectors.

For example, Legg Mason began buying Countrywide in 2004, when the stock was in the $20s. “We said: O.K., the Fed is raising interest rates. That is bad for housing,” he recalled. “We studied housing stocks in other countries. We looked at the U.K. experience, the Scandinavian experience, places where governments had raised interest rates. And the answer was that stocks underperformed for about a year and then outperformed.”

What Mr. Miller missed, he acknowledges, was that lending standards had become much more relaxed in the United States than they were in other countries. As for Bear Stearns, he views its demise as a classic run on the bank. While some investors consider Wall Street firms to be inscrutable black boxes, Mr. Miller takes a wider view.

“To a certain extent almost every company is a black box,” he says. “How many people know what is going on inside General Electric? As of March 14, Jeffrey Immelt did not even know what was going on,” he adds, referring to a Webcast in which Mr. Immelt, G.E.’s chief executive, was optimistic about the company’s performance a month before it reported disappointing quarterly earnings.

Mr. Miller notes that AES, a power plant operator that is his fund’s second-largest position, once plunged.

In fact, it went from the mid-$20s in September 2001 to just over $1 in 2002.

“We bought all the way down,” he recalled. By the end of 2004, the stock recovered to close out the year at $13.61 a share. “So a lot of what we tend to do is buy things with a lot of headline risk. Our question is whether the business will survive. Is its market position impaired and then what are the normalized results likely to be?”

That Mr. Miller is still willing to stick with stocks like Countrywide does not surprise Lisa Rapuano, who worked with Mr. Miller for a decade until 2003. She now heads her own hedge fund, Lane Five Capital Management.

“When you are buying it, people think you’re crazy,” she says of Mr. Miller’s preference for out-of-favor gambits. “Of course, if it goes up a lot, it’s because it was really cheap. If not, it was bad. So, looking backward, it’s always clear. But when you have a valuation-driven way of investing, you’ll buy things that go down.”

Sometimes that pays off handsomely, as it did with Amazon. But on occasion, Mr. Miller has been slow to recognize that management problems may trump valuations. “That tends to be a weakness of mine,” he concedes. “I tend to believe the numbers and I tend to give management the benefit of the doubt.”

A case in point: Sprint’s inability to successfully integrate Nextel, a competing telecommunications company it bought in 2005. Mr. Miller bet heavily that Sprint could pull it off; Legg Mason owns 4.5 percent of the shares.

“There were a lot of warning signs that the integration was not working,” he says. “There were 8 or 10 issues of soft management, but at the micro level we were too willing to say that valuation dominates.”

His devotion to Eastman Kodak is another example of this chink in his armor: He thought that Kodak, a pillar of film-based photography whose stock he still owns, would adapt faster to the pressures presented by the rise of digital photography. He was wrong.

Mr. Miller said, however, that he believes “the cultural transformation is largely complete” at Kodak.

As to the causes of his setbacks, Mr. Miller denies that the quality of research or the size of the assets overseen has been the problem, and notes that a number of large funds have done well. Mr. Miller says he is cautiously optimistic that better days are ahead. But his resolve will continue to be tested, especially over the next year.

“I am often asked, how long do we have to wait before the fund starts to do better? The real answer here is the same as it is about most such forecasts: no one knows,” Mr. Miller said in an April 23 letter to his shareholders.

“For planning purposes, here is my forecast,” he wrote. “I think we will do better from here on, and that by far the worst is behind us.”

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