

Market Commentary

Global equities markets were severely damaged in September, undergoing a meltdown that has only accelerated during the first seven days of trading in October. The Dow Industrials were the standout performer for the month domestically, down “only” -5.83%. As shown below, the S&P 500 Index shed -8.91%, while the broader based Dow Jones Wilshire 5000 Index lost nearly -10%.

TOTAL RETURNS

	September	QTD	YTD
S&P 500 Index	-8.91%	-8.37%	-19.29%
Dow Industrials	-5.83%	-3.72%	-16.60%
Nasdaq Composite Index	-11.60%	-8.59%	-20.64%
S&P MidCap 400 Index	-10.71%	-10.87%	-14.35%
Russell 2000 Index	-7.97%	-1.11%	-10.38%
Dow Jones Wilshire 5000 Index	-9.30%	-8.67%	-18.64%
S&P 100 Index	-7.82%	-5.85%	-19.22%
Russell 1000 Growth Index	-11.58%	-12.33%	-20.27%
Russell 1000 Value Index	-7.35%	-6.11%	-18.85%

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

As bad as returns were in the U.S., they were worse overseas. In dollar terms, markets in the U.K., Germany, France, Russia, Japan, South Korea and India all dropped more than the broadest based U.S. index, the Wilshire 5000. Of the major foreign bourses, only China fared better than the U.S. market, down -4.26% for the month. There was little to cheer about even in Shanghai, as that market has lost more than -60% in value since its October 2007 high.

September Returns (%)

	Local Currency	U.S. Dollars
FTSE 100 Index (U.K.)	-12.83%	-14.61%
DAX Index (Germany)	-9.21%	-12.78%
CAC 40 Index (France)	-9.88%	-13.42%
MICEX Index (Russia)	-23.82%	-26.82%
NIKKEI 225 (Japan)	-13.29%	-11.17%
Hang Seng Index (HK)	-14.74%	-14.31%
Kospi Index (So. Korea)	-1.78%	-10.35%
Shanghai SE Comp.(China)	-4.11%	-4.26%
BSE Sensex 30 Index (India)	-11.62%	-17.67%

Source: Bloomberg

September’s dismal market performance has proven to be a mere warm-up act for the gut-wrenching global meltdown that has occurred during the first seven trading days in October. Through Thursday, October 9, the S&P 500 Index is down -21.9% for the month to date, boosting year-to-date losses to -37.0% and the fall from last October’s high to -40.6%. The carnage has sent investors scurrying for the safety and security of short-term U.S. Treasuries, whose yields have dropped to as little as a few basis points on a couple of occasions in the last few weeks.

So what happened? Why has investor confidence been so shaken? While we can’t yet say definitively, we’re inclined to agree with the view of GaveKal’s Anatole Kaletsky and others that the serious trouble began on September 7, when Treasury Secretary Henry Paulson placed Freddie Mac and Fannie Mae into conservatorship despite the fact that each was then in full compliance with all existing regulatory capital requirements. By effectively throwing Freddie and Fannie common and preferred shareholders under the bus in the interest of “preserving the system,” Paulson sent a message to the market that equity shareholders had been bad and needed to be punished. In Mr. Kaletsky’s words: “After what Mr. Paulson did [to] investors who had poured \$20 billion into Fannie and Freddie preferred stocks since last November—with the strong support and encouragement of the U.S. Treasury itself—what conclusions would a rational investor draw about recapitalizing U.S. financial institutions in the future? The answer is obvious: No rational investor anywhere in the world will dream of helping to recapitalize any U.S. financial institution that could conceivably run into trouble and require government support. In fact, it would seem extremely rash to put money even into seemingly healthy U.S. institutions, if these could be suddenly declared undercapitalized or insolvent by a change of [regulatory] or accounting requirements, which is basically what happened to Fannie and Freddie, after Congress passed the Housing and Economic Recovery Act in July.”

The market uncertainty created by the Treasury’s manhandling of the GSEs was exacerbated by its quasi-nationalization of AIG on extremely punitive terms to common and preferred shareholders. Next in the line of confidence-shaking events was the Lehman bankruptcy. Unlike J.P. Morgan Chase’s takeover of Bear Stearns where debt-holders were protected, in the Lehman bankruptcy, debt-holders were left to fend for themselves. The subsequent massive losses experienced

by Lehman debt-holders led to tumult for money-market funds and caused the Reserve Fund, the largest and one of the oldest U.S. money funds, to “break the buck,” precipitating a mini-run on money-market funds generally. Once the safety of money-market funds came into question, anxiety levels among institutional investors and the general investing public soared. Demand for commercial paper and other forms of non-governmental short-term debt dried up as money fund operators shunned nearly everything but short-term U.S. Treasuries. The threat of a full-blown run on the \$3.5 trillion money-market business was, in our view, the precipitating event for the Treasury’s \$700 billion bailout proposal.

As the world watched the legislative process surrounding the bailout plan, it became clear that there is more than a little truth to the old saw that there are two things you don’t want to see made: sausage and legislation. In one end of the meat-grinder went a three-page memo from Secretary Paulson outlining the plan. Out the other end came a 451-page, pork-laden monstrosity dubbed the Troubled Asset Recovery Plan (TARP). While TARP is far from perfect, we thought at the time it passed that it was better than no bill at all. Given the market’s extreme weakness since the legislation was enacted, we may need to revise our view. The basic flaw in the bill, in our opinion, is that it provides strong disincentives to participate and may not, therefore, be as effective as was intended. For example, sellers of so-called troubled assets to the government are required to grant the government some form of incremental compensation such as warrants, preferred stock or debt, even if the purchased assets are subsequently resold by the government at a profit. We think many prospective sellers may find this unappealing. The anti-equity spirit of the bill is likely, in our opinion, an important reason why the market has been so weak since its passage.

In real estate investing, experts say the three most important factors to consider are: location, location and location. In the stock market, we believe the three most important factors to consider today are: confidence, confidence and confidence. Once confidence is lost, as it has been lately, it is very difficult to restore. Prices drop with no regard for valuation until someone is willing to step in and buy. But unlike a half-off sale at Macy’s, stock market buyers are not attracted to bargains. Instead of lining up around the block to buy, they run the other way. A year ago, investors were eagerly buying stocks with the Dow Industrials over 14,000. Today, investors are abandoning the market in droves with the Dow under 8600. It is ever thus and always will be. Most people are not wired properly to be successful investors. Hundreds of thousands of years of human history have wired their brains to seek pleasure and avoid pain. Since studies show that a loss of a given magnitude is twice as painful as a gain of similar size is pleasurable, it should be

no surprise that lower prices are now producing urgent selling rather than eager buying.

As an illustration of how “unnatural” a rational investment process is for the average person to employ, another study by Antonio Damasio and others found that individuals whose brains had been damaged in such a way as to prevent them from experiencing emotions outperformed a group of individuals with “normal” brain function in an investment experiment. Both groups were given the opportunity to participate in a series of coin-flips where the payoff for winning exceeded the cost of losing. Since the expected value of each round was positive, the rational thing to do was play every time, which is exactly what the brain-damaged participants did. In contrast, the “normal” group let their experience in prior rounds affect their decision to play in subsequent rounds. If they won, they kept playing. If they lost a few times, they began sitting out rounds, even though the odds had been structured to be in their favor each round. At the end of the exercise, the brain-damaged group had accumulated more money than the normal group because they kept playing.

Outlook

With the benefit of hindsight, we have obviously been wrong to be as constructive on the market as we have been. Since the middle of last year, it has paid handsomely to be cautious, skeptical and defensive. The correct posture has been to assume that the situation would continue to deteriorate, rather than look for reasons that it might improve. We are optimists by nature, a trait that has served us well over the long haul, but not recently. We thought the market might be turning in January and again in March, following the takeover of Bear Stearns. The May bottom also looked promising, and we really thought the July low would hold. It did not. We now find ourselves in early October with the Dow Industrials at 8579.19 and the S&P 500 at 909.92.

Having been prematurely bullish—and wrong—on the market, is it now proper to be bearish or to equivocate? We think not. As humbly as we can, we state that we believe investors are now being afforded one of the best buying opportunities of their lifetimes, comparable, in our view, to the opportunities presented at the bottoms of the bear markets of 1974 and 1982. If we are wrong about that, we will have yet another reason to apologize. Even if we’re right—and we see a lot of indicators that suggest to us that we might be—few people will have the courage to take advantage of the opportunity. The market is in full panic mode. Selling is begetting more selling. Mutual funds are selling to meet redemptions. Hedge funds are selling to reduce leverage and meet redemptions of their own. When will the selling end? We don’t know. What will end it?

We're not sure. We know only that the market appears significantly undervalued to us now, that anxiety levels—as measured by the VIX, the TED Spread, credit spreads and the miniscule yields on short-term Treasuries—are through the roof and pessimism about the outlook for stocks and the economy is rampant.

While valuation doesn't seem to matter much right now, ultimately we believe it will. We continue to put the fair value multiple of the S&P 500 at 17.4 times earnings, based on a 6% long-term growth rate, a 10-year Treasury rate of 3.83% and an equity risk premium of 4.50%. The difficult task right now is trying to figure out what earnings will be. According to the latest figures from Standard and Poor's website, the current bottom-up consensus earnings estimates for the S&P 500 Index for 2008 and 2009 are \$77.60 and \$104.15, respectively, implying earnings multiples of 11.7 and 8.7, respectively, for 2008 and 2009. The 2008 estimate could be close, but the 2009 estimate looks way too high to us now. We believe it is highly likely that the U.S. economy has fallen into recession, with negative implications for corporate earnings. S&P's top-down estimates seem more reasonable to us, and perhaps even conservative. They show S&P 500 Index earnings being roughly flat in 2009 over 2008 at \$68.52, implying an earnings multiple of 13.3 on both this year's earnings and next. Another way of looking at it is to say that earnings would have to fall below \$52.25 in 2009 in order for the market to be overvalued on our work.

Veteran market strategist Steve Leuthold normalizes earnings by using a five-year average to get around the difficulty of estimating earnings at economic turning points. His latest work indicates that as of October 3, 2008, the S&P 500 Index was trading at a normalized P/E of 14.8 times, implying normalized earnings as of that date of about \$74.25. Using that estimate and the S&P 500's October 9, 2008 closing low of 909.92, the S&P is currently trading at 12.3 times normalized earnings, versus a median value of 18.6 times, and an average value of 18.0 times earnings since 1957, according to Leuthold.

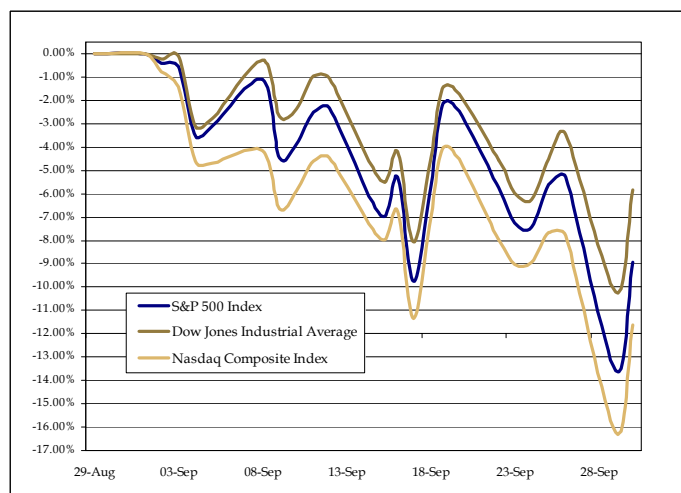
Leuthold, who is also currently bullish, notes in his latest *View from the North Country* (October 2008) that investors' longer-term returns are heavily influenced by the multiple of earnings they pay at time of purchase. Buying when stocks are in the bottom 30% of their range in terms of normalized P/E (as they are now) has produced 1- and 10-year annual compound total returns of 17.4% and 15.5%, respectively. Buying when stocks are in the top 30% of their range (as they were in the middle of last year) has produced 1- and 10-year annual compound total returns of 7.0% and 7.5%, respectively, not horrible, but well below average and nothing like the opportunity that presents itself today.

As we noted earlier, human beings are not naturally wired to be great investors. We believe the converse of this is also true. Great investors are wired differently than most human beings. One great investor—perhaps the greatest of our time—after sitting on a mountain of cash for several years, is now committing a sizeable chunk of that cash to the market. We're talking about Warren Buffett, who has invested nearly \$13 billion in three companies—Constellation Energy (\$4.7 billion), Goldman Sachs (\$5 billion) and General Electric (\$3 billion)—over the last few weeks. That's \$13 billion that we know about. Remembering Buffett's famous admonition to be "fearful when others are greedy, and greedy when others are fearful," we were fascinated to hear him say in a recent television interview that he has rarely seen investors more fearful than they are right now. We think it's safe to say that the \$13 billion of announced deals are not his only recent purchases. In our opinion, investors should follow Mr. Buffett's example.

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

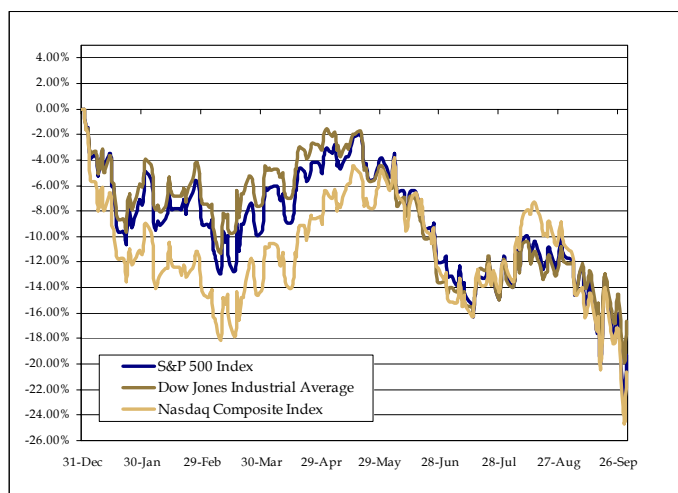
David E. Nelson, CFA
Chairman, Investment Policy Committee
Legg Mason Capital Management

Major Indices September Performance



Sources: 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	September	Q3	YTD
<i>Broad Market Indices</i>			
S&P 500	(8.91)	(8.37)	(19.29)
Dow Jones	(5.83)	(3.72)	(16.60)
Russell 1000	(9.53)	(9.35)	(19.50)
NASDAQ	(11.60)	(8.59)	(20.64)
Dow Jones Wilshire 5000	(9.30)	(8.67)	(18.64)
Russell 2000	(7.97)	(1.11)	(10.38)
Russell 1000 Growth	(11.58)	(12.33)	(20.27)
Russell 1000 Value	(7.35)	(6.11)	(18.85)
<i>S&P 500 Sector Indices</i>			
S&P 500 Consumer Discretionary	(7.79)	(0.65)	(13.79)
S&P 500 Consumer Staples	(1.28)	4.80	(2.99)
S&P 500 Energy	(11.96)	(24.65)	(17.96)
S&P 500 Financials	(4.89)	0.80	(29.16)
S&P 500 Health Care	(6.26)	0.49	(12.18)
S&P 500 Industrials	(11.88)	(8.55)	(21.03)
S&P 500 Information Technology	(12.72)	(11.92)	(23.44)
S&P 500 Materials	(17.04)	(22.47)	(21.49)
S&P 500 Telecomm Services	(12.60)	(14.78)	(29.52)
S&P 500 Utilities	(11.41)	(18.01)	(20.27)

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

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