Letter from the Manager

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Outlook on Global Equity Income

After experiencing weakness following US Federal Reserve (the Fed) Chairman Ben Bernanke's suggestion of potential future "tapering" of quantitative easing efforts, global markets rebounded strongly in the third quarter. Better-than-expected economic reports and the surprising decision by the Fed to not taper in mid-September saw markets recoup much of the second quarter's losses. The decision not to taper surprised market participants and led to speculation that a lack of confidence in the US recovery or a desire to reduce emerging markets currency volatility may have contributed to the Fed's decision. Political risks continued to be a potent theme with the German elections occurring during the quarter, signs of weakness in the Italian coalition emerging and the potential for a sovereign debt default and shutdown of the US government in the upcoming quarter. But markets for the most part overlooked these issues and focused on the improving global economic outlook which led to a rotation into the more lowly valued regions of the world, such as the EM and Europe, as well as into the more lowly valued cyclical sectors, such as materials, industrials and consumer discretionary.

The potential impact of a reduction in US quantitative easing on regions as well as individual companies has been the key determinant of price performance in recent months. Groups that benefited from the low short term rate environment, such as Real Estate Investment Trust (REITs) in the US which were able to reduce interest costs through refinancing, had been strong performers in recent years, but have corrected sharply in recent months. Conversely, life insurers rallied on the news, having been hurt by the recent low rate environment, as it became difficult for them to generate the returns promised to existing policyholders. Since the Lazard Global Equity Income strategy seeks to avoid investing based on forecasts of unknowable macro variables, such as interest rates, we have maintained a blend of fundamentally attractive companies with different rate sensitivities to reduce the overall portfolio's exposure to rate changes. Within REITs, we have focused on more cyclical companies that will benefit from a stronger US economy through higher occupancy and higher rents, partially offsetting an adverse impact from rate rises. In addition, while the sharp increase in longer term interest rates has reduced the attractiveness of REIT dividend yields, the spreads between their yields and government bond yields remain attractive compared to historical norms. While European insurance holdings have rerated materially and no longer trade at deep discounts to book value, they remain attractively valued compared to their Return on Equity (ROE) and offer robust and sustainable yields.

Of course, high yielding equities in general tend to be sensitive to changes in interest rates competing, as they do, with bonds for capital from income seeking investors. However, the sensitivity to rate changes varies widely among different types of high yielders. More defensive, larger cap, high yielding stocks tend to be far more sensitive to rate changes than, for instance, cyclical smaller cap stocks. This is because dividends from mega-cap defensives are a far more appropriate substitute for a bond than a dividend stream from a cyclical. Quantitative easing has driven investors from the bond market to the equity market in search of yield, driving up the valuations of higher yielding defensive stocks, as well as increasing those stock's sensitivity to rate changes. For instance, high yielding US stocks from more defensive sectors (healthcare, utilities, telecom services, consumer staples) trade at a substantial P/E premium to the broad US market while these mature, slow growing businesses have historically traded at a substantial valuation discount. In addition, these high yielding US equities are moving increasingly in lockstep with changes to interest rates, as investors buy them for the yields, rather than based on valuation and fundamentals. This leaves them vulnerable to further rate rises, particularly given their extended valuations. Examples of such stocks include tobacco companies and US telecoms, which have lagged the broad market since rates began to rise, but we feel this trend has much further to go before valuations approach historical norms.

The global economic recovery that started with the improvement of the US housing market roughly 18 months ago has now broadened, with Europe recently emerging from recession and Chinese growth showing signs of stabilization. This synchronised recovery is a clear positive for equity markets globally and it has led investors to begin to return to equity markets after consistent outflows since the financial crisis. Emerging markets equities have the most to gain from this recovery as they possess the lowest valuations globally and companies are often export-oriented with substantial operating leverage. However, the potential end of quantitative easing in the US has triggered currency weakness and capital outflows have weighed on emerging equity markets. While currency weakness will increase inflationary pressures in these economies, potentially leading to rate hikes which slow growth, investors don't seem to appreciate that the emerging countries are in a much better position to deal with tightening US monetary policy than in previous cycles. Emerging markets currencies pegged to the US dollar and corporate borrowing in foreign currencies both contributed to economic turmoil during the late 1990s Asian crisis, but far fewer countries peg their currency to the US dollar now, and companies are far more careful to borrow in the same currency where revenues are generated. The Fed's decision to not taper in September gives these countries more time to adjust to an environment of less abundant liquidity, while the aggressive quantitative easing in Japan will also offset a decline

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in liquidity from the US. And while it is clear that many emerging markets countries need to shift from export-driven to domestic consumer-driven growth, exports remain a key driver of growth in these economies and they will benefit materially from the economic recoveries in the US and Europe. Our valuation-driven process has led the strategy to have a heavy exposure to the emerging markets and a relatively modest exposure to the US. While this positioning has been detrimental to returns year-to-date, it began to benefit returns during the third quarter, and we expect it to continue to enhance performance.

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