LEGG MASON CAPITAL MANAGEMENT

Month-End Commentary

November 2007

## Market Commentary

Investor concern that credit market conditions were worsening again, rather than improving as had appeared to be the case in October, led to a sharp and broad-based decline in the U.S. equity market in November. The decline bottomed—for the time being at least—on the Monday after Thanksgiving, with both the Dow Industrials and S&P 500 having experienced their first corrections of more than 10% from a prior closing high since the first quarter of 2003. From its November 26 low, the stock market rallied strongly through month-end, buoyed by separate comments from Fed Governor Donald Kohn and Fed Chairman Ben Bernanke that implied that the Fed was likely to cut rates further at its December 11 meeting.

TOTAL RETURNS

| | Nov | QTD | YTD |
|---|---|---|---|
| S&P 500 Index | -4.18% | -2.66% | +6.23% |
| Dow Industrials | -3.63% | -3.27% | +9.60% |
| Nasdaq Composite Index | -6.84% | -1.36% | +10.95% |
| S&P Mid-Cap 400 Index | -5.04% | -2.54% | +8.19% |
| Russell 2000 Index | -7.18% | -4.52% | -1.50% |
| Dow Jones Wilshire 5000 Index | -4.46% | -2.63% | +6.26% |
| S&P 100 Index | -4.21% | -2.76% | +6.92% |
| Russell 1000 Growth Index | -3.68% | -0.41% | +12.22% |
| Russell 1000 Value Index | -4.89% | -4.88% | +0.80% |

Sources: Bloomberg, Wilshire, Russell

The Dow Industrials and Russell 1000 Growth Index held up best during the month, and continue to be—along with the Nasdaq Composite—the best-performing major market indices on a year-to-date basis. The Russell 2000 Index continued to lag and is the only major market index that is down for the year. Growth continued to outpace value and now leads by over 1,100 basis points year-to-date.

Surprisingly, considering the shellacking they took during the month, the financial stocks were not the worst-performing group in the S&P 500 Index for November. That distinction fell to the technology stocks, which declined 7.99% for the month, but are still up 14.57% year-to-date. Financial stocks were the second-worst performers for the month, down 7.74%, and are the worst-performing sector year-to-date, down 13.95%. Also notably weak were the telecom (-7.25%) and consumer discretionary (-5.52%) sectors. The traditional safe havens during times of market stress—consumer staples (+2.98%), health care (+1.12%) and utilities (+0.56%)—all posted positive returns. The financials and the consumer discretionary stocks hold the dubious distinction of being the only S&P 500 sectors to be down and also underperforming the index on a year-to-date basis.

Market returns in 2007 have been as bifurcated as any we can remember. Investment strategies based on price momentum have worked brilliantly, while value-based approaches have failed miserably. According to Empirical Research Partners, through November, returns to the quintile of stocks ranked best on price momentum have performed 2,390 basis points better than the quintile ranked worst on this factor, a spread only rarely seen in the past. In contrast, returns to valuation-based strategies have been hugely negative according to their work. Specifically, the cheapest stocks in the market—as measured by a super factor comprising a number of valuation techniques that have traditionally produced good results—have underperformed the most expensive stocks by 2,050 basis points this year through November.

The other winning stock market strategy for 2007—the so-called global growth trade—has been to have positioned portfolios to benefit from faster growth overseas than domestically. Whatever one calls it, it has worked in spades. Simply emphasizing the S&P 500 sectors with the highest percentage of foreign sales and de-emphasizing those with the least would have produced exceptional results in 2007, as shown below:

| S&P 500 Sector | Foreign Exposure (%) | YTD % Chg* |
|---|---|---|
| Energy | 54.7% | 27.1% |
| Information Technology | 54.1% | 15.6% |
| Materials | 45.3% | 21.3% |
| Consumer Staples | 41.3% | 9.0% |
| Industrials | 36.8% | 12.0% |
| Average | 46.4% | 17.0% |
| Health Care | 36.1% | 4.5% |
| Consumer Discretionary | 24.7% | -9.4% |
| Financials | 17.7% | -18.1% |
| Utilities | 8.1% | 14.7% |
| Telecommunications | 3.4% | 7.1% |
| Average | 18.0% | -0.2% |

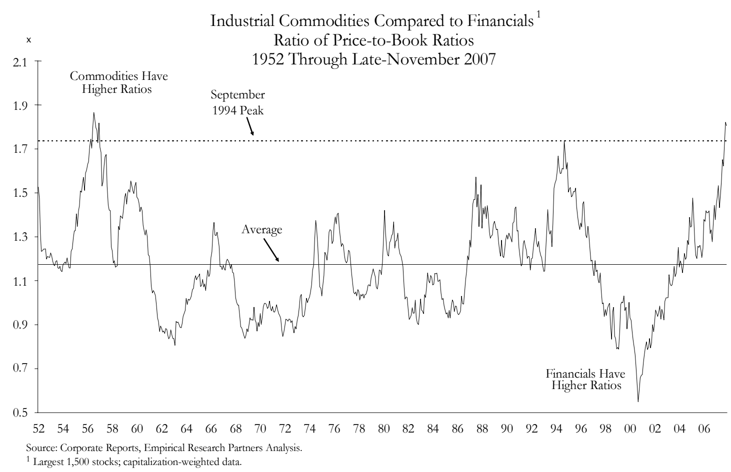
Source: Francois Trahan, ISI Group (* thru 11/23/07)

Many market participants seem to believe that what has worked in 2007 will continue to work in 2008 and have positioned their portfolios accordingly. We disagree. We believe that instead of remaining decoupled, as most investors expect, the U.S. and foreign economies will begin to "re-couple" (to borrow a term from Goldman Sachs' Head of Global Economic Research, Jim O'Neill), as the expected slowdown in the U.S. begins to exert downward pressure on growth rates overseas. In our view, this would be an unpleasant surprise to the market, which has discounted a meaningful slowdown domestically, but virtually none overseas.

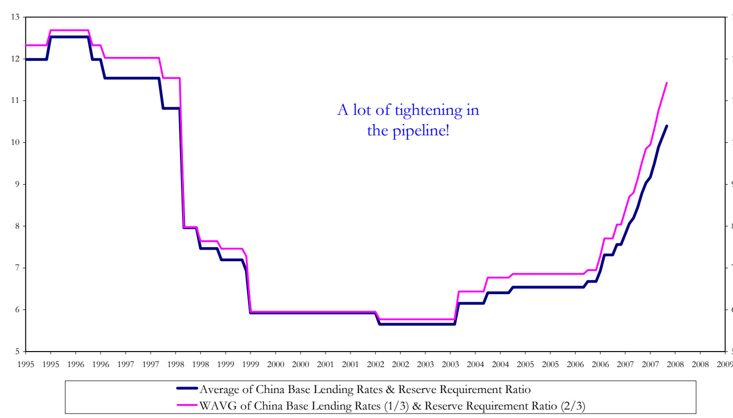
The chart on the next page from Empirical Research Partners showing the relative price-to-book ratios of industrial commodity and financial stocks is illustrative of the market's current enchantment with all things global, in our opinion. Industrial commodity stocks are currently priced as optimistically relative to financial stocks as at any time since the mid-1950s. Since demand for industrial commodities has been driven strongly in the last few years by emerging markets, and especially by China, we see the optimistic pricing of the stocks as evidence of a high degree of investor confidence in the prospects for continued strong global growth, led by growth in China. In contrast, the dismal relative pricing of financial stocks indicates a high degree of investor pessimism about the economic outlook domestically. In our opinion, equity investors are far more vulnerable to the risks of a slowdown overseas than one domestically, because they've largely discounted the latter, but not the former.

What would cause investors to begin worrying about the outlook for global growth? A slowdown in China would certainly do it, in our view. How likely is that? More so than is commonly recognized, we think.

Though it only recently officially adopted a "tight" monetary policy, the People's Bank of China (PBoC) has been raising two key rates—its reserve requirement ratio and its benchmark lending rate—rather aggressively since mid-2006. Specifically, the PBoC has boosted its reserve requirement ratio thirteen times from 7.5% to 14.5% since June 2006. Over the same period, the Chinese central bank has raised its benchmark lending rate six times. The chart to the right, courtesy of Francois Trahan of ISI Group, shows a composite index of these two indicators of monetary policy. The blue line is an equal-weighted average of the two rates. The pink line weights the reserve requirement ratio more heavily, on the theory that it has a more powerful effect. Whichever index one chooses, it is clear from the chart that the degree of tightening by the Chinese monetary authorities has been considerable. Since monetary policy tends to act with a lag of eighteen months or so, we believe the tightening cycle that began in mid-2006 could begin to slow the Chinese economy in 2008. Such a slowing, should it occur, would be a major surprise to many market participants, in our view, and could, therefore, have major implications for the direction of oil and other commodity prices, as well the efficacy of the global growth trade in general.




Source: Empirical Research Partners




Source: Francois Trahan, ISI Group

## Outlook

Rather than speculate about what the Fed would do at its December 11 meeting, we decided to delay posting our monthly commentary to see what they actually did do. To say the least, we are disappointed that the Fed failed to act as aggressively as we think they should have to help heal the credit markets, which in some important respects are in worse shape now than they were in August. The equity market was disappointed as well. From an intra-day high of 1523.57 reached just prior to the Fed's announcement, the S&P 500 dropped just over 3% to close at 1477.65, wiping out December's month-to-date gain in the process.

The market's severe negative reaction suggests disappointment on a number of fronts. First, a minority of investors were expecting a 50 basis point cut in the Fed funds rate, rather than the 25 basis points that the Fed delivered. Second, even among the majority of investors who expected only 25 basis points on the funds rate, there were many (including ourselves) who believed that the Fed should, and would, cut the discount rate by 50 basis points or more, bringing the two rates more into alignment, and thus lessening the stigma and rate penalty for borrowing at the discount window. Third, many investors had hoped the Fed would introduce additional measures—such as broadening the collateral accepted at the discount window—designed to improve the liquidity and functioning of credit markets. Finally, some change in the Fed's assessment of risks in the statement accompanying its rate action was also expected by many. Relative to market expectations, the Fed delivered the bare minimum: a 25 basis point cut in both the Fed funds and discount rates and minimal change in its assessment of the balance of risks.

Despite our short-term disappointment that the Fed did not act more forcefully, and recognition that, as a consequence, the market could be volatile over the next several months, we believe that the stock market is so attractively valued relative to bonds and cash, we cannot help but be optimistic about its longer-term prospects. The chart below is one we have used many times before, but not recently. It presents key valuation metrics for stocks, bonds and cash at the top of the market in 2000, the bottom of the market in 2002 and as of the end of November.

| | March 24, 2000 | October 9, 2002 | November 30, 2007 |
|---|---|---|---|
| 10 Year T-Notes | 6.20% | 3.56% | 3.95% |
| 10 Year TIPS | 4.09% | 2.21% | 1.61% |
| 6 Month Bills | 6.16% | 1.51% | 3.26% |
| S&P Price | 1,527.46 | 776.46 | 1,481.14 |
| Dividend Yield | 1.06% | 2.04% | 1.92% |
| Earnings Yield | 3.62% | 7.41% | 7.04% |
| P/E Ratios: | | | |
| 10 Year T-Notes | 16.1x | 28.1x | 25.3x |
| S&P 500 | 27.6x | 13.5x | 14.2x |
| 6 Month T-Bills | 16.2x | 66.2x | 30.7x |

Sources: Bloomberg, Factset Data Systems, LMCM Estimates

We usually use the chart to make the point that investors almost always want to do the exact opposite of what they should want to do. For example, at the top of the market in 2000, when 10-year Treasury note yields were nearly 360 basis points higher than the earnings yield on stocks, investors were avoiding bonds like the plague and jumping into stocks with both feet. Two years later, when bonds were half as attractive and stocks were twice as attractive, investors were dumping stocks in favor of the safety and security of bonds. In our view, the relevant point to be made from the chart now is that the relative valuation statistics as of the end of November 2007 look a lot more like those that prevailed at the bottom of the bear market than at the top of the previous bull market. Stocks are not quite as cheap now relative to bonds as they were in 2002, but nearly so, with the earnings yield on stocks more than 300 basis points higher than the 10-year Treasury note yield.

Based on November month-end valuation levels, we estimate fair value on the S&P 500 Index to be 18.8 times earnings. Even with the slight back-up in rates we've seen since month end, we believe fair value for the S&P 500 is still over 18 times earnings, versus current price/earnings multiples of 16.0 and 14.2 times consensus estimates for 2007 and 2008, respectively. The S&P 500 thus appears to us to be about 10% undervalued on 2007 estimates, and over 20% undervalued based on 2008 consensus numbers. That is as big a difference between market prices and fair valuation as we've seen for at least a year, and if earnings come through as forecast, 2008 could be a very good year for equity investors. Even allowing for the possibility that consensus 2008 estimates may be too high by 5% or so, we still see mid- to high-single-digit returns for 2008 as being a very reasonable expectation.

We believe 2008 could be a very different kind of year than 2007. The big surprise to investors could be a global growth slowdown. If we're right, 2008 may reward very different investment strategies than 2007 did. Expectations of a 2008 slowdown in U.S. GDP growth are widespread and fairly well discounted in the market, in our judgment. Some sectors—notably consumer discretionary and financials—are priced for recession, or nearly so. On the other hand, sectors such as energy, materials and industrial commodities are priced as though strength in emerging market economies will power them through any slowdown in the U.S. relatively unscathed. To the extent that proves not to be true, these groups could be vulnerable to disappointment because investor expectations are currently so elevated.

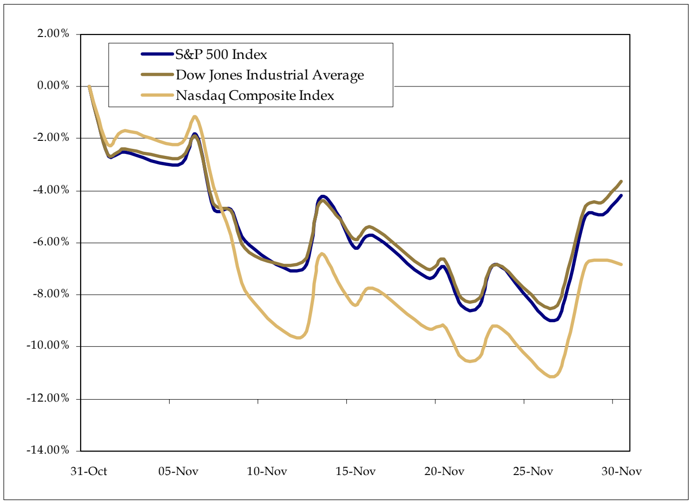
We think a global slowdown is more likely than many now seem to believe. Clearly, the U.S. is slowing, as is the U.K. Japan is not growing very fast, and the strength of the euro is likely, in our opinion, to cause a slowing of growth in Continental Europe. If the developed economies—which account for roughly 70% of world GDP—slow, that leaves it to the developing economies to pick up the slack. But most developing economies' customers are in the developed world. Not only that, but the Chinese central bank has been tightening credit conditions for nearly eighteen months in an effort to slow China's torrid growth rate and ease inflationary pressures. We expect them to continue to tighten until they achieve the result they want. China has been the marginal consumer of a wide range of industrial commodities. As an example, ISI Group's Francois Trahan told us in a recent meeting that he estimates China will consume more copper in 2007 than the U.S. and Japan combined. That's a lot of copper. Even a modest fall-off in Chinese demand could have a very material effect on the pricing of a number of industrial commodities, as well as the price of oil.

So, as is often the case with us, we find ourselves increasing our investment in areas such as financials, where fear and loathing are rampant, and underweighting or avoiding areas where optimism seems to us to be excessive or unjustified. We do not do this arrogantly, but with humility, recognizing that we could be wrong or early, but mindful that historically the most gut-wrenching decisions for us have also been the most profitable. Benjamin Graham said it better than we could, so we'll leave you with his admonition: "Have the courage of your knowledge and experience. If you have formed a conclusion from the facts and if you know your judgment is sound, act on it—even though others may hesitate or differ. (You are neither right nor wrong because the crowd disagrees with you. You are right because your data and reasoning are right.)"

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.

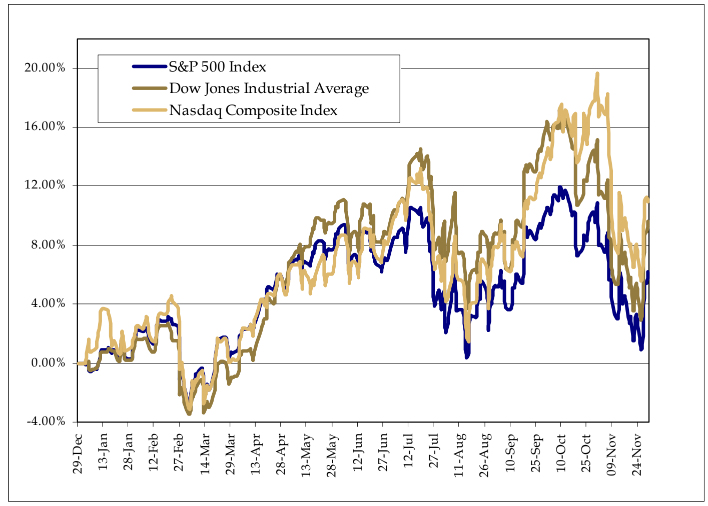
**David E. Nelson, CFA**
**Chairman, Investment Policy Committee**
**Legg Mason Capital Management**

## Major Indices November Performance




*Sources: Bloomberg and FactSet*

## Major Indices YTD Performance




*Sources: Bloomberg and FactSet*

## Monthly U.S. Market Update (Total Returns)

| Sector Index Name | November | QTD | YTD |
|---|---|---|---|
| *Broad Market Indices* | | | |
| S&P 500 | (4.18) | (2.66) | 6.23 |
| Dow Jones | (3.63) | (3.27) | 9.60 |
| Russell 1000 | (4.26) | (2.59) | 6.47 |
| NASDAQ | (6.84) | (1.36) | 10.95 |
| Dow Jones Wilshire 5000 | (4.46) | (2.63) | 6.26 |
| Russell 2000 | (7.18) | (4.52) | (1.50) |
| Russell 1000 Growth | (3.68) | (0.41) | 12.22 |
| Russell 1000 Value | (4.89) | (4.88) | 0.80 |
| *S&P 500 Sector Indices* | | | |
| S&P 500 Consumer Discretionary | (5.52) | (5.46) | (8.84) |
| S&P 500 Consumer Staples | 2.98 | 4.84 | 15.28 |
| S&P 500 Energy | (3.75) | (2.71) | 25.23 |
| S&P 500 Financials | (7.74) | (9.41) | (13.95) |
| S&P 500 Health Care | 1.12 | 3.09 | 10.50 |
| S&P 500 Industrials | (3.53) | (4.05) | 12.69 |
| S&P 500 Information Technology | (7.99) | (1.41) | 14.57 |
| S&P 500 Materials | (4.90) | (1.00) | 21.22 |
| S&P 500 Telecomm Services | (7.25) | (7.99) | 8.51 |
| S&P 500 Utilities | 0.56 | 7.27 | 19.07 |

*Sources: Bloomberg, FactSet, Russell, Wilshire*