

Market Commentary

The S&P 500 Index fought through a spate of selling pressure in mid-December to post a respectable +1.93% gain for the month, thus finishing the year up +26.46%. The ARMS Index (also called the Traders' Index or "TRIN"), a trading index that measures the relative degree of buying and selling pressure in the market, soared to 6.81 on December 17, its highest level since late March 2009, indicating a surge in selling pressure, as many investors apparently decided to lock in profits before year-end. Following a year that greatly exceeded most people's expectations, the outlook for the economy and stock market in 2010 are the key questions on most investors' minds.

U.S. INDICIES—TOTAL RETURNS

	December	Q4	2009
S&P 500 Index	+1.93%	+6.04%	+26.46%
Dow Industrials	+0.95%	+8.10%	+22.68%
Nasdaq Composite Index	+5.87%	+7.20%	+45.36%
S&P MidCap 400 Index	+6.27%	+5.56%	+37.38%
Russell 2000 Index	+8.05%	+3.87%	+27.17%
Dow Jones US Total Market Index	+2.84%	+5.81%	+28.57%
S&P 100 Index	+0.80%	+5.86%	+22.27%
Russell 1000 Growth Index	+3.09%	+7.94%	+37.21%
Russell 1000 Value Index	+1.77%	+4.22%	+19.69%

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

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

	December	Q4	2009
FTSE 100 Index (UK)	+2.78%	+7.11%	+41.71%
DAX Index (Germany)	+1.39%	+2.79%	+25.92%
CAC 40 Index (France)	+2.54%	+2.09%	+31.19%
MICEX Index (Russia)	+3.87%	+14.37%	+119.96%
NIKKEI 225 (Japan)	+5.52%	+1.12%	+18.31%
Hang Seng Index (HK)	+0.21%	+4.62%	+56.57%
Kospi Index (So. Korea)	+8.36%	+1.56%	+66.56%
Shanghai SE Comp. (China)	+2.56%	+17.91%	+82.58%
BSE Sensex 30 Index (India)	+3.28%	+5.66%	+91.71%

Source: Bloomberg

In our monthly commentary at this time last year, we said: "We expect 2009 to be a tug-of-war between the near-term outlook—which will continue to be very challenging—and the

long-term investment opportunity offered by common stocks at present—which we believe is quite substantial. Ultimately, we expect this tug-of-war to be resolved on the upside and believe the Dow and S&P 500 could both be up 25% to 30% for the year. That might seem 'extreme,' but such gains would do nothing more than return those indices to the ranges in which they traded as recently as September 2008."

While the Dow Industrials failed by a few percentage points to reach the low end of our target range, the S&P 500's return fell within it, and most other major U.S. market indices met or exceeded it, as shown nearby. Thus, notwithstanding the minor shortfall in the Dow, our forecast essentially proved to be on the money, though it certainly didn't seem likely to be so in February and March, as the market slipped through its November 2008 lows—levels we had thought would hold—like a hot knife through butter, before bottoming in early March. From its closing low on March 9 through year-end, the S&P 500 Index returned +67.80%, while the Dow Industrials returned +63.13% and the Nasdaq Composite, +80.25%.

For those investors who were underinvested or sitting on the sidelines in March, the market's advance has proven to be quite frustrating, as corrections were, for the most part, shallow and brief. Such pullbacks as did occur were quickly met with surges in the CBOE Put/Call ratio and other signs of bearishness, as investors—scarred by the brutal bear market of 2007 to 2009—sought quickly to protect themselves from a renewed decline. We commented last month that never, in our experience, had investors seemingly derived so little pleasure from such a spirited advance as we saw in 2009.

Market forecasts for 2010 are all over the map, as is to be expected. The most pessimistic one we could find was that of Toronto-based hedge fund manager, Eric Sprott, reported on by Bloomberg staff writer, Matt Walcoff, on December 29, 2009. According to Walcoff, Sprott, a long-time investor in gold mining stocks and gold bullion, sees the S&P 500 Index ultimately dropping below its March 9, 2009 low of 676.53 before the bear market ends. "We're in a bear market that will last 15 to 20 years, and we've had nine of them," was Sprott's less-than-cheery prognosis in a Bloomberg interview on December 18.

Market veteran Byron Wien, a long-time strategist with Morgan Stanley and now vice president of Blackstone Advisory Services, is a bit more sanguine on the outlook, though by no means optimistic. He shared his annual Top 10 Surprises for 2010 with CNBC on Tuesday, January 5, 2010. Even though he expects the economy to be strong this year and corporate earnings to exceed expectations, Wien predicts

a roller-coaster year for the stock market, with the S&P 500 rising to 1300 in the first half, before running out of steam and declining to 1000, then rallying again to end the year about where it began.

Kevin Pleines of Birinyi Associates compiled a consensus of sorts by averaging the forecasts of nine major Wall Street firms—Bank of America/Merrill Lynch, Barclays, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, JP Morgan, Morgan Stanley and UBS. The average of these firms' year-end 2010 targets for the S&P 500 Index is 1222, while they forecast, on average, S&P EPS of \$76, and real GDP growth of 3.1%. All of these forecasts seem reasonable to us, but our internal forecasts, which we will share presently, are more optimistic on all counts.

If Birinyi's Wall Street consensus target of 1222 for the S&P 500 is achieved, it implies a gain of about +9.6% for 2010. After a gain of over +25% in 2009, many observers might think that another year of nearly double digit gains in 2010 would be too much to expect. Interestingly, market history suggests just the opposite. According to work by Birinyi Associates' Cleve Rueckert, since 1945, there have been 17 years in which the S&P 500 gained at least +20%. In the following year, the market has been up 13 of 17 times (76.47%) by an average of +9.78%. A final bit of research by Birinyi's Amanda Crumb and Kevin Pleines provides further encouragement that 2010 might be another good year in the market. Using Birinyi's own Traders Handbook, Crumb and Pleines found that, of the ten years since 1945 which began with a first-day gain of +1% or more, the market has been up an average of +14.57% for the entire year, with only one instance of negative returns (1990).

Outlook

We are bullish on the outlook for U.S. equities in 2010. Some of us are more bullish than others, but it basically boils down to varying degrees of optimism. In recent commentaries, we have written that we thought the S&P 500 Index could trade in the range of 1250 to 1350 by the end of 2010. As we review the available evidence today, that still seems to us like a reasonable range of expectations.

Every December, LMCM has a stock-picking contest designed to surface investment ideas for our funds as well as to measure levels of consensus and conviction on the outlook for individual stocks, the economy and the stock market as a whole. Each LMCM employee—not just the investment team, but everyone—is asked to pick a 12-stock portfolio for the coming year. Everyone is also asked to forecast next 12-month returns for the major market indices—S&P 500 Index, Dow Industrials and Nasdaq Composite—as well as a number of key economic statistics, including real GDP growth and the CPI for the coming year, and the year-end levels of the Fed funds rate, the 10-year Treasury yield and oil prices.

Last year's stock contest winners were head trader, Michael Ray, and client service associate, Mark Andrusis, with 2009 returns of 144.62% and 113.14%, respectively. Composite performance was also strong, with 75 of 82 twelve-stock portfolios bettering the S&P 500's +26.46% return, and the median return exceeding +48%. Our group was bullish last year, but as it turned out, not bullish enough. The group forecast an average gain for the S&P 500 for 2009 of +14.69%, while its actual return was nearly 1200 basis points better.

As noted above, our team is bullish on the outlook for U.S. stocks in 2010, with average expected gains in the Dow, S&P 500 and Nasdaq composite of +15.69%, +17.24% and +20.09%, respectively. Our Chairman and Chief Investment Officer Bill Miller is even more optimistic about the market, believing the S&P 500 could be up +20% or better for the year. The group consensus is that real GDP will be about 3% in 2010, the CPI will average 2.4%, oil prices will end the year at \$77.50 and the Fed funds rate and 10-year Treasury will finish the year at about 1% and 4%, respectively. Bill is also more bullish on the economy than the group consensus, expecting real GDP to average +5.0% or better in 2010, and believing the Fed funds rate will end the year at 50 basis points and the 10-year Treasury will yield about 4.25%.

In formulating our expectations for the coming year, we consider four factors: (1) historical precedent, which we discussed earlier, (2) investor sentiment, (3) the outlook for economy and corporate earnings, and, most importantly, (4) market valuation.

Measuring investor sentiment is tricky, because the data is often mixed, allowing people to see what they want to see. Bearish investors see everyone else as too bullish and vice versa for those who are bullish. That is why when sorting through the data, we always try to remember veteran market technician John Mendelson's admonition to watch what people do, rather than what they say. A number of investor surveys such as Ned Davis' Crowd Sentiment Poll and survey of investment advisors have moved into "extreme optimism" territory. So, many advisors and investors seem to be talking bullish lately, but the flow of funds data we monitor suggests to us that they are still acting bearish. In December, according to data compiled by the Leuthold Group, mutual fund investors withdrew \$8 billion from U.S. focused equity funds, bringing total net withdrawals for all of 2009 to \$37 billion. That is hardly bullish action, in our view. We would also note that at the first hint of any market decline since March, the CBOE Put/Call ratio has quickly soared to very bearish levels, suggesting that investors remain very skeptical of the market's advance and are quick to take action to protect themselves on the downside. In summary, while investor sentiment is certainly not as bleak as it was in March 2009, we still rate it a positive for the market, because we believe investors continue to be too pessimistic about the outlook for equities.

Recent economic data offer fairly convincing evidence, in our view, that the recession has ended and the economy has begun

to recover. The Institute for Supply Management (ISM) announced on January 4 that its factory index rose to 55.9 in December, the highest level since April 2006. The latest release came on the heels of an earlier ISM announcement that their Chicago manufacturing orders index increased to 64.4 in December, the highest reading since May 2007. ISI Group is also seeing broad-based signs of economic strength. They reported on January 4 that their retailer survey index ended December at 53.2, the strongest December showing in 16 years, and up from a recession low of 22.8. ISI is also seeing continued strengthening in its truckers' and temporary employment surveys. Despite the recent rush of good economic news, most observers still seem to be expecting a tepid recovery, with a current Bloomberg consensus forecast for real GDP in 2010 of about 2.7%. We believe the recovery will be much stronger than that, with real GDP growth in the range of 4% to 5%, and possibly higher. We also believe employment will begin to grow in the next month or so. Even though employment is a lagging indicator, and therefore not of much use as a predictive tool, we think when employment does start growing again it will provide a huge psychological lift to consumers, because the employment statistics receive so much attention from the media.

We believe the outlook for corporate earnings is also quite strong. First Call's earnings revision index was a remarkably strong 74.3% in the last week of December. In fact, ISI Group calls the strength in First Call's revision index over the last 13 weeks "unprecedented by a fairly wide margin." The regression model ISI uses to forecast corporate earnings is projecting +35% annualized increases in the fourth quarter of 2009 and the first half of 2010. In our view, the current Bloomberg consensus forecast for S&P 500 earnings of \$76.25 per share in 2010 has as good a chance of being low as it does of being high.

On the very important question of valuation, we rely on a discounted cash flow (DCF) model developed by Michael Mauboussin for insight. As a brief refresher, our DCF requires estimates for four factors to calculate a fair-value multiple: (1) a long-term growth rate of earnings, (2) a long-term return on equity, (3) a weighted-average cost of capital (calculated by adding an equity risk premium (ERP) to the 10-year Treasury rate), and (4) a competitive advantage period (i.e., the number of years over which returns are forecasted to exceed the cost of capital). Three of our four base assumptions for the S&P 500 Index have remained the same for some time: a long-term earnings growth rate of 6%, a return on equity of 16% and a competitive advantage period of 20 years. During the recent financial crisis, we increased our assumed ERP by 50 basis points from 4% to 4.5% to reflect a heightened degree of risk aversion among investors. Adding our crisis level ERP of 4.5% to the current 10-year Treasury yield of 3.82% gives us a weighted-average cost of capital (WACC) of 8.32%. Combining that WACC with our other base assumptions, our DCF estimates the fair-value multiple of the S&P 500 to be about 17.5, yielding an implied

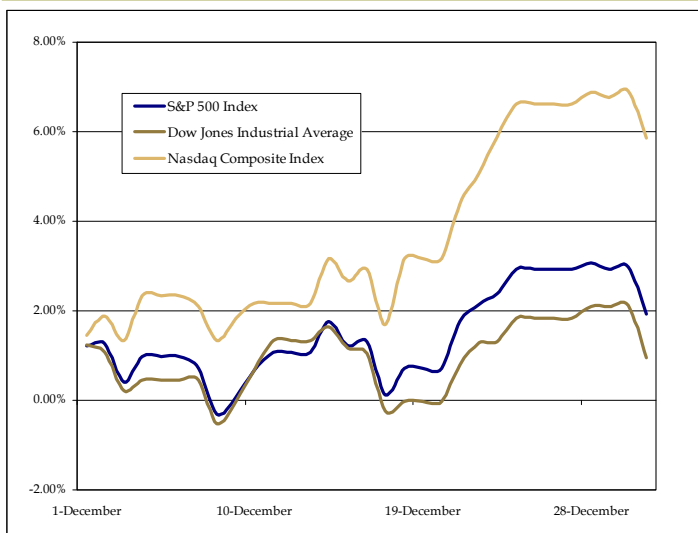
fair-value target for the S&P 500 of 1334 based on consensus EPS of \$76.25. If we assume that the worst of the financial crisis is past and that the ERP will revert to its long-term average of 4% over time, the fair-value multiple of the S&P rises to 19.3, and the implied year end 2010 target price for the S&P 500 rises to 1472. We'll leave it to clients to decide for themselves which risk premium has the greater validity in the current environment. Our conclusion is that the market has meaningful upside even using the more conservative assumptions.

In closing, we would note that beginning with this month's commentary, we are adopting a new naming convention. Thus, we have titled this piece the January 2010 Market Commentary rather than the December 2009 Market Commentary. We found that titling the commentary based upon the month in which it was written, rather than the month just ended, was more in keeping with the practices of other investment firms.

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

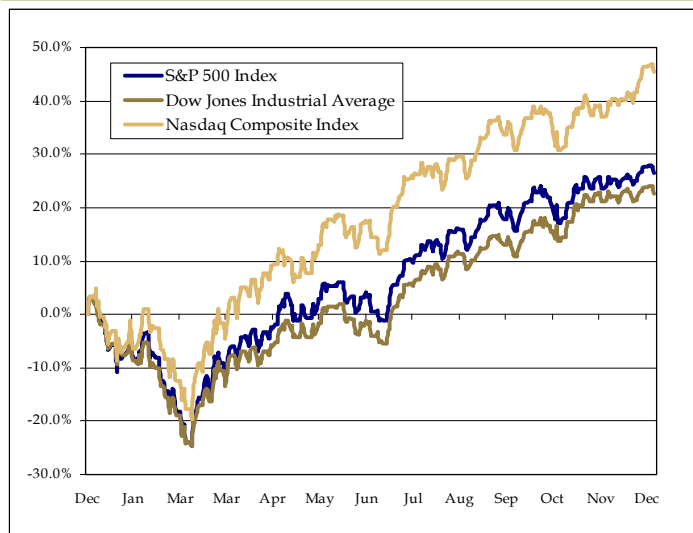
David E. Nelson, CFA
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Major Indices December Performance



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	December	Q4 '09	2009
<i>Broad Market Indices</i>			
S&P 500	1.93	6.04	26.46
Dow Jones	0.95	8.10	22.68
Russell 1000	2.43	6.07	28.43
NASDAQ	5.87	7.20	45.36
Dow Jones US Total Market Index	2.84	5.81	28.57
Russell 2000	8.05	3.87	27.17
Russell 1000 Growth	3.09	7.94	37.21
Russell 1000 Value	1.77	4.22	19.69
<i>S&P 500 Sector Indices</i>			
S&P 500 Consumer Discretionary	4.54	9.10	41.33
S&P 500 Consumer Staples	(0.26)	5.02	14.89
S&P 500 Energy	(0.93)	5.62	13.86
S&P 500 Financials	(1.51)	(3.31)	17.24
S&P 500 Health Care	2.08	9.09	19.70
S&P 500 Industrials	1.29	5.39	20.93
S&P 500 Information Technology	5.62	10.70	61.72
S&P 500 Materials	1.61	7.36	48.57
S&P 500 Telecomm Services	4.64	7.43	8.93
S&P 500 Utilities	5.54	7.26	11.91

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

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