

ClearBridge Energy MLP Strategy

3Q11

Market Review

Much like the broader equity market, Master Limited Partnership (MLP) stocks endured a volatile third quarter, declining 3.4%. At their worst point during the quarter, MLP stocks were down almost 11% from June 30, 2011, levels. Such wild swings in MLP stock prices have tested the resolve of all MLP investors. Yet, as we take a step back from the day-to-day volatility endured during the third quarter, MLP fundamentals remain positive and are largely unchanged since our last update. We continue to expect MLPs to grow their distributions at a 5-6% annualized rate for the foreseeable future. With positive MLP fundamentals intact, we remain positive on the total return potential for MLP investments.

Before we address current MLP fundamentals, we think it is important for MLP investors to remember that fear and emotions can trump fundamentals in the short run. This certainly occurred during the third quarter as fears of another 2008-09 economic environment led investors to “shoot first and ask questions later.” Yet, in the intermediate to long term, fundamentals always trump emotions. With the fundamental landscape unchanged, we will endure volatility like that seen in the third quarter and continue to look for long-term investment opportunities that such short-term market dislocations may present.

Portfolio Highlights

There were no significant changes to the Strategy’s portfolio composition during the third quarter. On an average weighted basis, approximately 96% of the portfolio was invested in energy sector holdings and about 4% was invested in utilities sector holdings. The leading contributors to Strategy performance included Oneok Partners L.P., El Paso Pipeline Partners L.P., Magellan Midstream Partners L.P., Sunoco Logistics Partners L.P. and Williams Partners L.P. The bottom contributors to performance included Energy Transfer Equity L.P., Inergy L.P., NuStar Energy L.P., Energy Transfer Partners L.P. and Linn Energy LLC.

Market Outlook

Current MLP quarterly distributions are safe.

Most MLPs and certainly the MLP stocks we invest in have limited commodity price exposure. We focus on MLPs with stable, predictable cash flows and many of our portfolio companies have revenues that are supported by long term contracts with take-or-pay provisions. Our view on the safety of MLP distributions is also rooted in the history of MLPs. During the depths of the 2008-09 economic crisis, only seven of 75 MLPs cut their distributions and the seven that did were companies with high levels of direct commodity price exposure—again, the type of MLP securities we intentionally shy away from. On average, MLPs actually increased their distributions through 2008 and again in 2009. In fairness, distribution growth rates slowed in 2008 and 2009, but there was still growth. We expect nothing different looking to 2012 and beyond—irrespective of commodity price levels.

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MLPs also have limited exposure to overall economic activity. Into the teeth of the 2008-09 financial crisis and recession, gasoline consumption, for example, declined at its worst point 3% year-over-year. Yes, volumes or throughputs declined, but not a material enough decline to jeopardize MLP distributions. Into any double dip recession (should one occur), we would expect energy infrastructure throughputs to be no worse than in 2008 and 2009.

Finally, MLPs currently have distribution coverage of 1.25 times. This means that for every \$1 in distributions, the average MLP has distributable cash flow of \$1.25. In our view, this is sufficient cushion to have confidence that current MLP distributions should be at least sustainable.

MLP quarterly distributions are still expected to grow.

Not only do we view current MLP distributions as safe, we continue to believe distributions will grow annually at approximately 5%-6% year-over-year. Our distribution growth estimates include only announced organic growth projects and acquisitions. To the extent there are incremental organic growth projects and acquisitions our expectations for 5%-6% annualized distribution growth could prove to be conservative. As it pertains to our MLP Strategy, we also remain optimistic that we can grow distributions over time as well.

MLP balance sheets are well capitalized.

Relative to the 2008-09 environment, MLP balance sheets are in decidedly better shape today. Debt-to-cash flow for the sector has declined from 4.6 times at year-end 2009 to 3.5 times currently. In addition to improving their debt ratios, MLPs have also taken advantage of the attractive interest rate environment to term out their debt – pushing maturities far into the future, positioning them well to weather any potential storms.

Valuations remain supportive.

If current distributions are safe and distribution growth expectations are unchanged, how does valuation look for MLPs following the recent downdraft? With the exception of the period immediately following Lehman Brothers' bankruptcy, MLPs have historically traded at an average yield of 7.0% and in a fairly tight band of 6.0-8.0%. At current distribution rates, MLPs were yielding 6.9% at September 30. Thus, on current distribution rates, MLP stocks are trading almost right at their historical average yield. At expected 2012 distribution rates (up 5%-6% over 2011 distribution rates), MLP stocks were yielding 7.3% at September 30—a modest discount to historical yield.

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