

Core Plus Global Bond Trust

Objective

The Trust aims to earn a before fees and taxes return of 1.25% p.a. in excess of its benchmark over rolling three-year periods.

Benchmark

Barclays Capital Global Aggregate Index (hedged into Australian dollars).

Value

\$42,956,371.

Performance (before fees and taxes)

	TRUST %	BENCHMARK %
3 months	1.76	1.11
1 year	17.06	8.03
3 years p.a.	2.71	7.96
5 years p.a.	3.73	6.98

Past performance is no indication of future performance.

Profile

PORTFOLIO CHARACTERISTICS

Duration (years)	6.5
Average credit quality (Standard & Poor's)	AA-

SECTOR ALLOCATIONS

	TRUST %
Government	53.9
Investment grade	28.0
Mortgage and asset backed	0.9
High yield	8.1
Emerging markets	1.7
Banking Government Guaranteed	0.2
Cash and other	7.2

Market Review

In global bond markets, riskier assets outperformed risk-free government debt following ongoing improvements in economic conditions. Leading central bankers spoke of the eventual withdrawal of extraordinary liquidity support. The European Central Bank confirmed that its 12 month refinancing operation in December was the last, and that six-month lending operations would conclude in March 2010. The U.S. Federal Reserve reiterated that it expects most of its special liquidity facilities to expire on schedule throughout the first half of 2010. The Federal Reserve also announced the establishment of a term deposit facility which could be used as a tool to drain excess reserves from the banking system. Both central banks balanced these messages by emphasising the need to keep interest rates low until the nascent recovery is self sustaining. In contrast, the Bank of Japan announced additional liquidity measures and remained focused on deflation, suggesting that another round of quantitative easing may be under consideration.

The biggest surprise in the U.S. was the better than expected non-farm payrolls release of just 11,000 losses compared to expectations of 125,000 losses. Initial jobless claims continued to point to further improvements in labour market conditions in coming months. Housing sales continued to surge and the inventory of unsold new homes reached its lowest level in nearly 40 years. A number of major financial institutions announced repayment of TARP funds. Bank of America, Citigroup and Wells Fargo together returned US\$90 billion. The biggest news in Europe was the downgrade of Greece to BBB+. The possibility that Greece would lose access to the European Central Bank's funding window, which will not accept its collateral beyond 2010 per current rating guidelines, raised new questions over sovereign solvency. In the extreme, Euro-sceptics highlighted these strains as the beginning of the end of Europe's common currency.

Government bond yields around the world generally rose across the maturity spectrum. Investment-grade corporate bonds outperformed government bonds, led by the Financials sub-sector. High-yield corporate bond spreads narrowed, which allowed this sector to outperform government bonds. The U.S. dollar rallied during the quarter, especially against the yen as the short dollar trade became crowded.

Performance

The Legg Mason Core Plus Global Bond Trust outperformed its benchmark by 0.7% over the quarter.

The largest contributor to the portfolio's outperformance was an overweight allocation to the corporate sector, particularly selected European Financials issues and below investment-grade holdings. A modest underweight to agency mortgage-backed securities also added value. Currency strategies had a positive impact. A long U.S. dollar against a short Japanese yen and euro position contributed to performance. A significant long duration position in the U.S. detracted some value.

Legg Mason

Core Plus Global Bond Trust

Outlook

Economic activity continues to rebound. Most indicators suggest that manufacturing activity is set for above-average expansion over the next few quarters. Production will have to expand to restock inventory to more normal levels. While lending remains restricted, the banking system is steadily rebuilding its capital base and weaning itself from government support facilities. Rapid growth has been common following many past banking crises - the depth of losses are currently so large that a year or two of above average expansion still leaves the economy far from its efficient frontier. While possible, this is not our base case scenario.

The global economy has passed through its worst point and we would not be surprised by a few quarters of above average growth, particularly in the U.S. However, the inventory cycle is driving much of the rebound and we expect this to fade later in 2010. Fiscal stimulus should begin to fade around the same time, and growing concern over sovereign solvency should limit the political willingness to pass additional fiscal measures. As these positive influences wane, and in the absence of any obvious growth substitutes, we remain suspicious over the durability of any above trend growth past 2010. We believe this is also a primary concern for central banks as well. Re-employing idle resources, especially labour, would be the best indicator of a more sustainable recovery.

We will closely watch employment conditions for signs of such possibilities but continue to expect an extended phase of monetary accommodation. We have positioned for flattening yield curves. Long forward rates in the U.S. and Europe have risen above what we expect to be terminal levels. On a relative value basis, we find the best opportunities in the U.S. relative to Europe and Japan, where optimism and expected rate hikes have risen past levels we find most probable. We are most concerned with the situation in the U.K. Uncertainty surrounding the upcoming election combined with rising debt levels and a heavy dependence on foreign funding make for an unstable environment. We have reduced duration in the gilt market and have a bias to short the pound sterling should opportunities arise. We tend to favour the U.S. dollar against the euro and yen. This position may also serve as a partial hedge should financial strains resurface and the global economy once again scramble for U.S. dollar liquidity.

Despite our caution over the strength of the economic rebound, an overweight to non-government markets seems the best strategy. We continue to hold a substantial overweight position to investment-grade corporate debt as well as high-yield corporate debt. Issue selection continues to focus on select Financials issues of large European and U.S. banks. We look to maintain a modest underweight to agency mortgage-backed issues.

As default rates begin to recede, risky assets could continue to perform relatively well, at a minimum outperforming risk-free sovereign debt. Should employment conditions stabilise or even begin to improve modestly, the economic rebound would then appear to gain a degree of durability which could further lift prices of risky assets. An oft-cited risk to this position is that central banks will choke off the recovery if/when they begin to remove accommodation. Premature policy removal is a genuine risk but we believe it is important to distinguish the reduction of stimulus from outright contractionary monetary policy. The latter does not usually occur until the business cycle is mature, economic growth is booming and pricing pressures are dominant. This remains a distant concern. The market may even interpret initial tightening moves as an endorsement of the recovery's durability.

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