

Lazard Insights

Conference Call Series

10 November 2009

Summary

Capitalizing on Post-crisis Dislocations

Featured Speakers: **Ronald Temple**, CFA, Managing Director, Portfolio Manager/Analyst
Joe Ramos, Director, Portfolio Manager/Analyst
Sean H. Reynolds, Managing Director, Portfolio Manager/Analyst

Challenging Established Assumptions

The current economic and financial crisis has challenged a range of investment methodologies that have been used to identify, measure, and allocate risk. Specifically, mean reversion philosophies, the assumption of a normal distribution and pattern of returns, and the assumption of long-term stability of expected correlations have all been called into question. We do not propose that these methodologies are completely invalid. On the contrary, we believe it is important to balance these long-held views with the lessons that we have learned from the crisis. Foremost of these lessons is the importance of relying on fundamental research that is forward-looking. Also important is an understanding of what can and cannot be analyzed with precision, and to utilize scenario analysis in assessing how portfolios might behave.

Key Investment Drivers

We believe there are several key drivers to the road ahead, which we will discuss in further detail:

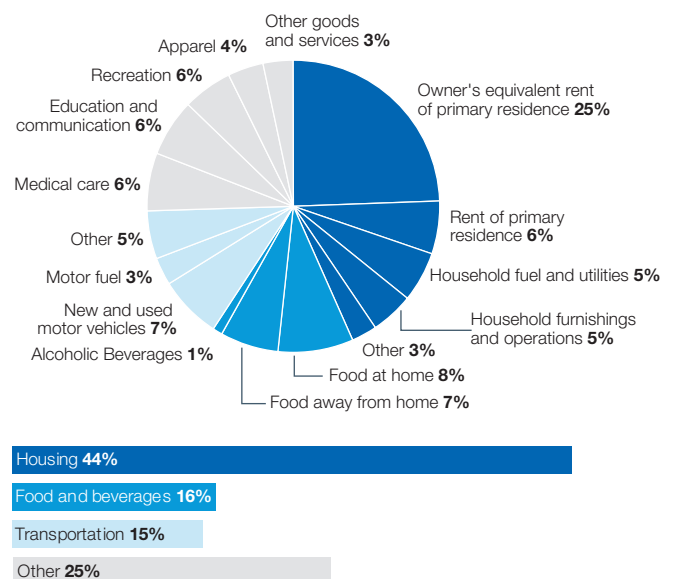
- Inflation/deflation
- Volatility
- Security selection

Deconstructing Inflation

We think it is worthwhile to define how inflation is calculated. While there are many different ways in which to approach this topic, we believe it is important to start with the Consumer Price Index (CPI), as it is one of the most-cited metrics in

inflation discussions. Exhibit 1 illustrates the composition of the CPI as of the end of 2008. The composition changes every two to three years based on the basket of goods used by the Bureau of Labor Statistics. As you can see, the predominant factor in the CPI is housing and housing-related expenditures. Inflation might look different to different people depending on socioeconomic or demographic status (e.g., a person may spend more or less on health care or education throughout different periods of their life).

Exhibit 1: The Composition of the CPI



As of December 2008

Source: Bureau of Labor Statistics

We believe it is useful to distinguish factors within the CPI that are likely to be deflationary and factors that are likely to be inflationary. Our base case views are illustrated in Exhibit 2. Owner's equivalent rent and rent on primary residence, which equate to 31% of the CPI, are likely to be deflationary or, at best, a neutral inflationary factor. We believe that food (at home), energy for housing and vehicles, medical care, and education are likely to be inflationary, despite the government's efforts to control cost increases.

Another approach to calculating inflation includes extrapolating the cost of the individual drivers of the components of the CPI, as shown at the bottom of Exhibit 2. We will discuss labor in more detail in the following sections.

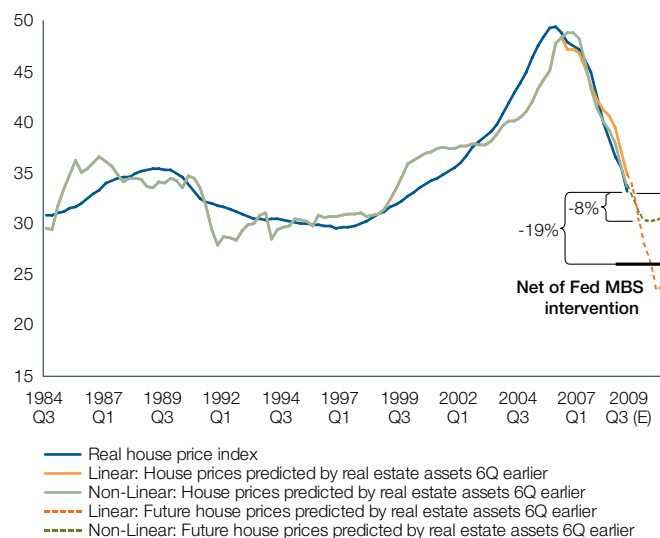
House Prices are Likely to Decline Further

Exhibit 3 illustrates our house price analysis. Our base case for housing is for another 10% decline beginning in the next month or two. We expect that as many as six million homes in the United States will foreclose within the next few years. From an inflation perspective, it is important to note that, even if our base case scenario of -10% does not occur, there will likely be a large number of homes hitting the market. Currently, approximately 1.00 to 1.25 million homes are absorbed each year.¹ Taking into account the potential six million homes that might head into foreclosure, it could take five years to absorb the excess inventory. Therefore, we are unlikely to see much inflation in housing for the next five years. However, there is an unpredictable variable in these calculations: How many of the modified loans (i.e., loans that are delinquent for 60 days or more that are modified to help the borrower) will default again? We estimate that 30% to 50% will re-default within a year.

Exhibit 2: Base-case Views of CPI and Non-CPI Components

Deflationary	Neutral	Inflationary
<ul style="list-style-type: none"> Owner's equivalent rent on primary residence (31%) 	<ul style="list-style-type: none"> Food away from home (7%) 	<ul style="list-style-type: none"> Food at home (8%) Energy for housing and vehicles (9%) medical care (6) Education (6%)
Deflationary	Neutral	Inflationary
<ul style="list-style-type: none"> Unskilled labor 		<ul style="list-style-type: none"> Commodities Skilled labor

Exhibit 3: Real House Price Index versus House Price Predicted By Real Estate Assets and Mortgage Liabilities



As of 31 March 2009

Source: Board of Governors of the U.S. Federal Reserve System, Flow of Funds Accounts of the United States, Section B.100 Balance Sheet of Households and Nonprofit Organizations, OFHEO, Standard & Poor's/Case-Shiller Home Price Indices, Bureau of Labor Statistics, Bloomberg

Seasonal adjustments were made using a linear moving average.

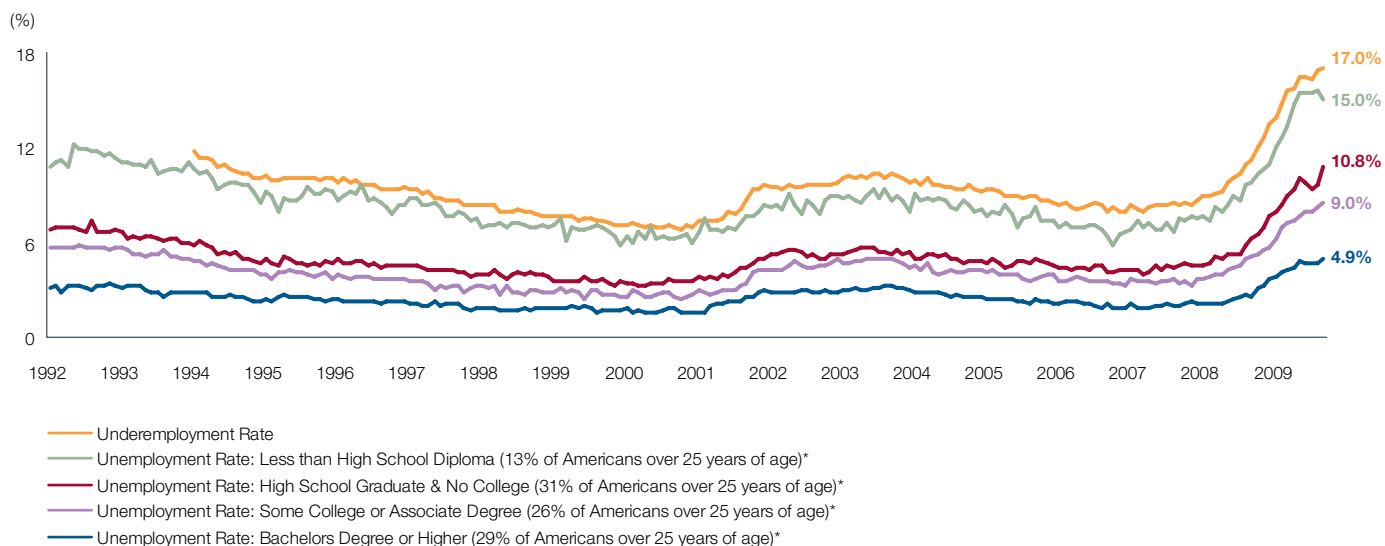
Predicted changes in mortgage debt based on a single-factor linear regression model developed by Dr. Emma Rasiel, Assistant Professor of the Practice of Economics, Duke University. For more information, refer to the Lazard Investment Research paper "The Crumbling Foundation of U.S. House Prices: August 2009 Update," available at http://www.lazard-net.com/lam/us/literature_research.shtml.

There is no guarantee that the stated forecast will be realized.

Labor – Not As Simple As It Looks

Exhibit 4 deconstructs the U.S. labor market. The highest line on the chart illustrates the total underemployment rate, while the other lines show unemployment based on educational attainment. As illustrated, those Americans with a lower level of education (less than a high school diploma) have a higher level of unemployment, while those with a higher level of education (a bachelors degree or higher) have a much lower level of unemployment. One could imagine a situation in a few years where the United States has a shortage of college-educated workers and a large surplus of unskilled labor, which will have different ramifications in different areas of the country. Additionally, U.S. unskilled laborers are working record-low hours per week (only 33 hours, the lowest since 1964). Therefore, even if the economic slack begins to

Exhibit 4: Underemployment Rate and Unemployment Rate by Educational Attainment

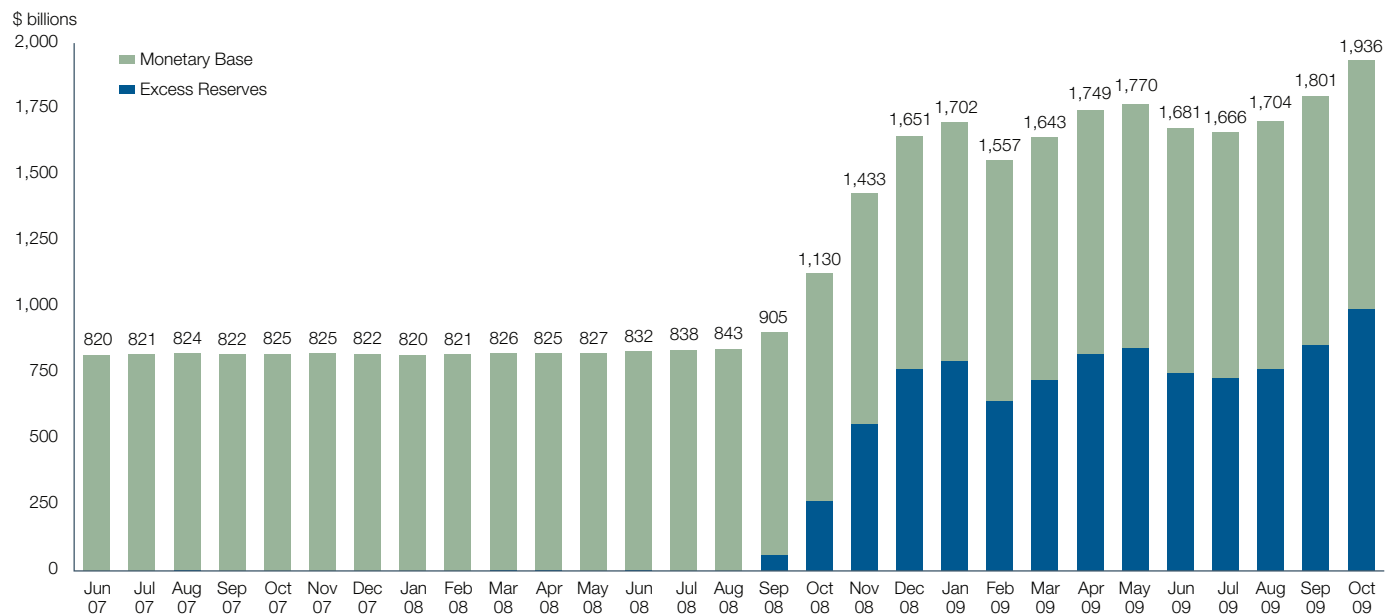


As of 30 September 2009

* Source: U.S. Census Bureau, Current Population Survey, 2008 Annual Social and Economic Supplement

Source: Bloomberg

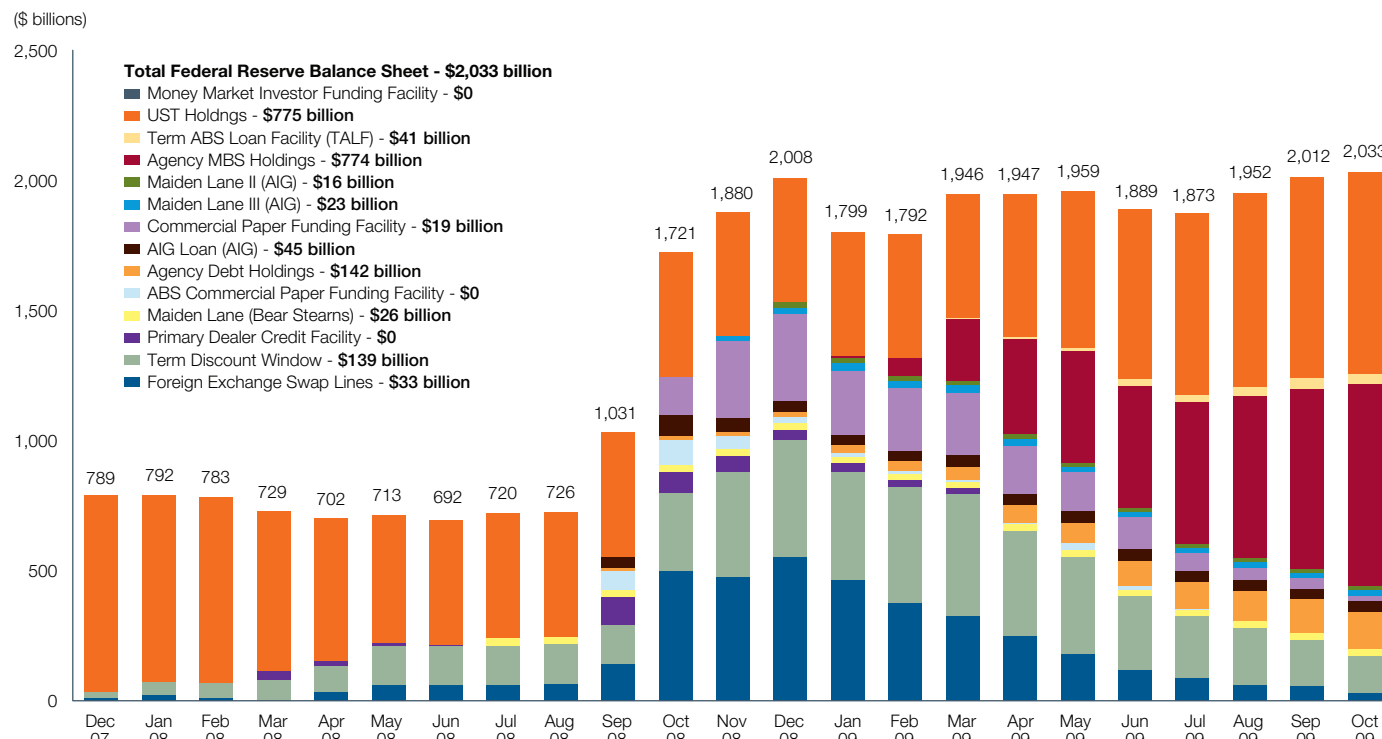
Exhibit 5: The U.S. Monetary Base and Excess Reserves



As of 31 October 2009

Source: U.S. Federal Reserve

Exhibit 6: U.S. Federal Reserve Lending Initiatives



As of 31 October 2009

Source: U.S. Federal Reserve

tighten, unemployment rates for unskilled workers will not decrease quickly, as workers could just work more hours at their current job before any incremental hires are needed at their companies. Due to this, we feel that labor is currently not an inflationary factor.

Monetary Base and Excess Reserves

There is no question that the U.S. Federal Reserve (the Fed) has been very assertive in intervening in this crisis. However, some investors are worried that the Fed's intervention may lead to inflation. Put simply, there are concerns that there is too much money in the United States chasing too few goods, which leads to inflation. Exhibit 5 illustrates the monetary base and the excess reserves proportion of the monetary base. The Fed has aggressively pumped money into the system since 2008. However, even if one argues that the Fed is creating too much money, that money is chasing very few goods, as shown by the blue portion (excess reserves) on the bar chart. In our view, the increase in money supply has not been an inflationary pressure.

Federal Reserve Lending Initiatives

Another aspect that some investors view as potentially inflationary is the fact that the Fed has been using its own balance sheet for the first time to intervene in the markets and gain a handle on the dislocations, which is illustrated in Exhibit 6. We believe that the growth in the Fed's balance sheet is a sign of weakness of the U.S. banking system rather than a sign of inflation. In our estimation, in order for the Fed's intervention to be inflationary, it would have to be at a multiple of its current size. In addition, it is not clear that the intervention is affecting the macroeconomic environment. For example, the Term ABS Loan Facility (or TALF) was originally intended to create \$1 trillion worth of new loans. However, TALF has only created \$41 billion worth of new loans to date. As programs such as TALF are not jumpstarting aggregate demand, again we feel that the Fed's intervention is not inflationary.

Summarizing our observations on the drivers of inflation, we continue to believe that deflationary forces have the upper hand and do not anticipate materially higher rates of inflation in the near term. However, the exercise of deconstructing the drivers of inflation highlights the fact that the current invest-

ment environment is subject to substantial directional uncertainty. Therefore, regardless of direction, we believe that uncertainty will be a material driver of investment returns.

Volatility – The Price of Uncertainty

Whether an investor feels that inflation or deflation is on the horizon, an unassailable fact, in our view, is that volatility will reign. The Chicago Board Options Exchange Volatility Index (VIX Index) is a measure of the implied volatility used to price options. It represents the future price for S&P 500 Index options that are closest to expiration, or closest to the money. Each time there is uncertainty in the market there is a considerable pickup in the VIX Index.

Exposure to volatility as an asset class can improve the quality of portfolios. As shown in Exhibit 7, the VIX is consistently uncorrelated to the majority of asset classes—the minimum and maximum correlation from 1986 through 2006 is -0.83 and

-0.32, respectively. This significantly negative correlation has the potential to offset risks in extreme-outlier situations that could cause real damage to the value of a portfolio.

How can investors add volatility to their portfolios? There are five primary approaches: Taking a long position in the VIX Index itself through futures, exchange-traded funds (ETFs), or options; accessing the listed volatility market; accessing the variance or OTC volatility market; accessing the warrens market; or accessing the convertible market. We believe there are significant opportunities to own volatility through the convertibles market. The top of Exhibit 8 shows the approximate current spread (over LIBOR) and the long-term average spread of four credit classes—investment grade, bank loans, high-yield, and converts. The implied spread of the convertible market is almost 1,250 basis points. Therefore, one is currently able to buy into volatility through convertibles at an attractive valuation, especially relative to other credit classes.

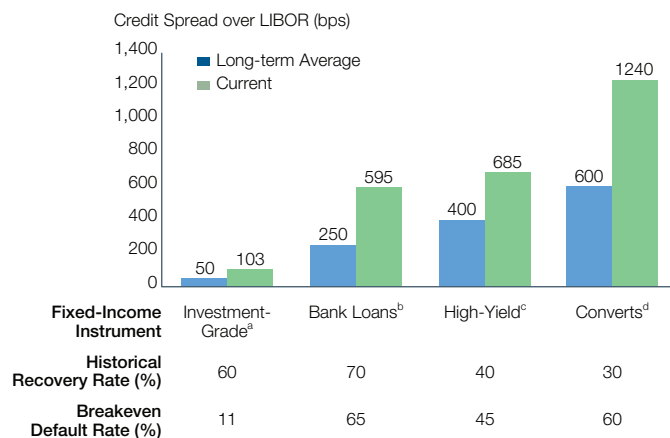
Exhibit 7: Calendar Year Correlations between the S&P 500 Index and Various Assets

	S&P 500 Annual Returns	Moody's BAA Corp Bond index	Goldman Sachs Commodities Index	Oil Spot Price	Gold	Silver	\$/Euro	VIX Index
1986	14.56%	-0.32	-0.06	-0.14	0.04	0.04	0.04	-0.32
1987	2.34%	-0.32	0.11	0.08	-0.28	-0.19	-0.23	-0.83
1988	12.43%	-0.32	-0.03	-0.05	-0.06	0.10	-0.3	-0.69
1989	28.25%	-0.17	0.05	-0.02	-0.10	0.04	-0.05	-0.66
1990	-8.97%	-0.28	-0.40	-0.28	-0.08	0.07	-0.1	-0.54
1991	27.63%	-0.36	-0.26	-0.24	-0.21	0.01	0.21	-0.56
1992	5.19%	-0.15	0.03	0.06	-0.04	0.03	-0.08	-0.55
1993	7.21%	-0.35	0.02	-0.04	-0.17	-0.03	0.03	-0.51
1994	-2.06%	-0.55	-0.14	-0.16	-0.18	-0.04	-0.20	-0.72
1995	33.18%	-0.44	0.00	0.03	-0.12	-0.07	-0.23	-0.45
1996	22.11%	-0.56	0.03	0.03	-0.10	-0.16	-0.17	-0.68
1997	24.07%	-0.35	-0.16	-0.12	0.00	-0.05	-0.33	-0.70
1998	31.56%	0.21	0.08	0.01	0.02	0.04	-0.17	-0.82
1999	18.54%	-0.30	-0.04	-0.02	0.03	-0.07	-0.38	-0.80
2000	-13.28%	0.00	-0.08	-0.06	-0.03	-0.07	-0.08	-0.78
2001	-9.08%	0.01	0.00	0.01	-0.08	-0.15	-0.22	-0.82
2002	-22.42%	0.50	0.20	0.17	-0.31	-0.11	-0.32	-0.82
2003	20.70%	0.29	-0.24	-0.24	-0.20	0.06	-0.40	-0.66
2004	11.95%	0.04	-0.08	-0.12	0.14	0.09	0.08	-0.75
2005	5.54%	-0.04	-0.06	-0.07	-0.02	0.05	-0.04	-0.82
2006	10.99%	-0.11	0.04	0.01	-0.05	-0.05	0.12	-0.82
minimum		-0.56	-0.40	-0.28	-0.31	-0.19	-0.40	-0.83
maximum		0.50	0.20	0.17	0.14	0.10	0.21	-0.32

Source: "Index Volatility Futures in Asset Allocation: A Hedging Framework," Lazard Asset Management and Duke University, available at: http://www.lazardnet.com/lam/us/tpd/pdfs/index_volatility.pdf

It is not possible to invest directly in an index. Past performance is not a reliable indicator of future results.

Exhibit 8: Approximate Current Spread, Long-term Average Spread, and Historical Recovery and Breakeven Rates



Information is as of 7 October 2009 and is subject to change. Long-term average returns are for the time period 1990 – Present. Breakeven default rate is assessed over a cumulative 5-year period.

Source: Lazard Asset Management, Bloomberg.

a Instrument, IG-13

b Instrument, LCDX13

c Instrument, HY-13

d Instrument, Converts ICRD (Implied Credit). Only includes convertible securities with a positive yield to put/yield to maturity.

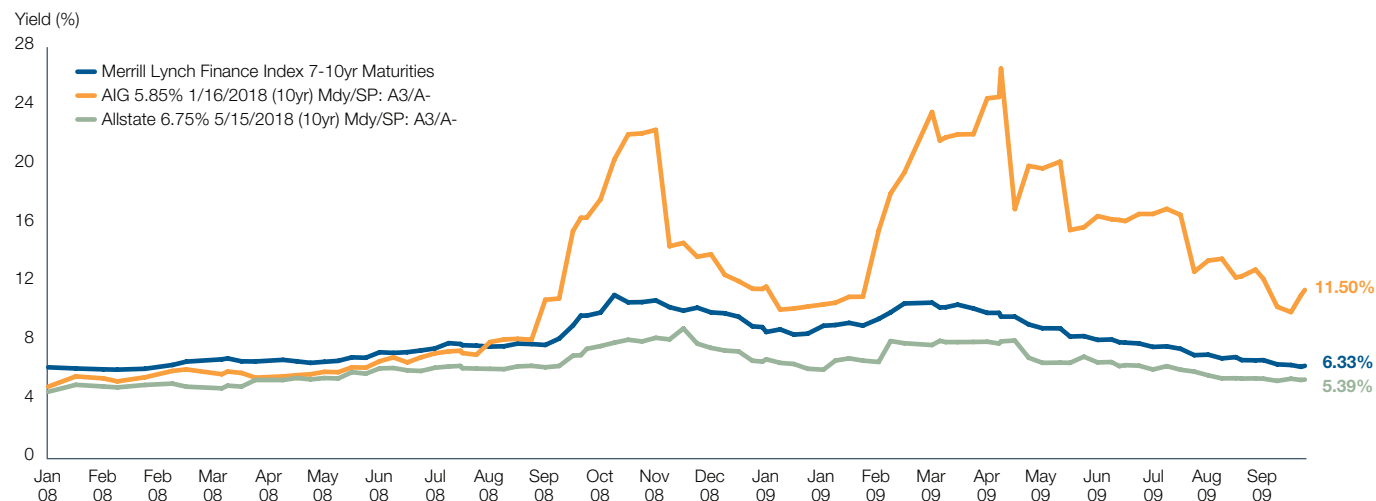
The bottom of Exhibit 8 illustrates historical recovery and breakeven rates over a 5-year cumulative period for the four credit classes. Specifically, the table shows that a convertibles portfolio can currently afford for 60% of its book to default and still breakeven, over the 5-year period, assuming a recovery rate of 30% (equal to the historical recovery rate). For high yield, 45% of the book can default for the portfolio to breakeven with a 40% recovery rate; 65% of a portfolio of bank loans can default with a 70% recovery rate; and 11% of an investment-grade portfolio can default with a 60% recovery rate. Again, this highlights how convertibles may be a responsible choice to add volatility to a portfolio.

Security Selection is Pivotal

The last item that we believe is important in asset allocation is security selection. Regardless of what drives investment decisions, risk is engaged at the security level and choosing the wrong security has proven to be fatal. Prior to the crisis, many investors believed that Goldman Sachs and Lehman Brothers represented interchangeable risks. In the current environment, we believe it is crucial to properly deconstruct the fundamental drivers of returns and select the correct securities when engaging market risk.

Unlike the 1998 crisis, when impairment occurred in emerging markets, impairment today is occurring in developed and developing markets. Investors can easily be misled by securities that, on the surface, appear to be similar, but are vastly different once deconstructed. Exhibit 9 shows yield for two

Exhibit 9: Investment-grade Fixed Income



As of 2 October 2009

Source: Merrill Lynch, Bloomberg

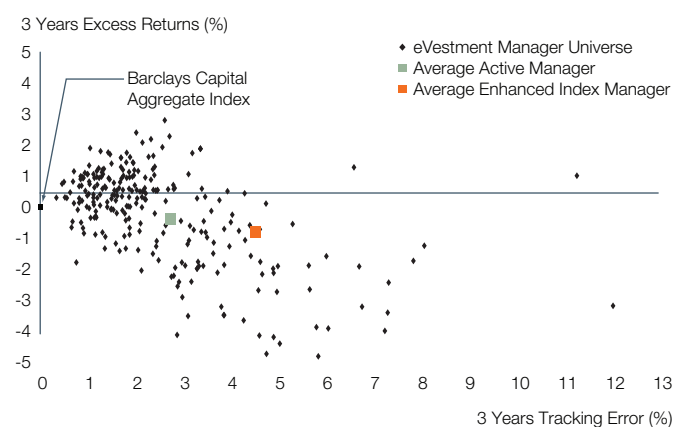
fixed-income securities, Allstate (10-year, rated A3/A-) and AIG (10-year, also rated A3/A-), as well as the Merrill Lynch Finance Index 7-10 year maturities, which is an investment-grade index. From our perspective, it is surprising that AIG has retained its A3/A- rating, as we believe AIG to be fundamentally impaired. Regardless of an investor's impairment opinion on AIG, what is clear from the graph is that AIG fixed-income securities no longer exhibit a behavior pattern consistent with what is generally expected of an investment-grade fixed-income allocation, as its yield has traded in a range from 6% to 26%. Conversely, Allstate continues to demonstrate the volatility of a fixed-income allocation. In addition, unlike AIG, which currently trades at an 11.5% yield that is much higher than its pre-crisis level, Allstate trades at a yield that reflects a spread that is tighter than it was at the beginning of the crisis, which is consistent with the relative pricing of other non-impaired credits in the marketplace. An investor looking at the Merrill Lynch Finance Index that holds both these credits could be easily misled into believing that this segment of the market is attractively valued when, in fact, it is the impaired credits in the Index that are making the segment averages look attractive. Not paying attention to security selection in the current environment will, at best, lead to unpredictable outcomes and, at worse, lead to a permanent loss of capital.

The recent performance of money managers within the fixed-income space has been characterized by an unprecedented dispersion of results. Exhibit 10 illustrates the excess return

and tracking error of managers in the fixed-income space (versus the Barclays Capital Aggregate Index). Security selection is likely responsible for the material dispersion exhibited over that last three years on this chart, as the average enhanced index manager experienced a higher tracking error than the average active manager. This same chart in 2006 was very different, as the managers' performance was much more clustered and did not experience the extreme dispersion that characterized the following three years. The numeric details are located in the table on the right of the chart. Statistically based sampling was not reliable in reducing tracking error risk in this environment, as industry populations are not homogenous. As a result, individual winners and losers in investment portfolios dominated performance results. Similar considerations can be done for equity managers. This environment poses significant challenges for fixed-income and equity indexation strategies, and highlights the fact that skill truly does matter in this environment in terms of security selection.

In conclusion, we believe it is important to note that we are entering a multiyear period of greater differentiation between winners, survivors, and losers. It is key that investors, whether they believe in inflation or deflation, understand what the implications could be on each industry and on each company to help make the right choices as it relates to security selection. The other important lesson, in our view, is that high volatility is likely, no matter what the inflation outcome is, and there are ways to potentially benefit a portfolio by investing in this asset class.

Exhibit 10: U.S. Fixed Income Manager Returns, 3 Years Ended 30 June 2009



	Tracking Error (bps)		Excess Returns (bps)	
	Pre Crisis	Crisis	Pre Crisis	Crisis
5th Percentile	73	336	49	86
95th Percentile	31	133	-10	-119
Spread	42	203	59	205
Worst Observation	406	2,882	-179	-1,093
# of Observations	292	266	292	266

Pre crisis: 3 years ending 30 June 2006

Crisis: 3 years ending 30 June 2009

As of 30 June 2009

Source: eVestment Alliance, Lazard Asset Management

Y-axis truncated at -500 basis points.

NOTES

1 In any given year in the United States there are about 1.5 million new households formed, of which approximately 1.0 million purchase a home. About 450,000 new homes are generated per year, leaving approximately 550,000 homes that are needed for new households. In addition, old homes that are demolished need to be replaced. Source: U.S. Census Bureau, Current Population Survey, March and Annual Social and Economic Supplements, 2008 and earlier. There is no guarantee that these results will be achieved. These results are subject to change.

IMPORTANT INFORMATION

Published on 10 December 2009.

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