Portfolio Manager Commentary

ClearBridge Advisors
A Legg Mason Company

Mid Cap Growth 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.

We manage our portfolios with a bottom-up stock selection process, analyzing company fundamentals and valuations, stock by stock, precisely to take 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.

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

Aram Green
Managing Director, Portfolio Manager

- 10 years of investment industry experience
- BA from Union College

Jeffrey Russell, CFA
Managing Director, Senior Portfolio Manager

- 30 years of investment industry experience
- MBA from the Wharton School at the University of Pennsylvania
- BS from the Massachusetts Institute of Technology

> **"In some cases, we have been trading in somewhat mispriced companies, for significantly mispriced companies that represent, in our view, truly rare values."**

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.

Looking ahead, investors are apparently coming to grips with a new U.S. reality and, in our view, it isn't pretty. Over the next year or two, it appears federal spending cuts and expiring tax incentives and stimulus packages, in tandem with state and local budget constraints, could combine to generate a fiscal drag estimated by some forecasters at 1-2 GDP percentage points. At the same time, private consumption is expected to remain subdued as individuals increase their savings and restore their personal debt balance – both worthy goals!

While business investment should remain a source of growth, especially to replenish capital stock depleted in the last recession, investment either in physical plant or human resources will likely be muted due to the frustrations in Washington. We expect that the likely direction for the U.S. economy is modest growth at best, and a return to recession (with fewer public policy options) at worst.

Considering the muted macroeconomic outlook, we believe it's best to re-examine the merits of every position in the portfolio. Traditional safe-haven sectors and industries are not necessarily likely to be so in this unorthodox business cycle, given government spending pressures. For instance, health care industries are traditionally viewed as defensive, yet reimbursement cuts may prove quite large, as was recently experienced by the skilled nursing home sector.

We're also thinking through the investing-through-austerity approach, as are many other investors. Our concentration on market-share takers, innovative products and services to drive productivity, and appropriate capital structures to support growth, feels ever-more timely. In our opinion, our investments are significantly undervalued in the public equity markets after the markdown of the past quarter. We expect recurring revenues, such as in the software industry, will be highly attractive when macroeconomic growth is tough to come by. Surplus cash generation for tactical expansion and reinvestment in businesses with substantial growth opportunities, or for return-enhancing share repurchases, should also be prized.

In conclusion, we continue to believe that the innovative and entrepreneurial spirit in the U.S. is alive and well, and that investing in mid cap growth 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.

Strategy 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 third quarter returns came from the information technology (IT), industrials and energy sectors, while the smallest detractors came from the consumer staples, telecommunications services (telecom) and health care sectors.

Relative to the benchmark, overall sector allocation made a marginally positive contribution to relative performance while overall stock selection detracted from performance. In particular, stock selection in the health care, consumer discretionary and telecom sectors helped relative performance while selection in the industrials, IT, materials, financials and energy sectors hurt it for the quarter. As for allocation, an underweight in the materials sector and an overweight in the

"We continue to believe that the innovative and entrepreneurial spirit in the U.S. is alive and well, and that investing in mid cap growth companies is a great way to participate in our country's growth potential."

health care sector helped relative performance, but this was offset by the negative impact of an underweight in the consumer staples sector.

Leading individual contributors to Strategy performance included Alexion Pharmaceuticals Inc. and Regeneron Pharmaceuticals Inc. in the health care sector, Blackboard Inc. in the IT sector, Advance Auto Parts Inc. and Ross Stores Inc. in the consumer discretionary sector. The bottom individual contributors to performance included Solutia Inc. and Rockwood Holdings Inc. in the materials sector, Monster Worldwide Inc. and F5 Networks Inc. in the IT sectr and Peabody Energy Corp. in the energy sector.

During the third quarter, we initiated a new position in Pioneer Natural Resources Co. in the energy sector while we closed our existing position in United Rentals Inc. in the industrials sector.

ClearBridge Advisors

www.clearbridgeadvisors.com

800-691-6960

info@clearbridgeadvisors.com