

Bill Miller Commentary

Bill Miller, CFA
Chief Executive Officer
Legg Mason Capital Management

A Note to New Shareholders

During the fourth calendar quarter of 2005 Legg Mason and Smith Barney completed an agreement whereby Legg Mason's financial advisors became part of Smith Barney's sales force, which will now be able to distribute Legg Mason mutual funds, including the Value Trust.

We are extremely grateful to the former Legg Mason financial advisors who have entrusted their clients' assets to us over the years. We share our chairman Chip Mason's respect and admiration for the Legg Mason sales team and believe working with people you like and respect is a true gift. Our Legg Mason brokers have been wonderful partners with us over the years and we look forward to continuing that relationship with them at Smith Barney.

As a result of this new distribution agreement, we are now welcoming a substantial number of new shareholders. I thought it might be helpful, in addition to saying how much we appreciate your confidence in allowing us to invest your savings, to say a little about the principles and approaches we bring to that task.

You are probably aware that the Legg Mason Value Trust has outperformed the S&P 500 index for each of the past 15 calendar years. That may be the reason you decided to purchase the fund. If so, we are flattered, but believe you are setting yourself up for disappointment. While we are pleased to have performed as we have, our so-called "streak" is a fortunate accident of the calendar. Over the past 15 years, the December to December time frame is the only one of the twelve month periods where our results have always outpaced those of the index. If your expectation is that

we will outperform the market every year, you can expect to be disappointed. We would love nothing better than to beat the market every day, every month, every quarter and every year. Unfortunately, when we purchase companies we believe are mispriced, it is often difficult to determine when the market will agree with us and close the discount to intrinsic value. Our goal is to construct portfolios that have the potential to outperform the market over an investment time horizon of 3-5 years without assuming undue risk. If we achieve that goal, we believe we will be doing our job, whether we beat the market each and every year or not.

What you should expect is for us to follow a sensible investment philosophy that you understand and agree with, and that you think will enable you to achieve your investment objectives, consistent with your risk tolerance and your investment time horizon. Our investment philosophy applies what we believe are the best analytical skills and resources available to reach investment decisions for your portfolio.

What follows is a brief, and by no means complete, description of how we think about investing. If you find it congenial, that is great. If you don't, or you are uncomfortable with it, or it does not fit your psychology, then you probably should not be in this fund.

We are value investors. We take both of those terms seriously: we value businesses, and not just stocks, and we invest in them long term. We do not buy stocks based primarily on accounting based relationships such as price earnings or price to book value or cash flow (although we carefully consider these metrics and many others besides), and

we do not sell when the securities we own reach some pre-determined target based on the relation of price to such metrics as may have prevailed in the past (though we also take that into consideration).

As value investors, we are valuation driven. The most common error in investing is confusing business fundamentals with investment merit. A company that is doing terrifically well, that has great management and returns on capital, and great products and prospects, may be a terrible investment if the expectations embedded in the current valuation are in excess of those fundamentals. A company with poor business fundamentals, a mediocre management, and indifferent prospects may be a great investment if the market is even more pessimistic about the business than is warranted.

The most important question in investing is what is discounted, or put slightly differently, what are the expectations embedded in the valuation? We believe markets are pragmatically efficient, which means that it is very difficult to analyze the available information about a company and use that to outperform a relevant benchmark. The evidence in favor of that proposition is overwhelming, as any look at the percentage of money managers who are able to outperform over long periods of time will readily attest.

Systematic outperformance requires variant perception: one must believe something different from what the market believes, and one must be right. This usually involves weighting publicly available information differently from the market, either as to its magnitude or its duration. More simply, the market is either wrong about how important something is, or wrong about when that something occurs, or both.

This all sounds fine, maybe even conventional. You may be thinking, of course one needs to think independently, one needs to value things carefully. It becomes clear how well these generalities are understood only when they become specific investments.

Was Google good value at \$85 when it came public? Well, it appears so, since it is now trading at \$436 a

year and a half later. But when it came public it was universally panned as another internet hype stock with all the trappings of 1999's over-optimism.

How about now, at \$436? Is it worth as much as IBM? The market says it is, at least on the basis of simple equity capitalization. How can that be? IBM's earnings are more than Google's sales. We owned Google on the IPO and we own it now. We own IBM, too.

Is the largest financial services company in the world, Citigroup, really worth a substantial discount to the average company based on its price earnings ratio, despite having substantially better returns on its equity and a powerful global presence? The market says yes. We disagree and that is why we own it.

How about Kodak? Doesn't everyone know chemical-based film is going away? How could you own that? We are asked that all the time. We are Kodak's largest shareholder.

Sometimes we are right when we think the market is wrong, and sometimes we are not. One never knows until later, and then hindsight bias colors the analysis. It always appears obvious in retrospect. We were right, for example, to buy Tyco under \$10 when it was involved in an accounting scandal. We were wrong to buy Enron when it was also involved in such a scandal. Our analysis of Enron was excellent, in my opinion, despite our investment being unsuccessful. Process and outcome are two different things.

Our positions are usually regarded as contrarian, which means that most people who look at them will not like them. If you are uncomfortable owning controversial stocks, stocks involved in scandals, stocks whose prospects are uncertain, or which are considered, "too risky" because the valuation looks too high, or the company has too much debt, or it has poor prospects, you should not own this fund.

We are often asked, what is the secret to the fund's success? The answer, of course, is there is no secret; but there are some aspects of what we do that differentiate us from other investors, and from other value investors.

I would highlight three:

1. Our portfolio contains a mix of businesses, some of which we believe are cyclically mis-priced, and some of which we believe are secularly mis-priced. The former are often called value stocks, the latter growth stocks, not helpfully in either instance. Value investors rarely own so-called growth stocks because they are uncomfortable with doing the kinds of analysis and projections necessary to value them, especially when they involve high technology, or when they involve new business models such as Google. There is a lot of uncertainty in doing that, which means risk, and value investors think of themselves as risk averse. We believe we have an analytical advantage over more traditional value investors because we will look at such businesses, and over growth investors because our analysis of them is based on valuation, not some short-term factor such as whether they beat next quarter's earnings estimate, or whether guidance is raised or lowered. Our ability to properly price risk is our advantage over both types of investors.
2. We average down relentlessly. Two things seem pretty clear to me: first, no one can consistently buy at the low or sell at the high (except liars, as Bernard Baruch said), and second, lowest average cost wins. We constantly strive to lower the average cost of our positions by buying more if and when the price drops. Throwing good money after bad, others call it. Many investors think a drop in the price of stocks they own is evidence they were wrong. We think of it as an opportunity to increase our implied rate of return by lowering our average cost. Someone once asked me how I knew when we were wrong to do that. When we can no longer get a quote, was my answer.

3. We practice the Taoist *wei wu wei*, the "doing not doing" as regards our portfolio, otherwise known as creative non action. We are mostly inert when it comes to shuffling the portfolio around, with turnover that has averaged in the 15 to 20% range, implying holding periods of more than 5 years. Many funds have turnover in excess of 100% per year, as they constantly react to events or try to take advantage of short term price moves. We usually do neither. We believe successful investing involves anticipating change, not reacting to it.

The combination of these three things means we manage money substantially differently from most other managers. Different doesn't necessarily mean better, but it does mean different!

I hope the foregoing has been helpful. If you understand what we do, you should be better able to judge how well we are doing it. We have our own money invested alongside yours because our team believes this is the way we will build wealth for our own families along with our shareholders'. As we have said to our shareholders over the years, we cannot promise performance, but we can promise no one will care more about your money or work harder for you than our investment team.

Bill Miller
1/19/06

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.

To the extent specific securities are mentioned in this commentary, they have been selected by the author on an objective basis to illustrate views expressed in the commentary. If specific securities are mentioned, they do not represent all of the securities purchased, sold, or recommended for clients of LMCM and it should not be assumed that investments in such securities have been or will be profitable. There is no assurance that any security mentioned in the piece has ever been, or will in the future be, recommended to clients of LMCM.

LEGG MASON
CAPITAL MANAGEMENT