LEGG MASON
GLOBAL ASSET MANAGEMENT

Legg Mason
Brandywine Global Opportunistic 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

$48,009,549.78

Performance (before fees and taxes)

	Trust %	Benchmark %
1 month	0.21	0.08
3 months	4.64	1.59
1 year	15.82	11.87

Past performance is no indication of future performance.

Profile

Portfolio Characteristics

Modified duration (years)	5.58
Average credit quality (Standard & Poor's)	A-

Sector Allocations	%
Government sovereign	52.5
Government regional agencies	9.2
Municipal bonds	1.8
Corporate bonds	17.5
Mortgage backed securities	0.5
Cash and currency	18.5

Market review

The first quarter of 2012 witnessed the biggest reflationary push since 2009 which, in turn, was the biggest in modern economic history.

The European Central Bank (ECB) implemented its version of quantitative easing by expanding its balance sheet by several hundred billion euros. Euro-zone tensions resurfaced late in the first quarter. Italian President Monti backtracked on labor reform proposals and Spain announced that it would miss its budget target. This negative news partially reversed the sharp drop in yields on Italian and Spanish debt and helped provoke a violent reaction across global markets in early April. Europe needs more pro-growth strategies in order to generate the positive feedback mechanisms needed to emerge from sovereign debt stress. The watered-down Italian labor reform proposals were a step backward. Spain's reliance on taxation to help stabilize its fiscal shortfall is counter-productive given the sensitivity of the government's contingent liabilities stemming from bad real-estate loans in the banking system.

The Bank of Japan moved to end two decades of deflation by adopting an inflation target along with proposals to expand its balance sheet sending the yen down almost 10% and the Nikkei up 20%.

In addition, China reversed its policy pendulum by granting credits to small- and medium-sized businesses, cutting taxes and reducing reserve requirements at banks. More stimulus has been announced across the world with the research firm ISI documenting over 130 stimulative policy actions in the last seven months.

Performance and Strategy

The Legg Mason Brandywine Global Opportunistic Fixed Income Trust outperformed its benchmark by 3.1% over the quarter with most of the gains coming from currency selection. Performance over the past 12 months is 3.9% ahead of benchmark.

Our large underweight in the yen paid off as the currency tumbled in response to the Bank of Japan's promise to generate inflation. Our exposure to higher-yielding currencies with sensitivity to the global growth outlook benefited from the aggressive reflation that played out during the quarter.

Exposure to longer-duration, safe-haven bonds—mainly U.S. Treasuries—detracted from performance during the quarter. As threats of an acute banking crisis in Europe dissipated during the quarter and signs of a pickup in U.S. economic strength emerged, yields in high quality countries increased.

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.

Outlook

Our macro thoughts give us some very clear ideas about currency allocation. The U.S. outlook is a lot brighter over the next couple of quarters than what we see playing out in Europe, Japan and China which argues in favour of the dollar, at least for now.

The Europeans face important elections and the re-emergence of more tensions across some of the peripherals argues for more ECB intervention. In addition, softness in some of the early leading indicators for Germany suggests more policy stimulus, not less, is needed for Europe.

Federal Reserve (Fed) Chairman Ben Bernanke has reaffirmed the current stance of the Fed which is to keep rates at zero until 2014. But the Fed's policy stance is highly conditional on economic developments which are extremely uncertain. It is clear that the Fed Chairman has bought into the deflationary sub-par new-normal paradigm and must be very concerned that premature withdrawal of policy support would upend the expansion. As a financial historian, he probably sees parallels with the experience of 1936/37. He wants to keep his options open. Nonetheless, the dollar seems more likely to be king over the euro given the economic momentum we see building over the next quarter or two.

We continue to own the British pound as well as a few European currencies outside the euro. This is in line with our view that the economic scenario in Europe won't be so bad as to create a general scenario of risk aversion. As for sterling, it is remarkable that this currency has not weakened despite severe fiscal cutbacks and hyper-expansionary monetary policy. The lack of price weakness is informative.

The yen has regained a portion of its spectacular sell off during the first quarter and may continue to correct early in the second quarter. However, we believe that the outlook for the currency has hit an inflection point. Japan's politicians are fed up with the stinginess of the Bank of Japan and its unwillingness to end deflation and are putting maximum pressure on the central bank to reflate. The Diet's recent rejection of economist Ryutaro Kono's nomination to the Bank of Japan's board because he was too moderate was a powerful signal that the politicians want more aggressive measures. In bigger picture terms the story for Japan looks very poor. The government is under pressure by the International Monetary Fund to rein-in its budget deficit and is proposing to boost the consumption tax even though the population is shrinking and government spending has not stopped going higher. Tight fiscal policy and easy monetary policy is a recipe for currency weakness. But tight fiscal policy on the back of the people instead of government is especially negative. In the background, the general trend in the country's balance of payments is deteriorating. Households are net sellers of bonds and commercial banks were as well in the latest reporting period.

We shed our position in non-deliverable Chinese RMB in the first quarter, helping to reduce slightly our exposure in Asian currencies. The switch to monetary expansionism drove the decision on the RMB.

We continue to own local-currency Australian bonds but have hedged this commodity currency along with others. Our view on the controlled pace of China's policy stimulus leaves us to believe that there is not much support for the commodity complex at this time.

In addition, we suspect considerable speculation in commodities given the special attention it has received over the last 10 years as an asset class. Moreover, Australia's economy shows signs of wear and tear from a number of quarters. Rising commodity prices have propped up Australia's nominal trade balance but real net exports have been falling since 2010 and are a significant drag on growth. In addition, the Reserve Bank of Australia tough stance on monetary policy may be starting to impact the housing sector at a time when many regard it to be in a bubble.

We have been steady sellers of duration since the final quarter of 2011, especially in some of the safe-haven markets of the world which benefited from the flare-up of the European financial crisis last year. The main reason has been price risk. At current yields, there is limited investment value in Treasuries, Gilts, Bunds or Japanese Government Bond. Central banks are always late. They are late reacting to downturns and late turning off the tap. This time around, Fed Chairman Bernanke has openly warned that he does not mind being late because he assesses the consequences of downside risk as much more devastating than getting a little inflation for a while. Most investors and central banks appear to be pre-occupied with deflation risks. But these risks seem well captured in current price levels of these various safe-haven bond markets. What these markets are not priced for is that monetization actually works to successfully reflate the world economy.

Last year's sell off in corporate bonds was almost completely reversed in the first quarter, reducing U.S. investment-grade corporate spreads back to historic levels or below. Corporate bonds from the financial sector continue to offer reasonable value but in general we are looking to reduce our holdings in this area.