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A Decade of Unconstrained Investing

Executive Summary

- Western Asset has one of the longest track records in the unconstrained fixed-income investment space with TRU.
- Over its 10-year history, TRU has largely met its objectives for bond-like annualized total returns and annualized volatility.
- TRU is not managed against a benchmark, but a volatility target of 3% to 5%.
- TRU has greater flexibility in terms of duration, curve, sector and quality compared with traditional fixed-income strategies, which are typically managed versus the US Barclays Aggregate Index.
- TRU may be a strategy to consider for a possible rising interest rate environment.

While unconstrained investing seems to be a new and revolutionary approach, Western Asset's Total Return Unconstrained (TRU) strategy is celebrating its 10-year anniversary. This gives Western Asset one of the longest track records in the growing unconstrained space. At the time of TRU's inception, the market was grappling with many of the same issues it's wrestling with today as investors consider the implications of the end of extremely accommodative policy from the Federal Reserve (Fed). While the fed funds rate currently stands at essentially zero, in mid-2004 it was beginning to inch up after holding at 1.00% for 12 months. Since then, investor demand for strategies free from the constraints imposed by traditional benchmarks has grown, and investors are increasingly aware of the unintended consequences of index construction rules.

What is "Unconstrained" Investing?

Unconstrained investing is relatively new in the marketplace and still lacks a common definition. Although most unconstrained strategies lack a formal benchmark, the similarities end there. Western Asset defines unconstrained bond investing as strategies that are based on volatility targets. On one end of the spectrum are less aggressive strategies that target bond-like volatilities and thus, more moderate returns. These strategies tend to have a longer-term investment bias and generally do not make sudden allocation changes. On the other end of the spectrum are more aggressive strategies that target larger returns and a higher level of volatility. These strategies may employ active trading and may make frequent and/or significant allocation shifts.

TRU's Place in the Unconstrained Universe

TRU fits squarely into the category of targeting a lower level of volatility and moderate returns. To a large degree, TRU can be thought of as an unconstrained version of a traditional fixed-income strategy. Whereas traditional fixed-income is usually benchmarked against the US Barclays Aggregate Index (BAGG), which also serves as the main guidepost in portfolio construction, TRU does not have a benchmark, so it has significantly more flexibility in terms of duration, curve, sector and quality considerations.

Measuring TRU

It is a testament to the design of TRU and its management team that the strategy has largely achieved its goals over the last decade—a period that included the intense market volatility surrounding the financial crisis.

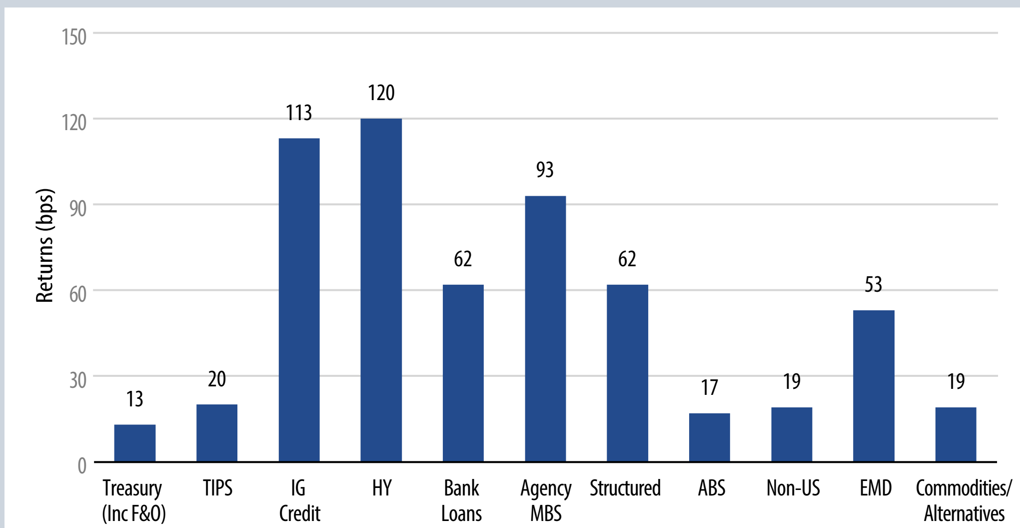
Since its inception, the TRU composite has returned 5.91%, annualized (Exhibit 1). This represents annualized outperformance of 0.97% over the BAGG, a proxy for the broad fixed-income market, over this same 10-year period. TRU's one-, three- and five-year annualized returns are all above 5.00% and beat the BAGG for each period. TRU's performance was negatively impacted during the financial crisis, but performance rebounded during the recovery. In fact, the TRU composite has generated absolute positive annual returns in eight of its nine calendar years. The sources of TRU's returns have reflected the strengths of Western Asset: an emphasis on spread sector and long-term, fundamental value investing.

Exhibit 1
TRU and Barclays US Aggregate Index—Returns[1] and Risk

	TRU			BAGG		
	Return	Volatility	Sharpe Ratio	Return	Volatility	Sharpe Ratio
1 Year	6.30%	1.05%	5.82	5.66%	2.29%	2.41
3 Year	5.68%	2.26%	2.43	2.91%	2.59%	1.10
5 Year	7.01%	2.87%	2.35	4.48%	2.79%	1.56
10 Year	5.76%	5.53%	0.77	4.72%	3.21%	0.98
Since Inception[2]	5.91%	5.50%	0.80	4.94%	3.22%	1.05

Source: Western Asset. As of 31 Aug 14
[1]Returns are gross
[2]Since inception data for BAGG set to correspond with TRU's inception date

Exhibit 2
TRU—Since Inception Contributions to Return (+596 bps annualized, gross)



Source: Western Asset. As of 31 Aug 14

Despite their name, unconstrained strategies are still subject to certain limitations. Volatility targets are used to help keep these strategies within a client's desired risk and return profile even though they are not managed against a benchmark. TRU has a volatility target range of 3.00% to 5.00%, which reflects the volatility profile of the broad fixed-income market while including some extra leeway to account for the moderately higher volatility typically generated by exposure to non-BAGG sectors. TRU's one-, three- and five-year trailing annualized volatility levels are currently at the lower end of its target range, which is reflective of the exceedingly low volatility seen in the market in recent years. TRU's since-inception volatility of 5.50% reflects extreme downside moves during the financial crisis and extreme upside moves in the post-crisis recovery. Western Asset subsequently substantially de-risked TRU while maintaining superior alpha generation; the last five years show a Sharpe ratio that is dramatically higher than the BAGG.

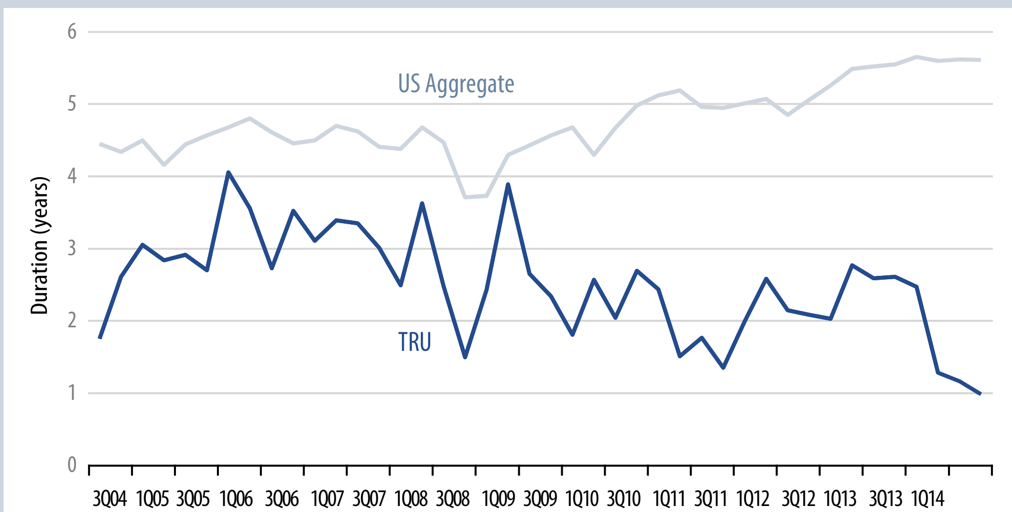
TRU in Action

TRU's greater flexibility in terms of duration, yield curve, sector and quality has enabled it to outperform the broad market, as defined by the BAGG, over TRU's history while generally having meaningfully different characteristics than the BAGG. Below, we offer a brief examination of our historic and current positioning regarding these key attributes.

1. **Duration Flexibility:** TRU's duration has historically ranged from about 1 to 4.5 years. The BAGG, over the same period, has generally had a higher duration and in a tighter range (3.7 to 5.7 years). TRU's lower duration has helped to balance its overall risks (credit versus rate) and adhere to its volatility target. Despite the falling interest rate environment over the last 10 years and TRU's lower duration range, TRU outperformed the BAGG in the one-, three-, five- and 10-year time periods. It is also critical to note that TRU outperformed the BAGG in 20 of 22 months when rates increased (defined as a 15-basis-point increase in the yield on the Barclays US Treasury Index). The average monthly outperformance over all of these 22 periods was 1.29%. Exhibit 3 shows the duration profile of the TRU composite versus the BAGG over its lifetime.

   Traditional fixed-income mandates typically adhere to a +/- 20% duration band relative to the BAGG, which has an average duration of approximately five years. Our current positioning demonstrates the flexibility that the TRU strategy has. In the current environment, we believe we are at the low end of the yield range. We have lowered TRU's duration to just 1 year to protect the portfolio from a potential increase in rates.

Exhibit 3
Duration—TRU vs US Aggregate Index



Source: Barclays, Western Asset. As of 31 Aug 14

2. **Yield Curve Flexibility:** We have the freedom to adjust TRU's term structure positioning in an effort to take advantage of anticipated yield curve changes to an extent most traditional fixed-income portfolios cannot match.

   To illustrate, consider how we have positioned TRU given our expectations for future Fed action. Barring extreme changes in the economy's trajectory, we expect the Fed will begin to raise the fed funds target rate sometime in mid-2015. This action typically ripples through the yield curve, with short to intermediate rates bearing the brunt of the increase. Often the yield curve may react in anticipation of the actual news, "pricing in" what the market expects. Given our expectation, we

Exhibit 4
TRU's Yield Curve Positioning

Duration Contribution per Key Rate

Key Rate	6 Mos	2 Yr	5 Yr	10 Yr	20 Yr	30 Yr	Total
Duration Contribution	-0.05	0.53	-0.87	-0.61	0.7	1.29	0.99

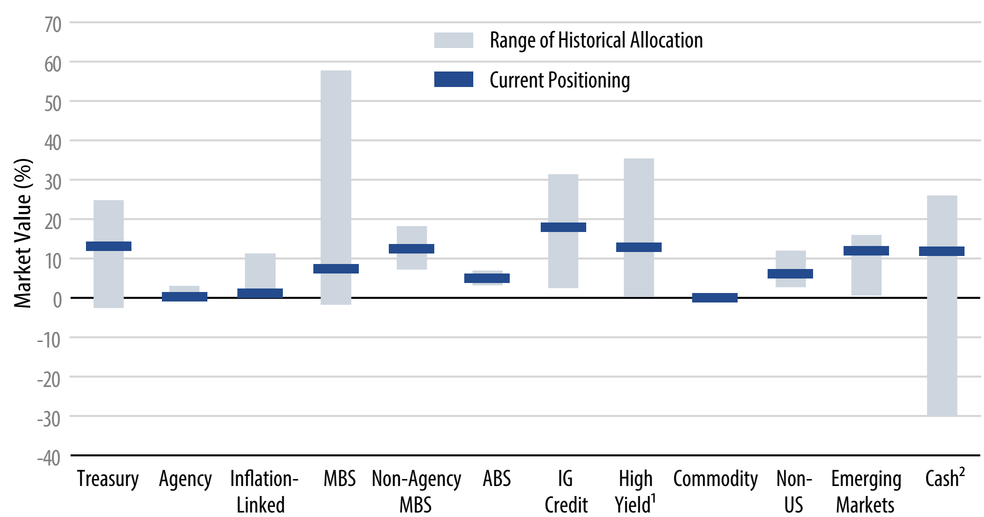
Source: Western Asset. As of 31 Aug 14

believe we are positioned to benefit from a flattening of the yield curve.

Currently, we are short duration in the "belly" of the yield curve while we are long duration on both the front and back ends. The exposure at the longer end (> 10 years) is there in an effort to protect the portfolio from any increase in volatility that might occur, while the short in the belly reflects our view on the likely path of interest rates. The greater yield curve flexibility that this product offers allows us to maintain a low duration profile without having to concentrate assets on the front end of the yield curve where rates are likely to rise most significantly if and when the Fed increases the fed funds rate.

3. **Sector Flexibility:** Traditional fixed-income strategies cannot stray far from benchmark sector allocations due to both guideline restrictions and the worry of increasing tracking error. TRU is not constrained by benchmark sector allocations, freeing us up to place more (or less) emphasis on sectors that we prefer (or dislike). Exhibit 5 depicts TRU's sector allocation ranges over its history.

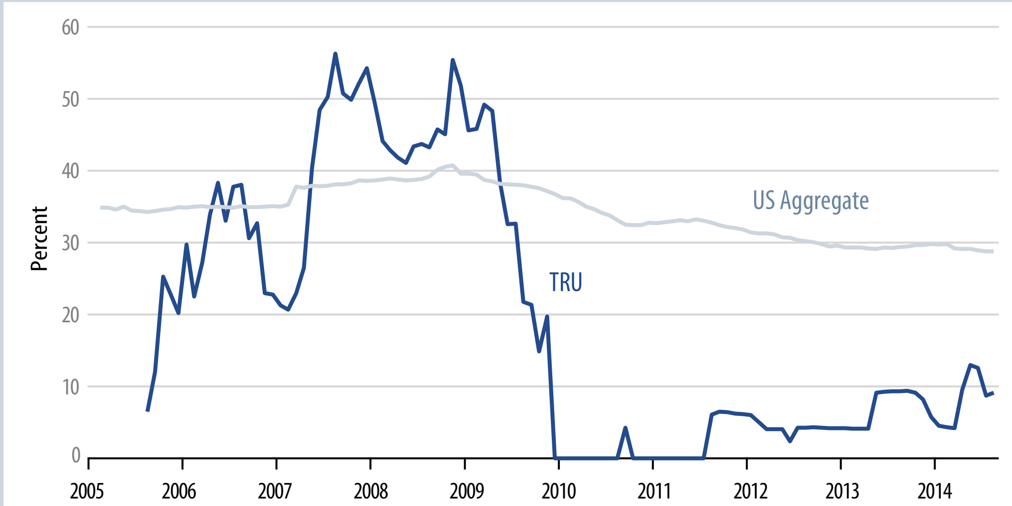
Exhibit 5
TRU's Holdings by Sector—Historical and Current



Source: Western Asset. As of 31 Aug 14
[1] Includes bank loans
[2] Cash allocation reflects portfolio weight since 31 Jan 05

Over TRU's history, the MBS sector has experienced the greatest allocation range for a spread sector. Exhibit 6 specifically examines TRU's agency MBS allocation in greater detail and compares it with the agency MBS allocation within the BAGG.

Exhibit 6
Historical Agency MBS Allocation—TRU vs US Aggregate Index

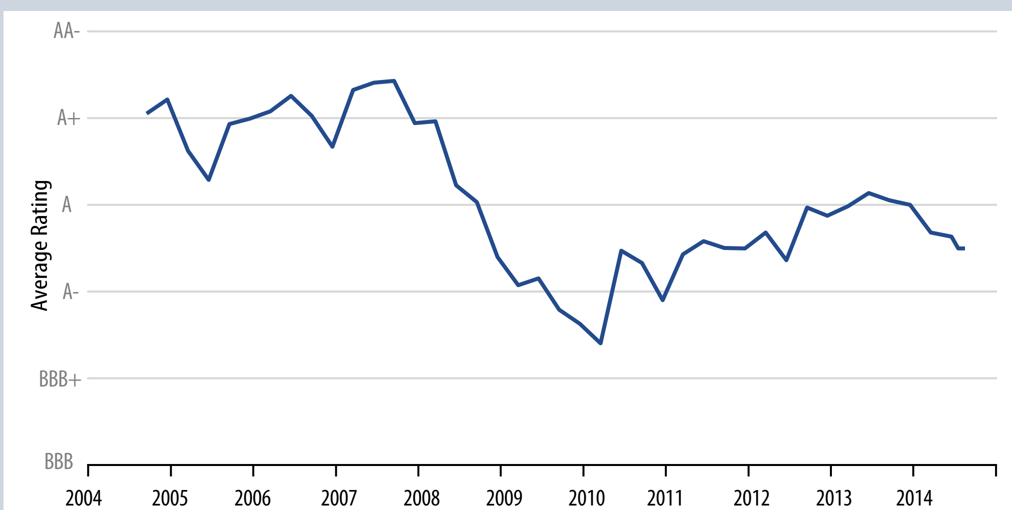


Source: Barclays, Western Asset. As of 31 Aug 14

In 2007–2008, TRU held a large allocation to agency mortgages because we believed that the sector's relatively high yields and implied government guarantee translated into value. Heading into the post-financial crisis recovery period in early 2009, we felt that the greatest opportunities shifted to other sectors with spreads that widened excessively. TRU's mortgage allocation was reduced to zero. More recently, we increased our exposure to agency mortgages as the sector became more attractive, in part due to the Fed's purchases of mortgages in its balance sheet expansion program.

4. **Quality Flexibility:** One of the key features of the TRU strategy is that a minimum of 50% of the portfolio must be invested in investment-grade securities. This helps maintain an overall

Exhibit 7
TRU—Average Historical Quality



Source: Western Asset. As of 31 Aug 14 investment-grade credit rating and allows investors to use this strategy as a substitute for, or a complement to, their traditional bond allocation. As can be seen in Exhibit 7, coming out of the financial crisis, we believed there were significant value opportunities in lower rated securities whose spreads had widened more than higher rated securities. As valuations have normalized, credit quality has increased.

Ten More Years of TRU

Looking ahead, we expect US Treasury rates will eventually increase as the Fed continues to normalize monetary policy. The rally in global spread sectors has amplified the importance of fundamental analysis as true value opportunities are scarce. Western Asset's TRU is a dynamic product that we believe is well equipped to meet these future market challenges. TRU has the duration and curve flexibility to fully express our views on interest rates and help protect the portfolio in a potential rising rate environment. TRU has the ability to move in or out of sectors depending on our assessment of value, without being constrained by a benchmark. TRU's volatility target of 3.00% to 5.00% helps keep the strategy's risk and return profile similar to that of the broad fixed-income market even though it is not managed against a benchmark. We believe that TRU could make a compelling anchor or complement portfolio for investors who seek broad-market, fixed-income exposure. We look forward to the next 10 years as TRU seeks to help our clients achieve their goals.

Total Return Unconstrained (TRU) Bond Composite

Composite Inception Date: 07/01/2004 | Composite Creation Date: 10/01/2004

	No. of Accts	Gross Total Return	Net Total Return	Benchmark Total Return	Gross Total 3-Yr St Dev	Benchmark Total 3-Yr St Dev	Internal Dispersion	Mkt. Value (US$mil)	Percentage of Firm Assets	Firm Assets (US$mil)
2004[1]	1	6.22%	5.90%	-na-	-na-	-na-	-na-	$330	0.17%	$197,837
2005	1	3.86%	3.24%	-na-	-na-	-na-	-na-	$1,487	0.60%	$249,233
2006	3	7.25%	6.62%	-na-	-na-	-na-	-na-	$3,472	0.68%	$510,172
2007	4	2.53%	1.92%	-na-	2.19%	-na-	-na-	$5,410	0.87%	$621,493
2008	4	-14.62%	-15.14%	-na-	7.18%	-na-	-na-	$5,294	1.05%	$505,660
2009	4	32.41%	31.64%	-na-	9.37%	-na-	-na-	$4,585	0.95%	$482,218
2010	4	9.42%	8.77%	-na-	9.45%	-na-	-na-	$4,442	0.98%	$453,909
2011	4	1.74%	1.14%	-na-	5.97%	-na-	-na-	$4,019	0.91%	$443,140
2012	3	9.91%	9.26%	-na-	2.99%	-na-	-na-	$4,113	0.89%	$461,891
2013	4	2.20%	1.59%	-na-	2.63%	-na-	-na-	$4,968	1.10%	$451,632

Description: Western Asset's Total Return Unconstrained (TRU) Bond Composite includes portfolios that employ actively managed, diversified fixed-income portfolios. Portfolio construction is based on Western Asset's fundamental view of the fixed-income markets and is independent of broad market benchmarks. The approach is to construct a portfolio in which the manager intends to actively manage sector, duration and term structure exposure.

Objective: Maximize return consistent with the current market environment and outperform the broad market over the course of a market cycle.

Benchmark Description: The Composite is not measured against a benchmark as accounts that may comprise the Composite are measured on an absolute return basis. There is no benchmark available that appropriately reflects the guidelines of all accounts within the Composite.

Base Currency: USD | **Composite Minimum:** No minimum asset size requirement.

Fee Schedule: .60 of 1% on first US$100 million, .40 of 1% on amounts over US$100 million.

Examination Period: The Composite has been examined for the period from July 1, 2004 to December 31, 2013.

[1]Partial period return (July 1, 2004 to December 31, 2004).

Western Asset claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Western Asset has been independently verified for the periods from January 1, 1993 to December 31, 2013.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The verification and performance examination reports are available upon request.

For GIPS® purposes, the Firm is defined as Western Asset, a primarily fixed-income investment manager comprised of Western Asset Management Company, Western Asset Management Company Limited, Western Asset Management Company Pte. Ltd., Western Asset Management Company Ltd, Western Asset Management Company Pty Ltd, and Western Asset Management Company Distribuidora de Títulos e Valores Mobiliários (DTVM) Limitada, with offices in Pasadena, New York, London, Singapore, Tokyo, Melbourne, São Paulo, Hong Kong, and Dubai. 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 Firm is comprised of several entities as a result of various historical acquisitions made by Western Asset and their respective performance has been integrated into the Firm in line with the portability requirements set forth by GIPS.

The Composite is valued monthly. The Composite returns are the asset-weighted average of the performance results of all the accounts in the Composite. Gross-of-fees returns are presented before management fees, but after all trading expenses. Net of fees results are calculated using a model approach whereby the current highest tier of the appropriate strategy's fee schedule is used. This model fee does not reflect the deduction of performance based fees. The portfolios in the Composite are all actual, fee-paying and performance fee-paying, fully discretionary accounts managed by the Firm for at least one full month. Investment results shown are for taxable and tax-exempt accounts and include the reinvestment of all earnings. Any possible tax liabilities incurred by the taxable accounts have not been reflected in the net performance. Composite performance results are time-weighted net of trading commissions and other transaction costs including non-recoverable withholding taxes. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

The returns for the accounts in the Composite are calculated using a time-weighted rate of return adjusted for weighted cash flows. The returns for the commingled funds in the Composite are calculated daily using net asset values (NAV), adding back the funds' total expense ratio or equivalent. Trade date accounting is used since inception and market values include interest income accrued on securities held within the accounts. Performance is calculated using asset values denominated in a base currency. Composite assets at year-end presented in the schedule are translated to U.S. dollars using end of year exchange rates.

Composite returns are measured against a market index. The market index is unmanaged and provided to represent the investment environment in existence during the time periods shown. For comparison purposes, its performance has been linked in the same manner as the Composite. The market index presented was obtained from third party sources deemed reliable but not guaranteed for accuracy or completeness. Benchmark returns and benchmark three-year annualized ex-post standard deviation are not covered by the report of independent accountants.

Internal dispersion is calculated using the asset-weighted standard deviation of annual gross returns of those portfolios that were included in the Composite for the entire year. For each annual period, accounts with less than 12 months of returns are not represented in the dispersion calculation. Periods with five or fewer accounts are not statistically representative and are not presented. The three-year annualized ex-post standard deviation measures the variability of the composite and the benchmark returns over the preceding 36-month period. Any gross total three-year annualized ex-post standard deviation measures prior to 2011, included within the "Examination Period" identified above, are not covered by the report of independent accountants.

Past investment results are not indicative of future investment results.

Western Asset's list of composite descriptions is available upon request. Please contact Veronica A. Amici at 626-844-9535 or ramici@westernasset.com. All returns for strategies with inception prior to January 1, 2004 are available upon request.