

# Lazard Non-U.S. Small Cap Equities

## Investment Strategies

Lazard offers three investment strategies investing in non-U.S. small cap equities. These offerings are managed with a common approach and philosophy to meet the objectives of our clients.

- European Small Cap Equity
- International Small Cap Equity
- Global Small Cap Equity

## Performance Objective(s)

These small cap equity strategies seek to generate strong relative returns over a 3–5 year time horizon by investing in companies with strong financial productivity at attractive valuations. Each strategy seeks to:

- Outperform relevant benchmark over a full market cycle
- Participate in rising markets; preserve capital in falling markets
- Outperform our investment competitors
- Generate consistent results

## Investable Securities

The investable universe for the non-U.S. small cap equity strategies includes equity securities with market capitalizations typically between \$300 million and \$5 billion, and that are domiciled in those countries that comprise each strategy's relevant index.

## Why Invest in Small Cap Equities with Lazard?

The discipline to find undervalued securities with attractive financial productivity is the hallmark of Lazard's small cap equity capabilities. This practice has enabled our small cap strategies to participate in the upside of sharply rising markets, and to defend well in down markets. Small cap equities seek to provide portfolio diversification and historically have provided greater returns than large cap stocks over a long-term investment horizon. The small cap universe can be unique because it does not typically have the same sell side coverage from analysts and fund managers compared to the widely covered large cap universe. This lack of coverage creates information and pricing inefficiencies. Lazard seeks to capitalize on these inefficiencies, thereby assisting the portfolio management team(s) in their effort to add value as an active manager.

## Lazard's Small Cap Equity Platform Offers

- Bottom-up stock selection process
- Global footprint, including the resources of a dedicated small cap equity platform, as well as those focused on global sector research
- Proprietary accounting validation and portfolio construction process
- Large opportunity set
- World class companies – bigger does not mean better
- Higher potential for alpha through primary research
- Diversification, which provides potential for higher returns with lower volatility
- Unique portfolio characteristics
  - Capitalization range under \$5 billion at time of purchase
  - Predominately developed markets
  - Benchmark aware but not focused
  - Clearly defined targets: ROA, ROE, stock price development
- Historically strong pattern of performance
- Consistent application of relative value investment philosophy

## Investment Team

Lazard's small cap equity platform averages 18 years of industry experience\*.



**Brian Pessin, CFA**  
Managing Director,  
Portfolio Manager/  
Analyst  
Joined Industry 1994



**Patricia Biggers**  
Senior Vice  
President, Portfolio  
Manager/Analyst  
Joined Industry 1992



**Michael DeBernardis**  
Senior Vice  
President, Portfolio  
Manager/Analyst  
Joined Industry 1996



**Neal Doying, CFA**  
Senior Vice  
President, Portfolio  
Manager/Analyst  
Joined Industry 1989



**Edward Rosenfeld**  
Director, Portfolio  
Manager/Analyst  
Joined Industry 1999



**Alan Clifford**  
Senior Vice  
President, Portfolio  
Manager/Analyst  
Joined Industry 1989

\* Team membership is current as of the date of this document.

Personnel data are calculated as of year-end 2010; YTD 2011 experience/tenure is not reflected.

## Investment Philosophy

Our investment philosophy is based on our core belief in “relative value” investing. Lazard’s small cap equity strategies are based on this core investment philosophy. This focuses on the trade-off between valuations and financial productivity. The process focuses on finding securities with a combination of sustainably high or improving returns on capital, at attractive valuations.

Companies with sustainably high returns on capital have three attractive features for investors:

- A strong competitive advantage or other barrier to entry, giving strong reliable cash flows
- A disciplined management team which deploy shareholders’ capital sensibly, i.e., at high returns
- Often the potential in the future to invest capital at high returns, therefore producing a compounding effect on the value of the company

Trends in returns are also very important as declining returns get devalued and rising returns revalued by the market, hence the attraction of companies with improving returns on capital through price rises, cost reductions, portfolio optimization, or other measures.

Having found securities with sustainably high or improving returns on capital, investments will be made only if these returns are available to investors at an attractive valuation. This will be based upon a range of techniques including but not limited to:

- Multiples of sustainable cash flows/earnings
- Internal discounted cash flow analysis to determine implied margins, capital intensity, and growth rates
- Asset-based valuations including sum-of-the-parts analysis
- The most appropriate valuation metrics relative to the history of the stock and its sector

We believe that the combination of sustainably high or improving returns on capital, at an attractive valuation, produces consistently strong performance over time in a range of market environments.

The strategies seek to defend well in weak market environments, and participate in rising markets, while displaying a lower level of absolute volatility.

## Investment Process

In searching for under-valued, under-appreciated and financially productive stocks, we follow an investment process as depicted in the diagram below, as well as other investment selection techniques.

### Idea Sourcing

We employ various screening processes to search global databases for companies that appear to offer strong financial productivity at attractive valuations. Screening seeks to identify companies that are attractively priced (e.g., low price/earnings, price/book, and price/cash flow), relative to their financial returns (e.g., return on equity, free cash flow yield, return on assets, operating margins).

### Fundamental Research

#### Return Analysis

The first step of our fundamental research process is Return Analysis. We seek to:

- Leverage sector expertise and relationships (e.g., regulators, suppliers, competitors, and customers) to maximize our understanding of the industry and company
- Identify key drivers of profitability and capital requirements
- Understand how management can influence profitability
- Assess sensitivity of cash flows to key drivers to link returns and valuation

Ultimately, our objective is to understand the potential trajectory of financial productivity of each company incorporating considerations including but not limited to:

- Quality and depth of management
- Competitive position
- Sensitivity to economic/market cycles
- Margin and sales trends
- Brand name strength



Lazard’s investment process is presented here in sequential steps. In practice, the process is neither static nor sequential, but ongoing.

- Geographical breakdown
- Macro environment

Fundamental research efforts are enhanced through communication among our global equity investment professionals who conduct both global and local research on companies worldwide. On-the-ground visits to company management together with local knowledge help to provide unbiased opinions critical to successful investment on a global basis.

## Accounting Validation

Accounting Validation has long been a hallmark of our investment process. We use this process to examine a company's stated financial statistics (income statement, cash flow statement, balance sheet, and all related footnotes) to consider how major accounting decisions and policies reflect reported financial productivity. While this process is not designed to detect fraud or other misrepresentations or omissions, by focusing on detailed cash flow analysis and discretionary balance sheet items, analysts seek to:

- Identify material differences between reported financials and actual cash flows including decisions related to revenue recognition, depreciation and amortization, deferred taxes, etc.
- Ensure that comparisons among companies are on a consistent basis, i.e., based on cash flows net of any adjustments for material discrepancies in accounting choices
- Determine whether a level of comfort can be gained in a company's stated financial productivity and cash flows including a qualitative assessment of management's inherent conservative or liberal approach to portraying actual cash results
- Quantify significant risk factors not included in financial statements
- Incorporate identified discrepancies and risks into modeling of future cash flows and financial productivity and the resulting valuation

While no single process will always lead to a perfect outcome, the focus on actual cash flow encourages our investment professionals to build their forecasts on the cash that will accrue to equity holders rather than accepting reported figures without question. The added importance of this process lies in seeking to avoid mistakes and minimize forecasting errors.

## Modeling, Valuation, and Recommendation

The results from our return analysis and accounting validation are incorporated in the construction of a set of expectations for future cash flows and profitability. In each scenario, we value the company. This process requires a clear understanding of which key variables we can and cannot forecast with confidence, as well as an awareness of the sensitivity of valuation to each variable, with particular emphasis on those that are difficult to forecast.

## Portfolio Construction

Through the research process, global sector analysts and portfolio management teams members discuss ideas and progress on fundamental research related to these stocks. When the initial research process is completed, the global sector analyst and portfolio management teams discuss the key scenarios that might occur as well as the likelihood of each scenario. The discussion typically focuses on the most likely scenario and the resulting valuation expectation as well as milestones against which we would measure progress against our expectations to validate our thesis.

Stock selection for inclusion in a particular portfolio is not the responsibility of the analysts, but rather the responsibility of the portfolio management teams. Portfolio management teams, with input from the Global Risk Management team, pay particular attention to risk attributes of the portfolio to ensure the portfolio is adequately diversified.

## Buy Discipline

We believe that companies that generate free cash flow and returns on capital will outperform over time. The portfolio management team(s) seeks to purchase securities of these kinds of companies at attractive valuations. Thus, when the portfolio management teams considers a company for a potential purchase, it looks for:

- Strong free cash flow yields
- Sustainable financial productivity (high ROE, ROIC)
- Low P/E multiples
- The point when market sentiment creates an attractive valuation entry point

## Sell Discipline

Our sell discipline is a very important component of our investment management process. Upon purchase each security is given a target valuation. Targets are reviewed and re-evaluated on a regular basis and performance is monitored daily. Strict adherence is given to the sell discipline. A security may be sold for any of the following reasons:

- Its price rises to a level where it is no longer believed to reflect value (target valuation)
- The underlying investment assumptions are no longer valid
- Company management changes their strategic direction; or
- External events occur (e.g., geo-political risk, changes in regulation, taxes, and competitive position)

## Risk Management

The teams believe that risk management is paramount to the investment process. As such, it employs three independent levels of risk management: portfolio management, independent risk oversight, and central compliance.

## Lazard's Non-U.S. Small Cap Equity Platform

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	European Small Cap Equity	International Small Cap Equity	Global Small Cap Equity
Benchmark Index	MSCI Europe Small Cap Index	MSCI EAFE Small Cap Index	MSCI Global Small Cap Index
Investment Universe	Europe	Europe & Asia-Pacific	Europe, Asia-Pacific & N. America
Market Cap Range	\$300 Mil-\$5 Bil	\$300 Mil-\$5 Bil	\$300 Mil-\$5 Bil
Typical Number of Holdings	60-80	60-80	60-80
Return Targets over a Market Cycle*, pa	+3.00%	+3.00%	+3.00%
Typically Expected Tracking Error	4-10%	4-10%	4-10%
Typical Turnover**	20-50%	20-50%	30-60%
Typical Cash Weight	0-5%	0-5%	0-5%
Strategy Inception	January 1, 1994	December 1, 1993	July 1, 1993
Team Members	Brian Pessin Patricia Biggers Alan Clifford Ed Rosenfeld	Brian Pessin Patricia Biggers Neal Doying Ed Rosenfeld	Brian Pessin Patricia Biggers Michael DeBernardis Neal Doying Ed Rosenfeld

\* Performance targets are shown relative to the benchmark index, annualized, gross of fees, over a full market cycle. There is no assurance that the strategies' objective or performance target will be achieved. Target returns do not represent a promise or guarantee of future results.

\*\*Lazard calculates turnover as the lesser of buys and sells divided by average assets over a period.

### 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. 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. Small- and mid-capitalization stocks may be subject to higher degrees of risk, their earnings may be less predictable, their prices more volatile, and their liquidity less than that of large-capitalization or more established companies' securities.

The information and opinions presented do not constitute investment advice and have been obtained or derived from sources believed by Lazard to be reliable. Lazard makes no representation as to their accuracy or completeness. All opinions and estimates expressed herein are as of the published date unless otherwise specified, and are subject to change.

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