

Summary

Emerging Markets Debt: A Strategic or Tactical Asset Class?

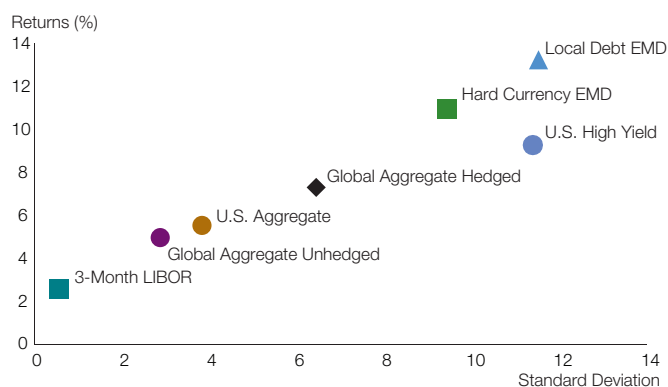
Featured Speaker: **Arif Joshi**, Managing Director, Portfolio Manager/Analyst

Emerging markets continue to garner headlines as investors increasingly recognize the potential long-term growth trends of the asset class. Additionally, as many of these markets continue to develop, they often represent very different structures and opportunities compared to developed markets. We believe the strengthening and differentiated fundamentals of emerging debt markets create opportunities for investors in both hard and local currency markets; this evolution represents a long-term secular development as opposed to a short-term tactical opportunity.

Emerging Markets Debt Has a Discernable Profile

Exhibit 1 is a risk-return chart since 2001, outlining both hard currency emerging markets debt and local currency emerging markets debt. Hard currency debt is defined as emerging markets debt issued in USD, whereas local currency debt is emerging markets debt issued in the currency of the country that it is domiciled. In hard currency emerging markets debt, which is shown in the green square, the historic returns are nearly 12% on an annualized basis compared to a volatility of just under 10% resulting in an attractive return-risk ratio of over one. In the local currency space, historic returns have been approximately 13% compared to a volatility of just under 12%, thus providing a similar return-risk ratio to hard currency. These ratios are impressive in both absolute terms and also in relative terms compared to many of the other asset classes shown in the chart. It should be noted, however, that these are backward-looking numbers, and it is important for investors to consider current valuations when projecting the attractiveness of the asset class going forward.

Exhibit 1 Emerging Markets Debt Has a Discernable Profile



As of 31 December 2010

Hard Currency EMD = JPM EMBI Global Diversified; Local Currency EMD = JPM GBI-EM; US Aggregate = BC US Aggregate; US High Yield = BC US High Yield; Global Agg Hedged = BC Global Agg USD Hedged; Global Agg Unhedged = BC Global Agg Unhedged; 3-Month LIBOR = ML 3-Mo USD LIBOR

Time period represents the longest shared history of all the asset classes (the Local Debt EMD benchmark, JPM EMBI Global Diversified, launched in January 2002.)

Past performance is not a reliable indicator of future results.

Source: Lazard, Bloomberg

Emerging Markets Debt is a Growing Part of the Global Bond Market

Exhibit 2 shows emerging markets debt as a part of the entire global market capitalization. Emerging Market debt represents approximately 20% of the entire market capitalization for debt. This is typically a number that surprises many given that it is one-fifth of the entire asset class. When we talk to emerging markets debt investors, they typically have 0-2% allocated to emerging

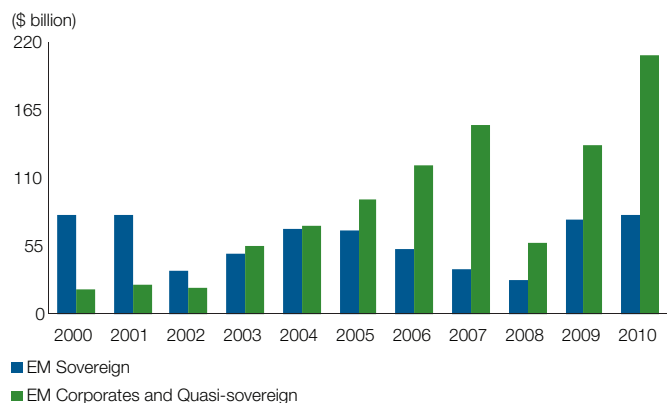
markets debt in the United States and as high as 4-6% allocated to emerging markets debt internationally. As such, most investors are underinvested in emerging markets debt.

Emerging markets debt is separated between hard currency and local currency as mentioned previously. Exhibit 3 focuses on hard currency, denominated in USD. Hard currency debt is segmented into both sovereign debt, which is issued by countries, and corporate debt, which is issued by emerging markets companies. Since 2005, emerging markets companies have issued more debt than their respective sovereigns and this ratio is now about two and a half to one going into 2011. This makes sense given that emerging markets sovereigns have generally had balanced budgets or slight deficits since the mid-part of the last decade. As such, they have not felt the need to issue in dollars, and this has opened up the space for the companies within their countries to issue debt in order to fill investor needs. Exhibit 4 demonstrates the difference between the growth in emerging markets local currency debt and emerging markets external debt. The green line shows the growth in locally denominated debt, and this has grown approximately seven-fold over the last nine years, while hard currency had doubled.

Exhibit 2 EM Debt is a Growing Part of the Global Bond Market

Total Global Bond Market Capitalization	2010
U.S. Aggregate and High Yield	\$13.4 trillion
Global (ex-U.S.) Aggregate	\$19.5 trillion
Emerging Market Local Bonds	\$6.9 trillion
Emerging Market Hard Currency Bonds	\$1.5 trillion

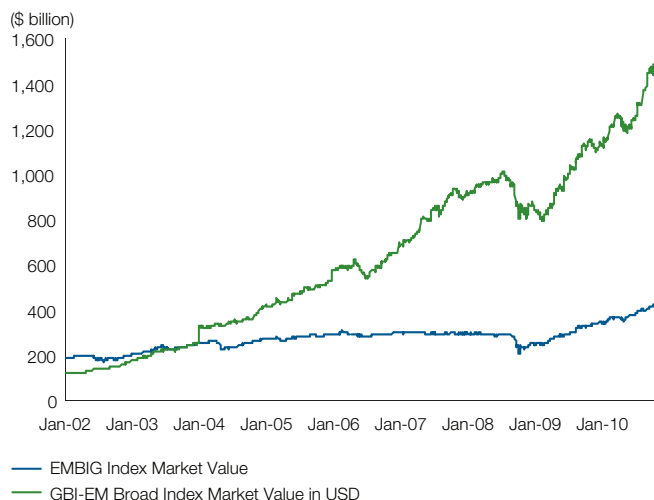
Exhibit 3 Hard Currency Issuance Sovereign and Corporate



As of 31 December 2010

Source: Bank of America Merrill Lynch

Exhibit 4 Hard and Local Currency Index Market Values



As of 31 December 2010

Source: Bank of America Merrill Lynch

Defining Hard Currency & Local Currency Indices

Investors typically use the J.P. Morgan indices for emerging markets debt for both hard and local currencies. On the left hand side of Exhibit 5 is the J.P. Morgan EMBI Global Diversified Index representing hard currency debt, and with a duration of approximately seven years, it is a relatively long duration index. The yield of that index as of the end of 2010 was about 6%; it is now about 6.25%. The index itself is made up of sovereign bonds and quasi-sovereign bonds. Quasi-sovereign bonds are companies within these emerging markets countries that are more than 50% owned by that country. There are no corporate bonds in the index; this is a disadvantage of merely following index products. In order to access the entire opportunity set, active management allows a manager to follow the value across the asset class. The J.P. Morgan GBI-EM Global Diversified Index represents local currency debt, and the duration of this index is much lower at four and a half years. We expect the duration of local currency debt to continue to increase over time, especially as issuance increases in this segment. The yield of this index is higher than the hard currency index. The entire index is made up of sovereign bonds. Again we expect a growth in local currency bonds to be in both local sovereign, quasi-sovereign, and corporate bonds going forward, which is another reason that we argue managers should be able to invest in the entire opportunity set within emerging markets debt.

Exhibit 5

Defining Hard Currency & Local Currency Indices

	Hard Currency	Local Currency
Denomination	USD	EM currencies
Duration (years)	7.0	4.5
Yield (%)	6	6.3
# of countries	41	15
% Sovereign	81	100
% Quasi-Sovereign	19	0
% Corporate	0	0
Annualized return* (%)	11.2	14.1
Annualized standard deviation* (%)	9.5	11.6
Worst monthly loss* (%)	-16	-14.1
Sharpe Ratio*	0.9	1

As of 31 December 2010

Hard Currency = JPM EMBI Global Diversified; Local Currency = JPM GBI-EM Global Diversified.

The return and risk characteristics presented for Hard Currency and Local Currency represent the period between January 2003 to September 2010.

Source: Lazard, J.P. Morgan

Shown for illustrative purposes only, not a product managed by Lazard.

Past performance is not a reliable indicator of future results.

Exhibit 7

Broad and Diverse Universe

Hard Currency Universe (70+ Countries)

Latin America	Asia	Eastern Europe	Africa/M.E.
• Argentina	• China	• Albania	• Algeria
• Aruba	• Fiji	• Belarus	• Bahrain
• Bahamas	• India	• Bosnia	• Cote d'Ivoire
• Barbados	• Indonesia	• Bulgaria	• Congo
• Belize	• Hong Kong	• Croatia	• Egypt
• Brazil	• Malaysia	• Czech Republic	• Gabon
• Cayman Islands	• Mongolia	• Georgia	• Ghana
• Chile	• Pakistan	• Hungary	• Iraq
• Colombia	• Philippines	• Kazakhstan	• Israel
• Costa Rica	• Seychelles	• Lithuania	• Jordan
• Dominican Republic	• South Korea	• Macedonia	• Kuwait
• Ecuador	• Sri Lanka	• Poland	• Lebanon
• El Salvador	• Thailand	• Romania	• Morocco
• Grenada	• Vietnam	• Russia	• Nigeria
• Guatemala		• Serbia	• Oman
• Jamaica		• Turkey	• Qatar
• Mexico		• Ukraine	• Senegal
• Panama			• South Africa
• Peru			• Tunisia
• Trinidad			• U.A.E.
• Uruguay			
• Venezuela			

As of 31 December 2010

Countries listed in blue are included in the Index.

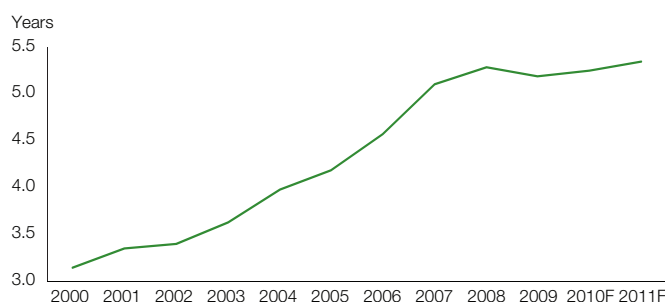
Source: J.P. Morgan

Breadth and Depth of Local Markets Expanding

Local markets are expanding in both breadth and depth as seen in Exhibit 6. The average maturity of local currency bonds has increased from a little over three years in 2000 to over five and a half years going into 2011. We not only had an increase depth in the market in terms of total maturities, but also breadth of the market with more countries issuing debt on the local currency side to give investors a larger opportunity set.

Exhibit 6

EM Average Maturity of Domestic Central Government Debt Outstanding



As of 31 December 2010

Source: J.P. Morgan

Local Market Universe (45+ Countries)

Latin America	Asia	Eastern Europe	Africa/M.E.
• Argentina	• China	• Belarus	• Angola
• Brazil	• India	• Bulgaria	• Egypt
• Chile	• Indonesia	• Czech Republic	• Ghana
• Colombia	• Hong Kong	• Georgia	• Kenya
• Costa Rica	• Malaysia	• Hungary	• Israel
• Dominican Republic	• Mongolia	• Kazakhstan	• Malawi
• Mexico	• Pakistan	• Poland	• Mauritius
• Peru	• Philippines	• Romania	• Nigeria
• Uruguay	• Singapore	• Russia	• South Africa
	• South Korea	• Serbia	• Tanzania
	• Sri Lanka	• Turkey	• Uganda
	• Thailand	• Ukraine	• U.A.E.
	• Vietnam		• Zambia

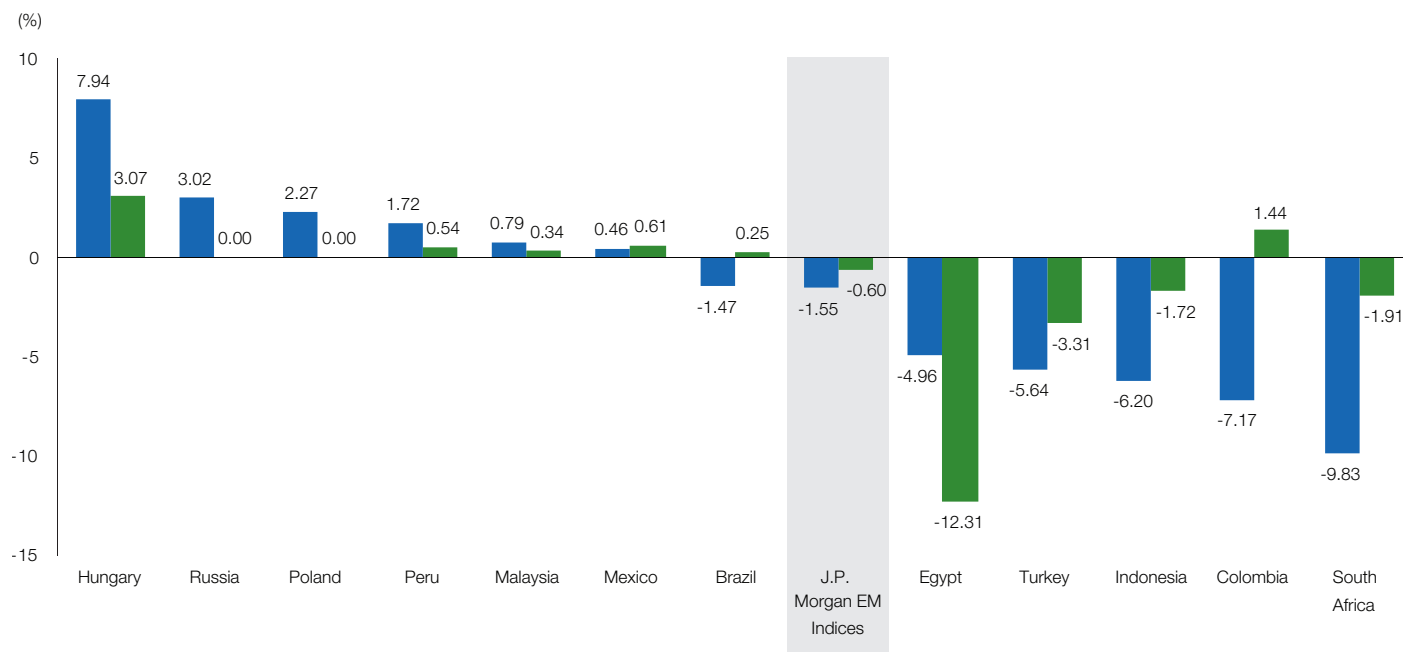
Broad and Diverse Universe

We outline various indices and their components in Exhibit 7. On the left hand side we show the hard currency universe. This is comprised of over 70 countries that issue external debt across the external market space. This is across all the regions of the emerging markets with numerous countries within each region. Outlined in blue are the countries that are actually in the index, approximately 40 countries; therefore, there are more than 30 countries which are outside of the index that we believe are offering significant value. Again, we believe this is a good opportunity for active managers to be able to invest in the entire emerging markets space. On the right is the local currency universe. Local markets have fewer countries that issue debt and that are in the index. Notably, within the index for local currency debt, two very large issuers of local currency debt, China and India, are not actually in the index. This is because foreigners typically cannot access the local markets as these bonds are not euro clearable. When we consider the evolving nature of the emerging markets debt space, we expect these markets to open up over the next couple of years, so that the large amount of issuance in these two countries will become investable by international investors.

YTD Hard and Local Currency Sovereign Returns

Exhibit 8 shows the different types of returns investors can get within a single country from both hard currency and local currency using January 2011 as an example. When we analyze potential investments in emerging markets, we take a look at fundamental indicators such as inflation, fiscal surpluses or deficits, and foreign exchange reserves. Some of these indicators are more important for external debt and others for local debt and, therefore, will drive returns in different manners. A country like Hungary, for example, had large returns of almost 8% in a single month in local currency debt, and that was driven by the foreign exchange component of the local currency bond in Hungary versus a lower return for the external debt component. Another example is Colombia, which had positive returns for external debt and negative returns for local debt. It is essential to do bottom-up analysis in each one of these countries to understand where the value is. We advise clients to choose a manager who is comfortable transitioning between external debt and local debt depending on where they can find value.

Exhibit 8 YTD Hard and Local Currency Sovereign Returns



■ J.P. Morgan EMBI Global Diversified Index, Hard Currency (YTD)
 ■ J.P. Morgan GBI-EM Global Diversified Index, Local Currency (YTD)

As of 31 January 2011

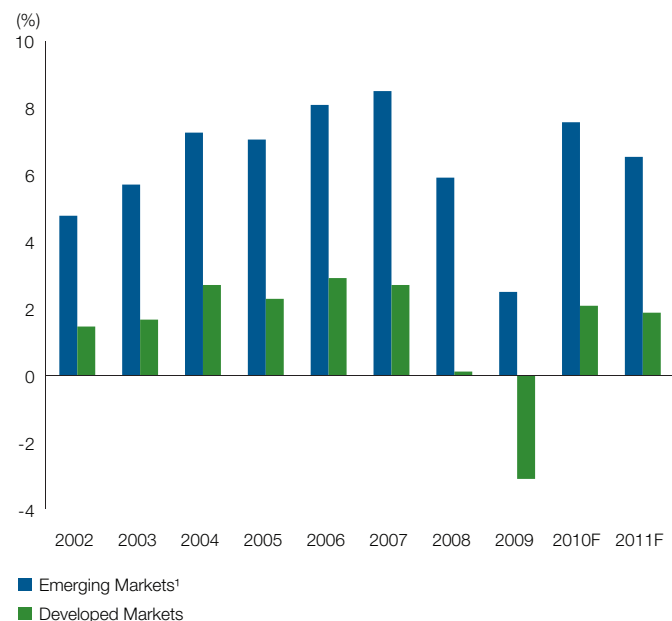
Past performance is not a reliable indicator of future results.

Source: J.P. Morgan

Improving Fundamentals

The press has covered the improving fundamentals in emerging markets over the last couple of years. It is no secret that emerging markets, in general, have outperformed developed markets. GDP growth rates for emerging markets have outstripped the developed world for the past decade (Exhibit 9). We believe GDP growth rates in emerging markets will be approximately 6% in 2011 versus just 2% for the developed world. This is a trend we expect to continue over the next couple of years. As a result, the share of global GDP has increased over time where emerging markets now represent about one quarter of the total share of GDP which is quite staggering compared to the 16% we had in 2000 (Exhibit 10). In addition, emerging markets have generally recorded current account surpluses (Exhibit 11). Emerging markets still are generally commodity exporters, and as such, benefit in the type of environment that we have now. However, one risk that has persisted in emerging markets over time and appears to be something investors have always been concerned about, is the level of inflation in emerging markets. In the earlier part of the last decade the average inflation in emerging markets was almost 8%. This has come down over time because of very strong monetary policy across most central banks where policy makers hiked rates proactively in order to keep inflation under control (Exhibit 12).

Exhibit 9 Real GDP Growth Rate



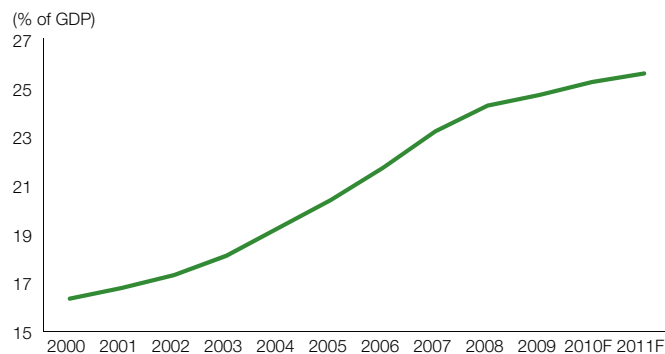
As of November 2010

1 Includes 20 EM countries

Forecasted or estimated results do not represent a promise or guarantee of future results and are subject to change.

Source: Moody's, Lazard

Exhibit 10 Emerging Markets¹ Share of Global GDP (%)

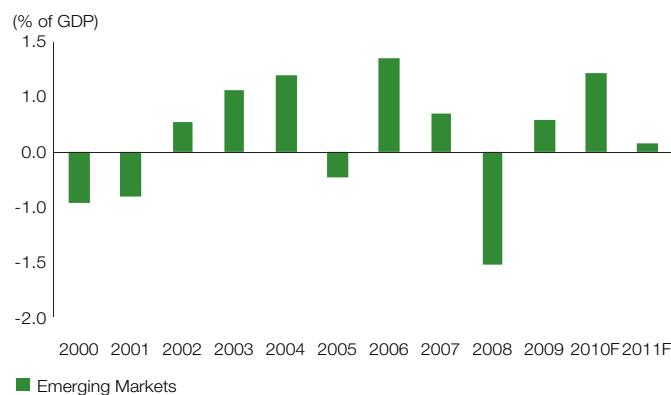


As of November 2010

1 Includes 19 EM countries

Source: World Bank, Bloomberg

Exhibit 11 Current Account Balance



Emerging Markets

As of November 2010

1 Includes 19 EM countries

Source: World Bank, Bloomberg

Exhibit 12 Consumer Price Index



As of December 2010

Includes 20 EM countries

Forecasted or estimated results do not represent a promise or guarantee of future results and are subject to change.

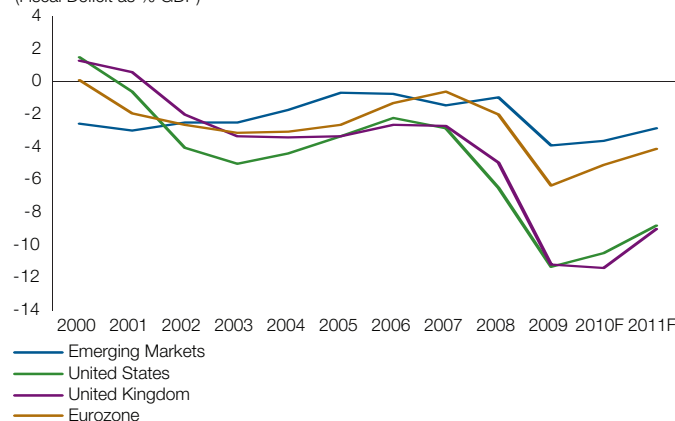
Source: Moody's, Lazard

Exhibit 13

Differentiated Fiscal Position and Debt/GDP Ratios

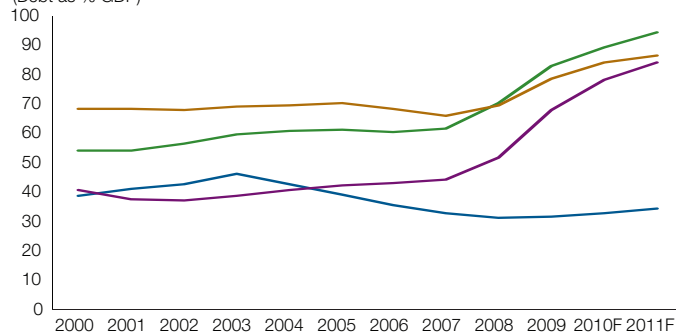
Strong Fiscal Indicators in EM

(Fiscal Deficit as % GDP)



Lower Debt / GDP Ratios in EM

(Debt as % GDP)



As of December 2010

Includes 20 EM countries

Forecasted or estimated results do not represent a promise or guarantee of future results and are subject to change.

Source: Moody's, Lazard

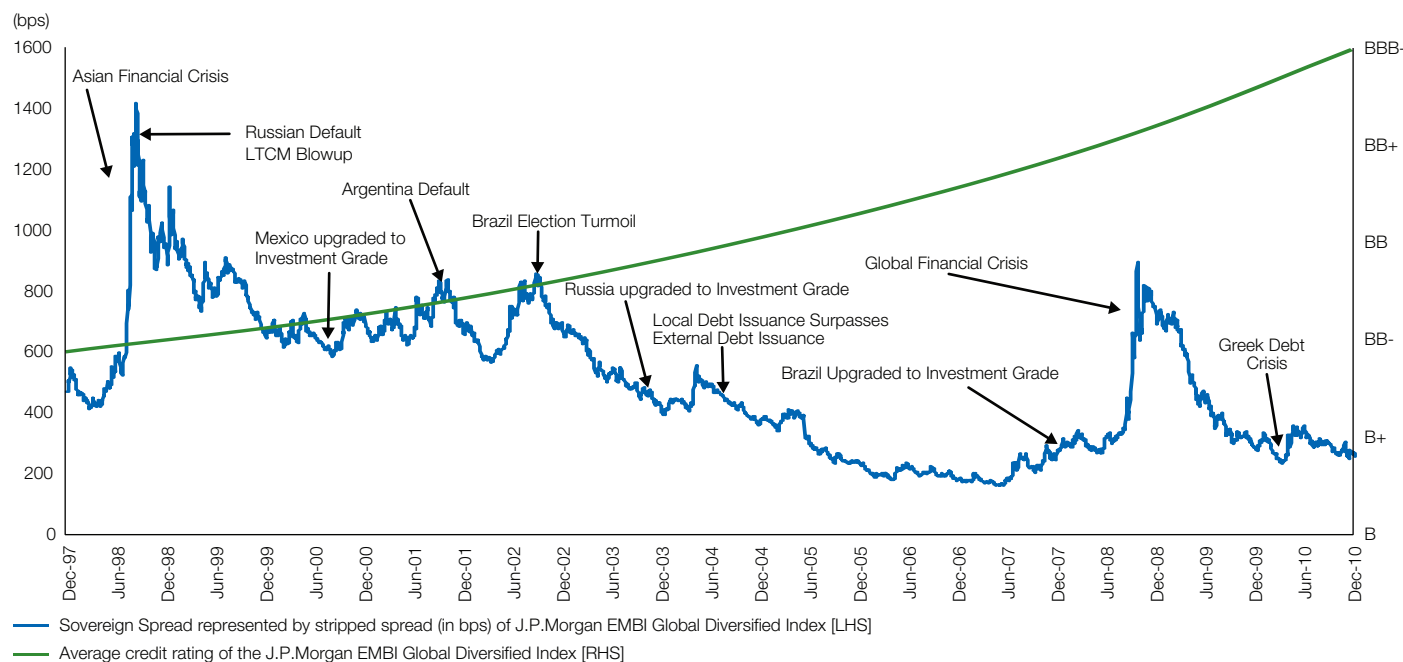
Differentiated Fiscal Position and Debt/GDP Ratios

Exhibit 13 shows fiscal indicators and balance sheet indicators which are all relative numbers of emerging markets versus the developed world. We believe most investors are very well aware

of the fiscal improvement of emerging markets compared to the developed world. What is quite surprising, however, are the absolute debt to GDP ratios. In emerging markets we have debt to GDP, even through the financial crisis, of just 40% as opposed to the developed world which is reaching levels of 60-100% depending on the country.

Exhibit 14

Improving Credit Quality and Lower Spreads



As of 31 December 2010

Source: J.P. Morgan

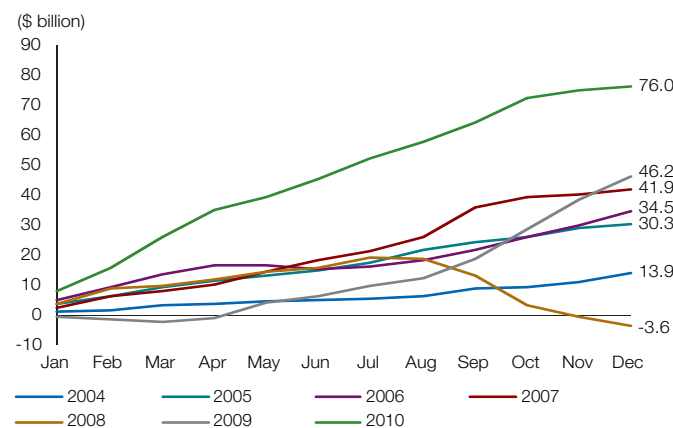
Improving Credit Quality and Lower Spreads

Exhibit 14 shows the credit quality and spread changes for the last 13 years of the emerging markets. Going back to 1998 with the Asia crisis, we have come through many periods over the past 13 years of booms and busts in emerging markets. The volatility of spreads was quite high in the late 1990s and early 2000s with the Russian default and the Argentine default in 2001. There are also some positive events with Mexico, Russia, and Brazil all being upgrading to investment grade over this time. The global financial crisis certainly hurt emerging markets with external debt spreads moving up to approximately 800bps over that time. However, we also witnessed the resilience of emerging markets spreads as investors refocused on the fundamentals that we mentioned earlier, especially the strong GDP to debt ratios, such that emerging markets debt spreads are currently down to 275bps over Treasurys. It is important to note that the tightest spreads ever reached for emerging markets external debt was in June 2007 when spreads were approximately 150 bps over Treasurys. Interestingly, spreads are still approximately 125 bps higher than that level with arguably stronger fundamentals now than before.

Strong Fundamentals Support Strong Flows in 2010

One characteristic of the market that has been prevalent for last couple of years is strong flows into emerging markets. Exhibit 15 shows cumulative inflows into emerging markets debt. The top line shows cumulative flows in 2010 of approximately \$76 billion, almost double the highest amount we have seen in any previous years. We view this as both a positive and negative for the asset class. Clearly most investors are underexposed to the market, and as a result they are looking to catch up with at least a market

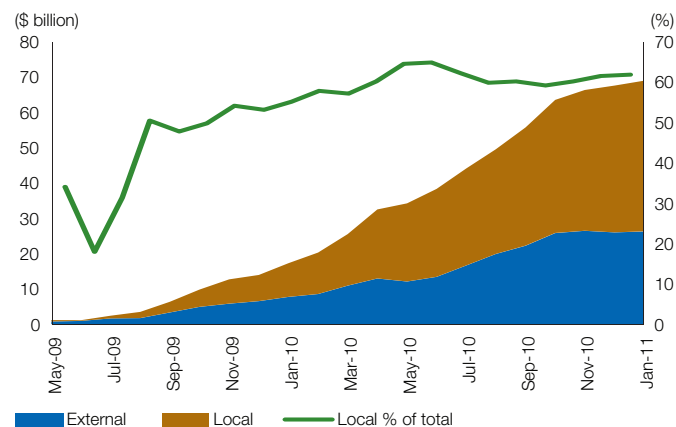
Exhibit 15 Cumulative Inflows Into EM Debt



As of 31 December 2010

Source: J.P. Morgan, Bloomberg, EPFR

Exhibit 16 Inflows Into EM Mutual Funds



As of 31 December 2010

Source: J.P. Morgan, Bloomberg, EPFR

weight position in their portfolios. In addition, we have seen strong flows because of the strong returns we have witnessed over the last few years. We monitor these flows since it is important that the asset class can actually handle those flows. Exhibit 16 separates flows into external debt versus locally denominated debt. Most recent flows have gone into the locally denominated part of the asset class in order to capture some of the FX appreciation that you can get in local currency bonds.

Lenders versus Borrowers

Exhibit 17 outlines countries that are exporters of capital versus importers of capital. Most countries that export capital are indeed emerging markets countries. They are countries that either have commodities bases or a manufacturing base that export to the developed world. On the right hand side of the exhibit are the opposite countries that continue to import capital, which reinforces the earlier point that emerging markets have current account surpluses supporting stronger flows into the asset class.

Outlook

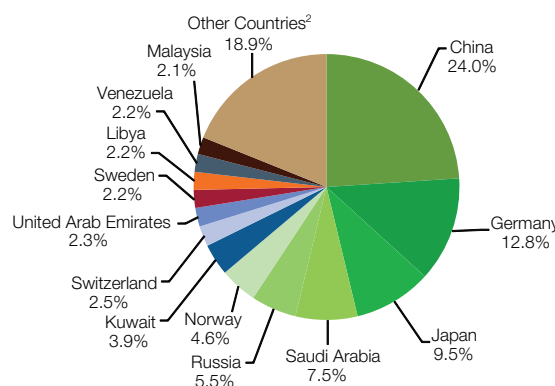
We believe the outlook for emerging markets debt in 2011 is positive. We expect continued strong growth in 2011, both domestic growth and growth from exports. This is compared to slow growth in both the G3 and the developed world. There will also be a strong dichotomy of fiscal deficits in the developed world versus fiscal surpluses in the emerging markets world. In the beginning of 2011 there have been some outflows from the asset class, and while we believe these flows will be volatile, we ultimately expect them to be strong over the full year. Finally, and perhaps most importantly, is an assessment of the valuations across the asset class. We see significant value in external debt with spreads at

Exhibit 17

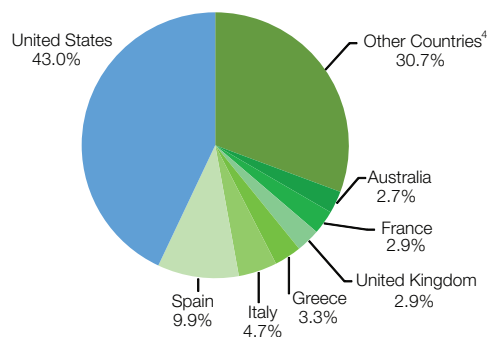
Lenders versus Borrowers

The Economies of Emerging Market Countries Have Fundamentally Changed Over the Last Decade.

Strong Fiscal Indicators in EM¹



Lower Debt / GDP Ratios in EM³



As of 16 April 2009

- 1 As measured by countries' current account surplus (assuming errors and omissions are part of the capital and financial accounts).
- 2 Other countries include all countries with shares at total surplus less than 2.1%.
- 3 As measured by countries' current account deficit (assuming errors and omissions are part of the capital and financial accounts).
- 4 Other countries include all countries with shares at total deficit less than 2.7%.

Source: IMF, World Economic Outlook database

approximately 275bps. These spreads are typically quoted over Treasuries, so if you believe the Treasury yield will continue to rise, this will create a headwind for total returns in the external debt space. So again, in our opinion, investors need to be very opportunistic and perform bottom-up analysis here to pick attractive countries and the points on the yield curve in order to extract value. We are more constructive on local currency at this time given our generally positive view on exchange rates of emerging markets currency versus the U.S. dollar and euro. We think that structurally most currencies in emerging markets ought to continue to see appreciation over the long term compared to the developed world. Absolute yields of local currency bonds are offering significant real yield pick-up for emerging markets versus developed world as well. We are starting to see attractive entry points for local currency bonds given a recent sell-off due to heightened inflationary concerns. Again bottom-up analysis here, going country by country, is paramount in creating alpha.

Concerns

There are many risks associated with investing in emerging markets. We believe the largest concern continues to be China and any potential slowdown in Chinese growth. We have seen a slowdown over the last 18 months with various changes in the economic, monetary, and fiscal policies in China. China has telegraphed these measures in a very straightforward manner to the

market, and as a result, it has not created large disjointed returns across the asset class. We expect this trajectory to continue in the medium-term. Our second largest risk is unorthodox monetary policy in emerging markets. This has been in the headlines recently with taxes in Brazil, interest rate cuts in Turkey, and capital controls in areas of Asia. Investors are starting to see central banks in emerging markets trying different techniques to limit FX appreciation while still trying to control inflation. There is a risk that some of these monetary policy tools will not be as effective as they think. Finally, there is political instability, which has been in the headlines, especially in North Africa. In general, while the recent event in Egypt created new opportunities in terms of valuation, we continue to believe there are structural issues in the countries in North Africa with relatively high levels of debt and a relatively large working class that is unemployed which will take years to work out. Currently, we do not find valuations to be attractive enough to enter a position, and we expect continued volatility in most of these countries going forward.

Emerging markets have evolved quite a bit over the last decade. We now have a deep and diversified market, not only in terms of countries and duration, but also being able to choose between external debt, local debt, corporate debt, etc. With the ability to invest throughout the entire asset class and capitalize on the divergent returns in both country and currency, it is now imperative that managers have the flexibility to invest across the asset class.

Important Information

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Securities in certain non-domestic countries may be less liquid, more volatile, and less subject to governmental supervision than in one's home market. The values of these securities may be affected by changes in currency rates, application of a country's specific tax laws, changes in government administration, and economic and monetary policy. Emerging market securities carry special risks, such as less developed or less efficient trading markets, a lack of company information, and differing auditing and legal standards. The securities markets of emerging market countries can be extremely volatile; performance can also be influenced by political, social, and economic factors affecting companies in emerging market countries.

An investment in Emerging Markets Debt positions are subject to the general risks associated with fixed income investing, such as interest rate risk and credit risk, as well as the risks associated with emerging market investments, including currency fluctuation, devaluation and confiscatory taxation.

Investments in global currencies are subject to the general risks associated with fixed income investing, such as interest rate risk, as well as the risks associated with non-domestic investments, which include, but are not limited to, currency fluctuation, devaluation and confiscatory taxation. Furthermore, certain investment techniques required to access certain emerging markets currencies, such as swaps, forwards, structured notes, and loans of portfolio securities, involve risk that the counterparty to such instruments or transactions will become insolvent or otherwise default on its obligation to perform as agreed. In the event of such default, an investor may have limited recourse against the counterparty and may experience delays in recovery or loss.

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