

Lazard Global Thematic Equity

COMMENTARY / DECEMBER 2011

PERFORMANCE*

<i>Portfolio/ Benchmark</i>	<i>December %</i>	<i>3 Months %</i>	<i>1 Year %</i>	<i>3 Years % p.a.</i>	<i>5 Years % p.a.</i>	<i>Since Inception % p.a.</i>
Global Thematic ex-Australia Composite	-1.5	0.1	-5.1	-2.1	-4.1	3.5
MSCI World ex-Australia	0.2	2.0	-5.3	-2.6	-7.5	-0.1

*Performance reported gross of fees. Past performance is not necessarily indicative of future performance.

Date of inception is 1-October-2003.

Benchmark returns are MSCI net official numbers. Source: MSCI.

COMMENTARY

Market Overview

"Risk on/risk off" is a phrase that describes market conditions, pulled to and fro on low volumes as a function of the developing crisis and inconclusive policy response in Europe. Policy initiatives multiplied late in the fourth quarter. First, the world's biggest central banks announced a coordinated move to boost liquidity by cutting the price of emergency dollar loans by 50 basis points. Then, European countries (principally France and Germany) failed again to reach agreement. The German government's objective over time is to create a legally enforceable fiscal union for the Eurozone. Its central bank and successive governments have been opposed to central bank funding of government debt, including by the European Central Bank (ECB). The French government's preference is to avoid a formal fiscal, financial, and political union, emphasising the need for greater fiscal discipline without the clear commitment to formal union while buying time through encouraging the ECB to buy sovereign debt.

The negative impact on stock markets of the failure of the European summit was mitigated by the ECB's announcement that it would provide unlimited 3-year liquidity at 1% to banks. 523 banks immediately took up €489 billion, the largest amount ever allocated in a single ECB liquidity operation. This may side-step German concerns about correct central bank actions and ease short-term liquidity pressures, but bank balance sheets face heavy refinancing needs in the first half of 2012. It is unclear to what extent banks will use these funds to purchase sovereign debt (so-called "financial repression" as discussed in earlier letters), or to provide funding to small- and medium-size enterprises, or whether they will focus on strengthening their balance sheets by running down assets. These various steps, however, do not solve Europe's fundamental problems. At best, they buy some time. The focus on fiscal discipline and austerity at a time when economic activity is slowing runs the risk of deepening recessionary forces, as does balance sheet shrinkage by banks. We believe the mechanisms are in place for a liquidity and solvency crisis to become a balance of payments crisis, in time.

The slowing pace of economic activity in Europe is reverberating across the globe with its impact so far more noticeable in certain emerging markets, especially China and Brazil. China's export growth fell to the single digits in November. Major changes in Chinese economic policy are unlikely to be implemented until after next year's National People's Congress, which is due to be held in March.

Economic statistics released during December suggest that for the moment, in the face of a broad global slowdown, the U.S. economy stands almost alone in seeing some modest acceleration in growth. But fresh policy initiatives are unlikely as the Presidential election nears, personal income growth remains



weak, and employment data is not encouraging as new temporary jobs, which are on the rise, fail to fully replace permanent jobs lost since late 2007. The most likely conjuncture for the United States remains a long period of deleveraging and, consequently, slow growth. The weakening Euro and, thus, a stronger U.S. dollar may even exacerbate this outlook.

U.S. and European equities rose strongly during the quarter. Commodities, including gold, fell. The Euro fell and the Australian dollar rose. Emerging markets equities remained weak.

Europe

Since Europe's problems dominate market concerns, this part of the letter sets out how we think about Europe, and how the portfolio is positioned with this in mind.

Neither the survival nor the demise of the Euro are foregone conclusions, and we believe that either outcome will be a function of political factors. The former requires the surrender of national fiscal sovereignty by all Eurozone members, and a very, very, large financial commitment from Germany, in particular, whatever the degree of austerity exacted from other countries for this financial commitment. The latter suggests that these political commitments are not possible at a national level for richer and poorer countries alike, whether the demise of the Euro is orderly or disorderly. Non-European developed countries are not in a position to help much, and international institutions such as the International Monetary Fund (IMF) are accordingly limited in their ability to help solve the problem, as their involvement can only be financial. Wealthy emerging market countries may be willing to provide some financial assistance, but if this happens, assistance is likely to be very limited, secondary to any developed world package, and with many unknowable strings attached. The recent swaps program and the provision of financing to European banks by the ECB merely provide more liquidity but no advance towards a solution, and show again how intractable is the problem of governmental decision making. We are left with central bankers making money available at little cost.

There are many possible outcomes: No Euro, a core Euro surrounded by various new currencies of invalid countries, a new Deutschemark and a Euro without Germany, or even the preservation of the Euro in its current form are just some. Whatever we may hope or believe to be the eventual outcome, we must acknowledge that there is no analysable asymmetry available to us, and that we must be very careful to avoid taking a strong position one way or another in the portfolio.

We are reluctant to add to the endless discussion about Europe flooding all media. But, recognising that to take a strong view on any particular outcome today would be unwise, we believe that it is true to point out that Germany holds the most important cards. We would make two general points about history and geopolitics that are perhaps relevant. History suggests that Germany's priorities have been, first, the bond market and, second, the banks. Even in the most favorable outcome, we believe equity investors should expect significant dilution. A likely outcome of imposing these priorities would be a strong currency, which we imagine large corporations would accept as the price of long-term success. Our second point is that we suspect that geopolitics have to be taken into consideration since students of German history should know that this is where the consequences of today's financial crisis will ultimately lie. Consider the growing distance of the United States with respect to direct involvement and its defense burden. Consider the pull of China, Russia's ambition, and religious extremism in the Middle East. In our view, all these factors will push the German establishment to preserve the Euro and move towards a fiscal union. Whether the German electorate will accept this, we cannot know. But the Germans can be decisive. The achievement of currency unification with East Germany may provide a lesson. In recent decades, a resurgent Germany has been taking a leadership role in Europe as the United Kingdom has ceded influence and as Russia has lost its preeminence in U.S. policy, while remaining a challenge.

What is analysable is that, at the very best, Europe is faced with the prospect of deleveraging against the background of austerity and, thus, slow growth if the Euro survives; and if it doesn't, at the worst, we believe there will be debt destruction in one form or another (any of default, devaluation, and inflation), whether the Euro's demise is orderly or disorderly and, ab initio, even weaker economic activity. We also know that the portfolio must be prepared for stormy weather in advance of events, since experience has taught us that hoping to trade once events unfold is foolish.



Portfolio Positioning

Defensive positioning in the portfolio today, as it has for some time, attempts to accommodate this poor outlook for Europe. This positioning takes into account the fully invested requirement of our mandate. Factors include:

- Almost zero exposure to developed world banks and insurance companies (not including Japan), since Europe's stresses have systemic implications.
- Almost zero exposure to domestic European companies, relevant to Europe's economic conjuncture.
- Lower-than-benchmark exposure to European equities in general, almost entirely in the form of global companies which may suffer, but which we believe are relatively advantaged.
- A general emphasis on balance sheet quality in the portfolio as a whole, since the Euro's crisis is about debt.
- Exposure to gold and precious metals producers, also relevant to central bank activity globally (vis-à-vis the new swap lines), and potentially most significant in the context of a possible demise of the Euro.
- Exposure to domestic Japanese companies that are not involved in the crisis in Europe, and which may benefit from higher interest rates in Japan that may be triggered by external factors.

And, given that even weaker economic activity in Europe would probably cause global economic activity to weaken further:

- Avoidance globally of deep cyclical companies most sensitive to levels of global economic activity.

To answer the question of whether this portfolio positioning assumes that the Euro will not survive, our response is that we believe the positioning is reasonable even in the best case, that is, protracted deleveraging against the background of fiscal austerity in Europe. While the portfolio would inevitably miss a short-term, powerful, relief rally in European shares and financials globally if it becomes absolutely clear that the common currency will survive, this is not an event that we believe we can time or execute.

Performance Commentary

The composite ended the fourth quarter almost unchanged, underperforming the MSCI World ex-Australia Index, which rose. Over the full calendar year, the composite declined yet slightly outperformed the benchmark.

The main reasons for the underperformance in the quarter were the decline in the price of gold, now about 20% down from its peak and poor performance from Japanese equities, as investors feared that the weak Japanese economy would suffer further as competition from European companies intensified, stimulated by the weaker Euro.

Themes helping returns were Oil, Simplifying Structure, Regulatory Change, and Intergenerational Assets. Themes hurting returns were Antimatter, Gold & Precious Metals, and Managing Complexity.

The higher oil price, in part due to Iranian sabre rattling in the Straits of Hormuz, was the reason for the strong performance of the Oil theme. Almost all holdings rose. Under the Simplifying Structure theme, *Pfizer* performed well on good pipeline prospects and improving results; *Exxon Mobil* on good results; and *Amgen* on good pipeline prospects. *ThyssenKrupp* performed poorly due to poor results and problems with a new Chinese-built coking plant in Brazil, as did *Kellogg*, on poor results earlier in the quarter. Under Regulatory Change, *CVS Caremark* performed well on improving results and better management of its pharmacy benefits management business, and *Visa* on good results. *CME Group* declined, as trading volumes remained weak during the quarter. Under Intergenerational Assets, North American pipeline owner *Spectra Energy* and genetic seeds business *Monsanto* performed well on improving results. *National Grid* fell slightly on the prospect of a less favorable regulatory environment.

Under the Antimatter theme, almost all holdings declined in a weak market, for the reason described above. Financials holdings *Nomura* and *Mitsubishi UFJ Financial Group*, and real estate companies *Mitsui Fudosan* and *Sumitomo Realty & Development* were notably weak, although operating results were not the issue. Housing materials producer *JS Group* fell, as housing starts fell sharply year on year. Under Gold & Precious Metals, almost all holdings declined on the weaker bullion price. *Kinross Gold* fell most sharply on an announced acquisition. *Barrick Gold* fell too on news of a mining company



acquisition that included base metals in its portfolio. Under Managing Complexity, poor returns were almost entirely due to *Oracle's* unfavorable earnings surprise as the company missed revenue guidance. We have met company management since and, for the time being, believe that maintaining the position is reasonable. Elsewhere, under the National Platforms theme, Indian mortgage provider *HDFC* fell sharply, as Indian equities and the rupee fell against the backdrop of rising inflation.

Since the current themes have been in place only for the fourth quarter, there will be no annual theme performance commentary.

From a sector perspective, energy (Oil), healthcare (Simplifying Structure), and telecom services (Simplifying Structure) contributed to relative returns during the quarter. Financials (Antimatter), capital goods and materials (Gold & Precious Metals) detracted from relative returns. For the full calendar year, energy (Oil), information technology, materials (Gold), telecom services, and utilities added value.

On a country basis, during the quarter, our underweight in Europe contributed to relative returns. Positions in North America (gold, Oracle, underweight the United States) and Japan detracted. For the full calendar year, our underweight in Europe and stock selection in Japan and the United Kingdom helped. Our overweight in Canada, Hong Kong, Singapore, and the emerging markets detracted.

Purchases during the quarter included the initiation of a position in Japanese electronics business *Sharp* under the Simplifying Structure theme. The company is exiting its commodity LCD television business and is focusing on higher-value-added segments in small touch sensitive screens (an outsourced arrangement has just been signed with *Apple*), and large displays. U.S. cable business *Comcast* was also acquired under this theme, on evidence that with its network built out, capital expenditure will decline (barring media acquisitions, which remain a possibility), and we believe that the company has the ability to enter and compete successfully in other businesses requiring communications infrastructure. The position in *Tingyi Holdings* (National Platforms) was increased on market weakness.

Sales included the continuing sale of *New World Department Stores* and the sale of *ICBC* to reduce exposure in China, as well as the continuing sales of *Cielo* and *Redecard*—both on broken investment theses. All these companies were held under National Platforms. *Hochtief* (Intergenerational Assets) was sold on corporate governance grounds.

Strategy/Outlook

Market concerns are focused on the crisis in Europe and the broader outlook for economic growth, both in developed and emerging economies. We believe that these issues may take some time to play out. We also maintain a focus on the long cycle transition that we believe is underway.

History suggests that changes in technology are only fully incorporated into the economy after long delays. A simple example might be the mass production of the motor car by Ford in the early 20th century. It was only with the completion of the Interstate Highway system by the 1960's that the implications of this technology were fully absorbed. By this we mean, for example, the emergence of suburbs and, therefore, larger living accommodations, which in turn permitted mass sales of large consumer durables such as washing machines, freezers, and so on—the foundation of the consumer economy. In the meantime, between the new and old technologies, the economy was disrupted. Yet, between 1929 and 1944, multi factor production (growth not attributable to increases in inputs) grew faster than at any time in the 20th century. The Great Depression was a period of rapid progress.

We believe that today, similarly, we find ourselves caught between the advent of digital technology and its full rollout across the global economy; between the analogue and the fully digital world, in a single economy based on two systems. This thought underpins our thinking on complexity. Imagine as a simple example, a bricks and mortar retailer that must also run an Internet-based distribution business. Imagine the tension between legacy and change. Global Platform companies outsource production and services, insource ideas and innovation, and build on scale and market dominance. But in doing this, increasingly they co-ordinate and organise internal networks with customers, colleagues, outsourced suppliers, and capital providers. A modern corporation may be increasingly defined by a collection of interacting networks, rather than, say, assets and capital. Data and information systems are essential to managing this. Corporations in the information age may be scaled to information and decision making capacity, rather than capital availability.



Looking beyond the concerns of the moment, this thinking lies behind our new themes, Managing Complexity and Simplifying Structure. How will corporations deal with the contradictions of scale and the emergence of upstarts based on outsourced infrastructure, and the traditional challenges of new Asian giants? How should investors think about the pre-eminence of insider knowledge workers? Can corporations finance the education of knowledge workers? How can we finance goods with no market price? Given the risks now apparent in stretched supply chains and the resulting dependencies, what is the right balance between efficiency and the robustness of redundancy? (The reregulation of the banking industry is an early example of this). We believe these are some of the questions that will influence the company choices the portfolio will make in the context of the two new themes.



THEME WEIGHTS AND RETURNS

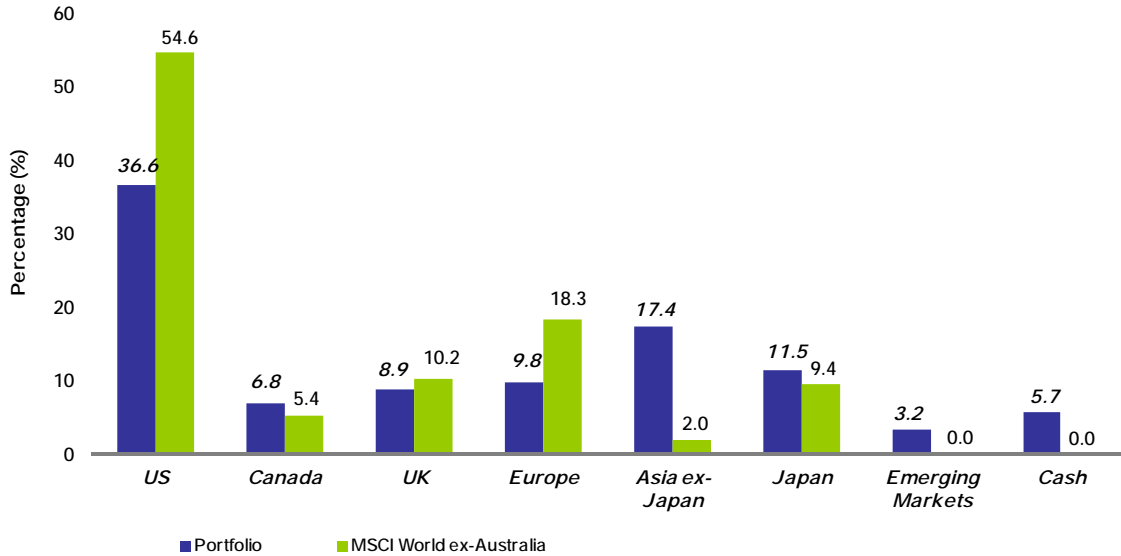
<i>Theme</i>	<i>Theme Weight* (%)</i>	<i>December Theme Return (%)</i>	<i>Q4 Theme Return (%)</i>
Antimatter	10.6	-1.3	-11.2
Gold & Precious Metals	8.8	-13.1	-10.0
Managing Complexity	12.3	-4.1	-0.8
Simplifying Structure	13.6	2.8	4.1
National Platforms	14.1	0.9	0.8
Emerging Markets Real Estate	5.2	0.0	1.4
Intergenerational Assets	10.3	-0.7	2.0
Regulatory Change	4.6	3.8	7.9
Oil	9.3	-1.6	11.6
Other	5.4	2.0	3.9

*Total will not add to 100. The balancing item is cash. Theme weights are as at 31 December 2011. Allocations and security selection are subject to change.



PORTFOLIO HOLDINGS BY SECTOR AND COUNTRY

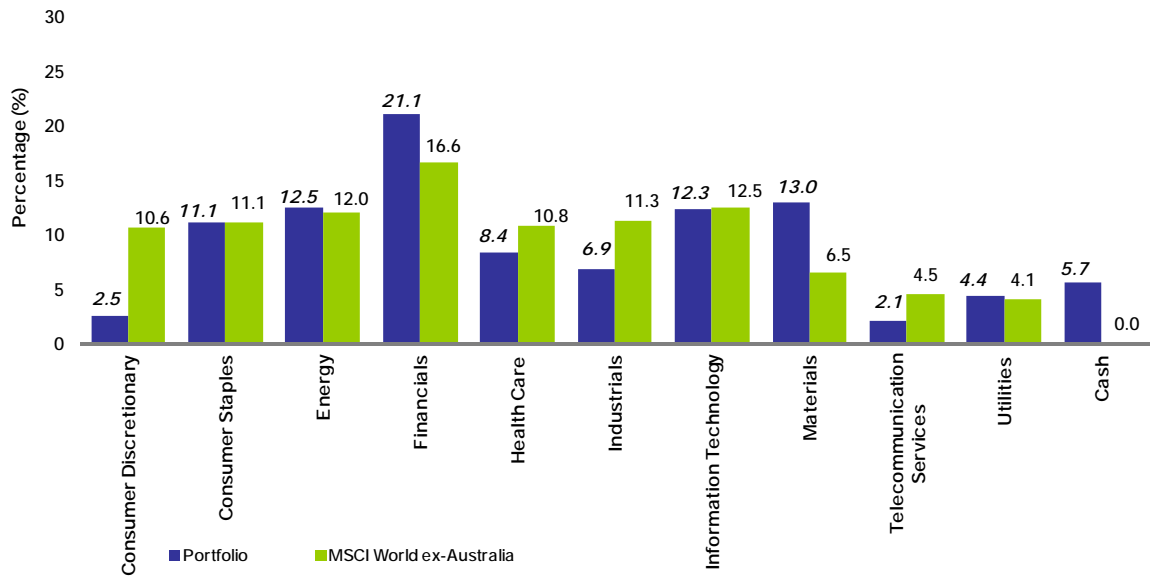
By Country/Region



Allocations and security selection are subject to change. Total may not add to 100% due to rounding.

India, Taiwan and China, which represent 1.0%, 4.2% and 4.2% of the portfolio respectively, are included as part of the Asia ex-Japan exposure due to the nature of the product.

By Sector



Allocations and security selection are subject to change. Total may not add to 100% due to rounding.

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