

Institutional All Cap Strategy

4Q09

Market Review

After collapsing in 2008, the U.S. equity market finished 2009 with its third straight quarterly advance as the S&P 500 Index (S&P 500) gained nearly 6% in the fourth quarter and 23% for all of 2009, its best year since 2003. The market's recovery since the lows of the past spring was remarkable, with the S&P 500 gaining 65% from its 12-year low on March 9 through the end of the year. Perhaps more notable, however, was the fact that stocks closed the decade below where they began it, with the S&P 500 dropping 24% over the last 10 years for an average decline (including dividends) of 0.9% a year since 1999, the first decade of negative annualized returns for the S&P 500 since its inception in 1927.

As we emerge from the recent financial crisis, investors of every ilk are questioning their investment beliefs and goals. Our sage, CIO Harry "Hersh" Cohen, recently noted that in the wake of the recession and recovery "...the biggest losers, tragically, are the people who have done everything right. They saved, paid their mortgages, and lived within their means." These investors – many of them retirees on fixed incomes – are struggling to find higher yields, while hoping to find a way to replenish their retirement accounts.

While we understand the importance of retirement income, we also recognize that someone retiring today at 65 may live for another 30 years, and that a baby born today will not matriculate for another 18 years. In our view, these realities call for investment solutions that include a "go anywhere, do anything" all-capitalization strategy like the Capital Strategy, as part of the investment solution that can generate strong capital appreciation over long time horizons, while controlling risk.

We believe the flexibility built into the investment mandate of the Capital Strategy is one of its strongest advantages. That belief was put to the test in a very volatile 2009. We have had significant investments in foreign-domiciled companies including China, the United Kingdom, and the Netherlands. We also have investments in U.S. companies that have significant operations overseas. The flexibility of the Capital Strategy not only allows for meaningful investment in companies outside the U.S., but for investments in equities of all capitalizations, derivatives, and in other parts of the capital structure such as convertible bonds.

“We will continue to use the strategy’s flexibility to seek out and invest in the most undervalued assets we can find and to take advantage of opportunities, wherever they arise.”

Brian Angerame Managing Director, Portfolio Manager

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

Derek Deutsch, CFA Managing Director, Portfolio Manager

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

Currently, the Capital Strategy could be generally characterized as a blend of large cap growth and mid cap growth stocks, but in reality, it is simply a selection of the most attractively priced securities we have found. And while that is how the Strategy could be characterized at the end of calendar 2009, that may not be how it will look in six months or a year.

Portfolio Highlights

On an absolute basis, for the fourth quarter the Strategy had positive returns in six of the eight economic sectors in which we invested (there are 10 sectors in total). The greatest contributions to returns came from the information technology (IT), healthcare, consumer discretionary and

energy sectors, while the industrials sector detracted from returns and the consumer staples sector was flat.

Relative to the benchmark Russell 3000 Index, for the fourth quarter both overall stock selection and overall sector allocation detracted from performance. In terms of sector allocation, the Strategy's overweights to the industrials, healthcare and IT sectors and its underweight to the consumer staples sector hurt relative performance, but an overweight to the financials sector helped it. Stock selection in the financials sector helped performance while it hurt relative performance in the industrials, healthcare, IT and consumer staples sectors.

Over the course of the fourth quarter, we made a number of adjustments and changes to the Strategy's portfolio. We established new positions in a number of stocks, including Family Dollar Stores Inc. (in the consumer discretionary sector), Huabao International Holdings Ltd. (materials), Amgen Inc. (healthcare), and Bank of America Corp., XL Capital Ltd. and Allstate Corp. (financials). We also closed a number of existing positions during the quarter, including our holdings of CarMax Inc., American Eagle Outfitters Inc. and Sherwin-Williams Co. (consumer discretionary); Baker Hughes Inc. (energy); and General Electric Co. (industrials).

The leading individual contributors to Strategy performance for the fourth quarter included our positions in Google Inc. (CI A), Blackboard Inc. and Check Point Software Technologies Ltd. (IT), Li Ning Co. Ltd. (consumer discretionary) and ION Geophysical Corp. (energy). The bottom individual contributors to performance for the quarter included Palm Inc. (IT), Weatherford International Ltd. (energy); Shaw Group Inc. (industrials), American Eagle Outfitters Inc. and Family Dollar Stores Inc. (consumer discretionary), as well as puts tied to the S&P 500 Index.

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Outlook

We will continue to use the Strategy's flexibility to seek out and invest in the most undervalued assets we can find and to take advantage of opportunities wherever they arise. For example, in our experience, small cap and mid cap stocks have historically made attractive acquisition candidates for acquirers looking to supplement growth. We expect merger and acquisition activity to accelerate as corporate balance sheets are flush with cash, the credit markets are functioning again, and the economy is showing signs of stabilization. Even more exciting, M&A premiums have been high recently, averaging 56% above the recent share price of the acquired company in 2009, compared to a 47% premium for 2008 and just 19% in 2001. Additionally, we believe our ability to create an information advantage and find undervalued companies is as strong as ever today. We feel the short time horizon of hedge funds and high-frequency trading funds, combined with headcount reductions across the investment community lends itself to creating buying opportunities for mispriced stocks. In our opinion, the existence of these inefficiencies also makes a strong case for active management within all cap equities, and against the use of exchange traded funds (ETFs).

As we move beyond the market collapse and the recession, visibility of future economic and stock market activity remains extremely limited. The events leading up to and during the financial crisis, the seizing up of the credit markets, and the implosion of the housing market necessitated such drastic fiscal, monetary and regulatory measures that trying to make macroeconomic predictions is unwise, in our opinion. Thankfully, with a mandate to invest in many types of securities and equities of any market capitalization, we feel there are plenty of opportunities to make attractive investments.

Past performance is no guarantee of future results.

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