LMCM
Point of View

May 2012 Market Commentary
“April is the cruelest month...”

-The Waste Land, by T.S. Eliot

Market Review

It’s doubtful that T.S. Eliot had financials and information technology in mind when he wrote the famous opening line to his poem *The Waste Land* in 1922, but given those sectors’ performance this April, he could have. In fact, April’s broad market action disappointed investors by breaking a four-month streak of positive returns as the S&P 500 Index posted a -0.63% total return. Nonetheless, the index is up a robust 11.88% so far this year and an impressive 28.76% from the October low. Growth stocks outperformed value for the fourth month in row with the Russell 1000 Growth Index down only 0.16% for the month versus a drop of 1.02% for its value counterpart.

Stocks stumbled coming out of the gate with the S&P down over almost 4% cumulatively during April’s first six trading sessions. On April 3, the market construed freshly released Federal Open Market Committee meeting minutes as indicating a diminished Fed appetite for further easing measures, an interpretation reinforced by Atlanta Fed President Dennis Lockhart’s comments that he would need to see “pretty severe circumstances” to endorse additional Fed action. Then on April 6, a disappointing March employment report (since revised higher) ignited a growth scare, sending stocks on their way to the month’s lows.

Jane Trust, CFA
Portfolio Manager,
Executive Director

However, US equities managed to recoup the bulk of their losses over the balance of the month. A statement from New York Fed President William Dudley asserting that the US central bank would keep borrowing terms low through 2014 and noting that it was “still too soon to conclude that we are out of the woods,” helped turn the market higher. Additional support emerged when European Central

Bank President Mario Draghi called for a binding growth pact for the eurozone, in addition to the already proposed fiscal discipline pact – in our view a solid move towards a sensible policy to reduce the risks of a European implosion. In general, investors looked past some disappointing US economic data to focus on strong earnings reports from US companies. Through May 1, 69% of the 343 S&P 500 companies reporting first-quarter earnings beat consensus EPS estimates with earnings increasing 8.5% year over year.

Exhibit 1. Broad US Market Total Returns[1]

Index Name	April	QTD	YTD
S&P 500 Index	-0.63%	-0.63%	11.88%
Dow Industrials	0.16%	0.16%	9.01%
Nasdaq Composite Index	-1.40%	-1.40%	17.31%
S&P 100 Index	-0.66%	-0.66%	12.13%
Russell 1000 Index	-0.58%	-0.58%	12.25%
S&P Mid-Cap 400 Index	-0.22%	-0.22%	13.24%
Russell 2000 Index	-1.54%	-1.54%	10.70%
Dow Jones Wilshire 5000 Index	-0.67%	-0.67%	12.33%
Russell 1000 Growth Index	-0.16%	-0.16%	14.51%
Russell 1000 Value Index	-1.02%	-1.02%	9.99%

Information technology and financials were the worst performers in April, returning -1.87% and -2.37%, respectively, although they remain the best performing sectors year-to-date with each up over 19%. However, April's pain was fairly widespread as only four of the ten S&P sectors posted positive returns for the month. The energy sector dropped for the second month in a row, which makes the sector one of the weakest performers year to date, reflecting skepticism about the sustainability of current oil prices and energy asset values.

Exhibit 2. S&P 500 Sector Returns[2]

Index Name	April	QTD	YTD
S&P 500 Consumer Discretionary	1.32%	1.32%	17.49%
S&P 500 Consumer Staples	0.30%	0.30%	5.86%
S&P 500 Energy	-0.97%	-0.97%	2.87%
S&P 500 Financials	-2.37%	-2.37%	19.16%
S&P 500 Health Care	-0.22%	-0.22%	8.83%
S&P 500 Industrials	-1.08%	-1.08%	10.11%
S&P 500 Information Technology	-1.87%	-1.87%	19.19%
S&P 500 Materials	-0.90%	-0.90%	10.19%
S&P 500 Telecomm Services	5.39%	5.39%	7.58%
S&P 500 Utilities	1.82%	1.82%	0.17%

[1]Source: Wilshire, Russell®, NASDAQ® (via Bloomberg), S&P (via Bloomberg)
[2]Bloomberg

With the exception of the Chinese markets, investors had little to cheer about outside of the US, whether measured in US dollars or local currencies. The French and German markets were particularly hard hit, falling 5.84% and 2.67%, respectively, during the month, no doubt manifesting continued investor concern about a European recession or worse.

Exhibit 3. Broad Foreign Market Total Returns *(US Dollars)*[3]

Index Name	April	QTD	YTD
FTSE 100 Index (UK)	1.35%	1.35%	9.50%
DAX Index (Germany)	-3.42%	-3.42%	17.01%
CAC 40 Index (France)	-6.56%	-6.56%	4.37%
MICEX Index (Russia)	-2.35%	-2.35%	15.87%
NIKKEI 225 (Japan)	-3.03%	-3.03%	8.68%
Hang Seng Index (Hong Kong)	2.78%	2.78%	15.04%
Kospi Index (South Korea)	-1.42%	-1.42%	11.06%
Shanghai SE Composite (China)	5.95%	5.95%	9.03%
BSE Sensex 30 Index (India)	-3.78%	-3.78%	13.22%

Exhibit 3A. Broad Foreign Market Total Returns *(Local Currency)*[3]

Index Name	April	QTD	YTD
FTSE 100 Index (UK)	-0.17%	-0.17%	4.61%
DAX Index (Germany)	-2.67%	-2.67%	14.63%
CAC 40 Index (France)	-5.84%	-5.84%	2.25%
MICEX Index (Russia)	-2.37%	-2.37%	5.71%
NIKKEI 225 (Japan)	-5.58%	-5.58%	13.57%
Hang Seng Index (Hong Kong)	2.70%	2.70%	14.91%
Kospi Index (South Korea)	-1.59%	-1.59%	8.56%
Shanghai SE Composite (China)	5.93%	5.93%	8.99%
BSE Sensex 30 Index (India)	-0.49%	-0.49%	12.32%

Comment

US companies hold a record level of cash, with the liquid assets of non-financial companies climbing to over $2 trillion (Exhibit 4). Despite this improvement in corporate liquidity and balance sheets, valuations remain modest and current prices reflect very low expectations for future growth opportunities. Exhibit 5 shows the present value of growth opportunities (PVGO) for the S&P 500 Index as a percentage of market capitalization. The theory behind the graph is that a company's total value is comprised of two parts: the value of the existing business and the present value of the

[3] *Source: Bloomberg*

business' future growth opportunities. PVGO as a percentage of market capitalization for the S&P 500 Index has averaged about 35% since 1961, meaning that roughly two-thirds of the index's value is accounted for by the value of existing businesses and about one-third by investor's expectations for the future. Currently, according to our research, the present value of the future earnings of the S&P 500 accounts for less than 10% of the index market value, a level more than two standard deviations below the 35% average over the last forty years. In essence, the market does not believe management will create future value with their record cash balances.

Exhibit 4. US Corporate Liquid Assets[4]

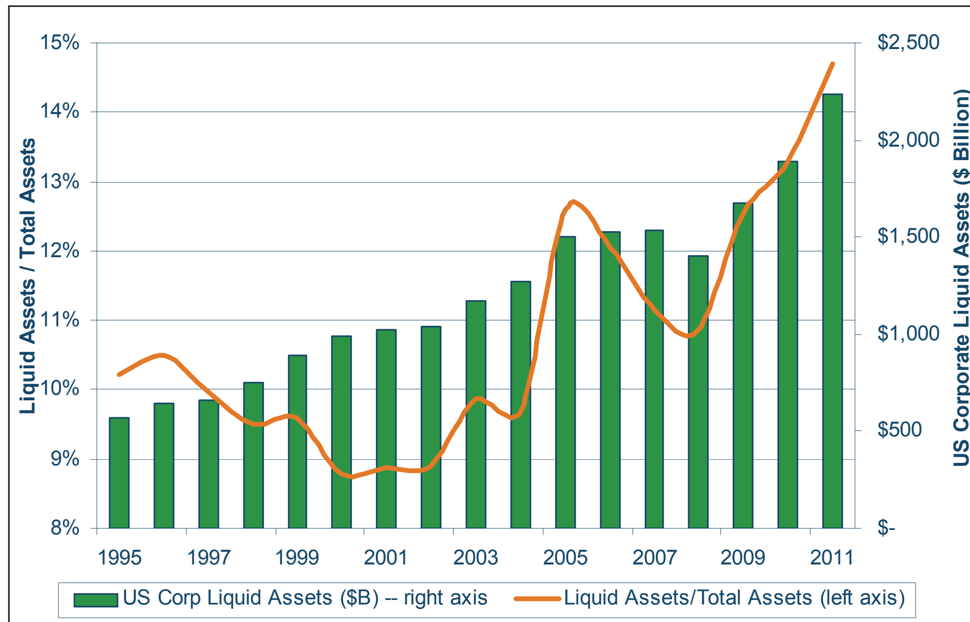
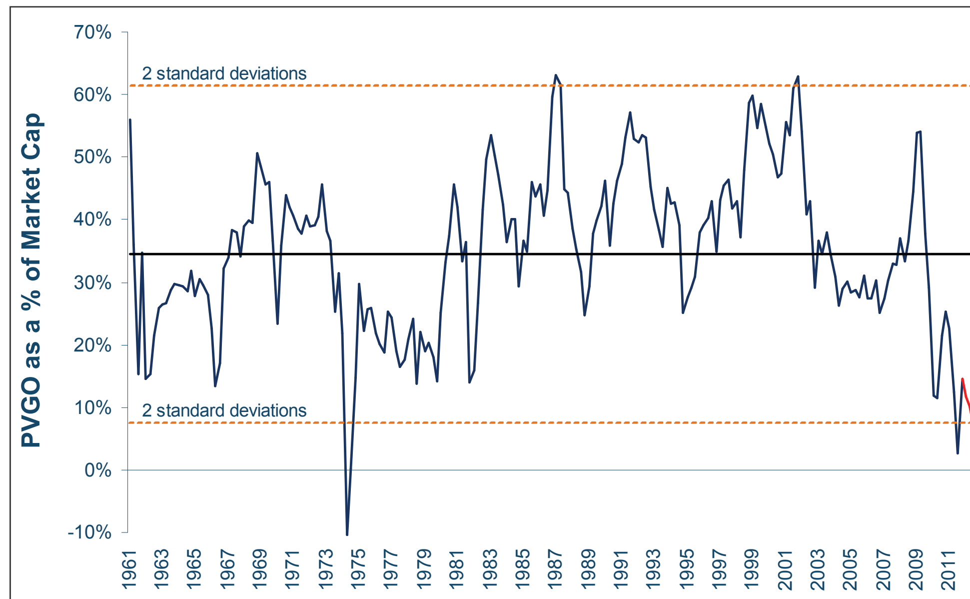


Exhibit 5. Percent of Market Value Attributable to the PV of Future Earnings[5]



[4]Source: Federal Reserve. Data does not include financial institutions.
[5]Standard & Poor's, Aswath Damodaran, LMCM estimates.

If companies lack reinvestment opportunities generating returns above their cost of capital, they destroy value. The solution is simple – return the cash to shareholders. One way to accomplish this is through higher dividend payouts, yet companies seem reluctant. The average dividend payout ratio has settled around 30%, below even the paltry levels of the 2000s and well below the 86-year average of 58% as calculated by Ned Davis Research (Exhibit 6). Ample liquidity and robust cash flows provide US companies with the ability to increase their dividends at attractive rates for a long time, in our view. According to Empirical Research Partners, stocks offering the highest dividend yields are valued at parity with those showing the greatest dividend growth, a rarity over the last forty years. Empirical's research also notes that non-dividend paying stocks are as cheap as they've been in two decades. We believe the current valuation differential between high-yielding dividend payers and low-but-growing or non-dividend payers gives company managements plenty of incentive to boost their dividends as a way to lever their stock prices higher.

An alternative to returning cash to shareholders is to create growth, thereby forcing investors to revise their expectations. While creating successful mergers and acquisitions presents a greater challenge, there are potentially greater rewards. Merger and acquisition activity has been very low on both an absolute basis and historically relative to the market level (Exhibit 7). We believe deal activity will continue to heat up as confidence is slowly returning, and debt financing is available and very cheap versus equity. Deals, in combination with intelligent capital deployment, should help move the market higher and the equity risk premium lower as the cycle plays out.

Exhibit 6. Dividend Payout Ratio on the S&P 500 Index[6]

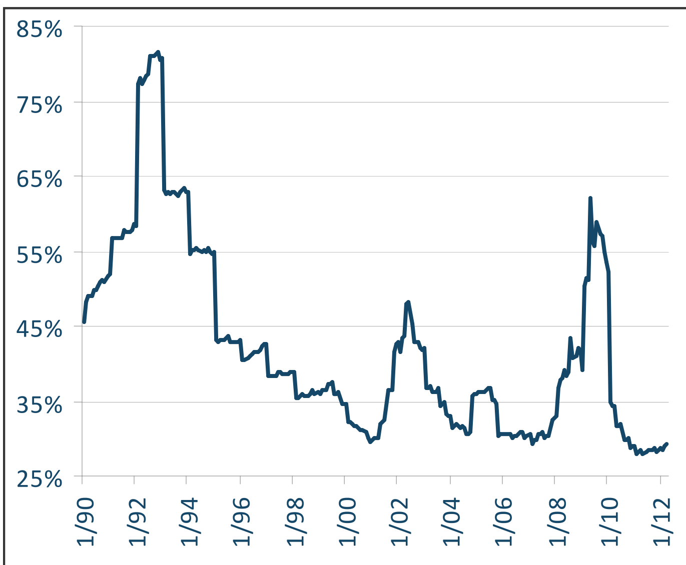
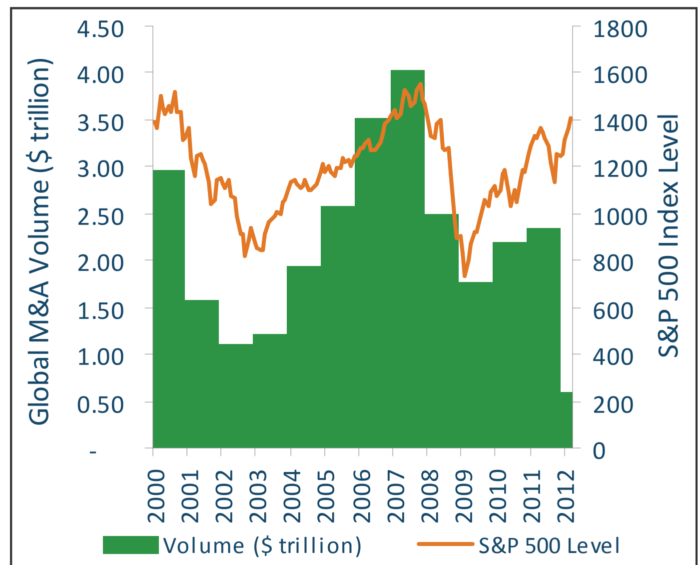


Exhibit 7. Global M&A Volume and S&P 500 Index[7]



[6] *Source: Factset*
[7] *Source: Bloomberg*

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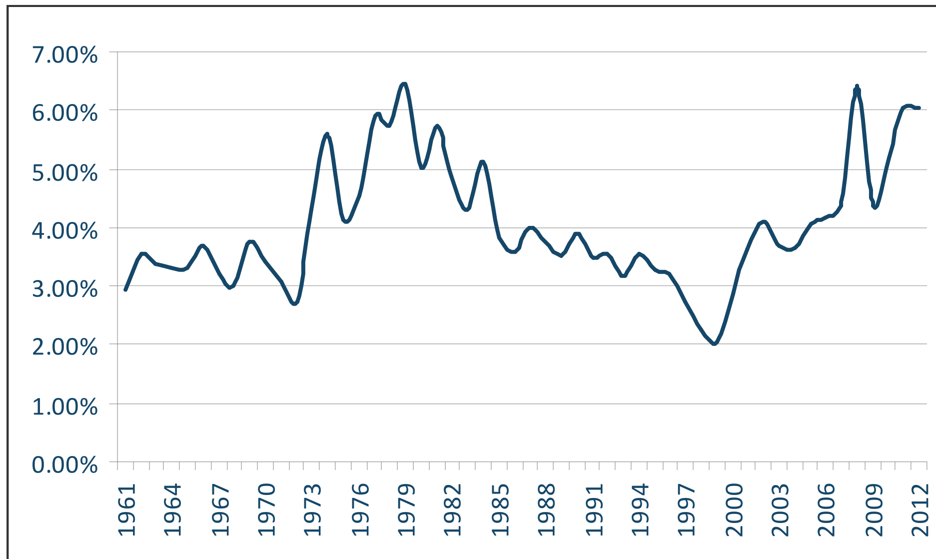
Outlook

Current valuations reflect investor skepticism about future earnings and the key, of course, is good capital allocation on the part of company managements. While down from peak levels, the US equity risk premium, as estimated by Stern School of Business Professor Aswath Damodaran, hovers over 6% and near credit crisis levels (Exhibit 8). Despite the recent rally, the S&P 500 still trades at only 13x forward earnings, at the low end of the post-1993 range. In our view, improved capital allocation will reduce the equity risk premium by decreasing reinvestment risk and reducing the extreme skepticism about the future – whether embodied in future earnings or the future uses of current earnings – that has investors embedding expectations that are simply too low. While April came as a cruel disappointment to investors, in our view, the pervasive skepticism about the future is providing US equity investors with starting valuations that provide ample opportunity to achieve attractive returns over the coming three to five years.

Exhibit 8. Implied Equity Risk Premium[8]

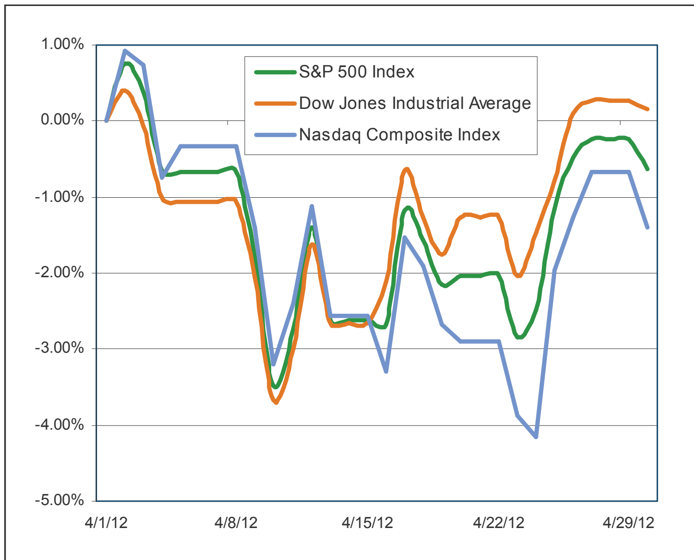


As always, we thank you for your support and welcome your comments.

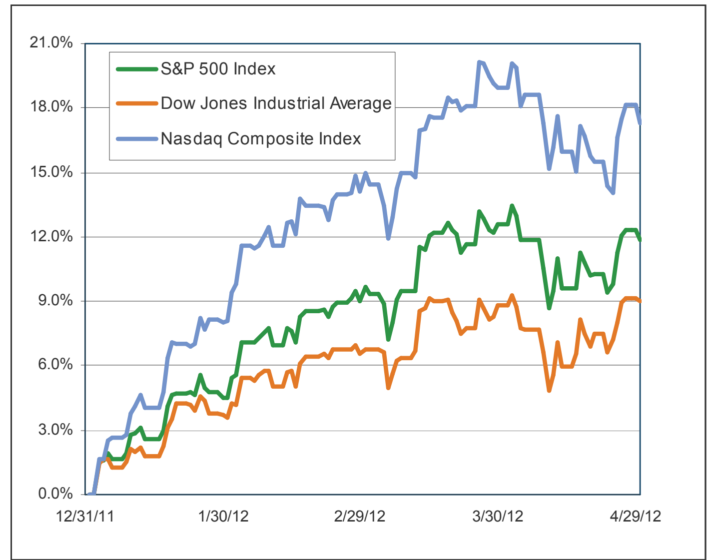
Jane Trust, CFA
Portfolio Manager, Executive Director
Legg Mason Capital Management
May 9, 2012

[8] *Source: Aswath Damodaran*

Major Indices: April Performance[9]



Major Indices: YTD Performance[9]



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[9] *Source: Dow Jones, NASDAQ® (via Bloomberg), S&P (via Bloomberg)*
[10] *Source: Bloomberg*

About the Author

Jane Trust joined Legg Mason in 1987 and is currently Executive Director overseeing client service. Jane also serves as an institutional portfolio manager for the Value Equity separate accounts. She earned a B.A. in Engineering from Dartmouth College and an M.A.S. in Finance from The Johns Hopkins University. Jane received the CFA designation in 1991 and is a member of the CFA Institute and the Washington, D.C. Association of Money Managers.

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