Portfolio Manager Commentary

ClearBridge Advisors
A Legg Mason Company

Convertible Securities Strategy 3Q11

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Market Overview

The third quarter brought extreme levels of volatility and a precipitous decline in equity markets that stemmed mainly from the sovereign debt crisis in Europe. Moreover, uncertainty about the credit quality of European banks, the future of the European Union, the potential for a hard landing in China and the increasing odds of a global recession caused investors around the globe to sell risk assets and seek the relative safety of U.S. Treasuries and gold. The convertible market was unable to escape the high levels of correlation in global risk assets and the panic selling that occurred during the third quarter.

Driven by a decline in the underlying common stocks and a widening of credit spreads, the benchmark Bank of America Merrill Lynch All U.S. Convertibles Index decreased during the third quarter by 12.94%.

The current yield on the benchmark Index stood at 3.75% at the end of the quarter and offered a yield advantage of 2.23% as compared to the dividend yield of the underlying common stocks. As compared to 2Q, the conversion premium increased to 62.8% from 55.4% and the delta declined to 42% from 54%. This occurred due to the decline in the underlying common stocks.

The convertible new issue market was quiet during the third quarter as issuers remained on the sidelines due to global, political and economic uncertainty. The convertibles benchmark “cheapened” relative to theoretical value to “fair value” from a level of 0.42% rich. This occurred due to increased risk aversion by convertible investors.

Strategy Highlights

In terms of absolute performance during the third quarter, the Strategy had negative performance in all nine of the economic sectors in which it was invested (out of 10 total.) The largest detractors from Strategy returns included the consumer discretionary, information technology (IT) and financials sectors. Relative to the benchmark index, overall security selection detracted from Strategy performance, while overall sector allocation made a positive contribution to relative performance.

> **“In this environment, we believe convertible securities offer an attractive risk adjusted return relative to most other asset classes.”**

Security selection in the IT, consumer discretionary, financials, materials, industrials, consumer staples, energy and health care sectors detracted from the Strategy’s relative performance during the quarter. The Strategy’s cash position and its underweight position in the materials sector made a positive contribution to relative performance, while its underweight position (no holdings) in the utilities sector detracted from relative performance. Leading individual contributors to Strategy performance included Rightnow Technologies Inc., Cameron International Corp., Sunpower Corp. and Novellus Systems Inc. Leading detractors from Strategy performance included Suntech Power Holdings Co., Faurecia SA, Citigroup Inc., Cemex SAB de CV and Interpublic Group of Cos.

Outlook

While the macroeconomic outlook appears challenging in the near future, from a bottom-up perspective, we are finding compelling long-term investment opportunities in the convertible securities market. We believe this environment of modest economic growth, low interest rates and volatile equity markets could persist for several years as the world continues the deleveraging process that commenced in 2006. In this environment, we believe convertible securities offer an attractive risk adjusted return relative to most other asset classes. In these volatile markets, we do not try to guess where the market is going, we seek to take advantage of securities that are being mispriced in the short-term and have a favorable long-term risk reward profile.
We believe that Convertible bonds are a wise investment in this period of great uncertainty and offer a way to reduce the volatility of an equity portfolio or increase the expected return of a fixed income portfolio.

Convertible bonds can provide investors a less risky way to invest in companies of all market capitalizations. With a bond, investors sit higher in the capital structure, collect a coupon payment and have less volatility than common stocks. A traditional balanced convertible allows investors to participate in the upside movement of the common stock, but offers investors downside protection if the common stock should decline. Bonds also allow investors to get their money back at par when the bond matures or has a put/call - whereas; if a stock declines it can stay down forever. By adding an allocation to convertible bonds to a traditional stock and bond portfolio, an investor can increase expected return and reduce risk, as measured by standard deviation.

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