

Lazard Insights

Conference Call Series

24 March 2010

Summary

Exploring Opportunities Down the Market Capitalization Spectrum

Featured Speaker: **Daniel Breslin**, Director, Portfolio Manager/Analyst

Defining the Market Spectrum

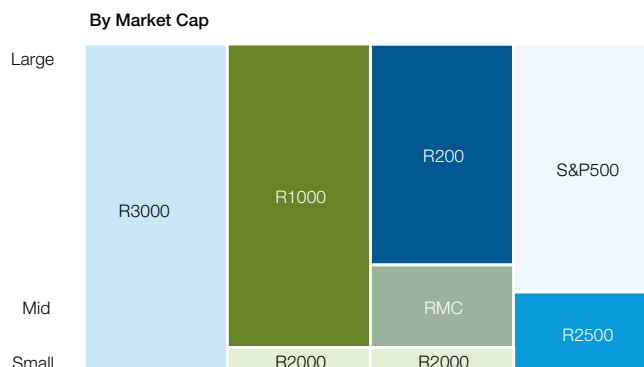
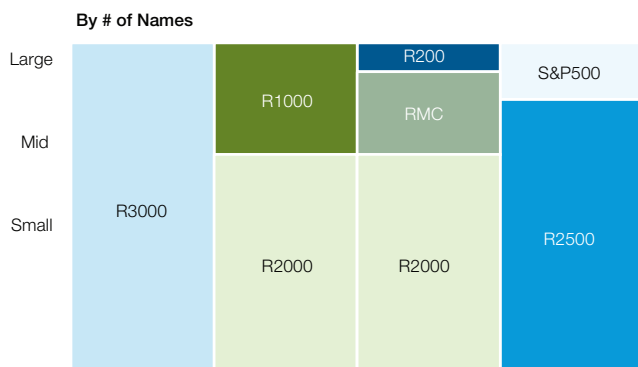
The Russell 3000 Index measures the performance of the largest 3,000 companies in the United States. The constituents of the Russell 3000 can be broken out into several sub-indices by market capitalization, as shown in Exhibit 1. Exhibit 1 also illustrates the stark difference between the percentage of the Russell 3000 that each index represents by number of stocks versus the percentage each index represents by market capitalization.

If managers were to benchmark themselves to the Russell 3000 Index, they would essentially be investing in a large-cap universe, as the market capitalization of the top 1,000 stocks currently make up almost 92% of the entire market cap of the Index. Conversely, we believe that utilizing the Russell 2500 Index as a benchmark is an efficient way to participate across the U.S. equity market. The Russell 2500 currently includes over 83% of the investable names in the U.S. equity market, which highlights the diverse opportunity set and flexibility afforded to managers who utilize a broader benchmark. Additionally, the Russell 2500 Index may serve as a complement to the standard S&P 500 benchmark.

Exhibit 1

Percentage of Russell 3000 Index by Number of Names and by Market Capitalization

	Russell 1000 Index	Russell Midcap Index	Russell 2500 Index	Russell 2000 Index
Market Capitalization Range (\$M)	239 – 307,255	239 – 17,472	16 – 10,253	13 – 4,600
Weight of Russell 3000 Index (by # of names)	33.3%	26.7%	83.3%	66.7%
Weight of Russell 3000 Index (by market cap)	91.8%	26.6%	19.6%	8.8%



As of 28 February 2010

Source: Russell Investments, Standard & Poor's

Performance by Style and Size

Over the last 12 years, both value and growth indices have rotated in and out of outperformance. However, in the majority of the observations, the style of a given index dominated the market cap of an index. Put another way, most returns were predicated on style investing versus market-cap investing.

Over the same period, there was also a rotation in performance of core indices by market capitalization. What is interesting to note here is the performance of the Russell 2500 Index, which has been either in the upper or middle range of performance for each year over the past 12 years. We believe that this illustrates the benefits of the dispersion of returns within a broader-based Index, regardless of market conditions.

Index Style Biases

Over the last three years, the Russell 2000 Growth Index (the Growth Index) has outperformed the Russell 2000 Value Index (the Value Index), as shown in Exhibit 2. What is striking is that almost two-thirds of the outperformance of the Growth Index over this period was due to sector allocation as opposed to stock selection.

The allocation effect is strong because each of the style indices are heavily weighted in certain sectors. Exhibit 3 illustrates the weighting of both indices for the past two years,

which are relatively representative of what occurs year-in and year-out. The weighting in the financials and utilities sectors of the Value Index made up approximately 40% of the total Index over the past two years, while the health care and information technology sectors made up approximately 45% and 50% of the Growth Index in 2008 and 2009, respectively. It is important to understand that an investment in a U.S. equity style index in the non-large-cap universe is essentially a sector bet due to the general nature of the indices within this asset class.

Beneath Overall Index Performance Lies Opportunity

Over the last three years, the Russell Midcap Index (the Midcap Index) has outperformed the Russell 2000 Index (the Small-cap Index). However, when broken down by sector, six of the ten sectors outperformed in the Midcap Index, while four sectors outperformed within the Small-cap Index. As an example, the Midcap Index beat the Small-cap Index for the 3-year period overall, but the Small-cap Index outperformed the Midcap Index by over 1,400 basis points in the materials sector. An active manager that has the ability to invest throughout the market-cap spectrum represented by both of these indices has the potential to take advantage of the pockets of outperformance.

Exhibit 2

3-Year Attribution of Russell Growth versus Value Indices

	Russell 2000 Growth Index		Russell 2000 Value Index		Total Return (%)		Total Effect
	Average Weight	Total Return	Average Weight	Total Return	Allocation Effect	Stock Selection	
Consumer Discretionary	14.66	-16.36	12.02	-43.14	0.15	4.72	4.87
Consumer Staples	2.91	18.51	3.86	-1.78	-0.13	0.72	0.59
Energy	6.73	-20.69	4.91	-18.72	-2.77	0.18	-2.59
Financials	6.91	-27.89	34.05	-41.63	5.28	1.54	6.81
Health Care	22.56	-3.22	5.21	9.49	3.49	-3.01	0.48
Industrials	17.04	-20.99	14.24	-12.54	0.86	-2.65	-1.78
Information Technology	23.65	-3.72	12.31	-14.03	2.03	2.51	4.54
Materials	3.29	19.01	6.03	34.76	-1.79	-0.43	-2.23
Telecommunication Services	1.44	-34.76	1.16	-30.56	0.09	-0.00	0.09
Utilities	0.54	3.04	6.14	-5.27	0.11	0.08	0.19
Unassigned	0.27	-54.61	0.07	24.58	0.07	0.09	0.16
Total	100.00	-11.59	100.00	-22.72	7.39	3.75	11.13

As of 31 December 2009

Source: Russell Investments, Lazard

Past performance is not a reliable indicator of future results.

Exhibit 3

Sector Weightings of the Russell 200 Growth and Value Indices

	2008			2009		
	Average Weight (%)		Difference	Average Weight (%)		Difference
	Russell 2000 Growth Index	Russell 2000 Value Index		Russell 2000 Growth Index	Russell 2000 Value Index	
Financials	6.61	34.10	-27.48	5.55	34.74	-29.19
Utilities	0.73	6.17	-5.44	0.54	7.02	-6.47
Total:	7.35	40.27	-32.92	6.09	41.76	-35.66
Health Care	22.80	5.45	17.36	24.93	5.13	19.80
Information Technology	21.89	12.12	9.77	25.26	11.73	13.54
Total:	44.69	17.56	27.13	50.19	16.85	33.33

As of 31 December 2009

Source: Russell Investments, Lazard

Exhibit 4

3-Year Performance Attribution – Russell Midcap versus Russell 2000 Indices

Sector	Industry	Russell Midcap Total Return	Russell 2000 Total Return
Consumer Discretionary	Consumer Services	-12.85	-30.54
	Media	-31.51	-53.93
	Automobiles & Components	-33.31	-49.65
	Retailing	-13.83	-12.56
	Consumer Durables & Apparel	-39.54	-27.63
Consumer Staples	Food Beverage & Tobacco	5.50	14.92
	Household & Personal Products	7.55	-2.19
	Food & Staples Retailing	-40.52	-6.86
Energy	Energy	8.94	-20.38
Financials	Banks	-60.55	-53.52
	Real Estate	-37.92	-33.14
	Diversified Financials	-35.93	-27.53
	Insurance	-35.76	-18.30
Health Care	Health Care Equipment & Services	11.34	-9.75
	Pharmaceuticals Biotechnology & Life Sciences	6.12	8.58
Industrials	Capital Goods	-6.51	-12.18
	Commercial & Professional Services	-23.22	-21.50
	Transportation	-13.08	-26.67
Information Technology	Semiconductors & Semiconductor Equipment	-9.47	-22.92
	Technology Hardware & Equipment	-10.27	-16.09
	Software & Services	1.63	6.78
Materials	Materials	16.45	30.74
Telecom Services	Telecommunication Services	-22.81	-33.18
Utilities	Utilities	-9.37	-4.70
Total		-13.19	-17.17

■ Outperformed

As of 31 December 2009

Source: Russell Investments, Lazard

Past performance is not a reliable indicator of future results.

This dispersion of returns is even more apparent when broken down by industry. The Small-cap Index outperformed the Midcap Index in several cases at the industry level, even in instances where the Midcap Index had outperformed at a sector level. Exhibit 4 shows the 3-year attribution at the industry level within the Russell Midcap and Small-cap Indices. While the Midcap Index clearly outperformed the Small-cap Index in the information technology sector, the Small-cap Index significantly outperformed the Midcap Index in the software and services industry within the sector. We believe that this again illustrates how an active manager with the flexibility of a broader mandate can potentially add value by selecting the outperforming industries and sectors, regardless of overall index performance.

Benchmark Nuances

There are numerous characteristics of the small- and mid-cap indices that can significantly impact an investor's stock selection, allocation, and returns. These effects are typically either muted or nonexistent within the Russell 2500 Index.

Earners versus non-earners.

Currently, approximately 3% of the constituents of the Russell Midcap Index are non-earners, while 12% of the Russell 2000 Index are non-earners. This suggests that, during a lower-quality rally, the Small-cap Index has a better base to outperform due to its higher number of lower-quality stocks.

Size. The Russell 2000 Index has the potential to be dominated by a micro-cap rally—an environment in which it is very tough for a small-cap manager to outperform. Conversely, the Midcap Index has issues on the larger side; as the Russell Midcap Index is only

rebalanced once a year, a mid-cap manager is forced to make a decision whether or not to own the largest names in the benchmark. This also lends to a high level of volatility around the time when the Russell indices are rebalanced, as the names that have a higher market capitalization may graduate to a larger index. However, the Russell 2500 Index mitigates the impact of these problems, to a certain extent, due to its size and breadth. The Russell 2500 Index still experiences pressures on both ends, but to a much smaller extent versus the Russell 2000 and Midcap Indices.

Index Rebalancing. As noted in the previous point, there is often a higher level of volatility surrounding the annual rebalancing of the Russell Indices. This effect is also heightened by the impact of hedge funds, which currently and often hold an overweight position in mid-cap stocks.

Concentration. Within indices that are dominated by their larger constituents, it becomes increasingly important for the manager to decide what not to own versus what to own. This effect is obvious further up the market capitalization spectrum within the Russell Midcap Index, especially during the time surrounding the index rebalancing. Stocks within the Midcap Index that are not owned by the manager can often impact returns just as much as stocks that the manager does own during this time.

Small-Mid Opportunity Set and Performance

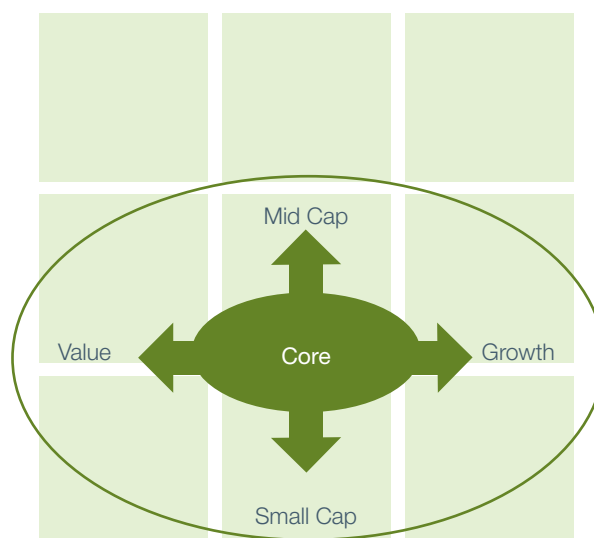
The Russell 2500 Index includes the 2,000 constituents within the Russell 2000 Index plus the next 500 stocks by market capitalization. The additional 500 names that are included in the Russell 2500 Index have added to its return in 13 out of the past 19 years and, over the 19-year period overall, have added approximately 130 basis points to its annualized return. An active manager that utilizes the Russell 2500 Index as a benchmark has the opportunity to move in and out of these names to potentially capture value and to avoid potential detractors during the times when these 500 stocks reduce the Index returns.

This benefit has been demonstrated in manager performance (as measured by Morningstar¹). Over the past 10 years, the Russell 2500 Index has outperformed both the Russell 2000 and Russell Midcap Index. The average manager in the mid-cap category has underperformed the Midcap Index benchmark. However, the average small blend manager (which includes both small-cap and small-mid-cap managers) has not only outperformed its benchmarks, the Russell 2000 and 2500 Indices, but has also outperformed both the average mid-cap manager and the Russell Midcap Index.

Role of Active Manager in a Broad Mandate

Many investors have chosen to look at the Morningstar style boxes as a “T,” utilizing large-cap value, core, and growth managers to fill the top three boxes, while hiring just one small-mid-cap manager to fill the following six boxes (or the stem of the “T”). This concept is illustrated in Exhibit 5. The ability of small-mid-cap managers to move up and down the market-cap spectrum and back and forth across the style spectrum allows them to efficiently cover a much wider range of investments, thus filling the gap that six different managers might have previously covered.

Exhibit 5 The Style and Size Role of Small-Mid Cap Managers



As of 31 December 2009

Source: Morningstar,¹ Lazard

Conclusion

The market becomes fragmented and returns can disperse widely as an investor moves down the market capitalization spectrum, and broad-based managers are afforded more of an opportunity to take advantage of these dispersions. Regardless of markets conditions, there will always be pockets of outperformance; in our view, what is imperative is the flexibility to potentially take advantage of those opportunities and avoid the negative areas.

NOTES

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Past performance is not a reliable indicator of future results.

Equity securities will fluctuate in price; the value of your investment will thus fluctuate, and this may result in a loss.

The Russell 3000 Index measures the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market. The index is unmanaged and has no fees. One cannot invest directly in an index.

The Russell Top 200 Index measures the performance of the largest cap segment of the U.S. equity universe. The Russell Top 200 Index is a subset of the Russell 3000 Index. (The Russell 3000 Index measures the performance of approximately 3000 of the largest U.S. companies, representing approximately 98% of the investable U.S. equity market.) It includes approximately 200 of the largest securities based on a combination of their market cap and current index membership and represents approximately 65% of the U.S. market. The index is unmanaged and has no fees. One cannot invest directly in an index.

The Russell 1000 Index measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000 Index and includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership. (The Russell 3000 Index measures the performance of approximately 3000 of the largest U.S. companies, representing approximately 98% of the investable U.S. equity market.) The Russell 1000 represents approximately 90% of the U.S. market. The index is unmanaged and has no fees. One cannot invest directly in an index.

The Russell Midcap Index includes approximately 800 of the smallest securities in the Russell 1000 Index, representing roughly 27% of the total market capitalization of Russell 1000 companies. (The Russell 1000 Index measures the performance of the large-cap segment of the U.S. equity universe. It includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000 represents approximately 90% of the U.S. market.) The index is unmanaged and has no fees. One cannot invest directly in an index.

The Russell 2500 Index measures the performance of the small- to mid-cap segment of the U.S. equity universe, commonly referred to as "smid" cap. The Russell 2500 Index is a subset of the Russell 3000 Index. (The Russell 3000 Index measures the performance of approximately 3000 of the largest U.S. companies, representing approximately 98% of the investable U.S. equity market.) It includes approximately 2500 of the smallest securities based on a combination of their market cap and current index membership. The index is unmanaged and has no fees. One cannot invest directly in an index.

The Russell 2000 Index includes approximately 2000 of the smallest securities in the Russell 3000 Index, representing roughly 8% of the total market capitalization of Russell 3000 companies. (The Russell 3000 Index measures the performance of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market.) The index is unmanaged and has no fees. One cannot invest directly in an index.

The Russell 2000 Value Index measures the performance of small-cap value segment of the U.S. equity universe. It includes those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values. (The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.) The index is unmanaged and has no fees. One cannot invest directly in an index.

The Russell 2000 Growth Index measures the performance of the small-cap growth segment of the U.S. equity universe. It includes those Russell 2000 companies with higher price-to-value ratios and higher forecasted growth values. (The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.) The index is unmanaged and has no fees. One cannot invest directly in an index.

The S&P 500 Index is a market capitalization-weighted index of 500 companies in leading industries of the U.S. economy. The index is unmanaged and has no fees. One cannot invest directly in an index.

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