

Market Commentary

Following the late February mugging recounted in last month's commentary, the U.S. equity market traded down modestly in early March before regaining its footing mid-month and posting respectable gains for the month as a whole.

TOTAL RETURNS

	Mar	Q1	Memo Item 5/5/06 - 3/30/07
S&P 500 Index	+1.12%	+0.64%	+9.06%
Dow Industrials	+0.84%	-0.33%	+9.03%
Nasdaq Composite Index	+0.29%	+0.44%	+4.05%
S&P Mid-Cap 400 Index	+1.35%	+5.80%	+5.08%
Russell 2000 Index	+1.07%	+1.95%	+3.57%
Dow Jones Wilshire 5000 Index	+1.11%	+1.40%	+8.67%
S&P 100 Index	+1.06%	-1.06%	+9.98%
Russell 1000 Growth Index	+0.54%	+1.19%	+6.08%
Russell 1000 Value Index	+1.55%	+1.24%	+12.49%

Sources: Bloomberg, Wilshire, Russell

On a sectoral basis, March's returns were more like the "Old Game" than the "New Game" we've talked about in the last several months. For the month, telecom, electric utility, materials, energy and consumer staples stocks led the S&P 500 Index, while financial, technology, health care, industrial and consumer discretionary stocks lagged.

Market cap sector returns were relatively homogeneous in March, but for the quarter, mid- and small-cap stocks handily outperformed large caps, and the S&P 100 Index (our mega-cap proxy) was the worst performer. On a style basis, growth and value are running neck and neck through the end of March, though value continues to dominate growth on a longer-term basis.

As continuing believers in the relative attractiveness of mega caps, we take some comfort from the fact that since the market's May 5, 2006 interim peak (the date we postulate as the beginning of the transition from the Old Game to the New Game), the S&P 100 is the best performing major market index (excluding those based on style) and large caps have outperformed small and mid caps. If our New Game thesis is to continue to prove valid, mega caps need to reassert themselves in coming months.

The most damage the S&P 500 Index suffered on the downside during the month was an intraday low of 1363.98 on March 14, a 2.5% drop from the S&P's February 27 close (mugging day) and a 6.6% decline from its year-to-date closing high of 1459.68 (February 20). The lack of downside follow-through was no doubt a disappointment to the bears, who had

probably been licking their chops at the prospect of finally getting a market correction greater than 10% after more than 1000 trading days without one. We're happy to report that the bears will have to wait a while longer.

The headline-grabbing story for the month was the continuing turmoil in the subprime mortgage market. We flagged this situation last month as one that warranted "careful attention." We're not sure about the "careful" part, but it obviously generated plenty of "attention" in March. Do a Google search on the word "subprime" and you get about 7.6 million hits. That's not Britney Spears (29.8 million hits) or Paris Hilton (23.8 million hits) territory, but it's still a lot of interest in a term most people had never heard of a few months ago.

In our view, what began as a justifiable pummeling of the stocks of a few overly aggressive monoline subprime mortgage originators has—under the white hot glare of media attention—morphed into a fairly indiscriminate dumping of anything and everything related to residential mortgage finance and/or construction.

As is fairly typical of phenomena that have garnered intense media coverage, we believe investors have overreacted to the likely dimensions of the problem and are—in effect—throwing out the baby (prime-based mortgage lenders and homebuilders) with the bath water (monoline subprime mortgage originators).

A number of members of this latter group may well deserve the shellacking they are experiencing in the stock market. Their business models seem to have been built on the idea of generating enormous fee income by arranging and subsequently selling off loans extended to weak or no-credit borrowers who had a high likelihood of being unable to repay the loans. The underlying assumption of all three key players in these transactions—the originator, the lender and the borrower—was that if anything went wrong, the powerful trend of home price appreciation would bail them out. Once that underlying assumption was called into question, the jig was up.

Some market pundits and politicians seem to want to put the blame for this lending orgy primarily on the originators, calling them predators—preying on innocent, gullible and unsophisticated first-time home buyers. Considering that a number of subprime lenders have seen their stocks decimated and at least one—New Century Financial—has recently filed for bankruptcy, James Surowiecki in "Subprime Homesick Blues" (*The New Yorker*, 4/9/07) wryly noted that "subprime lenders appear to have been predators in the sense that Wile E. Coyote was." (For those not familiar with Road Runner cartoons, Wile E. Coyote's schemes to catch Road Runner always ended up with him smashing into a wall, going over a cliff or blowing himself up.)

Blaming only subprime lenders for the sector's excesses seems far too simplistic to us. In his piece in *The New Yorker*, Surowiecki notes: "Borrowers were not passive recipients of this money—instead, many of them used the lax lending standards to make calculated, if ill-advised, gambles. In 2006, for instance, the percentage of borrowers who failed to make the first monthly payment on their mortgages tripled, while in the past two years the percentage of people who missed a payment in their first ninety days quadrupled. Most of these people did not suddenly run into financial trouble; they were betting that they would be able to buy the house and quickly sell it."

More important, in our minds, than who is to blame for the problems in the subprime market is how likely they are to spread. Bears argue that rising delinquencies in the subprime segment will spill over into Alt-A and, ultimately, prime loans. Up to now, that doesn't seem to be happening. The table below summarizes the latest available data on mortgage delinquency rates by loan type.

DELINQUENCY RATE ESTIMATES				
Loan Type	Q4 '06	Q3 '06	Q4 '05	Vs. 2001-2002
Subprime ARMs	14.4%	13.2%	11.5%	100 bps Lower
Subprime Fixed	10.1%	9.6%	9.8%	650 bps Lower
Prime ARMs	3.4%	3.1%	2.5%	70 bps Lower
Prime Fixed	2.3%	2.1%	2.2%	30 bps Lower

Source: Mortgage Bankers Association, LMCM analysis

Adjustable-rate subprime loan delinquencies have, indeed, spiked sharply, but remain below the levels recorded in the last housing downturn (2001-2002). Delinquencies of adjustable-rate prime mortgages are also up, but not nearly as much, while fixed-rate mortgage delinquencies for both prime and subprime borrowers have only modestly ticked up. The overall residential delinquency rate (which includes home equity loans) of 1.91% (12/06) is up, but still lower than the historical average of 2.22%.

Thus, up to this point, mortgage loan delinquencies in aggregate seem manageable. According to Wachovia Securities, the problem does not appear to have spread to other forms of credit either.

Comfortingly, Fed Chairman Ben Bernanke seems to share our sanguine view, having opined during his March 28 congressional testimony: "At this juncture, however, the impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained. In particular, mortgages to prime borrowers and fixed-rate mortgages to all classes of borrowers continue to perform well, with low rates of delinquency."

Outlook

We continue to be optimistic about the outlook for the U.S. equity market for the balance of 2007. Despite all the hand wringing surrounding the sharp late-February market sell-off and worries engendered by rising delinquencies in subprime loans,

the market was up in March and has gotten off to a promising start in the first few days of the second quarter.

Our formula for double-digit total returns for the S&P 500 Index this year continues to be the same as it has been: modest earnings growth plus dividends plus some degree of P/E multiple expansion. We believe that—at worst—the Fed will be on hold throughout 2007 and that they could even cut rates a time or two depending on how the economic news breaks.

We continue to believe that the U.S. economy is in the midst of a housing-led mid-cycle slowdown that began in the second quarter of 2006. We think the odds of this slowdown morphing into recession this year remain low. This view was bolstered by the latest employment report (released Friday, April 6), which showed non-farm payrolls climbing 180,000 in March and the jobless rate dropping to a six-year low of 4.4%. Former Fed Chairman Alan Greenspan recently put the odds of recession in 2007 at 1-in-3. We'd put those odds at more like 1-in-4 or 1-in-5.

In terms of investment themes, we continue to find some of the most attractive investment opportunities in mega-cap stocks. In our large-cap portfolios, this leads us to stocks like General Electric, which has nearly doubled its earnings in the last five years from \$11 billion (in 2001) to \$21 billion (in 2006) while its stock has gone nowhere. GE has one-, five-, ten-, fifteen- and twenty-year earnings growth rates of 11%, 10%, 11%, 12% and 11%, respectively, versus a twenty-year average earnings growth rate for the S&P 500 Index of 8%. That kind of consistently superior growth deserves a significant valuation premium to the market, in our opinion. GE trades at virtually no premium.

We also believe that growth is undervalued in the marketplace, a view that is shared by a number of strategists whose work we admire, including Michael Goldstein (Empirical Research Partners) and Steve Leuthold (The Leuthold Group, LLC). A long-running feature in Leuthold's monthly *Perception for the Professional* is his "Royal Blue" study of the 99 largest institutionally held stocks. He divides these stocks into three equal tiers: a high P/E tier (which he calls "Growth Stocks"), a low P/E tier ("Value Stocks") and a middle tier of the remaining 33 stocks. The current and historical average valuations as reported in Leuthold's March 2007 *Perceptions* are listed below.

ROYAL BLUE INDEX			
	Current Median P/E	Historical Average P/E	Percent Above/Below Avg
High P/E Tier	19.1x	24.6x	-22%
Middle P/E Tier	15.4x	15.6x	-1%
Low P/E Tier	10.9x	10.1x	+8%

Source: The Leuthold Group, *Perception for the Professional* (March 2007)

Leuthold notes that the high P/E tier is undervalued relative to its history, while the low P/E tier is overvalued. He further notes that the current relative P/E ratio (high tier/low tier) of 1.75 times is very low compared to its historical median relationship of 2.30 times.

Apart from the broad themes of mega caps and growth being relatively attractive, in our view, we continue to look for and attempt to exploit diversity breakdowns in the marketplace. A prime current example, in our opinion, is the homebuilders—where we see increasing opportunity for outsized future returns amidst investors' gloom.

Multi-billionaire Carl Icahn also seems to sense opportunity in the builders as he bids to take over WCI Communities, Inc., a Florida builder of high-rise condominiums. When asked why he was interested in investing nearly \$1 billion in an area most others were avoiding, Icahn said: "My investment philosophy, generally, with exceptions, is to buy something when no one wants it."

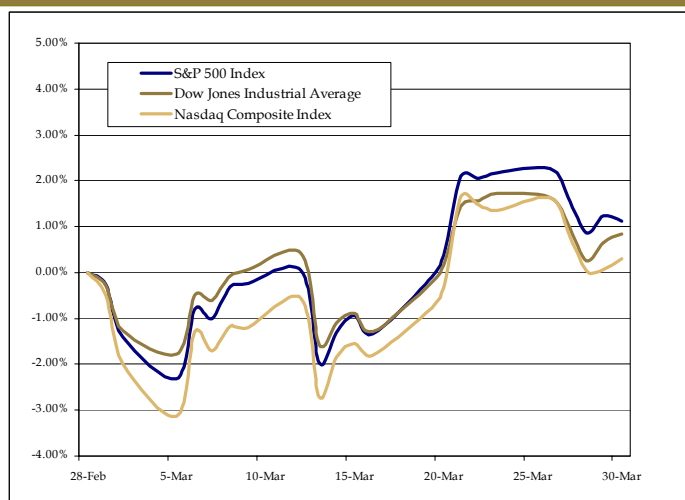
Icahn's brain is wired differently than most investors who avoid controversy and feel most comfortable doing what others are doing. (Incidentally, that's probably an important reason why he's a billionaire.) James Surowiecki points out in a recent piece entitled "Reasonable Panic" (*The New Yorker*, 3/12/07) that "investors often overvalue new information, particularly when it's presented in dramatic fashion. In one famous experiment by the psychologist Paul Andreassen, investors who selected a portfolio of stocks and then saw nothing but the stock's changing prices managed their portfolios significantly better than investors who were also given a stream of news about the companies they'd invested in. The reason, Andreassen suggested, was that the media's tendency to overplay stories led investors to place too much weight on news that turned out to be of transient importance."

We think this phenomenon has happened in spades to the homebuilders, which—after their March downdraft—now trade as a group slightly below book value. Since 1989, the homebuilding group has traded this cheaply in relationship to book value less than 14% of the time, and from these valuation levels investors in homebuilding stocks have earned significant excess returns in the next year or two over that time frame. We expect much better results going forward from the homebuilding group, which—to this point—has been a drag on performance.

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

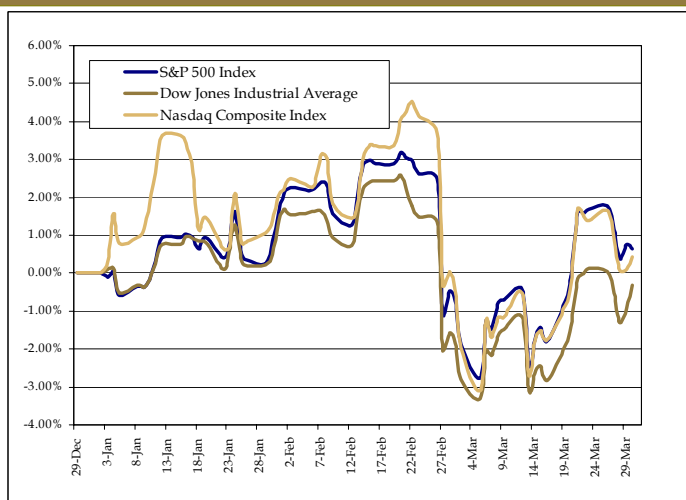
David E. Nelson, CFA
Chairman, Investment Policy Committee
Legg Mason Capital Management

Major Indices March Performance



Sources: Bloomberg and FactSet

Major Indices YTD Performance



Sources: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

Sector Index Name	March	Q1
<i>Broad Market Indices</i>		
S&P 500	1.12	0.64
Dow Jones	0.84	(0.33)
Russell 1000	1.04	1.21
NASDAQ	0.29	0.44
Dow Jones Wilshire 5000	1.11	1.40
Russell 2000	1.07	1.95
Russell 1000 Growth	0.54	1.19
Russell 1000 Value	1.55	1.24
<i>S&P 500 Sector Indices</i>		
S&P 500 Consumer Discretionary	(0.49)	(0.74)
S&P 500 Consumer Staples	1.88	2.17
S&P 500 Energy	6.12	2.14
S&P 500 Financials	(0.74)	(2.84)
S&P 500 Health Care	0.27	1.03
S&P 500 Industrials	0.89	1.09
S&P 500 Information Technology	0.58	(0.94)
S&P 500 Materials	1.90	8.96
S&P 500 Telecomm Services	3.95	7.28
S&P 500 Utilities	4.11	9.29

Sources: Bloomberg, FactSet, Russell, Wilshire

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.