LEGG MASON
GLOBAL ASSET MANAGEMENT

Legg Mason
Permal Global Absolute Trust

Objective

The Trust aims to earn a gross return of 8 to 10% p.a. over a full market cycle (three to five year periods).

Value

$10,072,772.

Performance (before fees and taxes)

	Trust %
3 months	2.85

Past performance is no indication of future performance.

Key points

- The Trust's gains were focused primarily in gold, precious metals and commodities, as well as equities in the U.S. and Japan.
- On the downside, the Trust's losses were concentrated in the fixed income and alternatives asset classes. Investments in the fixed income sector were hurt by the portfolio's exposure to U.S. government bonds and credit.

Market Review

Markets finished December sharply higher, which capped off a strong quarter and a positive 2010. Notably in the December quarter, U.S. equity markets finally surpassed levels last seen prior to the collapse of Lehman Brothers. The portfolio's investment manager notes that two catalysts aided markets at the year-end. The first was the extension of the Bush tax cuts in the U.S. (plus additional fiscal stimulus via a payroll tax holiday), which essentially acts as stimulus to the global economy. Secondly, economic data from the developed world continued to improve. Equities, commodities and cyclically oriented currencies all performed well, while government bonds were laggards.

As markets enter 2011, the consensus is almost uniformly bullish and sentiment is positive and elevated for the reasons cited above as well as supportive monetary policy in the form of quantitative easing by the U.S. Federal Reserve. However, the outlook is certainly not without risks.

Fund Review

The Legg Mason Permal Global Absolute Trust returned 2.9% for the December quarter. In a challenging environment for global macro strategies, all of the portfolio's strategies were profitable in 2010, with the exception of its alternative strategies, which were flat. The Fund's real asset strategies contributed the most to its performance, largely due to allocations to commodities and precious metals.

The portfolio's investment process begins with an assessment of the factors driving returns of global macro hedge funds, with its proprietary factor model placing more weight on recent data. Gold remains a core long factor exposure in the model with the other factor exposures entering 2011 being commodities and small-cap equities in Europe.

Turning to portfolio positioning, benefits accrued from its diversification across asset classes during the fourth quarter. Gains were focused primarily in gold, precious metals and commodities, as well as equities in the U.S. and Japan. Losses were concentrated in the fixed income and alternatives asset classes. Investments in the fixed income sector were hurt by the portfolio's exposure to U.S. government bonds and credit. The portfolio's European exporter pair trade (long European exporters that export outside the European Union to benefit from lower euro and short U.S. companies exposed to Europe) was also a detractor and the position was closed.

Looking at the portfolio's equity exposure at the end of the fourth quarter, this comprised a long exposure of 24%. This allocation became more diversified over the period, being spread across the U.S., Canada, Europe, Japan and the emerging markets. In particular, new positions in northern Europe and Canada focused on industrial or natural resources companies that benefit from global growth trends and are denominated in currencies that are currently not experiencing stress.

Elsewhere, the portfolio had a 24% exposure to fixed income strategies at the end of the quarter, within which its allocation to government bonds was reduced considerably during the period as economic fundamentals turned positive. At a 10% allocation, the short dated government bonds in Europe and 7 year to 10 year maturity U.S. treasuries act as a hedge when a flight to quality ensues. The portfolio retains a bias to corporate credit in the U.S., with exposure divided among investment grade, high yield and floating rate bank loan securities.

Turning to the portfolio's real asset strategies, this exposure at the quarter end was 15%, with allocations to precious metals and commodities remaining a core part of the portfolio.

The portfolio's alternative strategies exposure, meanwhile, comprised two systematic macro strategies, one discretionary macro strategy, one long/short equity strategy and one event driven strategy. The alternative strategies exposure weighting was 11% at the end of the period. This provides a diversified return stream to the broader portfolio. Finally, within the portfolio foreign exchange strategies, notable exposures at the end of the quarter included short positions in the euro and Japanese yen.

Outlook

The manager notes that the economic outlook has improved markedly as recent data has shown some positive momentum. The extension of the Bush tax cuts and the additional stimulus by way of a payroll tax holiday have provided a positive catalyst for growth in the first half of 2011. Additionally, the U.S. Federal Reserve remains committed to its policy of quantitative easing via purchases of longer dated treasury securities.

While inflation remains low in the US and the developed world, the same is not the case in China and other emerging markets. It believes that this tension between developed countries pursuing quantitative easing policies (i.e., the U.S. and Japan) and developing economies facing inflationary risks will continue to be an issue for the markets in 2011. Attempts to tighten monetary policy to control inflation in certain emerging market economies could lead to a hard landing that has the potential to destabilise markets, especially commodity markets.

Equities are the most likely beneficiaries of the policy support measures and improved economic fundamentals. In the US, for example, the impact of quantitative easing places a perceived floor under asset prices, inviting investors to exit government bonds and take on more risk in their portfolios.

Meanwhile, interest rates globally began rising in the December quarter and this could continue into 2011. There remain pockets of opportunity in both government bonds and credit, but investors will certainly need to be selective.

In Europe, given the severity of the sovereign debt crisis in the region, the European Central Bank may be forced to increase its own sovereign bond purchases. This crisis is not over, and its impact will continue to be felt by the European banking system as well as the euro.

In the currency markets, investment opportunities remain as a result of the varying macroeconomic policies being undertaken by governments globally. Active trading is a necessity, however. In this environment, gold remains a good hedge to policy error and an overall lack of confidence in central banks. Other precious metals have also performed well and are expected to continue to do so in the current environment.

Broad commodity markets should continue to benefit from improved global growth, although the potential for destabilising price spikes similar to 2008 exist and need to be monitored.

In addition to the risks of excessive tightening in China and the ongoing European sovereign debt crisis, the following risks are prevalent:

- oil and agricultural commodity price spikes that act as a tax on both developed and emerging market consumers;
- fiscal problems at both state and local municipalities in the U.S.; and
- housing prices double dip in the U.S.

Ultimately, for sustainable growth to take hold, an improvement in the U.S. employment picture must occur.

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