LEGG MASON
GLOBAL ASSET MANAGEMENT

Legg Mason
Core Plus Global Bond Trust

Objective

The Trust aims to earn a before fees and taxes return of 1.25% p.a. in excess of its benchmark over rolling three-year periods.

Benchmark

Barclays Capital Global Aggregate Index (hedged into Australian dollars)

Value

$21,398,941.

Performance (before fees and taxes)

	Trust %	Benchmark %
3 months	-1.60	-0.48
1 year	12.81	9.28
3 years p.a.	6.29	8.84
5 years p.a.	4.88	7.50

Past performance is no indication of future performance.

Profile

Portfolio Characteristics	
Duration (years)	5.3
Average credit quality (Standard & Poor's)	AA-

Sector Allocations	%
Government	54.8
Investment grade	22.5
Mortgage and asset backed	6.3
High yield	4.8
Emerging markets	1.4
Banking Government Guaranteed	0.4
Cash and other	9.8

Market Review

Government yields rose significantly on the perception that the global economic recovery was becoming more durable.

Economic optimism lifted interest rate hike expectations late in the period.

U.S. corporates outperformed European corporates, as the latter were led lower by the Financials sub-sector.

U.S. agency mortgages had a strong quarter.

Volatile components had an uplifting influence, but in general pricing pressures remained subdued. Once again, the U.K. was the anomaly.

U.S. high yield outperformed on rising economic sentiment, whereas U.K. high yield was dragged lower by subordinated Financials issues.

Rising government bond yields were a drag on total returns. Deepening concern over Europe's periphery also had a negative influence.

Performance

The Legg Mason Core Plus Global Bond Trust underperformed its benchmark over the quarter. However, performance over the past year was 3.5% ahead of benchmark.

Over the quarter, tactically long duration management had a negative impact on performance, as yields rose in the U.S. and Europe. An underweight to the European periphery aided performance, but these gains were more than offset by losses from a long duration position in Poland.

Yield curve positioning had a positive impact, with gains in the U.S. offsetting losses in Europe. Most of the positive impact occurred in December, as 30 year yields rose much less than 10 year yields.

Agency mortgages performed so the portfolio's underweight to this sector detracted value, though issue selection helped limit some of the negative impact.

Spreads narrowed, and the high-yield corporate market significantly outperformed.

The euro weakened in November on rising concerns over Ireland. The Japanese yen continued to strengthen, however, as did the Australian dollar.

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Outlook

In light of the surprisingly strong U.S. economic data, we reiterate our longstanding, cautiously optimistic outlook for modest economic growth combined with subdued pricing pressure. The recent fiscal package reinforces this view as it reduces downside risks to both growth and inflation. Just as we tethered our investment strategies to this longer-term outlook when the market became fearful of a double-dip recession, we will continue to embrace a staid approach through the current cyclical upswing in market expectations.

We believe the environment of economic recovery in the absence of rising inflation, combined with supportive policy, argues for an emphasis on risk assets. We expect the broad outperformance of large, globally diversified banks as a result of ongoing de-leveraging. The increase in regulation and government oversight should make the financial system more stable. Within Europe, we note that a number of select subordinated issues continue to trade at prices that more than compensate for the greater emphasis on bail-ins. We cannot stress enough the importance of issue selection.

Overall, corporate default rates continue to decline and upgrades clearly outnumber downgrades. This should persist throughout 2011 and provide a lift to the corporate sector. The ratio of corporate to government yields remains at an extreme level. If the current market enthusiasm proves accurate, and growth and inflation increase in coming quarters, the emphasis on spread sectors should also offer some protection, as government yields would be expected to rise more than corporate yields. We would expect to further de-risk the portfolio following such a scenario.

The greatest threat to current portfolio positioning comes from the ongoing sovereign solvency strains in Europe. Policymakers have yet to announce any semblance of a clear resolution, and we doubt anything game changing will be announced pre-emptively. The policy announcements of 2010 should help prevent the next crisis but do little more than buy time during the current crisis. Even if loans are extended, we are not convinced it is at all possible for the periphery to achieve the degree of internal devaluation that is required. The market should eventually price in a greater chance for peripheral bond restructuring beyond just Greece. The only other alternative is for the European Central Bank to engineer further external devaluation - euro depreciation - in order to relieve the need for internal devaluation.

We look to maintain an underweight to Spain, Portugal and Italy, and we will calibrate the size of the short position on the euro against a basket of currencies. This should provide some ballast against the scenario in which the European subordinated financial position is challenged, either as a result of slower global growth or the decision to emphasise private sector burden sharing.

We are comfortable holding slightly more duration than the benchmark in the U.S. and Europe. Portfolios that hold more spread risk also tend to hold more U.S. duration as an additional hedge against downside risks. We will continue to target an underweight duration position in Japan. Given the sharp rise in U.S. treasury yields over the past month, we find better value in the U.S. than in Europe, but this is a tactical position that should shift along with market pricing. Forward markets currently price for the U.S. 10 year to finish the year near 4%. While this is very possible, we believe there is a meaningful chance that the 10 year yield will finish below the level implied by forward markets.

Finally, we remain bullish on emerging markets as a long term secular theme. Inflationary pressures are building in Asia, and currency reserves continue to grow. We expect that exchange rate intervention will continue and that policymakers will use a host of alternative policy instruments to limit inflation, but that currency appreciation eventually will have to be allowed. We are targeting a long position to a basket of emerging market Asian currencies, including the Korean won, the Malaysian ringgit and the Indonesian rupiah. Against this, we are targeting a short Japanese yen position. The longer-standing long to the Brazilian real and Polish zloty should remain, barring any sharp market movements.

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