

Large Cap Value Strategy

4Q11

Market Review

The equity market rallied strongly in the fourth quarter to finish another roller coaster year up a modest 2.11%. After a solid start to the year, supported by a gradually improving economy, investors became increasingly concerned about a lack of political will in both the U.S. and Europe to address unsustainable budget deficits. These concerns became particularly acute during the third quarter as investors focused on the possibility of actual default by weaker European countries and the unknown contagion within Europe and globally. Remarkably, despite limited progress in resolving these issues, markets demonstrated impressive resilience as the year concluded.

Massive fiscal and monetary stimuli, generated by record budget deficits and unprecedented monetary actions, have helped the U.S. economy sustain relatively steady growth throughout 2011. Capacity utilization improved modestly to 77.8% in the most recent reading from 75.8% in the prior year. Weekly initial U.S. jobless claims drifted below 400,000 and total employment increased a bit throughout the year. These government driven stimuli are unsustainable in the long run, but over time, we expect a more robust private sector to play a larger role. This is particularly true in housing where falling home prices and low mortgage rates have led to record levels of housing affordability. It is our expectation that the gradual healing we have seen in the economy will continue, but that rates of economic expansion will be limited by the eventual need to significantly reduce the federal budget deficits.

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Perhaps the biggest surprise of the year for us has been the continued strength exhibited by U.S. Treasuries in the face of ongoing record federal budget deficits. Apparently, the Federal Reserve’s unprecedented commitment to maintain near zero short term interest rates at least through mid-2013 combined with investor preference for the relative safety of U.S. government debt (compared to the near term default concerns in much of Europe) has generated an intense flight to safety.

As we have stated previously, it is our view that periods of uncertainty create attractive long term investment opportunities. While investors are understandably shaken by the turbulence experienced in the

markets over the past few years, we believe that over the intermediate and long term, equities offer superior return prospects compared to other investment options.

We expect markets to remain choppy due to U.S. political uncertainty, concerns over the European debt crisis and ongoing system-wide deleveraging. While challenging, we believe these issues are well understood and will ultimately be resolved. As a result, we remain optimistic about the return potential for equities over the next several years. We believe our sound investment philosophy and consistent approach properly positions us to generate competitive, risk-adjusted returns over the long term. We remain selective in our approach, focusing on high quality companies that we think have competitively advantaged business models and trade at attractive valuations.

Robert Feitler, Jr. **Managing Director, Portfolio Manager**

- 17 years of investment industry experience
- MBA in Finance from the University of Wisconsin
- BA in Economics from Haverford College

Dmitry Khaykin **Managing Director, Portfolio Manager**

- 15 years of investment industry experience
- MBA in Finance and Accounting from the Wharton School at the University of Pennsylvania
- BA in Economics and Computer Science from New York University

PORTFOLIO MANAGER COMMENTARY



Strategy Highlights

On an absolute basis, the Strategy had gains in all 10 economic sectors for the fourth quarter, with the greatest contributions to returns coming from the financials, energy and consumer discretionary sectors, and the smallest contributions from the utilities, materials and telecommunication services sectors.

Relative to the S&P 500 Index, both the Strategy's overall stock selection and overall sector allocation contributed to performance for the quarter. Specifically, stock selection in the consumer staples, financials, energy and consumer discretionary sectors contributed meaningfully to relative performance, as did an underweight in the IT sector.

Leading individual contributors to Strategy performance included El Paso Corp. in the energy sector, Philip Morris International Inc. in the consumer staples sector, News Corp. and Time Warner Inc. in the consumer discretionary sector and Honeywell International Inc. in the industrials sector. The bottom contributors to Strategy performance included Transocean Ltd. in the energy sector, SES SA in the consumer discretionary sector, Charles Schwab Corp. in the financials sector and WellPoint Inc. and Novartis AG in the health care sector.

During the fourth quarter, we closed our position in Total SA in the energy sector. Total, based in France, is a high-quality global integrated energy company. Despite remaining inexpensive on an absolute basis, we felt the shares had grown less compelling in comparison to Total's peers. We sold our position and reinvested the proceeds into our existing position in Chevron Corp., another integrated energy company. We believe Chevron's disciplined management has consistently generated high returns on equity, while maintaining a very strong balance sheet with no net debt, yet the shares have remained attractively valued, relative to the company's earnings.

Market Outlook

Many domestic large cap companies have demonstrated impressive operating discipline, enabling them to maintain high levels of profitability and generate substantial amounts of cash flow on top of already strong balance sheets that are flush with cash. With high levels of profitability that often exceed reinvestment opportunities, many high quality companies have been returning increasing amounts of cash to shareholders in the form of dividends and share repurchases. A company buying back its stock doesn't automatically create value and we would oppose a management team's decision to repurchase shares for the sake of appeasing shareholders. However, it is a sound use of capital as long as the stock is intrinsically undervalued and the buyback does not jeopardize balance sheet strength. We are seeing prudent shareholder friendly capital allocation from many of our portfolio companies. These are companies that trade at reasonable valuations, have strong balance sheets, and generate sufficient cash flows to reinvest in their businesses, while increasing returns to shareholders through rising dividends and share repurchases. In our view, a portfolio of large cap companies with growing profits, undemanding valuations, strong balance sheets and competitive dividend yields should generate attractive returns for investors over time.

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Past performance is no guarantee of future results.

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