LEGG MASON CAPITAL MANAGEMENT Month-End Commentary

January 2006

Market Commentary

The uncannily accurate January Indicator flashed a positive signal for stock market returns in 2006, as the S&P 500 Index ended January 2.55% higher than it began the year. As noted in previous commentaries, we believe it is sensible to have an optimistic bias about the market, since the S&P 500 has shown positive returns in 56 of the last 78 years, or roughly 72% of the time. Thus, based on history, the odds are about 2.5-to-1 (72%/28%) that the market will be up in any given year. After the S&P 500 posts positive returns in January, the odds rise to over 5-to-1 (84%/16%) that the year will also be up, since in the 50 years since 1927 that the market was up in January, it was up for the year 42 times, and down only 8. There are obviously no guarantees for this year, but we like the odds.

TOTAL RETURNS

	January
S&P 500 Index	+2.65%
Dow Industrials	+1.50 %
Nasdaq Composite Index	+4.68 %
S&P 400 Mid-Cap	+5.89 %
Russell 2000 Index	+8.97%
Wilshire 5000	+3.57 %

Sources: Bloomberg, Wilshire, Russell

We (and many others) have opined that 2006 might be the first year in many that large-cap stocks outperform small and mid-cap stocks. There is no evidence yet to suggest that is so. To the contrary, small and mid-cap stocks continued to trounce large caps in January. In fact, last month the "January Effect" was turned on its head. Instead of buying last year's losers for a rebound, investors continued to buy last year's winners. The superior performance of small and mid-cap stocks over large is evident in the broad indices, with the S&P Mid-Cap and Russell 2000 Indices up +5.89% and +8.98%, respectively, for the month, while the S&P 500 Index and Dow Industrials posted more modest returns of +2.65% and +1.50%, respectively. The continuing superiority of small over large is also evident within the S&P 500 Index itself. The 100 largest stocks by market value were up +1.70% in January, while the bottom 400 stocks were up +3.99%.

Investment strategies based on price momentum also continued to be rewarded in January. According to data from Empirical Research Partners, "Stocks with the best trailing nine-month returns outperformed by over +5%, the third-best January since 1950, and a premium topped in just 2.5% of all months. By comparison, last year's losers lagged by just over (1%) in January."

Our primary reason for believing that large cap stocks might give a better account of themselves this year is based on valuation. The average large-cap stock now trades at about a 20% P/E discount to the average small cap despite sporting an average free cash flow yield of nearly 5% versus just under 3% for the average small cap. But valuation alone might not be sufficient to turn the tide in favor of large-cap stocks. Market trends have a way of developing a life of their own. We remember standing in awe in the late 1990's as a group of mega-cap stocks seemed to go up every day, rising to levels that made little sense on a pure valuation basis. At the same time, the small and mid-cap sectors of the market languished despite having what appeared to be highly attractive valuations. The conventional wisdom then was that a portfolio manager wishing to beat the market needed to be where the action was, namely in large caps. And, the thinking went then, if small caps were so attractive, why weren't they going up? That argument has been turned on its head lately. Small and mid-cap stocks have been performing well, while large caps as a group have lagged. Most investors see little reason to change a game that has been working in favor of one that has not. It took a decisive break in large caps in 2000 to get people interested in small caps back then, and it may well take a break in small and mid-cap stocks to get people to focus on large caps now.

The world may or may not be flat (although Thomas Friedman's fascinating book The World Is Flat assures us it is), but the yield curve certainly is. As of the January month-end, after the 14th 25-basis point increase since June 2004, the Fed Funds rate stood at 4.50%, while the 2-year Treasury note yielded 4.53% and the 10-year Treasury bond yielded 4.52%. That's about as flat as you can get. The key question, of course, is what happens next? Will the curve stay flat, steepen, or invert? The Fed's January FOMC statement implies that it is approaching the end of the tightening cycle that began in June 2004, but it has left itself some wiggle room by saying that some future policy firming "may" be necessary, a more ambiguous assertion than the December statement's phraseology that more firming was "likely" to be necessary. The Fed has also indicated that its future course of action will now depend on "changes in economic prospects." On that score, the economic evidence continues to be mixed. Fourth quarter real GDP growth of 1.1%, coupled with an apparent cooling in the housing market, suggests that the economy is slowing. The latest drop in the unemployment rate from 4.9% to 4.7%, together with an uptick in the employment cost index, has triggered concerns about wage inflation, and possible resultant pressure on corporate profit margins. The Fed Funds futures market continues to discount one more 25 basis-point rate increase in March, bringing the Funds rate to 4.75%. That remains our best guess as well.

Outlook

We continue to believe that stock market returns in 2006 could be in the range of 12% to 15%, powered by expected earnings growth of about 10%, dividends approaching 2% and some price/earnings multiple expansion. While earnings growth could vary from expectations, the real swing factor in 2006 returns will be whether—after two straight years of P/E multiple contraction—the market's earnings multiple can expand. The years 2004 and 2005 marked the eighth instance since 1955 in which P/E multiples contracted for two years running. As illustrated in the table below, in all prior instances, the market advanced in the third year, showing an average gain of 22%. We would liken the market during these periods to a coiled spring that is compressed for a time but ultimately snaps back as earnings continue to grow.

Years of Back-To-Back P/E Contraction Since 1955

Years	P/E Contraction	Earnings Growth	3rd Year Return
1965-1966	(22%)	+22 %	+20 %
1973-1974	(58 %)	+39 %	+32 %
1976-1977	(23 %)	+39 %	+1 %
1977-1978	(29 %)	+25 %	+12 %
1978-1979	(16 %)	+36 %	+26 %
1987-1988	(24%)	+51%	+27%
1994-1995	(31%)	+52%	+34%
Average	(29%)	+38%	+22%
2004-2005	(18%)	+37%	?

Source: Morgan Stanley

Obviously, we have no assurance that history will repeat itself with an advance in 2006, but it seems like a reasonable bet since the same principles are currently at work. The S&P 500 Index's earnings grew about 37%, cumulatively, in 2004 and 2005, while its trailing P/E multiple declined from 20.1 to 16.4 times earnings. Historically, the market has recovered about half of its previous P/E multiple contraction via multiple expansion in the third year. Were that to occur in 2006, the market's trailing P/E would expand from 16.4 to about 18 times earnings. Such an eventuality would produce market returns well in excess of our current range of expectations.

While we expect 2006 to be a good year in the market, it will not necessarily be an easy year. For one thing, we expect the market to be a good bit more volatile in 2006 than in 2005. That won't be too difficult, since 2005 was one of the lower volatility years on record. According to James Stack, editor of *InvesTech Market Analyst*, a newsletter, "2005 had the second-narrowest trading range for stocks in the past century," as measured by the difference between the Dow Industrials' yearly high and low as a percentage of its year-end closing price. Last year was also a low volatility period as measured by the number of days when the S&P 500 Index rose or fell by more than 1%. In 2002, a year of relatively high volatility, the S&P 500 gyrated by more than 1% in 125 of 252 trading days, while 2005 saw only 30 such days, the lowest number since 1995. Anecdotal evidence suggests that 2006 may not be so tame. Increased volatility—should it occur—does not necessarily imply weak market returns. Market volatility rose substantially from 1995 to 1999, accompanied by strong market returns in each year. Volatility continued to rise as the market declined precipitously in the early years of the new millennium, peaking at the bottom of the bear market in 2002. So, increasing volatility does not provide any definitive guidance regarding this year's returns, but it does suggest that we should keep our seat belts fastened, with seat backs and tray tables in their full upright and locked positions. We also suspect that 2006 will be a year in which we will need to play both offense and defense well to be successful.

As always, we appreciate your support and welcome your comments

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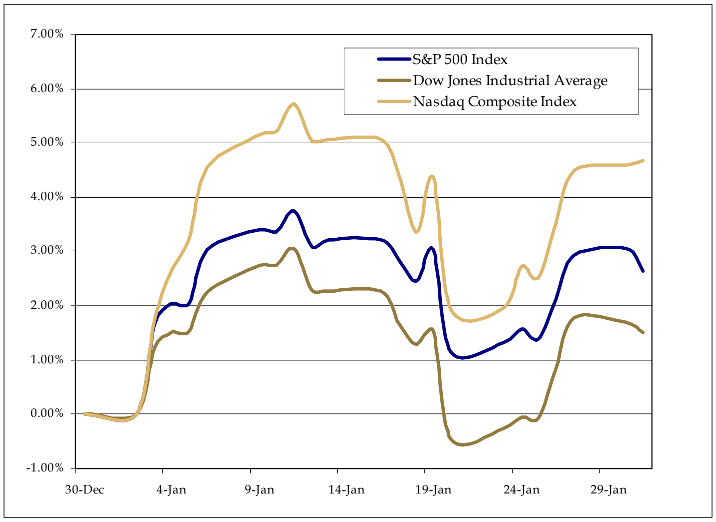
Major Indices January Performance



Source: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

	January
Broad Market Indices	
S&P 500	2.65
Dow Jones	1.50
Russell 1000	2.80
NASDAQ	4.68
Dow Jones Wilshire 5000	3.57
Russell 2000	8.97
Russell 1000 Growth	1.76
Russell 1000 Value	3.88
S&P 500 Sector Indices	
S&P 500 Consumer Discretionary	1.75
S&P 500 Consumer Staples	(0.02)
S&P 500 Energy	13.87
S&P 500 Financials	0.90
S&P 500 Health Care	1.48
S&P 500 Industrials	(0.43)
S&P 500 Information Technology	3.20
S&P 500 Materials	4.71
S&P 500 Telecomm Services	4.14
S&P 500 Utilities	2.46

Sources: Bloomberg, FactSet, Russell