LEGG MASON CAPITAL MANAGEMENT *Month-End Commentary*

October 2006

Market Commentary

Investors enjoyed another month of strong stock market returns in October. They certainly had a lot better month than casino magnate Steve Wynn, who had to cancel the planned $139 million sale of Picasso's "Le Rêve" to collector Steven Cohen after accidentally poking a hole through the middle of the painting with his elbow while showing it to friends. Mr. Wynn is reported to have said: "Oh s***! Look what I've done. Thank goodness it was me." Amen to that.

TOTAL RETURNS

	OCT	YTD
S&P 500 Index	+3.26%	+12.06%
Dow Industrials	+3.57%	+14.81%
Nasdaq Composite Index	+4.82%	+7.99%
S&P Mid-Cap 400 Index	+4.16%	+7.40%
Russell 2000 Index	+5.76%	+14.95%
Dow Jones Wilshire 5000 Index	+3.63%	+11.91%
S&P 100 Index	+3.42%	+14.38%
Russell 1000 Growth Index	+3.52%	+6.59%
Russell 1000 Value Index	+3.27%	+16.89%

Sources: Bloomberg, Wilshire, Russell

Market strength was broad-based during the month, with every major market index up in excess of 3%. The Russell 2000 Index led the way, followed by the Nasdaq Composite which—by virtue of its strong performance in October—is no longer the worst performing major market index year to date. That distinction is now held by the S&P Mid-Cap Index.

Not much seemed able to rattle the market in October. Ten-year U.S. Treasury note yields backed up by about 20 basis points mid-month on fears that economic growth might be reaccelerating and force the Fed to tighten further. By October 23, just prior to the Federal Open Market Committee (FOMC) meeting, the fed funds futures markets had priced in a small probability of further tightening in December or January, reversing their beginning of the month bets that the Fed would be easing over that time frame. Following a benign statement from the FOMC at the conclusion of its October 25 meeting, futures market participants reversed course again, renewing their bets that the Fed was through tightening and could well be easing by next spring. By month end, the 10-year had done a complete round trip, falling in price to yield 4.8% by mid-month, then rallying to yield 4.6%, where it began the month.

The equity market was unfazed by all these bond market gyrations. It rallied while long rates were rising, and rallied further when they came back down. Even the uncertainty surrounding the mid-term elections could not derail the market.

We have often sung the praises of Tradesports.com as an invaluable tool for harnessing the "wisdom of crowds." We have found it to be a much more reliable source of information on elections than polling data, for example. Tradesports again proved to be extremely useful—though not perfect—in handicapping the mid-term elections. Bettors on Tradesports accurately predicted that the Democrats would wrest control of the House of Representatives from the GOP. They also bet wrongly that the GOP would maintain control of the Senate. With GOP incumbent George Allen's concession to Democrat Jim Webb in the Virginia Senate race eliminating the need for a recount, the Senate now also swings over to the Democrats by a margin of 51-49, assuming that both independents—Bernie Sanders of Vermont and Joe Lieberman of Connecticut—continue to caucus with the Democrats.

We find it odd, and interesting, that the aggregate probability of the GOP maintaining control of the Senate stayed in the high 60s all the way up to Election Day, despite the fact that it appears that Tradesports bettors had all of the key individual state Senate races handicapped properly. As of mid-morning on election day, Tradesports bettors accurately predicted that of the seven Senate seats that might reasonably be expected to swing from Republican to Democratic control—Missouri, Montana, Ohio, Pennsylvania, Rhode Island, Tennessee and Virginia—only Tennessee would remain in Republican hands.

One possible explanation for the counterintuitive result that Tradesports bettors would get the individual state races right and the GOP control issue wrong is contingent probabilities. If we look at only the three tightest Senate races with the probabilities of a Democratic victory in parentheses—Missouri (62%), Montana (70%) and Virginia (67%)—then the contingent probability that the Democrats would win all three races was (.62)*(.70)*(.67) or about 29%. The implied probability of the GOP winning at least one of those races was thus about 71%, within a percentage point or two of the Tradesports-implied odds. Another way of looking at the results is to recognize that the most probable event does not always occur. Anyone who has played much Texas Hold 'Em knows that pocket aces are the best hand you can be dealt. Pre-flop, pocket aces are about a 7-to-1 favorite to win the pot heads up against any two other cards. But even in these highly favorable circumstances, 12% of the time those aces get cracked. It is a bad beat when it happens, but it does happen. Our colleague Michael Mauboussin might call this an example of a good process-bad outcome.

So, assuming that the Democrats have taken control of both houses of Congress, where does that leave us as investors?

Should we be worried? The short answer is no. History shows that irrespective of which party controls the White House, the stock market fares better when Congress is controlled by the other party.

Gains (%) for Stocks by Party of the President and Majority Party in Congress (03/04/1901-11/06/2006)

	Stocks (DJIA)
Democratic President	7.19%
Republican President	3.85%
Democratic Congress	6.46%
Republican Congress	3.51%
Dem. Pres., Dem. Cong.	6.53%
Dem. Pres., Rep. Cong.	9.60%
Rep. Pres., Rep. Cong.	1.53%
Rep. Pres., Dem. Cong.	6.37%
All Periods Buy/Hold	5.34%

Source: Ned Davis Research

According to Ned Davis Research, the best of all possible political backdrops for the market (as measured by the Dow Industrials) is a Democratic President and Republican Congress. Stocks have shown a 9.60% annualized (price-only) gain during those periods, versus a buy-and-hold return of 5.34% annualized. The second-best situation historically is a Democratic President and Democratic Congress. Third best is the situation investors appear to face for at least the next two years, namely a Republican President and a Democratic Congress. Annualized stock returns over these periods have been about 6.37%, a bit more than one percentage point better than the buy-and-hold average for all periods.

Interestingly, the political backdrop that seems to be ending—Republican control of both the Presidency and Congress—has historically been the worst environment for stock market investors, showing only 1.54% annualized returns. Annualized price gains for the Dow Industrials since President George W. Bush took the oath of office on January 19, 2001, are in the range of 2% to 3%, so he's doing better than the Republican average thus far, but not by much.

According to a fascinating paper entitled "Congress and the Stock Market" by Michael Ferguson and Douglas Witte, the type of Congress that investors like most is one that is not in session. As humorist Dave Barry says: "I am not making this up." Ferguson and Witte discovered that returns for the Dow Industrials and several other leading market indices were significantly higher and volatility significantly lower when Congress was out of session. Specifically, they found that from 1897 to 2004, the DJIA gained an average of 5.14 basis points per day on days when Congress was adjourned versus a 0.80 basis point average daily gain on days when it was in session. Over the entire 107-year period, 93.3% of the capital appreciation of the DJIA occurred while Congress was on recess. Ferguson and Witte further learned that what they called the "Congressional Effect" varies systematically with the public's opinion of Congress based on polling data. Stock returns are lowest and volatility highest when Congress is in session and the public has a relatively low opinion of Congress (as it does now, incidentally). The "Congressional Effect" disappears completely in the rarer instances when the public has a high opinion of Congress.

Outlook

At the risk of sounding like a broken record, we remain constructive on the outlook for the U.S. equity market for the balance of this year and in 2007. We believe the market can make modest upward progress through the end of 2006 and gain an additional 10% or so—and maybe more—in 2007. On a very short-term basis, we think the market could be vulnerable to a pullback because it is overbought on a technical basis, and the deep mood of pessimism evident this summer has been replaced by an improved sense of optimism among the investing public. When we term the market overbought, we are referring to the percentage of stocks trading above their 10-week moving average. When this percentage is below 25%, as it was in June of this year, it normally indicates that investors are too pessimistic on a short-term basis and that a rally may be in the offing. When the percentage exceeds 75%, as it has for the last month or so, it suggests that investors should be on the lookout for a market correction. Since underlying corporate and economic fundamentals as we read them remain favorable and the overall valuation level of the market remains attractive, in our judgment, we would view any correction as a buying opportunity, rather than something about which to be concerned. The timing of any correction that might occur could derail our expectation that the market will be up modestly between now and year-end 2006, but in no way alters our view that the market can be up on the order of 12% to 14% between now and year-end 2007.

We believe the overall economic backdrop is also supportive. The economy is definitely slowing, but not precipitously, in our view. The housing market is weak as speculators exit the scene, but the positive long-term fundamentals—namely, employment and income growth, moderate interest rates, household formation and immigration—remain in place. The manufacturing sector is weak, but the much larger service sector is holding up well. Gasoline prices have dropped from about $3 per gallon this summer to closer to $2 per gallon in many areas recently, buoying consumers' spirits and lowering their expenses. The stock market has rallied as well, and the Fed appears to be firmly on hold. All of these factors point, in our view, to a mid-cycle slowdown, rather than a recession.

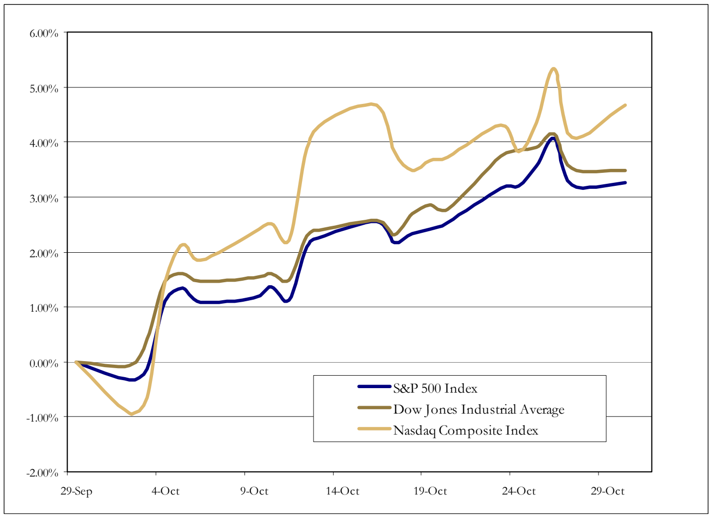
Next year is the third year of the Presidential election cycle, a pre-Presidential or post mid-term election year, depending on how one wishes to look at it. Historically, the third year of the election cycle has been by far the strongest. Since 1929, the S&P 500 has been up 16 of 19 times in pre-Presidential election years and flat once, averaging gains of 14.7% over all 19 periods. Since 1958, the S&P has been up in all 12 pre-Presidential election years, averaging gains of 19.0%. Could returns in 2007 be that good? We certainly believe it's possible, though, perhaps, not likely.

Whether or not 2007 turns out to be as good as history suggests it could be, we believe that investors can have reasonable expectations of a decent year in the market next year. As we look at the available evidence, we see 2007 as a year of moderate economic growth, high single-digit profit growth, moderating inflation and—beyond mid-year—declining short-term interest rates. We believe this environment will be a constructive one for investors in U.S. equities.

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

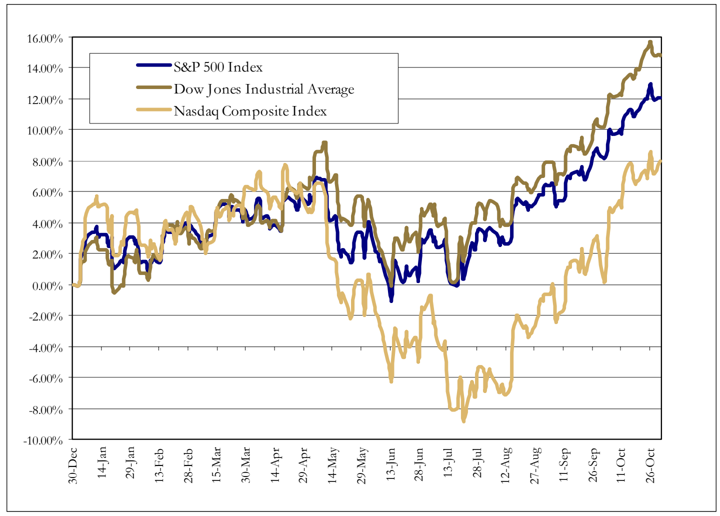
David E. Nelson, CFA
Chairman, Investment Policy Committee
Legg Mason Capital Management

Major Indices October Performance



Sources: Bloomberg and FactSet

Major Indices YTD Performance



Sources: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

Sector Index Name	October	YTD
Broad Market Indices		
S&P 500	3.26	12.06
Dow Jones	3.57	14.81
Russell 1000	3.40	11.62
NASDAQ	4.82	7.99
Dow Jones Wilshire 5000	3.63	11.91
Russell 2000	5.76	14.95
Russell 1000 Growth	3.52	6.59
Russell 1000 Value	3.27	16.89
S&P 500 Sector Indices		
S&P 500 Consumer Discretionary	6.47	14.55
S&P 500 Consumer Staples	1.98	12.66
S&P 500 Energy	4.53	16.79
S&P 500 Financials	2.43	14.05
S&P 500 Health Care	0.49	6.56
S&P 500 Industrials	2.34	9.45
S&P 500 Information Technology	4.13	6.38
S&P 500 Materials	5.91	12.74
S&P 500 Telecomm Services	4.20	31.15
S&P 500 Utilities	5.41	16.84

Sources: Bloomberg, FactSet, Russell