

Large Cap Growth 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. Investors are factoring in a fair amount of skepticism as it relates to the magnitude and duration of the recovery that began in 2009. To apply some numbers to this thesis, consider this: In 2011, the S&P 500 Index return was flat compared to the previous year, while earnings (according to consensus estimates) should be up 16%, and in 2010, the S&P 500 was up 13%, yet earnings were up 38%. In other words, the market has been compressing the price-to-earnings multiple for two years, mathematically becoming cheaper. Relative to U.S. Treasuries, equities are nearing unprecedented valuation levels.

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 market economies. To varying degrees, all three issues affected stock performance during the past year, but clearly the European debt situation occupied center stage.

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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, even though the problem is not new and had the same origin as the U.S. problem. The analogy of “kicking the can down the road” fits well here. 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. Furthermore, in a show of solidarity, a massive coordinated effort was created (by the ECB, the U.S., the Bank of Japan and others) to provide a dollar-swap facility for those banks and sovereigns’ having difficulty accessing U.S. dollars.

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 good news is that we have finally pulled back the curtain on the looming

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financial disaster in Europe and there is no going back. Years and years of benign neglect have taken its toll. Tangible improvements and significant sacrifices will have to be made.

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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 Joint Select Committee on Deficit Reduction (the “Supercommittee”) tasked with reducing ongoing deficits had a near-zero chance of success, in our view. The current political environment remains poisonous and is unlikely to result in any material change to the status quo until, possibly, after next year’s election.

We believe that after three years of deleveraging, U.S. growth, while likely to continue to be modest, is on a path toward 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 likely focus on the sustainability of these improvements, we believe that growing optimism will have a positive effect on purchasing and investment decisions.

That said, as we see it, there are still major issues that must be balanced out. One of the more significant challenges is the massive refinancing risk that has to occur in 2012: In excess of \$7 trillion of developed nations’ sovereign debt has to be refinanced, at the mercy of the buyer (i.e. rates could be unfavorable). Another risk is the eventual depth and duration of Europe’s recession. With Europe being the largest trading partner with China, what are the knock-on effects of China’s manufacturing engine? The implications are potentially large as this base has to get right-sized. The risk that is hardest for us to handicap would be the oil price implications surrounding barge transit within the Strait of Hormuz if a conflict were to erupt with Iran.

Strategy Highlights

In terms of absolute performance, the Strategy had gains in all eight economic sectors (out of 10 total) in which it was invested during the fourth quarter. The greatest contributions to Strategy performance came from the information technology (IT), consumer staples and health care sectors, while the smallest contributions came from the materials, financials and energy sectors.

Relative to the benchmark Russell 1000 Growth Index, the Strategy’s stock selection in the IT and consumer staples sectors significantly contributed to performance for the quarter. Stock selection in the consumer discretionary sector, along with underweights in the energy, industrials and materials sectors and an overweight to the IT sector, detracted from relative performance.

Leading individual contributors to Strategy performance during the fourth quarter included Google Inc., Visa Inc. and Akamai Technologies Inc. in the IT sector, Home Depot Inc. in the consumer discretionary sector and CVS Caremark Corp. in the consumer staples sector. The bottom individual contributors to Strategy performance included Amazon.com Inc. in the consumer discretionary sector, Oracle Corp. and Broadcom Corp. in the IT sector, Thermo Fisher Scientific Inc. in the health care sector and Apache Corp. in the energy sector.

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Over the course of the fourth quarter, we established new Strategy positions in EMC Corp. in the IT sector and EOG Resources Inc. in the energy sector, and closed existing positions in Halliburton Co. in the energy sector and Human Genome Sciences Inc. in the health care sector.

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Market Outlook

Looking ahead, we will continue to seek companies exposed to large secular global themes. We believe brands are growing in importance. Without a powerful brand or a well-protected niche that can be differentiated by service or protected by large barriers, such as patents or distribution networks, the twin specters of globalization and the Internet will be felt by all but the most localized of companies. We seek large installed bases that benefit from scale, which in turn, can create natural monopolies or companies that have a sustainable cost advantage.

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