LEGG MASON
GLOBAL ASSET MANAGEMENT

Legg Mason Western Asset Global Multi Strategy Fund

Key Points

- The Legg Mason Western Asset Global Multi Strategy Fund generated a return of 1.36%[1] in US dollar terms over October. It lagged its composite benchmark[2], which returned 1.72% over the month.
- In terms of changes to the portfolio, the manager gradually began diversifying its exposure to local currency emerging market debt. It also took profits in some investment grade US non-financials and adjusted the credit risk of the portfolio through derivatives.
- The manager does not expect global government bond yields to rise meaningfully from current levels, but also notes that current levels offer little protection against upside surprises in either the economic or inflation data. It will tactically manage overall duration and believes that yield curve strategies take on increased significance in this environment.
- The manager remains comfortable with its investment thesis backing its overweight to corporate bonds issued by the financial sector. It continues to monitor the amount of risk coming from currency strategies given the market's extreme volatility.

Market Review

Over October, fears of a double-dip recession in the US receded and further asset purchases by the US Federal Reserve (Fed) looked increasingly likely. While the major government bond markets suffered, the non-government sectors of the global bond market performed well and the US dollar lost significant ground against most major currencies. High yield corporate bonds and emerging market debt performed particularly well.

Investors hunted for clues in economic data releases and speeches by members of the Fed on the likelihood of a second round of quantitative easing (QE2) by the Fed. Market sentiment improved over the month as enacting such a programme seemed increasingly imminent in the US. By month end, inflation expectations had risen significantly, and the question was not if the Fed would enact QE2, but how large it would be and how spread out the asset purchases would be. (In early November, the Fed announced an asset purchase programme amounting to $600 billion over 8 months.) The Bank of Japan is pursuing a course similar to that of the Fed. It announced further measures, including an intention to purchase riskier assets than most other central banks would be willing to put on their balance sheets. Speculation also intensified about further asset purchases in the UK. Policy makers at the Bank of England remained divided over the further course of action. The European Central Bank, meanwhile, once again distinguished itself as the most hawkish of the major central banks.

Fund Review

The Legg Mason Western Asset Global Multi Strategy Fund generated a return of 1.36%[1] in US dollar terms over October. It lagged its composite benchmark[2], which returned 1.72% over the month. Yield curve positioning was the main negative performance driver as the US curve continued to steepen.

In terms of changes to the portfolio, the manager gradually began diversifying its exposure to local currency emerging market debt, adding allocations to Egypt, Malaysia and Peru, while reducing its exposure to Brazil following recent strength. The manager took profits in some investment grade US non-financials and adjusted the credit risk of the portfolio through derivatives. In terms of currencies, the manager reduced its underweight in the euro versus the dollar, given the impending quantitative easing in the US. It also took a modest position in the Norwegian krona, as it expects Norway to benefit from concerns in peripheral Europe as a net saving country.

[1] Class A Distr. (D) US Dollar Shares.
[2] Composite Benchmark: 50% Barclays Capital Global Aggregate Index, 25% Barclays Capital U.S. Corporate High Yield - 2% Issuer Capped Index (Lehman Brothers U.S. High Yield Index prior to 01/12/2005), 25% JP Morgan EMBI+ Index.
Source for performance figures – Legg Mason. Performance is calculated on a NAV to NAV basis. Performance calculations include reinvested dividends, without deduction of withholding tax, and the deduction of the Total Expense Ratio over the calculated period. Sales charges, taxes and other locally applied costs to be paid by an investor have not been deducted.

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Outlook

The manager notes that, after weeks of speculation, the Fed finally clarified the size of QE2 (in early November). However, uncertainty remains over whether more QE will stimulate economic growth, increase employment and stabilise core inflation at a level near the Fed's official target. It also notes that uncertainty goes well beyond the future path of key economic variables in the US alone, with currency wars and rising trade barriers increasingly being mentioned across markets. The manager remains sceptical that QE2 will have a significant impact and continues to expect ongoing, modest growth in the US, only a gradual decline in the unemployment rate and little pricing pressure in the near term. It believes Eurozone growth is likely to soften slightly, after holding up better than the other major economies, and fears Japan is again stuck with self-reinforcing deflation.

Against this backdrop, it does not expect global government bond yields to rise meaningfully from current levels. It also notes, though, that government yields are near century lows and offer little protection against upside surprises in either the economic or inflation data. The manager believes that tactical duration management is the only prudent course and that yield curve strategies take on increased significance in this environment. The manager has implemented yield curve flattening strategies in the US and, to a lesser extent, in Europe, which should perform well under two scenarios: if central banks tighten policy more aggressively than expected or if economic conditions are weaker than expected and policy rates remain lower for a longer period.

The manager remains comfortable with its investment thesis backing its overweight to corporate bonds issued by the financial sector. The manager interprets the recent equity offering by the UK's Standard Chartered Bank as a possible signal that other global banks could raise capital well in advance of the 2019 deadline laid out in the Basel III regulatory reform. The crisis revealed as unacceptable any system in which banks' equity holders enjoy the upside to risky activity, while much of the downside rests with society. While imperfect, the Basel III accord dramatically rebalances this allocation of risk, placing it back onto shareholders.

The manager continues to monitor the amount of risk coming from currency strategies given the market's extreme volatility. Although it has limited the size of its underweight position in the euro, it is sticking with this position due to its long-term fundamental view that nominal currency depreciation is the most effective vent for eurozone strains. Along similar lines, it also aims to maintain an underweight to the periphery of Europe - partially offset with an overweight to Poland - both in terms of bond market and currency exposure.

The G20 countries last month agreed to an overhaul of International Monetary Fund (IMF) voting rights in which emerging-market (EM) economies will gain an additional 6% voting share and Europe will cede two of its spots on the 24-seat executive board. Brazil, Russia, India and China will be among the top-10 shareholders at the IMF after the transition occurs next year. The manager takes seriously not just this rebalancing at the IMF, but also the transformation of the global economic dynamic caused by EM economies. It continues to focus its emerging market allocations on a mix of local currency issues and external debt issued by corporates and sovereigns.

This Fund is managed by Western Asset Management

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