

Market Commentary

The major U.S. equity market indices posted respectable returns for the fourth quarter of 2005, primarily driven by strong returns in November. For the year, mid-cap stocks continued to lead the equity market parade, as they have in recent years. The S&P 500 Index was up 3% on a price-only basis, exactly in line with its 77-year average price gain in a post-Presidential election year. With a droopy finish to the year in December, the Dow Industrials broke a twelve-decade-old record by failing to close a year ending in five higher than it began. Prior to 2005, the Dow (and its predecessor indices) had shown a price gain twelve straight times in years ending in five, with the average gain being over 30%.

TOTAL RETURNS

	Oct	Nov	Dec	4th Qtr	2005
S&P 500 Index	-1.67%	+3.78%	+0.03%	+2.09%	+4.91%
Dow Industrials	-1.09%	+3.91%	-0.70%	+2.06%	+1.72%
Nasdaq Composite Index	-1.38%	+5.40%	-1.17%	+2.73%	+2.13%
S&P 400 Mid-Cap	-2.15%	+4.89%	+0.69%	+3.34%	+12.56%
Wilshire 5000	-1.74%	+4.03%	+0.10%	+2.32%	+6.32%

Sources: Bloomberg, Wilshire

The S&P 500's 2005 total return of 4.9% was a disappointment to us. We had expected better from the market in a year in which corporate earnings (even excluding energy) were up more than 10% and valuations at the beginning of the year were reasonable, in our judgment. Rising energy prices, eight Fed tightenings, and worries about inflation and the overall economic outlook trumped the favorable earnings backdrop, as the market's price-to-earnings multiple contracted again in 2005, as it had in 2004. We believe a change for the better is in store in 2006, as an expected end to Fed rate increases in the spring should lead to an end to market multiple contraction, and could even lead to multiple expansion.

If investors had known what the Federal Open Market Committee (FOMC) was thinking about the economy in December, the market may have ended 2005 on a much more positive note, but the minutes of the Fed's December 13 meeting were not released until 2 PM on Tuesday,

January 3, 2006. The response to the release was virtually immediate. The market, which had been down earlier in the day, took off on the upside, with the S&P 500 closing the first day of the year up over 1.6%. The strength in the market continued through the end of the week, with most indices up 3% or more in the first four trading sessions of the New Year.

In our judgment, the market reacted correctly to the Fed minutes, which show the FOMC to be quite sanguine on the outlook for the economy, and, by implication, the equity market. We believe a full and careful reading of the Fed's comments is well worth the effort. They can be accessed on the Fed's website (www.federalreserve.gov). To provide a flavor of the Fed's thinking, we present a series of direct quotations from the December 13 minutes below:

The information reviewed at this meeting suggested that the economy continued to expand at a solid rate in the fourth quarter. Industrial production rebounded, and employment growth appeared to have recovered smartly from the depressing effects of recent hurricanes. . . . Real personal consumption expenditures appeared to be increasing solidly over the course of the fourth quarter, led by improvements in the fundamental determinants of consumer spending. Real disposable personal income was bolstered by gains in employment and falling retail energy prices, while continued brisk advances in house prices and the recent strengthening of equity prices contributed importantly to increases in household wealth. . . .

Rising business sales, a declining cost of capital, and ample financial resources in the corporate sector continued to foster a favorable environment for capital spending, a sentiment echoed in executive surveys, which generally pointed to widespread increases in planned capital outlays. . . . The staff forecast prepared for this meeting suggested that growth of economic activity would slow from this year's pace, but remain solid, with output staying near the economy's potential over the next two years. . . .

In their discussion of the economic situation and outlook, meeting participants noted that incoming

data over the intermeeting period had been encouraging with regard to both economic growth and inflation. The economic expansion had shown considerable resilience in the face of higher energy prices and hurricane-related disruptions, suggesting greater underlying strength than had been apparent at the time of the November meeting. At the same time, incoming inflation data had been benign, indicating relatively modest pass-through of higher energy prices to core inflation to date. . . .

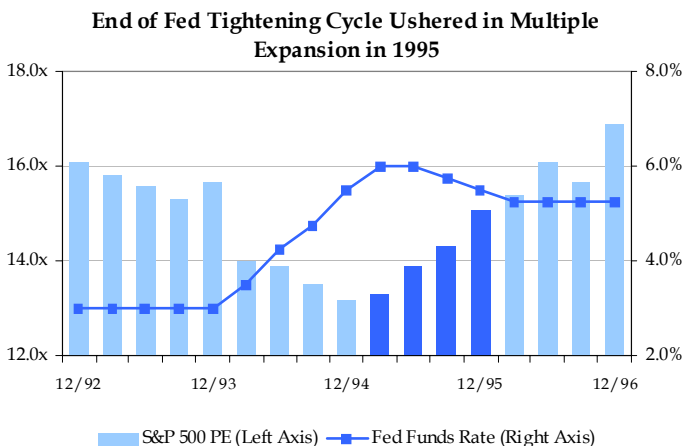
The Committee agreed that several changes in the wording of the announcement would be appropriate. **The federal funds rate had been boosted substantially, and, in the view of some members, it was now likely within a broad range of values that might turn out to be consistent with output remaining close to potential. In these circumstances, the Committee thought that policy should no longer be characterized as accommodative** (our emphasis added). . . . Some members thought that the word “measured” was no longer necessary, but its retention for this meeting was seen as potentially useful to preclude a possible misinterpretation that the Committee now saw a significant possibility of adjusting policy in larger increments in the near future. . . . The members agreed that the announcement should end by noting that policy will respond to changes in economic prospects as needed to foster the Committee’s objectives.

Outlook

For the last two years, stocks have appreciated less than their underlying growth rate in earnings. We expect that to change this year. In 2006, we believe that stocks will be up at least as much as their underlying earnings growth, and probably more. We were optimistic about 2006 before reading the FOMC minutes from December 13. After reading them, we are bordering on giddy. The thing we find so encouraging about the minutes is that they strongly suggest that the Fed shares our basic optimism about the economic outlook, namely that economic growth will slow but remain healthy in 2006, that inflation must be watched but looks to be under control, and that—therefore—an end to Fed tightening is close at hand. The fact that the Fed seems to share our view on the outlook doesn’t necessarily make us

right, but we must admit it does give us some comfort that our views are reasonable.

Depending upon whose estimates one uses, earnings growth for the S&P 500 Index in 2006 is forecast to be between 7% and 13%. The economists’ top-down forecasts are, as usual, at the low end of the range, and the analysts’ bottom-up estimates, again, as usual, are at the high end. Let’s split the difference and call it 10% growth. On that basis, the S&P 500 Index was valued at about 16.5 times estimated earnings for the year just ended, and 15 times 2006 estimates at its year-end 2005 closing price of 1,248.29. If, as we expect, an end to Fed tightening leads to an end to multiple contraction, then the market should be up at least 10% in 2006 on the strength of earnings growth alone. Throw in a couple of points for dividends and you’re up to 12% total return for the year. The wildcard in the mix is how much help the market might get from multiple expansion in 2006. As illustrated below, when the Fed stopped tightening in the early part of 1995, the S&P 500’s P/E ratio expanded from about 13 to 17 times earnings over the next two years. We don’t need nearly that much improvement this time around to turn 2006 into a very good year in the market. If the trailing P/E of the market rises to 17 from 16.5 by the end of 2006 and earnings come through as expected, the S&P 500’s total return will be about 15% for the year. While there is obviously no certainty, we believe return expectations in the range of 12% to 15% for 2006 are entirely reasonable.



Not everyone shares our optimism on the outlook for 2006. In late December, a number of market commentators noted with alarm that the yield-curve had “inverted” between 2’s and 10’s, meaning that the yield on the 2-year Treasury note exceeded that of the 10-year Treasury bond. Their worry is that curve inver-

sions in the past have always led to an economic slowdown and, more often than not, to a recession. We do not share these concerns for several reasons. First, the inversion in December was relatively minor (only a few basis points) and, since the release of the Fed minutes, has reversed itself. Second, we do not fear a slowdown in the economy. In fact, we expect it and believe it would be healthy. Third, we think a recession is quite unlikely within the next 12 to 24 months, because the imbalances that lead to a recession do not appear to us to be present now. According to the December 13 FOMC minutes, the Fed agrees with us. Fourth, even if the yield curve did re-invert and remain that way, that would not necessarily be bad for the stock market. In fact, history suggests much the opposite. According to Tony Dwyer, a market strategist with FTN Midwest Securities, whose work we admire and have referenced before, there is normally an 18 to 24 month lag between the time the yield curve inverts and the onset of recession—when, in fact, a recession occurs. In the four instances of 2-year to 10-year yield curve inversion since 1982, the S&P 500 was up an average of 13.3% in the ensuing twelve months, showing gains of 25%, 27% and 18% on three occasions, and a loss of 5% on the other. The loss occurred when the yield curve inverted in 2000, when the market was far less attractively valued than it is today.

Two long-standing trends in the market appeared to reverse themselves in 2005. For the first time in over five years, the Russell 1000, a well-known large cap index, beat the Russell 2000, a small cap benchmark. Because of the trouncing small caps have given large caps since the turn of the millennium, the Russell 2000 is still miles ahead of the 1000 over the last 3-, 5- and 7-year periods. Interestingly, the 10-year performance of the two indices is only basis points apart. On a valuation basis, we think large caps now have a clear edge over small caps.

Periods Ended 12/31/05	1-Year	3-Year*	5-Year*	7-Year*	10-Year*
Russell 1000	6.27%	15.42%	1.07%	2.34%	9.28%
Russell 2000	4.55%	22.13%	8.23%	8.29%	9.26%
Russell 3000	6.12%	15.90%	1.58%	2.76%	9.20%
Russell Mid Cap	12.65%	23.78%	8.45%	9.77%	12.49%

*Annualized

According to work done by Michael Goldstein’s Empirical Research Partners, large cap stocks as a group now trade at about a 20% discount to small caps, whereas normally the P/E’s of the two are similar. Also according to Empirical, the large cap group sports a free cash flow yield of nearly 5%, versus only about 3% for small caps. We believe this combination of more attractive valuation and superior cash flow generation capability could trigger a period of superior relative performance by large caps over

small for several years.

Within the large cap arena, we believe large cap growth funds may be entering a period of superior performance relative to large cap value funds. This is the second trend reversal we saw in 2005 that we expect to continue in 2006. On the strength of the late surge in the fourth quarter, large cap growth funds outperformed large cap value funds in 2005 for the first time in many years, according to data from Lipper Analytical Services. This also makes sense to us since some of the best “values” we see in the market lately are in what many might consider growth stocks.

Periods Ended 12/31/05	1-Year	3-Year*	5-Year*
Lipper Large-Cap Growth	6.18%	13.01%	-3.98%
Lipper Large-Cap Value	5.72%	15.05%	3.10%
<i>Value - Growth</i>	<i>-0.46%</i>	<i>2.04%</i>	<i>7.08%</i>

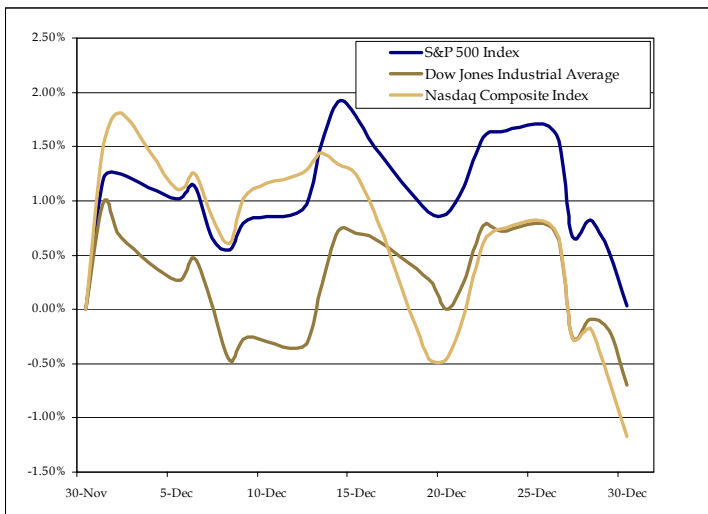
*Annualized

In summary, we believe investors can look forward to a better year in 2006 than they experienced in 2005. The year has certainly gotten off to a rousing start, with the S&P 500 Index up over 3% in the first four trading days of the New Year. We think large cap stocks will give a much better account of themselves in 2006 than they have in recent years. From a valuation perspective, we think it makes sense to have a growth tilt to all portfolios. Within the context of each of our individual investment mandates, we have positioned our portfolios accordingly.

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

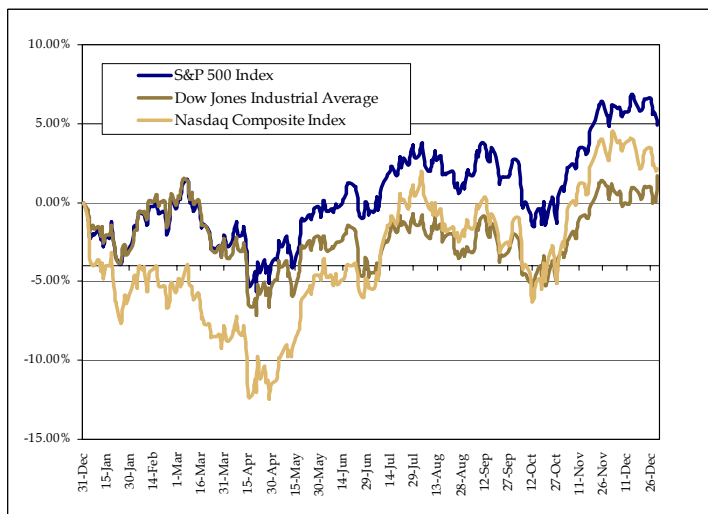
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Major Indices December Performance



Source: Bloomberg and FactSet

Major Indices 2005 Performance



Source: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

	December	Q4	2005
<i>Broad Market Indices</i>			
S&P 500	0.03	2.09	4.91
Dow Jones	(0.70)	2.06	1.72
Russell 1000	0.14	2.12	6.27
NASDAQ	(1.17)	2.73	2.13
Dow Jones Wilshire 5000	0.10	2.32	6.32
Russell 2000	(0.46)	1.13	4.55
Russell 1000 Growth	(0.31)	2.98	5.26
Russell 1000 Value	0.61	1.27	7.05
<i>S&P 500 Sector Indices</i>			
S&P 500 Consumer Discretionary	(0.79)	1.17	(6.36)
S&P 500 Consumer Staples	(0.12)	0.45	3.58
S&P 500 Energy	0.53	(7.36)	31.37
S&P 500 Financials	0.23	8.24	6.43
S&P 500 Health Care	3.41	1.43	6.46
S&P 500 Industrials	0.41	5.02	2.32
S&P 500 Information Technology	(2.92)	1.07	0.99
S&P 500 Materials	2.95	11.19	4.44
S&P 500 Telecomm Services	(3.64)	(0.14)	(5.63)
S&P 500 Utilities	1.11	(5.48)	16.84

Sources: Bloomberg, FactSet, Russell

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