LEGG MASON CAPITAL MANAGEMENT Month-End Commentary

March 2005

Market Commentary

The S&P 500 and Dow Industrials went on a rollercoaster ride in the first quarter—down in January, up in February and back down in March—ending down 2.15% and 2.06%, respectively, for the three months.

TOTAL RETURNS[1]

	January	February	March	YTD
S&P 500 Index	-2.44%	+2.10%	-1.77%	-2.15%
Dow Jones Industrial Average	-2.59%	+2.92%	-2.31%	-2.06%
Nasdaq Composite Index	-5.18%	-0.43%	-2.50%	-7.95%

The Nasdaq Composite's ride was in only one direction—down in January, down in February and down in March—making the quarter, well, a real downer.

The most obvious explanation for the market's poor first quarter performance was oil prices, which increased over 30% through the end of March, as measured by the NYMEX front-month crude-oil futures contract. Not surprisingly, energy stocks were standout performers in the quarter, up over 17% as a group. The materials group and utilities were also up for the quarter, but nothing like oil stocks. The other seven S&P 500 sectors were flat or down year-to-date, with tech, telecom, financials and consumer discretionary stocks especially hard hit.

As the largest sector in the S&P 500 at over 20% of total market value, the financial stocks' nearly 7% quarterly decline made them the largest detractor from performance on both a relative and absolute basis. The market, in general, and financials, in particular, responded poorly to the Federal Reserve Open Market Committee's March 2005 warning that "pressures on inflation have picked up in recent months and pricing power is more evident," thus increasing the odds, in the minds of many, that the Fed might need to become more aggressive in raising interest rates to fight inflation.

Investors' decided preference in the first quarter for the lower volatility, more defensive groups such as energy and utilities, over the higher volatility, more venturesome groups such as tech, telecom and financials is reflective of a mood of caution and anxiety that seems to prevail in the market currently. John Mendelson, a long-time market observer now at Leerink Swann & Company, has made note of this cautious mood in a number of recent reports. We have high regard for John's investor sentiment work because he bases it solely on what people do, not what they say. He characterizes investors' current mood as "distrustful" and "uncomfortable," with "one eye on the door" and a "strong desire to be hedged."[2] Reflecting this mood, he notes recent high levels of put buying relative to calls, and record NYSE short interest of 8.4 billion shares as of mid-March, surpassing the previous peak of 8.2 billion shares short in October 2002. Obviously, in retrospect, October 2002 was not a good time to be short, since it marked an important bottom in the stock market. But it is at least understandable that investors would be frightened and bearish after a 2-year market decline that saw the S&P 500 drop almost in half. What is remarkable to us is that investors are displaying an even higher level of anxiety today, after a 54% rally off the October 2002 bottom, and within 4% of a recovery high in the S&P 500.

In sharp contrast to the investing public, NYSE specialists—who have an outstanding record of knowing when and when not to be short—want no part of the short side of the market now. In March 2000, at the top of the market, specialists accounted for 56% of all short activity, a record percentage as far as we know. In March 2003, they accounted for 32% of all shorts. In the latest two March reporting periods, specialists were doing between 25% and 26% of all short selling, lower even than March 2003, which proved to be an important low in the market. Before proceeding, we should note that the tremendous growth of hedge funds in recent years and the introduction of exchange traded funds (ETFs)—which can be shorted without an up tick—may have reduced the comparability of the current specialist short ratio with prior periods. In other words, specialists' percentage of shorting may be low not because they are doing less shorting, but because

[1] *Source: Bloomberg*
[2] *John Mendelson, "Weekly Market Analysis: A View of the Market," Leerink Swann & Company, March 29, 2005, p.2.*

other players are doing much more.

That caveat aside, we currently have a situation in which the public—which is almost always wrong at turning points—wants desperately to be hedged, while the pros seem to be avoiding the short side of the market. As between the two, we think it makes more sense to side with the specialists, who—Mendelson wryly notes—while not the most beloved figures on Wall Street, rarely have benefits thrown on their behalf.

In our opinion, the reason why investors are so skittish lately, and become bearish very quickly whenever the market sells off, is that they are still traumatized by the bear market of 2000-2002. It is well documented that investor attitudes are strongly influenced by their recent experience. Warren Buffett has called this the "rear-view mirror" approach to investing. Investors looking in their rear view mirror today see a grim picture compared to what they saw at the beginning of 2000. The compounded annual return of the S&P 500 for the 5 years ending 12/31/99 was 28.5%[3], among the highest in market history. Those once-in-a-generation returns engendered a sense of well-being and appetite for risk among the investing public that precipitated the tech and Internet bubble and subsequent crash.

Looking in their rear view mirrors today, investors see that the 5-year return of the S&P 500 is negative, and has been so for 10 of the last 11 calendar quarters.

5 Yrs Ended	S&P 500 5-Yr Compounded Annual Return[4]
09/30/02	-1.62%
12/31/02	-0.58%
03/31/03	-3.76%
06/30/03	-1.61%
09/30/03	+1.00%
12/31/03	-0.57%
03/31/04	-1.20%
06/30/04	-2.20%
09/30/04	-1.31%
12/31/04	-2.30%
03/31/05	-3.16%

What the table above makes clear is that, despite the market rally in 2003 and 2004, most investors' 5-year returns don't look very good. Now, obviously, not all investor returns are the same. Some have done much better, but—based on studies by John Bogle and others that show that mutual fund investors as a group trail the return of the S&P 500 by roughly three percentage points per year—most have done much worse. In fact, the 2 ½ years since September 2002 is the longest period of largely negative 5-year market returns since the Great Depression.

As we noted in a September 2002 market commentary when S&P 500's 5-year return first went negative, the important consideration for investors is not what has happened, but always what is likely to happen next. Negative trailing 5-year returns on the S&P 500 are relatively rare, having occurred only ten times (roughly 13% of the time) since 1926 on a calendar year-end basis. Without exception, following such periods, the subsequent 5-year return of the S&P has been decidedly positive, averaging about 15% compounded annually.

S&P 500 Compound Annual Returns[5]

5 Years Ended 12/31	Trailing 5 Yr Return	Susequent 5 Yr Return
1931	-5.1%	22.5%
1932	-12.5%	14.3%
1933	-11.2%	10.7%
1934	-9.9%	10.9%
1941	-7.5%	17.9%
1974	-2.4%	14.8%
1977	-0.2%	14.1%
	Average:	15.0%

Ironically, at the times when investors can see nothing but losses in their rear view mirrors and are abandoning stocks in favor of less risky alternatives, they should instead be focusing on the opportunities that lie ahead. We believe those investors who can summon the courage to stick with stocks now will profit nicely in coming years.

Outlook

We continue to be optimistic about the outlook for the economy and equity market for the balance of the year. The earnings outlook for corporate America continues to be promising, corporate balance sheets are loaded with cash, and earnings quality is the best it has been in fifteen years, according to Empirical Research Partners. Real GDP growth for the first quarter should be up about 4%. Even allowing for an expected slow down to 3% or so in

[3] *Bloomberg*
[4] *Bloomberg*
[5] *Ibbotson Associates*

the second quarter, full year real GDP growth of 3.6% or better still looks like a good bet. We continue to expect earnings per share growth of 10% or more for the S&P 500 as a whole for 2005, and overall market gains of that same order of magnitude.

The market's (and our) assessment of the outlook for short-term interest rates has worsened moderately since the beginning of 2005, but not sufficiently to alter our market outlook. As we entered 2005, the futures market was pricing in a Fed Funds rate of 3% by June and 3.5% by year-end. The futures market is still pricing in 3% by June, but is now discounting a Fed Funds rate of about 4% by year-end. Along with higher than expected oil prices, we think the discounting of higher short-term interest rates is a principal cause of the market's weakness in the first quarter.

Now that the market has adjusted its outlook for short-term rates, a key question is whether it can make upward progress from here. We believe that it can. Having become inured to low rates over the last several years, we think investors might be surprised to learn that the Fed Funds rate averaged over 5% for the decade of the 1990's, a period of well above-average economic growth and strong financial markets.

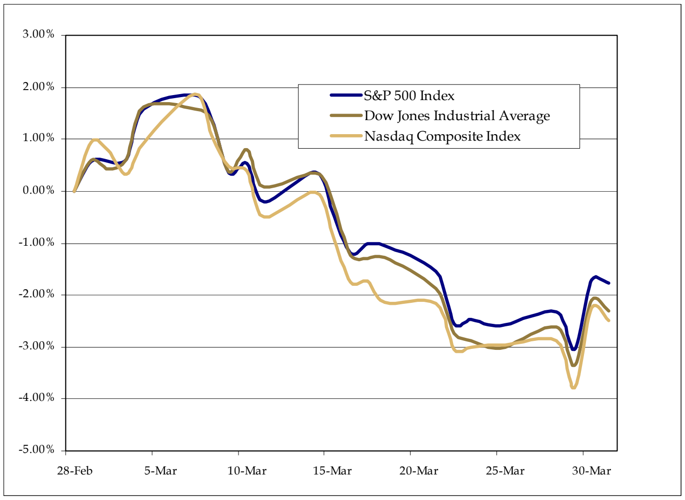
The 10-year Treasury bond yield has also backed up recently—to about 4.5% from 4% earlier in the year—but is still lower than when the Fed began raising rates in June 2004. It is very unusual for 10-year Treasury yields to be lower after 175 basis points of Fed tightening. In fact, in the five other instances since 1980 when the Fed has raised short rates by 175 basis points, the 10-year bond yield has been up between 25 and 225 basis points, averaging an increase of about 130 basis points. Only in this instance are long rates lower. We are not sure exactly why this time is different, but we suspect that it is because the Fed Funds rate was unusually and forcibly depressed this cycle, and therefore, the spread between the Fed Funds rate and the 10-year Treasury was unusually wide when tightening began. In addition, we share former assistant Treasury Secretary Richard Clarida's view that the low level of nominal and real interest rates that prevails currently may be a reflection of an "excess of global savings compared with perceived profitable global investment opportunities." Whatever the reason, we would expect the yield curve to continue to flatten in the second half of 2005, and would not be surprised if 10-year Treasury yields rose to 5% or so by year end.

This quarter marks the 5-year anniversary of the market's March 2000 peak, and—though much has changed—we see some interesting parallels between then and now. Then it was all about tech and telecom. Now it is all about energy. Then it was all about playing offense. Now it is all about playing defense. Then it was all about how fast you could make money. Now it is all about how to avoid losing money. Keeping Warren Buffett's advice to be "greedy when others are fearful, and fearful when others are greedy" firmly in mind, we think that now is a time to be, if not greedy, at least opportunistic. With so many investors focused on being defensive and on whether they have enough energy exposure, we think the opportunities in the market are likely to lie elsewhere. We are especially drawn to some of the more venturesome areas of the market—including selected technology and Internet-related stocks—and have been increasing the beta and growth component of all portfolios to take advantage of an expected rally in these areas of the market, triggered by a near-term peaking in oil prices.

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

David E. Nelson, CFA
Director of Market Analysis

Major Indices March Performance



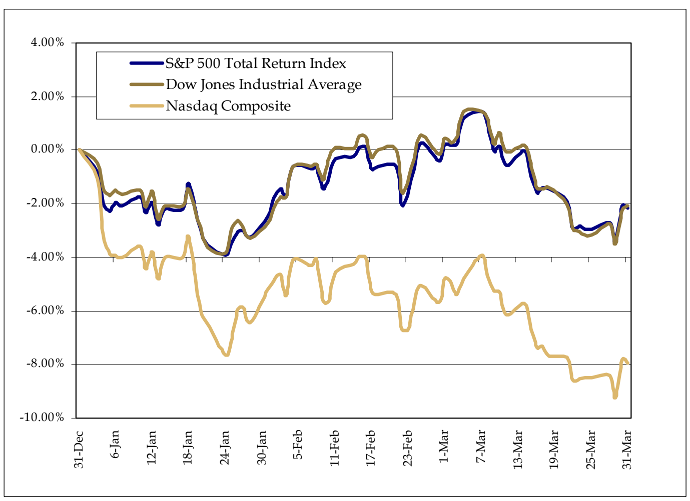
Source: Bloomberg and FactSet

S&P 500 Index Sector Performance

	March	YTD
Consumer Discretionary	(1.19%)	(5.69%)
Consumer Staples	(0.69%)	0.68%
Energy	(3.60%)	17.58%
Financials	(3.80%)	(6.38%)
Health Care	(0.47%)	(0.60%)
Industrials	0.31%	(1.59%)
Information Technology	(2.29%)	(7.33%)
Materials	(2.64%)	1.81%
Telecommunication Services	(1.59%)	(7.78%)
Utilities	1.13%	5.42%

Source: Bloomberg and FactSet

Major Indices YTD Performance



Source: Bloomberg and FactSet

Major Indices Performance

	March	YTD
S&P 500 Index	(1.77%)	(2.15%)
Dow Jones Industrial Average	(2.31%)	(2.06%)
Russell 1000	(1.58%)	(1.91%)
Nasdaq Composite Index	(2.50%)	(7.95%)
Dow Jones Wilshire 5000	(1.77%)	(2.39%)
Russell 2000	(2.86%)	(5.34%)
Russell 1000 Growth	(1.82%)	(4.09%)
Russell 1000 Value	(1.37%)	0.09%

Source: Bloomberg and FactSet

Legg Mason Capital Management ("LMCM") is comprised of (i) Legg Mason Capital Management, Inc., (ii) Legg Mason Funds Management, Inc., and (iii) LMM LLC.

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