

Legg Mason Capital Management Value Trust

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Market overview

After a mid-month rally that propelled the S&P 500 Index briefly back above its 200-day moving average, the market correction which began in late April resumed in the last half of the month, as political uncertainties and growing fears of a double-dip recession continued to overshadow what we regard as increasingly compelling stock valuation levels.

Selling pressure was particularly acute late in the month with several 90% down days on the New York Stock Exchange in the last week. The selling appears to have reached washout proportions on June 29, as the Arms Index (TRIN) soared to an intraday high reading of 16.47. Veteran market technician John Mendelson calls the TRIN a “pressure monitor”; the index measures the percentage of volume flowing into rising and falling stocks, where 1.00 is equal pressure, a ratio below 1.00 indicates buying pressure, and a ratio over 1.00 indicates selling pressure. Many investors regard a TRIN of 2.00 as indicative of high selling pressure, while Mendelson himself uses 4.00. In a June 30, 2010 morning note, Mendelson called the 16.47 TRIN recorded on June 29 the highest he had ever seen, noting that it greatly exceeded the TRIN’s September 2008 high of 11.63 and its March 2009 high of 8.77.

It is not just the Arms Index that indicates that investors are, in some respects, more bearish now than they were in either late 2008 or early 2009, but also the CBOE Put/Call data, which shows that the volume of put buying has once again soared to levels higher than those recorded at the market low in March 2009. We find this degree of investor bearishness to be, at once, quite remarkable and, at the same time, very understandable. It is remarkable in the sense that – looking at things logically and objectively – the economy is now clearly in recovery, earnings are in a steep uptrend, cash yields next to nothing, stocks are attractively valued and bonds look expensive. It is understandable in the sense that none of that seems to matter much right now. Investors are not currently thinking objectively, in our view. Their principal motivation at

Average annual total returns and fund expenses – Class C (%) as of June 30, 2010

	3-mo	1-yr	5-yr	10-yr	Since incept. (4/16/82)	Gross*	Net**
Excluding sales charges	-16.09	8.97	-9.81	-4.08	11.32	1.76	1.76
Including effects of maximum sales charges	-16.88	8.02	-9.81	-4.08	11.32		
S&P 500 Index	-11.43	14.43	-0.79	-1.59	N/A		

Performance shown represents past performance and is no guarantee of future results. Current performance may be higher or lower than the performance shown. Investment return and principal value will fluctuate, so shares, when redeemed, may be worth more or less than the original cost. Class C shares have a one-year contingent deferred sales charge (CDSC) of 0.95%. Total returns assume the reinvestment of all distributions at net asset value and the deduction of all Fund expenses. Performance data do not reflect trade date adjustments made to the NAV at month-end. Performance would have been lower if fees had not been waived in various periods. Returns for less than one year are cumulative. For the most recent month-end information, please visit www.leggmason.com/individualinvestors.

**Gross expenses are the Fund’s total annual operating expenses for the share class indicated as of the date of the Fund’s most current prospectus and do not reflect fee waivers or reimbursements. These expenses include management fees, 12b-1 distribution and service fees, and other expenses.*

*** Because the Fund does not currently have fee waivers or reimbursements, gross and net expense ratios are the same.*

The S&P 500 Index is a market capitalization-weighted index of 500 widely held common stocks. Please note that an investor cannot invest directly in an index.

present is the avoidance of pain. They remember vividly the pain of the bear markets of 2000-2002 and 2007-2009. They have seen their stock portfolios melt in half or worse twice in the last decade and many, if not most, have completely lost faith in the long-term value of stocks as a wealth builder. Even the sharp recovery in stocks from March 2009 to April 2010 was met by the investing public with an enormous degree of skepticism and mistrust. Now that a market correction of an as yet undetermined magnitude is upon us, investors are heading for cover, their tolerance for pain and volatility having been exhausted. We can hardly blame them.

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The investment environment has recently been as frustrating and enervating as any time we can remember. As we noted last month, the market has become increasingly dominated by high frequency traders (HFTs), many of whose strategies appear to be momentum-based and designed to profit from short-term movements in the market.

The fact that index ETFs have become such a significant portion of total trading activity suggests to us that most HFT strategies are either short-term directional bets on the overall market or inter-sector arbitrage bets, as opposed to efforts to discern the relative merits of one individual security versus another. This trend is consistent with our view that stocks are becoming increasingly commoditized and helps explain why the movements of individual stocks are near all-time high correlation levels of almost 80%. We find this environment a challenging one as we try to make fundamental judgments about the relative attractiveness of individual securities.

We also see the political environment as a negative. There is an anti-business rhetoric emanating from the Obama administration that we find counterproductive. The administration claims to want to promote job growth, but most of its actions are acting at cross-purposes to this goal, in our opinion, as it has created a great deal of uncertainty in the business community concerning future health care costs, regulatory burden and tax regime. Until business leaders get some clarity on these issues, we think they will be inclined to sit on their hands (and their cash hoards), rather than hiring new workers or committing capital to new projects.

Further heightening investors' near-term concerns, the economy has hit a soft patch, with most recent economic data – including private sector job growth, ISM manufacturing and new order data, auto sales and housing starts – coming in weaker than expected. On top of that, the war in Afghanistan does not appear to be going well, the Macondo oil well continues to foul the Gulf of Mexico, and concerns persist about growth prospects in Europe and China. The spate of weak numbers, coupled with the stock market downturn and a growing sense of ennui, has triggered a sharp drop in consumer confidence, engendering fears that a “double dip” back into recession may be in the offing.

With the plethora of concerns facing investors, they seem to have adopted an “anything but stocks” investment approach. After a brief foray into the stock market in April, investors resumed dumping their U.S. equity mutual funds in May and June, while increasing their commitment to both gold and U.S. Treasuries. Gold and Treasuries might seem at first like

strange bedfellows, but their concurrent popularity could be the result of investors trying to hedge against the opposing risks of inflation (gold) and deflation (Treasuries). There might be an even simpler explanation. Investors are attracted to investments that have been treating them well recently and gold and Treasuries have been going up for the last 10 years, while stocks have been going down.

As frustrating as the current environment is, we believe that the market merits a much higher valuation level than it is currently being accorded. Unless the economy slips back into recession – a scenario we view as quite unlikely – and corporate earnings turn down, we would expect the market to be meaningfully higher than it is now in the next six months to one year.

Fund highlights

During the second quarter of 2010, the Legg Mason Capital Management Value Trust – Class C shares generated a total return of -16.09%. In comparison, the Fund's unmanaged benchmark, the S&P 500 Index, returned -11.43% and the Lipper Large Cap Core Funds¹ category average was -12.26% for the same period.

As of the quarter end, the Fund was diversified in 46 names. The Fund had exposure across nine sectors of the market and the top 10 names made up 36% of the portfolio, down from 44% a year ago and over 50% at the end of the second quarter in 2008. The Fund is significantly overweight the financials, information technology, and consumer discretionary sectors.

On an absolute basis, the Fund had negative total returns for the second quarter, with the greatest detractors coming from the industrials, consumer discretionary and utilities sectors.

Relative fund underperformance was driven by our security selection decisions. In particular, security selection hurt relative performance in the consumer discretionary, industrials and information technology sectors, and selection in the energy, materials and consumer staples sectors helped relative performance.

Sector allocation also had a negative impact on relative performance. The Fund's underweight to consumer staples and telecommunications and its overweight to financials

¹ Source: Lipper Inc. Past performance is no guarantee of future results. Lipper returns are based on the three-month period ended March 31, 2010, calculated among 970 Funds in the Lipper Large-Cap Core Funds peer group, with reinvestment of dividends and capital gains, if any, and excluding sales charges.

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detracted from relative performance, while the Fund's overweight to utilities and underweight to materials and energy contributed to relative performance.

The interaction of our sector allocation and security selection also had a negative impact on our relative performance.

Top detractors

The sluggish consumer sector impacted retailer Sears Holdings Corporation during the quarter as shoppers continued to shy away from stores. Sears gained some ground early in the period when it boosted its stake in Sears Canada to over 90%, both improving Sears' near-term liquidity position and increasing long-term strategic options. The end of the federal government's home-buyer tax credit and "cash for clunkers" appliance program also eroded sales, leading Sears to significantly reduce prices on its appliances and other hard goods. The result was a disappointing quarterly report in late May. Although Sears beat expectations on the bottom line, analysts were critical of Sears' declining margins and EBITDA². Although we reduced our position in the stock modestly during the quarter, we continue to think Sears is making progress in its turnaround under Eddie Lampert and that the stock is undervalued on almost every metric as a result of the market's pessimism.

Global power provider AES Corporation's in-line first-quarter results were overshadowed by its lower 2010 earnings guidance stemming from a dilutive capital raise from Chinese investors. That change in guidance coincided with general market weakness signaling a lack of investor confidence in the global economic recovery, pushing the stock down during the quarter. However, AES still has several strong drivers for future returns. As demonstrated by the sale of its 55% stake in its Qatari power generation and desalination business, AES is committed to divesting businesses that aren't growing quickly. Such moves should bump up the company's returns in the long run. Further, AES will benefit from economic recovery and rising demands for energy in emerging markets, as evidenced by strong gains in the company's Asian and Latin American revenue during the first quarter.

Internet auctioneer eBay detracted from performance during the period after the company forecast second-quarter and fiscal-year 2010 earnings and revenues below consensus estimates. Lost amid the selling frenzy, however, was eBay's

success in delivering a better-than-expected first quarter, marked by strength in ecommerce and in the company's payments segment, in particular. Also being overlooked is the stock's attractive valuation and the forward-thinking and rational capital allocation decisions of CEO John Donahoe. We continue to believe the shares are significantly undervalued.

Aetna shares moved consistently lower during the quarter as a debt rating cut and concerns regarding the implementation of health care reform pressured the shares. The stock rallied in the first quarter after health care reform proved less onerous than expected, but the second quarter brought forth concerns that the proposed methodology to calculate the medical loss ratio floor could take a significant chunk of managed-care organizations' (MCO) profits. In addition, Aetna's senior debt rating was cut by Moody's to "Baa1" from "A3" partly because of an "unfavorable" political and economic climate. While regulatory pressure on the managed-care space is palpable, we believe regulators will preserve the MCO business model, as the administration's reform efforts hinge on a stable private insurance market. Trading at just 9x 2010 EPS and 8.4x 2011 EPS, we believe Aetna offers a compelling value to long-term shareholders.

Aflac shares dragged down the portfolio's performance over the past quarter as Europe's deteriorating sovereign debt situation led investors to sell shares in many financial companies. At the beginning of the second quarter, Aflac told shareholders that it held approximately \$2 billion in Greek and Portuguese debt. An ugly political situation caused many market participants to doubt the less fiscally sound countries' abilities to repay their debts, which could imply investment portfolio losses for companies like Aflac. The company has some exposure to European debt through its Japanese subsidiary, but the subsidiary has sufficient capital to withstand potential losses. Meanwhile, the stock trades at 8x this year's earnings estimate – implying a contagion beyond Europe, which we believe is an overreaction – and that makes Aflac an attractive investment.

Outlook

The market decline from its April 23 peak through the end of the second quarter sent stock returns into negative territory and ushered in a wave of skepticism and fear not seen since the lows of the bear market in March 2009. The drop in the market was likely amplified by rising concerns that austerity measures in Europe and an engineered slowdown in China may have a more significant impact on growth in the U.S. than previously expected.

² EBITDA is an abbreviation for "Earnings Before Interest, Taxes, Depreciation and Amortization," a measure of a company's cash flow.

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It is reassuring to recall that despite the decline in the market this year, it is still up over 55% since the low in March 2009. We continue to focus intently on values in the market while popular narratives drive day-to-day volatility. The volatility during the first six months of the year has presented us with an opportunity to position the Fund in what we believe are attractive valuations.

At the end of the second quarter, the Fund had a forward P/E average of under 8x earnings, an average long-term earnings growth forecast of nearly 12%, an average return on invested capital of 23%, and most importantly, upside potential.

The financial sector remains the largest sector weight in the Fund at just under 28%. However, within financials, the exposure is well diversified among five different industry groups. While there were no new financials purchased in the second quarter, activity was brisk to take advantage of the considerable volatility in prices. We continued to build up the Citigroup position that was initiated late in the first quarter. After the stock briefly rallied close to \$5 during April, it pulled back below \$4 per share, allowing us to build a full position within the Fund. At current prices, the stock trades at 70% of book value, under 9x next year's earnings, 6x normalized earnings, and has tremendous upside to what we believe is fair value. In addition to Citi, we added to our position in Goldman Sachs. After finishing the first quarter essentially flat, Goldman sold off over 20% during the second quarter and almost 30% from its high in mid-April, opening up an opportunity to add to our position at very attractive levels.

During the second quarter, we exited four positions completely (Boeing, Nucor, Apollo and Google), amounting to a little over 5% of the holdings from the end of March. The largest of these sales was Google, which has been in the Fund since its IPO at \$85 per share. Google remains a wonderful company, but it is facing slowing growth and stronger competition. With about 35% of its revenues derived from Europe, the significant rise in the dollar will also likely weigh on Google's results.

Six new positions were added to the Fund during the quarter. The largest and likely most controversial of the new positions is Transocean. The stock collapsed over 50% from its peak in April in the midst of uncertainty surrounding its liability related to the Gulf oil disaster. Before we initiated a position, our research involved meeting with the company, looking into their contracts and assessing their liabilities, consulting industry veterans and legal experts, comparing the Gulf disaster to the nuclear disaster at Three Mile Island, and conducting a thorough review of the valuation of the entire business. The

result was that we were able to buy Transocean at levels we believe represent significant upside under reasonable scenarios and at close to an all-time low in valuation relative to its history. The company is trading at 80% of book value, under 6x earnings and has a free cash flow yield of 20%. While we recognize the potential for outcomes that could further negatively impact the value of the business, we believe the market has overly discounted those scenarios in the price and thus opened up an exceptional opportunity.

Other new names include Gilead Sciences, Sprint Nextel Corporation, Intel Corporation, Wal-Mart and BestBuy. These six new names have an average P/E of 8x, an average long-term growth rate of 11.25%, an average return on invested capital of 25%, and an average free cash flow yield of 13%. For the three that pay a dividend, their average dividend yield is 2.5%.

The U.S. economy appears to have slowed during the second quarter, coincident with the market's sell-off. Growth is slower than historic norms, but still positive, and is supported by positive trends in key indicators, such as the ISM and Employment Trends Index. We believe the high level of fear and uncertainty resulting from the market decline and the "flash crash" of May 6 has created an environment where both corporations and individuals are behaving far more conservatively than would be expected at this stage of a recovery. U.S. corporations currently have net cash on their balance sheets of \$1.7 trillion, which is a record high relative to nominal GDP. Consumer borrowing in the U.S. dropped more than forecast in the most recently reported period, indicating that consumers are increasingly anxious despite the fact that incomes grew faster than spending.

While we are likely to see slower growth numbers in the quarters ahead, the projected gain in earnings for the S&P 500 is 34% for the second quarter. Expectations are that earnings in the third quarter may rise as much as 25%, according to consensus expectations on Bloomberg. Financial companies are expected to post an average gain of 54% in the third quarter, while the estimated increase is 36% at information technology firms, the Fund's second-largest sector. While these numbers represent declines from the second quarter, they are still very high by historical measures.

We believe investors will ultimately be drawn back into the U.S. market by returns that are among the best relative return opportunities available. With cash effectively earning zero, and as uncertainty recedes and earnings continue to come through, we believe companies will begin to deploy their cash more pro-

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actively – whether through buybacks, dividends or acquisitions. This should help to underpin the market.

While volatility may remain elevated due to the aftereffects of the financial crisis of 2008, we believe the path of least resistance is higher. We have a history of performing quite well following periods of financial distress, and we have opportunistically repositioned the Fund in the midst of the most volatile periods in the market. We believe long-term, patient investors will be rewarded for staying the course and adding during any sell-offs that may occur while the market fights its way higher from here.

(Commentary continues on next page...)

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Top 10 holdings	(%)
AES Corp.	6.5
Genzyme Corp.	4.1
International Business Machines Corp.	3.7
AFLAC Inc.	3.5
Capital One Financial Corp.	3.1
Goldman Sachs Group Inc.	3.1
Transocean Ltd.	3.1
Texas Instruments Inc.	3.0
Time Warner Inc.	3.0
Citigroup Inc.	2.9
Top five sectors	
Financials	27.6
Information technology	24.5
Consumer discretionary	16.9
Health care	16.0
Utilities	6.5

Percentages are based on total portfolio as of quarter end, are subject to change at any time, and do not include trade date activity. For informational purposes only and not to be considered a recommendation to purchase or sell any security.

What should I know before investing?

Equity securities are subject to price fluctuation and possible loss of principal. International investments are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility. These risks are magnified in emerging markets. The manager's investment style may become out of favor and/or the manager's selection process may prove incorrect; which may have a negative impact on the Fund's performance. The Fund may focus its investments in certain regions or industries, increasing its vulnerability to market volatility. Additional risks may include those risks associated with investing in fixed-income and high-yield securities. Please see the prospectus for more information.

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Portfolio holdings and sector allocations may not be representative of the portfolio manager's current or future investment and are subject to change at any time.

Prior to October 5, 2009, the Fund was known as Legg Mason Value Trust. The Fund's investment objective, portfolio managers and investment strategy have not changed. Please see the prospectus for details.

Before investing, carefully consider a fund's investment objectives, risks, charges and expenses. You can find this and other information in each prospectus, which is available at www.leggmason.com/individualinvestors. Please read it carefully.

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