Portfolio Manager Commentary

ClearBridge Advisors
A Legg Mason Company

Institutional Opportunity 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.

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

During the second quarter, stock selection in the information technology sector was the largest contributor to performance relative to the benchmark. Stock selection in the health care, energy, industrials, financials, materials and consumer discretionary sectors detracted from relative performance.

Individual stocks that were the greatest contributors to Strategy performancde included Thomas Weisel Partners, Lawson Software Inc. and Ericsson LM Telephone Co. Individual stocks that were the largest detractors from Strategy performance included Compugen Ltd., Anadarko Petroleum Corp., Network Equipment Technologies Inc., Janus Capital Group Inc. and FBR Capital Markets Co.

During the second quarter, stock selection in the information technology sector was the largest contributor to performance relative to the benchmark Russell 3000 Index, while stock selection in the energy and health care sectors detracted from relative performance.

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Significant changes to the Strategy during the period included new positions established in Allied World Assurance Company Holdings, Cameron International Corp., Diana Shipping Inc., Ligand Pharmaceuticals Inc., Noble Energy Inc., Stifel Financial Corp. and Schlumberger Ltd. Several existing positions were closed during the quarter, including those in Anadarko Petroleum, Federated Investors Inc., Murphy Oil Corp., Thomas Weisel Partners and United States Cellular Corp.

Relative to the benchmark, at the end of the second quarter the Strategy's largest overweight positions were in the financials and energy sectors and its largest underweights were in the consumer discretionary and consumer staples sectors.

Market Outlook

Currently approximately 50% of the portfolio is made up of larger companies, often ones with fortress balance sheets. However, we have not abandoned smaller companies, which we believe have much better upside than the stock market over the next 1-2 years. At the end of the second quarter, 17 of these companies had share prices in single digits, which means a $1 change in share price can have a material effect on the portfolio. We would not be surprised to see a number of these stocks appreciate significantly over the next 12-18 months.

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The stock market may be nearing an important bottom. We recognize the uncertainties that the market has been discounting recently, but we notice that simple measures, such as the percentage of stocks above their 10 and 30 week moving averages, are registering very oversold readings. We note that insider buying activity, relative to selling, is once again suggesting, in many cases, that officers and directors of companies see real value in their own companies' shares. Michael Goldstein, of Empirical Research Partners, analyzed the relationship between systematic risk (measured by price movements among large-cap U.S. issues) to stock market returns using quarterly data going back to 1926. His work indicates that current readings, a window into understanding how important systemic risk is, have been exceeded only 3% of the time over the last 84 years. Spikes in systemic risk measurements correlate well with major market turning points such as July 1932 and March 2009.

At the current time there is legitimate concern about the European economies and their banking system, and things such as the Gulf of Mexico oil spill. There also is growing concern about the focus of the Obama administration. We point out, however, that any good news could have a dramatic effect on stock prices given present investor sentiment. How will the market react if BP is successful in capping its well in the Gulf? What would be the effect if the Bush tax cuts were extended for another year? If the latter were enacted, we believe the effect could be to cause the Dow Jones Industrials to appreciate 500-1000 points in a short period of time.