

# Non-traditional **Investments**

Lazard Capital Allocator Series

The Lazard Capital Allocator Series Investment Team (“Investment Team”) has taken recent market, economic, and global developments into consideration in developing a non-traditional portfolio. The strategy seeks specialized investments within the global capital markets that offer unique investment characteristics with the objective of outsized excess returns and correlation or risk benefits. The investments can be equity, debt, commodity, real estate, currency, or market hedging instruments. Typically, these investments are not clearly defined by asset allocation limitations and are unconstrained by region, size, or style. There are four categories of investments:

## **Thematic**

Investments that are most consistent with our overall market viewpoint and represent unique or niche opportunities that we believe will provide performance benefits, to the extent our viewpoint materializes.

## **Contrarian**

Investments that reflect out-of-favor or non-consensus views to potentially capture inflection points of attractively valued areas of the market.

## **Discounted**

Investments across global markets that are viewed favorably by the Investment Team and that can be purchased at a tangible discount to net asset value.

## **Diversifying**

Investments in areas that tend to be uncorrelated to the overall equity market, or that we believe possess attractive absolute return-oriented characteristics, including fixed-income securities and other market hedging tools.

## Thematic

### U.S. Savings Rate and Balance Sheet

- The 2008–2009 financial crisis resulted in substantial capital destruction and balance sheet deterioration. Our view is that, after a period of destruction, a period of accumulation and creation will follow, led by the rebuilding of household and corporate balance sheets. The investment team has identified two specific themes to potentially take advantage of this insight.

#### – U.S. Large Cap: Rising Savings Rate

- We believe that the United States has entered an era of higher personal and corporate savings compared to recent history. Cash held by individuals and by corporations is at record levels and is rising, highlighting this change.
- The Investment Team employed an episodal analysis method to identify a group of U.S. large-cap stocks that we believe will benefit from this environment, and then created a customized basket to gain exposure to these securities.

#### – U.S. Large Cap: High Free Cash Flow

- Profits, as a percentage of U.S. GDP, are near record levels. Large U.S. companies dramatically cut expenses during the recession as revenues declined. With revenues back near 2008 levels and limited employment growth, the result has been extraordinary profits and high free cash flow levels.
- We believe low valuations on growth companies with high free cash flows indicate that investors remain unconvinced that this environment can continue and that profits will be invested wisely or productively by these companies.
- The Investment Team has created a custom basket of companies with a record of growth, high free cash flow, and strong capital allocation.

### U.S. Consumer Discretionary

- This sector includes U.S. companies from the retail, media, hotel, restaurant, household durable, luxury goods, and automobile industries.

- The continued strength of U.S. equity markets bodes well for high-end retailers, as their customers' wealth is tied directly to market performance.
- The entire consumer discretionary sector declined by more than 60% during the last recession and has outperformed the S&P 500 Index consistently since then.<sup>1</sup> Fears that U.S. consumers would enter a prolonged period of austerity have proved to be unfounded.
- Many companies in this sector continue to benefit from the demise of weak competitors during the recession, lower real estate rental prices, and growth in highly profitable online sales.

### Korea

- South Korea is one of the fastest-growing and well-positioned economies in the world. It is a leading supplier of high-value exports to China and Southeast Asia.
- In our opinion, Korean technology and industrial companies, such as Samsung, Hyundai, Kia, and LG, have made the transition into highly developed, world-class companies with rising market shares and sustainable advantages.
- We believe Korean equities are attractively priced; the price-to-book ratio is now 1.3 times, which is just above all prior cycle lows and 8% below the long-term average.<sup>1</sup>
- The Investment Team's outlook for 2012 of increasing economic activity in most regions is, in our opinion, very favorable for Korean equities.

### U.S. Energy

- The Bakken Shale oil field is the largest contiguous oil deposit in the continental United States. Combined with the Three Forks and Sanish formations, the Bakken has the potential to be one of the largest oil producers over the next 30 years.<sup>2</sup>
- Incremental oil demand from developing (non-OECD) nations has averaged 1.6 million barrels per day (bpd) during the past five years, which works out to be a 4.3% compounded annual growth rate. If this growth continues, demand will approach 52 million bpd by 2015. With average supply growth of only 0.6 million bpd, OECD consumption needs to decline by 7.1 million bpd to balance the oil market. We

believe that this has created a favorable supply/demand environment that U.S. energy companies are poised to take advantage of.<sup>3</sup>

- A more normalized level of global GDP growth would support the long-term demand history for refined products, which has occurred over the past 30 years. Demand for refined products is up 1.6% (0.9 million bpd) so far this year, and has eclipsed the peak reached in 2007.<sup>3</sup>

## U.S. Industrials

- GDP data suggests that the United States is in the early stages of a new industrial capital expenditure cycle and that manufacturing remains expansionary in almost all regions.
- Recently released data from the Institute of Supply Management and the Purchasing Managers Index for the United States, Europe, and China showed that manufacturing activity remained solidly in growth territory. Manufacturing in Japan understandably collapsed following the 2011 earthquake, tsunami, and subsequent nuclear concerns, but has begun to recover.
- We believe that large-cap U.S. industrial companies are well-positioned to benefit from improving global economic activity. A high percentage of sales originate from non-U.S. markets, and these companies are currently benefiting from the rebound in the global capital expenditure cycle.
- The commercial aerospace, rail freight, and heavy electrical equipment industries are all in multi-year growth phases as a result of past under-investment, new efficient designs, and growth in emerging market demand.

## Global Agribusiness

- In our view, the macro environment is favorable for companies involved in all segments of agriculture. The world population continues to grow, increasing the need for more food, and diets continue to improve as protein consumption increases in emerging countries.
- Resources (e.g., arable land or water for irrigation) to meet the increasing need for food in general—and protein in particular—are becoming scarcer. This requires an increase in yield per acre to meet the demand. Some of the most efficient means of generating a higher yield per acre are better

seeds, greater use of fertilizers, and more use of mechanized farming.

- Companies in the agricultural sector provide a hedge to potential inflation and are a beneficiary of government investment in many countries.

## Contrarian

### Information Technology – Equal Weight

- The emergence of the tablet as the computer industry's fastest-growing segment is changing the technology sector and creating new markets, such as cloud computing and higher demand for technology security.
- Mergers and acquisitions continue at a robust pace in the sector, as large firms need to catch up in new markets.
- The technology industry's share of GDP is rising, and technology's share of capital expenditure budgets has increased to 45%, ex-construction.<sup>4</sup>
- Many global service and industrial firms cut back dramatically on information technology spending over the past few years, and are now in a position of playing catch-up on their technology infrastructure.

### Japan Small Cap

- With GDP expected to grow 1.9% in 2012, Japan could be the fastest-growing G-3 economy. Earnings in the next fiscal year (which ends March 2013) are expected to grow 10%. Profits would rebound from the effects of the 2011 earthquake and tsunami even with minimal top-line growth.<sup>5</sup>
- The Japanese stock market remains attractively valued and is cheaper today than it was at the 2008–2009 lows. The Topix Index trades on 0.88 times trailing price-to-book ratio, compared with a long-term average of 1.7 times, and 28% of companies in the Topix Index trade below 7 times the enterprise-value to free-cash-flow ratio. The same rate was 21% in early 2009, up from a low of 2% in 2006.<sup>6</sup>
- The country's low price-to-book ratio and improving cash flow will likely support further stock buybacks and

shareholder returns. In addition, Japan has a low exposure to European debt.<sup>5</sup>

- We believe that the small-cap sector in Japan is positioned to benefit from this outlook, as the companies are generally domestically focused and less vulnerable to the negative impact of a rising yen.

## European Financials

- Cheap funding provided by the European Central Bank's Long Term Refinancing Operation (LTRO) has allowed for the gradual recapitalization of the banking system, greatly reducing the fears of systematic collapse of either the euro currency or the European banking system.
- This recapitalization has led to a rapidly improving financial environment and the normalization of conditions.
- Credit markets for financial firms in the Eurozone have improved dramatically.

## Italy

- Prime Minister Mario Monti has begun to implement dramatic reforms in Italy. These reforms—which include raising the retirement age and removing barriers to entry in previously protected professions such as pharmacists, bakers, and taxi drivers—have become powerful drivers of market performance. Monti has become very popular with the electorate that realizes that more competition means more jobs and, as a result, a higher standard of living.
- The Italian banking system is not currently burdened by non-performing loans like Spain, nor is it highly exposed to non-Italian sovereign debt.
- In U.S. dollar terms, the Italian equity market is down 62% from its high in 2007. The average dividend yield of the stocks in the iShares MSCI Italy Index Fund ETF is now 5.2%.<sup>1</sup>
- The constitutional amendment for a balanced budget for the country seems likely to pass.

## U.S. Financials: Private Equity

- Less volatile financial and economic conditions may lead to an improved environment for mergers and acquisitions activity and private equity investment in 2012.

- The upward-trending mergers and acquisitions cycle remains intact, driven by low interest rates, available credit to strong buyers, rising equity markets, and generally better business conditions. CEO confidence in the United States—which is a key leading indicator for transactions and has been the limiting factor for the past several years—is improving.
- We believe that the likely changes to tax rates on income, capital gains, and dividends in the United States beginning in 2013 could accelerate deal activity in 2012.

## U.S. Financials

- The macro environment in the United States seems to be improving. U.S. net interest margins are back to pre-crisis levels.<sup>7</sup>
- Recent job growth and low mortgage borrowing rates have combined to drive the National Association of Home Builders Index to a nearly five-year high in recent months. We believe that any pick-up in U.S. house prices will likely lead to improved earnings and stronger balance sheets in the financials sector.
- Tremendous focus on cost control over the last few years has positively levered the financials industry to improvement in economic conditions.
- Credit demand continues to improve, and firms have continued to build capital as a result of the spread between short-term borrowing and long-term lending.
- Valuations are near historic discount levels to the overall market.<sup>1</sup>

## Discounted

### U.S. Large-cap Equity Closed-end Fund

- Tri-Continental is one of the oldest and largest closed-end investment funds. It invests in U.S. large-cap equities, an asset class we still find attractive.
- The fund uses a quantitative strategy to evaluate stocks based on three broad measures: quality, valuation, and catalysts. The fund's holdings are defensive relative to the entire U.S. equity market.

- The fund currently trades at an attractive discount to net asset value of approximately 15%; in 2007, it traded at a discount of only 5%.<sup>1</sup>

### China Closed-end Fund

- The China Fund is one of the largest, most liquid, and, in our view, best-managed closed-end funds investing in China, Hong Kong, and Taiwan. The Investment Team believes that stock selection can add substantial value in these markets.
- As recently as the fourth quarter of 2009, the fund traded at net asset value; its current discount to net asset value is 8.6%.<sup>1</sup>
- The fund's holdings are skewed to domestic consumption stories with little exposure to property or commodity stocks. After the recent decline in share prices, we believe that the Chinese market is attractively valued.

## Diversifying

### U.S. High Yield Fixed Income

- In our opinion, U.S. high yield fixed income fundamentals remain strong; companies in the space posted higher revenue and cash flows in 2011 than in 2010, and also raised their capital expenditure budgets.<sup>8</sup>
- Ratings agency upgrades continued to outpace downgrades by approximately 1.5 to 1.0 within the U.S. high yield asset class. For 2012, default rates are expected to rise modestly, but remain below their long-term average of 4%.<sup>8</sup>
- High yield bank and bond maturities for 2012 and 2013 combined total about \$160 billion, considerably less than the \$215 billion in new high yield bond issuance in 2011.<sup>8</sup>
- Currently, high yield market spreads are approximately 600 basis points over the U.S. 10-year Treasury yield. Given the current economic outlook, we believe spreads could narrow in 2012 by as much as 150 basis points, should high yield continue to produce an attractive current yield and as investor demand grows.

### Fixed Income: Short-term U.S. Corporate Bonds

- Most investment-grade corporate issuers currently have attractive cash flows, strong balance sheets, and healthy profit levels. Many sovereign borrowers do not possess

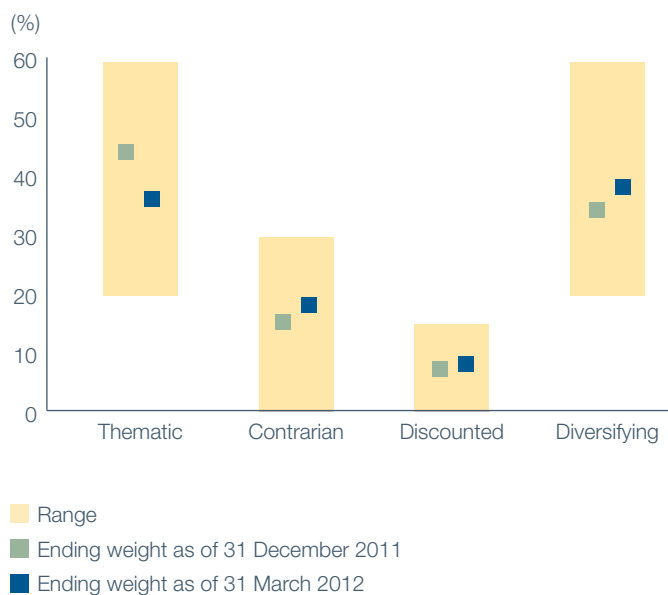
these characteristics and, as a result, we believe that short-term corporate debt may provide a relatively better hedge to equity exposure than government debt.

- Our preference is for exposure to short-duration fixed income instruments to reduce inflation and interest rate risk.

### Gold

- We believe gold is one of the best hedges against inflation and against any resurgence of financial market instability. Among its many uses, gold has served as an alternative currency for millennia.
- There are few signs that sovereign risks will disappear any time soon. Fiscal deficits in developed economies are very large and are adding to government debt burdens. The problems go beyond just the debt-laden peripheral Europe and include the United States, the United Kingdom, and Japan.

### NON-TRADITIONAL ALLOCATIONS BY CATEGORY



Ranges and allocations are based upon a portfolio which represents the proposed investment for a fully discretionary account and are subject to change.

## Notes

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- 1 Source: Bloomberg, as of 29 March 2012
- 2 Source: U.S. Department of the Interior, U.S. Geological Survey 10 April 2008
- 3 Source: Bloomberg Markets, as of December 2011
- 4 Source: U.S. Department of Commerce – BEA, ISI Analysis, as of September 2011
- 5 Source: Goldman Sachs, “Enter the Dragon: 2012 Outlook,” Japan: Portfolio Strategy, 1 December 2011
- 6 Source: CLSA Asia Maxima, as of first quarter 2012
- 7 Source: Deutsche Bank, as of 22 March 2012
- 8 Source: JPMorgan, Bloomberg Markets, as of 16 December 2011

## Important Information

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Published on 9 April 2012.

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.

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 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.

Investments in closed-end funds are non-redeemable and are subject to the same risks as other publicly-traded equity securities. Sometimes, however, there may be no public market for units of closed-end funds. The shares of closed-end funds, and exchange-traded funds (“ETFs”) may trade at prices at, below, or above their most recent net asset value. There is no guarantee that a fund’s discount will ever be narrowed or eliminated. Additionally, the performance of an ETF pursuing a passive index-based strategy may diverge from the performance of the index. Exchange-traded notes (“ETNs”) may not trade in the secondary market, but typically are redeemable by the issuer. Unlike ETFs and closed-end funds, ETNs are not registered investment companies and thus are not regulated under the 1940 Act. In addition, as debt securities, ETNs are subject to the additional risk of the creditworthiness of the issuer. ETNs typically do not make periodic interest payments. An investment in these types of instruments is indirectly subject to all the risks associated with the investments made by the closed-end fund, ETF, or ETN.

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