

Legg Mason

Australian Value Equity Trust

Objective

The Trust aims to earn a before fees and taxes return of 3.5% p.a. in excess of its benchmark over rolling three year periods.

Benchmark

S&P/ASX 200 Accumulation Index.

Value

\$41,502,582

Performance (Before fees and taxes)

	Trust %	Benchmark %
3 months	1.02	2.12
1 year p.a.	-16.20	-10.54
2 years p.a.	-8.05	-4.68
3 years p.a.	8.83	7.58
5 years p.a.	-4.36	-2.31

Past performance is no indication of future performance.

Profile

Overweight Positions

Active %

ASX Ltd	+5.0
Seek Limited	+4.7
Henderson Group	+4.1
Iluka Resources	+3.8
ANZ Banking Group	+3.8
National Australia Bank	+3.0
Ins Australia	+3.0
Spotless Group	+2.7
Pacific Brands	+2.3
Seven Group Holdings	+2.3

Underweight Positions

Active %

Commonwealth Bank Of Australia	-4.4
Telstra Corporation Ltd	-4.3
Westpac Banking Corporation	-4.2
Wesfarmers Ltd	-3.5
BHP Billiton Ltd	-2.9

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.

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 Value Equity Trust underperformed its benchmark by 1.1% over the quarter. Whilst market returns were positive, the defensive sectors were the best performing which was unfavourable for Trust performance. Portfolio returns from Consumer Discretionary holdings hurt performance whilst Mining and Industrial positions helped.

Negative consumer sentiment and weak pre Christmas retail sales announcements were the most significant negative impact on performance. JBH (-25.7%) and Billabong (-46.7%) each announced weak pre Christmas trading results and Pacific Brands (-17.9%) AGM commentary underlined difficult trading conditions and the impact of high cotton prices. The consumer confidence contagion spread to other holdings such as Harvey Norman (-12.3%) and Fairfax Media (-12.7%). Whilst we are cognisant of consumer issues (low confidence due to Euro debt concerns, High AUD highlighting offshore bargains, the rise of internet shopping, a rising savings rate to reduce high household debt, rising utility bills) we believe a number of these stocks are offering very attractive valuations as each has a PE <10 on downgraded earnings forecasts experienced in the toughest retail environment in 20 years. As consumer confidence will ultimately recover, boosted by strong Household Income growth and likely RBA rate cuts, these stock are likely to perform strongly with both earnings and PE multiple improvements. The strength of the value argument was underlined early in January with KKR approaching Pacific Brands regarding a potential acquisition of the company.

Other holdings that hurt performance included Bluescope (-34.5%) and Henderson Group (-8.4%). 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. Such action is shareholder value destructive as the rumours of the capital raising drove the price down, and then the raising is done at a deep discount to the last price.

Today we believe Bluescope offers a deep discount to the replacement cost of its manufacturing capacity and will benefit strongly from a recovery in Australian construction activity. 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.

On the positive side, 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.

Spotless (+32.5%) benefitted from a second approach from Private Equity in the last 12 months. We believe Spotless offers significant value above the price been touted by Pacific Equity Partners. For a number of years Spotless has been investing in its Business and IT platform. It is near the end of the this investment and once completed will remove a barrier from Spotless earning margins inline with peers. The earnings impact of the higher margins is significant. At a \$2.68 bid price, we believe PEP is getting a free option on this earnings improvement which belongs to existing shareholders. The trend for Boards to accept low ball Private Equity bids based on bottom of the economic cycle earnings and decade low valuation multiples reeks of short termism and is very concerning for long term superannuation investors.

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	35
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Sector Allocations

	Active %
Consumer Discretionary	+9.3
Consumer Staples	-4.5
Energy	-6.3
Financials	+0.4
Health Care	-3.1
Industrials	+9.8
Information Technology	-0.6
Materials	-2.0
Telecommunication Services	-4.5
Utilities	-1.6