

## Legg Mason Capital Management Value Trust Bill Miller's Commentary



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In my colleague Michael Mauboussin's terrific new book, *Think Twice*<sup>1</sup>, the opening chapter tells the story of Big Brown, the super looking colt who'd won such impressive victories in the Kentucky Derby and the Preakness, the first two legs of racing's Triple Crown. This is a story with a lesson that directly relates to investing, and to understanding the kind of recovery that appears to be getting underway in the U.S. economy.

After winning all 5 of his starts by a combined total of almost 40 lengths, Big Brown was a 3-10 favorite to win the Belmont Stakes and became the first horse in 30 years to win the Triple Crown. Those odds indicated the "wisdom of crowds" putting a 77% probability on Big Brown's winning the race and making horse racing history. Part of that was right: he did make horse racing history — by being the only horse to win the first two legs of the Triple Crown and finish last in the Belmont.

That so many were so sure of Big Brown's success was due to a common analytical error that manifests itself in investing as well as horse racing. That error is the neglect of base rates. Psychologists call it the "inside" view, in contrast to the "outside" view. As Michael explains in his book:

*The inside view considers a problem by focusing on the specific task and by using information that is close at hand. The outside view... asks if there are similar situations that can provide a statistical basis for making a decision. The outside view wants to know if others have faced comparable problems, and if so, what happened. It's an unnatural way to think because it forces people to set aside the information they have gathered.*

In the case of Big Brown, taking the outside view would be to see how many horses in the past had won the first two legs of the Triple Crown and then went on to win the third. The inside view focused on Big Brown, his history, the competition he faced, the tracks he ran on and their condition, his time between races, and so on.

The outside view revealed that 29 horses had won the first two races of the Triple Crown in the 130 years it had been run, with 11 of those horses going on to win the third race. Parsing the data a little more finely showed a remarkable divergence in winning percentages. Before 1950, 8 of the 9

<sup>1</sup> Source: "Think Twice," by Michael J. Mauboussin, Copyright 2009, Michael J. Mauboussin; Bloomberg; and "From Bear to Bull," by James Grant, The Wall Street Journal, September 19, 2009.

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horses that had a shot at the Triple Crown won it. After 1950, only 3 of 20 were successful. Moreover, when Big Brown's speed ratings were compared to the most recent 6 Triple Crown contenders (and not just to his competition in the race), he was the slowest by a wide margin. If those who were betting on the Belmont had used the outside view instead of the inside view, no one would have believed what everyone did believe, that Big Brown had a nearly 80% chance to win the Belmont.

Investors are faced with these sorts of problems constantly: if I put my money in bonds now, what rate of return should I expect over the next 5 or 10 years? What is the outlook for stocks over the next 12 months? What are the chances of a significant rise in inflation over the next few years? What kind of economic recovery will we have? Should I fire my active money manager and replace him with a passive index product? What are the chances we have a "double-dip" recession? And on and on.

Faced with these sorts of questions, most people default to the inside view, and then augment its flaws with the usual assortment of behavioral biases long known to psychologists: they anchor on the most recent experience, they assume instances are representative of deeper patterns, they give more weight to vivid examples or dramatic outcomes, they place twice the weight on a dollar lost as on a dollar gained, etc.

The financial crisis that is now abating has created a near perfect environment for the admixture of all of the above, and that is perhaps why what Nobel winning economist Ken Arrow called the "clouds of vagueness" seem particularly thick and forbidding just now. Taking the outside view on some of the issues facing investors won't make an inherently unknowable future predictable, but it can improve the odds of getting things right, or getting fewer things wrong.

The difference between the inside and the outside view is well on display in the different and in some cases strongly held views about what kind of recovery is now unfolding in the U.S. PIMCO's Mohamed El-Erian is the most prominent advocate of the "new normal," a term he coined to describe a recovery with real growth of 1-2%, persistently high unemployment,

and much greater government involvement in the economy. He has recently warned of a big letdown from the "sugar high" we are now experiencing in the market and the economy as the effects of the abatement of the credit crisis and massive government stimuli, both fiscal and monetary, begin to wear off.

He may be the most prominent, but he is not alone. In fact, it looks like he is the leader of a not so silent majority. The current consensus growth rate for the U.S. economy in 2010 is 2.4%. This is way below "normal" for the first year of a recovery, yet even it is well above what most thought only 6 months ago. In April the IMF projected negative growth in world output of 1.3% this year, and only 1.9% growth in 2010. That included a projection of zero growth in 2010 for developed countries.

Projections such as these follow the classic inside view pattern: they look at current conditions, current trends, anchor on the most recent data, and adjust from there. Since the economy bottomed in March, almost all time series forecasts of economic improvement have been adjusted higher as the year wore on. They are still well below "normal."

A recent Bloomberg story noted how in the second quarter of 2009 almost 75% of companies in the S&P 500 beat consensus expectations, which were then revised upward. Now, the consensus is for profits growth in 2010 to be up about 25% from 2009. Yet economic growth is expected to be only 2.4%, a ratio of profits growth to GDP<sup>2</sup> growth of about 11. The outside view would show that the ratio has historically been around 6x, indicating either profits expectations are way too high, or growth expectations way too low. The outside view would favor the latter, as both time series have been steadily revised higher, and the early indications are that third quarter earnings are also coming in better than expected.

What does the outside view say about what we should expect? In an article in *The Wall Street Journal* ("From Bear to Bull," Sept. 19, 2009) Jim Grant quotes economist Michael Darda as follows: "The most important determinant of the strength of an economic recovery is the depth of the downturn that preceded it. There are no exceptions to this rule, including the 1929-1939 period." In the first year of

<sup>2</sup> Gross Domestic Product ("GDP") is the market value of all final goods and services produced within a country in a given period of time.

the recovery from the bottom of the Depression, the economy expanded 17.3%. If one adjusts for the drop in output in this recession, the outside view would put 2010's expected growth rate at around 8%.

Is the 'new normal' wrong? No one knows, yet. The core of the argument in its favor is an inside view: the consumer is over-leveraged, savings rates have risen from negative to positive and may stay elevated or go higher, balance sheets have been shocked by home price declines and the stock market collapse and need to be rebuilt. A mountain of corporate debt has to be refinanced, banks are not disposed to lend and capital requirements are going higher, and corporations will be cautious about hiring or expanding due to pervasive uncertainty.

A variant of the argument has it that with consumption elevated at 70% of GDP and the consumer retrenching, growth must be sluggish, profits will disappoint, and it will be hard for the stock market to make any headway. The outside view helps here too. In 1933, consumption as per cent of GDP was even higher than today, at 83%, and the savings rate was negative. The consumer deleveraged aggressively, pushing consumption as a percent to 73%, while the savings rate rose. Yet unemployment fell sharply, output grew rapidly, and the stock market went up over 100% from 1933-1937. There have been 8 times the consumer has deleveraged, and the market rose in 6 of those periods, with an average gain of 39%.

Since the bottom in March, the S&P 500 is up over 60%, and year to date returns exceed 20%, yet skepticism (if not downright pessimism) remains high. This judgment is not based on sentiment readings, or surveys. As market veteran John Mendelson often points out, it is not what people say that matters, it is what they do. And what they are doing is buying bonds and selling stocks. Through the first 9 months of this year, domestic equity funds had net outflows of \$8 billion. During the first week of October, another \$5 billion was redeemed. Bond funds, in contrast, had inflows of nearly \$300 billion in the first 9 months of this year. Of the top 10 selling funds in America this year, 9 are bond funds and only one is a stock fund, and that one is the Vanguard 500 index fund.

Stocks are pretty unpopular, despite having had a decent year so far, and why not? "Riskless" Treasuries have trounced stocks over this decade, having risen 85%, while if you'd bought the S&P 500 at the end of 1999 and held it through Sept. 30 of this year, you'd have lost 14% over the same period. No profits at all for a 10-year period of investing in the biggest US stocks! Buy and hold is dead is a common refrain. Who wants to own a risky asset that does not go up, and one denominated in a currency that will surely go down? (We "know" the dollar will go down because it is on the front pages of the financial papers and magazines that it will do so. Everyone knows that—the only question is how far and how fast and will it collapse?)

That is the inside view, anyway. The outside view provides a different perspective. According to data compiled by Jeremy Siegel at the University of Pennsylvania, stocks have provided average annual real returns (after inflation) of 6.66% for all 10-year periods going back to 1871. (It is a curious coincidence that stocks bottomed on March 6, at 666 on the S&P 500). There have been 14 10-year periods where stock returns have been negative, including this one. In every one of the previous 13, the subsequent 10-year returns have exceeded 10% real, about 50% more than average, and more than double the return of government bonds. So every time stocks have performed poorly for 10 years, they have performed better than average for the next 10 years, and they have beaten bonds every time by an average of 2 to 1, yet investors can't put money fast enough into bond funds, and continue to redeem equity funds.

As we sit at our desks pondering the myriad questions we're faced with as investors, questions of great complexity, and ones of undeniable importance to our future well-being, it probably makes sense to get up and go outside, where the view is likely to be different, and clearer, and better. (Commentary continued on next page)

BEFORE INVESTING, CAREFULLY CONSIDER A FUND'S INVESTMENT OBJECTIVES, RISKS, CHARGES AND EXPENSES. YOU CAN FIND THIS AND OTHER INFORMATION IN EACH PROSPECTUS, WHICH IS AVAILABLE AT [WWW.LEGGMASON.COM/INDIVIDUALINVESTORS](http://WWW.LEGGMASON.COM/INDIVIDUALINVESTORS). PLEASE READ IT CAREFULLY.

**Average annual total returns and fund expenses – Class C (%) as of September 30, 2009**

	1-yr	3-yr	5-yr	10-yr	Since inception (4/16/82)	Gross*	Net**
Excluding sales charges	-3.16	-14.37	-6.01	-1.82	12.03	1.72	1.72
Including effects of sales charges	-4.08	-14.37	-6.01	-1.82	12.03	–	–
S&P 500 Index	-6.91	-5.43	1.01	-0.15	N/A	–	–

Performance shown represents past performance and is no guarantee of future results. Current performance may be higher or lower than the performance shown. Investment return and principal value will fluctuate, so shares, when redeemed, may be worth more or less than the original cost. Class C shares have a one-year contingent deferred sales charge (CDSC) of 0.95%. Total returns assume the reinvestment of all distributions at net asset value and the deduction of all Fund expenses. Performance data does not reflect trade date adjustments made to the NAV at month-end. Performance would have been lower if fees had not been waived in various periods. For the most recent month-end information, please visit [www.leggmason.com/individualinvestors](http://www.leggmason.com/individualinvestors).

\* Gross expenses are the Fund's total annual operating expenses for the share class indicated as of the date of the Fund's most current prospectus and do not reflect fee waivers or reimbursements. These expenses include management fees, 12b-1 distribution and service fees, and other expenses.

\*\* Because the Fund does not currently have fee waivers or reimbursements, gross and net expense ratios are the same.

The S&P 500 Index is a market capitalization-weighted index of 500 widely held common stocks. Please note that an investor cannot invest directly in an index.

## Fund highlights

During the third quarter of 2009, the ValueTrust rose 19.6% vs. a rise of 15.6% for the S&P 500 Index. The Fund's cumulative return (excluding sales charges) for 2009 through the end of the quarter is 36.3% vs. 19.3% for the benchmark. Security selection was responsible for the majority of the outperformance and the biggest contributions during the quarter came from names in the utilities, technology, financials and consumer discretionary sectors.

Following the second quarter, during which AES Corporation's stock doubled in price, the company continued to perform well making it the single biggest contributor to the Fund's performance during the third quarter and since the beginning of the year. Stabilization of the credit markets as well as increased guidance from the company for the year helped propel the returns this year. While the share price of the company has risen considerably over the past year and strongly off the lows in March, it trades at under 12x next year's earnings, should grow nicely over the next 5 years and owns and operates power plants and utilities in 29 countries on five continents. A recent Fortune article pointed out that global investors, including China's sovereign wealth fund, China Investment Corp., have approached AES about taking a stake in the company.

Online auction company eBay Inc. also performed well during the quarter, as the company's CEO, John Donahoe, continues to move the company to a more customer-focused model which centers on the core auction and payments business. Donahoe negotiated the sale of 65% of Skype in a deal that increased eBay's cash while retaining upside in the company.

Shares of Capital One rallied over 60% during the quarter as they returned to profitability after two quarters of losses. The firm also repaid the funds it received from the government's Troubled Asset Relief Program (TARP). Recent data on the bank's delinquencies and charge-offs also suggested that expectations were too pessimistic which likely contributed to the recent performance.

The only meaningful detractor to the fund's performance in the quarter was Electronic Arts, which dropped over 12% during the three month period. While it is up close to the market's rate of return year-to-date, it struggled during the quarter as the company posted disappointing results that showed falling profitability and a deteriorating cash position. We are encouraged by their recent commitment to reduce costs given the misalignment in their cost structure during the downturn in the economy. The company has over \$7 per share in cash and no debt and we believe has significant upside potential.

## Fund Activity

After taking advantage of significant fear and disruption in the market late last year and during the first quarter of this year by adding 20 names and eliminating 5 for the six-month period ending March 31st, subsequent activity has been fairly modest by comparison. As fears receded in the financial sector following the earlier calls for the nationalization of Citigroup and Bank of America, we added only 2 names during the second quarter and eliminated a modest position in MetLife, Inc.

At the end of the third quarter, we initiated modest positions in five new securities: DirecTV Group Inc, Genzyme Corp., Qualcomm, Safeway and YUM! Brands.

DirecTV Group, Inc. provides digital television entertainment in the US and Latin America. The company acquires, promotes, sells and distributes digital entertainment programming via satellite to residential and commercial subscribers. DirecTV has been able to add subscribers and pay down debt through this recession. The important strategies at both AT&T and Verizon have shifted to video and we believe DirecTV could be a target of a takeover by either AT&T or Verizon in the next couple of years. John Malone controls the company and he is simplifying the ownership structure by folding in the Liberty ownership. They have had an aggressive stock buyback program which is currently on hold until the integration with Liberty is complete. Ultimately, John Malone believes there may be a bidding war for the company and he has indicated he is ultimately a seller at the right price.

Genzyme is a global biotech company that develops therapeutics and treatments for various genetic disorders and other chronic disease conditions. The company's flagship product, Ceredase, was launched in the US in 1991 and was followed in 1994 by the next-generation Cerezyme, which helped to solidify the company's position in enzyme replacement therapy. Genzyme has been under pressure because of issues surrounding manufacturing contamination and capacity constraints. We believe it is at an important inflection point in improving operating margins given the scale in profitability recently achieved in several of its businesses. The stock is currently at a free cash flow yield of close to 7% and it has been able to maintain double digit growth rates for both revenues and earnings. We expect a significant M&A wave in healthcare as soon as there is clarity from Washington on the Healthcare Reform Bill.

Qualcomm is a dominant company in semiconductor chipsets for wireless handsets and infrastructure vendors and they license their intellectual property to handset vendors. The company has a near monopoly of third generation (3G) wireless technology patents and receives royalties on all 3G devices

sold. With the migration from 2G to 3G, Qualcomm is uniquely positioned to benefit. The company has no debt, is generating about \$1 billion per quarter in free cash flow and has nearly \$10 billion, or \$6/share, of cash on its balance sheet. The company has a long-term growth rate of over 15% and close to a 20% return on invested capital. We believe the market is currently underestimating the growth at the company from network migration and continued movement in mobility.

Safeway Inc. operates a retail food and drug chain in the US and Canada. The company also has a network of distribution, manufacturing and food processing facilities. Safeway recently reported earnings that were better than consensus expectations and they maintained their guidance for the full year. The company's price reduction program is 80% complete and they expect price cuts to slow materially in 2010. Safeway expects to generate over \$3 per share in free cash flow, representing a yield of nearly 14%. The company has continued to buy in shares and they have reduced their shares outstanding 5.5% over the past 12 months.

YUM! Brands, Inc., owns and franchises quick-service restaurants worldwide. They have the dominant franchise in China with Kentucky Fried Chicken (KFC). The company has indicated that the opportunity for KFC and Pizza Hut brands in China is at least as big as the US market. YUM! recently announced a 10.5% dividend increase and a \$300 million share repurchase authorization. This brings the current dividend yield to 2.5% for the company. Shares outstanding shrank 8% in 2008 and almost 6% in 2007. The company believes it can grow at a minimum of 10% per year for the foreseeable future.

In general, we expect that as we add names to the fund, or as names come out of the fund once they've reached fair value or another opportunity emerges that offers a better risk-adjusted return alternative, the overall market capitalization average of the fund will likely move higher. All of the names we purchased are small positions and, depending on price movements, we may build them up quickly or move into other opportunities that offer better risk-adjusted return potential. (Commentary continued on next page)

**Top 10 holdings (%) as of September 30, 2009**

AES Corporation	9.8
Aetna Inc	4.0
eBay Inc	4.0
Aflac Inc	3.8
Hewlett-Packard Co	3.5
Cisco Systems Inc	3.5
State Street Corporation	3.4
CA Inc	3.4
UnitedHealth Group Inc	3.4
Sears Holding Corporation	3.3

**Top five sectors (%) as of September 30, 2009**

Information Technology	27.8
Financials	27.1
Consumer Discretionary	14.2
Health Care	11.2
Utilities	10.0

Percentages are based on total portfolio as of quarter-end, are subject to change at any time, and do not include trade date activity. For informational purposes only and not to be considered a recommendation to purchase or sell any security.

**What should I know before investing?**

Equity securities are subject to price fluctuation and possible loss of principal. The manager's investment style may become out of favor and/or the manager's selection process may prove incorrect, which may have a negative impact on the Fund's performance. The Fund may focus its investments in certain regions or industries, increasing its vulnerability to market volatility.

Additional risks may include those risks associated with investing in fixed-income and high-yield securities. Please see the prospectus for more information.

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Prior to October 5, 2009, the Fund was known as Legg Mason Value Trust. The Fund's investment objective, portfolio managers and investment strategy have not changed. Please see the prospectus for details.

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