

Market Commentary

October was the most volatile month in the 80-year history of the S&P 500 Index. It was also the worst month for the S&P in 21 years—since the crash of 1987. Encouragingly, the S&P soared 14.15% in the final four days of the month, posting its best weekly gain since 1974. The S&P 500's weekly surge 34 years ago heralded the bottom of the brutal 1973-74 bear market. The bear markets of 1990 and 2000-2002 also both recorded their lows in October. We think this October could well have marked the low for the current bear market. If so, the S&P 500's -46% decline from 2007's high to the October 27 closing low of 848.92 will have nearly matched in severity its -48% decline recorded in 1973-74 and its -49% drop in 2000-02.

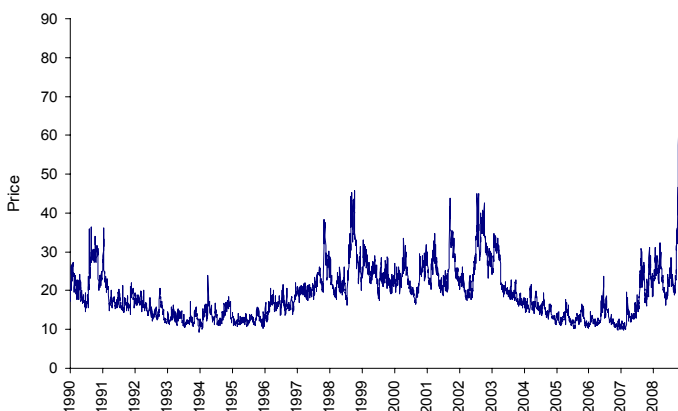
TOTAL RETURNS

	October	YTD
S&P 500 Index	-16.79%	-32.84%
Dow Industrials	-13.88%	-28.16%
Nasdaq Composite Index	-17.69%	-34.68%
S&P MidCap 400 Index	-21.74%	-32.97%
Russell 2000 Index	-20.80%	-29.02%
Dow Jones Wilshire 5000 Index	-17.57%	-32.94%
S&P 100 Index	-14.59%	-30.84%
Russell 1000 Growth Index	-17.61%	-34.31%
Russell 1000 Value Index	-17.31%	-32.90%

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

The chart of the CBOE Volatility Index (VIX) below illustrates rather dramatically the surge in market volatility that occurred in October. After trading no higher than 50 for nearly 20 years, the VIX surged to an inter-day high of almost 90 on October 24, implying monthly volatility for the S&P 500 of over 25%. For

Chicago Board of Options Exchange Volatility Index (1990-2008 YTD)



Source: Bloomberg; LMCM Analysis

perspective, in the past 80 years or so, the S&P 500's annual volatility has averaged about 20%. Huge price swings became commonplace in October. From 2003 to 2007, there were no instances in which the S&P 500 Index was up or down 4% or more in a single day. In the whole decade of the 1950s, there were only three such instances, and in the 1960s, only two. In the month of October, there were nine such days.

Amazingly, as bad as the stock market was in the U.S., declines were worse overseas. All nine foreign markets listed below underperformed the S&P 500 Index (in dollar terms) for the month of October and on a year-to-date basis. In all, veteran market strategist, Steve Leuthold, identified 43 foreign markets that suffered bear market declines greater than the -46% posted by the S&P 500 Index. Fourteen of those markets were down more than -70%, based on MSCI data. The worldwide loss of equity market value in October alone was estimated by Birinyi & Associates to have been \$8.9 trillion. Astounding!

Returns in US Dollars (%)

	October	YTD
FTSE 100 Index (U.K.)	-18.83	-42.60
DAX Index (Germany)	-22.61	-46.52
CAC 40 Index (France)	-21.74	-44.02
MICEX Index (Russia)	-32.46	-65.00
NIKKEI 225 (Japan)	-17.68	-34.62
Hang Seng Index (HK)	-22.28	-48.00
Kospi Index (So. Korea)	-31.87	-59.23
Shanghai SE Comp.(China)	-24.52	-64.40
BSE Sensex 30 Index (India)	-27.32	-61.06

Source: Bloomberg

The electoral landslide victory for Senator (now President-elect) Barack Obama forecasted by Intrade.com bettors in recent weeks, indeed, came to pass. As of about noon, Monday, November 3, Intrade.com predictions showed Sen. Obama winning 364 electoral votes to Sen. John McCain's 174. While final results are not all in as this is written, it appears that the electoral vote totals may end up exactly as Intrade.com bettors predicted at 364/174. The only thing Intrade bettors appear to have gotten wrong is that Missouri's 11 electoral votes went to McCain, not Obama, as predicted on Monday. This mild upset was exactly offset by an even bigger upset in Indiana, as that state's 11 electoral votes went to Obama, not McCain.

We have indicated to clients on a number of occasions in recent weeks that Senator McCain faced an uphill battle trying to retain the White House for the Republicans, carrying the triple-burden of a hugely unpopular, second-term president in a weak economy. McCain managed to stay reasonably close in the polls until early September, when the financial crisis morphed into a full-blown global financial panic and equity market meltdown. That sealed McCain's fate. Exit polls indicated that over 60% of voters viewed the state of the

economy as the most important issue in this election, dwarfing the war in Iraq, which registered as most important with only 10% of voters. Given the outcome, it is not hard to tell which party the electorate held most responsible for our current economic problems.

In addition to widespread discontent with the present administration, President-elect Obama rode to his historic victory on the strength of an arguably superior campaign organization and a huge fund-raising advantage. His vastly more effective use of the Internet and social networks, such as Facebook, likely helps explain his huge success among younger voters, where he garnered 66% of the under-30 vote, compared to 32% for McCain. Obama's strong appeal to younger voters, together with his overwhelming support among African Americans, surprisingly strong showing among Hispanics, and better performance among white voters than Senator Kerry, is our best explanation for his convincing win.

President-elect Obama now confronts a problem akin to that of a dog chasing a car when he finally catches it. Namely, what does he do next? On the one hand, Obama faces a daunting list of near-term problems, including a rapidly deteriorating employment picture, an economy mired in what is likely to be a fairly severe recession, a soaring fiscal deficit, challenging geopolitical situations in Iraq, Afghanistan, Iran, North Korea and elsewhere, and a continuing global financial crisis. On the other hand, he can plausibly blame all that stuff on the other guy. In fact, if things work out as we expect, Obama's timing in winning the Presidency could be near-perfect. Four years from now when it's time to run for re-election, we think the stock market will very likely have delivered well above-average returns over that period, and when Obama asks: "Are you better off now than you were four years ago?" Most people will be able to answer: "Yes!" We certainly wish him well, as we would anyone about to step into what is arguably one of the toughest jobs in the world.

Outlook

We believe there is a very good chance that the stock market made its bear market low on October 27, 2008 at 848.92 on the S&P 500 Index. Even if that turns out not to be so, we firmly believe that for anyone with a longer-term time horizon (which we define as anything longer than one year) the stock market offers return potential that is well above-average, better—in our view—than it offered in October 2002, the bottom of the last bear market. As an indicator of just how attractive stocks are right now, we cite the venerable *Value Line Investment Survey*. Each week, the front-page of *Value Line's* Summary & Index presents the estimated median price appreciation potential of all 1700 stocks in the survey over the next three to five years. At the October 9, 2002 market low, *Value Line* judged the three- to five-year median appreciation potential to be 115%. In contrast, last July, near the end of a five-year bull market in stocks, *Value Line* forecast three- to five-year appreciation potential of only 35%, about the lowest we can remember seeing. The latest issue of *Value Line* (October 31, 2008) projects three- to five-year median returns for their 1700 stock universe of 145%, nearly 30 percentage points greater than in 2002.

We believe it is the appreciation potential of the magnitude estimated by *Value Line* that motivated Warren Buffett to write his recent editorial in *The New York Times* (October 17, 2008) entitled "Buy American. I Am." In the piece, which we regard as required reading for any investor, Mr. Buffett makes the important point that the best time to invest is most often when stock prices are down, the outlook is uncertain, and investors are fearful. Times such as those we face right now. He further notes that those who are currently seeking the safety and security of cash may feel more comfortable in the short-term, but "they have opted for a terrible long-term investment asset, one that pays virtually nothing and is certain to depreciate in value." While offering no opinion on the short-term direction of stock prices, Mr. Buffett opines that: "Equities will almost certainly outperform cash over the next decade, probably by a substantial degree. Those investors who cling now to cash are betting they can efficiently time their move away from it later." Those sitting on the sidelines waiting for the outlook to improve are forgetting the fact that the stock market normally bottoms well before either sentiment or the economy turns up.

Like generals, investors are prone to fighting the last war. For over a year, it has paid handsomely to eschew risk and be maximally defensive. Those who have looked for the light at the end of the tunnel have been greeted, each time, by yet another oncoming freight train, while those who have remained defensive have been right, and therefore see no reason to alter their stance. We believe this dynamic is why the latest *Barron's* Big Money poll (November 3, 2008) shows that 92% of respondents believe the market is either fairly valued (30%) or undervalued (62%), and 69% believe that stocks will be the best-performing asset in 2009, but only 20% of respondents are aggressively positioned to take advantage of it. This is a classic case of people talking bullish and acting bearish.

In our opinion, investors now face a classic good news/ bad news situation. The good news is that stocks are cheap and, for the first time in a good while, investors are being paid handsomely to take risk. The bad news is that the economy is likely in the midst of a fairly severe recession; bottom-up earnings estimates are still probably way too high, and the market is likely to remain unusually volatile. Resolving this conundrum will be investors' principle challenge over the next several months.

One approach to balancing the risks of short-term volatility against the rewards of long-term investing is to be like Warren Buffett and simply buy good stocks when they're cheap (as he, and we, believe they are now) and ignore the near-term fluctuations of the market. The problem with trying to be like Warren is that most investors don't have his equanimity or his brains. They don't know how to value businesses as well as he does, and they are prone to letting market fluctuations influence their investment judgments. If they are money managers themselves, they may have—or at least feel they have—more short-term performance pressure than he faces, and may be subject to client redemptions in a way that he is not. In short, being like Warren isn't that easy, for a variety of reasons.

But just because it's hard doesn't mean it's not the right thing to do. At LMCM, we continue to focus on valuation, ignoring—to the extent humanly possible—short-term market volatility. In our view, the stocks, in general, that currently offer the best

combination of upside potential and downside protection are the mega-cap stocks.

The second approach to balancing short-term risk against long-term potential is to analyze the nature of the latest bear market, probing for its underlying causes and looking for clues as to when the problems that precipitated it will be resolved. Our thinking on this was galvanized by Steve Leuthold's latest *View From the North Country* (November 2008). Steve argues persuasively that the bear market which began in October 2007 and—he also believes—ended on October 27, had two distinct phases, with two distinctly different economic drivers. Phase I was a garden-variety bear market which began in October 2007 and ended in July 2008 with the market discounting a fairly typical and relatively mild recession in the U.S., Japan and Europe. July 15 marked the bottom of this phase of the bear market and the market rallied in August, led by the financial stocks, on early evidence that credit conditions were improving in the U.S. and that the worst may have passed.

Phase II of the bear market began in early September with a series of what turned out to be disastrous decisions by Treasury Secretary Paulson, including placing the GSEs into conservatorship (punishing common and preferred shareholders severely), leaving Lehman debt holders to fend for themselves following Lehman's bankruptcy rather than protecting them, as had been done in the case of Bear Stearns, and effectively nationalizing AIG, again on extremely punitive terms to the equity holders. These events in combination precipitated a collapse in investor confidence, a mini-run on the money market funds, and a complete freezing up of the fixed income markets, first in the U.S., and then globally. The commercial paper market shut down, as did the inter-bank lending market. Credit spreads of all descriptions blew out on the upside and a global equity market meltdown ensued in September and October.

We see a number of signs that the second—far more vicious, and in many ways, unprecedented—phase of the bear market may be ending. Liquidity is being restored to the system. Libor is coming down and the TED Spread has narrowed from a high of 4.57% on October 10 to 2.40% at month end and 1.99% currently. Lending markets are beginning to open up and the commercial paper market is reviving. Now that money from the Troubled Asset Relief Program (TARP) is actually getting into market participants hands, the massive government interventions and capital injections finally appear to be producing the desired result, both here and abroad.

Given how violently equity markets sold off in the second phase of the bear market, it seems to us they have the potential to snap back equally sharply as more normal credit conditions are restored. Investors sitting on the sidelines risk missing this rally, in our view.

That is Steve Leuthold's opinion, as well. He notes that since 1892, the U.S. stock market has averaged about a 44% gain in the 12 months following a recession bear market low. Assuming the October 27 low holds, this implies upside targets of 1223 and 11770 for the S&P 500 and Dow Industrials, respectively, over the next year. Interestingly, if these targets are achieved, the Dow and S&P would be back roughly to where they were in late August

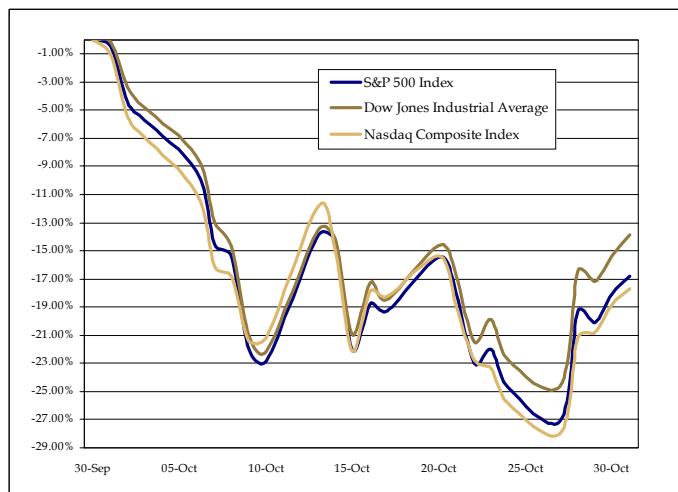
2008, when the second phase of the bear market began.

Steve's bullish case for the stock market is bolstered by his valuation work, which indicates that at its recent low, the S&P 500 Index was trading at 11.3 times normalized earnings, placing it in the bottom 15% of its valuation range over the last 52 years. From those valuation levels, one-, three-, five- and ten-year returns for the S&P 500 have historically been quite attractive, averaging in the mid-teens.

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

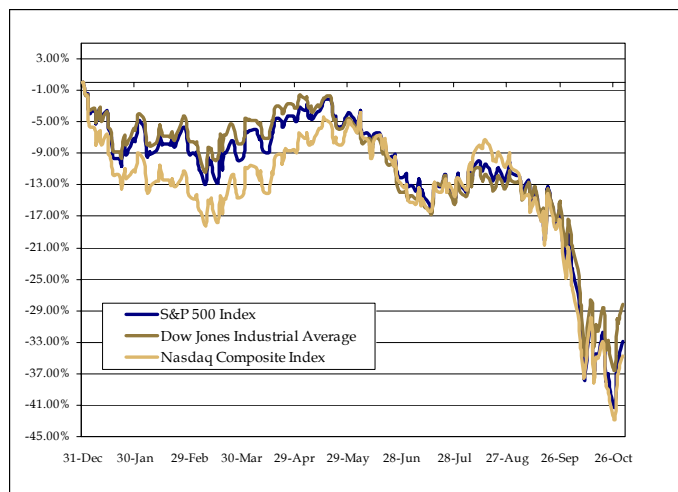
David E. Nelson, CFA
Chairman, Investment Policy Committee
Legg Mason Capital Management

Major Indices October 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	October	YTD
<i>Broad Market Indices</i>		
S&P 500	(16.79)	(32.84)
Dow Jones	(13.88)	(28.16)
Russell 1000	(17.46)	(33.55)
NASDAQ	(17.69)	(34.68)
Dow Jones Wilshire 5000	(17.57)	(32.94)
Russell 2000	(20.80)	(29.02)
Russell 1000 Growth	(17.61)	(34.31)
Russell 1000 Value	(17.31)	(32.90)
<i>S&P 500 Sector Indices</i>		
S&P 500 Consumer Discretionary	(19.18)	(30.33)
S&P 500 Consumer Staples	(10.91)	(13.57)
S&P 500 Energy	(17.95)	(32.68)
S&P 500 Financials	(22.48)	(45.09)
S&P 500 Health Care	(11.69)	(22.45)
S&P 500 Industrials	(18.87)	(35.93)
S&P 500 Information Technology	(17.79)	(37.06)
S&P 500 Materials	(22.07)	(38.82)
S&P 500 Telecomm Services	(8.30)	(35.37)
S&P 500 Utilities	(11.70)	(29.60)

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

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