

Lazard Insights

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Summary

The Search for Fixed Income Returns in a Low-yield Environment

Featured Speaker: **Joe Ramos**, Managing Director, Portfolio Manager/Analyst

Fixed-income investors are facing many challenges as a result of the current low-yield environment. During such times, we believe it is important for investors to consider the underlying investment conditions that define the environment and to reconnect with the appropriate fundamental framework for making sound investment decisions.

Defining Fixed Income Objectives and Strategies

Fixed-income securities are loan contracts with cash flows that are governed by mathematical constructs. Due to the consistency of these constructs, fixed-income securities are utilized to solve a number of investment needs, including capital preservation, excess return generation, cash flow generation, liability hedging, and to provide correlation benefits relative to equity investments. In general, historical return observations of different fixed-income risk profiles confirm that the higher the level of interest rate or repayment risk, the higher the potential for both rewards and losses. As a result of the consistency of fixed income return/risk profiles, we believe it is key for investors to define and stick to their return/risk objective when considering the fixed-income asset class.

The Secular Era of Favorable Credit that Defined The Great Moderation has Ended

The Great Moderation was an era characterized by increasing returns, declining volatility, and relatively low levels of business and consumer impairment. Beginning in 1980, inflation

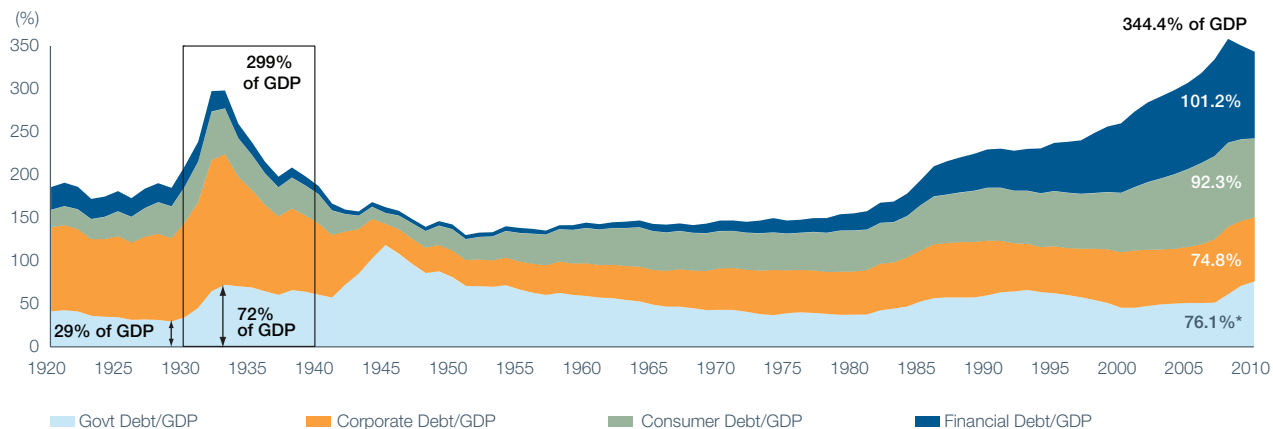
collapsed and interest rates declined for over 20 years. During this period, the cost of servicing debt continuously decreased, while the availability of credit was increasingly plentiful. Solvency and bankruptcy—two metrics that are normally correlated to each other—were often uncorrelated during this period due to the low cost and availability of credit. Investing in higher-yielding securities during The Great Moderation paid off, as issuers could simply borrow more to service their debts, leading to very low levels of impairment in fixed-income securities. We believe this extended period of cheap and plentiful credit led many investors to believe that yield and rating are strong predictors of the total return and credit quality, which is untrue.

Private sector debt increased to unprecedented levels during The Great Moderation as wealth became synonymous with leverage, which is illustrated in Exhibit 1. Unsurprisingly, an excessive amount of leverage magnifies all outcomes (both good and bad). The Great Moderation ended abruptly with the credit/liquidity crisis of 2008 and, so too, did the false predictive power of yield and rating.

The current environment of deleveraging has been characterized by cash flow disruptions, defaults, restructurings, and government intervention. Much of the private debt has shifted to the public sector, leading to ever higher levels of sovereign risk. We believe we will continue to experience the consequences created by The Great Moderation until the private and public sectors deleverage to more sustainable levels.

Exhibit 1

The Great Moderation Created Excessive Leverage



As of 30 June 2010

*Government debt above excludes \$4.6 trillion of federal debt owned by other government entities. The largest amount excluded is that owned by the Social Security Trust Fund totaling \$2.6 trillion. Including the debt owned by other government entities, government debt/GDP was 106.9% at 30 June 2010.

Source: U.S. Federal Reserve, U.S. Bureau of Economic Analysis, Morgan Stanley, Bloomberg, U.S. Treasury Department, Social Security Administration

Exhibit 2

January 2007 versus June 2009 Composite Credit Ratings

Industry	Description	Jan '07 Eff Dur	Jan '07 Yield	January 2007 Composite Rating	June 2009 Composite Rating
Brokerage	GOLDMAN SACHS	7.2	5.69	AA-	A
	LEHMAN BROS.	7.9	5.69	A+	Default
Banking	WELLS FARGO	13.5	5.82	AA	AA-
	WASH MUTUAL	7.9	5.75	A-	Default
Banking/Brokerage	BARCLAYS PLC	7.4	5.82	AA-	A-
	KAUPTHING BANK	7.1	6.07	A	Default
Insurance	MASS MUTUAL	13.3	5.80	AA	A+
	AMBAC	13.4	6.05	AA	C+
Apparel/Textiles	VF CORPORATION	12.6	6.43	A-	A-
	JONES APPAREL	12.1	7.13	BBB-	B+
Printing & Publishing	DONNELLEY & SONS	7.4	6.16	BBB	BBB-
	KNIGHT RIDDER	7.5	6.67	BBB-	CC+
Building & Construction	MDC HOLDINGS	6.6	6.41	BBB-	BBB-
	LENNAR CORP	6.5	6.20	BBB	B+

The securities identified are not necessarily held by Lazard Asset Management for all client portfolios, and should not be considered a recommendation or solicitation to purchase or sell these securities.

Source: Bank of America Merrill Lynch, Bloomberg

Shown for illustrative purposes only.

The Reality of Yield and Rating

No matter what investors experienced during The Great Moderation, yield does not equal return, and rating does not equal credit quality.

Yield equals risk. Yield is a valuation metric used to compare securities that have different cash flows. It is the discount factor that is used to come at the price that fairly compensates an investor for the risk of lending. The yield utilized to value a cash flow reflects the uncertainty of the cash flow, including the terms and conditions of the cash flow, the operational collection risks, the credit quality of involved parties, and the market for disposing of the cash flow to another investor prior to its termination. The higher the uncertainty, the higher the yield.

A rating is a sophisticated credit score derived through financial modeling. The validity of the credit score is dependent on the assumptions, methodology, and the transition data available to the model. Even the most robust credit model can fail

over time, as no model can fully capture the nuances present in reality.

Yield and Rating are Not Reliable Predictors of Investment Outcome

Absent further analysis and context, yields and ratings shed no light on outcomes. This is illustrated by Exhibits 2 and 3. Exhibit 2 pairs corporate issuers that were perceived to be synonymous prior to the credit/liquidity crisis of 2008. A money manager that owned the top security in each pairing would not have noticed that there was a crisis, while a manager that owned the bottom security in each pairing would now be broke. The commonly implemented investment strategy of maximizing yield for a given rating failed abruptly with the end of the favorable credit conditions that defined The Great Moderation.

Exhibit 3 compares the annual total returns of a variety of the highly rated sectors that comprise the short-duration market. During The Great Moderation, the highly rated short-dura-

Exhibit 3 Short-duration Sector Performance (0 to 3 year average life)

		2006	2007	2008	2009	2010
U.S. Treasuries	Beg. Excess Yield	-1	-1	-5	0	-1
	Total Return	4.0%	7.3%	6.6%	0.8%	2.3%
	Beg. Par Amount	882,464	952,151	891,468	980,638	1,556,318
U.S. Agencies	Beg. Excess Yield	33	21	58	71	20
	Total Return	4.5%	6.7%	7.1%	2.2%	2.2%
	Beg Par Amt	440,422	443,799	368,972	485,773	680,477
U.S. Agency MBS	Beg. Excess Yield	34	38	125	166	14
	Total Return	4.6%	6.9%	5.3%	6.0%	4.7%
	Beg. Par Amount	27,165	29,331	282,076	4,021,556	2,019,879
Corporates A and above	Beg. Excess Yield	49	44	160	662	135
	Total Return	4.6%	6.0%	-2.4%	11.6%	3.7%
	Beg. Par Amount	250,809	255,287	252,208	278,426	338,085
ABS Floater	Beg. Excess Yield	83	70	397	1,027	261
	Total Return	5.6%	-5.8%	-24.3%	9.1%	3.9%
	Beg. Par Amount	745,259	917,576	950,574	695,636	422,841
ABS Floater - AAA Rated	Beg. Excess Yield	70	59	235	805	138
	Total Return	5.4%	0.8%	-17.4%	13.5%	1.9%
	Beg. Par Amount	597,343	712,594	736,098	398,096	297,735
RMBS - AAA Rated	Beg. Excess Yield	88	82	335	1,018	625
	Total Return	5.1%	0.6%	-27.2%	17.1%	18.7%
	Beg. Par Amount	24,530	34,629	41,632	13,383	4,222

As of 31 August 2010

Source: Bank of America Merrill Lynch

Past performance is not a reliable indicator of future results.

tion market was believed to have little investment risk and was subject to low capital requirements. As a result, maximizing yield and leverage in this market segment was viewed as the superior low-risk investment strategy for financial institutions looking to increase their return on capital (i.e., wealth through leverage). The eventual collapse of this strategy was ultimately responsible for the collapse of the entire financial system in the United States.

The fallacy of the strategy first becomes apparent in 2007. In the beginning of 2007, U.S. Treasuries provided the lowest excess yield in the short-duration market, while AAA-rated residential mortgage-backed securities (RMBS) provided the highest excess yield (versus U.S. Treasuries). Despite the lower excess yield, U.S. Treasuries provided a total return of 7.3% in 2007. AAA-rated RMBS, however, provided one of the lowest total returns at just 0.6%.

By the beginning of 2008, highly rated asset-backed securities (ABS) floaters provided an extremely high amount of excess yield (risk) and, subsequently, produced a total return of -24.3%. U.S. Treasuries, which began the year with the lowest excess yield, provided a total return of 6.6%.

In 2009 and 2010, the best-performers were AAA-rated RMBS, however, this was mainly due to survivorship bias, as the par amount of these securities had deteriorated to the

point that these large percentage returns had little positive impact on the impaired investment portfolios that owned them. Many of yesterday's highly rated, higher yielding sectors became today's toxic waste.

Technical Flows into Fixed Income

The consequence of the unprecedented magnitude of investment-grade impairment has been massive government intervention. Through initiatives such as quantitative easing, the U.S. government has attempted to re-create the favorable credit conditions of The Great Moderation through direct lending and investment programs, often to the same consumers and institutions that failed during the crisis. The goal is to soften the blow of the investment impairment by extending the resolution time to "cure" it. Whether these initiatives will work or not remains to be seen; however, what is certain is that government intervention of this magnitude can lead to valuation distortions that we believe investors need to consider.

The nature of the government's intervention has reduced fixed-income liquidity concerns, leading to record flows toward fixed-income assets that are perceived to be safe bets. The U.S. investment-grade bond market—intermediate-term corporates in particular—has been a major beneficiary of unprecedented investor flows. These conditions have

Exhibit 4 Wal-Mart Investment Opportunity

	Type of Security	Coupon (%)	Maturity	S&P	Market Yield (%)	Market Valuation	
Wal-Mart	5-year Securities	2.250	7/8/2015	AA	1.46	103.646	
UST 5yr		1.250	8/31/2015	AAA	1.31	99.734	
Excess Yield Spread					0.15		
Breakeven Total Return Analysis					B/E Yield (%)	B/E Valuation	B/E Change
A 3 bps change in excess spread erases Wal-Mart's advantage					1.49	103.487	+3 bps
A rise of 32 bps in yield produces a zero return					1.78	102.133	+32 bps
	Type of Security	Coupon (%)	Maturity	S&P	Market Yield (%)	Market Valuation	
Wal-Mart	10-year Securities	3.625	7/8/2020	AA	3.08	104.568	
UST 10yr		2.625	8/15/2020	AAA	2.54	100.734	
Excess Yield Spread					0.54		
Breakeven Total Return Analysis (B/E)					B/E Yield (%)	B/E Valuation	B/E Change
A 7 bps change in excess spread erases Wal-Mart's advantage					3.15	104.003	+7 bps
A rise of 38 bps in yield produces a zero return					3.46	101.347	+38 bps

As of 23 September 2010.

Source: Bloomberg.

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led to an unusually low yield environment at a time of great uncertainty, and many investors seem unconcerned with this paradox or the risk that the market could shift away from these fixed-income assets when risk appetites change. Much of these flows are, again, the result of the search for yield based on ratings, leading to the question: Is this investment behavior rational?

Investing for Total Return

As total return investors, we do not ask ourselves how much excess yield we are getting for a particular investment, but rather whether the yield used to price the investment is sufficient to protect us and meet our investment objective. As an example, Exhibit 4 illustrates the total return potential of investing in Wal-Mart bonds.

Our investment objective is to place our capital somewhere liquid and earn some excess return while we wait for better times. For the purposes of our analysis, we have estimated our holding period to be one year. Based on our credit quality analysis, we are confident that Wal-Mart is a strong issuer and that Wal-Mart will likely meet its debt obligations over the foreseeable future. Based on our investment objective, we have selected 5- and 10-year securities as investment candidates that are senior in the capital structure, that we consider to be liquid, and that have had no issues with regard to the timeliness or the mechanism for collecting cash flows. In order to come to an investment decision, we need to establish the pricing thresholds that will dictate investment outcomes over our holding period. These are three questions that we must consider:

1. What level of widening in excess yield spread of Wal-Mart creates a total return that breaks even with U.S. Treasury alternatives over the holding period?
2. What rise in the level of interest rates (U.S. Treasury yields) equates to a zero holding period return?
3. Are either of these changes in yield probable?

In the 5-year securities, Wal-Mart has a coupon of 2.250%, is rated AA by S&P, and matures on 8 July 2015, while the U.S. Treasury holds a coupon of 1.250% with a similar maturity of 31 August 2015. The market yield of Wal-Mart is 1.46%, which produces an excess yield spread of 0.15% versus the U.S. Treasury. Assuming that we would own the security for one year and that interest rate changes can happen instantly, it takes a change of only three basis points in the excess spread of Wal-Mart (from 15 to 18 basis points) to erase the total return advantage of owning the Wal-Mart security over the U.S.

Treasury security over the one year holding period. It takes a 32 basis point increase in yield to bring the total return of the Wal-Mart security to zero over the one-year holding period.

In the 10-year securities, it takes an increase of only seven basis points in the excess spread of Wal-Mart to erase the advantage of owning Wal-Mart versus the U.S. Treasury for a one-year holding period, and a rise of 38 basis points in yield produces a zero return over the holding period.

As investors, we then ask ourselves: Is a widening of seven basis points probable, and is a 38 basis point rise in yield probable? Further, if the capital is needed within a year, is an investment in intermediate securities the right choice to meet our stated objective?

Lending Rates are Low: Borrower's Perspective versus Lender's Perspective

Wal-Mart is an example of a high-quality company where bond prices and equity prices reflect different expectations. Based on its stock price, equity markets seem uncertain about Wal-Mart's future. The share price currently trades below the levels it did during the crisis, despite the company's 30 years of rising earnings.

Conversely, fixed-income investor behavior has lowered Wal-Mart's excess borrowing cost to levels that are significantly below where they were before the crisis. This has motivated Wal-Mart to borrow money, as it finds the cost of fixed-income capital to be very low. Prior to the crisis, Wal-Mart borrowed at approximately 95–125 basis points off of U.S. Treasuries. Currently, Wal-Mart's borrowing rate is approximately 15–54 basis points off of U.S. Treasuries. We believe these levels are too expensive, as the potential for further fixed-income appreciation is limited, and the risk of experiencing a negative total return from lending to Wal-Mart relative to U.S. Treasury alternatives over our holding period is high. At both the 5-year and 10-year levels of interest rate risk, we believe U.S. Treasury securities will outperform Wal-Mart securities in the coming year. Should we then still reach for yield in intermediate U.S. Treasury securities?

Current interest rate volatility is approximately 100 basis points per annum. While there is speculation in the market that 10-year U.S. Treasury yields could move below 2%, the last time this occurred was in the period following the dramatic declines in price that characterized the Great Depression—CPI declined by over 24% and GDP fell by 27% from 1930–1932. Currently, both CPI and GDP are positive.

Absent a massive deflationary event or a significant decline in interest rate volatility, we believe that it is probable for yields to rise more than 38 basis points from current levels and that the probability of the 10-year U.S. Treasury yield falling below 2% is low. As a result, we feel that the possibility for experiencing a negative total return from investing in intermediate-maturity securities within a one-year timeline is high.

Based on our analysis, we have determined that it is not prudent to buy intermediate securities in general, and Wal-Mart securities in particular, as doing so violates our investment objective in this example.

Finding Return Opportunities

Great opportunity, in our experience, is found during times of great uncertainty. We believe, however, that investors should follow three basic principles when considering opportunities:

1. **Be selective.** Do not lose sight of the fact that fixed-income securities are loan contracts. In our experience, it pays to be ready for when opportunities present themselves. Pre-determine what issuers and securities meet the investment objective irrespective of current valuations.
2. **Be tactical.** Over-the-counter markets with weak intermediaries are often driven by the behavior of crowds. Under such conditions, opportunities often lie in securities that are

out-of-favor. Keep in mind that, like our Wal-Mart example, sometimes doing nothing is better than doing something.

3. **Focus on total returns.** While excess yields may be enticing, they are not predictive of outcomes. They are simply an analytical tool to help determine whether an investment is appropriate to meet the investment objective. Keep in mind that often the lowest-yielding security may produce the highest holding period return.

We believe investors that are selective, tactical, and that are focused on total returns can find strong opportunities. Currently we are finding opportunities in: U.S. Treasuries, based on government policy and technicals; Agency mortgage-backed securities, based on loan analysis and a broken prepayment framework; lower-rated corporate bonds, based on fundamental credit analysis; municipals and/or Build America Bonds, based on structural analysis; emerging market local currency debt from countries with healthy balance sheets and that are suppliers of raw industrial goods and sophisticated services; and in convertibles, based on volatility and underlying divergences. Each opportunity needs to be analyzed to ensure that it fits the investment objective, and should be considered within the context of the current investment environment.

Important Information

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An investment in bonds carries risk. If interest rates rise, bond prices usually decline. The longer a bond's maturity, the greater the impact a change in interest rates can have on its price. If you do not hold a bond until maturity, you may experience a gain or loss when you sell. Bonds also carry the risk of default, which is the risk that the issuer is unable to make further income and principal payments. Other risks, including inflation risk, call risk, and pre-payment risk, also apply. High yield securities (also referred to as "junk bonds") inherently have a higher degree of market risk, default risk, and credit risk.

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