LEGG MASON
GLOBAL ASSET MANAGEMENT

Legg Mason
Emerging Market Trust

Objective

To earn a before fees and taxes return of 3% p.a. in excess of its benchmark over a complete market cycle of three to five years.

Benchmark

MSCI Emerging Markets Index, expressed in Australian dollars.

Value

$199,451,329.

Performance (before fees and taxes)

	Trust %	Benchmark %
3 months	2.78	1.39
1 year	3.29	4.30
3 years p.a.	-5.83	-5.34
5 years p.a.	5.75	5.48

Past performance is no indication of future performance.

Profile

Regional Allocations	Trust %	Benchmark %
Europe / Middle East / Africa	18.7	18.6
Asia	57.3	57.9
Latin America	21.6	23.5
Cash	2.4	-

Sector Allocations	Trust %	Benchmark %
Energy	14.4	14.1
Materials	15.8	14.9
Industrials	4.2	7.4
Consumer Discretionary	5.8	7.0
Consumer Staples	4.5	6.7
Health Care	0.9	1.0
Financials	27.1	25.2
Information Technology	15.2	12.8
Telecommunications	8.9	7.5
Utilities	0.8	3.4
Cash	2.4	-

Market Review

Emerging markets equities advanced 1.4% during the December quarter, leaving the sector up 4.3% for the year. 2010 was characterised by an inverse relationship between market size and performance within the emerging market sector. Smaller markets posted by far the largest returns while the two heavyweights, Brazil and China, lagged.

Europe/Middle East/Africa

Russia reacted to continued deterioration in its inflation numbers as the central bank raised its deposit rate by 0.25%. After a few months of depreciation linked to strong capital outflows for debt repayments, the basket exchange rate appreciated in December and the central bank reduced its foreign exchange interventions.

Supported by signs of a stronger global economic recovery, rising commodity prices and a significant interest rate differential, the South African rand appreciated against the U.S. dollar. November inflation bounced back on higher transportation costs and food prices. The current account deficit settled at 3% of gross domestic product in the September quarter, a result supported by a reduced trade deficit.

Asia

In India, inflation declined on the back of lower food prices; however, non-food prices remained high. The Reserve Bank of India implemented measures to ease the liquidity shortage as it cut its Statutory Liquidity Ratio and injected liquidity through open-market-operations. After several disappointing results, October industrial production was ahead of expectations on a rebound in volatile capital goods production and continued strength in consumer durables.

In Korea, industrial production rose in November after falling for two consecutive months. Industrial output regained momentum in December but it was not enough to make a positive contribution to the December quarter gross domestic product. Meanwhile, consumer prices decelerated in October following a well-flagged correction in agricultural prices. We expect the central bank to continue to gradually normalise monetary policy throughout 2011.

In China, manufacturing declined in the wake of increases in reserve requirements and interest rate rises over the past two months. Confirming the government's desire to reduce income inequality and promote consumption, Beijing increased its monthly minimum wage by 21%.

Inflation in Indonesia pierced Bank Indonesia's target range of 4 to 6%. However, Bank Indonesia pointed out that food prices were the main driver of inflation and that core inflation remained benign. As such, the central bank left the reference rate unchanged.

Taiwan's November trade report confirmed that the sequential trend in the export sector improved solidly after several recent months of contraction. This was a good omen for the rest of the region's export-oriented sector, as Taiwan tends to lead export activity in the region. Taiwan's inflation rate ticked up in November, which strengthened the case for the central bank to raise policy rates at a modest, steady pace.

LEGG MASON
GLOBAL ASSET MANAGEMENT

Latin America

In Brazil, the central bank's latest Inflation Report made it clear that interest rates are likely to rise as early as mid-January to address the deteriorating inflation outlook linked to the strong domestic demand. The expected rate rise will come after a December increase in reserve requirements. Meanwhile, the government granted only a 6% increase in the minimum wage in 2011. This is a zero increase in real terms and is well below the 6% real increases awarded annually during the Lula's presidency.

The Mexican economy continued its steady recovery, with October industrial production and retail sales both higher. The economy remained well-balanced, with no apparent pressures on the fiscal, inflation or external accounts sides.

Performance

The Legg Mason Emerging Market Trust outperformed its benchmark by 1.4% over the quarter.

The bulk of the outperformance came from favourable stock selection decisions. In particular, portfolio holdings in China, Brazil and Korea contributed positively to performance.

From a country allocation perspective, an overweight position in Russia was a positive contributor as Russia outperformed the broader market.

At the sector level, an overweight position in some of the more cyclical sectors, such as Information Technology and Energy, contributed positively to portfolio performance.

Outlook

We expect global growth of around 3.2% in 2011, with emerging markets and developed markets contributing equally to this growth. In developed markets, the growth drivers will be private consumption and investment, while government spending will contribute little. Geographically, developed markets growth is supportive in the U.S., Germany and the Commonwealth area but less so in Japan and the smaller, heavily indebted Euroland countries.

Within emerging markets, we expect growth to be close to trend, although we will see differentiation with respect to their positions in the economic cycle. We have highlighted in the past how China, Brazil and India were near or had closed their output gap during 2010. In these countries we saw action to tighten policies and we expect to see more in 2011, centred on fiscal policy in Brazil and slower lending in China.

In India, it seems that the optimal policy path would be to boost investment. Countries that will close their output gaps in 2011 include Indonesia, Korea and Turkey. Mexico, South Africa and Russia continue to have ample spare capacity.

At the end of 2009, the expected earnings growth for the next 12 months stood at 26%. By December 2010, the actual calendar 2010 earnings growth was closer to 30%. For the next 12 months, we see consensus expectations of 16% earnings growth as reasonable given the supportive macro economic backdrop. However, we remain cautious about potential margin pressures coming from rising commodity and other input prices. We will keep a keen focus on earnings delivery in coming quarters.

Emerging market valuations are not demanding at this stage as they are close to historical levels. We also expect to see more appetite for equities among global investors, given stocks attractive valuations relative to bonds and the favourable global growth backdrop. This phenomenon has already started; we saw significant inflows into U.S. equities in the December quarter and more recently some outflows from bond funds.

The improved U.S. economy could push the U.S. dollar higher, at least for a while, which has historically been associated with headwinds for emerging market assets. Also, potential talks of exit strategies by the U.S. Federal Reserve later in the year, in response to expected improvements to macro fundamentals and/or deteriorating inflation, might lead to renewed market volatility. Within emerging markets, we could see the imposition of outright capital controls as governments continue to try to prevent further currency appreciation, while central banks might need to step aggressively on the brakes to control “bubbles” and rein in inflation. As the political calendar in the U.S. heats up towards the end of the year, we could see the political rhetoric against China’s exchange rate regime, and by extension most of Asia, escalate. Finally, the European sovereign debt issue is yet to be resolved. Even though a cataclysmic outcome for the euro has probably been averted by the actions taken in 2010 during the market upheaval surrounding Greece and Ireland, volatility might ensue if a large market were to be forced to tap the emergency facilities put in place.

Any reference to “Legg Mason Australia” is a reference to Legg Mason Asset Management Australia Limited ABN 76 004 835 849 AFSL 240827. Neither Legg Mason Australia, nor any of its related parties, guarantee the repayment of capital or performance of any of the trusts referred to in this document. Past performance is no guarantee of future performance. Applications to invest in the Legg Mason Emerging Market Trust can be made using an application form comprising part of the current Product Disclosure Statement, which is available from our offices or on our website at www.leggmason.com.au. Certain eligibility criteria applies. Legg Mason Australia does not guarantee the accuracy or completeness of this document. To the extent permissible by law, Legg Mason Australia accepts no liability in contract, tort (including negligence) or otherwise for any loss or damage suffered as a result of reliance on this document. This document does not constitute investment advice, does not include recommendations on any particular security and has not been prepared to take into account the investment objectives, financial objectives or particular needs of any particular person. Before making an investment decision you should read the Product Disclosure Statement carefully and you need to consider, with or without the assistance of a financial advisor, whether such an investment is appropriate in light of your particular investment needs, objectives and financial circumstances. The opinions and outlook are subject to change without notice.