

# 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

\$228,006,225.

## Performance (before fees and taxes)

	TRUST %	BENCHMARK %
3 months	2.36	1.03
1 year	6.32	1.73
3 years p.a.	6.64	6.56
5 years p.a.	5.97	5.72

Past performance is no indication of future performance.

## Profile

ATTRIBUTION	BASIS POINTS
Duration	+7
Yield curve	-1
Sector selection	+13
Security selection	+105
Residual	+8

SECTOR ALLOCATIONS	TRUST %
Government	29.0
Supranational	5.5
Corporate investment grade	47.0
High yield	0.6
Mortgage and asset backed	5.9
Index linked	1.4
Government guaranteed banks	9.4
Cash and cash equivalents	1.2

## Market Review

Australia was the first G20 nation to begin reversing emergency monetary policy settings when the Reserve Bank of Australia lifted the target cash rate by 0.25% at its October meeting, and then again in November and December. The Reserve Bank indicated that a resilient employment market, sticky underlying inflation and generally stronger than expected economic activity were the reasons for removing the "emergency" stimulatory settings put in place during the crisis period. The short term yield curve flattened slightly as a result, with the market forecasting cash rates to be in the range of 4.5% to 5.0% by mid 2010.

Mid quarter concerns about the sustainability of the global economic recovery and issues in Dubai led to a strong rally in global bonds, which initially helped Australian bond yields move lower. However the steady flow of positive data, both domestic and offshore, and the heavy supply of U.S. government bonds into year end caused global bond yields, and Australian bond yields with them, to rise at the end of the quarter. The Australian bond curve steepened over the quarter, as 10 year yields rose 0.28% for the quarter and three year yields declined 0.17%.

The credit sector continued to strongly outperform along with equity and other risk markets. Lower rated credit outperformed higher rated alternatives as spreads continued to grind tighter and the idea of a double dip recession seemed to lose currency with many market participants.

Early in the quarter the Reserve Bank's monetary policy decision helped the Australian dollar to a 15 month high against the U.S. dollar and a 24 year high against the sterling. However, the U.S. dollar regained some ground with signs of an improving economy giving investors reason to consider an earlier exit from aggressive monetary policy stimulus there.

## Performance

The Legg Mason Australian Bond Trust outperformed its benchmark by 1.3% over the quarter.

The portfolio's overweight exposure to corporate debt continued to aid performance throughout the December quarter, as credit spreads tightened further and corporate credit again outperformed the broader fixed income market.

Within the corporate sector, exposure to the Financials sub-sector again had the largest positive impact on outperformance, with National Australia Bank, Swiss Re, AXA and Wells Fargo the most significant contributors.

The portfolio benefited from tactical interest rate strategies as bond yields remained volatile throughout the quarter.

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## Outlook

Gross domestic product growth in Australia is expected to improve to around trend in 2010 as government infrastructure spending gains traction and export demand improves.

Inflation is likely to remain below average through 2010 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.

Portfolio duration is expected to be tactically managed as volatility is likely to remain high while markets 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, 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 should benefit from an economy that is returning to growth and in those that have de-leveraged.

We also maintain an overweight position in government guaranteed bank issuance as a defensive strategy. These securities offer the assurance of the Commonwealth Government and have greater yield benefit relative to government bonds.

## Further Information

### PORTFOLIO CHARACTERISTICS

Duration (years)	3.4
AAA	48.6
AA	12.6
A	22.8
BBB	14.0
Sub investment grade	2.0

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