

Legg Mason Diversified Trust

Objective

The Trust aims to earn a before fees and taxes return (over rolling three year periods) in excess of a benchmark constructed in accordance with the natural asset allocation of the Trust.

Benchmark

The performance of the Trust is measured against a benchmark comprising the following sectors:

35 % Australian equities	S&P/ASX 200 Accumulation Index
10% Property securities	S&P/ASX 200 A-REIT Accumulation Index
23% Global equities	MSCI All Country (ex-Australia) World Index, net dividends reinvested, expressed in AUD
12% Australian bonds	UBS Australian Composite Bond Index
12% Global bonds	Barclays Capital Global Aggregate Index, hedged into
5% Cash	UBS Australian Bank Bill Index
3% Alternative investments	UBS Australian Bank Bill Index

Value

\$34,081,285

Performance (Before fees and taxes)

	Trust %	Benchmark %
3 months	2.47	2.13
1 year p.a.	-4.92	-2.60
3 years p.a.	7.11	4.92
5 years p.a.	-2.62	-1.51

Past performance is no indication of future performance.

Market Review

After a strong performance during the month of October, equity markets came once again under selling pressure, on the back of rising risk aversion. Despite further evidence of the resilience of the US economy, investors continued to be concerned about a potential meltdown of the Eurozone. Volatility reached high levels but global equity markets ended the quarter on a positive note.

For much of the period, the Australian share market was very volatile. With investors looking for safety, defensive stocks outperformed more cyclical stocks. The Australian equity market gained 2.1% over the quarter, as measured by the S&P/ASX 200 Accumulation Index.

The Australian Real Estate Investment Trusts (A-REIT) sector was up 3.8% over the quarter, as measured by the S&P/ASX 300 A-REIT Accumulation Index. A-REITs outperformed the broader Australian equity market by 1.7% during the period.

The MSCI World (ex Australia) Index rose 2.0% in AUD terms in the fourth quarter due solely to solid gains in October when fears of a US recession subsided and it appeared that European leaders would hammer out a solution to the debt problems in the peripheral markets. However, throughout the remainder of the year markets again pulled back to a "risk-off" environment, reacting to headlines including slowing global growth, fears of a hard landing in China and, most importantly, European leaders' continued inability to find common ground on the debt crisis.

The broad Australian fixed-income market returned 1.9% for the quarter, according to the UBS Composite Bond Index, as yields declined across the yield curve and the yield curve flattened in the three- to 10-year range. The 10-year government bond yield hit its lowest level in over 50 years in the last days of December, finishing at 3.67%, well below the cash rate. Domestic credit spreads moved wider over the quarter and European supranational issuers were scrutinised as much as corporate issuers.

Australian economic data released during the quarter continued to highlight softness in the economy. Retail sales remained weak and employment fell further. The Reserve Bank of Australia cut the target cash rate by 50 basis points to 4.25%, reflecting the slowing momentum in the domestic economy. The market has priced in a few potential rate cuts by June 2012.

Performance

The Legg Mason Diversified Trust outperformed its benchmark over the quarter. Performance this quarter was affected by the overweight allocation to Australian and overseas equities, which contributed positively. Australian bonds underperformed mostly due to the short duration positioning. The listed property sector outperformed its benchmark.

In Australian equities, both stock selection and sector allocation added value over the quarter. Iluka (+23.9%) continued to add significant value to the portfolio. The company benefitted from a further 10% increase in the price of Zircon in the December quarter and more interestingly an 80-85% price increase for Rutile (Titanium).

In developed market global equities stock selection added value this quarter, most notably in the US and Japan; selection was also modestly positive in the UK and continental Europe. In emerging markets equities the pro cyclical nature of the portfolio meant that it performed very strongly during October; but it gave some of that performance back during the following two months.

In A-REITs, the portfolio outperformed its benchmark over the quarter. Portfolio's holdings that aided performance included Charter Hall Group, Stockland and the underweight to GPT Group and CFS retail property.

In Australian bonds, portfolio duration positioning remained short relative to the benchmark and was the most significant detractor, as bond yields continued to push deep below cash amid foreign investors' continued search for higher yielding safe-haven assets. At a sector level, the portfolio underperformed due to the overweight in corporate bonds as spreads pushed wider.

Outlook

Currently market concerns and uncertainty are high with European debt concerns, potential slowing in China and a 2 speed domestic economy. This has resulted in high volatility levels but also attractive valuations.

In respect of stock specific investment opportunities, we continue to observe a valuation spread between the most attractive and least attractive stocks in the investment universe that is well above averages seen through out the last 15 years. We currently see opportunities in more cyclical names whose earnings are well below normal and will benefit from a recovery in sentiment and risk aversion.

A-REITs are attractively valued based on implied value relative to unlisted property, global REITs, the broader Australian equity market as well as Australian and global bonds.

At the security level, the investment opportunity for selected A-REITs continues to be attractive. The valuation spread between the most attractive and least attractive securities in the investment universe remains at around two times historical averages.

Within developed markets, we expect that the slow pace of growth will continue, though EU markets have slipped into technical recession. We expect market volatility to continue in 2012 until European policy leaders deal with their sovereign debt woes with more decisiveness.

In the bond sector, duration positioning will be tactical, with a short duration bias relative to the benchmark. Volatility is likely to remain high while markets consider the fragile state of developed-nation economies and continue to test the eurozone's resolve to stand by its member countries and their financial systems.

The portfolio is expected to maintain an overweight position in corporate bonds, with an emphasis on large financials, as market valuations and increased regulation continue to appeal.