LEGG MASON
GLOBAL ASSET MANAGEMENT

- **INVESTMENT INVOLVES RISKS. PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE PERFORMANCE.**
- The Fund is a sub-fund of Legg Mason Global Funds plc, an open-ended umbrella investment company constituted in Ireland. The Fund seeks to maximise total return through income and capital appreciation by investing at least 70% of its Total Asset Value in debt securities issued by Asian issuers and in derivatives on Asian interest rates and currencies.
- The Fund may invest up to 100% of its NAV in mortgage related securities, including mortgage-backed securities (MBS), below investment grade securities, stripped securities, and asset-backed securities (ABS) and derivatives (e.g. options, futures and options on futures, swaps and/or forward currency exchange contracts), which can involve material additional risks, e.g. counterparty default risk, and may expose the Fund to significant losses.
- Investors should read and understand the Fund's most current offering document, including details of risk factors relevant to the Fund and, in particular, the risk of investment in the securities of emerging markets issuers, MBS, stripped securities, ABS and derivatives, before making an investment in the Fund.
- An investment in the Fund may not be suitable for all investors and should not constitute a substantial proportion of an investment portfolio. The investment decision is yours but you should not invest in the Fund unless the intermediary who sells it to you has advised you that it is suitable for you and has explained why, including how buying it would be consistent with your investment objectives.

Legg Mason Western Asset Asian Opportunities Fund

Key Points

- Near-term risks to our overall still-constructive view on Asia stem primarily from external factors and, unsurprisingly, include contagion from Europe and heightened China-US trade tensions.
- Our base case is not of an inordinate fall-off in aggregate demand, but more a soft landing across all of Asia and, specifically, China. The region appears to have overcome the cyclical phase of maximum consumer price pressure.
- Portfolio positioning remains defensive. An emphasis on higher rated countries should benefit the Fund in periods of broad market stress. In currencies, the manager favours lower-beta names, including the Chinese yuan and the Singapore dollar.

This Q&A is based on a teleconference that took place on the 9th November 2011 with Chia-Liang Lian, portfolio manager of the Legg Mason Western Asset Asian Opportunities Fund.

Q: How did Asian debt markets fare over the third quarter of 2011?

CL: Against a backdrop of generally heightened risk aversion – mostly from exogenous forces – Asian local currency debt suffered its first quarterly decline in total return terms since the first quarter of 2009. In the three months to 30 September 2011, the HSBC Asian Local Bond Overall Index fell 1.7% in US dollar terms. However, Asian debt significantly outperformed other risk assets within the region. The MSCI Far East index fell more than 20% during the same period.

Currency depreciation in Asia accounted for the bulk of the poor performance with higher-beta currencies such as the South Korean won and the Indian rupee among the laggards. Even so, it is worth noting that in periods of generalised market sell-offs, lower-beta currencies such as the Singapore dollar are not usually spared and the lone exception this time was the Chinese yuan.

Moves in the yield curve in countries such as Korea and Singapore unsurprisingly mirrored the broad trends in US Treasuries but, interestingly, Indonesia demonstrated a similar pattern. This is striking as it has historically been viewed as the barometer of risk in the Asia-Pacific region. However, even though it is rated below investment-grade, the Indonesian curve now tracks higher-grade countries, underscoring the rerating of the country's fundamentals.

Credits were not spared either as spreads in Asia on average widened to the highest levels seen since the Lehman crisis in late 2008. Nonetheless, the extent of weakness in August and September this year has been nowhere close to the levels reached then.

Q: So how are you positioning the portfolio?

CL: We remain defensive. We continue to prefer high-grade government debt, emphasising our allocation to countries such as Singapore, Malaysia and South Korea. The high-grade nature of government debt in these countries has meant they stand to benefit from their safe-haven status, particularly in periods of broad market stress.

We also see value in strategic allocation to potential upgrade candidates – particularly Indonesia. On currencies, we advocate a structural long position in Asian foreign exchange, favouring lower-beta names, including the Chinese yuan and the Singapore dollar. Keeping in mind the global risk environment, we hold a medium-term constructive view on the Korean won, anticipating sharp gains in competitiveness.

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Similarly, in the hard currency space and for off-index positioning, we maintain a defensive posture, noting performance could be potentially dampened by a supply overhang. Nevertheless, for investors seeking diversification opportunities into a neighbourhood of growth, we view high-quality quasi-sovereign names with strategic national roles, such as utilities and banks in South Korea, as offering attractive value.

Q: What is your outlook for the region and the asset class?

CL: Near-term risks to our overall still-constructive view on Asia stem primarily from external factors and, unsurprisingly, include contagion from Europe and heightened China-US trade tensions. We are also guarded about the possibility of policy slippage under extreme market conditions although, based on the recent past and our ongoing discussions with analysts and policymakers in the region, we would not attach a high probability to such an outcome in most countries we are invested in.

We do not anticipate an aggressive ease across the region any time soon, but the pace of economic activity and, more broadly, GDP expansion based on the numbers released so far have moderated significantly from the 2010 highs and, given the external headwinds, risks going forward are skewed to the downside.

That said, our base case is not of an inordinate fall-off in aggregate demand but more a soft landing across all of Asia and, specifically, China. Barring new supply shocks, however, the region appears to have overcome the cyclical phase of maximum consumer price pressure.

Q: What are the implications of China's recently stated intention to focus policy more on generating growth than controlling inflation?

CL: All economic policies in China ultimately point to the need to preserve social stability so the comments from senior policymakers highlight a couple of factors. As we were expecting, the country's headline CPI moderated in October to a sub-6% level for the first time in months because the progressive policy tightening since early 2010 has begun to be felt. As such, while inflation remains above historical trend levels, there is less concern than for most of the last year and a half.

On the flipside, there is evidence in the PMIs to suggest the economy is heading towards a soft patch and the policymakers are probably most concerned about job creation because there is a still-significant pool of labour supply coming from the rural regions in search of employment.

Numbers into the fourth quarter and early 2012 are likely to remain high, though certainly lower than in 2010, and that will lend support to a soft landing for growth – potentially softening from between 9% to 9.5% for 2011 to around 8% in 2012. The Chinese government has the wallet and also the will to spend.

As for the yuan, any reversion back to a de facto peg to the US dollar as we saw, for example, through mid to late 2009 is unlikely. Reinventing the sources of growth in China involves encouraging domestic household consumption and a stronger exchange rate is part of that equation so I do see policymakers gradually warming to that. The issue is really a matter of degree – most external observers expect a faster pace of yuan appreciation than the more controlled rise China's policymakers would prefer.

Q: What are your thoughts on regional Chinese governments now being able to issue bonds?

CL: The central authorities hope, over time, to encourage more accountability at the provincial level so China's debt markets not only mature but diversify. This is likely to be done in a very gradual fashion, with a lot of control from the central authorities, but it is a constructive development as the engine of fiscal accountability becomes less concentrated in central government.

Q: How would you summarise the case for Asian debt?

CL: Combining our cyclical and structural perspectives, the ongoing developments reinforce its progressive maturation as an asset class. From a strategic viewpoint, Asian debt offers attractive risk-adjusted returns for investors looking to diversify into a neighbourhood of relative strength. In the current fluid global environment, we view it as sitting in a sweet spot, offering investors the benefit of diversification in what remains – though hopefully not for much longer – an underappreciated asset class.

We no longer view Asian debt as a peripheral part of the emerging market universe that merely acts as a supplement to global bond exposure, which was the case 20 years back. Asian debt is slowly but surely asserting itself as a mainstream asset class for regional and international investors alike.

The basis for this assertion starts with how indices are used for strategic allocation. Traditionally, global bond indices tend to be heavily weighted towards developed markets. However, in the most recent decade, the share of the G7 countries in world GDP has steadily declined from roughly two-thirds to about half. Over the same period, Asia's share has doubled to approaching 20%. Yet the weights assigned to emerging Asia in global bond benchmarks remain below 3%, which shows a disconnect with those markets' economic importance.

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Importantly, the changing trends in the share of the world economy come at a time when sovereign ratings trajectories mirror a similar divergence. A decade ago, Standard & Poor's rated just three of Asia's 10 largest economies A or above. Today that has doubled to six, while Hong Kong and Singapore are rated AAA. Once again the developed economies offer a sharp contrast with ratings distinctly more mixed than they were. As we recently saw with the US, even the best-quality sovereigns are now vulnerable to downgrades.

In GDP growth terms, over the past decade, Asia has on average outpaced developed economies by some six percentage points, allowing countries in the region to build up foreign reserves dramatically. Many Asian countries are now key exporters of capital to the rest of the world and the resulting accumulation of reserves acts as a form of self-insurance in periods of exogenous pressure. Market volatility in Asian currencies has declined noticeably in recent years precisely because policymakers are now better equipped to minimise unintended currency fluctuations arising from external forces.

At the same time, policy credibility has been reinforced by strict adherence to macroeconomic discipline and, in particular, a demonstration of fiscal responsibility. When the Lehman crisis hit in late 2008, China was, from a position of strength, willing to turn on the fiscal taps to stimulate the economy. This same fiscal flexibility is now becoming a common feature in other Asian countries and, as a result of fiscal prudence, we see Asia as having far better public debt dynamics than many developed countries.

This same prudence is also exercised in the management of monetary policy. Historically, Asia has taken its cue from the US Federal Reserve – following in lockstep with moves in accordance with global and, specifically, US economic cycles. However, this relationship has not applied in the last few years as the de-synchronisation of Asia's economic cycle, coupled with the liquidity-induced impact on asset prices, has forced central banks to tap on the monetary breaks since the early part of 2010.