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News Release

For Immediate Release
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Emerging market equities closes gap on developed equities

- **Cost of capital gap narrows**
- **Faster earnings growth, leading to higher price-to-earnings ratios**
- **Emerging markets have flexibility to leverage up for a higher return-on-earnings**

London – 23 November 2010 – Claudio Brocado, senior portfolio manager at Legg Mason affiliate, Batterymarch's Emerging Markets team, says that emerging market companies are delivering faster earnings growth versus their counterparts in the developed world as the cost of capital gap narrows. They will enjoy higher price-to-earnings ratios as a result and will eventually trade at a premium compared to developed market stocks in terms of both asset-backed and earnings-related valuations.

Brocado comments: "Emerging markets have historically had a significantly higher cost of capital than developed markets, putting them, all else being equal, at a cost-of-capital disadvantage. These markets have used other competitive advantages—lower labour costs, for example—to thrive in the global economy. However, as globalisation broadens to include more aspects of corporate life, the cost of capital has become increasingly global, too, reducing the price of doing business for emerging markets companies. Their ability to add more value than developed markets has been climbing as the cost-of-capital gap narrows."

While emerging markets still trade at a discount in terms of earnings, they already trade at a premium on asset-based valuations such as price-to-book. Batterymarch states that the higher price-to-book ratio seems fully justified in light of their better return-on-equity (ROE) as, according to financial theory, a company whose returns exceed its cost of capital should trade above book value. This means the higher the ROE, the higher the fair price-to-book ratio for a given stock or for an equity market as a whole.

Brocado says: "Just as ROE has a direct bearing on price-to-book value, sustainable earnings growth rates have an impact on the price-to-earnings multiples investors are willing to pay. Emerging markets companies are generally expected to deliver faster earnings growth than those in developed markets well into the foreseeable future, theoretically leading to higher P/E ratios. While we currently don't count on an expansion in P/E multiples—let alone the development of a premium versus developed-market stocks—we believe that this is likely to happen in time."

Batterymarch says that emerging markets have achieved their return-on-equity advantage despite a far more prudent use of leverage than in developed markets. Due to their relatively low debt levels, their return-on-asset superiority is even more significant than their ROE premium. Companies in emerging markets have the flexibility to leverage up to an even higher ROE, facilitated by the decreasing cost of capital.

Brocado concludes: "We believe that as long as emerging market companies continue to deliver higher returns than those in the developed world, their price-to-book premium should remain intact. If their ROE superiority is magnified through to a higher spread over the cost of capital, that valuation premium is justified and could even increase."

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Notes to editors

About Legg Mason Global Asset Management
Legg Mason is a global asset management firm with $677 billion in assets under management as of October 31, 2010. The Company provides active asset management in many major investment centres throughout the world. Legg Mason is headquartered in Baltimore, Maryland, and its common stock is listed on the New York Stock Exchange (symbol: LM).

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Notes to Editor

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