LEGG MASON
GLOBAL ASSET MANAGEMENT

Legg Mason
Brandywine Global Fixed Income Trust

Objective

The Trust aims to earn a before fees and taxes return of 2% p.a. in excess of the benchmark over a complete market cycle of three to five years.

Benchmark

Citigroup World Government Bond Index, hedged into Australian dollars.

Value

$95,471,254

Performance (before fees and taxes)

	Trust %	Benchmark %
1 month	2.09	2.09
3 months	2.48	1.85
1 year	12.57	10.56
2 years	13.49	9.24
3 years	14.26	7.41

Past performance is no indication of future performance.

Profile

Portfolio Characteristics

Average modified duration (years)	7.23
Average credit quality (Standard & Poor's)	A-

Sector Allocations	%
Government sovereign	59.32
Government regional agencies	9.68
Municipal bonds	1.89
Corporate bonds	14.94
Mortgage backed securities	1.54
Cash and currency	12.63

Market Review

The past year, 2011, was another year of living dangerously in what has become a way of life for investors. Last year's challenges ranged from the fallout of a potential Greek debt default to anxiety that a catastrophic collapse of Europe would propel the world into a depression. Speculation is rampant about the possible fracture of the euro zone and fear that this may be the early stages of a global sovereign debt-default contagion.

Europe wasn't the only concern. In China, the real-estate bubble looks like it has burst. Non-performing bank loans and bankrupt municipalities are sure to be exposed as this tide goes out. On top of it all, this is a transition year for leadership in China, usually a negative during a period of turbulence. In the U.S., investor confidence is flimsy despite the year-end rally in equities. Political gridlock continues to prevent restitution of America's fiscal monstrosity while the administration's anti-growth agenda is a continuous cold shower on the business sector struggling to overcome the forces of deleveraging.

The good news is that all the possible things to worry about at least are out on the table. Investment strategies that focus on the "new normal" and that insure against tail risk and black swans are the rage—although preparing in advance for a surprise seems like an oxymoron. Correlations across risk assets rose to a peak in late September/ early October, leaving the impression that many investors' expectations are centred directly on what look like some very fat tails along the distribution of expected returns and outcomes.

A recession this year would be a very different development in comparison with business cycles experienced over the last 50 years. Normally, recessions come after the sixth or seventh year of an expansion, when all the excesses cumulate into too much inflation, excess inventory and over-production. Central banks have to tighten monetary policy conditions, raise rates and slow things down.

These classic conditions for recession do not exist currently. The "old normal" pattern of the business cycle calls for 2012 to be an up year in the world economy. Typically, there is a tremendous amount of policy stimulus coming out of recession, just as there was in 2009. Once there is recovery, policy makers tend to take their foot off the gas pedal or even tap the brakes. This played out in 2011 with the European Central Bank (ECB) raising rates the first half of the year, the Chinese authorities draining their financial system of liquidity to fight inflation and the Fed suspending QE2 on June 30. Last year's global economic slowdown fits the classic profile of previous business cycles' mid-course correction.

The ECB has embarked on its own form of quantitative easing via long-term lending to commercial banks and its balance sheet has exploded by 40% since July. China has begun to ease economic policy, granting credits to small and medium enterprises, cutting taxes, and reducing the reserve requirement ratio at banks. Brazil cut rates in the third quarter. Russia, India and Australia have followed. The Bank of England introduced a new liquidity facility. Policy makers are reacting to the credit squeeze/slowdown in economic activity through unorthodox balance sheet measures as in Europe or a combination of fiscal and monetary stimulus as in China. We think these pro-growth policy forces are likely to stabilise economic expectations and dominate investment trends for some time.

Issued and approved by Legg Mason Asset Management Australia Limited, ABN 76 004 835 849, AFSL No. 240827. Level 47, 120 Collins Street, Melbourne VIC 3000.

LEGG MASON GLOBAL ASSET MANAGEMENT

Performance

The Legg Mason Brandywine Global Fixed Income Trust outperformed its benchmark by 0.6% over the quarter. Performance in the last 12 months is 2.0% ahead of benchmark.

During 2011, the big performance driver was exposure to duration and falling interest rates, a substantial portion of which came from our holdings of government and high quality corporate debt in the U.S. But there were also significant contributions from sovereign bond positions in Australia, New Zealand, Mexico and a range of other countries.

Currencies did not add value to the portfolio for the year as a whole. In hindsight, the optimal currency mix would have been to own only yen and U.S. dollars. While the portfolios have not owned any euro and have been overweight the U.S. dollar, the portfolios did not own any yen either and have been invested in other non-dollar currencies. During the fourth quarter, currencies provided a strong contribution to performance with the yen fairly flat.

Outlook

Performance going forward as always hinges on what is priced into the market relative to the economic scenario likely to play out. We are value investors and don't believe current prices offer much value in U.S. Treasury securities or many of the other "safe-haven" sovereign bond markets that participated in the 2011 bull market, unless world economic conditions get much worse. Real long-term government yields in the U.S. are negative and have fallen sharply in many other countries. In the first week of the New Year, Germany sold six-month treasury bills at a negative nominal yield. These prices say a lot about the fat tailed fears that investors have in the economic outlook. They also say a lot about the price risk embedded in some of these sovereign government bond markets which could translate into capital loss if things turn out a little more like the old normal. We think another global reflationary push is getting underway which will stabilise economic expectations at least in the short run.

The upcoming year, 2012, looks like it will be a year of rifle shots instead of a shotgun bond strategy. The combination of poor value in some of the higher quality sovereign bond markets biases us towards reducing duration in select markets. For example, in recent weeks and months we have trimmed holdings of long-term bonds including U.S. Treasuries and British Gilts. At the same time, however, other bond markets offer good value and the prospect for global policy reflation often works to the advantage of some of these markets. For example, we have added bonds from South Africa and Mexico to the portfolio in recent months.

Mexico is one example where we are invested both in the bond market and the currency. Real yields are high, the inflation outlook is positive, Mexico's economic fortunes are tied to the U.S.' which are improving and the currency is depressed relative to its intrinsic value.

As for the currency markets, among the big three we remain biased to the U.S. dollar. We still do not own any euros. The currency has only fallen about 15% from its peak in 2011 and is still overvalued relative to our measures of purchasing power parity (PPP). A credit event relating to Greece would probably drive the currency even lower and many might take it as the beginning stages of a break up of the euro zone. Our view is that Greek debt needs to be restructured and the sooner the better. Once Greece has lightened its load and the banks have bit the bullet, Europe will be less encumbered and it could mark at least a temporary bottom in the euro.

Nor have our views or our position on the yen changed. It is very apparent that the Japanese authorities do not want the currency to appreciate any further based on the intervention activity in the second half of 2011 and the flat to mildly negative profile in the currency since July. Germany is a capital goods exporter and competitor of Japan. Since 2008, the yen has appreciated by almost 75% against the euro. This year's government budget proposals include a cut in government primary outlays by about 3.5% with the government looking to boost the consumption tax although not until 2014. Interest payments continue to rise despite near-zero interest rates. It remains to be seen whether the Bank of Japan will step up expansion in its balance sheet sufficient to depress the yen relative to the dollar. It is hard to see it catching up with the ECB.

Outside of the big three, our currency bets are selective. We sustained our hedges on most of the commodity currencies into the year end. Much will depend on how the Chinese economy stabilises in coming months. However, as with our bond and country allocations we expect a more rifle-shot approach to currencies this year. For example, the Australian dollar—a commodity-linked currency— remains overvalued relative to their PPP while the rally in Australia has pushed real yields significantly lower. Elsewhere we continue to own select peripheral European currencies and their bond markets. These currencies tend to trade as substitute risk assets. Consequently, our outlook for a resumption of reflation is friendly for these currencies relative to the euro and should be at least flat relative to the U.S. dollar.