CONSUELO MACK | WEALTHTRACK

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Legendary investor Bill Miller has always been an independent thinker and investor with a 100% "active share" in his funds, as different from any benchmark index as you can be. He is also now his own boss, having recently purchased 100% of his fund business from his long time employer Legg Mason and establishing his own investment advisory firm, Miller Value Partners. His two funds now bear his name and carry on his contrarian tradition of concentrated holdings in largely unloved stocks. His flagship Miller Opportunity Trust was the number one U.S. stock fund for the five year period ended in 2016. In a rare interview Miller gives his rationale for some of his most controversial holdings, including Valeant Pharmaceuticals.

BILL MILLER
Chairman, Chief Investment Officer
Miller Value Partners

CONSUELO MACK: This week on WEALTHTRACK, a rare interview with Bill Miller. He's the number one U.S. stock fund manager of the last five years and the only one to beat the market for a record fifteen years in a row. He is also now totally independent and running his own shop. Great investor Bill Miller is next on Consuelo Mack WEALTHTRACK.

Hello and welcome to this edition of WEALTHTRACK, I'm Consuelo Mack.
Being an independent thinker on Wall Street has never been easy because like most human beings investors are more comfortable traveling with the herd. That has never been more true than it is today because for the first time in history investors can invest as a group in low cost, tax efficient index funds which mimic the performance of various markets. And ever since the financial crisis and even before those indexes have outperformed most actively managed mutual funds.

However "actively managed" might be a misnomer because for a number of reasons many such funds are what are known as closet indexers, meaning they closely track their benchmark indexes. On the other hand, according to some academic research, the truly independent funds which have what is known as high active share, meaning they take large but diversified positions away from the index, tend to do much better. According to one paper: ***"****The most active stock pickers outperformed their benchmark indices even after fees, whereas closet indexers underperformed."*

This week's guest is known for having a very high active share in his funds and for his record-setting performance over the years. He is Bill Miller and he is the only fund manager to beat the S&P 500 for fifteen consecutive years. That happened with his former Legg Mason Capital Management Value Trust from 1991 through 2005. That was followed by a stretch of underperformance in 2006-08 and again in 2010- 2011.

But Miller has not lost his touch, far from it. He is now Founder, Chairman and Chief Investment Officer of Miller Value Partners, an independent investment advisory firm he launched in 2016 after acquiring his money management business from Legg Mason. He is Portfolio Manager of the Miller Opportunity Trust, the successor to his flagship Legg Mason Opportunity Trust Fund which he launched in 1999 and has run with Portfolio Manager Samantha McLemore since 2008. Opportunity Trust was ranked the number one U.S. stock mutual fund for the five year period ending in 2016. Its 23% annualized total returns far outdistanced the market and its peers.

He is also Portfolio Manager of the Miller Income Opportunity Fund which he started at Legg Mason in 2009, he opened to the public in early 2014, with his son as Co-Portfolio Manager. In going independent Miller expressed his commitment to his team's value-based, long-term investment approach and to true active management. I asked him what true active management means to him.

BILL MILLER: Well, active management has several things going against it, the most common of which is the higher fees than passive management. So you have to make sure if you're buying an active manager they are truly an active manager, meaning that they operate relatively unconstrained with respect to their weightings, position sizes relative to the benchmark, and so the academics refer to that as having high active share. Our active share in the funds that I've done has averaged about 100 percent, meaning it's as far away from the benchmark as it can possibly be. So we don't have any constraints with respect to things like being in every sector of the market or only be allowed to be 20 percent overweight in financials for example. We can be double weight or triple weight as long as it doesn't trip any of the issues in the Investment Company Act of 1940. But we have all the flexibility that that regulatory act allows us to do anything in the fund to try and add value.

CONSUELO MACK: You're also committed to value, and you're known as a value investor. You're known as a contrarian investor. What does value mean to Bill Miller?

BILL MILLER: Well, people have asked me that question a lot over the years, and one of my stock answers is if I had my own personal definition of value, who would care? It wouldn't have a chance of operating in the market. So if you're going to try and buy things, value names, they have to be trading at a discount to intrinsic business value, and intrinsic business value comes right out of the textbooks which is the present value of the future free cash flows of the business. So we look for businesses that are naturally cash-generative, and we're trying to buy them when their free cash flow yield, their free cash flow divided by the shares outstanding is 50 percent or more higher than the market. So you're buying things that are demonstrably cheaper. It's similar in equity investing if you were buying bonds. So high-yield bonds, because they tend to be lower quality, they trade at big spreads to Treasuries, but historically they've done quite well, and similarly companies that have high free cash flow yields and trade at big discounts to the overall market tend to do well.

CONSUELO MACK: That's the classic definition and you subscribe to that definition.

BILL MILLER: Well, many value investors are driven more by what I call accounting value as opposed to economic value, and I think probably the greatest example of that in the markets in the last 25 years is the people that have hated Amazon since it became public because they claimed it never made any money. So while Amazon rarely reported GAAP accounting profits, it didn't go from a $400 million company to a $400 billion company not making any money. They generate enormous economic value, but it wasn't captured by the accounting metrics.

CONSUELO MACK: So what sets you apart? When you talk about being a value investor, what do you mean aside from just the traditional accounting metrics? What are you looking for in a company?

BILL MILLER: Well, we're looking for companies that can earn above their cost of capital through an economic cycle. So the reason, for example, that auto companies trade at two and a

half times enterprise value to EBITDA among the cheapest of any group is they don't earn their cost of capital through an economic cycle. Where you can really make significant amounts of money is where an industry changes from being one that doesn't generate economic value to one that does. That's recently happened or we believe it's happened with the airlines, which were among the worst industries in history to ever try and invest in.
In fact, prior to the financial crisis, 25 years before the financial crisis, they had exactly two years of positive cash flow. Now they've had positive cash flow in every year except for 2009, and we actually believe if we have a recession that's as bad as the 2008 or '09 recession, that the quality companies in that industry like Delta will be profitable.

CONSUELO MACK: So United Airlines, United, Continental, Delta. American. Those are major holdings in the Opportunity Fund.

BILL MILLER: Yes, the main difference has been consolidation. So prior to the Delta-Northwest merger, the highest market share of the major carriers is around 12 percent.
But with the major consolidations taking place, now the top three carriers control 75 percent of the industry. Each has about 25 percent. Throw in Southwest, you're up to 90 percent, and then even in a commodity business typically if it gets down to two or three major players, they can usually make money, and that's what's happened since then.

CONSUELO MACK: Are there times when the market just doesn't catch up to what you're seeing, the value that you're seeing? Therefore, that you are really swimming against the tide for a whole cycle or for many years.

BILL MILLER: So right now, for example, we're swimming against the tide with Valeant, the controversial drug company that Bill Ackman just sold out of recently.

CONSUELO MACK: So you own the common stock.

BILL MILLER: We own the common stock.

CONSUELO MACK: Because I looked at your Income Fund, and you own the bond.

BILL MILLER: And we own the bond. We own both of them. The common ...

CONSUELO MACK: So explain that one, Bill.

BILL MILLER: Well, so our going-in cost in ... Valeant's now around 11. Our starting cost in Valeant was around in the 30s, so it wasn't 190 like Bill Ackman.

CONSUELO MACK: But still.

BILL MILLER: But no. I wouldn't have bought it in the 30s if I thought it was going to go to

11, so there have been several things that have happened since then. One of the major ones is a significant drop in guidance when they announced in February that they were going to give the guidance for the year and it was considerably lower than people expected, although they were signaling that for a couple of months before that. So I think most people don't get into the detail companies, and when that happened it sold off. With something like Valeant, we happen to believe that especially since 2009 people have become risk-phobic, and so typically perceived risk is way underpriced relative to real risk, not always but in general since that period of time. Bonds trade at 45 times what they earn, and stocks trade at 18 times what they earn, a huge premium for safety and for liquidity. So with Valeant we're trying to pay attention to the fundamentals and what's going on with the business. We think actually when they report this quarter, it'll probably be a beat and raise quarter. The stock looks to have bottomed and gone down. We've gotten a lot of heat for owning Valeant.

CONSUELO MACK: I'm sure you have.

BILL MILLER: Although at the time we mentioned Amazon earlier. We bought Amazon on the IPO. We sold it after it doubled. We bought it back again in 1999 three years later at $88. It went to six from 88. I think our average cost on Amazon is around ten. So it went to 400. It's 880 or 90 today.

CONSUELO MACK: Would you compare the two, though? I mean is there any comparison?

BILL MILLER: No, but there is a good comparison which is Tyco. So Tyco with Dennis Kozlowski.

CONSUELO MACK: Absolutely.

BILL MILLER: Mark Swartz was the CFO. They were kicked out, and people thought the company's going to go bankrupt. They brought in a new team. Ed Breen who had worked at General Instrument before and now is CEO of DuPont, he came in, and it was the same thing. Highly levered company built on acquisitions, stripping out the costs, and when Kozlowski and Swartz left, the stock collapsed down to single digits. It's the same story basically. Good underlying businesses, good cash flows, overlevered, so two things need to happen. Number one, they need to sell some assets to bring the leverage down to a more manageable level and, second, they need to have the free cash flow then to pay down the debt over time. You've made many, many times your money with Ed Breen in Tyco. I think from the $11 level, we think it could be a 50 or 60-dollar stock in three to four years.

CONSUELO MACK: One of the discussions that you and I had before this interview was that you said that the structure of the market has really changed and that, in fact, individual stocks have become even more volatile than they have been in the past. Am I accurately reflecting what you said?

BILL MILLER: Yes. It's accurate at the high level generality, and by that I mean that if you looked at probably the academic evidence on all stocks, it may or may not show that all stocks are more volatile, because what's happened since the crisis is the so-called safe stocks, the consumer staples, the utilities, have become much more stable than they have in the past, much less volatile.

CONSUELO MACK: I see.

BILL MILLER: Because they're acting as bond proxies, and the bond market was in a 35-year bull market that I think ended last summer. But the rest of the market, and especially the high beta stocks, have become more volatile, and their betas have continued to go up, meaning their volatility relative to the market. So you would have never seen, for example, something like – at least in my opinion – a Valeant get to ten dollars. It might have gotten to $20, but not to ten dollars, and I think it's a combination of people's fears about headline risk and looking bad and just the fact that nobody wants to step in when stocks are dropping. Part of that is the structural change that you mentioned. So I think ...

CONSUELO MACK: The structural change, for instance, that there are no specialists any longer that are putting up their capital and that have a role in making an orderly market in stocks.

BILL MILLER: Specialists are required to "maintain an orderly market." So we had that flash crash a couple summers ago when JPMorgan closed at 61 or so on a Friday, and then two trades opened at 50 with no news. Many, many stocks did that because there's nobody in there trying to ... if there was some terrible thing that happened, could it go from 60 to 50? It could, but it would have gone 60, 59 and a half. It wouldn't have been two trades to get it there. so lack of liquidity, and that's due to no specialists and to Dodd-Frank. So the big investment banks can't go in and stabilize markets or take large chunks of stock off. If we had to sell 500,00 shares, they're not going to step in there the way they could because they can't except on a base if they had the other side of the trade. But again so much less liquidity, and then also the third factor is risk management. So I think we probably had three more layers of risk management at Legg Mason from the time the crisis.

CONSUELO MACK: Than you had had before.

BILL MILLER: Than we had had before, yes, and I've said many times that I've never met a risk manager in my life who believes you should hold more of an asset that's falling in price because it's risky, and they want to know your risk mitigation strategy. So I think that's also something that's happened, because what happens is they want to know. Do you have anything like if a stock falls more than 15 percent relative to the market, you'll sell it? Well, you just have to review it. You have to have a trigger point and all this other kind of stuff, but again it discourages people from stepping into controversial situations or, if something's down a lot on a day, to step in there because you trigger off all the risk management concerns.
CONSUELO MACK: We mentioned earlier the fact that so many investors are going passive,

and one of the advantages that passive investing has is that it's cheaper. The fees are a lot cheaper. So your fees, according to Morningstar, are considered to be above average on the Opportunity Trust, for instance. Any chance that those fees are going to come down?

BILL MILLER: There are several classes of shares that we have, and the share class that they're probably referring to is a C class share which had a fairly high distribution charge, 12b-1 charge, that mostly went to the brokers that sold the fund. So really the difference there would be if you have a load on the fund. The client pays that upfront and it's visible, and if you don't have that, if you have a 12b-1 fee, it's invisible and it's part of the expenses of the fund. So for a variety of marketing reasons, Legg though that was a good thing. It put more of a burden on anybody who had high 12b-1 fees. You have to do better to outperform. So that's something that we're going to review is just the whole fee structure of the overall funds.

CONSUELO MACK: You also have an income fund, but you describe it as a different kind of income fund. What's different about it?

BILL MILLER: Well, many income funds are constrained by either asset class. They can only own bonds, or they can only own stocks that have dividends on them, or they can only have U.S. names. This fund is structured so that the objective is high income, and by high income we mean income. Part of our objective is to deliver more income than the high-yield index can deliver. So higher income than the high-yield index while still ...

CONSUELO MACK: Wow. That's quite a standard.

BILL MILLER: … while still preserving the opportunity for capital gains. The reason that we think we can do that – we've done it over the five-year history of the fund, and the fund had a really good year last year and is doing great this year – is that we can go anywhere in the world looking for high income and we can also go anywhere in the capital structure looking for high income. When we started out we were all high-yield bonds.

CONSUELO MACK: Because that's where the best income was.

BILL MILLER: Now we're mostly in equities of one sort or another, either higher-yielding equities or things we think will have high income but they're hard to predict like companies like the private equity firms, like Apollo and Carlyle and those types of things where we think that the income, the actual distributable income will be considerably above the visible income, and also we think they're cheap actually as operating businesses.

CONSUELO MACK: How ...

BILL MILLER: I'm sorry. Then stocks that we will have in our portfolio that pay no income like Valeant that are perceived as troubled and have very high yields as a result of that.
CONSUELO MACK: Your view of the market looking at the longevity of the bull market. It

started in March of 2009. How expensive do you think the market is?

BILL MILLER: I don't find the market expensive either on an absolute basis or on a relative basis. On a relative basis, it's cheap and it's crazy cheap because bonds are yielding 2.3.

CONSUELO MACK: Relative to other asset classes that you can invest in, the stock market looks cheap.

BILL MILLER: Yes, so I think it's very cheap relative to other asset classes. I don't think it's expensive even against itself, because if you go back to the 1920s when good records were being kept, the market's kind of averaged around 14 times earnings. Now it's 18 times earnings for the median stock, but what you also find is two things. One of them is that the market was trading at single-digit multiples for most of the 1970s because we had high inflation, and multiples got compressed. So if you throw that period out, we don't have high inflation now. We've come close to deflation. If you throw that period out, then you're talking about a market which historically would trade just about where it is right now. Then the other thing is that when we're in an economic expansion as we've been in since spring or fall of '09, the multiples tend to rise because again earnings are growing and people get more confident each year that that happens, and so they put a little bit more money in the riskier asset. So I think relative to its history, I think the market is I'd say fairly valued across most of the spaces which means there's a core part of it that's overvalued, and there's another part that's undervalued.

CONSUELO MACK: What are you most excited about now? Is there a company in one of your portfolios that kind of exemplify, that could be a future Amazon for instance or that you really see tremendous potential for?

BILL MILLER: Well, I'd say a company which is controversial in our portfolio but not controversial in the way that Valeant is for all the things that Valeant did but controversial because of the CEO is somebody that there are differing views about even though he's a self-made multi billionaire, but the company is called Intrexon, and it's in synthetic biology.
It's the leading company in synthetic biology, and so synthetic biology is the ability to manipulate DNA, to rewrite DNA, and so DNA is to living things what software is to hardware. It's the construction set, and whether it's a plant or a bacteria or a person, they're all driven by DNA, and we just scientifically reached the point where we can edit that and much more effectively than we ever could before, and we're just at the very beginning of this. So it'll be miles better in years.

CONSUELO MACK: So the kinds of things that they're working on are ...

BILL MILLER: So the type of thing that this company could be, I mean it has the potential, underlying potential – there's nothing certain – but it has the potential to be the largest market cap company in history because it has the potential to potentially cure every disease, improve productivity across all aspects of agriculture, create new consumer products that never existed before all by changing DNA. So they're the leader because they're the only company out there that now has a product that has been approved by the FDA and the agriculture department for human consumption that is an artificial, GMO-type of product which is an apple called an Arctic apple which doesn't turn brown. You slice an apple open. It turns brown, and the reason it turns brown ... it's still fine to eat but it turns brown in a couple of hours. It's still fine to eat, but the problem is it reacts. There's an enzyme in there that reacts to air, and so what they've done is just gone in and turned off that enzyme so it doesn't react to air anymore. A huge amount. I think about a third of the apple crop is thrown away each year because people don't want it.

CONSUELO MACK: Because people don't want brown apples.

BILL MILLER: Salmon is farm-raised now. Most of the salmon is farm-raised. It has all kinds of problems with antibiotics, with lice, with now tapeworms. They've genetically modified a salmon so that it can grow to twice its size in roughly half the time.

CONSUELO MACK: Which eliminates some of the problems that they have in ...

BILL MILLER: Which eliminated all those problems also because it can be grown in freshwater tanks without antibiotics, without that type of thing. That took 20 years to get that approved, but it's approved now, and it'll probably begin to be marketed by the end of this year, maybe early next. The Arctic apple should begin to be marketed then, and then just a couple other things that they do that might be more interesting to people but still there's a lot of opposition to genetically modified foods.

CONSUELO MACK: To anything GMO.

BILL MILLER: I did ask the CEO, R.J. Kirk – who we have a high degree of confidence in by the way – if when the salmon got approved if there was a lot of opposition to it.

CONSUELO MACK: Opposition.

BILL MILLER: He said in Europe, yes. He said in the U.S. a fair amount, and he said but none in Africa, none in Latin America, none in Asia. He said, "We like to be on the side of inevitability." He said, "If somebody is going to either starve or eat the salmon, they will eat the salmon," but I think we're all genetically modified organisms. Right? We've all been evolving in different ways. We've selectively bred dogs and animals and domesticated them, and we've also selectively bred all kinds of crops.

CONSUELO MACK: Final question. One investment for a long-term diversified portfolio. What do you think we all should own some of?

BILL MILLER: Well, I think that Amazon is probably, as much as it's gone up, they have such a competitive advantage over so many different instrumentalities. Warren Buffett recently said that Jeff Bezos was the single best business man he'd ever met, and I heard Warren say that Jeff was, as he called him, an authentic business genius, and he also said that Amazon will kill anything it goes after. So I think if you look at the total addressable market for Amazon, so Google and Facebook both have market caps. Google is higher than Amazon and Facebook's is close to or about the same as Amazon, but Google and Facebook together are basically addressing the global ad market. That's where they get their business. That's a 500 to 600 billion dollar market growing let's call it five percent a year. You have two companies whose market caps together are almost double the size of that market. Now they're going to be doing other things, but right now that's their core business just as Amazon's core business is retail, but U.S. retail alone is $5 trillion.

CONSUELO MACK: Wow.

BILL MILLER: There they have less than one tenth of that as a market cap. Global retail is many, many times that, and they also have AWS, Amazon Web Services, which has the revenue potential. Well, I asked Jeff Bezos last time I saw him. I said, "What's the total addressable market of AWS?" He just looked at me and said, "Trillions." So I think that's one where you have great management and long-term competitive advantages.

CONSUELO MACK: As you've said, you've owned it since the IPO.

BILL MILLER: Off and on. Well, we've owned it off and on since that, but we've owned it continuously since 1999.

CONSUELO MACK: Bill Miller, such a treat to have you on WEALTHTRACK.

BILL MILLER: Thanks, Consuelo. Great to be here.

CONSUELO MACK: Thanks so much.

At the close of every WEALTHTRACK we try to give you one suggestion to help you build and protect your wealth over the long term. This week's Action Point is: Consider some high active share funds with low turnover.

Most investors are moving money into passive index funds. A contrarian move would be to own a few actively managed ones, the real ones. Then add low turnover as a criteria.
A recent study in the *Journal of Financial Economics*, quoted by *Barron'*s shows that *"Funds with high active share and long holding periods… tend to outperform by two percentage points a year after fees. Those with high active share and short holding periods underperform."*
If you have gravitated to index funds along with everyone else, holding a few long term oriented, high active share funds will add some diversity and hopefully performance to the mix.

Next week, we will talk to ETF Hall of Famer, Matt Hougan about why he is convinced exchange traded funds will soon surpass mutual funds as the investment vehicle of choice.

In the meantime on our website's EXTRA feature I will ask investment legend bill miller about one of his passions – collecting rare books!

Thank you for watching. Have a great weekend and make the week ahead a profitable and a productive one.