LEGG MASON CAPITAL MANAGEMENT
Month-End Commentary

September 2009

Market Commentary

The S&P 500 Index posted its seventh consecutive monthly gain in September, up +3.73%, continuing to frustrate the bears, and surprising even bulls like us, who thought the market might be due for a breather. September has historically been the weakest month on average and this year seemed to be following that pattern, as the S&P 500 swooned -2.51% in the first two days of the month. We opined at the time that the much anticipated market correction could finally be upon us. Instead, September 2 proved to be the low point for the month, as the S&P turned on a dime and streaked pretty much uninterrupted to a new year-to-date closing high of 1071.66 on September 22. From there, the market weakened modestly, closing the month at 1057.08, -1.36% off its high, but still up +15.61% for the quarter and +58.25% from its March low on a total-return basis.

TOTAL RETURNS

	September	Q3	YTD
S&P 500 Index	+3.73%	+15.61%	+19.26%
Dow Industrials	+2.43%	+15.82%	+13.49%
Nasdaq Composite Index	+5.69%	+15.91%	+35.59%
S&P MidCap 400 Index	+5.72%	+19.98%	+30.14%
Russell 2000 Index	+5.77%	+19.28%	+22.43%
Dow Jones US Total Market Index	+4.14%	+16.32%	+21.52%
S&P 100 Index	+3.02%	+14.33%	+15.50%
Russell 1000 Growth Index	+4.25%	+13.97%	+27.11%
Russell 1000 Value Index	+3.86%	+18.24%	+14.84%

Sources: Dow Jones, Russell®, NASDAQ® (via Bloomberg), S&P (via Bloomberg)

Small- and mid-cap stocks and the Nasdaq Composite led the way in September, with "quality" proxies, the Dow Industrials and S&P 100 Index, lagging somewhat. For the quarter, returns were relatively uniform across market-capitalization sectors, but stylistically, in a switch from the first half, value beat growth by more than 425 basis points, though growth still leads value handily year-to-date. Year-to-date returns reveal similar leadership patterns to those exhibited during the month of September, with mid-caps and the Nasdaq Composite well in front and the Dow Industrials and S&P 100 Index bringing up the rear.

In terms of S&P 500 sector returns, industrial (+6.77%), consumer discretionary (+5.32%) and materials (+4.96%) stocks led for the month, while healthcare (+1.05%), utilities (+1.39%) and financials (+2.04%) lagged. For the quarter, financials (+25.51%), industrials (+21.99%) and materials (+21.51%) were notably strong, while telecom services (+5.58%), utilities (+6.15%) and healthcare (+9.53%) lagged meaningfully.

Overseas stock returns (in dollars) continued to largely outpace U.S. equity returns for the month, quarter and year-to-date. Japan is a notable exception, having posted poor relative returns over all three time periods. Perhaps a bit surprisingly, given the strength virtually everywhere else, China's Shanghai SE Composite posted negative returns for the September quarter, in both local currency and dollar terms. The Shanghai Composite (+54.84%) has now slipped to fourth place on a year-to-date dollar-return basis, with Russia's MICEX Index (+92.32%) now leading the pack, followed by India's BSE Sensex 30 Index (+81.44%) and South Korea's Kospi Index (+64.00%).

TOTAL RETURNS IN U.S. DOLLARS

	September	Q3	YTD
FTSE 100 Index (UK)	+2.99%	+18.69%	+32.30%
DAX Index (Germany)	+6.03%	+23.01%	+21.41%
CAC 40 Index (France)	+6.06%	+26.28%	+28.51%
MICEX Index (Russia)	+16.13%	+27.92%	+92.32%
NIKKEI 225 (Japan)	+0.44%	+9.86%	+16.96%
Hang Seng Index (HK)	+6.75%	+14.78%	+49.66%
Kospi Index (So. Korea)	+11.68%	+30.27%	+64.00%
Shanghai SE Comp. (China)	+4.43%	-5.69%	+54.84%
BSE Sensex 30 Index (India)	11.13%	+18.33%	+81.44%

Source: Bloomberg

With the U.S. equity market having shown such remarkable resilience, it is logical to wonder who has been stepping in to stem market declines. This is a difficult question to answer, but one thing is crystal clear from the data we've seen: it hasn't been the general public. Their main contribution to the advance is that they've stopped selling stocks, but their activity on the buy side has been anemic given that the S&P 500 is up nearly 20% year-to-date, and over 55% from its March low. Despite the powerful move off the bottom, investors are still sitting on $3.5 trillion in money market funds, assets which are yielding them a return somewhere in the range of five to ten basis points, annualized. The decline in money fund assets from the $3.9 trillion peak in January 2009 has been largely directed to bonds and bond mutual funds. Bond funds have

attracted net deposits of $209.1 billion through August, according to Morningstar, and $249.8 billion through September 16, according to Leuthold Group. In comparison, investors have purchased only $6 billion of U.S. equity funds through mid-September. Admittedly, this is a big turnaround from the -$173.9 billion that investors pulled from stock funds in 2008 (according to Morningstar), but the comparatively modest sum speaks to the continuing skepticism with which the general public views stocks.

Investors' reticence to embrace the stock market's advance is reflected in the behavior of 401K participants as well. According to Lincolnshire, Illinois-based, Hewitt Associates, despite the spirited advance, investors have not shifted back into equities in a meaningful way thus far this year. The reason, says Pamela Hess, director of retirement research at Hewitt, is that people are still too traumatized by last year's losses to summon the courage to increase their exposure to equities.

So, if it's not mutual fund investors and not 401K participants, who is stepping in to buy when the market sells off? Our candidate is the under-invested professional money manager. Obviously, any manager that is fully invested can't be a net buyer of stocks in a decline because they have to sell something to buy something else. Only managers with cash reserves can be net buyers. What is their mindset right now? Praying for a correction would be our guess. All last year, cash reserves were a boon to performance. Ten percent cash boosted a manager's relative performance nearly 400 basis points versus the down -38% S&P 500, assuming the rest of the portfolio tracked the S&P. If ten percent felt good, twenty percent probably felt better. But since March, cash reserves have gone from being a blessing to being an albatross. Any equity manager with 20% cash in March who still has it today has lost over a thousand basis points of relative performance since then, again assuming the rest of the portfolio tracked the S&P 500 over that time frame.

We would imagine that the performance pressure on equity managers with "too much" cash is probably getting excruciating. The anecdotal evidence is that there are a good number of managers in this position. Veteran market technician, John Mendelson, now hanging his hat at Potomac Research Group, has reported on several occasions that a frequent comment from managers he sees on client visits is something to the effect that: "I have too much cash. When do you think we'll see a meaningful correction, so I can put the money to work?" When the market pulls back, we suspect that under-invested managers are putting money to work. That suspicion is borne out by data from the Investment Company Institute which indicates that the composite cash-to-asset ratio of stock mutual funds has dropped from 5.51% in February to a most recent reading of 3.96%.

Another phenomenon that Mendelson has observed, which probably helps explain the shallowness of corrections so far in the market advance since March, is the speed with which investors become bearish on any pullback. Mendelson has long measured investor sentiment by watching what investors do, rather than what they say. One indicator he monitors closely is the CBOE Put/Call data. In the dark days of March 2009, a period of deep investor pessimism that Mendelson called "one of the blackest ever," the five-day average CBOE Put/Call ratio reached a high of 99.3 on March 5. The S&P 500 Index bottomed two days later and rallied +40% into mid-June, whereupon a month-long -7.1% correction ensued. By July 10, at what proved to be the end of the correction, the Put/Call ratio reached 101.3, exceeding the March low and suggesting that investors were even more bearish than they had been in March. On August 17, after a **two-day** correction of -3.3%, the Put/Call ratio hit 99.4, again exceeding the March low. In early September and again in late September, the five-day average Put/Call ratio spiked over 90, hitting 93.3 on September 1, and 98.5 on September 24. Fascinatingly, on September 28, a day when the S&P 500 rallied +1.8%, the Put/Call ratio hit 100.3, indicating heavy put buying into a strong rally.

We have cited Mendelson's work on the Put/Call ratio in such detail because we think it illustrates very dramatically how quickly and easily spooked investors are by any hint of a downturn. The S&P 500 Index has rallied over 380 points (+58.25%) from its March low and investors are still incredibly jumpy. What this means is that at the first hint of trouble, investors are taking aggressive action to protect themselves on the downside, which, ironically, has the effect of mitigating the decline. As long as investors continue to react this way, corrections will likely continue to be moderate. When all the under-invested money managers get fully invested, and when investors stop fearing the downside, then we need to watch out.

Outlook

We continue to be bullish on the outlook for U.S. equities over the next 12 to 18 months, believing that the S&P 500 Index has the potential to reach the 1250 to 1350 range by the end of 2010. We also continue to believe that an intermediate market correction is increasingly likely. As this is written, the S&P 500 has already pulled back about -4% from its September 22 closing high, so some kind of correction seems to have begun, the only question is how severe it will be. Our guess, and it's obviously only a guess, is that the damage will likely be contained to the -5% to

-10% level, implying risk in the S&P 500 down to the 965 to 1015 level. At worst, we think the S&P 500 could drop back to the low 900s before stabilizing. We believe the proper mindset for investors will be to remain constructive through any correction because the risk/reward ratio becomes increasingly favorable as the market declines.

Our bullish outlook over the next 12 to 18 months is based on the following reasoning: credit markets continue to normalize with credit spreads back to pre-Lehman levels; every meaningful leading economic indicator is pointing to recovery; the recession appears to be ending or over; real GDP growth should be meaningfully positive (+3% to +4%) in the third quarter; corporate profits are poised to snap back sharply and appear to be continuing to surprise on the upside; inflation remains well contained; and the Fed will likely not begin tightening until the latter half of 2010. In short, all of the pieces necessary for a constructive backdrop for equities are falling into place.

The current market downdraft appears to have been precipitated by the release of a number of weaker-than-expected data points over the last couple of weeks, culminating in the announcement by the Institute for Supply Managers (ISM) on September 30 that the Chicago Purchasing Managers Index (PMI) for September had dropped to 46.1 from 50.0 in August, after investors expected a rise to 52.0. This was followed the next day by the announcement that ISM's monthly index of U.S. manufacturing activity had slipped to 52.6 in September from 52.9 in August, again disappointing consensus expectations of a rise to 54.0. Slightly higher-than-expected initial unemployment claims, also released on October 1, only served to exacerbate investor concern.

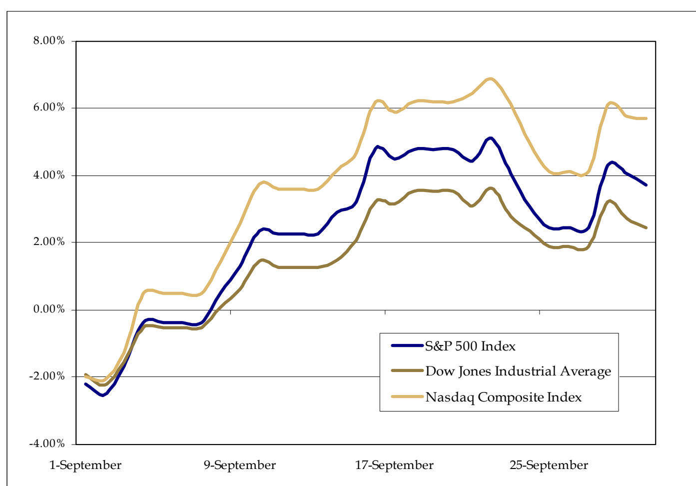
We think investors are likely making too much of the latest ISM data. Most monthly economic statistics are inherently "noisy" and, in our view, one month does not negate the strong trend of improvement that has emerged in this data over the last several months. We would note that eight of 12 regional PMIs showed gains in September, with three of those showing strong gains. On a national basis, a September reading of 52.6 for the manufacturing index, though lower than expected, indicates that the manufacturing sector of the economy is continuing to expand. This trend of improvement is evident overseas as well, as 18 of 26 manufacturing PMIs released so far in September showed gains, while only 8 were down, according to ISI Group.

The recent spate of disappointing economic numbers notwithstanding, we believe the weight of the evidence continues to suggest that the economy has begun to recover. Even modest nominal GDP growth of 5% over the next year, a well below-average recovery rate by historic standards, will likely produce corporate profit growth of three to four times that rate because corporate America is so "lean and mean," having cut payroll, inventories and overhead costs so aggressively. If profits recover sharply, as we expect, stock prices will ultimately follow. With the market up so strongly since March, a correction at some point is to be expected. As we said earlier, we believe the best course of action will be for investors to get more bullish, not less, as the market pulls back.

As always, we thank you for your support and welcome your comments.

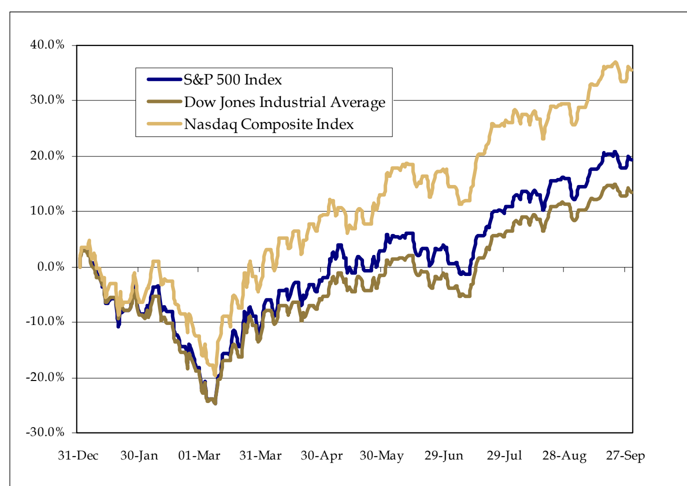
David E. Nelson, CFA
Chairman, Investment Policy Committee
Legg Mason Capital Management

Major Indices September Performance



Sources: Dow Jones, NASDAQ® (via Bloomberg), S&P (via Bloomberg)

Major Indices 2009 Performance



Sources: Dow Jones, NASDAQ® (via Bloomberg), S&P (via Bloomberg)

Monthly U.S. Market Update (Total Returns)

Index Name	September	Q3	YTD
Broad Market Indices			
S&P 500	3.73	15.61	19.26
Dow Jones	2.43	15.82	13.49
Russell 1000	4.06	16.07	21.08
NASDAQ	5.69	15.91	35.59
Dow Jones US Total Market Index	4.14	16.32	21.52
Russell 2000	5.77	19.28	22.43
Russell 1000 Growth	4.25	13.97	27.11
Russell 1000 Value	3.86	18.24	14.85
S&P 500 Sector Indices			
S&P 500 Consumer Discretionary	5.32	19.30	29.54
S&P 500 Consumer Staples	3.70	11.37	9.40
S&P 500 Energy	4.66	10.13	7.80
S&P 500 Financials	2.04	25.51	21.25
S&P 500 Health Care	1.05	9.53	9.73
S&P 500 Industrials	6.77	21.99	14.75
S&P 500 Information Technology	4.50	16.99	46.09
S&P 500 Materials	4.96	21.51	38.38
S&P 500 Telecomm Services	2.96	5.58	1.39
S&P 500 Utilities	1.39	6.15	4.33

Sources: Dow Jones, Russell®, NASDAQ® (via Bloomberg), S&P (via Bloomberg)

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