

# Western Asset

## Current Market Muni Portfolios

### Market overview

The U.S. economic recovery continued during the second quarter. However, there were signs that the expansion may moderate during the second half of the year as the government's fiscal stimulus programs largely expire. Looking back, the Commerce Department reported that fourth-quarter 2009 gross domestic product ("GDP")<sup>1</sup> growth was a positive 5.6%. After initially estimating that first-quarter 2010 GDP growth was a solid 3.2%, the Commerce Department later revised the figure down to 2.7%. This was partially due to lower consumer spending figures.

There was some mixed news in the long-ailing housing market. According to the National Association of Realtors, after existing home sales fell from December 2009 through February 2010, they increased 7.0% and 8.0% in March and April, respectively. The rebound was largely attributed to people rushing to take advantage of the government's \$8,000 tax credit for first-time home buyers that expired at the end of April. With the end of the tax credit, existing home sales then declined 2.2% in May. Looking at home prices, the S&P/Case-Shiller Home Price Index indicated that month-over-month U.S. home prices rose 0.8% in April. This marked the first increase following six consecutive monthly declines.<sup>2</sup>

While there was some positive news in the labor market, unemployment remains elevated. During the first five months of 2010, the U.S. Department of Labor reported that employers added an average of nearly 200,000 new positions per month. Some of these gains were given back in June, as 125,000 jobs were lost. While the private sector added jobs during the month, 225,000 temporary government positions tied to the 2010 Census were eliminated in June. At the end of the quarter, the unemployment rate was 9.5%, versus 9.7% in May and 9.9% in April.<sup>3</sup>

One area of the economy that continues to perform well is the manufacturing sector. According to the Institute for Supply

Management's Purchasing Managers Index (PMI), manufacturing has now expanded during each of the last 10 months. May 2010's PMI reading indicated that the manufacturing sector's growth was broad-based, as 16 of the 18 industries tracked by the Institute for Supply Management grew during the month.<sup>4</sup>

Given continued high unemployment and questions regarding the sustainability of the economic recovery, the Federal Reserve Board ("Fed")<sup>5</sup> held rates steady in a range of zero to 0.25% during the second quarter. The Fed has now held rates at this record low since December 2008. In conjunction with its June 2010 meeting, the Fed said that it anticipated keeping short term rates low "for an extended period."

In contrast to much of the previous year when the taxable spread sectors (non-U.S. Treasuries) outperformed equal-duration Treasuries, a series of factors caused Treasuries to be the performance leaders during the second quarter. Whereas investor risk appetite had been robust, the sovereign debt crisis in Europe, uncertainties surrounding financial reform legislation in the U.S. and mixed economic data triggered a flight to quality during the second quarter. Over that period, the yield on the 2-year Treasury fell from 1.02% to 0.61% and the yield on the 10-year Treasury fell from 3.82% to 2.97%.<sup>6</sup> Several of the strongest performers during the last year, including high-yield bonds and emerging market debt, were the largest laggards during the second quarter.

The municipal bond market posted a positive return during the second quarter but lagged equal duration Treasuries. This was due to increased investor risk aversion and concerns regarding the fiscal strength of a number of municipalities. Against this backdrop, inflows into municipal bond mutual funds moderated during the quarter, whereas the new issuance market remained fairly strong.

<sup>1</sup> Gross domestic product ("GDP") is the market value of all final goods and services produced within a country in a given period of time.

<sup>2</sup> Bloomberg, 6/10.

<sup>3</sup> Bloomberg, 6/10.

<sup>4</sup> Bloomberg, 6/10.

<sup>5</sup> 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.

<sup>6</sup> Bloomberg, 6/10.

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The municipal yield curve<sup>7</sup> flattened over the three-month period, as the yield on 1-year AAA municipal securities moved from 0.32% to 0.30% and the 30-year segment went from 4.17% to 4.02%. Consistent with what we saw over the last year, lower-quality issues generated better returns than their higher-quality counterparts, as investors were drawn to the relatively higher yields available from lower-rated securities.<sup>8</sup>

### Contributors and detractors

The Portfolio's yield curve positioning, in particular its exposure to the 6+ year portion of the curve, was a positive for performance during the quarter. However, its duration, which was shorter than that of the benchmark, slightly detracted from results. We moved to extend the portfolio's duration during the period to move closer to a neutral position.

The Portfolio's positioning from a sector perspective produced mixed results. Positively contributing to performance was the Portfolio's exposure to high-quality local general obligation bonds, as well as its water/sewer, education and housing bonds. In contrast, the Portfolio's underweights to state general obligation bonds, as well as its exposures to the pre-refunded and transportation sectors detracted from results. In addition, the Portfolio's higher-quality bias was not rewarded, as lower-quality municipal bonds outperformed their higher-rated counterparts during the quarter.

### Outlook

We continue to feel that economic growth in the U.S. will decelerate during the second half of the year given the winding down of the government's stimulus programs. However, the combination of slower growth and elevated unemployment will likely mean that the Fed will keep short-term interest rates at their historical low until at least 2011.

We remain somewhat cautious on near-term outlook for the municipal market. Given the prolonged economic downturn, many states and local governments are still facing budgetary challenges. We believe that bonds issued by municipalities that are demonstrating better fiscal discipline will hold up relatively better than those that are not making meaningful adjustments to their spending patterns.

While market volatility could remain elevated as the year progresses, we maintain our positive view regarding the long-

term prospects for the municipal bond market. In particular, we feel that demand for tax-exempt bonds will be strong given the demographics in the U.S., as well as the likelihood of higher state and federal tax rates in the future.

Western Asset Management team.

### Current Market Muni Portfolios - Retail

Annualized returns net and gross of fees							
(%) as of June 30, 2010							
	Q210	YTD	1-yr	3-yr	5-yr	7-yr	10-yr
Net of fees	1.36	1.49	4.15	4.57	3.03	2.21	3.20
"Pure" gross of fees	1.73	2.25	5.71	6.13	4.57	3.74	4.74
Barclays Capital 5-Year Muni Bond Index	1.68	2.46	6.88	6.75	4.85	4.12	5.21

*Quarterly and YTD numbers are not annualized. Please see the GIPS® Endnotes on the back page of this document for important additional information. Past performance is no guarantee of future results.*

<sup>7</sup> The yield curve is the graphical depiction of the relationship between the yield on bonds of the same credit quality but different maturities.

<sup>8</sup> Bloomberg, 6/10.

## Western Asset Current Market Muni Portfolios

All opinions and data included in this market commentary are as of the date indicated and are subject to change. The opinions and views expressed herein are those of the portfolio managers specified and may differ from those of other managers or the firm as a whole, and they are not intended to be relied upon as predictions or forecasts of actual future events or performance, or a guarantee of future results, or investment advice. The information contained should not be used as the sole basis to make any investment decision. The statistics have been obtained from sources believed to be reliable, but the accuracy and completeness of this information cannot be guaranteed. **Past performance is no guarantee of future results.** All investments involve risk, including possible loss of principal amount invested. There is no guarantee that investment objectives will be met. An investor cannot invest directly in an index. Investments are not FDIC insured or guaranteed by any government agency. Values may fluctuate due to market conditions and other factors.

### Risks

For tax-exempt securities, certain investors may be subject to the federal Alternative Minimum Tax, and state and local taxes may apply. Capital gains, if any, are fully taxable. Please see the "Important tax information" that follows. Fixed-income securities are subject to interest rate risk. As interest rates rise, the price of fixed-income securities declines.

There is also a risk that an issuer will be unable to make principal and/or interest payments.

State-specific and state-biased portfolios within Western Asset Current Market Muni Portfolios focus on individual states and are more vulnerable to losses caused by adverse developments in those states than are national portfolios, which diversify investments across multiple states.

### Definitions

The Barclays Capital 5-Year Municipal Bond Index is a market-value-weighted index representative of the medium-term (four to six years) tax-exempt bond market. Please note that an investor cannot invest directly in an index.

U.S. Treasuries are direct debt obligations issued and backed by the "full faith and credit" of the U.S. government. The U.S. government guarantees the principal and interest payments on U.S. Treasuries when the securities are held to maturity. U.S. Treasury securities, debt securities issued by federal agencies and instrumentalities and related investments may or may not be back by the full faith and credit of the U.S. government.

Even when the U.S. government guarantees principal and interest payments on securities, this guarantee does not apply to losses resulting from declines.

General obligation municipal bonds are backed by the credit and taxing power of the issuing jurisdiction rather than the revenue of a given project.

Professional money management may not be suitable for all investors.

### Important tax information

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**WESTERN ASSET CURRENT MARKET MUNI-SCHEDULE OF INVESTMENT PERFORMANCE RESULTS –GIPS® Endnote**  
**(January 1, 2000 through December 31, 2009)**

Year	Net return (%)	"Pure" gross return (%)	Benchmark total return (%)	% of bundled fee portfolios in the composite	No. of Portfolios	Composite dispersion (%)	Composite assets (\$mm)	% Of firm assets
2000*	7.23	8.81	7.71	100	555	0.75	-	-
2001*	3.69	5.23	6.21	100	619	0.45	-	-
2002*	6.43	8.00	9.27	100	680	0.99	-	-
2003*	1.65	3.17	4.13	100	709	0.40	-	-
2004*	0.32	1.82	2.72	100	791	0.25	-	-
2005*	-0.31	1.19	0.95	100	2,248	0.23	1,951	-
2006	1.93	3.46	3.34	100	2,059	0.20	2,000	0.39
2007	3.40	4.95	5.15	100	1,864	0.24	1,995	0.32
2008	3.82	5.37	5.78	100	1,961	0.79	1,954	0.39
2009	4.91	6.48	7.40	100	2,143	0.71	2303	0.48

Western Asset has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS®). A complete list and description of Western Asset's composites is available upon request. Western Asset has been verified for the periods January 1, 1993 through December 31, 2008. A copy of the verification report is available upon request.

Western Asset, the Firm, is primarily a fixed-income investment manager composed of Western Asset Management Company, Western Asset Management Company Limited, Western Asset Management Company Pte. Ltd., Western Asset Management Company Pty Ltd, Western Asset Management Company Ltd, and Western Asset Management Company Distribuidora de Títulos e Valores Mobiliários (DTVM) Limitada, with offices in Pasadena, New York, London, Singapore, Melbourne, Tokyo, and São Paulo. Each Western Asset company is a wholly owned subsidiary of Legg Mason, Inc. ("Legg Mason") but operates autonomously, and Western Asset, as a firm, is held out to the public as a separate entity. Western Asset Management Company was founded in 1971. The former Citigroup Brazil's asset management business, located in São Paulo, was integrated into Western Asset Management Company DTVM Limitada (previously known as Western Asset Management Company Limitada), and was subsequently incorporated into the definition of the Firm in March 2009.

Western Asset – Current Market Muni portfolios are discretionary fixed-income portfolios that offer tailored municipal bond management to individual and taxable institutional investors. Effective April 2007, Western Asset manages these portfolios as subadvisor to its affiliate, Legg Mason Private Portfolio Group, LLC. From January 2006 through March 2007, Western Asset portfolio managers managed these portfolios as dual employees of ClearBridge Advisors, LLC, and ClearBridge Asset Management Inc. (each a Western Asset affiliate), following Western Asset's investment process and having access to Western Asset's investment resources, expertise and investment outlook. Previously, these portfolios were managed by an unaffiliated business that was acquired by Legg Mason in December 2005 and subsequently integrated into Western Asset. Net and gross composite returns for periods prior to January 1, 2006\* (i) were achieved by this business and not by Western Asset and (ii) do not comply with GIPS standards. All or substantially all of the individuals responsible for security selection for the portfolios at the unaffiliated business immediately prior to December 2005 joined Western Asset as part of the above-noted integration.

The Western Asset – Current Market Muni composite is composed of accounts that are separately managed accounts (SMAs) managed in accordance with the Western Asset – Current Market Muni strategy. For periods after 2005, all such SMAs without client-imposed restrictions are included. For prior periods, the composite is composed of a majority of such SMAs, except that for periods prior to 2004, certain SMAs with client-imposed restrictions are also included. Terminated accounts are included through the last month of management (last quarter prior to 2003). Portfolio returns of included SMAs are weighted according to asset size for periods after 2005 (equal-weighted for prior periods). For comparison purposes, composite returns are shown against returns of the Barclays Capital Municipal Bond Index 5 Year (4-6), which is composed of 35% state general obligation bonds, 50% revenue debt and 15% pre-refunded bonds. An investor cannot invest directly in an index. The composite was created on January 1, 2006.

Before-tax composite returns are presented "Pure" Gross and Net of fees, are calculated in U.S. dollars, and assume reinvestment of dividends, interest, capital gains and other earnings. "Pure" gross returns do not reflect the deduction of any fees, transaction costs or expenses, and they are presented only as supplemental information to net returns. Net returns reflect the deduction of the anticipated maximum annual bundled fee of 1.5% applied quarterly. Bundled fees may vary across different financial firms and across different accounts based upon account size and other factors. The bundled fee applied includes custody, trading, and investment management. Fee schedules of financial firms that offer the portfolios should be requested from such firms. All returns are gross of withholding tax on interest and capital gains, as are benchmark returns. Additional information regarding policies for calculating and reporting returns is available upon request.

The dispersion of annual returns is measured by the standard deviation of the asset-weighted portfolio returns represented within the composite. Dispersion for periods during which the composite had five or fewer accounts is not statistically significant and is not presented.

**Past investment results are not indicative of future investment results.**

To receive a complete list and description of Western Asset's composites and/or a presentation that adheres to the GIPS standards, please contact Marianne Kerry at 212-601-6194 or mkerry@westernasset.com.

**Risk**

An investor cannot invest directly in an index. Past performance is no guarantee of future results. All investments involve risk, including possible loss of principal