

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

\$88,060,199.

Performance (before fees and taxes)

	Trust %	Benchmark %
1 month	2.07	1.33
3 months	3.49	2.24
1 year	14.64	5.84
3 years p.a.	5.65	7.66

Past performance is no indication of future performance.

Profile

Monthly Performance	Trust %	Benchmark %
Australian bonds	1.76	1.32
Global bonds	2.41	1.35

Monthly Performance	Trust %	Benchmark %
Australian bonds	51.1	50
Global bonds	48.7	50
Cash	0.2	-

Market Review

Australian economic data released during the month was relatively strong, led by a solid employment report as the unemployment rate fell to 5.5%. Retail sales, consumer confidence and building approvals all rose. The December quarter inflation report was mixed, with the 12 month headline rate somewhat subdued at 2.1% while the Reserve Bank'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 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, 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. 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.

Globally, 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 recovery plan but details were far from complete and doubts remained over the government's ability to impose the necessary restraint. 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%.

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 Australian Diversified Fixed Income Trust outperformed its benchmark by 0.7% over the month. Performance over the past year is 8.8% ahead of benchmark. Portfolio exposure to both Australian bonds and global bonds added value this month.

Domestically, 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.

Globally, 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

Australian 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.

Domestic portfolio duration is expected to be tactically managed as volatility is likely to remain high while investors 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.

Globally, 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.