

Mid Cap Core Strategy

3Q11

Market Review and Outlook

The third quarter saw continued high levels of stock market volatility, driven largely by macroeconomic concerns focused on sovereign debt issues in Europe and fears of a potential recession at home. In response, most segments of the domestic stock market declined for the quarter with correlations at historically high levels.

While we are fully aware of the market's gyrations and appreciate the impact of global economic factors, we believe we can add the most value by analyzing businesses and valuing stocks. That is how we have directed our efforts in the past, and we will continue to do so in the future. As has been the case over the course of our tenure as portfolio managers, we purposely don't maintain a top-down market view and tend to be relatively sector neutral, focusing on seeking out the best stocks within each industry without exhibiting a bias as to which sectors we think are going to outperform. We typically look for companies that exhibit consistently good cash generation, have strong balance sheets, produce high economic returns, have management teams that exercise capital discipline and trade at valuations that we feel offer superior risk-reward relationships. In the short run, especially during periods of stress, macroeconomic forces may overwhelm individual company dynamics but we believe that over time, fundamental analysis will prevail in driving superior results.

Regarding mid cap equities, our preference for these companies should be well known to our clients. The mid cap equity asset class, which we affectionately refer to as the "sweet spot" of the market, has outperformed both large caps and small caps on a 3-, 5-, 10-, 15-, 20-, 25-year basis (as measured by the S&P MidCap 400 Index, the S&P 500 Index and the S&P SmallCap 600 Index, respectively).

We believe mid cap stocks have historically performed so well because they are typically not starved for growth like many large cap or mega cap companies, yet they tend to have better balance sheets and less business risk than small cap stocks. Mid caps often have diversified revenue streams, with substantial growth opportunity in developing markets overseas, yet are typically not complex multinationals that are difficult to understand. These characteristics, which have helped mid cap stocks perform so well historically, also tend to attract the attention of large cap companies looking to make acquisitions. Indeed, the premium paid to the acquired mid cap company shareholders has been as much as 30% recently, highlighting yet another reason mid cap stocks are the "sweet spot" of the market.

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We believe that mid cap stocks are more likely to be consistently under-analyzed and under-appreciated than their large cap peers, and therefore more likely to be mispriced than large cap stocks. We manage our portfolios with a bottom-up stock selection process, analyzing company fundamentals and valuations, stock by stock, precisely to take

Brian Angerame

Managing Director, Portfolio Manager

- 17 years of investment industry experience
- BA in Government from Dartmouth College

Derek Deutsch, CFA

Managing Director, Portfolio Manager

- 12 years of investment industry experience
- MBA from Georgetown University
- BA from Brown University

advantage of the higher likelihood that individual mid cap stocks may be mispriced. It is very frustrating to us when virtually all stocks move in one direction, and to the same magnitude – a condition known as high correlation – which in September reached a level not seen since the 1987 “Black Monday” crash. Our ability to pick stocks and find mispriced assets is less valuable at times like these, when correlation is high.

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However, as difficult as high correlation markets can be, a positive byproduct of a market with high correlation and declining stocks is that great companies with strong balance sheets, cash flow growth and capital discipline often trade at prices that don’t reflect the true value of the company. When these opportunities arise, portfolio managers should take advantage of them. In some cases, we have been trading in somewhat mispriced companies, for significantly mispriced companies that represent, in our view, truly rare values.

These are not mundane companies offering well-understood and technologically obsolete products and services, but rather exciting mid cap companies that in many cases, are changing the way we live, eat, dress, communicate, care for ourselves and others, get from one place to another, etc. We are talking about companies that see a need in society, and seek to fill that need in an innovative way, and to profit while doing so. These are companies that not only have the opportunity to become the next great large-cap company, but we believe could also become key engines for hiring, and investment, and economic growth in the U.S. economy.

Mid cap stocks have also held up well in comparison to other equities over the longer term. Mid cap stocks have generated a compounded average annual total return of 11.03 % over the last 20 years, superior to that generated by both large cap (8.72%) and small cap (10.42%) stocks (as measured by the S&P MidCap 400 Index, the S&P 500 Index and the S&P SmallCap 600 Index, respectively). During that time, a lot of bad and unpredictable stuff has happened. Had investors chosen to ignore mid cap stocks, or equities in general during that period, they would have done a great disservice to their total returns. Likewise, we expect there will be wars, misfortune, inflation, deflation, earthquakes, tsunamis, expansions, recessions, and other crises in the future that are difficult to predict today. We also expect that people will find a way to get through those crises, as the Japanese are demonstrating (once again).

We continue to believe that the innovative and entrepreneurial spirit in the U.S. is alive and well, and that investing in mid cap companies is a great way to participate in our country’s growth potential. As always, we are so thankful for your trusting us to help you reach your financial goals.

Portfolio Highlights

On an absolute basis, for the third quarter the Strategy had losses in all nine economic sectors in which it was invested (out of 10 sectors in total). The greatest detractors from performance came from the financials, industrials and information technology (IT) sectors. Relative to the benchmark, overall sector allocation contributed to performance, while overall stock selection detracted from it.

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In particular, stock selection in the financials, consumer staples, consumer discretionary, energy, health care and industrials sectors detracted from relative performance for the quarter. In terms of allocation, an underweight to the utilities sector detracted from relative performance, but was offset by the positive impact of the Strategy's cash position.

Leading individual contributors to Strategy performance during the quarter included Nalco Holding Co. in the materials sector, Nuance Co. and Blackboard Inc. in the IT sector, Arch Capital Group Ltd. in the financials sector and Wisconsin Energy Corp. in the utilities sector. The bottom individual contributors to performance included Whiting Petroleum Corp. and Oil States International Inc. in the energy sector, Warner Chilcott PLC in the health care sector, Lazard Ltd. in the financials sector and Solutia Inc. in the materials sector.

During the quarter, we initiated positions in Lam Research Corp. in the IT sector, Lincoln Electric Holdings Inc. and CNH Global N.V. in the industrials sector, Pioneer Natural Resources Co. in the energy sector, Accretive Health Inc. in the health care sector, as well as Autoliv Inc., Tenneco Inc. and CarMax Inc., all in the consumer discretionary sector.

ClearBridge Advisors

www.clearbridgeadvisors.com

800-691-6960

info@clearbridgeadvisors.com

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