LEGG MASON
GLOBAL ASSET MANAGEMENT

Legg Mason
Diversified Fixed Income Trust

Objective

The Trust aims to earn a before fees and taxes return of 1.0% p.a. in excess of its benchmark over rolling three-year periods.

Benchmark

50% UBS Australian Composite Bond Index and 50% Barclays Capital Global Aggregate Index, hedged into Australian dollars.

Value

$42,457,989.

Performance (before fees and taxes)

	Trust %	Benchmark %
3 months	-0.54	-0.33
1 year	10.51	7.65
3 years p.a.	7.73	8.15
5 years p.a.	5.87	6.66

Past performance is no indication of future performance.

Profile

Quarterly Performance	Trust %	Benchmark %
Australian bonds	0.45	-0.19
Global bonds	-1.60	-0.48

Asset Allocation	Trust %	Benchmark %
Australian bonds	49.8	50
Global bonds	50.1	50
Cash	0.1	-

Market Review

The release of September quarter gross domestic product, inflation and housing starts all surprised to the downside. This caused some to question the likelihood of further near term interest rate rises. However, consistently strong monthly employment growth and positive balance of trade data provided substantial counterbalance. The Reserve Bank of Australia, in raising the target cash rate by 0.25% at its November meeting, noted the economic conditions were finely balanced but considered it prudent to move at that time. Despite the 0.25% increase in the targe cash rate, 90 day bank bill yields rose only 0.03% over the quarter.

The U.S. Federal Reserve began a second phase of its quantitative easing program, dubbed QE2, in an attempt to keep yields low and ward off deflationary pressures. Initially, anticipation of the new round of quantitative easing caused a rally in U.S. treasuries, which helped two year yields to record lows. Ironically, as the Federal Reserve engaged in its purchasing program, U.S. treasuries were sold off largely due to the release of a string of positive economic statistics, which prompted the market to reassess its outlook for the U.S. economy and inflation. 10 year U.S. treasury notes finished the quarter 0.78% higher. The sell-off in the Australian bond market was less pronounced as 10 year bond yields 0.58% while 3 year bond yields rose 0.52%. This resulted in a slightly steeper Australian curve.

Concerns with Europe's peripheral economies persisted. Attention focused on Ireland's need to support its troubled banking industry. Ireland was forced to seek a bailout package from the European Union, which spruiked new regulations related to the Europe's banking and financial entities. Spreads on subordinated debt of European Financials widened as a result.

Broad risk sentiment improved over the quarter, with equity and commodity markets posting sound returns. Spread markets enjoyed the improved risk sentiment, with corporate spreads generally tightening modestly. The Australian dollar appreciated on a trade weighted basis, having recorded its highest post float levels against the U.S. dollar, euro and pound sterling in the final days of 2010. Investors continued to seek higher yielding currencies as the interest rate differential between Australia and developed western economies widened with the Reserve Bank's November rate rise, and further widening is expected through the coming year.

Globally, 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.

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Performance

The Legg Mason Diversified Fixed Income Trust underperformed its benchmark over the quarter. However, portfolio performance over the past year was 2.9% ahead of benchmark. This quarter, the portfolio domestic bonds exposure added value. However, this was more than offset by the portfolio's global exposure.

Domestically, the corporate sector outperformed government bonds, through higher running yield as well as spread contraction. This aided portfolio performance. Further, holding Swiss Re, AXA, Macquarie Bank, NAB and Suncorp added further vllue as spreads on Financials contracted. Duration management also contributed to portfolio performance. Portfolio duration was short relative to benchmark at the start of the quarter. The portfolio's short duration position was reduced to almost neutral after yields increased.

Globally, tactically long duration management had a negative impact, 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 yen continued to strengthen, however, as did the Australian dollar.

Outlook

Domestic gross domestic product growth is likely to remain around trend throughout 2011 as government stimulus continues to wind down and an expected self-sustained growth phase ensues. Strong terms of trade and commencement of major projects in the resource sector are expected to help domestic economic growth.

Inflation is forecast to return to the upper band of the Reserve Banks target however the relatively strong Australian dollar should assist its containment.

With Australia's labour market in very good shape and broader economic growth strengthening, we expect the cash rate to move higher through the second half of 2011, with a target of 5.50% to 5.75% by year end.

Portfolio duration is expected to be tactically managed, since volatility is likely to remain high while markets debate the speed of the global recovery, the possible return of inflation, sovereign risk issues and regulatory changes to the financial markets.

The portfolio maintains an overweight position in corporate bonds, with an emphasis on Financials, as market valuations and increased regulation continue to appeal. We are also selectively buying primary corporate deals in industries that will benefit from an economy that is returning to trend growth, as well as in industries that have de-leveraged, namely property trusts and infrastructure.

As a defensive strategy, we also maintain an overweight position in government-guaranteed bank issues, which offers the assurance of the Commonwealth Government along with an attractive yield. Finally, the portfolio is underweight government bonds as they remain relatively expensive.

Globally, 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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