LEGG MASON CAPITAL MANAGEMENT *Month-End Commentary*

November 2005

Market Commentary

Stocks rebounded sharply in November from their October sell off. Total returns are now positive year-to-date for all major market indices, though only modestly so in the case of the Dow Industrials and Nasdaq Composite.

TOTAL RETURNS

	November	YTD
S&P 500 Index	+3.78%	+4.88%
Dow Industrials	+3.92%	+2.44%
Nasdaq Composite Index	+5.40%	+3.33%
S&P Mid-Cap 400 Index	+4.89%	+11.78%
Russell 2000 Index	+4.85%	+5.03%
Dow Jones Wilshire 5000 Index	+4.03%	+6.22%

Sources: Bloomberg, Wilshire, Russell

Materials stocks led the performance derby for the month and quarter-to-date, as reports of stronger than expected third quarter real GDP growth of 4.3% brought cyclically sensitive stocks to life. Also turning in market beating performance for the month were the technology, industrials, telecommunication services, financials and consumer discretionary sectors. Energy stocks continued to lag for the month and quarter-to-date as did the healthcare, consumer staples and utilities sectors. Utilities were the only S&P sector to post a negative return for the month. As in October, higher beta stocks outperformed lower beta ones, as investors continued to show an increased appetite for risk.

On the economic front, the data continued to be mixed, with most available evidence pointing to a slowdown in housing but surprising resilience in the overall economy. Existing home sales dropped 2.7% in October, according to the National Association of Realtors, with the inventory of unsold homes rising 3.5% to 2.9 million, the highest in nearly 20 years. That sounds worse than it is, since the selling rate for homes is a good bit higher now than it was 20 years ago. Still, the implied 4.9 month supply of unsold homes is the highest in more than 2 years. Existing home sales fell in all four major regions of the country in October, led by a 7.4% decline in the Northeast.

Surprisingly, the day after existing home sales were reported down, sales of new homes were reported up 13% in October, much better than expected. Some observers speculated that the increase reflected a rush by consumers to close purchases ahead of an expected increase in mortgage rates. If that is the case, one would expect new home sales to fall short of expectations in the next month or so, now that mortgage rates have risen. To be sure, new home sales were not strong across the board. For example, they dropped 40% in Northern California in October, as affordability became a bigger stumbling block. The introduction of promotional incentives by homebuilders in previously red-hot markets such as Atlanta, South Florida and Phoenix, also suggests that the housing market is cooling.

The slowdown in housing notwithstanding, economic growth has remained surprisingly robust, as evidenced by the 4.3% growth in third quarter real GDP. Considering that hurricanes Katrina and Rita are thought to have knocked a percentage point off growth for the quarter, this is an amazingly good performance. For the most part, the bond market has taken the evidence of underlying economic strength in stride, with the 10-year Treasury bond continuing to trade in the range of 4.5%, plus or minus a few basis points. We think the key reason for the bond market's muted reaction is the continued strength in productivity growth (+4.7% in the third quarter) and its attendant subduing effect on unit labor costs (down 1% in the third quarter). This favorable combination suggests that underlying inflation should remain in check, thus obviating the need for the Fed to lean too hard on the funds rate. As a consequence, we continue to believe that the Fed is within six months—and a maximum of three 25 basis-point rate hikes—of completing its tightening.

Both Bill Miller and I expect a 25 basis-point hike at the Fed's December 13th meeting, but Bill is also anticipating a language change in the Fed's accompanying statement, which could presage a pause at the January meeting. I'm still thinking the Fed will do another 25 basis points in January, thus more or less forcing incoming Chairman Bernanke to establish his inflation-fighting credentials with another 25 basis-point bump, to 4.75%, in March 2006. A material slowing in December new home sales would likely shift me into Bill's "pause" camp, but it matters little. We're both bullish, he just a bit more than I.

Surveying the economic and investment scene, there's really very little to crab about lately, in our judgment. The economy is growing nicely, productivity growth is strong and underlying inflation trends appear to be under control. Oil prices have come down, the equity market has rallied sharply and our portfolios are behaving well. Some have pointed to the recent surge in gold prices—above $500 for the first time since 1987—as a cause for concern. We disagree. Adjusted for inflation, gold prices are not all that high. On a nominal basis, gold peaked at $873 in January 1980. In today's dollars, that equates to a price of over $2000 an ounce. So gold's recent strength may be no more than a catch-up move, or it may reflect seasonal demand for jewelry for the Christmas holiday, Chinese New Year and Indian wedding season. Gold bugs attribute the metal's strength to declining confidence in the U.S. dollar and a desire on the part of some central bankers to diversify their reserve base. There may be an element of truth to this, as paper money has tended to depreciate at varying rates throughout history. For example, as of the end of 2003, the U.S. dollar had lost 93% of its purchasing power since 1802, according to statistics from Jeremy Siegel's new book, The Future for Investors. Over that same period, gold held its real value admirably, as a dollar "invested" in gold in 1802 would have been worth an inflation-adjusted $1.39 as of the end of 2003 (the endpoint of Siegel's study). Too obsessive a focus on gold, however, might have caused an investor to miss an even better bet—namely, stocks. According to Siegel, a dollar invested in stocks in 1802, with all dividends reinvested, would have been worth an inflation-adjusted $597,485 (this is not a misprint) by the end of 2003. One does not have to be a financial genius to see that $597,485 is a good bit more than $1.39. So, if preserving purchasing power is your aim, gold will do just fine over time. But if you are interested in building long-term wealth, Siegel's data suggests that stocks are clearly the way to go.

Outlook

As we approach the year end holiday season, we see many more things to be thankful for than to worry about. As noted earlier, the economy seems to be perking along nicely and most major market indices are at or near multi-year highs. As energy and utility stocks have sold off, investors have turned their attention to previously neglected sectors such as financials and technology. We find the better recent performance of financial stocks especially encouraging as this is often a harbinger of an end to Fed tightening.

Another trend we applaud is the increasing return of capital to shareholders in the form of increasing dividends and record share buyback activity. According to Standard and Poor's, the companies in the S&P 500 Index are on track to pay out more than $500 billion to shareholders this year—over $200 billion in dividends and the rest in share repurchase. That is up 30% from last year's record. So far this year, 275 companies in the S&P 500 have raised their dividends, while only eight have cut them. With the aggregate dividend payout ratio of the S&P 500 just above 30%, we think the recent trend of dividends rising faster than earnings is likely to continue. Because of the general decline in options issuance compared to several years ago, share repurchase activity is tending to actually reduce the number of shares outstanding, rather than just offsetting options issuance, as before. This is especially true among technology companies, many of which used to regularly dilute their shareholders by 5% to 10% a year through options issuance, but have now "seen the light" and are reducing their share counts instead. Not coincidentally, we think, tech stocks have begun to act better in the marketplace.

As readers of our commentaries over the last year or so are aware, we have been, and remain, more constructive on the outlook for equities than many other market observers. We believe that investors as a whole are still traumatized by the bear market of 2000-2002, and, as a consequence, have a more negative mindset toward equities than is warranted by the facts. Our sentiments were eloquently expressed in a recent editorial in The Wall Street Journal entitled "Pouting Pundits of Pessimism," by Brian Wesbury, Chief Investment Strategist at Claymore Advisors LLC. Wesbury wrote in part: "During a quarter century of analyzing and forecasting the economy, I have never seen anything like this. No matter what happens, no matter what data are released, no matter which way markets move, a pall of pessimism hangs over the economy. It is amazing. Everything is negative. When bond yields rise, it is considered bad for the housing market and the consumer. But if bond yields fall and the yield curve narrows toward inversion, that is bad too because an inverted yield curve could signal a recession. If housing data weaken, as they did Monday [11/28/05] when existing home sales fell, well that is a sign of a bursting housing bubble. If housing data strengthen, as they did Tuesday [11/29/05] when new home sales rose, that is negative because the Fed may raise rates further. If foreigners buy our bonds, we are not saving for ourselves. If foreigners do not buy our bonds, interest rates could rise. If wages go up, inflation is coming. If wages go down, the economy is in trouble."

We could not agree more. People are far too negative on the market, in our view. Now that the market is actually up for the year, maybe investors will cheer up, but then again maybe not. Since the S&P 500 has returned over 70% since its October 2002 bottom, you'd think people would already be happy. But that's not the way most people are looking at it. They're thinking, "I haven't made any money in the market in five and a half years…why do I need stocks?"

The reason people need stocks, in our opinion, is that—properly selected and patiently held—stocks are the greatest wealth builders known to man. Their superiority over other financial asset classes over long periods of time is remarkable. We quoted some statistics from Jeremy Siegel's latest book earlier on the long-term returns of gold versus stocks. Here's the whole table from his book showing the cumulative inflation-adjusted value of one dollar invested for 201 years in five different financial assets:

TOTAL REAL RETURN INDEXES
1802-2003

Dollar	$0.07
Gold	$1.39
Treasury Bills	$301.00
Treasury Bonds	$1,072.00
Stocks	$597,485.00

Source: Jeremy Siegel, The Future for Investors, page 171.

Pretty powerful stuff, we think. Why do stocks so significantly outperform other financial assets over long periods of time? We actually think the answer is fairly simple. Stocks represent ownership interests in businesses. Over time, businesses have the ability to adapt and adjust to changing economic circumstances. Some succeed grandly, others fail miserably. But as a group, they have the ability to evolve, thus giving them the capacity to deliver returns that other financial instruments—whose terms are largely fixed—cannot match. To secure that advantage, equity owners must bear greater risk of short-term loss and higher volatility. Given the magnitude of the difference in returns over time, that strikes us as a risk worth taking.

In closing, we would like to wish you all a joyous holiday season, and a happy, healthy and prosperous New Year. As always, we appreciate your support and welcome your comments.

David E. Nelson, CFA
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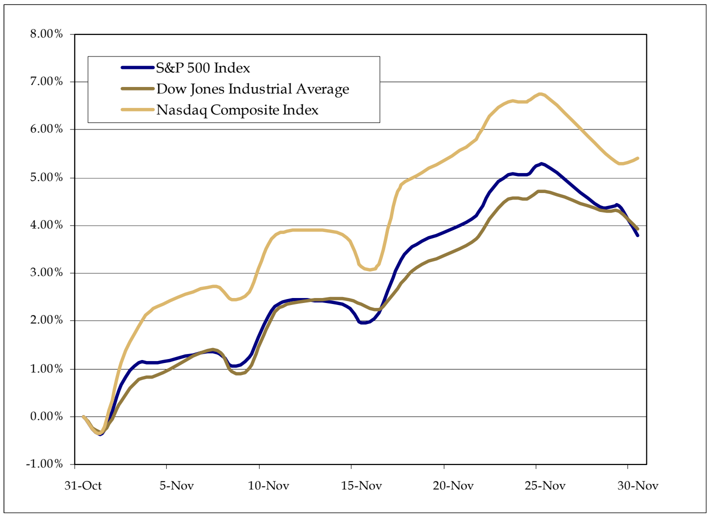
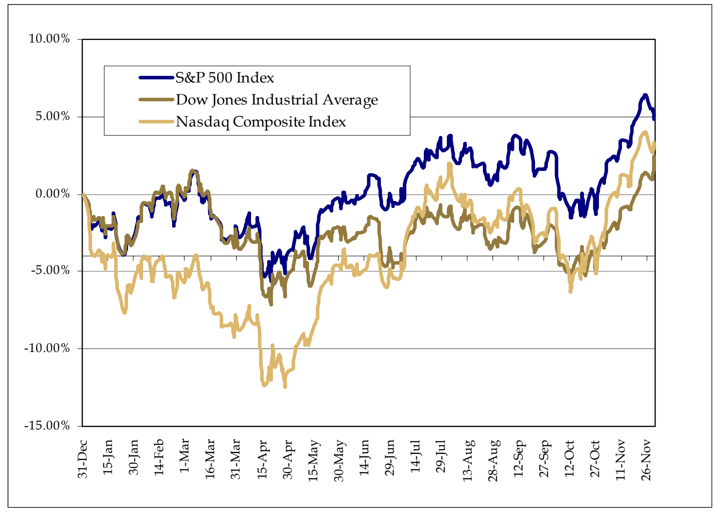
Major Indices November Performance



Source: Bloomberg and FactSet

Major Indices YTD Performance



Source: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

	November	QTD	YTD
Broad Market Indices			
S&P 500	3.78	2.05	4.88
Dow Jones	3.92	2.79	2.44
Russell 1000	3.80	1.98	6.12
NASDAQ	5.40	3.94	3.33
Dow Jones Wilshire 5000	4.03	2.22	6.22
Russell 2000	4.85	1.60	5.03
Russell 1000 Growth	4.31	3.30	5.59
Russell 1000 Value	3.27	0.65	6.40
S&P 500 Sector Indices			
S&P 500 Consumer Discretionary	4.03	1.98	(5.61)
S&P 500 Consumer Staples	0.85	0.57	3.71
S&P 500 Energy	1.66	(7.84)	30.68
S&P 500 Financials	4.69	7.99	6.18
S&P 500 Health Care	1.07	(1.91)	2.95
S&P 500 Industrials	5.77	4.59	1.91
S&P 500 Information Technology	6.44	4.11	4.03
S&P 500 Materials	7.45	8.00	1.45
S&P 500 Telecomm Services	4.91	3.63	(2.07)
S&P 500 Utilities	(0.21)	(6.52)	15.55

Sources: Bloomberg, FactSet, Russell