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*"The tumult of the time disconsolate
To inarticulate murmurs dies away,
While the eternal ages watch and wait."*

— Longfellow, 1864

As disconsolate as we all may be, looking at our investment results for 2008, contemplating our errors and thinking about what might have been if only... those words from Longfellow's first sonnet on translating Dante, written during the height of the Civil War, remind us that "*gam zeh ya'aver*," "this too shall pass," as King Solomon was reminded in Hebrew folklore and as Abraham Lincoln recounted in a speech in 1859.

Events in this financial and economic crisis are moving so fast that one is constantly revising one's view as conditions unfold and the evidence warrants, making much commentary obsolete soon after it has been written. As Wittgenstein said in a different context, the words look like corpses soon after they are on the page. I will say a bit about how things look now, and what I expect in 2009, but such comments are even more provisional than usual.

2009 outlook

It *appears* (emphasis mine) that the S&P 500¹ bottomed November 21st at 741 intraday. The number of new lows was less than at the previous October bottom, something market technicians consider a positive. Stocks then rallied over 20% into early January, and then turned down, with the S&P 500 standing now at 805, down almost 11% so far in early 2009. As has been the case during this entire bear market, financials led on the way down, and they led off the bottom. They are again leading this mid January sell-off. I believe the trend of the financials leading the market will continue.

This financial crisis began with housing in the US but has spread to encompass the global economy. It will not end until the financial system is stabilized and credit

flows are restored. As Fed Chairman Bernanke said in an important speech on January 13, "History demonstrates conclusively that a modern economy cannot grow if its financial system is not operating effectively." If 2009 is a bad year for US equities, it will be a bad year for financials, and if it is a good year for equities, I believe financials will outperform.

Quoting Chairman Bernanke again: "The global economy will recover, but the timing and strength of the recovery are highly uncertain. Government policy responses around the world will be critical determinants of the speed and vigor of the recovery." The question for investors centers on the evaluation of policy and its impact on securities. So far, the picture is, at best, mixed.

For policy to be effective, it must accomplish two things: stabilize collateral values, and stimulate aggregate demand. The massive stimulus under consideration in Congress will help the second, but nothing so far has been effective in doing the first, which is far more important since it is the source of the problem, as I noted in my last letter. The release of additional TARP funds and the capitalizing of an aggregator bank to buy assets directly should both help, and ultimately the government will succeed, but they can do substantial damage in the interim by ill conceived words and actions.

FDIC Chairwoman Sheila Bair expressed a view apparently widely held in the government when she said last week, "It is essential to get some private capital back into these banks." I completely agree with that, but the problem for private capital is there has to be some prospect of earning a return by investing in banks, something the government seems not to understand. As this is being written, private capital is fleeing even what have heretofore been thought to be the strongest banks: Wells Fargo, down 50% this year, Bank of America, down almost 60% this year, PNC down 54%, US Bancorp down almost 40%. The story is the same or even worse in Europe, where Deutsche Bank is down 46%, HSBC down 30%, Barclays down 57% despite announcing it will have profits that exceed analyst's estimates. Then there's Royal Bank of Scotland, down 79%, and Allied Irish, down 64%, in just the first 3 weeks of the year. Clearly, the market is concerned the forthcoming government policies are not going to be effective and may be counterproductive. It is the substance of those policies, and not the market's fears or hopes for them, that will determine the outcome.

The financial authorities seem to think of private capital as, to borrow a phrase from Justice Holmes, some “brooding omnipresence in the sky.” Private capital is us, it is Davis, it is Dodge & Cox, it is Brandes and so on. That is, it is mutual funds and pension plans and endowments, and every time we have bought bank shares, either new capital or existing shares, we have been killed. Until policy becomes clearer and more capital friendly, the chances of attracting new capital to banks is nil, in my opinion.

Policy has improved. It has moved away from being purely punitive—wipe out shareholders (private capital) if the institution needs government support, a counterproductive policy if there ever was one when you are saying the banking system needs more private capital—to one that is opaque and apparently confused.

Coincidence or not, the rout in banks now underway began when reports began to circulate that regulators wanted Citigroup to sell assets and shrink its balance sheet. Citi has since announced a plan to do just that, and the stock has collapsed. There are at least two major problems here: first, the regulators are subverting the governance process (if the stories are true) and making strategic decisions that are the purview of management, and second, who is going to buy hundreds of billions of dollars worth of assets from Citi in this environment? If the government wants board seats in return for capital, that would be fine. But to have an anonymous regulator apparently deciding what the right size of Citi is, or declaring that Bank of America has to cut the dividend to a penny per quarter, leaves investors completely in the dark as to who is responsible for their capital and what policies the institution will pursue. As to the second issue, no one will buy those assets without the prospect of earning a significant risk adjusted return, and if the buyer is going to get such a good deal, then it is a bad deal for Citi.

At this point, no one knows what policy is. Is it to shrink the size of the biggest banks so they don't pose systemic risk, as Chairman Bernanke apparently suggested in his speech, and as the actions of Citi may suggest, or is it to have them bigger and more diversified, as the additional capital to Bank of America to complete the Merrill deal suggests?

Attracting private capital to banks requires, first, that there be a reasonable prospect of earning a good return on that capital, and so far the record is that there has been the opposite: capital committed has been capital lost. Second, policy has to be transparent and not opaque and ad hoc. Third, the accounting rules need to be sensible instead of idiotic, as is now the case with so-called Fair Value accounting.

None of these involves heroic or herculean efforts. There is some prospect of relief on the latter, as The Group of Thirty², has recently recommended changes in the accounting standards (although the FASB³ has so far resisted efforts to enact sensible rules). To reiterate what I have written elsewhere: the

transparency of marking assets to market is valuable to investors; but rules that equate the marginal price at which an asset trades with its “fair value,” and require banks to raise capital as a result of changes in those prices, are an important part of why the industry is capital short and we have a financial crisis. Price is one thing, value is another. State Street Bank fell 60% because it showed several billion of mark to market losses on debt securities in its portfolio in the quarter, raising fears about its capital adequacy, despite having regulatory capital well over double what is necessary to be considered well capitalized. And all of those debt securities are current as to interest and principal payments. Fears, not facts, are driving prices.

To come full circle: I agree completely with Chairman Bernanke that we need to stabilize the financial system and restore the flow of credit, and with Chairwoman Bair, that we need to get private capital into banks. The question is, when will policies be adopted that will lead to more credit being extended and to investors making money in banks and other financials?

We have been investing in banks and other financials for over a quarter of a century, and were involved in putting new capital into them during the last crisis around 1990. That worked out very well. We have also been part of the private capital that has put money into financials in this crisis, and that has been a disaster, for us and for every other investor who has done so. If we are typical, the appetite for private capital to go into banks now approaches zero, unless there are substantial changes in policy that are capital friendly.

The problem with credit, by the way, is not that banks are not lending, a statement one reads almost every day in the Wall Street Journal or the Financial Times, or hears from some politician or other. The facts are, according the Federal Reserve⁴, that bank lending has grown 5.7% since the recession began in December 2007, and consumer loans grew 8.9%. Only home equity loans actually declined.

The problem with credit is that it is far too expensive to make it economic to use it to grow. With investment grade debt having yields greater than the growth rate of nominal GDP, the cost of new debt in the system exceeds the ability to earn enough to pay for it. Hence, the deleveraging going on. The government on the other hand, can borrow at half the growth rate of nominal GDP⁵, and hence, it is the government that will, and should, borrow aggressively to invest in the country's future.

All of this was explained a generation ago by Keynes when we last had a crisis like this, and anyone seeking to understand it should either go to the source, or to the second volume of Robert Skidelsky's monumental three-volume biography.

I remain optimistic that the new administration, which is staffed with first rate financial talent, coupled with the Fed,

will craft policies that will be effective in stabilizing the financial system and restoring the flow of credit.

Despite the raggedy start, I also think this will be a pretty good year for equity investors. Last year was the worst for US (and most other) stocks since the 1930s. Pessimism and gloom abound. Short-term trading has replaced long-term thinking. The consensus is for economic growth to resume in the second half of the year, but of course no one knows. But growth will resume, and when it does equity prices will be much higher, in my opinion. Valuation based strategies had a strong December and early January and we performed very well, as one would expect when that is happening. The sell-off in financials and the market in the past two weeks has interrupted that trend, and the S&P 500 has now had its worst start to a new year ever. Fear has returned to the fore.

This too shall pass.

Value Trust comments

During the fourth quarter we added 15 new names to the fund, which is now exposed to every sector of the market for the first time in many years. Values abound and we believe we can broaden and diversify the portfolio without sacrificing future rates of return. The fourth quarter sell-off was driven by a panic stampede for liquidity that encompassed all sectors (“Of the maxims of orthodox finance none, surely, is more anti-social than the fetish of liquidity...” Keynes). In my opinion, the long-term opportunities for the fund have never been better and the overall quality of the portfolio has never been higher. Financials are now under 10% of the market’s capitalization for the first time since 1992, which was a great time to buy financials. This is also the best time to buy quality in my investing career; it has never been cheaper and we continue to look for, and to find, names with excellent financial strength, good and growing dividends, leading positions in their industry, and trading at five- or 10-year lows and at historically low valuations. We believe this should lead to quite satisfactory results over the next five to 10 years.

Bill Miller
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³Since 1973, the Financial Accounting Standards Board (FASB) has been the designated organization in the private sector for establishing standards of financial accounting and reporting.

⁴The Federal Reserve Board (“Fed”) is responsible for the formulation of policies designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.

⁵Gross Domestic Product (“GDP”) is the market value of all final goods and services produced within a country in a given period of time.

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¹The S&P 500 Index is an unmanaged index of 500 stocks that is generally representative of the performance of larger companies in the U.S. Please note an investor cannot invest directly in an index.

²The Group of Thirty, often abbreviated to G30, is an international body of leading financiers and academics which aims to deepen understanding of economic and financial issues and to examine consequences of decisions made in the public and private sectors related to these issues. The group consists of thirty members and includes the heads of major private banks and central banks, as well as members from academia and international institutions. It holds two full meetings each year and also organizes seminars, symposia, and study groups. It is based in Washington, D.C.