

Institutional Convertible Securities Strategy

2Q10

Executive Summary

- The convertible market has outperformed the S&P 500 Index for the year-to-date period, providing higher income and a lower standard deviation.
- Convertible prices declined in 2Q10 as stocks were weak and credit spreads widened
- The benchmark Bank of America Merrill Lynch All U.S. Convertibles Index is 2.04% cheap as compared to theoretical value vs. 1.12% cheap at the end of 1Q10
- The new issue market was quiet in the second quarter of 2010.
- We believe the economic recovery remains intact and the recent weakness presents an attractive buying opportunity.

Market Overview

Notwithstanding a 7.7% decline in the underlying equities and a 130 basis point widening in high yield credit spreads (as measured by the Bank of America Merrill Lynch High Yield Index), the benchmark Bank of America Merrill Lynch All U.S. Convertibles Index declined during the quarter by 5.80%, outperforming the S&P 500 Index which was down 11.43%.

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weak equity market conditions and fear of a “double dip” recession. The convert benchmark “cheapened” relative to theoretical value to 2.04% cheap from a level of 1.12%. This may have been a result of dealers reducing their inventory ahead of increased financial regulation. There didn’t appear to be forced selling by convert arb funds on the days where the market was down and liquidity remained decent.

Peter Luke

Director, Portfolio Manager

- 43 years of investment industry experience
- BSc in Economics from the University of London

Patrick McElroy, CFA

Director, Portfolio Manager, Research Analyst

- 17 years of investment industry experience
- MBA from New York University's Leonard N. Stern School of Business
- BA in Comprehensive Science and Math from Villanova University

The conversion premium increased to 69% from 61% and the delta declined from 48% to 42% as the underlying equities declined and the universe became slightly less equity sensitive. The current yield on the benchmark Index stood at 3.83% and offered a yield advantage of 2.80% as compared to the dividend yield of the underlying common stocks. The yield to maturity increased to 1.65% at the end of the second quarter, up from 0.42% at the end of the first quarter of 2010, while the duration remained steady at around 1.7 years. The relatively short duration of the convertible universe should allow convertible bonds to be less impacted by rising interest rates than longer duration straight bonds.

The convertible new issue market was quiet during the second quarter as issuers remained on the sidelines due to

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Strategy Highlights

For the second quarter, the Convertible Securities Strategy underperformed the benchmark Index, mainly due to the portfolio being positioned with a higher delta. The Strategy's under-performance for the quarter was due almost exclusively to its stock selection as the impact of its sector allocation was negligible.

For the second quarter, the information technology sector was the greatest detractor from Strategy returns, led by securities of Sunpower Corp. and Suntech Power Holdings, both producers of solar cells.

The second greatest group detractor to Strategy returns for the quarter was the health care sector, led by our position in Incyte Corp., a biotechnology firm specializing in developing drugs for use in treating cancers as well as hematological, chronic inflammatory and autoimmune conditions. The second largest detractor within the health care sector was Teva Pharmaceuticals., a manufacturer of generic and branded drugs.

There were no sectors that had a positive contribution to returns in the quarter.

Outlook

The recovery in the U.S. economy appeared to have slowed in the second quarter of 2010, as Real GDP for the 1st quarter of 2010 came in lower than expected at 2.7% and forecasts for full-year 2010 and 2011 were revised downward. Weakness in consumer spending, employment and housing contributed to the slower economic growth.

The benefits from the economic stimulus package and inventory rebuilding have also started to wear off. Notwithstanding a pause in the 2nd quarter, we believe the economic recovery remains intact and that the massive cost cutting by U.S. corporations and the extremely stimulative Fed Fund's rate will allow companies to post solid earnings growth in 2010 and beyond.

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We remain positive on the convertible market for the remainder of 2010 and into 2011. The recent decline in common stock prices and the widening of credit spreads has presented a compelling buying opportunity, in our opinion. We believe the U.S. economic recovery has just gotten underway and that any market weakness caused by the fear of a "double dip recession", sovereign debt issues in Europe, and a temporary deceleration of growth in China will be a good buying opportunity. There is, in our view, a very powerful earnings cycle ahead. Corporate America has reacted very forcefully to the recession by trimming costs aggressively (hence the rapid rise in unemployment that we experienced) so we expect the coming improvement in sales to result in very strong growth in profits and cash flow for corporations. We also believe that the convertible market is an excellent investment vehicle in which to participate in the global economic recovery, due to the equity sensitivity offered by convertibles. Moreover, the convertible market can provide current income and offer downside protection in volatile markets, while sitting higher than equity in the capital structure.

Past performance is no guarantee of future results.

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