

Conference Call Series

The following are notes based on a conference call on January 21, 2010. The call featured insights from John Goode, Scott Glasser and Brian Angerame from ClearBridge Advisors ("ClearBridge"). The team shared their insights on the financial markets in 2009 and their outlook for 2010.

Market Review

- Goode explained that U.S. stocks had an historic rally in 2009, with the S&P 500 Index rising roughly 67% from its March low through the middle of October. Since that time, many stocks have settled into a trading range, as investors digest what took place earlier in the year.
- Glasser explained that 2009's sharp rally was led by lower quality or higher beta stocks. For example, from their bottom, banks were up over 100% and consumer discretionary names, which had been hard hit in 2008, were likely the second largest contributor to overall returns.
- Glasser characterized the March through October 2009 rally as Phase I, and the transition since that time as being Phase II. He said this is consistent with the market's historical trend.
- According to Glasser, we're beginning to see a gradual change in market leadership, as financials and consumer discretionary names give back some of the gains they posted in 2008. In contrast, there has been a pick-up in certain healthcare, consumer, and industrial names. One exception has been technology, as it has continued to perform well.
- Despite what some financial pundits called the lost decade for equities, Angerame explained that mid-cap, and also small-cap, stocks posted a 6% average annual return during the last 10 years. He believes that many of the same characteristics that have allowed mid-caps to perform so well over the last 10 to 20 years still exist today.
- Despite their strong performance in 2009, Angerame said that investors can still find attractively valued, high quality mid-cap companies that have very strong balance sheets, solid cash flow and highly disciplined management teams.

Portfolio Positioning

- In terms of portfolio positioning, Goode said he favors the biggest and best companies he can find that possess strong balance sheets. He said these types of companies are as attractively valued as they have been over the last two or three decades. Goode went on to say that, in many cases, these companies derive 40% or more of their earnings and revenues overseas. As such, they give him access to some of the faster growing parts of the world.
- From a sector perspective, Goode believes that technology-- which has largely been in "investment purgatory" since 2000--will be a strong performer over the next few quarters. He also said that world infrastructure is a growth market for at least the next five to ten years, which bodes well for engineering construction companies. In the energy sector, Goode feels the federal government's interest in alternative energy sources could be a positive for nuclear power.
- Glasser said there are now many "reflationary stocks" whose prices reflect very aggressive economic growth in 2011-2012. Glasser is being very cautious with those name, as he'd rather own companies that generate consistent earnings that have a high probability of achieving their earnings targets.
- In the energy sector, Glasser finds the most attractive value in certain integrated companies, rather than some of the core exploration and production (E&P) names.

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Outlook

- According to Goode, corporate profits held up fairly well in 2009, and many companies actually strengthened their balance sheets during the year. Another reason for Goode's optimism for the market is the extremely steep yield curve, as it has historically been correlated with a very positive stock market environment.
- Goode expects to see bank lending improve in 2010. In the labor market, he is forecasting a monthly average of 100,000 to 125,000 new jobs created during the first six months of the year. Goode also believes that the worst is over psychologically, as well as economically, in the housing market.
- Glasser said we are seeing a slow, but improving underlying dynamic to the economy. While ClearBridge expects to see further improvements as the year progresses, overall they anticipate below average growth in 2010. He said this isn't necessarily bad, because if the economy snapped back quickly there would be more pressure on the Federal Reserve Board ("Fed") to raise short-term interest rates.
- According to Glasser, the worst thing the market could do right now is go up another 10%. He believes that if the market declined 5% to 10% it would reset expectations and reintroduce risk back into the equation. He feels this would be a very healthy building base for future gains.
- According to Angerame, mid-caps have produced strong results over the last three recessions, as well as during the 24 months after the downturn ended. He believes that mid-caps will continue to post solid returns over the next 12 to 24 months.

Q&A

Q: What does ClearBridge consider to be a mid-cap stock and could you discuss how many analysts typically cover mid-caps?

Angerame: We define mid-caps as having a market capitalizations between \$1 billion and \$15 billion. The number of such companies fluctuates, but it's currently about 2,000. When you look at large-cap stocks, most have at least five analysts covering them, and it's usually 10, 15, or 20. When you get into mid- and small-cap space, well over 25% of the universe is ignored or largely ignored. And that equates to a tremendous opportunity for us. If there's only a few sets of eyeballs looking at a stock, it's likely that the stock is mispriced.

Q: What factors will contribute to a good environment for increased M&A?

Angerame: We're coming out of a period when even companies with a lot of cash on their balance sheets were hesitant to use it. That's because they didn't know what the credit markets were going to be like a year from now, or in five years. Now that the credit markets have healed, some of those companies are feeling more confident about looking at M&As.

Glasser: I'd add that organic growth is going to be hard to find and companies with solid balance sheets and good cash flow characteristics will increasingly look to do acquisitions. The flipside is there are a lot of companies that once again have access to capital and they may shy away from being acquired. In fact, there's going to be a lot of smaller companies that are going to try to go it alone.

Q: What is your outlook for gold and the dollar?

Goode: If I'm correct and GDP grows 4% during the coming quarters--which is subpar at this stage of the cycle--you're going to probably see the dollar strengthen. One of the big beneficiaries of a weaker dollar was gold and commodity related stocks, including energy. So you may have a period of time when they don't do as well. I have no problem with people having 5% in their portfolios in gold as kind of a disaster

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insurance policy. But I think that it's going to be a challenging time for hard assets. There's so much slack in the economy, both domestically and internationally, that it's going to be hard to generate a real inflation scare in the near term.

Q: What are your thoughts on the financial sector?

Goode: Lending levels are so low relative to their historical average that you'd think the prospects are good for some improvement over the next three to six months.

Angerame: As far as bank stocks go, we've been hesitant to jump on the bandwagon of those companies with balance sheets that are not very transparent. This has kept us out of some stocks that have rallied quite a bit, but I'd rather buy something that I know what I own. So we'll pick our spots elsewhere in financials versus some of the banks.

Glasser: I agree that you need to be really picky about what you own in financials and the valuations that you pay. There is a big question regarding the underlying earnings power for the bigger banks. And that's made worse by some of the government's proposals that have been thrown out there, whether they be taxes or restrictions on their future business activities.

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AN INVESTOR SHOULD CONSIDER A FUND'S INVESTMENT OBJECTIVES, RISKS, CHARGES AND EXPENSES CAREFULLY BEFORE INVESTING. FOR A FREE PROSPECTUS WHICH CONTAINS THIS AND OTHER INFORMATION ON ANY LEGG MASON FUND, VISIT WWW.LEGGMASON.COM/INDIVIDUALINVESTORS. AN INVESTOR SHOULD READ THE PROSPECTUS CAREFULLY BEFORE INVESTING.

Investment Risks

Small-and mid-cap stocks involve greater risks and volatility than large-cap stocks. Investments in medium-capitalization companies are subject to higher volatility than larger-capitalization companies. Investing in mutual funds involve risks, including possible loss of principal. Common stocks generally provide an opportunity for more capital appreciation than fixed income investments but are subject to greater market fluctuations.

Definitions

The S&P 500 Index is an unmanaged index of 500 stocks that is generally representative of the performance of larger companies in the U.S. Please note an investor cannot invest directly in an index.

The Federal Reserve Board ("Fed") is responsible for the formulation of policies designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments

Mergers & Acquisitions ("M&A")

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Gross Domestic Product ("GDP") is the market value of all final goods and services produced within a country in a given period of time.

Beta measures the sensitivity of the investment to the movements of its benchmark. A beta higher than 1.0 indicates the investment has been more volatile than the benchmark and a beta of less than 1.0 indicates that the investment has been less volatile than the benchmark.