LEGG MASON CAPITAL MANAGEMENT Month-End Commentary

March 2006

Market Commentary

The U.S. equity market posted strong results in the first quarter of 2006 by any measure. The S&P 500's total return of 4.2% was its best first quarter showing since 1999, while the Nasdaq had its best March quarter since 2000, and the Dow Industrials its best since 2002.

TOTAL RETURNS

	March	YTD
S&P 500 Index	+1.24%	+4.21%
Dow Industrials	+1.20%	+4.24%
S&P 400 Mid-Cap	+2.50%	+7.63%
Russell 2000 Index	+4.85%	+13.94%
Wilshire 5000	+1.94%	+5.53%

Sources: Bloomberg, Wilshire, Russell

The stars of the show in the first quarter continued to be the small and mid-cap stocks. As shown above, the S&P Mid-Cap Index was up 7.63% and the Russell 2000 Index gained a mind-blowing 13.94%. Is this surge a last hurrah for small cap relative performance, or powerful evidence that the trend has further to run? We obviously can't say for sure, but from our perspective, the valuation case for large cap is becoming more compelling, while the valuation underpinnings are weakening in the small cap sector. As a consequence, we believe the risk in small caps is rising relative to large caps.

We'll get to the valuation case for large versus small stocks in a minute, but first we should note that the recent strength in small caps may well have very little to do with relative valuation. We may instead be seeing evidence of piling on, or piling in, by the hedge funds. Many, if not most, hedge funds are trend followers. They go where the action is. Lately, the action has clearly been in small caps. According to Albert Richards, Citigroup's U.S. small and mid-cap strategist, a representative sample of hedge funds have 59% of their assets in companies with market floats (shares outstanding less insider holdings) less than $10 billion, compared to the 28% that those companies represent of the Russell 3000 Index.

Recently, there is anecdotal evidence that investors have also been buying small cap exchange traded funds (ETFs) as a means of gaining exposure to the small cap sector without having to choose individual stocks. The ETFs must then use their cash inflows to buy the underlying shares of the companies in their benchmark, thus adding democratically (or indiscriminately, depending how you look at it) to overall small cap stock demand.

On a valuation basis, stocks in the Russell 2000 Index trade at 44 times 2005's earnings, compared with 18 times for the S&P 500. Within the S&P 500 itself, the bottom decile of companies (the smallest 50 by market value) trades at 20.1 times estimated 2006 earnings, while the top decile trades at a cap-weighted average of 14.4 times earnings as of the end of March.

Is the P/E multiple premium currently accorded to small cap stocks justified? Small cap advocates think so. They argue that the largest companies in the S&P 500 are "too big" to grow very fast, while small caps as a group have the opportunity to post superior growth rates for many years to come. Maybe so, but we remember when people made the exact opposite argument back in 2000. Then, the conventional wisdom was that mega caps should trade at a premium to the market because their results were more predictable and they were the primary beneficiaries of globalization. The small caps, while admittedly cheap, were thought to warrant a discount valuation due to their greater business risk and illiquidity.

The truth is that investors' views on the relative merits of small versus large caps fluctuate over time. Since 1960, large and small cap stocks have traded at roughly the same average P/E multiples, with large caps' greater stability being valued about equally with small caps' probable superiority in terms of growth prospects. In our experience, investors' enthusiasm for either group is heavily influenced by recent relative performance trends. Investors tend to gravitate towards groups or sectors that have been doing well, and avoid sectors that have not. Small caps are popular now principally, in our view, because they have been going up sharply. Large caps—and especially mega caps—are unpopular because they have been performance dogs in recent years. The worm will turn, as it always does. The only question is when.

Changing gears a bit and following up on last month's discussion of the homebuilders, we want to make clients aware of a fascinating paper called "Bubble, Bubble, Where's the Housing Bubble?" by Margaret Hwang Smith and Gary Smith, husband and wife economics professors at Pomona College in Claremont, California. We learned about the paper, which the couple presented at the Brookings Institution in late March, from an article in The New York Times (Saturday, April 1, 2006) entitled "Some New Math on Homes." The Smiths' paper concluded that the current real estate market is not a "bubble" and that, in fact, nine of the ten markets that they evaluated ranged from fairly priced to dramatically under-priced.

More interesting to us than their conclusion was their valuation methodology. The Smiths rejected as flawed the commonly used approach of comparing broad measures of house prices to consumer incomes to determine degrees of over- or under-valuation in a given market. Instead, they endeavored to calculate the "fundamental value of a house," using John Burr Williams' classic definition of the value of any asset as being equal to the net present value of the future free cash flows that are available to the owner of that asset. In the case of a house, the value is a function of the income that could be derived from renting the house less all relevant costs of ownership, discounted at an appropriate rate.

In determining whether it made more sense to rent or buy in a given real estate market, the Smiths identified and compared "matched pairs" of similar houses: one rented, one owned, but both in the same neighborhood and having the same basic characteristics in terms of architectural style, square footage, bedrooms, baths, etc. The Smiths were able to identify approximately 100 "matched pairs" in each of ten cities. The two found only one market—San Mateo County—to be significantly overvalued. Orange County—widely thought to be overpriced by many observers—was deemed to be roughly fairly valued by the Smiths. Four markets—Indianapolis, Atlanta, New Orleans and Dallas—showed up as hugely undervalued based on the Smiths' methodology. The Times article noted that a number of prominent economists, notably Yale professor and author Robert Shiller, who is in the "bubble" camp, reject the Smiths' conclusion that there is no bubble, but didn't say why. We are impressed with the Smiths' work and are inclined to agree with it. We certainly agree with Wellesley College economics professor Karl E. Case, who believes that the Smiths' methodology is "absolutely the correct way to think about it."

Outlook

We remain constructive on the outlook for equities for the balance of 2006. Our optimism is tempered somewhat by the fact that long-term interest rates have begun to rise, potentially putting a lower ceiling on the market's fair value P/E multiple than was justified when long-rates were closer to 4%. We'll get into a more detailed discussion of this valuation question after reviewing news from the Federal Open Market Committee (FOMC).

As expected, the Fed increased the funds rate at Ben Bernanke's first meeting as chairman by 25 basis points to 4.75%. In a bit of an unpleasant surprise, the FOMC also left unchanged its judgment that "some further policy firming may be needed to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance." While that statement is not a guarantee that the Fed will raise the funds rate to 5% in May, the interest rate futures market has taken it as such, pricing in a 100% probability that 5% is in the cards for May, and about a 36% probability that 5.25% is in prospect for June. Unlike 2005, yields at the long end of the market have also been moving higher, with the 10-year Treasury now in the range of 4.85%, and 30-year mortgage rates making 2 ½ year highs at 6.43%.

The move in long rates prompted us to take a look at the handy-dandy spreadsheet created by our Chief Investment Strategist, Michael Mauboussin, for determining what a company (or the market as a whole) is worth depending on one's assumptions about the long-term earnings growth rate, return on invested capital (ROIC), weighted average cost of capital (WACC) and competitive advantage period (CAP). For interested parties, a fuller explication of Michael's methodology is available in his paper M&M on Valuation (January 14, 2005).

Clients may recall that we prepared a thumbnail valuation of the market about a year ago which suggested that the S&P 500 Index was worth about 18.6 times earnings at that time based on the following assumptions:

Long-term EPS Growth Rate:	6%
ROIC (unlevered ROE):	16 %
Equity Risk Premium (ERP):	4 %
10-year Treasury Bond Yield:	4%
WACC (ERP + 10-Yr Treasury):	8 %
Comp. Advantage Period:	20 years

Using those same assumptions, but varying the 10-year Treasury bond rate from 4% to 5.5%, Michael's model spits out the following warranted P/E's:

10-Year Treasury Rates	4.00%	4.50%	4.85%	5.00%	5.50%
WACC (ERP + 10-Yr Treasury)	8.00%	8.50%	8.85%	9.00%	9.50%
Warranted Price/Earnings Ratio (P/E)	18.6X	16.9X	15.8X	15.4X	14.1X

Based on bottom-up, capitalization weighted First Call consensus earnings estimates for the S&P 500 for 2006 ($84.96) and 2007 ($93.76), the implied price range for the S&P 500 as of the end of 2006 is 1,198 to 1,580, and for the end of 2007 is 1,322 to 1,744. Admittedly, those are fairly wide ranges, but they provide some idea of the sensitivity of equity prices to the change in long rates.

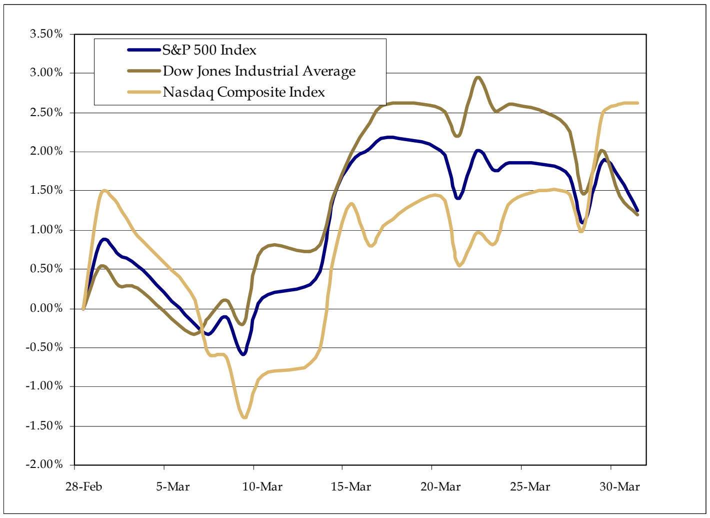
Another factor that complicates this type of analysis even further is the fact that long rates themselves have two elements: a real return component and an inflation factor. Depending on which component is pushing rates higher at any given point, the implications are different for stock valuations. If real interest rates are rising, the impact on warranted P/E valuations is roughly as shown in the table above. If rising inflation expectations are pushing long rates up, then the impact on warranted valuations in the table is probably overstated. This is because over time corporate America has shown the ability to adapt to higher inflation and pass through some or all of its effects. We would account for this in our model with a higher assumed nominal earnings growth rate. Without getting into the gory details, suffice it to say that the impact of a rise in long rates that is entirely the result of an increase in inflation expectations would be about half as severe as that shown in the table above.

In summary, we continue to expect the market to give a decent account of itself this year, with the extent of the gain being dependent on the trend of earnings and long rates. If earnings come through as (or better than) expected and long rates stay between 4.85% (roughly where they are now) and 5.5%, we think S&P 500 returns of 8% to 10% for the full year are a reasonable expectation. If the 10-year Treasury yield moves back into the mid-4%'s or lower, and earnings hold up, we think the market could produce total returns in the mid-teens. Obviously, the market will do whatever it's going to do, and the fact that we are reasonably optimistic doesn't mean a thing. All we've tried to do here is give clients some insights into how we are thinking.

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

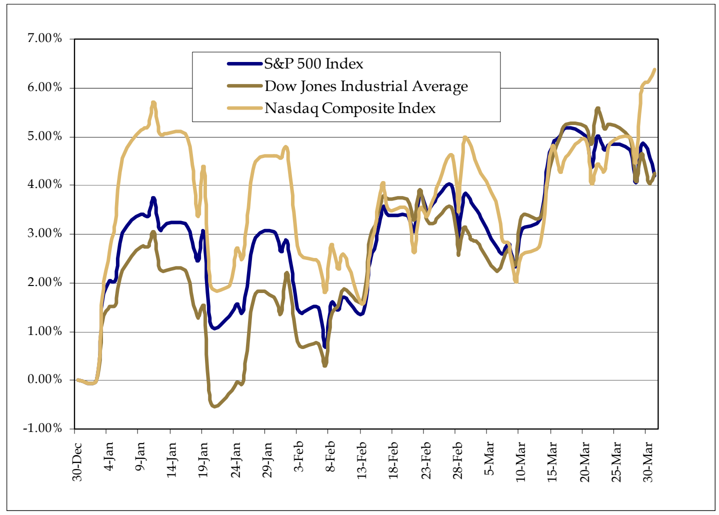
David E. Nelson, CFA
Chairman, Investment Policy Committee
Legg Mason Capital Management

Major Indices March Performance



Source: Bloomberg and FactSet

Major Indices 2006 Performance



Source: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

Sector Index Name	March	YTD
Broad Market Indices		
S&P 500	1.24	4.21
Dow Jones	1.20	4.24
Russell 1000	1.42	4.49
NASDAQ	2.62	6.38
Dow Jones Wilshire 5000	1.94	5.53
Russell 2000	4.85	13.94
Russell 1000 Growth	1.48	3.09
Russell 1000 Value	1.35	5.93
S&P 500 Sector Indices		
S&P 500 Consumer Discretionary	0.48	2.96
S&P 500 Consumer Staples	0.53	1.56
S&P 500 Energy	3.89	9.05
S&P 500 Financials	0.29	3.24
S&P 500 Health Care	(1.23)	1.25
S&P 500 Industrials	4.59	7.04
S&P 500 Information Technology	1.83	4.17
S&P 500 Materials	4.53	7.43
S&P 500 Telecomm Services	3.11	14.45
S&P 500 Utilities	(4.59)	(1.16)

Sources: Bloomberg, FactSet, Russell