

# Legg Mason

## Australian Core Equity Trust

### Objective

The Trust aims to earn a before fees and taxes return of 3% p.a. in excess of its benchmark over rolling three year periods.

### Benchmark

S&P/ASX 200 Accumulation Index.

### Value

\$79,791,550

### Performance (Before fees and taxes)

	Trust %	Benchmark %
3 months	2.67	2.12
1 year p.a.	-9.23	-10.54
3 years p.a.	9.80	7.58
5 years p.a.	-2.44	-2.31

Past performance is no indication of future performance.

### Profile

Overweight Positions	Active %
ASX Ltd	+2.5
National Australia Bank	+2.5
Fairfax Media Limited Holdings	+2.5
Seek Limited	+2.5
Iluka Resources	+2.4
Henderson Group	+2.4
ANZ Banking Group	+2.3
Santos Limited	+2.2
News Corporation	+1.7
Commonwealth Bank Of Australia	+1.7

Underweight Positions	Active %
Westpac Banking	-2.2
Wesfarmers Ltd	-2.2
Woodside Petroleum	-1.9
CSL Ltd	-1.8
Westfield Group	-1.7

### Market Review

After a strong performance during the month of October, equity markets came once again under selling pressure, on the back of rising risk aversion. Despite further evidence of the resilience of the US economy, investors continued to be concerned about a potential meltdown of the Eurozone. Volatility reached high levels but global equity markets ended the quarter on a positive note.

For much of the period, the Australian share market was very volatile. With investors looking for safety, defensive stocks outperformed more cyclical stocks. The Australian equity market gained 2.1% over the quarter, as measured by the S&P/ASX 200 Accumulation Index.

In the Australian bond market, the yield on the Australian 10-year government bonds fell on rising risk aversion and finished at 3.7%, down from 4.2% at the start of the period.

Australian economic data released during the quarter continued to highlight softness in the economy. Retail sales remained weak and employment fell further. The Reserve Bank of Australia cut the target cash rate by 50 basis points to 4.25%, reflecting the slowing momentum in the domestic economy. The market has priced in a few potential rate cuts by June 2012.

The Australian dollar rallied against the U.S. dollar at the beginning of the quarter. Despite some volatility, it ended the December quarter at US1.022 cents, up 4.9US cents.

### Performance

The Legg Mason Australian Core Equity Trust outperformed its benchmark by 0.5% over the quarter. Performance over the past 12 months is 1.3% ahead of benchmark. Both stock selection and sector allocation added value over the quarter.

In terms of individual stocks, Iluka (+23.9%) continued to add significant value to the portfolio. The company benefitted from a further 10% increase in the price of Zircon in the December quarter and more interestingly an 80-85% price increase for Rutile (Titanium). Whilst a slowdown in China demand is a concern, there is no significant new capacity coming on stream in the next few years and we expect the market to remain tight.

Another positive contributor was the overweight position to James Hardie Industries (+18.6%) in Materials. James Hardie benefitted from the resilience of the US economy and potential for an improvement in US housing starts.

In Financials, shares of ANZ Banking group (+5.3%) and National Australia Bank (+4.5%) outperformed. During the quarter, both companies held their AGM. ANZ received a favourable court ruling from the Federal Court of Australia for four of the five fee types subject to the class action brought against the Bank by IMF (Australia).

In terms of negative contributions, the overweight position to Fairfax Media (-12.7%) was the main detractor. The company held its AGM during the quarter and provided a trading update. The soft retail market impacted the flow through to advertisement revenue and shares plunged. In Financials, shares of Henderson Group (-8.4%) underperformed. Henderson is performing well as a funds management business, benefiting from Gartmore acquisition synergies, generating good performance and reasonable flows versus the industry. However falling equity markets have a leveraged impact on the company and with the current risk off market sentiment Henderson has underperformed. We believe Henderson is well positioned to benefit from any market recovery and offers greater value than domestic fund managers.

The small overweight position to BlueScope Steel (-34.8%) also detracted from performance. BlueScope has been suffering from import price competition due to a high AUD and weak domestic sales of steel products. Whilst we believed the shuttering of steel export capacity would reduce the volatility of BlueScope earnings, the short term impact was to cause a build up of working capital and increase debt levels at a time of cyclically low earnings. The company believed it needed to pre-empt pressure from bankers with a capital raising.

## Outlook

Currently market concerns and uncertainty are high with European debt concerns, potential slowing in China and a 2 speed domestic economy. This has resulted in high volatility levels but also attractive valuations. The current PE of 10.7 represents 35% upside to the long term average PE of 14.5x or is equivalent to adding 3% pa to the expected long term return of equities.

Fortunately for Australian investors, the fundamentals of the domestic market are also strong. High Commodity prices and massive capital investments are boosting the Australian economy. There is a \$140bn pipeline of mining capital expenditure that has started but yet to be completed which will support employment and business across Australia. The price of Australia's exports versus imports (Terms of Trade) is at 140 year highs and should provide a boost to national income. The household sector is growing and strong. Unemployment is low at around 5%, the saving rate is now 10% and real income growth is positive. The growth of the population also appears solid given skilled immigration and supportive family policies. Official interest rates are high with plenty of scope to be cut which boosts the attractiveness of alternative yielding assets. The easing monetary policy by the RBA should help consumer sentiment going forward. Australia is also a low risk market with the ratio of Government Debt/GDP at 20% and the Government budgeting a small deficit. The banking system has remained strong with high deposit growth and access to global credit markets. Corporate balance sheets are strong.

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 averages seen through out the last 15 years. We currently see opportunities in more cyclical names whose earnings are well below normal and will benefit from a recovery in sentiment and risk aversion.

## Further Information

### Portfolio Characteristics

Number of securities at period end	47
<b>Sector Allocations</b>	
	<b>Active %</b>
Consumer Discretionary	+3.5
Consumer Staples	-0.4
Energy	-0.7
Financials	+1.0
Health Care	-3.2
Industrials	-1.9
Information Technology	-0.6
Materials	+2.4
Telecommunication Services	-1.1
Utilities	+0.4