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- **Investors should read and understand the Fund's most current offering document, including details of risk factors relevant to the Fund before making an investment in the Fund.**
- **An investment in the Fund may not be suitable for all investors. The investment decision is yours but you should not invest in the Fund unless the intermediary who sells it to you has advised you that it is suitable for you and has explained why, including how buying it would be consistent with your investment objectives.**

Legg Mason Capital Management Value Fund

Key Points

- The manager continues to believe that large-cap US equity valuations are very reasonable, being most attractive in the financials, technology, and healthcare sectors.
- While noting that there are risks to the outlook, the manager believes that the conditions are in place for a good year ahead for US equities.
- The manager expects that there will be market corrections going forward and thinks investors should view such times as buying opportunities.

This Q&A is based on a teleconference that took place on 23 February 2011 with Sam Peters (SP) and Mary Chris Gay (MCG), managers of the Legg Mason Capital Management Value Fund.

Q: How do you view the current macro market environment in the US?

SP: I generally gauge any market environment on a broad framework that may be applied globally though I'll keep my comments US-centric. Within this framework I look at four considerations: the banking system and credit cycle; inflation, which is currently on all investors' minds; valuation levels; and a 'wall of worry.'

On the first one, the US banking system is now back in very good shape, even if scepticism remains, and the data is there to support that view. Two years ago the US market was discounting about \$1.6 trillion in credit losses in our banking system and capital was raised against that during the crisis. But moving the clock forward, losses have come in at about half that level, leaving the US banking system with tangible capital levels in the 7% range and well-positioned for Basel III. There is excess capital on many bank balance sheets to an extent that puts the US in very good stead relative to a lot of other places in the world. In addition, credit is continuing to get better, having been improving for over a year. Assets have been detoxified and, very importantly, private credit growth is positive again. This is the case with consumer credit, as well as commercial and industrial credit.

Turning to inflation, it's very much under control in the US, which allows much bigger policy flexibility than in other parts of the world. Inflation-linked bond spreads in the US suggest that inflation expectations are anchored in the 2% range. Since the

Federal Reserve (Fed) confirmed its second round of stimulus via quantitative easing (QE2) late last year, inflation expectations have moved up about 100 basis points. That's exactly what Fed Chairman Ben Bernanke wanted as the 2% mark is about the Fed's target. So we're on track with inflation in the US. QE2 also supports the stock market. We firmly agree with Chairman Bernanke that the stock market is positive for the real economy, and that the higher stock market is supporting a growth rebound in the US.

Importantly, we don't expect that quantitative easing will be extended beyond June, which is the Fed's target to complete the renewed programme. We believe this because private credit growth in the US, as I've mentioned, is now positive and capital spending in the US is rebounding very strongly. The data is again there to show this, so we believe the economy is moving and has recovery momentum.

Thirdly, looking at valuation levels, these are very reasonable in the US. The S&P 500 Index is trading on about 13.5 times this year's earnings and 12 times earnings for 2012. Looked at another way, free cash flow yields for the S&P 500 are still well above 5% and this discounts almost no future growth for a lot of US companies. We also find large-cap US stocks very attractive compared to bonds, where yields remain relatively low. By contrast, with stocks you can buy a growing cash flow stream and we expect large-cap stocks will re-rate with their valuations rising over the next several years.

PLEASE REFER TO THE IMPORTANT INFORMATION ON THE FINAL PAGE.

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Finally, regarding the 'wall of worry,' this is obviously not a world without concerns and risks. The situation in Libya is deteriorating, for example, and this is knocking on with a spike in oil prices. I also worry about risk spreads rising again in peripheral Europe and about the banking system in Europe broadly. The question for us is observing how such factors are impacting the US recovery and the key for us is to invest in assets that have valuation protection and a margin-of-safety. We believe high quality large-cap US stocks are absolutely providing these attractive attributes. So while there's certainly plenty to worry about in the world, we're focused on the best margin-of-safety assets and we believe that cyclical and secular bull markets can climb a wall of worry.

Q: Which areas of the market do you see as having the most attractive valuations?

MCG: Looking at valuation metrics going back to the early 1950s, three sectors of the market can be seen to be currently trading in the bottom decile of their historic trading ranges, namely financials, technology and healthcare. We still believe that there are significant opportunities from a valuation standpoint in these areas and the portfolio remains overweight in each one, significantly so in the financials and technology sectors.

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At the year-end 2010, the Fund was most overweight in financials. In addition to these sectors, another area where we believe we have found good opportunities is in consumer stocks.

Q: Could you elaborate on your strategy in the financials sector?

SP: We hold the big systemic financial companies that are credit sensitive, with positions in Citigroup, Wells Fargo, JP Morgan, and Bank of America. While valuations are historically very cheap, as mentioned earlier credit and loan growth is improving, and capital strength is not an issue. One critical thing that we're also looking for is dividends to return to attractive levels, which we expect could boost the dividend yield in the portfolio above that of the S&P 500 Index. This

could also help to drive a re-rating of these financials stocks, and we believe we're seeing some evidence of that.

On the insurance side, we retain our position in Aflac and added MetLife to the portfolio in last year's third quarter. With both companies we see very cheap multiples, very good capital levels, and big global exposures. MetLife bought AIG's Asian exposure on what we thought was an excellent price, and we view the move as a good diversifier and growth driver.

We also hold American Express and Capital One Financial, the big credit card companies, and they've done well. Consumer spending in the US has rebounded quite nicely, which has actually surprised me, and consumer credit and credit card delinquencies have improved. Delinquency rates are coming in below previous norms and we think may reach previous troughs some time in the next year or so, which is remarkable given what we've been through.

Elsewhere, we own Goldman Sachs and Morgan Stanley, which are plays on global transactions, and in the case of the latter, global distribution. Both are on very attractive price-to-book values so we don't think we're paying anything for their franchise values, which is key. We added Morgan Stanley in the fourth quarter of last year, when we also bought BlackRock, the big asset management group. We like its acquisition of Barclays Global Investors, which gave BlackRock more equity fund management exposure. It also gave them an exchange traded funds (ETF) platform, which we think will grow. We bought BlackRock on an attractive 10%-plus free cash flow yield and a 2.2% dividend yield. So the company has ample capital and with asset management being a global scale business we think that it can do a great job globally and also view the stock as a good diversifier within our financials exposure.

Q: What other stocks have you added to the portfolio recently?

MCG: As mentioned we like the technology and healthcare sectors from a valuation standpoint and in the fourth quarter of last year we added several holdings to the portfolio from these groups. In technology we bought Research in Motion and MasterCard, while in healthcare we added Johnson & Johnson and Pfizer.

I also mentioned that we have found what we consider to be good opportunities in consumer stocks and earlier last year we added positions in Best Buy and Wal-Mart Stores. Going back to last year's second quarter we also added energy company Transocean to the portfolio in the midst of the oil spill in the Gulf of Mexico, and its stock price rallied well over the rest of the year.

Legg Mason Capital Management

Value Fund

Q: Has the overall number of Fund holdings changed significantly?

MCG: We finished the year with 47 positions in the portfolio and the top ten holdings make up about 32% of the Fund. That contrasts with two years ago where we had about 45 stocks, but the top ten names were around 50% of the Fund. So the portfolio has somewhat flattened out, which is a reflection of the opportunities that we think are inherent among some of the key sectors.

Q: How exposed is the Fund to growth outside the US?

MCG: A rising part of the portfolio has exposure outside of the US. We see opportunities for investors as they move out of emerging markets and bond funds and into US companies that have exposure to those faster growing parts of the world, but that are domiciled in the US. We believe this is beginning to be reflected in the performance of US equities. The Fund has a higher exposure to non-US sales from its portfolio holdings than the S&P 500 Index. Specifically, at the end of last year's third quarter some 45.6% of the revenues earned by the portfolio on a weighted average basis were sourced from outside the US, while for the S&P 500 Index the figure was 36.1%.

Q: With inflation and monetary tightening gathering pace in emerging markets, have expectations of them as growth drivers for US exports been too optimistic?

SP: We would argue that the US has a relative growth advantage this year versus the rest of the world, which is tightening its monetary policy while the US policy is still very loose. But we also think that growth is attractive in parts of the world outside the US, and that over time emerging markets are going to grow faster. The key here is that we believe large-cap stocks that we are buying are not pricing in growth outside the US. So if it does not materialise, we're not paying for it, but if it materialises over time, which we think it will and we're seeing evidence of that, we should get upside.

Those who are bearish on emerging markets growth would say that certain areas are being driven by a credit cycle that's driven asset inflation in some sectors, such as real estate. If there is a continued tightening phase and then asset compression and there is underlying debt, there could be a material drawdown or decline in growth. That's why we keep emphasising the words 'margin of safety' and again for us all

roads lead back to valuation. It's important to highlight as well that we are focusing on areas in the US that we believe are domestic cyclical growth recovery plays and that's about the US getting better, not about emerging markets tightening.

Q: How big a risk are rising gasoline prices for retail sales in the US?

SP: While it's a concern, the US economy's ability to absorb commodity price spikes is much better than it used to be. I think it will affect lower end retail sales, but the key is that I don't think it's going to be enough to derail the expansion that we're seeing in the US\$15 trillion US economy. It's important to remember that the US economy works in a way that the top 10% of income earners, who are not impacted very much by the current gas price rises, contribute to a huge percentage of marginal consumer spending. That's where the game is won and lost as far as that 70% of GDP that's driven by the consumer is concerned. The data will certainly have to be watched closely. I think you'll see some slowing on the edges, though not material because once this US\$15 trillion super-tanker of an economy starts moving, I think it has its own momentum that should carry it through.

Q: How would you sum up your outlook for the US economy and stock market?

MCG: Over the last two years the US economy has moved from contraction to stabilisation to signs of a recovery. Consumer confidence numbers that were just released are at a three-year high and they marked the fifth consecutive monthly gain. What's encouraging is that consumer confidence in the US rose across all age groups and across almost every income category. We believe that's consistent with above-trend growth.

We believe there are risks to the outlook, the greatest risk being the geopolitical situation, but we also believe that the conditions are in place for a potentially above-average year ahead for US equities, especially within the mega-cap market.

Relative to competing instruments, such as bonds or emerging markets, we think US equities continue to offer among the best risk/reward opportunities for investors. We expect there to be corrections, which can be painful but are a natural part of the progression of a bull market, and we would view them as times to increase positions.

Legg Mason Capital Management Value Fund

IMPORTANT INFORMATION

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The Fund may continue to hold, and in some cases add to, a declining position so long as the Investment Manager believes the security is undervalued by the market. Hence, the Fund faces the risk of mis-estimation by the Investment Manager in its fundamental analysis regarding the companies in which it invests. The performance of the Fund may not closely correlate to specific market indices over time and may include extended periods of underperformances as compared to the broader market. Investment in equity securities may involve risks, including issuer, industry, market and general economic related risks.

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