

Institutional SAI Appreciation Strategy

3Q09

Market Review

If one were to look only at the stock market, one would think things were back to some semblance of “normal.” Our belief is that the economy has hurdles to overcome that are significantly different from what were faced in prior recoveries from recessions. This belief has led us to invest in a manner different from prevailing trends, but which respects the enormous problems facing the economy.

After turning very bullish on a washed out market in February and March, we returned to our more cautious posture during the summer. The climactic selling over the past winter, caused by fears for the financial system, created bargains. Given the fragile state of the entire country, we chose to emphasize higher quality stocks when we took cash off the sidelines. Our approach proved too conservative, as lower quality stocks coming off levels suggesting possible bankruptcy had much bigger rallies while the highest quality stocks often languished. Our portfolios are up nicely, but after several years of outperforming the market, we are lagging this year.

Market Outlook

The question then becomes how to proceed? We believe it is appropriate to continue with the approach that we have been using. We grew up in this business learning that the phrase “this time is different” leads to serious mistakes in judgment, so we are going out on a limb by continuing in our belief held since 2007 that indeed, this period is different.

We can enumerate many factors that represent obstacles to a return to normalcy that we think are different from other post-WWII recoveries. While we agree with the steps the Federal Reserve and Treasury have used to prevent a collapse of the financial system and to prevent housing from falling even further, we worry about the strength of the current recovery after these stimulus programs run off. We wonder how the Fed will be able to benignly wean the economy from its “zero” interest rate policy.

The Fed, through its policies, is practically forcing people to take risk to earn higher returns. The single most often asked question we get these days is how to obtain more yield with no risk. The answer, of course, is one cannot get more returns with no risk. Our investment philosophy, in these fragile times, is to try to get some yield from dividends from companies that we believe have the ability to sustain and possibly raise them, regardless of economic outcomes. For the first time in memory, dividends are competitive with bond yields.

“Our problem is seeing where revenue growth will come from next year.”

The economic growth of the past four decades has been accompanied by massive increases in both consumer and government debt. Past recoveries have benefited from increasing credit. One reason why we believe this time is different is because debt is so extended that it cannot

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fuel recovery, either in housing or other consumer demand. The average consumer is faced with lower wealth from their home, the threat of losing a job, and increased feelings of insecurity concerning sending their kids to college or future retirement. In addition, we believe the government will have difficulty sustaining its current level of spending, as it continues to put pressure on its currency.

Although some are worried about inflation, the Fed is fighting to combat asset deflation, which was one of the major problems during the 1930s. A collapse of housing, lower quality credit and commercial real estate is a combustible mix that is being tamped down by incredibly low interest rates and government stimulus. Yet, government deficits are spawning calls for tax increases, which carry the risk of adding to deflationary pressures. The stock market has applauded earnings that, while down from a year ago, came in better than diminished expectations. Cost cuts, not revenues, have been responsible for most of these positive earnings surprises. Our problem is seeing where revenue growth will come from next year.

In sum, there are enough unprecedented uncertainties to make us consider downside risks to be at least as important as upside potential. We will stick with our policy of preferring high quality stocks with sustainable business models. Having good dividends, plus solid balance sheets is not a bad place to be.

Socially Aware Investment Update

On the Socially Aware Investment (SAI) front, we would like to discuss a recent movement in the socially responsible investing (SRI) community to require mandatory risk disclosures on environmental, social, and governance (ESG) data in corporate reporting that may materially affect the risk profile of publicly traded companies. This effort has been led by the Social Investment Forum (SIF), the U.S. association for socially and environmentally responsible investment professionals and institutions, which recently addressed the subject in a letter to Chairman Mary Schapiro of the U.S. Securities and Exchange Commission.* The letter, submitted pursuant to discussions with the SEC, sets forth a proposed framework for uniform mandatory ESG disclosures and requests that the SEC make such disclosure a required part of publicly traded companies' annual reports.

One key driver behind the movement for mandatory ESG disclosure is the preference of analysts and investors to have such data standardized across industry peers. Currently, the approach by companies to voluntarily provide ESG information has not been widely consistent in its transparency, nor an imperative. Moreover, while many leadership companies have provided quantifiable Key Performance Indicators (KPIs) and significant disclosure on potential ESG impacts from their operations, there are still a large number of companies who have chosen to not disclose comprehensive data on these risks.

For years, SRI investors have requested more transparency and sustainability information from the companies either being considered for, or currently maintained in, their investment portfolios. As part of our due diligence process on our portfolio holdings, ClearBridge's SAI team routinely requests and reviews data on ESG impact for both risk assessments and for quantifying potential positive effects on a company's businesses, its environment and community relations, as well as on its shareholders and the bottom line. As members of the SIF, we also support the notion that increased transparency of ESG information could promote market efficiency and longer-term sustainable planning, potentially benefiting U.S. companies and investors and strengthening U.S. markets.

* A copy of the letter is available online at http://www.socialinvest.org/documents/ESG_Letter_to_SEC.pdf

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