Portfolio Manager Commentary

ClearBridge Advisors
A Legg Mason Company

Institutional Aggressive Growth Strategy 2Q10

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Market Review

The stock market declined in the second quarter, with most of the major domestic indexes closing out the month of June at new lows for the year and recording the worst quarterly returns since late 2008. The broad S&P 500 Index fell almost 12% for the quarter and lost nearly 8% in the first half of the year, while the blue-chip Dow Jones Industrial Average was down almost 10% for the quarter and lost more than 6% for the year-to-date period.

The second quarter also saw a marked rise in volatility, as measured by the Chicago Board Options Exchange (CBOE) Volatility Index (VIX) – also known as the "fear index." The VIX closed the month at over 34 – values above 30 are generally associated with higher levels of volatility and investor fear or uncertainty – a reading more than double the multi-year low near 15 set at the start of the quarter in April. There was no shortage of negative economic and fiscal news during the three-month period. These included concerns about the sustainability of the U.S. economic recovery and its ability to overcome a persistently high unemployment rate and a troubled housing market, the growing economic impact of the Gulf of Mexico oil spill, uncertainty about the potential impact of financial regulatory reform in the U.S, and the so-called "flash crash" of May 6th when the Dow plunged 700 points in just a few minutes.

> **"Potentially negative news was generally ignored as investors who fled the market 15 months earlier started to return. This made us nervous."**

Overseas, the sovereign debt crises of Greece and Spain, the weakening of the euro and the strengthening of the dollar, and indications of an economic slowdown in China all added to investors' fears and helped drive them from risk-based assets into the relative safety of the fixed-income markets and gold. Indeed, Treasuries recorded the best first-half returns since 1995 and yields on 2-year Treasury notes closed the quarter near an all-time record low.

Portfolio Highlights

In terms of absolute performance, the Strategy had negative returns in all seven (out of 10 total) sectors in which it was invested for the quarter. The greatest detractors from returns were the energy and health care sectors, while the smallest were the financials and materials sectors.

Relative to the benchmark, both the Strategy's overall stock selection and sector allocation detracted from performance, with stock selection accounting for the majority of the second quarter's underperformance. In terms of sector allocation, the Strategy's overweight to the energy sector and its underweight to the consumer staples sector hurt relative performance while its overweight to the health care sector helped performance for the quarter. Stock selection in the energy and industrials sectors detracted from relative performance while it contributed to performance in the consumer discretionary, information technology (IT) and financials sectors.

Leading individual contributors to Fund performance for the second quarter included
SanDiisk Corp. and Advent Software Inc. in the IT sector, Core Laboratories N.V. in the energy sector, Valeant Pharmaceuticals International in the health care sector and Liberty Capital Group in the consumer discretionary

sector. Leading detractors from Strategy performance during the second quarter included Anadarko Petroleum Corp. and Weatherford International Ltd. in the energy sector, Biogen Idec Inc. and UnitedHealth Group Inc. in the health care sector and L-3 Communications Holdings Inc. in the industrials sector.

We made no significant changes to the Strategy's portfolio over the quarter.

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Market Outlook

While our bottom-up investment approach to portfolio management emphasizes stock selection and keeps us focused on the fundamentals of the stocks we hold, we do maintain our own market outlook. Earlier this year, we had a positive view on the stocks we held in our portfolios, but were essentially ambivalent about the market overall, writing in our first quarter commentary that “…At this time we are not focused on making a ‘market call’ of the sort we made in late 2008….” We felt that given the strong and relatively uninterrupted advance off the market bottom of 2009 – what we had referred to as a “generational low” – certain parts of the market had grown somewhat extended, and investors had become generally more sanguine and upbeat. Potentially negative news was generally ignored as investors who fled the market 15 months earlier started to return. This made us nervous.

In fact, it was not long after many sentiment indicators grew rosier and many of the previously jaded investors returned, that the “flash crash” of May 6th occurred. That incident, together with the run of headline events that followed in May and June, helped turn investor sentiment very negative, very quickly and this, combined with the 13-15% pullback in the major indices has led us to be more positive about the market than in quite some time.

We firmly believe that the market has undergone a moderate but much-needed correction within an ongoing, primary bull market which began in the fall of 2008. We expect the market to resume its advance on the upside, given the combination of reasonable valuation and enormous liquidity present in the market. The missing piece of the puzzle, in our view, had been investor sentiment which, as noted above, has improved significantly from the prior quarter.

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