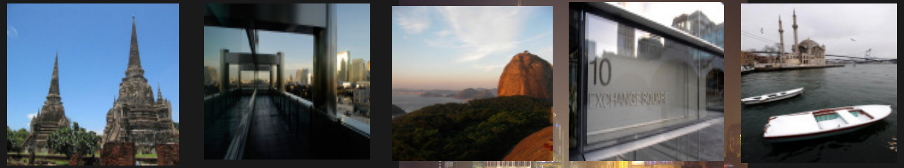
ESEMPLIA EMERGING MARKETS
Review and Outlook
January 2010



2009 In Review

The emerging markets equities asset class posted a record gain of 79% in 2009, after what was a very challenging period (to say the least) for global equity markets during 2008.

Whilst the asset class was not isolated from the sell off which occurred across equity markets as a result of the global financial crisis, the speed and magnitude of the recovery which followed paid heed to the Emerging Markets structural story.

Over the course of 2009, not only did we witness a significant recovery in the asset class (partially offsetting the record loss of 53% in 2008), but we also witnessed a major structural shift in the economies set to lead contribution to global growth (for at least over the medium term). Where previously we had been accustomed to the developed states flexing their muscle in this regard, it became obvious over the course of last year that the tide had indeed changed in favour of some of the more notable emerging markets economies. Institutional investors globally recognised this shift and the asset class experienced near record inflows of US $65 billion for the year.

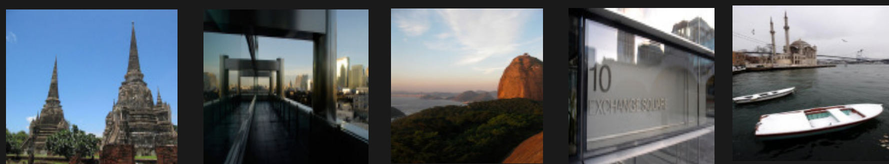
Performance for the MSCI EM Index to end December was 78.50% while our 'Core' portfolios returned circa 90.0%, (a relative return of 11.0%) and our 'Alpha Extension' and 'Long-Short' strategies returned 117.85% (a relative return of 39%) and 35.26% respectively. The key contributors to portfolio performance for the period were stocks with strong valuation and earnings support and which were concentrated in countries and sectors which are more cyclical in nature. Some notable examples of such stocks were Novatek (Russia, Energy), Gammon Gold (Mexico, Materials) and Banco Itau (Brazil, Financials). Rather than being characterised by any particular theme at the country or sector level, stock specific events were the major cause behind the leading detractors to performance for the period. Perhaps the most notable detractor for the period was Satyam Computer Services, a company which was devastated by an incidence of fraud and which serves to act as a constant reminder of the need for broad diversification.

Our Macro Outlook for 2010

We believe the most important factor in setting the tone for global financial markets going forward is the impact of the removal of the Quantitative Easing put in place by Central Banks in the early days of 2009. This was an extraordinary response to extraordinary times and on balance we believe it was justified. However, as growth returns to more normal levels and output gaps close, its removal will become increasingly necessary. It is difficult to ascertain exactly what the impact will be due to the removal of the Quantitative Easing on markets' sentiment and liquidity, but just as their implementation marked the turnaround of markets at the lows, their end, in isolation, could be seen as market negative.

Markets are also set to pay close attention to interest rate increases as Central Banks move to respond to rising inflation, whether perceived, on the back of depressed base effects or real, if economic growth gathers momentum. This process will be particularly important for Emerging Markets, as we believe it will be the larger and more important markets in this space that will tighten first (i.e. Brazil, India, Korea and China). The stabilization of the US economy and the eventual normalisation of the Fed's monetary policy could trigger a bout of appreciation in the US dollar, which might constitute a risk factor for Emerging Markets Equities, as it could lead to a reversal of the sizeable flows into the asset class observed during the latest period of USD weakness.

Regarding our outlook for growth, we are in the midst of synchronized growth acceleration in developed markets to above-potential levels in 4Q09 and 1H10. Stock rebuilding is the key driver behind this growth spurt, as in the midst of the crisis, corporations cut inventories and production levels more deeply than warranted by the actual fall in underlying demand. The economic outlook for 2H10 and going into 2011 is murky at this stage, as it hinges on whether or not the ongoing restocking cycle will spark a new round of demand expansion as Western economies remain over-leveraged. For most Emerging Markets the picture is brighter, as strong growth will continue to be underpinned by healthy domestic demand expansion, even in the face of sluggish consumption growth in the developed world. China, the largest Emerging market, will continue to punch above its weight in terms of its contribution to world economic growth. We expect Chinese growth to reach circa 9% in 2010, driven again by investment but increasingly also by consumption. China's exchange rate policy will also be important to watch as a depegging from the USD will become increasingly central to prevent rising protectionist pressures in the West. Over the medium term we expect the emerging markets equity asset class' strong fundamentals will translate into healthy returns. In the short term however (i.e. the next 12-months), we expect greater volatility in our markets.



Our Outlook for Emerging Markets

We believe there is sufficient support for consistent levels of growth in the asset class on the basis of the structural story presented. However, as stated previously, this assessment hinges on the sustainability of the global economic recovery which is currently underway.

Corporate earnings growth looks set to play an important role in supporting equity markets in general and emerging markets equity in particular. Positive earnings growth and revisions have, in the past six months, allowed 12-month forward PE to remain stable in a tight range (12.5-13x), despite market gains of 30% in 2H09. As we move into 2010 and 2011, earnings will become essential to the formulation of the market's valuation assessment and it is possible that the current consensus expectations of +20% yoy earning growth in 2011 may need to be adjusted down over the course of 2010. We believe it is still too early to state a strong position here however we are cognisant that vigilance and close monitoring of this factor will be of utmost importance.

On a valuation basis, even after a year of stellar returns, valuation levels for the emerging markets equity asset class remain supportive. At 13.2x, MSCI EM's forward PE is back to its long-term average and 8% below MSCI World (developed markets) levels. On a PBV basis, EME's 2.2x is slightly above its long-term average of 1.8x but this reflects the structural improvement in underlying profitability of the asset class during the last decade with the MSCI's ROE in 2010 expected to reach 16% vs. an average realized ROE of 12% since 1995. Similarly, MSCI EM's 15% premium vs. MSCI World on a PBV basis is justified by EME's superior expected ROEs (16% vs. 13%).

Portfolio Positioning

We remain most overweight Mexico, Thailand, and China, and to a lesser extent Russia, India, and Turkey. During the last quarter of 2009, we cut more than 300bps from Brazil consumer names, moving to an underweight position in the country. This move reflects fuller valuation in many sectors as well as the expected impact from early interest rate increases on the consumer discretionary / real estate sectors. In China, we moved to an overweight position by increasing our consumer discretionary weight, reflecting rapid growth and expectations that the government will continue to rebalance the economy, slowly, toward the consumer. We also reflected the view of continuing cyclical upswing by increasing exposure to Korea and IT names in Taiwan.

For Further Information please contact a member of Esemplia's Client Management team.

North America
Beatrice Khine
T: +1 212 805 6057
E: bkhine@esemplia.com

UK/Europe
Benjamin Day
T: +44 207 858 3024
E: bcday@esemplia.com

UK/Europe
Jim Kandunias
T: +44 207 858 3020
E: jkandunias@esemplia.com

Esemplia Emerging Markets (Esemplia) is the trading name of Legg Mason International Equities Limited. Registered in England & Wales No. 3752343. Confidentiality and Reliance: The contents of this document are proprietary or licensed to Esemplia and may not be reproduced in any way. The information has not been delivered where to do so would represent a breach of regulation or offence under law, and those seeking to rely on this information should ensure that they were the intended recipient or otherwise should satisfy themselves that their receipt of this information did not cause a breach of regulation or offence under the law of any relevant jurisdiction. The information provided is for illustrative purposes only and does not constitute investment advice or recommendation and is subject to change. Investors and advisers: This document is intended for and provided to an Institutional Investor (being a professional client or eligible counter-party) or their professional advisor and is not intended for nor provided to a retail client. Investment Risk: While the portfolio manager will attempt to minimise risk, the value of investments in discretionary accounts may fluctuate and it is possible that the investor could incur losses, including the loss of principal invested. Date of information and opinion: Information and opinions given herein are current only as at the date indicated, or if no date is so indicated they are current at the date of this document. Legg Mason, Inc and affiliates: Esemplia is ultimately owned by Legg Mason, Inc., Baltimore, USA. Other units or affiliates within Legg Mason, Inc. may hold different views to those stated in this information. Regulatory and corporate information This document is issued by Esemplia which is authorised and regulated in the UK by the Financial Services Authority (FRN: 190952). Registered Office: 10 Exchange Square, 9th Floor, Primrose Street, London EC2A 2EN. Legg Mason International Equities Limited is a US Securities and Exchange Commission (SEC) registered investment adviser in order to provide services into the USA and complies with the Advisers Act only with respect to US clients.

© 2010 Legg Mason International Equities Limited.

Esemplia
Emerging Markets