

Lazard Insights

Conference Call Series

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Breaking Down Global Barriers: Benefits and Challenges of Investing in the Broadest Opportunity Set

Featured Speaker: **Patrick Ryan**, CFA, Director, Portfolio Manager/Analyst

We believe unconstrained global equity portfolios offer many advantages over the traditional regional approach, most importantly higher levels of alpha, as the broad opportunity set enables one to maximize the potential of stock selection. Therefore, carving out space for a global equity allocation and removing benchmark-imposed constraints on portfolio managers may allow them to enhance returns.

In addition, we are seeing increasing interest in global strategies coming from investors, and this is being driven by the greater integration of the global financial markets and the outperformance of truly unconstrained global strategies. We will discuss how global strategies generally outperform, the drivers of the relative performance versus their regional competitors, and how this has evolved over time. Lastly, we will discuss the challenges of managing assets on a truly global basis.

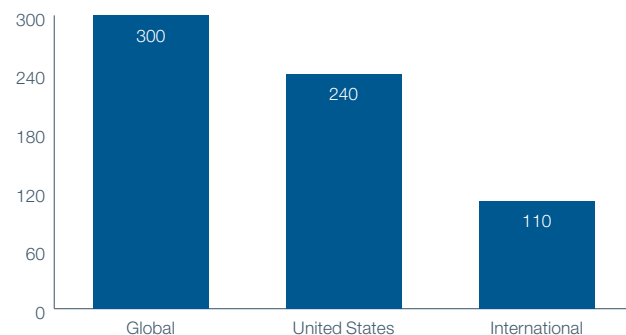
Performance Drivers of Global Mandates

Exhibit 1 shows how global strategies have performed compared to U.S. and international portfolios based on the eVestment Alliance All-cap Core universes over the last 10 years. We can see clearly in this 10-year period that global strategies maximized the alpha. Active global managers benefited from the broad opportunity set they had to invest in during the period. They were able to avoid the economically challenged areas of the global markets and take advantage of the different economic cycles around the world. Furthermore, they were able to benefit from stock selection within the broadest opportunity set.

What was that broad source of that outperformance for global strategies? Here we introduce the concept of “active share” based on a 2006 study from Yale.¹ Portfolio managers use the term active position to mean the weight of the stock in the portfolio minus the benchmark weight, or the position weight above or below the benchmark. Similarly, active share looks at the summation of the difference in weight of every position in the portfolio and

Exhibit 1 Global Managers Outperform Regionally Constrained Managers

10-yr Annualized Median Excess Returns (%)



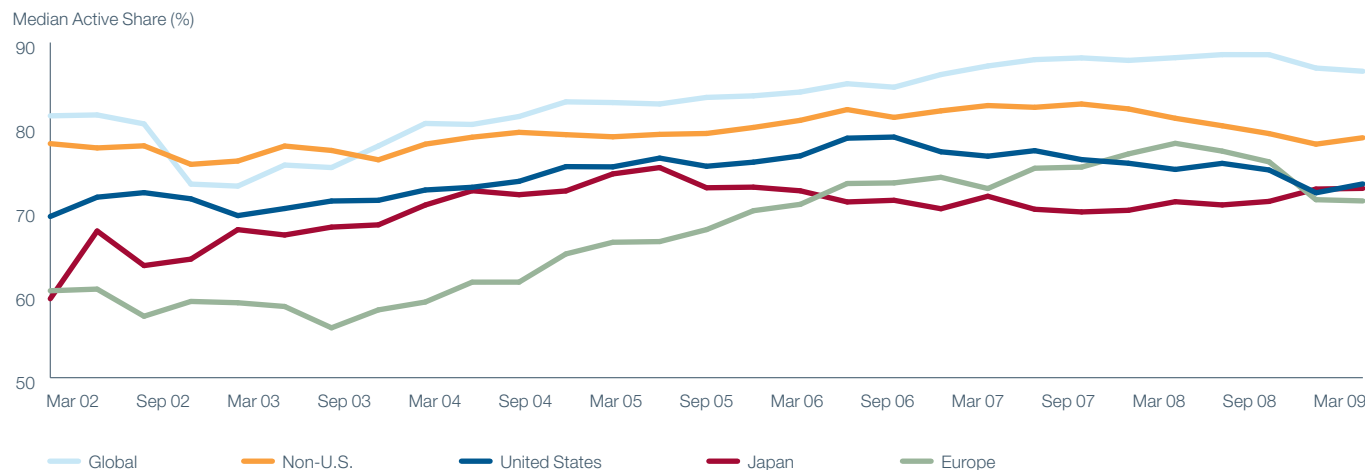
As of 31 March 2011

Data represents the eVestment 10-year annualized median manager excess returns based on 31 March 2011 data, as reported on 20 May 2011. Global represents the Global All-cap Core universe, United States represents the U.S. All-cap Core universe, and International represents the ACWI ex-U.S. All-cap Core universe. Past performance is not a reliable indicator of future results.

Source: eVestment Alliance

Exhibit 2

Global Equity Managers Tend to Have High Active Share



As of 31 March 2009

Data based on median active share for the Russell Global Equity Universe from 31 March 2002 to 31 March 2009.

Source: Russell Investments

the index weight. In other words, it is the portion of the portfolio that does not overlap the benchmark. Exhibit 2 shows the median active share of global and regional strategies from March 2002 through March 2009 based on the Russell Global Equity Universe. Global managers have consistently had higher active share compared to the other regional strategies.

Why do global strategies have a higher active share compared to regional strategies? In large part it is due to the structure of the benchmarks to which managers are compared. Exhibit 3 shows the largest companies in the MSCI All Country World Index (ACWI): Exxon Mobil and Apple are the two largest U.S. securities; Nestle is the largest non-U.S. company. Their weights are listed in their regional and global indices. Their weights in the regional benchmarks are approximately two-and-a-half times those of the broader global index. Consequently, global managers may have a higher active share because of the index's structure. It is a function of the more diversified, less concentrated benchmark. To

Exhibit 3

Regional and Global Index Weights

Security	S&P 500 Index or MSCI EAFE Index Weight (%)	MSCI All Country World Index Weight (%)
Exxon Mobil	3.3	1.4
Apple	2.5	1.0
Nestle	1.9	0.7

As of 18 May 2011

This information should not be considered a recommendation or solicitation to purchase or sell any security.

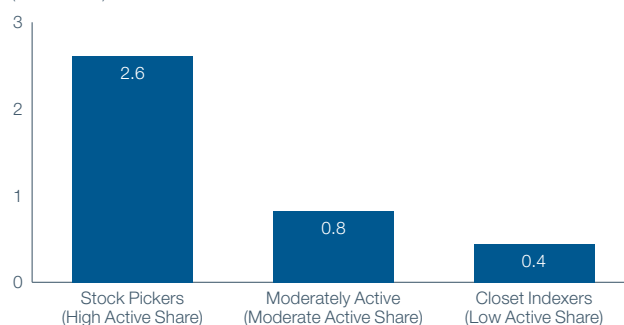
Source: Standard & Poors, MSCI

further develop this idea, consider how managers think about risk. They think about relative risk—to the benchmark—and absolute risk—the risk of losing client money. Exxon is 3.3% of the S&P 500 Index. A U.S. manager may need to have a position as large as 5%–6% to have a meaningful active position in Exxon. Many managers are not willing to have that large of an absolute position from an absolute risk perspective. However, a global manager may

Exhibit 4

Managers with High Active Share Have Outperformed

Annualized Performance of U.S. All-equity Mutual Funds (%) (1990–2009)



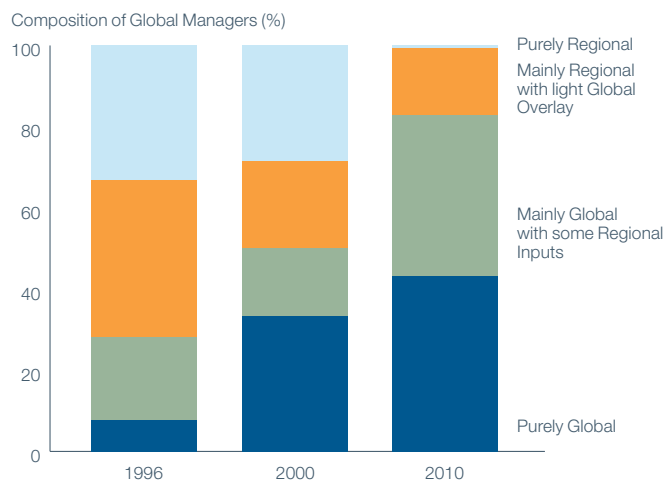
As of 31 December 2009

Performance reflects the gross returns of a fund's stock holdings and do not include any fees or transaction costs. Index funds, sector funds and funds with less than \$10M in assets were excluded from the results.

Past performance is not a reliable indicator of future results.

Source: "Active Share and Mutual Fund Performance," by Antti Petajisto of the NYU Stern School of Business, December 2010. Data reflects annualized performance of U.S. all-equity mutual funds from January 1990–December 2009.

Exhibit 5 Transfer from Regional to Purely Global Managers



As of 31 December 2010

Global managers as defined by Russell Investments; Analyst assessment is qualitative in nature and aggregated for this analysis. Research analysts were surveyed, then categorized into four buckets on the basis of how global in nature their processes were.

Source: Russell Investments

have a 3.3% position in Exxon, and thus an active position because of the broader, less concentrated index. As a result, this can translate to higher active positions in a number of holdings, resulting in a higher active share that is structural and sustainable. Therefore, we believe there is greater opportunity to have better relative performance based on stock selection.

Exhibit 4 shows the performance of U.S. equity funds broken into high active share, moderate active share, and closet indexers or funds with significant overlap with the benchmark. This study of U.S. funds over a 20-year period found strong outperformance of high active share portfolios. Since global portfolios structurally have that higher active share, we suggest their performance will also tend to look more like that of the left bar. It is often difficult to stay as aligned to a global index that itself is so diversified. In our view, the structurally higher active share partly explains why global funds have outperformed U.S. and international managers that are benchmarked to regional benchmarks over the past 20 years.

Evolution of Global Equity Mandates

Global strategies have evolved over time. Exhibit 5 represents data from Russell Investments that breaks out the composition of the global manager universe over three time periods. In the mid-1990s, when global investing first became of interest and clients began to request it, most investment managers were not structured to deliver a truly global strategy. Their response was to take their U.S. and EAFE portfolios and bolt them together to provide global

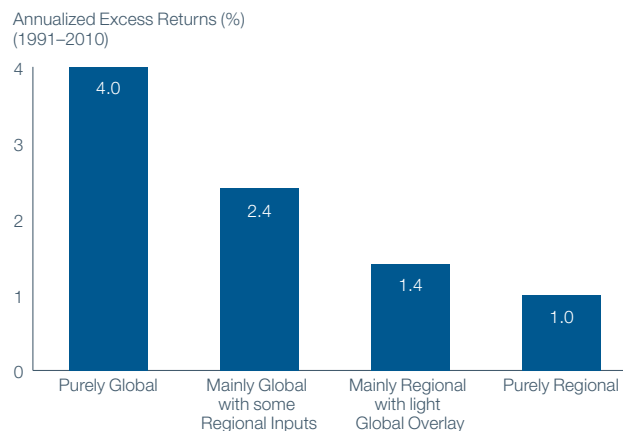
exposure. There has been a remarkable shift in strategy over time. The “pure” and “mainly global” categories were at 29% in 1996, and now they make up over 80% of the global managers. The purely regional managers are essentially gone, representing only 1% of managers in 2010, and even the “regional managers with a light global overlay” are also a smaller percentage of managers. Clients are seeking strategies that are truly global and are allocating capital to global managers.

Exhibit 6 shows the excess return generated by the various approaches and helps explain part of the shift that occurred. Clients are gravitating towards purely global managers as the purely global funds have outperformed the bolt-together strategies.

Exhibit 7 reinforces this decision by investors as the composition of non-U.S. equity allocations changed materially between 2005 and 2008. The global equity allocation nearly doubled from 18% to 34% in the 3-year period. It gained share from EAFE mandates, themselves down from 51% to 43%, and even more surprisingly, it gained some share from dedicated emerging markets mandates as well, which went from 20% to 14%. Institutions are looking to capture this strong performance through their allocations to global mandates.

Institutional managers’ response to implement these truly global structures has enhanced their ability to make cross-border comparisons without regional biases. Decisions that a manager makes in a global portfolio cannot necessarily be achieved in a regional portfolio. Global managers have a second dimension to consider:

Exhibit 6 Purely Global Managers Tend to Outperform Regional Strategies



Data from 1991 to 2010. Excess returns vs. MSCI World Index.

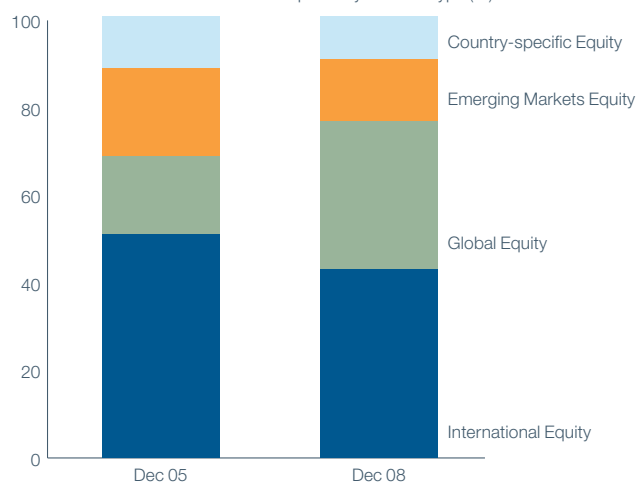
The universe is INTWORLD, the Russell Global Equity Universe.

Past performance is not a reliable indicator of future results.

Source: Russell Investments

Exhibit 7 Global Equity Managers are Growing in Popularity

Institutional Allocations to Non-U.S. Equities by Product Type (%)



Data based on Casey Quirk survey responses from U.S. institutional investors with over \$1 trillion in assets. As of 31 March 2009.

Source: Casey Quirk, Russell Investments

they do not just have sector exposures, they have regional exposures as well. This second dimension facilitates risk control by allowing managers to build positions they like in certain sectors or regions yet avoid economically challenged areas. Exhibit 8 provides an example of how one manager here at Lazard allocated capital among the various sectors and regions in a portfolio at the end of 2010. In the information technology sector, there is a skew to North America because this manager feels the bulk of the high quality technology companies are currently in the United States, where the sector is a strong market. The financials sector presents a different scenario as the opportunities in North America are more limited. The manager has concerns surrounding the U.S. regulatory environment, as well as the deleveraging that the American

consumer continues to have to implement. However, in the emerging markets there has not been a binge on credit over the last 10 years; in fact, in the emerging markets credit is just becoming available to the general population. In Asia and the emerging markets he believes there are better options for investors to gain exposure to the financials sector.

In our view, risk control is really key to portfolio management. It ensures that the relative performance of a strategy is from stock selection rather than from making unintended macroeconomic decisions. We believe the risk control process is easier in a more flexible global environment, and enables managers to control risk effectively while holding stocks they fundamentally like.

A broad opportunity set is particularly important for specialty mandates because they focus on very specific characteristics for stocks. We are seeing increasing interest in these specialty mandates including areas like yield, deep value, or aggressive growth. We believe equity income strategies are becoming more popular because of the scarcity of yield across the world. If managers were looking for stocks with a current yield over 3%, they would find 100 stocks in the United States, whereas they would find 600 stocks outside the U.S. If they were looking for stocks below book value, they would encounter 50 stocks in the United States with a price-to-book ratio of less than 1.0, but they would find 350 more stocks outside the U.S. Similarly, if managers have a growth orientation, there are 350 U.S. stocks with expected EPS growth above 10%, and 950 stocks outside the United States.² These are very significant differences in the numbers. Why would you limit your opportunity set especially when you have a narrow investment focus?

We use yield as an example to emphasize how the global opportunity set maximizes the alpha generating capabilities of a specialty mandate. Exhibit 9 shows the performance of a portfolio manager that is long the highest yielding stocks in the market and short the lowest yielding stocks on both a regional and global basis. First note that the global line performs quite well, in fact it is the

Exhibit 8 Investment Opportunities across Two Dimensions

	Consumer Discretionary	Consumer Staples	Energy	Financials	Health Care	Industrials	Information Technology	Materials	Telecom Services	Utilities
North America	••••	•••	•••	•	••••	•••••	•••••••	•		
United Kingdom		•••	••	•••	•			•		
Continental Europe	••	••	•	••	••	•	•	•		
Asia ex-Japan							•		••	
Japan				•••		•	••			
Emerging Markets	•		•	••••			•	•	••	

• Represents a security in a sample portfolio.

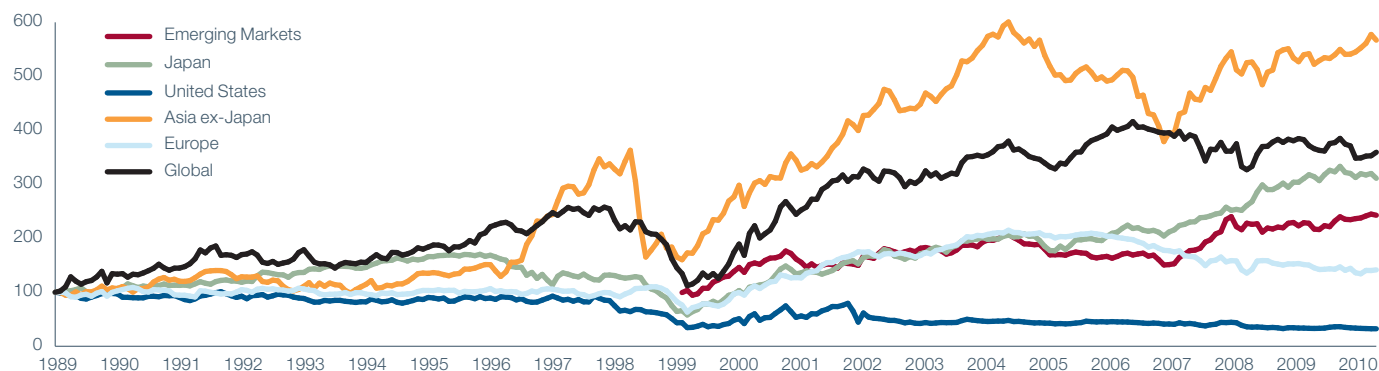
For illustrative purposes only and is subject change.

Source: Lazard

Exhibit 9

Opportunity Set Is Particularly Important for Specialty Mandates: Yield

Relative Return of High-yielding Versus Low-yielding Stocks (%)



As of 31 March 2011

The above returns do not represent the performance of any product managed by Lazard Asset Management. The performance presented represents historical performance of an unmanaged index. Returns would have been lower if they were subject to management fees and other trading expenses.

Past performance is not a reliable indicator of future results. Performance indices based on highest/lowest quartile of stocks screened on dividend yield on an equal-weighted basis in USD. Portfolios have been rebalanced quarterly. The benchmark universe is the 500 largest stocks in the FTSE World Index.

Source: Nomura

second best performer of all regions. This is surprising given that the United States is the lowest performer—the one market where yield does not outperform—and it makes up 40% of the global performance. One would expect the global line to be in the middle. However, it is one of the best performers because the broad opportunity set maximizes the alpha from a yield strategy. The ability to shift capital from one region to another based on shifts in relative valuation maximizes the alpha generating capability of a yield screen. Therefore, having a valuation-driven processes, a broad opportunity set, and the ability to shift capital from one region to another helps maximize the alpha generating capability of these strategies.

Exhibit 10 highlights that it is getting more difficult to identify where many companies are domiciled. We have known for a long time about global multinationals: McDonald's has two-thirds of its sales outside of the United States; Royal Dutch Shell, which is Dutch and English, has shares listed in both markets.³ With companies increasingly moving their domiciles for tax reasons, this becomes even more complex. Transocean, a drilling rig operator, is now legally incorporated in Switzerland with its shares listed on both the New York Stock Exchange (NYSE) and the CHIX Exchange in Switzerland. MSCI put it in the MSCI Switzerland Index, but it is not included in the S&P 500 Index or the Russell indices. However, Weatherford, another oil service company, which also moved its domicile to Switzerland, is included in the MSCI Switzerland Index and MSCI U.S. Index. It continues to be in the Russell indices, but not the S&P 500 Index. Tyco also moved to Switzerland, but did not list its shares there. As a result,

it remained in the MSCI U.S. Index, the Russell indices, and the S&P 500 Index. This can affect how managers implement a strategy because different client guidelines, depending on how they are phrased, can lead to very different conclusions on whether stocks such as these are available to a U.S. manager to purchase. As a global manager, geographic guidelines are not as relevant. If a security trades in any market, it is part of the global opportunity set.

Exhibit 11 addresses one recent criticism of global diversification: In the fourth quarter of 2008 when stocks collapsed, global investing did not preserve capital as much as people would have liked. This analysis from Russell looks at performance over the last 60 years for the worst one-, five-, and ten-year periods in the U.S. equity market and compares it to global performance in the same time frame. Generally, during a crisis with a sharp sell-off, correla-

Exhibit 10

Determining a Company's Domicile Is Not Always Straightforward

Company	Legal Incorporation	Listings
Transocean	Switzerland	NYSE, CHIX
Weatherford	Switzerland	NYSE, CHIX
Tyco	Switzerland	NYSE
Cooper Industries	Ireland	NYSE
Seadrill	Bermuda	Norway, NYSE

As of 20 May 2011

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tions rise, and everything collapses. However, as time goes on, the underlying economic growth of the countries eventually matters. Over the five- and ten-year periods, there was much greater preservation of capital from global performance. In the current cycle, the S&P 500 Index and the MSCI ACWI both fell approximately 55% from the October 2007 peak down to the March 2009 trough. Subsequently, the S&P 500 Index is up 103%, and the MSCI ACWI is up 108%. The performance of the global markets captures the outperformance of various countries, notably those in the MSCI Emerging Markets Index, which itself is up 152% since March 2009.⁴ We believe that global diversification provides the opportunity to preserve capital in down markets while potentially capturing outperformance within specific markets over time. In fact, we are already starting to see the differentiation based on economic outcomes take hold in the current cycle.

Benefits and Challenges to Global Investing

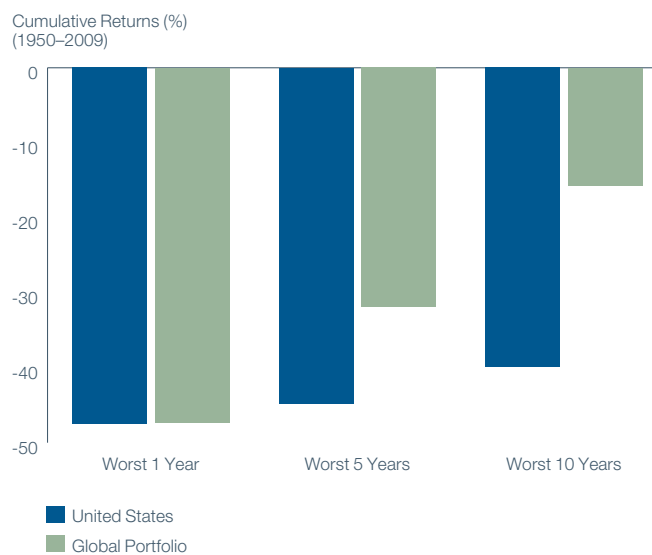
Finally, we address some of the challenges to a global strategy. There are barriers to entry to managing money globally with an unconstrained strategy. Clearly, it is a big world out there. Managers need enough people to cover it. However, if they had 1,000 investment professionals, that may not help either. It can be very difficult to encourage communication among a large group. We think it is critical to have enough people to cover the world, but be small enough to encourage communication. There are advantages and insights managers can glean by having people in the local markets, but effective communication flow is needed in order to be able to incorporate their insights into a global portfolio. In addition, we believe research efforts need to be organized on a global sector basis. Managers cannot build a global strategy if they only have regionally structured research teams.

There are also impediments to cross-border comparisons. Accounting standards diverge between U.S. and international methods. While the Financial Accounting Standards Board in the United States and the International Accounting Standards Board are working to make these methods more consistent, there is still a long way to go. Cultural business practices, such as the way companies manage their balance sheets and the way they manage their dividend policies, differ significantly around the world. Local regulations clearly differ as well. And while English is considered the global language of finance, some companies still will not release their earnings in English.

We believe the most important element to global investing is the investment managers' perspective. They must have a truly global focus with no regional biases. If a manager is more familiar with certain areas of the world, it could lead the manager to allow securities from that area to have a lower hurdle to get into the portfolio. We believe managers should compare companies from different parts of the world on a truly equal footing, with the same hurdles to be overcome by all for inclusion in a portfolio.

Clearly the time to bolt together U.S. and EAFE portfolios to implement a global mandate has passed. Investors are increasingly seeking truly global unconstrained portfolios and as we have seen, this approach has allowed investors to capture the alpha generation from the broadest opportunity set.

Exhibit 11 Benefits of Global Diversification Realized over Time



Data from January 1950 to August 2009.

Past performance is not a reliable indicator of future results.

Source: Datastream; Russell Investments, "Globalization, equity markets evolution and the perils of home country bias."

Notes

- 1 Martin Cremers and Antti Petajisto, Yale School of Management, "How Active Is Your Fund Manager? A New Measure That Predicts Performance," 2006.
- 2 MSCI, data based on constituents of the MSCI All Country World Index, 20 May 2011.
- 3 Bloomberg, 20 May 2011.
- 4 MSCI, Standard and Poor's, 20 May 2011; MSCI All Country World Index peak to trough performance is 31 October 2007 to 9 March 2009; MSCI Emerging Markets Index peak to trough performance is 29 October 2007 to 2 March 2009; S&P 500 Index peak to trough performance is 9 October 2007 to 9 March 2009.

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Published on 15 June 2011.

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