

ClearBridge Small Cap Growth Strategy

4Q11

Market Review

Small capitalization growth stocks surged during the fourth quarter of 2011 despite more than enough excuses to decline. The news from Europe was worrisome, while China and other emerging economies slowed and the political discord in Washington reached a fever pitch with the budget Supercommittee failing to accomplish anything. Since many investors and short-term traders remained transfixed by European market developments, the U.S. equity markets have been practically schizophrenic day-to-day, based on the latest yield spread inflection.

Yet the “real” U.S. economy surprised to the upside during the fourth quarter, with each week bringing improved data on industrial production, labor markets, and quiescent inflation.

Despite the trans-Atlantic distractions and real possibility of contagion, the U.S. equity market remained resilient, powered by good corporate earnings reports and very attractive valuations compared to fixed income alternatives.

During the quarter, we believe equity markets were powered by four key factors. First, earnings ranged from good to very good, while guidance from companies was guarded given the likely European contraction, but better than many had feared. Second, a variety of macroeconomic indicators showed that U.S. economic growth accelerated in the fourth quarter, in contrast with the depressingly high headline unemployment rate. Third, mergers and acquisitions continued to be announced, though at aggregate amounts lower than expected given the political noise in Washington. Nevertheless, strategically sensible transactions are financeable and almost invariably accretive. Finally, nominal interest rates remained low. Our Federal Reserve has stated plainly that short-term benchmark rates would remain subdued until at least 2013. Longer-dated Treasury instruments were again the safe-haven of choice for both domestic investors and non-U.S. investors seeking perceived safety.

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included stock selection in the health care, utilities and energy sectors, as well as an underweight to the energy sector and an overweight to the utilities sector. Leading individual contributors to Strategy performance included Taleo Corp. and MercadoLibre Corp. in the IT sector, Bally Technologies Inc. in the consumer discretionary sector and United Rentals Inc. and MSC Industrial Direct Co. in the industrials sector. The bottom contributors to performance included Athenahealth Inc., Volcano Corp., Integra LifeSciences Holdings Corp. and Endocyte Inc., all in the health care sector, and Digital River Inc. in the IT sector.

Aram Green Managing Director, Portfolio Manager

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

Jeffrey Russell, CFA Managing Director, Senior Portfolio Manager

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

Portfolio Highlights

In terms of absolute performance, the Strategy had gains in nine out of 10 economic sectors during the fourth quarter, with the greatest contributions to returns coming from the information technology (IT), consumer discretionary and industrials sectors, while the utilities sector detracted from returns for the period.

Relative to the benchmark Russell 2000 Growth Index, stock selection in IT, consumer discretionary, financials and consumer staples sectors helped performance for the quarter, as did an underweight to the consumer staples sector. Detractors from relative performance for the quarter

PORTFOLIO MANAGER COMMENTARY



Throughout the quarter, we continued to uncover what we feel are promising small cap growth stocks. We harvested gains in several positions during the quarter, as the companies had matured to the upper end of our capitalization range. We also began investments in several small cap growth stocks. New positions initiated during the fourth quarter included FEI Co., Imperva Inc. and Jive Software Inc., all in the IT sector, as well as Newpark Resources Inc. in the energy sector. We closed our existing positions in several companies, including GMX Resources Inc. in the energy sector, A123 Systems Inc. in the industrials sector, Fusion-io Inc. and Blackboard in the IT sector, Urban Outfitters Inc. in the consumer discretionary sector and Regeneron Pharmaceuticals Inc. in the health care sector.

We focus on companies that have what we believe are innovative products and services to drive productivity or improved outcomes for businesses and consumers. During the quarter, one of our IT sector holdings, Novellus Systems Inc., reached an agreement to be acquired by Lam Research Corp. This is one of many examples during the past 24 months of companies in the Strategy that have been acquired or approached due to undervaluation. We expect that larger companies, struggling to grow organically and deploy capital productively, will continue to find the small cap space to be fertile acquisition ground.

Outlook

Looking ahead, we continue to view small cap stocks as attractively valued, though patient selectivity and risk awareness are values to which we adhere strongly. While it is difficult to imagine a more eventful year than 2011 – one filled with political regime changes, substantial gyrations of security and commodity prices, and natural disasters – there doubtless will be events in 2012 that will give equity markets pause, none of which can be foreseen or anticipated now. At a minimum, the political messaging in the U.S. will be piqued during the upcoming election year.

We believe that recurring revenues and innovation will continue to be highly attractive, while macroeconomic growth is challenged. Compared to the Russell 2000 Growth Index benchmark, we remain overweight information technology sector stocks, with a clear bias towards cash generating software companies, and underweight health care and consumer discretionary sector stocks.

The Small Cap Growth Strategy's portfolio is split between high growth companies investing for competitive advantage (therefore consciously limiting profit margin expansion) and steady growth companies with abundant surplus cash generation being used for capitalization shrinkage and/or constructive acquisitions. We manage the portfolio with a balanced view toward driving returns, yet with an equal awareness of the operating and capital risks assumed in each of our portfolio holdings. Partnering with forward thinking managements in well-capitalized, innovative small cap growth companies is the best way we know of to preserve and grow investors' capital.

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Past performance is no guarantee of future results.

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