

Legg Mason Capital Management Value Trust

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Market overview

The S&P 500 Index fought through a spate of selling pressure in mid-December to post a respectable +1.93% gain for the month, thus finishing the year up +26.46. Following a year that greatly exceeded the expectations of most people, the outlook for the economy and stock market in 2010 are the key questions on most investors' minds.

In our commentary at this time last year, we said: "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 indexes to the ranges in which they traded as recently as September 2008."

Our outlook essentially proved to be on the money, though it certainly didn't seem likely to be so in February and March, as the market slipped through its November 2008 lows — levels we had thought would hold — like a hot knife through butter, before bottoming in early March. From its closing low on March 9 through year end, the S&P 500 Index returned +67.80%, while the Dow Industrials returned +63.13% and the Nasdaq Composite, +80.25%.

For those investors who were underinvested or sitting on the sidelines in March, the market's advance has proven to be quite frustrating, as corrections were, for the most part, shallow and brief. The pullbacks that did occur were quickly met with surges in the CBOE Put/Call ratio and other signs of bearishness, as investors — scarred by the brutal bear market of 2007 to 2009 — sought quickly to protect themselves from a renewed decline. We commented last month that never in our experience had investors seemingly derived so little pleasure from such a spirited advance as we saw in 2009.

Average annual total returns and fund expenses – Class C shares (%) as of December 31, 2009

	1-yr	3-yr	5-yr	10-yr	Since incept. (4/16/82)	Gross*	Net**
Excluding sales charges	40.64	-16.12	-8.03	-3.20	12.04	1.72	1.72
Including effects of maximum sales charges	39.69	-16.12	-8.03	-3.20	12.04		
S&P 500 Index	26.46	-5.63	0.42	-0.95	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 does 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. 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.

Market forecasts for 2010 are all over the map, as is to be expected. Kevin Pleines, of Birinyi Associates, Inc., compiled a consensus of sorts by averaging the forecasts of nine major Wall Street firms — Bank of America/Merrill Lynch, Barclays, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, JP Morgan, Morgan Stanley and UBS. The average of these firms' year-end 2010 targets for the S&P 500 Index is 1,222, while they forecast, on average, S&P EPS of \$76, and real GDP growth of 3.1.

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If Birinyi's Wall Street consensus target of 1,222 for the S&P 500 is achieved, it implies a gain of about +9.6% for 2010.

After a gain of over +25% in 2009, many observers might think that another year of nearly double-digit gains in 2010 would be too much to expect. Interestingly, market history suggests just the opposite. According to work by Birinyi Associates' Cleve Rueckert, since 1945 there have been 17 years in which the S&P 500 gained at least +20%. In the following year, the market has been up 13 of 17 times (76.47%) by an average of +9.78%. A final bit of research by Birinyi's Amanda Crumb and Kevin Pleines provides further encouragement that 2010 might be another good year in the market. Using Birinyi's own Traders Handbook, Crumb and Pleines found that, of the 10 years since 1945 which began with a first-day gain of +1% or more, the market has been up an average of +14.57% for the entire year, with only one instance of negative returns (1990).

We are bullish on the outlook for U.S. equities in 2010. Some of us are more bullish than others, but it basically boils down to varying degrees of optimism. In formulating our expectations for the coming year, we consider four factors: (1) historical precedent, (2) investor sentiment, (3) the outlook for the economy and corporate earnings, and, most importantly, (4) market valuation. In recent commentaries we have written that we thought the S&P 500 Index could trade in the range of 1,250 to 1,350 by the end of 2010. As we review the available evidence today, that still seems to us like a reasonable range of expectations.

Fund highlights

During the fourth quarter of 2009, the Legg Mason Capital Management Value Trust – Class C shares generated a total return (excluding the effects of sales charges) of +3.17% bringing the full-year total return to +40.64%. In comparison, the Fund's unmanaged benchmark, the S&P 500 Index, returned +6.04% for the quarter and +26.46% for the year and the Lipper Large Cap Core Funds category average was +5.58% for the quarter and +27.14% for the year.

As of the end of the quarter, the Fund remained largely concentrated, with the top 10 holdings accounting for approximately 40% of its total assets, and over 50% of the assets invested in two sectors: information technology and financials.

On an absolute basis, the Fund had positive overall total returns and in seven sectors for the fourth quarter, with the greatest contributions coming from the consumer discretionary, healthcare and telecommunications sectors and the smallest

contributions coming from the utilities, consumer staples and financial sectors.

Relative portfolio underperformance was driven primarily by our security selection decisions (-250 basis points). In particular, security selection detracted from relative performance in the information technology, consumer staples and utilities sectors and helped relative performance in the healthcare, consumer discretionary and financials sectors.

Sector allocation also had a slightly negative impact on relative performance (-4 basis points). The Fund's overweight to information technology and consumer discretionary and its underweight to consumer staples contributed to relative performance, while the Fund's overweight to financials and underweights to healthcare and materials detracted from relative performance.

The interaction of our sector allocation and security selection had a mildly negative impact on our relative performance (-33 basis points).

Top contributors

Amazon was a top portfolio contributor, after its quarterly earnings (reported in October) exceeded even the most optimistic estimates and the company hiked its outlook for the fourth quarter. Amazon saw broad strength across its businesses, amplified by a Kindle-fueled reacceleration in its media segment. While the company continues to dominate in online sales of books, music and videos, it has expanded over the past five years to become the one-stop shop for all online commerce, taking significant share from competitors over the same period. Despite this excitement, we believe the market is underestimating the company's growth potential going forward, and that Amazon will continue to benefit from its scale advantages.

Sears Holdings shares posted positive returns in each month of the fourth quarter, as an improving U.S. economy, better holiday sales outlook, and a six-fold increase in the company's share repurchase authorization in mid-December encouraged investors. We continue to believe in the ability of Chairman Eddie Lampert to realize significant value through improvements in Sears' current operations and through intelligent allocation of the company's cash flow.

Aetna and UnitedHealth Group were among the top performing stocks in the portfolio during the fourth quarter, as U.S. health care reform legislation proved to be less terrifying than investors expected. The uncertainty surrounding the attempted

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reform restrained the managed-care stocks for much of 2009, but reports that the Senate would scrap the so-called “public option” in favor of covering more people under the plan ended up helping the stocks significantly toward the end of the year. We continue to believe that investors are underestimating the earnings potential of the managed-care companies, and we like the stocks on a valuation basis for the longer term.

At Google, recovering revenue growth combined with expense management bode well for the company's future operating results, driving the stock's gains during the fourth quarter. We think Google has a monster opportunity in display advertising, which could drive free cash flow growth through the middle of this decade, and potential growth opportunity YouTube is approaching profitability. We think Google's innovations here will sustain higher than embedded rates of growth over the next few years.

Top detractors

AES raised \$2.15 billion through an equity issuance and a joint venture with Chinese sovereign-wealth fund China Investment Corporation. While enhancing its ability to invest in new generation projects, this dilutes its existing shareholders and contributed to the stock's underperformance during the quarter. While we believe AES benefits longer-term from the growing need for power generation around the world and will grow significantly as a result over the foreseeable future, deploying new capital in a competitive environment creates uncertainty about long-term growth.

State Street's performance lagged in the fourth quarter after the company reported disappointing third-quarter results and lowered guidance. Shares sold off after management lowered sales and earnings guidance for 2010. In addition, some investors criticized earnings quality, as about one-third of what the company classified as “operating earnings” came from the reversal of prior negative marks on investment securities, not operations. Despite the near-term disappointment, we believe that the shares are undervalued because the market underestimates the company's normalized earnings power.

JC Penney was also a major detractor in the fourth quarter, largely due to a series of disappointing monthly same-store sales reports. The company missed consensus expectations for same-store sales in both October and November. While the company achieved its guidance for both months, investors apparently expected more as a result of an improving economy and easy comparisons from the prior-year periods. We continue to believe that the long-term expectations now

embedded in JC Penney's stock price are too low and that the company has the balance sheet and management to ride out the currently weak consumer environment.

Outlook

Value Trust remains well positioned for the current environment, even with strong performance in 2009 and modest portfolio activity at year end. We believe that 2010 will be a year best characterized by better returns from larger companies with strong valuation characteristics, low embedded expectations, and strong cash flow and growth prospects, both from the U.S. and abroad.

Technology remains the Fund's largest sector weight. During the course of the year, we reduced our exposure to most of the names within the sector as the group dominated other areas of the market in performance. Despite the group's strong performance, we believe the fundamentals remain among the most compelling for selective securities over the next several years. IBM is an example of the type of value inherent in the space. During what arguably has been the worst financial crisis since the Great Depression, IBM has been able to maintain a strong dividend growth rate, rising revenues and operating income; has bought back stock; derives about 60% of its revenues from outside the Americas; and is a continuing beneficiary of strong growth in the emerging markets – yet its stock trades at only 12x this year's earnings and around 10x what we believe the company will earn next year. With a strong balance sheet and management team, we believe it's among the most compelling values in the market today.

Financials are the next largest group in the Fund. We believe there remains considerable upside in the sector, as sentiment is poor, valuations are low and the environment is improving. Even though the S&P 500 financial sector was up over 130% from the March lows through year end, it still underperformed the index for the year. After three consecutive years of underperformance, investors hate the group, and it is the most widely shorted area of the market. Banks in particular have underperformed the market for six consecutive years, which has happened only one other time since the data started being collected in 1925; and they've never done so for seven consecutive years, so it would be unprecedented for them to underperform this year. The environment for banks, and many other financials, is good and improving. The yield curve is near record levels of steepness, employment is improving, balance sheets have been shored up through capital raises, and non-performing assets should peak this year, yet banks remain cheap on both book value and normalized earnings.

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Companies such as JP Morgan, Bank of America, Capital One Financial and Goldman Sachs trade at an average earnings multiple of under 7.5x next year's estimates and 6.5x for the following year. This compares to the S&P 500's multiple of around 12x and 10.7x, respectively, for the same two years. Even with the uncertainty of further changes in the regulatory environment, given the dramatic reduction in capacity and competition in the sector, we believe the financials are very well positioned to provide strong returns for shareholders.

At the end of 2008, our exposure in the managed care stocks, United Healthcare and Aetna, amounted to over 14% of the portfolio. As fears receded surrounding the most severe changes in the healthcare industry as a result of the pending Health Care Reform bill, those securities posted strong recoveries from the lows reached in March 2009. Aetna rose over 67% and United rose 86% from their March 5 levels, and we used their strength to redeploy the proceeds into areas of the market which in our judgment remain significantly mispriced. The two stocks combined still represent almost 6% of the portfolio, but we believe they are more appropriately sized given our optimism in the longer-term outlook for other parts of the healthcare sector. Given the attractive valuations, we would not be surprised to see an acceleration in M&A activity in this sector once the regulatory picture is clear in Washington.

We remain quite optimistic in the upside that remains for the portfolio overall, and we will continue to migrate the assets into where we believe the best values are on a risk-adjusted basis. Pessimism is rampant and expectations are low – conditions that typically support upside surprises. Those that fear they have missed the move in the market, which has risen about 65% from the low in March 2009, need only look at the fact that we are still not back to the level the market traded at during the early weeks of September 2008, as the environment was getting materially worse. It is also the case, according to Birinyi Associates, that the peak in the market's P/E of the last five bull markets has averaged 26x. Should that be the case this time, the market would reach between 1,986 and 2,402 based on consensus expectations for this year and next. That would result in a rise from current levels of 78-115%. Given the low level of inflation and interest rates, a multiple of 16-20x earnings is not unreasonable to put the market closer to fair value.

Time will tell how the returns will be delivered, but given our long history of navigating well after periods of distress and crisis in the market, and strong absolute and relative returns since the Fund's inception almost 28 years ago, we are very

excited about the prospects for the companies within the Value Trust and the returns for the Fund over the next several years.

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Top 10 holdings	(%)
AES Corp	8.3
Aflac Inc	3.7
Sears Holdings Corp	3.6
Aetna Inc	3.4
eBay Inc	3.3
IBM Corp	3.2
Hewlett-Packard Co	3.1
CA Inc	3.1
Capital One Financial Corp	3.0
Cisco Systems Inc	3.0

Top five sectors	(%)
Information technology	28.1
Financials	26.1
Consumer discretionary	16.2
Health care	10.4
Utilities	8.3

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. 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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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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