Portfolio Manager Commentary

ClearBridge Advisors
A Legg Mason Company

Small Cap Value Strategy

3Q11

Market Review

Bad economic news from the U.S. and Europe drove trading activity during the quarter, causing stocks to underperform across the globe. While the risk of a recession has increased, economic growth appears to remain positive, although sluggish and sporadic. These events have brought both the U.S. and Europe to a critical inflection point concerning political and economic management.

In each case, there is no confidence in government's ability to continue to prop up spending patterns that are unsustainable. The good news is that the markets are forcing policy makers towards pro-growth tax and entitlement reforms that we believe will be favorable to stock performance. Reaching this inflection point, however, has been painful.

Strategy Highlights

For the quarter ended September 30, 2011, the Strategy's overall stock selection and interaction in the utilities sector contributed to relative performance, whereas stock selection and interaction in the financials and industrials sectors detracted from relative performance.

Leading individual contributors to Strategy performance during the quarter include Children's Place Retail Stores Inc. in the consumer discretionary sector, Rex Energy Corp. in the energy sector, Mueller Industries Inc. in the industrials sector and Laclede Group Inc. and MGE Energy Inc. in the utilities sector. The leading individual detractors from Strategy performance include Russell 2000 Value Index Fund, an exchange-traded fund, Altra Holdings Inc. in the industrials sector, SVB Financial Group and HFF Inc. in the financials sector and Carrizo Oil & Gas Inc. in the energy sector.

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During the quarter, we added a new position to the Strategy's portfolio in Greenhill & Co. in the financials sector. We sold out of existing positions in California Pizza Kitchen in the consumer discretionary sector, Enzo Biochem Inc. in the health care sector, Mueller Industries Inc. in the industrials sector and Verigy Ltd. in the information technology sector.

Peter Hable
Managing Director, Senior Portfolio Manager

- 28 years of investment industry experience
- MBA from Wharton School at University of Pennsylvania
- BS in Economics from Southern Methodist University

Mark Bourguignon
Director, Portfolio Manager

- 14 years of investment industry experience
- BA in Criminology and Law from Marquette University
- BS in Finance from Marquette University

Marina Chinn, CFA
Director, Portfolio Manager

- 10 years of investment industry experience
- MBA in Finance & Accounting, Simon Business School at University of Rochester
- BA in English and World Literature from Kiev T. Schevchenko University

Mark Feasey, CFA
Director, Portfolio Manager

- 15 years of investment industry experience
- MBA from the Anderson School at University of California Loss Angeles
- Bsc in Statistics from University of Bath

Michael Kang
Director, Portfolio Manager

- 13 years of investment industry experience
- BA in Economics from University of California at Berkeley

Outlook

The challenge for all investors remains: how to judge the tradeoff between what is likely to occur and what has already been discounted. In the short term, disappointing economic and employment reports may lead to renewed policy efforts by both fiscal and monetary officials to stimulate the economy creating a modest rebound. More importantly, economic realities are forcing the implementation of long term structural reforms that we think are pro-growth. The better the performance of the U.S. economy, the less painful the choices are to address our federal debt and entitlement problems. This is true for Europe as well, although more difficult to implement. As such, given compelling valuations, we believe that it is important to cautiously implement a pro-cyclical stance in portfolios highlighting those sectors that we expect should perform well in an improving economy.

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