

Appreciation Strategy

4Q11

Market Review

While 2011 was a difficult and trying year, as macroeconomic and political events created a volatile environment for investors on a global basis, the S&P 500 Index ended almost exactly where it started the year. There were more daily moves above 1% in the market during 2011 than in any prior year. Correlation (the tendency for stocks to move together) was at a record high and dispersion (how tightly clustered stock returns are) was low. These trends made for a difficult year for most money managers. One approach that did work in many cases was to focus on high quality stocks with strong capital management - more specifically, those companies that returned capital to shareholders through high or rising dividend yields, or by large share repurchases. Fortunately, the Appreciation Strategy has consistently used this approach to stock selection in building our portfolios for shareholders.

We entered the year believing that stock valuations were generally attractive. However, we worried that three significant risks had the potential to disrupt forward growth assumptions, and therefore stock prices. These concerns included the fear of government policy mistakes in the U.S., the effects of the European sovereign debt crises, and the potential for a meaningful slowdown in the emerging economies. To varying degrees, all three issues affected stock performance during the past year but clearly the European debt situation occupied center stage.

“We believe that after three years of deleveraging, U.S. growth, while likely to continue to be modest, is on a path towards improvement.”

In Europe, fiscal profligacy in Greece caused a default in all but name. Large budget deficits in Spain and a high debt burden as a percentage of GDP in Italy threatened to create a liquidity squeeze. The resulting decline in the value of sovereign bonds in Europe damaged the capital levels of banks across Europe. The European Union, as a confederation, was unable to respond as quickly as the U.S. was during the 2008 financial crisis. Nonetheless, it now appears to us that the European Central Bank (ECB) together with the leading sovereign states, has made enough progress to forestall a larger crisis. The creation of the various TARP-like funding mechanisms (i.e., the European Financial Stability Facility and the European Stability Mechanism), along with the participation of the International Monetary Fund, and the decision to allow European banks to borrow cheap funds from the ECB for an extended period, has averted a liquidity squeeze. Looking forward, we believe it is critical that the European banks

build capital through earning attractive spreads, divesting non-critical operations, and continuing to raise capital to stabilize financial conditions. Germany appears to be moving in the direction of providing a financial backstop for the Southern European countries in return for more control over their fiscal policies.

The U.S. has suffered its own crisis, stemming from a lack of confidence in our government's ability to create a credible jobs-oriented growth plan and its failure to address our growing budget deficit. The issue reached a boiling point in August with Standard & Poor's downgrade of the U.S. credit rating to AA. The current political environment is unlikely to result in any material changes to the status quo until, possibly, after next year's election. Fortunately, the Federal Reserve, which we believe has acted credibly throughout the economic crises, has promised to keep rates low for an extended period of time to foster growth and investment. In fact, we believe that after three years

Scott Glasser Managing Director, Senior Portfolio Manager

- 20 years of investment industry experience
- MBA from Pennsylvania State University
- BA from Middlebury College

Michael Kagan Managing Director, Senior Portfolio Manager

- 26 years of investment industry experience
- BA in Economics from Harvard College

of deleveraging, U.S. growth, while likely to continue to be modest, is on a path towards improvement. Recent economic data including climbing housing starts, auto sales, lower unemployment claims, and importantly, increased bank loan activity has created some upside momentum. While the debate will focus on the sustainability of recent data, we are becoming more optimistic on U.S. growth in 2012. Ironically, we spent the last few years being more pessimistic than most, so this signifies an uptick in expectations.

“While the debate will focus on the sustainability of recent data, we are becoming more optimistic on U.S. growth in 2012.”

Meanwhile, emerging economies like China, India and Brazil have continued to slow after outsized growth during prior years. This process has moved at a digestible pace for the rest of the world and to date, they have avoided the dreaded “hard landing” that many feared. It is worth noting that the majority of these economies had been raising interest rates to curb speculation and growth rates and to slow inflation. With these objectives more or less achieved, their Central Banks have reversed course and are actively lowering interest rates to stimulate demand. We are modestly negative on emerging markets growth and have positioned the Appreciation portfolio from a stock and sector perspective accordingly.

We expect these three issues, as well as possible problems in the Middle East, to continue to create headlines and volatility in 2012. In short, we are more optimistic about the U.S. economy, more pessimistic about the European economy, and think emerging economies will continue to slow at a managed pace but avoid a more dire consequence.

Portfolio Highlights

In terms of absolute returns, all 10 industry sectors in the Strategy’s portfolio had positive performance for the fourth quarter. The greatest contributions to returns came from the energy, information technology (IT) and consumer discretionary sectors, while the smallest came from the utilities, telecommunication services and consumer staples sectors.

Relative to the benchmark S&P 500 Index, significant contributors to performance included stock selection in the consumer discretionary and materials sectors, while selection in the industrials sector detracted from relative performance for the quarter.

Leading individual contributors to Strategy performance included Travelers Cos. in the financials sector, Exxon Mobil and Spectra Energy Corp. in the energy sector, Pfizer Inc. in the health care sector and Walt Disney Co. in the consumer discretionary sector. The bottom contributors to performance included Oracle Corp. and eBay Inc. in the IT sector, Newfield Exploration Co. and Apache Corp. in the energy sector and Novartis AG in the health care sector.

During the fourth quarter, we took advantage of the market’s volatility to establish several new Strategy positions where we felt an attractive long-term opportunity had arisen, including those in Intel Corp. and VeriFone Systems Inc. in the IT sector, Occidental Petroleum Corp., National Oilwell Varco Inc., Devon Energy Corp. and Cameron International Corp., all in the energy sector, Emerson Electric Co. in the industrials sector, McCormick & Co. Inc. in the consumer staples sector, NV Energy Inc. in the utilities sector, as well as in Prudential Financial Inc. and Morgan Stanley, both in the financials sector.

“During the fourth quarter, we took advantage of the market’s volatility to establish several new Strategy positions where we felt an attractive long-term opportunity had arisen...”

PORTFOLIO MANAGER COMMENTARY



We also closed several of our existing positions, including those in Potash Corp. of Saskatchewan Inc. in the materials sector, Halliburton Co., El Paso Corp. and Brigham Exploration in the energy sector, Cummins Inc., Deere & Co. and Stericycle Inc. in the industrials sector, PPL Corp. in the utilities sector, NetApp Inc. in the IT sector, and Human Genome Sciences Inc. in the health care sector.

Market Outlook

Our outlook has led us to shift our portfolio positioning. During 2009 and 2010, we had felt that the international economies would grow more quickly than the U.S., but we are currently looking to add stocks with more of a U.S. focus, or stocks where concerns over international exposure are already reflected in low valuations. Our portfolio has had a significant underweight in the financials sector since 2007.

Stronger capital ratios, improved lending activity and low valuations appear to offer attractive opportunities in selected U.S. financial stocks, and we no longer hold as negative an opinion on the sector. In contrast, and consistent with our concerns about global growth rates, our weighting in the industrials sector and in more cyclically-oriented companies has declined from prior levels.

Finally, our exposure to health care companies, and in particular pharmaceuticals companies, has increased. After a decade-long period of underperformance marked by multiple contraction and slowing earnings growth, we think that drug companies earnings are likely to start rising again. In addition, we feel new CEO leadership, cost cuts, low valuations and high and rising dividend yields make the sector attractive and worthy of increased exposure.

In the current environment, we remain convinced that the Appreciation Strategy's focus on owning a diversified portfolio of high quality companies with strong capital management continues to make sense. In our opinion, this is also the best way to manage risk in a world where growth is challenged and outcomes less certain.

ClearBridge Advisors

www.clearbridgeadvisors.com

800-691-6960

info@clearbridgeadvisors.com

Past performance is no guarantee of future results.

All opinions and data included in this commentary are as of December 31, 2011. The opinions and views expressed herein are of the ClearBridge Advisors, LLC Appreciation 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.

Copyright © 2012 ClearBridge Advisors