LAZARD

Investment **Focus**

THE CASE FOR Global Market Exposure

Global Market Exposure provides investors with a broad pool of investments across asset classes, thereby diversifying the variable economic inputs that drive capital market returns and, as a result, smoothing out volatility.

What Is Global Market Exposure?

Asset allocation can be described roughly as the process of dividing investments among several large and distinct asset groups in order to reduce risk and increase the opportunities for generating sound returns. It is a proven, modern framework for wealth accumulation over the long run. That said, for any quality asset allocation program to consistently meet even the minimum return requirements over an investment horizon, it should start in the best risk-adjusted position possible—a point from which, even if the actual allocation is never adjusted, it will still produce acceptable gains relative to the overall market's return.

At Lazard we discuss this optimal starting point in terms of global market exposure (GME). GME is what we consider to be a *rational* beginning: It is a raw, strategic allocation to the existing world of asset classes that reflects no biases, valuations, or relative opinions about the opportunities in the marketplace. The investment community at large, in effect, sets this allocation, since it is based on the world market shares—or market capitalizations—of the separate public capital market asset classes.

The rationale behind GME is both intuitive and responsible: Specifically, GME is an allocation to the various asset classes in the same proportion that the rest of the world owns those assets.

In a way, GME can be considered the underlying passive component of an asset allocation program. This brings up the concept of the *efficient frontier*, a breakthrough formulation of the economist Harry Markowitz. Markowitz theorized that the "market" portfolio—an idealized construction of the range of assets and market weights available to investors—is on the efficient frontier, the point at which expected returns are optimal for a given level of risk. Related to this is the idea that markets are efficient, whereby all available information is priced into the market and, hence, no smaller set of information can consistently beat the market. This is a key rationale behind the passive buy-and-hold formula: Buy the market, own an efficient portfolio, sit back, wait, and, in time, cash in. It is in this way that GME, since it is a representation of the world's capital markets, is a good portfolio, in and of itself. GME provides investors with a broad pool of investments across asset classes, thereby diversifying the variable economic inputs that drive capital market returns and, as a result, smoothing out volatility.

Of course, the question is not only whether those returns will be high enough to meet expectations, but also whether an investor will have made the most of the opportunities presented by the markets over time. However, in terms of a starting position, we at Lazard agree that the global market portfolio is a solid proposition. In fact, to own the market portfolio, or more expressly, GME, is to preserve purchasing power relative to the world as a whole. Think of it this way: By owning the world allocation to the available asset classes one is assured of performing on par with the world. Yet since world performance is average and average cannot exceed itself, GME is locked into average performance—no less than the average upward trajectory of the market, but certainly no more.

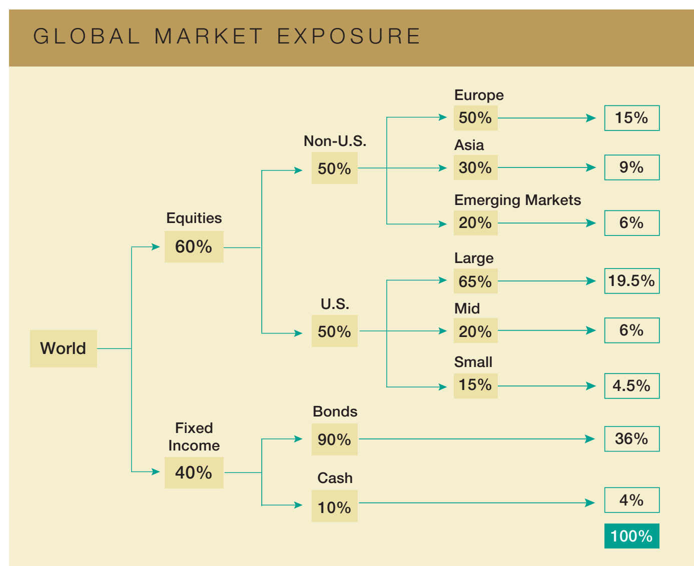
Building a Neutral GME

There is a good reason why global market exposure is categorized by broad and significant asset classes—stocks/bonds, domestic/international shares, large caps/small caps—and the market-cap breakdowns of those classes. GME needs to be both representative and easily investable.

Today there is no shortage of broad-based investment vehicles—such as index funds and exchange traded funds (ETFs)—that allow for targeted allocations within the pair-wise asset-class breakdowns mentioned above. And again, the current market caps, or market shares, of the different asset classes are what determine GME. So to build a GME within a starter portfolio, all one needs to do is purchase index funds and/or ETF products in the same proportion as the existing world market shares of the major asset classes.

In the public capital markets, the capitalization distribution between equities and bonds runs 60 percent equities, 40 percent bonds. This is a long-term phenomenon that represents investor demand for assets as well as the proportions by which the world chooses to capitalize itself. Thus, a neutral GME would begin with a classic 60/40 stock/bond split.

This process continues seamlessly with the subdivision of assets by region, capitalization, and duration. And again, since these breakdowns are large and significant, they can be represented in a portfolio with ease. Additionally and importantly, these breakdowns allow Lazard to make the relative value calls that can be critical to a portfolio's performance—or *outperformance*.



An Essential Foundation

Left alone, GME is a reasoned, efficient, passive, low-cost, long-term allocation to the world of investments—an allocation on par with the world distribution of assets that can *only* guarantee average results. However, when considered a benchmark that can be periodically adjusted based on one's convictions about the expected movements of major asset classes, GME becomes a springboard toward returns that can be *in excess* of average.

In and of itself, GME is an unexceptional foundation; simply, there is no additional value represented in a GME since it is the market itself. In the financial phraseology, a neutral GME would exhibit a beta of 1, beta being the systematic risk inherent in the market, and that a value of 1 represents 100% of the average market return, whether the market is headed up or down. At any given time, however, asset classes may exhibit betas in excess of 1, meaning they would perform with a greater (or exaggerated) sensitivity to the market. As a matter of course, pinpointing an asset group with a high beta (in excess of 1) when the overall market is rising is a desirable end, while avoiding high-beta asset groups during down markets is equally advantageous. While the static GME, strictly speaking, is not able to capture this above-average market return over the long run, reasoned and periodic adjustments within a portfolio that is based on a GME should be able to.

This is exactly why global market exposure is so essential to Lazard's asset allocation process: It is the optimal risk-adjusted position off which all active decisions can be made—a predetermined set of levers that can be "tilted" at periodic intervals in order to seek *above-market* returns.

Beta decisions are a large part of this tilting process, as are alpha calls. Alpha is the commonly used measure of the risk-adjusted outperformance of an asset in relation to a benchmark. It is, indeed, the true "extra" in investing, over and above the market return. Typically, alpha is rigorously pursued by way of a range of alternative, non-traditional, and uncorrelated investments, and it can be considered the definitive measure of active investing. Yet GME once more becomes the best risk-adjusted position off of which to pursue the alpha extra that exists in the market.

Simply, without the framework of a GME, a portfolio lacks the best-possible foundation on which to graduate from average (beta of 1) to above-average (beta + alpha) investing.

The Secular Rationale for Adjusting a GME

Outside of the active, tactical adjustments that periodically can be made within a portfolio, GME also can change. In fact, it must change from time to time. If the world allocation to the various asset groups shifts in an enduring manner, a GME should reflect that adjustment—but "enduring" is the operative word.

GLOBAL MARKET EXPOSURE ANALYSIS

Risk Return Table - January 1987 - June 2007: Annualized Summary Statistics

	Return (%)	Standard Dev (%)	Downside Risk (%)	Sharpe Ratio
Merrill Lynch 91-day Tbill Actual Price	4.90	0.60	0.43	0.3638
Lehman U.S. Aggregate Bond Index	7.21	4.06	2.97	0.6238
S&P 500	11.87	14.75	11.25	0.4870
MSCI World Index	9.68	14.36	10.85	0.3609
Lazard Global Market Exposure Study	10.00	8.56	6.56	0.6215

Source: Zephyr StyleADVISOR
As of June 2007

The global investment markets are in a constant state of flux, with the market shares of well-defined asset classes and international locales gaining or falling by degrees all the time. Cyclical changes are the norm, and for a GME to be a useful benchmark it must remain stable in the face of these shorter-term shifts. However, if the global investment environment exhibits secular, longer-lasting change, a GME should be adjusted to reflect this new, neutral position.

Of course, cyclical and secular can be hard to tell apart, which means that maintenance of a portfolio's GME will at times require judgment calls.

The Japan boom of the 1980s is instructive in this regard. Across the 1960s and 1970s, Japan exhibited exceptional growth, and when the Japanese economy continued to expand in the1980s, many believed the Rising Sun had risen for good. In particular, a strong and strengthening yen attracted a vast amount of capital to Japan; investment in Japanese stocks and real estate surged to unprecedented levels, while claims of "Japan, the new economic powerhouse" became commonplace. What a difference a few years can make. By the early 1990s, Japan's GDP growth had petered out, its stock market had collapsed, land prices had plummeted, and its banking system had caved in. The Japan boom of the 1980s, rather than being a secular event, was nothing but a cyclical bubble—one of history's most infamous.

In contrast, the emerging-markets story of the twenty-first century is a momentous *secular* shift. Generally speaking, the emerging markets—what we consider to be the less-developed world locales—have made great economic strides in recent decades as

democracy and free trade have spread across the globe. Added to this, the developed markets can be considered the demand that drives the emerging-market supply. So, if one believes the fundamentals for sustainable world demand are in place—as we at Lazard do—then it follows that the emerging markets will enjoy a solid customer base for the foreseeable future. Finally, the ascendancy of China (as well as India) on the world stage has been a tectonic event. In terms of sustainable output, GDP growth, and investment potential, China appears to be a true standout. And should the Chinese government continue to take steps toward regulatory and economic reform, the country will remain a powerful engine of ongoing global growth.

We will note here that GME is not intended to be a perfect reflection of the market caps of the world's current investment opportunity set. However, in our view, it remains a rational, strategic, and stable first step in the asset allocation process. When secular changes assert themselves, we will adjust our GME accordingly. And when cyclical changes occur in the global markets, we will let our GME stand.

Global market exposure is both an important theory and an essential tool for Lazard and its Capital Allocator Series. It represents our opportunity set, in total, and forms the basis for our active decision-making. In and of itself, it is a portfolio, but from there it becomes the benchmark by which we measure the success of our active decisions. In a good sense, it holds our investment thinking together, giving it critical shape as we look to add value to a portfolio—and hence above-average returns.

NOTES:

Foreign securities may be less liquid, more volatile, and less subject to governmental supervision than in the United States. The values of foreign securities are affected by changes in currency rates, application of foreign tax laws, changes in government administration, and economic and monetary policy.

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