LMCM
Point of View

August 2012 Market Commentary

"I have not failed. I've just found 10,000 ways that won't work."

-Thomas Edison

Jane Trust, CFA
Portfolio Manager, Executive Director

Market Review

In July, equity markets bounced around on the vicissitudes of the European crisis. Bankers and politicians remained stubbornly noncommittal about finding a credible solution for the slow-rolling disaster now in its third year. Late in the month, markets were buoyed by a show of resolve from Mario Draghi, president of the European Central Bank, who pledged during a July 27 speech that "the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough." Luckily, investors overlooked his baffling analogy during the same address that the "euro is like a bumblebee… because it shouldn't fly but instead it does." As entomologists could point out, unlike the euro, bumblebees have been flying reliably for millions of years.

A few days later, however, following what has become the script for this crisis, Mr. Draghi disappointed investors. Rather than reinforcing his assurance of bold action, he seemed to put the burden on politicians by saying that the ECB would only buy bonds after a country asked for aid – which none have yet done. Fortunately, subsequent comments from German Chancellor Angela Merkel and other politicians indicated that the political aversion to the purchase of troubled euro states' government bonds may be softening. While history would argue against optimism on this front, at the moment, it appears that eurozone bankers may be inching towards an effective quantitative easing program, similar to that undertaken by the US Federal Reserve. Hopefully, unlike Thomas Edison, it won't take 10,000 attempts to settle on a workable solution.

Despite the somewhat trendless trading, the S&P 500 Index managed to post a 1.4% total return for July, bringing its year-to-date gain to a very respectable 11.0%. Consistent with the trend over the last year, large-cap equities beat small and growth stocks beat value. Although the actions and inaction of European leaders continued to flummox investors, major European markets did quite well during the month, especially in local currency terms, with Germany besting the group as the DAX Index rose 5.6% for the month and 14.8% for the year. In contrast and perhaps reflecting concerns about incipient slowing in China, the Shanghai SE Composite fell -5.1% in July.

[1]http://quotations.about.com/od/stillmorefamouspeople/a/ThomasEdison3.htm.

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Exhibit 1. Broad US Market Total Returns[2]

Broad US Market Indices		
Index Name	**July**	**YTD**
S&P 500 Index	1.39%	11.01%
Dow Industrials	1.15%	8.06%
Nasdaq Composite Index	0.20%	13.54%
S&P 100 Index	2.07%	12.84%
Russell 1000 Index	1.19%	10.70%
S&P Mid-Cap 400 Index	-0.04%	7.85%
Russell 2000 Index	-1.38%	7.03%
Dow Jones US Total Stock Market Composite	0.88%	10.44%
Russell 1000 Growth Index	1.34%	11.55%
Russell 1000 Value Index	1.03%	9.80%

Exhibit 2A. Broad Foreign Market Total Returns (US Dollars)[3]

Broad Foreign Market Indices (Returns in US Dollars)		
Index Name	**July**	**YTD**
FTSE 100 Index (UK)	1.15%	4.89%
DAX Index (Germany)	2.67%	9.02%
CAC 40 Index (France)	0.25%	2.43%
MICEX Index (Russia)	2.25%	3.00%
NIKKEI 225 (Japan)	-1.40%	2.41%
Hang Seng Index (Hong Kong)	1.88%	10.42%
Kospi Index (South Korea)	2.63%	5.51%
Shanghai SE Composite (China)	-5.19%	-3.21%
BSE Sensex 30 Index (India)	-1.19%	7.78%

[2] *Source: Bloomberg*
[3] *Source: Bloomberg*

Exhibit 2B. Broad Foreign Market Total Returns (Local Currency)[4]

Broad Foreign Market Indices (Returns in Local Currency)		
Index Name	**July**	**YTD**
FTSE 100 Index (UK)	1.23%	3.82%
DAX Index (Germany)	5.55%	14.82%
CAC 40 Index (France)	3.06%	7.87%
MICEX Index (Russia)	1.42%	3.19%
NIKKEI 225 (Japan)	-3.46%	3.94%
Hang Seng Index (Hong Kong)	1.84%	10.25%
Kospi Index (South Korea)	1.51%	3.09%
Shanghai SE Composite (China)	-5.08%	-2.24%
BSE Sensex 30 Index (India)	-0.87%	13.06%

There was little shift in sector leadership in July except for the energy sector, which reversed its recent weakness and posted a 4.2% gain on the back of an almost 7% increase in the price of Brent crude oil. The second quarter's best performers – telecommunication services, utilities and consumer staples – repeated their strong showings in July, with telecom again leading the pack, up 6.6%.

Exhibit 3. S&P 500 Sector Returns[5]

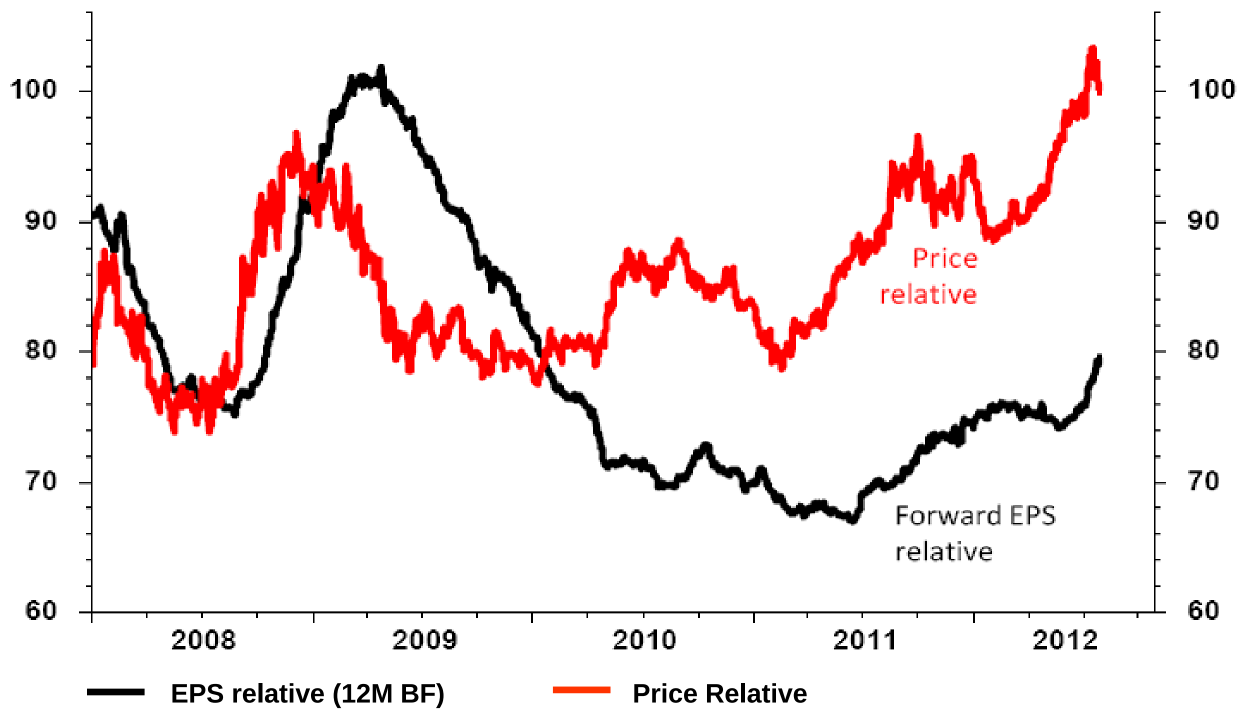
S&P 500 Sector Indices		
Sector	**July**	**YTD**
S&P 500 Consumer Discretionary	-0.30%	12.61%
S&P 500 Consumer Staples	2.81%	11.63%
S&P 500 Energy	4.17%	1.72%
S&P 500 Financials	0.17%	13.91%
S&P 500 Health Care	1.06%	12.14%
S&P 500 Industrials	0.42%	7.80%
S&P 500 Information Technology	0.99%	14.47%
S&P 500 Materials	-1.20%	5.25%
S&P 500 Telecomm Services	6.55%	24.13%
S&P 500 Utilities	2.54%	7.49%

[4] *Source: Bloomberg*
[5] *Source: Bloomberg*

Economic Comment

The divergence of performance among certain market groups reflects two key investor preoccupations –concern about non-US growth and the search for current income. With regards to the US, investors are confronting the twin specters of the drag from the US fiscal cliff (where US tax increases and budget cuts kick in at the end of the year unless Congress takes action) combined with a US GDP growth scare for the third year in a row (US GDP posted subpar 1.5% growth in the second quarter down from the first quarter's 2.0%). Despite this, investors appear to be even more spooked by slowing growth in Europe and China. According to the International Strategy & Investment Group (ISI), the S&P 500 in aggregate now generates 30% of its revenue from outside the US, up from 20% a decade ago. Fully two-thirds of this international revenue comes from Europe, which remains in recession and whose recovery remains dependent on what to date has been a feckless policy response. As shown in the chart below, the expected forward earnings per share of companies with the most US revenue has moved sharply higher relative to those companies with the most international revenue. Not surprisingly, the relative price of shares of US-centric companies has moved sharply higher as well.

Exhibit 4. S&P 500 Top 100 Most Domestic Revenue Exposed Companies Relative to 100 Most International[6]



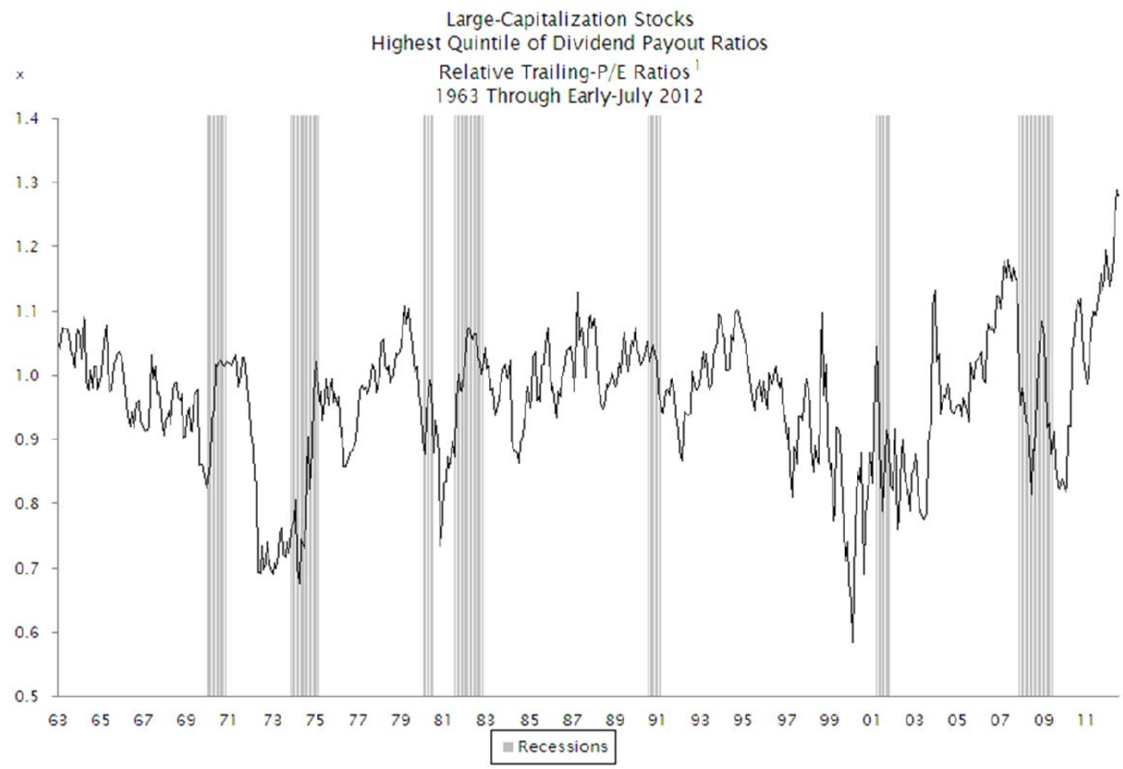
Investors also remain focused on current income and we believe that this appetite has created a bubble in the valuations of many types of income-oriented securities. Federal Reserve easing has driven risk-free rates across the curve to anemic levels. On July 25, the yield on the 10-year US Treasury note dipped to an all-time low of 1.4% and money market funds yield close to zero, spurring investors to hunt for income. Demographics have amplified the move as a bulge of US baby boomers now speeds towards retirement. Their inclinations have translated into inflows of $775 billion for fixed-income funds since mid-2008 while equity funds (including both active and passive strategies) have lost $277 billion, according to Bernstein Research data.

This $1 trillion swing towards income-generating securities is also reflected in the relative valuations of high-yielding stocks within the equity market. According to Empirical Research Partners, companies with the highest payout ratios are trading at a record price-to-earnings (P/E) premium to the market and are valued at lower free cash flow yields than those with no payout at all. This relationship is particularly confounding when the S&P's

[6] Source: International Strategy & Investment Group, LLC, "Breakfast with Bijal," July 31, 2012.

payout ratio is just 28%, the lowest in 140 years, also according to Empirical. Based on our research, utilities and telecom stocks, which serve as bond proxies for yield-starved investors, are trading at historic valuation premiums to other sectors. We believe that, similar to most classes of bonds, they are overpriced. Other cheaper sectors, primarily technology and healthcare, should grow their respective cash flows and dividends at a much higher rate than the bond proxies, and are underpriced relative to their total return potential. Essentially, high current dividend stocks are generally very expensive, while dividend growth potential is historically cheap.

Exhibit 5. High Payout Stocks are Expensive[7]



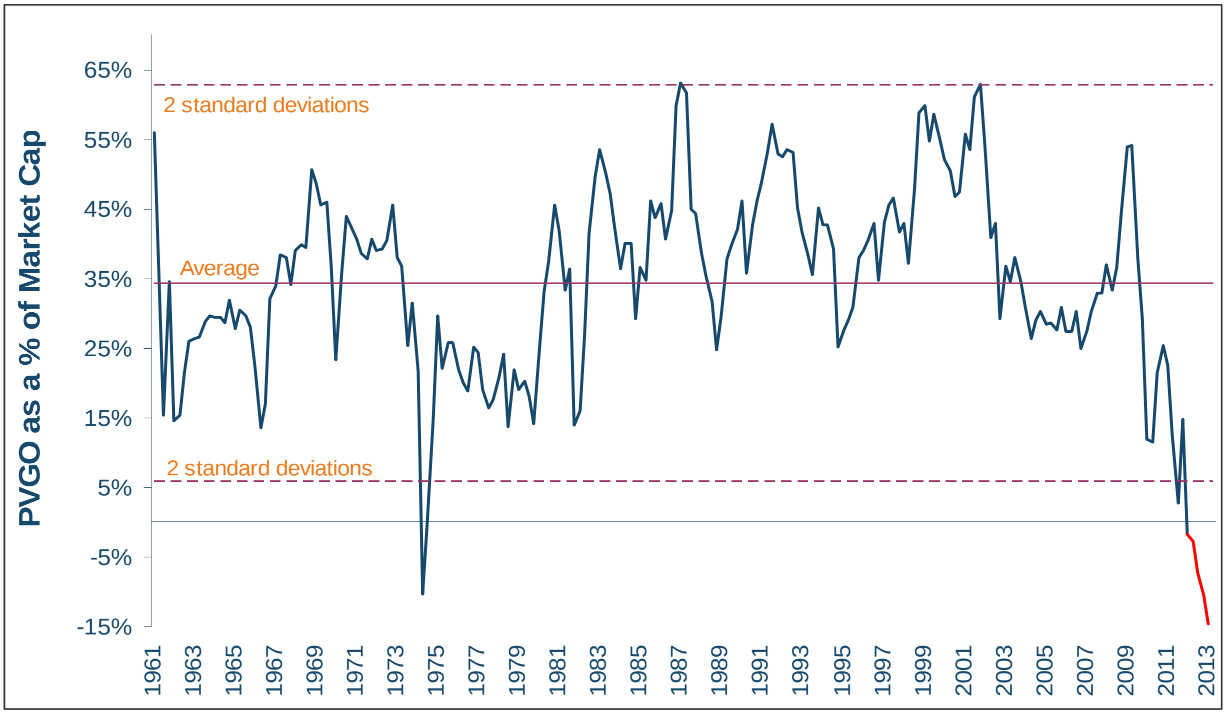
Source: Corporate Reports, National Bureau of Economic Research, Empirical Research Partners Analysis.
[1]Capitalization-weighted data.

Outlook

As we've discussed previously, based on our analysis, US equity prices appear to be discounting very little future growth in company earnings. Exhibit 6 below shows the present value of growth opportunities (PVGO) for the S&P 500 Index as a percentage of its 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 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 the existing businesses and about one-third by investors' 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 5% of the index market value, a level more than two standard deviations below the 35% average over the last forty years.

[7]*Source: Empirical Research Partners, Stock Selection: Research and Results, July 19, 2012. Corporate Reports, National Bureau of Economic Research. The chart shows the relative trailing-P/E ratio of the top quintile of dividend payout ratios versus the market trailing-P/E ratio.*

Exhibit 6. Percent of Market Value Attributable to the PV of Future Earnings[8]



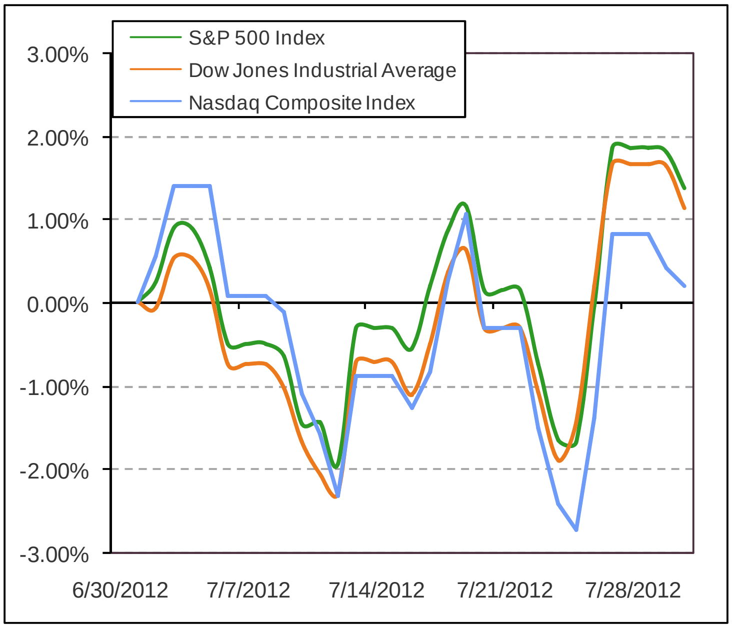
We recognize the array of macroeconomic challenges confronting the markets. The fears of continued policy errors and a banking crisis in Europe are legitimate. We see evidence of a slowdown in China in the weaker orders for some US companies. However, just as we recognize these risks, the market recognizes them as well, and we believe that all but the most cataclysmic outcomes are likely discounted in prices. What the market seems to be missing are the ongoing material improvements in the US. The housing cycle appears to be bottoming, which would help both US financials and the economy broadly through housing's powerful multiplier effect. Domestic shale oil and gas production is forging a comparative energy cost advantage that is helping fuel a US manufacturing renaissance. Innovation in technology and healthcare provides the US with huge competitive advantages and sources of future growth. With the S&P 500 trading at less than 13x forward earnings, the market seems to be ignoring these US tailwinds. The current level of skepticism about future earnings seems unwarranted to us and in our view is providing investors with an ample opportunity to achieve attractive returns in US equities over the coming three to five years.

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

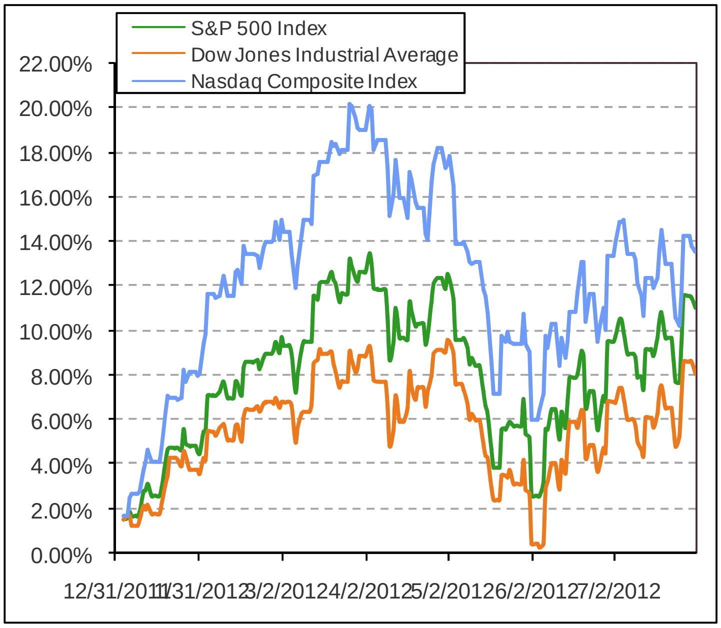
Jane Trust, CFA
Portfolio Manager, Executive Director
Legg Mason Capital Management
August 4, 2012

[8]*Source: Standard&Poor's, Aswath Damodaran, LMCM estimates.*

Major Indices: July Performance[9]



Major Indices: YTD Performance[9]



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[9] *Source: Bloomberg*

About the Author

Jane Trust joined Legg Mason in 1987 and is currently an Executive Director with LMCM overseeing client service. Jane also serves as an institutional portfolio manager for the Value Equity separate accounts. She earned a B.A. in Engineering Sciences 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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