Webcast Q&A

LEGG MASON
INCOME OPTIMISER FUND

As bond yields race to zero, the Legg Mason Income Optimiser Fund continues to deliver its objective of relatively high levels of income and capital protection. This Q&A is based on a webcast that took place on 20 April 2015 in which Regina Borromeo outlines the opportunities and risks in global bond markets.

KEY POINTS

- **The world is experiencing a non-inflationary expansion, and interest rates are likely to stay lower for longer**
- **The manager has reduced the allocation to global high yield, and taken profits on peripheral European bonds**
- **The quality and liquidity of the portfolio has been increased to ensure the manager can be tactical if required**

Q: How would you characterise the first quarter of 2015?
RB: It has been an interesting quarter, filled with financial milestones and increased market volatility. For bonds, this year has essentially been a race towards zero: 10-year German Bunds are now yielding 7 basis points while Swiss government bonds up to 15 years in maturity have negative yields. Against such a backdrop, 10-year and 30-year maturity US Treasuries, and even UK Gilts, have become the higher yielders in the developed bond market.

Q: How has the fund performed against this backdrop?
RB: The fund's distribution yield has dropped slightly to 4.7% - but this is still a decent yield pick up compared to 10-year UK Gilts at 1.6% and European high yield on 3.9%.

The biggest contributors to the fund's returns have been our positions in peripheral European sovereign debt: for example, our position in a 2040-maturity Italian government bond rallied by 30 basis points. The other main contributors were our holdings of US high yield bonds, especially in Wind and Penn Virginia. Our currency positions also helped, given our overweight to the US dollar and our short in the euro.

Q: What effect is the strength of the US dollar having on the domestic economy?
RB: In the first quarter, only the Swiss franc and Indian rupee appreciated against the US dollar, which has rallied at its fastest pace in over 40 years. Based on its effect on important prices and the drag on exports, every 10% rise in the US dollar is equivalent to a 1% increase in interest rates. The US Federal Reserve (Fed) has acknowledged the potential economic drag from the strong dollar; exports have fallen and multinational profits have been hit. However, if history repeats itself, there is a good chance that the dollar rally will pass, particularly around the first rate hike by the Fed.

In each of the previous four Fed tightening cycles (1986, 1994, 1999 and 2004) the dollar traded sideways-to-down in the months right after the first rate hike. The dollar has come a long way in a short period of time, so there is a risk of a counter-trend move, considering how much is already priced in.

Q: What effect is the drop in oil prices having on the global economy?
RB: The drop in oil prices since last summer equates to about a $2 trillion tax cut for global consumers. The developed world is in a low inflationary growth environment which, combined with further Quantitative Easing (QE) from many of the emerging market central banks, should lead to an upside surprise in the global growth story in the second half of 2015.

Q: So, what are your main themes for 2015?
RB: First, the majority of central banks will continue to be accommodative, with the baton being passed from the Fed to the European Central Bank (ECB) and the Bank of Japan. The People's Bank of China is also starting to be reflationary. In fact, since the beginning of the year, there have been over 24 monetary authorities undertaking easing actions.

Second, the US is leading expansion among the developed world but, due to the speed of the US dollar appreciation and some of the deflationary factors coming from the rest of the world, non-inflationary expansion is occurring. With this in mind and a global savings glut, rates may stay lower for longer.

Third, while economic data is starting to pick up in Europe and inflation remains low, the main risk is a policy mistake and the continued escalation of geopolitical risk.

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Q: What changes have you made to the fund so far in 2015?

RB: Global high yield has been a large contributor to income generation and total returns during the past three years. Throughout the first quarter, we have continued to take profits in this sector, ending the quarter with an allocation of just under 50% with about 19% in CDS protection. Meanwhile, we have raised the allocation to mortgage-backed and asset-backed securities, and have slightly more in cash. Since we believe we have entered a more volatile period, we have been raising the quality and liquidity of the fund to make sure we can be tactical when there are bouts of short-term panic in the markets.

In March, we also took profits in some of our intermediate and long-dated European sovereign positions given the dramatic yield compression: in particular, we trimmed our Italian and Irish positions.

In terms if duration, one of the main changes has been our decrease in duration hedges during the last four months.

Q: Are there any areas where you see particular value?

RB: We continue to see value in higher yielding credits, such as TMT (Technology, Media, Telecommunications) plays, although we remain mindful of specific idiosyncratic risk. We also like developing market sovereigns, such as Mexico and Indonesia, due to their attractive real yields, and will look to take advantage of opportunities in emerging market corporate angels (high-yielding local currency corporate emerging market debt).

LEGG MASON
GLOBAL ASSET MANAGEMENT

leggmason.co.uk

UK: +44 (0) 20 7070 7444