June 2012

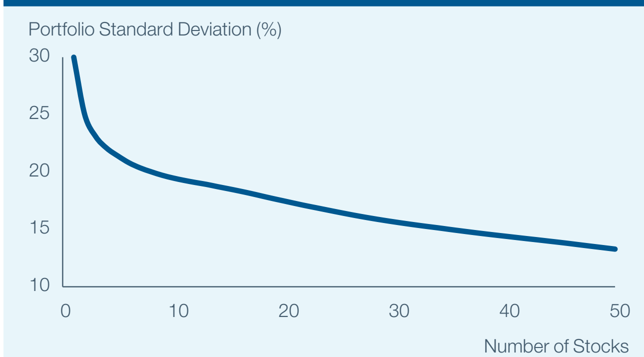
Less is More
A Case for Concentrated Portfolios

There is a commonly held belief that diversification is the key to successful investing. However, we feel that diversification is often taken to an extreme and, at times, some managers have exchanged diversification for market-like returns. We believe that many investors would be better served by using more concentrated portfolios, which allow the portfolio manager to invest only in his or her best ideas and function as a true stock-picker. While it is sometimes difficult to identify concentrated managers—as the number of investments in their portfolios will vary by manager and by investment universe—what identifies a concentrated portfolio is that the manager is picking stocks based on his or her level of conviction, not for portfolio diversification.

While it is generally believed that a portfolio with a concentrated number of holdings is too risky for many investors, it should be noted that most diversification benefits are realized after relatively few securities are added to a portfolio. In Exhibit 1 we show the standard deviation pattern of a hypothetical equal-weighted portfolio. As illustrated in the exhibit, the steepest drop in risk reduction is reached before the addition of the tenth security. The curve flattens thereafter showing a slower rate of reduction in total portfolio risk. We note that diversifying a portfolio would likely minimize short-term volatility, but in concentrated portfolios, we believe adding new securities should be justified based on the manager's conviction and not solely by the need to diversify. It can be concluded from the exhibit that concentrated strategies will prove to be riskier than diversified portfolios. However, in practice, we have found differing results.

In Exhibit 2, we examine the returns and volatility of various market indices against the Lazard U.S. Equity Concentrated strategy, an all-cap, concentrated portfolio of 15 to 35 holdings. Since the strategy's inception in August 2003, it has outperformed most major U.S. indices, as well as developed market indices. Contrary to the belief that concentrated portfolios are more volatile than diversified portfolios, the Lazard U.S. Equity Concentrated strategy has provided lower levels of volatility over time. In our view, these results can be attributed to the depth and detail of our fundamental analysis, as well as the typical characteristics we look for in investments: attractive valuations, high levels of financial productivity, and low levels of leverage. It should be noted that benchmarks which include holdings in emerging markets realized higher returns, but also provided significantly more risk (however, indices that include emerging market investments are not directly comparable, as Lazard U.S. Equity Concentrated is a U.S. strategy).

Exhibit 1
Risk Reduction Rate Slows Down with More Stocks[1]



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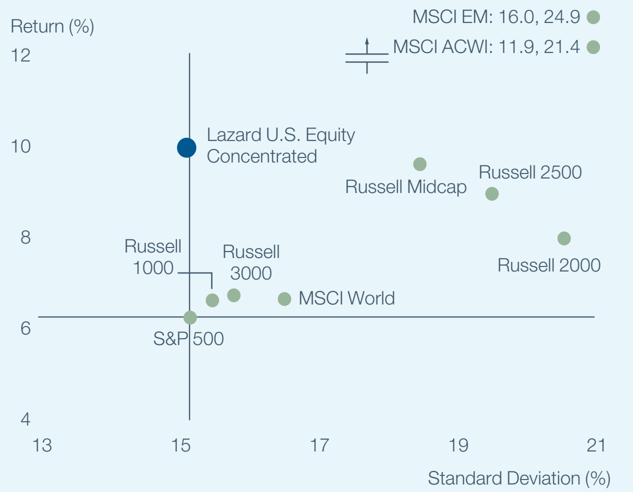
In order to understand how a strategy will likely perform in a volatile environment, it is important to analyze more than standard deviation. While standard deviation allows one to compare multiple strategies and indices, the capture ratio allows one to better understand how a strategy generally reacts in different market environments. With this in mind, we examined the upside and downside capture for the Lazard U.S. Equity Concentrated strategy versus the S&P 500, the Russell 1000 Value, and the Russell 1000 Growth indices. The results reveal that, in up quarters, the strategy experienced a better up capture than all three indices,

Exhibit 2
Risk/Return Profile Highlights Absolute and Risk-Adjusted Returns



As of March 31, 2012

Inception date August 1, 2003

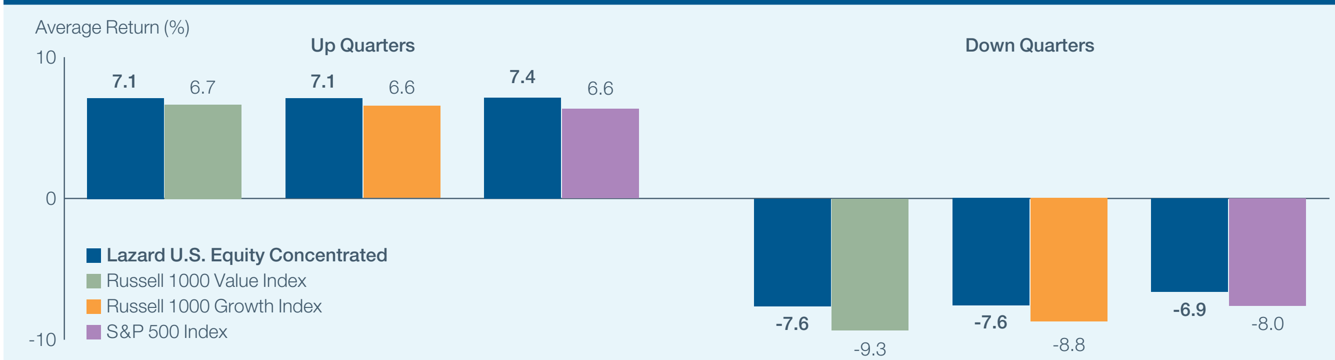
Performance is preliminary and presented gross of fees. The performance quoted represents past performance. Past performance is not a reliable indicator of future results. This information is being provided for illustrative purposes only and is supplemental to the complete composite performance. Please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

Source: Lazard, Russell Investments, Standard and Poor's, MSCI

capturing approximately 112% of the S&P 500 Index, 106% of the Russell 1000 Value Index, and 108% of the Russell 1000 Growth Index. In quarters when the market declined, the strategy protected capital, capturing only 87% of the S&P 500 Index, 82% of the Russell 1000 Value Index, and 86% of the Russell 1000 Growth Index returns, as shown in Exhibit 3. In our view, the strategy's focus on strong free cash flow, balance sheet strength, and low levels of leverage, which provides operational flexibility, has created this attractive pattern of performance.

It has been widely reported that many active managers do not consistently outperform their benchmarks, net of fees. In our view, using a concentrated manager greatly increases one's odds of outperformance. In 2006, a working paper by Martijn Cremers and Antti Petajisto, then of the Yale School of Management, introduced active share as a metric for active management. Cremers and Petajisto argued that active share, which is the percent of a portfolio's holdings that differs from its benchmark, is a better measure of active management than tracking error alone, as well as a better indicator of future outperformance. According to the study, active share measures differentiation from the benchmark, and hence is a proxy for stock selection. Tracking error, on the other hand, measures the volatility of portfolio returns in excess of the benchmark, and thus is a proxy for systemic factor risk. Active share ranges from 0% (a pure index fund) to 100% (fully active and completely different than the benchmark). The study considers a manager with an active share of 60% or greater as truly active, and concludes that managers with high active share have historically outperformed.

Exhibit 3
Participate in Up Markets and Protect on the Downside



As of March 31, 2012

Inception date is August 1, 2003. Since inception performance starts with first full quarter of performance (2003Q4).

Performance equals average quarterly results during up/down quarters for the S&P 500 Index (23 up quarters/11 down quarters), the Russell 1000 Value Index, and the Russell 1000 Growth Index (24 up quarters/10 down quarters in both Russell indices).

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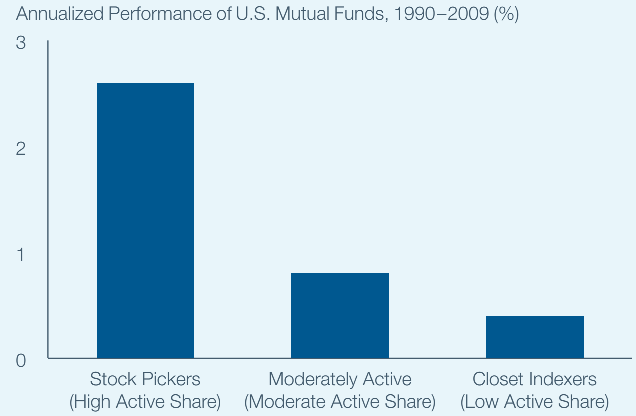
Source: Lazard, Standard & Poor's, Russell Investments

Exhibit 4 shows the relative performance of U.S. all-equity funds from 1990 to 2009, segmented by active share. The results reflect strong outperformance for high active share portfolios. As concentrated portfolios structurally have higher active share because of their limited number of holdings, we suggest their performance will resemble that of stock pickers.

Another key observation from the study is that the "average" manager in the U.S. Equity universe tends to underperform because the universe itself is full of "closet indexers". Closet indexers typically maintain positions that overlap closely with the benchmark to ensure that their performance does not deviate significantly from the index, while many times claiming to be active managers. We believe closet indexers may prove to be significantly expensive managers, as their strategies are unlikely to provide meaningful outperformance, net of fees. It is also noted in the study that the amount of assets managed by closet indexers exploded in the mid 1990s. In 2009, these managers represented about a third of the total assets, an increase from approximately 1% in 1980, as illustrated in Exhibit 5. This trend reinforces the previous observation as to why, on average, the active management universe appears to underperform.

Exhibit 4
U.S. Managers with High Active Share Have Outperformed



Performance reflects the gross returns of a fund's stock holdings and do not include any fees or transaction costs. Index funds, sector funds, and funds with less than $10 million in assets have been excluded.

The information in the chart above is being provided for illustrative purposes only and does not represent any product or strategy managed by Lazard.

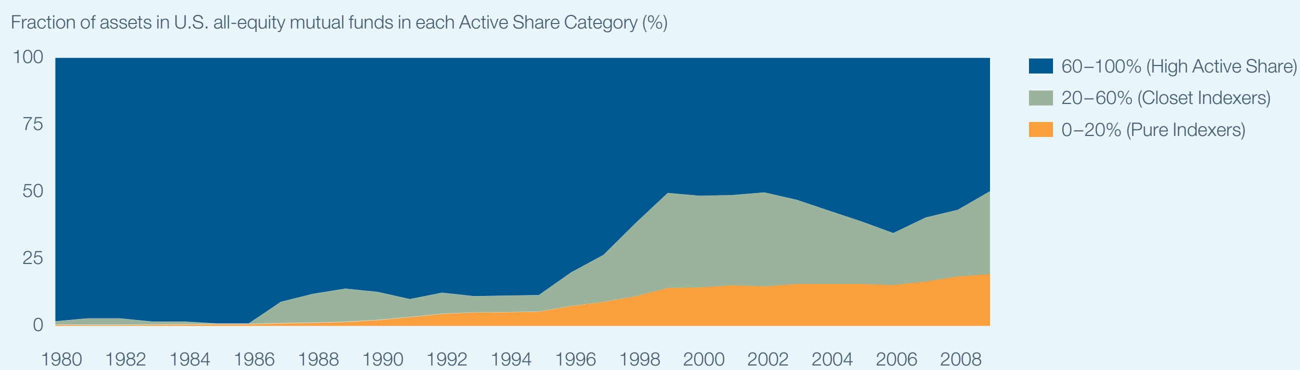
Source: Antti Petajisto, "Active Share and Mutual Fund Performance," December 2010

The structure of concentrated portfolios generally leads to high active share and potentially subsequent outperformance. By design, concentrated strategies facilitate investing in the highest-conviction ideas and have limited overlap with an index. In the Lazard U.S. Equity Concentrated strategy, active share has averaged 91% (measured against the S&P 500 Index) since inception, which is not surprising as the strategy generally only holds 15 to 35 securities.[2]

In our view, concentrated portfolios are well-positioned to generate alpha based on the extensive fundamental research that reveals the most compelling investment ideas. Using the Lazard U.S. Equity Concentrated strategy as an example, we draw attention to the performance results in Exhibit 6. While some investors lament the lost decade in U.S. equities, we would point out the strategy's 9.9% annualized return since inception nearly 10 years ago. Furthermore, in our view we are transitioning to a new backdrop for investing. Looking forward, we believe the importance of macroeconomic volatility is likely to decrease and company-specific factors are likely to drive investment performance more so than in the recent past.

We feel that by adding a concentrated strategy investors will capture the returns of the foremost investment ideas without diluting performance with over-diversification. Based on our analysis, carefully constructed concentrated portfolios are positioned to outperform an index

Exhibit 5
The Amount of Assets in Index and "Closet-Index" Funds has Grown Dramatically since 1980



The information in the chart above is being provided for illustrative purposes only and does not represent any product or strategy managed by Lazard.

Source: Antti Petajisto, "Active Share and Mutual Fund Performance," December 2010 given that the structure of concentrated portfolios generally leads to high active share and concentrated managers are choosing their best investment ideas. In conclusion, we remain optimistic about the opportunity set for the Lazard U.S. Equity Concentrated strategy and the ability of U.S. companies to deliver revenue and earnings growth. We continue to find excellent investment opportunities, many of which are in companies that have been de-rated in spite of great results. We believe these companies not only have excellent organic cash flow, strong balance sheets, and operational flexibility, but also have attractive valuations. We feel these companies should persevere through volatility and be rewarded appropriately for their resilience when major macroeconomic concerns become less prominent, leading to favorable performance.

Lazard U.S. Equity Concentrated Team

Exhibit 6
Lazard U.S. Equity Concentrated Performance Summary

Trailing periods ending March 31, 2012 (annualized)	Lazard U.S. Equity Concentrated (%)	S&P 500 Index (%)	Excess Returns (bps)
Last 3 years	27.33	23.42	391
Last 5 years	4.86	2.01	285
Last 7 years	7.15	4.71	244
Since Inception (8/1/03)	9.99	6.27	372

As of March 31, 2012

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

Source: Lazard, Standard & Poor's

Notes

1 For simplicity, we assumed correlation throughout the hypothetical portfolio is equal to an average value across all assets; in this case correlation is equal to 0.4. Furthermore, the total portfolio standard deviation is calculated using equal weights for each stock. We should note that in a practical case, seeking low correlation between securities or computing the minimum variance portfolio, would lead to greater overall risk reduction. However, the pattern of diminishing returns to portfolio risk through the addition of more stocks would remain.

2 As of March 31, 2012. Investment characteristics are based upon a portfolio that represents the proposed investment for a fully discretionary account.

Important Information

Published on June 19, 2012.

Lazard Asset Management LLC is a U.S. 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 is a description of the composite, the performance of which appears on the preceding pages.

Lazard U.S. Equity Concentrated 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 15–35 securities with a market capitalization of $1 billion or greater.