

Market Commentary

The S&P 500 Index resumed the recovery off its March bottom in November, after a down month in October, posting a +6.00% return for the month just ended. The monthly performance was likely a surprise to many investors, who began the month in a sour mood, following a -2.8% drubbing on the last day of October. Expecting more of the same in November, investors quickly went into a crouch on the first trading day of the month (11/2/09), as the Chicago Board Options Exchange put/call ratio soared to 104.1, evidencing a higher level of bearishness than at the March 9 low. Instead, the S&P 500 turned on its heels and forged to a new recovery closing high on the Wednesday before Thanksgiving. News that the Government of Dubai was seeking a payment standstill from creditors until May 2010 on Nakheel and Dubai World financial obligations sent world equity markets into a tail-spin on Thursday, while the U.S. equity market was closed for the Thanksgiving holiday. Joining the selling party on Friday (11/27/09), U.S. investors again scurried for cover as the put/call ratio spiked up, to 105.1 this time. Never, it seems, has a market advance produced so much skepticism and so little joy among investors.

It seems clear from the flow of funds data that the general investing public continues to have no appetite for stocks despite the monster rally we have witnessed since March. According to the latest data from the Investment Company Institute (ICI), investors have pulled \$37.3 billion from U.S. equity mutual funds since August, the fastest three-month withdrawal rate of the year. The last time mutual funds saw outflows this big was in the nine months up to February 2003, according to Bloomberg, just as the market was beginning a five-year advance during which the S&P 500 nearly doubled. Relying almost exclusively on the “Rear-View Mirror” theory of investing, individuals are abandoning stocks—which have punished them over the last several years—in favor of bonds—which have provided both better returns and lower risk. According to ICI, individuals, who account for 82 percent of mutual fund owners, have withdrawn \$21.4 billion (net) from equity funds so far this year, while pumping \$312.8 billion (net) into bond funds. By their actions, investors are viewing the market advance not as an indication of better things to come, but, rather, as an opportunity to recoup at least a portion of their prior losses.

U.S. INDICIES—TOTAL RETURNS

	November	QTD	YTD
S&P 500 Index	+6.00%	+4.03%	+24.07%
Dow Industrials	+6.92%	+7.08%	+21.52%
Nasdaq Composite Index	+5.05%	+1.26%	+37.30%
S&P MidCap 400 Index	+4.05%	-0.67%	+29.27%
Russell 2000 Index	+3.14%	-3.86%	+17.70%
Dow Jones US Total Market Index	+5.61%	+2.88%	+25.02%
S&P 100 Index	+6.17%	+5.02%	+21.30%
Russell 1000 Growth Index	+6.14%	+4.70%	+33.09%
Russell 1000 Value Index	+5.64%	+2.40%	+17.61%

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

NON-U.S. INDICIES—TOTAL RETURNS IN U.S. DOLLARS

	November	QTD	YTD
FTSE 100 Index (UK)	+3.23%	+4.21%	+37.88%
DAX Index (Germany)	+5.59%	+1.38%	+24.10%
CAC 40 Index (France)	+4.09%	-0.44%	+27.95%
MICEX Index (Russia)	+3.43%	+10.10%	+111.75%
NIKKEI 225 (Japan)	-2.88%	-4.17%	+12.12%
Hang Seng Index (HK)	+0.52%	+4.39%	+56.23%
Kospi Index (So. Korea)	+0.30%	-6.28%	+53.71%
Shanghai SE Comp. (China)	+6.66%	+14.96%	+78.01%
BSE Sensex 30 Index (India)	+7.47%	+2.30%	+85.62%

Source: Bloomberg

The value-destroying tendency to want to do now what they should have done five years ago, is not the exclusive purview of individual investors. The behavior seems to be deeply embedded into the psyches of nearly all financial decision-making entities, even committees of investment professionals, who should theoretically know better. The latest *Financial Analysts Journal* (Nov/Dec 2009) features an article by Stewart, Neumann, Knittel and Heisler entitled “Absence of Value: An Analysis of Investment Allocation Decisions by Institutional Plan Sponsors.” Using a dataset of 80,000 yearly observations of institutional investment product assets, accounts and returns for the period 1984-2007, the authors show that, in aggregate, “investment products that receive contributions subsequently underperform products experiencing withdrawals over one, three and five years.” Thus, “much like individual investors who switch mutual funds at the wrong time, institutional investors do not appear to create value from their investment decisions.”

Even the world’s central bankers are not immune from the all-too-human tendency to buy high and sell low, as evidenced by their collective buying and selling activity in gold. In 1999, with gold trading under \$300 an ounce, many European central banks were regular sellers of gold. In fact, in late summer 1999, when gold dipped into the low \$250s, concern became so great that uncoordinated central bank gold sales were destabilizing the gold market that the Central Bank Gold Agreement (also known as the Washington Agreement on Gold) was drawn up. Announced on September 26, this agreement limited its 15 central bank signatories to collective sales of no more than 400 tons of gold per year for five years. Gold spiked up on the news to about \$325 in early October 1999, but by the end of the year was back under \$300, as central bank gold sales continued according to the terms of the agreement.

In contrast to their selling in 1999, many central bankers are finding reasons to buy gold today at prices four to five times higher than those that prevailed ten years ago. In fact, the last \$100 spent in gold to over \$1,200 an ounce is being widely attributed to the November 4 announcement that the Reserve Bank of India bought 200 metric tons of gold from the International Monetary Fund (IMF) in October, increasing its gold reserves by nearly 56%. Russia's central bank also bought 15.6 metric tons of gold in October, increasing its total gold reserves by 2.7% to 568.4 metric tons. China, too, has been a big buyer of gold in the last year or so, increasing its official reserves by 75% from 600 metric tons in April 2008 to 1054 metric tons in August 2009.

Only time will tell whether this buying is smart or not, but it is certainly understandable. Even after their recent buying spree, most Asian central banks hold a relatively small percentage of their total reserves in gold. The vast majority of their reserves are in foreign currencies, principally U.S. dollars. The table below shows the gold holdings (in metric tons) of selected Asian central banks and the percentage of their total reserves that gold represents (valuing gold at about \$1,000 per ounce).

Selected Asian Central Bank Gold Holdings			
Country	Metric Tons		% Reserves
China	1,054.0		1.9%
Japan	765.2		2.3%
Russia	568.4		4.3%
India	557.7		6.0%
Taiwan	423.6		3.9%
Singapore	127.4		2.2%
Thailand	87.4		2.2%
Indonesia	73.1		4.3%
Malaysia	36.4		1.2%
South Korea	14.3		0.1%
Hong Kong	2.1		0.0%
Total	3,709.6	Avg.	2.6%

Source: World Gold Council (via Wikipedia)

In contrast to the rather small percentage holdings of gold by Asian central banks, the U.S. holds 77.4% (8,133.5 metric tons) of its reserves in gold; Germany, 69.2%; France, 70.6%; and Italy, 66.6%. In view of the fact that yawning U.S. budget deficits have shaken investors' confidence in the longer-term value of the dollar, it is unsurprising that countries with a low percentage of their reserve holdings in gold would want to diversify away from the dollar into gold. Should the 11 countries listed above decide to increase their collective gold holdings to 10% of reserves, the incremental demand for gold would rise by about 10,600 metric tons. A collective move to 25% would produce incremental demand of approximately 32,000 metric tons.

To put those potential incremental demand figures in context, the World Gold Council estimates that through 2006, approximately 158,000 metric tons of gold had been produced since the beginning of time, the vast majority of which is likely still in existence. A widely accepted estimate of above-ground supplies

of gold is 150,000 metric tons. Worldwide production has been running about 2,300 metric tons per year recently, adding about 1.5% annually to above-ground supply. Net consumption of gold is difficult to calculate, but is likely to be modest, since most gold used for industrial purposes is ultimately reclaimed for future use.

Of the estimated 150,000 metric tons of above-ground supply, a little over 30,000 metric tons of gold is held as central bank reserves, including the 3,710 metric tons listed above. Incremental Asian central bank demand of 10,000 to 30,000 metric tons, should it develop, could obviously have a materially positive effect on the price of gold. It is not hard to envision the price of gold going to \$1,300 to \$1,500 over the next year or so, and even \$2,000 (the old inflation-adjusted high) over the next three to five years is not out of the realm of possibility. At some unspecified, but apparently not yet reached price, a good-sized chunk of the 120,000 metric tons of available non-central bank supply will come off people's necks, fingers and wrists and out of their safety deposit boxes and wall safes onto the market. It will be very interesting to see how the gold saga plays out over the next several years. Because "there's no fever like gold fever," the current bull market in gold has the distinct possibility of turning into a bubble of truly gigantic proportions.

As to the question of whether gold is a better wealth creator than stocks, that depends on whether you take what our colleague, Michael Mauboussin, in his new book *Think Twice*, calls the inside view or the outside view. The inside view, which looks at only the current situation, would suggest that gold is the better wealth creator since it has done better in recent years. Gold is up roughly three-fold since the end of 2003, while stocks over that time period are basically flat, excluding dividends. More importantly, given investors' heightened sensitivity to volatility, gold is up nine years in a row, including 2001, 2002 and 2008 when stocks were down meaningfully. Taking the inside view, it's not hard to see why gold is now attracting so many adherents. It appears to offer both better returns *and* lower risk of loss.

Taking the outside—and we believe more appropriate—view, one would come to an entirely different conclusion. As Mauboussin's book makes clear, the outside view looks at not just the current situation, but at all relevant historical information, in order to put the current circumstances into a broader context. According to data from Jeremy Siegel's excellent book, *The Future for Investors*, a dollar invested in gold in 1802 would have been worth \$1.39 by 2003 on an inflation-adjusted basis, thus providing essentially no real return for a period of over two hundred years. In sharp contrast, a dollar invested in stocks over the same timeframe, with dividends and capital gains reinvested, would have been worth \$597,485. That is not a misprint. Stocks creamed gold as a wealth builder over the long term, because they represent ownership interests in business enterprises that can grow and prosper over time, and because they generate cash flow in the form of dividends, which can be reinvested to enhance returns.

What about since 2003, you might say? Gold has been great since then, and stocks have done nothing. Well, that's partly true. Gold is indeed up about three-fold since the end of 2003, from about \$400 to about \$1,200. Updating the return index for gold

to the present brings it to roughly $3 \times \$1.39 = \4.17 . Inflation-adjusting that number would lower it a bit, but we'll ignore that because we're feeling generous, and, as you can see, gold needs all the help it can get versus stocks. The S&P 500 Index closed out 2003 at 1112 and is within hailing distance of that level as this is written. So, let's call it flat. But that's before dividends which probably averaged about 2% compounded. It's also before inflation, which also averaged about 2% since 2003. We'll call it a wash, and figure that the updated return index for stocks stays about the same at \$597,485. So, up to the present, instead of being 429,845 times better than gold since 1802, stocks are only 143,282 times better. To match the long-term return of stocks, we estimate that gold would have to sell for about \$173.5 million an ounce. That seems unlikely.

Outlook

We remain constructive on the outlook for the U.S. equity market over the next year. We continue to see upside potential for the S&P 500 to 1250 to 1350 by the end of 2010. Our estimate of downside risk for the S&P remains, for the time being, 950 to 1000, but that range should rise over time as the economy recovers and earnings continue to improve. With the S&P 500 at about 1110, the reward-to-risk ratio (now roughly 1.4-to-1) is not as favorable as it was earlier in the year, but there's still more upside than downside over the next year, in our view. Importantly, any meaningful correction would quickly tilt the odds in investors' favor, in our opinion. At 1050, the reward-to-risk ratio on the S&P 500 jumps back over 3-to-1. At 1000, it's 12-to-1. So, to our way of thinking, if the market gets whacked for whatever reason, don't despair; get busy buying.

Before closing, we'd like to leave our readers with two views of the market—the inside view and the outside view—and let each reader decide which is the more relevant framework for investing. The inside view says that the market can't go up because our current circumstances are too perilous and uncertain. The laundry list of worries has been well chronicled by the media: a still-fragile financial system, a likely sub-par economic recovery, yawning budget and trade deficits, a vulnerable dollar, threats from both inflationary and deflationary forces, high and still-rising unemployment, continuing wars in Iraq and Afghanistan, nuclear saber-rattling by Iran, massive funding requirements for Social Security, Medicare and Medicaid, the burden of health care reform and a probable rise in tax rates. Yada, Yada! It's a wonder any of us can get ourselves out of bed in the morning.

The outside view says, yes, we've got plenty of things to worry about, but that's been true throughout history. Worries, concerns and problems are always an unavoidable part of the investment landscape, just as they are an unavoidable part of life. The outside view asks us to look past the current situation at the bigger picture. Over the long term, stocks have been great wealth builders. This has been especially true after they have suffered extended periods of poor performance, such as the 10-year period we have just witnessed. To be more specific, according to data compiled by Jeremy Siegel at the University of Pennsylvania, stocks have provided average annual real returns (after inflation) of 6.66% for

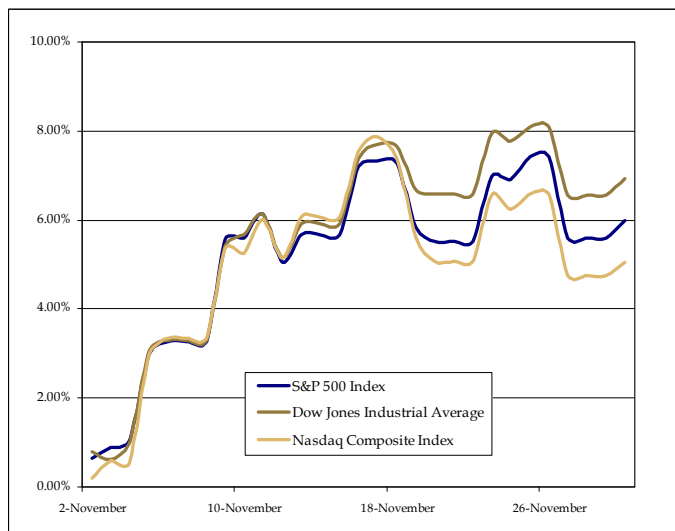
all 10-year periods going back to 1871. There have been fourteen 10-year periods, including the current one, where stock returns were negative. In the previous 13 instances, the subsequent 10-year returns have averaged 10% real, about 50% better than the long-term average, and more than twice the return of bonds.

With funds currently flowing out of domestic equity mutual funds and pouring into bond funds, investors are being overwhelmingly influenced by the inside view. We think they are making a big mistake.

All of us at LCM wish our clients a healthy and happy holiday season, and, as always, we thank you for your support and welcome your comments.

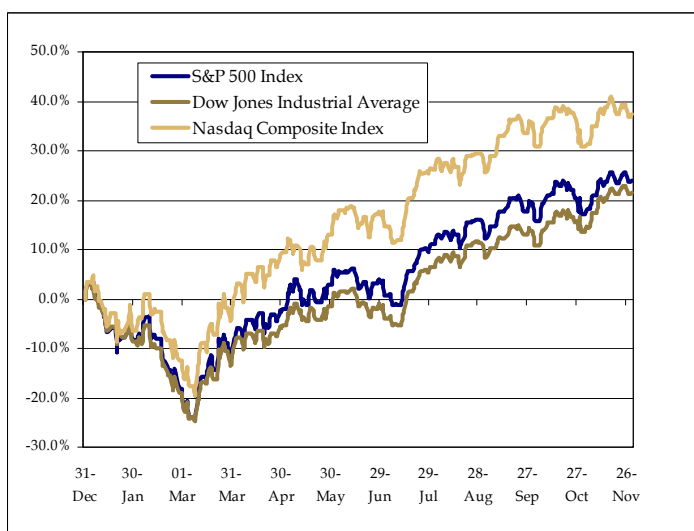
David E. Nelson, CFA
Chairman, Investment Policy Committee
Legg Mason Capital Management

Major Indices November Performance



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

Major Indices 2009 Performance



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

Monthly U.S. Market Update (Total Returns)

Index Name	November	QTD	YTD
<i>Broad Market Indices</i>			
S&P 500	6.00	4.03	24.07
Dow Jones	6.92	7.08	21.52
Russell 1000	5.89	3.55	25.38
NASDAQ	5.05	1.26	37.30
Dow Jones US Total Market Index	5.61	2.88	25.02
Russell 2000	3.14	(3.86)	17.70
Russell 1000 Growth	6.14	4.71	33.09
Russell 1000 Value	5.64	2.40	17.61
<i>S&P 500 Sector Indices</i>			
S&P 500 Consumer Discretionary	6.95	4.37	35.20
S&P 500 Consumer Staples	4.00	5.30	15.20
S&P 500 Energy	3.26	6.61	14.93
S&P 500 Financials	4.42	(1.82)	19.04
S&P 500 Health Care	9.30	6.87	17.26
S&P 500 Industrials	9.06	4.04	19.39
S&P 500 Information Technology	5.19	4.82	53.12
S&P 500 Materials	11.56	5.67	46.22
S&P 500 Telecomm Services	6.50	2.67	4.10
S&P 500 Utilities	4.81	1.63	6.04

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

The information contained herein has been prepared from sources believed reliable but is not guaranteed by us as to its timeliness or accuracy, and is not a complete summary or statement of all available data. This data is intended solely for our clients, is for informational purposes only, and may not be publicly disclosed or distributed without our prior written consent.

The views expressed in this commentary reflect those of Legg Mason Capital Management ("LMCM") as of the date of this commentary. These views are subject to change at any time based on market or other conditions, and LMCM disclaims any responsibility to update such views. These views may not be relied upon as investment advice and, because investment decisions for clients of LMCM are based on numerous factors, may not be relied upon as an indication of trading intent on behalf of the firm. The information provided in this commentary should not be considered a recommendation by LMCM or any of its affiliates to purchase or sell any security.

The Dow Jones IndexesSM are proprietary to and distributed by Dow Jones & Company, Inc. and have been licensed for use. All content of the Dow Jones IndexesSM ©2009 is proprietary to Dow Jones & Company, Inc. The Dow Jones Wilshire IndexesSM are jointly produced by Dow Jones & Company, Inc. and Wilshire Associates, Inc. and have been licensed for use. All content of the Dow Jones Wilshire IndexesSM ©2009 is proprietary to Dow Jones & Company, Inc. & Wilshire Associates Incorporated.

Russell®, Russell 2000® Index, Russell 1000 Growth® Index, and Russell 1000 Value® Index are trademarks/service marks of the Frank Russell Company.

Neither LMCM nor its information providers are responsible for any damages or losses arising from any use of this information.