Charles Schwab Impact Investment Conference
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Bill Miller, Evan Bauman, and Stephen Smith of Legg Mason gave a presentation at the Schwab IMPACT conference titled "Off the Bench: Unconstrained Investing and the Quest for Alpha", which focused on how investors can earn above market returns with a "go anywhere" value investment strategy. Below are our notes from their presentation.

All three investors attribute their long-term benchmark outperformance to investments unconstrained by benchmarks. Investors pay investment professionals to form and make judgments. The goal is to make money for clients. Evan Bauman's style is unconstrained by holdings. He takes concentrated positions in stocks not included in the Russell 3000 top ten holdings and does not hold stocks included in the benchmark's top ten holdings. Bill Miller's style is unconstrained by sector. He over-weights sectors that appear attractively valued and underweights the portfolio in sectors that appear fully valued. Steve Smith's style is unconstrained by region of the world.

Beating the benchmarks is very difficult. By definition, index funds underperform the indexes. This underperformance widens over time. At best, index funds earn the benchmark return minus management fees. The index investor is further disadvantaged by the way stocks are added to the indexes. When a stock is expensive, it gets added to the benchmark after the stock has made a move. Further, when a stock included in the index has had a big run up in price, its position in the index grows. The most overvalued stocks represent a larger share of the index. One goal of unconstrained active managers is to buy stocks before they are added to the index.

As for actively managed funds, ninety-two percent of large cap growth funds have trailed their benchmark over a three year period and eighty-seven percent have trailed their benchmark over a five year period. Every investment manager can have a bad quarter or two over a market cycle. Even quintessential investors like Warren Buffett and Peter Lynch beat the market only two-thirds of the time. Successful investors own good managers for the long term.

Bill Miller began his segment of the presentation contending that ***growth is not the opposite of value – it's an input to value***. In 1992, Warren Buffett said,

> Growth is always a component in the calculation of value, constituting a variable whose importance can range from negligible to enormous and whose impact can be negative as well as positive. In addition, we think that the very term "value investing" is redundant. What is "investing" if it is not the act of seeking value at least sufficient to justify the amount paid?

Succinctly, Aswath Damodaran, professor of corporate finance and valuation at the Stern School of Business at New York University, declared in 2012 <u>"Growth can be valuable, but the real issue is whether you can buy it at a reasonable price."</u>

Bill Miller looks everywhere to find innovative companies that are addressing big unmet needs that can deliver ten to fifteen years of sustainable growth. The important piece of the puzzle is to have a disciplined investment strategy and not overpay for sustainable growers. He buys sustainable growers at reasonable valuations and holds them for the long-term. Examples include Amgen and Genentech, healthcare companies he bought in 1983 that he continues to hold today.

The emergence of "style box" driven investing where investors allocate their investments among fund categories called Large Cap Value, Small Cap Growth, International Large Cap Growth and the like, caused Bill Miller to start a fund to look for the best values wherever they appear. He looks for companies selling at huge discounts to the value they are creating. These companies generate earnings above their cost of capital.

Bill Miller contends that making investment decisions based on financial theory is bad for your financial health. He pointed to Ergodic Theory, pioneered by researchers at the London Mathematical Laboratory where he serves as board member. Ergodic theory is about the relationship between time averages and ensemble averages. If a system is non-ergodic, time averages are not guaranteed to equal expected values. The market is non-ergodic, which means, according to Bill, that financial theory is flawed.

Mark Buchanan, physicist and science writer, explains the theory, "…the usual ensemble averages used to compute "expected" returns in finance are, in many cases, simply inappropriate to making decisions in the real world. Take a risky gamble, and the usual average over different outcomes mixes potential worlds in which we go broke with others in which we get rich, and, importantly, takes the often irreversible consequences of these outcomes (bankruptcy, for example) out of the picture. If you make hugely risky investments, this average gives you full credit for all the wonderful possible outcomes, weighted appropriately for their likelihood, which of course seems sensible. What it doesn't do is account for the very real fact that the bad outcomes may effectively wipe you out entirely and take you out of the game, making it impossible to play again -- in which case you will never get to experience those eventual big payoffs. Learn more.

Investment time horizons have gone from long-term to milliseconds. If you really know the businesses you invest in, time-arbitrage provides a big opportunity. Bill Miller and his team at Legg Mason exploit near-term volatility by building positions in high-conviction stocks when their prices decline. Volatility in the wake of headlines also provides big opportunities for long-term investors. Bill presented a slide featuring the front page of *The Economist* magazine from the fall of 2011. Pictured on the front was the galaxy with a dark hole in the middle. The caption "Until politicians actually do something about the world economy…" "Be afraid" was Inside of the dark hole. In the two years since publication of the issue, the S&P 500 Index has gained more than 65%.

Miller noted that Warren Buffett is known for his stock picking ability, but he should also be known for his market calls. In 1974, he called the market bottom in a Forbes interview. In 1982, he liked the market. In 1999, near the market top, he wrote a Fortune article warning that future returns would likely be modest given current valuations. In Oct. 2008, during the financial meltdown, he wrote a NY Times editorial saying he was buying stocks. Instead of buying stocks close to the market bottom, investors instead poured their savings into bonds. Miller noted that people generally do just the opposite of what Warren says and joked that is why Warren has all the money.

On the outlook for the next eighteen months: Evan feels better about faster growing companies that do not pay dividends. He finds it interesting that investors are paying up for dividend-paying stocks. Normally investors pay up for growth. Today, because of low interest rates, slower growth, dividend-paying stocks are selling at a premium. He thinks growth stocks will increase in value just by virtue of their growing earnings. P/E multiple expansion that will come when investors begin paying for growth again should provide investors with attractive returns.

Steve Smith looks at human behavior across the globe to exploit mispricing of securities. Markets become overvalued and undervalued based on where they are in the business cycle. He believes investors should stay away from emerging markets as they appear expensive given that even a whisper of taper wreaks havoc in emerging markets.

Bill Miller sees the market as fairly valued, which investors rarely find at points along the journey from undervaluation to overvaluation. The market rarely sells at the average valuation of 15 times earnings. In 2009, stocks were extremely undervalued. He expects stocks to be trading above the historical average valuation twelve months from now, and they will probably head to overvaluation in the next couple of years. He cautioned, “My ability to predict markets is fruitless and rounds to zero.” The market isn't as cheap as it was, and we’re holding 10% cash now, the highest level in five years. We’re looking for values to present themselves. We own Apple. Investors should look for compounding machines with high returns on equity as far as the eye can see which are reasonably valued. We can't find many things that are reasonably valued. Some stocks are bizarrely priced like Netflix. Despite a sea of red ink, Spotify may come to market valued above $5 billion, which is a ridiculous valuation.