

Institutional Small Cap Growth Strategy

4Q09

Market Review

Investors have every right to feel spent after the events of 2009. Following the collapse of some major financial institutions and the evaporation of credit markets in the second half of 2008, the U.S. fell into a severe economic contraction that continued through the start of 2009. Consumer spending froze, businesses large and small cut costs and inventory with a ferocity not seen before, and the equity market sank to a dispiriting low in March 2009. Fortunately, an economic depression was averted through the timely, unconventional, and at times unimaginable policy responses implemented by the federal authorities and their counterparts in non-U.S. economies. From the March lows to the end of the year, the benchmark Russell 2000 Growth Index of small-cap growth companies has risen over 80%, a stunning reversal that has many investors questioning whether stocks have moved ahead of likely fundamental earnings trends in the year ahead.

Earlier this year, the rally was led by the “smallest of the small” stocks and those with relatively low returns on capital, while the last few months of the year saw the larger and often higher-quality small-cap stocks assert performance leadership. The Small Cap Growth Strategy continued to be composed primarily of what we believe to be soundly capitalized companies with durable earnings trajectories.

The last several months of the year were marked by the raising of tens of billions in capital, primarily for institutions that were at the center of the vortex of the financial crisis. More-forgiving financial markets and growing risk appetites allowed companies to raise much-needed capital and repay emergency resources (i.e., TARP funds) back to the U.S. Treasury. We anticipate a heavy schedule of fundraising activities in the first half of 2010, from companies looking to exploit the weaknesses of their competitors to those that still have overly debt-leveraged capital structures with looming debt maturities, as well as initial public offerings. While investors were reminded of the considerable risks remaining in selected sovereign credits (i.e., Dubai, Greece), risk appetite and attractive valuations trumped cautious inertia as corporate executives launched deca-billion dollar mergers in the U.S. energy sector (i.e., Exxon and XTO Energy) and transportation sector (i.e., Berkshire Hathaway and Burlington Northern). A host of smaller transactions were also announced in the healthcare and technology sectors as the year drew to a close.

“While the equity rally earlier in 2009 could be attributed to hopes that stimulus would lead to improved aggregate demand, there is little argument now that the economy is on the mend.”

Jeffrey Russell, CFA, Managing Director, Senior Portfolio Manager

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

Aram Green, Managing Director, Portfolio Manager

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

Portfolio Highlights

In terms of absolute performance, the Strategy had positive returns in nine out of the 10 economic sectors during the fourth quarter, with the greatest contribution to returns coming from the information technology (IT) and healthcare sectors, while only the energy sector detracted from performance. Relative to the benchmark Russell 2000 Growth Index, both the Strategy's overall stock selection and its overall sector allocation contributed to performance for the quarter, with stock selection

PORTFOLIO MANAGER COMMENTARY



accounting for the majority of the Strategy's outperformance. In particular, stock selection in the IT, healthcare, utilities and telecommunications services (telecom) sectors made significant contributions to relative performance, while stock selection in the energy and consumer staples sectors had a negative impact. As for sector allocation, the only significant impacts on Strategy performance for the quarter were its overweight to energy and its underweight to healthcare, both of which helped relative performance.

Looking at our activity in the past quarter, we continued to trim selected portfolio positions for the purpose of risk control and we said goodbye to a few positions that either moved out of our target capitalization range or whose fundamentals had become problematic for us, including Lawson Software Inc. (in the IT sector), American Tower Corp. and Leap Wireless International Inc. (telecom), SandRidge Energy Inc. and ION Geophysical Corp. (energy), Herman Miller Inc. (industrials), and Alexandria Real estate Equities Inc. (financials).

A number of positions were initiated during the fourth quarter, including our new holdings in Regeneron Pharmaceuticals Inc. and Vanda Pharmaceuticals Inc. (in the healthcare sector); Penn National Gaming Inc., Jos. A. Bank Clothiers Inc. and PetMed Express Inc. (all in the consumer discretionary sector); AeroVironment Inc. (industrials); and ComScore Inc., Cymer Inc., Fortinet Inc. and Hollysys Automation Technologies Ltd. (all in the IT sector). We look forward to reporting to you on these companies, and what we expect will be their significant progress and growth, in the future.

The leading individual contributors to Strategy performance for the fourth quarter included MercadoLibre Corp., Blackboard Inc. and Sourcefire Inc. all in the IT sector, SBA Communications Corp. in the telecom sector, and Regeneron Pharmaceuticals Inc. in the healthcare sector. The bottom individual contributors to Strategy performance for the quarter included Digital River Inc. in the IT sector, SandRidge Energy Inc. in the energy sector, Primus Guaranty Ltd. in the financials sector, Auxilium Pharmaceuticals Inc. in the healthcare sector and The Shaw Group Inc. in the industrials sector.

ClearBridge Advisors

www.clearbridgeadvisors.com

800-691-6960

info@clearbridgeadvisors.com

Outlook

While the equity rally earlier in 2009 could be attributed to hopes that stimulus would lead to improved aggregate demand, there is little argument now that the economy is on the mend. The debate has moved on to the vitality of the recovery once stimulus is removed. In the meanwhile, we look forward to leveraged earnings recovery as an important impetus to stocks, given the substantial cost-cutting and inventory reductions by companies for much of the past year. Gold prices ascended enormously during 2009 and many have interpreted gold's rise as a barometer of rising inflation pressures. The European and U.S. central banks held short-term interest rates constant and at historic low levels as 2009 ended, while the Australians increased short-term interest rates by 25 basis points during the fourth quarter, the first major economy to begin the policy "tightening process." We believe that inflation will remain under reasonable control in 2010, yet concede that the removal of monetary stimulus from a still fragile economy will be a delicate balance, especially during upcoming mid-term U.S. elections. Given the extent of the uncertainty about 2010, we remain steadfast in our stock selection approach, which stresses high-quality, well-capitalized small-cap growth companies with above-average growth trajectories.

Past performance is no guarantee of future results.

Copyright © 2010 ClearBridge Advisors

ClearBridge Advisors consists of ClearBridge Advisors, LLC and ClearBridge Asset Management Inc.

All opinions and data included in this commentary are as of December 31, 2009 and are subject to change. The opinions and views expressed herein are of the ClearBridge Advisors, LLC Small Cap Growth portfolio management team and may differ from other managers, or the firm as a whole, and are not intended to be a forecast of future events, a guarantee of future results or investment advice. The statistics have been obtained from sources believed to be reliable, but the accuracy and completeness of this information cannot be guaranteed. Neither ClearBridge Advisors, LLC nor its information providers are responsible for any damages or losses arising from any use of this information. Russell®, Russell 2000® Index and Russell 2000® Growth Index are trademark/service marks of the Frank Russell Company. Further distribution is prohibited.