

## Institutional Large Cap Value Strategy

2Q10

### Market Overview

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.

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 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

On an absolute basis, the Fund had negative returns in all 10 sectors for the second quarter, with the greatest detractors from returns coming from the financials and energy sectors while the smallest detractors were in the utilities and materials sectors.

Relative to the S&P 500 Index, the Fund’s overall sector allocation contributed to performance for the quarter, while the overall impact of stock selection was negative. Specifically, stock selection in the consumer discretionary sector contributed to relative performance but was offset by the negative impact of stock selection in the energy, industrials and financials sectors.

During the quarter we established new Fund positions in Honeywell International Inc. in the industrials sector and Charles Schwab Corp. in the financials sector but closed our existing positions in UnitedHealth Group Inc. in the health care sector and Capital One Financial Corp. in the financials sector.

### Outlook

In our prior quarterly commentary, we expressed our concerns regarding a growing U.S. federal budget deficit. Over the past few months, this issue has grown globally with the collapse of Greek sovereign debt and the subsequent bailout package orchestrated by the European Union and the International Monetary Fund. After temporarily losing confidence in the global banking system at the height of the credit crisis, investors are now

### **Robert Feitler, Jr.** Managing Director, Portfolio Manager

- 16 years of investment industry experience
- MBA in Finance from the University of Wisconsin
- BA in Economics from Haverford College

### **Dmitry Khaykin** Managing Director, Portfolio Manager

- 14 years of investment industry experience
- MBA in Finance and Accounting from the Wharton School at the University of Pennsylvania
- BA in Economics and Computer Science from New York University

# PORTFOLIO MANAGER COMMENTARY



questioning their governments' abilities in paying their obligations. Budget deficits have become a pressing issue for many of the developed economies.

Meanwhile, in the U.S., aggressive fiscal policy, in response to the financial crisis, combined with weaker tax revenues have resulted in a deficit approaching \$1.6 trillion. We feel the U.S. is faced with two choices. It can either follow in Europe's footsteps, where substantial austerity measures combined with tax increases are becoming a fact of life or the U.S. can tax and spend, arguing that the economy is still too fragile to withdraw the stimulus and hope that we'll spend our way out of this situation. Either way, one thing appears to be clear to us – taxes are going up.

Government policies remain a focal point of the private sector. While private enterprises have weathered the crisis reasonably well by aggressively slashing expenses and strengthening their balance sheets, they are now faced with regulatory challenges spanning critical sectors of the economy such as health care, financial services and energy. Even though healthcare legislation was passed in March, it will take years to sort out the impact this reform will have on consumers and businesses and how we as a country will be paying for universal coverage. At the same time, we appear to be on the verge of the biggest overhaul in the financial industry since the Glass-Steagall Act of 1933, which is likely to have long term implication on the availability of credit for the economy as a whole. Additionally, the Gulf oil spill has not only resulted in a temporary moratorium on drilling in the Gulf of Mexico, but could potentially lead to major regulatory changes across the entire sector. Regulations can undoubtedly impact the business models and earnings power of all industries. These changes coupled, with a fragile economic environment, have created a highly uncertain business environment which we believe could temper long term growth.

On the positive side, in our opinion, periods of high uncertainty often create the best investment opportunities. We continue to believe that long term investors will benefit from equity market returns compared to fixed-income and cash. With interest rates at historically low levels and growing budget deficits, we think that allocating more to fixed

## ClearBridge Advisors

[www.clearbridgeadvisors.com](http://www.clearbridgeadvisors.com)

800-691-6960

[info@clearbridgeadvisors.com](mailto:info@clearbridgeadvisors.com)

income assets will make it difficult for investors to meet their long-term financial objectives. We continue to think that the type of companies we seek to invest in - competitively advantaged business models with solid balance sheets and cash flows - should be able to navigate these volatile times and generate better returns than their competitors. Many of these companies have accumulated cash which should enable them to acquire businesses or return cash to shareholders through buybacks and dividends. By investing in large capitalization companies, investors are offered an attractive way to gain exposure to fast-growing emerging markets.

Within the Fund, we continue to hold an aggressive position in the consumer discretionary sector and a meaningful underweight in the utilities sector. In the consumer discretionary sector, we maintain a constructive view of media stocks and own companies with what we feel are both strong franchises and solid balance sheets. In addition to an advertising rebound, we continue to believe that high quality professional video content should continue to grow in value over time. We have an underweight in the utilities area as we remain concerned that in the current environment of budget deficits and potentially higher inflation, there is risk to the ownership of regulated return businesses which lack pricing power. Conversely, we believe that consumer staples offer similar cash flow characteristics to utilities but with more flexible business models. As always, we continue to look for opportunities offering attractive risk-adjusted returns for long-term investors.

Past performance is no guarantee of future results.

Copyright © 2010 ClearBridge Advisors

ClearBridge Advisors consists of ClearBridge Advisors, LLC and ClearBridge Asset Management Inc. All opinions and data included in this commentary are as of June 30, 2010 and are subject to change. The opinions and views expressed herein are of the ClearBridge Advisors, LLC Large Cap Value portfolio management team and may differ from other managers, or the firm as a whole, and are not intended to be a forecast of future events, a guarantee of future results or investment advice. The statistics have been obtained from sources believed to be reliable, but the accuracy and completeness of this information cannot be guaranteed. Neither ClearBridge Advisors, LLC nor its information providers are responsible for any damages or losses arising from any use of this information. Russell® and Russell 1000 Value® Index are trademark/service marks of the Frank Russell Company. Further distribution is prohibited.