

## Institutional All Cap Strategy

2Q10

### 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 S&P 500 Index had losses of 11.43% for the quarter and 6.65% for the first half of the year, while the blue-chip Dow Jones Industrial Average lost 9.36% and 5.00% for the same periods.

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 6<sup>th</sup> 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.

**“In short, confidence in the U.S. equity market fell significantly since the start of the second quarter, as did share prices.”**

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#### Managing Director, Portfolio Manager

- 16 years of investment industry experience
- BA in Government from Dartmouth College

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#### Managing Director, Portfolio Manager

- 11 years of investment industry experience
- MBA from Georgetown University
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In short, confidence in the U.S. equity market fell significantly since the start of the second quarter, as did share prices. We are convinced this decline must be a positive factor for equities over the long term as they present, in general, a better value at the end of the quarter than they did at the start.

### Portfolio Highlights

The Portfolios had investments in eight out of the 10 economic sectors during the quarter and had losses in all of them except for the consumer discretionary sector. The leading detractors from absolute performance for the quarter came in the energy and financials sectors. Relative to the benchmark Russell 3000 Index, overall stock selection contributed to Portfolio performance for the quarter, while the relative effect of overall sector allocation was negative. In particular, stock selection in the consumer discretionary, materials and industrials sectors helped relative performance for the quarter, while the impact of stock selection in the energy, financials and consumer staples sectors was negative for the quarter. In terms of sector allocation, an overweight in the materials sector and underweights in the utilities and telecommunications services sectors (no holdings in either) hurt relative performance for the quarter.

Over the course of the first quarter, we made a number of adjustments and changes to the Capital portfolio. We established new positions in a number of stocks including State Street Corp., Microsoft Corp., BlackRock Inc., Jarden Corp. and Xilinx Inc. We also closed a number of existing positions during the quarter, including our

# PORTFOLIO MANAGER COMMENTARY



holdings of Chimera Investment Corp., Family Dollar Stores, BP PLC, Bank of America Corp., Covanta Holding Corp. and Allstate Corp.

The leading individual contributors to Strategy performance for the second quarter included our positions in Newmont Mining Corp. in the materials sector, Family Dollar Stores Inc. in the consumer discretionary sector, Quanta Services Inc. in the industrials sector, Agnico-Eagle Mines Ltd. in the materials sector and The Pantry Inc. in the consumer staples sector. The bottom individual contributors to performance for the quarter included Monsanto Co. in the materials sector, Charles Schwab Corp. in the financials sector, Walgreen Co. in the consumer staples sector, Oceaneering International Inc. in the energy sector and Google Inc. in the Information Technology sector.

## Outlook

At the end of the first quarter, we voiced our concerns that the remarkable rally of the preceding months had pushed valuations to the point where we were still finding attractively priced stocks to invest in, but not to the extent we were at the start of 2009.

We noted in March that "...buoyant psychology and valuations which are no longer cheap leave the market vulnerable to a correction if the economic data wane, corporate profits disappoint, or if there is some unforeseeable shock like a new war or a terrorist attack."

Considering that we have since experienced that major correction, we believe stock valuations in general look more attractive, but we don't have a much-improved view from a macroeconomic standpoint. In fact, we believe that it may have even deteriorated over the past quarter and we do not see any significant improvement in housing, employment or consumer spending data.

At present, we feel market valuations now are relatively attractive, based on valuation multiples and current free cash flow yields. The second quarter's correction has removed some of the "froth" from the market in our view, putting valuation on our side. We also expect to have a persistently low interest rate environment and no inflation (and there is even some deflationary pressure which will need to be monitored). In short, we feel the economic situation is not growing much worse, but it's not getting much better either.

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