

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

\$87,805,496.

Performance (before fees and taxes)

	TRUST %	BENCHMARK %
3 months	2.06	1.07
1 year	11.83	4.85
3 years p.a.	4.99	7.27
5 years p.a.	5.09	6.36

Past performance is no indication of future performance.

Profile

QUARTERLY PERFORMANCE	TRUST %	BENCHMARK %
Australian bonds	2.36	1.03
Global bonds	1.76	1.11

Past performance is no indication of future performance.

SECTOR ALLOCATIONS	TRUST %	BENCHMARK %
Australian bonds	51.2	50
Global bonds	48.6	50
Cash	0.2	-

Market Review

Australia was the first G20 nation to begin reversing emergency monetary policy settings when the Reserve Bank of Australia lifted the target cash rate by 0.25% at its October meeting, and then again in November and December. The Reserve Bank indicated that a resilient employment market, sticky underlying inflation and generally stronger than expected economic activity were the reasons for removing the "emergency" stimulatory settings put in place during the crisis period. The short term yield curve flattened slightly as a result, with the market forecasting cash rates to be in the range of 4.5% to 5.0% by mid 2010.

Mid quarter concerns about the sustainability of the global economic recovery and issues in Dubai led to a strong rally in global bonds, which initially helped Australian bond yields move lower. However the steady flow of positive data, both domestic and offshore, and the heavy supply of U.S. government bonds into year end caused global bond yields, and Australian bond yields with them, to rise at the end of the quarter. The Australian bond curve steepened over the quarter, as 10 year yields rose 0.28% for the quarter and three year yields declined 0.17%.

The domestic credit sector continued to outperform along with equity and other risk markets. Lower rated credit outperformed higher rated alternatives as spreads continued to grind tighter and the idea of a double dip recession seemed to lose currency with many market participants. Early in the quarter the Reserve Bank's monetary policy decision helped the Australian dollar to a 15 month high against the U.S. dollar and a 24 year high against the sterling. However, the U.S. dollar regained some ground with signs of an improving economy giving investors reason to consider an earlier exit from aggressive monetary policy stimulus there.

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.

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.

Legg Mason

Diversified Fixed Income Trust

Performance

The Legg Mason Diversified Fixed Income Trust outperformed its benchmark by 1.0% over the quarter; this continued a period of strong relative performance for the portfolio. Portfolio exposure to both Australian bonds and global bonds added value this quarter.

Domestically, the portfolio's overweight exposure to corporate debt continued to aid performance throughout the December quarter, as credit spreads tightened further and corporate credit again outperformed the broader fixed income market. Within the corporate sector, exposure to the Financials sub-sector again had the largest positive impact on outperformance, with National Australia Bank, Swiss Re, AXA and Wells Fargo the most significant contributors. The portfolio benefited from tactical interest rate strategies as bond yields remained volatile throughout the quarter.

Globally, 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.

Outlook

Australian gross domestic product growth in Australia is expected to improve to around trend in 2010 as government infrastructure spending gains traction and export demand improves. Inflation is likely to remain below average through 2010 as wage pressures remain weak and the economy continues to operate below its productive capacity. With Australia's labour market in reasonable shape, and broader economic growth returning, cash rates are expected to continue to move higher throughout 2010.

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.

At the portfolio level, domestic portfolio duration is expected to be tactically managed as volatility is likely to remain high while markets debate the speed of the global recovery and the possible return of inflation. We maintain an overweight position in corporate bonds, with an emphasis on Financials, as market valuations, continued government support and increased regulation provide significant appeal despite spreads tightening through 2009. We are also selectively buying primary corporate deals in industries that should benefit from an economy that is returning to growth and in those that have de-leveraged. We also maintain an overweight position in government guaranteed bank issuance as a defensive strategy. These securities offer the assurance of the Commonwealth Government and have greater yield benefit relative to government bonds.

Globally, 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.

DISCLAIMER

Any reference to "Legg Mason Australia" is a reference to Legg Mason Asset Management Australia Limited ABN 76 004 835 849 AFSL 240827. Neither Legg Mason Australia, nor any of its related parties, guarantee the repayment of capital or performance of any of the trusts referred to in this document. Past performance is no guarantee of future performance. Applications to invest in the Legg Mason Australian Diversified Fixed Income Trust can be made using an application form comprising part of the current Product Disclosure Statement, which is available from our offices or on our website at www.leggmason.com.au. Certain eligibility criteria applies. Legg Mason Australia does not guarantee the accuracy or completeness of this document. To the extent permissible by law, Legg Mason Australia accepts no liability in contract, tort (including negligence) or otherwise for any loss or damage suffered as a result of reliance on this document. This document does not constitute investment advice, does not include recommendations on any particular security and has not been prepared to take into account the investment objectives, financial objectives or particular needs of any particular person. Before making an investment decision you should read the Product Disclosure Statement carefully and you need to consider, with or without the assistance of a financial advisor, whether such an investment is appropriate in light of your particular investment needs, objectives and financial circumstances. The opinions and outlook are subject to change without notice.