

**Market Commentary**

The US equity market continued to make solid upward progress in November. The market had a minor wobble late in the month as investors reacted negatively to hawkish comments on inflation by Fed Chairman Ben Bernanke during a speech on November 28, but righted itself in the closing days of the month to finish near yearly highs. Market strength has continued into early December as the S&P 500 Index has pushed to several new yearly and recovery highs.

**TOTAL RETURNS**

	<u>Nov</u>	<u>QTD</u>	<u>YTD</u>
S&P 500 Index	+1.90%	+5.22%	+14.19%
Dow Industrials	+1.55%	+5.17%	+16.58%
Nasdaq Composite Index	+2.86%	+7.82%	+11.07%
S&P Mid-Cap 400 Index	+3.22%	+7.51%	+10.86%
Russell 2000 Index	+2.63%	+8.54%	+17.97%
Dow Jones Wilshire 5000 Index	+2.27%	+5.97%	+14.45%
S&P 100 Index	+1.74%	+5.23%	+16.38%
Russell 1000 Growth Index	+1.98%	+5.57%	+8.71%
Russell 1000 Value Index	+2.28%	+5.63%	+19.56%

Sources: Bloomberg, Wilshire, Russell

We believe the best way to understand what has been happening in the market this year is to think of it as a transition from what we have started calling the “Old Game” to a “New Game.” We first presented our Old Game/New Game analysis at a mid-November Legg Mason Funds board meeting and have since used it in a number of client reviews. We thought the monthly commentary was an appropriate venue for sharing our analysis more broadly. Please refer to the table below entitled “Out with the Old, In with the New” to follow the analysis.

What we have elected to call the “Old Game” is the market environment that has existed for most of the last six years, since the last bull market peaked in March 2000. That environment has been characterized by substantial outperformance of small and mid cap stocks and substantial underperformance of large and (especially) mega cap stocks. It has also been characterized by weak relative performance of the Nasdaq composite and strong outperformance by value stocks over growth stocks.

The basic patterns that characterized the “Old Game” continued in 2006 until the S&P 500 Index reached its then recovery peak of 1325.76 on May 5. Small and mid-cap stocks, up 16.53% and 11.07%, respectively, during this period, continued to outpace large (+6.85%) and mega (+6.58%) cap stocks by a wide margin. The Nasdaq also lagged the small and mid-cap indices, and the Russell 1000 Value Index bested the Russell 1000 Growth Index by over 600 basis points.

Following the May peak, a correction ensued which took the S&P 500 Index down to its yearly closing low of 1223.69 on June 13. During the market correction, the character of the market began to change. For the first time in several years, small (-13.86%) and mid-cap (-12.11%) stocks corrected much more sharply than large (-7.46%) and mega (-6.74%) caps. Mega caps were the star performer for the first time in several years. Remnants of the “Old Game” remained in place, however, as Nasdaq Composite stocks (-11.46%) were down nearly as much as small and mid-caps, despite having trailed badly in the previous up cycle. In another carryover from the “Old Game,” value continued to outperform growth.

The patterns established during the correction persisted in the “transition” period as well. The transition period extends from the market’s yearly low on June 13 until August 9, the day after the Fed’s August meeting, when investors were certain that the Fed had gone on hold.

**OUT WITH THE OLD, IN WITH THE NEW**

(An Analysis of 2006 Market Returns Through 11/30/06)

	<b>OLD GAME</b>	<b>CORRECTION</b>	<b>TRANSITION</b>	<b>OLD SUMMARY</b>	<b>NEW GAME</b>	<b>YTD</b>
	12/30/05- 5/5/06	5/5/06- 6/13/06	6/13/06- 8/9/06	12/30/05- 8/9/06	8/9/06- 11/30/06	12/30/05- 11/30/06
<b>INDICES</b>						
S&P 100 Index	6.58%	-6.74%	4.56%	3.93%	11.98%	16.38%
S&P 500 Index	6.85%	-7.46%	3.72%	2.56%	11.34%	14.19%
S&P Mid-Cap Index	11.07%	-12.11%	1.59%	-0.83%	11.79%	10.86%
Russell 2000 Index	16.53%	-13.86%	1.47%	1.86%	15.89%	17.97%
Nasdaq Composite	6.56%	-11.46%	-0.50%	-6.12%	18.31%	11.07%
<b>STYLES</b>						
Russell 1000 Growth	4.09%	-8.00%	0.42%	-3.83%	13.09%	8.71%
Russell 1000 Value	10.12%	-7.25%	6.39%	8.66%	10.15%	19.56%

Sources: Bloomberg, Russell

Not all large and mega stocks outperformed during the correction and transition, only those perceived as safe and defensive—low beta, high-yielding stocks such as the regional Bell operating companies (RBOCs), international oils, utilities, big Pharma and consumer staples stalwarts. Tech and internet stocks, growth stocks in general, and mega cap Nasdaq stocks—with the notable exception of Google—continued to lag meaningfully.

It was not until after investors were sure that the Fed had stopped tightening (when they refrained from doing so at their August 8 meeting) that we believe the “New Game” finally began. The “New Game” so far has been characterized by strong overall market returns, led by growth stocks and the Nasdaq Composite. The emerging leadership of these two groups is what’s new about the New Game. Their leadership—together with the overall strength of the market and the sharp snapback in the Russell 2000 Index—suggests to us that investors as a whole have begun to play offense again. In wider recognition of the fact that the Fed is firmly on hold for the present, and could be easing by the middle of 2007, investors appear to have begun to lengthen their investment time horizons, showing greater appreciation for the appeal of longer duration equity assets, namely, growth stocks.

If we are correct in our assessment that the economy is currently undergoing a mid-cycle slowdown that will not morph into a recession, and that the Fed’s next move is more likely to be an easing than a tightening, then the so-called “New Game” could be in effect for at least the next couple of years, if not longer, in our judgment. The old small-mid-value game lasted a little over six years. It would be odd if the new large-mega-growth game were not in place for a multi-year period, as well.

## Outlook

It will probably not surprise clients to learn that we continue to believe that the outlook for the US equity market is quite favorable. We joke that opinions on the outlook for stocks fall into two camps in our group: those who are bullish and those who are very bullish. I fall into the former camp; Bill Miller is in the latter. If I’m right about the market next year, we should have a good year. If he’s right, we could have a great year.

The cornerstones of our bullish view on equities are: (1) attractive valuation, (2) a favorable economic backdrop, (3) a benign to supportive Fed policy environment, and (4) a huge disconnect between bond market and stock market valuations that should accrue to the benefit of stocks. We’d like to discuss each of these factors in turn.

Our valuation work suggests to us that the S&P 500 Index (our proxy for the US equity market) is more than two P/E multiple points undervalued based on 2007 bottom-up consensus earnings estimates. We estimate that the fair value earnings multiple for the S&P 500 Index is currently about 17 times, based on the following assumptions (which are unchanged from

past presentations, save for the yield on the 10-year Treasury): (1) long-term nominal earnings per share growth of 6%, (2) a 16% return on equity, (3) an 8.48% weighted average cost of equity capital (consisting of a 4% equity risk premium plus the current yield on the 10-year US Treasury Note), and (4) a 20-year competitive advantage period (the estimated time over which the S&P 500 will earn in excess of its cost of capital). Based on current First Call cap-weighted, bottom-up earnings estimates, the S&P 500 traded at 16.1 times and 14.8 times 2006 and 2007 estimates, respectively, as of the end of November. The implied year-to-year earnings per share growth rate for 2007 is about 9%. Even if this estimate turns out to be a bit high—which we think is quite possible—we do not see a modest earnings growth shortfall as overly damaging to our investment case. In contrast to the last several years when equity returns have been driven by strong earnings growth *partially offset* by P/E multiple contraction, we expect equity returns in 2007 to be driven by more modest earnings growth *enhanced* by P/E multiple expansion, as investors discount the next Fed easing cycle and reacceleration of economic growth in late 2007. As long as earnings are up at a mid-single digit rate or higher in 2007—which we fully expect and believe is supported by the available evidence—we think equity returns in 2007 will be very satisfactory. With P/E multiples in the mid-teens, each point of multiple expansion is worth between 6% and 7% in market appreciation. Thus, for example, 7% earnings growth plus one multiple point of P/E expansion plus the dividend yield would produce total returns of 15% or so for the S&P 500 Index next year. We can obviously make no guarantees on that, but we believe this provides a framework for how the numbers could work next year.

As far as the economy is concerned, we continue to expect a slowdown in GDP growth in the current quarter and first half of 2007, but at this point we see no signs of recession. With the unemployment rate at a cyclical low, it would be highly unusual for there to be a recession in 2007. Normally, the unemployment rate rises for many months before a recession begins.

To be sure, signs of economic weakness are much in evidence. The housing downturn knocked about 1% out of third quarter GDP growth and is expected to have a similar impact on the fourth quarter. The manufacturing purchasing managers’ index (PMI) declined below 50 to 49.5 in November, signaling that the manufacturing sector of the economy is now contracting moderately. Since 1984, the PMI has dropped below 50 five times and the Fed has eased soon thereafter in every case. In only two of those cases did a recession ensue; the other three were mid-cycle slowdowns.

Fed officials continue to talk tough on inflation, but the data increasingly support a sanguine view. As noted earlier, remarks by Fed Chairman Bernanke in New York on November 28 briefly spooked the market into believing that the Fed might actually be thinking of raising rates again. We think the data released since Bernanke’s speech should offer him and his fellow Fed governors great comfort on inflation, especially on the issue of wage inflation—about which Bernanke talked extensively in his November 28 remarks. On December 5, the Bureau of Economic Analysis (BEA) revised its 2Q 2006 estimate of the growth rate in

compensation per hour from +6.6% to -1.2%, a rather significant adjustment, in our view. In addition, the BEA's estimate of 3Q 2006 hourly compensation growth was revised down from 3.7% to 2.6%. A related Labor Department report showed total labor-cost inflation running at a 2.9% annual rate for the 12-month period through September 2006, compared to the previously estimated 5.3% rate. We tip our hat to our colleague Ernie Kiehne, who thought the originally reported hourly compensation numbers looked fishy and said so at the time. Turns out he was right.

The bond market and the Fed fund futures market have greeted the latest round of good news on the economic and inflation front with enthusiasm. Ten-year US Treasury Note yields have fallen below 4.5% and the futures market is pricing in a high probability of three 25 basis point rate cuts next year. We think the market has it about right.

The final—and perhaps least understood—reason we are bullish on the outlook for next year is the huge disconnect we see between bond market and stock market valuations. On the one hand, bonds of all quality grades—from Treasuries to junk—are trading at relatively low nominal yields, while quality spreads are at near record lows. As a consequence, truly mind-boggling amounts of debt financing seem to be available for someone who has a good idea what to do with it. On the other hand, we have corporate America enjoying record profits and returns on equity, sitting on a mountain of cash and generating more cash flow every day.

With these two sets of circumstances existing simultaneously, it is not hard to see why the private equity and M&A businesses are booming. Borrow at 7% or 8% to leverage up assets that generate cash flow yields in the low to mid-teens. What's not to like about that? Companies certainly see the value in their shares. That's why share buybacks are at record levels, in our view. Private equity investors see the opportunity too. That's why we're seeing a flood of deals. And fewer and fewer companies are considered "too big" to take private. Rumors circulated just last week that a number of private equity and buyout firms were considering a joint bid for Home Depot, whose market cap is about \$80 billion. We doubt it will happen, but the funny thing is that the idea is not completely crazy. At an assumed price of about \$100 billion, the numbers actually do seem to work.

So who doesn't see the value in the market? The general public doesn't, for one. Until October, when they finally made net purchases of \$400 million, individual investors had been net sellers of domestic equity mutual funds for five months straight, selling over \$14 billion (net) worth of shares into a rising market. It is highly unusual behavior for the investing public to be net sellers into a sharply rising market. Normally, market strength attracts investors: "Buy high and sell low" being their apparent watchword.

Investors' recent behavior is reminiscent of their behavior following the brutal bear market of 1973-1974. Back then, following a brief spate of bargain hunting near the 1974 lows, disillusioned investors were net sellers of mutual fund shares from 1975 to 1979, according to veteran market strategist Steve

Leuthold, even as the market more than doubled in value over that time period.

In similar fashion, we believe traumatic memories of the bear market of 2000-2002 remain with investors today, and are still affecting their behavior. We see no better explanation than this for the previously discussed results of the UBS/Gallup poll of investor sentiment which shows them to have been optimistic in only 3 of 49 months since October 2002, despite an 85% return in the S&P 500 Index over that period.

The UBS/Gallup sentiment poll is only now registering a high neutral reading of 93 according to Ned Davis Research, after a market rise of over 15% since June. True to form, mutual fund investors are dipping their collective toe back in the water with modest net purchases of domestic equity funds in October. Sadly, history suggests that it will take further market strength to bolster investor optimism and increase buying activity. At that point, the market will no doubt undergo a correction, sending investors scurrying for the sidelines yet again. Watching investors' collective behavior is a lot like watching a train wreck in slow motion. You know what's going to happen, and it's horrible to watch, but you can't look away.

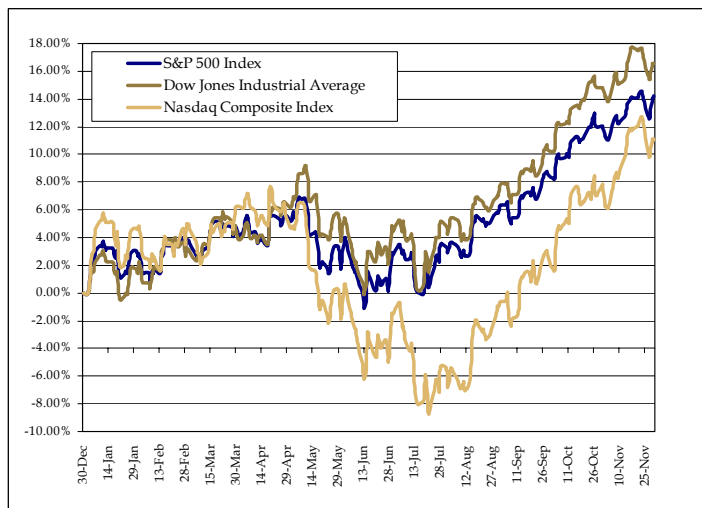
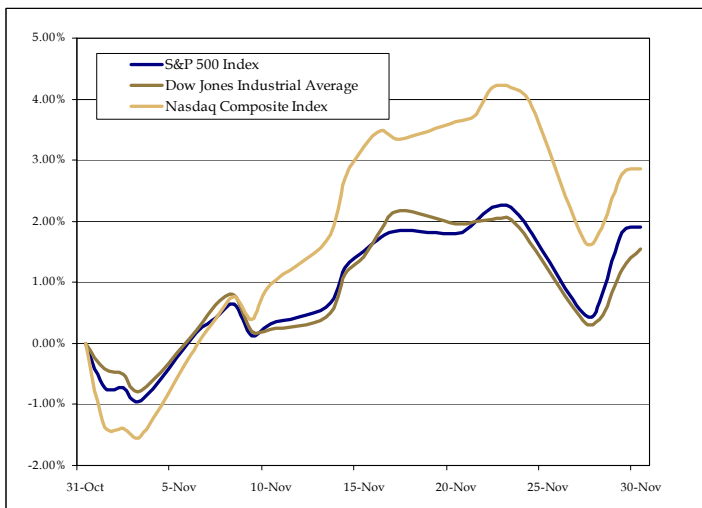
As we prepare to enter the New Year, let's resolve not to behave like the typical investor, but rather to follow legendary investor Warren Buffett's admonition to be "fearful when others are greedy and greedy when others are fearful."

On behalf of all of us at Legg Mason Capital Management, I wish each of you a joyous Holiday Season and a Happy New Year. 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 November Performance

Major Indices YTD Performance



Sources: Bloomberg and FactSet

Sources: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

Sector Index Name	November	QTD	YTD
<i>Broad Market Indices</i>			
S&P 500	1.90	5.22	14.19
Dow Jones	1.55	5.17	16.58
Russell 1000	2.13	5.60	14.00
NASDAQ	2.86	7.82	11.07
Dow Jones Wilshire 5000	2.27	5.97	14.45
Russell 2000	2.63	8.54	17.97
Russell 1000 Growth	1.98	5.57	8.71
Russell 1000 Value	2.28	5.63	19.56
<i>S&amp;P 500 Sector Indices</i>			
S&P 500 Consumer Discretionary	1.26	7.81	15.99
S&P 500 Consumer Staples	(0.95)	1.01	11.59
S&P 500 Energy	8.36	13.27	26.56
S&P 500 Financials	0.62	3.06	14.76
S&P 500 Health Care	(0.30)	0.20	6.24
S&P 500 Industrials	2.36	4.75	12.04
S&P 500 Information Technology	3.28	7.54	9.87
S&P 500 Materials	4.45	10.62	17.75
S&P 500 Telecomm Services	(0.33)	3.86	30.72
S&P 500 Utilities	2.39	7.92	19.63

Sources: Bloomberg, FactSet, Russell

The information contained herein has been prepared from sources believed reliable but is not guaranteed by us as to its timeliness or accuracy, and is not a complete summary or statement of all available data. This data is intended solely for our clients, is for informational purposes only, and may not be publicly disclosed or distributed without our prior written consent.

The views expressed in this commentary reflect those of Legg Mason Capital Management ("LMCM") as of the date of this commentary. These views are subject to change at any time based on market or other conditions, and LMCM disclaims any responsibility to update such views. These views may not be relied upon as investment advice and, because investment decisions for clients of LMCM are based on numerous factors, may not be relied upon as an indication of trading intent on behalf of the firm. The information provided in this commentary should not be considered a recommendation by LMCM or any of its affiliates to purchase or sell any security.