

Lazard Insights

Conference Call Series

20 January 2011

Summary

Kick-off Report: Engaging Risks and Finding Opportunities in 2011

Featured Speaker: **David Cleary, CFA**, Managing Director, Portfolio Manager/Analyst

Global Overview

Last year proved to be a good one for investors, and bullish sentiment has grown as we have entered 2011. We witnessed fundamental improvement in economic growth, particularly in the United States, and we continue to see data that validates this growth. A critical data point that we closely monitor is corporate profits, and strong earnings reports support our optimistic outlook. Additionally, the economy continues to receive support from monetary authorities, particularly from the U.S. Federal Reserve (the Fed). The second round of quantitative easing, or QE2, has been a boon to investor confidence, as risk-based assets have rallied and we believe this action will ultimately benefit real economic activity. An improved employment rate would validate the Fed's action.

Risks remain in the marketplace, but, importantly, they have changed. Two years ago the risks were deflationary and private sector-oriented, particularly in financials. Today they are inflationary and public sector-oriented, as evidenced by the European debt crisis and the concerns about U.S. municipals. The changing risk dynamic is both positive and negative: Positive because it appears as if the 2008 problems are largely behind us, but negative because resolution of the debt problems in the government space will likely cause volatility and concern, and will be challenging to solve. Politicians do not tend to move quickly; however, there is a silver lining within the political arena, as policymakers around the world seem to be seriously addressing these issues.

Exhibit 1

Key Economic and Investment Drivers

The directionality of several economic variables provides the basis for market viewpoints

Real Economic Growth	Rising Stable Contracting	Global economic growth is gathering momentum and sustainability.
Inflation	Rising Stable Contracting	Accommodative central banks have sparked increased inflationary pressures, particularly in the emerging markets.
Real Interest Rates	Rising Stable Contracting	In spite of quantitative easing, interest rates are rising due to increased inflationary and sovereign credit risks.
U.S. Dollar F/X Value	Rising Stable Contracting	The U.S. dollar will likely rise as relative economic performance improves.
Taxes and Regulation	Rising Stable Contracting	Policymakers are increasingly adopting pro-market initiatives and dealing with fiscal imbalances.
P/E Ratios	Rising Stable Contracting	Investors' appetite for equities will continue to rise, particularly as the economic environment improves and corporate profitability is sustained.
Fixed Income Risk Premiums	Rising Stable Contracting	Continued widening likely among sovereign and other governmental credit risk. Tight spreads will remain among private sector borrowers.
Volatility	Rising Stable Contracting	Volatility has fallen sharply and is likely to remain low as economic news improves.

■ Bullish
 ■ Neutral
 ■ Bearish

As of 20 January 2011 and is subject to change.

Key Economic and Investment Drivers

Exhibit 1 lays out the eight fundamental variables that help formulate our market viewpoint. We look at the forward directionality of these variables on both a global and regional basis, which helps to determine if investors will be compensated for risks taken and to locate where the opportunities may lie. Based on this analysis, we believe the global economy is growing, but, importantly, that the gap between emerging markets growth and U.S. growth is narrowing as the U.S. economy improves. This is a dramatic change in our viewpoint, as we have long believed in the secular, demographically-driven emerging markets growth story. Is this a

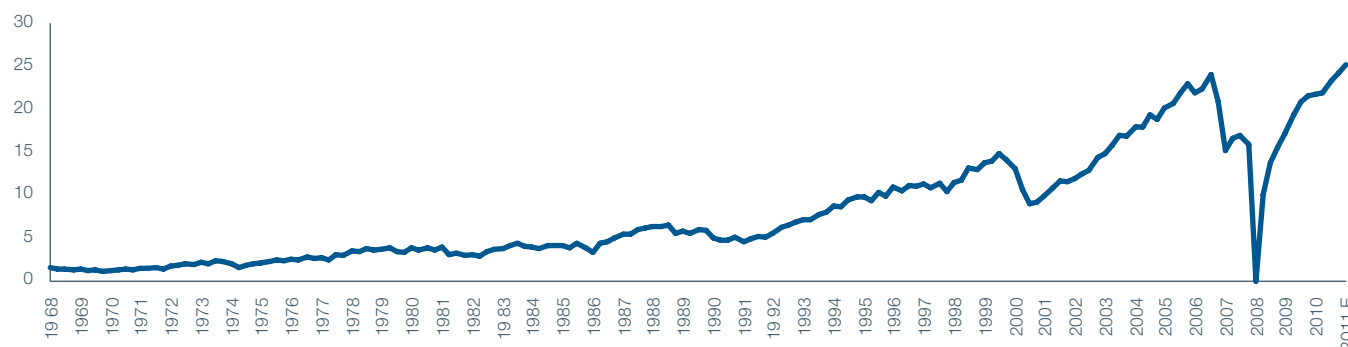
cyclical or secular change? We believe this is most likely cyclical, but that it can be powerful over the near term, particularly as asset flows have been heavily skewed toward the emerging markets. Separately, most of the variables we are concerned about will impact bond markets more than equity markets, particularly on the inflation front.

Corporate Profits Rally

We have focused on profits as a source of optimism for our 2011 outlook because, ultimately, from profits wealth is created, equipment is bought, taxes are paid, and people are hired. Throughout 2009 and most of 2010, skeptics declared that profitability was

Exhibit 2 Corporate Profits Rally

S&P 500 Index Earnings Per Share (\$)



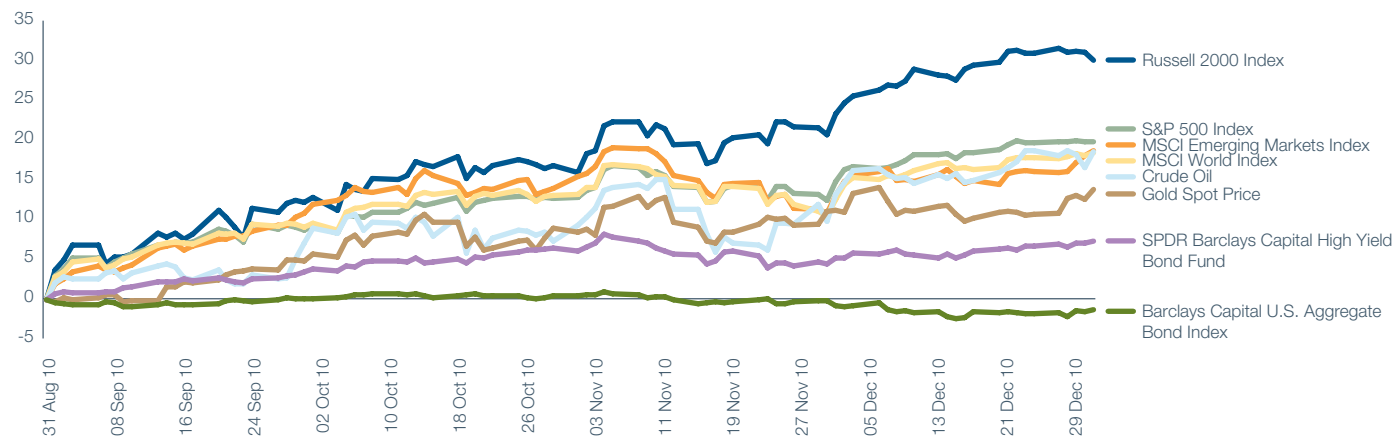
As of 31 December 2010

Estimated data is not a promise or a guarantee to future results and is subject to change.

Source: ISI Group

Exhibit 3 Market Returns Since QE2 Announced

Cumulative Return (%)



As of 31 December 2010

Source: Bloomberg

unsustainable due to little or no top-line growth. However, with GDP expected to grow somewhere from 3% to 4% in 2011, these sustainability issues diminish. It is also important to note that the U.S. recovery has not been driven by the consumer or by housing, nor does it have to be. As illustrated in Exhibit 2, we are witnessing corporate profits rally based on a business-led recovery, with increases in capital spending and improvement in export volumes. To the extent that employment improves and the consumer begins to contribute to economic expansion, this could become an even more powerful driver of growth.

Market Returns since the Announcement of QE2

The effects of QE2, from the Fed's announcement in August 2010 through the end of 2010, are shown in Exhibit 3. Risk assets are rallying, which we believe has been the Fed's goal: to provide liquidity to the marketplace and flatten the risk curve. Importantly, this is not just a U.S. phenomenon; the Bank of Japan is undergoing quantitative easing as well, and the European Central Bank (ECB) and the Bank of England are both aggressively easing. In the case of the ECB, the purpose of the easing is to solve a particular issue in regard to the European debt crisis, as well as to provide general support to the economy. The liquidity being provided by central banks globally is unprecedented and, we believe, is having the desired effect.

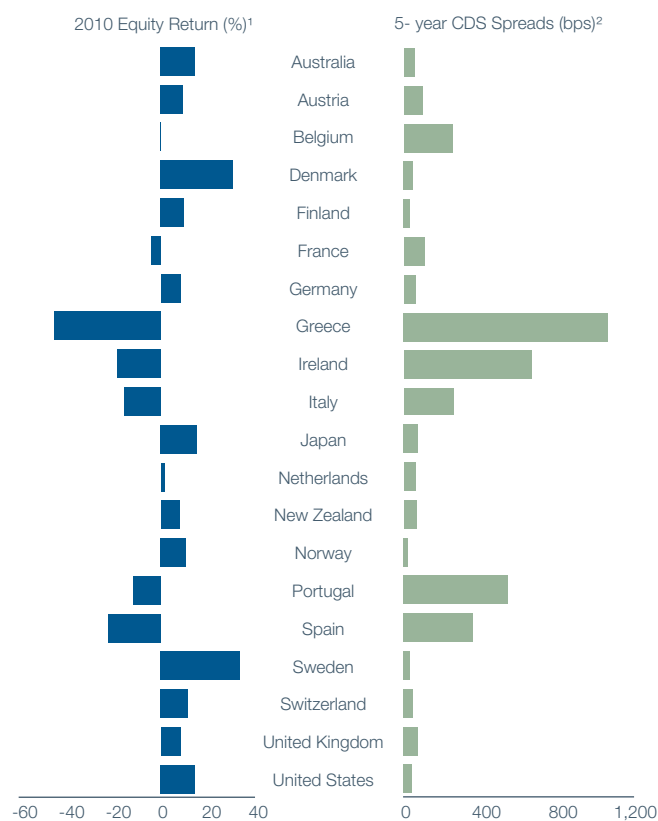
Inflation

Inflation, however, is the risk associated with this easing. Can the central banks reverse course when needed and not let the inflationary genie out of the bottle? U.S. Federal Reserve Chairman Ben Bernanke recently stated that the Fed could "...raise interest rates in 15 minutes if we have to." We believe that it would take longer than that, and that the ultimate reduction of the central bank's balance sheets will prove to be more difficult. Today, central banks around the world are coordinating their monetary policy easing, but we believe investors should not expect coordinated monetary policy tightening. To the extent that Europe or Japan do not recover as fast as the United States, central banks in those regions may remain in easing mode, thus adding to inflationary pressures in the longer term. In addition, it has been widely discussed that emerging markets are going to have to deal with inflationary problems on their own, which could result in monetary policy tightening in a series of markets with more acute inflationary issues. Recent examples include China's increase of reserve requirements and monetary tightening by the Indonesian, Korean, and Thai central banks. Inflation is definitively a worry point for us, but one which is most likely to impact bond investors to a greater degree than equity investors over the near term.

Fiscal Discipline Matters: Disparity Reigns

Another structural issue impacting bonds is sovereign credit risk. Exhibit 4 shows that markets are punishing nations that have not managed their fiscal affairs well, and we now see a huge dispersion between the fiscally prudent and imprudent countries, in both the credit and equity markets. This is a large cause for concern. We are generally bullish on equity markets, but, as sovereign credit issues increase and impact larger and larger markets, it could have a negative impact on equity markets globally. Notably, resolution in Europe remains unclear, particularly as political and fiscal mechanisms to solve these problems are weak. This will likely be a source of volatility and further dispersion in 2011. This volatility is a focus point for investors, as it is difficult to say whether or not there are opportunities in Europe without having an opinion as to how to implement a European investment. For example, an investor today that wants to buy a European government bond can choose among investments that yield from 1% up to 15%.

Exhibit 4 Fiscal Discipline Matters: Disparity Reigns



¹ 2010 performance of respective MSCI country index.

² As of 10 January 2011

Performance presented in U.S. dollars. Performance quoted represents past performance. Past performance is not a reliable indicator of future results.

Source: Lazard, MSCI, Bloomberg

We believe that this high level of dispersion will create selective opportunities.

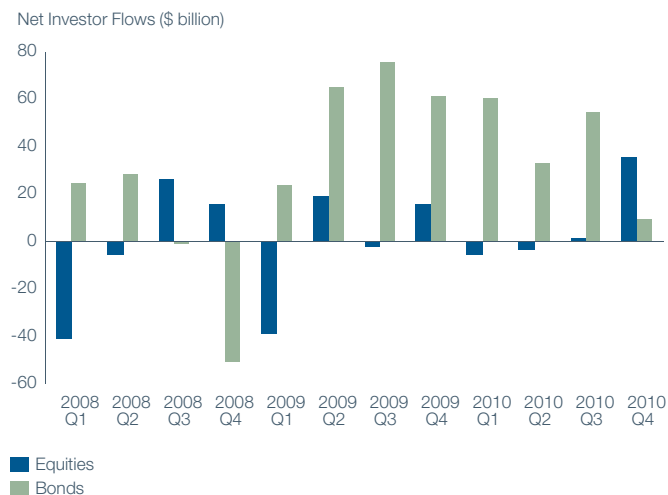
Policy Issues Remain Paramount

The good news on the sovereign credit front is that policymakers are now becoming more serious. This is not just a U.S. phenomenon, but is truly a global story. Governments have been actively addressing their fiscal issues, as evidenced by the austerity packages passed in Greece and Ireland and the extension of the retirement age in France. In the United States, the bipartisan Deficit Commission Report was released at the request of the President in December. This is a very serious document, putting many issues that were once considered untouchable on the table, including discretionary spending, tax reform, health care, and retirement policies. The policy reforms are not just tax and spending issues, either. On 18 January 2011, the U.S. President wrote an editorial in the *Wall Street Journal* that discussed federal regulations and their impact on private business. In fact, Ed Hyman of the ISI Group reported that, since the November 2010 elections, the U.S. President has proposed 41 pro-market initiatives. We believe this is good news, as the government is attempting to right-size itself and strike an appropriate, fiscally manageable balance with the private sector.

Historic Asset Flows

Exhibit 5 shows asset flows between stocks and bonds over the past three years. Over this time period—given the generally negative viewpoint that many investors had—assets flowed into the fixed income market on an unprecedented scale. Whether it is

Exhibit 5 Historic Asset Flows

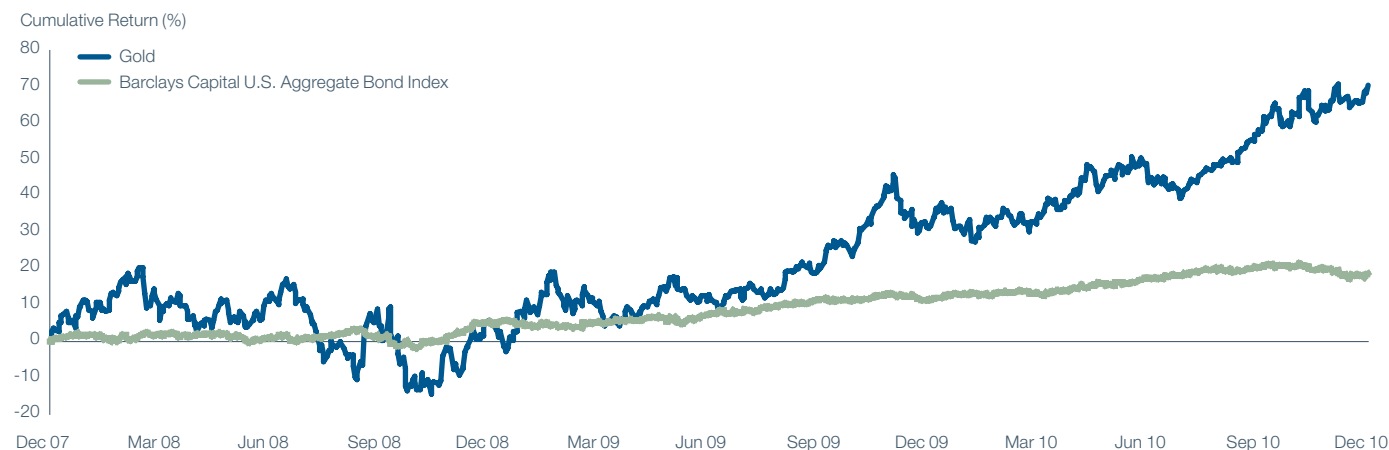


As of 31 December 2010

Source: Bank of America Merrill Lynch

due to an improved economy and profits or due to inflationary concerns, investors are now starting to return to equities, illustrated by the strong flows during the fourth quarter of 2010. Again, encouraging investors to move toward riskier assets has been a goal of the Fed and other monetary authorities. If this return-to-equities trend persists, we believe it will continue to positively impact equity markets.

Exhibit 6 Gold as a Diversification Tool



As of 31 December 2010

Source: Bank of America Merrill Lynch

Diversification Tools

Given the sovereign debt issues and unprecedented investor flows addressed previously, we have stated, and still believe, that bonds may not provide the correlation or diversification benefits relative to equity markets that they have historically. We believe that investors should consider alternative diversification tools, such as gold and other commodity-based assets, which currently represent a good hedge. Gold in particular, as seen in Exhibit 6, has been an attractive diversification tool relative to bonds. We believe it will continue to offer correlation benefits, particularly given the easing stance of central banks and existing inflationary pressures.

Asset Class Viewpoints

Our current investment viewpoints for major market asset classes are laid out in Exhibit 7. The most significant change from our previous viewpoints is a more constructive view on the U.S. equity markets relative to the emerging markets. As discussed earlier, the improved outlook for GDP growth in the United States and potential for further increases in profitability drive this view. Importantly, we are not trying to make a contrarian statement on emerging markets, we simply believe that asset flows and expectations for emerging market growth are very high, and the markets need to digest those assets. In Europe, we believe it is less critical to define how attractive the region is on the whole, but than it is to implement investments carefully in the region. We have tended to focus on opportunities in Germany, which benefits from a weaker euro, and diversify away from euro markets into Switzerland, Sweden, and the United Kingdom.

Unattractive investments to us right now are government bonds in various formats, and we believe investors should minimize interest-rate risks in their portfolios. However, we believe private-sector bonds are more attractive. For example, high yield corporates can currently offer 500 basis points of additional yield for reasonable risk.

Non-traditional Investment Ideas

Given the dispersion of the opportunity set, we believe investors should focus on non-traditional investments in specific sectors during 2011. While we have found direct emerging markets investments less attractive due to current valuations, we do currently like sector investments in industrials, materials, and commodi-

ties, which have the potential to benefit from emerging markets growth. Given our bullish stance on U.S. equities, we have focused these sector investments in the United States. Additionally, we believe investors need to diversify their diversification tools, as bonds may not provide the same returns or correlation benefits that we have seen in the past. Given that volatility has dropped sharply, the costs of hedging broad market risks or specific investment risks have subsequently dropped and should be considered selectively.

Summary

While we do believe that the global economy has improved and will likely continue to improve, investors should be compensated for risks taken. We believe the United States can surprise on the upside, but caution investors to beware of growing inflation, to be mindful of their fixed income allocations, and to monitor developments on the European credit front—the systemic risk about which we are most worried. Importantly, we believe an active viewpoint in 2011 will be imperative to take advantage of an environment that continues to provide a diverse opportunity set.

Exhibit 7 Asset Class Viewpoints

	Attractive	Fair Valued	Unattractive
EQUITY			
Cap	Large Cap	Small Cap Mid Cap	
Region	United States	Japan United Kingdom Asia-Pacific ex-Japan Continental Europe	Emerging Markets
Style	Non-traditional	Value Growth	
FIXED INCOME			
	Non-traditional	Cash Credit	Sovereign Debt

For illustrative purposes only and is subject to change.

Important Information

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

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.

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.

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