

Market Commentary

Anyone stranded in outer space for the last thirty days and cut off from all news sources would be forgiven for thinking that not much happened in the U.S. equity market in August. After all, equity returns were positive—above average, in fact—across all major market indices. Those of us back on planet Earth know different, however. August was an eventful month, and one that could have ended much worse than it did, in our view, had not the Fed stepped in mid-month.

Events were so unprecedented, in fact, that we decided to make this month's commentary a twofer of sorts—with thoughts from both Bill Miller and me. Just below is my normal recap of the market's performance over the last month. Next, representing the heart of the letter, are some thoughts on the current market environment and our likely response to it penned by Bill Miller in the immediate aftermath of the Fed's mid-month rescue operation. Finally, I offer my concluding observations on the importance of what the Fed does and says at its next FOMC meeting on September 18.

On August 16, less than a month after hitting an all-time high, the U.S. equity market reached a climactic low in response to turmoil in the fixed income markets, particularly the mortgage market. Intraday on August 16, the Dow Industrials were down 343 points before recovering to close down only 16 points. Volume on the NYSE was a record 2.988 billion shares, new lows hit a multi-year high of 1181, and the option volatility index (VIX) spiked 7 points to an intra-day peak of 37.5, a four-year high. According to data from long-time market observer Bob Farrell, evidence of investor panic and pessimism was widespread, with put-call ratios at record levels and Farrell's own five-week advance-decline diffusion index reaching 40.4% (a rare oversold extreme not seen since the last bear market). Whether the August 16 low will prove to be "the" low remains to be seen, but it might have been. Even if it was, further "tests" of this low are likely in the weeks ahead, in our view, as the market tries to find its footing.

TOTAL RETURNS

	August	QTD	YTD07	YTD06
S&P 500 Index	+1.50%	-1.65%	+5.20%	+5.80%
Dow Industrials	+1.40%	+0.04%	+8.79%	+7.90%
Nasdaq Composite Index	+2.07%	-0.10%	+8.06%	-0.43%
S&P Mid-Cap 400 Index	+0.92%	-3.42%	+8.14%	+2.43%
Russell 2000 Index	+2.27%	-4.73%	+1.41%	+7.79%
Dow Jones Wilshire 5000 Index	+1.39%	-2.05%	+5.35%	+5.67%
S&P 100 Index	+1.99%	-0.40%	+5.61%	+7.26%
Russell 1000 Growth Index	+1.59%	+0.02%	+8.15%	+0.22%
Russell 1000 Value Index	+1.12%	-3.56%	+2.45%	+10.98%

Sources: Bloomberg, Wilshire, Russell

In addition to the usual monthly, quarter-to-date and year-to-date returns presented above, we have included last year's year-to-date returns through August 2006 for comparison purposes. While the year-to-date returns of the Dow Industrials, S&P 500 and Dow Jones Wilshire 5000 Index are similar this year and last, the flip-flops in the performance of the Nasdaq Composite versus the Russell 2000 Index, and the Russell Growth versus Russell Value indices, highlight rather convincingly, in our view, the emergence of growth stocks as this year's market leaders.

Bill Miller's Thoughts on the Current Market Environment

As of 8/22/07

Although we have not heard any market observers say it, we have just experienced a crash in the mortgage market that was as acute as the Crash of 1987 was in the equity market. It was far more severe and important than the Long-Term Capital Management problem in 1998, or the subprime problems in 1990 or 1994. If the Fed had not acted, we think the equity market may have dropped very sharply, perhaps leading to a new bear market.

In mid-August, the market for financing even the best assets effectively closed, as access to credit dried up during a global scramble for liquidity. That is why even what had been the strongest equities, currencies, and commodities all plunged, despite having nothing to do with the subprime problems in the U.S. This became a global crisis, which is why the Fed acted. It is important to understand just how unprecedented these events were. Never before had the Fed changed its economic policy statement between meetings, and never had it gone from a bias to tighten to an implied bias to ease in 10 days.

Although we expect the market to move higher from here, it may be unsettled over the next few weeks as the economic implications of the mortgage market crash and the drying up of the market for asset-backed commercial paper, the severe disruption of the commercial paper market, and the general credit market turmoil are felt.

The risks to the global economy, in addition to the U.S. economy, have now increased. We expect the Fed will act decisively to fulfill its mandate to promote employment and growth by providing sufficient liquidity to keep the U.S. economy moving forward, and we think they will be successful. This should enable our equity market to move forward, but we think it will be a different kind of market from the one we have seen since the market started to rally in March 2003.

In the past year, the credit markets have gone from risk seeking, where any asset, no matter how weak or poorly protected by covenants, could get financed on extremely favorable terms, to risk phobic, where practically no assets could get financed at all as of

last week. We think the Fed will bring credit markets back to normal, and as they stabilize, equities should move higher. The key word is normal. In this new environment, we expect:

- A normal yield curve to be sustained, with short rates falling and long rates rising to bring it about.
- Commodities markets to be in a normal state of backwardation, as new supplies respond to record capital expenditures, and for commodities prices to be at best stable in real terms.
- Buyouts by private equity to continue, but at a normal pace, and not the frenetic one of the past few years, as credit conditions return to normal.
- A return to normal mortgage conditions, with reasonable loan documentation and down payments, and with subprime mortgages once again being granted, but at about 20 percent of the peak levels.
- Home prices to stop falling (which is not normal) in 2008 and resume rising thereafter at a normal pace.
- Equities to outperform bonds, as they normally do, but which has not been the norm during this new century.
- The return of stocks over the next five years to be about what has been normal for the past 80 years since good records have been kept, at about 10 percent total return per year.

In our opinion, absent the current credit market dislocations, the fundamental backdrop supporting stocks is quite positive:

- Valuations are the most attractive since 1991.
- Balance sheets are strong.
- Buyback activity is robust.
- Free cash flows and earnings are both growing.
- Insiders are buying.

Periods of market turmoil typically provide excellent buying opportunities, and this time is no exception. Once the Federal Reserve restores liquidity, the path of least resistance in stocks is up.

With the dramatic change in the economic outlook due to the credit collapse, we have entered a different environment, one that likely will result in a number of Value Equity portfolio changes. We have already begun to consider a number of new names and weighting changes in existing holdings as a result of an environment where U.S. and global growth slow at the margin.

In terms of general direction, our moves will likely involve those stocks that benefit from a steeper yield curve, a more normal credit environment, slower growth, and benign inflation. Thus, we will likely have a greater emphasis on financials, which have led this market down, and which we expect will lead it up. Particular attention will be focused on those that have been hard hit in this decline. Slower growth and lower inflation mean that growth will command a premium, so we will be looking for names with strong secular growth prospects, outstanding management, and declining share counts. Areas that have lagged but have excellent outlooks, such as biotech, will also be under consideration. In general, the long-awaited and anticipated move of the mega caps has likely begun.

Recall that Legg Mason Capital Management's investment process is long term, patient, and contrarian, seeking through disciplined analysis of businesses to identify companies trading at significant discounts to their intrinsic value, defined as the present value of the future free cash flows the business will generate. When this is working—that is, when we are outperforming—we often hear it asked why everyone doesn't invest this way: buying stocks that are down, that are unpopular, that most people don't like. When it is not working, such as now, the question is why you would ever buy things where it is obvious they have problems and avoid those that are doing well.

This hindsight bias is why contrarian investing is so difficult (but also leads to good long-term returns). When you are wrong, it looks as if only you made that mistake, because that is what contrarian investing involves: doing what others think is wrong. Sometimes it is wrong and you look very stupid. Often it is not, and then people say you were lucky, or that it was obvious.

Our process at the core has been the same for 25 years, though, of course, it has evolved and is now much more sophisticated and robust than it was in 1982 when we started. We are constantly researching ways to improve it to lessen the inevitable periods of underperformance and lengthen those where we are doing well. Calendar year 2006 and (so far) 2007 are our first years of being behind the benchmark since 1990, not coincidentally a period similar to today, one with a run-up in energy prices and a softening housing market. As you know, when that ended we were fortunate to have 15 consecutive years of beating the benchmark.

We think we are in a similar position right now, as we believe energy prices have peaked, and the Fed's action on August 17 to reduce the discount rate, coupled with what we believe will be coming reductions in the Fed funds rate, will end the present credit crunch, freeing up capital and eventually leading to a much better housing market.

We think we will have a different market with different leadership from what we have had over the past several years, and we expect our portfolio and our results will reflect that.

Outlook

In our opinion, the near-term outlook for both the U.S. economy and U.S. equity market is heavily dependent upon what the Fed does and says at its upcoming meeting on September 18. Will they cut rates or not, and if so, by how much? We think they will cut the Fed funds rate. The futures markets are now pricing in a 97.5% probability of at least a 25 basis point cut and over a 60% probability of a 50 basis point cut. The problem is, with expectations of a rate cut so universally held, if the Fed doesn't cut, the market could be in for a huge disappointment, and the economy could be headed for a recession.

The Fed funds futures market is now pricing at least 75 basis points of rate cuts by late this year or early next. Former Fed Governor Lyle Gramley, a man not usually given to making extreme statements, calls a Fed rate cut on September 18 as close to a "no brainer" as it gets in economics. Even Martin Feldstein, former chairman of the Council of Economic Advisors under

President Reagan and a noted inflation hawk, warned at a Federal Reserve Symposium in Jackson Hole, WY, on August 31 that the odds of recession have increased meaningfully as a result of the ongoing credit crunch, and that the Fed must act aggressively to try to prevent a recession from developing, cutting the Fed funds rate by as much as 1%.

It is our understanding that Fed Chairman Ben Bernanke was not in the audience at Jackson Hole to hear Feldstein's remarks, but we have reason to believe he knew what was to be said. In earlier remarks at the Jackson Hole Symposium, Bernanke himself noted, "Well-functioning financial markets are essential for a prosperous economy." He went on to say that the Fed's decision to lower the discount rate 50 basis points on August 17 was based on its judgment that "the deterioration in financial market conditions and the tightening of credit since its August 7 meeting had appreciably increased the downside risks to growth." He further stated, "The Federal Reserve stands ready to take additional actions as needed to provide liquidity and promote the orderly functioning of markets." On the other hand, Bernanke also said, "It is not the responsibility of the Federal Reserve—nor would it be appropriate—to protect lenders and investors from the consequences of their financial decisions." These latter two statements neatly frame Bernanke's dilemma, in our opinion. On one hand, he doesn't want to croak the economy, but on the other, he doesn't want to be seen as bailing out speculators.

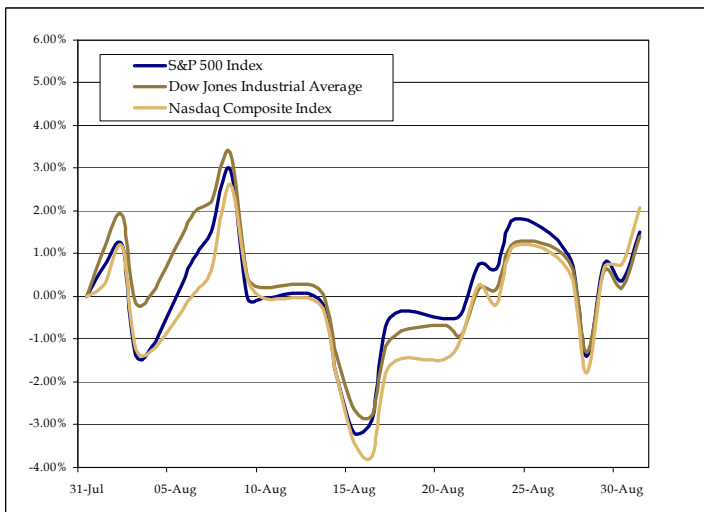
In our judgment, the weight of the evidence suggests that the Fed should cut rates on September 18, and they probably will. The economy appears to be slowing and inflation seems to be waning. The surprise decline in employment in August (the first in four years) argues powerfully for a rate cut, in our opinion. Then too, evidence that the credit markets are still under considerable stress is fairly widespread. U.S. Treasury bills are trading at yields far below the Fed funds rate, suggesting a massive "flight to quality" is underway among investors. In addition, the London Interbank Offered Rate (LIBOR), the rate at which banks lend to each other and off which many loans are priced, is currently 50 basis points higher than the Fed funds rate, and the spread between the two has widened (as this is written) 10 days in a row. Normally, LIBOR tracks the Fed funds rate within 10 basis points or so. A 50 basis point spread suggests that a high degree of suspicion and mistrust is still present in this critically important market.

In summary, we—like many other market participants—will be on high alert until September 18. We have a suspicion that the less well the equity market does in the interim, the more likely it is that the Fed will cut rates. The last thing we probably need between now and then is a huge market rally.

On behalf of all of us at Legg Mason Capital Management, Bill Miller and I both thank you for your support and welcome your questions and comments.

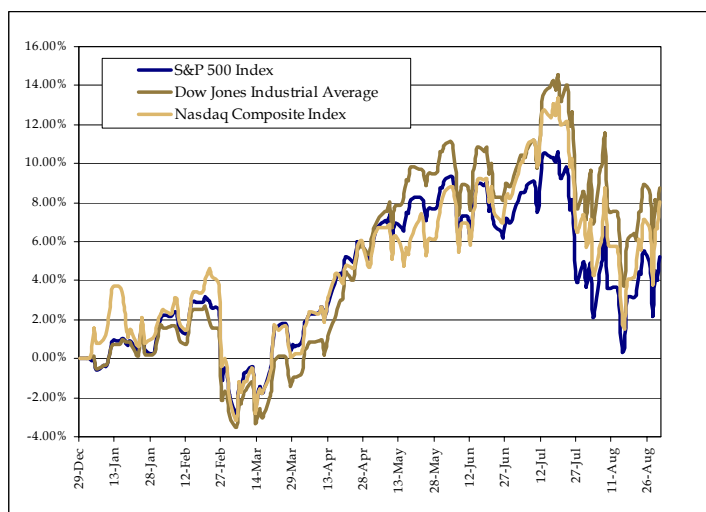
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Major Indices August Performance



Sources: Bloomberg and FactSet

Major Indices YTD Performance



Sources: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

Index Name	August	QTD	YTD
<i>Broad Market Indices</i>			
S&P 500	1.50	(1.65)	5.20
Dow Jones	1.40	0.04	8.79
Russell 1000	1.36	(1.77)	5.28
NASDAQ	2.07	(0.10)	8.06
Dow Jones Wilshire 5000	1.39	(2.05)	5.35
Russell 2000	2.27	(4.73)	1.41
Russell 1000 Growth	1.59	0.02	8.15
Russell 1000 Value	1.12	(3.56)	2.45
<i>S&P 500 Sector Indices</i>			
S&P 500 Consumer Discretionary	0.38	(5.44)	(2.71)
S&P 500 Consumer Staples	2.58	0.30	5.23
S&P 500 Energy	0.84	1.60	19.09
S&P 500 Financials	1.54	(6.37)	(7.11)
S&P 500 Health Care	2.54	(1.90)	4.05
S&P 500 Industrials	(0.01)	1.01	12.08
S&P 500 Information Technology	2.88	2.42	11.97
S&P 500 Materials	(0.51)	(2.75)	13.51
S&P 500 Telecomm Services	(0.08)	(2.31)	12.81
S&P 500 Utilities	2.29	(1.54)	7.19

Sources: Bloomberg, FactSet, Russell

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