IT'S BILL MILLER'S TIME

The country's best fund manager has beaten the market ten years running by buying what everyone else is selling. What's he betting on now? Would you believe Amazon.com?

by William Green

SITTING IN HIS 22ND-FLOOR OFFICE OVERLOOKING THE harbor in Baltimore, Bill Miller gazes at the computer screens on his desk and surveys the damage to his portfolio. It's Sept. 25, and investors have just endured the market's worst week since the Great Depression. In the first five trading sessions after Sept. 11, the S&P 500 dropped 12%, and Miller's flagship fund, Legg Mason Value Trust, fared even worse, falling 14%. It's now down more than 40% from last year's peak.

The economy is reeling. Today's newspapers are filled with chilling headlines about anthrax. Companies like Coca-Cola and Lehman Bros. are reporting dismal profits. But Miller is remarkably sanguine—happy, even. To him, investing has rarely seemed so simple, so basic, so *obvious*. "I think we're at the end stage when people are just giving in," he says. "Everybody is in a panic." It's at times like these, when others are selling, that Bill Miller starts buying—and buying precisely the stocks that the rest of the world has given up on.

"Buy 500,000 Nextel," he tells his chief trader, who is sitting near Miller's desk in a brown-leather sofa shaped like a giant baseball mitt. (Miller is a huge Orioles fan.) Nextel has been hammered, tumbling from $80 to $9 since March 2000 as the euphoria over telecom stocks has evaporated. "The market doesn't like companies that have no earnings, negative cash flow, and massive debt—and are in telecom," Miller observes wryly. But that's fine by him. The stock is cheap, he likes the technology, and he expects the company to get acquired for $25 to $30 a share. His stake is worth $400 million.

As manager of Legg Mason Value Trust, Miller is redefining what it means to be a value investor.

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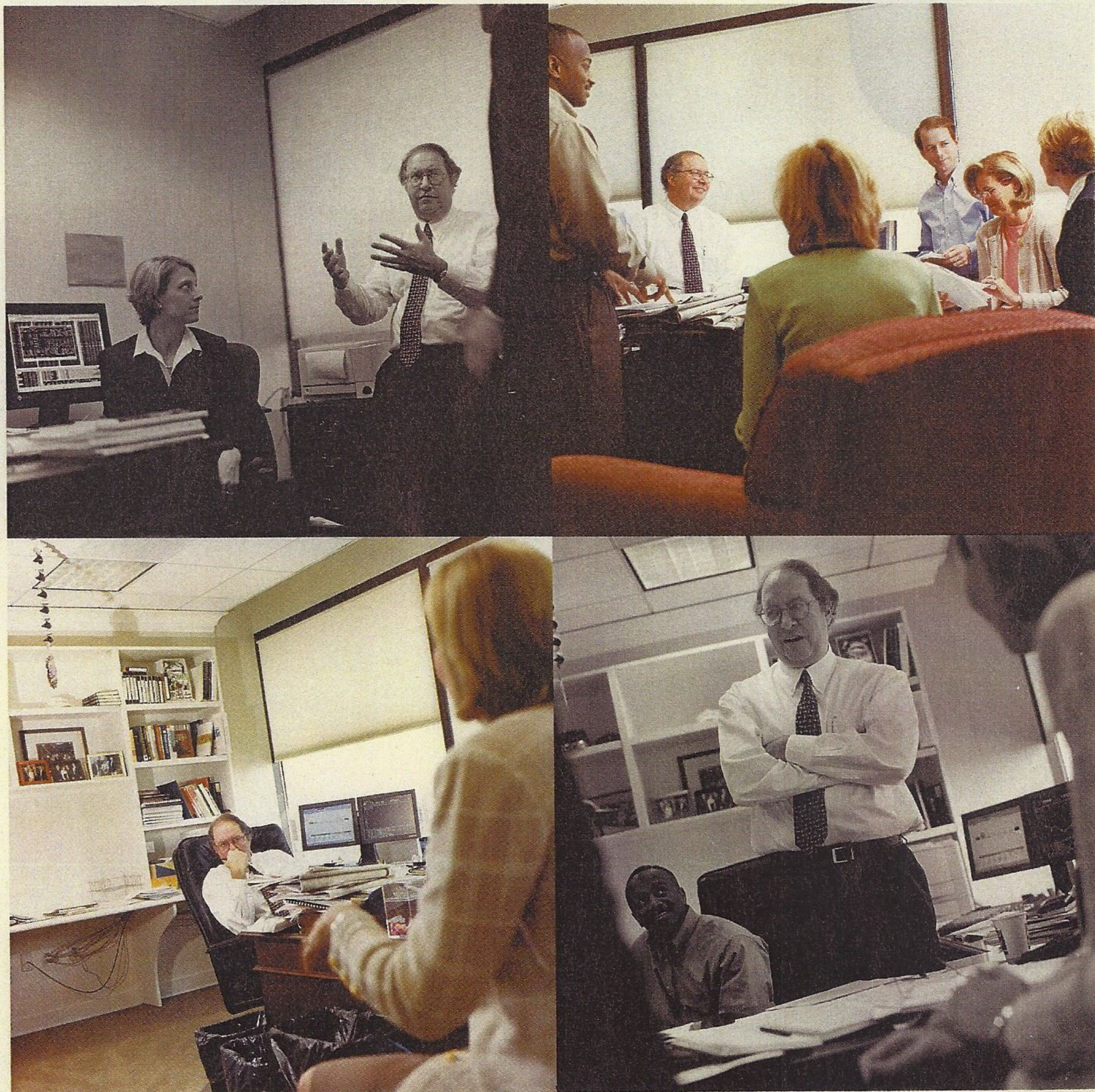
"Buy 200,000 Corning," he says in the next breath. (Corning has dropped from $100 to $10 in the past year.) "Buy 40,000 Comverse at market." (Down from $122 to $24 since January.) "Buy a million AES at $24 to $25." (An energy producer, AES has seen its stock drop 65% in recent months.) For good measure, he loads up on Eastman Kodak—a company that's careening toward a nine-year low. Miller, who's already the biggest shareholder, views the decline as a positive, not a negative. It means the stock is cheaper to buy.

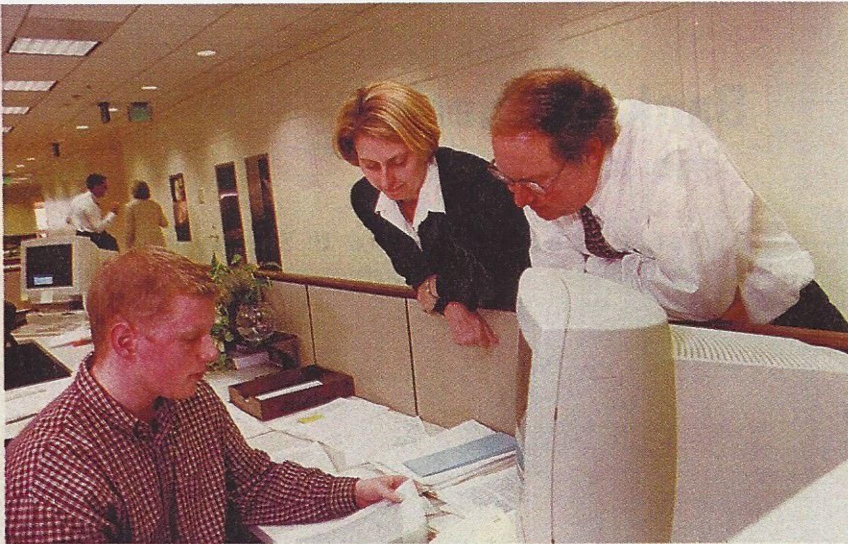
Is this lunacy? To most investors, it would seem so. But Miller's record suggests otherwise. He is, after all, one of the greatest investors of our time—on a par with giants like Warren Buffett, Peter Lynch, and John Templeton. His claim to fame, of course, is that Legg Mason Value Trust has beaten the S&P 500 for ten straight years, something no other mutual fund manager can say—not even Lynch during his Fidelity Magellan heyday. Miller's average margin of victory—5.5 percentage points a year—is astonishing, and all the more so when you consider that this is *after* management fees. And he's on track to do it again; as of mid-November, Legg Mason Value Trust was four percentage points ahead of the S&P 500.

Miller's record has helped transform Legg Mason from a sleepy Baltimore-based brokerage into an investment powerhouse. When he took over Value Trust in November 1990, the fund had assets of around $700 million. It's now at $11.8 billion and counting. When you add the various Legg Mason institutional funds Miller oversees, he's effectively in charge of $23 billion.

But his investing style has also made him a figure of controversy. Legg Mason Value Trust, after all, has the word "value" in its name. Yet the bulk of Miller's record was built during a decade in which growth stocks were the rage—and



Miller and his staff: always calculating the odds



Miller and aide Lisa Rapuano check on a trade.

value managers, as a class, were hopeless underperformers. Miller's outperformance was fueled, in large part, by the explosive success of two winners—AOL and Dell—that nobody else regarded as value stocks. In effect, he has redefined what it means to be a bargain hunter in the modern age.

It's in the past two years, though, that Miller has made his most controversial bet ever: becoming the largest outside investor in online retailer Amazon.com. (Only CEO Jeff Bezos owns more.) To the bewilderment of his peers, Miller believes Amazon's business model will one day emerge victorious. And on the strength of that conviction, he has bought over 50 million shares. When he first began buying the stock on Sept. 29, 1999, it stood at $80—and he has doggedly continued to buy even as it has fallen into the single digits. If he's wrong, it will be the most public failure of his career. But if he's right—and Miller still believes he is—the Amazon bet will rank as one of the great investment calls of all time.

It takes guts to be a great investor. It takes an analytical mind, an ability to size up managements, and enough mental flexibility to juggle both the narrow (what does this inventory change mean?) and the broad (how will the economic outlook affect the stock?). But most of all, it takes guts. It takes guts to believe that you're right when the market is saying you're wrong. And it takes guts to buy when everyone else is selling. Rarely were these traits more apparent in Miller than in the weeks after Sept. 11—a time when he gave FORTUNE extraordinary access as he calmly went about the business of buying beaten-down stocks.

Miller was in New York City when the World Trade Center was hit. He saw the second explosion on TV and wondered whether a plane would attack midtown. "I wasn't scared or nervous. It was just a question of trying to understand what was going on," he says. "My orientation toward these events is more analytical than emotional. The first issue for me from an economic standpoint was, Is this going to happen again tomorrow?"

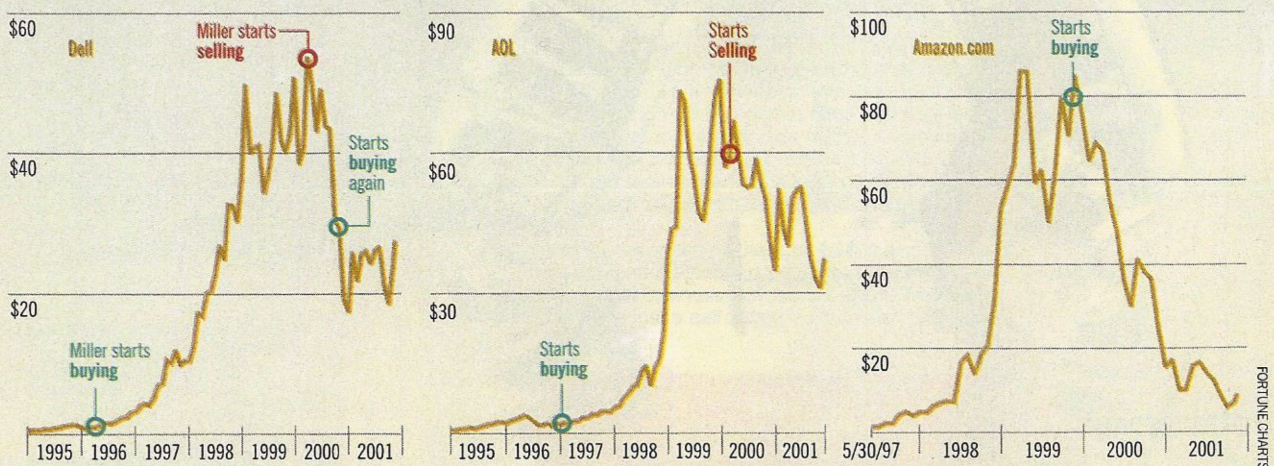
His cell phone didn't work, so he fired off instructions using his BlackBerry, deploying his analysts to assess the impact on dozens of stocks. Over the next few days he gathered insights from an array of sources—everyone from ex-Fed governor Lyle Gramley to Brigadier General David Baker, an expert on military affairs. "I was weepy," recalls Lisa Rapuano, Miller's research director. "Everybody was emotionally charged. But Bill was taking in information and processing it without emotional input. He's like a military guy. Here are the facts. Assess. Assess. Assess. Action."

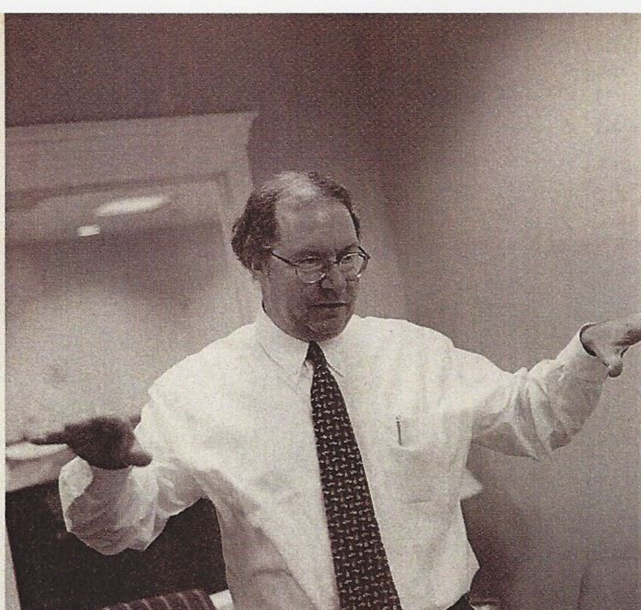
Everyone knew that stocks would tank when trading resumed. But Miller was already looking past that moment. His bet was that Sept. 11 would trigger a bottom in the market that would be followed by a strong rebound. The Fed, he was sure, would slash interest rates, and Washington would fibrillate the economy with fiscal stimulus. Miller also believed that the war would actually "improve the long-term economic prospects of our country by improving our security."

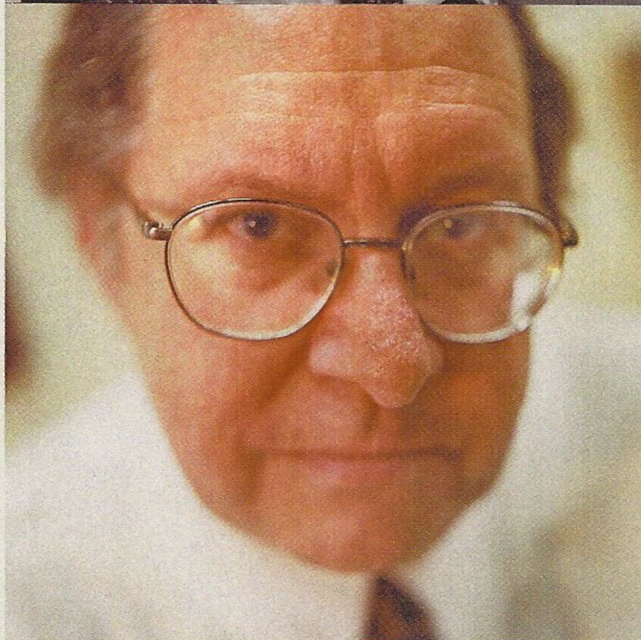
When the market reopened Sept. 17, investors dove into cash and bonds—and ran from any stock that seemed even remotely vulnerable. Miller did the opposite. He cut his fund's cash position to just 0.3% of assets. He also pared his stakes in sturdy companies that had held up well—blue chips like Fannie Mae, Waste Management, and United Healthcare. He wagered instead on more volatile stocks that he expected to make a bigger move when the market revived. Hence his bet on Nextel. He also snapped up a trio of reviled telecom stocks—Tellabs, Comverse,

The (fever) line between a hero and a goat

Miller saw plenty of glory with both Dell and AOL ... but will Amazon be his downfall?







and Corning. And he bet heavily on financials like Citigroup, which tend to outperform when the market surges. To Nancy Dennin, his second-in-command at Value Trust, it was vintage Miller: "Bill prefers uncertainty because it provides him with more buying opportunities."

All week long the market kept nosediving. The VIX index, a measure of market volatility, leaped to 57 on Sept. 21, up from 22 in August. The index had hit such nausea-inducing levels only a few times before—during the crash of 1987, for example. For most investors, wild volatility is a sign to run for cover. Miller saw it differently. "In every previous instance," he explains, "it's been an outstanding buying opportunity."

And the fact that his fellow contrarian legends, Buffett and Templeton, were lukewarm on the market? (For Buffett's view, see "Warren Buffett on the Stock Market.") From Miller's point of view, that was just fine: If even the great contrarians weren't buying, chances were good that the pessimism had reached its peak.

To Miller, investing is a constant process of calculating the odds. "It's all probabilities," he says. "There is no certainty." But as he contemplated the market mayhem that followed Sept. 11, he was about as certain as he'd ever be: This was the moment to play offense. The chances that he would turn out to be right, thought Miller, were "overwhelming."

His entire career, the 51-year-old Miller has been buying when others were selling. That, of course, is the essence of value investing: Such investors seek out battered stocks—shares that have been hit with bad news or that have been beaten down because investors have soured on the sector. Value investors buy these beleaguered stocks because they believe they can see potential that others have missed—a good management team, say, or a gem of a division whose value should eventually be unlocked.

In his first five years at the helm of Legg Mason Value Trust, Miller invested like a classic value guy—and beat the market handily. Nobody so much as blinked. Then, in the mid-1990s, his "willingness to look wherever the values appear," as he likes to describe his style, led him to a pair of high-profile tech stocks, Dell and AOL (now the parent of FORTUNE's publisher). Ultimately it was his bet on those two companies that made him both legendary and controversial.

There's an unwritten rule in the value game: You don't buy tech stocks. Maybe the rule exists because Buffett has always eschewed tech. (His reason, he has said, is that technology changes too fast for him to identify the long-term winners.) Or maybe it's because most people assume that tech stocks are, by definition, growth stocks.

But Miller has never been a purist. In the mid-1990s, when he began to eye the tech sector, he was struck by the realization that the industry was more predictable than Buffett believed. Some technology companies, such as Microsoft and Intel, had achieved almost total dominance in their spheres—and it was nearly impossible to topple them. There were "winner-takes-all markets" in tech, he concluded, so the key was to identify the future monopolists.

In 1996, Miller sensed that he'd discovered a company with the potential to join the elite: Dell. Although that insight seems obvious now, it wasn't back then; investors had soured on the PC industry, viewing it as an unlucrative commodity business. But Miller recognized that Dell's low-cost business model would make it the dominant player. "Dell could be the Wal-Mart of the PC industry," he thought. "It had a sustainable competitive advantage, and the market didn't understand it."

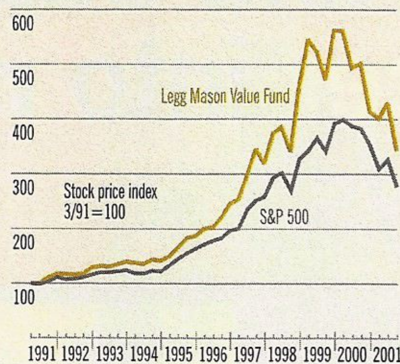
> If Miller is wrong about Amazon, it will be his most public failure ever. But if he's right, it will rank as one of the greatest calls of all time.

Was Dell a classic value stock? Actually, it probably was. The stock had a P/E of less than ten in March 1996, when Miller bought $20 million worth. But shortly thereafter, the stock took off, and here's where Miller next violated the value manager's unwritten rulebook. Even as Dell's P/E rose above 70, Miller held the bulk of his stake, watching as it ballooned to $1 billion. "So long as Dell is generating superior returns on capital and its superior business model is intact, I won't sell," he said in 1999. When he finally sold heavily, in the spring of 2000, the stock was around $50. (Late last year, as Dell dropped toward the teens, he started buying again, amassing 21 million shares. The stock has since climbed to $27.)

His bet on AOL was equally inspired. Again, he got interested when the market turned against it. In the midst of some serious problems—among them, angry subscribers and questionable accounting practices—AOL stock had fallen by more than 60%. Undeterred, Miller took the plunge. "People were telling us that

A perfect ten

Miller is the only fund manager to have beaten the S&P 500 ten years running.



it was a massively stupid thing to do," he recalls. As he saw it, though, AOL, like Dell, had a strong chance of becoming a global monopoly. It had already locked up over 50% of U.S. consumers using the Internet, and "there wasn't a chance in the world that Microsoft or anybody else" could catch up, he explains. What's more, he adds, the company had the potential to be far more profitable than other investors realized. The result? "We made 50 times our money." (At $600 million, it's still one of his biggest holdings, although it's down from a peak of more than $2 billion.)

But Miller's most daring bet was yet to come. In 1999 he ran into some Amazon executives at the Santa Fe Institute, a think tank for the study of complex systems—like the economy and the human immune system. (Miller is vice chairman of the institute's board.) They spoke "for hours on end," Miller recalls, about the company's economic model, and he was struck by a resemblance to Dell. Amazon, he argues, "has incredible economies of scale, which will eventually become apparent. It doesn't have to keep inventory in stores, which is hugely expensive. So its cost of operations is much lower." (For a less cheery take on the company, see "Can Amazon Be Saved?" on fortune.com.)

Here, he figured, was another company with the potential to become a tech monopoly. This time even Miller didn't try to argue that it was a pure value play. When he began buying the stock in September 1999, it was at $80—down from its peak of $107 but hardly cheap after rising 966% in 1998. A few months later the dot-com crash began. But as Amazon's stock cratered, Miller didn't bail out. When it skidded below $20, he bought even more aggressively, boosting Legg Mason's stake to 15% of the company. In the days after Sept. 11, the stock got as low as $5.50.

Miller has refused to sell a single share. Unbowed, he insists that he still believes in Amazon's business model. But, he admits, "we were clearly wrong in buying when we did." His big mistake, he says, was to try to single out a "relatively" cheap stock in a grossly overvalued sector.

Last April, at a conference on value investing, Miller made a bold prediction. "If we're right," he declared, "we think we'll make 50 times our money over ten years." But after Amazon reported disappointing second-quarter results, he asked Rapuano to "stress test" every assumption they'd made about the company. "He kept harping on issues I thought were dormant and making me defend them," she recalls. "I was, like, 'Stop it. We're right.' "

Of course, they might not be right—and Miller is prepared to accept that he might be "spectacularly wrong." Yet this possibility doesn't trouble him. Which is yet another way he differs from his value peers. "Buffett is constantly searching for certainty," he says. Miller, on the other hand, is willing to risk huge losses if the potential reward is rich enough. With Amazon, Miller calmly explains, the most he can lose is 100%—or about $500 million. But there's no limit to how much his funds can gain if his bet works out. "Most people try to maximize the number of times they're right," he says. "The real question is how much you make when you're right."

How does a person come to think like this? How does someone acquire both the skills and the mentality to invest with that kind of audacity? In Miller's case, it probably begins with the fact that he's been involved in the market virtually all his life; he was barely 9 years old when he was first seduced by stocks. His father, who managed a truck terminal in Jacksonville, "didn't have any money," Miller says, "but he bought a few stocks." Seeing his father scanning the financial pages one day, Miller asked him what stocks were. "He said, 'If you own this thing, and it goes up, you make 25 cents.' " Miller was hooked. As a teenager, he bought his first investment book, *How I Made $2 Million in the Stock Market*, written by a dancer-turned-speculator who studied stock charts. At 16, Miller purchased his first stock, RCA, using $75 he'd earned umpiring baseball games. "I made about $600," he recalls. He blew it on a second-hand Triumph TR4 convertible.

There's another factor, though, which goes beyond experience: Miller is blessed with an unconventional mind. As an undergraduate at Washington & Lee University, he "was interested in just about everything on the face of the earth," says his former economics professor, John Gunn. It's a trait that has never left him—he talks as easily about "Zeno's paradox" and chaos theory as he does about the stock market, and he makes connections between disciplines that would never occur to most of us.

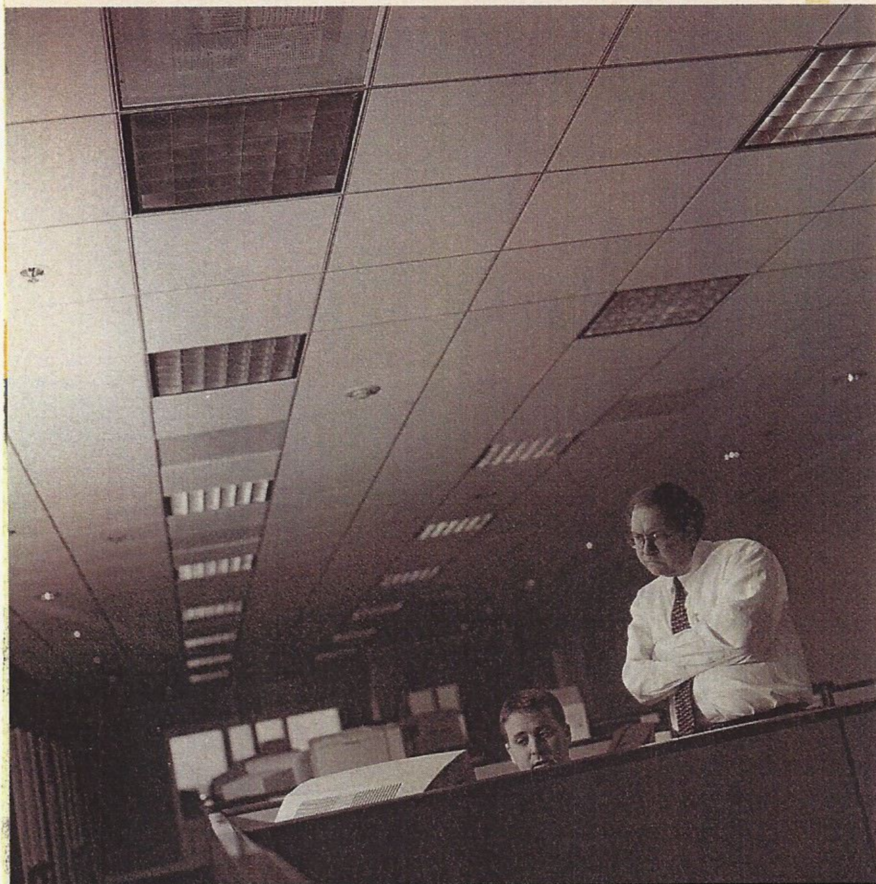
While other future fund managers headed for business school, Miller joined a Ph.D. program in philosophy at Johns Hopkins. Here, strangely enough, he stumbled upon the thinker who would have the greatest influence on his investment style. No, it wasn't Graham or Dodd. It was a philosopher named William James.

James, a Harvard professor who died in 1910, was a brilliant polymath who taught everything from anatomy to philosophy, wrote landmark texts on psychology, and was even an expert on paranormal phenomena like mind reading. But he was also a great observer of the way our prejudices wreck our judgment—an insight that underpins much of what Miller does as an investor.

It is Miller's belief, for instance, that people have turned against Amazon because they are biased right now to do so: "Amazon symbolizes all the things people hate about the Internet—a young man like Jeff Bezos making a billion dollars, these companies losing vast amounts of money." The challenge for investors, he adds, is to set aside such "preconceived notions" and focus on "the long-term reality, not the perception."

Like James, Miller strives to view the world with an open mind. Many value managers, Miller says, "sound like Old Testament prophets," speaking as if their approach to investing "corresponds to some deep structure in the way the world works." Miller wants to be less "theological" about how he invests. He's not wedded to any one metric or analytical technique. Indeed, one reason he bought AOL, he says, was his knowledge of the mathematics of networks—an understanding he derived, in part, from a book on theoretical biology called *At Home in the Universe.*

Miller's bias-free approach has enabled him to succeed in all kinds of markets. It allowed him to gravitate to tech when he saw money to be made there and to shift into more traditional value stocks when that seemed to make sense. "The world changes," he likes to say. "This is the biggest problem in markets."



When bad news hits, Miller's first instinct is to buy. "It's highly probable that people are overreacting," he says.

It's Sept. 25 again, midafternoon. Miller is cruising along the highway in his dark-gray Mercedes S500, listening to classical music and chatting with his usual good humor. This evening he's scheduled to deliver a speech at his alma mater, Washington & Lee, on his outlook for the stock market. Tomorrow he'll give an undergraduate lecture on investing. Some 30 years have passed since his graduation, and this trip has the hallmarks of a triumphant homecoming.

Miller parks at the airport and strolls out to the runway where his private plane awaits him, a seven-seater Lear 60 that costs him $2,500 per hour of flying time. Along with his three homes—including an 80-acre waterfront estate in Maine—the plane is one of his few extravagances. But Miller has an economic rationale. "The scarce resource is not money," he says. "It's time. The question is, What's the economic value of your time?"

He arrives at the school, in Lexington, Va., a few hours later and wanders around the campus, trying to find someone who can let him into the Morris House, the elegant building where the school houses its A-list guests. The stock market has closed for the day, so Miller calls the office for an update. Rapuano delivers the bad news: AES—the energy firm in which Miller had bought one million shares this morning—has just warned the Street that its earnings will fall 30% short of expectations.

Miller can't believe it. All the Wall Street analysts his team had spoken with had insisted that AES always hits its numbers. Now they're blaming the shortfall on British electricity prices and the weakness of the Brazilian currency—as if they've only just realized that those might be concerns. "It's not like it was a secret," Miller says contemptuously. "It's just so annoying. I can't tell you how annoying it is."

The faculty throws a dinner in Miller's honor, then he heads over to a well-filled chapel to deliver his lecture. He talks fast, sprinkling his speech with quotes from Wittgenstein, Auden, Borges, and (of course) William James.

The next morning Miller teaches the undergrad investment class, then heads back to the Morris House for a shot of coffee. His travel companion, Kyle Legg, who runs part of Legg Mason's institutional investment business, looks visibly shaken. "Did you see AES?" she asks. "It's at 13."

"*What*?" says Miller. "That makes no sense at all." On Sept. 10 he'd started accumulating it at $27.55, and with the million shares he bought only yesterday—at $24 a pop—Legg Mason now owns four million shares. Today's plunge has cost his investors about $50 million, and it's not even lunchtime. "Let me grab my phone here," he says. "I've got to find out where my cash is." Pacing around the room, he speaks with quiet intensity, his bonhomie suddenly gone. Furious charges are swirling on Wall Street that AES management has lost all credibility, and analysts have raced to downgrade the company.

So what does Miller do? "Let's buy 2½ million shares today," he says. "Let's just get it done."

That afternoon the dean of the School of Commerce offers Miller a guided tour. They drive off in the dean's Lincoln Town Car and park beside an idyllic baseball field that's carved out of a forest. Miller, who pitched for the Washington & Lee baseball team, steps out to admire the field. Standing beneath a perfect blue sky in the middle of nowhere, he calls Rapuano for a market update. She asks him how he's doing, and he replies: "Okay, all things considered, I think."

At the close of trading, says Rapuano, AES is languishing at $12.25—down 49.5% for the day. And that's not all. Nextel, which Miller bought yesterday, has fallen 14% today. Amazon has sunk 10%, and Comverse—another of yesterday's buys—has dropped 13%. "Oh, man," he mutters. "It's almost unbelievable."

Miller slips the phone back into his pocket, turns to the dean and smiles gamely: "This is a great field."

Loading his bags into his rented Oldsmobile, Miller spots a piece of paper tucked under the windshield wiper. It's a brightly colored chart showing the implosion of AES—a gift, presumably, from one of the students he taught today. As he drives to the airport on his way back to Baltimore, Miller wrestles with how to play AES. Until yesterday he had viewed the company as a well-run outfit with a predictable business and excellent growth prospects. And after dropping from $73 last year to the high 20s, the stock seemed cheap, with a P/E of only ten.

"We don't know enough," he concedes now. Still, his inclination is to buy another 2½ million shares tomorrow. Why? Because one of his deepest-held beliefs is that other investors get overly spooked by bad news. Even in a situation where he doesn't have all the facts—as with AES—his instinct is to buy now and ask questions later. "It's highly probable that people are overreacting" to the company's sudden earnings shock, he says.

Miller's willingness to throw more and more money at holdings that are getting smashed has paid off richly over the years. In 1999 he bought Waste Management at $51.65, shortly before it got hit by an accounting scandal. He kept buying as it plunged to a low of $13 and has made $135 million as the stock has rebounded to $29. "If you want to boil down everything we do," he explains, "it's this: The guy with the lowest average cost wins." He's right, of course. Consider Amazon again. In the middle of this disaster, he has managed to lower his average per-share cost to $30. That's a far cry from its current price, to be sure—but it's a lot better than the $80 he originally paid.

By the time he reaches the airport, Miller has made up his mind about AES. "I want to get this thing really covered. I want it remodeled and to sit down with management." Suddenly there's a sense of excitement in his voice. "This has the potential to be like Waste Management at $13. We could double our money in two years and make five times our money in five years." In the weeks that follow, he ratchets up his stake in AES to 32 million shares at a cost of about $500 million, cutting his average price to $16.34 a share. "It's the only thing that has to work next year," he says, "and we'll beat the market."

Three weeks later Miller is in his office on a Friday morning. He's dressed nondescriptly in a gray suit, white shirt, yellow tie, and black tassel loafers. The shelves are filled with books—*Swarm Intelligence*, *The Metaphysical Club*, *The Biology of Business*, *Zen in the Markets*, *The Essential Buffett*, *The Pre-Socratic Philosophers*. Hanging from a ribbon behind him is a badge that reads, ASK ME ABOUT 10 FOR 10. Yes, Miller cares—a lot—about his market-beating record.

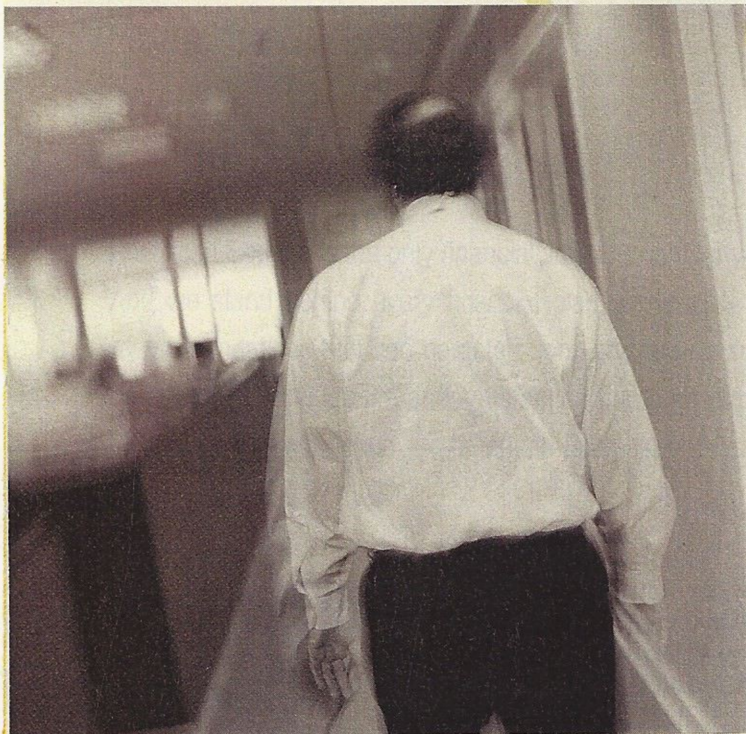
An analyst stands beside Miller's desk, nervously sliding his foot in and out of his shoe. He's in the throes of explaining to his boss the precarious debt situation at Providian Financial, a subprime lender owned by several Legg Mason funds. At Washington & Lee, Miller had called it an "exceptionally cheap" stock, but today it's in the process of dropping 58% to $5.15, down from a high of $64. The analyst says he has a headache; Rapuano says she wants to kill herself. But Miller isn't fazed. "Okay, cool," he says—and buys some more. As Rapuano puts it, this is just the normal functioning of "the superprobability machine in Bill's head." (With the stock trading at less than five times last year's earnings, explains Miller, "we're not taking that much risk.")

Truth is, his gift for playing the odds has served him brilliantly in recent weeks. On the trip to his alma mater, he even identified the exact bottom of the market: Sept. 21. Since that day stocks have regained all the ground they lost in the aftermath of Sept. 11. The panic on Wall Street has dissipated, and the volatility index has eased, as Miller predicted. More to the point, many of the stocks he bought during the late-September plunge have surged. Since Sept. 30, Nextel has risen 26%, Dell 45%, Gateway 50%. His holdings in Citigroup, IBM, and Lucent have all risen between 20% and 50%. The Tellabs shares he bought Sept. 25, at $10.50, recently hit $18. Even Amazon has done well of late, soaring more than 50% from its low, to $9.20. As for AES, it hit a low of $11.60 on Oct. 2 and has since jumped 46%.

Behind Miller's desk is a badge that reads, ASK ME ABOUT 10 FOR 10. Yes, he cares enormously about his market-beating streak.

Though Legg Mason Value Trust is down 8.9% for this year, it's still running four percentage points ahead of the S&P 500 as of mid-November. Which is to say, his streak is intact. At times it can seem as though nothing matters more to him. He knows at virtually any moment how he stacks up in this endless race. "He's awful like that," laughs Kyle Legg. "Every day he's staring at the screen saying, 'Goddamn it. A minute ago I was 20 basis points ahead, now I'm 20 behind."

Beating the market is an "exceptionally difficult endeavor," Miller admits, "especially when you're loaded with expenses." Value Trust charges shareholders a hefty 1.68% a year, making it wonderfully profitable but lowering Miller's odds of outperforming. Then there's the added burden of managing so much money. Legg Mason's average holding is over $500 million, which makes it difficult to move in and out of stocks quickly. In Value Trust, which owns just 37 stocks, Miller is forced to focus primarily on the index's 200 biggest companies, which have the kind of liquidity a fund this large requires.



Even now, after a decade of beating the market, Miller knows that it's way too soon to declare victory. Arguing the case against himself, he points out that his stellar returns may well be a fluke, as some academics would argue: "There's a very reasonable chance that it's pure luck going on here," he says. "One can't conclude anything about my record before it's over."

He walks to his bookshelf and pulls down a volume about the demise of Long-Term Capital Management. He opens the book to a chart showing the hedge fund's inexorable rise and devastating collapse: "Up until here, you could say, 'Well, these guys are the greatest.' " For now, so is Miller. But the stock market can be a brutal adversary. "I've constantly got to figure out what's going to get me," he says. "If we were to have some spectacular flameout, it could easily wipe out the entire record." He slides the book back onto the shelf, then goes back to work, calculating the probabilities, buying against the grain. F

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