

Market Commentary

The S&P 500's relatively modest March decline gave little hint of the tumultuous nature of market activity during the month. The U.S. equity market spent the month probing for a near-term bottom. The good news is that it looks as though it may have found it. The bad news is that it took the near-death of Bear Stearns to bring it about. The quarter as a whole was a bummer, with the S&P 500 down just under 10%, the Dow Industrials faring a bit better, down 7%, and the Nasdaq Composite seeing the worst of it, down nearly 14%.

TOTAL RETURNS

	March	Q1
S&P 500 Index	-0.43%	-9.44%
Dow Industrials	+0.11%	-7.00%
Nasdaq Composite Index	+0.41%	-13.88%
S&P Mid-Cap 400 Index	-1.02%	-8.85%
Russell 2000 Index	+0.42%	-9.90%
Dow Jones Wilshire 5000 Index	-0.69%	-9.52%
S&P 100 Index	+0.18%	-9.94%
Russell 1000 Growth Index	-0.61%	-10.18%
Russell 1000 Value Index	-0.75%	-8.72%

Sources: Bloomberg, Wilshire, Russell

Unlike last year, foreign markets provided no safe haven for investors as most overseas bourses fared even worse than the U.S. market in local currencies. The generally weak dollar made dollar-based returns a bit less painful, but still not pretty for the most part.

Q1 Total Returns

	Local Currency	Dollar-Based
FTSE Index (U.K.)	-10.36%	-10.19%
CAC 40 Index (France)	-16.12%	-9.07%
DAX Index (Germany)	-18.99%	-12.95%
NIKKEI 225 (Japan)	-17.55%	-6.86%
Hang Seng Index (H.K.)	-17.40%	-17.22%
Shanghai SE A Shares (China)	-34.01%	-31.26%
Kospi Index (So. Korea)	-10.18%	-15.20%

Source: Bloomberg

The Shanghai "A" share market was notably weak, down 34% in local currency terms, and down 31.3% in dollars. Pockets of strength were few and far between, as we could find only six foreign markets—Mexico, Taiwan, Thailand,

Pakistan, Sri Lanka and Bangladesh—that posted gains for the quarter.

Back in the U.S., sector returns for the month were mixed, with consumer staples (+3.35%) and telecomm services (+4.98%) leading the pack. Energy stocks (-2.63%) and financials (-2.73%)—which have tended to move in opposite directions in recent quarters—were weak together, as were health care (-4.90%) and materials (-1.11%) stocks. For the month, growth and value fought to a relative standstill, while value eked out a slight edge for the quarter. Sized-based trends were mixed for the month and almost indiscernible for the quarter, as small-, mid-, large- and mega-cap stocks were all down by roughly the same amount. Only the venerable Dow Industrials (-7.00%) stood out as most resistant to decline.

The most notable financial event of the month was, of course, the Fed-brokered acquisition of Bear Stearns by JPMorgan Chase. Fed Chairman Bernanke was adamant that the Fed's rescue operation was not a "bailout" of Bear Stearns. He noted in testimony before the U.S. Congress' Joint Economic Committee on April 2 that Bear Stearns shareholders "took a very significant loss," one that no other company was likely to be "interested in repeating." During the Q&A following his prepared remarks, Bernanke told committee members, "We did what we did because we felt it was necessary to preserve the integrity and viability of the American financial system, which in turn is critical for the health of the economy." In defending the Fed's decision to orchestrate Bear Stearns' rescue, Bernanke had said earlier, "Our financial system is extremely complex and interconnected, and Bear Stearns participated extensively in a range of critical markets. With financial conditions fragile, the sudden failure of Bear Stearns likely would have led to a chaotic unwinding of positions in those markets and could have severely shaken confidence. The company's failure could also have cast doubt on the financial positions of some of Bear Stearns' thousands of counterparties and perhaps of companies with similar businesses."

We think Chairman Bernanke's pointed reference to counterparty risk is significant, as we believe it was the underlying rationale for the Fed's actions. We believe the Fed was probably especially concerned about a possible meltdown in the market for credit default swaps (CDS), which, according to *The New York Times*, has grown from \$900 billion in 2001 to more than \$45.5 trillion currently. Bear Stearns was reportedly a \$2.5

trillion player in this market. As an aside, we find it fascinating—and not a little unnerving—that a market with a notional value of almost \$50 trillion could spring up so quickly to provide default insurance against corporate bonds whose total par value is only about \$2.5 trillion. In the event of any significant corporate default, it strikes us as virtually impossible to know who would owe what to whom. The failure of a major player—such as Bear Stearns—in this wholly unregulated market could also have had highly unpredictable and potentially catastrophic results. We believe the Fed acted rightly in preventing this from occurring.

In our opinion, Bear Stearns' loss of independence under the threat of bankruptcy is the most recent, and a particularly vivid, example of the risks posed to financial companies by a loss of market confidence. We believe that Bear Stearns was a very valuable entity right up to the moment when it agreed to be acquired for \$2 (subsequently raised to \$10) per share. In our view, the strongest evidence of Bear's value was that on the day its deal with JPMorgan Chase (JPM) was announced (3/17/08), JPM's stock popped 10.3%, a \$12.8 billion increase in market value that works out to \$87.93 per Bear Stearns share. Since the market was down and the financials were weak on March 17, we can think of no other reason for the rise in JPM stock except that investors recognized what a terrific deal JPM got on Bear.

So, if Bear was so valuable, why did it sell out for a small fraction of that value? The answer is that once market participants believed that Bear was in jeopardy, that belief alone *put* it in jeopardy. This phenomenon is akin to George Soros' theory of reflexivity, which posits that perception has the power to create its own reality. In our opinion, the shorts have used this principle of reflexivity to particular advantage since the decades-old "Uptick Rule" was rescinded in July 2007. Since then, short-selling hedge and quant funds have been able to pound stocks relentlessly, possibly helping their cause along with a well-placed rumor. We believe that financial stocks have proven to be especially susceptible to bear (no pun intended) raids since last July, because they are more highly leveraged than other companies and their businesses are based largely on confidence. If confidence can somehow be shaken, a problem may be created where none existed before. The extent to which the passing of the "Uptick Rule" has benefited the shorts is, of course, speculation on our part, but there is clear evidence that the overall volatility of the market has increased dramatically since the rule was eliminated. Birinyi Associates estimates that the Volatility Index (VIX) has averaged 10 points higher (23.25 vs. 13.25) since July 2007 and that the absolute value of each S&P 500 member's daily price change has increased more than 70% over that same period. Whether the elimination of the "Uptick Rule" caused this increase in volatility or is merely correlated with it, we cannot know for sure. One easy way to get more data would be to

bring back the "Uptick Rule" and see what happens. While we're pretty sure the shorts would not agree, we think it's worth a try.

Outlook

Primarily as a result of the Fed's aggressive actions to restore confidence and liquidity to the credit markets, the outlook for the U.S. equity market has improved considerably in the last month. We applaud the Fed's decision to supplement its Term Auction Facility and Term Securities Lending Facility with its newly established Primary Dealer Credit Facility, which allows non-depository primary dealers (investment banks) access to the Fed's discount window. We regret only that it took the near-failure of Bear Stearns to see the facility put in place. With the addition of the Primary Dealer Credit Facility to its other funding programs, the Fed has now given depository institutions and primary dealers—and, by extension, their customers and counterparties—access to nearly \$500 billion in funding resources. The early evidence is that the Dealer Credit Facility is being well used, as daily borrowings have averaged more than \$30 billion since the facility was introduced. Credit markets have responded positively to the enhanced liquidity. Spreads on a wide range of fixed-income instruments have narrowed and the credit markets have begun to free up, if only moderately.

The U.S. equity market has also given two thumbs up to the Primary Dealer Credit Facility, bottoming on the day it was made available (3/17) and rallying sharply the next day. As this is written (4/4), the S&P 500 is up almost 100 points (7.3%) since the facility was put in place.

Now that the credit markets appear to have begun to heal, we think the pieces are falling into place for a more sustainable upturn in the stock market. For one thing, investor sentiment remains quite negative, which, as a contrary indicator, is bullish. Investors have not just been talking bearish, they have been acting bearish. They have been bailing out of the U.S. equity market in droves and aggressively building cash. Retail and institutional money market funds now total nearly \$3.1 trillion, a record, and their year-over-year growth rate of over 40% is the highest since 1983. The dreary trifecta of declining stock and home prices, the interminable Iraq war and the shaky economy seems to have put consumers in an especially gloomy mood, with the most recent Conference Board survey of consumer expectations hitting its lowest reading since December 1973. It has historically been the case that the stock market puts in meaningful bottoms amidst an air of gloom and pessimism such as exists today in the U.S.

As we noted last month, at the same time that the public is pessimistic, corporate insiders have stepped up their buying meaningfully. This is another encouraging sign, as insiders

have a history of sensing favorable investment opportunities in their own companies' shares.

Given his outstanding recent record of calling market twists and turns, we were also heartened to see that veteran market technician John Mendelson turned bullish on March 17, the day the market made its recent bottom. How's that for timing! In his work, Mendelson—who also correctly called the beginning to the market's downturn in June 2007—looks for divergences that suggest that the market may be in for a change in direction. He sees a number of these in place currently, including: (1) a shrinking number of daily and weekly new lows on the NYSE from January to March despite a continued fall in the popular averages, suggesting to him that more and more stocks were resisting decline; (2) relative strength in the Dow Jones Transportation Index vs. the Dow Industrials and S&P 500, which offers early evidence that the economy may be healthier than many now believe; and (3) relative strength in his proprietary "Last Hour Indicator," which compares the action of the market in the last hour of trading to the action during the remainder of the trading day under the theory that the "smart" money tends to act late in the day, and buying in the last hour in the face of an otherwise weak market often portends a change in market direction.

Mendelson is also encouraged by the high level of shorting and put buying, which is normally in evidence near market lows. Finally, Mendelson's somewhat crudely—but certainly descriptively—named "Diaper Indicator" has flashed its first buy signal since March 11, 2003, an important market low. Mendelson's "Diaper Indicator" measures the difference between advancing and declining volume and its rate of change. He looks for "highly emotional action" to identify market bottoms under his oft-stated theory that "there has never been an intellectual low." Mendelson's "Diaper Indicator" gave a buy signal at the market close on March 17, with the S&P 500 at 1276.60.

In addition to the technical indicators that are suggestive of a market low, we also find the valuation level of the market to be supportive of a constructive view on equities. Even after adjusting our equity risk premium upward from 4% to 4.5% to build in an additional margin of safety in an uncertain economic environment, we still estimate the fair value multiple of the S&P 500 Index to be about 18 times earnings, versus a current P/E ratio of about 14.2 times the index's 2008 bottom-up, cap-weighted consensus estimate of \$96. With the U.S. economy continuing to weaken, the consensus estimate remains somewhat at risk, but even were it to fall to \$85 to \$90, the S&P 500's multiple would still be in the range of 15 to 16 times, for an earnings yield of 6.25% to 6.66%. This is attractive, we believe, in the context of a 3.50% 10-year Treasury.

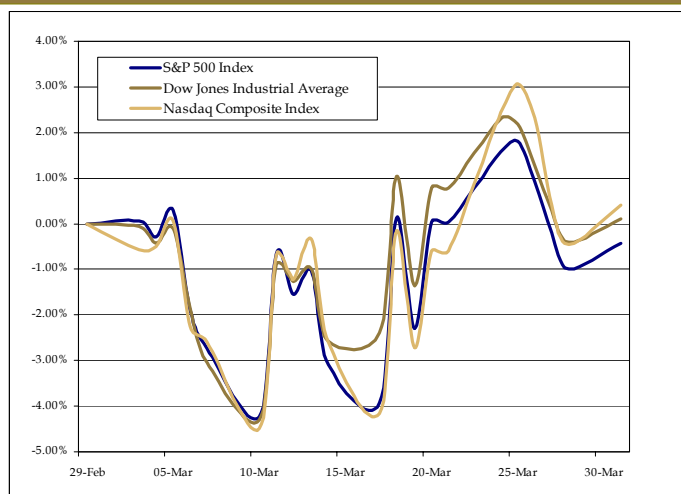
Despite our constructive view on equities, we recognize that we are far from out of the woods. The credit markets—though they have begun to improve in our judgment—are still not functioning properly, and the healing process will take time. Corporate earnings remain somewhat at risk, as we noted, and another round of financial sector write-downs in the first quarter of 2008 seems likely. That said, we do think there's a reasonably good chance that the market has discounted most or all of the bad news, and that the March 17 low on the S&P 500 will hold.

In terms of our own performance expectations, we believe that after a period of very disappointing results, our valuation-based investment approach is poised to do better. According to data from Empirical Research, valuation spreads between the cheapest and most expensive stocks in the market now stand at one standard deviation above their long-term average. Empirical's work shows that it historically has paid handsomely to bet on valuation when spreads are this wide. Specifically, their work indicates that the top quintile of valuation in their core model generated excess returns of 1200 basis points when valuation spreads were more than 0.5 standard deviations above average, about twice their long-term average excess return in all other periods. Early indications on performance trends for the new quarter are very favorable, and we are optimistic about our prospects for delivering much improved results to our clients.

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

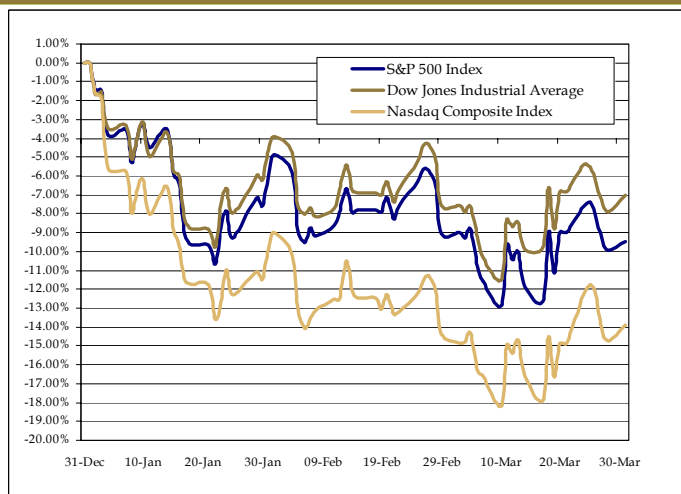
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Major Indices March Performance



Sources: Bloomberg and FactSet

Major Indices YTD Performance



Sources: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

Index Name	March	Q1
<i>Broad Market Indices</i>		
S&P 500	(0.43)	(9.44)
Dow Jones	0.11	(7.00)
Russell 1000	(0.68)	(9.48)
NASDAQ	0.41	(13.88)
Dow Jones Wilshire 5000	(0.69)	(9.52)
Russell 2000	0.42	(9.90)
Russell 1000 Growth	(0.61)	(10.18)
Russell 1000 Value	(0.75)	(8.72)
<i>S&P 500 Sector Indices</i>		
S&P 500 Consumer Discretionary	(0.79)	(5.88)
S&P 500 Consumer Staples	3.35	(2.21)
S&P 500 Energy	(2.63)	(7.19)
S&P 500 Financials	(2.73)	(13.96)
S&P 500 Health Care	(4.90)	(11.52)
S&P 500 Industrials	3.24	(3.94)
S&P 500 Information Technology	0.95	(15.19)
S&P 500 Materials	(1.11)	(3.02)
S&P 500 Telecomm Services	4.98	(13.73)
S&P 500 Utilities	1.67	(9.94)

Sources: Bloomberg, FactSet, Russell, Wilshire

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