July 2011

Outlook on **Fixed Income**

The key lingering issues of the second quarter remain, but are all scheduled to reach some conclusion during the third quarter: The U.S. Federal Reserve's bond buying program is set to end June 30, the U.S. debt ceiling legislation is expected to come to a head in early August, and steps toward the resolution of the funding issues related to Greece are expected to transpire throughout the summer. In addition, investors are grappling with the ongoing question: are we experiencing a global recovery, a double-dip, or a mid-cycle slowdown? In our opinion, the most important points regarding each of these significant issues is that all are vetted daily in the markets, investors have likely staked out their positions based on their views and biases, and most of the news and expectations are already priced into security valuations.

While each of these events is important and will continue to move markets, we believe that many observers are oversimplifying these broad themes or issues. Clearly the above issues weigh on all investors' minds; however, it is very difficult to profit from some of these global macro events, as most of the evidence is currently known and discussed by market participants. Further, much of today's markets are driven by investors rapidly maneuvering portfolios in an attempt to take advantage of the changing "risk-on" or "risk-off" expectations. The availability of liquid, easy-to-access securities or baskets of securities—such as ETFs, currency forwards, or credit derivatives—allow for these rapid reactions to the fear-greed cycle.

Regardless of the outcome of the current macro stories, we believe that there is true excess return potential across all of Lazard's fixed income strategies. In our opinion, much of this potential comes from the fact that fixed income index methodology is flawed, and a number of opportunities for impairment still exist within U.S. and global benchmarks. Avoidance of impairment and the ability to perform in up markets are a powerful combination. We believe that the current market conditions are creating opportunities for fundamentally-driven managers that are small and flexible enough to select individual securities that have excess return potential separate from sector or regional asset categories.

It is useful and interesting to analyze how these key events may conclude, but we believe it is considerably more critical to be focused on security selection as the key returns driver and to make sure that portfolios are positioned away from issuers and sub-sectors that may face significant downside from the potential adverse volatility of these high profile events.

U.S. Fixed Income

Investment Grade

While we believe that the financial crisis in the United States is over, many of the conditions that the crisis left behind continue to have a significant impact on today's markets.

The markets remain in the middle of an unprecedented deleveraging and a transition away from what were considered the key pillars of stability: financials, housing, and consumers. In order to create liquidity and stimulate these sectors, central bank policies entered into the uncharted waters of aggressive intervention and balance sheet leverage. This intervention, in turn, has led to abnormally low interest rates, which we believe are unlikely to fall significantly without the advent of a prolonged disinflationary environment.

In addition to the market distortions introduced by deleveraging and intervention, ratings— the standard barometer of impairment outcomes—have proven to be unreliable. This is evidenced not only by the obvious impairment of a large number of AAA-rated bonds throughout the 2008-2009 crisis, but in the current environment as well. For example, Standard and Poor's admitted to incorrectly rating over 1,000 securities as recently as December 2010; these securities were subsequently placed on credit watch negative.[1] The commod-

itization of fixed income sectors that rating agencies helped to create in the past has now ended, leading to an unprecedented amount of valuation distortions at the individual security level.

These factors, and the resulting panic-like reactions to asset allocation, are currently dominating asset valuations in the fixed income markets. It is this oscillation of fear and greed that continues to create opportunity for disciplined investors. For instance, sell-side concerns about massive municipal defaults led to a 23-week sell-off in that market.[2] This dislocation provided select opportunities to cross over into the individual municipal market credits and derive better risk/return benefits over investment-grade corporates. Similarly, fears in the housing market created opportunities to purchase select agency mortgage-backed securities (MBS) with beneficial underlying collateral characteristics at attractive prices, which has led to materially differentiated positive results.

Compounding these risk conditions for fixed income investors, many active managers hug benchmarks as the practice of indexation has been validated by the industry as a de-risking strategy. However, we believe within the current volatile environment, indexation cannot be considered a safe haven. Even considering the current recovery, a material number of individual securities within fixed income indices still have a high potential for impairment. As such, we believe that successful investment strategies in such an environment will be driven by those that manage individual exposures from a risk process that is benchmark-aware, not benchmark-driven.

In our opinion, the key to adding value is to avoid impairment and valuation risks. While remaining focused on the investment objective supported by the specific characteristics of a client's selected benchmark, we tactically rotate exposures toward opportunities while simultaneously considering the need to step out of individual securities and sub-sectors in the benchmark when they represent unacceptable risks or offer insufficient excess compensation. We currently believe that many commercial mortgage-backed securities (CMBS), asset-backed securities (ABS), commercial banks, and private-label MBS should be avoided either due to impairment or valuation concerns.

In addition, we believe that investors that are focused on guarding against fat-tail risks utilizing hedging strategies may actually be increasing risk, as correlations and counterparties remain subject to random instability, possibly invalidating the effectiveness of these formerly reliable strategies. As a residual of the crisis, we believe that past experience and relationships have to be re-examined, as they may become materially unreliable: forward-looking, fundamental analysis is a critical component to successful investing in the current environment.

High Yield

U.S. high yield bonds—which had been trading at recent highs with yields at record lows—unsurprisingly underperformed at the end of the quarter amid disappointing U.S. economic data. In addition, due to the demand for yield by investors that had been driving new issuance in the high yield market, we began to see weaker covenants and deteriorating conditions in the space, especially for CCC-rated securities.

Much of the headline news is currently focused on the negatives within the space, which we believe may drive investors away from the asset class at a macro level, but creates substantial opportunities for investors focused on the fundamentals of individual securities that are "money good." As such, we remain optimistic about our current positioning, which allows us to capture the coupons and excess spread associated with the BB-B non-distressed market, particularly away from financial securities. We believe that, on a selective basis, investors can find opportunity in many of the companies that have recently refinanced to strengthen their balance sheets.

Municipals

As a result of the crisis, many investors avoided the municipal market, due to the lack of credit guarantees in the face of headline risks of default and impairment. Year-to-date, however, non-impaired municipal debt has actually been one of the best-performing investments in the investment-grade markets as tax revenues continue to recover, budget deficits and spending are being brought under control, and new issuance supply continues to be tight. While the worst fears for the space are not close to being realized, challenges remain and continue to offer selective investors opportunity to add value. With the concerns of massive and disruptive bankruptcies subsiding, institutional buyers have stepped in to put a floor on pricing, leading to a more orderly allocation of investment resources for worthy issuers.

The uncertainty that currently characterizes the municipal marketplace presents enormous opportunities for investors that can identify issuers and security structures that are financially sound. It remains critical, however, to pay attention to the details, as they will differentiate the winners from the losers in this space.

Global Fixed Income

Within the developed markets, the intense discussion surrounding the sovereign and financial issues within Europe continues. We believe the headlines, however, mask the underlying strength in much of the European corporate manufacturing sector and the Scandinavian econ-

omies that are thriving, due in part to increased exports and higher commodity prices. Evidence of this strength can be seen in Switzerland which, in our view, remains an attractive safe-haven away from the euro with a currency that has performed well, despite the worries in peripheral Europe. We believe the fears of developed market debt are also largely unfounded when considering Canada, Australia, or New Zealand. These markets are in quite a different situation versus other parts of the Anglo-Saxon world, with yield curve and central bank policies that are dissimilar to their developed market peers.

Despite potentially weaker data in some countries, we expect the European Central Bank to continue its gradual rate tightening over the next 18 months, as the inflation-fighting mentality prevails and because it considers 1% base rates as a "temporary" or "emergency" level. We plan to be selective in emerging markets based on valuations, and continue to believe that diversified currency exposure this year may provide an additional—and potentially uncorrelated—source of incremental return, so we will be tactical in attempting to exploit these opportunities.

Global markets represent a variety of investment opportunities as countries and regions are all at different points on the economic cycle. The wider opportunity set allows a wider range of implementation ideas to take advantage of market conditions.

Notes

1. Source: Standard and Poor's, Bloomberg, December 15, 2010.
2. Source: Bank of America Merrill Lynch, May 2, 2011.

Important Information

Published on July 8, 2011.

Past performance is not a reliable indicator of future results.

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