Lazard Insights

Conference Call Series

27 September 2011

Summary

Gripped by **Fear**

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

Uncertainty Prevails across Many Markets

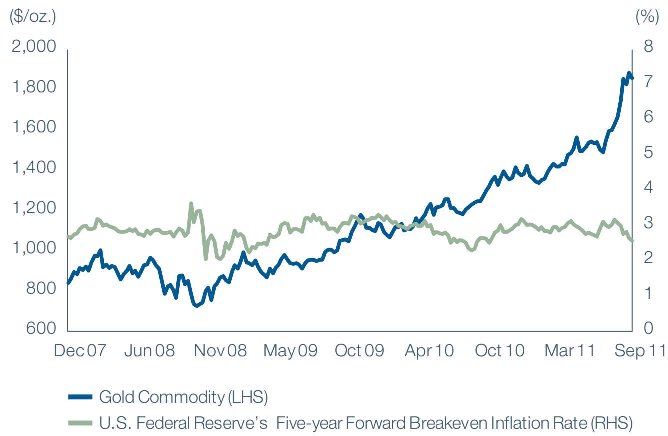
Amid the recent market volatility, many key data points that investors have historically relied upon, including the price of gold, the 10-year Treasury yield, and corporate bond and equity markets, are now pointing to very different outcomes. In such an environment, the questions investors face are: "Which of these indicators are pointing to something tangible, and how can we interpret these conflicting signs?"

Exhibit 1 shows the price of gold and the U.S. Federal Reserve's (the Fed's) five-year forward breakeven inflation rate. The Fed's five-year forward breakeven inflation rate is a calculation of inflation expectations based on the five- and ten-year TIPS rates that identify a breakeven rate for investing over a five-year period, five years forward. As the graph shows, the price of gold has recently peaked above $2,000 per ounce and is trending higher. Historically, such a move would be consistent with rising inflation expectations. However, the rise in gold is currently at odds with inflation expectations, as expectations have remained in the 2% to 4% range since 2008. The price of gold has decoupled from the trend in underlying inflation and forward expectations.

In contrast with the soaring price of gold are U.S. Treasury yields, illustrated in Exhibit 2. A 10-year U.S. Treasury yield below or near 2% has, in the past, indicated the onset of a period of severe economic destruction. The current levels are comparable only to the Great Depression, after which the United States sustained a 2% yield for 10-year Treasuries for the next 10 years. In order to attain that sustained level, however, the United States first experienced back-to-back years of nearly double-digit deflation (as shown in red in Exhibit 3), an overall decline in prices of 25%, and a 30% decline in GDP.[1] Nominal GDP did not surpass the peak of 1929 until 1941. This is in contrast with the financial crisis that began in 2007, where CPI has remained positive and the trend in nominal GDP, while not strong, has been positive and has already surpassed the peak recorded in 2008.

Exhibit 1

Gold versus Inflation Expectations



As of 9 September 2011
Source: Bloomberg

The last major signals come from the corporate bond and equity markets, which we believe are essentially pointing to a slow recovery or soft patch for the economy with little to no implications for inflation.

Exhibits 4 and 5 show corporate borrowing levels and equity valuations for three corporations that are in different industries, that have global footprints, and that have demonstrated a history of being productive and well run. While the borrowing cost relative to Treasuries of these companies has increased slightly in recent months (Exhibit 4), they remain well below the spikes seen during the financial crisis, and are currently at levels that are even lower

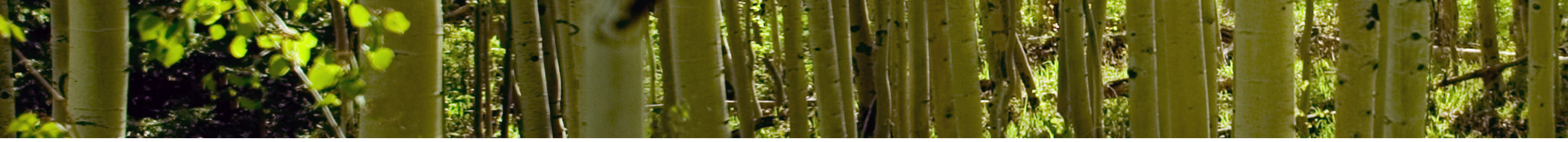
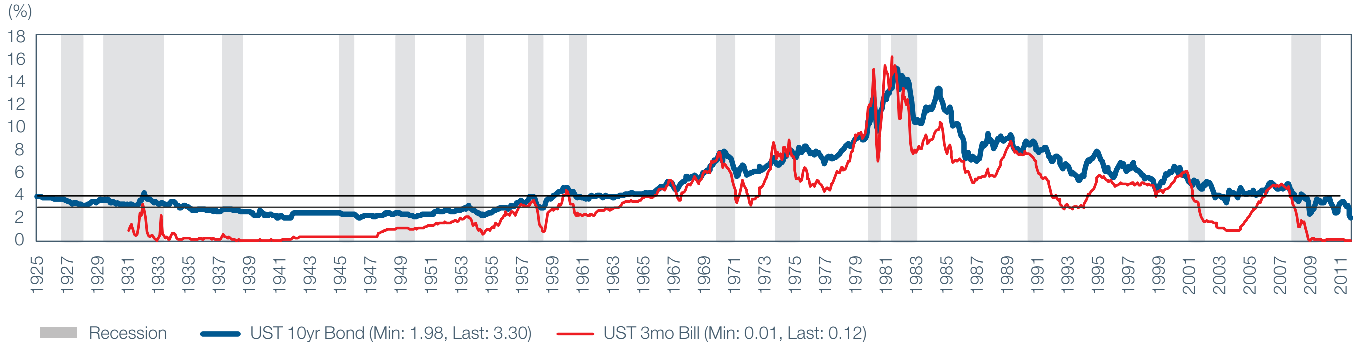


Exhibit 2

U.S. Treasury Yields from 1925 to Present

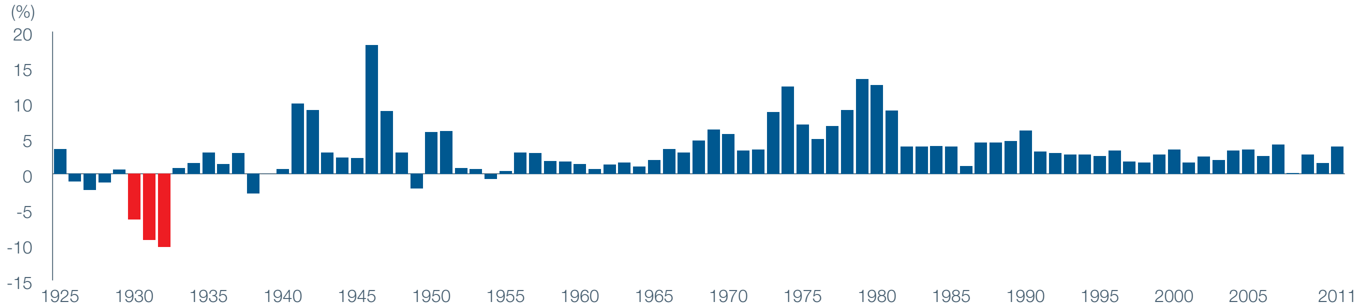


As of 15 September 2011

Source: U.S. Federal Reserve, Bureau of Labor Statistics

Exhibit 3

Annual CPI Percentage Change from 1925 to Present



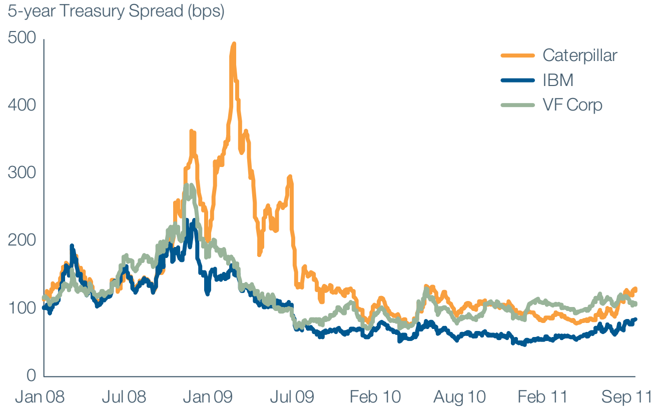
As of 15 September 2011

Source: U.S. Federal Reserve, Bureau of Labor Statistics

than they were in the higher-rate environment that existed prior to the crisis. These companies are currently able to borrow money for five years at rates of 1.75% to 2.25%, indicating that investors find their underlying fundamentals to be compelling. Both their earnings and revenues are higher than they have been historically, and their balance sheets remain strong. These fundamentals are also being confirmed by the equity valuations of these same companies in Exhibit 5, as they continue to trade at levels commensurate with the environment that existed prior to the crisis. Even more economically sensitive companies, such as Caterpillar, that have suffered greater declines in recent months are trading well above the trough reached in 2009. We find the price signals exhibited in the equity and corporate bond markets for solid, large-cap companies to be consistent with the underlying fundamentals demonstrated in the financial performance of those companies. Furthermore, we find these signals and underlying financial performance to be consistent with the steady growth in nominal GDP and the benign outlook reflected for inflation in instruments directly tied to expectations. We believe the price signals exhibited by gold, U.S. Treasuries, as well as other bellwethers in the mar-

Exhibit 4

Borrowing Costs

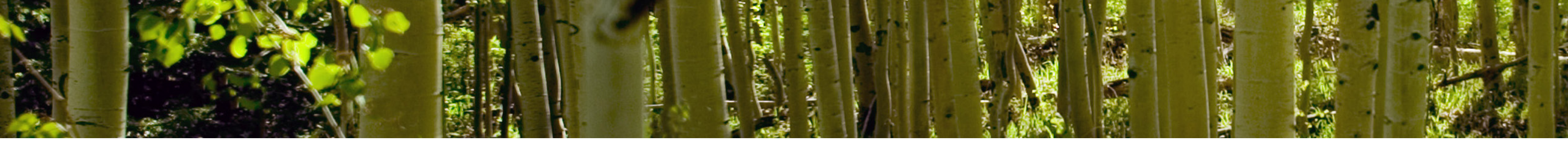


As of 14 September 2011

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.

Shown for illustrative purposes only.

Source: Bloomberg



ketplace have decoupled from these underlying fundamentals. We see these decouplings as symptoms of an environment defined by a fear and extreme uncertainty. We need to examine additional factors to further understand what is driving this uncertainty.

Identifying the Main Drivers of Uncertainty

We believe the main driver of uncertainty currently in the fixed income market is the material breakdown in the credit-scoring models that ratings agencies have historically applied to assessing the credit-based performance of debt. The ratings assigned to securities, when compared to the subsequent outcomes that have materialized, have not been predictive of credit-driven outcomes. We believe this has created enormous doubt in the market, as the level of impairment of what were considered sound credit investments has been very broad and high over the last three to four years. We will review corporate, structured, tax-exempt, and sovereign securities to illustrate this breakdown.

Exhibit 6 demonstrates that ratings have been highly unreliable in predicting the credit performance of corporate securities. We paired like securities of similarly rated investment-grade companies by industry to show how they compared in January 2007 and how they actually performed through June 2009. Prior to the 2008 financial crisis, the securities of these paired companies would have been interchangeable with each other based on observed rating and market metrics. However, only one company in each industry pairing survived the crisis of 2008, while the other company either defaulted or collapsed into speculative grade credit risk. For example, in 2007 the securities of Goldman Sachs and Lehman Brothers had similar ratings, yields, and effective durations, but, in less than five years, Lehman Brothers defaulted while Goldman Sachs continued to thrive.

Exhibit 5
Equity Valuations

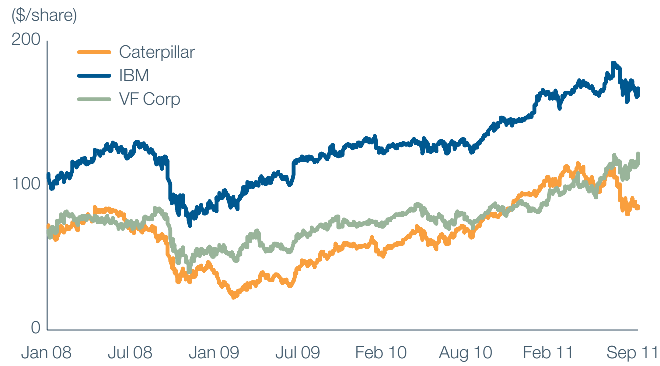


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Exhibit 6
Ratings Have Been Unreliable in Corporate Securities

Industry	Description	January 2007 Effective Duration	January 2007 Yield	January 2007 Composite Rating	June 2009 Composite Rating
Brokerage	Goldman Sachs	7.2	5.69	AA-	A
	Lehman	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	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 Corp	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	6.5	6.20	BBB	B+

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Shown for illustrative purposes only.

Source: Bank of America Merrill Lynch, Bloomberg

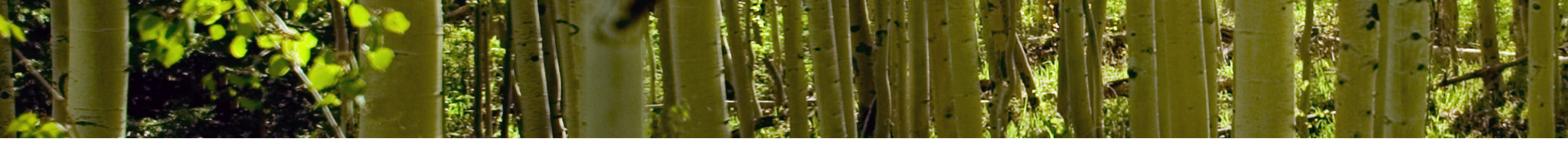


Exhibit 7

Percentage of the Original AAA Universe below Investment Grade

Vintage	2005 (%)	2006 (%)	2007 (%)
Prime Fixed	75	97	91
Prime ARM	84	97	89
Alt-A Fixed	89	98	99
Alt-A ARM	88	98	97
Option ARM	77	97	97
Subprime	64	97	96

As of December 2010

Source: Amherst Securities Group LP

Exhibit 8

Ratings Transitions in Municipal Securities

Rating	2007 (%)	2011 (%)
AAA	60	11
AA	20	50
A	12	26
BBB	5	12
Total	100	100

As of 31 March 2011

2007 to 2011 static credit transition analysis based on 7,518 out of 12,705 securities in the BofA Merrill Lynch Municipal Master Index.

Source: Bank of America Merrill Lynch, Lazard

Exhibit 7 demonstrates that ratings were unreliable in predicting the credit performance of structured securities. The vast majority of outstanding residential mortgage-backed securities (RMBS) that were rated AAA for each of the issuance years shown either defaulted or collapsed to low speculative grade by 2010. The rating agency models utilized to rate these structures failed to predict the subsequent credit behavior of all of these securities, regardless of the vintage year, underlying classification of the mortgage borrower (prime or sub-prime), or seller/servicer.

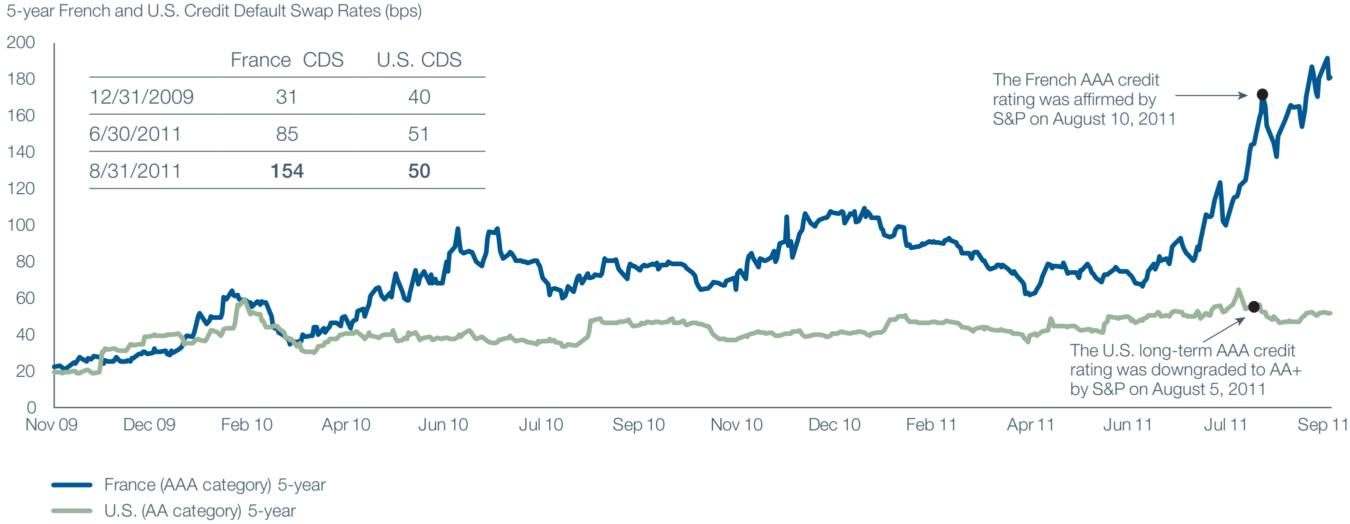
Ratings were also unreliable in predicting the credit performance of municipal securities. Exhibit 8 shows the percentage of securities that were in each rating category in 2007 versus the current ratings of those same securities in 2011. While not as easy to quantify based on available information, the experience during the crisis for municipal market participants was similar to those of the structured sector, where investors suffered disruptions in cash flows of AAA-rated securities that often ended in unexpected losses. The most visible example of this can be seen in Jefferson County, Alabama, which is restructuring its debt due to the ratings collapse of the securities of its investment-grade sewer system. While still not completely resolved, bondholders that own this debt are expected to permanently lose approximately 33% of their investment.[2]

Prior to recent history, the sovereign credit ratings of developed countries have traditionally been considered stable and predictive of outcomes; however, we are now in the midst of testing the predictive validity of the rating agency sovereign models as well. Exhibit 9 illustrates the cost of insuring against a default, or the 5-year credit default swap rates (CDS), of France and the United States. As shown, Standard and Poor's (S&P) made two important

Exhibit 9

Ratings Have Been Unreliable in Sovereign Securities

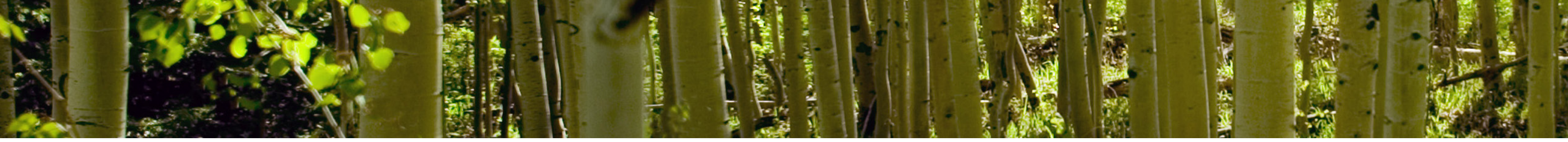
5-year French and U.S. Credit Default Swap Rates (bps)



	France CDS	U.S. CDS
12/31/2009	31	40
6/30/2011	85	51
8/31/2011	**154**	**50**

As of 15 September 2011

Source: Bloomberg



announcements in August. It downgraded U.S. long-term debt, the consequence of which (if the credit was worse) would be that the cost of insurance would increase for U.S. debt holders. S&P also affirmed the AAA credit rating of France, which would subsequently lead investors to believe that the cost of insurance would stay the same or decline. Exactly the opposite has happened, as the cost of insuring against a default of the United States has remained relatively stable while the cost of insuring against the default of France has moved sharply upward.

The bottom line is that the credit-scoring models employed by rating agencies have proven to be unreliable. This has contributed to the uncertainty investors are facing, as they can no longer infer the potential credit loss of a security from a traditional rating. We believe the difficulty the market is experiencing in assessing credit performance is being further exacerbated by the number and breadth of new policies that are being implemented by governments and monetary authorities around the world. The lack of reliable ratings models discussed earlier is now occurring in an environment of change in underlying forces unlike any observable in history.

Reliable Insurance? Potential Opportunities Outside of Risk-Off Investments

In our opinion, the divergence that we are seeing in market bellwethers is due to the buying behavior of insurance-like investments. We believe we are living in a world where prior relationships, correlations, and tenets that drive backward-looking and trend-based analysis have lost predictive meaning. Absent reliable credit metrics, investors are understandably seeking to buy what they deem to be reliable insurance against impairment risk, as they have recently been through cycles of uncertainty marked by discontinuous outcomes. As such, we believe all investments that have historically proven to be reliable though these cycles by providing correlation benefits and downside protection during times of market uncertainty have been subject to excessive levels of demand. Three examples of insurance-like investments that have been subject to this demand recently are gold, the Swiss franc, and U.S. Treasuries, illustrated in Exhibit 10.

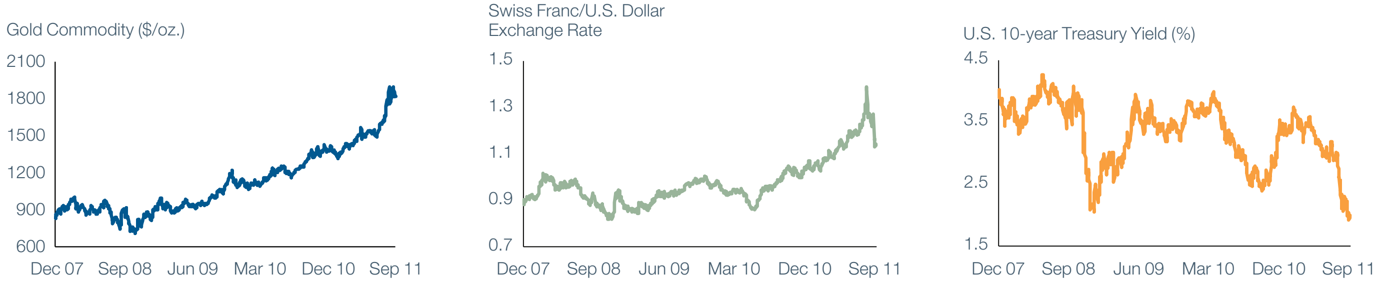
While they have been effective historically, we believe the downside protection represented by these asset classes is too expensive right now relative to the pricing of other asset classes. For example, based on recorded history there does not seem to be much downside protection if you are purchasing a 10-year U.S. Treasury security at 2%, particularly if—as a 2% yield has indicated in the past—it is already trading to the peak upside experienced in an extremely destructive economic period. In addition to the current valuation risks, investors need to consider that these insurance-like investments are not legal insurance contracts. For example, those who purchased Swiss francs for protection against other developed currencies accomplished just the opposite when the Swiss National Bank intervened to peg the franc to the euro, as is evident by the sharp reversal shown in the chart in Exhibit 10. This intervention changed the underlying expected behavior of the asset; what the investor once relied upon as insurance can no longer be deemed to be reliable.

While we believe the cost of insurance is currently high and generally undependable, there may be well-priced opportunities outside of more volatile areas that would not necessitate insurance. The bond market that exists today looks nothing like the bond market that existed in 2007. It is no longer homogenous and it does not yield 2%; the 10-year Treasury does. We have not been in a bond market that has as much dispersion in terms of valuation as the one we are in today. Pairings of like-rated items with similar structural characteristics no longer trade to the same valuation.

As illustrated in Exhibit 11, there has been a high amount of dispersion amid corporate, sovereign, and municipal securities. Ratings have not been reliable indicators of results. However, the same underlying conditions that have created uncertainty have created opportunity for forward-looking investors that are able to conduct their own comprehensive analysis. This is illustrated by

Exhibit 10

Investors Seek Reliable Insurance



As of 14 September 2011

Source: Bloomberg

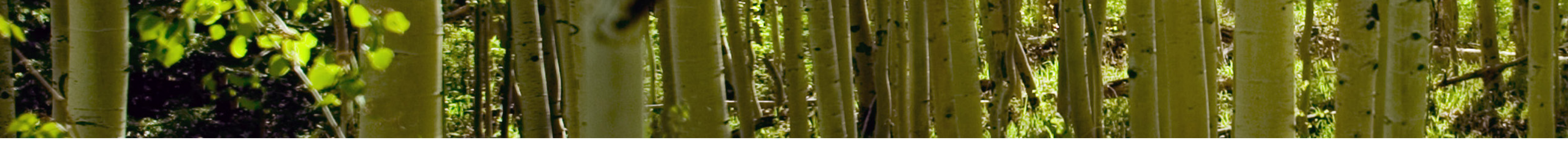
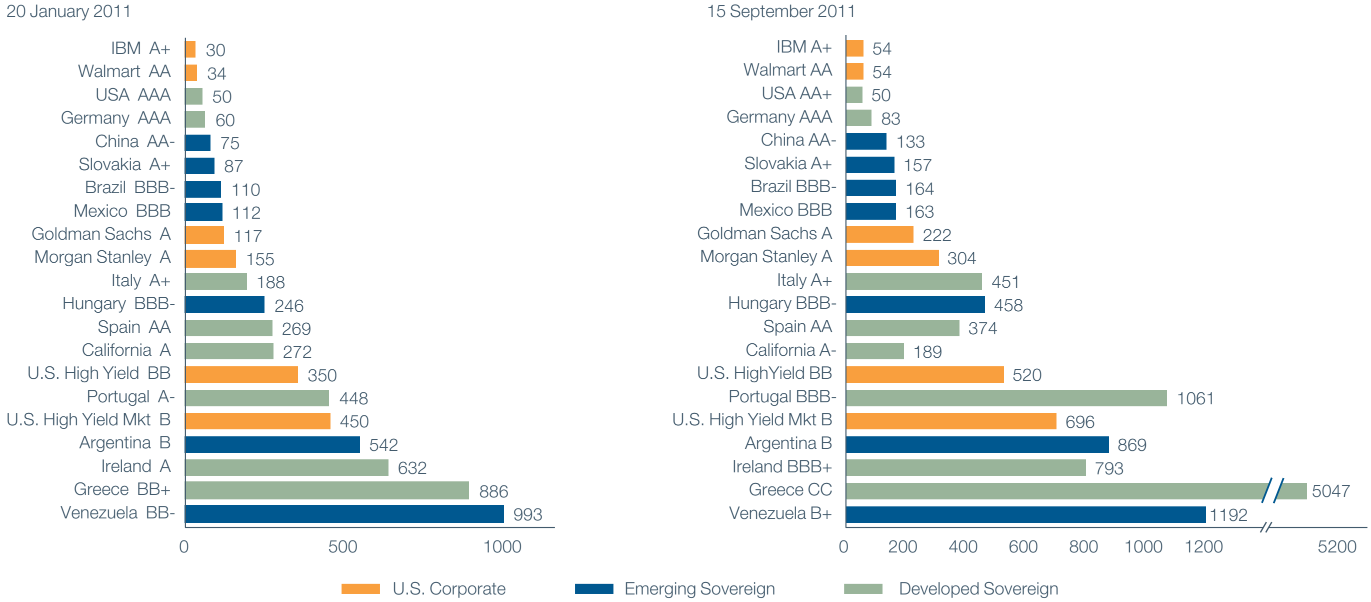


Exhibit 11
Spread in Basis Points for 5-year Risk



The information should not be considered a recommendation or solicitation to purchase or sell any securities.
Source: Bloomberg

spreads on securities such as California, which tightened over the period that it was being downgraded from A to A-, while spreads in both Italy and Hungary widened substantially absent any change in ratings. More importantly, both of these European countries started and ended the period at higher ratings than California. Yet another opportunity over this period was the U.S. high yield BB sector. This sector has not been subject to material impairment, is at breakeven levels, and is likely to generate value going forward even at wider spreads. Opportunities are available for those who have the ability to consider what is driving the securities they are purchasing, and what the potential outcomes are around those drivers.

Navigating through the Minefields

We believe it is important to fundamentally understand the behavioral context of securities and asset classes and, thus, to ask and seek the answers to investigative questions. Investors should not simply identify what is happening in market bellwethers and extrapolate broader implications based on recent history or a model, but should go further to ask "Why is this happening?" and "What else has to happen along with it?" to confirm the validity of the initial signals they have identified.

In our view, there are two reliable actions long investors must take to secure excess returns. The first is to seek value in what is being overlooked. Investors must work to locate mispriced opportunities, particularly in areas where there has been dislocation. For example, as corporate credit spreads widen due to ongoing growth concerns, there are likely quality securities that suffer in sympathy with the lower-quality securities and pose an attractive buying opportunity. This is similar to what happened with California, which was a terrific opportunity near the beginning of 2011 as market concerns about municipal debt widened spreads for the state's debt.

The second is to fully understand all the risks that are being acquired in an investment in order to prevent potential impairment. For example, owning an index or benchmark-hugging strategy without completing an analysis of how the index is constructed and determining the underlying individual security risks is particularly dangerous in a non-homogenous world. Many investors purchased private-label mortgage-backed securities in the past because they were in a benchmark that they assumed was benign, but ended up greatly increasing risk due to impairment and the loss of capital. Investors must determine not only what credit impairment risk may exist in the index, but also consider what individual constituents of the index will be driving its returns. For example, if an index (like most U.S. fixed income benchmarks) is overweight to U.S. government securities, and you believe these securities may be excessively overvalued, then owning the index puts you firmly in an overvaluation bubble.

In addition to the above, long/short investors must also worry about the reliability of their hedging strategies (i.e., credit, currencies, interest rates). Hedgers need to deconstruct their hedges and think about the fundamental risks inherent in collecting and pricing outcomes. Again, consider the Swiss franc versus the euro;

simply because something has historically shown a correlation benefit does not mean that it will continue to do so—when the Swiss National Bank pegged the franc to the euro, the hedge lost value. It may be better not to own something rather than hedging it with another position.

While it is important to be sensitive to the historical behavior of benchmarks in developing a sound investment asset allocation framework, we believe it is critically important that the current anomalies inherent in any utilized benchmark not be allowed to drive the engagement of risk. In our view, the key to reducing volatility, avoiding impairment, and adding return is in the careful deconstruction of the sources of benchmark returns, coupled with the surgical engagement in the sound opportunities that they may present. Ultimately, we believe that careful engagement of risk will allow investors to better preserve and increase their capital than flights to overvalued safety.

Notes

1 Source: U.S. Federal Reserve, U.S. Bureau of Economic Analysis, U.S. Department of Treasury, Lazard

2 As of 13 August 2011. Source: Bloomberg

Important Information

Published on 1 November 2011.