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Fourth Quarter Commentary

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With so many factors and events buffeting the financial markets, it's hard to know where to begin a letter that summarizes the past and has relevance for the year ahead. It's now apparent that the biggest issue for the markets is not the jobless rate, the European debt, or the possible slowdown in China. Rather, it's the remarkable and disturbing volatility of all the financial markets that is most responsible for keeping both individuals and professional investors either very cautious, and/or out of stocks entirely. According to the best information we can gather, the last time volatility was as high as today was in the 1930s.

While the economy is not as dire as it was 80 years ago, clearly this ongoing recession, which is the product of the collapse of a world-wide debt bubble, has more in common with the 1930s than with any other post-World War II contraction. We believe that the removal of certain safeguards and reforms from the Great Depression has contributed greatly to the wild market fluctuations, and resulting anxieties. In particular, we think the overturn of the Glass-Steagall Act's banking regulations, the abolition of the uptick rule on short selling, and sophisticated rapid computer trading that can exacerbate market moves are responsible agents for much of the equity market volatility. This volatility, combined with the ominous headlines out of Europe, has sent potential investors fleeing to the safety of minimal return treasury securities.

What we find most disturbing about this reaction to the volatility is that we fear the nation is losing both a generation of potential young investors and also older folks now fearful at exactly the time when they need income. While Federal Reserve Chairman Bernanke has done a masterful job of saving the country from financial disaster after the crash of 2008, his policy of ultra-low interest rates has punished savers. The Federal Reserve is even now considering extending their commitment to keep short-term interest rates near zero from 2013 to 2014.

Two years ago, we talked about the need for individuals as well as non-taxable portfolios to step out a bit on the risk curve. We were asked repeatedly how to get more income with no risk. We replied that one could not get more income with NO risks but advocated a portfolio of high quality stocks with the ability to pay a rising stream of dividends for a portion of a client's funds.

For the first time since the 1950s, high quality stocks offered greater up-front yields than fixed income securities. As a result of the decade long economic and stock market malaise, valuations on these stocks are quite reasonable, one of the reasons that despite the rash of bad news in 2011, the popular stock averages have not caved in.

Despite yields that are attractive on both an absolute and relative basis, and despite attractive valuations, investors continue to abandon the market. We fear that by the time discouraged investors feel comfortable returning to stocks, they will have missed the cream of any move. The story of stocks with rising dividends continues to be valid, but long-term benefits are enhanced materially by good entry points.

While we still believe that attractive valuations would limit downside, we need to see several conditions met before the stock market can break out of its doldrums. First, we need to see volatility abate (unfortunately, this will likely be a drawn out process). Consequently, we endeavor to use volatility on the downside to our advantage, by making purchases during weak spells. Second, it appears that some miracle must change the way Washington politics continue to cast an ominous shadow over our country. These are extraordinary times for the economy, and we have stated previously our belief that the world cannot "cut its way to prosperity." Third, a U.S.-type solution to the European banking crisis would enhance confidence. Recent moves by the European Central Bank to provide liquidity are promising steps in that direction. Finally, the domestic economy, showing minor signs of bottoming, needs to continue to recover without falling back into a quagmire. Job creation would benefit greatly from some housing stabilization - recent signs suggest a bottoming process is occurring.

One bright spot has emerged which could prove to be meaningful. Through major advances in technology, the outlook for the domestic energy sector has improved dramatically in the last few years. The development of shale energy has the potential to create significant jobs, reduce energy costs, reduce dependence on foreign oil and materially improve the country's balance of payments. Imagine all the funds flowing overseas staying at home instead!

We continue to feel that high quality stocks with the ability to pay a rising stream of dividends, despite stomach-churning dips, remain the asset category of choice. In a very difficult environment, we are proud of our successful efforts to handle entrusted money in a prudent and profitable manner.



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