Lazard
US Fixed Income

1Q14
Platform
Review

Performance Summary as of March 31, 2014

			Annualized	
	QTD	1 Year	3 Years	5 Years
Lazard US Core	2.14	1.38	5.02	5.48
Barclays Capital US Aggregate Bond Index	1.84	-0.10	3.75	4.80
Excess Return (bps)	+30	+148	+127	+68
Lazard US Short Duration Fixed Income	0.33	0.67	1.51	2.43
BofA Merrill Lynch 1-3 Year US Treasury Index	0.14	0.38	0.82	1.10
Excess Return (bps)	+19	+29	+69	+133
BofA Merrill Lynch 90-day US Treasury Bill Index	0.01	0.07	0.08	0.12
Excess Return (bps)	+32	+60	+143	+231
Lazard US Tax-Exempt	1.27	0.45	2.99	3.19
Linked Index[1]	1.27	0.82	3.47	3.93
Excess Return (bps)	0	-37	-48	-74
Lazard US High Yield	2.58	6.76	8.05	13.53
Linked Index[2]	2.97	6.85	8.45	13.12
Excess Return (bps)	-39	-9	-40	+41

Performance is preliminary and presented gross of fees. Please refer to the Important Information section for a brief description of each composite. The performance quoted represents past performance. Past performance is not a reliable indicator of future results.

Key Highlights

The primary focus of current headlines with regard to US fixed income markets remains on the direction of central bank policy; namely, the timing and direction of the quantitative easing policy changes by the US Federal Reserve (the Fed), the possibility of rising interest rates, and the potential flattening of the front end of the yield curve. We have written about these conditions over the past few quarters and have been invested accordingly for some time. As we look ahead, our focus lies not on the direction of interest rates, but rather on the lack of a visible path for the return of market fluidity as we return to normalcy.

The entire infrastructure that created seamless secondary markets in over-the-counter securities collapsed in 2008. The long-term repercussions of this structural change in the marketplace are now being tested, as broker/dealer cash inventories remain at historically low levels due to regulatory and economic disincentives designed to end previous risk-taking activities. As we have seen, recent periods of potential reversals have been marked by material changes in volatility and large gaps in market price discovery. At this juncture, we find that there is little two-way fluidity for transacting in cash securities.

Much of this change in market fluidity has been resolved by the strength of the new issuance market and the fact that many investors have been able to manage cash market exposures through derivatives, exchange-traded funds, and other narrowly defined structured instruments. However, over the last seven years the market has been favorable to such a resolution as the buy-side of the market has remained oversubscribed in an environment engineered by the Fed to reduce financial instability. The question is how will this risk be resolved when both of these conditions revert to normalcy?

Performance Review

Lazard US Core

The Lazard US Core strategy outperformed the Barclays Capital US Aggregate Bond Index for the quarter, returning 2.14% versus 1.84% for the index. Returns were helped by selective allocations to taxable municipal and non-distressed US high yield securities, while hurt by a shorter relative duration.

Based on our outlook and observations, we have for some time been mitigating fluidity risk by limiting our investable universe in two critical ways: 1) we invest only in securities that we are willing to hold to term, and 2) we invest only in securities that we believe have strong long-only institutional support, such that a bout of severe illiquidity can be ultimately resolved by a peer-to-peer transaction. Based on current valuation, we have avoided utilizing structured instruments to mitigate risk as we remain concerned that a return to normalcy will tend to exaggerate the underlying mark-to-market movements of these instruments.

As a result of our risk mitigation, our investment time horizon has been stretched out longer than normal. The recent periods of wide bid-offer spreads create a higher hurdle for us to transact, as returns have the potential to be materially eroded by trading costs. In addition, new money to be invested takes longer to align with established investments because opportunities must be carefully chosen and executed. Under such circumstances, sidelined money is only invested in short-duration government securities where primary dealers are required to make orderly markets.

Lazard US Short Duration Fixed Income

The Lazard US Short Duration Fixed Income strategy outperformed the BofA Merrill Lynch 1–3 Year US Treasury Index for the first quarter with a return of 0.33% versus 0.14% for the index. The strategy also outperformed the BofA Merrill Lynch 90-day US Treasury Bill Index, which rose 0.01% for the quarter. Performance for the period was helped by an overweight exposure to US Agency mortgage-backed securities (MBS) and to US corporate financials, as well as the strategy's shorter relative duration. There were no notable detractors for the quarter.

Currently, our duration positioning is shorter based on valuations. We believe that accommodative Fed policy warrants continued bias toward curve steepening. We are currently overweight US municipals, US corporates, and US Agency MBS, and are significantly underweight in US Treasury debt. We continue to find opportunities to capture excess yield premiums relative to convexity in the pricing of specific MBS and municipal securities.

Lazard US Tax-Exempt

The Lazard US Tax-Exempt strategy performed in line with the BofA Merrill Lynch 1–10 Year Municipal Bond Index for the quarter with a return of 1.27% versus 1.27% for the index. Exposure to the 10-year portion of the curve and an underweight exposure to Puerto Rico helped returns for the quarter, while the overall shorter relative duration detracted from performance.

The municipal market started the year on a strong note, posting the best first-quarter returns of the high-grade US fixed income markets and outpacing the S&P 500 Index. Weaker economic data kept interest rates range-bound, helping to anchor demand for fixed income assets in spite of the tapering of the Fed's Treasury and MBS purchases. Longer maturities this quarter significantly outperformed due to weakening economic data. Shorter-term maturities underperformed due to comments by Fed Chair Janet Yellen following the March Federal Open Market Committee meeting, which indicated that the horizon for a zero-interest-rate policy may be shorter than market expectations. These comments were the catalyst to the re-pricing of interest rate risk in the two-to five-year maturity spectrum. As a result, the municipal yield curve flattened. Three-and four-year rates rose the most, rising 19 and 15 basis points (bps), respectively, while 10-year and 30-year rates fell 28 and 54 bps, respectively.

We expect yield curve reshaping to continue to be a major factor in performance this year. Municipal supply and demand dynamics (including the reduction of supply in both primary and secondary markets) have been favorable to issuers, helping to drive yields lower. These solid supply and demand dynamics, coupled with market expectations for a slow normalization of interest rates, suggest that the municipal sector remains an attractive option for taxpayers who seek a high-quality bond portfolio that diversifies against risk assets such as equity. In this environment, we will continue to maintain an overall duration that is modestly short to neutral versus our index, and intend to manage curve exposures in an effort to benefit from a yield curve flattening scenario. In addition, we believe that the opportunities in the market will continue to be driven by prudent security selection. To that end, we continue to find attractively valued municipal securities utilizing our credit process, by carefully reviewing bond terms and conditions, and by taking advantage of trading dynamics.

Lazard US High Yield

For the first quarter of 2014, the Lazard US High Yield strategy under performed the BofA Merrill Lynch BB-B US Cash Pay Non-Distressed High Yield Index, returning 2.58% while the index gained 2.97%. Performance was helped by overweight positions in the cable, technology, and publishing/printing sectors, and by underweight positions in the utility and super retail sectors. The strategy's underweight positions in the bank, health care, and energy sectors, as well as its shorter maturity structure, detracted from returns for the quarter.

High-yield market spreads tightened by about 25 bps during the quarter to 368 bps. The BB sector tightened about 22 bps to 255 bps, while the CCC sector tightened only 7 bps to 724 bps. High-yield mutual fund flows were very positive as investors injected approximately $3.4 billion into the high yield market. Flows for all of 2013 were a negative $4.1 billion. New high yield bond issuance in the US market was $88.0 billion in the quarter. The Moody's trailing 12-month issuer default rate was 1.7% as of March 31, 2014, down from 2.2% in December 2013.

Even though credit spreads have narrowed, better-quality high yield still appears to offer an attractive risk/reward mix, in our opinion. Credit spreads have continued to tighten, driven by strong demand for high yield and from rising Treasury rates. Moreover, overall improvements in fundamental credit quality, driven by a period of very low interest rates and the economic rebound, have likely peaked. Thus, material upside from here is probably limited. Even so, we continue to believe that, for long-term investors, there is good relative value in better-quality high yield. We like the risk/reward profile relative to other income-producing assets. In our opinion, a shorter-maturity, higher-quality portfolio will continue to protect against permanent capital impairment and provide a buffer to potentially rising interest rates. We are sticking to our year-end forecast of mid-single-digit returns for the high yield sector in 2014.

Notes

1 From inception through December 31, 2010, this composite's benchmark was the Barclays Capital US 5 Year Municipal Bond Index. As of January 1, 2011 this strategy's index has switched to the BofA ML 1-10 Year Municipal Bond Index. The Barclays Capital US 5 Year Municipal Bond Index is a market-value-weighted index for the intermediate-term tax-exempt bond market. This index includes a portfolio of municipal bonds with an investment grade of Baa3/BBB- or higher and with an average maturity of five years. The BofA Merrill Lynch US Municipal Securities Index tracks the performance of US dollar–denominated investment-grade tax-exempt debt publicly issued by US states and territories, and their political subdivisions, in the US domestic market. The BofA Merrill Lynch 1–10 Year Municipal Bond Index is a subset of the BofA Merrill Lynch US Municipal Securities Index and includes all securities with a remaining term to final maturity of less than 10 years. The reason for this change is that the new benchmark better reflects the yield curve exposures in Lazard's intermediate strategies versus the Barclays 5 Year which reflects only 4–6 year maturities. In addition, the BofA ML 1–10 Year Municipal Bond Index is being used by more managers in the investment industry for intermediate mandates.

2 The Linked Index consists of the BofA Merrill Lynch High Yield Master II index from inception through December 31, 1996, and the BofA Merrill Lynch BB-B US Cash Pay Non-Distressed High Yield Index from January 1, 1997 to present.

Important Information

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This report is being provided for informational purposes only. The information and opinions presented in this report have been obtained from sources believed by Lazard Asset Management to be reliable. Lazard makes no representation as to their accuracy or completeness. All opinions and estimates expressed herein are subject to change.

Lazard Asset Management LLC is a US registered investment advisor and claims compliance with the Global Investment Performance Standards (GIPS®). To receive a complete list and description of Lazard Asset Management's composites and/or a presentation that adheres to the GIPS standards, please contact Henry F. Detering, CFA at Lazard Asset Management, 30 Rockefeller Plaza, New York, New York 10112-6300 or by email at Henry.Detering@Lazard.com. Provided below are descriptions of each of the composites, the performance of which appears on the preceding pages.

Lazard US Core seeks to outperform the returns of the investment grade bond market as represented by the Barclays Capital US Aggregate Bond Index. The strategy relies on fundamental security selection and disciplined portfolio construction as it seeks to generate excess returns within a volatility framework that is representative of investment grade active management.

Lazard US Short Duration Fixed Income is a mark-to-market strategy that seeks to outperform cash total returns over a calendar year holding period. Typical comparison benchmarks are usually the BofA Merrill Lynch 90-day US T-Bill Index, BofA Merrill Lynch 1–3 Yr US Treasury Index, or other short duration indices. The primary objective of the strategy is to maintain on-demand settlement date liquidity. The strategy relies on fundamental security selection and disciplined portfolio construction as it seeks to generate excess positive annual returns from the combination of income and mark-to-market gains and losses.

Lazard US Tax-Exempt seeks to outperform the total return of the intermediate municipal investment grade market as represented by the Bank of America Merrill Lynch 1–10 year Municipal Bond Index. The strategy relies on fundamental security selection and disciplined portfolio construction as it seeks to generate excess returns within a volatility framework that is representative of intermediate municipal investment grade active management.

Lazard US High Yield seeks to outperform the total return of the high yield investment grade bond market as represented by the BofA Merrill Lynch BB-B US Cash Pay Non-Distressed High Yield Index. The strategy is invested in US corporate bonds generally rated below BBB, concentrating in BB and B rated issues. Securities are selected based on credit fundamentals and relative value. The average maturity is 5–10 years.

Past performance is not a reliable indicator of future results.

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. 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. High yield securities (also referred to as "junk bonds") inherently have a higher degree of market risk, default risk, and credit risk.

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.

Derivatives transactions, including those entered into for hedging purposes, may reduce returns or increase volatility, perhaps substantially. Forward currency contracts, and other derivatives investments are subject to the risk of default by the counterparty, can be illiquid and are subject to many of the risks of, and can be highly sensitive to changes in the value of, the related currency or other reference asset. As such, a small investment could have a potentially large impact on performance. Use of derivatives transactions, even if entered into for hedging purposes, may cause losses greater than if an account had not engaged in such transactions.

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