

Institutional SAI Large Cap Core Strategy

3Q09

Market Review

The third quarter of 2009 saw a sharp 15.61% increase for the broad S&P 500 Index. The bond and commodity markets also continued their rallies during the third quarter. The stock market's rise was led in general by more volatile, high-beta stocks. The more defensive large-cap and higher quality stocks that held up better than most of the stock market in 2008 have tended to lag this year. This type of pattern is not unusual in a rally following a financial crisis; the initial leaders are often companies whose survival is in question until economic fundamentals firm.

Economic fundamentals showed progress in July and August, but several data points in late September were less positive. Our view is that the better numbers in August overshoot to the strong side, while the September numbers were merely on trend with the improving pattern of the previous six months. The factor we watch most closely is the rate of job losses, which peaked in January at -741,000 and fell to -263,000 in September – faster in September than the August rate – but still on an improving trend line. Both the Conference Board Consumer Confidence Index and the Purchasing Manager's Index rebounded during the third quarter, although their absolute levels still indicate a shrinking economy to us. Railcar loadings and package volumes at Federal Express and UPS show year over year declines, but sequential improvement. The most encouraging economic signs are in the housing market.

Housing prices continued to decline during the quarter, but, all 20 markets in the July data for the S&P/Case-Shiller Composite of 20 Home Price Index showed an improvement in the annual rates of decline versus the prior month. Housing inventories peaked in late 2007 and have steadily declined since then. We believe that stable or increasing home prices would buoy consumer confidence and enable banks to accurately mark the value of housing related assets on their books.

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Market Outlook

While we are encouraged by the economic stabilization, we believe that the economic recovery will be limited by several headwinds. The U.S. consumer is over leveraged and must repair his balance sheet. The large increase in the savings rate seen so far in 2009 must be sustained for at least four years for the U.S. consumer debt level to be brought down from its current 1.33x to below 1.0x current income. The Federal budget deficit, now at almost 10% of GDP, the highest percentage since 1945, must be reduced by raising taxes and eliminating spending. The healthcare bill, which will add about \$130 billion per year to the annual deficit, only

worsens the pressures. We believe that the U.S. is a wealthy country and we can work our way out of our leverage, but it will take hard decisions on the part of Congress, and will limit economic growth during the next several years.

The likelihood of a muted economic recovery and the demanding valuations of more economically sensitive stocks, have caused us to steadily reduce the aggressiveness of our portfolio since May. We remain modestly bullish on

Michael Kagan Managing Director, Senior Portfolio Manager

- 24 years of investment industry experience
- BA in Economics from Harvard College
- Attended Massachusetts Institute of Technology Sloan School of Management

Mary Jane McQuillen Director, Socially Aware Investment Portfolio Manager, Research Analyst

- 13 years of investment industry experience
- MBA in Finance from Columbia Business School
- BS in Finance from Fordham University

the stock market, but we believe that there will be a rotation from the more expensive, economically sensitive stocks into the attractively priced, large-cap higher-quality stocks that have lagged during the rally so far.

Socially Aware Investment Update

On the Socially Aware Investment (SAI) front, we would like to discuss a recent movement in the socially responsible investing (SRI) community to require mandatory risk disclosures on environmental, social, and governance (ESG) data in corporate reporting that may materially affect the risk profile of publicly traded companies. This effort has been led by the Social Investment Forum (SIF), the U.S. association for socially and environmentally responsible investment professionals and institutions, which recently addressed the subject in a letter to Chairman Mary Schapiro of the U.S. Securities and Exchange Commission.* The letter, submitted pursuant to discussions with the SEC, sets forth a proposed framework for uniform mandatory ESG disclosures and requests that the SEC make such disclosure a required part of publicly traded companies' annual reports.

ClearBridge Advisors

www.clearbridgeadvisors.com

800-691-6960

info@clearbridgeadvisors.com

“For years, SRI investors have requested more transparency and sustainability information from the companies...in their investment portfolios.”

One key driver behind the movement for mandatory ESG disclosure is the preference of analysts and investors to have such data standardized across industry peers. Currently, the approach by companies to voluntarily provide ESG information has not been widely consistent in its transparency, nor an imperative. Moreover, while many leadership companies have provided quantifiable Key Performance Indicators (KPIs) and significant disclosure on potential ESG impacts from their operations, there are still a large number of companies who have chosen to not disclose comprehensive data on these risks.

For years, SRI investors have requested more transparency and sustainability information from the companies either being considered for, or currently maintained in, their investment portfolios. As part of our due diligence process on our portfolio holdings, ClearBridge's SAI team routinely requests and reviews data on ESG impact for both risk assessments and for quantifying potential positive effects on a company's businesses, its environment and community relations, as well as on its shareholders and the bottom line. As members of the SIF, we also support the notion that increased transparency of ESG information could promote market efficiency and longer-term sustainable planning, potentially benefiting U.S. companies and investors and strengthening U.S. markets.

* A copy of the letter is available online at http://www.socialinvest.org/documents/ESG_Letter_to_SEC.pdf

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