LEGG MASON CAPITAL MANAGEMENT

Monthly Commentary

February 2005

Market Commentary

The S&P 500 and Dow Industrials bounced back in February from their January sell off, finishing the month close to the levels where they began the year.

TOTAL RETURNS*

	January	February	YTD
S&P 500 Index	-2.44%	+2.10%	-0.38%
Dow Jones Industrial Average	-2.59%	+2.92%	+0.25%
Nasdaq Composite Index	-5.18%	-0.43%	-5.59%

In contrast, the Nasdaq Composite continued to decline during the month, as tech and Internet stocks continued, for the most part, to take it on the chin.

The big story in February was energy stocks. On a capitalization-weighted basis, the energy sector was up 18.7% during the month, accounting for roughly two-thirds of the S&P 500's monthly return. Exxon Mobil, alone, tacked on a cool $75 billion of market value in February, finishing the month up 22.7%, and in the process passing General Electric as the world's most highly valued company in terms of market capitalization. Not coincidentally, we think, Exxon Mobil passed General Electric on February 23, 2005, the day after the April 2005 WTI oil future closed above $50 for the first time since November 2004.

While the stock market action during the month was largely concentrated in the energy sector, basic materials stocks also made a good showing, up 7.6% on a cap-weighted basis. Health care and utilities were the only other S&P sectors to post benchmark-beating returns. The consumer discretionary and financial sectors actually posted declines for the month.

Source: Bloomberg and FactSet

On the economic front, the news was quite encouraging. On Friday, March 4th, the U.S. Labor Department reported that non-farm payrolls grew by 262,000 in February, the biggest increase since October 2004, surpassing expectations of 225,000 and nearly twice January's total of 132,000. At the same time, the unemployment rate ticked up from 5.2% to 5.4%. Friday's payroll data came one day after the government substantially revised upward its fourth-quarter 2004 estimate of business productivity growth to +2.1% from +0.8%, and revised downward its accompanying estimate of unit labor cost growth to +1.3% from +2.3%. These data points suggest that—despite the pick up in employment growth—slack remains in the labor market, enabling the Federal Reserve to stay on its present course of removing monetary accommodation at a "measured" pace.

Business capital spending trends also remain strong in the early months of 2005, contrary to the expectations of many economists who forecast that expiration of bonus depreciation tax incentives in December 2004 would lead to a drop in expenditures. That not being the case, economists at Merrill Lynch, J.P. Morgan and other Wall Street firms are busily revising upward their first quarter 2005 estimates of capital spending and GDP growth. The spate of favorable news on capital spending moved former Fed Governor Lyle Gramley to conclude that "spending appears to have gained a degree of vigor not previously experienced in the current economic expansion," and, therefore, that "animal spirits may have finally awakened in the business community."

On the eve of the second anniversary of the beginning of the war in Iraq, the news from the Middle East is also encouraging. While the situation remains challenging and the continued loss of life is unsettling, the successful Iraqi elections in late January appear to us to have been an enormously positive symbol of hope for the entire region. The March 5, 2005 issue of The Economist puts it this way:

"Arabs everywhere were affected by the spectacle in January of Iraqis defying terrorists to cast their vote and elect a new government, and of Palestinians managing to hold a free election even while under Israeli occupation. The past week has brought even more transfixing scenes, as Lebanese thronged the streets of Beirut with their flags in an unprecedented show of 'people's power,' forcing the country's pro-Syrian government to resign. At the same time, Hosni Mubarak, Egypt's president for the past 24 years, has astonished his countrymen by calling for constitutional changes to allow rival candidates to vie for his position for the first time."

In our judgment, developments on the economic and political front suggest that a much more sanguine view of the equity market than seems to currently prevail is justified.

Outlook

We remain optimistic about the outlook for the economy and equity market for the balance of this year. Thus far, the stock and bond markets have reacted with equanimity to the Fed's efforts to remove previous monetary accommodation. Since June 2004, when the Fed began raising rates, the S&P 500 is up about 7% (through February 2005) and ten and thirty-year Treasury bonds are up as well (i.e., yields on both have declined).

Despite much hand wringing by a host of market commentators—especially during January's decline—we believe the equity market has much to recommend it. Corporate America has a mountain of cash and is beginning to spend it. Capital spending grew 14% in the fourth quarter, and continues strong in January and February. M&A activity is booming. Record numbers of share buyback programs are being announced and dividend growth is accelerating. All of these factors bode well for share prices, in our judgment. In addition, real GDP estimates for 2005 are on the rise from their beginning year level of 3.6%, and the outlook for corporate profits is being buoyed by stronger than expected growth in capital spending. The Fed's preferred measure of inflation—the chain price index for personal consumption expenditures (PCE)—at 1.6%, remains well within the Fed's comfort zone of 1% to 2%. This fact suggests to us that the Fed will likely continue to raise rates at a "measured" pace.

Based upon the data available so far this year, we believe it is more—rather than less—likely that S&P 500 earnings per share will grow at 10% or better in 2005. Since we believe the market is roughly fairly valued on trailing earnings and can appreciate in line with earnings this year, a 10% gain in the S&P 500 remains our best guess for 2005. As Warren Buffett points out in his latest Chairman's Letter (2004 Berkshire Hathaway Annual Report), while 10% is close to the long-run average of stock returns since 1965, it is far from "normal"—since in only 4 of the last 40 years has the market's return been between 8% and 14%. The other thirty-six years have either been better than 14% (20 years) or worse than 8% (16 years). If we had to bet this year, we'd wager that any surprise in returns would come on the upside, rather than the downside.

In the past, we have tended to confine our comments in this section to the outlook for stocks over the coming year or so. We thought it might be useful to share our thoughts about the longer-term outlook for equities, say over the next five years.

We approach this exercise as a "thought experiment." We will make what we regard as a reasonable set of assumptions and see where those assumptions take us. Obviously, we could be very wrong, either by being too optimistic or too pessimistic. We are trying to be neither. We are trying, instead, to be realistic. We invite clients to challenge our assumptions where they differ, or offer their own forecasts, if they feel so inclined. If we get enough responses, we may report back (protecting anonymity, of course) the

"Wisdom of Crowds" on this topic.

Our first assumption is that the S&P 500 is about fairly valued currently based on trailing earnings. The framework that our colleague, Michael Mauboussin, uses in his January 2005 piece on valuation suggests that an entity with a cost of capital of 8%, earning 16% on unlevered equity, growing at 6% should trade at about 18 times earnings. These statistics closely approximate the S&P 500's current characteristics, and – happily for us—the S&P 500 does, in fact, trade at about 18 times trailing earnings. An important implication of the assumption of fair-valuation is that future earnings growth will be reflected in stock prices on a one-for-one basis, i.e., the P/E multiple of the market will stay the same (on average) over the next five years.

Our second major assumption follows from the first, namely that S&P 500 earnings per share will grow at 6% long-term. We think this assumption has considerable appeal from two points of view. First, the S&P has achieved a best-fit growth rate of 6% over the last 50 years, so our assumption is consistent with history. Second, the assumption also squares with our assumption that nominal GDP will grow at just less than 6%--3% real and 2.85% inflation—over the next five years, and that S&P earnings per share will grow in line with nominal GDP. Three percent real GDP growth may sound a bit low—and it might, in fact, be low—but it is the average U.S. growth rate over the past 30 years, and we thought it was a reasonable place to start. The 2.85% inflation assumption might also look a bit odd. It is simply the break-even inflation rate between the yield on the 5-year TIP as of March 7, 2005 (1.13%) and the yield on the 5-year Treasury note (3.98%) as of the same date.

All we need now is an assumption about dividends and we are ready to go. The dividend yield of the S&P 500 is currently about 1.8%, but the dividend payout ratio is an unusually low 32%. Assuming that the payout ratio rises to a more normal—but still low—40% in 5 years, the average dividend yield over that period should be about 2%.

Let's summarize our key assumptions:

P/E Multiple: No Change
Earnings Growth Rate: 6%
Real GDP Growth Rate: 3%
Inflation Rate: 2.85%
Nominal GDP Growth Rate: 5.94%
Average Dividend Yield: 2%.

The assumptions above lead to a 5-year forecast of nominal total returns for the S&P 500 of 8.12% (1.06 X 1.02) and real total returns of 5.12% (1.0812/1.0285). If these forecasts prove to be near the mark, they suggest 10-year returns for the S&P 500 beginning in 2000 as follows:

Compound Annual Returns	5 Yrs. Ended 12/31/04A *	5 Yrs. Ended 12/31/09E*	10 Yrs. Ended 12/31/09E*
Nominal	-2.30%	+8.12%	+2.78%
Inflation	+2.62%	+2.85%	+2.75%
Real	-4.79%	+5.12%	+0.00%

The table above has a number of interesting implications, in our opinion. First, it reveals the startling degree of over-valuation of the S&P 500 at the beginning of 2000. Based upon this forecast, the S&P 500 will not better its 2000 high of 1527.46 until sometime in late 2008. It also indicates that the Calvinistic market observers who believe we must continue to suffer for our collective excesses during the "Bubble" years need not be right. Real returns slightly in excess of 5% compounded for the next 5 years will produce real 10-year returns (from the beginning of 2000) of ZERO!—surely enough collective pain to suit most people.

Are these forecasts too optimistic? Possibly, if something dreadful happens to the world in the next five years. Are they too pessimistic? They certainly might be, especially with respect to our assumptions about earnings growth. The S&P

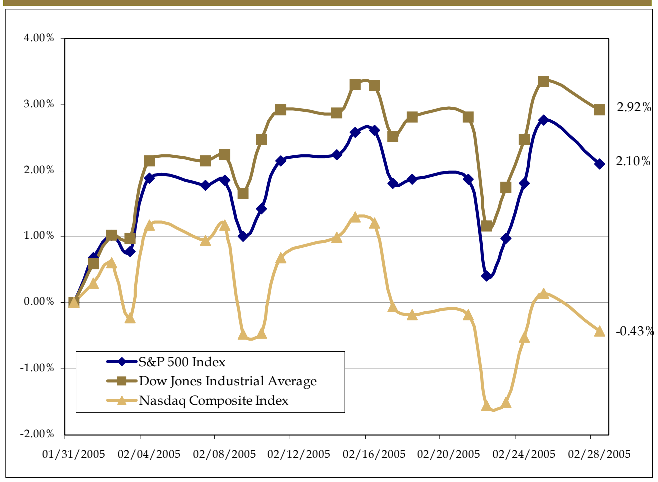
**Source: Actual Data (A) – Ibbotson Associates, Estimates (E) – Legg Mason Capital Management*

500's current reinvestment rate of about 10.9% suggests that Corporate America collectively has the wherewithal to grow its earnings a lot faster than 6%, at least in the near-term.

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

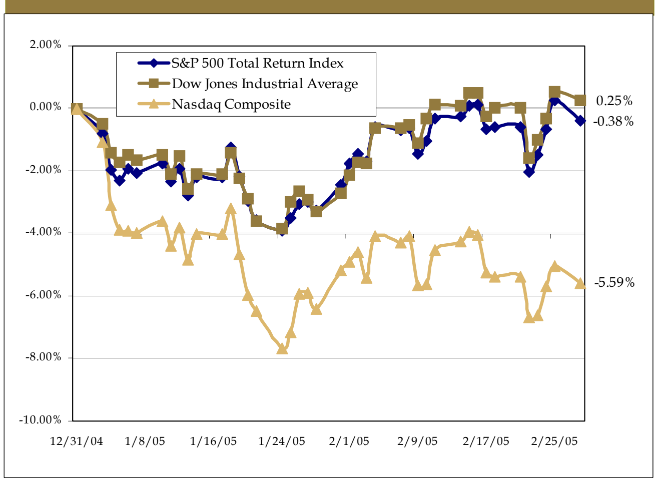
David E. Nelson, CFA
Director of Market Analysis

Major Indices February Performance



Source: Bloomberg and FactSet

Major Indices YTD Performance



Source: Bloomberg and FactSet

S&P 500 Index Sector Performance

	February	YTD
Consumer Discretionary	(0.42%)	(4.56%)
Consumer Staples	0.16%	1.37%
Energy	18.72%	21.97%
Financials	(0.53%)	(2.68%)
Health Care	3.13%	(0.13%)
Industrials	0.82%	(1.89%)
Information Technology	0.08%	(5.16%)
Materials	7.91%	4.57%
Telecommunication Services	0.68%	(6.29%)
Utilities	2.16%	4.24%

Source: Bloomberg and FactSet

Major Indices Performance

	February	YTD
S&P 500 Index	2.10%	(0.38%)
Dow Jones Industrial Average	2.92%	0.25%
Russell 1000	2.25%	(0.33%)
Nasdaq Composite Index	(0.43%)	(5.59%)
Dow Jones Wilshire 5000	2.08%	(0.63%)
Russell 2000	1.69%	(2.55%)
Russell 1000 Growth	1.06%	(2.31%)
Russell 1000 Value	3.31%	1.48%

Source: Bloomberg and FactSet