

Legg Mason Global Multi Sector Bond Trust

Objective

To maximise total return through income and capital appreciation.

Comparative Index

The Trust does not formally measure its performance against a benchmark. However, for the purpose of illustrating the Trust's performance, the Trust may state its investment performance against the Comparative Index.

The Trust's Comparative Index comprises 50% the Barclays Capital Global Aggregate Index, 25% the J.P. Morgan Emerging Markets Bond Index Plus and 25% the Barclays Capital U.S. Corporate High Yield Index (all hedged into Australian dollars).

Value

\$24,854,051.

Performance (before fees and taxes)

| | Trust % | Comparative Index% |
|--------------|---------|--------------------|
| 1 month | 3.18 | 2.61 |
| 3 months | 2.83 | 3.63 |
| 1 year | 21.48 | 17.86 |
| 3 years p.a. | 10.12 | 10.70 |

Past performance is no indication of future performance.

Profile

Portfolio Characteristics

| | |
|--|------|
| Effective duration (years) | 4.5 |
| Average credit quality (Standard & Poor's) | BBB+ |

| Sector Allocations | % |
|--------------------------------|------|
| Government | 14.9 |
| Investment grade | 18.8 |
| Mortgage and asset backed | 2.9 |
| High yield | 26.1 |
| Emerging markets | 23.1 |
| Inflation protected securities | 0.9 |
| Cash and other securities | 13.3 |

Market Review

Markets were calmed by positive earnings announcements and reasonable results from the European stress tests. The 'risk-off' investment sentiment of the past few months swung back toward 'risk-on'. Volatility declined and spread sectors and equities performed well relative to risk-free government debt. Nevertheless, the fundamental debate over the state of the global economy continued, including whether inflation or deflation was the larger threat, the possibility of a double-dip recession and the need for a second round of quantitative easing.

The European bank stress test results were released by the Committee of European Banking Supervisors late in the month. Of the 91 banks tested, representing 65% of the sector, just seven banks failed the test as the

Tier-1 capital ratio fell below the stress scenario's 6% hurdle. The seven banks that failed were comprised of one German bank, one Greek bank and five Spanish banks. Overall, most of the largest banks seemed to be strong and the tests helped to reduce market anxiety regarding the state of the European banking system. The financial corporate sector performed particularly well in response to the news, with issues further down the capital structure leading the rally.

One of the more surprising data releases was the advance estimate of second quarter gross domestic product in the U.K., which was nearly twice market expectations at 1.1% quarter-over-quarter. In contrast, U.S. gross domestic product was much weaker than expected at 2.4% on slower consumer spending and a pause in inventory accumulation. This played into the hands of those predicting a double-dip recession. Talk surfaced about the possibility of further unconventional monetary stimulus, including a second round of quantitative easing. James Bullard, President of the Federal Reserve Bank of St. Louis, argued in a research paper that the best option would be to purchase additional treasuries rather than agency mortgage-backed securities.

Government bond markets were mixed. Yields declined in the U.S., across much of Europe and in Japan. However, German bund yields increased. Ten-year yields declined 0.02% on both U.S. treasuries and Japanese government bonds, increased 0.09% on German bunds and declined 0.03% on U.K. gilts. U.S. treasuries (hedged into Australian dollars) returned 1%.

Corporate bonds had a strong month. Financials issues led the outperformance, particularly subordinated issues. Tier-1 European issues generated nearly 10% excess returns. Spreads on high-yield debt compressed 0.58% in the U.S. Agency mortgage-backed securities outperformed treasuries by 0.44%. The euro gained over 6% against the U.S. dollar while the pound gained 4.9% and the Japanese Yen gained 2.4%. The Brazilian Real gained 2.8% against the U.S. dollar while the Polish zloty rebounded 3.5% versus the euro.

Performance

The Legg Mason Global Multi Sector Bond Trust outperformed its comparative index by 0.6% over the month. Portfolio performance over the past year was 3.6% ahead of the comparative index.

This was primarily driven by exposure to subordinated Financials and local markets such as Brazil and Poland. The underweight to Japan was also a positive factor. Yield curve positions detracted somewhat as the yield curve steepened in the U.S. Sector allocations generated some value as the overweight to high yield was mostly offset by the underweight to emerging sovereign debt. Currencies detracted some value as the yen and euro appreciated.

In portfolio activity, we added to select non Financials investment grade corporate bonds given the sell off in June, along with select BB high yield bonds, which we favour in a slow growth, low inflation environment. With respect to Interest rate strategies, we added to our curve trade in Europe by buying the long end and selling the front end. The idea here is that yield curves should flatten over time as central banks remain on hold and inflation remains low. If the economy slows further then, we believe the longer end of the curve will outperform.

Outlook

The 'risk-on/risk-off' investment environment will persist as long as fundamental questions about systemic repercussions continue to divide the market, including whether the U.S. is headed for a double-dip recession, the need for fiscal stimulus or fiscal austerity, the long-term sustainability of the European Monetary Union and whether inflation or deflation is more likely. We doubt consensus will be reached on these polarising questions anytime soon. So we will have to continue to look through these short-term swings in sentiment and remain focused on underlying valuations.

That said, the binary nature of markets may offer opportunity for tactical scaling of positions. While the underlying investment thesis has not changed - a double-dip is unlikely, the European Monetary Union should hold together and ongoing disinflation is the most likely outcome - we will continue to scale the size of our strategies following swings in market pricing. For example, consistent with our view of ongoing disinflation, we have retained a bias toward extra duration in the belief that the U.S. Federal Reserve, the European Central Bank and the Bank of England will remain extraordinarily accommodative for some time.

However, we have scaled down the size of the long duration strategy in response to the government bond rally over the past three months. We would look to increase duration should yields rise once again. Likewise, we recently reallocated duration from the U.S. toward Europe given that the rally was much stronger in the U.S. Within currency markets, the short position in the euro against the U.S. dollar was scaled down as the euro weakened through the second quarter; we are currently looking to reintroduce a more meaningful euro short now that the euro has strengthened in recent weeks. Despite these tactical adjustments, the underlying thesis remains unchanged and continues to guide positioning.

A number of critics argued that the European bank stress tests were not stringent enough. Nevertheless, the information released provided greater transparency of bank balance sheets, enabling independent analysts to scrutinise risks more concretely. This enhanced clarity seems to have led to a more sober assessment of tail risk, which, in turn, has enabled spreads to grind tighter. We believe this will continue. Profitability remains strong, driven more by traditional banking business rather than investment banking business. Net interest margins should remain high and banks should continue to benefit from a general improvement in economic activity. As a result, we remain convinced that the Financials sub-sector will be a significant driver of outperformance over coming months. July was a strong month; accordingly, we have been looking for opportunities to move up the capital structure into more senior issues, or to reduce outright the size of the overweight. Consistent with the tactical approach to scaling positions, we will look to trim the amount of risk should spreads compress further.

We will maintain an underweight to the periphery of the eurozone, based both on our scepticism of the long-term health of the European Monetary Union and currently poor market liquidity. That said, there is now significant dispersion across countries and this has opened up far greater scope for active management down the road. We still do not find compelling valuations in agency mortgage-backed securities. We believe non-agency mortgages offer better valuations and we will continue to hold a modest allocation to select issues.