

# 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

\$50,236,037.

## Performance (before fees and taxes)

	Trust %	Benchmark %
1 month	1.24	1.31
3 months	3.50	3.48
1 year	16.05	9.68
3 years p.a.	7.15	8.74

Past performance is no indication of future performance.

## Profile

Monthly Performance	Trust %	Benchmark %
Australian bonds	1.15	1.37
Global bonds	1.29	1.25

Asset Allocation	Trust %	Benchmark %
Australian bonds	52.1	50
Global bonds	47.4	50
Cash	0.5	-

## Market Review

Economic growth momentum appeared to soften during the month as March quarter gross domestic product data released in early June showed economic activity grew at 0.5%, compared with 1.1% the prior quarter. Confidence and building approval measures also declined. However the unemployment rate provided some positive news with a fall to 5.2%.

The Reserve Bank of Australia kept the target cash rate at 4.5%. Softer economic data, heightened sovereign risk aversion and the Reserve Bank's assessment that borrowing rates were back to average appeared to contribute to this decision. Bank bill rates increased through the month to levels not seen since November 2008. Domestic government bond yields inched higher through most of June before market sentiment darkened and yields declined sharply at the end of the month. The decline in yields late in the period was driven by offshore leads as the U.S. and other international bonds rallied on weaker economic data, including a downward revision of March quarter gross domestic product.

Australian credit spreads on highly rated corporate bonds remained largely unchanged while spreads on lower rated investment grade debt widened. This caused lower rated credit to underperform. Domestic debt issued by Australian based corporates tended to outperform their international peers. Currency volatility continued as concerns of weaker than expected global growth resurfaced. The Australian dollar finished the month even to slightly down against most major currencies.

Globally, the highly anticipated shift in China's exchange rate regime was finally announced, although it seemed a statement of intent rather than a roadmap for future policy. While details remained thin, it seemed that China will reintroduce the crawling peg that existed from July 2005 until July 2008, at which time a parity of 6.83/USD was fixed. The Peoples Bank of China will allow a +/-0.5% daily trading band around a central parity against the US dollar. Movements may begin to reflect a broader basket of currencies, consistent with China's major trading partners. Appreciation expectations remained modest. Non-deliverable forward contracts implied yuan appreciation of around 3% over the next 12 months against the U.S. dollar, below expectations seen earlier in the year.

Government bonds performed well as the bid for low risk assets increased. Ten-year yields declined by 0.35% on U.S. treasuries, 0.08% on German bunds and 0.17% on Japan government bonds. Corporate bonds struggled to keep up with government bonds, as they were dragged down by financial issues and the Energy sub-sector. The sterling market was the worst performed. Spreads on US high-yield debt widened 0.21% but compressed 0.16% on European high-yield issues. Agency mortgage-backed securities outperformed treasuries by 0.10% and non-agency debt gained 0.5% to 2.0%, depending on the structure of the issue. Yields on peripheral European government debt widened relative to Germany. The S&P 500 lost 5% while European stocks lost over 1%. The price of oil rose after tumbling last month. The euro stabilized while the pound recovered some ground against the U.S. dollar. The Chinese yuan finished the month up 0.7%, its first meaningful move in two years.

## Performance

The Legg Mason Diversified Fixed Income Trust marginally underperformed its benchmark over the month. However, portfolio performance over the past year was 6.4% ahead of benchmark. Over the month, the portfolio's domestic bond exposure detracted from portfolio performance while the portfolio's global bond exposure aided performance.

Domestically, portfolio duration remained short relative to benchmark duration during the month. This provided a positive contribution to performance for much of the month. However, the sharp decline in bond yields late in the period reversed the gains to finish the month as a detractor from portfolio performance. Credit spreads were generally less volatile than the outright bond market, with the exception of Loy Yang, which detracted from portfolio performance along with RBS and Orica. This was partly offset by the excess running yield from the portfolio's overweight to the corporate sector. Spread tightening by Wells Fargo and Macquarie contributed positively to performance.

Globally, government bond yields declined and the portfolio's long duration, with a focus on intermediate maturity issues, had a positive impact on performance. Portfolio duration and curve positioning in the U.S. was the largest positive contributor to performance. The portfolio's overweight to corporate debt, with an emphasis on the Financials sub-sector, detracted from performance as subordinated financial issues had a challenging month. An underweight allocation to agency mortgage-backed securities was neutral, while currency strategies were flat as the euro stabilised against the U.S. dollar.

## Outlook

Domestic gross domestic product growth is expected to move towards trend in 2010/11. As government stimulus begins to wind down, a self sustaining growth phase is expected to ensue. Inflation is forecast to remain in the upper band of the Reserve Bank's target range and may push above the band over the short-term due to one-off items. High inflation is expected to continue to pressure the Reserve Bank as strength in the mining sector may lead to wage and cost pressures, as witnessed in 2007/08.

With Australia's labour market in very good shape and broader economic growth strengthening, cash rates are expected to continue to move higher throughout 2010, with an expectation that rates could reach around 5% by the end of the year.

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

The domestic portfolio maintains an overweight position in corporate bonds, with emphasis on Financials, as market valuations and increased regulation provide significant appeal despite spreads tightening over the past year. We are also selectively buying primary corporate deals in industries that will benefit from an economy that has returned to growth and in those that have de-leveraged, namely property trusts and infrastructure.

We also maintain an overweight position in government guaranteed bank issuance as a defensive strategy. This issuance offers the assurance of the Commonwealth Government with a relatively attractive yield. The portfolio maintains an underweight exposure to government bonds as they remain relatively expensive.

Globally, we are comfortable running additional duration and curve flattening strategies. We are managing these strategies tactically as both market pricing and underlying fundamentals change. For example, with government yields down substantially over the past two months, we have reduced duration positions closer to neutral in the U.S. and Europe. Conversely, we increased duration in the U.K. toward neutral despite falling yields as economic fundamentals have become more supportive of additional duration. The coalition government seems more unified than initially assumed and the emergency budget should help limit the government's cost of borrowing.

We continue to maintain an overweight to the Financials sub-sector, with a clear emphasis on globally diversified banks that are large and benefit from multiple sources of funding. Small regional banks with concentrated assets and single business lines are expected to struggle. We will continue to avoid these issues. Our preference is to gradually shift up the capital structure into more senior issues as pricing and market conditions warrant. Against this, we continue to run neutral to slightly underweight positions in the Industrials and Utilities sub-sectors. As has been the case for six months now, we look to also remain underweight agency mortgage-backed securities.