

Market Commentary

On the surface, it appears that June was a rather tranquil month in the equity market, with most major U.S. indices up or down fractionally. Nothing could be further from the truth. June actually witnessed a nasty correction in the market, accompanied by the sharpest spike in the CBOE Volatility Index (VIX) since July 2002. The damage done during the correction was pervasive, as indicated in the last column of the performance chart below.

TOTAL RETURNS

	June	Q2	YTD	5/5-6/13
S&P 500 Index	+0.14%	-1.44%	+2.71%	-7.46%
Dow Industrials	-0.05%	+0.94%	+5.22%	-7.18%
Nasdaq Composite	-0.26%	-7.01%	-1.08%	-11.46%
S&P Mid-Cap	+0.02%	-3.14%	+4.24%	-12.11%
Russell 2000 Index	+0.64%	-5.02%	+8.21%	-13.86%
Wilshire 5000	+0.18%	-1.91%	+3.51%	-8.41%
S&P 100 Index	-0.15%	-0.84%	+2.80%	-6.74%

Sources: Bloomberg, Wilshire, Russell

The performance symmetry we observed in May's commentary was also in evidence during the correction and for the second quarter as a whole. During all three periods, mega cap stocks (as measured by the Dow Industrials and S&P 100 Index) performed best, followed, in descending market cap order, by large caps, mid-caps and small caps.

We believe that the superior performance of large and mega cap stocks exhibited during the quarter may mark the beginning of a more extended period of superior relative returns for large cap stocks after six and a half years of relative underperformance versus small and mid-caps. It really has been a tale of two markets in the last several years, as illustrated below:

COMPARATIVE RETURNS
12/31/99 – 06/30/06

	Price Only	Total Return	Relative Return (Vs. S&P 500)	Annualized Return
Russell 2000 Index	+43.57%	+56.54%	+60.63%	+7.14%
S&P 500 Index	-13.55%	-4.08%	-	-0.64%
S&P Mid-Cap Index	+72.01%	+85.01%	+89.09%	+9.93%

Source: Bloomberg

If you've been invested in the S&P 500 Index since the end of 1999, it can't feel like anything but a bear market. You lost about half your money from 2000 to 2002, after six and a half years your portfolio is still 14% under water, and, even after dividends, you haven't made any money. In contrast, small and mid-cap investors sailed through the bear market of 2000 to 2002 relatively unscathed and have prospered since. Of course they love their respective asset classes. How could they not?

If investors in the S&P 500 Index have found the last six and a half years discouraging, imagine how investors in a broad range of mega cap stocks feel. As the table below illustrates, the ten largest market cap companies in the S&P 500 Index as of December 31, 1999 are down an average of 53% from their respective all-time highs. With the exception of Exxon Mobil Corporation, which made its all-time high recently, all of the other companies' highs occurred in 1999 or 2000.

Company	All-Time High Price	% Change From High (Through 6/30)	Change in Market Value (Billions)
Microsoft Corporation	\$59.97	-61.1%	-\$374.1
General Electric	\$60.50	-45.5%	-\$286.4
Cisco Systems, Inc.	\$82.00	-76.2%	-\$381.4
Wal-Mart Stores, Inc.	\$70.25	-31.4%	-\$92.0
Exxon Mobil Corp	\$65.96	-7.0%	-\$27.9
Intel Corporation	\$75.81	-74.9%	-\$330.5
Lucent Technologies	\$64.69	-96.3%	-\$279.0
IBM Corporation	\$134.94	-43.1%	-\$90.1
Citigroup Inc	\$55.15	-12.5%	-\$34.3
AOL/Time Warner	\$95.81	<u>-81.9%</u>	<u>-\$336.2</u>
		-53.0%	-\$2,231.7

Sources: Bloomberg, Factset, LCMCM Estimates

The loss of market value from their respective highs for these ten companies is more than \$2.2 trillion. By comparison, the combined market value of the S&P Mid-Cap Index (\$1.16 trillion) and the Russell 2000 Index (\$1.49 trillion) is currently about \$2.65 trillion. By our estimate, the gain in market value of these two indices since the end of 1999 is about \$938 billion. The loss of market value of the ten mega caps listed above exceeds that total by well over two times.

Putting aside total wipeouts such as Worldcom, and near total wipeouts such as Lucent and Nortel Networks, is it any wonder that investors in the likes of Intel, Cisco, and Microsoft—or even General Electric and IBM—are anything but thrilled with their investment results over the last few

years? The law of the investment jungle is that poor performance breeds discouragement, which breeds disgust and abandonment, which creates opportunity. Someone taking a fresh look at a broad cross section of mega cap stocks today—someone not burdened with the emotional baggage of their dismal price performance over the last several years—would find a lot to like in these stocks, in our opinion. As a group, the ten largest companies in the S&P 500 by market value (our proxy for the mega caps) now trade at a discount to the S&P 500 Index as a whole, while having higher average dividend yields, much higher returns on equity, rock solid balance sheets and decent growth prospects.

In summary, we believe the conditions are right for a transition in market leadership from small and mid-cap stocks to large/mega caps. Small and mid-caps have been great performers and everyone loves them, but they have gotten expensive relative to their history, and earnings expectations are elevated. In contrast, large/mega caps have been performance dogs and investors are worn out on them, but they are now cheap and expectations for them are modest. The first solid evidence that this transition may be in progress was the relative performance of the two groups during the market correction in May and June, and for the second quarter as a whole. So, step one of the leadership shift has been accomplished—the large caps held up better than small and mid-caps on the downside. It's an open question whether they can establish a leadership position on the upside. So far, they have not. From the recent low on June 13 through the end of June, small and mid-caps bounced back more sharply than large caps. Stay tuned.

Outlook

We regard the current market environment as an especially difficult one to navigate. There seem to be more than the usual number of questions and uncertainties. Are we in a bear market or a correction? Will the Fed pause in August or not? Is the economy slowing or not? Will earnings growth disappoint or continue to surprise on the upside? Is the market attractively valued or isn't it? Is a change in market leadership in process or not? Whatever one chooses to believe, one can find company in that belief and reasonable evidence to support it.

Space does not permit a full discussion of all these questions here, but briefly, our current thinking is as follows. We think the recent market weakness was a correction—which could have further to go on the downside—rather than the start of a bear market. We think the Fed is near the end of its tightening regime, but will probably bump the Fed funds rate one more time by 25 basis points to 5.50% in August. We think a leadership change from small and mid-cap stocks to large/mega caps is in process, but may take more time to become apparent. We expect the economy to slow, but not collapse, and we expect earnings growth to slow, but hold up well enough to support higher stock prices once it becomes apparent that the Fed is done tightening. Finally, we believe that the market is increasingly attractively valued, as it goes more or less sideways while earnings continue to rise. In the space remaining, we'd like to more fully address the questions of the likely course of Fed policy and whether we're in a bear market or not.

Our opinion concerning the Fed is that it *should* pause in August, but that it probably will not. Prior to the June 29 FOMC meeting, the Fed funds futures markets rated the likelihood that the Fed would tighten again in August at better than 80%. A less hawkish than expected statement following the meeting cheered investors and lowered the odds of another tightening to about 60%/40% in favor. The wording of the FOMC's June 29 statement was a relatively significant departure from previous statements and made clear that the "extent and timing of any additional firming that may be needed . . . will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information." We read this statement to mean that even the Fed does not yet know whether or not it will tighten in August.

As to whether the market weakness we saw in May and June is the beginning of a bear market or a correction in an ongoing bull market, we remain in the correction camp. While taking into account that we are heading for the seasonally weakest portion of the year in terms of stock performance, and that a number of knowledgeable market observers—including John Mendelson, Bob Farrell and Ned Davis—disagree with us, we remain constructive on the outlook for equities over the next twelve months or so. In support of that view, we offer two indicators (dare we call them buy signals?) which: (1) don't occur very often, (2) have both occurred recently, and (3) in past instances, have been followed by above average stock market returns in the ensuing six months. One relates to spikes in market volatility and the other to a surge in upside trading volume.

On June 14, 2006, Birinyi Associates published a study on the performance of the S&P 500 Index following periods of "extreme volatility," which they defined as periods during which the 50-day rate of change (ROC) in the CBOE Volatility Index (VIX) is greater than 100%. According to Birinyi Associates, there have been only six such occurrences since 1990, the latest of which ended on June 13 with the VIX at 23.81. The prior five occurrences and subsequent performance of the S&P 500 over various time periods are listed below.

Date	S&P 500 Performance (%)				
	VIX 50-Day ROC (%)	Prior 50 Days	Next Month	Next 3 Months	Next 6 Months
8/6/1990	107.3	-5.7	-3.4	-5.9	4.2
4/4/1994	115.2	-7.5	3.2	1.7	5.2
8/31/1998	101.8	-13.2	9.5	21.6	29.1
9/17/2001	122.6	-16.0	4.9	9.2	12.2
7/23/2002	116.8	-25.8	17.5	11.6	11.3
6/13/2006	105.8	-5.7	-	-	-
Average		-13.6	6.4	7.6	12.4

Source: Birinyi Associates, Inc.

Interestingly, in every case since 1990, while the VIX is in the process of spiking upward, the market has been weak, declining between 5.7% and 25.8%, with an average decline of 13.6%. This makes intuitive sense to us, since the VIX measures the relative volatility of puts and calls on the Chicago Board of Exchange (CBOE), and when it is rising, it indicates that the perceived risk in

the market is rising and stock prices are adjusting downward to reflect that.

The table above also clearly shows that in the six months following a spike in the VIX, the performance of the S&P 500 has tended to be quite good in both an absolute sense and relative to stocks' long-term average returns. Since June 13, the S&P 500 Index has gained 4.12% (through 7/6/06), so we're off to a promising start this time around as well.

The second phenomenon that occurs even less frequently than the VIX spikes we just discussed, and which comes to us courtesy of Ned Davis Research, is instances in which the advancing volume on a given day exceeds declining volume by a factor of 9-to-1. For the signal to be valid, two 9-to-1 up days must occur within a three month period, without an intervening 9-to-1 down day. Tuesday, April 18 was a 9-to-1 up day and so was Thursday, June 15; however, two intervening 9-to-1 down days between these two dates invalidated that signal. A buy signal was triggered on June 29, though, as the post FOMC meeting rally led to another 9-to-1 up day, with no intervening 9-to-1 down days.

So how much weight should we give this signal? To our way of thinking, a good buy signal should: (1) make some kind of intuitive sense, (2) happen relatively infrequently, and (3) produce reasonably reliable results. We think the 9-to-1 up day indicator qualifies in all three respects. In our view, a 9-to-1 up day is like a trumpet blast announcing the arrival of an important advance. It implies that a large number of market participants conclude that the market is attractive for investment at the same time and act forcefully on that conviction. According to Ned Davis Research, since 1950 there have only been 26 such signals triggered, or about one every two years. Since 1962, the signals have been even less frequent, with only 13 in 44 years, or about one every 4 years. Specifically, there were two signals in the '60s, two in the '70s, five in the '80s, one in the '90s and three (7/29/02, 8/16/04 and 6/29/06) since the turn of the millennium. The table below summarizes the performance of the S&P 500 Index over various time periods (measured in trading days) following the second 9-to-1 up day signal being triggered.

	S&P 500 Performance (%)		
	22 Days	63 Days	126 Days
Mean	4.1	7.0	12.6
Median	3.2	6.5	12.2
Times Up/Total	21/25	22/25	21/25

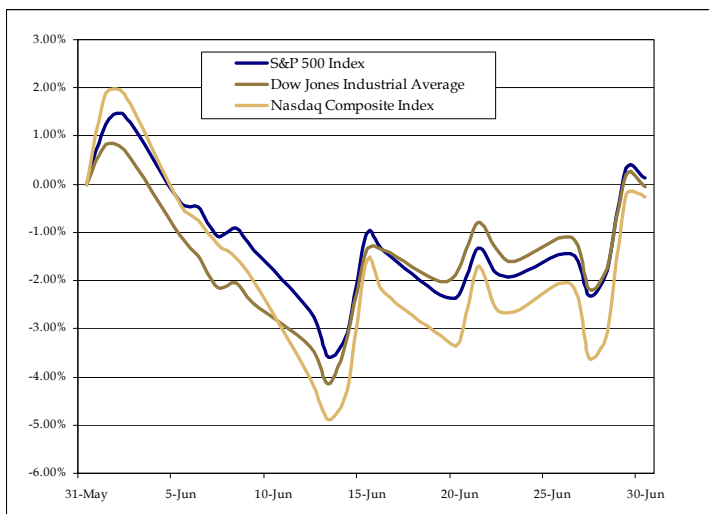
Source: Ned Davis Research

Obviously, there are no guarantees in the stock market, but this 9-to-1 up day indicator looks like one to which it is worth paying attention. Not only is there reasonable correspondence between the median and mean returns, but the instances of positive returns are remarkably high over all time periods measured.

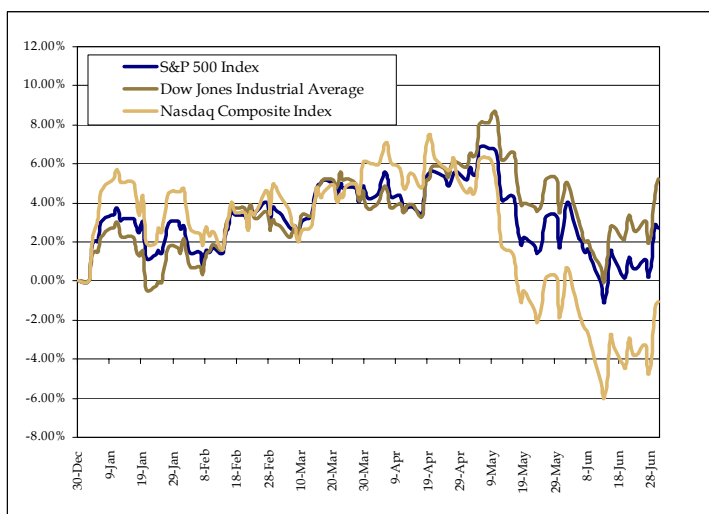
On that happy note, we'll conclude our commentary and, as always, thank you for your support and welcome your comments.

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Major Indices June Performance



Major Indices YTD Performance



Source: Bloomberg and FactSet

Source: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

Sector Index Name	June	Q2	YTD
<i>Broad Market Indices</i>			
S&P 500	0.14	(1.44)	2.71
Dow Jones	(0.05)	0.94	5.22
Russell 1000	0.13	(1.66)	2.76
NASDAQ	(0.26)	(7.01)	(1.08)
Dow Jones Wilshire 5000	0.18	(1.91)	3.51
Russell 2000	0.64	(5.02)	8.21
Russell 1000 Growth	(0.39)	(3.90)	(0.93)
Russell 1000 Value	0.64	0.59	6.56
<i>S&P 500 Sector Indices</i>			
S&P 500 Consumer Discretionary	(0.25)	(0.47)	2.48
S&P 500 Consumer Staples	1.52	2.92	4.52
S&P 500 Energy	2.09	4.28	13.71
S&P 500 Financials	(0.61)	(0.13)	3.11
S&P 500 Health Care	0.03	(4.99)	(3.80)
S&P 500 Industrials	(0.41)	0.01	7.06
S&P 500 Information Technology	(1.65)	(9.63)	(5.86)
S&P 500 Materials	0.18	(0.43)	6.97
S&P 500 Telecomm Services	4.76	(0.57)	13.80
S&P 500 Utilities	2.41	5.69	4.47

Sources: Bloomberg, FactSet, Russell

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