

January 2011

Outlook on **Emerging Markets**

Emerging markets finished the year strongly, with a positive final quarter capping a year of robust growth. In many ways, 2010 was the year of emerging markets—they became the engine of global growth, grew in influence economically and politically, and were the source of strong returns for both debt and equity investors. While strong performance and record flows into the asset class make us somewhat cautious in the short term, we remain confident in the robustness of emerging-market fundamentals, and believe that the longer-term outlook for the asset class is bright.

A generally positive outlook is shared across our strategies—our two stock selection strategies, the relative-value Lazard Emerging Markets Equity (EME) and the fundamental-growth Lazard Developing Markets Equity (DME); as well as our three other strategies, Lazard Emerging Income (LEI), Lazard Emerging Markets Debt (EMD), and Lazard Emerging Markets Discounted Assets (EMDA). We believe that all five of these strategies are poised for attractive long-term growth.

Chinese monetary and fiscal policy remain at the forefront of our thinking across all strategies, particularly since mid-October, when the People's Bank of China raised its one-year deposit and lending rates by 25 basis points each, to 2.50% and 5.56%, respectively—the first increases since 2007. With inflationary pressures building, we do not anticipate that this will be the last round of fiscal and monetary tightening we see in China. The Chinese government has indicated that further measures will include tightening tools such as policy-rate hikes, increased bank reserve requirements, property tax measures, possible stamp duty increases, and eventually the strengthening of the renminbi. The timing and scope of these tightening policies are still unknown, but our expectation is that the authorities will be prudent in guiding growth and inflation down. Even under this largely positive scenario, we still expect some bouts of volatility around each major move.

Also in Asia, we are closely monitoring the escalating tensions in Korea, following an attack by North Korea on a South Korean island. We see this action as another in a series of events engineered by North Korea to try to gain leverage with the international community in negotiating over its disputed nuclear program. It may also represent an attempt to consolidate power within North Korea, as Kim Jong Il elevates his son Kim Jong Un to a powerful position within the reclusive regime. In our view, North Korea does not have enough money to implement a war, and barely maintains internal stability. Reports suggest that as many as half its population may suffer from malnutrition. Were the conflict to escalate, we would expect foreign selling to increase and capital to flow out of Korea. We view this scenario as highly unlikely and have already seen steps implemented by the Bank of Korea to ensure liquidity and currency stability.

In Latin America, the presidential election in Brazil, the region's biggest economy, has dominated the news. We do not anticipate the win by Dilma Rousseff—the hand-picked successor of outgoing President Luiz Inacio Lula da Silva, from Brazil's Workers' Party—to disrupt the strong progress being made in the Brazilian economy. We are not expecting a major shift in macroeconomic policy in Brazil under the new president, as her election policies are broadly in line with those of the departing president. There have been recent moves in Brazil to curtail the rising real, including an increased tax on direct foreign investment into fixed income markets. The rise was not surprising, however, as foreign investors have been alert to policy shifts to dissuade investment or to aggressively deflate currency.

Within Emerging Europe, Middle East, and Africa, performance has not been nearly as strong as elsewhere in the emerging world in 2010, primarily because of the sovereign debt crisis that has gripped the developed economies on the periphery of Europe. As a result of more modest performance, we are now seeing value in many of these markets. There are relatively buoyant conditions within many countries with local economies that are divorced from the troubles of Eurozone.

While emerging markets have done extremely well, substantially outperforming the developed world this year, their robust performance has clearly been supported by relative fundamentals. Public finances in the majority of emerging-market countries appear to be healthy; banks continue to lend profitably and consumer debt remains low. We believe that the case for economic growth in emerging markets will be much stronger than for the G7 economies over the next few years. With intra-emerging-market trade an ever-larger proportion of exports, this growth also appears to be increasingly self-sustaining.

Therefore, we remain optimistic about emerging markets in the medium and long terms. With concerns surrounding large investor inflows, as well as record levels of corporate issuance and potential fiscal tightening in China, there is potential for some volatility. As a result we do urge some caution around asset allocation decisions. In addition, the second round of quantitative easing in the United States may pose another risk, since it may put pressure on certain emerging-market governments to weaken their currencies in order to remain competitive, which could result in rising inflation globally.

Lazard Emerging Markets Equity

In the Emerging Markets Equity strategy, our relative-value equity strategy, our positioning going into 2011 remains broadly similar to our positioning for much of last year. Our biggest overweight country is Brazil, and our biggest sector position is in consumer staples. We remain significantly underweight the MSCI Emerging Markets Index in China and the energy sector.

We are still finding many highly profitable companies in Brazil with shares trading at what we believe to be low valuations, considering the strong growth prospects in a relatively low-inflationary environment. While Brazil underperformed within the MSCI Emerging Markets Index in 2010, this was largely attributable to the country's largest constituent member, Petrobras, whose performance was negatively affected by its extensive capital expenditure program. We believe that the smooth transition to the new government bodes well for a relatively friendly macroeconomic policy framework, and the potential for Brazil's quality companies to continue to make progress.

The strategy has benefited from an overweight holding in South Africa, and we retain this position—although we have reduced it following a period of outperformance. As we have stated before, South African companies, in large part, operate in less-competitive industries, and the macroeconomic environment continues to improve.

In Turkey, we are finding value where growth rates remain strong. Turkey surprised the market during the final quarter by lowering interest rates, despite inflationary concerns. We share some of the market's concerns about this move and will closely monitor its impact, but we do not see it as having a negative impact on our holdings at this stage.

In China, we maintain our low exposure. However, we do believe that China remains the engine of global growth and, while we anticipate some tightening of monetary and fiscal policy, we are not seeing signs that the government is overly concerned about inflation; therefore we believe that strong growth will continue. We remain underweight in China because our relative-value, bottom-up investment process is simply not finding opportunities in an environment where valuations are being stretched as a result of massive foreign capital inflows.

Elsewhere in Asia, as mentioned earlier, we do not anticipate the Korean conflict to escalate to a point where it significantly affects the strategy. Under such a scenario, however, domestically oriented names, especially banks and consumer companies, would likely see the sharpest falls. Exporters may cushion some of the fall with increased competition through a depreciating currency. We are broadly neutral in our weighting versus the MSCI Emerging Markets Index in Korea.

At the sector level, we currently favor consumer staples, as emerging-market consumers continue to drive significant increases in demand. The companies in our strategy are not only favored by these longer-term demographic trends, they are also currently generating high returns on equity and trading at surprisingly modest valuation multiples today.

Through our disciplined investment process, we are finding very few opportunities in energy stocks. High oil prices have extended valuations, and the capital expenditure demands of firms in the sector are making stocks unattractive for relative-value investors.

We are optimistic for emerging-market equities for the medium- and long terms. Although from a valuation perspective we are also constructive in the short term, we believe there may be a pullback in equities at some point in 2011. Therefore, we believe those with long-term objectives should be patient, and maintain exposure to the asset class.

Lazard Developing Markets Equity

Currently, the Developed Markets Equity strategy—our fundamental-growth equity strategy—continues to have relatively high exposure to China, Brazil and Russia. Our largest exposure, relative to the MSCI Emerging Markets Index, continues to be Russia. Even when

accounting for the high levels of political risk associated with investing in Russia, the market remains inexpensive and we believe contains numerous growth opportunities from a bottom-up basis. For example, we currently have a preference for Russian banks.

While Chinese growth stocks are often priced more expensively than those of many of their peers, we continue to find opportunities, although our exposure is less than that of the Index. We are currently finding the most value in China in areas such as industrials and materials. Finally, some Brazilian shares have lagged the broader emerging-market index, and we find that both banks and home-builders offer attractive valuation/growth characteristics.

Relative to the Index, our biggest sector position is in consumer discretionary. Exposure to automakers, homebuilders, and department stores comprise the majority of this sector's exposure. The strategy currently also has a large relative exposure to industrials, as we favor companies that have high capital expenditures, as long as they have high returns on capital investment. We are also overweight information technology, a sector where earnings are now growing strongly again.

Our investment philosophy is based on finding the optimal balance between valuation and earnings growth. For example, while we believe that consumer staples companies are attractive for their stable cash flows and dividend potential, they are also often excessively valued relative to their long-term growth rates. Therefore, we feel they are not suited to this strategy. Also, we believe that the materials sector has already priced in its growth, so we are materially underweight that sector as well.

Growth stocks tend to outperform in periods of slower global GDP growth, because very few companies can generate earnings growth in such an environment. Therefore, we believe those who feel we are entering a new secular period of slow global economic development should look toward growth-oriented strategies. In our view, with the valuation premium on growth stocks below historical levels, accessing emerging markets through its fast-growing companies is now worth careful consideration.

Lazard Emerging Income

In the LEI strategy, our local currency and debt strategy, the portfolio management team believes that many emerging market countries may continue their trajectory of strong, stable growth (and at a higher level than their developed-world counterparts), abetted by healthy private sector credit expansion and sound banking systems. These countries' prospects for sustained growth are less dependent on a rebound in the global economy, and more supported by increasing intra-emerging market (EM) trade, cross-border investment flows and, in countries such as India and Brazil, domestic-demand-led growth.

The orthodox policies that EM policymakers and central banks have adopted to achieve and maintain growth over the past two years have added to their credibility. This credibility will prove to be critical as policymakers continue to grapple with inflationary pressures that persist in several EMs. Intervention carries its own risks: potentially higher inflation, asset bubbles and sterilization costs. Lower-yielding countries have scope to continue intervening for longer than higher-yielding countries, which have to resort to other measures to discourage high money inflows. These policy measures could have varying degrees of success, depending on the environment and the country, but intervention will likely only delay inevitable foreign exchange appreciation.

Risks in peripheral Europe remain and will continue to play a role in risk appetites during 2011. We continue to closely monitor the economic response to policy moves, the impact of quantitative easing (QE) on rates and currencies, etc.). We also remain vigilant on the risks associated with rising protectionist tendencies (be they trade-related or capital-flow-related) and uncoordinated, unilateral policy moves.

We expect investors increasingly to differentiate among EM economies based on balance-of-payments sustainability, central bank foreign exchange intervention policies, and the sustainability of growth. LEI's index-agnostic approach and 50-plus country investment universe allow us to achieve diversification across EM local currency and debt markets, as we seek to capitalize on countries' differing trade sensitivities, policy stances, funding sources, and balance of payments influences. We believe that the frontier markets should continue playing a valuable role in our goal of delivering consistent absolute returns in a sub-6% volatility profile.

We expect differentiated returns across markets and rising discrimination between countries on fundamental and policy grounds, while remaining watchful for any renewed signs of deleveraging worldwide.

Lazard Emerging Markets Debt

What a difference a couple of months make. Worries about the sustainability of the U.S. economic rebound have largely subsided as a positive news flow has persisted over the last ten weeks. While improvement in new orders and leading economic indicators provided the first impetus for the market to recover, more important has been the nascent recovery in commercial bank lending that has emerged since mid-

November. Commercial banks have become net sellers of both Treasuries and mortgage-backed securities over the last couple of weeks in order to deploy this capital into the new loan market.

The flip side of this positive news has been the brutal effect on the U.S. Treasury market over the same period. Ten-year yields have widened by 85 basis points (bps) since early November and have the potential to widen another 20-45 bps to reach their post-QE1 (the first round of quantitative easing) trading range of 3.50-3.75%. Capital losses from Treasury yield widening will likely serve as a fierce headwind for fixed income investors until the completion of QE2 in June 2011. As a result, we anticipate limited absolute return for most USD-denominated investment-grade and BB-rated EM sovereign debt in the near term. Most of the opportunity in external debt is concentrated in higher-beta sovereign credit in countries such as Argentina, Ukraine, Venezuela and Iraq. However, due to the higher forecasted volatility of these names, we believe that it is important to limit position sizes in order to maintain liquidity and reduce concentration risk.

The other asset class that should benefit from improved global economic conditions, in our view, is high-yield EM corporate debt. This subset of the asset class continues to trade wide to its developed-market peers and similarly rated sovereign paper. In addition, with the large supply of EM corporate debt over the last couple of years, the asset class now offers considerable breadth and depth. We continue to find opportunities across the EM corporate debt universe; particularly in the Indonesian coal sector, global metals and mining names, and consumer names in Latin America. We expect credit work to continue to pay dividends as weaker EM corporate credits use the buoyant market to issue additional paper.

In local markets, we believe returns will be driven more by FX and carry, with durations negative to neutral. Positive growth prospects, rising local rates and strong secular flows into emerging markets continue to support EM FX appreciation versus developed-world currencies. However, given concerns over the sustainability of global growth, we expect EM authorities to remain fixated on limiting any sharp appreciation of their currencies. History has shown that in the context of a positive EM economic backdrop, these measures typically serve to slow down the rate of appreciation of EM FX, rather than reversing their trajectory. As such, we favor structural plays in Asian FX, where our top picks are Malaysia and Indonesia. In Latin America, currencies are supported by a solid cyclical rebound, strong terms of trade, and attractive real rates.

We see fewer opportunities in Europe, the Middle East and Africa (EMEA), and intend to focus more on relative-value plays in Poland, Russia and Egypt. On local rates, we see the most value in the 2-5-year area of the curve. Although central banks have started to normalize policy, we expect the pace to be gradual and not dependent solely on interest rate hikes, but rather a mix of measures (reserve ratio hikes, macro prudential measures, etc.). The effectiveness of these policy tools against rising domestic inflation and higher U.S. Treasury yields will keep pressure on the longer end of the market.

We believe that the largest risk to emerging markets is a downturn in global risk appetite. While we enter 2011 bullish on the asset class, we are cognizant that risk-seeking sentiment is becoming extended. Equity risk appetite in the U.S. is approaching three-year highs and investor euphoria (both individuals and financial advisors) appears to be reaching its high.

Over the last couple of months, global investors have been greeted by a plethora of positive economic and political news; yet the market will need additional positive catalysts to sustain its strong run. Typically after an initial surge in New Year buying and what will likely be a positive earnings season (Jan 10th – Jan 21st), investors will be bereft of catalysts. Within this context, we continue to focus on value while maintaining higher cash levels than normal to be in a position to capitalize on better entry levels in our favored markets.

We believe that 2011 is shaping up to be another strong year for emerging-market fixed income markets. While valuations are more balanced, we believe that the secular shift into emerging-market debt will continue based on both strong fundamentals and flows.

The case for EM debt remains compelling, and investors will likely be rewarded for increasing allocations to local FX and high yield sovereign/corporate debt to potentially capitalize on the EM re-rating story, a story we believe will persist well into the future.

Lazard Emerging Markets Discounted Assets

The Emerging Markets Discounted Assets strategy (EMDA) invests in emerging-market companies trading at compelling discounts to their underlying holdings' value, or net asset value (chiefly closed-end funds and holding companies). Portfolio discounts, currently greater than 13%, remain wider than historical averages, and, we believe, will continue to narrow. Our EMDA team takes an active approach aimed at narrowing the discounts of our holdings, and we believe that we will continue to create value for our investors.

It is important to point out that regional and country positions are always driven by our stock selection, as we maintain a benchmark-agnostic approach, and we build our portfolio one holding at a time. Within this bottom-up process, the strategy remains underweight Latin America and Africa, especially Brazil and South Africa, as discounts in these areas are generally not attractive at present. We will continue to adhere strictly to our investment discipline and invest only where we see attractive discounts.

The strategy maintains an overweight position in Europe, driven by a large and overweight exposure to Russia, where we are finding substantial value today. In Asia, we are finding compelling investment opportunities in the infrastructure and consumer goods sectors of the Philippines and Indonesia, which has driven our overweight position to both countries. Also, Thailand has become increasingly attractive to us, leading to an overweight position to this country, where we have made investments in companies trading at discounts in excess of 14%.

Our strategy also maintains equal-weight exposures to both China and India, although these two countries are the strategy's largest individual country weights. The average discount for our holdings focused on China and India are 11% and 13%, respectively. These attractive discounts highlight our ability to access two of the most prominent and fastest-growing economies in the world at compelling valuations. Such examples lead us to remain confident in our ability to continue to bring value to investors through quality stock selection and diligent corporate governance.

Important Information

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Past performance is not a reliable indicator of future results.

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.

LEI is an alternative investment strategy. An investment in any alternative investment is speculative, involves a high degree of risk, and may lose value at an accelerated rate. Privately offered investment vehicles ("hedge funds," which includes "funds of funds") are unregistered private investment funds or pools that invest and trade in many different markets, strategies, and instruments. Hedge funds generally are not subject to regulatory restrictions or oversight. Opportunities for redemptions and transferability of interests in hedge funds are often restricted so investors may not have access to their capital if and when it is needed. Typically, there is no secondary market for an investor's interest in a hedge fund. The fees imposed on hedge fund investments, including management and incentive fees/allocations and expenses, may offset trading profits. An investor should not invest in any hedge fund unless he or she is prepared to lose all or a substantial portion of his or her investment. These and any other risks involved in an investment in any hedge fund should be considered carefully before an investment is made.

The performance of the LEI strategy is largely dependent on the talents and efforts of certain individuals. There can be no assurance that LAM's investment professionals will continue to be associated with LAM and the failure to retain such investment professionals could have an adverse effect on the strategy.

The LEI strategy is subject to a number of actual and potential conflicts of interest involving LAM and its affiliates. LAM and its affiliates provide investment management services to other investors whose investment objectives may be similar to, or different from, the investment objective of the strategy. The directors, members, officers and employees of the LEI strategy, LAM and its affiliates may buy and sell securities for their own account or for the account of others. The investment manager may receive an incentive allocation and such a compensation arrangement may create an incentive to make investments that are riskier or more speculative than would be the case if such an arrangement were not in effect.

The LEI strategy invests primarily in short-term emerging market local currencies and debt positions. The strategy will generally invest in currency and debt investments denominated in emerging market currencies and the strategy will maintain significant exposure to such local currencies. As such, an investment in the strategy is subject to the general risks associated with fixed income investing, such as interest rate risk and credit risk, as well as the risks associated with emerging market investments, including currency fluctuation, devaluation and confiscatory taxation. The LEI strategy may use derivative instruments that are subject to counterparty risk.

Investments in global currencies are subject to the general risks associated with fixed income investing, such as interest rate risk, as well as the risks associated with non-domestic investments, which include, but are not limited to, currency fluctuation, devaluation and confiscatory taxation. Furthermore, certain investment techniques required to access certain emerging markets currencies, such as swaps, forwards, structured notes, and loans of portfolio securities, involve risk that the counterparty to such instruments or transactions will become insolvent or otherwise default on its obligation to perform as agreed. In the event of such default, an investor may have limited recourse against the counterparty and may experience delays in recovery or loss.

The EMD strategy invests primarily in emerging market debt positions. The strategy will generally invest in debt investments denominated in emerging market currencies. As such, an investment in the strategy is subject to the general risks associated with fixed income investing, such as interest rate risk and credit risk, as well as the risks associated with emerging market investments, including currency fluctuation, devaluation and confiscatory taxation. The strategy may use derivative instruments that are subject to counterparty risk.

The EMD strategy will invest in securities of non-U.S. companies and which trade on non-U.S. exchanges. These investments are denominated or traded in currencies other than U.S. dollars involve certain considerations not typically associated with investments in U.S. issuers or securities denominated or traded in U.S. dollars. There may be less publicly available information about issuers in non-U.S. countries that may not be subject to uniform accounting, auditing and financial reporting standards and other disclosure requirements comparable to those applicable to U.S. issuers.

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 and exchange-traded funds ("ETFs") may trade at prices at, below, or above their net asset value. There is no guarantee that a fund's discount will ever be narrowed or eliminated. An investment in either type of fund is indirectly subject to all the risks associated with the investments made by the closed-end fund or ETF. Additionally, the performance of an ETF pursuing a passive index-based strategy may diverge from the performance of the index.

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