

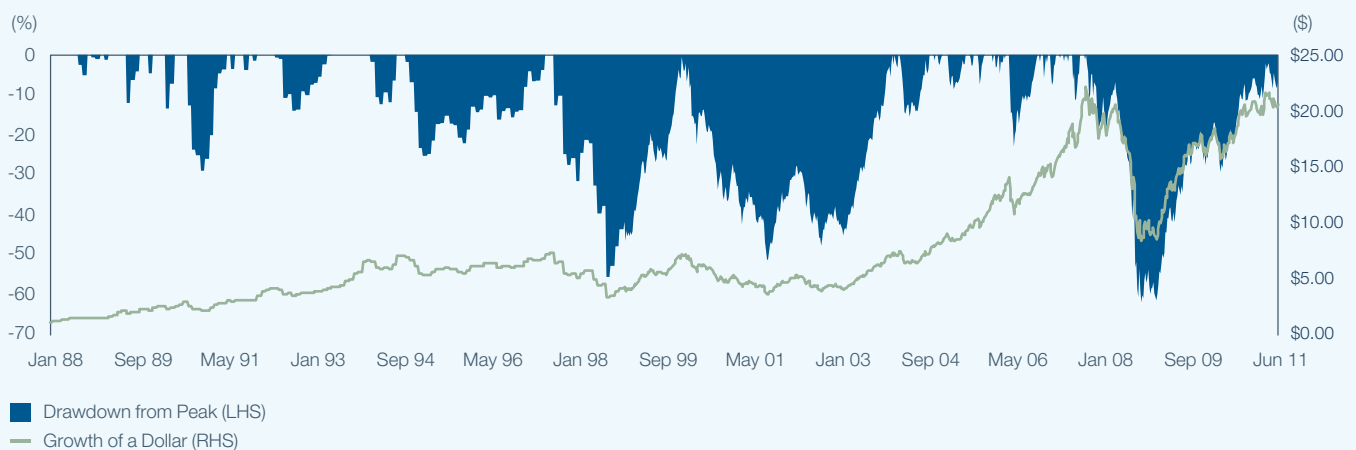
August 2011

# Blending Growth with Value in Emerging Markets

As a result of improving macro economic conditions, we have seen the MSCI Emerging Markets Index clearly outperform the MSCI World Index over the past 10 years. However, despite the impressive returns, the emerging world still remains a somewhat volatile market for investors. Since 1988, the asset class has experienced 11 drawdowns lasting at least three months, as illustrated in Exhibit 1. In order to mitigate these losses and achieve higher risk-adjusted returns, we believe a sufficient degree of diversification is required. In our view, alpha can be generated by diversifying into the multiple investment styles that have evolved in the emerging markets space and by embracing an active management approach. As Exhibit 2 on the following page shows, the differentiation between size and style has gone hand-in-hand with the growth of the market itself. We will specifically discuss the benefits of allocating to emerging markets relative growth and emerging markets relative value within an emerging markets equity portfolio.

It is possible for investors to add value by allocating to growth and value investment strategies—strategies that will seek to take advantage of different market conditions. In this respect, investors can potentially obtain upside capture and downside protection by taking an active management approach, while taking advantage of strategies that employ strong stock selection. Using the examples of the Lazard Emerging Markets Equity strategy (a relative value approach) and the Lazard Developing Markets Equity strategy (a relative growth approach), the possibility of capturing alpha through such diversification is apparent in Exhibit 3. We can see that the information ratio increases as capital is moved from the value to the growth portfolio, before starting to level off somewhat at around 65%. The tracking error also begins to rise more steeply at this point, reducing the benefits of the increased information ratio.

**Exhibit 1**  
MSCI Emerging Markets Index

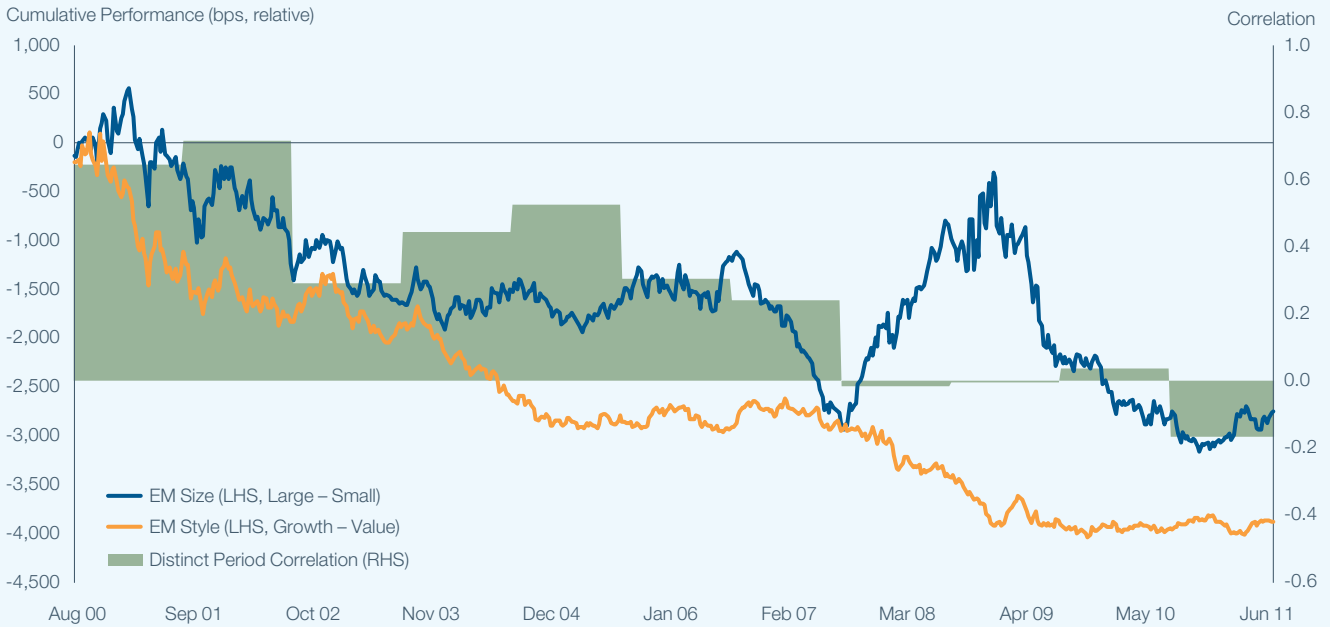


As of June 30, 2011

The information in the chart above is for illustrative purposes only and does not represent any product offered by Lazard.

Source: Lazard, MSCI

### Exhibit 2 Emerging Markets Style versus Emerging Markets Size



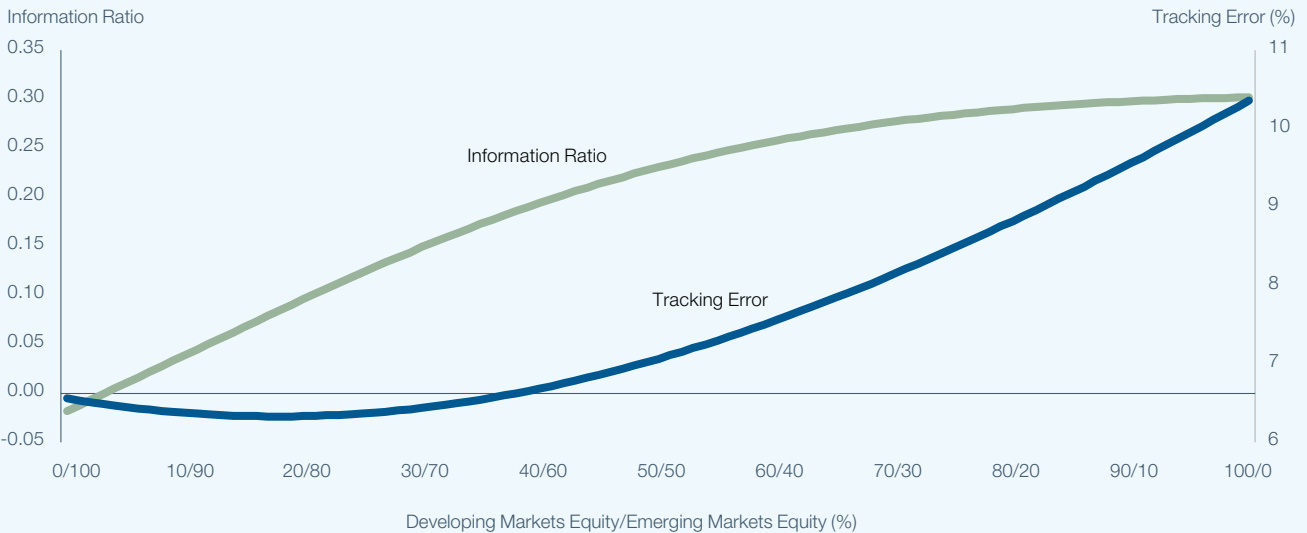
As of June 30, 2011

Data represent the MSCI Emerging Markets (EM) Large Cap Index, MSCI EM Small Cap Index, MSCI EM Value Index (Total Return), and MSCI EM Growth Index (Total Return). It is not possible to invest directly in an index. Indices are unmanaged and have no fees.

The information in the chart above is for illustrative purposes only and does not represent any investment strategy offered by Lazard.

Source: Lazard, MSCI, Bloomberg

### Exhibit 3 Injecting Developing Markets Equity into Emerging Markets Equity



Data for period from October 1, 2008 to June 30, 2011

Performance statistics are based upon representative portfolios. This analysis is provided for illustrative purposes only, as values are calculated based on returns gross of fees. Performance would be lower if fees and expenses were included. Past performance is not a reliable indicator of future results.

Source: Lazard

Emerging markets growth has made great advances in the past 18 months. As Western businesses have been involved in a protracted process of balance sheet reduction during the still uncertain recovery, many investors have turned to emerging markets for companies that can demonstrate sustainable growth. This allowed growth investors to capture much of the outperformance in 2010.

In general, growth strategies are expected to perform well in rising markets with greater upside capture. So, as capital flows into the emerging market space, growth should capture that rising market with the potential to outperform. However, they should decline at a slower pace in a falling market due to the cheaper valuations and return on equity of the companies. When markets are volatile, value ordinarily will outperform, while growth becomes more attractive when volatility levels are low. As we can see from Exhibit 4, volatility levels in emerging markets can often drop below the long-term average where growth portfolios have the greater potential to outperform. Growth companies tend to be more expensive, as they often require debt to fund their growth, and may find their ability to grow hindered in a declining market. However, active management and position sizes, as well as the focus on valuations, can mean a growth portfolio declines no more than the index during a full market cycle.

**Exhibit 4**  
Low Volatility in Emerging Markets



As of June 30, 2011

Volatility shown is the implied volatility of the iShares MSCI Emerging Markets Index ETF calculated using the Chicago Board Options Exchange VIX methodology.

Source: Lazard, MSCI, Bloomberg

**Exhibit 5**  
Differentiated Equity Investment Philosophies: Relative Value and Relative Growth

**Emerging Markets Equity (relative value) team's Implementation and Interpretation**

- Relationships between **valuation and profitability proficiency**
- How representative are the financial statements and footnotes?
- Consider material and specific accounting issues
- Can comparable (historic) ratios be computed?
- Expectations over next 3 years for **sustainability or profitability?**
- Focus on potential catalysts
- Can **ROE** be sustained?
- Highest conviction and greatest risk-adjusted upside, liquid ideas
- Political risk – 20%
- Portfolio risk – 20%
- Environmental, social and governmental risk – 40%
- Macro risk – 20%

- Analytical Framework Initial Opportunity Set
- Accounting Validation Applicable Comparison
- Fundamental Analysis Price Target After Fundamental Analysis (PTAFA)
- Security Selection
- Portfolio Construction/ Risk Evaluation

**Developing Markets Equity (relative growth) team's Implementation and Interpretation**

- Relationship between **growth forecasts and valuations**
- How representative are the financial statements and footnotes?
- Consider material and specific accounting issues
- Can comparable (historic) ratios be computed?
- Expectations over next 3 years for **EPS growth**
- Focus on potential catalysts
- Can **rate of growth** be sustained?
- Highest conviction and greatest risk-adjusted upside, liquid ideas
- Political risk – 20%
- Portfolio risk – 20%
- Environmental, social and governmental risk – 40%
- Macro risk – 20%

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

Source: Lazard

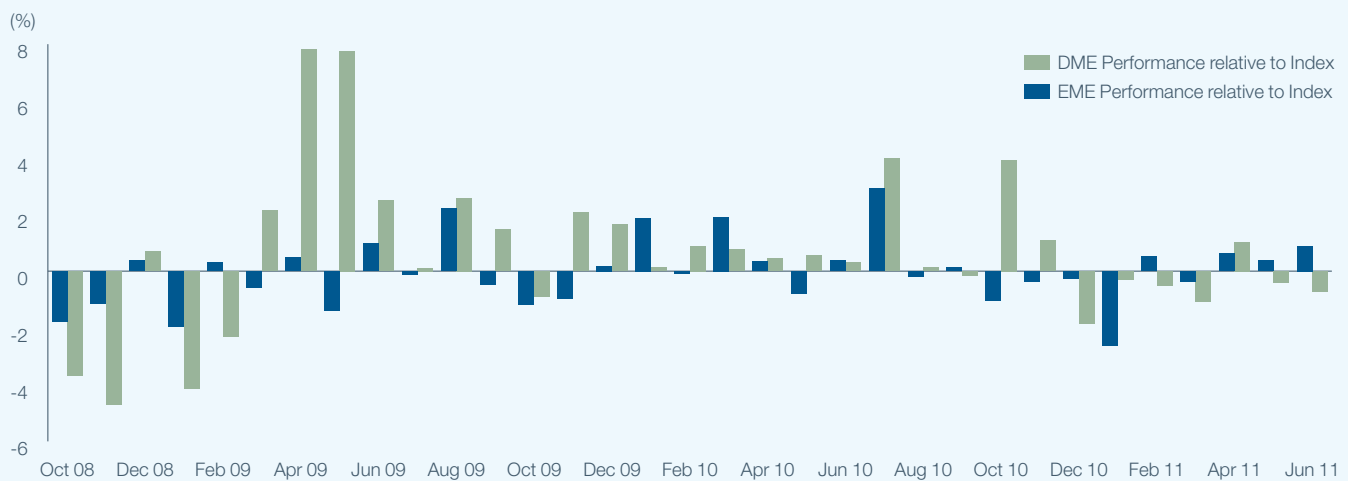
In reality, all strategies investing in emerging markets are trying to unlock value. How value and growth funds unlock that value is what makes them, and their performance in varying conditions, different. A value fund defines value based upon the return on equity, while a growth fund defines value based upon earnings per share growth. As the former prefers companies that reward investment with dividends and share buybacks, and the latter prefers companies with high levels of capital expenditure, they will realize value in different areas of the market.

If we again use the examples of the Lazard Emerging Markets Equity strategy (a relative value approach) and the Lazard Developing Markets Equity strategy (a relative growth approach), we can see how the fundamental analysis employed by each strategy accesses opposing areas of the market. Despite employing a similar analytical framework and investment process, the fundamental analysis used differs as the two strategies endeavour to produce different outcomes. The Developing Markets Equity strategy looks at the earnings per share growth in the coming three years and at whether this rate of growth can be maintained. Conversely, the Emerging Markets Equity strategy looks at a company's sustainability of profitability in the coming three years and whether the resulting return on equity can be maintained. The differences, and similarities, between the two strategies can be seen in Exhibit 5.

An example of the differences in asset allocation between the two strategies would include the Developing Markets Equity strategy's higher weighting in energy where there is currently a high degree of capital expenditure. In addition, high earnings per share growth in China at present would also make this an attractive region for the growth strategy. Conversely, Korea would not appeal, given that Korean companies currently tend to have valuations in excess of their sustainable growth rates. The distinct differences between the two strategies can be seen in their divergent performance patterns, as shown in Exhibit 6.

#### Exhibit 6

Emerging Markets Equity and Developing Markets Equity Monthly Out/Under Performance versus MSCI Emerging Markets Index



As of June 30, 2011

Performance is presented gross of fees and is being provided for informational and comparative purposes only. This information is supplemental to the complete composite performance. Please refer to the Important Information section for additional information and for a description of these composites. The performance quoted represents past performance. Past performance is not a reliable indicator of future results.

Source: Lazard, MSCI

We believe it has become increasingly important for investors in emerging markets to embrace an active management approach in order to take advantage of, and protect against, varying market movements. In our view, this should smooth portfolio volatility and offer higher risk-adjusted returns relative to investing in a strategy incorporating only one approach to emerging markets investing. A value strategy's focus on sustainable profitability, free cash flow, and attractive valuations seeks to protect returns when uncertainty looms in the marketplace and hopefully generates alpha through stock selection. Adding an emerging markets growth strategy can allow investors to take advantage of emerging markets that are expanding capacity, either domestically or internationally, by focusing on capital expenditure to potentially capture the ensuing upside.

## Important Information

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Lazard's Emerging Markets Equity strategy seeks to generate strong relative returns over a long-term time horizon by investing in companies with strong financial productivity at attractive valuations. The strategy typically invests in 70–90 securities of companies, generally with a market capitalization of approximately \$300 million or greater, that are located, or that do significant business in, emerging markets countries.

Lazard's Developing Markets Equity strategy seeks to generate strong relative returns over a full market cycle by investing in companies with sustainable earnings growth at attractive valuations. The investable universe includes all sufficiently liquid securities with a market cap over US\$300 million that are typically domiciled in countries included in the MSCI Emerging Markets Index. Companies that have more than 50% of their net assets or sales from emerging markets countries are also included in the initial universe.

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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. 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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