MANAGER INSIGHTS

Conference Call Series

The following is a summary of a portfolio manager conference call that took place on January 19, 2010. The call featured insights from Joe Deane and Rob Amodeo from the Western Asset Management (“Western”) Municipal Bond Team.

Market Review

- Amodeo described 2009 as being a "spectacular year" for the municipal market. In particular, there was a dramatic decline in muni interest rates across the curve and spreads significantly narrowed.

- Amodeo said there was a great deal of uncertainty within the muni market when 2009 began. This was due to a variety of factors, including a supply/demand overhang and questions regarding the market's ability to function properly. However, conditions rapidly improved and the clouds had largely lifted by the middle of the year.

- Also aiding the municipal market in 2009 was the Build America Bond program. According to Amodeo, it took supply away from the traditional municipal space and helped to equalize supply and demand in the tax-free area. There was also strong demand for the muni asset class as investors were reaching for yield while, at the same time, looking for value and trying to shield themselves from taxes.

- Amodeo explained that muni technicals improved dramatically last year, as there was approximately $400 billion of new supply in 2009.

- Amodeo said that muni fundamentals continued to be challenged, as tax receipts have been declining for several years. He pointed out that all sources of revenue have fallen, including sales tax, personal income tax, corporate tax and user fees. Even though spending at the state and the local levels have declined, Amodeo doesn't feel it has been enough to offset the weakness in the revenue cycle.

Portfolio Positioning and Outlook

- In terms of Western's muni portfolios, Amodeo said that in 2009 they were rewarded for emphasizing essential service revenue bonds that had broad and diverse revenue streams. He explained that with these securities, they didn't have to rely on the political will or the financial flexibility at the state level. In contrast, Western minimized their exposure to state general obligation (GO) bonds.

- Deane doesn't expect to see a repeat of 2008's muni market in his career. During that time, there was a tremendous backup in rates and an explosion of spreads. He said an enormous amount of leverage had been built into the municipal, corporate and mortgage markets and 2008 was all about deleveraging. He now believes this has been significantly wrung out of the muni side of the business.

- According to Amodeo, Western believes that, in 2010, a potential opportunity will be to selectively buy into the weakness at the state level by purchasing certain tax-backed debt. He feels that new issuance of these securities is likely to be sizeable throughout the year. These types of purchases would be driven by valuations and improving fundamentals and Western would have to be adequately paid to take on the incremental risk.

Q&A

Q: What are Western's expectations in terms of muni supply in 2010?

Amodeo: Tax-free supply will likely be down 2010 versus last year, in large part due to the success of the Build America Bond program. Keep in mind, there will be a sizeable need to borrow within the municipal marketplace. If you're an issuer and you have the opportunity to issue in the Build America Bond program or the traditional municipal market, traditional munis are more expensive from an issuer's perspective.

Q: Could you provide some additional background on Build America Bonds?

Amodeo: Build America Bonds offer between 50 and 100 basis points of financing cost advantage for issuers versus the traditional municipal market. Most of the Build America Bonds are long dated securities, as roughly 52% is longer than 25 years; whereas about 10% of the issuance is less than 12 years. And Build America Bonds are dominated by general obligation debt.

Q: What is your forecast for inflation down the road?

Deane: There is so much excess capacity in the U.S. right now that Western doesn't see inflation being a factor in 2010 to any great degree, maybe even for several years.

Q: What are your expectations in terms of the Federal Reserve Board ("Fed") raising short-term rates?

Amodeo: We're not expecting much in the way of Fed activity in the near term. For the most part, our view is that the Fed will remain on the sidelines this year. If anything, their activity would pick up at the latter part of 2010.

Deane: I personally think that when the Fed eventually makes a move, it would be a positive sign. That's because they would be indicating real improvements on the economic front.

Q: How are you managing your various muni portfolios from a duration perspective relative to their benchmarks?

Amodeo: Based on the curve today, whether it's a short-, intermediate- or long-term portfolio, we're at the industry average or a bit longer. You're getting paid right now to go out the curve a little. So if you're a one- to a 10-year buyer, you probably should be buying 10 years. If you're a 10- to a 20-year buyer, you should probably be buying 20, and so on.

Deane: Just to add on that, if you look at the slope that's embedded in the curve today--really since the early part of 2009--you have not seen such a steep level for quite some time. So there is good value on the longer end of the respective maturity ladder, whether it's a short, intermediate or long duration product. Whenever the Fed does begin to remove the punch bowl a bit, it's going to have a more dramatic impact on the front end of the curve than the long end. That's because the long end is already pricing in the economic fundamentals in the country.

Q: What is your outlook for the California muni market?

Amodeo: We believe that the structural imbalances on the West Coast are sizeable. California is a boom-to-bust type state. By that I mean its revenue cycle is amplified because it's heavily reliant on stock market related gains, personal income taxes, and other taxes that are highly dependent on the business cycle. And California was at the epicenter of the housing downturn. Another challenge is its government's requirement for a two-thirds majority to approve state budgets and taxes. This makes it difficult to get creative legislative initiatives passed. But once the economic recovery takes root and everything continues to grow, California's finances will improve. But again, its structural imbalances are sizeable and it will take time to correct those imbalances.

Deane: At the moment, we have a very minimal exposure to California GOs. Until we see the state start to make some tough decisions and begin to balance the budget we're comfortable with this position.

Q: Any final thoughts on the muni market?

Amodeo: The dynamics of the municipal marketplace have changed dramatically--and perhaps forever--with the evaporation of the monoline business. Given this, we believe investors will be well served by having a professional manager attend to their muni portfolio. Western has a team of dedicated credit analysts for municipal securities that focus on particular regions and geographic regions, as well as on specific sectors.

Deane: If you're considering muni products of any kind, you should look at a manager's five-year return numbers. The muni market had a tough year in 2007, a disaster in 2008 and a spectacular rally in 2009. If a manager has a good five-year performance record, you've got to figure they can manage money when times are tough, not just when times are easy. If you look across the spectrum of most of the Western muni funds, our five-year numbers are very solid.

Investment Risks

All investments involve risk, including possible loss of principal. Fixed income securities involve interest rate, credit, inflation, and reinvestment risks; and possible loss of principal. As interest rates rise the value fixed income securities falls. High yield bonds possess greater price volatility, illiquidity, and possibility of default. An investor may be subject to the Federal Alternative Minimum Tax (AMT), and state and local taxes may apply. Capital gains, if any, are fully taxable.

The views expressed are those of the portfolio managers as of January 19, 2010 and are subject to change based on market and other conditions. These views may differ from other portfolio managers or the firm as a whole, and are not intended to be a forecast of future events, a guarantee of future results or investment advice. The mention of any individual securities or sectors should neither constitute nor be construed as a recommendation to purchase or sell such securities, and the information provided regarding such individual securities is not a sufficient basis upon which to make an investment decision.

The information provided is intended solely to describe the managers' management style, investment strategies and securities selection process, and does not have regard to specific investment objectives, financial situation and particular needs of any specific person who may receive it. The information provided does not constitute, and should not be construed as, an offer or solicitation with respect to any securities, products or services mentioned or discussed.

Past performance is no guarantee of future results. Any statistics have been obtained from sources the portfolio managers believed to be reliable, but the accuracy and completeness of the information cannot be guaranteed. All investments involve risk, including possible loss of principal. Dividends represent past performance, and there is no guarantee that dividend payments will continue. Diversification does not assure a profit or protect against market loss.

AN INVESTOR SHOULD CONSIDER A FUND'S INVESTMENT OBJECTIVES, RISKS, CHARGES AND EXPENSES CAREFULLY BEFORE INVESTING. FOR A FREE PROSPECTUS, WHICH CONTAINS THIS AND OTHER INFORMATION ON ANY LEGG MASON FUND, VISIT WWW.LEGGMASON.COM/INDIVIDUALINVESTORS. AN INVESTOR SHOULD READ THE PROSPECTUS CAREFULLY BEFORE INVESTING.

Definitions

A **basis point** is one one-hundredth (1/100 or 0.01) of one percent.

A **General Obligation ("GO")** bond is a municipal bond backed by the credit and "taxing power" of the issuing jurisdiction rather than the revenue from a given project.

Essential Service Revenue bonds are issued by entities considered fundamental to the operation of the government, which can include public universities, primary/secondary schools, water and sewer utilities, and state highway authorities. They are secured by a specific stream(s) of revenue(s) rather than the general taxing power of a municipality.

The **Build America Bond** program authorizes state and local governments to issue Build America Bonds as taxable bonds in 2009 and 2010 to finance any capital expenditures for which they otherwise could issue tax-exempt governmental bonds. State and local governments receive a direct federal subsidy payment for a portion of their borrowing costs on Build America Bonds equal to 35 percent of the total coupon interest paid to investors.

The **yield curve** is the graphical depiction of the relationship between the yield on bonds of the same credit quality but different maturities.

Valuation is the process of determining the current worth of an asset or company.

The **Consumer Price Index or Inflation** measures the average change in U.S. consumer prices over time in a fixed market basket of goods and services determined by the U.S. Bureau of Labor Statistics.

Duration is the measure of the price sensitivity of a fixed-income security to an interest rate change of 100 basis points. Calculation is based on the weighted average of the present values for all cash flows.

Credit spread is the difference between the yield of a particular security and a benchmark security that has the same maturity as that particular security.

Credit quality informs investors of a bond or bond portfolio's credit worthiness, or risk of default.
Investment grade bonds are those rated Aaa, Aa, A and Baa by Moody's Investors Service and AAA, AA, A and BBB by Standard & Poor's Ratings Service, or that have an equivalent rating by a nationally recognized statistical rating organization or are determined by the manager to be of equivalent quality.

The **Barclays Capital Municipal Bond Index** is a broad measure of the municipal bond market with maturities of at least one year. Please note that an investor cannot invest directly in an index.

The **Federal Reserve Board ("Fed")** is responsible for the formulation of policies designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.

U.S. Treasury securities are backed by the full faith and credit of the U.S. Government. Corporate bonds and municipal securities are subject to risks.

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