LEGG MASON CAPITAL MANAGEMENT Month-End Commentary

November 2008

Market Commentary

November was another extraordinary month in what is turning out to be an extraordinary year. Thanks to a +19.1% rally in the last 5 trading days of the month (the best such rally since 1932), the S&P 500 closed the month down "only" -7.18%. But for the rally, it could have been a lot worse. After holding valiantly above its October 27 closing low (848.92) on Monday, November 17 (850.75 close) and Tuesday, November 18 (859.12 close), the S&P 500 finally succumbed on November 19, closing at 806.58. The low that many (including us) thought would hold having been breached, the S&P 500 went into virtual free-fall on Thursday, November 20, closing at 752.44, down over -22% for the month-to-date and nearly -52% from its October 2007 closing high of 1,565.15.

It got so bad on Thursday (11/20) that AAA-rated Berkshire Hathaway dropped nearly $10,000 to an inter-day low of $74,100, on rumors that it had a $40 billion liability for puts that it had sold on a number of major market indices. It turns out that figure is a rough approximation of the future liability that Berkshire could theoretically incur between 2019 and 2027, if all four indices (including the S&P 500 index) upon which it has sold puts go to ZERO in that timeframe. The fact that such an outcome is patently absurd did not stop the stock from getting pounded during the day, and is reflective, in our view, of the degree of fear-induced irrationality that has overtaken the market.

TOTAL RETURNS

	November	QTD	YTD
S&P 500 Index	-7.18%	-22.77%	-37.66%
Dow Industrials	-4.86%	-18.07%	-31.65%
Nasdaq Composite Index	-10.61%	-26.42%	-41.60%
S&P MidCap 400 Index	-9.27%	-28.99%	-39.18%
Russell 2000 Index	-11.83%	-30.17%	-37.42%
Dow Jones Wilshire 5000 Index	-8.01%	-24.17%	-38.31%
S&P 100 Index	-6.43%	-20.08%	-35.28%
Russell 1000 Growth Index	-7.95%	-24.16%	-39.53%
Russell 1000 Value Index	-7.17%	-23.24%	-37.71%

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

Considering the monthly, quarter-to-date, and year-to-date performance numbers listed above, it is not hard to see why investors are discouraged. Foreign equity markets have performed no better. In fact, in most cases, they're worse. Year-to-date, of the foreign indexes listed below, only Japan's Nikkei 225 has outperformed the S&P 500.

	Returns in US Dollars	
	November	YTD
FTSE 100 Index (U.K.)	-5.99%	-46.05%
DAX Index (Germany)	-6.54%	-50.01%
CAC 40 Index (France)	-5.95%	-47.34%
MICEX Index (Russia)	-18.99%	-71.65%
NIKKEI 225 (Japan)	+2.04%	-33.29%
Hang Seng Index (HK)	+0.14%	-47.93%
Kospi Index (So. Korea)	-11.38%	-63.87%
Shanghai SE Comp.(China)	+8.18%	-61.48%
BSE Sensex 30 Index (India)	-8.31%	-64.30%

Source: Bloomberg

And it's not only stocks that have been hit. Investment grade bonds have gotten killed this year. The same is true for junk bonds, emerging markets, commodities, many hedge funds, private equity, and real estate. In 2008, there has truly been no place for long investors to hide—except U.S. Treasuries, which look to us like the latest bubble. The paltry yields that investors are willing to accept all along the Treasury curve are not quite as goofy as the prices they were willing to pay for Internet start-ups in early 2000, but they are pretty close. Both sets of prices are born of the same phenomenon though: an intense desire on the part of the investing public to own now what they should have owned last year or the year before.

People looking for reasons to stay out of stocks don't have to look far. The market remains extremely volatile, the credit markets remain in disarray, and the flow of economic news continues to be horrific.

To our way of thinking, the extreme volatility of the market in the last few months remains its most off-putting feature. When investors can make, or more commonly lately, lose, a year's worth of returns in a few trading sessions, it becomes all but impossible for most people to stick with a long-term investment program. Human beings are not wired to endure that kind of volatility. Even grizzled market veterans' resolve has been severely tested. One hopeful sign with respect to the market's recent spike in volatility is that, according to Birinyi & Associates, market volatility usually peaks near the end of bear markets. According to Birinyi, in the six bear markets since 1962 prior to this one (1962, 1966, 1968, 1974, 1980 and 2000), the peak average five-day price change was 2.3%. In the current bear market, the peak average five-day price change has been 6%.

Apart from the incredible volatility that has accompanied it, the market's recent November 20 low has been psychologically debilitating to investors for at least two other important reasons. First, the S&P 500's November 20 closing low of 752.44 was below its closing low of 776.76 on October 9, 2002, thus effectively wiping out the entire gain of the bull market of 2002 to 2007. On a total return basis, the S&P 500's return from the low in 2002 to the recent low was still modestly positive, but only just. On a 10-year basis, the news is even more depressing. Measured to the November 20, 2008 low, the 10-year annualized total return of the S&P 500 is -2.66%, a cumulative loss of 23.59% over that period, according to calculations from Steve Leuthold. The total return loss for the ten years ended November 20, 2008 matches the worst 10-year performance in U.S. stock market history, 1929 to 1939. We think that is worth repeating. Investors have *already* suffered trailing 10-year stock market returns comparable to those suffered by investors during the Great Depression.

Given the dismal trailing five-year and ten-year returns that investors see as they look in their rear view mirrors, it is not hard to understand why they are heading for the exits in droves. Equity mutual fund redemptions were huge in October and November, and will likely remain elevated for some time. It was this same rear view mirror logic that had investors piling into the market in 2000, expecting a continuation of the high teens compounded annual returns the S&P 500 had delivered over the preceding 10 years. On both occasions, investors were taking their cues about what *would* happen by looking at what *had* happened. This is entirely understandable, but also entirely wrong. Stocks were observably expensive in 2000 and their prospective returns from that point were below average, as they, in fact, have turned out to be. In our view, stocks are observably attractive now and their prospective returns are above average. Talk to us in 10 years and we'll know for sure, but the historical evidence on this point is encouraging. According to data from Leuthold Group, since 1926, when trailing 10-year compound annual returns have been 1% or less, subsequent 10-year compounded annual returns have averaged 10.7%, in a range of 7.2% to 15.6%.

Outlook

The weight of the evidence continues to suggest to us that the brutal bear market is in its final throes; that a bottoming process is taking place, and that stocks are exceptionally attractive for long-term investors at current levels. Before summarizing our bullish case, we'd like to spend a little time talking about the four things that bother us most about the current environment and that need to improve or be clarified before a sustained recovery in the market is likely.

Our first concern is market volatility and its debilitating effect on investors' psyches and the all-in cost of trading. The Volatility Index (VIX) has closed above 50 for all but one of the last 42 trading days, after averaging 15 to 20 for years prior. The only sustained market volatility comparable to the recent past occurred during the 1930s. In our view, two related trends have inadvertently greatly exacerbated market volatility. These are the "pennization" of spreads and the dramatic increase in automated, program, and algorithmic trading. In the past, NYSE specialists would commit capital because they were charged with maintaining "orderly markets." Nasdaq market-makers would commit capital because there was enough spread in it to make it worth their while. Our sense is that both parties' willingness to commit capital in the current environment is much diminished because they can't make any money doing it. As a consequence, they stand aside and stocks move precipitously on relatively low volumes. We're not sure how to fix this, but one approach might be to increase spreads. The all-in cost of trading might actually go down.

The second thing that concerns us is the opacity of the credit default swap (CDS) market. We are certainly not experts in this arcane market, but our sense is that what was originally created as a market to hedge default risk and, therefore, reduce systemic risk, is now being used in ways that greatly amplify systemic risk. We continue to find it extremely odd that the dollar value of CDS contracts outstanding is roughly 15 times the size of the corporate bond market. Unless multiple parties are long or short the same paper, we can't see how this could be. On the theory that sunshine is the best disinfectant, we think the CDS market should be subject to regulation by one of the exchanges.

The third thing that bothers us is the destructive effect that we believe strict adherence to mark-to-market accounting is having on the financial system. We understand that the current standard was developed to replace the mark-to-model (and, in all too many cases, mark-to-myth) system that led to abuses in the form of unrealistically optimistic portfolio valuations. In our opinion, the pendulum has now swung too far in the other direction, and accountants and auditors have become slaves to depressed "market" prices and are giving insufficient weight to the "fair value" of assets as measured by their cash flow generating characteristics.

The last thing that bothers us about the current environment is the fact that credit and lending markets remain largely frozen, and credit spreads remain elevated. True, we have seen some improvement in LIBOR and the TED Spread, which is encouraging, but both these indicators of systemic risk remain uncomfortably high relative to their history. Bank lending activity is being severely restricted by mark-to-market accounting, in our judgment, and some forbearance on those rules would be hugely beneficial, in our opinion. Finally, until recently, mortgage rates have remained far too high relative to Treasuries, which is why the Fed's November 25 announcement that it would buy up to $600 billion in mortgaged-based securities directly was so encouraging. The mortgage market's response to the Fed's announcement has been both dramatic and immediate, with 30-year fixed rates dropping from 6.3%, before the announcement, to 5.1% today.

These concerns notwithstanding, we continue to believe that the stock market is unusually attractive at current levels. We cite the following in support of that view:

(1) According to the most recent Value Line Investment Summary, the median three- to five-year appreciation potential of the Value Line universe of 1,700 companies now stands at 185%. This compares to appreciation potential of 115% at the bottom of the last bear market in 2002, and 35% appreciation potential in July 2007.

(2) At its recent November 20 low, the S&P 500 Index traded at 10.4 times its normalized earnings, according to Leuthold Group, placing it in the bottom decile of valuation for the last 52 years. From this level, the subsequent median 12-month return has been 20.2%, with median 10-year returns of 17.1% annually (+385% cumulative).

(3) The dividend yield of the S&P 500 Index recently went above the yield on the 10-year Treasury for the first time in 50 years. With the recent decline in the 10-year Treasury yield to 2.70%, the S&P 500 dividend yield of 3.37% (according to Bloomberg) is now comfortably above the 10-year.

(4) According to data from InsiderScore.com, insiders are as bullish as they have been since 1975. They are buying stock at record high levels and selling stock at record low levels.

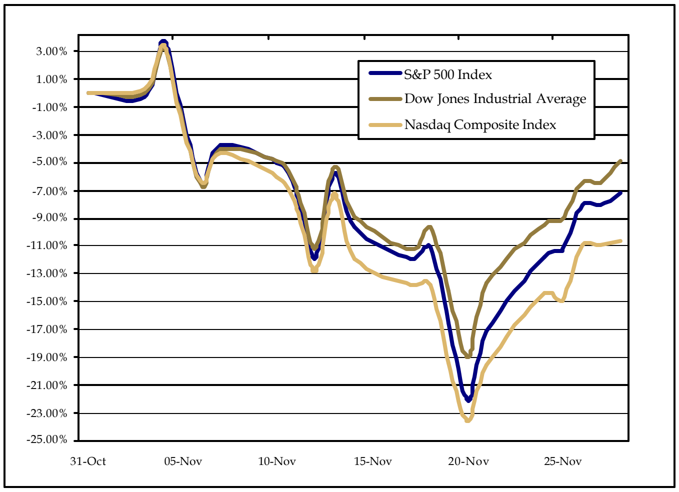
(5) The capitalization of the stock market as a percentage of GDP recently dropped to 59%, versus its long-run average of 79% and a high in 2000 of nearly 200%. A move back to its long-run average implies a price of 1,090 for the S&P 500 Index, +25% higher than current levels.

All of the factors listed above suggest to us that the market is very attractively valued at present and will deliver above average returns to investors over the next several years, and quite possibly over the next decade as well. In the near term, we expect the market to remain unusually volatile and vulnerable to earnings disappointments and economic news flow that is likely to be pretty grim. In our opinion, while the near-term risks and vulnerabilities are real and must be taken into consideration, the greater risk to long-term investors is failing to take proper advantage of the investment opportunities available in today's market.

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

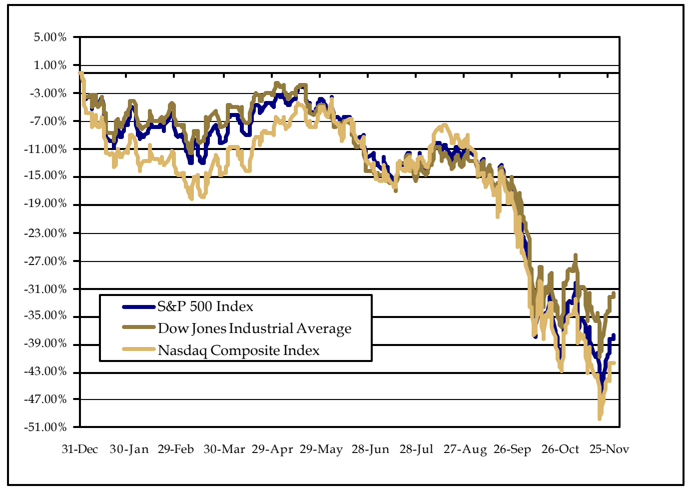
David E. Nelson, CFA
Chairman, Investment Policy Committee
Legg Mason Capital Management

Major Indices November Performance



Sources: 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	November	QTD	YTD
Broad Market Indices			
S&P 500	(7.18)	(22.77)	(37.66)
Dow Jones	(4.86)	(18.07)	(31.65)
Russell 1000	(7.56)	(23.70)	(38.58)
NASDAQ	(10.61)	(26.42)	(41.60)
Dow Jones Wilshire 5000	(8.01)	(24.17)	(38.31)
Russell 2000	(11.83)	(30.17)	(37.42)
Russell 1000 Growth	(7.95)	(24.16)	(39.53)
Russell 1000 Value	(7.17)	(23.24)	(37.71)
S&P 500 Sector Indices			
S&P 500 Consumer Discretionary	(9.54)	(26.90)	(36.98)
S&P 500 Consumer Staples	(1.83)	(12.55)	(15.16)
S&P 500 Energy	0.77	(17.31)	(32.15)
S&P 500 Financials	(18.39)	(36.73)	(55.16)
S&P 500 Health Care	(6.81)	(17.71)	(27.73)
S&P 500 Industrials	(7.23)	(24.73)	(40.56)
S&P 500 Information Technology	(11.22)	(27.02)	(44.12)
S&P 500 Materials	(10.84)	(30.52)	(45.45)
S&P 500 Telecomm Services	6.49	(2.34)	(31.15)
S&P 500 Utilities	3.06	(9.00)	(27.45)

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

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