

Institutional Convertible Securities Strategy

4Q09

Market Overview

The U.S. economy turned the corner in the third quarter of 2009, with GDP posting a growth rate of 2.8% and marking the end of the worst recession since the Great Depression of the 1930s. The economic momentum has clearly continued, with the fourth quarter likely to show an acceleration of economic growth extending into the new year. The U.S. equity market, having anticipated recovery since the lows in March, gained another 6% in the fourth quarter (as measured by the S&P 500 Index) to finish the year with a gain of 26%.

Driven by a nearly 61% gain in the underlying equities and a more than 1100 basis point contraction in high yield credit spreads over the year, the Merrill Lynch All U.S. Convertible Index (“Convertible Index”) enjoyed a spectacular year in 2009, gaining over 49%.

Strategy Highlights

For the full year, not only did the Convertible Securities Strategy outperform the benchmark Convertible Index meaningfully, but it also outperformed the S&P 500 Index, a relatively unusual occurrence in a period of rising equity prices. The Strategy’s outperformance for the year was due primarily to its stock selection, while its sector allocation was also a positive factor, but to a lesser extent. For the fourth quarter however, the Strategy underperformed the benchmark, due largely to security selection, while sector allocation had a positive impact relative to the benchmark.

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led by our position in Conexant Systems Inc., a provider of semiconductor products for use in communications electronics including wireless communications, network access, network processing, digital entertainment, personal imaging and personal computing applications. The second largest contributor within the IT sector was Corning Inc., a global technology company that produces a range of glass, ceramics, crystals, plastics, fiber optic cable and related materials for use in the manufacturing, telecommunications, pharmaceutical, scientific and other industries.

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For the fourth quarter, the financials sector made the greatest contribution to Strategy returns, led by securities of Dollar Financial Corp., which provides check-cashing, short-term consumer loans, money orders and money transfers. The second greatest contributor in the sector was Simon Property Group Inc. a real estate investment trust (REIT) that owns, develops, and manages retail real estate properties including regional malls and outlet centers.

The second greatest group contributor to Strategy returns for the quarter was the information technology (IT) sector,

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The only negative group contributors to Strategy returns for the fourth quarter came from the smallest group in the Strategy, the utilities sector, where the sole holding was the convertible preferred shares of NRG Energy Inc., operator of a diverse portfolio of power-generating facilities in the U.S., The smallest contributor for the quarter was the energy sector, where the worst contributors were our positions in Trico Marine Services Inc., which provides marine support vessels and services to the oil and gas industry, and El Paso Corp., which operates natural gas pipeline and storage facilities, transports natural gas, imports liquefied natural gas and also explores for and produces natural gas.

For the full year, the IT sector, which grew from the third largest to second largest group in the Strategy during the year, was the best contributor to returns. Within the sector, the leading contribution to performance came from the convertible bonds of Powerwave Technologies Inc., a manufacturer of wireless communications products including antennas, boosters, filters, radio frequency power amplifiers and advanced coverage solutions, followed by the securities of Savvis, Inc., a provider of hosting, network and application services to information intensive customers.

The second best group contributor to Strategy returns for 2009 was the Financials Sector, which remained the largest sector in the Strategy for the year. Within the group the top contribution to performance came from the convertible bonds of Dollar Financial Corp., a provider of check-cashing, short term consumer loans, money orders and money transfers in the U.S., Canada and the U.K., followed by the convertible preferred shares of Bank of America Corp., a large diversified financial services provider.

There were no negative group contributors to Strategy returns for the year. As with the fourth quarter's results, the weakest contribution came from the utilities sector and its sole holding, NRG Energy Inc. which had a modest gain for the year. This was followed by the consumer staples sector which fell from third to second smallest in the Strategy over the year. Within that group, the poorest performance came from the convertible bonds of Rite Aid Corp., operator of a retail drugstore chain in the U.S., followed by the convertible bonds of Central European Distribution Corp., a producer and distributor of beer, wine and spirits in Eastern Europe.

Outlook

We have a positive view of U.S. equity markets for 2010. We believe the economic recovery has just gotten underway and think it likely has years to go. There is, in our view, a very powerful earnings cycle ahead – corporate America reacted very forcefully to the recession by trimming costs aggressively (hence the rapid rise in unemployment that we experienced) so we expect the coming improvement in sales to result in very strong growth in profits and cash flows for corporations.

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The recovery seen in the credit market has been dramatic, and while the contraction in high-yield credit spreads may not be over, we believe the pace of improvement will certainly slow. The influence of interest rates on the convertible market is therefore declining, while that of the underlying equity prices is increasing. Since the lows of March, the delta of the convertible market to its underlying stocks has increased by 150 basis points. We expect this process to continue.

Past performance is no guarantee of future results.

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