LEGG MASON
GLOBAL ASSET MANAGEMENT

Legg Mason Permal Global Absolute Fund

Key Points

- The Fund's investment manager believes that some of the headwinds facing the global economy have become stronger since the end of the first quarter.
- Consequently, the manager adjusted the portfolio during May to be less cyclical and more defensive.
- Looking ahead, with a number of different factors currently shaping the world and financial markets, the manager believes that a global multi strategy investment vehicle is well suited to capitalise on the opportunities that will play out for the remainder of the year.

This Q&A is based on a teleconference call that took place on 1 June 2011 with Chris Zuehlsdorff (CZ), portfolio manager of the Legg Mason Permal Global Absolute Fund.

Q: How do you view the current global investment landscape?

CZ: We feel there are a number of macroeconomic cross currents that are impacting markets today and that they highlight the importance of why investors should be diversified across all asset classes on a global basis.

Looking at China, for example, investors continue to consider whether or not there will be a hard or soft landing given the tightening measures being undertaken by the government. We expect that there will most likely be a couple more interest rate hikes in China but that the economy will be able to achieve a soft rather than a hard landing. It's one of the factors that we're monitoring very closely and we feel that markets are as well. In Japan, meanwhile, reconstruction efforts are underway following the recent devastating earthquake there. We feel that Japanese equities remain undervalued. There is potential for the yen to weaken and the reconstruction efforts also create some interesting opportunities.

Turning to Europe, we have felt for a while now that the European sovereign debt crisis is not over and indeed in May, Greece came to the forefront again with further discussions regarding the options for a financial restructuring. We have had some sovereign debt protection in the portfolio for exactly these reasons.

Additional topics that we're monitoring would include the interest rate hikes that started in the emerging markets and are slowly spreading west to the developed world. The European Central Bank (ECB) raised rates in April and while we feel that it may now be on hold for a month or two, the ECB has made it clear that it is going to fight inflation and further rate hikes in Europe are still possible.

The big picture obviously must also include the US, where investors are asking is growth sustainable? Our view is that stability is needed in the housing market along with improving employment numbers in order to maintain a sustainable growth path in the US. Yesterday we saw some disappointing data in the US housing market and with the Federal Reserve's second round of quantitative easing (QE2) due to end soon there are some concerns that the removal of stimulus may cause a growth scare in the US over the summer.

Also important in our global assessment is the ever present geopolitical risk and the potential for oil price spikes. The Libyan situation remains unresolved and we've seen a tightening of spare capacity in oil markets, which creates the potential for further price spikes that could destabilise the global economy.

Another point that we would highlight includes the "currency wars" that we feel are creating opportunities for trading in forex markets. We currently like the environment for active trading in currencies.

Q: How are these views reflected in the portfolio?

CZ: As we entered 2011 we thought about all these issues and how they might shape markets. We felt that global growth was sustainable despite these headwinds. For much of the first quarter and into April we had what I would describe as a cyclical bias in the portfolio. But we have seen some of these headwinds grow and become stronger, and our overall view has become more cautious over the last three-to-five weeks as they are beginning to impact the global economic environment. We therefore made some adjustments to the portfolio in May to reflect this more cautious view.

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Q: Could you elaborate on the Fund's positioning?

CZ: As mentioned the portfolio retained a cyclical bias in April. We also had some built in hedges in case our base case was wrong. At the end of April, our equity allocation was about 23% of the portfolio and within this we had a bias to what might be considered core Europe such as Germany and the Nordic countries. We also had allocations to US and Canadian stocks. With the Nordic countries and Canada we got some nice late-cycle economic exposure in areas such as materials, energy, and industrials, which all performed well in the first four months of the year. We also had exposure to Japanese equities, which hurt us in the first quarter in the post-earthquake environment. In emerging markets, we had a small allocation to frontier markets, which we feel have underperformed the broader emerging markets over the last two years. Given that frontier markets are generally commodity- or resource-rich, we feel they have the potential to perform well going forward.

The largest portfolio allocation at the end of the month was in fixed income, which was about 26% of the Fund. Here we like the opportunities in credit, specifically convertible bonds and mortgage-backed securities, where our exposure is primarily to non-agency residential mortgage backed securities in the US. We also hold some floating rate bank loan securities. Elsewhere, we retained an exposure to US Treasuries, which benefit during a flight to quality, and held some European sovereign debt protection in the portfolio.

Real asset strategies represented about 15% of the Fund at the end of April, with the largest allocation being in gold and platinum. We also had a broad commodity basket, again being consistent with the desire to have a cyclical bias in the portfolio through the first four months of the year.

Our alternative hedge fund strategies represented about 13% of the portfolio, being a diversified mix of global macro strategies, which consists of both systematic and discretionary macro managers, and long-short equity and event driven strategies. Our alternative strategies are managed by hedge fund managers that Permal has known for a number of years and that we currently use in our broader fund of hedge fund portfolios. We have conviction in these managers and feel that they add a good source of diversified returns to the overall portfolio.

Rounding out the portfolio is about a 10% allocation in currencies. We are short the Japanese yen as well as the Australian dollar, both being about 5% positions. The Australian dollar short position is really a hedge in case our view on China is wrong. If there is a hard landing in China we feel that the Australian dollar, given how much it exports in terms of commodities to Asia and China, could deteriorate significantly.

Q: What have been the positive performance drivers in the portfolio recently and what has detracted from its returns?

CZ: The portfolio benefited from its diversification across asset classes during the first quarter, with its gains for the period focused primarily on our equity and real assets strategies. This was counterbalanced by a small loss in our FX strategies. More specifically in the first quarter, the Fund's holdings in two exchange traded funds (ETFs) investing in US equities and commodities respectively, together with an MSCI Canada index swap, were the largest positive contributors to returns over the period. The largest three detractors from the Fund's performance were its holdings in a Japanese ETF, a European sovereign debt hedge and our short position in the Australian dollar.

Q: What is your view on the euro given your cautious outlook for Europe's sovereign debt situation?

CZ: We are bearish on the euro and one of the changes that we made to the portfolio in May was to add a short position in the currency.

Q: What other changes have you made to the portfolio?

CZ: We wanted to position the portfolio more defensively and more cautiously. We feel there has been a loss of economic momentum and we took off the cyclically biased exposure we had in the Fund's equity allocation. We switched cyclical holdings from the Nordic countries and Canada into defensive sectors such as utilities, healthcare and consumer staples. We also trimmed some of our commodity exposure, but have maintained the portfolio's gold and platinum exposure. We feel gold overall is a very good hedge to central bank policy error and inflation, and it has held up well even during the period in May when the dollar started to strengthen. We think that the defensive sectors to which we gained exposure should continue to do well until we see economic momentum either bottoming or starting to improve.

Q: At what levels do higher oil prices become a detriment to global economic growth?

CZ: The numbers that we feel are critical would be US$125 per barrel or US$4 per gallon at the pumps in the US. We got pretty close to those numbers here about three or four weeks ago and that was reflected in deteriorating consumer confidence in the US. It was also when some of the leading economic indicators globally started rolling over.

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Q: Is slower than expected growth in the US a bigger threat to the global outlook than the prospect of a soft landing in China?

CZ: Our view is that there will be a soft landing in China with the authorities being able to control inflation and we think that's going to be very positive for Chinese equities in the second half of this year. In the US we're currently undergoing what the media has labelled a 'growth scare', but we are not currently of the view that there's going to be a double-dip recession, rather that there will be slower growth.

Q: How are you positioned in emerging markets?

CZ: We are in the frontier equity markets, primarily the Middle East and frontier Africa. We feel these regions have underperformed the broader emerging markets and being resource-rich, we feel that they will be able to outperform going forward. The other area that we are starting to look at given our view on a soft landing in China is Chinese equities.

Q: How would you summarise your outlook for the Fund?

CZ: We're excited about the opportunity set that remains for the Fund going into the second half of 2011. As discussed earlier, there are certainly a number of different factors that are currently shaping the world and financial markets. We think that with a global perspective, a multi strategy investment vehicle is well suited to capitalise on the opportunities that will play out for the remainder of the year.