LEGG MASON
GLOBAL ASSET MANAGEMENT

Legg Mason Western Asset
Australian Bond Trust

Objective

The Trust aims to earn a before fees and taxes return of 0.75% p.a. in excess of the benchmark over rolling three year periods.

Benchmark

UBS Australian Composite Bond Index.

Value

$210,458,896

Performance (before fees and taxes)

	Trust %	Benchmark %
1 month	0.75	0.77
3 months	1.74	1.93
1 year	10.75	11.36
3 years p.a.	8.45	6.30
5 years p.a.	7.79	7.40

Past performance is no indication of future performance.

Profile

Attribution	Basis Points
Duration	-8
Yield curve	7
Sector selection	0
Security selection	-2

Sector Allocations	Trust %
Government	33.7
Supranational	11.5
Corporate investment grade	39.0
High yield	0.0
Mortgage and asset backed	3.4
Index linked	0.8
Banking government guaranteed	7.6
Cash and cash equivalents	3.9

Market Review

Markets rebounded in October from September's depressed levels, but the cautious optimism about European leaders' ability to provide a palatable and sustainable solution to Europe's fiscal and sovereign problems eventually gave way to disappointment. October's gains on risk assets were largely eroded by the end of the quarter. The Reserve Bank of Australia (RBA) was sufficiently concerned about the downstream effect on Australia's economy that it decided to lower the cash rate by 25 basis points (bps) for first time since April 2009 and followed up with a further 25 bps cut at its December meeting. The cash rate finished 2011 at 4.25% as the central bank indicated that areas outside Europe, particularly Asia, were beginning to feel the economic effects of the European problems. The rate cuts were delivered as the RBA noted that declining inflationary pressures in food, commodities and wages afforded the central bank room to move from a slightly restrictive monetary policy to a marginally accommodative stance.

The broad Australian fixed-income market returned 1.93% for the quarter, according to the UBS Composite Bond Index, as yields declined across the yield curve and the yield curve flattened in the three- to 10-year range. The 10-year government bond yield hit its lowest level in over 50 years in the last days of December, finishing at 3.67%, well below the cash rate. Domestic credit spreads moved wider over the quarter, and European supranational issuers were scrutinised as much as corporate issuers.

Equities managed to hold onto a positive return for the quarter, with the S&P/ASX 200 returning 1.2%, having gained as much as 7.2% through the end of October.

The Australian dollar outperformed all major currencies in the December quarter, but remained volatile and traded in a 12-cent range relative to the US dollar, dipping below parity on three occasions as bouts of negative sentiment caused flights to the safety of the US dollar and Japanese yen. The Australian dollar gained 5.7% on the US dollar, and its trade-weighted index gained 4.3% over the quarter.

Performance

The Legg Mason Western Asset Australian Bond Trust underperformed its benchmark over the quarter.

Portfolio duration positioning remained short relative to the benchmark and was the most significant detractor, as bond yields continued to push deep below cash amid foreign investors' continued search for higher yielding safe-haven assets. Positioning for a flatter yield curve brought marginal benefit, as the yield curve flattened approximately 6 bps over the quarter.

At a sector level, portfolios underperformed due to the overweight in corporate bonds as spreads pushed wider. However at stock selection level, portfolios benefited from select underweights in European supranational issuers such as KFW and European Investment Bank (EIB), which saw significant spread widening during the quarter. Portfolios also received a boost from HBOS, which was tendered at a premium to market rates by the issuer.

Outlook

We forecast domestic GDP to grow at around trend level (3.0%– 3.5%) in 2012 and 2013. We recognise that the challenges faced in Europe have resulted in slowing economic conditions there and, in turn, pose challenges to broader global growth. However, we are constructive on the US economic recovery (albeit at a slow pace), and recent data have been supportive of this position. We also believe that Chinese authorities have the will and the means to navigate external challenges to China's economy to ensure that growth there remains solid. Such factors are supportive of our domestic growth outlook.

Unemployment is currently hovering at 5.2%–5.3%, but we expect it to drift higher and peak at around 5.5% before edging lower as a large uptick of employment begins to take hold in Western Australia and Queensland due to new projects coming on line. An improvement in sentiment for the rest of the economy should further aid the decline in the unemployment rate through 2012.

Inflation is continuing to drift lower at both the headline and core levels. It no longer poses the risk that it did six months ago, thanks to a slowdown in the non-mining sectors and the restoration of agricultural crops damaged in weather catastrophes in early 2011. The RBA has signaled that it is comfortable with current levels of inflation, which give the central bank the scope to further respond to global challenges, particularly those posed by Europe, should the need arise.

Technical issues have continued to push bond yields deep below the current cash rate and at a level that we consider very expensive, considering fundamentals. Duration positioning will therefore be tactical, with a short duration bias relative to the benchmark. Volatility is likely to remain high while markets consider the fragile state of developed-nation economies and continue to test the eurozone's resolve to stand by its member countries and their financial systems.

We maintain an overweight position in corporate bonds, with an emphasis on large financials, as market valuations and increased regulation continue to appeal. We are being very selective with supranational issuers due to the headline risk that has been causing volatility, particularly among European issuers, in that space. We maintain a defensive strategy to be overweight in government-guaranteed bank issues—which offer the assurance of the Commonwealth Government with greater yield benefit—versus a strong underweight to government bonds, which remain expensive.

Further Information

Portfolio Characteristics

Duration (years)	3.3
AAA	52.7
AA	14.1
A	23.6
BBB	8.9
Below BBB	0.8