

Institutional ESG Large Cap Core Strategy

2Q10

Market Review

Quite a quarter! We have seen a shift from markets in which complacency had set in, to wide scale pessimism in three months. 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's 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.

On the positive side, however, U.S. economic growth – while still slow at around 3% for the first half – continued to outpace most of the rest of the developed world. Job growth turned positive in the first half, and corporate earnings have shown signs of strength and given indications for continued strong growth this year. Inflation remains a non-issue while the low interest rate environment is expected to continue, supporting long-term asset growth. Finally, the combination of a slow growth environment and strong free cash flows could support an increase in merger and acquisition activity.

Market Outlook

We expressed doubts in our last commentary about the ability of the economy to sustain its growth pattern as government stimulus was withdrawn. The question then moves to what happens in the financial markets as a result. Perhaps nowhere is it more apparent how the private sector has relied on government help than in housing. As the tax incentive for new buyers expires, sales have dropped precipitously, and home prices are under renewed pressure. Consumers continue to struggle, as high unemployment and accumulated debt weigh on their ability to aid in any economic upswing.

Michael Kagan Managing Director, Senior Portfolio Manager

- 25 years of investment industry experience
- BA in Economics from Harvard College
- Attended Massachusetts Institute of Technology Sloan School of Management

Mary Jane McQuillen Director, Portfolio Manager, Head of Environmental, Social and Governance Investment

- 14 years of investment industry experience
- MBA in Finance from Columbia Business School
- BS in Finance from Fordham University

We believe we are in for a protracted period of slower-than-normal growth, as debt levels across individuals and government need to slowly unwind. The market has quickly adjusted to the idea of a renewed economic slowdown. When we look at our companies, we see many of them in the best financial shape in decades. Cash on corporate balance sheets is at levels rarely seen. Dividends have been raised, often sharply, for many. Coming out of the worst recession of our lives, we cannot help but believe that these high quality companies offer the best values in the financial spectrum. Equally important, overly rosy expectations for earnings have come down, muting the potential for disappointment down the road.

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The markets always seem to find a way to surprise the most people. Almost every economist and portfolio manager (including us) was concerned about a potential rise in interest rates. Instead, with the Federal Reserve keeping short term rates at effectively zero, we also have seen a drop in 2, 5, and 10 year Treasury rates. Money from risk-averse investors and institutions has avoided stocks, and instead seems to be directed toward low-yielding government paper. The fear of inflation has given way to fears of deflation. Apparently, the Fed, by keeping short rates at zero, is also showing concern about a deflationary spiral.

Just as the stock market seemed to be ignoring potential pitfalls in March, we believe that people are now too pessimistic on some segments of the market. Clearly, stocks have inherent risks and volatility, but sometimes, the risk-reward pendulum favors stocks. With interest rates low, it is fair to ask whether Treasuries are reflecting artificial depressants or because of weak economic demand and diminished inflationary expectations, they truly reflect a subdued economy. We think it is mostly the latter, and that is why stocks have perversely become more attractive. We can buy a variety of stocks with current dividend yields that we believe can grow over time, well above the risk-free rate of return. That is a rare occurrence, one we have not seen since the 1950s.

The past quarter was marred by two significant factors: the huge ongoing oil spill, and problems in Greece and Spain. The dislocations from both will be felt for quite awhile, but the markets have had time to factor them into prices.

Financial “reform” is practically impossible to decipher, given the lengthy and complicated text. In our opinion, three important things NOT dealt with, are leading to increased volatility and decreased individual participation in stocks. These are the 2007 abandonment of the uptick rule on short sales, computerized high frequency trading and trading in naked credit default swaps. Investor confidence continues to erode. The stock market has compelling values, but few willing participants.

We prefer to do our investing when pessimism is high. We believe we are at a better juncture than a few months ago.

Environmental, Social and Governance Investment Update

On the Environmental, Social and Governance (ESG) front, we’d like to discuss one of the most prevalent global issues today: the exploitation of labor rights. In particular, one of the fastest growing problems afflicting workers around the world, including the U.S., is human trafficking, forced labor and modern-day slavery.

According to a recently published report¹ by the non-governmental organization Verité, an estimated 12 to 27 million people are currently victims of modern-day slavery and other forms of forced labor around the world. In the U.S. alone, more than 10,000 people are forced to work at any given time. This report addresses current labor

¹ “Help Wanted: Hiring, Human Trafficking and Modern-Day Slavery in the Global Economy,” www.verite.org.

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broker practices and the subsequent effects on the lives of the estimated 200 million international migrant workers involving 161 countries that serve as a source, a transit point or a destination for human trafficking.

In the Verité report, the key findings highlight the intersection of brokers, migrant workers and slavery. For example, in the Indian domestic garment manufacturing industry, juvenile girls may be forced to work 12-15 hour or 24-hour shifts under three-year contracts for a lump-sum payment of \$750, all the while being exposed to hazardous chemicals and other safety risks, isolated from their families and the outside world. Another example is in the U.S. agricultural sector, where Guatemalan, Mexican and Thai migrant workers, both documented and undocumented, are regularly trapped into forced labor through exorbitant broker fees, threats of violence and wages below the legal minimum.

In examining causes of the proliferation of labor exploitation overseas, poor governance and corruption are seen as key issues in trade and business operations.² In a World Bank study, six measures of country-level governance were analyzed with regard to the impact on the economy: voice and accountability, political stability, government effectiveness, regulatory quality, rule of law, and the control of corruption.³ Poor governance has been cited to have contributed to labor strikes or work stoppages, which, as noted in a World Bank study on Bangladesh, could cost the country \$60 million each day and cost the government 3-4% of GDP each year.⁴

Given the rise of globalization and international expansion, many of the companies in our portfolios will often outsource a portion of their labor needs and be indirectly involved with factory labor through their supply chain.

As investors, we can work directly with our companies to increase the transparency and reporting around labor practices and sourcing policies. We can ask companies about their recruitment and hiring practices and whether or not they conduct audits of their factories and monitor the enforcement of standards. Equally important in our view, we can ask companies about their remediation process in cases where violations are discovered.

For over a decade, in our ESG Investment Program, we have funded research on sweatshop and forced labor practices at the companies in our investment universe. [Please contact us for a copy of our current screening guidelines on Sweatshop and Child Labor Issues.] The results of the research have been both positive and challenging in that much progress has been made in the various sectors that source factory and low-wage workers with regard to human rights and labor standards. However, as the recent Verité report has shown, there is much more work to be done across the globe to improve fair labor conditions and end modern slavery.

ClearBridge Advisors

www.clearbridgeadvisors.com

800-691-6960

info@clearbridgeadvisors.com

As always, thank you for your support of our ESG Program.

² Citigroup Global Markets, Inc. Economic and Market Analysis: “Bangladesh 2007: Economy Holding Up Despite Politics”, 12 April 2007.

³ “Measuring Governance Using Cross-Country Perceptions Data,” Kaufman, Kraay and Mastruzzi, The World Bank, August 2005.

⁴ See Citigroup.