1Q 2015 | Product Commentary

CLEARBRIDGE VALUE TRUST

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Market overview

Major U.S. averages opened the year with mixed gains, as investors continued to focus on the Federal Reserve's rate strategy amid mixed economic reports, suppressed crude prices, and the climbing dollar, as well as another flurry of merger and acquisition announcements. The dollar strengthened +12.7% against the euro over the quarter and it is now up more than +20% against a broad basket of foreign currencies over the past nine months. The 10-Year yield closed March at 1.93%, after falling as low as 1.4% in January and rising above 2.24% in mid-March. Oil prices fluctuated between $45 and $54 throughout the quarter, largely reacting to reports that capacity in Cushing, Oklahoma is running out for crude supplies, as well as Saudi Arabia launching air strikes against Iranian-backed rebels in Yemen while U.S. diplomats carry out nuclear program negotiations with Iran and other world leaders.

The S&P 500 and Dow Jones posted modest gains of +1.0% and +0.3%, respectively, while the Nasdaq climbed +3.9% over the quarter. The small-cap Russell 2000 and Russell MidCap each jumped more than +4.0%, outstripping the +1.6% rise for the large-cap Russell 1000. Meanwhile, growth outperformed value substantially, with the Russell 1000 Growth's +3.8% return more than +450 bps above that of the Russell 1000 Value. The S&P was weighed down by the utilities sector, off -5.2%, and energy once more, down another -2.9%. Meanwhile, the health care and consumer discretionary sectors paved the way higher, up +6.5% and +4.8%, respectively.

Average annual total returns and fund expenses

(%) as of March 31, 2015

Class C	3-mo	1-yr	5-yr	10-yr	Since Incept. (4/16/82)	Gross	Net
Excluding sales charges	0.23	9.09	11.68	2.49	12.06	1.77	1.77
Including effects of maximum sales charges	-0.72	8.14	11.68	2.49	12.06	–	–
S&P 500 Index	0.95	12.73	14.47	8.01	N/A	–	–

Performance shown represents past performance and is no guarantee of future results. *Current performance may be higher or lower than the performance shown. Investment return and principal value will fluctuate, so shares, when redeemed, may be worth more or less than the original cost. Class C shares have a one-year contingent deferred sales charge (CDSC) of 0.95%. If sales charges were included, performance shown would be lower. Total returns assume the reinvestment of all distributions at net asset value and the deduction of all Fund expenses. Total return figures are based on the NAV per share applied to shareholder subscriptions and redemptions, which may differ from the NAV per share disclosed in Fund shareholder reports. Performance would have been lower if fees had not been waived and/or reimbursed in various periods. Returns for less than one year are cumulative. Performance for other share classes will vary. For the most recent month-end information, please visit www.leggmason.com/individualinvestors.*

Gross expenses are the Fund's total annual operating expenses for the share class(es) shown. Because the Fund does not currently have fee waivers or reimbursements, gross and net expense ratios are the same. Please see the prospectus for more details on fees, expenses and expense limitation arrangements, if any. In periods of market volatility, assets may decline significantly, causing total annual Fund operating expenses to become higher than the numbers shown in the table above.

The **S&P 500 Index** is a market capitalization-weighted index of 500 widely held common stocks. Investors cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges.

INVESTMENT PRODUCTS: NOT FDIC INSURED • NO BANK GUARANTEE • MAY LOSE VALUE

Fourth-quarter GDP expanded at an annualized rate of +2.2%, below consensus and well short of the third quarter's +5.0% growth. Retail sales excluding energy declined three months in a row between December and February, with reports pointing to record-cold temperatures during the season as the culprit for the disappointment. A 17% decline in housing starts was also attributed by many to the harsh winter weather. On a positive note, U.S. employers added nearly 600K jobs in the first three months of the year, pushing down the unemployment rate to 5.5% from 5.6% at year-end. Consumer confidence also unexpectedly spiked to the highest level in 11 years.

Fed Chair Janet Yellen delivered her semi-annual testimony to the Senate in February and asserted the committee would not nail down a timetable for raising target rates, nor point to one specific metric to trigger an increase. Yellen further commented that "raising rates too soon would be undermining to the recovery that is just taking hold." Following their March meeting, the committee dropped its long-held "patience" assurance with regard to raising rates, as expected. However, the central bank unexpectedly pared back its expectations for the scale of rate raises and downgraded its forecasts for economic growth and inflation. Fed-funds futures now show market participants seeing an 8% likelihood of a rate increase in June, compared with 30% as of year-end.

Approximately 68% of the S&P's constituents reported better-than-expected bottom-line results during earnings season, while 21% disappointed. However, many companies tempered guidance for 2015, citing significant foreign exchange headwinds as the dollar strengthened against foreign currencies. Meanwhile, low borrowing rates continued to foster M&A activity as a slew of multibillion-dollar deals were announced recently, particularly in the health care sector. Notably, Pfizer announced a $17B cash offer for Hospira, AbbVie agreed to buy drug maker Pharmacyclics for $21B, and UnitedHealth Group plans to purchase Catamaran for $13B. Elsewhere, H.J. Heinz and Kraft Foods Group signed a definitive merger agreement to form the Kraft Heinz Company, which will create the third-largest food and beverage company in North America. In other news, the Fed announced that its annual "stress test" of the 31 largest banks operating in the U.S. found all the banks had sufficient capital to withstand a hypothetical economic shock. Nearly every bank's capital return proposals passed the CCAR tests, as well.

The World Bank lowered its 2015 growth expectations from +3.4% to +3.0% due to weakness in Japan and the eurozone, though it pointed to the U.S. as one of the strongest economies. This tempered forecast was underscored by China's +7.3% GDP expansion in 2014, its weakest pace in over 20 years. European GDP also expanded by only +0.3% in the fourth quarter, thanks to German output buoying contractions and stagnation in other member countries. ECB President Mario Draghi announced an expanded asset-purchase program through at least September 2016 to combat threats of deflation. Overseas headlines also centered on ongoing debt talks between Greece and its creditors after the new anti-austerity Syriza party unveiled plans to cut about a third of its economic reforms dictated in the terms of its debt. Ultimately, the International Monetary Fund, the ECB and the European Commission approved a four-month extension, preventing the country's current loan agreement from expiring, and easing fears that Greece could leave the eurozone.

Fund highlights

During the first quarter of 2015, the ClearBridge Value Trust – Class C shares generated a total return of 0.23%. In comparison, the Fund's unmanaged benchmark, the S&P 500 Index, returned 0.95% and the Lipper Large Cap Core Funds category average was 0.91% for the same period.

Using a three-factor performance attribution model,[1] relative portfolio performance was driven by security selection effects and sector allocation, partially offset by the interaction of sector allocation and security selection. In terms of sector allocation, an overweight position in financials and an underweight in consumer discretionary hurt relative performance, as the former sector underperformed the benchmark while the latter outperformed. NXP Semiconductors, Amazon, UnitedHealth Group, E*TRADE Financial and Apple were the largest contributors to performance, while the biggest detractors included Microsoft, Ralph Lauren, EMC, CONSOL Energy and Yahoo!.

During the first quarter we initiated four new positions: Steel Dynamics, McDonald's, Albemarle and AbbVie. Four positions were eliminated, as well, during the quarter: Target, Phillips 66, Realogy Holdings and Dr Pepper Snapple Group.

[1] A three-factor attribution consists of the allocation effect, the selection effect and the interaction effect, which sum to the portfolio's performance relative to the benchmark. Allocation refers to excess performance attributable to the manager's decision to overweight and underweight certain sectors relative to the market. Selection represents the portion of performance attributable to the manager's stock-picking skills. Interaction, as the name suggests, represents the interaction between weighting and selection effects, and does not represent an explicit decision of the manager.

Top 10 equity holdings (%)	
Citigroup Inc.	3.9
Microsoft Corp	3.6
Merck & Co. Inc.	3.0
Cisco Systems, Inc.	3.0
JPMorgan Chase & Co.	2.9
Pultegroup Inc	2.9
Wells Fargo & Co	2.8
Amgen Inc.	2.8
Medtronic PLC	2.7
Unitedhealth Group Inc.	2.7

Sector Allocation (%)	
Financials	22.0
Information Technology	19.2
Health Care	16.9
Consumer Discretionary	12.1
Energy	9.0
Industrials	8.2
Materials	4.6
Utilities	4.4
Consumer Staples	3.8
Telecommunication Services	0.0
Cash/Other	-0.1

Percentages are based on total portfolio as of quarter end and are subject to change at any time. For informational purposes only and not to be considered a recommendation to purchase or sell any security.

Top contributors

NXP Semiconductors shares rallied after the company announced a deal to acquire Freescale Semiconductor for $12 billion, to create the fourth-largest semiconductor company. NXPI is using stock to fund the bulk of the deal, though the slim premium limits shareholder value-at-risk, according to our analysis. The combined entity will enjoy a strong competitive positioning as the market-leading automotive semiconductor company and broad-based microcontroller unit (MCU) supplier, and it should generate substantial cash synergy beyond the $200 million to $500 million cost synergy range that management projects. As such, we continue to hold the stock despite the recent rally.

Amazon stock spiked after the company reported fourth-quarter earnings that more than doubled Street estimates on higher-than-expected margins. Investors were also pleasantly surprised with a new tone from management focusing on cost management and on transparency in operating reporting, moves that suggest we could see a much more shareholder-friendly management team going forward. We believe the company is poised to expand its operating margins into the double digits by leveraging its hefty fulfillment center investments and by growing its Amazon Web Services (AWS) business.

Apple was among the major contributors in the first quarter following above-expectations earnings results. The company beat consensus expectations on the top and bottom lines as the success of its iPhone 6, the latest version of the iconic handset, far outpaced forecasts. Going forward, we believe investors are overestimating the risk that Apple faces a sharp decline in earnings within the next year due to difficult sales comparisons against a strong iPhone 6 launch. We also believe the market underappreciates the company's ability to leverage its large, loyal and still-growing installed base across its platform of digital devices and services. While it is difficult to assign significantly higher valuation to a $730 billion market-cap company, strong free-cash-flow generation and a large cash balance also provide meaningful downside protection at current levels.

Top detractors

Microsoft was among the major detractors last quarter as the software giant's guidance for the current quarter missed analysts' estimates even as it posted above-consensus results for its second fiscal quarter ending in December. The disappointing revenue guidance for the fiscal third quarter was impacted by several near-term factors, including negative foreign exchange effects and difficult comparisons from last year's end-of-life support of Windows XP-driven upgrade cycle. While the consumer-dominated Windows business remains under pressure in terms of units and pricing, Microsoft's enterprise business, representing nearly two-thirds of its gross profits, remains stable and management is doing a good job transitioning its key franchises to the cloud. With strong growth potential from the cloud opportunity and the attractive valuation in terms of single-high-digit free-cash-flow yield, we believe Microsoft is an attractive risk-adjusted stock for patient, long-term investors.

Ralph Lauren detracted from returns this quarter as a surge in the U.S. dollar caused the company to lower its earnings guidance significantly more than expected due to the company's large EU and Japan revenue exposure, paired with a cost base largely located in Switzerland and Hong Kong. Holiday promotions and weaker retail traffic also caused management to temper bottom-line expectations. While the news weakens our investment case in Ralph Lauren, we believe it remains intact for now. Our analysis shows that the market underappreciates the company's impending mix shift to higher margins, which includes greater exposure to retail channels, accessory products and international markets.

Additionally, we believe earnings will rebound with top-line growth and margin expansion as the company's heavy investment cycle in SAP, aggressive retail expansion, new product concepts, and ecommerce comes to a conclusion.

EMC stock dropped during the quarter after management announced plans to delay a strategic update until the fall of 2015. The update comes after the stock rallied last year on news that hedge fund activist investor Elliott Management is pushing for a spinoff of VMware, where a bulk of the business' value lies. While spinning out VMware could potentially unlock shareholder value and provide a tailwind for the stock, our investment case in EMC does not hinge on this outcome. Rather, we see the core EMC business undervalued at approximately 5x EV/EBITDA, a steep discount to peers. We find this discount unwarranted, given that EMC owns a stronger product portfolio that is better positioned to withstand the industry's evolution and boasts healthier operating margins and higher returns. We expect this valuation gap to close as the company continues to deliver revenue growth and return capital to shareholders via share repurchases going forward.

Outlook

Forecasting complex adaptive systems, such as the weather, the economy and the market, is a futile exercise. However, we carefully observe current market conditions, and just like with individual stocks, we assign probabilities to different possible future outcomes that we update as fundamental and valuation levels change. In general, we are most optimistic about future market returns when a recessionary storm is well under way, investors are discouraged by the violence of the storm and resulting valuations are low. This is clearly not the case today, as the extreme pessimism that understandably formed during the Great Recession has continued to recede, and fear is steadily giving way to greed. As a result, U.S. stocks are no longer cheap, though we can still find good absolute value with some work, as we will highlight later. We also do not see imminent storm clouds forming that would indicate a recession, and we put the probability of a U.S. economic downturn in 2015 at less than 20%. Just as thunderstorms typically form on hot days, recessions tend to come when economic recoveries get too hot, resulting in wage inflation, higher interest rates and commodity price pressure. Despite the current length of the U.S. economic recovery, it is awfully hard to compare the current pace of growth to a hot summer day. Yes, the Fed will likely bump interest rates sometime in 2015, but the absolute level of interest rates remains historically low, wage pressure is modest at this point, and commodity price declines are still providing a significant tailwind to several sectors.

Although we don't see imminent recessionary storm clouds, we are observing rising and in some cases historic market price volatility. In the last few quarters we have witnessed a dramatic return of energy market volatility as oil prices collapsed about 50%; steadily rising volatility in the "risk-free" 10-Year Treasury yield; and the biggest daily price move ever in a developed currency – the >21% change in the Swiss franc after they de-pegged from the euro was the first time in 44 years that a G-10 currency moved more than 10% in one day. We expect fat tails in markets, but the non-linear jump of this magnitude was historic, it almost put two smaller firms out of business, and it clearly highlights a dangerous dance as the Swiss National Bank reacted to the imminent introduction of Quantitative Easing (QE) by the European Central Bank (ECB).

As always, human brains look for causal narratives, but the natural question to ask is whether ongoing central bank monetary experiments are distorting prices beyond the Swiss Alps. If so, these aggressive policies could introduce the risk of mountain wave-like turbulence, as dislocated prices inevitably "de-peg" and jerk back toward fundamental value. We have touched on this potential distortion risk in previous letters, but with the ECB engaged in aggressive QE that amounts to about 250% of all EU sovereign debt issuance, the topic and potential risk is worth revisiting.

The direct lever that is likely being highly influenced by central bank activities is risk-free interest rates, which are the sovereign debt that are primarily targeted by QE programs. Within our investment process, we value most stocks by dividing the expected future free-cash-flow generation of a business (the numerator) by a discount rate (the denominator). The discount rate, which represents the company's estimated cost of capital, is composed of an Equity Risk Premium (ERP) and a Risk-Free Rate (RFR) equal to the 10-Year Treasury yield, among other components. The majority of long-term value creation occurs when a business can grow its free cash flow stream at a return above its cost of capital. Accordingly, the analytical value of our process comes from having a variant view of how much long-term value a business can create relative to what the market has embedded in the current stock price: we always want to get potential long-term value on the cheap. On the flip side, we generally leave it up to the market to set the cost of capital, as we believe the market's guess on the right level for interest rates and risk premiums is a lot better than ours.

The question all investors face, however, is how much today's discount rate reflects the market's best guess as opposed to an artificially deflated central bank policy peg that will eventually become unglued. After all, the explicitly stated goal of QE is to increase asset levels by deflating the RFR, which forces people to seek higher-yielding and riskier assets, thus also deflating risk premiums. This certainly seems to have been the order of things with EU risk assets in the first quarter. At the very least, the shrunken level of risk-free rates is introducing more daily RFR volatility due to a small number effect: changes on a smaller base result in bigger percentage moves. The increasing volatility of the risk-free rate challenges the notion of "risk free" and introduces the potential for turbulence and volatility across markets. In the first quarter alone, the 10-Year Treasury yield varied from approximately 1.6% to 2.25%, with that 0.65% range changing the value of an asset by about 8%, holding everything else constant. The risk-free rate is supposed to be boring, but now it's where the valuation action is!

Despite the potential noise and turbulence from central bank activity, the goal of our investment process is to isolate long-term valuation signal regardless of the challenges in different market environments. Thus, despite today's higher overall valuation levels and potentially inflated assets, we are still finding attractive absolute price-to-value gaps where future convergence of price and value would generate attractive risk-adjusted long-term returns. In particular, we continue to find attractive absolute valuation levels relative to historic ranges in legacy tech, financials and energy. In every valuation exercise we don't just focus on one scenario, but rather we assign probabilities to fundamental outcomes that range from awful to dreamy. If we are getting paid to take the risk of awful while not paying anything for dreamy, the return profile should have the asymmetry we find attractive.

Beyond finding absolutely mispriced individual stocks, portfolio construction always plays a critical investment process role. In this particular environment we are keenly focused on maximizing the diversification of our valuation opportunities, without sacrificing the potential upside from price and value convergence. The goal is to have a highly liquid portfolio that is not overly exposed to any single environment and can withstand unexpected market turbulence, especially the extreme dislocations that markets could experience when the crowd panics. If you have the liquidity, the emotional fortitude and a process that can isolate the signal of underlying value, then volatility is an opportunity and not just an unavoidable investment risk.

Definitions and additional terms:

Please note that an investor cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges.

Category Average Returns' Source: Lipper Inc. **Past performance is no guarantee of future results.** Lipper returns are based on the three-month period ended March 31, 2015, and they are calculated among 876 funds in the Lipper Large Cap Core peer group, including reinvestment of dividends and capital gains, if any, and excluding sales charges.

A **basis point** is one one-hundredth of one percent (1/100% or 0.01%).

Dow Jones Industrial Average (DJIA) is an unmanaged index composed of 30 blue-chip stocks, each with annual sales exceeding $7 billion. The DJIA is price-weighted, reflects large-cap companies representative of U.S. industry, and historically has moved in tandem with other major market indexes such as the S&P 500.

EBITDA is an abbreviation for "Earnings Before Interest, Taxes, Depreciation and Amortization," a measure of a company's cash flow.

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.

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

NASDAQ Composite Index is a market capitalization-weighted index that is designed to represent the performance of NASDAQ securities and includes over 3,000 stocks.

Russell 1000 Growth Index is an unmanaged index of those companies in the large-cap Russell 1000 Index chosen for their growth orientation.

Russell 1000 Value Index is an unmanaged index of those companies in the large-cap Russell 1000 Index chosen for their value orientation.

Russell 2000 Index is composed of the 2,000 smallest companies in the Russell 3000 Index.

Russell Midcap Index measures the performance of the 800 smallest companies in the Russell 1000 Index, which represents approximately 25% of the total market capitalization of the Russell 1000 Index.

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

A three-factor attribution consists of the allocation effect, the selection effect and the interaction effect, which sum to the portfolio's performance relative to the benchmark. Allocation refers to excess performance attributable to the manager's decision to overweight and underweight certain sectors relative to the market. Selection represents the portion of performance attributable to the manager's stock-picking skills. Interaction, as the name suggests, represents the interaction between weighting and selection effects, and does not represent an explicit decision of the manager.

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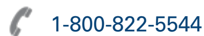

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Equity securities are subject to price fluctuation and possible loss of principal. International investments are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility. These risks are magnified in emerging markets. The manager's investment style may become out of favor and/or the manager's selection process may prove incorrect, which may have a negative impact on the Fund's performance. Because this Fund expects to hold a concentrated portfolio of securities, and invests in certain regions or industries, it has increased vulnerability to market volatility. Additional risks may include those risks associated with investing in fixed income and high-yield securities.

Income and dividends can fluctuate and are not guaranteed, and a company may reduce or eliminate its dividend at any time.

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Portfolio holdings and sector allocations may not be representative of the portfolio manager's current or future investment and are subject to change at any time.

Percentages are based on total portfolio as of quarter end and are subject to change at any time. For informational purposes only and not to be considered a recommendation to purchase or sell any security.

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