

## Institutional Large Cap Growth Strategy

2Q10

### Market Review

The stock market tumbled 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 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.

After the outsized returns off the market bottom in early 2009, at the start of the second quarter the stock market had become vulnerable to any bad news, which then appeared in many forms. 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. 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.

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The result, in our opinion, was a broad realization that we are not returning to the “old normal” yet, and will in fact have a “new normal” slower-growth and lower-rate environment for an extended period of time. We had warned about this scenario in our commentary last quarter, noting that “We remain cautious about avoiding what we consider to be reflationary stocks, whose prices reflect very aggressive economic growth assumptions in 2011-2012” and we continue to feel this way.

We believe it is important to point out that stock valuation, one of the key factors in our growth-oriented stock selection approach, was overwhelmed by the events of the quarter and effectively detached stock fundamentals from performance. Put another way, cheap stocks offered no downside protection. Instead, the market appeared to react almost instantaneously to negative macroeconomic data or company news, indicating to us that we

were in a short-term trading market and not a long-term investing market. That helps explain the performance seen in the second quarter, where stocks that we expected to behave defensively often didn’t, and stocks of what we felt were high-quality companies with very attractive valuations and terrific free cash flow yields often languished.

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- 19 years of investment industry experience
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- MBA from Pennsylvania State University
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However, this doesn't change our view that these key fundamentals eventually do matter to stock performance over the longer term. We do not manage our portfolio of holdings for quarterly results and neither do the management teams at the companies in which we prefer to invest. Instead, we invest in stocks for multiple market cycles and seek out companies that we think are building durable and dominant businesses.

## Portfolio Highlights

In terms of absolute performance, the Strategy had negative returns in all eight economic sectors (out of 10 total) in which it was invested during the first quarter. The greatest detractors from performance came from the information technology (IT) and health care sectors, while the materials and industrial sectors were the smallest detractors for the quarter and the energy sector was effectively neutral.

Relative to the benchmark Russell 1000 Growth Index, the Strategy's overall sector allocation contributed to performance for the quarter, while its overall stock selection had a negative effect. In particular, stock selection in the IT, consumer discretionary, health care, financials, materials, consumer staples and industrials sectors detracted from relative performance. An underweight in the consumer staples sector helped relative performance but was offset by the negative impact of an overweight in the financials sector.

We made a number of minor adjustments to the Strategy's portfolio over the course of the period, trimming stocks where we felt valuations were strong and using the proceeds to invest in either new or existing holdings that we thought were more attractively priced. We closed existing positions in both Sears Holdings Corp. and Qualcomm Inc.

The top contributors to strategy performance included Akamai Technologies Inc., Schlumberger Ltd., Thermo Fisher Scientific Inc., Red Hat Inc. and Texas Instruments Inc. The bottom individual contributors to strategy performance included Nvidia Corp., BlackRock Inc., Amazon.com Inc., Google Inc. and eBay Inc.

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## Market Outlook

As we did at the end of the first quarter, we continue to seek large, dominant, global franchises with sustainable competitive advantages that are trading at attractive valuations. These companies typically have the ability to grow their top line in many market conditions. We also continue to selectively increase the Strategy's non-U.S. exposure, primarily through investments in U.S.-based multinationals with significant and growing international market share. We believe these types of firms will be able to take market share and prosper in a low-growth environment for the developed markets. We still feel that our focus on

investment in high quality, self-financing companies is a wise strategy as the equity market is likely to be increasingly discriminating for the remainder of the year.

The positive corollary to the low-growth “new normal” environment is that interest rates appear likely to stay low for an extended period of time, which is ordinarily a positive for long-duration assets and the growth-oriented stocks we favor. We believe another upside for the market is that we have already passed or are near passing some of the more controversial government initiatives such as health care reform and financial regulatory reform, which offers clarity on the likely impact of the new rules and the potential impact on the affected industries.

Looking ahead, we expect that the markets will reward those companies that have continued to demonstrate unit sales growth and/or possess some sort of technology advantage, with balance sheets that can support further growth and developing market exposure.

# PORTFOLIO MANAGER COMMENTARY



The risks that we are most concerned about in the near term are the continued sovereign debt issues and continued questions about the cumulative effects of high unemployment, as well as continued de-leveraging. Onerous political policy initiatives and perceived hostility to corporations can also put a lid on future growth.

Overall, we feel these positives and negatives are somewhat offsetting, leading us to continue to believe that the equity market should be increasingly discriminating for the rest of the year and produce an uneven recovery that will favor high-quality large cap companies.

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