



## EDITION 7

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## A Return to "Normal"

This past September marked the one-year anniversary of the financial crisis. An array of articles and news segments took a look back at the events of that chaotic period, which worsened the downward turn of the equity markets and intensified an already serious recession.

Given the fears that prevailed at that time, it's actually quite gratifying to consider where we are today. Government intervention, while costly, appears to have helped avert economic collapse and the credit markets, once dysfunctional, have essentially returned to normal. Indeed, it seems that we may have already emerged from the recession with most forecasters expecting positive GDP growth for the third quarter. Meanwhile, the stock market, after dropping to March lows, has regained substantial ground, although remaining well below 2007 market highs.

At Neuberger Berman, our portfolio managers relied on experience and investment discipline to weather the chaos of the last year and position client portfolios for a recovery. Today, as an independent, employee-controlled investment management firm, our mission is clear and straightforward: to partner with you to achieve your investment objectives. This means adhering to investment processes, paying careful attention to risk and providing the highest level of client service. Although less turbulent times have arrived, we understand the trust you have placed in us and will remain vigilant as we seek opportunities on your behalf.

### MARKET RECOVERY CONTINUES

In the last issue of *Investment Quarterly*, we described a dramatic change in market sentiment as investors moved from panic about the potential for economic collapse to relief that disaster had been averted. The result of this changing sentiment was a sharp two-month rally of 37% in the S&P 500 off the March 9 low. Following the initial rally, the S&P 500 maintained a tight trading range for nearly three months, which included a slight retrenchment in late June and early July. Equities continued their upward movement in July, this time a reflection of improving fundamentals and signs of a broad economic recovery. Since July 10, the S&P 500 has risen over 20% and now stands 17% higher from the start of the year.<sup>1</sup>

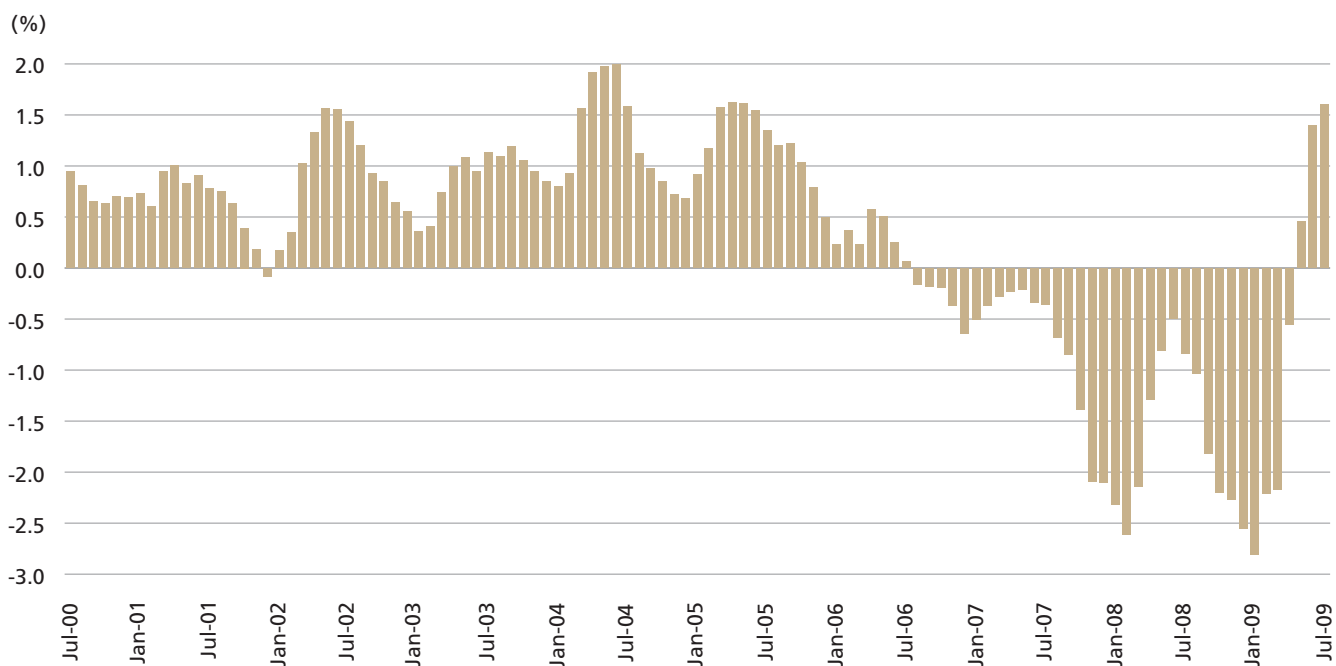
<sup>1</sup> As of September 30, 2009.

In the past, there have been periods of market strength that appeared unjustified by economic fundamentals, and those rallies ultimately failed. However, we believe that support for recent gains and continued upward movement in equities comes from numerous sources:

- **Manufacturing trends**—The U.S. manufacturing sector, as measured by the Institute for Supply Management’s (ISM) manufacturing composite, is now expanding for the first time in 19 months. According to ISM, New Orders far exceed Inventories, which bodes well for an increase in production for the remainder of 2009 and 2010.
- **Improving real estate market**—The real estate sector is showing moderate improvement, as reflected in three straight monthly increases in residential home prices in May, June and July—something that has not occurred since 2006. New sales volumes have also been on the rise for five consecutive months through August while mortgage rates remain near historic lows.
- **Stabilizing labor market**—Although the unemployment rate remains high, job losses continue to slow, averaging 256,000 per month in the third quarter compared with 428,000 in the second and 691,000 in the first.
- **Positive leading indicators**—The leading economic indicators developed by the Economic Cycle Research Institute (ECRI) currently show pervasive, rapid growth, with the Institute’s long-leading indicator index hitting a 26-year high.
- **Favorable supply/demand for equities**—The second quarter saw the highest volume of equity issuance in 19 years—roughly \$92 billion, much of it from financial companies seeking to improve their balance sheets. Despite the large number, however, issuance was well absorbed into the market as investors increased their equity exposure. Given our expectation for relatively low issuance moving forward, we believe that supply/demand for stocks should remain healthy.
- **Normalizing credit markets**—The absence of credit was a huge pressure on many companies in the wake of the financial crisis. Today, the credit markets are far more accommodating. Prices for high yield securities have increased to 90% of par (face value), compared with 55% last December, and the difference in yield between investment-grade bonds and Treasuries has returned to pre-crisis levels. Given the price gains that bonds have realized, we are seeing relative value in the equity markets.

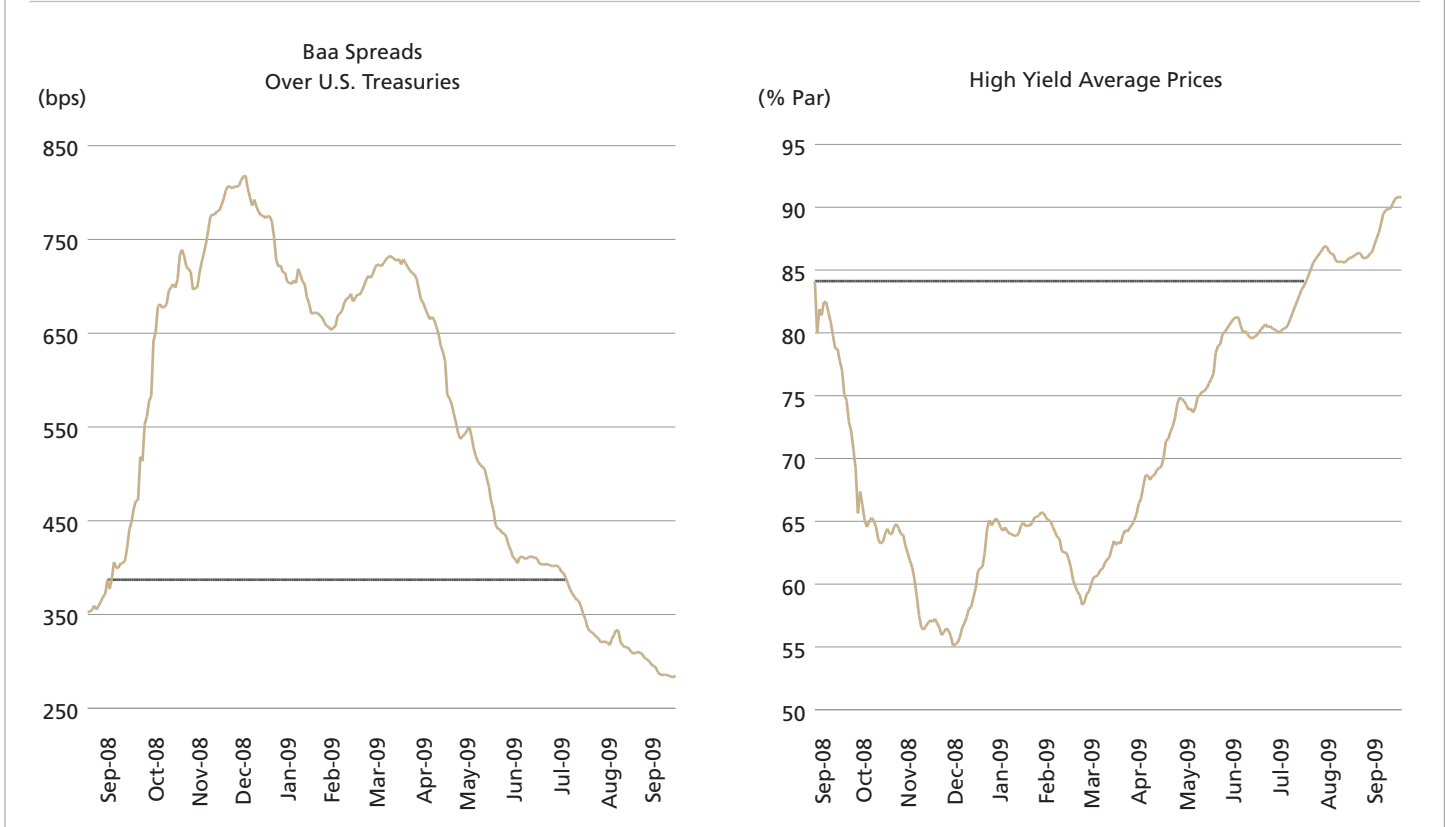
**FIGURE 1 — U.S. RESIDENTIAL REAL ESTATE SHOWING SIGNS OF A RECOVERY**

Case-Shiller Home Price Index: Month-over-Month % Change



Source: Standard and Poor’s. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. Past performance is no guarantee of future results.

**FIGURE 2 — CREDIT MARKETS BACK TO PRE-CREDIT CRISIS LEVELS**



Source: Barclays Capital. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. Past performance is no guarantee of future results.

Overall, we agree with consensus estimates that the third quarter will see positive economic growth—the first time that has happened since the second quarter of 2008. Moreover, the latest quarterly earnings season indicates to us that earnings have troughed, and that many companies are well positioned to benefit as the economic environment improves. During the economic downturn, companies were aggressive in cutting costs and reducing inventories. As a result, we believe there is considerable operating leverage (with additional revenues generating higher growth in operating income) and, thus, the potential for higher profit margins moving forward.

Despite all these positive trends, we are not anticipating an economic boom by any means. As we've said in the past, the withdrawal of cheap credit and losses in the real estate and financial markets have severely hindered the spending power of consumers. And although the labor market is stabilizing, unemployment will probably remain high as job growth lags in our current economic recovery.

As such, we anticipate that consumers will go through an extended period of “deleveraging” as they mend household balance sheets. Recent statistics are not encouraging. For

example, consumer credit outstanding plunged by a record \$21.6 billion in July—the sixth consecutive decline—following a \$15.5 billion drop in June. Of course, increased savings will help households replenish their nest eggs but, from a growth standpoint, represents a long-term negative offset to the economic benefits of government stimulus.

### INVESTING FOR RECOVERY

Given the pressures faced by domestic consumers, we believe that the current recovery is most likely to benefit cyclical business sectors such as energy, technology, industrials and materials. Companies with exposure to foreign markets, recovering commodity prices and stimulus infrastructure spending should be particularly well positioned. In our opinion, consumer discretionary businesses will have a difficult time, suggesting that consumer staples companies (which sell goods needed even during times of weakness) are a more secure alternative. Still, it bears noting that emerging market populations are far less debt-laden than their established market counterparts, potentially benefiting global firms with greater exposure to emerging market consumers.

In terms of asset allocation, recent share price gains have come from across the equity markets, but the most pronounced strength domestically, as of late, has been in value and small-cap stocks. On the fixed income side, high yield bonds have been standouts. These are areas that traditionally outperform early in an economic recovery, and we believe that they will continue to show leadership for the near future. Although individual portfolios may vary depending on the investment needs of the client, we think it makes sense to maintain exposure to these areas within a diversified portfolio.

Overall, we believe this is a good time to be an equity investor. Equity markets have experienced substantial gains since March as the real estate, labor and credit markets stabilized and investors recognized the beginning of an economic recovery. Although valuations have crept up, we believe that they are reasonable when taking into account earnings projections for next year. Our portfolio managers are finding what they consider to be compelling investment opportunities in the current environment. Still, no one can predict the short-term swings of the market, so we believe that maintaining a long-term perspective, aligned closely with individual investment goals, continues to be crucially important.

Recent changes in the macro environment provide a valuable reminder that identifying overarching trends can be just as important to investing as bottom-up research. Along these lines, I think you'll be interested in our next article, authored by Neuberger Berman's Paduano Group. Over the years, this team has developed a "thematic" investment approach that capitalizes on secular changes, including advances in technology and demographic shifts. Also in this issue, Matthew Rubin, director of investment strategy, discusses the merits of active investing and offers some compelling arguments as to why experienced portfolio managers are well positioned to navigate today's difficult markets and generate favorable risk-adjusted returns.

As always, we hope you find insights in our newsletter. Please contact your Neuberger Berman representative if you have any questions about what you read or suggestions for future articles. ■



**JOSEPH V. AMATO**

PRESIDENT, CHIEF INVESTMENT OFFICER—EQUITY  
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# Thematic Investing: Forecasting Tomorrow's Forecast



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What are the themes that have shaped civilizations? Throughout history, themes such as the control of natural resources, dominant societal trends and shifts in demographics have emerged as critical players in the success or failure of many of the world's societies and economies. Access to a dependable water supply, for example, has been a recurring theme throughout history. For ancient civilizations, water enabled the development of agriculture, trade, permanent settlements and, later, cities. Today, water remains an important but increasingly strained resource as population growth and industrial development increase demand and an aging infrastructure reduces societies' ability to meet it.

In many ways, financial markets are a reflection of these ever-changing global secular trends. More dynamic than a typical mirror, however, financial markets at times price in assumptions well ahead of a trend and at times lag behind them. As a theme achieves broad acceptance, it often is exploited in the market. Until then, it may represent an investment opportunity.

Thematic investors study these trends and where the market is in relation to them, then position their portfolios ahead of the market's recognition of the trend with the goal of achieving attractive rates of return. Put simply, thematic investing is about attempting to "forecast tomorrow's forecast."

Thematic portfolio managers attempt to capture excess returns by making investments in the path of developments before they unfold. This "top-down" investment approach begins at the highest levels with an attempt to understand the way in which the world works and, based on that under-

standing, find sustainable trends and the companies that will benefit from them.

Thematic portfolio managers typically follow an unconstrained investment approach that permits investing across market capitalizations, styles and the geographic spectrum, all based upon where the prevailing themes lead. In essence, a thematic portfolio manager has the flexibility to pursue any opportunity within a theme.

Identifying themes requires thinking and study away from Wall Street. At the Paduano Group, we actively study a range of foreign affairs, scientific, historical and social theory books and journals, industry trade publications and a host of other periodicals. In addition, we maintain an ongoing dialogue with professionals across a broad spectrum of industries and geographies. We observe the world through the insights we glean and seek to identify global trends: major societal and demographic shifts, evolutions in technology or changes in the demand for certain products and services. Hence the discovery of themes becomes our initial stepping stone for further research. The themes serve as our screening tool for investments and a foundation for investment conviction.

*"In the field of observation, chance favors only the prepared mind." —Louis Pasteur*

Professional investors are regularly inundated by peers and colleagues with compelling investment suggestions spanning the gamut of industries and end markets. A thematic approach emphasizing a deep knowledge of prevailing multi-year themes can help in sifting efficiently

through the myriad of recommendations. By knowing where we want to be, it maximizes our capacity to focus our time and attention only on those investment ideas that are well positioned to benefit from dominant secular trends.

*“If you don’t know where you’re going, any road will get you there.” —Lewis Carroll*

The thematic approach emphasizes opportunity, not limit. Once trends have been identified, thematic investors seek those investments that represent the most compelling direct or indirect beneficiaries. For us, the “most compelling” are those we believe will provide the most attractive risk-adjusted return opportunity over a three- to five-year period. We make this assessment regardless of market capitalization, geographic location or style characterizations based on rigorous quantitative and qualitative analysis, comparing all thematically relevant investment candidates with one another.

While the importance of particular financial metrics can vary by industry, we emphasize cash-on-cash rates of return on invested capital over our investment horizon. We seek businesses that will have visible and predictable streams of cash flow and underappreciated levels of operating leverage. Our entry price for an investment is the level at which we would be willing to own the entire company based upon future free cash flows. The discipline of buying only at a price at which you would theoretically cede market liquidity is a powerful means of mitigating downside risk.

High-caliber management teams improve the odds of consistently excellent performance. With every investment, knowing the jockey is as important as knowing the horse. We spend time getting to know management and specifically evaluating their ability to execute their stated operating objectives. We work to understand the market potential of their strategy and whether their long-term plan puts them in the path of the theme to which we seek exposure. Through the combination of our quantitative and qualitative work we seek to answer the question: Does the company have a competitive edge and the capacity to be best in class?

This approach has demonstrated success over the long term, yielding attractive results on a 1-, 3-, 5- and 10-year basis. During periods of market turbulence, our process truly demonstrates its strength as a well-researched set of themes can serve as the wind at our back. The recent global economic contraction and credit crisis, for example, dramatically slowed the development of certain themes, and the prices of many securities in our portfolio suffered.

Testing and retesting our themes in the midst of this crisis provided us with confidence in our convictions and acted as a lighthouse on the horizon for our portfolio of holdings. As the crisis has, in our view, abated, our theses have emerged as relevant and intact as prior to this period. We were able to weather the storm confident in the belief that our companies would emerge as among the best-positioned to reaccelerate out of the downturn, given their respective exposure to key overarching themes.

#### FIGURE 1 — CURRENT INVESTMENT THEMES

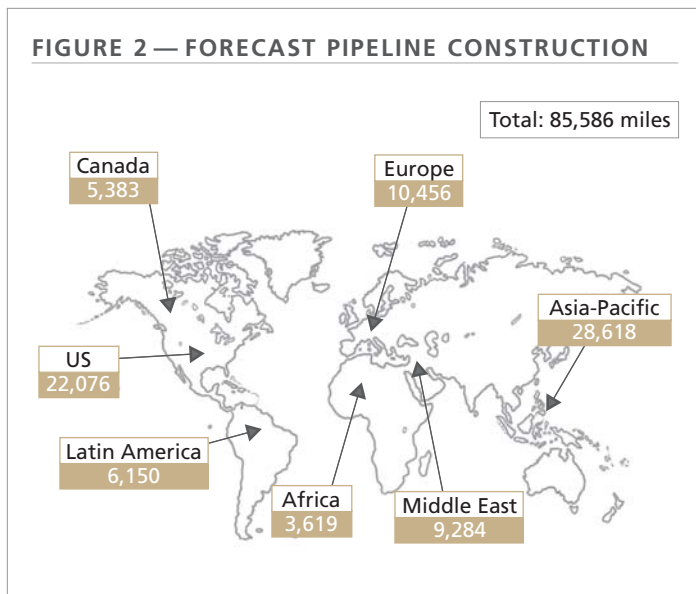
- Health and well-being: Rising global demands
- Energy: Delivery requires infrastructure investment
- Personalization of media: Voice, video, data, anytime, anywhere, any device
- Water: An undervalued resource
- Emerging global consumer: Developing world incomes on the rise
- Pets: The newest member of the family
- Education: Crisis in America

Figure 1 outlines the themes represented in the portfolios today. We highlight three of these themes below to illustrate how they evolved and how we are positioning investments to capture the theme while reducing risk.

#### ENERGY INFRASTRUCTURE

In 1998 oil prices hit \$10 a barrel. Based on replacement and finding costs reported by oil producers, we believed this price was unsustainable and that higher prices would materially improve the profitability of these companies. We took advantage of this theme in our portfolios over the next seven years through an allocation to energy based largely on exposure to the producers.

As the thesis matured, we began to ask ourselves, “What’s the next turn of the screw?” It was becoming apparent that we were starting to run low on cheap oil and gas, and producers were increasingly forced to go further afield to find and deliver the resource. Our conclusion in the summer of 2005 was that, having spent very little in the prior decade on infrastructure, the exploration and production companies, now awash in cash, would once again embark on significant infrastructure projects. Digging deeper, we identified hundreds of billions of dollars in energy infrastructure projects that need to be completed over the next five to 10 years. Figure 2, for example, shows a global forecast of oil and natural gas pipeline construction projects.



Source: "Global Pipeline Plans Expand," Pipeline Editor Christopher E. Smith, Survey Editor Leena Koottungal, *Oil and Gas Journal*, February 18, 2008.

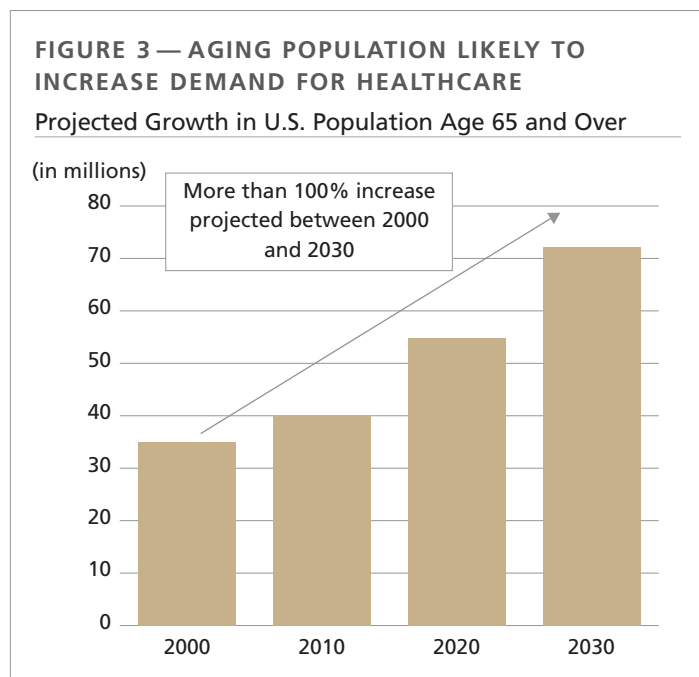
In the meantime, backlogs were just beginning to build and the markets were still debating the price of oil going to \$140 or \$200. At this point the energy infrastructure theme began to take shape in the portfolios. Proceeds from successful investments in the oil and gas producers were slowly migrated to energy infrastructure companies (those that build pipelines, LNG facilities or make the compressors that are a required component of both). Sure enough, project announcements accelerated and a shortage of resources led to solid pricing power and cash flow growth for these energy infrastructure companies over the subsequent years.

We believe the energy infrastructure thesis remains intact today, though it was temporarily disrupted by the global recession and credit contraction. In addition, over the past two years we have begun to focus on what we believe will be the next turn of the screw: alternatives, renewables and conservation. We envision that over the next five years our energy exposure will increasingly include companies focused on both saving energy and producing energy in alternative ways to the traditional fossil fuels.

#### HEALTH AND WELL-BEING: RISING GLOBAL DEMAND

Shifting demographics have an enormous impact on a country's economy and the demand for goods and services. Demographics suggest that the demand for healthcare products and services will rise exponentially over the next seven to 10 years. In many developed societies, including the U.S., the population is edging toward the oldest, best-educated and wealthiest the world has ever seen (see Figure 3).

Meanwhile in emerging economies, rising consumers are gaining increased access to healthcare as incomes and availability of services improve.



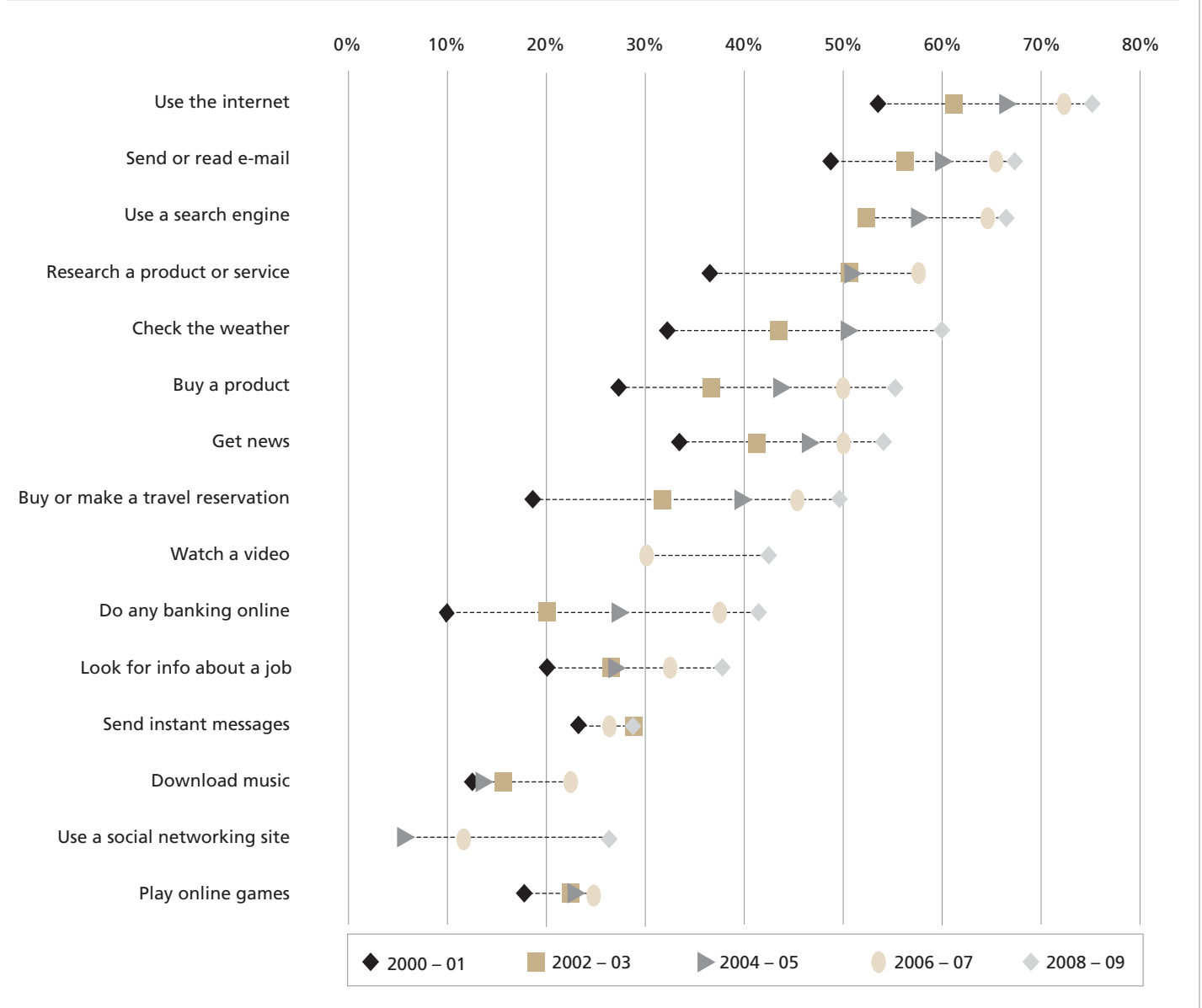
Source: U.S. Census Bureau, <http://www.census.gov/population/www/projections/summarytables.html>

However, with global pharmaceutical companies continuing to face a wall of patent expirations and ever-present generic competition, we believe the group fails to present truly compelling multi-year investment opportunities. The biotechnology industry, while blessed with a number of exciting compounds, carries a great deal of risk as even the scientists have difficulty identifying the next great drug that will make it through the gauntlet of research trials and an unpredictable FDA.

Nevertheless, there exists an underlying trend that we think is very investable: the shift from chemically based to biologically based compounds. This shift, still in its earliest days, will likely require an important change in the way the research, development and production of these next-generation biologically based compounds is completed. As a result, we are investing in companies that enable the emerging techniques: companies that provide equipment, media, reagents or outsourced research services. These are companies that we think of as "toll bridges" that provide exposure to the theme while mitigating certain risks inherent in them. In this case, these companies offer limited drug-specific risk, but are critical suppliers to both large pharma and biotech as this secular shift unfolds.

**FIGURE 4 — INCREASE IN ONLINE ACTIVITY (2000-2009)**

The percentage of all American adults (including both internet users and nonusers) who have done the following activities during the indicated two-year period.



Source: Pew Internet and American Life Project, <http://pewinternet.org/Trend-Data/Daily-Internet-Activities-20002009.aspx>, accessed on September 21, 2009. These data represent the average total participation in each activity over the two-year period. Therefore, they may not exactly reflect the combined yearly tracking numbers. The wording of some questions may have changed slightly over time.

**PERSONALIZATION OF MEDIA**

Highlighted by the success of Apple’s iPod and Digital Video Recorders (DVRs), the delivery of media and communications services is undergoing a transformation and is increasingly moving toward devices and services tailored to consumers’ preferences. We anticipate that over the next few years, telecom and cable companies will continue to compete with one another to offer suites of advanced services and applications to meet the evolving demand for personalization: voice, video and data, accessible anywhere, anytime, on any device.

Through our research we believe one thing is evident: Significant dollars will be spent over the coming years on products and services to enable next-generation personalized media. As this trend accelerates, we anticipate that new tools, systems and infrastructure will be required to enable consumers, armed with choices, to access the content and applications they desire anytime and anywhere. Increasing bandwidth; digital content storage, security and management; and operational and billing support for next-generation services are just a few of the areas that we anticipate will benefit from this underlying trend toward made-to-order media.

## LONG-TERM APPEAL OF A THEMATIC APPROACH

Over the course of history, wars have been fought over control of resources. Societies have risen and fallen based on shifting demographics. Technological innovation has enabled dramatic economic growth. In our view, successful investing requires foreseeing these changes and positioning a portfolio's assets to profit from them at the highest, risk-adjusted return. Identifying and investing in global secular themes that will last long enough to impact investment returns inherently mitigates risk by putting the wind of secular developments at an investor's back. Thus, these global secular trends become the screening device and pathway to specific investments in the businesses deemed most likely to profit from them. Businesses that are located along that pathway and that have the management capability to execute effectively are the focus of our investment process. By remaining focused on these

trends as they evolve over time and choosing investments without regard to market capitalization, investment style or geographical location, we believe our thematic approach is ideally positioned to yield results for investors. ■

***Daniel Paduano, CFA**, is the senior portfolio manager of the Paduano Group, which offers thematically based all cap core and concentrated core strategies. He has been with Neuberger Berman since 1977 and has 41 years of industry experience.*

***David Wilson, Jr., CFA**, is a portfolio manager in the Paduano Group. He joined Neuberger Berman in 2007 and has 36 years of industry experience.*

***Sherrell (Jay) Aston, Jr.**, is a portfolio manager in the Paduano Group. He joined Neuberger Berman in 1997 and has 13 years of industry experience.*

This material is intended to be a broad overview of the portfolio manager's style, philosophy and process and is subject to change without notice. Account holdings and characteristics may vary since investment objectives, tax considerations and other factors differ from account to account. Portfolio characteristics are subject to change without notice.

This material discusses small- and/or mid-capitalization stocks. Small- and middle-capitalization stocks are typically more vulnerable to financial and market risks and uncertainties than large- capitalization stocks. They may trade less frequently and in lower volume than large-capitalization stocks and thus may be more volatile and be less liquid. Consequently, investments in small- and mid-capitalization stocks may not be appropriate or suitable for all investors.

Please see disclosures at the end of this material, which are an important part of this article.

# Active Portfolio Management: An Attractive Option for Today's Market



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The recent market downturn had negative consequences for many investors' portfolios. In an environment marked by severe macroeconomic stressors and unprecedented volatility, both actively and passively managed investment strategies suffered. After a year of undifferentiated performance, some investors are revisiting the debate surrounding the merits of active versus passive investing styles.

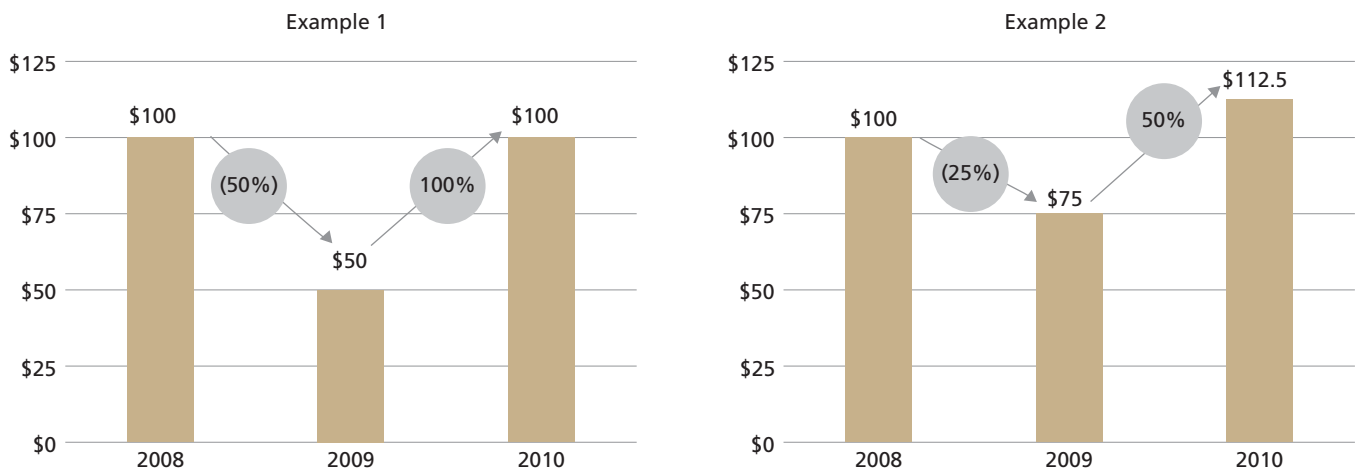
Active and passive portfolio managers approach investing from markedly different perspectives. While passive strategies such as index funds attempt to mimic the returns of the market, active managers believe there is value in being different and seek out ways to deliver that value to investors. Passive strategies attract investors with low fees and — when the market is performing well — market-like returns. The flipside is that during a downturn, the value of passive investors' portfolios fall in sync with the market, often experiencing significant volatility along the way.

At Neuberger Berman we are strong proponents of active portfolio management, particularly for individual investors, who may benefit from a customized approach. Further, looking at the active-passive debate from a purely performance (or outperformance) perspective, we feel that the current macroeconomic and market environment sets up well for active managers with strong stock-picking capabilities.

## THE TIMELESS CASE FOR ACTIVE INVESTING

One reason individual investors typically choose active portfolio managers is a desire to outperform the market, particularly on the downside. In a bull market, active and passive strategies alike can succeed, and outperformance often becomes less of a concern. This is not the case in a down market. Based on a study of the psychological experience of investing, behavioral finance experts Matthew Rabin and Richard H. Thaler found that the risk of loss outweighs the possibility of gains for investors: "Loss aversion is the

**FIGURE 1 — THE IMPORTANCE OF CAPITAL PRESERVATION**  
Illustrating the Impact of Negative Performance



This information is shown solely for illustrative purposes. This chart shows the impact of negative performance. This information is not representative of any Neuberger Berman investment product or service, and does not reflect the fees and expenses associated with managing a portfolio.

tendency to feel the pain of a loss more acutely than the pleasure of an equal-sized gain.”<sup>1</sup>

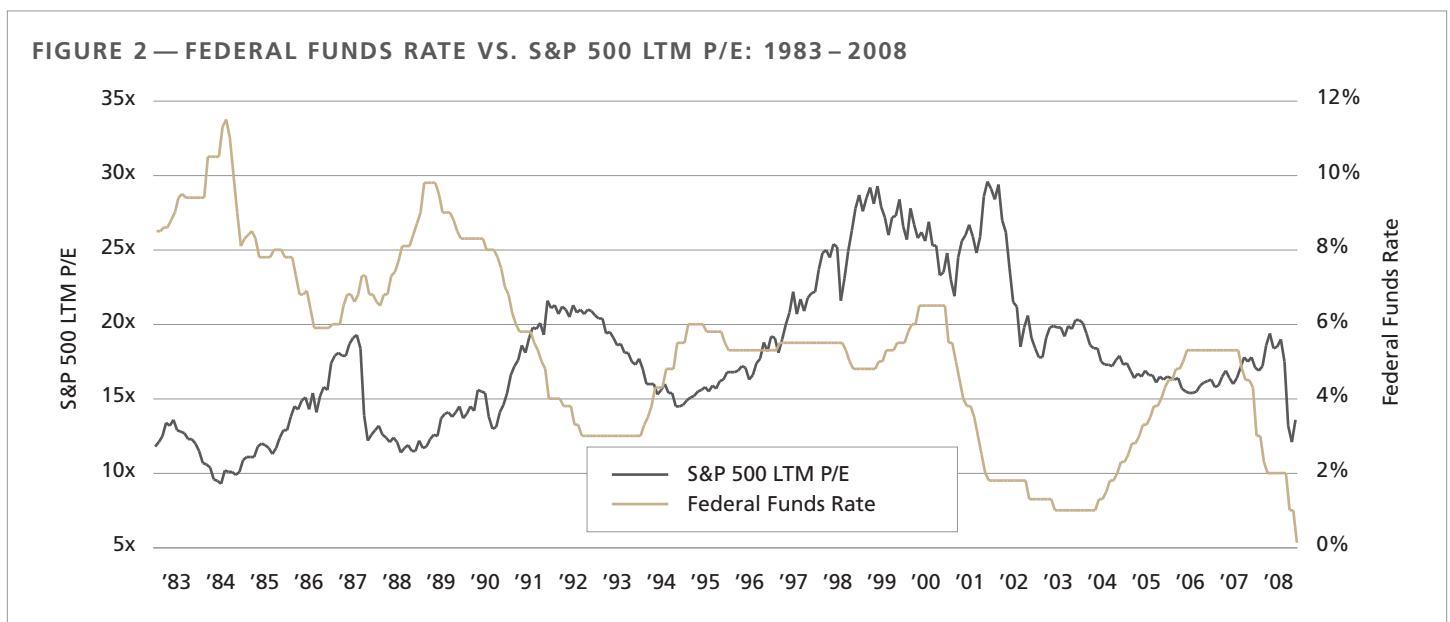
While passive strategies are often constrained by investment policy to remain fully invested, active managers may have the flexibility to protect on the downside by repositioning a portfolio in favor of more defensive stocks or holding higher cash levels until investment conditions improve. As shown in Figure 1, successful downside protection also improves the average returns of a portfolio over a full business cycle by shortening the path back to a break-even point.

*Behavioral finance studies show that underperformance in a down market is substantially more stressful for an investor than underperformance in a bull market.*

The value of active management extends beyond the possibility of downside protection. Active managers have an opportunity to outperform the market due to their ability to work outside the strict investment parameters that exist in passive management. While passive managers minimize or prohibit proactive investment decision-making and, in many cases, merely seek to mirror a benchmark in terms of sector weights and security selection, active managers take a wider view, looking for ways to add value. From the portfolio level down to the individual security level, active managers with some investment flexibility have a number of tools at their disposal that can help them achieve attractive returns. These include asset allocation, sector rotation and security selection.

**Asset allocation:** Based on market conditions, an active equity manager with a flexible investment mandate has the option to move from a portfolio that is fully invested in equities to one that incorporates a percentage of other asset classes such as cash or fixed income. In a declining market, for example, cash provides a safe haven, helping a manager ride out a downturn while positioning the portfolio to take advantage of opportunities as they arise. In the down market we recently experienced, higher cash levels helped many active equity managers produce milder declines and lower volatility than their benchmarks. In a strong positive market, equity managers can revert to a more fully invested model, which will help them keep pace and potentially outperform as the index rises. Further, active managers can look globally for returns when the outlook for the domestic market is less attractive.

**Sector rotation:** Passive managers tend to mirror their benchmark sector allocations, leading to a few potential issues. First, as certain sectors out- or underperform, their weightings within the index change, leading to imbalances within passively managed portfolios. This was the case during the tech boom of the late 1990s, when many indexes were overweight Technology due to relative outperformance of stocks within the sector. When the market turned, tech stocks took the biggest hit, leading to a steeper decline for passive index managers. Further, while passive portfolios reflect past successes and failures in their sector allocations, they lack the ability to look forward and may not be optimally positioned



Source: Standard & Poor’s, Federal Reserve Bank of New York. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. Past performance is no guarantee of future results.

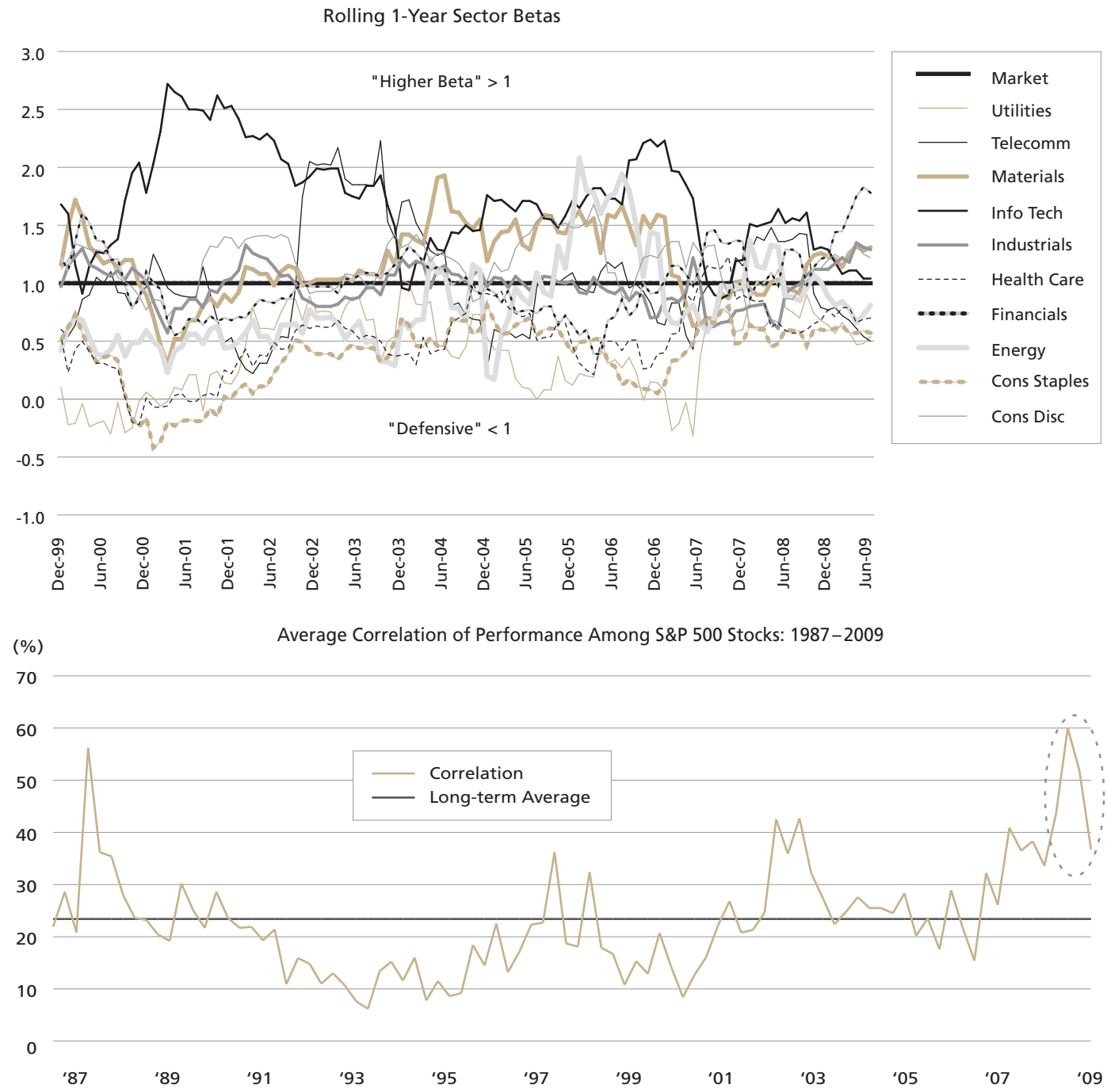
<sup>1</sup> Rabin, Matthew and Thaler, Richard H., “Anomalies: Risk Aversion,” Journal of Economic Perspectives, vol. 15, no.1, Winter 2001: 219–232.

to take advantage of opportunities in the market. Active managers, on the other hand, are often able to rebalance sector weights when performance leads to outsized allocations, and can more heavily weight or avoid sectors based on future performance expectations.

**Security selection:** Stock picking represents what many investors consider the essence of active management. Active managers rely on fundamental and quantitative research to help them find companies that they believe will outperform over time. Further, active managers have flexibility to

**FIGURE 3: STOCK CORRELATIONS AND SECTOR BETAS APPEAR TO BE NORMALIZING**

Stocks clustered and sector betas converged in 2008, but have since trended toward their long-term averages while correlations are dropping to normal levels.



Source: Factset, BAS-ML. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. Past performance is no guarantee of future results. Chart is an average pair-wise correlation of individual stock performance in S&P 500 using daily returns per quarter.

## ACTIVE MANAGEMENT THROUGH THE LENS OF TRACKING ERROR

Tracking error is a measure of the volatility of active returns, which represent the difference between a portfolio manager's performance and that of the passive index benchmark. Traditionally utilized by institutional investors concerned with finding passive portfolio managers who can produce index-like returns, tracking error has become a popular data point for investors examining how active managers differentiate themselves from their benchmarks.

High tracking error implies that a portfolio's performance deviates significantly from its benchmark—in some cases on the upside; in others, on the downside. Low tracking error, on the other hand, indicates that a portfolio manager's performance tracks the benchmark. On its own, tracking error does not tell a complete story. To gain the greatest value from the data point, investors need to understand the source of a portfolio manager's tracking error. Tracking error may derive from the use of cash, leverage, security or sector concentration or weightings, selection of a security outside the benchmark, style drift or poor benchmark selection.

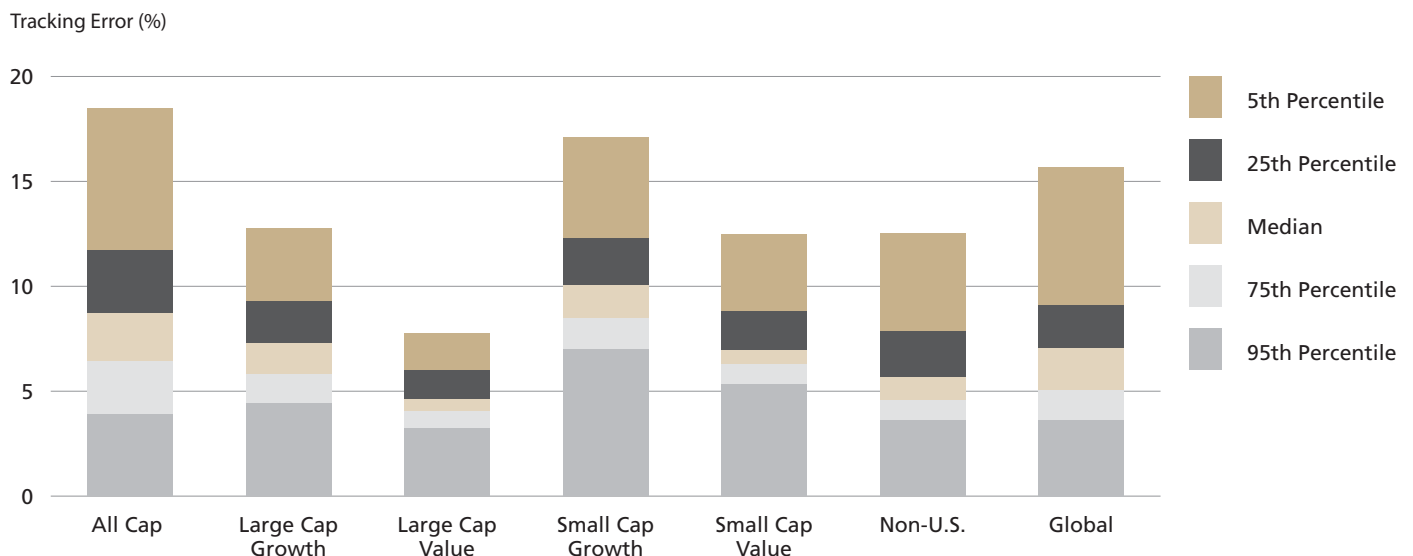
Active managers are usually bottom-up stock pickers, conducting in-depth research on each holding. As a result, their portfolios tend to be more concentrated than

their benchmarks and vary in composition relative to the benchmark in terms of portfolio company size, style, geography and sector concentration. When portfolio managers hold securities not included in the benchmark or in their asset class (for example, when an equity manager holds cash), it can produce significant tracking error.

It is important to differentiate between good and bad sources of tracking error. For instance, a good source of tracking error is the use of cash during a bear market to effect a defensive posture. A bad source of tracking error might be a manager's excessive, isolated use of leverage relative to an investor's overall desire to control risk and manage liquidity. However, when considered holistically across an investor's portfolio, both a leveraged manager with a negative cash position and a manager holding cash could be used in concert. The same type of aggregate approach could be used for high tracking error managers who make concentrated investments in individual securities or specific sectors.

### TRACKING ERROR RANGES FOR A VARIETY OF EQUITY STRATEGIES

Bottom-quartile tracking error managers (below the 75th percentile mark) tend to be passive indexers; top-quartile tracking error managers tend to be active managers. Tracking errors generally are higher for small-cap strategies than for large-cap strategies. For active managers, this may be explained by the fact that security selection can have a more dramatic impact on smaller, less-followed and less-frequently-traded stocks.



Source: Lipper, Morningstar. Tracking errors for the 10-year period 1999–2008 for the respective universe of equity managers, as reported to Lipper. Returns are net of fees. Past performance is not indicative of future results.

manage the entry point of holdings, and are thus able to wait for an attractive price to buy a new position. In contrast, passive strategies disregard valuations when buying a broad basket of securities, eliminating the added value that may stem from managing prospective entry points. Additionally, active equity managers may cross market capitalization, investment style or geographical boundaries when choosing stocks for a portfolio, opening up return opportunities that are unavailable to passive investors. Finally, active managers often hold a limited number of securities in a portfolio, frequently far fewer than passive strategies like index funds. Under the right circumstances, these factors may result in superior performance for investors.

### WHY ACTIVE MANAGERS ARE WELL POSITIONED FOR TODAY'S MARKET

Certain economic and market environments tend to favor an active investment approach. In particular, when equity returns are driven more by idiosyncratic risk than by systematic risk, stock-picking skill may add more value than a passive investment strategy. Said differently, in an environment where individual company fundamentals are more important than market-wide returns, active managers are more likely to earn their keep. An oft-cited study of active and passive managers in the *Journal of Financial Planning* points out that it is in periods entering or exiting recessions that active managers create the most value. According to authors Rich Fortin and Stuart Michelson, "It appears that active fund management is better than index funds at guiding portfolios through rough times."<sup>2</sup> Conceptually, it makes sense that in periods of economic turbulence, some companies stand to gain while others are apt to lose competitive positioning, creating both opportunities and danger areas for investors. Perhaps even more important, periods of financial market volatility often signal a deeper shift in the drivers of economic growth. Looking back at historical market environments and the relative performance of active and passive strategies, we believe the current market conditions may position active management to succeed today.

*In an environment where individual company fundamentals are more important than market-wide returns, active managers are more likely to earn their keep.*

In late 1982, the U.S. economy began to recover following a severe recession. After a period of stagflation where growth was stifled by persistently high inflation, the Federal Reserve, under the management of Paul Volcker, was forced to raise

interest rates to nearly 20%. At that time, the market was trading at less than 10x earnings. Given that starting point, interest rates were poised to move lower, while the economy moved into a period of broad growth, averaging 4% annual GDP growth over the following eight years. The market experienced a widespread expansion of P/E multiples, rising to around 15x earnings by the mid-1980s, while broad economic expansion buoyed the earnings of most companies. These factors ultimately fueled a bull market that benefitted active and passive investors alike.

*Today's low-growth environment sets the stage for market winners and losers; we believe some companies will gain share and grow stronger, while others will fail to recover or consolidate.*

We expect our current recovery to differ substantially from 1982. Today, short-term inflation is of little concern, interest rates are already near zero and the market is trading at a much higher multiple — 14x earnings. Additionally, we still face significant economic headwinds that we anticipate will continue to place a drag on company earnings. High unemployment, tighter credit conditions, higher savings rates and sluggish consumer spending will hamper growth. Rather than a broad economic expansion, we see the possibility of a period of lower growth and continuing uncertainty, with the unwinding of Fed intervention measures and prospects of future inflation or higher interest rates. For better or worse, these factors limit prospects for the kind of broad multiple expansion or widespread earnings growth we saw following the events of the early 1980s (see Figure 2).

Today's low-growth environment sets the stage for market winners and losers; we believe some companies will gain share and grow stronger, while others will fail to recover or consolidate. While 2008 was a year during which systematic risk dominated returns and drove correlations among sectors and stocks to increase dramatically, we believe these trends will reverse course as idiosyncratic risk regains the attention of equity investors. This will likely produce differentiated returns, both in terms of sectors and individual stocks (see Figure 3). Active stock pickers could therefore be positioned to hold the best-performers while avoiding the worst-performers, a benefit on both sides of the relative performance scale.

At Neuberger Berman, we have been in the business of active portfolio management since our founding in 1939

<sup>2</sup> Fortin, Richard and Michelson, Stuart, "Indexing Versus Active Mutual Fund Management," *Journal of Financial Planning*, Vol. 15, No. 9, 2002: 82-94.

and operate largely as a collective of diverse portfolio management teams, each following a unique investment style, with oversight from a centralized risk committee. We favor an unconstrained investment approach within the confines of a well-thought-out investment process. We feel that a flexible investment mandate provides an experienced active manager with the best opportunity to achieve success. We allow only highly experienced portfolio managers with strong investment philosophies and processes to manage client assets. Given what we believe is an attractive environment for stock picking, we feel that our portfolio management teams are well positioned to deliver results. ■

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