

Legg Mason Japan Equity Fund

Market Review

World stock markets continued to fall in the final quarter of 2008 as the shockwaves of the US financial crisis continued to spread out around the globe. However, the impact of this slowdown manifested itself in different ways from country to country. In Japan, it manifested itself in a sharp decline in external demand and a rapid appreciation in the yen, which took a heavy toll on the economy.

In an effort to combat the financial crisis and ease its effects on the domestic economy, the Bank of Japan implemented two interest rate cuts in the fourth quarter. The first cut was in late October, when the key interest rate was cut by 20 basis points, lowering it to 0.30%. The second cut came in late December, when the rate was reduced to 0.1%. These were the first rate cuts in over seven years.

Against this backdrop, the Nikkei 225 fell by 21.2% in Japanese yen terms over the period, while the TSE First Section (TOPIX) fell by 20.9%, and the TSE second section index, which consists predominantly of smaller cap stocks, fell by 17.2%. The TSE Mothers index, which follows high growth and emerging stocks, fell by 19.5%.

According to the Fund's manager, one reason for the underperformance of the stock market was net selling by overseas investors, who account for a significant proportion of the total trading activity in Japan. In 2008, overseas investors became net sellers for the first time in eight years. Other negative points included the steep appreciation in the value of the yen against most other currencies, which negatively impacted corporate profits, particularly for large export companies, and helped to cool off investor sentiment.

In terms of sectors, the best performing ones in Japanese yen terms over the period were electric power & gas and pulp & paper, which were the only two to post positive returns over the quarter. The worst performing sectors were transport equipment, precision instruments and other financial business, which all fell over 35% during the quarter.

Fund Review

Against this backdrop, the Legg Mason Japan Equity Fund rose by 24.41%¹ in the fourth quarter of 2008 while its benchmark, the TOPIX index, rose by a more modest 14.85% (both in sterling terms).

In terms of stock attribution, amongst the largest positive contributors to the Fund's performance over the period were Nitori (+12.34%), operator of the nationwide furniture and interior decoration chain store, Kakaku.com (+6.12%), operator of one of Japan's largest price comparison websites, and Start Today (+7.04%), operator of internet shopping sites for fashion retailers. Conversely, the principal negative contributors in terms of the Fund's performance were Village Vanguard (-45.47%), operator of nationwide chain stores that sell a wide variety of goods targeted at a younger clientele, Works Applications (-40.09%), developer of ERP (enterprise resource planning) business application software, and DeNA Co. (-30.97%), operator of an e-commerce business that specialises in mobile phone.

In terms of portfolio changes, the manager consolidated the portfolio during the Fund, liquidating six holdings, all of which were small positions in the portfolio.

Outlook

With the negative economic outlook that prevails and the ongoing financial crisis that is yet to show signs of a bottom, the manager believes that volatility in the Japanese stock market is likely to remain high for the time being. When the US credit crisis first started in August 2007, most market watchers believed that Japan would remain fairly unscathed from the serious effects of the crisis due to the nation's limited exposure to the toxic subprime mortgages. But the indirect effects of the credit crunch have been massive for the Japanese economy in the form of a slowdown in exports, a decline in capital expenditure, the rise of the yen, a fall in interest rates, a tighter credit market, job losses and worsening consumer sentiment.

In the manager's view, however, the present economic situation creates a unique opportunity for investing in domestic-oriented companies of smaller size that are not faced with the complex global challenges that export-oriented manufacturers are faced with. In its opinion, Japan's traditional source of economic growth and prosperity is now proving to be a double-edged sword, as over-reliance on exports has been hurting the nation in times of global economic meltdown. Against such a background, large-cap manufactures of the "Old Japan" are likely to make further downward revisions to their profits for the current and next fiscal years, whilst such risks are smaller, particularly for companies in the domestic-oriented service sectors which the Fund invests in. To the manager it seems clear that the much anticipated "New Japan" is starting to emerge as old-style manufacturing companies start to make way for service-oriented companies that thrive on domestic demand.

This Fund is managed by Shiozumi Asset Management

¹ **Source for performance figures** - Morningstar, NAV to NAV with net income reinvested without initial charges but reflecting annual management fees, based in sterling for A class shares. Copyright © 2009, Morningstar, Inc. All Rights Reserved. For more information, visit www.morningstar.co.uk

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This Fund may select fewer equities in which to invest. This concentration carries more risk than funds investing in a larger number of companies. This Fund may acquire shares in companies with relatively small market capitalisations and may involve a higher degree of risk. Owing to its investment philosophy, this Fund should be viewed as a high-risk investment.

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January 2009

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Legg Mason UK Equity Fund

Market Review

All major equity markets fell sharply again in the fourth quarter, making 2008 a bear market in all risk assets. During the final three months of the year, the US, Japan and Europe ex-UK declined in excess of 20% in local currency terms, while the UK equity market, as measured by the FTSE All Share Index, fell by 10.19% in sterling terms. Markets remained highly volatile as the effects of the banking crises on both sides of the Atlantic continued to unfold, economic releases became increasingly gloomy, and several economies slid into recession.

In the UK, the government acted in October to support several banks whose funding difficulties had become severe, including RBS and Lloyds TSB. The latter was also in the news for its proposed rescue takeover of banking group HBOS. At the same time, UK economic data deteriorated sharply. Surveys showed, for example, that industrial orders fell to their lowest level in five years and business confidence sank to its lowest level since the early 1980s. In the retail sector, meanwhile, established names such as Woolworths and furniture chain MFI became casualties of the downturn and went into receivership. In response to the speed of the slowdown, the Bank of England (BoE) began to aggressively cut interest rates to help the consumer and corporate sectors alike. UK rates began the fourth quarter at 5% but with cuts in each of the following three months they ended the period at 2%.

Within the UK equity market, small company stocks were the worst performing category, as they were in the third quarter. The UK small-cap segment fell by around 23% in the fourth quarter, while the mid-cap market fell around 19% and large-caps, as measured by the FTSE 100 Index, declined by 9%. The worst performing industry sector in the fourth quarter was financials. Although the financials group rallied during the third quarter, their poor showing in the final three months of the year contributed to make the sector the worst performer in the UK market for 2008 as a whole. The basic materials sector and the technology group also underperformed in the fourth quarter, while sectors that outperformed the market on a relative basis included oil & gas, healthcare and telecommunications.

Fund Review

The Legg Mason UK Equity Fund fell by 7.29%¹ in sterling terms over the fourth quarter, a relatively better result than its benchmark, the FTSE All Share Index, which declined in sterling terms by 10.19%. Positive stock selection and sector asset allocation both contributed to this outperformance, with the former consideration adding the most value to the Fund's relative returns.

Stock selection was most beneficial in the banks and financials ex-banks sectors, with selections within the consumer discretionary and healthcare sectors also being beneficial. In the banks sector, the Fund benefited by being underweight in stocks that underperformed most during a turbulent three months for the industry, such as RBS and Lloyds TSB. In the healthcare sector, which traditionally performs well in times of economic downturns, the Fund benefited from being overweight in the big pharmaceuticals company GlaxoSmithKline. This stock ranked as the Fund's third-largest holding at the end of 2008. Elsewhere, sectors in which stock selection was a negative influence on the Fund's relative performance included industrials, consumer staples, and utilities.

Within the Fund's sector asset allocation, positions that contributed positively to the Fund's relative performance included being underweight in the poorly performing banks sector and overweight in healthcare. Overweight exposures to industrials and consumer discretionary stocks were among negative influences, however. The Fund remained underweight in banks and overweight in healthcare at the end of the fourth quarter, while other key positions included being overweight in energy and telecommunication services, and underweight in materials.

Outlook

The Fund's investment manager notes that unemployment in the UK continued to climb during December, and that there are predictions that high numbers of jobs could continue to be lost in the next 12 months. Elsewhere, data showed a 12.2% drop in house prices year-on-year to the end of November, and some forecasters expect additional declines. Indeed, the manager notes that some economists think that 2009 will bring the deepest recession in the UK since 1947. The manager also notes that sterling depreciated sharply in December, hitting an all-time low against the euro, on the assumption that the BoE may significantly reduce interest rates beyond the 2% level at which they stood at the end of the year. (The BoE cut rates by another 0.5% to 1.5% in early January).

The unprecedented measures taken by central banks to tackle the global financial crisis and the slowdown in economic growth are likely to remain focal points for UK equity investors for the next few quarters. But against the difficult backdrop, the Fund's investment manager believes that value can still be found in the UK equity market, particularly after the recent share price declines, and as a disciplined, long-term investor it will continue to seek attractive stocks whatever the environment.

This Fund is managed by Batterymarch Financial Management

¹ **Performance Figure Source** - Morningstar. NAV to NAV, net income reinvested, and net of Annual Management Charge for A class shares. Copyright © 2009, Morningstar, Inc. All Rights Reserved. For more information, visit www.morningstar.co.uk

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January 2009

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Legg Mason UK Income Fund

Market Review

All major equity markets fell sharply again in the fourth quarter, making 2008 a bear market in all risk assets. During the final three months of the year, the US, Japan and Europe ex-UK declined in excess of 20% in local currency terms, while the UK equity market, as measured by the FTSE All Share Index, fell by 10.19% in sterling terms. Markets remained highly volatile as the effects of the banking crises on both sides of the Atlantic continued to unfold, economic releases became increasingly gloomy, and several economies slid into recession.

In the UK, the government acted in October to support several banks whose funding difficulties had become severe, including RBS and Lloyds TSB. The latter was also in the news for its proposed rescue takeover of banking group HBOS. At the same time, UK economic data deteriorated sharply. Surveys showed, for example, that industrial orders fell to their lowest level in five years and business confidence sank to its lowest level since the early 1980s. In the retail sector, meanwhile, established names such as Woolworths and furniture chain MFI became casualties of the downturn and went into receivership. In response to the speed of the slowdown, the Bank of England (BoE) began to aggressively cut interest rates to help the consumer and corporate sectors alike. UK rates began the fourth quarter at 5% but with cuts in each of the following three months they ended the period at 2%.

Within the UK equity market, small company stocks were the worst performing category, as they were in the third quarter. The UK small-cap segment fell by around 23% in the fourth quarter, while the mid-cap market fell around 19% and large-caps, as measured by the FTSE 100 Index, declined by 9%. The worst performing industry sector in the fourth quarter was financials. Although the financials group rallied during the third quarter, their poor showing in the final three months of the year contributed to make the sector the worst performer in the UK market for 2008 as a whole. The basic materials sector and the technology group also underperformed in the fourth quarter, while sectors that outperformed the market on a relative basis included oil & gas, healthcare and telecommunications.

Fund Review

The Legg Mason UK Income Fund fell by 7.69%¹ in sterling terms over the fourth quarter, a relatively better result than its benchmark, the FTSE All Share Index, which declined in sterling terms by 10.19%. Positive stock selection and sector asset allocation both contributed to this outperformance, with the former consideration adding the most value to the Fund's relative returns.

Stock selection was most beneficial in the banks and financials ex-banks sectors, with selections within the consumer discretionary sector also being beneficial. In the banks sector, the Fund benefited by being underweight in stocks that underperformed most during a turbulent three months for the industry, such as RBS and Lloyds TSB. Elsewhere, sectors in which stock selection was a negative influence on the Fund's relative performance included industrials and consumer staples.

Within the Fund's sector asset allocation, positions that contributed positively to the Fund's relative performance included being underweight in the poorly performing banks sector and overweight in telecommunication services. An underweight exposures to the utilities sector was among negative influences, however. The Fund remained underweight in banks at the end of the fourth quarter, while other key positions included being overweight in energy, healthcare and telecommunication services, and underweight in materials.

Outlook

The Fund's investment manager notes that unemployment in the UK continued to climb during December, and that there are predictions that high numbers of jobs could continue to be lost in the next 12 months. Elsewhere, data showed a 12.2% drop in house prices year-on-year to the end of November, and some forecasters expect additional declines. Indeed, the manager notes that some economists think that 2009 will bring the deepest recession in the UK since 1947. The manager also notes that sterling depreciated sharply in December, hitting an all-time low against the euro, on the assumption that the BoE may significantly reduce interest rates beyond the 2% level at which they stood at the end of the year. (The BoE cut rates by another 0.5% to 1.5% in early January).

The unprecedented measures taken by central banks to tackle the global financial crisis and the slowdown in economic growth are likely to remain focal points for UK equity investors for the next few quarters. But against the difficult backdrop, the Fund's investment manager believes that value can still be found in the UK equity market, particularly after the recent share price declines, and as a disciplined, long-term investor it will continue to seek attractive stocks whatever the environment.

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January 2009

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Legg Mason Continental European Equity Fund

Market Review

At the end of one of the most turbulent years on record for global equity markets, the final quarter provided little relief for investors with further big falls recorded in both developed and emerging markets. In Europe, the MSCI Europe Net Dividends Index declined over the quarter by 21.98% in euro terms, making an annual decrease for 2008 in euros of 43.65%. In addition to the ongoing crises in the banking industry and credit markets, the region's equity markets were impacted by mounting evidence that the wider economic slowdown was accelerating.

The important German and UK economies were among those that recorded sharp contractions in GDP and further quarters of negative growth are expected in 2009. In response to the deteriorating outlook, the European Central Bank (ECB) and the Bank of England (BoE) both cut interest rates. The ECB cut eurozone rates by 1.75% to 2.5% during the fourth quarter, while the BoE was more aggressive, slashing UK rates by 3% to 2% over the period.

Within the region's equity markets, the troubled financials sector was the worst performing group over the fourth quarter, with bank stocks lagging the most, followed by real estate companies. The materials sector also significantly underperformed the market, although oil & gas stocks held up better thanks to their relative outperformance in the first two months of the period. Elsewhere, sectors such as telecommunications, healthcare, and utilities – each of which traditionally do well in times of economic downturn – posted relative outperformance over the quarter.

Fund Review

The Legg Mason Continental European Equity Fund fell by 4.35%¹ in sterling terms over the fourth quarter, while its benchmark, the FTSE World Europe ex UK Index, recorded a sterling-denominated decrease of 2.46%. (A sharp appreciation of the euro against sterling during the period helped to improve these returns for the Fund and its benchmark after conversion into sterling terms). The Fund's stock selection accounted for this underperformance, as its overall sector asset allocation was a positive influence on its relative performance. Stock selection was detrimental to the Fund's relative returns in sectors that included materials and banks. This was partly offset by positive stock selection in the utilities and financials ex-banks sectors.

In terms of its sector asset allocation, exposures that benefited the Fund included being underweight in the consumer discretionary sector and overweight in telecommunication services. Being slightly underweight in the energy and industrials sectors was detrimental to the Fund's relative performance, however.

At the end of the quarter, the Fund's overweight positions included consumer staples, healthcare, and utilities, while it was underweight in areas such as materials, industrials, consumer discretionary, and banks.

Outlook

The Fund's investment manager notes that data released in December indicated a slowdown in European lending from October to November, due to a combination of tighter credit and sagging demand. The ECB's 0.75% reduction in interest rates in December was the largest single cut in the eurozone's 10-year history. Meanwhile, a drop in German inflation for the month suggested that the inflation rate for the eurozone as a whole will be within the ECB's target range, which many observers believe should give it more flexibility in terms of interest rate decreases. Although until only recently the central bank believed that room for additional cuts was very limited, rates were reduced another 0.50% in January. Despite the difficult backdrop, the Fund's investment manager continues to believe that value can still be found in European equity markets, and as a disciplined, long-term investor it continues to seek attractive stocks regardless of the environment.

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Legg Mason US Equity Fund

Market Review (All returns shown in this commentary are in US dollar terms unless otherwise stated)

The S&P 500 Index rallied a little over +1% in December, thus allowing 2008 to go into the record books as the worst year since 1937, rather than the worst year since 1931. A small victory, one might argue, but it was a welcome relief to see some "green on the screen" for a change. In truth, the S&P 500 has quietly rallied quite nicely off its November 20 bottom, up +20.47% on a total return basis through year end. Encouragingly, the rally continued in early 2009 with the S&P 500 managing to post a modest gain in the first 5 trading days of January, which historically has augured well for a positive January, which in turn has augured well for a positive year in the market. We have discussed the so-called "January Barometer," first identified by Yale Hirsch, in previous years. Some commentators have written it off as an irrelevant calendar anomaly. We're not so sure. In our view, anything that happens 94.6% of the time – which is the percentage of times since 1950 that the market is up for the year after being up in January – is worth some attention. Far more often than not, in our experience, trading patterns in January have tended to set the tone for the year.

US Index Returns

	December	Q4	2008
S&P 500 Index	+1.06%	-21.94%	-37.00%
Dow Industrials	-0.39%	-18.38%	-31.93%
Nasdaq Composite Index	+2.79%	-24.37%	-39.98%
S&P Mid-Cap 400 Index	+4.85%	-25.55%	-36.23%
Russell 2000 Index	+5.80%	-26.12%	-33.79%
Dow Jones Wilshire 5000 Index	+1.59%	-23.48%	-38.68%
S&P 100 Index	-0.02%	-20.10%	-35.31%
Russell 1000 Growth Index	+1.81%	-22.79%	-38.44%
Russell 1000 Value Index	+1.39%	-22.18%	-36.85%

Sources: Wilshire, Russell®, NASDAQ® via (Bloomberg) and S&P via (Bloomberg).

The pattern of returns in December provides some evidence of an increasing appetite for risk among investors, with the Russell 2000 Index, S&P MidCap 400, Nasdaq Composite, and the Russell 1000 Growth Index showing the best returns among major market indices, while the Dow Industrials and S&P 100 Index – the two strongest major market indices going into the month – lagged. The message – if there is one – from S&P 500 sector returns is less clear. The relative strength in consumer discretionary and technology stocks and weakness in consumer staples and utilities is supportive of the view that investors became a bit more venturesome in December. On the other hand, health care – a traditional safe haven – was the best performing S&P 500 sector for the month, and financials – the year-long wallflower group – remained weak.

Despite being down -37% in 2008, the S&P 500 Index fared reasonably well compared to most foreign markets. Of the nine foreign markets listed below, only the Japanese market performed better in U.S. dollar terms. Yen-based returns for the NIKKEI 225 were -41.14%, but yen appreciation versus the dollar in 2008 cut dollar-based losses in Japan to -26.51%. The abysmal performance of the Russian market (-73.64% in dollars) was exceeded only by the total collapse of the Iceland stock market (not shown below), down over 94% in 2008.

International Index Returns in US Dollars (%)

	December	2008
FTSE 100 Index (UK)	-1.89	-47.06
DAX Index (Germany)	+14.44	-42.80
CAC 40 Index (France)	+8.45	-42.90
MICEX Index (Russia)	-7.32	-73.64
NIKKEI 225 (Japan)	+10.21	-26.51
Hang Seng Index (HK)	+3.63	-46.05
Kospi Index (So. Korea)	+13.53	-58.98
Shanghai SE Comp.(China)	-2.42	-62.43
BSE Sensex 30 Index (India)	+9.33	-60.97

Source: Bloomberg.

A number of words come to mind to describe 2008, most of them not printable in a business-oriented publication. Perhaps the word that captures the zeitgeist of the year best is "extreme." Merriam-Webster defines "extreme" as "exceeding the ordinary, usual, or expected," and "going to great or exaggerated lengths." That sounds like 2008 in spades to us, when extremes ran in both directions. On the downside,

Legg Mason US Equity Fund

we saw extreme declines in stock prices, car sales, housing starts, consumer confidence, Treasury rates and bullish sentiment. On the upside, we saw extreme increases in stock price volatility, housing delinquencies and foreclosures, valuation spreads, credit spreads of all descriptions, cash in money funds and bearish sentiment. We even saw some extremes in both directions for the same item. Oil hit a high of \$147 in July supposedly on its way to \$200, then collapsed to \$32 in December, with many calling for a further drop of \$20 to \$25. If that's not extreme, we don't know what is.

The extremes we have all endured in 2008 have created an enormous degree of stress among investors. Under stress, human-beings react fairly predictably. Their time horizon shortens dramatically and their decision-making processes tend to be driven by their limbic system (or lower-brain function) which reacts instinctively and emotionally. Longer-term plans and rational thought go out the window and avoidance of pain becomes the dominant objective. Investment decisions made in this state are often emotionally satisfying in the short term, but often financially injurious in the long-run.

Because the news flow over the next couple of quarters is likely to be pretty grim, it will not be easy for investors to fight the all-too-human tendency to seek the safety and security of cash, the financial equivalent of hiding under the bed. We urge investors to fight this tendency. In our view, investment opportunities abound in the current environment in nearly every asset class but cash. Waiting for the economic all-clear signal could therefore prove quite expensive, in our judgment, in terms of lost opportunity. In other words, the opportunity cost of holding cash is currently "extremely" high in our view, while the financial rewards for holding it are fast approaching zero.

Portfolio Performance

The Legg Mason US Equity Fund portfolio outperformed the S&P 500 Index in the month of December, gaining +10.75%¹ in sterling terms versus a +7.86% gain for the index in sterling terms. For the full year 2008, the portfolio trails the S&P 500, down 42.44% versus a loss of 12.77% for the index. As a point of interest, since the market low on the 20th November until the end of the year, the portfolio has significantly outperformed the S&P 500.

Legg Mason US Equity Fund Top Contributors December '08²

	% Weight	% Return	Impact
Aetna Inc.	5.93	30.61	1.72
UnitedHealth Group Inc.	6.71	26.61	1.64
Amazon.com, Inc.	6.20	20.08	1.46
The AES Corporation	6.87	7.15	0.44
Time Warner Inc.	3.77	11.08	0.43
CA Inc.	3.54	10.04	0.33
NYSE Euronext	2.16	16.48	0.32
Sears Holdings Corporation	3.33	7.23	0.32
Nucor Corporation	1.07	30.47	0.29
eBay Inc.	4.15	6.32	0.29

Aetna and UnitedHealth Group. Managed care holdings Aetna and UnitedHealth Group rebounded nicely to lead the portfolio's December returns. Shares of the two companies had sold off in November as investors questioned the integrity of their investment portfolios amid severe credit market dislocations. Those fears abated as market liquidity improved and as the companies provided additional disclosure, leading to strong share price gains. Aetna, for example, allayed balance sheet concerns when the company outlined its liquidity and capital position in a conference call with analysts. As an indication of confidence in its balance sheet, the company repurchased \$100m of stock during the first two months of Q4. Further, the company believes it has \$1bn capacity for acquisitions and/or further repurchases. Similarly, UnitedHealth's December analyst meeting took an optimistic tone when the company maintained its guidance and laid out plans to generate \$4bn of free cash flow for 2009, \$2.5bn to \$3bn of which will be used to repurchase its own shares. With a diversified revenue stream, UnitedHealth appears well positioned to weather the current downturn, and its significant presence in the Medicaid market should benefit from the expanded State Children's Health Insurance Program (SCHIP) programme and increased Medicaid funding under the Obama Administration.

¹ **Source for performance figures** - Morningstar, NAV to NAV with net income reinvested without initial charges but reflecting annual management fees, based in sterling for A class shares. Copyright © 2009, Morningstar, Inc. All Rights Reserved. For more information, visit www.morningstar.co.uk

² This attribution represents our unconstrained portfolio. Exact weightings in some client portfolios may differ slightly from the model, and therefore, precise attribution may also differ slightly.

Legg Mason US Equity Fund

Retail. A gloomy retail environment seemed to have overshadowed even the secular growth trend of online commerce, judging by reports showing a 4% decline in fourth quarter e-commerce sales from last year's levels. Nevertheless, Amazon.com once again managed to report its "best holiday season ever," with its peak day unit volume up 17% from last year's record. With its customer focus, cost advantage and free shipping, Amazon is relentlessly gaining share in the online market, and its revenue growth in recent several quarters has significantly exceeded the industry average. Its shares gained 20% in December.

In a beaten down market segment tied to the "tapped out" US consumers, however, it does not take stellar fundamental results to generate positive returns. Despite minimal growth in gross merchandise volume on its namesake auction platform, EBay saw its shares up 6%. Even Sears Holdings, the struggling retailer that investors love to hate, managed to post a 7% gain in December after reporting a disappointing third quarter and pulling guidance for the fourth quarter. Management showed continued confidence with an additional share repurchase of \$81m in the third quarter, while most retailers are hoarding cash. Continued share repurchase activity also implies management is comfortable with Sears' liquidity position.

AES. Global power producer AES rose 7% in December. The stock's rebound from its five-year low of \$5.80, reached on December 5, appeared to be catalysed by nothing other than valuation. With falling commodity prices, slowing growth in emerging markets and a significant but poorly understood debt load, on the surface AES has a lot that makes one cautious. However, with benefits from lower fuel input prices, power growth overall pretty stable and most of the apparent debt actually non-recourse debt at a subsidiary level, if the market continues to value AES below the worth of its existing projects, then investors are presented with an attractive call option on the company's long-term growth potential for free.

Time Warner. The coming new year reminded investors of Time Warner's pending divestiture of its cable business and the increasing probability that its struggling AOL division, which is splitting into Access and Content/Advertising pieces for easier digestion by potential suitors, may be either turned around or sold. This should help investors focus on the value of Time Warner's cable network, movie and publishing "stub," whose valuation is the lowest in the media sector. Despite the 10% gain during December, Time Warner's shares still have a significant valuation gap versus their peers.

NYSE Euronext. NYSE Euronext, the operator of the prestigious New York Stock Exchange and a number of other cash and derivative exchanges, enjoyed a strong month without any apparent driver. Scuttled merger talks between the company and Germany's Deutsche Borse were enough to pique investors' interest and send its shares 16% higher. While the near-term outlook remains subdued as a result of weak volumes in stock and derivatives markets, the significant cost synergies from consolidating trading platforms may continue to encourage industry mergers and acquisitions, supporting the company's valuation.

CA. CA gained 10% after the software company increased its margin and cash flow projections in an upbeat analyst meeting in early December. After being mired in accounting irregularities years ago and the prolonged turnaround period that followed, the company seems to be emerging with accelerating sales and better profitability. The defensive nature of its business (driven by multi-year contracts covering mission-critical IT functions) is gaining greater appreciation in today's market, and secularly CA appears well positioned to benefit from the consolidation in the system management software market, where the company is the largest player.

Steel. Finally, the 30% surge in steel producer Nucor followed the company's preannouncement in early December cutting its fourth quarter guidance well below consensus estimates. Apparently, with rival ArcelorMittal's EBITDA forecast falling 50% below consensus, investors had been expecting worse for Nucor. Relative to peers, Nucor's greater control over its cost structure, its balance sheet strength, and the fact it still expects to break even at a 50% capacity utilisation level point to the company's more attractive risk-reward profile within the industry during this down cycle, in our view.

Legg Mason US Equity Fund Bottom Contributors December '08²

	% Weight	% Return	Impact
Citigroup Inc.	2.77	-18.61	-0.59
Eastman Kodak Company	2.93	-12.51	-0.46
Merrill Lynch & Co., Inc.	2.64	-11.63	-0.35
Electronic Arts Inc.	1.86	-15.84	-0.32
State Street Corporation	2.70	-6.03	-0.23
American Express Company	0.66	-20.01	-0.16
3M Co.	0.54	-13.89	-0.10
Bank of America Corporation	0.73	-11.30	-0.10

Financials. On the negative side, credit and capital concerns continued to haunt some of the portfolio's credit-oriented financials like Citigroup and Bank of America. Credit rating agency Moody's downgraded Citigroup's rating to A2 from Aa3 on December 18, followed by a similar cut by S&P on the next day, citing tangible equity cushion that had been worn thin by credit losses. While the immediate effects of the downgrades should be insignificant, they signalled lingering investor concerns, which the company sought to address in a conference call

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following the rating actions. In addition to the November government support, which bolstered Citi's Tier 1 capital by \$65bn, the company's efficiency initiative should also help by reducing total costs by 17% on a year-on-year basis. Shares of Citigroup declined 19%, while rival Bank of America (along with Merrill Lynch, whose merger with Bank of America was finalised in early December) slipped 11%, due to similar concerns as investors fretted about a low tangible common equity (TCE) ratio. We note, however, that from a regulatory standpoint, both companies have adequate Tier 1 capital (14.8% for Citi and 9.4% for Bank of America, both well ahead of the 6% regulatory minimum), and both are trading at depressed valuations of less than one times tangible book.

Credit concerns also hurt shares of State Street (down 6%) and American Express (down 20%). In State Street's case this was particularly questionable, as their business model is not driven by traditional spread lending and are not highly credit intensive. Instead, State Street specialises in processing as the world's third largest custody bank with a strong technology platform and a large global institutional client base. Further, while American Express definitely has a spread lending component, the company derives two thirds of its pretax income from running a proprietary global payment network and one of the world's largest travel agencies, making it less exposed to credit than many believe. Both companies are well capitalised with Tier 1 capital ratios of 18.6% for State Street and 11.8% for American Express, and are among the favoured group of financial institutions covered by the TARP.

Consumer Discretionary/Industrials. Outside of the financial sector, shares of Eastman Kodak dropped 12.5% after the company withdrew its '08 guidance, which it reduced merely one month before, due to the "deepening global recession." The company remains on track with its strategic initiatives, including the continued transition to digital, accelerated cost cutting, and additional revenue from monetising its intellectual property portfolio. In addition, the headwind of high commodity prices will become a tailwind with the recent commodities sell off. With ample cash of more than \$6 per share and limited debt maturities over the next few years, we believe Kodak is well positioned to weather the current downturn.

The 16% decline in the shares of Electronic Arts followed the company's disappointing announcement that its FY'09 revenue and EPS would fall short of previously reduced guidance. With investors clearly growing impatient with the glacial pace of its turnaround, the company followed up with plans to cut 10% of its workforce and consolidate nine studios, resulting in up to \$120 million in annual cost savings (vs. the \$50 million savings previously targeted). Manufacturing conglomerate 3M similarly saw its shares tumbling 14% after cutting '08 guidance that it reaffirmed in late October and issuing '09 guidance below expectations, citing production volume weakness. On the positive side, the company still sees resilient product pricing and flat margins, thanks to restructuring cost savings, lower raw material costs and productivity gains.

Outlook

We believe it is increasingly likely that November 20, 2008 marked the bottom of this bear market cycle for the major indices such as the S&P 500 Index and Dow Industrials. Whether or not, and how closely, we revisit those lows as the market goes through its bottoming process is an open question. Our current thinking is that while corrections are inevitable as the bottoming process unfolds, we do not believe we will see 750 on the S&P 500 or 7449 on the Dow Industrials again. We most sincerely hope that we do not. We expect 2009 to be a tug-of-war between the near-term outlook – which will continue to be very challenging – and the long-term investment opportunity offered by common stocks at present – which we believe is quite substantial. Ultimately, we expect this tug-of-war to be resolved on the upside and believe the Dow and S&P 500 could both be up 25% to 30% for the year. That might seem "extreme," but such gains would do nothing more than return those indices to the ranges in which they traded as recently as September 2008.

Figuring out what the economy and the market will do next is not easy, some would say impossible, but in my role as Chairman of the Investment Policy Committee and author of these monthly market commentaries, it is my job to give it my best shot. Our approach at LMCM has been to analyse what we know, make what we regard as reasonable assumptions about what we don't know, and then try to figure what portion of the knowns, and what likelihoods about the unknowns, the market has already discounted.

What we know about the current economic outlook is that it is bad. We know recent job losses have been severe and the unemployment rate is on the rise. We don't know how high it will go, but a good guess seems to us to be 8% or a bit higher by late 2009 or early 2010. We know domestic manufacturing is weak, the December report from the Institute of Supply Managers (ISM) that their factory index dropped to 32.4, the lowest reading since June 1980, tells us that. We don't know how much further manufacturing will fall, but we may be seeing the worst of it right now. Based on data from Case-Shiller, we know that house prices have fallen 18% for the 12 months ended October 2008, but, again, we don't know how much further they will fall. Our working assumption is that house prices will stabilise by mid-2009, down another 10% to 15% from here. We know that GDP will be very weak in the fourth quarter, the only question is how weak and for how long. We are expecting GDP growth of -6% or so in the fourth quarter, with a similar decline in the first quarter of 2009 and some modest improvement in the second quarter but still negative growth on the order of -4%. As of now, we're expecting modest positive GDP growth in the latter half of 2009. We know that earnings estimates for many companies and the S&P 500 as a whole are declining, the question, again, is by how much. The top-down 2009 estimate for the S&P 500 is now \$42.24 (from S&P) and \$65.36 (from Reuters). The corresponding bottom-up estimates are \$81.80 and \$76.43. Using the wisdom of crowds and averaging all those estimates together, we get about \$66.50. That seems like a reasonable place to set initial expectations for S&P 500 earnings for 2009.

Legg Mason US Equity Fund

As is obvious from the statistics on the previous page, most of what we know about the economy is not terribly encouraging. The question, though, is whether the market has discounted this news already or not. Our inclination is that it has. It's important to remember that the market **is a discounting mechanism**. The S&P 500 declined 52% from its peak on October 9, 2007 to the current trough of November 20, 2008, its worst such decline since the 1930s. Why? We think it's because it foresaw better than most observers (including us, by the way) the bad news that we're all reading about in the papers and hearing about on CNBC now. In similar fashion, the market will begin to rally before the news improves. In fact, it may have already begun to do so. Through today (08/01/09), the S&P 500 has returned 21.44% since November 20, 2008. Is the market saying the worst is over, or even if it's not, that the worst has been discounted? We don't know for sure, but a number of things suggest to us that this might be the case.

What is the market seeing that it finds encouraging? What are we seeing? For one thing, credit markets have begun to free up and credit spreads have started to narrow. Junk bonds have enjoyed a spirited rally since mid-December. Corporate bonds have also begun to act better. This is a necessary precondition to a sustained improvement in the stock market and economy, in our judgment. The TED spread is down from 450 basis points to 150 basis points, its lowest level since the collapse of Lehman Brothers. Credit Default Swap spreads have also narrowed materially. Finally, the Volatility Index (VIX), often referred to as the "Fear Index," has come down from the stratosphere. All of these developments are good news for the economy and the stock market.

Another thing we find very encouraging is that valuation spreads, which had blown out to an all-time record of over four standard deviations above their mean value since 1952, have begun to narrow, and valuation-based strategies have begun to perform exceptionally well. In our view, this is evidence that a measure of rationality is beginning to be restored to the pricing of stocks.

Investor behaviour is also worthy to note and consistent with their behaviour at prior important lows. Investors as a group are, unfortunately, their own worst enemies when it comes to making money in the market. They can be reliably predicted to throw money at the market after it has gone up, as they did by pouring \$260 billion into U.S. focused Equity Mutual Funds in 2000. Equally predictably, they were massive net sellers of domestic equity funds in 2008, withdrawing \$168 billion, most of it in the fourth quarter after nearly all the damage had been done to stock prices for the year. What investors want most dearly now is cash, and they have piled up \$3.8 trillion of it in money market funds. This cash hoard is now equal to a record 37.7% of the total market value of U.S. common stocks. Investors seem content to hold cash for now, but as the yield on money funds drops meaningfully below 1%, and especially if stocks and bonds continue to rally, investors' views on the desirability of holding cash will likely change.

A final thing we find encouraging about the current market environment is that the long-term returns on stocks have historically been powerfully mean-reverting. Periods of above average returns are followed by periods of below average returns which, in turn, give way to renewed periods of above average returns. The mid-teens returns of the 1980s and 1990s have been followed in the new millennium by a period of distinctly sub-par returns. Since the beginning of 2000, the nine-year return of the S&P 500 Index has been -28.13% (or -3.60% compounded). As we noted in our November monthly, measured to the November 20, 2008 low, the 10-year annualised total return of the S&P 500 is -2.66%, a cumulative loss of -23.59% over that period, according to calculations from Steve Leuthold. The total return loss for that 10-year period matches the worst 10-year performance in U.S. stock market history, 1929 to 1939. That's bad news looking backwards, but quite likely to be good news looking forward, because, according to Leuthold, since 1926, when trailing 10-year compound annual returns have been 1% or less, subsequent 10-year compounded annual returns have averaged 10.7%, in a range of 7.2% to 15.6%.

David E. Nelson, CFA
Chairman, Investment Policy Committee
Legg Mason Capital Management

Legg Mason US Equity Fund

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January 2009

Ref: 4252

Legg Mason Global Equity Income Fund

Market Review

The fourth quarter of 2008 completed a year of extreme volatility and disillusionment in the global equity markets. Despite a rally off November lows, most markets recorded significant losses for the final quarter of 2008. During the quarter, global policymakers embraced quantitative easing to help alleviate financial and credit market distress across the world. Despite significant government actions, credit markets remained strained and the global economic recession continued to run its course. At year end, investors were left to contemplate significant losses across almost all asset classes.

The MSCI World index was down -20.64% in local terms and -21.77% in US dollar terms. Index markets were negative across the board, with major indices in Europe reporting significant declines in local terms: Austria -42.63%; Belgium -36.36%; Italy -22.26%; and the UK -8.71%. In Asia, major country indices reported declines as reflected by Japan -22.30%, Singapore -25.69%, and Hong Kong -18.91%, respectively. On a relative basis, the US market underperformed the EAFE markets as the S&P 500 Index returned -21.94% versus -19.95% for the MSCI EAFE Index in US dollar terms. Performance in emerging markets was also dismal, with the MSCI Emerging Markets Index reporting -21.99% in local currency terms.

Fund Review

Against this backdrop, the Legg Mason Global Equity Income Fund, which was launched on the 23rd May, 2008, posted a return of +0.4%¹ in sterling terms over the quarter, while its benchmark, the MSCI World Index, fell by 3.02%, also in sterling terms, over the same period.

In terms of stock selection, the manager's positions in British American Tobacco, the international cigarette manufacturer, Bristol-Myers, the healthcare company, Park 24, the Japanese parking company, and Neopost, the French mailroom equipment company, all contributed positive returns. Turning to sector allocation, the Fund's underweight exposure to energy and overweight position in financials detracted from performance.

Turning to country allocation, the manager's positions in the US and Europe both made positive contributions to Fund performance as did the small but overweight bets in Hong Kong and Malaysia.

Outlook

The manager anticipates that economic growth will be difficult to generate in most developed economies in early 2009, with the duration of the slowdown mainly a function of the speed, impact and magnitude of the economic stimulus. Clearly the contraction in economic activity around the world and the risk of deflation will provide further impetus for central bank rate cuts – with the US essentially moving rates to zero. Additionally, it anticipates that fiscal policy actions and other initiatives planned by the new US president could be beneficial if actions are taken swiftly and executed correctly. Interest rates continue to fall around the world as inflation expectations fade. Commodity prices continued to decline during the quarter, taking pressure off of consumers around the world. As true value investors, it believes that markets have begun to 'normalise' and securities are increasingly tied to their underlying fundamentals.

Currently, the manager is very optimistic about the prospects of specific global companies going forward. It believes stocks are oversold and attractively valued in its models. Input cost pressures are moderating. The manager anticipates solid opportunities for high quality firms with strong profits and dividends and strong balance sheets – in other words, the strong getting stronger. It sees value in virtually all sectors with a focus on seeking superior business models that combine a large margin of safety with significant recovery potential. Its research analysts are evaluating their sectors for stocks that can generate solid returns over time, including quality emerging market companies and high value-added basic industries. Although the manager is a 'bottom up' stock picker, it believes Asia is an extremely interesting region currently: high yields, low valuations; low expectations; solid balance sheets; and, plenty of cash. It is also finding good values in Japan across all market capitalisations.

This Fund is managed by Global Currents Investment Management

¹ Class A Income Shares.

Performance figure source: Morningstar, NAV to NAV with net income reinvested without initial charges but reflecting annual management fees, based in sterling for A class shares. Copyright © 2009, Morningstar, Inc. All Rights Reserved. For more information, visit www.morningstar.co.uk

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January 2009

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Legg Mason Sterling Corporate Plus Bond Fund*

Key Points

- The Legg Mason Sterling Corporate Plus Bond Fund posted a return of -12.97%¹ in sterling terms over the fourth quarter, lagging the IMA UK corporate bond sector, which returned -2.14%.
- While government bonds rallied and UK gilts, in particular, performed strongly, non-government bonds continued to struggle over the period as the credit crisis deepened.
- The manager believes policymakers are likely to be successful in restoring a degree of stability to the global financial system. Indeed, it believes there is a profitable opportunity for investors with a medium- to long-term horizon.
- The manager continues to focus its strategy on the non-government sectors that it believes will perform well once market volatility begins to settle and investors start to take on risk.

Market Review

The credit crisis deepened over the fourth quarter and investors continued to position themselves for a drawn-out recession and the possibility of a prolonged period of deflation, leading to a sharp rally in global developed government bond markets. UK gilts outperformed the other major developed government bond markets during the fourth quarter as the Bank of England (BoE) was more aggressive than most of its counterparts in reducing rates during the period. Meanwhile, all non-government bond sectors underperformed government issues. The central banks and governments of the major developed economies responded with extraordinary measures. While this helped non-government bonds to rebound moderately in the US in late December, eurozone and UK markets continued to struggle in the run up to year end.

The Federal Reserve slashed its funds rate from 2.0% at the beginning of the quarter to a target of between 0.25% and zero in December and continued to implement other, more innovative, measures of monetary stimulus. Although the European Central Bank (ECB) and BoE had initially been hesitant in reducing policy rates, they have belatedly reacted to the gravity of current conditions. The ECB reduced rates by a cumulative 175 bps over the quarter, while the BoE slashed rates by a cumulative 300 bps. (Both the ECB and the BoE cut rates by a further 50 bps in January.)

Within non-government bonds, US mortgage-backed securities (MBS) and US and eurozone investment grade corporates managed to record positive total returns over the quarter. The Fed's plans to directly purchase agency-backed issues provided support to MBS late in the quarter. Meanwhile, UK investment grade corporate bonds and high yield corporate bond markets in all regions recorded further losses, as these asset classes suffered the most from investors' increased risk aversion.

Fund Review

The Legg Mason Sterling Corporate Plus Bond Fund posted a return of -12.97%¹ in sterling terms over the fourth quarter, lagging the IMA UK corporate bond sector, which returned -2.14%.

During the quarter, the Fund's exposure to investment grade corporate bonds – emphasising European subordinated bank issues – and its moderate and well diversified exposure to high yield corporate bonds, had a negative impact on performance. The poor performance of these asset classes was largely driven by investors' increased risk aversion and pessimistic economic outlook. Meanwhile, the Fund's exposure to mortgage-backed securities (MBS) and US Treasuries provided some relief.

Outlook

The manager believes policymakers are likely to be successful in restoring a degree of stability to the global financial system. Once liquidity conditions improve, it believes the pricing of riskier asset classes should stabilise. While the manager recognises that this view is relatively bullish, it does not expect economic conditions to be rosy for quite some time. As a result, it thinks credit spreads are not likely to enjoy as sharp a reversal as they have when past financial crises came to an end.

* Previously known as the Legg Mason Strategic Bond Fund.

¹ Source for performance figures: Morningstar, NAV to NAV with net income reinvested without initial charges but reflecting annual management fees, based in sterling for A class shares. Copyright © 2009, Morningstar, Inc. All Rights Reserved. For more information, visit www.morningstar.co.uk

Legg Mason Sterling Corporate Plus Bond Fund

Nevertheless, the manager believes there is a profitable opportunity for investors with a medium- to long-term horizon. Indeed, it believes that the economy does not have to stage a rebound for pricing on risk assets to improve. The market has priced in a deflationary economic scenario for years to come. Anything less catastrophic would be positive for investors with a bias away from government debt.

The manager continues to focus its strategy on the non-government sectors that it believes will perform well once market volatility begins to settle and investors start to take on risk. It aims to maintain an emphasis on investment grade corporate bonds, with a particular focus on financials. Indeed, the manager favours deposit-taking institutions with diversified revenue streams. It also aims to maintain a modest allocation to US MBS and a well-diversified exposure to high yield corporate bonds.

This Fund is managed by Western Asset Management

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Legg Mason US Smaller Companies Fund

Market Review

Both large- and small-cap securities were poor performers in a difficult fourth quarter. The S&P 500 Index was down 21.9% and the small-cap Russell 2000 Index fell 26.1%, both in US dollar terms, their worst quarterly showing since 1987's fourth quarter. Calendar-year performance was also disappointing for both indices – the S&P 500 was down 37.0% in 2008 versus a loss of 33.8% for the Russell 2000 (its worst year ever), again both in US dollar terms.

Three- and five-year US dollar returns to the end of December were in negative territory for both the Russell 2000 and the S&P 500. Ten-year US dollar returns for the S&P 500 were also negative, and were among the worst in the long history of the large-cap index.

Within small-cap, value continued its outperformance, with the Russell 2000 Value index down 24.9% in the fourth quarter versus a loss of 27.5% for the Russell 2000 Growth Index, both in US dollar terms. The same pattern was evident in calendar year results. For 2008, the Russell 2000 Value Index declined 28.9% versus a loss of 38.5% for the Russell 2000 Growth index, again both in US dollar terms.

Micro-cap results were even worse, with the Russell Microcap Index down 28.1% in the fourth quarter and down 39.8% for the full year, both in US dollar terms.

From the low on the 20th November, 2008 until the 31st December, 2008, equities staged a dynamic rally, with the Russell 2000 gaining 30.0% versus 20.5% for the S&P 500, both in US dollar terms.

Fund Review

The Royce Smaller Companies Fund struggled in what was one of the worst performance quarters ever for smaller-cap companies. The Fund marginally underperformed its benchmark index, the Russell 2000 Index, for the fourth quarter, posting a return of -9.59%¹ in sterling terms against a benchmark return of -8.41%, also in sterling terms, as it did for the full year, with a return of -13.17% against an index return of -8.33%. However, the Fund has outperformed the Russell 2000 Index since inception.

Fourth-quarter performance was negative across all but one of the Fund's nine major sectors. Natural resources was by far the worst performer for the quarter, followed by industrial products, technology and consumer products. At the industry level, substantial losses came from the energy services group, where losses were greater than for any of the Fund's sectors. The metal fabrication and distribution industry, semiconductors and equipment businesses, commercial services (in the industrial services sector) and apparel, shoes and accessories companies also fared poorly. The health sector made a modest positive contribution.

For the full year, results were similar with all but one of the Fund's nine equity sectors in negative territory. Natural resources made a substantial negative impact, led by energy services companies. Industrial products, technology and consumer products also posted large losses. Health was the only sector with positive, albeit quite modest, performance for the year.

The three worst stocks for the quarter were all in the natural resources sector and consisted of Major Drilling Group International, Trican Well Service and Unit Corporation. The three best performing stocks were Randgold Resources in the natural resources sector, Endo Pharmaceuticals Holdings in health and Agnico-Eagle Mines, also in the natural resources sector.

Outlook

The manager believes that the significant selling pressure that climaxed in November has produced extremely attractive valuations and set up the potential for strong returns for both large- and small-cap securities over the next three-to-five years. Indeed, the manager has been focusing on trying to lay the foundation for success once the market rebounds and observes that the number of attractive opportunities in today's smaller companies' market dwarfs anything it has seen in the past.

This Fund is managed by Royce & Associates

¹ **Source for performance figures** - Morningstar, NAV to NAV with net income reinvested without initial charges but reflecting annual management fees, based in sterling for A class shares. Copyright © 2009, Morningstar, Inc. All Rights Reserved. For more information, visit www.morningstar.co.uk

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Legg Mason Funds ICVC

Legg Mason Global Multi Strategy Bond Fund

Key Points

- The Legg Mason Global Multi Strategy Bond Fund returned -4.60%¹ over the fourth quarter, underperforming the IMA Global Bond sector, which returned 12.43%.
- Fund performance was affected by the poor performance of non-government bond markets compared to government issues over the quarter. While the Fund has significant exposure to corporate bonds and emerging market debt, the sector contains a number of funds that are largely weighted towards government bonds.
- The manager believes there is a profitable opportunity for investors with a medium- to long-term horizon. Indeed, it believes that the economy does not have to stage a rebound for pricing on risk assets to improve.
- The manager believes a well diversified portfolio should benefit from a gradual improvement of liquidity conditions and a reduction of elevated spread levels that more than compensate for rising defaults at current levels.

Market Review

The credit crisis deepened over the fourth quarter and investors continued to position themselves for a drawn-out recession and the possibility of a prolonged period of deflation, leading to a sharp rally in global developed government bond markets. Meanwhile, all non-government bond sectors underperformed government issues over the quarter. The central banks and governments of the major developed economies responded with extraordinary measures. This helped non-government bonds to rebound moderately in the US in late December, while eurozone and UK markets continued to struggle in the run up to year end.

The Federal Reserve slashed its funds rate from 2.0% at the beginning of the quarter to a target of between 0.25% and zero in December and continued to implement other, more innovative, measures of monetary stimulus. Although the European Central Bank (ECB) and Bank of England (BoE) had initially been hesitant in reducing policy rates, they have belatedly reacted to the gravity of current conditions. The ECB has reduced rates by a cumulative 175 bps, while the BoE has slashed rates by a cumulative 300 bps in recent meetings. The Bank of Japan reduced rates by 40 basis points.

Emerging market bonds

Emerging market debt continued to suffer as spreads widened and currencies plunged in sympathy with riskier asset classes. Although fundamentals remained positive, investors' reduced appetite for risk led investors to seek safety in the US dollar. A modest rally late in the quarter, particularly in the corporate sector, provided some relief. US dollar-denominated bonds generated a total return of -4.8%. Meanwhile, local currency debt generally performed well as central banks reacted to the worsening economic backdrop with interest rate cuts. Excluding the negative impact of currency depreciation, local currency emerging market debt returned 6.0%.

Mortgages/TIPS

The Fed's announcement of a purchase programme for agency-backed issues provided support to the asset class over the quarter. However, mortgage-backed securities (MBS) still underperformed Treasuries as the economic environment became highly uncertain. MBS returned 4.2% over the quarter. US Treasury Inflation-Protected Securities (TIPS) suffered as oil prices plunged and the market focused on the prospect of deflation. TIPS underperformed conventional Treasuries, with returns of -2.7% and 9.1% respectively.

Investment grade

As credit conditions deteriorated and government support had yet to make a meaningful impact on the availability of credit, spreads on investment grade corporate bonds reached record wide levels. Financials were hit particularly hard, with subordinated financial debt continuing to be severely challenged in the European market. While US corporate bonds posted a moderate rebound late in the quarter, the eurozone and UK markets continued to struggle. On a regional basis, the US outperformed the eurozone and the UK in local currency terms with returns of 1.6%, 0.3% and -0.1% respectively.

¹ Class A Distr. (D) US Dollar Shares.

Source for performance figures: Morningstar, NAV to NAV with net income reinvested without initial charges but reflecting annual management fees, based in sterling for A class shares. Copyright © 2009, Morningstar, Inc. All Rights Reserved. For more information, visit www.morningstar.co.uk

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High yield

Global high yield bonds remained under severe pressure, with the US market recording its worst quarterly performance on record. Spreads soared to new highs in the wake of a collapse in credit extension, a sharp deterioration in the global economy and concerns over soaring default rates. The US market saw some improvement before year end. The asset class was the weakest performer within fixed income in all the major regions, with total returns ranging from -15.1% to -22.7% in local currency terms.

Foreign government bonds

Peripheral market returns were mixed, with Australian bonds gaining slightly as the central bank began cutting rates, while Hungarian bonds struggled on the back of a rate increase.

Fund Review

The Legg Mason Global Multi Strategy Bond Fund returned -4.60%¹ over the fourth quarter, underperforming the IMA Global Bond sector, which returned 12.43%. Fund performance was affected by the poor performance of non-government bond markets compared to government issues over the quarter. While the Fund has significant exposure to corporate bonds and emerging market debt, the sector contains a number of funds that are largely weighted towards government bonds.

During the quarter, the Fund's exposure to subordinated financials and global high yield corporate bonds were the main detractors from performance. Meanwhile, the Fund's small exposure to the Japanese yen assisted returns.

Portfolio activity

During the quarter, the manager increased the Fund's exposure to eurozone government bonds. It also increased its exposure to TIPS (to around 6% of the Fund). Although it temporarily increased its exposure to MBS during the quarter, the allocation ended the quarter unchanged at an overweight position of 30%. The Fund's overall allocation to investment grade corporate issues was increased to around 20%, adding to both US non-financials and select emerging corporates, and it maintained a diversified exposure to US and European high yield corporate bonds (of between 25 and 30%) with a focus on less cyclical sectors. Within investment grade corporate bonds, the manager maintained positions in subordinated financials, as it believes valuations remained attractive and continued to reflect investors' fear rather than long-term fundamentals. In emerging markets, the manager reduced its exposure to local currency denominated government bonds in favour of foreign currency denominated debt. The Fund's local emerging market exposure (including peripheral markets) was reduced by around 3% to target levels of around 7%, with a further 7% allocated to external emerging market corporate bonds and 8% allocated to external government issues. In currencies, the manager reduced its exposure to local emerging market currencies. .

Outlook

Summary

The manager believes policymakers are likely to be successful in restoring a degree of stability to the global financial system. Once liquidity conditions improve, it believes the pricing of riskier asset classes should stabilise. While the manager recognises that this view is relatively bullish, it does not expect economic conditions to be rosy for quite some time. As a result, it thinks credit spreads are not likely to enjoy as sharp a reversal as they have when past financial crises came to an end.

Nevertheless, the manager believes there is a profitable opportunity for investors with a medium- to long-term horizon. Indeed, it believes that the economy does not have to stage a rebound for pricing on risk assets to improve. The market has priced in a deflationary economic scenario for years to come. Anything less catastrophic would be positive for investors with a bias away from government debt. A well diversified portfolio should benefit from a gradual improvement of liquidity conditions and a reduction of elevated spread levels that more than compensate for rising defaults at current levels.

Emerging markets

Although the global economic slowdown is having a significant impact on emerging economies, the manager believes emerging markets should continue to grow much faster than advanced economies in the years ahead. Greater central bank credibility and anchored inflation

¹ Class A Distr. (D) US Dollar Shares.

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expectations have had an influence on longer-term growth prospects. For the time being, however, extraordinary volatility has reduced the attractiveness of emerging market currency exposure and the manager therefore favours external markets, with a focus on corporate and quasi-sovereign issues. The manager will focus on corporates with strong government support, such as banks, and those that are strongly integrated into the global economy, including energy and construction companies. The manager aims to maintain its emerging markets exposure at current levels and will continue to reassess the underlying allocation to external and local issues..

Mortgages/TIPS

The manager believes the MBS market continues to look attractive at current valuations, particularly agency-backed issues, given the Fed's buying programme and the central role that the government-sponsored enterprises play in the eventual recovery of the ailing housing market. As liquidity improves and spreads narrow due to the buying programme, the manager may look to gradually reduce its allocation from current levels (30%). While current valuations in TIPS markets suggest that investors have priced in nearly a decade of deflation, the manager believes the massive monetary stimulus implemented by the Fed should be sufficient to prevent prolonged deflation. The manager is likely to maintain a moderate exposure to TIPS.

Investment grade corporates

The manager believes valuations in the sector remain attractive, as these reflect a too pessimistic view on default rates compared to its own expectations. While credit fundamentals are likely to experience some deterioration in the months ahead, it believes that, in general, company balance sheets are in better shape than they were in the previous two recessions. In addition, the magnitude of government support and capital injections have been very supportive of financials in particular, and the manager would expect performance to improve as liquidity returns to financial markets and uncertainty over the quality of assets held by financials abates. The manager expects to gradually increase its exposure (around 20%) and will target more defensive sectors, such as telecoms, media and energy.

High yield bonds

Although the manager recognises that the credit cycle has taken a turn for the worse and it expects to see a significant rise in default rates over the next 12 months, it believes that current valuations suggest that such a deterioration is widely anticipated by the market. The market should be able to absorb elevated defaults, while still generating strong overall returns. Indeed, a generous coupon income combined with marginal spread tightening should partially offset the impairment caused by an inevitable rise in default rates. The manager continues to have a preference for lower-rated securities over higher-rated issues. These bonds are likely to benefit most when the market returns to its focus on fundamentals rather than liquidity issues. The manager aims to have an allocation of around 30%.

Government bonds

The manager continues to hold a slightly more high-quality exposure to developed government bond markets relative to the benchmark, as a hedge against further volatility in the portfolio's credit positions. It favours exposure to the eurozone over the US and Japan in the expectation that the ECB will be forced to reduce rates further to combat deteriorating economic conditions. It also believes peripheral markets now look less attractive on a risk/reward basis and seeks to reduce exposure to Hungary, in particular, over time.

In currencies, the manager will continue to hold a small overweight exposure to the Japanese yen versus the euro as a hedge against ongoing global risk aversion.

This Fund is managed by Western Asset Management

Legg Mason Global Multi Strategy Bond Fund

The Legg Mason Global Multi Strategy Bond Fund is a sub-fund of Legg Mason Funds ICVC, an umbrella fund established as an investment company with variable capital, and is authorised in the UK by the Financial Services Authority as an undertaking for collective investment in transferable securities.

The annual charges are levied against capital and while this will increase distributable income, it may constrain or erode capital growth.

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