

## ClearBridge ESG Appreciation Strategy

3Q11

### Market Review

The third quarter of 2011 was the weakest quarter for U.S. stocks since the fourth quarter of 2008. Europe experienced a financial crisis that threatened to spread to the rest of the world. Market psychology was also hurt by partisan political bickering in Washington, and brinksmanship that nearly resulted in a U.S. government shutdown.

Despite its losses, the U.S. market outperformed almost all other global stock markets during the quarter and U.S. Treasuries had powerfully positive returns. In our view, it is clear that the U.S. markets continue to hold some degree of their safety status in the world, but we live in an increasingly connected world and the U.S. can no longer easily overcome overseas weakness.

The European financial crisis worsened in early August as fears emerged that problems in the economies of Greece, Portugal and Ireland might spread to Spain and Italy. Spanish and Italian sovereign debt interest rates spiked, threatening a liquidity crisis for many of their banks. We believe the EU responded appropriately by creating the EFSF, a fund to be used to purchase European sovereign debt, which we feel is analogous to the TARP fund created in the U.S. in 2008. Creating it was the necessary step to resolve the crisis. That said, after the TARP was established, the U.S. experienced numerous bank failures and it was six months before the U.S. stock market bottomed – and twelve months before economic data started to firm.

By analogy, we believe that there will be bank failures and negative headlines out of Europe for at least another six months, perhaps longer since the EU is a confederation and cannot act as quickly as can a single government.

We do not believe that the present situation will be as severe as 2008, or even that the U.S. will necessarily experience a recession. U.S. bank balance sheets and capital levels in general are much improved over 2008 and we believe they now are far better able to withstand shocks. Corporate balance sheets are flush with cash and even consumer balance sheets are generally in better shape now than in 2008. Steady saving by consumers has reduced consumer debt balances from nearly 100% of GDP three years ago to approximately 85% now. Debt service costs for consumers are the lowest since the early 1990s, thanks to lower interest rates.

Nevertheless, we feel there are clear signs of moderation in the U.S. economic growth rate. Unemployment remained stubbornly high at 9.5% and jobless claims remained elevated at around 400,000 a week. Railcar loadings have fallen to low single-digit growth rates and package volumes at the large carriers are up only 1-2%. Copper prices fell sharply during September; historically, copper is often a coincident indicator of economic weakness. On the positive side, housing sales and traffic did not fall off during the third quarter, and auto sales

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actually accelerated in August and September from the second quarter and July pace. The Purchasing Managers Index remained above 50%, signifying economic expansion.

## Market Outlook

Over the next several years we continue to expect constrained economic growth in the U.S. The U.S. budget deficit must be addressed, and almost all of the necessary changes, whether tax increases or spending cuts, will tend to slow economic growth.

The third quarter's sharp decline in stock prices is beginning to create what appear to us to be attractive entry points into many stocks that we have long wanted to own, but had found too expensive. In particular, many high quality stocks are available at multiples very similar to those for lower quality companies due, in part, to practically indiscriminate selling by asset managers. We tend to find the greatest value in companies with sustainable business models that produce a high and consistent level of cash flows.

While always important, we believe that capital management or simply, how business managers choose to use cash flow, is a critical variable in creating value for shareholders in a low growth environment. High and growing dividend yields and/or significant repurchases of company stock often make the most sense in this environment. In addition, acquisitions that take advantage of low financing costs also make sense for certain companies, and we expect to see an uptick in deals. After almost a decade of neglect, we believe high quality large cap equities are the most attractive companies in the market at a time when risk remains high.

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## ESG Investment Update

On the Environmental, Social & Governance (ESG) front, we will state the obvious in observing that this past summer was an unsettling season for the financial markets, the global economy, and the political arenas.

Aside from the overarching theme of flux set by the continuing Greek debt crisis; raising of the U.S. debt ceiling by Congress on August 1<sup>st</sup>; the Federal Reserve's Quantitative Easing II; European Central Bank moves, along with the new head of the International Monetary Fund added to the mix, the markets have been both volatile and interesting at the same time.

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From our ESG perspective, it is often during these tumultuous times that we further believe that confirmation of the long-term view on sustainability is essential to quality of management and the investment attractiveness of each holding. It is also during these times that many of the companies with strong fundamentals and valuable franchises take the opportunity to maximize the efficiency of their manufacturing processes, reduce energy use, track their emissions reductions, and raise health and safety standards, as well as, reaffirm their value to their shareholders, to the communities in which they operate, and to their employees.

In our regular internal and external interviews and meetings with the senior managements of our portfolio companies, we continue to be impressed by the increasing awareness of these management teams of the need to address societal issues – via their products & services, public reporting, communications with shareholders, and measuring of their overall sustainability footprint.

# PORTFOLIO MANAGER COMMENTARY



For example, a food industry company CEO and CFO started off our analyst meeting by discussing the need to include more nutritional and health considerations in the innovation of their products; with regard to sodium content, calories, metabolic reactions, quantity served, etc., while continuing to provide value in the current economy. Other areas discussed included responsible ingredients sourcing, cultural diversity in product offerings, sustainable packaging and reduction of water usage and waste.

Another example was an international energy company CEO who could not stress enough the need for safe workplace and contractor practices. He went on to discuss the importance of community relations (to the extent of local employment, medical and social services, and environmental impact), working well with governments (regarding bribery, corruption, avoidance of repressive regimes), and the extreme caution that the energy sector needs to apply when, or if, exploring unconventional sources.

In our meeting with a technology hardware company CEO, the copious statistics cited on increased efficiency in their products spanned from the construction process of the hardware, to the performance attributes of the product, to the speed of the results to the customer, to the lighter materials used – all within the context of the reduced energy usage by the products (and thus, by the consumer), as well as the ability for most of their technology hardware products to be fully recyclable or re-usable in refittings.

Also revealed in our cross-sector company meetings was that most of our ESG holdings with some form of packaging in the supply chain were acutely aware of the need to reduce the weight that went into packaging – with expected benefits of lower costs, fewer materials (paper, plastics, metals, glass, wood, chemicals, paints, etc.), re-engineering of shapes for storage and consumer applications, etc. All of this while maintaining the integrity of the product to be delivered, i.e.; meals & snacks, electronics, beverages, appliances, household goods. Moreover, the reduction in weight and materials usage in packaging has the effect of reduced waste in our landfills, reduced carbon emissions in transportation of such goods via more boxes fitting in the same space, lower cost overall for commodities in the packaging.

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Generally speaking, many of the observations in the above examples have taken place with most of our company holdings in one form or another, in the past and/or currently. We will continue to monitor, engage, and advocate for best practices with the managements of our holdings through periods of both expansion and contraction, which again, can be both challenging and encouraging.

As always, thank you for your support of the ESG Investment Program.

**Past performance is no guarantee of future results.**

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