LEGG MASON
GLOBAL ASSET MANAGEMENT

Legg Mason
Diversified Trust

Objective

The Trust aims to earn a before fees and taxes return (over rolling three year periods) in excess of a benchmark constructed in accordance with the neutral asset allocation of the Trust.

Benchmark

The performance of the Trust is measured against a benchmark comprising the following sectors:

Sector	Index
35% Australian equities	S&P/ASX 200 Accumulation Index
10% Property securities	S&P/ASX 200 A-REIT Accumulation Index
23% Global equities	MSCI All Country (ex-Australia) World Index, net dividends reinvested, expressed in AUD
12% Australian bonds	UBS Australian Composite Bond Index
12% Global bonds	Barclays Capital Global Aggregate Index, hedged into AUD
5% Cash	UBS Australian Bank Bill Index
3% Alternative investments	UBS Australian Bank Bill Index

Value

$46,031,950.

Performance (after fees, before taxes)

	Trust %	Benchmark %
3 months	2.94	1.97
1 year	3.75	2.68
3 years p.a.	-4.43	-3.65
5 years p.a.	0.74	1.77

Past performance is no indication of future performance.

Market Review

Equity markets gained ground over the December quarter as investors were generally positive on the economic outlook heading into 2011. This reflected positive momentum in macro data, particularly further quantitative easing in the U.S. Concerns around European sovereign debt contagion and increased interest rates in China tempered the gains of a number of equity markets.

The Australian equity sector gained 4.4% over the quarter, as measured by the S&P/ASX 200 Accumulation Index. The gain over the year to 31 December 2010 was 1.6%. Materials companies as well as a selection of small capitalised stocks outperformed during the quarter, in line with higher commodity prices and increased investor tolerance for risk. On the other side of the ledger, investors reduced their exposure to the more defensive Property, Consumer Staples and Telecommunication Services sectors.

Merger and acquisition activity was a feature of the Australian equity market during the quarter. The Singapore Exchange made a bid for the ASX (+15.7%) and Japanese insurer Dai-ichi Life announced it had entered into a scheme implementation deed to acquire the 71% of Tower Australia (+65.4%) that it did not already own. Meanwhile, James Packer acquired a substantial shareholding in the Ten Network (+2.2%).

In global equities, developed markets returned 2.9% over the quarter. Despite a year of significant volatility, global equities delivered solid returns in the December quarter, bolstered by continued optimism about economic recovery across the world. Emerging markets returned 1.4% during the quarter for a gain of 4.3% for the year. 2010 was characterised by an inverse relationship between market size and performance, as smaller emerging markets outperformed while Brazil and China lagged.

In the Australian bond market, the yield on Australian 10-year government bonds rose 0.55% over the quarter to 5.51%. The domestic bond curve became flatter over the quarter as yields generally shifted upwards. This followed a sell-off in U.S. treasuries, which was caused by supportive U.S. economic data.

Australian economic releases this quarter saw credit growth, retail sales and house prices all trend lower. However, employment growth remained robust. In October the Reserve Bank of Australia increased the target cash rate by 0.25% to 4.75%, which was quickly followed by a further 0.15% to 0.20% increase to mortgage rates by the major banks.

Meanwhile, the Australian dollar appreciated US4.96 cents against the U.S. dollar to finish the quarter at US$1.02. The Australian dollar gained US11.94 cents over the past year.

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Performance

The Legg Mason Diversified Trust outperformed its benchmark by 1.0% over the quarter .Performance this quarter was aided by choices in Australian equities, property securities, developed market and emerging market global equities and Australian bonds. Asset allocation decisions between Australian equities and bonds also added value. Choices in global bonds detracted some value.

In Australian equities, the portfolio's overweight exposure to Tower Australia and ASX added value as both were the focus of corporate activity. Tower surged as the life insurer was the focus of the aforementioned corporate activity by Dai-ichi Life. We have been overweight Tower for some time as we forecast that the company would be able to produce double digit top line growth and increased returns on equity over the medium term. Meanwhile, ASX gained ground on a bid for the company by the Singapore Exchange.

In A-REITs, the portfolio's overweight exposure to Charter Hall Office, Lend Lease and Charter Hall Retail REIT. In the cases of Charter Hall Office and Charter Hall Retail, the stocks outperformed following a move to increased stake in the entities from manager Charter Hall Group.

Exposure to developed market global equities added value as underlying stock choices generated positive performance over the quarter. Despite solid returns for stocks, given relatively high valuations and expectations for earnings, we would anticipate modest returns in the equity markets in early 2011.

In emerging market equities, the outperformance was largely driven by favourable stock selection decisions, with choices across all three emerging market regions adding value. In particular, portfolio holdings in Korea and South Africa contributed positively to performance.

In Australian bonds, the portfolio outperformed as both stock selection and sector allocation decisions added value. In particular, holdings of local subordinated issuance from NAB, the Bank of Queensland and Suncorp also contributed to portfolio performance. Portfolio duration positioning was a further source of added value.

At the asset allocation level, the portfolio was overweight Australian equities and underweight bonds. This position added value over the quarter as domestic equities outperformed domestic bonds. The portfolio remained overweight Australian equities and underweight bonds at quarter end to benefit from an expected return to more normal relative equity and bond market valuations.

Outlook

We remain favourably disposed to Australian equities and property securities at this time as improved corporate earnings, strong balance sheets and favourable underlying economic fundamentals should allow the Australian equity market to move higher on a medium term view.

Abundant cash levels in corporate Australia should lead to higher dividends, merger and acquisition activity, capital expenditure and strong employment levels. This further underpins the case for Australian equities at this time.

In respect of stock specific investment opportunities, we continue to observe a valuation spread between the most attractive and least attractive stocks in the investment universe that is well above historical averages. This signals to us that opportunities for stock selection are abundant and that active management should be handsomely rewarded.

In developed markets global equities, we remain concerned about forward earnings estimates, which appear to us to be very aggressive based on our bottom up assessments and the dubious sustainability of higher earnings assumptions. We are also concerned about excess capacity in many industries as well as operating rates that are relatively low. Our view is that despite current media hype, the underlying global economy is still fragile and lacks the dynamism that would signal sustained growth in 2011.

Emerging market valuations are reasonable given the supportive macro economic backdrop. However, we are cautious about potential margin pressures coming from rising commodity and other input prices.

In Australian bonds, Portfolio duration is expected to be tactically managed, since volatility is likely to remain high while markets debate the speed of the global recovery, the possible return of inflation, sovereign risk issues and regulatory changes to the financial markets.

The portfolio maintains an overweight position in corporate bonds, with an emphasis on Financials, as market valuations and increased regulation continue to appeal. We are also selectively buying primary corporate deals in industries that will benefit from an economy that is returning to trend growth, as well as in industries that have de-leveraged, namely property trusts and infrastructure.

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