

Market Commentary

July provided more evidence that the performance “worm” may have turned in favor of large and mega cap stocks over small and mid-caps. For the month, the S&P 100 Index—a reasonable proxy for mega caps—led the performance parade, followed by the S&P 500 and Dow Industrials. The Russell 2000, S&P Mid-Cap and Nasdaq Composite all trailed significantly.

TOTAL RETURNS		
	July	YTD
S&P 500 Index	+0.62%	+3.34%
Dow Industrials	+0.45%	+5.70%
Nasdaq Composite	-3.69%	-4.73%
S&P Mid-Cap	-2.85%	+1.27%
Russell 2000 Index	-3.25%	+4.69%
Wilshire 5000	-0.36%	+3.13%
S&P 100 Index	+1.70%	+4.55%
Russell 1000 Growth Index	-1.90%	-2.81%
Russell 1000 Value Index	+2.43%	+9.15%

Sources: Bloomberg, Wilshire, Russell

For the year to date, the Dow Industrials is now the best performing major market index, while the Nasdaq Composite is bringing up the rear. Contrary to our expectations at the beginning of the year, growth stocks have continued to take it on the chin relative to value stocks, trailing by over 400 basis points in July and by almost 1200 basis points year-to-date.

The superior relative performance of value over growth and the Dow Industrials over the Nasdaq Composite is evidence of investors’ recent aversion to anything perceived as risky. In today’s market, investors want current earnings, high dividends, low volatility and a sunny outlook. They are avoiding like the plague anything where the near-term outlook is murky or challenging, or where the rewards for investment are off in the future. In this environment, short-term earnings disappointments—even minor ones—are being severely punished. According to market strategist Bob Farrell (quoting statistics from *Investor’s Business Daily*), in the three-week period ending July 30, seventy-six companies selling for over \$10 lost 15% or more in one day following disappointing earnings reports, while 185 fell by 10% or more.

Within the S&P 500 Index itself, we see a similar pattern. During the month of July, more than 300 companies in the S&P 500 reported earnings. Donald Li of Legg Mason Capital Management analyzed these companies’ results and found that 30 of them missed earnings by a penny or less. Of these 30, six companies underperformed the market by 10% or more in the

48-hour window surrounding their earnings announcement. Donald found this to be the highest percentage of companies to get hammered by minor earnings misses since the third quarter of 2002, when 8 of 75 companies to miss earnings by a penny or less fell a relative 10% or more on the news. Though the market has been nowhere near as weak recently as it was in 2002, investors’ collective tendency to “shoot first and ask questions later” is reminiscent of that period of high market anxiety. The popular media seem to us to be feeding that mood. CNBC’s “Squawk Box” has titled its recent coverage “August Anxiety” and alternates regularly between segments on power outages brought on by the current heat wave and the hurricane watch in Florida and the Gulf Coast. With the laundry list of things to worry about—including the economy, interest rates, inflation, earnings, the Fed, multiple conflicts in the Middle East, structural deficits, the dollar, the axis of evil, and so on—it is no wonder that investors seem to be as “nervous as a long-tailed cat in a room full of rocking chairs.”

True to their mood of caution and concern, investors are moving to the sidelines in growing numbers. Domestic stock mutual funds had net outflows of \$8.4 billion in June, the first such outflow since February 2003, when investors withdrew a net of \$10.9 billion from stock funds. Will the market rally in the coming months as it did in 2003 following that period of net redemptions? No one knows for sure, but it would not surprise us at all. Investors as a group have a virtually flawless record of doing the opposite of what they should at market turning points. They tend to be sellers at the bottom and buyers at the top. It should come as no surprise that the most money ever put into stock funds in a month was \$53.7 billion in February 2000, at the top of a multi-decade bull market. Two-and-a-half years later in July 2002, after the S&P 500 had dropped almost in half, investors yanked a net of \$52.6 billion out of stock funds in that month. Perversely, then, history says it is bullish for the market going forward when investors are pulling money out of equity mutual funds. How bullish? Read on.

Outlook

We think evidence is accumulating that investors could enjoy a surprisingly good market over the next twelve months. We still have to get through September, which has been the weakest month of the year historically, and October, which has seen more than its share of yearly market lows.

As detailed above, the list of things to worry about is plenty long and we don’t wish to minimize any of it. The morass in Iraq and the recent border war between the Israelis and Hezbollah top my personal list of psychologically debilitating situations. Others may have different worries. Whatever one’s particular area of concern, chances are it is getting plenty of

attention in the media. In our opinion, this increases the odds that it is also factored into the market's current pricing structure.

The positives are less well understood and less discussed, in our opinion. For this reason, we believe they have more potential to surprise the market on the upside than the negatives do to precipitate further meaningful downside.

Prominent among the list of encouraging recent developments is the fact that it now appears more likely than not that the Fed will pause in August. They might even be done with their tightening regime. If so (and it's by no means certain), the new game on Wall Street would become: "When will the Fed start easing?" Our experience is that game is a lot more fun to play.

Recent data—including the sharp drop-off in housing activity, disappointing retail sales and weakening employment trends—suggest that economic growth is slowing. The slowdown was confirmed on July 28 when second quarter real GDP growth was reported at 2.5%, a half percent lower than consensus expectations. On the news, the Fed fund futures market dipped significantly, with most now betting that the Fed will not tighten in August. The equity market also had a celebratory rally.

Though core inflation came in at 2.9%, above the Fed's preferred range of 1% to 2%, the market chose to focus on the fact that growth was below expectations, rather than that inflation was above. We think this is a rational response by the market. Inflation is a lagging indicator and has historically risen for a period of time following a slowdown in economic activity. Statements by a number of Fed Governors—Chairman Bernanke among them—suggest that the Fed understands these lags. The clearest elucidation that we have seen of the Fed's thinking on this issue came from a recent (Monday, July 31) speech by Janet L. Yellen, Fed Governor and President of the Federal Reserve Board of San Francisco. After noting that core inflation was currently running at a rate above the Fed's "comfort zone," she opined as to the appropriate Fed response: "In these circumstances, it might be thought that policy should continue to tighten until the inflation data move back to a rate consistent with price stability. But I would argue that a gradual approach is likely to be better ... The need to incorporate lags between policy actions and effects on the economy is a key issue for monetary policy as well. We don't know what the lags are with precision, but we still need to do the best we can to take them into account. We simply don't get the necessary feedback on the effects of our policy actions for a long time. So if we kept automatically raising rates until we saw inflation start to respond, we most likely would have gone too far. Instead we need to be forward-looking."

We find Ms. Yellen's views—which we believe Chairman Bernanke shares—very encouraging. The fact that the Fed is taking lags between the timing of its policy actions and the effect of those actions into account lowers the odds that the Fed will overdo its tightening regime and tip the economy into recession.

Apart from the increasing likelihood that the Fed is either done or nearly done tightening, we see a number of other encouraging signs in the current market environment. Andrew Bary stated the bull case persuasively in the July 24, 2006 issue of *Barron's* in

an article entitled "Time to Buy." We admit to being a bit nervous that *Barron's* chose to make this its cover article for the edition. Usually, we're more partial to cover headlines that proclaim that it's "Time to Sell!" That aside, we thought the article made good sense. Mr. Bary shares our perception that strong earnings growth and attractive valuations provide solid underpinnings for the market. In addition, his article cites the surge in private equity transactions, coupled with record levels of both stock buybacks and mergers and acquisitions as evidence that corporations and deep-pocketed investors see value in today's market.

To those positives, we would add two bullish indicators that we mentioned in last month's commentary, namely instances of spikes in the volatility index (VIX) and back-to-back 9-to-1 up volume days. Those who missed last month's discussion can find copies of June's commentary on our website. To summarize our previous findings, in the five previous times since 1990 that the volatility index (VIX) has doubled in 50 trading days, the S&P 500 Index has been up an average of more than 12% in the ensuing six months. In the 25 previous times since 1950 that there have been two 9-to-1 up volume days within a 90-day period without an intervening 9-to-1 down day, the market has also been up an average of more than 12% in the next six months.

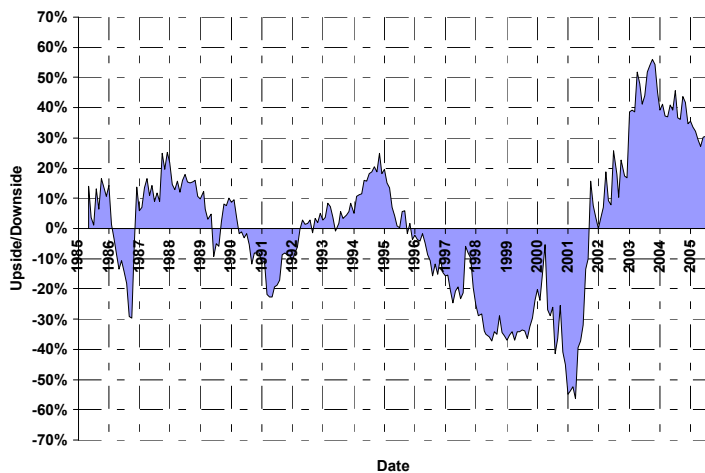
The VIX completed its sixth doubling since 1990 during the 50 trading days ended June 13, 2006, the closing market low year-to-date. The 26th instance since 1950 of back-to-back 9-to-1 up volume days occurred on June 15 and June 29. For good measure, a third 9-to-1 up volume day occurred on July 19. Both of these indicators point to better stock market performance than most people seem to be expecting for the balance of the year.

Two other sentiment-related indicators are also flashing green. The first is the aforementioned data on mutual fund flows, which in the past have been a reliable contrary indicator. The market and economy are forever changing and evolving, but human nature tends to remain the same. Few things are more reliable than investors' collective tendency to be selling when they should buy, and buying when they should sell.

The other sentiment indicator that is flashing a bullish reading is the number of bears versus bulls in the American Association of Individual Investors (AAII) sentiment poll. According to market strategist Don Hays of Hays Advisory, bears outnumber bulls in AAII's most recent poll by 1.5 to 1. Since 1987, when the ratio of bears to bulls has been this high, the market has been up 19% over the next year, compared to an average annual return of 10% over that same period.

In our opinion, perhaps the strongest argument the market has in its favor currently is valuation. Taking a slightly different tack to this subject than previously, we present below a graph by one of our analysts, Arturo Rodriguez, measuring the degree of under- or over-valuation of the S&P 500 relative to the 3-month US Treasury Bill and 10-year US Treasury Note over the last 20 years.

S&P 500 Historical Implied Upside/Downside to Fair Value



Source: LMCM Estimates

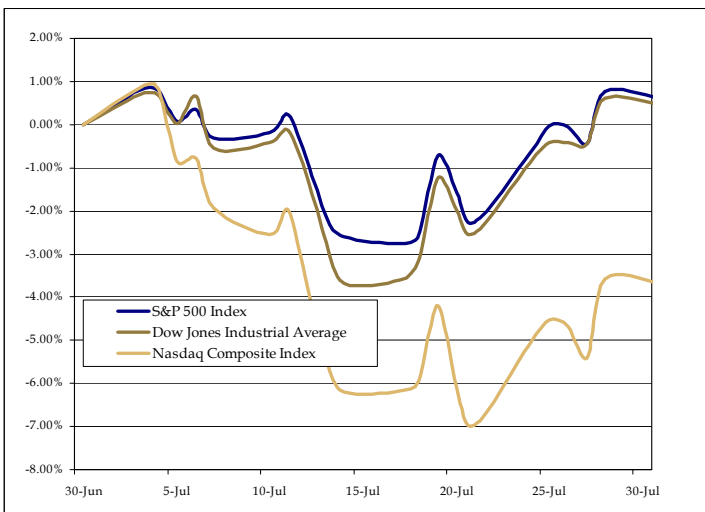
Arturo describes the output of the graph as follows: “The upside/downside chart compares the 12-month trailing earnings yield on the S&P 500 against what its historical regression line versus the 3-month and 10-year treasuries says it should be. For example, when the S&P 500 earnings yield is 10% above its predicted value based on its historical relation to treasury yields, the chart argues the earnings yield should come down and thus that there is approximately 10% upside to the S&P 500. The historical relation should hold more or less well over time, but what sometimes may distort the graph significantly is the earnings variability of the S&P 500 itself. The point of maximum downside shows up in the chart as being early 2002 (rather than early 2000 as might otherwise be expected) because there were so many large write-offs that year that earnings basically disappeared. Conversely, the unusually large upside seen since 2004 is in part due to historically high corporate profitability that may not last. Thus, earnings cyclicality exaggerates the size of the recent maximum downsides and upsides. Otherwise the general chart direction should tend to be right.”

We think Arturo’s analysis is basically correct. Even allowing for the possibility that S&P 500 profits are near a cyclical peak, we believe the market is a good deal more attractive than is generally recognized.

As always, we thank you for your support and welcome your comments.

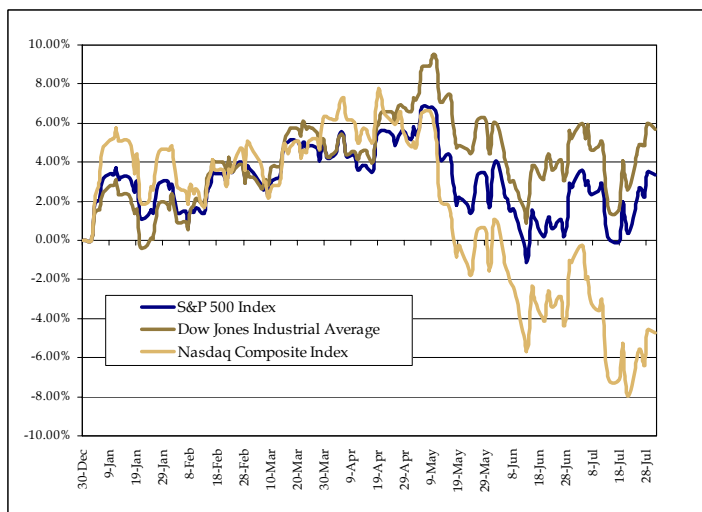
David E. Nelson, CFA
Chairman, Investment Policy Committee
Legg Mason Capital Management

Major Indices July Performance



Source: Bloomberg and FactSet

Major Indices YTD Performance



Source: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

Sector Index Name	July	YTD
<i>Broad Market Indices</i>		
S&P 500	0.62	3.34
Dow Jones	0.45	5.70
Russell 1000	0.22	2.98
NASDAQ	(3.69)	(4.73)
Dow Jones Wilshire 5000	(0.36)	3.13
Russell 2000	(3.25)	4.69
Russell 1000 Growth	(1.90)	(2.81)
Russell 1000 Value	2.43	9.15
<i>S&P 500 Sector Indices</i>		
S&P 500 Consumer Discretionary	(3.36)	(0.97)
S&P 500 Consumer Staples	1.97	6.58
S&P 500 Energy	5.03	19.42
S&P 500 Financials	2.48	5.67
S&P 500 Health Care	5.50	1.49
S&P 500 Industrials	(5.28)	1.41
S&P 500 Information Technology	(3.77)	(9.41)
S&P 500 Materials	(3.46)	3.27
S&P 500 Telecomm Services	5.04	19.54
S&P 500 Utilities	4.91	9.60

Sources: Bloomberg, FactSet, Russell

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