

# Legg Mason Diversified Fixed Income Trust

## Objective

The Trust aims to earn a before fees and taxes return of 1.0% p.a. in excess of its benchmark over rolling three-year periods.

## Benchmark

50% UBS Australian Composite Bond Index and 50% Barclays Capital Global Aggregate Index, hedged into Australian dollars.

## Value

\$50,236,037.

## Performance (before fees and taxes)

	Trust %	Benchmark %
3 months	3.50	3.48
1 year	16.05	9.68
3 years p.a.	7.15	8.74
5 years p.a.	5.79	6.69

Past performance is no indication of future performance.

## Profile

Quarterly Performance	Trust %	Benchmark %
Australian bonds	3.44	3.60
Global bonds	3.54	3.35

Asset Allocation	Trust %	Benchmark %
Australian bonds	52.1	50
Global bonds	47.4	50
Cash	0.5	-

## 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.

Australian 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. 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.

Globally, economic data suggested a slight moderation in the pace of economic expansion and inflationary pressures remained muted. Manufacturing indices declined around the globe and confidence surveys suggested that consumers were becoming more cautious. Home sales plunged in the U.S. as the first time homebuyer tax credit expired. Most major central banks held steady. The Bank of Canada was an exception, and surprised markets somewhat by raising its policy rate to 0.50%. A few Bank of England policy-makers raised concerns that U.K. inflation had not dampened in line with U.S. and European inflation.

Government bonds performed well as the bid for low risk assets increased. Corporate bonds saw spread contraction early in the quarter more than offset by sharp widening as the Eurozone crisis hit its peak in May. The Australian dollar reaffirmed itself as a "risk" currency; it lost US6.36 cents against the greenback to end the period at US85.23 cents.

After a brief rally in early June, global equity markets fell following weak economic data from the U.S., continued concerns over the sovereign debt situation in peripheral Europe and strains within the European banking system.

## Performance

The Legg Mason Diversified Fixed Income Trust marginally outperformed its benchmark over the quarter. Portfolio performance over the past year was 6.4% ahead of benchmark. Over the quarter, the portfolio's domestic bond exposure detracted from portfolio performance while the portfolio's global bond exposure aided performance.

Domestically, 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.

Globally, government bond yields declined and the portfolio's long duration, with a focus on intermediate maturity issues, had a positive impact on performance. Portfolio duration and curve positioning in the U.S. was the largest positive contributor to performance. The portfolio's overweight to corporate debt, with an emphasis on the Financials sub-sector, detracted from performance as subordinated financial issues had a challenging quarter.

## 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 domestic 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.

Globally, we are comfortable running additional duration and curve flattening strategies. We are managing these strategies tactically as both market pricing and underlying fundamentals change. For example, with government yields down substantially over the past two months, we have reduced duration positions closer to neutral in the U.S. and Europe. Conversely, we increased duration in the U.K. toward neutral despite falling yields as economic fundamentals have become more supportive of additional duration. The coalition government seems more unified than initially assumed and the emergency budget should help limit the government's cost of borrowing.

We continue to maintain an overweight to the Financials sub-sector, with a clear emphasis on globally diversified banks that are large and benefit from multiple sources of funding. Small regional banks with concentrated assets and single business lines are expected to struggle. We will continue to avoid these issues. Our preference is to gradually shift up the capital structure into more senior issues as pricing and market conditions warrant. Against this, we continue to run neutral to slightly underweight positions in the Industrials and Utilities sub-sectors. As has been the case for six months now, we look to also remain underweight agency mortgage-backed securities.