

Revisiting the Case for **Active Investing**

May 2010 Update

The current crisis has challenged a host of established investment analysis methodologies used to identify, measure, and allocate risk, including mean reversion, the normal distribution pattern of returns, and the long-term stability of expected correlations. While backward-looking, historical data are both interesting and important tools of financial analysis, we believe that, in today's environment, successful investing requires forward-looking, fundamental research, robust scenario analysis, and a disciplined investment process.

In the pages ahead, we will discuss the premise that the era of declining rates of inflation—otherwise known as disinflation—has come to an end. Mathematically, this era cannot be replicated from current levels. The changing operating environment has important implications in terms of how investment managers are evaluated and how equity and fixed-income portfolios are positioned.

Investing in a New Era

Regardless of which part of an entity's capital structure we are analyzing, a key component of Lazard's investment process is understanding its fundamentals—how it generates cash flow and how flexible and adaptable it is to different operating conditions. This is why it is important to study the likely environment in the years ahead, as it will define operating conditions. Keep in mind that a difficult future environment does not necessarily translate into a negative view on returns, as security valuations might reflect an outlook that is too negative.

From 1980 to the 2000s, interest rates in the United States declined consistently as a result of a decrease in the rate of inflation (the era of disinflation), as shown in Exhibit 1. While we recognize that interest rates reflect both underlying inflation rates and the real (net of inflation) cost of borrowing, going forward we focus on the inflation component of borrowing costs, as we see this variable as pivotal to all borrowers, whether sovereign, commercial, or consumer.

Exhibit 1
Over 20 Years of Disinflation



As of 31 March 2010

Source: Bloomberg, Bureau of Labor Statistics

The trend of sustained, long-term decreases in interest rates is now over, and we believe the road ahead presents three major inflation-driven scenarios:

- Stable inflation is the bull case, because interest rates would remain low, *ceteris paribus*. For businesses, investors, or consumers, it is much better to operate in an environment where the cost of financing is stable or declining. However, given the absolute level of borrowing rates, a decline in financing costs is no longer possible for most borrowers.
- Negative inflation, or deflation, is the bear case. There is no example of this in modern American history. The only parallel is Japan in the 1990s—obviously not a pretty scenario. Given how low inflation rates are presently, any further decline could move into deflation, as we saw in 2009. One year of deflation would not necessarily be problematic. Multiple years of deflation would be very dangerous.
- A sustained period in which inflation rates increase is another, less severe bear case. The key point here is that not only does inflation move to a higher level, but it continues increasing, as cost pressures in one segment of the economy lead to subsequent cost pressures elsewhere. Ultimately, the most important driver is labor, which currently accounts for 70% of the cost of goods sold in the United States.

Each of these scenarios will have an impact on equity and fixed-income investors in the United States, where debt is still close to the historically high levels reached at the beginning of 2009.

For over 20 years, the United States has enjoyed declining interest rates, which allowed borrowers to increase their borrowing at a pace well ahead of income growth, leading to record levels of leverage. As an example, median U.S. household income rose from \$23,167 at the beginning of 1985 to approximately \$50,303¹ at the end of 2009. Over the same period, the conforming mortgage rate from Fannie Mae fell from approximately 13.82% to 5.26%.² Assuming that, as per traditional underwriting standards, borrowers could dedicate 30% of income to a mortgage payment, the amount they could borrow increased from just over \$52,000 to over \$227,000. Put another way, borrowing capacity increased 337%, even though income only grew by 118%. In the aggregate, from 1980 to 2009, consumer debt outstanding rose from 48% to 94% of GDP, while financial sector debt outstanding rose from 20% to 108% of GDP.³

In such an environment, simply leveraging beta was a rational and profitable strategy; but these trends are not sustainable, as the only reason they were possible was because interest rates fell for more than 20 years. When rates stopped declining,

lenders eased terms and conditions—until the world experienced a credit bust, signaling the end of the era of disinflation and easy credit.

Now, as access to credit has diminished and home prices have fallen, we have entered a new era. What are the implications of this new era for investors?

The Case for Active Management: Equity

From 1965 to 1979, the 10-year U.S. Treasury yield increased from 4.2% to 10.3% (see Exhibit 2). The 10-year Treasury yield captures the market's expectations of future inflation, as well as the risk of default by the U.S. Government (i.e., the spread demanded by lenders to account for potential loss)—and indeed, inflation increased from 2% to more than 14% during that time.

Over this 15-year period of rising inflation, passive equity investors would have earned a 1.6% compounded annual return by investing in the S&P 500 Index, well below the rate of inflation. Investors would have probably lost money in real terms even by buying and holding Treasuries, because rates were going up. Conversely, active managers might have taken advantage of periods of rising equity markets, like the ones from 1969 to 1972 and from 1974 to 1976.

On the other hand, with disinflation and decreasing interest rates, such as the period from the beginning of 1980 through the end of 2000 (see Exhibit 3), Treasury yields declined from 10.3% to 5.1%, and inflation declined from over 14% to 3%, while the S&P 500 Index rose from 108 to 1,320, for a compounded annual rate of return of over 13%. The value of hard assets also went up significantly. Over that time period, it is questionable if investors would have benefited from hiring an active manager, as they could get a 13% annual return in equities, at a low fee, by indexing.

Exhibit 2
Passive Investing with Increasing Inflation (1965–1979)

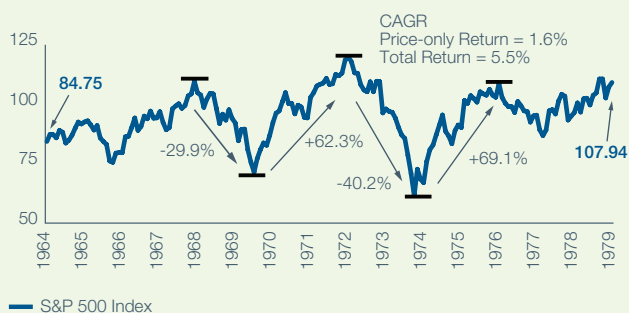
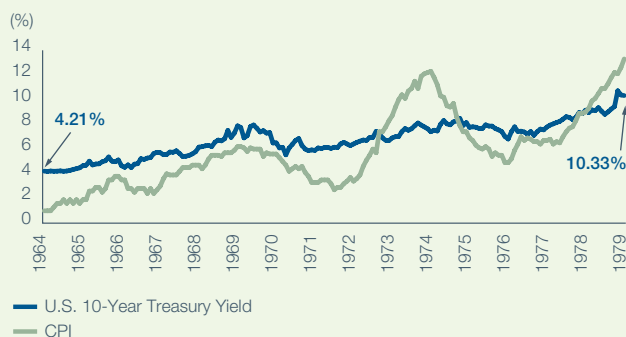


Exhibit 3
Passive Investing with Disinflation (1980–2000)

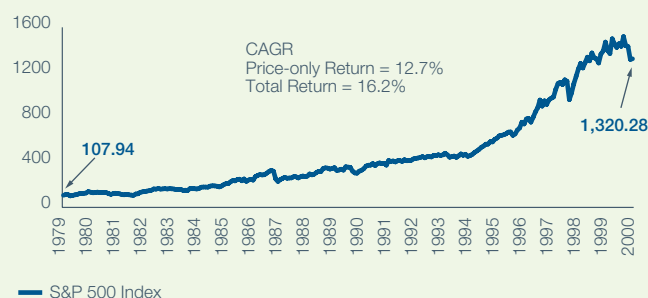
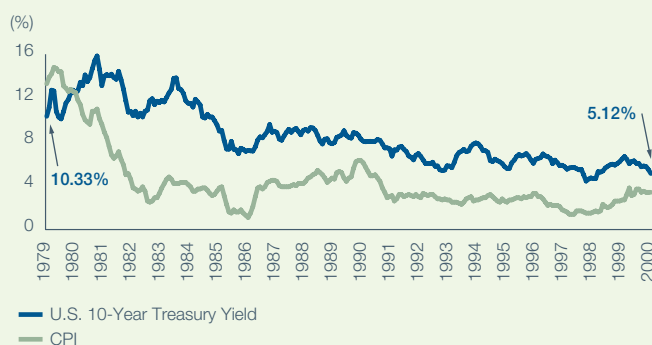
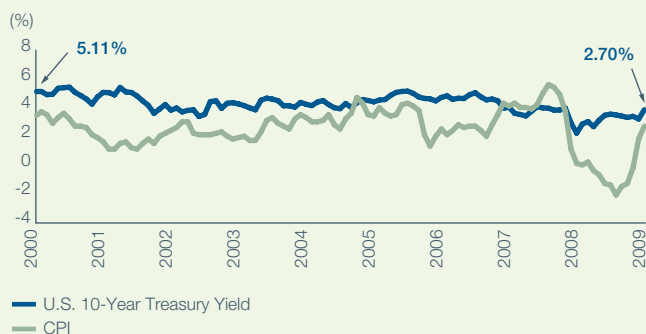


Exhibit 4 Passive Investing with Stable Inflation (2001–2009)



As of 31 December 2009

Source: Bloomberg

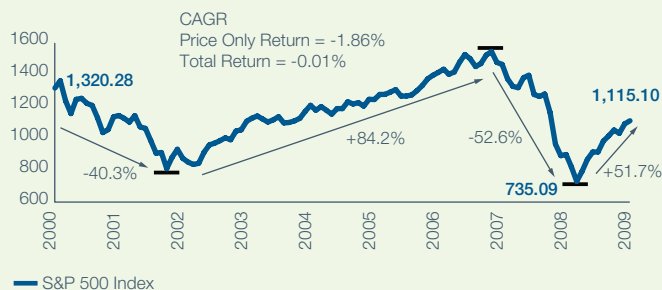
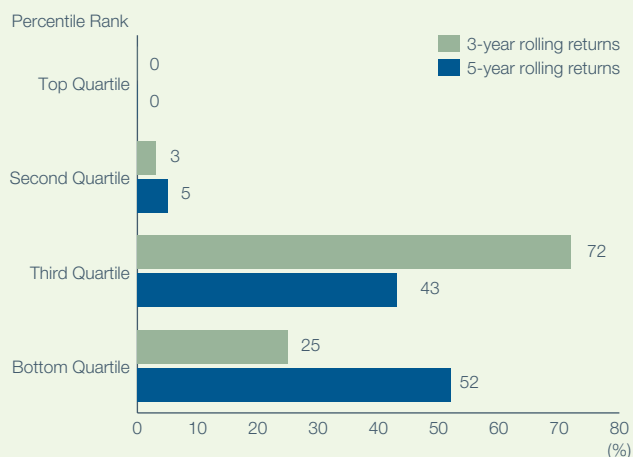


Exhibit 5 Historical Ranking Distribution* of the S&P 500 Index



As of 31 December 2009

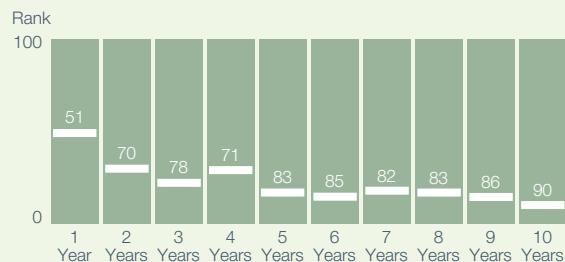
Source: eVestment Alliance

*eVestment Large-cap Core Equity Universe

Finally, as shown in Exhibit 4, from the end of 2000 to the end of 2009—a period of stable-to-low inflation rates (between -2.1% and 6%) and generally stable Treasury rates—the S&P 500 Index was down significantly, with a total return that was basically zero, including dividends. During this period, active managers, on average, outperformed the S&P 500 Index by a material magnitude. The contrasting performance between the 1980-2000 and 2001-2009 time periods begs the question of whether indexing is superior only in a specific set of circumstances.

As illustrated by the S&P 500 Index data in Exhibits 5 and 6, passive investing has consistently lagged the competition over the last 10 years, where the S&P 500 Index performed below

Exhibit 6 S&P 500 Index Percentile Rank in the eVestment Large-cap Core Equity Universe



As of 31 December 2009

Source: eVestment Alliance

the median active large-cap core manager 97% of the time on a rolling 3-year basis and 95% of the time on a rolling 5-year basis.

Our view is that the period from 1980 to 2000 was one in which macroeconomic variables, such as interest rates and availability of leverage, overwhelmed considerations related to individual securities. Clearly, there were still security-specific situations, but the predominant driver of returns was a combination of macroeconomic variables.

In summary, while passive, mean-reversion-based, and highly leveraged strategies were the winners in the old era, we believe that active, forward-looking strategies based on fundamental analysis and with little or no leverage are the likely winners in the new era. In our view, to generate higher returns in the new environment, investors will need the expertise of active managers who focus on the drivers of cash flow for the companies in which they invest, as well as the ability of companies to navigate a changing economic and market environment.

Regardless of the next secular era, we believe that certain characteristics will define the long-term winners for investors in equities:

- Strong organic cash flow
- Solid balance sheet
- Operational flexibility

Consider this: If the next era is characterized by the worst case of deflation, would an investor want to own equity in a highly leveraged company with weak cash flow? The answer is no. Why? If the economy were plagued by deflation, many companies would see their revenue decrease as prices fell. If a company had a high level of debt outstanding, its ability to service the debt would become more and more difficult as revenue declined. Given that equity holders only own the right to cash flows net of payments to debt holders, this would be a bad situation for equity investors.

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Conversely, in an environment of rapidly increasing inflation, one would expect interest rates to increase. Companies with high levels of leverage would see their cost of borrowing increase year after year to the extent they had to roll debt at maturity. Yet again, this would leave less and less cash for equity holders after payments of interest on debt.

Ultimately, we believe the transition from the era of disinflation also represents a transition from a period when passive investing could outperform many active strategies to a new era, where forward-looking, fundamental analysis is pivotal to potentially generate returns. Moreover, given the degree of uncertainty regarding the next era and the timing thereof, scenario analysis and a disciplined portfolio construction

process are equally important to ensuring client capital is protected and rewarded.

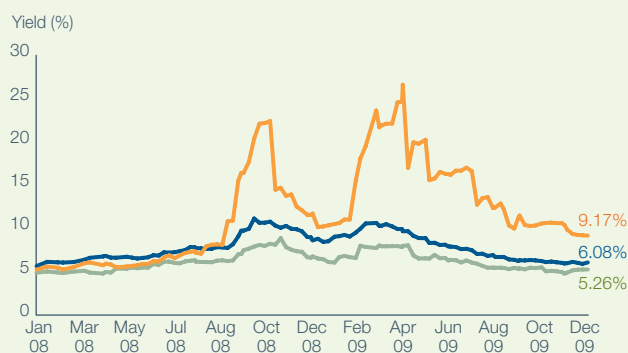
The Case for Active Management: Fixed Income

The prior environment of declining interest rates was accompanied by a multiyear period of easing credit terms that artificially reduced the risk of permanent capital impairment (i.e., default or restructuring). Under the new environment, a borrowing entity will no longer be able to mask potential insolvency through the availability of more credit. For fixed-income investors, the ability to generate returns by reaching for yield, regardless of the true economic risk embedded in a security, will no longer represent a profitable strategy.

A return to a fundamental assessment of a security's true economic value based on a detailed analysis is likely a better way to preserve capital and generate excess returns going forward.

As a result of the uncertainty in individual outcomes, we expect that valuation and return dispersion around industry averages will continue to be significant relative to the prior era. Until we fully transition into a different investment environment, we expect that this increased uncertainty will continue to generate sudden shifts in volatility, which will tend to further exaggerate individual mark-to-market shifts. Therefore, we believe that security selection will be the pivotal determinant of favorable investment results in this new era.

Exhibit 7
Security Selection Is Pivotal



Investment Grade Fixed Income
 — Merrill Lynch Finance Index 7-10yr Maturities
 — AIG 5.85% 1/16/2018 (10yr) Mdy/SP: A3/A-
 — Allstate 6.75% 5/15/2018 (10yr) Mdy/SP: A3/A-

As of 31 December 2009

Source: Merrill Lynch, Bloomberg

For illustrative purposes only.

Investors can easily be misled by securities that, on the surface, appear to be similar but, once deconstructed, are vastly different. Exhibit 7 shows yield for two fixed-income securities, Allstate (10-year, rated A3/A-) and AIG (10-year, also rated A3/A-), as well as the Merrill Lynch Finance Index 7-10 year maturities, which is an investment-grade index. From our perspective, it is surprising that AIG securities have continued to retain an A- category rating.

Regardless of an investor's credit opinion on AIG, what is clear from the graph is that AIG fixed-income securities no longer exhibit a behavior pattern consistent with what is generally expected of an investment-grade fixed-income allocation, as its yield has traded in a range from 6% to 26%. Conversely, Allstate continues to demonstrate the volatility of a fixed-income allocation.

An investor looking at the Merrill Lynch Finance Index, which holds both of these credits, could easily be misled into believing that this segment of the market is attractively valued when, in fact, it is the securities subject to credit impairment risk in the Index that are making the segment averages look attractive.

Not paying attention to security selection in the current environment will, at best, lead to unpredictable outcomes and may, at worst, lead to a permanent loss of capital.

The recent performance of money managers within the fixed-income space is characterized by an unprecedented dispersion

of results. Exhibits 8 and 9 illustrate the excess returns and tracking error of managers in the fixed-income space (versus the Barclays Capital Aggregate Index). Security selection is responsible for the material dispersion exhibited over the last three years. These same charts in 2006 were very different, as the managers' performance was much more clustered and did not experience the extreme dispersion that characterized the following period.

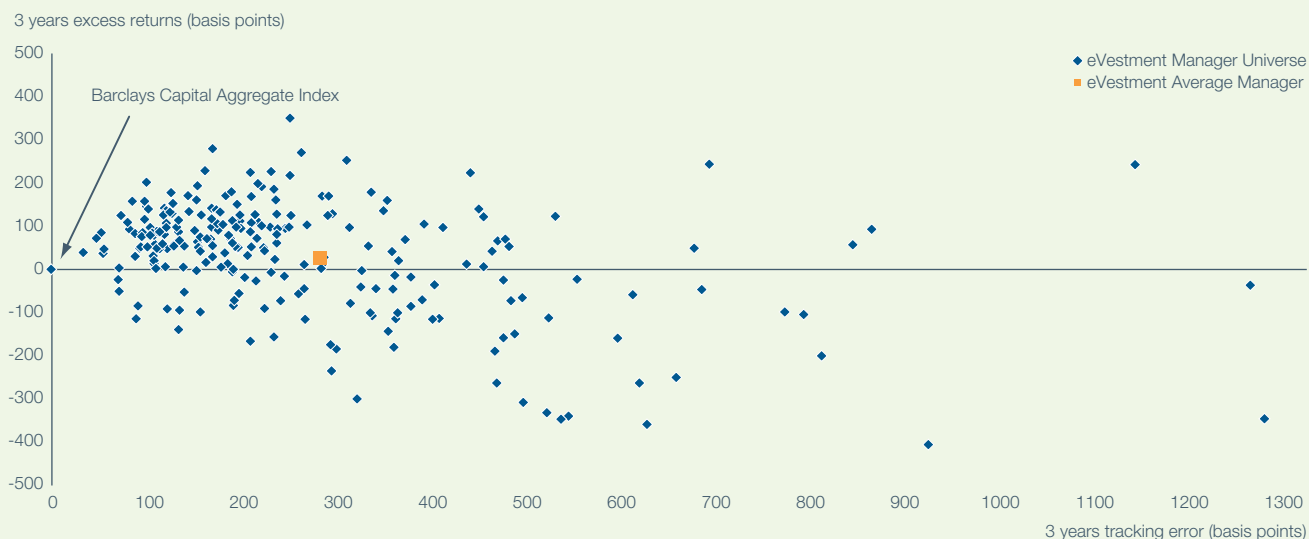
In this environment, statistically based sampling is not reliable in reducing tracking error risk, as industry populations are not homogenous. Fixed-income indexation strategies are likely to produce unreliable results in an environment dominated by individual winners and losers.

Exhibit 8
U.S. Core Fixed Income Universe

	Tracking Error (bps)		Excess Returns(bps)	
	Pre-Crisis	Crisis	Pre-Crisis	Crisis
5th Percentile	149	687	108	198
95th Percentile	18	89	-59	-260
Spread	131	598	167	458
Worst Observation	406	3,027	-179	-716
# of Observations	292	247	292	247

Benchmark: Barclays Capital Aggregate Index
Pre-Crisis: 3 years ended June 2006
Crisis: 3 years ended December 2009
Source: eVestment Alliance, Lazard Asset Management

Exhibit 9
Dispersion of Fixed Income Manager* Returns Has Increased Substantially



As of 31 December 2009

Source: eVestment Alliance, Lazard Asset Management

* eVestment U.S. Core Fixed Income Universe

Y-axis truncated at -500 basis points.

“Understanding an entity’s ability to make debt payments under the originally agreed-upon contractual terms, and how this ability is carried out under different operating conditions, is what will ultimately determine the success of an overall fixed-income allocation.”

Fixed-income investing is accompanied by many sources of valuation risk; however, the primary risk in this new era is fixed-income assets that could become permanently impaired. Permanently impaired assets will cause unrecoverable losses in portfolios that cannot be protected through diversification, so forward-looking, fundamental analysis focusing on the drivers of insolvency at the security level will be key to determining investment results.

Understanding an entity’s ability to make debt payments under the originally agreed-upon contractual terms, and how this ability is carried out under different operating conditions, is what will ultimately determine the success of an overall fixed-income allocation.

In summary, we recommend that fixed-income investors and managers follow three guiding principles in the new environment:

- Deconstruct sectors to understand how the distribution of constituents is potentially impacting the characteristics of each sector.

- Focus on security selection and on the solvency of the individual securities under consideration for purchase, being realistic about liquidity and bankruptcy expectations.
- Perform fundamental analysis—while this cannot predict market prices, it may help to limit the risk of unrecoverable loss.

Conclusions

For a period of over 20 years, indexing was a no-lose proposition for both equity and fixed-income investors, as index returns were substantial, and the potential incremental reward for active management was questionable relative to the additional risk. This environment changed after 2000, when passive investing no longer generated a good outcome, and, in many cases, investors would have needed to hire the right manager to generate any return at all.

We believe that we are entering a multiyear period of greater differentiation between winning, surviving, and losing companies. It is therefore key that investors—whether they believe that inflation or deflation is next—understand what the implications could be on each industry and on each company in order to make the right choices in security selection.

In our view, active managers who can differentiate between winners and losers, and who allocate capital based on a forward-looking, fundamental investment process, will be well positioned for the years ahead.

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Ronald Temple is a Portfolio Manager/Analyst on the U.S. Strategic Equity, U.S. Equity Select, and U.S. Equity Value portfolio teams. He is also Co-Director of Research and has primary research coverage of the financials sector. Ron has been a leading authority on the mortgage and credit crisis. He joined Lazard in 2001 with ten years of global experience including fixed-income derivative trading, risk management, corporate finance, and corporate strategy in roles at Deutsche Bank AG, Bank of America NT & SA, and Fleet Financial Group in London, New York, Singapore, San Francisco, and Boston. Ron has an MPP from Harvard University and graduated magna cum laude with a BA in Economics & Public Policy from Duke University. Ron serves as a trustee of the Link Community School in Newark, New Jersey and is a member of the Trinity Board of Visitors at Duke University.



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Notes

- 1 Lazard estimate
- 2 As of 31 December 2009. Source: U.S. Census Bureau, Fannie Mae, Bloomberg
- 3 Source: U.S. Federal Reserve, Bloomberg, U.S. Treasury Department, Social Security Administration

Important Information

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