

Market Commentary

The S&P 500 Index reached its yearly high on December 15 at 1427.09, then took a breather for the holiday season, closing the year at 1418.30, 0.6% off its peak but still up a highly satisfactory 15.8% for the year as a whole.

TOTAL RETURNS

	Dec	Q4	2006	Memo Item 5/5 - 12/29/06
S&P 500 Index	+1.40%	+6.70%	+15.80%	+8.37%
Dow Industrials	+2.11%	+7.39%	+19.04%	+9.38%
Nasdaq Composite Index	-0.62%	+7.15%	+10.39%	+3.60%
S&P Mid-Cap 400 Index	-0.49%	+6.98%	+10.32%	-0.68%
Russell 2000 Index	+0.33%	+8.90%	+18.37%	+1.59%
Dow Jones Wilshire 5000 Index	+1.17%	+7.21%	+15.78%	+7.17%
S&P 100 Index	+1.80%	+7.12%	+18.47%	+11.15%
Russell 1000 Growth Index	+0.34%	+5.93%	+9.07%	+4.83%
Russell 1000 Value Index	+2.24%	+8.00%	+22.25%	+11.11%

Sources: Bloomberg, Wilshire, Russell

Performance for the month of December was mixed, as large and mega cap stocks outperformed small and mid caps. For the quarter and year, returns were strong across the board. Notably, in our view, the two best performing indices for the year (excluding the style-based indices) were the mega cap-dominated Dow Industrials (+19.04%) and S&P 100 (+18.47%). Next best was the Russell 2000 Index, but this was principally due to its strong showing early in the year.

Through May 5, the Russell 2000 was up 16.51%, but it advanced only 1.59% further through year-end, as shown in the memo item above. Note, too, that the S&P Mid-Cap 400 Index was actually down from the May market peak through year-end. In sharp contrast, the Dow Industrials, S&P 100 and S&P 500 indices were up 9.38%, 11.15% and 8.37%, respectively, from May 5 through year-end.

We regard the shift in leadership from small and mid cap stocks to large and mega caps as the most significant development in the equity market in 2006. We believe the performance differential between these market cap sectors since May is solid evidence that the shift has occurred. How long it will last we do not know, but if our assessment is correct, we expect it to be a period measured in years, rather than months.

The reemergence of mega cap stocks as market leaders has been a mixed blessing for many investment managers. One might even say that “never have so many had so little fun in a generally rising market.” The reason is that a market dominated by mega cap stocks is a tough market for most equity managers to beat. The late 1990s—while a bonanza for equity investors as a

whole—were a nightmare for portfolio managers in terms of relative performance, as few were able to keep up with the S&P 500 Index, which was being driven by the relentless advance of 25 or 30 mega caps such as Dell, Microsoft, Intel, Cisco and the like. The year just ended witnessed a similar struggle as just 19% of all actively managed US diversified equity funds were ahead of the S&P 500 through December 27. This is the worst yearly aggregate relative performance showing since 1998.

Another significant development in the equity market in 2006, in our judgment, was the continuing surge in the number and size of private equity transactions. Some are calling this a bubble. We disagree. Taken to an extreme, it could *become* a bubble, but it's not one yet, in our view. Up to now, we believe the surge in private equity transactions is being driven by the simple fact that stocks are meaningfully undervalued relative to bonds, and huge quantities of debt-financing are available at upper-middle single-digit rates to buy companies whose returns on equity are in the mid to high teens and returns on total capital are in the low double-digits, or higher. With such an attractive spread available, deals don't have to be leveraged to the moon to make sense. According to a recent *Wall Street Journal* interview (1/3/07) with KKR partners Henry Kravis and George Roberts, the average private equity deal today is 33% equity and 67% debt, in contrast to 1987, when the average deal was only 7% equity and 93% debt. Another big change in the private equity business is that it has gone global. “Fifty percent of the money raised comes from outside the US. In the 1980s, everything was domestic,” says Mr. Kravis. “In 2006, eight of 12 deals we did were foreign.”

Another force spurring private equity transactions is what our colleague Michael Mauboussin calls “time arbitrage.” Many analysts and investors have become so focused on short-term earnings trends as an indicator of attractiveness that they fail to recognize a true investment opportunity when it presents itself.

The pressure that company executives feel not to disappoint “the Street” plays right into private equity investors' hands, according to Mr. Roberts. “Managements want to take the long-term view, but they know they get clobbered in the short term. A lot of companies want to start new projects but they can't because they are afraid of the hit to quarterly earnings, even though it may be right in three to five years. When we say our average hold [before selling the company or taking it public] is seven years, they sit up.” Adds Mr. Kravis: “There is constant churn in the share ownership of public companies. Activist shareholders beat up the company because the stock isn't going up. Our size and indifference to quarterly results may make chief executive officers and boards take us more seriously.”

The advent of the New Year is the traditional time for strategists, economists and market commentators such as us to trot out forecasts of the outlook for the coming year. We will share ours presently, but for now suffice it to say that we are bullish

on the US equity market for 2007. Obviously, not everyone agrees with us. We would be quite uncomfortable if they did. Those with a gloomier outlook than us tend to focus on a number of macro issues including the “unsustainable” trade and budget deficits, the impending collapse of the US dollar and the likelihood that the continuing weakness in the housing market will trigger a US recession. We lack the space to fully address all these issues here, except to say that we do not expect a recession in the US in 2007, we think the dollar could actually rally this year versus the euro and the pound (though likely not versus the renminbi), and we believe concerns about the trade and budget deficits—while valid to a degree—are way overblown.

For a well-reasoned analysis and defense of the US trade deficit, we refer clients to Bear Stearns’ chief economist David Malpass’ recent *Wall Street Journal* (12/21/06) editorial entitled “Embrace the Deficit.” Malpass’ principal argument is that “Though widely criticized as an imbalance, the trade deficit and related capital inflows reflect US growth, not weakness—they link the younger, faster-growing US with the aging, slower-growing economies abroad.”

For a cogent analysis of why the world is not coming to an end, we recommend reading Anatole Kaletsky’s piece in the January/February 2007 issue of *The Liberal* entitled “The Years of Reckoning.” Mr. Kaletsky, an associate editor of *The Times* and GaveKal Research partner, argues that secular bears fail to fully understand the positive implications of five forces that have powered the expansion of the global economy since the early 1990s. These are: (1) the collapse of communism, (2) the proliferation of free markets and explosion in world trade, (3) the advances in electronic technology that have cut communications costs to nearly zero, (4) the revolution in global finance, and (5) the coordinated effort of developed country central banks to keep economies growing as near as possible to their long-term potential.

Outlook

We firmly believe that 2007 will be a good year for the US equity market, and it could well be a great year. We will be quite surprised if the S&P 500 Index does not (finally) make a new all-time high this year. If our assessment of prospects proves correct, the S&P 500 will finish 2007 closer to 1600 than 1500.

We believe market returns in 2007 will be driven by a combination of moderate earnings growth, dividend return and some degree of P/E multiple expansion. In our view, how good 2007 turns out to be will be largely determined by how much of a tailwind P/E multiple expansion provides. Two possible scenarios are presented below. The “bullish” case is how I believe the market may play out this year. The “very bullish” case is Bill Miller’s best current thinking on how the year might evolve.

2007 US Equity Market Outlook

	“Bullish”	“Very Bullish”
Earnings Growth	7%	7%
Dividend Yield	2%	2%
P/E Multiple Expansion	5-6%	10-12%
Potential Total Return	14-15%	19-21%
Implied Year-End S&P 500 Price	1596	1674

Our valuation work suggests that the S&P 500 Index is worth about 17 times earnings at present, or roughly two multiple points higher than it actually trades. One multiple point of P/E expansion is worth about 6% to 7% in market appreciation. Our “bullish” scenario above assumes that the market achieves about one multiple point expansion in 2007, while the “very bullish” scenario assumes it enjoys nearly two.

Obviously, these are not the only two possible scenarios for 2007, but any alternate scenarios must consider the same three factors. People who are bearish on the market for 2007 must either believe that dividends will not be paid (a highly unlikely occurrence), that earnings will fail to grow or even contract, or that the P/E multiple of the market will stay the same or continue to decline.

Let’s consider each of these possibilities in turn. The dividend issue is easily dispensed with, in our view. Dividends will be paid. In fact, we think the dividend payout ratio will tend to rise over the next several years, causing dividends to grow faster than earnings for a number of years.

Earnings growth, on the other hand, could moderate. Since we expect economic growth to slow in 2007, our estimate of earnings per share growth for this year is already 2% below the current First Call, bottom-up, capitalization-weighted consensus forecast of 9%. Profit growth could moderate still further, in our view, but a steep decline in earnings does not look like a very good bet at this point. It would take a full-blown recession for that to happen, and right now, we don’t see that as likely. The impact on market returns of any shortfall in earnings growth from our current expectations may well be mitigated by the more aggressive Fed easing that would likely accompany such an occurrence.

The big swing factor in market returns for 2007 will almost certainly be P/E multiples. In our opinion, the most likely occurrence in 2007 is that the S&P 500’s P/E multiple will begin to expand after three years of contraction. The Fed went on hold in June 2006. We now believe they will remain on hold through the first half of 2007. In our opinion, the economy is currently neither weak enough to justify rate cuts, nor strong enough to justify rate increases. The mixed pattern of recent evidence on the economic outlook—with some data such as housing

suggesting weakness, and other data such as job growth suggesting strength—is consistent with what we regard as the most likely scenario: a mid-cycle slowdown, but no recession. According to data from ISI Group, the past three mid-cycle slowdowns—in 1967, 1985 and 1995—were accompanied by P/E multiple expansion of between 0.8 (1967) and 5.0 (1985), averaging 2.6.

Historical patterns, too, are strongly supportive of 2007 being a good year for the S&P 500. Pre-presidential election years—such as 2007—have historically been strong. In fact, 15 of the last 16 pre-presidential election (PPE) years (dating back to 1943) have been up years in the market (1947 was flat), showing an average price gain of 18.1%. A similar gain in 2007 would be entirely consistent with our “very bullish” scenario. Why PPE years have traditionally been so strong is a bit of a mystery. Conventional wisdom has it that the party in power likes to take any necessary economic medicine early in its four-year term so as to try to insure that the economy and stock market are cooking along as the time to run for re-election approaches. Whether valid or not, this theory is consistent with the historical evidence, as the first and second years of presidential terms have been up 3.0% and 4.1%, respectively, since 1929, while the third and fourth years have been up 14.7% and 9.0%, respectively.

The tendency of PPE years to be strong ones in the market even trumps the tendency for years ending in seven to be weak. Since 1917, in all years ending in seven, the Dow has been down an average of 1.4%, but those ending in seven that were PPE years—1927, 1947, 1967 and 1987—were up an average of 12.1%, while those that were not PPE years—1917, 1937, 1957, 1977 and 1997—were down an average of 12.4%.

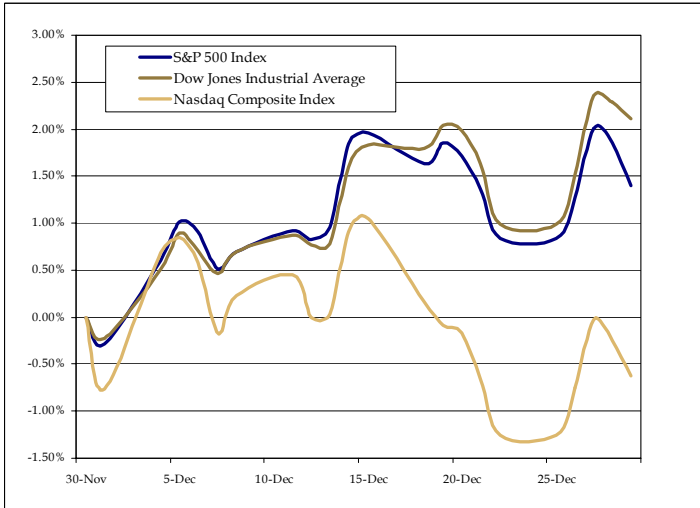
To summarize our current thinking, we believe investors have many reasons to be optimistic about the outlook for 2007. The ones related to the calendar and historical patterns are interesting and provide some comfort, but the determinative ones, in our view, are those related to valuation, the probable economic outlook and the most likely Fed response to it.

As constructive as we are on the outlook, we recognize that: (1) we might be wrong, and (2) even if we are not wrong, our bullish resolve is likely to be tested at one or more points during the year. We can promise you only that we will continue “to call them as we see them,” evaluating the economic evidence as it evolves in order to make the best judgments about your portfolios as possible.

All of us at Legg Mason Capital Management wish you a prosperous and happy New Year. As always, we thank you for your support and welcome your comments.

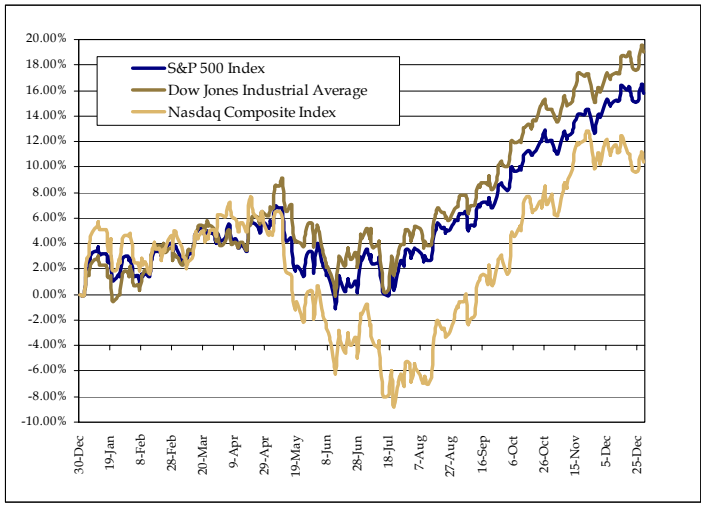
David E. Nelson, CFA
Chairman, Investment Policy Committee
Legg Mason Capital Management

Major Indices December Performance



Sources: Bloomberg and FactSet

Major Indices YTD Performance



Sources: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

Sector Index Name	December	Q4	2006
<i>Broad Market Indices</i>			
S&P 500	1.40	6.70	15.80
Dow Jones	2.11	7.39	19.04
Russell 1000	1.28	6.95	15.46
NASDAQ	(0.62)	7.15	10.39
Dow Jones Wilshire 5000	1.17	7.21	15.78
Russell 2000	0.33	8.90	18.37
Russell 1000 Growth	0.34	5.93	9.07
Russell 1000 Value	2.24	8.00	22.25
<i>S&P 500 Sector Indices</i>			
S&P 500 Consumer Discretionary	2.29	10.27	18.64
S&P 500 Consumer Staples	2.49	3.52	14.36
S&P 500 Energy	(1.86)	11.17	24.21
S&P 500 Financials	3.86	7.04	19.19
S&P 500 Health Care	1.21	1.41	7.53
S&P 500 Industrials	1.12	5.93	13.29
S&P 500 Information Technology	(1.32)	6.12	8.42
S&P 500 Materials	0.74	11.44	18.62
S&P 500 Telecomm Services	4.65	8.69	36.80
S&P 500 Utilities	1.14	9.15	20.99

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.