

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

\$43,184,209.

Performance (before fees and taxes)

	Trust %	Benchmark %
1 month	2.41	1.35
3 months	3.47	2.01
1 year	22.85	10.17
3 years p.a.	3.61	8.43

Past performance is no indication of future performance.

Profile

Portfolio Characteristics

Duration (years)	6.8
Average credit quality (Standard & Poor's)	AA-

Sector Allocations

	Trust %
Government/supranational	55.1
Investment grade	28.6
Mortgage and asset backed	0.9
High yield	8.3
Emerging markets	1.6
Banking Government Guaranteed	0.2
Cash and other	5.3

Market Review

Political developments took centre stage in January, overshadowing the impact of economic releases and central bank activity on investor expectations. In Europe, concern increased over the future of Greece and the risks embedded in lending to a country that is struggling under the binds of a common currency framework. The Greek Government released a fiscal recovery plan but details were far from complete and doubts remained over the government's ability to impose the necessary restraint. Investors were also spooked when a story broke that suggested the European Central Bank examined the legalities involved with exit from the monetary union. Still, Greece was able to tap the market with a new five-year bond deal that was heavily oversubscribed and ultimately priced with better terms than originally anticipated. The secondary market for Greek debt remained weak, however, and spreads relative to German bunds drifted wider over the course of the month. Greek government debt underperformed similar maturity German government debt by roughly 6% as the five-year spread widened 1.85% to 4.39%.

The Obama administration proposed sweeping reform of the U.S. banking industry, in-line with those long championed by former U.S. Federal Reserve chair Paul Volcker. The proposed reforms include limitations on the size of financial institutions, a fee on the largest firms that pose systemic risk and clearly separating commercial from investment banking activities. The Financials sub-sector, which had rallied during the first half of the month, sold off following the announcements. The market seemed to be concerned over the future profitability of the banking industry as well as the extended impact reforms could have on economic recovery.

Government bond yields declined across the maturity spectrum. The U.S. 10-year yield decreased 0.25%, while the 10-year German bund decreased 0.19%. Corporate bonds generally outperformed government debt, although the U.S. lagged significantly behind Europe, where the Financials sub-sector continued to perform well, especially subordinated issues. There was somewhat of a decoupling between pricing in debt versus equity markets. The S&P 500 lost 3.6% while the German DAX lost 5.9%. This contrasted with the high-yield market, which trailed treasuries by 0.16% in the U.S. but exceeded bund returns by 2.4% in Europe. The U.S. dollar continued to recover ground, particularly against the euro, which was weighed down by the Greek issue and depreciated by 3%.

Performance

The Legg Mason Core Plus Global Bond Trust outperformed its benchmark by 1.1% over the month. The largest contributor to relative portfolio performance was the overweight to the corporate sector, particularly select European Financials issues, including subordinated debt.

Duration strategies also added value. Extra duration, particularly at the longer end of the U.S. and European curves, had a positive impact on performance as yields declined and curves generally flattened.

Currency strategies were roughly flat. Gains from long positions in the U.S. and Canadian dollars, and the short Euro position, were not quite enough to offset losses from a short position in the Japanese yen.

Outlook

While encouraging for our emphasis on the corporate sector, we continue to look past the current rebound in the production cycle, which has been strong and converging rapidly toward final sales levels. We continue to expect medium-term economic growth to remain constrained by ongoing household de-leveraging and a restricted flow of credit. Inflation should remain subdued in most major economies as a result and may not trough for quite some time. We remain comfortable with additional duration and have positioned for curve flattening, particularly in the U.S. and Europe. As growth remains below trend and spare capacity is only slowly absorbed, central banks are more likely to hold policy rates at current low levels for an extended period. Should fiscal constraints become binding as investors focus on rising debt-to-GDP ratios, the policy burden will shift to interest rates for policy support. The U.K. is an exception. We have recently shifted duration away from gilt markets toward the U.S. and Europe and look to maintain a short position for the time being. With the upcoming general election and the dire state of public finances, we feel risk premiums on real gilt yields are likely to rise relative to equivalent maturity U.S. treasury and German bund yields.

A number of quantitative easing programs are set to wind down in the near-term - the Bank of England recently completed its £200 billion of pre-announced purchases and the U.S. Federal Reserve's mortgage backed securities purchase program is being scaled back - and there may be some volatility associated with this shift in the supply/demand dynamic. This is another reason to shy away from gilt markets. Similarly, we continue to target an underweight position to agency mortgage-backed securities in the U.S. as the Federal Reserve nears completion of its mortgage backed securities purchase program.

We are targeting a modest position in Greek government bonds following the significant spread widening in recent months. Public finances are in a very weak position and sovereign credit quality has come under pressure from the major rating agencies. Nevertheless, we believe that the premium available within Greek government bonds relative to their other eurozone counterparts makes them an attractive long-term proposition despite likely near-term volatility. It should be noted that we are targeting underweight exposure to other peripheral markets such as Portugal, Italy, Ireland and Spain in anticipation of spreads increasing over German bunds. While the fundamentals are clearly challenged across peripheral Europe, we find the current relative value opportunity offered by Greek debt compelling.

Despite our caution over the strength of the global economic rebound, an overweight to the corporate markets continues to be our preferred strategy. We continue to hold a substantial overweight position to investment-grade corporate debt and high-yield corporate debt. Issue selection continues to focus on select Financials issuance of large European and U.S. banks. The recent announcements by the Obama administration and related discussions across Europe have added considerable uncertainty to the future form of financial intermediation. We are not surprised that regulation is on the rise but we are surprised by the way markets reacted. Tighter regulation should be viewed as inevitable, logical and generally bond-holder friendly, and we continue to see compelling value in large strategic institutions with expanding market share. We expect the resultant financial industry to include less risky business activities, more capital and higher liquidity. We believe these would all be bond-holder friendly developments. They are not necessarily equity friendly and we continue to look for a gradual breakdown in correlation between debt and equity markets.