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At the end of the third quarter, a few observations:

On our results year to date:

We are behind our benchmark due to two decisions made late last year, one that still seems right, and one that was wrong. The decision I still think right was the one not to cut back some of our biggest winners, which were also among our biggest positions, late in 2003. The mistake was not owning energy stocks.

Not Cutting Back Our Winners

We had a very strong 2003 as the market rewarded higher risk and higher volatility issues, after punishing them for the three previous years. We began cutting back on these names during the tech euphoria and continued throughout most of 2000. We then increased our exposure to them significantly in 2002 when the market, suffering from the corporate scandals and a weak economy, pushed them to what we regarded as bargain levels.

Investors who had progressively reduced their exposure to riskier assets as their prices declined, and who were unprepared for the market's advance, often spoke of the market's rewarding low quality in 2003, citing the low absolute prices, lack of current earnings, and high debt levels of the best performers. The implication was that the market was suffering from an outbreak of speculation, or that the market had gotten it wrong by marking up the so-called "low quality" names.

The better explanation, I think, was that after three brutal down years, where the market pushed the values of many companies to unrealistically low levels—Amazon to \$6, Tyco to \$7, Nextel to \$2.50 or about what they will earn this year (!)—risk in most of its forms was mispriced and undervalued from the summer of 2002 until the market began to rally in the spring of 2003. After it became clear the market rally was sustainable, investors increasingly sought to chase the stocks that were doing the best, ultimately leading to these formerly shunned securities getting temporarily ahead of levels justified by near term fundamentals.

This time last year, I believed that 2004 was likely to see some retracement from the embrace of risk, and that more conservative, dividend paying, and generally higher quality issues would probably fare well in the ensuing months. I considered cutting back on some of our best performers of 03, including Amazon, Nextel, and Interactive, but elected to stand pat.

There were two reasons for this: first, we are the largest, or among the largest shareholders of these companies, and our holdings in them represented large positions in our portfolio. Reducing our positions sufficiently to make a difference might have created substantial market impact costs, especially if other investors believed we might be seeking to exit our holdings entirely. For example, when Amazon fell sharply in the first quarter of this year, it was widely (and falsely) rumored that we were selling.

Second, I believed that these investments would provide better long-term results for our clients than the other alternatives being considered, even if the latter out-performed over the next twelve months or so. That still seems right to me, even though Amazon is down 34% this year, Nextel 10%—after being down over 20% a few months ago— and IAC/Interactive 43%.

IAC/Interactive's current share price, in particular, is about half a reasonable assessment of the private market value of the company's assets. The stock languishes in large part due to the company's unwillingness to buy back a substantial amount of shares (say 50 million or so) at today's bargain prices, arguing it needs the money for currently unforeseen opportunities. I have a high regard for CEO Barry Diller, who has proven to be an astute value creator over the years. He believes the company should keep its options open as to the use of cash. I agree, but think a substantial share repurchase would not compromise those options, and may even add to them. If the company does not undertake or authorize a more substantial share repurchase program in the next few months, and the shares remain depressed, I intend

to return to this topic and address it at much greater length.

In any case, I believe these names all represent excellent value and that we will be well rewarded long term for owning them.

The Failure to Own Energy

Michael Goldstein of Empirical Research is one of the most thoughtful and careful market analysts in the business. He is rare in being someone who, when he has a testable thesis, actually tests it. Late last year he identified the energy sector as presenting unusually attractive value based on then existing oil and gas prices, and one that would provide exceptional returns should those prices increase, as they have.

Michael spoke to our investment team about the values in energy, and he and I subsequently had a dinner devoted to the subject. By early December I was prepared to initiate a position in the group. The shares then started to advance and, hating to pay up for anything, I waited. That was a mistake. The group corrected in February and March, but by that time prices were well above the early December levels, and the shares we planned on selling to fund the purchases had fallen below the levels they achieved in late 03, making the trade-off less compelling.

Commodity prices, in general, have declined in real terms, except for temporary price spikes, virtually forever. Technological progress enables more supply to be brought forth, usually at lower prices. Higher prices not only make previously uneconomic sources viable, they encourage substitution. Since 1971, the world has consumed about 700 billion barrels of oil, yet proven reserves today are about 500 billion barrels higher than they were 30 years ago.

Although we were aware that the short term supply-demand situation favored higher energy prices for a variety of reasons, so was the market. That made me question how such widely available information could not already be reflected in the oil price. Moreover, although supply cannot be expanded fast enough to make much of a difference this year and next, it is expected that substantial new non OPEC supply will enter the market in 06 and 07.

With the markets being discounting mechanisms, I thought prices would begin to reflect the increased supply well before it came on-stream, making an investment in energy shares probably an 18 or 24 month operation, even if successful. That may sound like a long time in the world of hedge funds and hyper-active traders, but we typically like to be invested for far longer due to transactions costs, market impact costs, time to establish a position, and estimation error.

As I said, not owning energy was a mistake, but not because

the stocks went up and out-performed. Decisions that turn out badly are not ipso facto bad decisions. We are going to be wrong often enough even if we are making the right decisions. No one knows the future, or the expected value of the future, with any precision. As Peter Bernstein has pointed out, even if one did know the expected value of the future with certainty, one's decisions would still appear wrong from time to time.

My mistake was due to not reasoning as follows: energy is cheap and represents good value. The odds of its turning out badly over the next couple of years are low. Since energy is negatively correlated with the market (historically), if energy stocks do poorly, the rest of our portfolio should be fine, especially since we have a surfeit of volatility. If cheap energy stocks do badly, it will be because the price of energy collapsed, which is great for global growth and profits, as well as for insuring inflation stays low. The market and we would probably do very well if that happened.

If, though, energy prices rose substantially and unexpectedly, the shares, being cheap, would soar. If prices rose a lot, it would also be the case that all the good things that would happen if they fell would be reversed and a lot of bad things could happen, or at least people would worry that they might. The market would then struggle, or even decline.

Our portfolio is more sensitive than most to what Ben Graham called "the determination of the future prospects of an enterprise." Despite describing this factor as of "vital significance," he accorded it "little space" in the 1934 edition of *Security Analysis*. In the fourth edition, 1962, he gave the topic much more prominence. Today, the market values most securities on little else.

If energy prices were to rise substantially and stay elevated, investors would likely judge the future prospects of the enterprises in our portfolio more conservatively, and if we held no energy (the judgment of whose future prospects would rise), our results would suffer accordingly.

In the parlance of modern portfolio theory, our expected risk adjusted rates of return would have risen had we included energy in the portfolio at the end of last year. That was why it was a mistake not to do so.

Is it a mistake not to own them now? I don't know. Energy prices and the stocks have soared this year; the market has been fixated on little else. Usually that is a sign that current prices well reflect future prospects. The shares of most energy companies are no longer cheap on an historic basis. It is widely reported and believed that oil prices contain a substantial premium, over \$10 per barrel, for

continued supply uncertainty or disruption. Should that prove unnecessary, prices and shares would probably fall sharply. Others believe prices will rise relentlessly, topping out at over \$100 per barrel. If that were to happen, today's shares prices for energy would have proved to be a bargain. We continue to study the matter in light of today's changed circumstances and probabilities.

In retrospect, it will all seem clear, indeed perhaps inevitable. That is what the psychologists call hindsight bias. Those who were right will credit their keen analysis of evident facts and trends. Those who were wrong will blame unforeseen and unexpected events.

A Note on Google

The initial public offering of Google took place during the quarter, amidst much publicity. We successfully bid on the shares, which have more than doubled in price since the company came public.

This was one we got right and (it must be emphasized again) not because of the outcome, but because of the process. What follows is a brief, impressionistic, and by no means fully complete version of the process.

Google chose to come to market using an auction mechanism, instead of the more usual way of having investment bankers set the price. The company indicated it planned to give each successful bidder roughly the same percentage of the dollar amount bid, creating a more equal distribution of shares.

Our sense of this was that many would choose not to bid, since the determination of what to bid would require considerable work to be done in order to value the company.

In my experience, few IPO participants do much work prior to putting in for shares of highly visible, very profitable, fast growing companies. They assume the bankers will set the price so as to insure a quick profit. Participating in such new offerings carries little short-term risk, at least most of the time.

The Google offering was different. First it required work; second, if you were wrong, you could get stuck with a substantial amount of shares that might go down. Then there was the news flow about the deal: how the founders were arrogant and inexperienced, how the dual class share structure smacked of bad corporate governance, how the company would not provide enough information about its business, how it refused to give guidance on future prospects, and so on.

We believed this created an opportunity. Our large ownership positions in Amazon, eBay, and IAC/Interactive gave us, we thought, a competitive advantage in understanding, analyzing, and valuing companies such as Google. We created a team of

analysts who studied every aspect of the company's business, focusing especially on the competitive dynamics that might ensue from Microsoft and Yahoo, as well as more targeted search providers such as Amazon's A9.

The result was a comprehensive assessment of Google's strategic position, competitive advantages and potential value. The valuation work was particularly well done, in my opinion. We ended up putting in 3 bids for the shares, one within the pre-announced range and two below. Our highest bid, valuing the company at over \$30 billion dollars, still provided us with a reasonable margin of safety had we received shares at that price.

We were delighted when the so-called FUD factor (fear, uncertainty, doubt) dominated the process, resulting in the shares coming at the bargain price of \$85, valuing the company at \$23 billion roughly.

Outlook

This section can be safely skipped, since I have no idea what the market is going to do. I thought things looked pretty good fundamentally at the end of the second quarter and the market went right down.

I still think things look fine: profits are growing, inflation is tame, productivity growth is high, cash flow and free cash flow are at record levels, corporate balance sheets are in great shape, and valuation is not demanding, although it is not compelling either. It only gets compelling when things are bad, and then no one cares. The problems every one talks about—energy prices, geopolitical uncertainty, deficits, the dollar—are fully reflected in current share prices in my opinion.

We will continue to try to make the best long term investment decisions we can, based on careful analysis and on as sound reasoning as we can muster.

As always, we appreciate your support and welcome your comments.

Bill Miller, CFA

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Security Name	Added or Sold	Initial Price (\$)*	Current Price (\$)
3rd Quarter 2003			
Seagate Technology	Added	13.52	12.70
1st Quarter 2004			
Electronic Arts Inc.	Added	47.68	45.59
2nd Quarter 2004			
Countrywide Financial Corp.	Added	31.97	32.02
3rd Quarter 2004			
Aetna Inc.	Added	85.00	95.85
Google Inc.	Added	85.00**	196.25
1st Quarter 2004			
General Dynamics Corporation	Sold	90.39	102.34
The News Company Limited ADR	Sold	30.25	32.11
3rd Quarter 2004			
Lloyds TSB Group plc	Sold	7.83	8.06
* The initial price is the price of the security on the first day of the quarter during which the security was added to or sold from the portfolio.			
**Price as of the Initial Public Offering on 8/19/04.			