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The rally that began following the March 6th bottom at 666 on the S&P 500 has had a different character from those embedded in the bear market that began with the credit disruptions of August 2007. Whether it is the beginning of a new bull market, which it will be if the economy begins a sustainable period of growth later this year, or if it is just a solid rally in an ongoing bear market, which appears to be the overwhelming consensus, is of course unknown at this point.

If it is a bear market rally, it is one we have not seen since the late 1930s. Its behavior is much more like the rally that ended the 1973-1974 bear market, or the one that began off the bottom in 1982, or even that which erupted in March 2003 from the last debt deflation scare. It has been longer and broader off the bottom, with fewer chances to get in, than the bear market rallies that characterized the post-war period. We have had six straight weeks of gains (seven for the NASDAQ), whereas the most we could muster in 2008 was three weeks of gains.

This move has been led by the classic early cyclicals: financials, housing, and consumer discretionary names such as retailers and restaurants - an encouraging sign that may be signaling the end of the long period of economic decline that began in December 2007. Another hopeful note is the strength of stocks in emerging markets, which are highly sensitive to incremental economic growth. China is up over 30 percent this year, Korea over 20 percent, India 17 percent, and most other Asian markets are higher by double digits on the year. In the Americas, Brazil and Venezuela are up over 20 percent, Chile and Argentina are up double digits, Canada is up 6 percent, as is the NASDAQ in the U.S.

The breadth of the rally globally is a good sign. The S&P 500 is still down 4 percent, and the Dow Jones Industrial Average is down almost 8 percent,

but it will be hard for them to remain down if most other global markets are able to hold their gains. This global bear market and financial crisis have shown how interconnected and correlated the world's economies and asset values are: Just as decoupling was wrong on the downside, it almost certainly will prove to be wrong on the upside.

One difference between this rally and the others has been the presence of (to use the metaphor du jour) "green shoots" in the economic numbers — data points that provide some hope things are getting better, or at least that the decline is slowing. The economic numbers are not as uniformly awful relative to expectations as they were only a month or so ago, and the first-quarter earnings season has provided some positive surprises, most notably in banks and other financials, which have had a powerful rally off the bottom, yet most of which remain very depressed relative to where they started the year, and extraordinarily so relative to their history.

The financials remain the source of greatest controversy, and in my opinion, the greatest opportunity in the market. We are in a global financial crisis, one that began in the U.S. with housing but has since spread to the global financial system, which is operating far below what is necessary to have a smoothly functioning global economy. Credit spreads remain extremely wide by historic standards, and banks are reluctant to lend to all but their best customers. The shadow banking system (i.e., investment banks such as Lehman and Bear Stearns, structured investment vehicles, the securitization markets) is, well, a shadow of what it once was, and as a result, that source of credit is almost gone, and banks are not in a position to replace it anytime soon.

Fed Chairman Bernanke has said repeatedly and correctly that we need the financial system and markets to improve before the economy can improve. The Fed has stepped into the breach left by the collapse of the shadow banking system with a series of innovative policy initiatives such as the Term Asset-Backed Securities Loan Facility (TALF) and the Public-Private Investment Program, both of which are just getting started. I appear to be more optimistic than most that these will work, either in their current form or through iterative redesign. The risk remains that a major

policy blunder will derail the progress that is under way, but that risk appears to be receding as we come to the conclusion of the stress test results, which are expected to be announced within the week.

I believe policy with regard to banks remains the greatest risk to market confidence and stability, and therefore to economic recovery. Until the late fall of last year, most efforts to deal with the crisis served only to accelerate it, destroying confidence instead of enhancing it. Think of the pre-emptive seizure of the government sponsored enterprises (GSEs) with the attendant wipeout not only of common shareholders but also the completely gratuitous evisceration of preferred holders. By prohibiting the payment of dividends to preferred holders, the government managed to blow a further hole in the banking system's capital (Fannie and Freddie preferreds counted as Tier 1 capital for banks) and at the same time, to shut down the market for capital raising via the issuance of preferred stock, which had previously been an important vehicle for private capital to invest in banks. The decision to let Lehman fail has been widely derided as a complete disaster, as it disabled the entire credit system, and its effects are still a large part of what has to be undone for the economy to begin functioning normally again.

Policy has improved since then, as it became clear to at least some authorities that policies that wipe out private capital (in obeisance to some idea about moral hazard or some other equally inane supposition) and are punitive to investors in financial institutions are hardly likely to lead private capital to invest in those institutions, which is the stated objective of the policies: to restore confidence so that private capital can do the investing, and not have the government putting taxpayer money at risk.

There are a few who have been voices of reason during this crisis, people who understand how the banking system works and how confidence can be restored. These include Ricardo Caballero, head of the economics department at MIT, Bill Isaac, former head of the FDIC, hedge fund manager Tom Brown, veteran bank analyst Dick Bove, Anatole Kaletsky of GaveKal Research, Eddie Lampert of ESL Investments (and controlling shareholder of Sears), and as usual, Warren Buffett, who in a recent interview pointed out the intellectual vacuity of the favorite new ratio the bears are using to beat up on banks, the tangible common equity ratio. These voices of reason appear, though, to be in the distinct minority, as the other side commands the likes of Nobel Laureates Paul Krugman and Joseph Stiglitz, politicians Barney Frank and Christopher Dodd on the left, George Will and Senator Richard Shelby on the right, most sell side bank analysts, Tom Friedman and a plethora of political and economic commentators in the U.S. and abroad, and

a witches brew of hedge funds and short sellers who hope to profit on economic misery, even if they have to create more of it to do so. If they prevail in their arguments, they will find themselves in the same place Pyrrhus did after the battle of Asculum in 279 B.C.

This is not the place for anything approaching a thorough look at the issue of the financial condition of banks, or the appropriate measures to accomplish the return of confidence and stability to the system, and the resumption of credit flows at reasonable spreads to creditworthy borrowers. There are a few points, though, that are germane even if they serve only to inform our clients and shareholders how we are thinking about these issues.

Let's start with what banks do. Banks are, broadly speaking, in the business of collecting liquid short-term assets in the form of deposits and turning them into illiquid long-term assets in the form of loans. Not only do they take our liquid assets and make them illiquid (they do retain enough liquidity to meet anticipated demands from depositors for cash), they create many more loans than they have capital to support if too many of the loans go bad. This leverage is about 10 to 1. Since the assets are 10x the capital supporting them, it doesn't take more than third-grade arithmetic to conclude that if the value of the assets they hold fall more than 10 percent on average, they are "insolvent" (the quotation marks are there because the whole argument of those who support some kind of nationalization turns on confusing the different predicate logics of the single term "insolvent"). Last year the S&P 500 fell 38%, which is a reasonable proxy for how much asset values declined on a mark-to-market basis. Ergo, the system is insolvent and either needs to be nationalized or it needs, say, a trillion dollars of new capital (which was an estimate from a bank analyst last week).

When I was in grad school well over 30 years ago, I had a professor who would occasionally mark "ISSW?" next to what I had thought was a particularly clever argument. It stood for: "If so, so what?" and might also be appropriately appended to the argument about insolvency. Sometimes those who make that argument say the banking system is "technically insolvent," which begins to shed some light on the "so what" part. The notion of insolvency, as typically understood, means you don't have the wherewithal to meet your obligations as they come due. But that is certainly not the case with the banking system as a whole, or with any major bank. Banks, in fact, are flush with cash, have deposits flowing in, and have \$800 billion of EXCESS reserves on deposit at the Fed. Most of the big banks that have reported results recently are

profitable (Wells Fargo had record profits), and most improved their capital ratios. Not surprisingly, the same analysts who expected the banks to report losses in the first quarter dismiss the earnings as due to nonrecurring items, unusual market conditions (very wide spreads) and accounting gains. Of course, when those same conditions led to large losses being reported last year, those losses were considered all too real.

Remarkably, those who so worried about the financial condition of banks have decided that accounting conventions should trump economic reality. Accounting conventions seek to present the financial condition of businesses — they are not themselves that condition. The underlying financial condition of banks depends on confidence and cash flows. The cash flows are robust, the system has record liquidity; it is clear thinking about the accounting that is wanting.

Consider the issue of mark-to-market accounting, which has been the subject of so much controversy. Supporters say it serves the goal of transparency and helps illuminate the true financial condition of the enterprise. Opponents say it does no such thing, just the opposite, in fact, confusing market prices with underlying values, and injecting needless volatility and confusion into bank financial statements.

The irony is that we have been here before: the same arguments were made in the 1930s when for most of the decade banks marked assets to market. As asset values fell, depositors fled, banks collapsed, and the depression wore on. In July 1938, the Federal Reserve bulletin announced that mark-to-market accounting was being suspended, and that bank assets should be valued on long-term safety and soundness, and not daily price fluctuations. That was also the time the uptick rule was instituted to slow down short selling. Coincidence or not, those two policy measures coincided with the end of the vicious bear market of 1937 and 1938. It is eerie how the relaxation of mark-to-market accounting rules a few weeks ago and the announcement that some form of uptick rule would be reinstated also coincided with the bottom of this bear market. Policies and rules matter.

A couple of other points on mark-to-market: Showing market values, or estimated market values, for assets is a good thing. But requiring bank capital ratios to be adjusted accordingly is not. Leaving aside the current controversy, consider that whenever we have another asset bubble and irrational exuberance returns, banks will have to mark up their assets, no matter how absurdly overpriced they are. It is also telling that the bears appear to want only those assets that can be marked down to market. None are calling for buildings built years or decades ago whose value is far in excess of carrying value (as was the Bear Stearns headquarters

building) to be marked up. And none has ever been heard to call for the deposit bases of major banks to be marked to market, which would generate billions of excess capital for those banks if the deposit franchises were carried at market. (Leave aside that deposits are on the balance sheets as liabilities, just another reason accounting conventions cannot be blindly taken to represent economic reality.)

Lastly, we consider the stress test, whose results will soon be available. This ill-conceived plan was designed, so its proponents say, to instill confidence in the system. It has only instilled confusion so far, and rightly so. First, banks do stress tests all the time and do so in conjunction with their regulators, as Dick Kovacevich at Wells Fargo has pointed out. So this is at best otiose. Second, it is clear that all of the 19 biggest banks are well capitalized according to regulatory requirements, as Sheila Bair, head of the FDIC, has also pointed out. Indeed, most have capital ratios far in excess of regulatory requirements (even the benighted Citibank). But the way the tests have been organized, they are supposed to demonstrate potential capital shortages under economic scenarios far worse than currently anticipated. Since the current situation is the most dire since the Depression, that is dire indeed. The major design flaw comes in that the government has indicated that banks that are currently well capitalized will be required to raise even more capital just in case things get a lot worse, to provide an additional cushion, as the saying goes.

This pre-emptive capital raise is exactly backward. It ought to be the case that if things get a lot worse, and banks' capital ratios fall enough, then they will have to raise additional capital. If they cannot do so privately, then the government will need to put more capital in, diluting, perhaps substantially, existing holders. But pre-emptive dilution is the first cousin of pre-emptive seizure, which was so disastrous with the GSEs.

There is another, broader point: here again policy is backward. Capital should be raised in good times and drawn down in bad times. To require capital to be raised pre-emptively creates perverse incentives that work against policy goals. The easiest way to raise capital is not to lend, and to force borrowers to repay when loans come due. Assets decline and capital ratios improve, and we are all a lot worse off as the economy sinks because credit is not available. Keynes made this point in the 1930s: Actions that seem individually rational can be collectively irrational.

It has been reported that the stress tests will also look to see if the banks have the “right” kind of capital, which is taken to mean tangible common equity. This new requirement is conceptually incoherent, despite its now being adopted as the gold standard of capital by sell side analysts and hedge funds who are short. They appear to have persuaded regulators it is important. It is idiotic. The

argument is being made that tangible equity is the first line of defense against losses. Other equity, like the preferred equity the government got for TARP (Troubled Assets Relief Program) money, is somehow not as good. But equity is equity. The cash the government exchanged for preferred stock could have been exchanged for common equity, but the government wanted taxpayers to be in senior position to the common shareholder, which seemed sensible then, and still seems so now.

Now, it is being argued that preferred equity should be converted to common, as this will be somehow “better.” No one seems to have noticed that no new capital is being created by moving from preferred to common; the equity has just been rearranged (dividends saved do create capital, but only later). It is impossible to understand what economic or political benefit the government gains by moving from a senior to a subordinate position in the capital structure, forgoing substantial dividends in the process. No new equity is created; accounting typology trumps economic reality. It does, though, dilute common shareholders and drive down the stock price, which of course is the objective of many of those who advocate it.

Warren Buffett noted recently that he never looks at tangible common equity in assessing banks’ financial strength (and neither should regulators). As he noted, Coca Cola has very little tangible common equity yet is highly profitable and financially strong. You don’t make money on tangible common equity, he said, you make it on the difference between your cost of funds and the return on your assets net of credit losses. Losses can be absorbed at banks through loan loss reserves, and through all forms of capital, not just tangible common equity. That is why regulators settled on Tier 1 capital, core capital, and leverage as the way to assess banks, and not tangible common equity. Sound policy would do the same. Changing the rules in ways that make banks seem weaker than they are, or requiring them to raise capital when they do not need to do so, is bad policy and is destructive of confidence.

This commentary has gone on a lot longer than intended and still isn’t very good, so I’ll stop here. The thoughts presented above are really just fragments of more extended arguments and are not meant to be complete or exhaustive. I do think they are directionally correct, however.

As for the capital markets, I expect them to be volatile, but less so than in the past six months. Credit spreads should gradually shrink, and equity prices should rise as the economy stabilizes, credit begins to flow, and volatility declines. I expect stocks in the U.S. to end the year higher than where they began, perhaps

considerably higher. In the short run, after the strong advance of the past seven weeks, it would not be surprising to see sufficient weakness to again engender enough fear to lay the groundwork for further gains.


Our portfolios, it should be stressed again, are not built based on macroeconomic forecasts, or expectations about the direction of equity markets in the next few months. They are constructed based on long-term considerations of value under average expected conditions over the next several years. That means that we believe the economy and the stock market will grow over the next few years, even if they do or don’t this year, and that businesses will earn returns on capital consistent with their competitive advantages, the underlying economics of their industries, and the capability of their managements.

After three years where the market was dominated first by price momentum, and then by panic, we have found value has once again begun to matter, as it has done 70 to 80 percent of the time. Consistent with that, our portfolio has once again begun to outperform. As the U.S. and global economy stabilize, risk aversion should attenuate, and capital should begin to return to credit and equity markets. That should be good for valuation-based strategies, and I am confident our results will reflect the value inherent in our portfolio.

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