

Market Commentary

February was another ugly month in the stock market. The market's inability to hold above its November low sent investors—including us—into a deep funk. Nothing seemed to be able to stem the relentless decline. In fact, the decline seemed to have begun to feed on itself. The S&P 500 Index was down 9 of the last 10 trading days of the month, shedding 91 points, or about -11% over that timeframe. Financials again led the market down, dropping -18% for the month and -39.6% for the year-to-date. Tech and telecom were relative bright spots in an otherwise dreary month, down -4.1% and -2.8%, respectively.

TOTAL RETURNS

	February	YTD
S&P 500 Index	-10.65%	-18.18%
Dow Industrials	-11.24%	-18.92%
Nasdaq Composite Index	-6.50%	-12.44%
S&P MidCap 400 Index	-9.68%	-16.23%
Russell 2000 Index	-12.15%	-21.92%
Dow Jones Wilshire 5000 Index	-10.41%	-17.73%
S&P 100 Index	-10.60%	-18.79%
Russell 1000 Growth Index	-7.52%	-11.97%
Russell 1000 Value Index	-13.36%	-23.32%

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

Investors were barraged with a continued stream of bad news in February. Fourth quarter 2008 real GDP was revised downward to -6.2% (its worst showing since 1982), from -3.8% initially. An amended 2009 economic forecast, released on February 18, revealed that the Federal Reserve now expects real GDP growth to be negative this year. Most private economists are expecting first quarter 2009 real GDP growth to be down -5% or -6%, and possibly worse. Hopes for an economic recovery in the second half of 2009 appear to be fading, with the Fed now believing that, at best, growth may resume late this year.

A mid-month chorus of calls for nationalization—led by former Federal Reserve Chairman Alan Greenspan, NYU professor Nouriel Roubini, Nobel Laureate Paul Krugman, and Senator Christopher Dodd (D-CT)—sent the large cap banks into freefall, with the rest of the financial sector following along to a greater or lesser degree. The drumbeat for nationalization died down somewhat later in the month, as Treasury Secretary Tim Geithner, Fed Chairman Ben

Bernanke and President Obama all voiced their opposition to the concept. In his March 2009 Investment Outlook, PIMCO's Bill Gross also came out squarely against nationalizing the big U.S. banks, saying supporters of such a plan "haven't thought this one through."

In thinking about how best to offer clients some understanding and sense of perspective about what is happening, we found the opening paragraphs of Warren Buffett's 2008 letter to shareholders—posted on Berkshire Hathaway's website over the 2/28-3/1 weekend—particularly insightful. We'd prefer to have had you read Mr. Buffett's words for yourselves, but unfortunately were unable to secure Berkshire Hathaway's permission to quote Mr. Buffett directly. What follows is a summary of his opening thoughts. We refer you to Berkshire Hathaway's website ([www.berkshirehathaway.com](http://www.berkshirehathaway.com)) for the complete text of Mr. Buffett's letter to shareholders.

After describing 2008 as the worst year for both Berkshire and the S&P 500 since he took control of the company in 1965, Mr. Buffett further noted that the year had also been devastating for all manner of financial and real assets, with no asset class unscathed save Treasury securities. As the year progressed, the credit markets went from being "dysfunctional" to "non-functional." By the fourth quarter, the credit crisis, together with the steep drop in home prices and stocks prices, had produced a fear-induced plummet in business activity rarely, if ever, witnessed. It was this vicious decline that began to become self-reinforcing that led the government to take massive action on both the monetary and fiscal fronts. Despite the longer-term inflation risks of the government's massive intervention, in Buffett's view, the authorities had no choice but to take bold action. Had the government failed to intervene, the consequences would have been even more dire than the circumstances we find ourselves in, according to Buffett. Like it or not, Wall Street and Main Street and the side streets in between are all in the same boat, and will sink or swim together.

Amid the bad news, Buffett urged his readers to remember that the U.S. economy had suffered severe challenges in the past—including two world wars, numerous panics and recessions, the virulent inflation of the 1970s and the Great Depression of the 1930s—and had always overcome them. While the path will not be a smooth one, Buffett expects no less this time around.

Mr. Buffett's sober, but ultimately hopeful, assessment of our present circumstances makes a number of points with which we agree. First, we are currently in the most

treacherous economic environment that any of us have ever lived through. Second, despite the risks involved, the U.S. government needs to take forceful action to help heal the credit markets, restore confidence in the financial system, and pursue pro-growth fiscal policies. Third, and most importantly, in our view, we are all in this together.

This last point seems to have been lost on Congress and the Obama Administration, both of which seem more intent on vilifying and punishing Wall Street “fat cats” than on implementing policies which will ultimately stabilize the financial markets to the benefit of all. Sadly, from our perspective, they seem to have learned nothing from the financial meltdown that occurred last September, following then-Treasury Secretary Paulson’s ill-fated decision to nationalize the GSEs on highly punitive terms to existing preferred and common shareholders. Holman Jenkins echoes this concern in a recent (Wednesday, 3/4) [Wall Street Journal](#) opinion piece. He writes:

No moral calculus yields the result that bank equity investors are bad and must be punished for the credit bubble while creditors are innocent and must be protected—though that haphazard political conceit seems recurrently to have guided policy. The consequences have been simply terrible. Nothing was inevitable about the collapse of equity values that has made the banking problem so much more difficult.

We believe the Obama Administration needs to pursue policies that are supportive of bank equities, not destructive to them. They claim to want a public-private partnership to recapitalize the financial system, but if investors don’t see a reasonable prospect of making money, they won’t invest. Or, as Sears Holdings’ chairman, Eddie Lampert, put it to Mr. Jenkins: “Investors won’t put up money if they don’t have clear rules and assurance that regulators won’t unreasonably damage their investment, and that boards won’t abandon their basic duty to stockholders.”

## Outlook

The U.S. equity market has discounted an enormous amount of bad news. Has it discounted the worst that we are likely to see? At the beginning of the year, we thought it had. Now we’re honestly not sure. While we remain firmly bullish on the longer-term outlook for equities, we must acknowledge that the range of near-term outcomes is unusually wide at present. Once the market finds a bottom, we believe the upside is substantial, even over the next 12 months, and certainly over the next three to five years. Now that the November 20, 2008 lows—that we thought would hold, but didn’t—have been breached, we need a new yardstick for calibrating the downside risk. Using the framework we

discussed in part two of January’s monthly commentary, we think a reasonable worst case for the S&P 500 Index is a further decline to the low 600s.

Recall that we estimated the current intrinsic value of the S&P 500 Index to be about 1125 using the methodology developed by Benjamin Graham in the 1930s and refined in 1962. Graham’s formula for the calculation of Intrinsic Value was:

$$\text{Intrinsic Value} = (\text{EPS} \times (8.5 + 2G) \times 4.4) / \text{AAA Bond Yield}$$

Our estimated intrinsic value of 1125 for the S&P 500 arises from using a normalized earnings per share estimate (EPS) of \$66.35 (a Leuthold Group estimate), a long-term earnings growth rate (G) of 6%, and AAA-bond yield of 5.32%. With the S&P 500 trading at a nearly -38% discount to intrinsic value (its widest discount in over 50 years) as of the end of February, our first inclination would be to say that the market is spectacularly undervalued, based on post-WWII valuation metrics, when bear markets tended to bottom at a premium to intrinsic value. However, given the severity of our current problems and the comparisons being made by many commentators of this period to the era of the 1930s, a post-WWII valuation framework may not capture the truly gruesome valuation levels that bear markets can plumb when people become enormously risk averse, as they appear to be now. Prior to 1958, the so-called “high risk aversion” period discussed in our last letter, bear markets bottomed at a median -46% discount to intrinsic value, implying a potential bear market low for this cycle of about 607. It need not be that bad this time around. In fact, there are some indications that we may be much closer to a bottom, both in terms of time and index values. We must acknowledge, however, that if we have, in fact, entered a sustained period of high risk aversion, a low 600s valuation on the S&P 500 Index is a possibility that we had not previously considered.

Wherever the bottom in the market cycle turns out to be, one thing is certain: investors have already experienced an enormous amount of pain. We noted in December that—measured to November 20, 2008—the trailing 10-year compounded return of the S&P 500 of -2.7% matched the returns from 1929 to 1939, the worst 10-year period in stock market history. Following an 18% year-to-date decline, through month end February 2009, the trailing 10-year compounded return of the S&P 500 is now -5.2%, a new all-time record, based on data from Barry Bannister (Stifel Financial) that extends back to 1836. This is a classic glass half-full, glass half-empty statistic. Looking backward, today’s stock market investors have now suffered through the worst 10-year returns in market history, and are understandably a pretty gloom lot. Looking forward, however, based on the powerfully mean-reverting tendencies of the stock market, equity returns over the next 10 years

should be quite attractive, probably in the low double-digits. Mr. Bannister's work indicates that if you caught the exact bottom of the previous six cyclical lows since 1836 in rolling 10-year returns, your forward 10-year return would have averaged 13.0%, in a range of 7.3% to 17.2%. Importantly, your timing did not need to be perfect. His work revealed that if you were a year early in catching the bottom, your forward 10-year return averaged 12.3%, in a range of 9.6% to 15.8%, whereas, if you were a year late, your forward return averaged 10.1%, in a range of 6.3% to 14.3%.

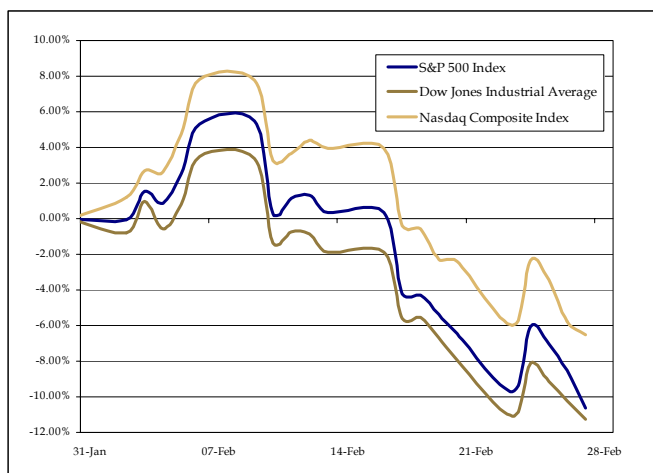
Our long-term bullishness on the market from these levels notwithstanding, we are troubled by several aspects of the current market environment. The first is the "vicious negative-feedback" loop that has developed lately, where declining equity markets lead to fear-induced cutbacks in business and consumer spending, which, in turn, lead to further weakness in stocks, and so on. Our second concern is that, to this point, government efforts to stabilize the financial markets have not met with much success, at least judging from the stock market's reaction. The primary reason for this, in our opinion, is that there is too much focus in Washington on punishing Wall Street and not enough focus on supporting and healing the capital markets. Our final concern is that President Obama, in trying to fulfill campaign promises, is attempting to do too much, too soon, on the income redistribution and tax increase front, rather than focusing on job one, which is to get the economy stabilized and growing again. In simple terms, President Obama needs to focus on getting the economic pie growing again before he tackles the issue of how to most equitably divide the pie up.

Because we cannot resist ending on a hopeful note, we would point out that two long-time bears, Doug Kass, of Seabreeze Partners, and Robert Prechter, a noted Elliott Wave theorist, have recently turned bullish. They both believe we are very near to an important market bottom. Let's hope they are right. A little green-on-the-screen would be a welcome change from the last couple of months.

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

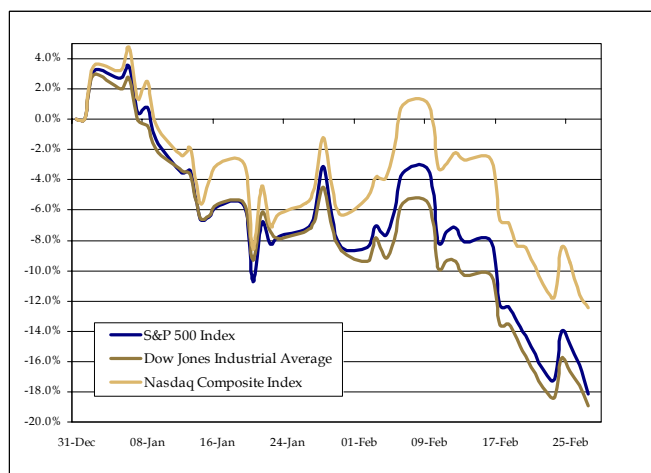
**David E. Nelson, CFA**  
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Major Indices February Performance



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

Major Indices 2009 Performance



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

Monthly U.S. Market Update (Total Returns)

Index Name	February	YTD
<i>Broad Market Indices</i>		
S&P 500	(10.65)	(18.18)
Dow Jones	(11.24)	(18.92)
Russell 1000	(10.34)	(17.66)
NASDAQ	(6.50)	(12.44)
Dow Jones Wilshire 5000	(10.41)	(17.73)
Russell 2000	(12.15)	(21.92)
Russell 1000 Growth	(7.52)	(11.97)
Russell 1000 Value	(13.36)	(23.32)
<i>S&amp;P 500 Sector Indices</i>		
S&P 500 Consumer Discretionary	(8.47)	(18.14)
S&P 500 Consumer Staples	(7.15)	(14.10)
S&P 500 Energy	(12.03)	(14.80)
S&P 500 Financials	(18.08)	(39.63)
S&P 500 Health Care	(12.50)	(13.58)
S&P 500 Industrials	(17.18)	(27.61)
S&P 500 Information Technology	(4.06)	(6.99)
S&P 500 Materials	(8.46)	(15.02)
S&P 500 Telecomm Services	(2.80)	(12.43)
S&P 500 Utilities	(12.41)	(12.98)

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

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