

Legg Mason 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

\$216,516,670.

Performance (before fees and taxes)

	Trust %	Benchmark %
3 months	3.44	3.60
1 year	12.77	7.86
3 years p.a.	8.05	7.67
5 years p.a.	6.45	6.06

Past performance is no indication of future performance.

Profile

Attribution	Basis Points
Duration	-9
Yield curve	0
Sector selection	-8
Security selection	+3
Residual	-2

Sector Allocations	Trust %
Government	28.0
Supranational	9.0
Corporate investment grade	45.7
High yield	0.7
Mortgage and asset backed	3.8
Index linked	1.3
Banking government guaranteed	10.1
Cash and cash equivalents	1.4

Market Review

The June quarter brought about a sudden halt to the recent pattern of global economic consolidation. Although there were periods of relative stability in terms of broad indices and market data, there were also times where markets were battered by eurozone uncertainty and the threat of a global double dip recession. Only the announcement of European Central Bank and International Monetary Fund backing of the euro currency and member states returned relative normalcy to global markets.

Australian data broadly reflected the global dichotomy, with higher than expected inflation and declining unemployment figures contradicted by softer March quarter gross domestic product growth, building approvals and confidence surveys. The Reserve Bank of Australia began the period continuing its tightening philosophy as it reduced the target cash rate by 0.25% to 4.50%. However, by June it was clear that there was a need to pause. The most recent meeting minutes even implied a loosening of monetary policy due to the reversal of conditions. Bank bill yields increased in line with Reserve Bank targeting and subsequent commentary.

Government bond yields moved 0.7% to 0.8% lower at the 3 and 10 year points of the curve, which caused a slight steepening. Credit markets followed the global lead, with spread contraction early in the quarter more than offset by sharp widening as the eurozone crisis hit its peak. By the end of the quarter, credit spreads had rallied and stabilised.

Various indicators clearly showed the market aversion to risk assets, with both the ASX200 and the U.S. S&P500 index significantly down over the quarter. The Australian dollar was also caught up in the global flight to safety, down around 6% in trade weighted terms and around 9% against the U.S. dollar.

Performance

The Legg Mason Australian Bond Trust marginally underperformed its benchmark over the June quarter. However, performance over the past year was 4.9% ahead of benchmark.

The portfolio retained its overweight exposure to corporate debt, with an emphasis on the Financials sub sector, which detracted from performance over the quarter. Individual holdings of names such as Wells Fargo, AXA, Rabobank and Swiss Re were the main culprits.

Running yield contributed steady outperformance to the portfolio throughout the quarter. However, tactical interest rate strategies generally detracted value throughout the quarter, as a short relative duration position magnified the effects of lower bond yields brought about by global uncertainty.

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 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.

Further Information

Portfolio Characteristics

Duration (years)	3.3
AAA	50.9
AA	13.4
A	24.7
BBB	9.1
Below BBB	1.9