

Legg Mason Australian Bond Trust

Objective

The Trust aims to earn a before fees and taxes return of 0.75% p.a. in excess of the benchmark over rolling three year periods.

Benchmark

UBS Australian Composite Bond Index.

Value

\$228,758,383.

Performance (before fees and taxes)

	Trust %	Benchmark %
1 month	1.76	1.32
3 months	3.55	2.46
1 year	6.46	1.66
3 years p.a.	7.08	6.86

Past performance is no indication of future performance.

Profile

Attribution	Basis Points
Duration	-1
Yield curve	0
Sector selection	+9
Security selection	+36
Residual	0

Sector Allocations	Trust %
Government	28.1
Supranational	5.6
Corporate investment grade	48.4
High yield	0.6
Mortgage and asset backed	6.0
Index linked	1.4
Government guaranteed banks	9.8
Cash and cash equivalents	0.1

Market Review

Economic data released during the month was relatively strong, led by yet another solid employment report as the Australian unemployment rate fell to 5.5%. Elsewhere, retail sales, consumer confidence and building approvals all rose. The December 2009 quarter inflation report was mixed, with the 12 month headline rate somewhat subdued at 2.1% while the Reserve Bank of Australia's preferred underlying rate remained above the target range.

Money market rates were mixed during the only month of the year that the Reserve Bank Board does not meet. However, speculation about increases in the target cash rate driven by stronger economic news saw short term interest rates move slightly higher for 90 and 180 days. Meanwhile, longer term rates moved lower on a more subdued global economic outlook and weaker share markets.

Rallying bond markets globally helped local bond yields move lower over the month, notwithstanding the stronger domestic economic news. In particular, the actions of the Chinese authorities to slow growth as well as investor anxiety over sovereign credit risk highlighted by concerns in Greece saw a "flight to quality" emerge, which benefited U.S. treasuries and Australian Government bonds. These actions saw risk assets sold off quite aggressively. As a result, share and commodity markets were sold down sharply late in the period after rallying earlier in the month.

Local credit markets performed well, initially by following stronger offshore markets and then by managing to hold onto those gains as offshore markets gave up ground towards the end of the month. Supply and demand fundamentals remained supportive and Australian economic news likewise supported the local credit market.

The Australian dollar was mixed as it faced the conflicting forces of stronger local economic fundamentals and weaker share and commodity markets.

Performance

The Legg Mason Australian Bond Trust outperformed its benchmark by 0.4% over the month. Performance over the past year is 4.8% ahead of benchmark.

Corporate spreads tightened at the start of the year on the back of relatively strong economic data. This aided portfolio performance given the significant exposure to corporate investment grade debt. Once again the portfolio's overweight exposure to Financials added value, with holdings in Swiss Re, AXA, National Australia Bank, Rabobank and Suncorp all beneficial.

Outlook

Gross domestic product growth is expected to improve to around trend in 2010 as government infrastructure spending gains traction and export demand improves.

Inflation will likely remain below average in the short term as wage pressures remain weak and the economy continues to operate below its productive capacity.

With Australia's labour market in reasonable shape and broader economic growth returning, cash rates are expected to continue to move higher throughout 2010.

Portfolio duration is expected to be tactically managed as volatility is likely to remain high while market participants debate the speed of the global recovery and the possible return of inflation.

We maintain an overweight position in corporate bonds, with an emphasis on Financials, as market valuations combined with continued government support and increased regulation provide significant appeal despite spreads tightening through 2009. We are also selectively buying primary corporate deals in industries that will benefit from an economy that is returning to growth and in those that have de-leveraged.

We also maintain an overweight exposure to government guaranteed bank issuance as a defensive strategy given that it offers the assurance of the Commonwealth Government with greater yield benefit. We are also underweight government bonds as they remain relatively expensive.

Further Information

Portfolio Characteristics

Duration (years)	3.3
AAA	47.2
AA	12.9
A	23.3
BBB	14.5
Sub investment grade	2.1