

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

\$104,296,894

Performance (before fees and taxes)

	Trust %	Benchmark %
1 month	-2.35	-1.00
3 months	-1.76	-1.00
1 year	-25.48	-18.44
3 years p.a.	3.95	5.59
5 years p.a.	-4.78	-2.84

Past performance is no indication of future performance.

Profile

Regional Allocations	Trust %	Benchmark %
Europe / Middle East / Africa	20.2	17.9
Asia	55.1	59.1
Latin America	23.1	23.0
Cash	1.6	0.0

Sector Allocations	Trust %	Benchmark %
Consumer Discretionary	7.8	8.1
Consumer Staples	6.0	8.1
Energy	15.7	14.0
Financials	27.1	23.8
Health Care	1.5	1.0
Industrials	4.9	6.4
Information Technology	15.1	13.1
Materials	12.8	13.3
Telecommunications	7.3	8.5
Utilities	0.3	3.7
Cash	1.6	0.0

Market Review

Positive returns in October were offset by two negative months in November and December while volatility remained high throughout the quarter. During 2011, EME dropped a large 18.4%, a substantial shortfall compared to the negative 5.5% return for MSCI World and the poorest relative performance since 2000. Circa 5% of the 18% EME loss came from Emerging Markets (EM) currency depreciations. EME's poor performance relative to MSCI World was driven by inflation worries and monetary tightening impacting three heavy weight countries (China, Brazil, India), and by the high-beta nature of the EME asset class in a mostly risk-off environment.

Europe/Middle East/Africa

Russia was the worst-performing EM market in December (after a strong November) following Duma elections that have significantly increased the political uncertainties. Meanwhile, economic data releases remain constructive in November: retail sales rose 8.5% year-on-year (yoy), Industrial Production almost 4%, Fixed Investment 8% and lending around 30% yoy.

In South Africa, October mining and manufacturing production data disappointed, showing negative yoy numbers on precious metals and vehicles' weaknesses. November CPI inflation was better than expected at 6.1% yoy, driven again by food and transportation costs, and, more generally, by the recent currency weakness.

Asia

In China, the policy-makers' statement following the National Economic Working Conference was similar to the one last year, emphasising proactive fiscal policy and prudent monetary policy. With yoy inflation rapidly falling (4.2% yoy in November) on lower food prices and high base effect, and the property sector exhibiting important signs of slowdown, we believe that the government will feel confident in continuing to lower reserve requirements.

India was again an under-performer, driven by negative economic news, currency weakness and poor policy-making decisions. October Industrial Production fell a shocking 5% yoy, the first yoy decline since the 2008/09 Financial Crisis. The Bank of India kept interest rates unchanged at its latest meeting while introducing a bias towards cutting in coming months on increased risks to growth.

In Korea, economic performance indicators continued to point to a moderate slowdown in the last quarter, as Industrial Production decelerated steadily on a sequential basis throughout the period on the back of cooling global demand and a cautious investment outlook domestically. At the same time, inflation surprised in the upside in December at 4.2%; core measures of inflation, however, remained well behaved, which suggests that inflationary pressures remain well contained.

In Indonesia, inflation in December surprised to the downside, hitting a new cyclical low of 3.8%, thus supporting the Central Bank's decision to cut rates by 50 bps in November after having cut rates by 25 bps in October.

Latin America

Brazil's economy is showing clear signs of deceleration. The third quarter yoy growth rate dropped to 2%, with deceleration evident in manufacturing and in services sensitive to domestic demand like commerce, transport and finances.

Performance

The Legg Mason Emerging Market Trust underperformed its benchmark by 0.8% over the quarter.

During a highly volatile quarter which saw a strong positive return in October being followed by two negative months in November and December driven by negative sentiment as worries over the euro crises continued, it was difficult to add consistent alpha through the quarter. The pro cyclical nature of our portfolios meant that we performed very strongly during October; however we gave some of that performance back during the following two months.

We saw positive performance with the IT, Financials and Materials sectors, driven by a combination on both strong stock selection and allocation. This performance was somewhat offset by the negative alpha within Consumer Staples and Utilities. This was partially due to our underweight in these outperforming sectors but mainly driven by stock selection.

Outlook

Going into 2012, the short-term outlook for Emerging Markets Equities remains highly uncertain, as the asset class remains subject to fluctuations in the global equity risk premium, which is clearly dependent on unpredictable developments in the Eurozone. Following its weak performance in 2011, when MSCI EM fell by 19% (net), the asset class valuation levels remain at depressed levels – roughly in line to those observed during the Great Recession of 2008. At the same time, the fundamental background for Emerging Markets Equities' economies and earnings remain relatively constructive, underpinned by strong sovereigns, healthy corporate balance sheets and supportive growth/inflation dynamics. In the medium-to-long-term, we expect the asset class to regain its footing, as the European crisis recedes and the fundamentals of the asset class reassert themselves.

Our global macro outlook for 2012 has deteriorated marginally over the last couple of months from 2.6% to 2.3%, as we have revised down our growth expectations in Europe and China. The only major economy where we have revised upwards our growth expectations is the US, where economic

activity accelerated in 4Q11 and momentum remains vigorous, on the back of stronger consumer confidence and initial signs of stabilisation of the housing market. All in all, we expect global growth in 2012 to remain at similar levels to those observed in 2011 (2.3% in 2012 vs. 2.6% in 2011).

The Eurozone continues to be the key focus of risk in the forecast, as the sovereign debt situation remains fragile, the risks of a disorderly resolution have increased and remain non-negligible. The underlying stress in the European sovereign markets persist, as Italian, Spanish and Portuguese yields remain way above sustainable levels and Greece is yet to restructure its debt to bring it back on a sustainable path. Even though worries about a potential breakup of the Euro have gained ground over the last few months, we still believe that such an outcome remains extremely unlikely, as the costs for a country of leaving the Eurozone far outweigh its benefits. Our base case is that the European sovereign markets will stabilise gradually throughout 1H12 following a successful voluntary restructuring of Greek debt by March 2012.

Within Emerging Markets, we have reduced our growth expectations in China in 2012 from 8.2% to 7.7%, mostly on the back of weaker investment activity. We have also revised downwards our growth forecasts for India, where we expect the Reserve Bank to maintain tight conditions in the short term. Elsewhere in Emerging Markets, we expect growth to remain more or less close to 2011 levels with the clear exception of Turkey, where the Central Bank is being forced to tighten policy aggressively, as inflation has accelerated rapidly in the last couple of months.

Our current positioning reflects our expectation of a gradual improvement in EME valuations throughout the year: we remain underweight the most defensive and expensive sectors -Telcos, Utilities and Consumer Staples. We expect these sectors will give back some of the relative outperformance that they have accrued in the market turmoil of the last six months. As we expect volatility levels to remain very high until the situation in Greece is finally resolved, we carry neutral rather than overweight positions in the most cyclical sectors (Energy and Materials), which we plan to build up as visibility improves in coming months. From a country perspective, India, Russia and China are our largest overweight positions. In India, the market looks significantly cheap in relative terms following its poor performance in 2011. Similarly in China, we expect the loosening of monetary conditions and the reduction of fears of a hard landing will prove a catalyst for market valuations. In Russia, our overweight remains supported by cheap valuations and gradual macro-economic improvement, but we remain vigilant to the uncertainties on the political front.

Any reference to "Legg Mason Australia" is a reference to Legg Mason Asset Management Australia Limited ABN 76 004 835 849 AFSL 240827. Neither Legg Mason Australia, nor any of its related parties, guarantee the repayment of capital or performance of any of the trusts referred to in this document. Past performance is no guarantee of future performance. Applications to invest in the Legg Mason Emerging Market Trust can be made using an application form comprising part of the current Product Disclosure Statement, which is available from our offices or on our website at www.leggmason.com.au. Certain eligibility criteria applies. Legg Mason Australia does not guarantee the accuracy or completeness of this document. To the extent permissible by law, Legg Mason Australia accepts no liability in contract, tort (including negligence) or otherwise for any loss or damage suffered as a result of reliance on this document. This document does not constitute investment advice, does not include recommendations on any particular security and has not been prepared to take into account the investment objectives, financial objectives or particular needs of any particular person. Before making an investment decision you should read the Product Disclosure Statement carefully and you need to consider, with or without the assistance of a financial advisor, whether such an investment is appropriate in light of your particular investment needs, objectives and financial circumstances. The opinions and outlook are subject to change without notice.