WIA and WIW Q3 2011 Review

NYSE: WIA & WIW

Q3 2011

Western Asset/Claymore Inflation-Linked Securities & Income Fund (NYSE: WIA) and Western Asset/Claymore Inflation-Linked Opportunities & Income Fund (NYSE: WIW) have made available their quarterly review for the period ended September 30, 2011.

Can you provide a recap of recent economic activity and how WIA and WIW were affected?

There was no shortage of issues confronting investors during the third quarter. Collectively, they triggered a significant flight to quality, which resulted in generally poor results for riskier assets.

Investor sentiment was challenged early in the quarter, as partisan bickering in Washington regarding the raising of the debt ceiling and debt reduction proposals led to media speculation that the U.S. may default on its debt obligations. While Congress reached an agreement at the 11th hour, it failed to quell investor concerns, especially after Standard & Poor's downgraded U.S. Treasuries from AAA to AA+ in early August. The escalating European debt crisis and its potential impact on U.S. financial organizations also weighed on investors' minds.

Even though the U.S. economy continued to grow, the pace of the expansion was far from robust. According to the Commerce Department, second quarter 2011 gross domestic product (GDP)[1] growth was 1.3%, versus 0.4% during the first three months of the year.[2] While initial third quarter GDP figures will not be released until late October, a ninth consecutive quarter of growth is expected. That said, based on data released in recent months, GDP is not expected to significantly improve.

Unemployment has remained elevated and has been a significant headwind for the overall economy. According to the Department of Labor, the unemployment rate remained unchanged at 9.1% throughout the third quarter. The number of Americans who have been out of work for an extended period remained high, as well. As of the end of September, approximately 14 million Americans looking for work have yet to find a job, and roughly 45% of these individuals have been out of work for more than six months.[3]

Housing data did little to quell fears that further price declines could occur. According to the National Association of Realtors ("NAR"), the median existing-home price for all housing types were $168,300 in August 2011, down 5.1% from August 2010. Sales of existing homes were mixed during the quarter. Following a modest 0.6% increase in June, sales then fell 3.5% in July and moved 7.7% higher in August. At the end of August, the inventory of unsold homes represented an 8.5 month supply, versus a 9.5 month supply in July.[4]

The manufacturing sector, one of the stalwarts of the economy in recent years, produced mixed results during the third quarter. The Institute for Supply Management's Purchasing Managers Index (PMI) showed that manufacturing activity moderated from a reading of 55.3 in June to 50.9 in July and 50.6 in August (a reading below 50 indicates a contraction, whereas a reading above 50 indicates an expansion). The PMI in September then rose to 51.6 in September, and 12 of the 18 industries tracked by the Institute for Supply Management expanded during the month.[5]

[1] Gross domestic product ("GDP") is the market value of all final goods and services produced within a country in a given period of time.
[2] Source of data in this paragraph: Bloomberg, 10/11.
[3] Source of data in this paragraph: Bloomberg, 10/11.
[4] Source of data in this paragraph: National Association of Realtors, 9/11.
[5] Source of data in this paragraph: Bloomberg, 10/11.

The PMI in September then rose to 51.6 in September, and 12 of the 18 industries tracked by the Institute for Supply Management expanded during the month.

Given ongoing concerns for the economy, the Federal Reserve Board ("Fed")[6] took a number of actions as it sought to meet its dual mandate of fostering maximum employment and price stability. As has been the case since December 2008, the Fed kept the federal funds rate at a historically low range between zero and 0.25% during the quarter. In August 2011, the Fed also declared its intention to keep the federal funds rate between 0 and 0.25% until mid-2013. At its meeting in September 2011, the Fed announced its plan to purchase $400 billion of longer-term Treasury securities and to sell an equal amount of shorter-term Treasury securities by June 2012 (dubbed "Operation Twist"). The Fed said "This program should put downward pressure on longer-term interest rates and help make broader financial conditions more accommodative."

Fears of contagion from the European debt crisis, the downgrade of U.S. government securities, generally poor economic data, and skepticism that the government and Fed had the tools and resolve to avert a recession caused investors to sell riskier assets and seek refuge in U.S. Treasuries. This resulted in a significant decline in both short- and long-term Treasury yields. The yield on the two- and ten-year Treasury began the quarter at 0.45% and 3.18%, respectively. During the height of the flight to quality in September, the yield on the ten-year Treasury fell as low as 1.72%, a level not seen since the 1940s. Two- and ten-year Treasuries ended September at 0.25% and 1.92%, respectively. While a number of taxable spread sectors (non-U.S. Treasuries) generated modestly positive returns during the quarter, they largely underperformed equal-duration Treasuries.[7]

Given signs that global growth was moderating, inflation expectations decreased during the third quarter. Against this backdrop, oil and certain commodity prices fell sharply during the three month period.

Headline inflation in the U.S., as measured by the Consumer Price Index for All Urban Consumers (CPI-U), increased, moving up to 3.9% at the end of September 2011 from 3.6% at the end of June, 2011, year over year. Core CPI (which excludes the effects of food and energy) also rose to 2.0%, up from 1.6%, during the same period. Personal Consumption Expenditures (PCE) core deflator, which we believe is the Federal Reserve's favorite inflation measure, also increased to 1.6 % from 1.4% over the quarter. Although official inflation measures moved higher, other reflation trades did not fare so well. This was largely driven by the US ratings downgrade and ongoing European worries which caused downward revisions to global growth estimates. Commodities lost over 11% as oil prices fell by $16 per barrel over the quarter. The U.S. dollar rallied by over 5% on a trade-weighted basis while gold rallied by about 8% U.S. TIPS underperformed treasuries even as intermediate maturity real yields rallied. Breakeven rates, the difference between nominal yields and real yields, fell sharply with 10-year TIPS now pricing in average inflation of 1.76% per year at the end of September vs. 2.38% at the end of June 2011.

The 10-year U.S. TIPS real yield rallied 55bps to yield just 0.14% at the end of September 2011 from approximately 0.69% at the end of June 2011. Along with coupon and CPI accretion 10-year TIPS generated 6.27% of total return for the second quarter. The 10-year U.S. Treasury, on the other hand, had a total return of 12.16% for the third quarter.

What is your outlook for inflation?

The growth outlook continues to be anemic, with weak consumer confidence sentiment. The Fed appears to be committed to keeping short nominal rates near zero over the next two years. In the long term, we are still facing an uncertain economic environment, given persistent unemployment concerns and weak housing numbers. Although inflation seems unlikely in the short term, we believe that long-term inflation concerns persist. For additional diversification, where permitted, we continue to look at international inflation-linked securities from commodity-driven economies, such as Australia and Canada. We also hold some short-maturity French linkers on the basis that if the European Central Bank eases, real short rates could fall further.

What is your outlook for the Funds' primary investments – U.S. TIPS, inflation-linked securities, high-yield (WIW) and corporate bonds (WIA)?

Undoubtedly, the state of the US economy is tepid. However, it has continued to grow at a low rate, despite alarmist headlines and increased volatility, and we expect continued, modest growth—not a fallback into recession. While we recognize that downside risks have increased and that prospects for the long term are uncertain, our view for the short-to-intermediate term is clearer and more sanguine.

[6] 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.

[7] Source: Bloomberg, 10/11.

While real rates on TIPS are very low so are nominal treasury rates. TIPS offer some protection for unexpected inflation in case the economy does better than expected or if the economy stays weak and the Fed decides to implement additional stimulus measures. Fed officials have repeatedly stated that their major concern is deflation, not inflation. Therefore, we believe that we are in an environment in which the risk of long-term inflation remains.

Investment Grade Credit

Based on our view that the US economy will avoid a recession and that credit fundamentals will continue to show modest improvement, we remain fully invested in our credit-only portfolios and have advocated for an overweight to credit in multi-asset-class portfolios. Despite positive economic growth, improved fundamental credit metrics and a fairly low supply of new issuance, investment-grade bonds turned in their third-worst quarter on a relative performance basis, trailing only the third and fourth quarters of 2008. Concerns regarding the state of the economy and the ability of US banks to get clear of the forces that ignited the financial crisis of 2008 weighed heavily on the market. The key driver of performance, however, was the lack of a credible and encompassing policy from European policymakers to deal with eurozone sovereign risk/contagion. The global fixed-income credit market will continue to be challenged until European policymakers are able to present and implement a comprehensive plan designed to stem the contagion risks associated with a restructuring of Greek debt. Although the market has seen investment-grade spreads quickly widen in a very short amount of time, we could also see spreads compress as quickly on concrete positive news.

High Yield

As a long-term value investor we consider all aspects of the investment landscape. Our credit team is very aware of the risk to our strategies posed by a recession, by the proliferation of bank litigation associated with the financial crisis, and by the European sovereign crisis and the potential damage that a un-orderly default would inflict on the global financial sector. We view these risks against the fundamental credit position of each credit in our portfolios. We then must consider these inputs versus market valuations and what prices imply. From our perspective, it appears that the market has priced in a high probability of a recession and believes that lawsuits filed against major banks will result in large write-offs for many of the big depository institutions. The market has also priced in a good chance that Greece will default on its obligations and that an un-orderly process will follow. We disagree. We believe that the economy will muddle along and avoid a recession and that the litigation risk for US banks is real but manageable. We also believe European policymakers will ultimately enact policy that will contain the fiscal problems of Greece, Portugal and Ireland and that when the full extent of the associated restructuring losses are realized, they will be manageable for the major financial institutions in Europe. From a fundamental perspective, corporate fundamental credit metrics are very much improved over the past five years—in most cases, better than long-term average levels. Yet valuations appear to reflect a recession and rapidly rising default rates. The option adjusted spread (OAS) of the high-yield index implies default rates will rise to over 10% for the next 12 months and remain there for five years. Moody's reports that the trailing 12-month default rate through September 2011 was 2.02%, and the agency forecast that the rate will rise modestly to 2.30% by September 2012. The liquidity and leverage levels of high-yield companies do not justify an implied default rate anywhere close to 10%. There are times in market history when events can overwhelm credit fundamentals. In these cases, our long-term value approach may be challenged. However, we are not market timers. Our style is to look for undervalued investment opportunities and invest accordingly. In our view, today's high-yield market offers an attractive investment opportunity. While near-term performance will be largely influenced by news out of Europe, the ultimate relationship between fundamentals and valuations should hold and lead high-yield to outperform. Our most recent purchases have been mainly focused on higher-quality issuers. Our view is that "quality" will be what most investors seek as they begin to put money back to work in high-yield, and this is where we will see a more pronounced near-term rally. Furthermore, if the markets reverse course and begin to trend lower again, these higher-quality issues should hold up much better than the lower-quality segment of the market.

Outside of U.S. TIPS, where are you finding value in the inflation-linked securities market?

As stated above, we remain invested in Australian linkers, although we have reduced our position somewhat by switching into Canadian TIPS. At the time we did this real yields in Australia had already fallen significantly vs. TIPS whereas Canadian real yields had lagged. We continue to believe that both of these countries' central banks will be forced to delay any previous plans for rate increases due to the ongoing European crisis.

We also continue to hold French TIPS, which have slightly outperformed US TIPS in Q3. While French inflation came in somewhat lower than expected, we continue to believe that these would do well if the ECB decides to ease policy.

What factors may affect the Funds' dividend rates?

Both WIA and WIW invest at least 80% of their total managed assets in inflation-linked securities. In addition, the Fund's may each invest in non-inflation-linked securities and instruments with the potential to enhance the Fund's income. There are some important differences between investing directly in inflation-linked securities and investing in inflation-linked securities through an actively-managed closed-end fund, such as WIA or WIW. Among these differences are the ways in which investors receive distributions from their investments. Whereas individual inflation-linked securities pay a semi-annual coupon based on a principal value that adjusts for inflation (using CPI-U), WIA and WIW pay monthly dividends based on the income derived from the underlying investments in U.S. TIPS, inflation linked securities and other fixed-income securities.

Historically, CPI-U figures (which are utilized for U.S. TIPS' principal value accretion) have fluctuated from month to month. As a result of this seasonality of inflation, the Funds' monthly distributions may be greater than or less than the amount of income generated by each Fund's underlying portfolio of investments. Although such shortfalls and excesses may occur, the Funds seek to avoid a net return of capital during the course of any given taxable year. In an effort to provide current income and a relatively stable monthly distribution, the Funds attempt to set their dividend rates based on current and projected net investment income at a level that is believed to be sustainable over a period of time.

Each Fund intends to continue to qualify as a regulated investment company for U.S. federal income tax purposes and to meet all other requirements necessary to be relieved of federal taxes on income and gains distributed in a timely manner to shareholders. Each Fund will distribute substantially all of its net investment income and net realized capital gains to its shareholders on a current basis. Accordingly, each Fund will be able to retain for use in the following year very little, if any, of its net investment income and net realized capital gains in excess of its regular monthly distributions for the current year. This means that the Funds may begin each calendar year without a significant "cushion" of undistributed income and gains.

What effect does the seasonality of inflation have on the Funds' income?

U.S. and non-U.S. inflation generally exhibits a normal seasonal pattern of being high in the first half of the year and lower in the second half. The Funds attempt to mitigate the effects of the seasonality of inflation-linked securities. We will look forward to the spring months because we believe they generally provide good inflation accretion for U.S. TIPS holders.

Inflation-linked securities may provide a hedge against inflation. What are some of the hedging strategies the Funds have pursued to address risks not directly associated with inflation?

We again did not implement any hedging strategies during the second quarter, consistent with the quarter ended September 30, 2011. Therefore these strategies did not impact the Funds' yields and had no impact on the total return of WIA and WIW, respectively.

When hedging strategies are implemented in the Funds' portfolios, it is primarily through the use of short futures and long put options. In the past, we have also been opportunistic sellers of calls.

Recall that one of our goals is to maintain a relatively stable NAV – so in bull markets, hedging strategies may cause us to underperform published indices on a total return basis. In bear markets, hedging strategies are designed to help protect the NAV against a significant decline in value. However, there can be no assurance such hedging strategies, if implemented, will be successful.

What are the key reasons you believe investors should hold WIA and WIW in their portfolio?

The key reasons investors should hold WIA and WIW in their portfolio are as follows:

- Current income potential.
- Opportunity for long-term inflation protection: The inflation-linked securities in which WIA and WIW currently invest continue to be one of the few yield-bearing securities that are directly linked to inflation. (The positive effects of inflation on the inflation-linked securities may not necessarily be reflected in the share prices of the Funds.)
- Diversification within investors' fixed-income portfolios.
- Any portion of the Funds' dividends directly attributable to U.S. TIPS principal adjustments is exempt from state and local income tax in certain states.
- An investment in WIA or WIW as compared to a direct investment in individual U.S. TIPS may help avoid the "phantom income" * concern.

We continue to believe that:

- Inflation-linked securities, such as those currently held by the Funds, can be an excellent diversifier for a fixed-income portfolio.

**"Phantom income" is generally any income that is reportable as taxable income but that does not generate cash flow for the investor. In the case of a direct investment in U.S. TIPS, phantom income exists because the investor receives the coupon income in cash but is taxed on both the coupon income and the accretion of principal (resulting from inflation).*

How have the NAVs and share prices of WIA and WIW performed?

Net Asset Value

NAV PER SHARE ($)					NAV PERFORMANCE: TOTAL RETURN				
	Inception	12/31/2009	12/31/2010	9/30/2011	YTD	1-Year	3-Year[1]	5-Year[1]	Since Inception[1]
WIA	$14.33	$12.85	$13.15	$14.07	9.34%	7.86%	9.18%	6.18%	4.88%
WIW	$14.33	$12.94	$13.27	$14.20	9.43%	8.01%	9.82%	6.36%	5.39%

Share Price

MARKET PRICE PER SHARE ($)					MARKET PRICE PERFORMANCE: TOTAL RETURN				
	Inception	12/31/2009	12/31/2010	9/30/2011	YTD	1-Year	3-Year[1]	5-Year[1]	Since Inception[1]
WIA	$15.00	$12.30	$12.83	$12.66	0.95%	1.18%	11.05%	6.93%	3.31%
WIW	$15.00	$12.04	$12.51	$12.63	3.44%	3.48%	11.62%	7.15%	3.67%

[1] Annualized

[2] Cumulative

Inception date of WIA is 9/25/2003; inception date of WIW is 2/24/2004

Since Inception returns assume a purchase of common shares at the initial offering price of $15.00 per share for share price returns and initial net asset value (NAV) of $14.33 per share for NAV returns. Returns for periods of less than one year are not annualized. All distributions are assumed to be reinvested either in accordance with the dividend reinvestment plan (DRIP) for share price returns or NAV for NAV returns. Until the DRIP price is available from the Plan Agent, dividends are assumed to be paid in cash for total return purposes.

Western Asset Management Company
September 30, 2011

RISKS AND OTHER CONSIDERATIONS OF THE FUNDS

This document may contain forward-looking statements representing Western Asset Management Company's beliefs concerning future operations, strategies, financial results or other developments. Investors are cautioned that such forward-looking statements involve risks and uncertainties. Because these-forward looking statements are based on estimates and assumptions that are subject to significant business, economic and competitive uncertainties, many of which are beyond Western Asset Management Company's control or are subject to change, actual results could be materially different. Other risks are detailed from time to time in the Funds' period reports filed with the Securities and Exchange Commission.

This document is not an offer to sell securities of the Funds and it is not soliciting an offer to buy securities of the Funds.

There can be no assurance that a Fund will achieve its investment objectives. The net asset value of each Fund will fluctuate with the value of the underlying securities. It is important to note that closed-end funds trade on their market value, not net asset value, and closed-end funds often trade at a discount to their net asset value. Past performance is not an indication of future performance.

There can be no guarantee that the Funds' hedging strategies will be employed under all market conditions or will be successful. Additionally, the cost paid for the hedging strategies may result in a reduction of the net asset value of a Fund and, as a result, could make the Fund worse off than if such hedging strategies had not been used.

Certain risks are associated with the leveraging of a Fund's common shares. Both the net asset value and the market value of the common shares may be subject to higher volatility and a decline in value. A Fund's leveraging strategy may not be successful.

An investment in a Fund is subject to certain risks and other considerations. Such risks and considerations include, but are not limited to: Investment Risk, Market Discount Risk, Interest Rate Risk, U.S. TIPS Risk, Credit Risk, Lower Grade and Unrated Securities Risk, Leverage Risk, Issuer Risk, Country Risk, (WIW only) Emerging Markets Risk, Prepayment Risk, Reinvestment Risk, Derivatives Risk, Inflation/Deflation Risk, Mortgage-Related Securities Risk, Management Risk, Turnover Risk, Anti-Takeover Provisions, Smaller Company Risk, and Market Disruption and Geopolitical Risk. Investors should consider the risks, expenses and fees of the Funds prior to investing.

Consider the investment objectives, risks, charges and ongoing expenses of any CEF carefully before investing. The prospectus contains this and other information about the CEF. Please read the prospectus carefully before investing. To obtain a prospectus, visit www.guggenheimfunds.com or contact a securities representative or Guggenheim Funds Distributors, Inc. 2455 Corporate West Drive, Lisle, IL 60532, 800-345-7999.