LEGG MASON CAPITAL MANAGEMENT *Month-End Commentary*

September 2007

Market Commentary

The U.S. equity market continued to recover impressively in September from its mid-August swoon. Heartened by a larger-than-expected 50 basis point cut in the Fed funds rate, the large-cap indices (S&P 500, S&P 100 and Dow Industrials) and the Nasdaq Composite all posted monthly returns in the range of 4%, while the S&P Mid-Cap 400 and Russell 2000 Index posted lesser, but still healthy, gains. From their inter-day lows on August 16 (not shown below), the Dow, S&P 500 and S&P Mid-Cap were all up 11% or so through month-end, while the Nasdaq Composite was up about 13% and the Russell 2000 Index about 9.5%. The credit-crisis-induced mid-August low has proven to be—so far at least—a great buying opportunity.

TOTAL RETURNS

	Sept	Q3	YTD
S&P 500 Index	+3.74%	+2.03%	+9.13%
Dow Industrials	+4.16%	+4.19%	+13.31%
Nasdaq Composite Index	+4.09%	+3.98%	+12.48%
S&P Mid-Cap 400 Index	+2.65%	-0.87%	+11.01%
Russell 2000 Index	+1.72%	-3.09%	+3.16%
Dow Jones Wilshire 5000 Index	+3.59%	+1.46%	+9.13%
S&P 100 Index	+4.11%	+3.70%	+9.95%
Russell 1000 Growth Index	+4.19%	+4.21%	+12.68%
Russell 1000 Value Index	+3.43%	-0.24%	+5.97%

Sources: Bloomberg, Wilshire, Russell

Two trends that have been evident in recent months—the superior performance of large- and mega-cap stocks over mid- and small-cap stocks and the emergence of growth stocks as market leaders—continued in September. For the quarter as a whole, these two trends are even more obvious, as the large/mega caps and the Russell 1000 Growth Index were up nicely, while mid and small caps and the Russell 1000 Value Index were all down.

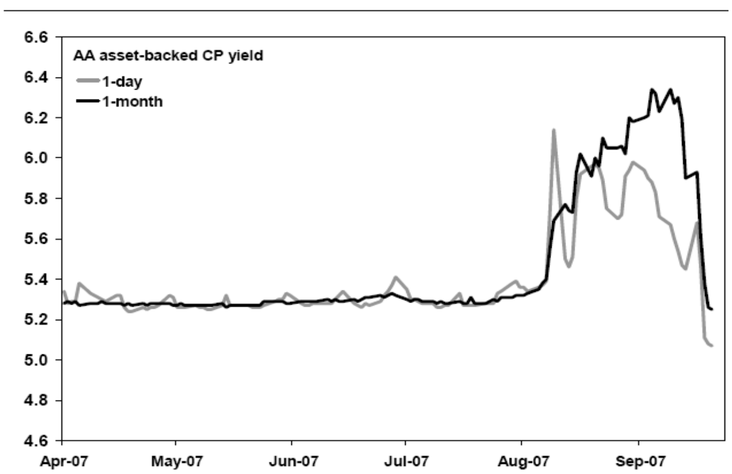
Market strength has continued in early October, led by the Dow Industrials, which reached a new all-time high of 14,087.55 on October 1. The S&P 500 Index also posted a new all-time closing high of 1,557.59 on Friday, October 5, following release of the September jobs report that showed stronger-than-expected employment growth last month and sizeable upward revisions to the July and August reports.

As we see it, the market's ability to continue to make upward progress through the balance of this year is primarily dependent on three things: (1) continued stabilization in credit markets, (2) the inflation outlook, and (3) the likelihood of recession. We see reasons for optimism on all three fronts.

When the commercial paper and LIBOR-based loan markets began seizing up in mid-August as a result of the subprime mortgage contagion, the Fed was forced to act decisively to try to prevent a complete meltdown in the fixed income markets. As the charts below illustrate, the Fed's efforts seem to be working, as these markets have begun to heal. LIBOR-based loan pricing has eased, with dollar-based rates now below their pre-August levels. The TED spread (the difference between LIBOR and T-bill rates) remains somewhat elevated, but has narrowed from its worst levels.

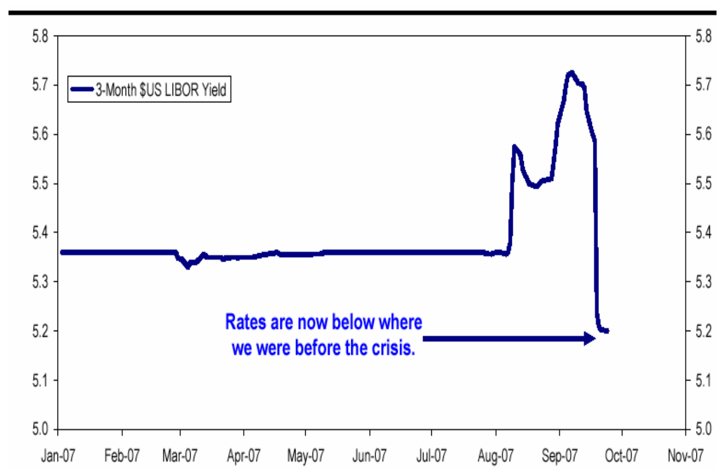
The commercial paper market also appears to be on the mend. According to recently released Federal Reserve data, total outstanding commercial paper rose by $4.5 billion to $1.859 trillion in the week ending Wednesday (10/3), the first increase in eight weeks. Increasing volumes and declining rates are clear evidence, in our view, of stabilization in this critically important market. Buyers remain leery of asset-backed commercial paper, which dropped by $6.1 billion in the most recent week. Still, that decrease was the smallest since mid-August, so we may have seen the worst in this troubled market as well. In another

Commercial Paper Markets Are Healing...



Source: Federal Reserve Board

As Are LIBOR-Based Funding Markets



ISI Portfolio Strategy.

sign of return to normalcy, longer-term bond issuance has been healthy in the last several weeks.

As regards the outlook for inflation, the evidence appears mixed, but we believe the most relevant factors point to a likely moderation in U.S. core inflation. Market observers fearing a rise in inflation point to rising gold and commodity prices and the declining value of the dollar. We acknowledge these concerns but are less worried about them than some.

Commodity and gold prices have been rising for several years without leading to rising core inflation rates in the U.S. If not then, why now? Especially when it appears that the U.S. economy is slowing.

A full explication of the issues surrounding the dollar is beyond the scope of this letter. Even internally, we have serious disagreements about the dollar's long-term outlook. In the short to intermediate term, however, we believe that consensus opinion is currently too bearish on the dollar—especially versus the pound and the euro.

On a purchasing power basis, we believe the dollar is about 20% undervalued versus both the pound and the euro and could well strengthen against them, rather than weakening further in the coming year as most people seem to expect. In addition, two factors often cited to explain movements in the dollar—the current account deficit and the budget deficit—are on improving trends. Suffice it to say, we think concerns about the dollar are well-discounted in the market at present.

Media focus on the dollar and gold has diverted investors' attention away from a monetary reality that will have far greater impact on the outlook for inflation over the next year or two, in our judgment: namely, that the velocity of money has collapsed in the last two months. Never before has the U.S. inflation rate risen in the face of such a decline, and the analysis that follows explains why we do not believe this time will be any different.

Noted economist Milton Friedman always argued that monetary policy acts with about an 18-to 24-month lag. The Fed tightened for two years from June 2004 to June 2006, before going on hold until last month. The effects of the Fed's tightening regime would have been more evident in the economy by now, in our opinion, except for one thing. While the Fed was tightening, the banking system was on a massive lending spree. To understand the dynamics, think of Irving Fisher's famous equation describing the behavior of the economy (MV=PQ). In Fisher's equation, the aggregate quantity of money (M) times the velocity of money (V) equals the aggregate price of goods (P) times the aggregate quantity of goods (Q). From June 2004 to August 2007, while the Fed was trying to rein in M, the banks were creating M of their own (through the money multiplier), as they—in concert with ravenous borrowers—were simultaneously sending money velocity (V) through the roof. As we now know, that lending orgy came to a screeching halt in August, as credit markets seized up, and money velocity collapsed. If the inflation rate accelerates from here, it would be the first time in history that it had done so in the face of such a severe contraction in credit.

We believe the collapse in money velocity explains why the Fed acted so decisively in mid-August to ensure that money was available to the system. We believe it also explains why the long-term inflation rate implied by the spread between 10-year TIPS and 10-year nominal Treasuries has remained relatively stable at about 2.25% to 2.30%. Bottom line: We think the odds favor a moderation in the U.S. core inflation rate from here.

The final key to the outlook for equities over the next 12 to 15 months is the likelihood of recession. Earlier in the year, we put the odds of recession in 2007 or 2008 at about 1-in-5. At our Thought Leader Forum in late September, we told a client gathering that we thought the recent credit crisis had raised the odds of recession to about 1-in-3. Following the release of the September jobs report, the odds have dropped a bit, in our view, to something like 3-in-10. In other words, we think the odds are at least 2-to-1 against recession, and probably higher.

At the risk of making too much of any one data point, the September jobs report seems quite significant to us. Non-farm payrolls were reported to have risen +110K last month (versus a consensus expectation of +100K). More importantly, the -4K change originally reported for August payrolls was revised up to +89K and July's reading was revised up to +93K from +68K.

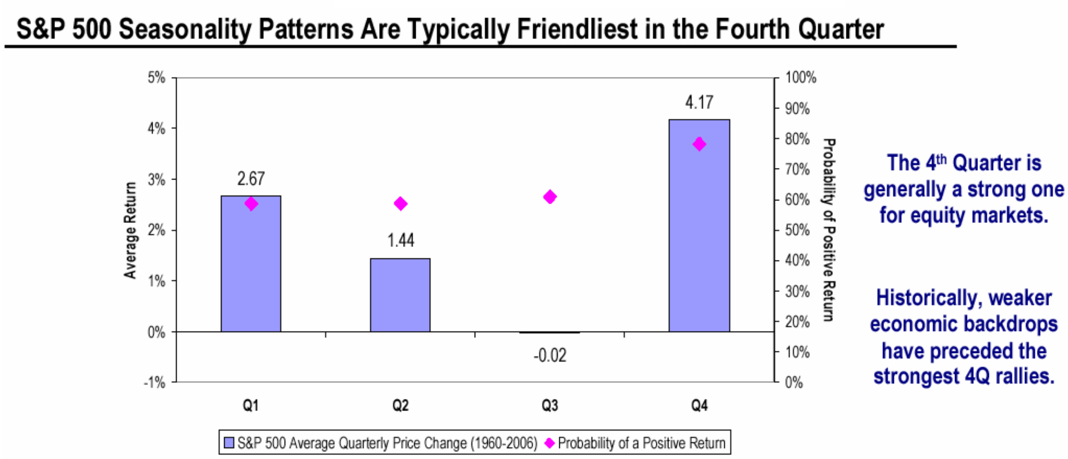
The initially reported drop in employment in August triggered a sharp drop in the stock market and was probably a major factor in the Fed's decision to cut rates by 50 basis points in September, rather than the more incremental 25. It turns out employment didn't actually decline after all, but only appeared to, as a number of local governments either failed to report on a timely basis or a later start to the school year this year distorted the apparent number of teachers working.

The revised numbers make a lot more sense to us and are consistent with a domestic economy that is slowing but not collapsing. The futures market has quickly priced this revised information into its outlook for the timing and magnitude of Fed rate cuts. Whereas at September month-end, the futures market was showing an 84% chance of a 25 basis point cut at the Fed's next meeting on October 31, it now sees less than a 50/50 chance of a cut in October.

Outlook

We continue to be constructive on the outlook for equities for the balance of this year and into 2008. For the reasons detailed earlier, we believe (1) credit markets are on the mend, (2) core U.S. inflation will moderate, and (3) the U.S. economy will likely avoid recession. In this environment, we expect corporate earnings growth to slow, but remain reasonably healthy. Our valuation work suggests to us that going into the fourth quarter, the S&P 500 Index was about 4% to 5% undervalued based on 2007 bottom-up, cap-weighted consensus estimates and about 13% to 15% undervalued based on 2008 estimates. Specifically, we see the S&P 500 as fairly valued at about 17x earnings, compared to quarter-end valuation levels of 16.3x and 14.7x for 2007 and 2008 estimates, respectively.

Fourth-quarter gains of 4% to 5% would be right in line with historical averages. As the table below illustrates, since 1960, fourth-quarter gains have averaged 4.17%, the best of any quarter in the year. The fourth quarter has also shown gains nearly 80% of



Source: ISI Quantitative Research.

the time, also the best of any calendar quarter. Encouragingly, the S&P 500 is already up 2% in the first five trading days of the quarter, so we are off to a promising start.

Despite having posted reasonably good returns so far this year and having good prospects for the balance of the year, in our judgment, 2007 has been a challenging year for investors in some important respects. The emergence of growth stocks as market leaders has brought with it a material change in the character of the market, one in which momentum-based strategies are dominating value-based strategies to a degree not often seen. Anecdotally, it has seemed that stocks that have been strong, stay strong, while stocks that have been weak, stay weak. Valuation considerations seem to have become secondary.

These impressions are borne out by a year-to-date factor return analysis done by Empirical Research Partners. Empirical's work shows that on an equal-weighted basis, the best quintile of valuation (i.e., the cheapest stocks) is down -3.8% year-to-date, while the worst quintile (the most expensive stocks) is up +7.9%, for an 1160 basis point negative spread. In contrast, returns to the factor they call "market reaction"—which is based on 3-month and 9-month price momentum as well as trends in earnings revisions—are strongly positive. Year-to-date through September, the quintile of stocks that entered the year ranked best in market reaction is up +8.8%, while the quintile ranked worst is down -6.1%, a 1480 basis point spread. In short, so far this year, it has paid to buy off the new high list rather than the new low list, an environment not entirely conducive to our normal contrarian bent.

Another trend we have noted—one which we expect to continue to influence sector returns for some time to come—is the better recent performance of large- and mega-cap stocks versus mid- and small-cap stocks. Large caps have looked more attractive than small caps on a pure valuation basis for more than a year. Small cap enthusiasts have argued that the valuation premium—while unusual—was justified because small caps, as a group, had better growth prospects. According to the latest work from Leuthold Group, that is no longer true. Large-cap stocks now have both better growth prospects and lower valuations than small-cap stocks. Investor recognition of this fact may explain why large caps have started to outperform small caps in the marketplace.

The table from Leuthold Group below shows the relative valuation of large versus small caps in September 2007 as well as in December 1999 and June 1983. Leuthold Group monitors the largest 3000 companies in the U.S. stock market by market value. It defines the top 300 (which currently have market caps greater than $12 billion) as large caps. It calls stocks with market caps between $410 million and $1.7 billion small caps.

		Median P/E		
	Median Oper. Earnings Growth	Sept 2007E	Dec 1999E	June 1983E
Large Caps	+18.1%	17.2X	28.2X	12.9X
Small Caps	+7.1%	19.2X	16.9X	14.2X
SC/LC Premium		+12%	-40%	+10%

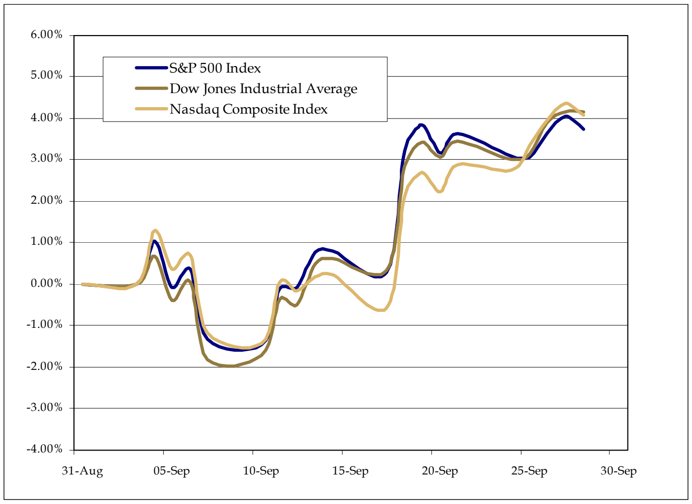
Source: Steven Leuthold, Leuthold Group, 9/24/07

Small caps were hugely undervalued relative to large caps in December 1999, and from there began an extended period of relative outperformance. We think it is quite possible small caps' period of outperformance is ending, as they now trade at a higher premium to large caps than they did at their last relative performance peak in June 1983.

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

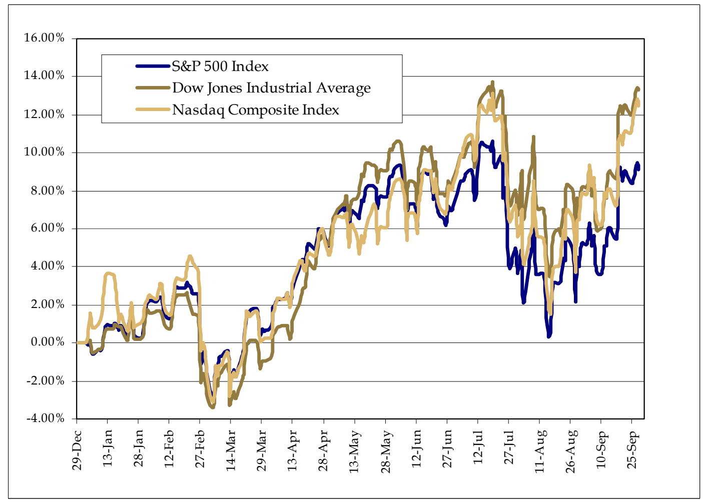
David E. Nelson, CFA
Chairman, Investment Policy Committee
Legg Mason Capital Management

Major Indices September Performance



Sources: Bloomberg and FactSet

Major Indices YTD Performance



Sources: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

Sector Index Name	September	Q3	YTD
Broad Market Indices			
S&P 500	3.74	2.03	9.13
Dow Jones	4.16	4.19	13.31
Russell 1000	3.82	1.98	9.30
NASDAQ	4.09	3.98	12.48
Dow Jones Wilshire 5000	3.59	1.46	9.13
Russell 2000	1.72	(3.09)	3.16
Russell 1000 Growth	4.19	4.21	12.68
Russell 1000 Value	3.43	(0.24)	5.97
S&P 500 Sector Indices			
S&P 500 Consumer Discretionary	(0.89)	(6.28)	(3.57)
S&P 500 Consumer Staples	4.49	4.80	9.96
S&P 500 Energy	8.07	9.80	28.71
S&P 500 Financials	2.26	(4.26)	(5.01)
S&P 500 Health Care	3.01	1.05	7.18
S&P 500 Industrials	4.79	5.85	17.45
S&P 500 Information Technology	3.78	6.30	16.21
S&P 500 Materials	7.86	4.90	22.44
S&P 500 Telecomm Services	4.55	2.13	17.94
S&P 500 Utilities	3.55	1.95	11.00

Sources: Bloomberg, FactSet, Russell, Wilshire