

ClearBridge Advisors Market Commentary



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Sometimes, the simplest things are the best things to do. As managers of assets for investors we try to balance risk and potential rewards. Given the very low interest rates available we have tilted toward stocks as the best asset category available. For several years in our commentaries we have emphasized the absolute and relative values available in high quality stocks. Of particular note are those with a history of dividend payments, or the ability to pay a rising stream of dividends.

By high quality we mean strong balance sheets, excess free cash flow, and business models that could maintain leadership positions in their respective industries.

That theme has continued to play out as we had hoped, for the right reasons. The long and painful bear market of 2000 through 2008 left stocks at levels that had already discounted worst-case scenarios, and with earnings yields that, in our opinion, kept the downside limited. For the first time since the mid-1950s, many high quality stocks offered up-front dividend yields that were higher than interest rates available on high quality bonds. One of the most striking features of this quarter has been the number and size of dividend increases by cash-rich companies. There is a growing awareness of the need to reward shareholders. Payout ratios of after tax profits remain well below historical levels which, combined with massive corporate liquidity, implies continued strong dividend growth.

Past performance is no guarantee of future results. All investments involve risk, including possible loss of principal.

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“One of the most striking features of this quarter has been the number and size of dividend increases by cash-rich companies.”

While the media seems to have caught on to our dividend story, evidence points to continued caution, if not outright fear, of stock ownership. In our year-end commentary we proposed the thesis that it was the enormous volatility of stocks, rather than actual losses that was keeping a generation of investors on the sidelines.

With the economy showing some minor signs of improvement, we still look to the Federal Reserve (Fed)¹ for clues about their intentions. Chairman Bernanke has recently restated his concerns about tightening money, or removing fiscal stimulus too early in what remains the most treacherous economy since the 1930s. The intent of the Fed to keep rates exceptionally low for another two years continues to promote the need for savers, pension funds, and endowments to own equities. While the rally over the past six months has taken the S&P 500 Index² from 11 times earnings to 14 times estimated earnings for 2012, stocks are still not particularly expensive.

We understand the reluctance of people to see occasional monthly declines in asset value but we are pleased that from a longer term perspective, many of our portfolios are at or near all time highs with the added benefit of higher annual dividends.

In our year-end commentary, we suggested that for the market to break out of its doldrums, certain things needed to happen. First, volatility needed to abate, and it has. Second, a U.S. type solution to the European banking crisis had to have been started, as it has. While we still harbor strong doubts about European economies showing growth, at

least the financial collapse has been averted. Finally, housing in this country, the main drag on any longer term outlook, has begun to show signs of bottoming. Sadly, the stabilization in housing is not due to a re-invigorated consumer, as unemployment remains stubbornly high and peoples' pocketbooks remain stretched. Rather, a lot of inventory is getting absorbed by investors who intend to own and rent out the very cheap homes.

As we pointed out in our last commentary, domestic energy has become the biggest engine for job growth. Articles are starting to appear about eventual energy independence. Now, if we can just get through what promises to be a contentious election period, the President and Congress could get down to solving some long term issues.

In the meantime, we continue to focus on balancing risk and opportunities.

¹ 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.

² The **S&P 500 Index** is an unmanaged index of common stock performance.

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Foreign securities are subject to the additional risks of fluctuations in foreign exchange rates, changes in political and economic conditions, foreign taxation, and differences in auditing and financial standards. These risks are magnified in the case of investments in emerging markets.

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