

Legg Mason Capital Management Growth Trust

Robert Hagstrom, CFA
 Portfolio Manager

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 that 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 show 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. (4/17/95)	Gross*	Net**
Excluding sales charges	-12.10	14.44	-8.38	-2.79	4.56	1.92	1.90
Including effects of maximum sales charges	-12.98	13.44	-8.38	-2.79	4.56		
S&P 500 Index	-11.43	14.43	-0.79	-1.59	6.70		

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 reflect a maximum one-year contingent deferred sales charge (CDSC) of up to 1.0%. 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.*

*** Net expenses are the Fund’s total annual operating expenses for the share classes indicated as of the date of the Fund’s most current prospectus and would reflect voluntary fee waivers and/or reimbursements, where these reductions reduce the Fund’s gross expenses. These waivers and/or reimbursements may be reduced or terminated at any time.*

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

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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.

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 Growth Trust – Class C shares generated a total return of -12.10%. In comparison, the Fund's unmanaged benchmark, the S&P 500 Index, returned -11.43% and the Lipper Large Cap Growth Funds category average was -12.29% for the same period.

As of the end of the quarter, the Fund remained largely concentrated, with the top 10 holdings accounting for over 40% of its total assets. The Fund is significantly overweight three sectors: information technology, health care and consumer staples.

On an absolute basis, the Fund had negative total returns. The biggest detractors came from the energy, materials and information technology sectors.

Relative portfolio underperformance was due primarily to our security selection decisions. In particular, security selection in the energy, materials, and information technology sectors hurt relative performance, and selection in the industrials, health care, and consumer staples sectors helped relative performance.

Sector allocation had a positive impact on relative performance. The Fund's overweight to consumer staples and health care and its underweight to the financials sector contributed to relative performance, while the Fund's lack of exposure to the utilities and telecommunication sectors and overweight to information technology detracted from relative performance.

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The interaction of our sector allocation and security selection helped to offset to some degree the Fund's relative underperformance.

Top contributors

Yum! Brands helped the Fund, as the quick-serve restaurant company impressed investors with its sales growth in China. Yum! reported better-than-expected sales and earnings per share for the first quarter, helping shares outperform the S&P by a double-digit percentage. Margins in China also grew alongside the sales. The Fund has since sold the name in favor of better risk/reward propositions.

Apple CEO Steve Jobs called the iPad a "magical" device, and indeed it appeared just so during the second quarter, keeping Apple's stock afloat while the market cratered. Just as investors had trouble forecasting the economic impact of the initial iPhone because it created a new category of device, most also underestimated the power of Apple's tablet PC – its first 2 million units sold faster than the original iPhone. Strong demand for the iPhone 4 also helped boost the company during the quarter, although some design and software issues hampered consumer enthusiasm for the device. If rumors come to fruition that the iPhone, currently exclusive to AT&T, will be available on Verizon by 2011, Apple's revenue growth and stock price likely have more room to run.

Quanta Resources, the \$4.3 billion specialty engineering and construction company, gained during the second quarter after earnings showed expanding operating margins. We think the larger story is that the first quarter appeared to mark a transition from a period of decline in the economically sensitive distribution unit to increased activity in bidding for transmission projects, both for electricity and natural gas pipelines. We see solid upside from here as the cycle begins to turn Quanta's way.

Top detractors

Transocean has hit a rough patch ever since the late-April explosion and subsequent sinking of the company-owned Deepwater Horizon offshore drilling rig in the Gulf of Mexico. While the market is correct that the underlying economics of the offshore drilling market will no doubt change after this tragic accident, the company's current stock price implies a much more bearish scenario than we think likely. Even factoring in potential liability scenarios beyond what we think are probable, Transocean's prodigious cash flow and solid contract structure makes this stock appealing at these levels.

Handset manufacturer Nokia Oyj was a leading detractor during the quarter, thanks to disappointing earnings and a gloomy outlook for its smartphone segment. The company not only failed to make up ground in the smartphone market on rivals Apple and Research in Motion, but actually lost market share as it delayed the release of its new Symbian smartphone operating system. Moreover, Nokia has seen the margins in its low-end handsets, once ubiquitous in emerging markets, pinched as new competitors from Asia enter the market in force. Because the company continues to struggle to regain its footing, we exited the position during the period in favor of other investment opportunities.

Qualcomm shares took a hit over the past three months after the company guided to weaker-than-expected sales for the second half of its current fiscal year (ending in September) due to lower-than-expected average selling prices (ASPs) for mobile devices. The lower ASPs pressured the company's royalty business, which is based on a percentage of selling price. We see these issues as temporary and believe they are blinding investors to long-term value. We believe the stock remains attractive due to low embedded-growth expectations, its leverage to increasing third-generation (3G) wireless adoption, and steady cash generation that should drive increased share buybacks.

Microsoft shares dropped after the company announced third-quarter results that fell short of the Street's most bullish estimates amid fears of a slowdown in European technology spending. With Europe comprising approximately a third of Microsoft's revenues, the fears are not without basis, but we believe that the company will likely power through such concerns. Management has hinted that it has a huge pipeline of renewal deals for its enterprise agreements, meaning that its historically strong fourth quarter could pack even more upside this year. We continue to like Microsoft at 10.5x next year's earnings, especially as companies around the world look to upgrade their operating systems.

Cisco Systems shares fell during the quarter after the company issued a disappointing sales forecast for the remainder of 2010. Specifically, Cisco guided to sales growth of between 25% to 28%, which includes the boost from acquisition of video conferencing company Tandberg. Consensus estimates, however, had been expecting growth north of the 26% midpoint, and expectations priced in greater than 28% as the company's business benefited from global recovery. Furthermore, Cisco guided for a 3% to 5% sequential sales growth range, which was below the historical 5% to 6% range. However, in our view this moderation in growth was due to the

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Tandberg acquisition, and when the deal is stripped out, the company's forecast was in line with historical trends. We think the market concerns are overblown, as Cisco remains a major player in several long-term growth markets and has a line of new products coming on the market that should help it maintain its position.

Outlook

We are your growth manager who is seeking to invest in the most undervalued part of the market. For the past year, we have told you we believe the greatest value resides in the larger-capitalization stocks versus the smaller- to middle-capitalization stocks. It seems this message is trumpeted almost daily on popular financial programs and Web sites. Still, mega-cap stocks have lagged their smaller-cap competitors, not only in 2009, but in 2010 year to date.

This observation begs the question, if everybody says the better value resides in the bigger-cap stocks, why hasn't the leadership in the market changed? The answer, we believe, is momentum. In the quest for short-term performance results, investors often continue to ride the bets that are currently working for too long, regardless of valuation differentials. Only after their stocks quit working and have sold off do they decide to make a change. As David Nelson, Chairman of our Investment Policy Committee, reminds me – "Investors change when there is pain." Based on current valuations and projected earnings growth rates, we surmise the "pain" in the market may not be too far off.

	Current P/E	Estimated P/E	Estimated earnings growth rate
S&P 100	14.7x	12.6x	16%
S&P 500	15.7x	13.4x	17%
S&P 400	21.3	17.2x	23%
S&P 600	28.3x	19.3x	46%

As you can see, smaller-cap stocks (S&P 600) are currently trading at twice the multiple of the mega-cap stocks (S&P 100). The multiple for mid-cap stocks (S&P 400) is 50% higher than that of larger-cap stocks. Small- and mid-cap stocks typically have higher growth rates than mega-cap stocks, potentially justifying somewhat higher multiples. Even so, by historical standards, the pricing differential between market caps is unusually wide. Furthermore, the estimated earnings growth rate for the S&P 600 is the highest it has been in the last 10 years. High price earnings multiples coupled with high earnings expectations can sometimes be a volatile combination. All works well so long as high-multiple stocks continue to meet

elevated expectations. If those expectations are not met, watch out below.

This is exactly what happened to the mega-cap stocks 10 years ago. They were high-multiple stocks with high expectations. When they failed to meet those lofty expectations, they fell off the cliff. After outperforming small- and mid-cap stocks for much of the 1990s, large-cap stocks summarily underperformed their smaller brethren for the next 10 years. In fact, the S&P 100, compared with the S&P 400 and the S&P 600, was the worst-performing index seven out of the last 10 years (eight out of 11 if you include 2010 year to date).

Based on these valuation differentials, we remain steadfast in our belief that a change in market leadership is forthcoming. Lest you think we are a lone voice still barking in the night, others have joined the chorus. Tobias Levkovich, Equity Strategist at Citi Investment Research, points out that 95% of the big-cap market is discounting flat earnings growth for the next 10 years. We believe this economic outcome is highly unlikely and creates the type of valuation anomalies we seek. This level of market pessimism has only happened four other times in the past 40 years (1974, 1979, 1982 and early 2009). After each episode, vigorous rallies have occurred over the subsequent 12 months. In addition, research by the strategists at Credit Suisse HOLT indicates that the big-cap market is about as cheap as it has been in over 15 years. Lastly, according to Strategas Research Partners, the big-cap equity risk premium (a measure of cheapness) is two standard deviations from its 50-year average.

A valuation approach to stock selection helps you answer what will likely change in the marketplace. Its weakness lies in telling you when it will occur. In other words, valuation approaches are lousy at market timing. Admittedly, this can be frustrating. Even so, I would rather endure the test of patience than live with the anxiety that comes from owning momentum stocks and knowing full well the ground beneath your feet will one day give way.

Other investors may decide to wait until it is clear that the market leadership has changed. We think this is unwise. Such a strategy leaves you in the unenviable position of having to sell stocks that are going down in price while chasing stocks that have already taken off.

We have therefore steadily increased the market-cap weighting of our Fund. As of December 31, 2008, the average market cap of Growth Trust was \$37.9 billion. Eighteen months later (June 30, 2010), the average market cap of Growth Trust stands at \$70.9 billion. Nine of our top 10 names and 20 of our

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34 names reside in the S&P 100 Index, representing 66% of the Fund.

Hockey legend Wayne Gretzky said the secret to playing the game is not to skate to where the puck is, but to skate to where the puck is going to be. This advice works equally well in markets. Investors should take note and position themselves accordingly.

(Commentary continued on next page...)

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Top 10 holdings	(%)
PepsiCo Inc.	5.2
Procter & Gamble Co.	5.0
American Express Co.	4.7
Genzyme Corp.	4.7
EMC Corp.	4.6
Johnson & Johnson	4.4
QUALCOMM Inc.	4.4
Cisco Systems Inc.	4.1
Apple Inc.	3.9
Medtronic Inc.	3.8
Top five sectors	
Information technology	32.9
Consumer staples	17.9
Health care	17.6
Industrials	8.4
Consumer discretionary	7.3

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. 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. As a nondiversified fund, it is permitted to invest a higher percentage of its assets in any one issuer than a diversified fund, which may magnify the Fund's losses from events affecting a particular issuer. The fund may focus its investments in certain regions or industries, increasing its vulnerability to market volatility. International investments are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility.

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Prior to October 5, 2009, the Fund was known as Legg Mason Growth 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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