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Intuitive Tools for Disciplined Investing

THINK BIG

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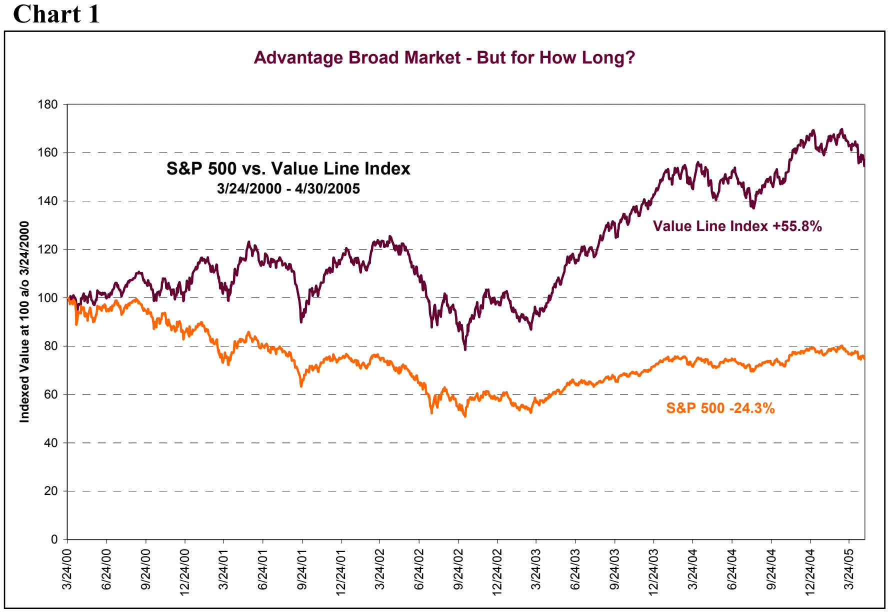
June 2005

- The adage that it's all about stock picking has not been more true than in the last three years. Of the largest 1,000 stocks, seven in 10 outperformed the S&P 500 with an average gain of five times that of the index.
- The broad market performance has been led from the bottom in terms of market capitalization and by stocks with lower quality fundamentals. The laggards have been the larger stocks with higher quality fundamentals. We anticipate a reversal of these performance trends.
- The two drivers of market breadth — cyclical market recovery and correction of the large stock valuation imbalance — have contributed to the extraordinary number of advancing stocks in the last three years. However, we believe these catalysts of broad market performance have matured.
- High-quality large stocks have become out-of-favor with investors frustrated with poor relative performance. However, we believe the relative valuation of large stocks has improved to a level that makes them a superior risk/reward choice for investors.
- As the number of advancing stocks narrows, stock picking will become more challenging as will outperforming the S&P 500.

Chart 1

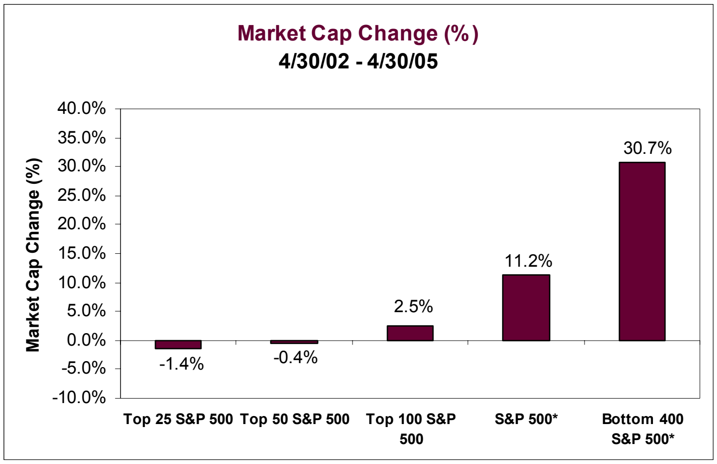


Source: Bloomberg, Legg Mason

All relevant disclosures and certifications appear on pages 7 and 8 of this report.

The adage that it's all about stock picking has not been more true than in the last three years. Of the largest 1,000 stocks, seven in 10 outperformed the S&P 500 with an average gain of five times that of the index.[1] This extraordinary period of market breadth has contributed mightily to the positive relative performance of active portfolio managers. According to Morningstar, 15 of the 20 domestic stock fund categories outperformed the S&P benchmark for the three years ending in April 2005. The broad market performance has been led from the bottom in terms of market capitalization and by stocks with lower quality fundamentals. The laggards have been the larger stocks with higher quality fundamentals. We anticipate a reversal of these performance trends.

Chart 2



Source: FactSet Research Systems Inc., Legg Mason
* Only 495 of current S&P 500 constituents were in existence on 4/30/02

The largest 50 stocks in the S&P 500 represent over half the market value and performance of the index. This group of stocks represents industry leaders and companies with global business franchises. Their underperformance in the last three years stands in stark contrast to the performance of the overall market. Among the largest 50, the ratio of stocks outperforming the index was just four in 10 and their aggregate market capitalization change was a negative 0.4% versus a gain of 30.7% for the S&P 500 excluding its largest 100 stocks.

Our anticipation of a narrowing in market breadth and better relative performance of large stocks is threefold: (1) the maturity of the market's recovery from a deep and long bear market has removed the overly depressed condition for many stocks, particularly those that are small- and mid-sized, (2) the valuation excess of large stocks has been fully corrected, and (3) larger stocks with global businesses, quality fundamentals, and attractive relative valuations typically offer investors a more favorable risk/reward investment opportunity than the broader market. As the number of advancing stocks narrows, stock picking will become more challenging as will outperforming the S&P 500.

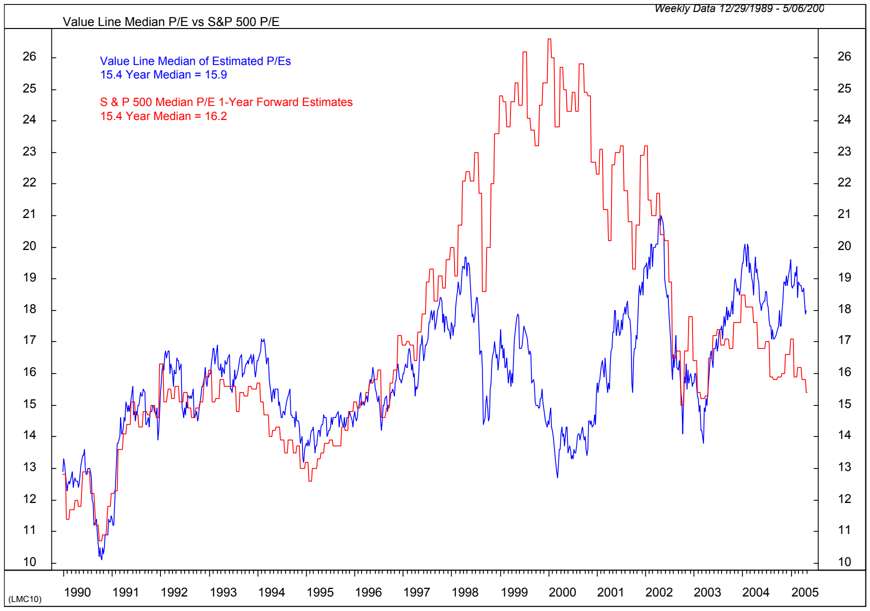
Cyclical Breadth Has Peaked

The cyclical improvement in breadth (the number of stocks advancing versus declining) peaked in April 2004, approximately one year after the market began a sustained recovery. Over this period, the year-over-year performance of the Value Line index outdistanced the S&P 500 by 32 percentage points.[2] The heady relative performance was a consequence of a long and deep bear market that depressed many stocks. As investors became confident in the market's direction, the vast majority of stocks responded with sharp gains. But now more than two years into a sustained market advance that has been underpinned by increasing earnings, the P/E multiple of the broad market is just a few points shy of its all-time high (Value Line Index). To the extent market breadth was coiled for performance from a cyclical bear market, these forces have been alleviated.

The second catalyst propelling positive market breadth is a legacy from the prior bull market. The ratio of advancing stocks peaked in the spring of 1998, when investors shifted their attention to a relatively narrow band of large stocks to almost a full exclusion of anything else (**Chart 3**). At its peak in March 2000, the S&P 500 was trading at over 26x expected earnings versus a P/E of 13x for the Value Line index. The ensuing bear market corrected the unprecedented disparity and excessive valuation of large stocks. From its peak in March 2000 through last April, the P/E ratio of the S&P 500 has *contracted* by more than one-third while the Value Line earnings multiple *expanded* by a similar amount. Over this time horizon, the S&P 500 has declined by 24.3% while the Value Line index has increased by 55.8% (**Chart 1**).

1 *Trailing-three-year performance of 1,000 largest market capitalization stocks as of April 30, 2005.*
2 *The Value Line Index is an equal weighting of approximately 1,800 stocks and is used as a proxy for the broad market in our discussions.*

Chart 3



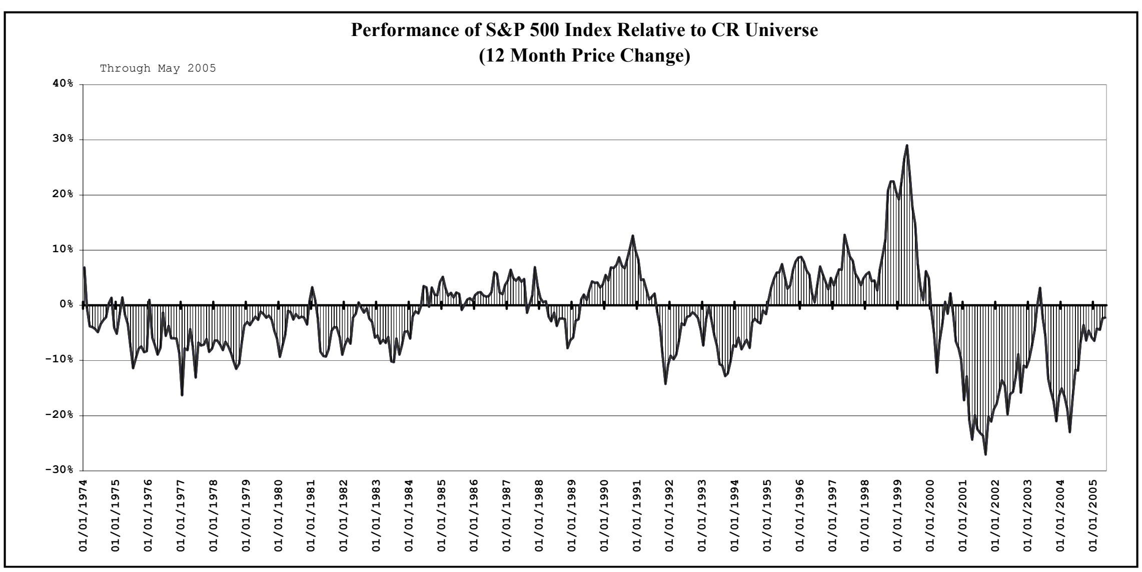
Source: Ned Davis Research Inc.

Evidence of Maturity

The two drivers of market breadth – cyclical market recovery and correction of valuation imbalances – have contributed to the extraordinary number of advancing stocks in the last three years. However, these forces are losing momentum from their inevitable maturity. Through April, the year-over-year performance of the Value Line index is slightly negative to the S&P 500 and the valuations of larger stocks are now at a discount to the broad market.

Chart 4 shows the year-over-year performance of an equally weighted stock universe similar to Value Line. Oscillations below 0% indicate the broad market is outperforming the S&P 500 on a year-over-year basis and the opposite when the oscillations are above 0%. As the chart indicates, there appears to be an alternating pattern between large and broad market performance with the last 10 years experiencing sharp extremes in one direction or another. The last five years have been as dramatically favorable for broad market performance as they were for the S&P 500 in the previous five years. However, the relative performance of the broad market is succumbing to a cyclical maturity that slows the momentum of market breadth. An important corollary to this chart is the insight to the performance of active managers. The S&P 500 outperforms most active managers when market breadth is narrowing (i.e., oscillations above 0%) and generally has underperformed when breadth is broadly positive.

Chart 4



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The valuation premium that was accorded to large stocks also has been completely eliminated. **Chart 5** shows current valuation measures using forward-12-month consensus forecasts of sales, earnings, cash flow, and book value of the S&P 500 and a broad universe of stocks. With the exception of P/BV, the broad market universe is showing a higher relative valuation to the S&P 500. The previous premium accorded to the very largest stocks in the S&P 500 has now become an appreciable discount. The powerful catalyst correcting historically disparate relative valuations has leveled the distinction between the large stocks of the S&P 500 and the broad market.

Chart 5

Valuation Profile[1]

	Price/Sales	Price/ Cash Flow	Price/ Earnings	Price/ Book Value
S&P Top 25	2.5x	11.9x	15.2x	4.0x
S&P Top 50	2.8	12.9	17.1	3.9
S&P Top 100	2.5	12.9	17.5	4.0
S&P 500	2.1	12.1	16.3	3.4
Broad Market Composite[2]	2.9	15.9	18.3	3.3

Source: Legg Mason

1 Based on forward-12-month consensus forecasts

2 Legg Mason Equity Compass

Big is Better

Large capitalization stocks are big for a reason. The underlying businesses usually include important industry leaders and they possess financial and management resources to enhance their competitive position. Large established companies are also more likely to provide tangible rewards to shareholders. Tangible rewards by our definition are the value creation (VC) in the business from the growth of revenues and changes in operating cash flow compared to shareholder benefits (SB) from dividends, stock buybacks, and a sound balance sheet. We measure these variables monthly over a three-year period and make sector comparisons to produce a percentile ranking from 0%–100%, which is further divided by quartiles to produce our Shareholder Value Index (SVI) from A to D. **Chart 6** shows the quality percentile rankings for stocks in the S&P 500. The bias to quality is directly proportional to market-cap size.

Chart 6

Quality Profile[1]

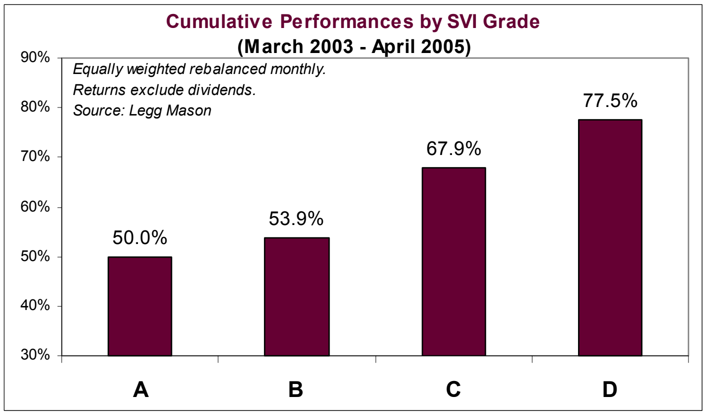
	% of S&P Market Cap	Value Creation Rank	Shareholder Benefit Rank	Shareholder Value Index
S&P Top 25	36%	58.5%	75.3%	81.3%
S&P Top 50	50%	53.7%	68.7%	74.5%
S&P Top 100	71%	52.9%	65.6%	71.0%
S&P 500	100%	49.7%	59.4%	60.0%
S&P 500 ex Top 100	34%	48.9%	57.9%	57.2%

Source: Legg Mason

1 Equal-weighted average

Quality is a tautology to stocks creating long-term value for shareholders. However, the cyclical and valuation issues favoring broad performance have been a more powerful force in the market recovery (**Chart 7**). While the higher risk of lower quality has provided greater rewards, we do not believe lower quality is a sustaining advantage for investors. Eventually, higher quality becomes a discriminating variable as superior fundamentals assert themselves in the form of a higher valuation premium, in our view. Opportunistically, the time for orienting to higher quality is when its perception as a discriminating variable is suspect and the relative valuation of stocks with better fundamentals is subdued. We believe both conditions are currently evident.

Chart 7



Source: Legg Mason

Chart 8 shows the average valuation measures of approximately 1,300 stocks ranked by our Shareholder Value Index (SVI). The stocks with superior fundamentals (SVI–A) are trading for roughly the same valuation as stocks with lower quality. From an expectations standpoint, investors are applying no premium for higher quality, or alternatively, no discount to stocks with more volatile fundamentals. We view this valuation neutrality the same as quality spreads in fixed income markets. Narrow yield spreads among bonds reflect optimism that credit risk is low. But as a seasoned fixed income investor is aware, narrow spreads become increasingly vulnerable to a negative change as the market becomes more balanced in its view of risk and reward. We see the same dynamics restoring differentiated valuations for quality in the equity market.

Chart 8

Valuation Profile of Quality Rankings[1]

	Price/Sales*	Price/ Cash Flow*	Price/ Earnings*	Price/ Book Value*
SVI - A	2.3x	12.4x	17.2x	3.5x
SVI - B	2.1	13.0	17.6	3.0
SVI - C	2.0	12.4	17.9	2.7
SVI - D	1.8	11.5	18.4	2.7
Average	2.0	12.3	17.8	3.0

Source: Legg Mason

1 Average of SVI category (equally-weighted)

**Based on forward-12-month consensus forecasts*

Investment Timing: Increase Exposure to Large Stocks

It is important for investors to recognize the importance of timing in investment decision making. An investor buying an S&P 500 index fund in March 2000 because it had outperformed most active managers is no doubt as dissatisfied as the investor who at the same time bought an out-of-favor small-cap value fund is quite pleased. Successful investing, in our view, is leaning against what has become popular and dispassionately evaluating the merits of what is out-of-favor. Investment timing is evaluating the best risk/reward over a time horizon that extends beyond the immediate future. With this in mind, we believe large stocks offer investors the best risk/reward opportunities and would overweight this segment in a portfolio.

One of Wall Street's oldest sayings is not to confuse luck and genius. That stock picking has been so favorable, or that the vast majority of active portfolio managers have outperformed the S&P 500 for the last three years, should not minimize the difficulty of outperforming the index in the long term. The **Appendix** shows the largest 25 stocks in the S&P 500 and would be the names that we believe should take increasing prominence in portfolios.

S&P 500 Largest 25 Market-Cap Stocks

		% Weight of S&P 500 Cumulative	Price 5/31/05	52-Wk High	52-Wk Low	Dvd Yield	EPS*	P/E* (x)	5 Yr EPS % Change	5 Year P/E % Change	June SVI Grade	P/CF	P/S	PEG
GE	General Electric Co	3.6%	$36.48	$37.75	$30.56	2.4%	1.64	22.2	44.7%	-52.8%	B	16.7	2.2	2.1
XOM	Exxon Mobil Corp	3.3%	56.20	64.37	43.06	2.1%	4.31	13.1	215.8%	-54.4%	A	9.5	1.2	1.3
MSFT	Microsoft Corp	2.6%	25.80	30.20	23.82	1.2%	1.04	20.5	16.9%	-45.0%	B	15.1	6.4	1.7
C	Citigroup Inc	2.3%	47.11	49.99	42.10	3.7%	3.29	11.4	33.3%	-36.3%	B	10.9	2.7	1.0
PFE	Pfizer Inc	1.9%	27.90	36.30	21.99	2.7%	1.25	13.0	115.5%	-74.1%	B	11.2	4.0	1.6
WMT	Wal-Mart Stores Inc	1.8%	47.23	57.89	46.20	1.3%	2.49	19.2	91.5%	-55.7%	A	10.7	0.6	1.2
JNJ	Johnson & Johnson	1.8%	67.10	69.99	54.37	2.0%	3.01	20.7	98.0%	-28.5%	A	16.9	3.8	1.7
BAC	Bank of America Corp	1.7%	46.32	47.47	41.08	3.9%	3.99	11.5	65.7%	2.2%	A	7.7	3.2	1.3
INTC	Intel Corp	1.5%	26.96	29.01	19.64	1.2%	1.26	22.1	4.6%	-56.6%	A	12.6	4.2	1.1
AIG	American Int'l Group Inc	1.3%	55.55	74.98	49.91	0.9%	4.26	15.2	90.0%	-55.4%	A	4.0	1.3	0.8
MO	Altria Group Inc	1.3%	67.14	68.50	44.50	4.3%	4.78	13.5	43.1%	74.1%	A	11.1	2.0	1.4
PG	Procter & Gamble Co	1.3%	55.15	57.40	50.53	2.0%	2.76	21.2	119.0%	-5.2%	A	15.3	2.3	2.0
JPM	JPMorgan Chase & Co	1.2%	35.75	40.45	33.35	3.8%	1.24	12.3	-72.3%	-5.8%	B	12.4	2.2	1.0
CSCO	Cisco Systems Inc	1.2%	19.40	24.20	17.01	0.0%	0.84	22.2	127.0%	-81.9%	A	16.9	4.5	1.0
IBM	Int'l Business Machines	1.1%	75.55	99.10	71.85	1.1%	4.96	15.1	15.3%	-47.0%	A	11.4	1.2	1.5
CVX	Chevron Corp	1.0%	53.78	63.15	44.77	3.3%	6.25	9.5	193.9%	-51.3%	A	6.7	0.6	0.6
KO	Coca-Cola Co/The	1.0%	44.63	52.75	38.30	2.5%	1.96	21.6	197.0%	-46.7%	A	18.1	4.5	2.9
WFC	Wells Fargo & Co	0.9%	60.41	64.04	56.12	3.2%	4.20	14.3	79.5%	-25.2%	A	12.6	3.0	1.3
DELL	Dell Inc	0.9%	39.93	42.57	32.71	0.0%	1.31	28.9	92.6%	-51.7%	A	25.5	1.6	1.3
VZ	Verizon Communications	0.9%	35.38	42.27	33.71	4.6%	2.82	13.8	-0.4%	-29.7%	B	4.8	1.3	13.4
PEP	PepsiCo Inc	0.9%	56.26	57.20	47.37	1.8%	2.52	23.7	72.6%	-25.9%	A	16.3	2.9	2.1
HD	Home Depot Inc	0.8%	39.35	44.30	32.39	1.0%	2.36	16.6	118.5%	-64.1%	A	10.7	1.0	1.2
UPS	United Parcel Service Inc	0.8%	73.65	89.11	66.65	1.8%	3.07	24.4	298.7%	-12.0%	A	13.8	2.0	2.0
TWX	Time Warner Inc	0.8%	17.40	19.90	15.41	0.0%	0.75	21.2	61.3%	-47.5%	D	11.7	1.8	1.9
WB	Wachovia Corp	0.7%	50.75	56.28	43.05	3.6%	3.93	12.7	12.9%	21.5%	A	8.4	3.0	1.3
	Average	1.5%	46.45	52.77	40.02	2.2%	2.81	17.6	85.4%	-34.2%	A	12.4	2.5	1.9

**Based on trailing-12-month earnings*

Source: FactSet Research Systems Inc., Bloomberg, Legg Mason

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