Horizons
Legg Mason Investment Outlook

February 2010

INSIDE

Australian equities and property securities

LEGG MASON Australian Equities

The uncertain business environment and falling revenues triggered by the global financial crisis has meant that a number of Australian companies have reduced their cost base, lowered their debt levels and de-levered their balance sheets.

As a result, Australian firms are poised to produce strong margin expansion once revenue growth returns. Indeed, we believe that earnings growth for selected firms over the medium term will be well above average; this should produce above normal equity returns.

Whereas macro trends dominated the investment environment over the past two years, first negatively and then positively, we anticipate that stock specific developments will be a critical market driver in the near term. Legg Mason Australia's equity portfolios are well positioned to benefit from stock specific investment opportunities as there remains a significant valuation spread between the most attractive and least attractive names in the investment universe.

While Australian real estate investment trusts (A-REITs) have underperformed the broader Australian equity market over the past year, we are cognisant of the fact that A-REITs have significantly reduced debt levels and refocused on traditional property rental streams. We believe that these significant structural improvements have favourably positioned A-REITs, particularly against their unlisted peers. As a result, the sector is poised to produce strong returns that are less correlated to the equity market.

We continue to observe a valuation spread that is around four times higher than normal between our fund and the market. The recent bid for Challenger Kenedix Japan highlights the latent value that exists in the portfolio. We expect to produce above normal portfolio returns and are optimistic about the portfolio's medium term return prospects.

Emerging market equities

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Emerging Markets

Over the medium term, we continue to expect that the strong fundamentals of emerging market equities will translate into healthy returns. In the short term however, we expect some volatility, making a point forecast return even more treacherous than usual.

The most important factor is likely to be the removal of the quantitative easing put in place by the various central banks in early 2009. This was an extraordinary response to extraordinary times and on balance we believe it was justified. However, as growth returns to more normal levels and output gaps close, its removal will become increasingly necessary. It is difficult to ascertain the impact of the end of quantitative easings on market sentiment and liquidity but just as their implementation marked the turnaround of markets at the lows, their end, in isolation, can be seen as market negative.

Of course, nothing works in isolation, and this brings us to our second driver, the global economic growth outlook. For most emerging markets the picture is bright, as strong growth will continue to be underpinned by healthy domestic demand expansion, even in the face of sluggish consumption growth in the developed world.

Corporate earnings growth should play another important role in supporting equity markets in general and emerging markets in particular. As we move into 2010, 2011 earnings forecasts will become essential to the formulation of the market's valuation assessment and it is possible that the current consensus expectations may need to be adjusted down during 2010.

Last but not least, even after a year of stellar returns, valuation levels for emerging markets remain supportive. In conclusion, we remain constructive towards the prospects for emerging markets equities over the medium term, but with the expectation that the outperformance of the asset class versus developed market global equities in the coming year may be less dramatic than the level witnessed over the past year.

Global equities

GLOBAL CURRENTS
INVESTMENT MANAGEMENT

We anticipate that the positive momentum of economic recovery will bode well for many stocks. However, we also expect headwinds and challenges that reaffirm the importance we place on building a margin of safety into our portfolio construction process. We believe we are likely to see range-bound markets over the foreseeable future. Finding stocks that outperform in such markets is a challenging endeavour and favours an active management approach.

We believe that by purchasing high-quality stocks we can generate a total return comprised of price appreciation, share repurchases, dividends and dividend growth over time. Looking ahead to 2010, we are satisfied that we have positioned the portfolio to take advantage of opportunities and we believe that investors who stay the course should benefit.

Recent earnings and cash flows generally have recently come in better than expected, with analysts significantly raising estimates recently. Margins are currently expected to be at relatively high levels in 2010, with expectations of record highs by 2011. We believe that one key going forward is the sustainability of earnings versus what currently appear to be unrealistic expectations.

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GLOBAL CURRENTS

Australian bonds

WESTERN ASSET

Gross domestic product growth in Australia is expected to improve to around trend in 2010 as government infrastructure spending gains traction and export demand improves.

Inflation is likely to remain below average through 2010 as wage pressures remain weak and the economy continues to operate below its productive capacity.

With Australia's labour market in reasonable shape, and broader economic growth returning, cash rates are expected to continue to move higher throughout 2010.

We expect volatility in bond yields to remain high while markets debate the speed of the global recovery and the possible return of inflation.

Legg Mason's Australian bond portfolio maintained an overweight position in corporate bonds, with an emphasis on Financials, as market valuations, continued government support and increased regulation provide significant appeal despite spreads tightening through 2009. Portfolios are also selectively buying primary corporate deals in industries that should benefit from an economy that is returning to growth and in those that have de-leveraged.

We also maintain an overweight position in government guaranteed bank issuance as a defensive strategy. These securities offer the assurance of the Commonwealth Government and have greater yield benefit relative to government bonds.

Global bonds

WESTERN ASSET

Economic activity continues to rebound. Most indicators suggest that manufacturing activity is set for above-average expansion over the next few quarters. Production will have to expand to restock inventory to more normal levels. While lending remains restricted, the banking system is steadily rebuilding its capital base and weaning itself from government support facilities. Rapid growth has been common following many past banking crises - the depth of losses are currently so large that a year or two of above average expansion would still leave the economy far from its efficient frontier. While possible, this is not our base case scenario.

The global economy has passed through its worst point and we would not be surprised by a few quarters of above average growth, particularly in the U.S. However, the inventory cycle is driving much of the rebound and we expect this to fade later in 2010. Fiscal stimulus should begin to fade around the same time, and growing concern over sovereign solvency should limit the political willingness to pass additional fiscal measures. As these positive influences wane, and in the absence of any obvious growth substitutes, we remain suspicious over the durability of any above-trend growth past 2010. We believe this is also a primary concern for central banks as well. Re-employing idle resources, especially labour, would be the best indicator of a more sustainable recovery.

Despite our caution over the strength of the economic rebound, an overweight to non-government markets seems the best strategy. We continue to hold a substantial overweight position to investment-grade corporate debt as well as high-yield corporate debt. Issue selection continues to focus on select Financials issues of large European and U.S. banks. We look to maintain a modest underweight to agency mortgage-backed issues.

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WESTERN ASSET

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