

# Conference Call Series

The following are notes based on a conference call on January 27, 2010. The call featured Steve Walsh, Chief Investment Officer at Western Asset Management (“Western Asset”). Mr. Walsh provided a recap on the fixed income markets and their performance in 2009, as well as Western's outlook for 2010.

## Recent Market Environment

- Walsh described how risk-taking in the fixed income market was highly rewarded in 2009, the exact opposite of what happened in 2008 when risk taking was substantially punished.
- In general, the riskier the asset class, the better the results in 2009. In particular, Walsh pointed out that high yield bonds and emerging market debt generated outstanding returns during the year. In contrast, Treasuries posted negative absolute returns.
- Walsh said that the magnitude of the outperformance by the spread sectors in 2009 took most everyone by surprise, including Western.
- In response to the question if the spread sectors have moved too far, too fast, Walsh said that investors needed to remember what triggered the weakness in 2008. One factor was the credit market mechanism breaking down in the fourth quarter. A second factor was the rapidly weakening economy and talk of another Great Depression.
- According to Walsh, the spread sector rally in 2009 was in reaction to meaningful improvements in the credit markets. In addition, while challenges remain, the economic outlook has greatly improved.

## Portfolio Positioning and Performance

- Walsh explained that the strong performance of the Western fixed income funds in 2009 was driven by the same things that hurt them in the latter part of 2007 and 2008; namely an overweight to investment grade corporates and, where allowed, having exposures to non-agency mortgages and high yield bonds.
- Western was rewarded for maintaining its investment discipline in 2009. Walsh said that, based on their analysis, Western even added modestly to the risk profiles in their Core Plus and Core strategies during the first quarter of 2009.
- Walsh said that beginning in late summer and again in the fourth quarter of 2009, Western proactively moved to reduce the overall risk in their portfolios. This included paring their high yield exposure in their Core Plus portfolios. They also reduced their investment grade credit exposure in their Core and Core Plus portfolios.
- Within the corporate market, Walsh said they instituted some sector rotating in 2009, specifically adding to financials. Western continues to believe that financials, from a bond investor's perspective, will be an attractive place to be in 2010, that's because the industry will behave more like a utility given the likely of increased regulation, coupled with less risk taking.
- Walsh explained that they also reduced their positioning in agency mortgages. At the beginning of the 2009, agency mortgages in the Western funds were roughly 50% of their portfolios. They subsequently moved from a meaningful overweight to an underweight. By October 2009, they had approximately a 25% allocation to the sector.
- One area where Western has maintained its exposure is non-agency mortgages, as the housing market looks fairly stable or nearing a bottom. In addition, Walsh said they believe non-agency mortgages will be supported by the Public-Private Investment Program (PPIP) and other initiatives designed to improve the technicals in that area.
- According to Walsh, bringing down portfolio risk was due to less attractive valuations given the significant spread narrowing during the year. In addition, they have a somewhat uncertain outlook with respect to the landscape for fixed income investing.

## MANAGER INSIGHTS

### Outlook

- In terms of the U.S. economy, Western believes that it might surprise people in 2010 by being slightly stronger than expected. Walsh said the current consensus for GDP is 2-1/2% to 3% growth, whereas Western feels we could see a 3% to 3-1/2% expansion in 2010. However, this is still a more muted recovery than what we typically experience coming out of a recession.
- Walsh said that some of the headwinds that will impede more robust growth in 2010 include the heavily indebted consumer who is more likely to save than spend, a relatively modest rate of credit expansion, and the fiscal problems facing the country. That said, Western does not expect to see a double-dip recession.
- Western does not feel that inflation will be a concern for fixed income investors in 2010. He said that the Federal Reserve Board's (the "Fed") policy response at the end of 2008 was both necessary and appropriate. Walsh believes that the Fed will also have the ability to back away when it's appropriate.
- Walsh said they feel that the Fed wouldn't start to raise short-term interest rates until the early part of the third quarter.
- Given Western's outlook, Walsh said they remain positive about the spread sectors, but they do believe paring back their risk exposure was warranted.

### Q&A

**Q:** If we do see a rising interest rate environment, what hedges has Western put in place to protect against this risk?

**Walsh:** Again, Western's belief is that rates will remain low. During the year, the 10-year Treasury note could fluctuate between 3-1/4% and 4-1/4%. It's currently at 3.60%. Given the challenging growth environment and low inflation, it's hard to get very bearish on interest rates as a general rule. We expect to stay neutral to a little bit long duration in our portfolios unless something meaningfully changes. Should rates move higher, it probably means that the economy is growing at a decent pace, which would be a positive for our corporate bond positions.

**Q:** Could you discuss any recent personnel changes at Western?

**Walsh:** I have been at Western for almost 20 years and I'm really excited about our team and our long-term track record. Of course, we always want to build on our performance. One way we have invested in our future is by increasing Western's resources to manage risk by adding a number of experienced experts in this area. We have also added to our investment grade and high yield analyst teams to take advantage of opportunities in the credit markets.

**Q:** One of your competitors has decided to make a foray into equity management. Has Western ever thought about doing that?

**Walsh:** We looked into this back in 1995 or 1996 and decided against it. We have since repeated that we want to be a pure play fixed income firm. We basically eat, sleep and drink the fixed income market. That's all we care about. If anything, there are many, many segments of the fixed income market today that you can expand into.

### 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.

## MANAGER INSIGHTS

The views expressed are those of the portfolio managers as of January 21, 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.

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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](http://WWW.LEGGMASON.COM/INDIVIDUALINVESTORS). AN INVESTOR SHOULD READ THE PROSPECTUS CAREFULLY BEFORE INVESTING.

### Risk

#### Western Asset Core Bond Portfolio

Fixed income securities involve interest rate, credit, inflation, and reinvestment risks; and possible loss of principal. As interest rates rise the value of fixed income securities falls. Derivatives, such as options and futures, can be illiquid, may disproportionately increase losses, and have a potentially large impact on fund performance. Investing in asset-backed, mortgage-backed or mortgage related securities subjects the fund to additional risks such as prepayment and extension risks. The fund may engage in active and frequent trading, resulting in higher transaction costs and increased investor liability. Diversification does not assure a profit or protect against market loss.

#### Western Asset Core Plus Bond Portfolio

Investments in fixed income securities involve interest rate, credit, inflation, and reinvestment risks; and possible loss of principal. An increase in interest rates will reduce the value of fixed income securities. The fund may use derivatives, such as options and futures, which can be illiquid, may disproportionately increase losses, and have a potentially large impact on fund performance. International investments are subject to special risks including currency fluctuations, social, economic and political uncertainties, which could increase volatility. These risks are magnified in emerging markets. Asset-backed, mortgage-backed or mortgage related securities are subject prepayment and extension risks. Risks of high yield securities include greater price volatility, illiquidity, and possibility of default. Potential active and frequent trading may result in higher transaction costs and increased investor liability. Diversification does not assure a profit or protect against market loss.

MANAGER INSIGHTS

Average Annual Total Returns and Expense Ratios (%) as of 12.31.09

WA Core Bond Portfolio - I share	Inception date	1 YR	3 YR	5 YR	10 YR	Since Inception	Expenses Gross**	Expenses Net***
Excluding Sales Charge	09/04/1990	23.68%	3.92%	3.97%	6.41%	7.45%	0.49%	0.49%
Including Sales Charge	-	23.68%	3.92%	3.97%	6.41%	7.45%	-	-
Barclays Capital Municipal Bond Index	-	5.93%	6.04%	4.97%	6.33%	N/A	-	-
WA Core Plus Bond Portfolio - I share	Inception date	1 YR	3 YR	5 YR	10 YR	Since Inception	Expenses Gross**	Expenses Net***
Excluding Sales Charge	07/08/1998	26.20%	5.31%	4.98%	7.23%	6.49%	0.47%	0.47%
Including Sales Charge	-	26.20%	5.31%	4.98%	7.23%	6.49%	-	-
Barclays Capital Municipal Bond Index	-	12.91%	4.41%	4.32%	5.75%	N/A	-	-

For the most recent month-end information, please visit [www.leggmason.com/individualinvestors](http://www.leggmason.com/individualinvestors)

Performance shown represents past performance and is no guarantee of future results. Current performance may be higher or lower than the performance shown. Investment return and principal value will fluctuate, so shares, when redeemed, may be worth more or less than the original cost. Total returns assume the reinvestment of all distributions at net asset value and the deduction of all Fund expenses. Performance data does not reflect trade date adjustments made to the NAV at month-end. Performance would have been lower if fees had not been waived in various periods. Performance of other share classes will vary.

\*\* Gross expenses are the Fund's total annual operating expenses for the share class(es) indicated as of the date of the Fund's most current prospectus and do not reflect fee waivers or reimbursements. These expenses include management fees, 12b-1 distribution and service fees, and other expenses. In periods of market volatility, assets may decline significantly, causing total annual fund operating expenses to become higher than the numbers shown in the table above.

\*\*\*Because share Class I of the Fund does not currently have fee waivers or reimbursements, gross and net expense ratios are the same for this share class.

An investor cannot invest directly in an index.

**Definitions**

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.

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.

## MANAGER INSIGHTS

Public-Private Investment Program (“PPIP”) is a plan designed to value and remove troubled assets from the balance sheet of troubled financial institutions in the U.S. Essentially, the Public-Private Investment Program's goal is to create partnerships with private investors to buy toxic assets. The program is designed to increase liquidity in the market and to serve as a price-discovery tool for valuing troubled assets.

Gross Domestic Product (“GDP”) is the market value of all final goods and services produced within a country in a given period of time.

The Barclays Capital Municipal Bond Index is a market value weighted index of investment grade municipal bonds with maturities of one year or more.

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