

Legg Mason Tactical Allocation Trust

Objective

The Legg Mason Tactical Allocation Trust aims to achieve a rate of return in excess of its benchmark over rolling three year periods by making active asset allocation decisions between Australian equities, bonds and cash.

Legg Mason continually assesses the relative values of Australian equities, bonds and cash. The portfolio is tilted toward the relatively undervalued asset class in the expectation that the undervalued asset class will outperform as it returns to its assessed fair value.

Benchmark

50% the S&P/ASX 200 Accumulation Index and 50% the UBS Australian Treasury Index.

Value

\$53,972,989

Performance (Before fees and taxes)

	Trust %	Benchmark %
1 month	-1.72	-0.20
3 months	2.97	2.82
1 year	-15.52	0.97
3 years p.a.	12.40	6.76

Past performance is no indication of future performance.

Asset Allocations

At 30 December 2011, the assets of the Legg Mason Tactical Allocation Trust were invested as follows:

	Trust %	Benchmark %
Australian equities	146.0	50.0
Australian bonds	-46.0	50.0

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.

In the Australian bond market, the yield on the Australian 10-year government bonds fell on rising risk aversion and finished at 3.7%, down from 4.2% at the start of the period.

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.

The Australian dollar rallied against the U.S. dollar at the beginning of the quarter. Despite some volatility, it ended the December quarter at US1.022 cents, up 4.9US cents.

Activity

The Legg Mason Tactical Allocation Trust started the quarter overweight Australian equities (+150%) and underweight Australian bonds (-50%).

The Australian equity market rallied strongly in October but then lost some ground during the quarter on increased risk aversion. The 10-year bond yields were up in October but fell in the second half of the quarter. We decided to decrease the allocation to equities to end the period at 146% (bonds -46%).

At quarter end, the portfolio remained overweight Australian Equities and underweight Australian bonds in order to benefit from the high expected return from Australian Equities. 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. The current PE of 10.7 represents 35% upside to the long term average PE of 14.5x or is equivalent to adding 3% pa to the expected long term return of equities. Fortunately for Australian investors, the fundamentals of the domestic market are also strong. High Commodity prices and massive capital investments are boosting the Australian economy.

There is a \$140bn pipeline of mining capital expenditure that has started but yet to be completed which will support employment and business across Australia. The price of Australia's exports versus imports (Terms of Trade) is at 140 year highs and should provide a boost to national income. The household sector is growing and strong. Unemployment is low at around 5%, the saving rate is now 10% and real income growth is positive. The growth of the population also appears solid given skilled immigration and supportive family policies. Official interest rates are high with plenty of scope to be cut which boosts the attractiveness of alternative yielding assets. The easing monetary policy by the RBA should help consumer sentiment going forward. Australia is also a low risk market with the ratio of Government Debt/GDP at 20% and the Government budgeting a small deficit. The banking system has remained strong with high deposit growth and access to global credit markets. Corporate balance sheets are strong.

In the portfolio's bond allocation, portfolio duration began the quarter 0.44 years shorter than benchmark duration. The portfolio's duration position was actively managed with portfolio duration always shorter than duration of the benchmark in response to changes in the 10-year bond yield. The portfolio's bond allocation ended the quarter 0.86 years shorter than the benchmark

Performance

The Legg Mason Tactical Allocation Trust outperformed its benchmark by 0.15% over the quarter.

Performance this quarter was hurt by the portfolio's overweight allocation to equities and underweight allocation to bonds, as the equity market underperformed the bond market. Meanwhile, duration management within the portfolio's bond allocation had a small impact on portfolio performance.

While weakness in the equity market has negatively impacted the recent performance of the portfolio, we remain of the view that more normal relative equity and bond market valuations will ultimately prevail.