

Mind on the Market

1st Quarter, 2009

Strategic Insight from Harry “Hersh” Cohen, Chief Investment Officer, Senior Portfolio Manager

It would be difficult to overstate the range and intensity of the emotions generated by the financial markets in the first quarter of 2009. From the despair when stocks, as measured by the S&P 500 Index and the Dow Jones Industrial Average, broke violently to a new bear market low, to the universal anger toward AIG and banking executives, to the tiny ray of hope when stocks rebounded from levels almost 60% below those of a year and a half earlier, feelings ran the gamut.

In our 2008 year-end letter, we stated our belief that the panic lows reached in October and November were consistent with the end of other major post-World War II bear markets, particularly 1974 and 2002. But we thought that a materially better market would not unfold until a possible end to the then-worsening recession could be anticipated.

For most of January and February, the news on the economy worsened. The jobless rate rose sharply, home prices continued to fall, consumer and business spending fell off a cliff, and financial institutions around the world were reeling from the ongoing markdown of assets on their books. Fear drove a flight to safety into Treasury bills, despite yields approaching zero. The massive government intervention of the prior several months seemed to be having no impact. Before President Obama’s economic plan was even voted on, partisan bickering was reaching new heights.

Things came to a head when it was disclosed that many of the people at AIG who had exposed the company and country to collapse, were being paid huge bonuses because of contracts struck a year earlier.

Similar to what happened in 2002 when Enron and WorldCom wiped out investor confidence, the overall market buckled. The lows of 2008 were breached in early March, and the stock market quickly fell nearly 10% in a week. Stocks were being sold, regardless of valuations. Comparisons were being drawn to the 1930s.

With the benefit of hindsight, we realized that the 50% post-WWII benchmark for brutal bear markets was not sufficient to reflect the massive unwinding of all the leverage built up over the previous decade. But when the popular averages reached the levels of early March, down almost 60% from the highs of 2007, buyers finally appeared in earnest, and stocks very quickly recovered back above the lows reached in November 2008.

In recent weeks, in the midst of chaos, two positive developments have occurred, offering us our first reasons for optimism that this terrible recession might begin to decelerate, with the possibility of stability by the latter part of this year. First, Chairman Bernanke of the Federal Reserve announced a program to inject massive liquidity into the mortgage market by making huge open market purchases of mortgage-backed securities, as well as direct purchases of longer-term Treasury notes and bonds. Mortgage rates have plummeted, opening the way for refinancings, and possibly tempting previously reluctant homebuyers. Second, Treasury Secretary Geithner finally announced a plan that offers the hope of clearing toxic assets from the banks. It creates incentives for the private sector to be part of the solution to this damaging overhang.

It has been a frustrating quarter, as the “quality” stocks have struggled more than others. The rally has been kinder to those stocks that were down the most. We believe it is important to stay with the discipline of having our core holdings be of the highest possible quality, including the ability to withstand economic and financial turmoil. As opposed to our view three months ago, we now believe that the economy could bottom this year.

We have discussed in the past why we believe the current economic pain will not turn into a replay of the 1930s. Not only are there social and economic safety nets that didn’t exist then, but the government is taking aggressive steps to avoid the mistakes that led to more than a decade of hard times. On a related note, we have often spoken with dismay of the disparity in the compensation between workers and high level executives that arose over the past 15 years. A return to certain values that existed after WWII up until the 1990s would be a good thing. In the decades of the 1950s, 60s and 70s, it was common for people of all categories to regard themselves as “middle class.” We are looking forward to higher savings rates, less conspicuous consumption, and a reduction in some of the disparities that have afflicted the economy and country.

We have been managing money for people for 40 years, and it has never been easy. These past six months have been impossible, but for the first time in two years, we can envision an end to the misery.

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Mid Cap Market

1st Quarter, 2009

Perspectives from Brian Angerame and Derek Deutsch, CFA, Mid Cap Core Portfolio Managers

After what can only be described as a disastrous 2008 in the financial markets, the first quarter of 2009 continued to display violent swings in stock prices. The November 2008 market lows were pierced in early March, bringing the peak-to-trough decline from the fall 2007 high-point to almost 60%, and marking one of the worse sell-offs in stock market history.

With this backdrop, it may be surprising that we are currently more optimistic about future equity returns than we have been since assuming the management of the Mid Cap Core Strategy in 2005. After 12 years of stock market gains were wiped out in a mere 18 months, we think the time to be bearish has passed and that it is time to start positioning for a recovery, which will take place even if we can't pinpoint when and to what magnitude.

In our 2008 year-end commentary, we wrote about some painful but necessary steps that we thought would be required for stock prices to stabilize and advance. First, we needed to wring out the excess leverage in both financial institutions and consumer balance sheets. While this process is by no means over, significant progress has been made. Second, we needed to see world leaders begin a coordinated program of historic fiscal and monetary stimulus to jolt the global economy back to life. We can argue about the wisdom of some of the specifics but clear progress has been made both at home and overseas.

Now we are awaiting the impact these actions will have on the world economy and financial markets. Despite being in the middle

of a severe global recession, we have seen some early signs of improvement. Some recent data on new home sales and consumer spending, for instance, have been better than expected. We are also encouraged by some signs that the credit market is improving and large corporate debt deals are finally getting done, but credit still remains very tight. By the time an economic recovery becomes apparent, however, we think it is likely that stock prices will already be higher as the market tends to move before an economic recovery becomes obvious. In fact, we would not be surprised if the March lows represent the bottom in this bear market.

Another consequence of economic crisis is the number of investment opportunities that are created for those with capital to invest. The evaporation of risk tolerance has made some assets extraordinarily attractive in terms of value. When compared to current depressed earnings, stocks may not look obviously cheap in many cases. But when compared to a more "normal" earnings environment, we find many stocks that we believe are extraordinarily attractive on an absolute basis. We think that anyone with a reasonable investment time horizon should be taking advantage of this period of maximum pessimism.

We continue to focus on companies with characteristics we believe will lead to strong returns: attractive valuations, fundamental strength, and managements that exercise capital discipline.

We continue to focus on companies with characteristics we believe will lead to strong returns: attractive valuations, fundamental strength, and managements that exercise capital discipline. Within this framework, we have begun to migrate toward stocks that we believe will react strongly in an economic recovery. We have added stocks in the consumer discretionary, financials and materials sectors, and are very close to being fully invested.

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