

# WESTERN ASSET SHORT DURATION MUNICIPAL INCOME FUND

## Team-managed

### Average annual total returns and fund expenses (%)

as of June 30, 2019

Class A	3-mo	1-yr	5-yr	10-yr	Since Incept.	Expenses	
					(03/17/03)	Gross	Net
Excluding sales charges	1.00	2.77	1.03	1.59	2.00	0.70	0.70
Including effects of maximum sales charges	-1.33	0.39	0.57	1.35	1.85	0.70	0.70
Bloomberg Barclays Municipal 3 Year (2-4)	1.11	3.48	1.44	1.94	N/A	-	-

**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. Class A shares have a maximum front-end sales charge of 2.25%. Total returns assume the reinvestment of all distributions at net asset value and the deduction of all Fund expenses. Total return figures are based on the NAV per share applied to shareholder subscriptions and redemptions, which may differ from the NAV per share disclosed in Fund shareholder reports. Performance would have been lower if fees had not been waived in various periods. Returns for less than one year are cumulative. For the most recent month-end information, please visit [www.leggmason.com](http://www.leggmason.com).

**Gross expenses** are the Fund's total annual operating expenses for the share class(es) shown.

**Net expenses** are the Fund's total annual operating expenses for the share classes indicated and would reflect contractual fee waivers and/or reimbursements, where these reductions reduce the fund's gross expenses. These arrangements cannot be terminated prior to December 31, 2020 without the Board's consent. 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.

The **Bloomberg Barclays Three-Year Municipal Bond Index** is a broad measure of the municipal bond market of bonds with maturities of approximately three years. Investors cannot invest directly in an index and unmanaged index returns do not reflect any fees, expenses or sales charges.

### Executive Summary

- The municipal ("muni") bond market posted a positive return, but it lagged its taxable counterpart during the second quarter.
- As was the case with the taxable bond market, falling interest rates were supportive for muni market returns.
- From a sector perspective, an overweight and security selection to industrial revenue along with security selection in state general obligation bonds and transportation and local general obligation bonds contributed to performance. The Fund's quality biases were also additive for returns.
- Having a shorter duration than that of the benchmark detracted from performance, as rates declined during the quarter.
- Western continues to see good fundamentals in the overall municipal market due to a number of factors, including strong market supply/demand technicals, low unemployment, improving tax revenues and modest budgetary spending proposals.
- Adjusted for credit quality ratings, Western believes municipal bonds are attractive versus their taxable counterparts for maturities five years and greater.

### Market overview

U.S. Treasuries generated a positive return during the second quarter of 2019, as did the spread sectors (non-U.S. Treasuries). Both short- and long-term U.S. Treasury yields fell sharply

during the quarter (yields and prices move in the opposite direction). This was partially driven by indications that the Federal Reserve Board ("Fed")<sup>1</sup> was getting closer to lowering interest rates, coupled with concerns over moderating global growth and modest inflation.

Looking at the U.S. economy, according to the Commerce Department, first quarter 2019 gross domestic product (GDP)<sup>2</sup> annualized growth was 3.1%. In contrast, the economy expanded 2.2% during the fourth quarter of 2018. The acceleration in GDP growth during the first quarter of 2019 was attributed to positive contributions from exports, personal consumption expenditures, nonresidential fixed investment, private inventory investment, and state and local government spending. These movements were slightly offset by a negative contribution from residential fixed investment. Imports, which are a subtraction in the calculation of GDP, decreased.<sup>3</sup>

The Fed kept its target rate unchanged in a range between 2.25% and 2.50% during the second quarter. However, at its meeting in June the Fed said, "The Committee continues to view sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective as the most likely outcomes, but uncertainties about this outlook have increased." In his press conference after the meeting Fed Chair Powell stated, "The case for somewhat more accommodative policy has strengthened."<sup>4</sup>

Both short-term and longer-term Treasury yields fell sharply during the second quarter. When the period began, the yield on the two-year Treasury was 2.27%, and it ended the quarter at 1.75%. Its low for the period of 1.71% occurred on June 25, and it rose as high as 2.41%, on April 16. The yield on the 10-year Treasury began at 2.41% and it ended the quarter at 2.00%, equaling its low for the period. Its peak of 2.60 occurred on April 16.<sup>5</sup>

The municipal ("muni") market posted a solid gain, but it underperformed the overall taxable bond market during the second quarter. As was the case with taxable bond market,

munis were supported by falling interest rates. All told, the Bloomberg Barclays Municipal Bond Index<sup>6</sup> returned 2.14% during the second quarter, whereas the overall taxable bond market, as measured by the Bloomberg Barclays U.S. Aggregate Index,<sup>7</sup> gained 3.08%.<sup>8</sup>

### **Contributors/detractors**

From a sector perspective, an overweight and security selection to industrial revenue along with security selection in state general obligation bonds<sup>9</sup> and transportation and local general obligation bonds contributed to performance. The Fund's quality biases were also additive for returns. In particular, an overweight to securities rated A and below contributed to performance, as did underweights to securities rated AA and AAA. On the downside, having a shorter duration than that of the benchmark detracted from performance, as rates declined during the quarter.

The Fund's duration was modestly increased during the quarter, but it remained shorter than that of the benchmark. From a sector positioning perspective, we increased the Fund's allocations to transportation and power, while paring its exposures to solid waste recovery and industrial revenue.

### **Outlook**

We continue to see good fundamentals in the overall municipal market, driven by a number of factors. These include strong market supply/demand technicals, low unemployment, improving tax revenues and modest budgetary spending proposals. Adjusted for ratings, municipal bonds are attractive versus their taxable counterparts for maturities five years and greater. We remain focused on idiosyncratic risks over market risk. In terms of positioning, we continue to favor revenue bonds<sup>10</sup> over general obligation bonds, with an emphasis on the industrial revenue and transportation sectors.

<sup>1</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>2</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>3</sup> Source of data in this paragraph: Bloomberg, 7/19.

<sup>4</sup> Source of data in this paragraph: Bloomberg, 6/19.

<sup>5</sup> Source of data in this paragraph: Bloomberg, 7/19.

<sup>6</sup> The Bloomberg Barclays Municipal Bond Index is a market value weighted index of investment grade municipal bonds with maturities of one year or more.

<sup>7</sup> The Bloomberg Barclays U.S. Aggregate Index is a broad-based bond index composed of government, corporate, mortgage- and asset-backed issues rated investment grade or higher and having at least one year to maturity.

<sup>8</sup> Source of data in this paragraph: Bloomberg, 4/9.

<sup>9</sup> A general obligation bond ("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.

<sup>10</sup> A revenue bond is a municipal bond supported by the revenue from a specific project, such as a toll bridge, highway or local stadium.

Sector allocation (%)	
Industrial Revenue	26.7
Transportation	22.1
State	12.4
Local	9.5
Power	9.5
Health Care	5.8
Education	4.2
Lease Backed	2.6
Water & Sewer	2.1
Other	1.2
Solid Waste/Res Recovery	1.0
Special Tax Obligation	0.9
Pre refunded / Escrowed to Maturity	0.6
Other Cash	-0.4
Commercial Mortgage Backed	0.9
Cash & Cash Equivalents	0.6

Percentages are based on total portfolio as of quarter end and are subject to change at any time. For informational purposes only and not to be considered a recommendation to purchase or sell any security.

Brandywine Global  
Clarion Partners  
ClearBridge Investments  
EnTrustGlobal  
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## Western Asset Management

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## What should I know before investing?

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. The Fund may, from time to time, invest over 25% of its assets in municipal securities from one state or region. This concentration may add additional risks. Derivatives, such as options and futures, can be illiquid, may disproportionately increase losses, and have a potentially large impact on Fund performance. An investor may be subject to the federal Alternative Minimum Tax, and state and local taxes may apply. Capital gains, if any, are fully taxable.

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Portfolio holdings and sector allocations may not be representative of the portfolio manager's current or future investment and are subject to change at any time.

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.

A credit rating is a measure of an issuer's ability to repay interest and principal in a timely manner. The credit ratings provided by Standard and Poor's, Moody's Investors Service and/or Fitch Ratings, Ltd. typically range from AAA (highest) to D (lowest), or an equivalent and/or similar rating. Please see [www.standardandpoors.com](http://www.standardandpoors.com), [www.moodys.com](http://www.moodys.com), or [www.fitchratings.com](http://www.fitchratings.com) for details. Please note that the Fund itself has not been rated by an independent rating agency.

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