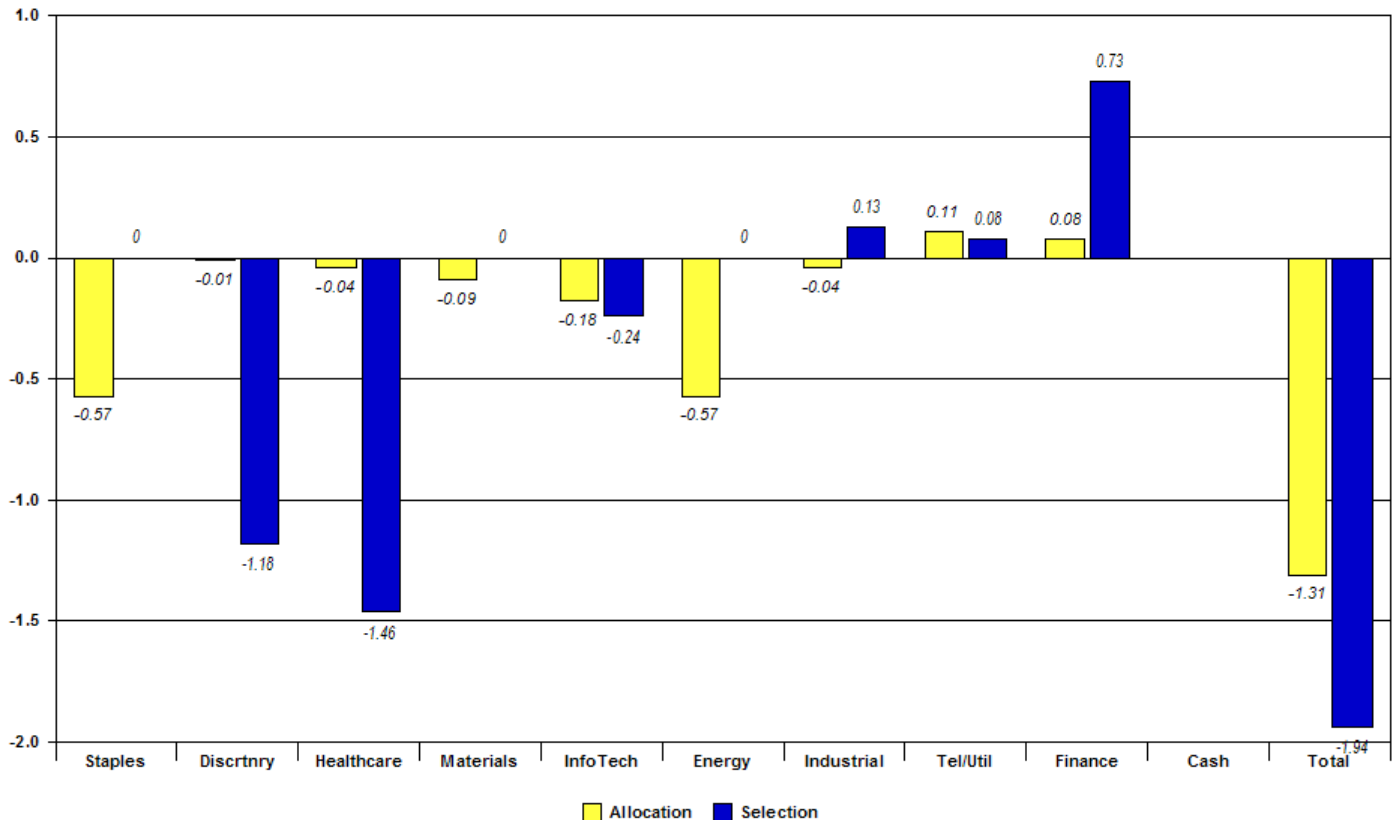




Looking Under the Hood 08.18.06

Stock Selection and Sector Allocation for Legg Mason Value Quarter Ending 6/30/06



Every car has its share of problems. When one occurs, a mechanic can't accurately diagnose it on the sound of the engine alone; eventually, they need to lift the hood and take a look inside. The same analogy applies to the analysis of investment managers and mutual funds. Even the most skillful managers can under-perform over the short-term. Because they have access to portfolio holdings, they know (or should know) what the causes are. The practical problem for advisors and investors is that they don't have access to this data, don't know how to process it, or don't know how to interpret it. In our view, the most insightful method to assess the causes of investment performance is in-depth, holdings-based attribution analysis.*

Let's take a look at a well known mutual fund that has lagged as of late – the Legg Mason Value Trust (LMVTX). Portfolio Manager Bill Miller received some press when he said in a shareholder letter, “we had a dreadful second calendar quarter.” Indeed, they did. The fund lost 5.67% vs. a decline of -1.44% for the S&P 500. The shareholder letter goes much further, discussing the short-fall in detail.

While the discussion by the fund manager is helpful to the investor typical, due diligence procedures require *independent* verification. Moreover, some fund managers aren't as forthcoming and willing to disclose such details. So, are Miller's sources of underperformance the entire story? An analysis of fund holdings and attribution of returns is necessary for that to be known. The points below are the four stated reasons for fund underperformance, as quoted by Bill Miller, followed by CMC's own findings.

1) Miller: The first has to do with our allocation to internet names which include Amazon, eBay, Yahoo, Expedia, Interactive and Google”

CMC's findings: mixed - This one has an extra level of complexity given that Compustat classifies Amazon, Interactive, and Expedia as Discretionary stocks. The remainder are Technology stocks. In both sectors, picking good stocks was hard. Taken



CAPITAL MARKET CONSULTANTS, LLC

217 North Broadway
Milwaukee, WI 53202

414.727.7990 *telephone*
414.727.7991 *fax*
www.cmarkc.com

together, the six stocks detracted 85 bps. Interestingly, Google and Amazon gained during the quarter and contributed modestly to performance. Mr. Miller also weaves in some bad third quarter news - Yahoo and Amazon sold off significantly in July, so their impact will be felt during the current quarter.

2) Miller: “The second source of poor performance was due to our exposure to the managed care industry”

CMC’s findings: true – Managed care stocks hurt a lot, detracting 175 bps from performance. With this burden, stock selection in the broader Healthcare sector detracted 146 bps from performance.

3) Miller: “The third area where we have not fared well has been in homebuilding...”

CMC’s findings: true – Homebuilding stocks are part of the Discretionary sector and sold off significantly. The five stocks in this industry detracted 144 bps from performance.

* CMC performs quarterly holdings based performance attribution and style analysis on investment managers, including separate accounts and mutual funds. The software used in this analysis is Stoktrib, created by Ron Surz (www.PPCA-inc.com) which in conjunction with PODs (portfolio opportunity distributions) provides the insight needed for thorough performance evaluation.