

Legg Mason Western Asset 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

\$8,876,870

Performance (before fees and taxes)

	Trust %	Benchmark %
1 month	-2.09	-0.20
3 months	-0.25	1.19
1 year	5.39	8.43
3 years p.a.	12.33	9.50

Past performance is no indication of future performance.

Profile

Portfolio Characteristics

Duration (years)	7.1
Average credit quality (Standard & Poor's)	A+

Sector Allocations

	%
Government	56.5
Investment grade	25.3
Mortgage and asset backed	8.3
High yield	6.3
Emerging markets	2.2
Banking Government Guaranteed	0.0
Cash and other	1.4

Market Review

The positive sentiment that characterised much of October quickly disappeared in November after Greek Prime Minister George Papandreou threatened to hold a referendum on the latest EU bailout. Investors continued to question whether European policymakers had the tools required to ring-fence further contagion and whether they had the resolve to confront the difficult decisions they have been postponing for years. The speed at which the European debt crisis escalated had left investors largely ignoring developments in Greece, given its relatively small size of outstanding debt in the context of overall eurozone GDP.

However, by throwing into the Greek public domain the October deal that European policymakers had spent significant time orchestrating, Papandreou had pushed the leaders of Germany and France one step too far, and the referendum was quickly called off. This was followed in quick succession by Papandreou's resignation and the formation of a new, technocratic government led by former European Central Bank (ECB) Vice-President Lucas Papademos. Italy also installed a technocratic government. Investors shed riskier assets in preference of liquidity and safety as they contemplated what would have been an unthinkable question only a year ago: how much longer will the euro survive in its current form?

Economic data deteriorated significantly in Europe and most forecasters have pencilled in at least a mild recession in the next few quarters. Growth is slowing sharply, even in Germany, where job creation came to a standstill and the unemployment rate ticked up for the first time in over two years. The ECB responded by cutting its policy rate by 25 basis points (bps) and signalled likely additional rate cuts at future meetings.

Economic conditions outside of Europe were generally better and it looks like the US will continue to grow at a modest pace for the next few quarters, supported by a US Federal Reserve that remains focused on growth, with a number of officials recently articulating the need to do more on the policy front. In the UK, the Bank of England also signalled that its asset purchase programme would continue and perhaps even be expanded to help support weakening economic activity.

US Treasury 10-year bond yields were largely unchanged, while the German 10-year bund yield increased 25 bps. The increase in bund yields largely occurred over the course of two days, triggered by a failed auction in which the Bundesbank had to retain a portion of the issuance to make up for insufficient private sector demand. While uncovered bund auctions have happened before, it does suggest that investors are beginning to shy away from European assets more generally as the crisis intensifies.

Spreads on peripheral sovereign debt continued to widen, with the yield on Italian five-year issues reaching more than 6.3% over equivalent-maturity German bunds, an increase of nearly 170 bps over the last month. Investment-grade credit spreads widened 40 bps in the US and 75 bps in Europe, with financial issuers leading the underperformance. High-yield spreads widened 65 bps in the US, and the S&P 500 and the Euro Stoxx-50 Index lost 0.5% and 2.3%, respectively. The euro depreciated against the US dollar by 3.6%, while oil prices rose nearly 8%.

Performance

The Legg Mason Western Asset Core Plus Global Bond Trust underperformed its benchmark by 1.9% over the month.

The overweight to investment grade corporate bonds and the opportunistic allocation to select high-yield issues had a negative impact as spreads widened. The allocation to the financial subsector across subordinated and Tier-1 issues also had a large negative impact.

Duration and curve strategies were mixed. A long duration position in Europe had a negative contribution, though this was partially offset by having most of our duration in the 30-year part of the curve, which outperformed. On currency, an overweight to high-beta emerging markets detracted; however, a short euro position versus the US dollar mitigated some of the losses.

Outlook

It looks like political leaders within the eurozone will soon have to confront the difficult decisions that they have been postponing for years. There is little that Italy—or Spain, for that matter—can do unilaterally to reverse the vicious cycle that it has found itself in since the early summer. Aggressive fiscal austerity will only slow growth further, pushing risk premiums higher. Alternatively, looser fiscal policy will aggravate Italy's debt trajectory, again with much the same effect. Either way, Italy's borrowing costs will not decline from the current threatening levels unless an agreement on a European-wide institutional solution is reached. This could include far greater intervention by the ECB, European Financial Stability Facility or International Monetary Fund.

It is difficult, if not impossible to predict what such a solution would look like, or when and if such a solution will be implemented. Therefore, we remain cautious and have not added to risk positions despite the significant increase in compensation for holding these positions. As year-end approaches, credit-market liquidity remains poor; hence, we continue to look for ways to mitigate portfolio risk using other strategies, via currencies, duration or yield curve positions, with our primary focus being to ensure a balance of risks in the global portfolios.

We have added to duration in German government bonds to reflect our negative outlook on European growth and our view that the ECB will be forced to cut rates further. This position also adds diversification against our overweight to investment-grade credit, as German bonds tend to rally in a flight-to-quality environment. For similar reasons, we are

maintaining a large underweight to the euro, preferring to reallocate exposure to the US and Canadian dollars, as well as to other net saver economies, although this is tempered somewhat by a small position in the Polish zloty, Mexican peso and Brazilian real, currencies which remain sensitive to global risk aversion in the short term but which have good long term fundamentals.

To balance the portfolio, we are focusing on select financial issuers, predominantly those domiciled in the US, where the banks have made significant progress to shore up their core Tier-1 capital ratios and have less exposure to the European periphery. Our meaningful overweight to select financial issues is not only driven by current extreme valuations (where spreads are much higher) but also, more importantly, our view that the sector should benefit from ongoing deleveraging and tighter regulatory oversight.

We continue to run a neutral position in the industrial and utility sectors, while we maintain an underweight to agency mortgage-backed securities. We also continue to like high-yield valuations where the sector is priced for a far worse economic outlook than our base-case scenario. We have only a small allocation to high yield bonds, focused on the non-cyclical sub-sectors. In sum, we continue to calibrate portfolios to benefit from a more constructive risk environment, a scenario where we should see some of the extreme risk premiums begin to fall. However, we recognise that uncertainty is likely to persist, and we continue to focus on offsetting strategies that are aimed at limiting portfolio volatility.