

Market Commentary

All of the major U.S. equity market indices we track on a regular basis posted positive returns for the month of August. The Russell 2000 Index led the pack, up +3.60% for the month, and is now the best-performing index on a quarter-to-date and year-to-date basis. The strength of the Russell 2000 is one piece of evidence of what looks to us like a growing preference for things domestic, as the strengthening U.S. dollar and slowdown overseas has cooled investors' ardor for the global trade that has dominated the investment landscape for the last couple of years.

TOTAL RETURNS

	August	QTD	YTD
S&P 500 Index	+1.45%	+0.59%	-11.39%
Dow Industrials	+1.81%	+2.25%	-11.43%
Nasdaq Composite Index	+1.92%	+3.40%	-10.23%
S&P MidCap 400 Index	+1.71%	-0.17%	-4.07%
Russell 2000 Index	+3.60%	+7.43%	-2.62%
Dow Jones Wilshire 5000 Index	+1.56%	+0.69%	-10.31%
S&P 100 Index	+1.44%	+2.14%	-12.37%
Russell 1000 Growth Index	+1.08%	-0.85%	-9.83%
Russell 1000 Value Index	+1.70%	+1.33%	-12.42%

Sources: Wilshire, Russell®, NASDAQ® via (Bloomberg), S&P via (Bloomberg)

S&P 500 sector returns gave further evidence of increasing investor interest in domestically oriented stocks as consumer discretionary stocks were the best performers in the S&P 500 for the month, up +7.21%, followed by telecom services (+3.61%), consumer staples (+2.65%) and technology (+2.18%). Energy (-0.54%) and materials (-2.59%) stocks continued their recent weakness in August, dragged down by continued declines in oil and commodities prices. Financial (-1.08%) and utilities (-1.40%) stocks joined energy and materials on the downside. The financials have generally given a good account of themselves since mid-July but were side-tracked in August by continued unsettled conditions in the credit markets, largely triggered, in our view, by the now moot debate among market observers and participants as to whether the GSEs, Freddie Mac and Fannie Mae, are adequately capitalized or not.

Investors' emerging preference for U.S. stocks is most clearly illustrated by comparing domestic and overseas returns for the month. In contrast to the U.S., the equity markets in the U.K., Germany, France, Russia, Japan, Hong Kong, South Korea, China, and India were all down in August in dollar terms. Of these markets, only Japan is outperforming the U.S. equity market on a year-to-date basis. Even markets such as the U.K., France, and India, which posted positive returns in their local currencies, saw those returns driven negative by the surging U.S. dollar. The strength of the dollar in August was quite striking and a big change from the pattern of recent years.

	August Returns (%)	
	Local Currency	U.S. Dollars
FTSE 100 Index (U.K.)	+4.91%	-3.79%
DAX Index (Germany)	-0.88%	-6.92%
CAC 40 Index (France)	+2.06%	-4.16%
MICEX Index (Russia)	-9.79%	-14.25%
NIKKEI 225 (Japan)	-2.24%	-2.96%
Hang Seng Index (HK)	-6.19%	-6.22%
Kospi Index (So. Korea)	-7.55%	-14.11%
Shanghai SE Comp.(China)	-13.61%	-13.69%
BSE Sensex 30 Index (India)	1.61%	-1.75%

Source: Bloomberg

Now that both the Republicans and Democrats have officially nominated their candidates for president and vice president, we thought an election update might be timely. While there are still two months left in the campaign, it seems clear that the Republicans face a daunting challenge to hold on to the White House. Most opinion polls now show Senator Barack Obama ahead of Senator John McCain by six to eight points. Bettors at online prediction market Intrade.com rate Obama about a three-to-two favorite to beat McCain. Two quantitative models developed by well-regarded presidential historians also suggest that Obama has high odds of winning in November. At this point, we think the percentage bet is that Senator Obama will, in fact, be our next president, but the Electoral College vote could be tighter than the popular vote.

Greg Valliere, a well-regarded political observer with Stanford Group in Washington D.C., recently detailed his current take on the Electoral College math as follows:

Safe Obama: California (55), Connecticut (7), Delaware (3), District of Columbia (3), Hawaii (4), Illinois (21), Maine (4), Maryland (10), Massachusetts (12), New Jersey (15), New York (31), Oregon (7), Rhode Island (4), Vermont (3), Washington (11). Total: 190.

Leaning Obama: Iowa (7), Michigan (17), Minnesota (10), New Mexico (5), Pennsylvania (21), Wisconsin (10). Total: 70.

Safe McCain: Alaska (3), Arkansas (6), Idaho (4), Kentucky (8), Nebraska (5), Oklahoma (7), South Carolina (8), Tennessee (11), Texas (34), Utah (5), Wyoming (3). Total: 94.

Leaning McCain: Alabama (9), Arizona (10), Florida (27), Georgia (15), Indiana (11), Kansas (6), Louisiana (9), Mississippi (6), Missouri (11), Montana (3), North Carolina (15), North Dakota (3), West Virginia (5). Total: 130.

Tossup: Colorado (9), Nevada (5), New Hampshire (4), Ohio (20), South Dakota (3), Virginia (13). Total: 54.

Based on Mr. Valliere's assessment, Senator Obama currently has 260 Electoral College votes safe or leaning his way, while Senator McCain has 224. With 270 electoral votes necessary for victory, if Valliere's assessment is correct, then McCain needs to win nearly

all the tossup states to win, while Obama must win either Ohio (20) or Virginia (13) to prevail.

The two quantitative models referred to above that predict the Democrats will win the White House were developed by two professors, Allan Lichtman of American University and Alan Abramowitz of Emory University. We recently learned of these gentlemen's work from a July 10, 2008 piece by Citigroup Strategist Ed Kerschner entitled "Election '08: Back to the Future?" As described by Ed Kerschner, Professor Lichtman's model is based on "13 diagnostic questions that are stated as propositions that favor re-election of the incumbent party. When six or more of these propositions are false, the party in power loses the White House." Lichtman's 13 questions deal with a number of issues including, whether the incumbent is the sitting president, the presence or absence of a third-party candidate, the general state of the economy, whether the incumbent party has achieved any military victories or suffered any defeats, and the charisma (or lack thereof) of the incumbent party candidate and the challenger. The model has been very effective "having retrospectively accounted for the popular vote winners of every presidential election from 1860 to 1980, and prospectively forecast the popular vote winners of all six presidential elections from 1984 to 2004." The model currently counts only four keys as favoring re-election of the incumbent party, seven against, and two uncertain.

The model developed by Professor Alan Abramowitz of Emory University, called the "Electoral Barometer" is far simpler. Again, as described by Ed Kerschner, the model looks at only three factors: "the incumbent president's approval rating at mid-year, the growth rate of the economy during the second quarter of the election year, and the length of time the president's party has held the White House." The higher the president's approval rating and the stronger the growth rate of the economy, the more likely it is that the incumbent will win. However, if the incumbent is finishing a second term, a change in the party controlling the White House is far more likely, irrespective of the incumbent's popularity or the state of the economy.

The formula for computing the Electoral Barometer is the president's net approval rating in the Gallup Poll, plus five times the annual growth rate of real GDP, minus 25 if the president's party has held the White House for two terms or longer. Since World War II, the Electoral Barometer readings have ranged from -66 in 1980 to +82 in 1964, with a positive reading favoring retention of the incumbent party and a negative reading predicting a change in the party in power. The current Electoral Barometer reading is a grim (from the point of view of the Republicans) -63, the second worst reading since World War II and exceeded only by the -66 reading prior to the 1980 election, won in a landslide by Ronald Reagan over sitting president Jimmy Carter. Senator McCain thus faces the "triple Whammy" of trying to follow a very unpopular second-term president presiding over a weak economy. I do not envy his position.

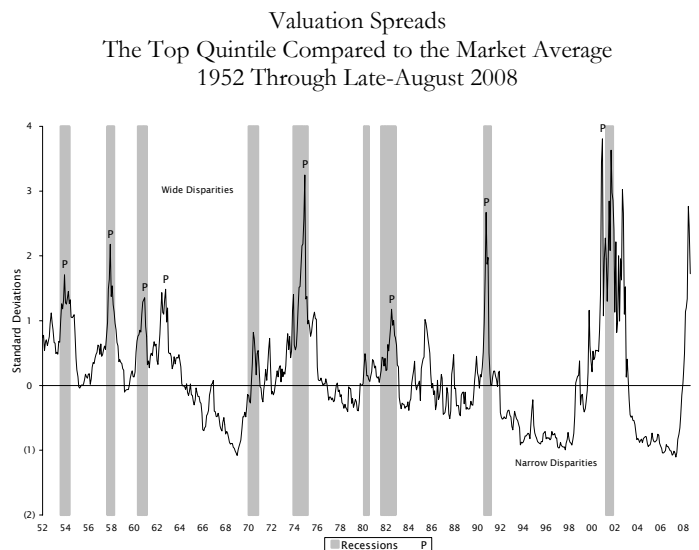
Outlook

Many market observers seem to be giving up on the idea of any kind of meaningful rally developing before year end. As this is written, the S&P 500 Index appears to be in the process of retesting its July 15 closing low of 1,214.91. Many believe that the July lows will not hold and that the market is vulnerable to a further 10% to 15% decline. Bears cite a number of concerns in support of their less-than-sanguine view of the market, including continuing unsettled conditions in the credit markets, a deteriorating economic outlook both here and abroad, and corporate profit expectations that are still too high, in

their judgment. We see merit in all of these concerns and none can be dismissed out of hand, but the key question, in our opinion, is whether or not these concerns are already adequately discounted in the market's current pricing structure. We think it is very possible that investors' preoccupation with what could go wrong has obscured their view of what could go right. Bearish investors seem to be forgetting that markets always bottom when the news is bad, when sentiment is negative, and when the outlook is murky. We see a number of signs that suggest to us that the market is near an important bottom and that the surprise over the next year or two could turn out to be how well the U.S. equity market performs, not how badly it does.

We cited a recent Conference Board survey last month that revealed that 55% of respondents thought that stock prices would decline in the next twelve months, the highest percentage in the 21-year history of the survey. In the past, when the percentage of bearish respondents has exceeded 36%, the market has risen, not fallen, in the next year by an average of over 20%. The tendency has also been that the more bearish the respondents, the better the market performed in the year ahead. The recent record number of survey bears is thus bullish for the market outlook, in our view.

The chart below is another important reason why we are more bullish about the market outlook than many others seem to be. The chart is one we've referenced before and comes to us courtesy of Empirical Research Partners. It shows valuation spreads (measured in standard deviations from the mean) between the cheapest quintile of stocks in the market and the market average. The "Ps" on the chart denote the eight prior cyclical peaks in valuation spreads back to 1952. We believe the ninth cyclical peak in valuation spreads may be occurring now. Valuation spreads reached their recent high in June 2008 at 2.76 standard deviations above the norm. Spreads narrowed in July to 2.46, and again in August to 1.72. Note that past peaks have tended to be like fevers that spike up sharply, and then fall equally sharply. Note, too, that seven of eight valuation spread peaks since 1952 have occurred during recessions. So, if the economic weakness we are currently experiencing is ultimately classified as a recession, it would be entirely consistent with history that valuation spreads were, indeed, peaking now.



Source: Empirical Research Partners Analysis, National Bureau of Economic Research

If—as we believe is increasingly likely—valuation spreads are peaking, that should be very bullish for valuation-based strategies such as ours. It should also be quite bullish for the market as a whole, as illustrated below. The table below shows the *relative* returns (equal-weighted) for the top quintile of valuation (as measured by Empirical Research Partners valuation super factor) and the *absolute* returns (cap-weighted) of the 1,000 largest capitalization stocks in the U.S. market for the one- and two-year periods following a peaking in valuation spreads.

Relative Returns to Top-Quintile of Valuation and Nominal Returns for Large-Cap Stocks After Peaks in Valuation Spread Levels (1952 Through Late-August 2008)

Peak Date:	Top Quintile of Valuation Measured Over:		Large-Cap Stock Returns Measured Over:	
	One-Year	Two-Years	One-Year	Two-Years
Dec-53	+17.7 %	+25.4 %	+50.0 %	+90.0 %
Dec-57	11.0	14.8	43.9	62.5
Dec-60	10.9	19.5	26.9	14.3
Oct-62	5.5	13.2	34.2	57.6
Dec-74	25.8	78.0	35.9	68.8
Jul-82	9.1	26.6	60.2	52.4
Oct-90	22.1	38.6	35.1	48.5
Dec-00	38.1	49.2	(13.6)	(32.3)
Average Above	17.5 %	33.2 %	34.1 %	45.2 %

Source: Empirical Research Partners

As the table reveals, after the prior eight peaks in valuation spreads going back to 1952, the top quintile of valuation outperformed the market by an average of 1,750 basis points over the next year and 3,320 basis points over the next two years. In no instance did it fail to outperform. In seven of eight instances, the stock market itself was very strong, showing an average gain over all eight periods of 34.1% over one year, and 45.2% over two years. December 2000 was the one instance in which the market was not up substantially following a peaking of valuation spreads. We have not analyzed the data, but we strongly suspect that the massive overvaluation of the mega-cap stocks at that time, and their subsequent substantial underperformance, pulled down cap-weighted returns during the next one- and two-year periods. We further suspect that equal-weighted returns were likely much better. In any event, the powerful outperformance of valuation-based strategies from December 2000 over the next one-year (+38.1%) and two-year (+49.2%) periods more than offset the weak overall market to produce positive returns.

Our valuation work also continues to suggest that a positive view of the market is warranted. Using the current 10-year Treasury yield of 3.65% and a 4.50% equity risk premium, our work indicates that the S&P 500 Index would be fairly valued at 18 times earnings, compared to current multiples of about 15.5, 14.3 and 11.7 times trailing-year, current-year, and forward-year earnings estimates, respectively. On 2009 estimated earnings, the S&P 500 has, theoretically at least, upside to fair value of more than 50%. We think the market is hedging its bets on a couple of fronts such that the actual upside over the next year—while attractive—is probably more like 15% to 20% than 50%.

A P/E multiple of 11.7 for 2009 implies S&P 500 EPS of nearly \$110 next year. We think that's optimistic. The top-down consensus estimate for 2009 is \$98.53, according to Strategas Research Partners. That equates to a P/E of 13 times, based on the S&P 500's August month end close of 1282.83. That is probably closer to right in our view.

Top-down estimates tend to be more accurate when the economy is weak.

Another impediment to the market trading closer to its fair value could well be investor worries about the tax regime of the new administration, which is likely to be Democratic, in our view. Investors will be focusing closely on likely winner Obama's intentions with respect to dividends and capital gains over the next two months. It seems clear that tax rates on both dividends and capital gains are going up (probably even under a McCain administration), the question is by how much. We remember seeing an analysis from Strategas Research last year that indicated that if capital gains tax rates go from 15% back to 28%, and tax rates on dividends revert from 15% to the rate schedule for ordinary income, it could knock two multiple points off the fair value of the market. We don't think it will end up being that bad, but clearly the impact of probable increases in dividend and capital gains tax rates must be factored into investors' thinking. The bottom line is that, even after accounting for the likelihood that bottom-up earnings estimates are too high and taxes on dividends and capital gains are going up, we still believe the market is meaningfully undervalued.

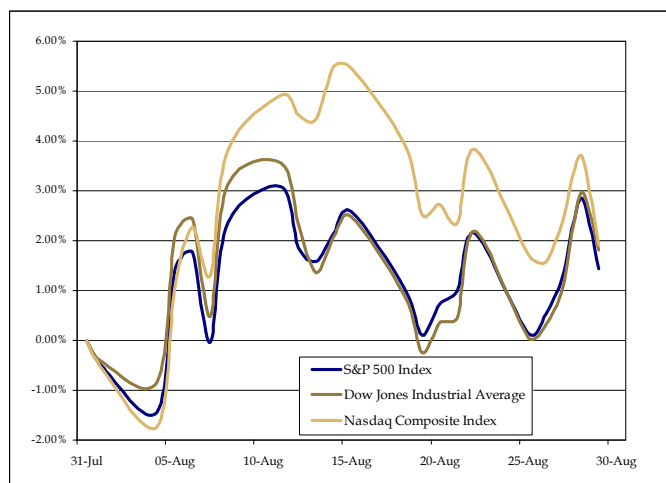
Over the past weekend, as this monthly was being edited, Treasury Secretary Paulsen took steps to place the GSEs—Freddie Mac and Fannie Mae—into conservatorship, protecting the interests of debt holders while severely diluting (but not wiping out) the interests of common and preferred shareholders. As common shareholders ourselves, we recognized this outcome as a risk, but did not believe that it needed to happen or would happen. At this writing, we are evaluating our options. Our principal regret—apart from the obvious incremental losses to clients—is that we will now never know whether or not our economic analysis of the GSE's position was correct, because it was not allowed to play out. In hindsight, we clearly underestimated the powerful political and governmental forces that would align to abrogate shareholders' rights in the interest of the "greater good."

As common shareholders, we are obviously very disappointed with this outcome, but in a broader sense, we recognize that restoring market confidence in the GSEs is a crucial step in the healing process that needs to occur and that we believe is underway in the U.S. financial system. Agency spreads have narrowed meaningfully in the wake of the Treasury's actions, and mortgage rates have dropped as well. We are not out of the woods yet, however. In particular, we'd like to see a continued narrowing of credit spreads and a return to more normal conditions in the fixed-income markets. That said, we remain far more constructive on the outlook for the U.S. equity markets than many other observers.

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

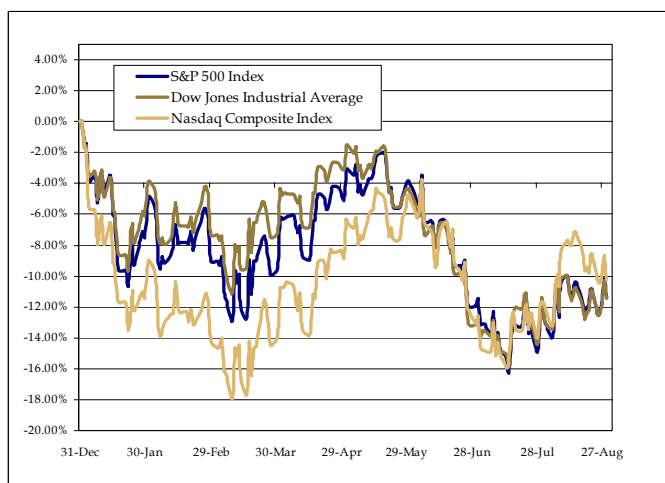
David E. Nelson, CFA
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Major Indices August Performance



Sources: Wilshire, NASDAQ® via (Bloomberg), S&P via (FactSet)

Major Indices YTD Performance



Sources: Wilshire, NASDAQ® via (Bloomberg), S&P via (FactSet)

Monthly U.S. Market Update (Total Returns)

Index Name	August	QTD	YTD
<i>Broad Market Indices</i>			
S&P 500	1.45	0.59	(11.39)
Dow Jones	1.81	2.25	(11.43)
Russell 1000	1.38	0.20	(11.02)
NASDAQ	1.92	3.40	(10.23)
Dow Jones Wilshire 5000	1.56	0.69	(10.31)
Russell 2000	3.60	7.43	(2.62)
Russell 1000 Growth	1.08	(0.85)	(9.83)
Russell 1000 Value	1.70	1.33	(12.42)
<i>S&P 500 Sector Indices</i>			
S&P 500 Consumer Discretionary	7.21	7.74	(6.51)
S&P 500 Consumer Staples	2.65	6.16	(1.73)
S&P 500 Energy	(0.54)	(14.41)	(6.81)
S&P 500 Financials	(1.08)	5.99	(25.52)
S&P 500 Health Care	2.04	7.20	(6.32)
S&P 500 Industrials	1.94	3.79	(10.38)
S&P 500 Information Technology	2.18	0.91	(12.29)
S&P 500 Materials	(2.59)	(6.55)	(5.37)
S&P 500 Telecomm Services	3.61	(2.49)	(19.36)
S&P 500 Utilities	(1.40)	(7.46)	(10.01)

Sources: Wilshire, Russell®, NASDAQ® via (Bloomberg), S&P via (FactSet)

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