

Legg Mason Australian Value Equity Trust

Objective

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

Benchmark

S&P/ASX 200 Accumulation Index.

Value

\$75,149,378.

Performance (before fees and taxes)

	Trust %	Benchmark %
3 months	-13.76	-11.14
1 year	16.23	13.15
3 years p.a.	-9.47	-1.785

Past performance is no indication of future performance.

Profile

Overweight Positions	Active %
Henderson Group	+4.5
National Australia Bank	+4.4
News Corporation	+4.2
Pacific Brands	+3.8
BlueScope Steel	+3.3
Amcor	+3.2
Iluka Resources	+3.1
Tower Australia	+3.0
ASX	+2.7
Fairfax Media	+2.6
Underweight Positions	Active %
BHP Billiton	-4.4
Telstra Corporation	-3.6
Woolworths	-3.3
Wesfarmers	-3.3
Westpac Banking Corporation	-2.9

Market Review

Equity markets around the world lost ground during the June quarter as investors became concerned by European sovereign debt levels and moderating growth expectations in China and the U.S. Domestically, wrangling over the Resource Super Profits Tax generated headlines, though Materials companies were not uniformly lower.

The Australian equity market closed down 11.1% over the quarter, as measured by the S&P/ASX 200 Accumulation Index. Over the past year, Australian equities gained 13.2% despite the recent declines.

Corporate activity continued to gain steam. Newcrest Mining (+6.7%) made an offer for Lihir Gold (+35.2%), Healthscope (+16.1%) announced that various private equity groups were interested in buying the business and Foster's Group (+6.6%) announced that the company would split its wine and beer operations into separate companies.

Meanwhile, Telstra (+8.3%) and the Federal Government announced that they had signed a non-binding Heads of Agreement with respect to Telstra's copper network and associated infrastructure to be sold to the National Broadband Network.

On the economic front, the Federal Budget saw the announcement of a reduced company tax rate, increases to the Superannuation Guarantee levy and a forecast return to surplus by 2012/13. The Reserve Bank of Australia raised the target cash rate by 0.25% to 4.25% in April, while the Australian dollar reaffirmed itself as a "risk" currency; it lost US6.36 cents against the greenback to end the period at US85.23 cents. March quarter gross domestic product recorded a 0.5% gain, in line with market expectations.

Performance

The Legg Mason Australian Value Equity Trust underperformed its benchmark over the quarter. However, portfolio performance over the past year was 3.1% ahead of benchmark. Performance over the quarter saw value detracted from the portfolio's exposure to some of the sector's relatively leveraged names, as investors reduced their exposure to cyclical securities. This negative impact was largely on a thematic basis rather than any significant negative stock specific news.

At the sector level, portfolio exposure to the Consumer Discretionary and Property sectors detracted value, while choices in the Banks and Materials ex Metals & Mining sectors.

In the Consumer Discretionary sector, portfolio overweight exposures to Pacific Brands (-40.4%) and Billabong International (-25.7%) detracted from performance. These securities lost some ground as investors sought the safe haven of some of the more defensive consumer names. Billabong was also impacted by a moderation in consumer spending in the U.S., while Pacific Brands also suffered from consensus downgrades and investor concern regarding the current trading environment.

Our view is that, on a forward looking basis, Billabong's growth strategy remains intact and that the stock is poised to outperform on any consumer rebound.

These factors are not reflected in the price of Billabong, which has been hurt by global risk aversion. In the case of Pacific Brands, a price to earnings ratio of seven times does not reflect the intrinsic value of the firm. Forecast earnings are strong, their brands remain very attractive and the strategy to control costs should allow it improve margins.

In the Property sector, an overweight exposure to Valad Property Group (-14.3%) detracted from performance as it lost ground this quarter over macro concerns regarding developments in Europe. We note that Valad had a win early in the quarter as its European business was confirmed as the new manager of European Commercial Real Estate (formerly Kenmore Europe) and believe that investors have underestimated the value and growth potential of Valad's European business.

Meanwhile, portfolio exposure to the Banks sector aided performance as the portfolio was underweight Westpac (-24.1%). Westpac lost the most ground among the big four banks following investor concerns around their ability to complete their current funding post the recent market dislocation.

Also adding back some value was stock choices in the Materials ex Metals & Mining sector, where the portfolio was overweight Adelaide Brighton (+3.8%) and Amcor (-0.2%). Adelaide Brighton rose as major concrete producers announced price increases, while Amcor gained ground on corporate activity that saw it acquire U.S. packaging assets.

Elsewhere, not holding Telstra (+8.3%), which detracted value as the stock gained ground on the heads of agreement with respect to selling Telstra's copper network and associated infrastructure to the National Broadband Network. Though this reduced some uncertainty, we remain concerned about the structural decline in fixed line revenues and what the firm's margins will be once the National Broadband Network comes online.

Outlook

Recent market weakness has created a significant opportunity for investors. Compared to our estimate of fair value, the sector has around 20% upside and the portfolio has around 70% upside. This 50% "value spread" represents a significant active management opportunity and is similar to what we witnessed in May 2009, post the end of the global financial crisis. Our view is that the recent market weakness is overdone and that it may partially be explained by memories of 2008, when investors that were slow to factor in the impact of the global financial crisis were hit hard. We maintain that there remains significant value on offer in selected underlying Australian equity securities and that the sector should be able to move higher on a medium term time horizon. This view is supported by evidence that Australian firms have reduced their risk profiles over the past year. As such, a number of firms are poised to produce strong margin expansion once revenue growth returns. Stock specific developments are likely to be a critical driver of Australian equities over the remainder of 2010. As such, we have positioned the portfolio to benefit from stock specific opportunities and we continue to expect to produce above normal portfolio returns over the medium term.

Further Information

Portfolio Characteristics

Number of securities at period end	30
Sector Allocations	
	Active %
Metals & Mining	-5.2
Materials ex Metals & Mining	+9.6
Energy	-5.7
Consumer Staples	-6.2
Consumer Discretionary	+10.7
Industrials	+2.0
Health Care	-2.1
Telecommunication Services	-3.9
Information Technology	-0.7
Banks	+3.6
Financials ex Banks & Property	+3.8
Property	-3.3
Utilities	-2.6

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