LAZARD

Investment **Focus**

The Lure
OF EUROPEAN LARGE CAPS

Europe's investment landscape has changed. Investors' perceptions of risk and reward, which had been shaped by nearly ten years of outperformance by small- and mid-cap stocks, may need to be adjusted. Large-cap stocks, which had been overlooked in recent years, present a powerful combination of quality and value that Lazard believes may offer higher relative performance in both today's highly challenging market conditions and quite possibly for many years to come.

The Real Alpha Generators: Investors' Misguided Perceptions?

EXHIBIT 1: LARGE CAPS HAVE LAGGED

	5-year Annualized Return to 31 December 2007 (in U.S. $ terms)
MSCI Europe Small Cap Index	30.5%
MSCI Europe Mid Cap Index	25.4%
MSCI Europe Index	22.8%

Source: FactSet

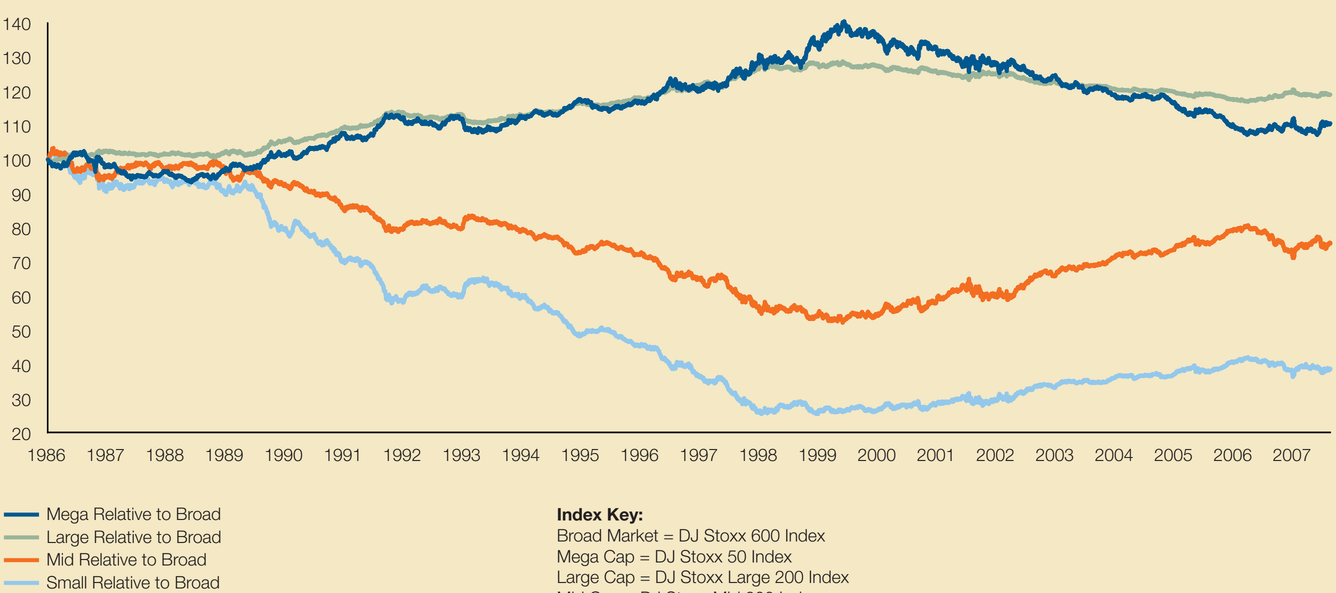
As can be seen from Exhibit 1, recent years have proved to be fruitful for European small- and mid-cap stocks. Such has been the strong performance of stocks from the small- and mid-cap areas of the market capitalization spectrum prior to 2008 that for some investors they have become synonymous with the notion of alpha; large-cap stocks, in contrast, have come to be regarded as offering a less dynamic pattern of returns. Our own anecdotal evidence of investors' contrasting attitudes to small/mid and large caps bears out this observation. A survey conducted by Lazard at a recent conference found that while the vast majority of respondents believed European small and mid caps will underperform the broad market over the next 12 months, almost all surveyed felt that they will outperform over the next 10 years. This despite the fact that, as indicated by Exhibit 2, a broader 20-year horizon shows how European large-cap stocks have outperformed their smaller counterparts over time. Compounding this bias in favor of small and mid caps, respondents also showed a broad tendency to understate their exposure to small- and mid-cap stocks and grossly underestimate the weighting of large-cap stocks within European equity benchmarks. We believe the message to be drawn from this anecdotal survey is simple: many active investors do not have enough large-cap exposure and probably still have too much small- and mid-cap exposure.

The outperformance of European small- and mid-cap stocks over large-caps stocks in recent years owes much to an investment environment that has since altered radically. In a world of very low volatility, investors' perceptions of risk were diminished. A favorable macroeconomic backdrop of consistent economic growth, low and stable interest rates, and low inflation, combined with a world awash with liquidity, led to fertile conditions for small- and mid-cap stocks, where investors did not necessarily have to distinguish between companies on grounds of quality.

Quality Comes To The Fore

Those benign conditions have gone, replaced by heightened volatility, much higher levels of risk aversion, and a far tougher earnings environment. In this new world, identifying the winners and avoiding the losers becomes a greater challenge. Investors need to be far more discerning than they were during the bull market of 2003-2007, when share prices benefited from a powerful wind at their backs. We feel investors now need to focus on quality. And it is large-cap stocks that tend to exhibit higher quality across a range of factors. Larger companies typically generate higher levels of free cash flow (see Exhibit 3), enjoy higher profit margins, and produce higher returns on capital employed than mid- and small-cap stocks, which may generally be more cyclical

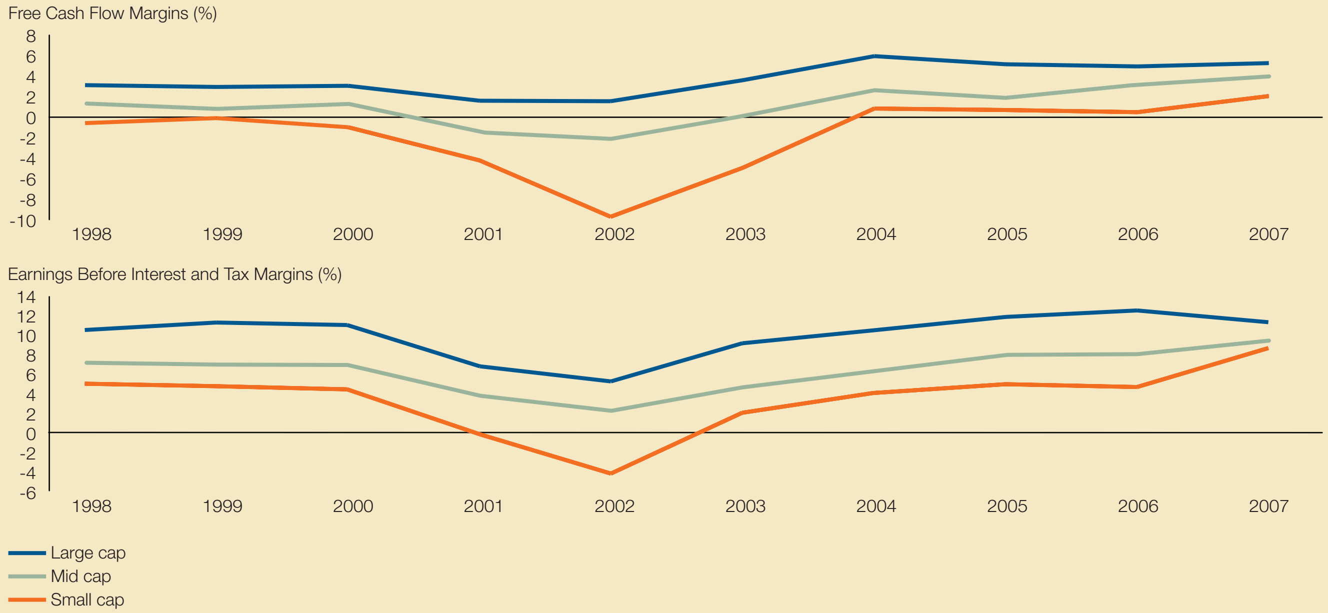
EXHIBIT 2: PERFORMANCE OF EUROPEAN SMALL, MID, LARGE, AND MEGA CAPS RELATIVE TO BROAD MARKET



Index Key:
Broad Market = DJ Stoxx 600 Index
Mega Cap = DJ Stoxx 50 Index
Large Cap = DJ Stoxx Large 200 Index
Mid Cap = DJ Stoxx Mid 200 Index
Small Cap = DJ Stoxx Small 200 Index

As of 31 August 2008
Source: DJ Stoxx
Shown for illustrative purposes only.

EXHIBIT 3: LARGE CAPS' FREE CASH FLOW AND OPERATING MARGINS COMPARED TO SMALL AND MID CAP



As of 31 December 2007

Source: MSCI, Worldscope, Morgan Stanley Research

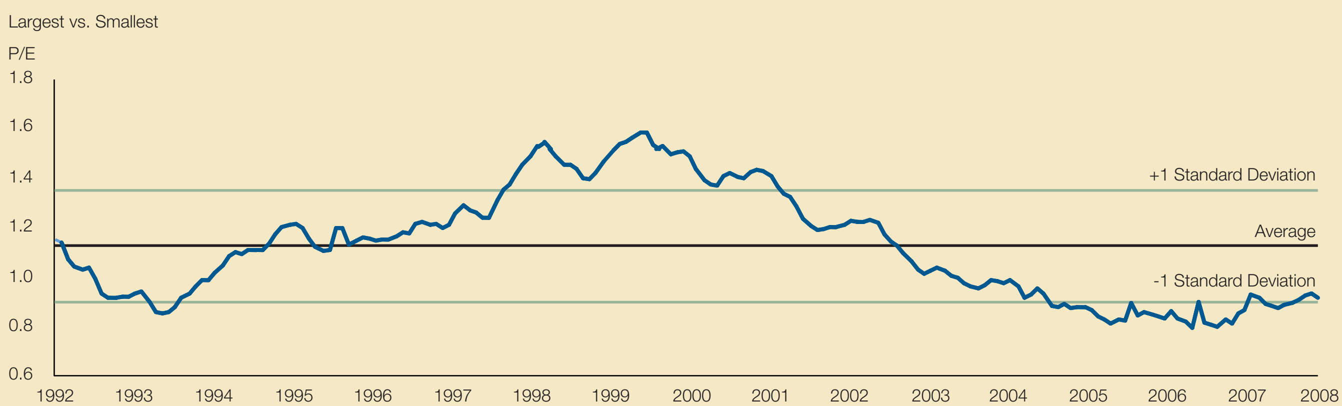
in their overall returns. Large companies also tend to benefit more from high barriers to entry, have higher asset quality, sounder strategic positioning, more sustainable returns, and stronger company management than their smaller company counterparts.

We believe that the improving relative fortunes of large-cap stocks versus small- and mid-cap stocks will probably not be a short-term phenomenon either. In fact, we think that any assumption that the valuation premium exhibited by European small-cap stocks versus large-cap stocks will unwind quickly could well prove misplaced.

As can be seen from Exhibit 4, taking the past two market cycles as a guide, this valuation differential typically takes approximately seven years to reverse. The valuation premium of small-cap stocks over large-caps stocks may have started to narrow in the past 12 months, but we feel there is still a long way to go before small caps look inexpensive relative to large caps.

Our own day-to-day experience of investing in Europe confirms the current relative appeal of large caps over their smaller brethren. Through our bottom-up, stock selection-driven

EXHIBIT 4: PROSPECTIVE RELATIVE P/E RATIO—PAN EUROPE LARGE-CAP VS. SMALL-CAP COMPANIES



As of 30 September 2008

Source: Merrill Lynch European Quantitative Strategy approach to building European portfolios at Lazard, we regularly find that small- and mid-cap stocks are more expensive than large caps, yet the companies concerned may have weaker balance sheets, less impressive management teams, and more cyclical and less sustainable business models. Value can still be found in the small- and mid-cap segments, but, unlike what was happening in the most recent past, we feel a thorough bottom-up, fundamental analysis is required to choose the winners.

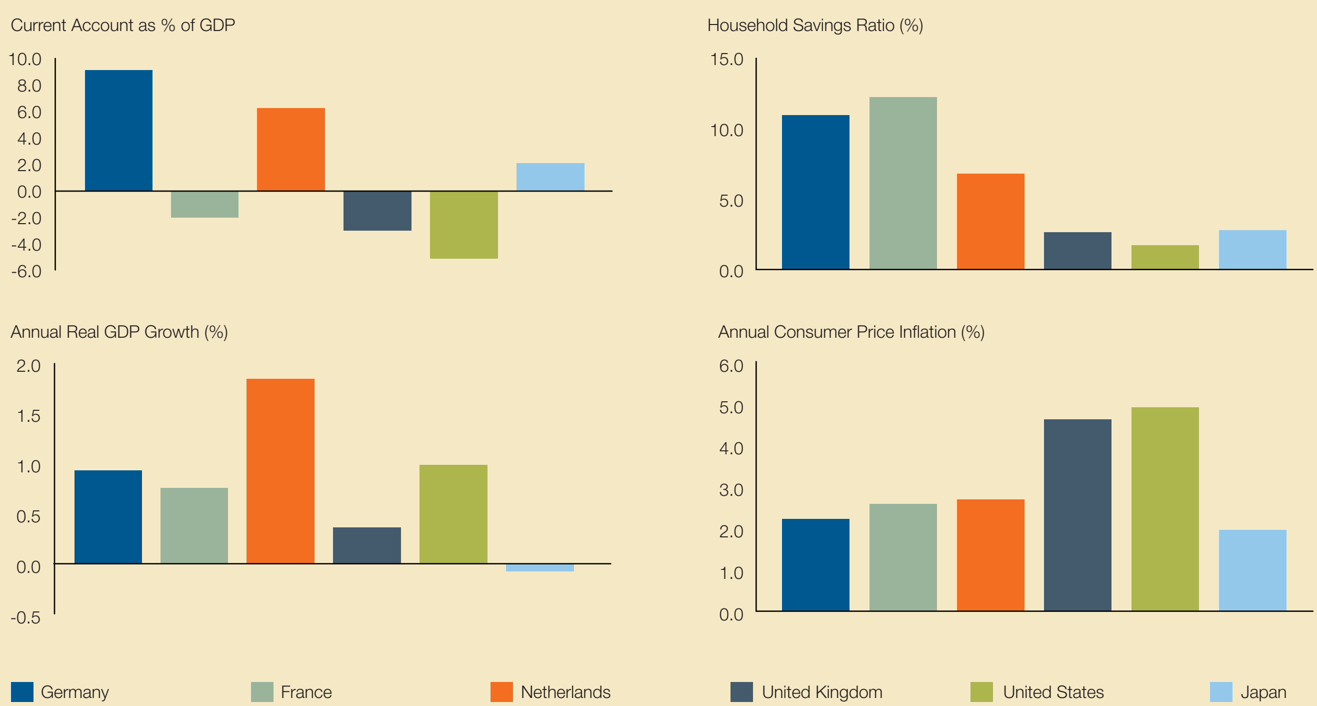
At Lazard, we are continuing to find many interesting investment opportunities in the European large-cap arena. These are companies with impressive management teams, strong balance sheets and growing business models that generate sustainable returns. Greek gambling company OPAP, which has a monopoly within the Greek gambling industry, is one such example. We believe the stock offers an attractive mix of growth and value, benefiting from the company's dominant market position, its robust growth rate, the stock's high dividend yield and the recent introduction of new and experienced management.

Europe Better Placed

The Eurozone economy is clearly now in a downturn. However, on a relative basis, parts of core Europe looks relatively well placed, compared to many other developed economies, for the far tougher global economic environment that we now face. Households in Germany, France, and the Netherlands benefit from far superior savings ratios and entered this slowdown with much lower levels of debt than their Anglo-Saxon counterparts (see Exhibit 5). These core European economies currently have lower rates of inflation than that of the United States and United Kingdom and, in the case of Germany and the Netherlands, current account surpluses rather than deficits. Furthermore, Europe's corporate tax environment has become less punitive in recent years, while an improving dividend culture has taken root, as European companies become more shareholder-friendly and dividend policies become more explicit, with an increasing focus on sustainability and growth.

At Lazard, we believe European large-cap stocks are better positioned than smaller European companies for relative outperformance in this tougher economic and market environment. Despite selling off heavily over the past year, as risk aversion levels have risen, European small- and mid-cap stocks still look overpriced relative to large-cap stocks on an historic basis. Large companies have a proven capacity to generate more sustainable returns through a full market cycle, while the levels of debt on the balance sheets of Europe's larger companies are low for this point in the cycle. Other inherent advantages, such as the ability to profit from barriers to entry, and generally more able and experienced management teams, suggest European large-cap stocks are likely to benefit from an environment where the strong will get stronger.

EXHIBIT 5: CORE EUROPEAN ECONOMIES IN RELATION TO OTHER DEVELOPED COUNTRIES



As of 18 November 2008

Source: FactSet

NOTES:

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LAZARD

Lazard Asset Management LLC

30 Rockefeller Plaza
New York, NY 10112-6300

www.LazardNet.com