CLEARBRIDGE ADVISORS
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Institutional Mid Cap Core Strategy 4Q09

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Market Review

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 can generate strong capital appreciation over long time horizons, while managing risk. We believe mid-cap equities can play a key role in investment solutions that are designed to help meet these long-term capital appreciation goals.

Indeed, while recent media reports have focused on the "lost decade" of equity returns, examining the actual returns of some common proxies reveals that mid-cap stocks performed relatively well when compared to their large-cap and small-cap peers over the last 5-, 10- and 20-year time periods. In the five years ended December 31, 2009, mid-cap stocks as measured by the S&P 400 MidCap Index generated an annualized return of 3.27%, compared to large-cap stocks (as measured by the S&P 500 Index) which returned 0.42% and small-cap stocks (represented by the S&P 600 SmallCap Index) which returned 0.51% for the same period. The pattern of outperformance holds over longer periods as well: for the 10-year period ended December 31, mid-cap stocks generated an annualized return of 6.36%, compared to returns of -0.95% and 6.35% for large caps and small caps, respectively. For the 20-year period, midcap stocks produced an annualized return of 11.71%, compared to large caps' return of 8.21% and small caps' return of 9.65%. Although there is no way to make predictions, we do not see any reason why mid-cap stocks could not post similarly competitive returns over the next 20 years.

However, there are three important reasons why we are bullish about mid-cap stocks for the short term as well. First, on average, mid caps have outperformed large and small caps for both the 12- and 24-month periods following the end of the last three recessions. Again, while the past is no guarantee of the future, based on this track record we believe mid-cap stocks may perform well as we exit this recession. Second, mid-cap stocks have historically made attractive acquisition candidates for acquirers looking to supplement growth, especially when the economy is sluggish and organic growth can be difficult to generate. We expect merger and acquisition activity to accelerate, because 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. Third, 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 highfrequency trading funds, combined with headcount reductions across the investment community, lends itself to creating buying opportunities for mispriced stocks. The existence of these inefficiencies, in our opinion, also makes a strong case for active management within mid-cap equities and against the use of indexing and exchange-traded funds (ETFs).

Portfolio Highlights

On an absolute basis, for the fourth quarter the Strategy had positive returns in seven of the nine economic sectors in which we invested (there are 10 sectors in total). The greatest contributions to returns came from the healthcare, consumerdiscretionary, materials and energy sectors, while the utilities and consumer staples sectors detracted from returns.

Relative to the benchmark S&P MidCap 400 Index, for the third quarter both overall stock selection and overall sector allocation detracted from performance, although the only significant negative factor in terms of sector allocation was the Strategy's cash position. In particular, stock selection in the healthcare, energy, consumer discretionary and materials sectors made significant contributions to relative performance, but stock selection in the information technology (IT), utilities, industrials and consumer staples sectors negatively impacted it.

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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 Jarden Corp., Family Dollar Stores Inc., AnnTaylor Stores Corp. and Ross Stores Inc. (in the consumer discretionary sector), Oceaneering International Inc. (energy), Rockwood Holdings Inc. and Huabao International Holdings Ltd. (materials), Great Plains Energy Inc. (utilities), Regeneron Pharmaceuticals Inc. (healthcare) and Valmont Industries Inc. (industrials). We also closed a number of existing positions during the quarter, including our holdings of Baker Hughes Inc. (energy); CarMax Inc., Hibbett Sports Inc., American Eagle Outfitters Inc. and Sherwin-Williams Co. (consumer discretionary); CenterPoint Energy Inc. (utilities); Digital River Inc. (IT) and Pharmaceutical Product Development Inc. (healthcare).

The leading individual contributors to Strategy performance for the fourth quarter included our positions inAllegheny Technologies and Celanese Inc. in the materials sector, Bristow Group Inc. and Blackboard Inc., both in the IT sector, as well as Regeneron Pharmaceuticals in the healthcare sector. Group Inc., in the energy sector,. The bottom individual contributors to performance for the quarter included Digital River Inc. and Palm Inc. in the IT sector, Agnico-Eagle Mines Ltd. in the materials sector, NRG Energy Inc. in the energy sector and Shaw Group Inc. in the industrials sector.

Outlook

As we move beyond the market collapse and the recession, visibility of future economic and stock market activity remains extremely limited. The events that led up to the financial crisis, and its consequences – 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 mid-cap stocks, we feel there are plenty of opportunities to make attractive investments. What is it about the mid-cap segment of the market that makes it such fertile territory for growth investing? Simply put, we believe it is that mid-caps tend to be well-capitalized, fast-growing and innovative companies, which are relatively less well known than their large-cap cohorts – companies we think of as diamonds in the rough. Examples of these gems, in our opinion, include companies we hold that own and manage convenience stores selling pizza and gasoline in the Midwest, a company that owns pediatric and anesthesiology practices, another company that builds nuclear power plants, and an innovative software maker helping secondary schools and colleges to operate more productively and cost-effectively.

We thank you for your continued confidence in us to find those diamonds in the rough, and for investing with us.

Past performance is no guarantee of future results.