Portfolio Manager Commentary

ClearBridge Advisors
A Legg Mason Company

Institutional Convertible Securities Strategy 1Q10

Executive Summary

• The convertible market has outperformed the S&P 500 Index for the year-to-date period, providing higher income and a lower standard deviation.
• Convertibles have benefited from contracting credit spreads and rising equity prices.
• The new issue market has improved and we anticipate further strengthening into year-end.

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- 43 years of investment industry experience
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Market Overview

The convertible market outperformed the S&P 500 Index for both the full year 2009 and in the first quarter of 2010. Driven by a 9.8% increase in the underlying equities and a 21 basis point contraction in high yield credit spreads (as measured by the Bank of America Merrill Lynch High Yield Index), the benchmark Bank of America Merrill Lynch All U.S. Convertibles Index enjoyed another strong quarter, gaining 5.64% and outperforming both the S&P 500 Index and the Barclay's Capital High Yield Index (up 5.39% and 4.62%, respectively). The conversion premium declined to 61% from 68% and the delta increased from 45% to 48% as the underlying equities appreciated and the universe became slightly more equity sensitive. The current yield on the benchmark Index stood at 3.58% and offered a yield advantage of 2.70% as compared to the dividend yield of the underlying common stocks. Not only do the convertibles offer a yield advantage over the underlying common stocks, but they allow investors to sit higher than stocks in the capital structure and provide downside protection if equity prices were to decline.

> **"The convertible new issue market got off to a slow start in January and February of 2010, as companies opted to take advantage of low interest rates and tight credit spreads being offered by straight bonds."**

The yield to maturity declined to 0.42% at the end of the first quarter, down from 1.12% at the end of the fourth quarter of 2009, while the duration remained steady at around 1.7 years. The relatively short duration of the convertible universe should allow convertible bonds to be less impacted by rising interest rates than longer duration straight bonds. The convertible new issue market got off to a slow start in January and February of 2010, as companies opted to take advantage of low interest rates and tight credit spreads being offered by straight bonds. As terms for issuers became more attractive in the convertible market during the month of March, new convertible issuance picked-up and $3.3 billion of convertible paper was issued in the U.S. in the first quarter of 2010. The U.S. convertible market outperformed both Europe and Japan as the U.S. economy continued to show signs of improvement.

Strategy Highlights

For the first quarter, not only did the Convertible Securities

Strategy outperform the benchmark Index meaningfully, but it also outperformed the S&P 500 Index, a relatively unusual occurrence in a period of rising equity prices. The Strategy's outperformance for the quarter was due almost exclusively to its stock selection as the impact of its sector allocation was negligible.

For the first quarter, the financials sector made the greatest contribution to Strategy returns, led by securities of Northstar Realty Finance SA, which is a real estate finance company that focuses primarily on originating and acquiring real estate debt, real estate securities and net lease properties. The second greatest contributor in the sector was global financial services company Citigroup Inc.

The second greatest group contributor to Strategy returns for the quarter was the health care sector, led by our position in Incyte Corp., a biotechnology firm specializing in developing drugs for use in treating cancers as well as hematological, chronic inflammatory and autoimmune conditions. The second largest contributor within the health care sector was Henry Schein Inc., a distributor of healthcare and veterinary products and services to dental practitioners and laboratories, physician practices, and animal health clinics worldwide.

The only negative group contributors to Strategy returns for the first quarter came from the energy sector, with the greatest detractor being our position in Trico Marine Services Inc., which provides undersea and marine support vessels and services to oil and natural gas exploration and production companies. The second biggest detractor in the group was GMX Resources Inc., which engages in the exploration, development, and production of properties for the production of crude oil and natural gas in Texas, Louisiana, and New Mexico.

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Outlook

The U.S. economy continued to show signs of improvement in both the fourth quarter of 2009 and the first quarter of 2010, posting GDP growth rates of 3.0 and 0.7, respectively. Low inventory levels combined with improved consumer and corporate spending allowed U.S. corporations to realize solid revenue growth for the first time in several quarters. Additionally, massive cost cutting and improved operating leverage allowed many U.S. companies to experience strong earnings and cash flow growth. As such, the S&P 500 was up 5.39% in the first quarter of 2010.

We remain positive on the convertible market for the remainder of 2010. We believe the U.S. economic recovery has just gotten underway and that any weakness from sovereign debt issues will be a good buying opportunity. There is, in our view, a very powerful earnings cycle ahead. Corporate America has reacted very forcefully to the recession by trimming costs aggressively (hence the rapid rise in unemployment that we experienced) so we expect the coming improvement in sales to result in very strong growth in profits and cash flow for corporations. We also believe that the convertible market is an excellent way to participate in the global economic recovery, due to the equity sensitivity offered by convertibles. Moreover, the convertible market can provide current income and offer downside protection in volatile markets, while sitting higher than equity in the capital structure.