

# Lazard Insights

## Conference Call Series

May 19, 2009

# Summary

## The Changing Landscape of U.S. Equity Markets

Featured Speaker: Andrew Lacey, Deputy Chairman, U.S. and Global Strategies

### The Current Market Environment

The widespread sentiment that the market freefall was bottomless is now being replaced by a feeling that markets will stabilize at a lower level of economic activity, though expectations for a rapid recovery are low. We believe that government actions have had a meaningfully positive impact on markets this year, and produced several results:

- Fiscal stimulus limited unemployment and supported consumer spending
- Incremental funding provided to financial institutions ensured banks access to funding at low cost, and facilitated borrowing by consumers and small businesses
- Efforts to hold down mortgage borrowing rates increased demand for housing by new purchasers and allowed refinancing by existing owners

Despite these accomplishments, it is important not to confuse signs of normalization with actual stability or recovery, as two key priorities still need to be addressed:

1. Mitigate the economic damage from home price normalization by:
  - Providing further tax incentives for purchases of existing homes
  - Ensuring low mortgage rates through continued purchases of mortgage-backed securities (MBS)
2. Revitalize the financials sector by:
  - Removing the toxic assets from the financial system
  - Recapitalizing banks
  - Reinvigorating lending to credit-worthy borrowers

After typical, business cycle-driven recessions, investors generally embraced risk at the first signs of normalization. We feel that this recovery will be different from the ones that followed past crises, and that the main theme coming out of this crisis is

a strong differentiation between winning and losing sectors, industries, and companies.

### Why U.S. Equities Now?

We believe that all the buzz surrounding the large rally that has taken place since March promotes the wrong kind of behavior, as we feel it is important to anchor investment actions on long-term data. For example, only two of the S&P 100 Index stocks were up over the past 12 months,<sup>1</sup> and, over the past decade, the S&P 500 Index has not created total return for those invested in it.

We have seen the impact of eight months of a -6% annualized growth rate of GDP, and how this does and does not affect companies. We have also seen the impact on equity markets of indiscriminate selling, both by choice and force. As investors, this allows us more confidence in our bear case scenarios.

Historically, when investors believed that the worst of a crisis was over, they thought it would be time to embrace the riskiest assets. Today, we believe that the right approach is to strike a balance among:

- the future risks associated with the global economy, and
- our view that we are unlikely to resume robust GDP growth for some time, and
- the risks of extreme safety associated with investing in very low-yielding Treasuries, which could expose investors to the impact of high inflation, and
- the attractive valuations that we see in the U.S. markets today, and
- the clear pattern we see where winners are gaining share and compounding their competitive advantage.

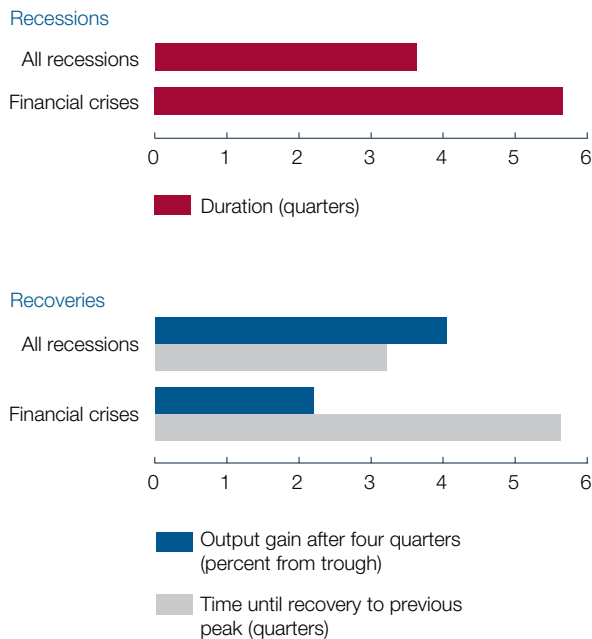
Therefore, we think that investors with a multi-year time frame can earn significant returns without taking undue risks.



## Recessions and Recoveries

As illustrated in the charts below, when considering data from 21 advanced economies over the last 50 years, the duration and time period it takes to rebound from financial crises (such as the current crisis) versus general, business cycle-driven economic recessions is significantly longer, as shown in Exhibit 1.

### Exhibit 1: Average Statistics for Recessions and Recoveries



As of April 2009

Source: IMF staff calculations.

Based on business cycles in 21 advanced economies from 1960 to the present.

## Accessing U.S. Equities

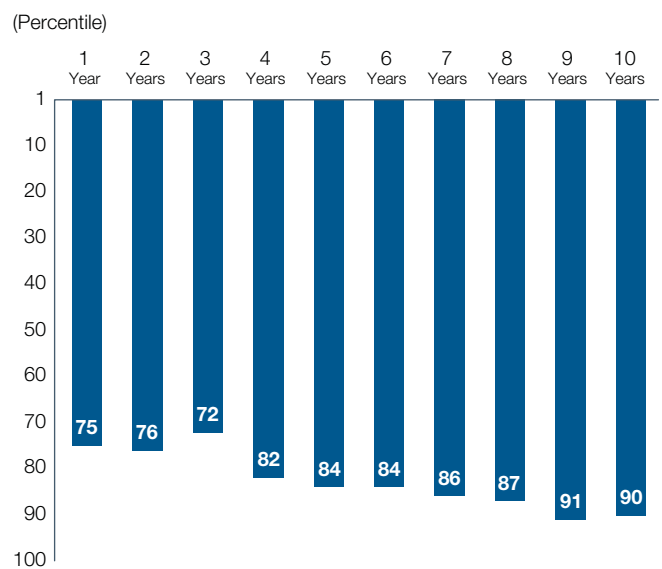
There are two main ways to invest in U.S. large-cap equities:

1. Passive investing, or indexing, is cheap and provides diversified access to a range of American companies
2. Active investing, via a hired manager or advisor, is plagued by the view that passive investors have higher returns versus active investors over the long term

## Passive Management

Coming as a surprise to many investors, passive strategies have underperformed large-cap core strategies consistently. As illustrated in Exhibit 2, 90% of active, large-cap core managers beat the S&P 500 Index on a trailing 10-year basis, as of 31 March 2009. The best that the S&P 500 Index has done is on a trailing 3-year basis, where it beat just 28% of active managers.

### Exhibit 2: S&P 500 Index Percentile Rank in the eVestment Large-cap Core Equity Universe



As of 31 March 2009

Source: eVestment Alliance.

Additionally, on a rolling 3-year and 5-year basis, the S&P 500 Index has performed below the median large-cap core active manager 90% and 85% of the time, respectively.<sup>2</sup>

How much does this cost to the average investor, and what is the opportunity for an active manager to add value for a client? The difference between the S&P 500 Index and the top quartile manager is:<sup>2</sup>

- 843 basis points on a cumulative 3-year basis
- 1,361 basis points on cumulative 5-year basis, and
- 4,027 basis points on a cumulative 10-year basis.



## Active Managers have Added Value by Avoiding Disaster

Looking at the S&P 500 Index, 19 stocks with market capitalizations of over \$30 billion as of 31 March 1999, which represented 19% of the Index then, lost between 70% and 100% of their values over the ensuing 10 years. The inability of the Index to exit these positions was significantly detrimental to performance for passive investors, but also provided considerable opportunity for active managers.

## Yesterday's Defense is Tomorrow's Offense

We believe that there are three key characteristics to focus on when looking for investment opportunities, now that the era of disinflation (or the past 25 years of declining inflation and interest rates) is over:

1. Free cash flow
2. Balance sheet strength
3. Operational flexibility

We believe that these characteristics will lead to one key theme: The differentiation between winners and losers across many sectors will likely continue to increase.

## Exhibit 3: Evidence of Differentiation from Debt Markets

Company	Issue Date	Coupon	Current Yield to Maturity
Abbott Laboratories	2/26/2009	6.000%	5.79%
Amgen	1/13/2009	6.400%	6.26%
AT&T	1/29/2009	6.550%	6.95%
Becton Dickinson	5/11/2009	6.000%	5.87%
Cisco Systems	2/9/2009	5.900%	6.38%
ConocoPhillips	1/29/2009	6.500%	6.43%
Emerson Electric	4/14/2009	6.125%	6.08%
IBM	10/9/2008	8.000%	6.24%
Medtronic	3/9/2009	6.500%	6.44%
Microsoft	5/11/2009	5.200%	5.05%

As of 13 May 2009

Source: Bloomberg

## Differentiation – Evidence from Debt Markets

In the midst of a very challenging economic environment, the ten companies listed in Exhibit 3 have been able to issue 30-year debt at low absolute rates, ranging from 5.2% to 8.0%. The debt markets have voted, with conviction, that these companies are differentiated, thus confirming their competitive advantage.

## Differentiation – Sector Level Examples

- **Information technology**  
Tech staples – A segment of the information technology sector, where companies are gaining market share and utilizing their balance sheet strength to extend their competitive advantage.
- **Consumer staples**  
Drugstores – The larger players in this segment are gaining competitive advantage versus the smaller, “mom and pop” drugstores.
- **Energy**  
Natural gas – Significant differentiation is occurring between producers with stronger balance sheets and the ability to access capital, and producers that are weaker and cannot access capital.

## Current Strategy

- Forward-looking analysis and active investing are both critical to take advantage of this period of increasing differentiation among stocks
- Recognize the opportunity that current valuations offer, as well as the uncertainty of issues that remain to be resolved, particularly regarding the continued decline of housing prices
- Avoid extreme behavior, such as embracing excessive risk or complete safety in Treasuries
- Focus on identifying the winners over the next three to five years, which we believe will be companies that compound their:
  - Cash flow
  - Capital
  - Competitive advantage



## NOTES

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1. As of 15 May 2009
2. As of 31 March 2009. Source: eVestment Alliance. eVestment Large-cap Core Equity Universe

## IMPORTANT INFORMATION

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