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

$187,742,717.

Performance (before fees and taxes)

	Trust %	Benchmark %
3 months	-1.57	-0.43
1 year	17.05	17.87
3 years p.a.	-3.46	-2.35
5 years p.a.	9.68	10.44

Past performance is no indication of future performance.

Profile

Regional Allocations	Trust %	Benchmark %
Europe / Middle East / Africa	18.8	20.6
Asia	57.6	56.7
Latin America	21.7	22.7
Cash	1.9	-

Sector Allocations	Trust %	Benchmark %
Energy	14.5	13.9
Materials	14.9	14.6
Industrials	4.4	6.7
Consumer Discretionary	8.0	6.0
Consumer Staples	5.4	6.1
Health Care	1.1	2.5
Financials	25.7	24.3
Information Technology	13.2	13.7
Telecommunications	9.7	8.6
Utilities	1.2	3.6
Cash	1.9	-

Market Review

The MSCI Emerging Markets Index, expressed in Australian dollars, declined 0.4% over the quarter. After a brief rally in early June, markets fell following weak economic data from the U.S., continued concerns over the sovereign debt situation in peripheral Europe and strains within the European banking system. Macroeconomic indicators within emerging markets continued to show strong growth across the board.

Europe/Middle East/Africa

In Russia, the government wants to reduce the tax burden on non-resources sectors and put a higher burden on the resources sector as needed. Meanwhile, the economy saw solid growth in manufacturing and extractive sectors, while the rest of the economy remains anaemic.

The South African Reserve Bank painted the picture of a stronger-than-expected consumer sector, with household spending higher on rising incomes and lower debt servicing costs. The current account surprised on the downside as it grew on a higher trade deficit and service costs.

Asia

In India, the government continues to take small reform steps. It announced a minimum float of 25% for quoted companies to be reached in three years (10% minimum now). This will introduce a clear, non-political schedule for partial privatisations.

Industrial production in Korea remained strong throughout the quarter. Korea's external position suffered slightly during the market sell-off in May, when it saw foreign outflows from its equity market; the blow was softened by its strong current account surplus. The Bank of Korea maintained policy rates at 2% throughout the period.

China's macro indicators and manufacturing data showed a moderation in growth due to earlier monetary normalisation, policy curbs that target the property market and local government investment activities. Meanwhile, industrial production rose more slowly than expected.

Bank Indonesia announced several measures intended to slow short term capital flows so as to reduce the risks associated with sudden capital flows into the Indonesian economy. Inflation measures remained within Bank Indonesia's target range despite the strong rate of economic growth.

Latin America

As expected, the central bank of Brazil increased interest rates by 0.75% to 10.25% in early June as they reacted to continuously strong activity indicators. Inflation remains the indicator to watch: food and commodity prices are better behaved but items that contribute to core inflation continue to rise at a fast pace.

In Mexico, the economy is steadily recovering. The domestic demand side has improved as job gains in the manufacturing sector slowly translate into higher activity in the overall economy. Inflation remains well-behaved and Banxico remains on hold.

Performance

The Legg Mason Emerging Market Trust underperformed its benchmark over the June quarter.

The bulk of the value detracted was from stock selection, where holdings in Brazil (Votorantim Celulose e Papel, CVRD, Banco Itau), Korea (LE Electronics, Hyundai Motor Co) and Taiwan (Au Optronics, Acer) underperformed their respective local markets. Adding back some value were holdings in Indonesia (Astra International, XL Axiata), China (Wynn Macau, China Yurun, China Mobile, CCB), and India (Indian Bank, JSW Energy).

At the country allocation level, an underweight exposure to Malaysia was a negative factor. However, an overweight position in Indonesia and an underweight position in Israel added back some value. In terms of sectors, a slight overweight position in Consumer Discretionary was a positive contributor, as the sector outperformed the broader market.

Outlook

The global economy is at an inflection point. Going into the second half of 2010 and 2011, global growth is likely to decelerate from the rapid rates observed during the last few quarters as the effects of restocking and fiscal policy support fade out and growth converges to trend levels. In this post-recovery environment, emerging markets are expected to be leading contributors to global economic growth due to robust domestic demand dynamics and sound policy mixes. Overall, we believe that the global macroeconomic environment will remain supportive for emerging markets' earnings growth, as a substantial proportion of the asset class' earnings power is geared towards domestic demand growth.

Despite the oncoming global growth deceleration, we still expect emerging market equities to deliver positive returns in the next one to two years. From a fundamental perspective, emerging market earnings expansion should be well supported by strong domestic demand growth across most regions, while inflation - which is already rising in most countries - is far from calling for drastic action by emerging market central banks. At the same time, following the recent bout of market volatility, valuations are at relatively attractive levels.

In terms of risks, we believe it is unlikely that we will see a repeat of the seizure of the global financial system akin to the one following the collapse of Lehman Brothers in 2008. Therefore, our base case remains for a continued cyclical recovery in the world economy and not the double dip scenario that many investors fear.

Markets may well remain volatile in coming quarters as Europe's fiscal troubles are far from over and negative headlines emanating from the region are likely to continue. In this context, we believe emerging market equities may remain range-bound as strong asset class fundamentals and attractive valuations are offset by negative sentiment towards risky assets in general.

On the portfolio side, our recent moves have been driven by a combination of responding to valuation opportunities arising from higher volatility and recycling gains from stocks where our thesis has broadly played out into new alpha ideas. As a net result, we have increased our exposure to Indonesia and Brazil, and reduced exposure to Mexico, India and Thailand.

As we come into the middle of the year our portfolio is overweight in Russia, Indonesia and Thailand and underweight in Malaysia, Taiwan and Korea. Our larger positive sector exposures are in the Telecommunications, Information Technology and Energy sectors while a negative sector tilt is in place in Utilities, Consumer Staples and Industrials.