



## Equity Outlook 2010: Anticipating a Return to Fundamentals

### EDITION 8

February 2010

#### EQUITY OUTLOOK 2010: ANTICIPATING A RETURN TO FUNDAMENTALS

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The past year was one of extremes, with the stock market moving from panic to a sharp relief rally to further improvement as confidence grew about the state of the economy. More recently, gains have slowed, as some observers have claimed that the markets have “moved too far too fast.” Overall, we are reasonably optimistic about stocks heading into 2010, believing that the impact of economic stimulus, consumer stabilization and the rebuilding of inventories will enhance earnings power. While much of the market recovery has benefited higher-beta stocks, we think that the rally is changing and that underlying company fundamentals will take center stage.

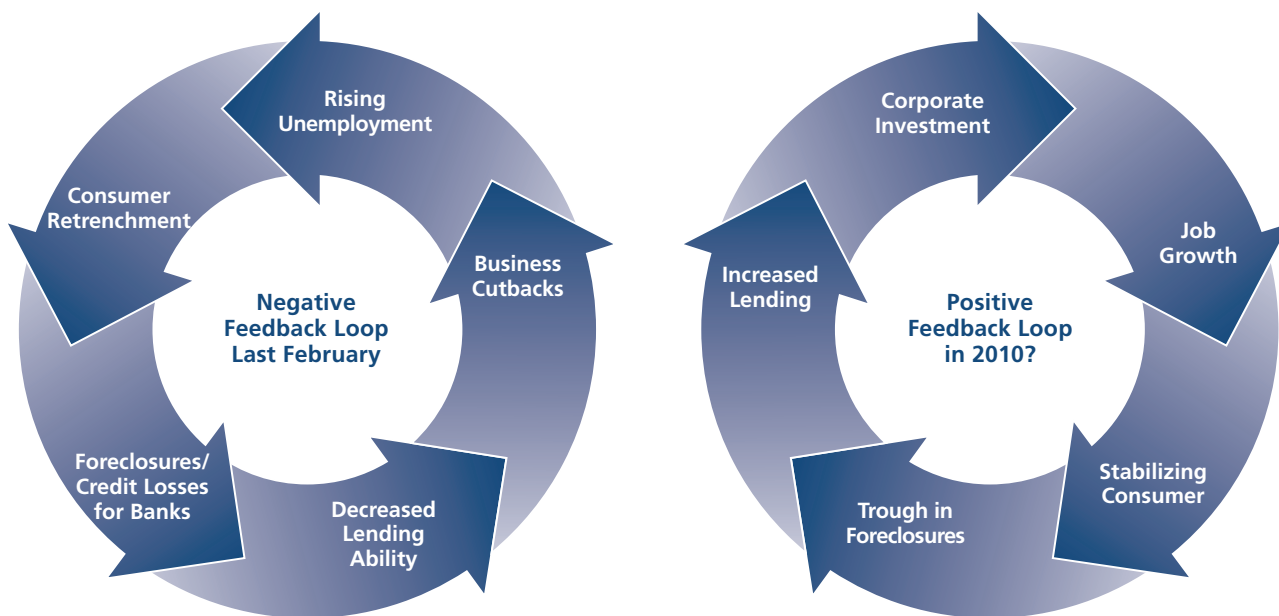
Below, we take stock of where we are today—reviewing the macroeconomic and market events in 2009 that brought us here, and explaining why we feel 2010 has much to offer equity investors. While risk remains in the market and the economy, we believe that the markets have regained a sense of rationality with the potential to reward purposeful, active investors.

### EARLY VOLATILITY

The year began in the midst of extreme market volatility, as the hangover associated with the housing market collapse and stresses on the balance sheets of financial firms continued to severely impact stocks. Underlying the market turbulence was continued uncertainty about the stability of the financial system, corporate profits and the health of the overall economy, particularly in relation to unemployment and consumer spending. With these influences, investor sentiment was deeply pessimistic, with the S&P 500 declining 18.2% for January and February—its worst two-month start of any year in history.

The economy and the markets are closely intertwined, and growth in one part of the economy will often promote consumption, investment and growth in other areas. However, the “virtuous circle” that prevails during boom periods is mirrored by a “vicious circle” during periods of economic contraction or market stress. Such a “vicious circle” was in place early in the year, as job losses, falling home values and market declines caused consumers to cut back on spending. This, in turn, hurt corporate earnings, which prompted more job losses, accelerated housing price declines and weakened financial conditions. On its own, the free market would eventually have found a bottom—but at what cost? In the case of the recent downturn, the swiftness and severity of the damage to corporations and individuals alike instilled fears of an especially deep and prolonged recession. Governments

FIGURE 1: "VICIOUS" AND "VIRTUOUS" CIRCLES CAN HASTEN AN ECONOMIC DOWNTURN OR RECOVERY



Source: Neuberger Berman.

around the world tasked themselves with the responsibility of promoting a faster return from a “vicious” to a “virtuous” circle (see Figure 1.)

### BOLD INTERVENTION

Indeed, the U.S. government and overseas counterparts intensified their unprecedented measures to stabilize the financial system and the economy. The Treasury and Federal Reserve stepped into the credit markets with extra liquidity, maintained the target Fed Funds rate in a range from zero to 0.25%, purchased troubled assets, and extended extra support to weakened financial institutions. Meanwhile, the federal government also introduced massive economic stimulus, including infrastructure spending, a tax credit for first-time home buyers and the “Cash for Clunkers” program as well as extended unemployment benefits.

All told, these efforts had the desired effect of turning the economic tide, taking worst-case scenarios off the table. The first area to show improvement was the credit market, as the LIBOR (London Inter-Bank Offer Rate, a key overnight lending rate for banks) returned to more moderate levels and as public capital became available to a broader array of companies. Later, positive data began to emerge from other pockets of the financial system: manufacturing indicators, which had bottomed in December 2008, began to improve (reflecting expansion by August 2009), long-term indicators from the Economic Cycle Research Institute gained ground, layoffs slowed (after a peak in January and February), and

home prices showed stabilization (and, by summer, even some actual gains.)

The intervention — particularly in the credit markets — appeared to have turned the previous “vicious circle” into a “virtuous circle” of gradually improving economic conditions.

### SHARP MARKET RECOVERY

With investor worries about a full-scale depression fading, stocks began a sharp rebound from their bottom on March 9. The recovery was broad-based with gains across industries, asset classes and market-cap ranges. However, the lowest quality and riskiest companies — the smallest, most leveraged and most exposed to cyclical growth — showed particular strength after suffering the worst during the previous market decline.

Much of this early upward movement was characterized by price/earnings (P/E) expansion as the pricing of risk in the marketplace gradually moved back to normal levels. As a result, the average market P/E expanded from very low levels (around 9x–10x for the S&P 500) to its typical long-term range (again for the S&P 500) of 14 to 17 times earnings by Fall 2009. As economic and financial conditions continued to stabilize, companies displayed more confidence in their ability to predict earnings, which led analysts to begin revising estimates upward for the balance of 2009 and into 2010. Positive earnings surprises from financial firms in the

second quarter of 2009 further reinforced positive market sentiment (see Figure 2.)

### SHIFTING INVESTOR SENTIMENT

In terms of investor behavior, the latter part of 2008 and early 2009 were largely characterized by risk aversion, as many investors waited on the sidelines with cash in money market funds and U.S. Treasuries. However, as signs of stabilization emerged, investors began to return to riskier assets — primarily the credit markets within fixed income as well as into some international equities. Credit-related assets (as measured by the Barclays Capital Corporate and High Yield indices) saw very high returns as credit spreads (or the difference in the yields provided by non-Treasury securities versus Treasuries) eased back to normal ranges, further attracting investor dollars.

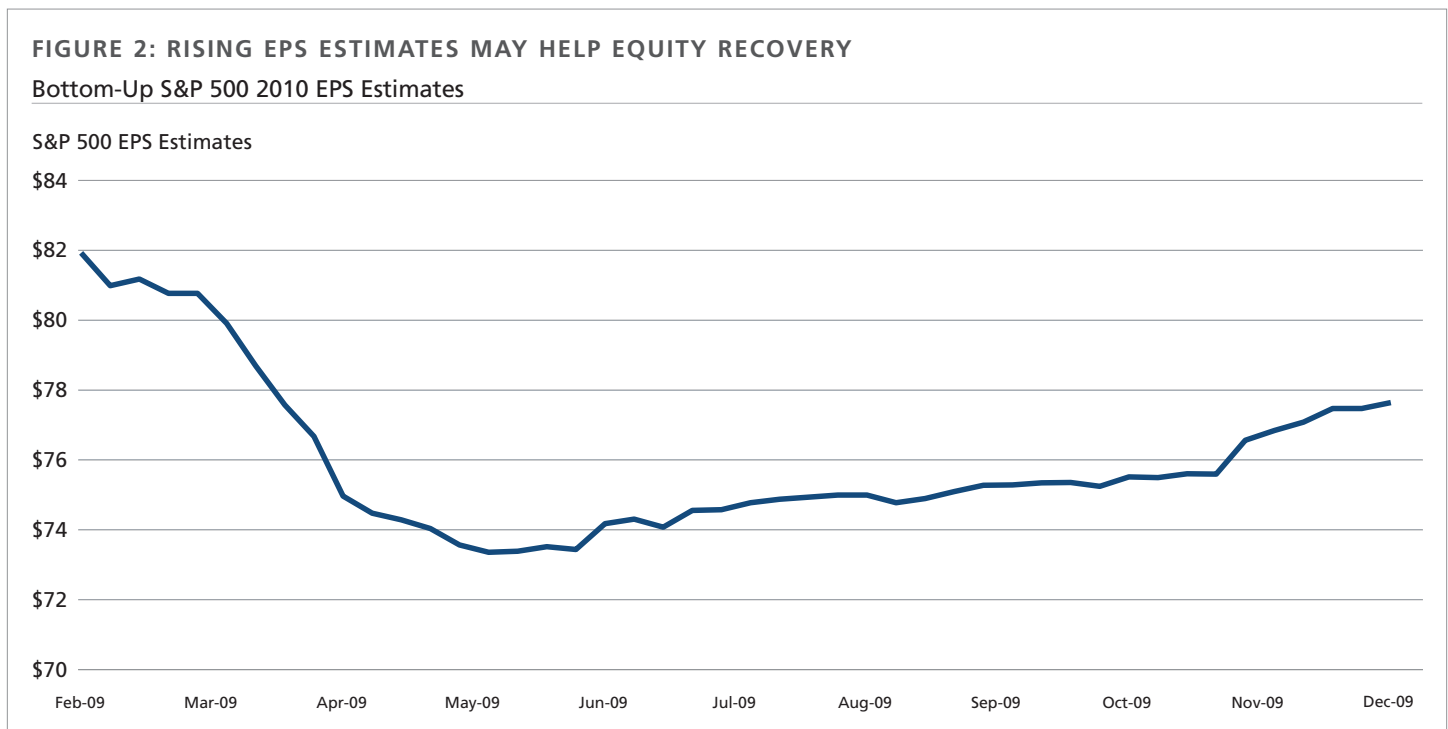
Despite positive results for stocks, some investors remained wary of the risks to the U.S. equity markets—retail U.S. equity products saw net outflows for 2009. One reason that investors remain on the sidelines of the U.S. equity market could be the fear that the market rally has gone “too far too fast”—and that the market may have overshot its value to land in an overpriced range. In our view, the quick and extreme recovery after March 9 was warranted, given that some of the market decline had been based on the fear of a prolonged depression. When

it was clear that outcome would not emerge, many investors realized that the market was oversold and were willing to pay more. Also, in the context of other previous recoveries and the gains made by developed international and emerging markets (up 32.5% and 79.0%, respectively, in 2009, as measured by the MSCI EAFE and MSCI Emerging Markets indices), we believe that the U.S. gains (of 26.5% for the year, as measured by the S&P 500 index) have been warranted.

### LOOKING AHEAD TO 2010

Overall, we believe that the current valuation range of today’s equity markets is appropriate, given the risk/return outlook over the medium term. We also think that this market provides an excellent opportunity to return to longer-term allocations—despite lingering concerns on the part of investors. We think this may be an opportune time for those with medium- to long-term time horizons to consider revisiting their asset allocation strategies.

Although no one is certain of the timing, it seems clear to us that the next move in interest rates will be up, given the low Fed Funds rate and potential inflationary pressures from the declining dollar, deficit spending by the U.S. government and rising commodity prices. In our view, this further supports a move back into equities, which historically have performed well in the early stages of tightening monetary policy.



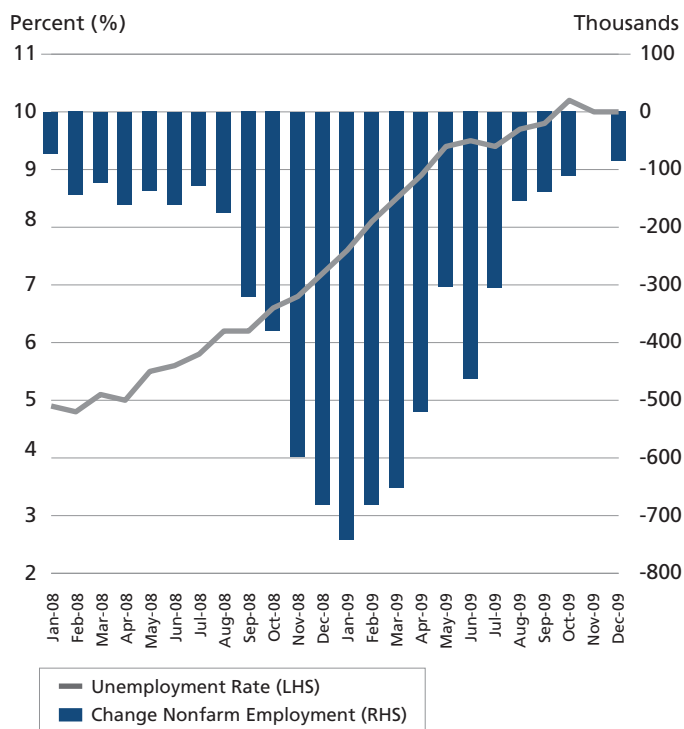
Source: FactSet.  
 Consensus estimates supplied by FactSet. Bottom-up estimates are collected from security analysts for the individual companies included in the index. The average for each company is then calculated and aggregated together to produce an estimate of earnings for the total S&P 500 index. Any ratios or other measurements using a factor of forecasted earnings of a company discussed herein are based on consensus estimates, not Neuberger Berman’s own projections, and they may or may not be realized. In addition, any revision to a forecast could affect the market price of a security. By quoting them herein, Neuberger Berman does not offer an opinion as to the accuracy of, and does not guarantee, these forecasted numbers.

**FIGURE 3: LABOR MARKET SHOWING DRAMATIC IMPROVEMENT**

**Initial Jobless Claims**



**Unemployment**



Source: St. Louis Federal Reserve. Unemployment rate and change in nonfarm payrolls provided by the Department of Labor. Initial jobless claims represent the number of jobless claims filed by individuals seeking to receive state jobless benefits.

**SUPPORTS FOR EQUITIES**

Keeping in mind various risks (to be discussed below), we see upside potential for equity markets in 2010. We believe the equity markets are fairly valued and have the ability to appreciate should companies return to prior levels of profitability, along with a number of other factors:

- **Domestic Economic Gains.** Data continue to show positive signs. In terms of employment, slowing job losses, leading indicators of hours worked, temporary employment figures, openings and hiring intentions are all showing improvement (see Figure 3.) Meanwhile, although the housing sector continues to absorb sizable defaults, overall conditions continue to stabilize, with growing sales volumes and increased pricing. With interest rates at low levels and many companies holding significant cash positions, there are signs of a pickup in mergers and acquisitions and a growing interest overall in business investment—something that’s also reflected in anecdotal evidence of improved sentiment among venture capitalists regarding the financing of small businesses.
- **Operating Leverage.** In the depths of the downturn, many companies underwent extreme cost-cutting in employment and other areas. With their cost structures

now in lean shape overall, many are positioned to enjoy potentially greater profits and margins in a recovery.

- **Current profitability** already reflects this trend: Roughly 25% of S&P 500 companies have returned to their 2007-08 peak level of earnings; and based on analyst estimates, 40% will be within 5% of those peaks in 2010. The remaining companies, many of which suffered extreme earnings weakness during the decline, could also become more profitable due to continued economic improvement and better access to capital.
- **Lagging Analyst Estimates.** In economic decline, Wall Street forecasts, which are largely based on recent results, tend to be slow to catch up to current reality. This also tends to be true on the upside, as forward-looking estimates in a recovery become hard to establish based on the negative numbers of the recent past. As such, we think it is likely that current analysts’ profit estimates, although improving, are still too low.
- **Global Economic Strength.** Although major challenges remain in the domestic landscape, global economic growth—particularly in emerging markets and a number of other key markets—could provide a tailwind for U.S.-domiciled companies with global businesses. It’s worth

noting that companies in the domestic S&P 500 draw roughly 45% of their revenues from non-U.S. sources, creating a sound basis for exposure to the global growth trend. Naturally, the purchase of non-U.S. stocks also offers an effective—and more direct—way to build such exposure.

- **U.S. Dollar and Sidelined Cash.** Other potentially bullish factors for equities include the weak dollar, which, if it persists, could support exports, and the large amount of cash on the sidelines, which could move into stocks should investors begin transitioning back to long-term asset allocations in the new year.

## ISSUES TO WATCH

Despite these positives, we continue to see a number of risks in the economy and the markets that could weaken the equity story:

- **Bank Lending.** Many banks are sitting on excess reserves, rebuilding their capital bases rather than lending, which has dampened the impact of the Federal Reserve's low interest rate policy. Financial institutions have also tightened lending standards across markets, which has limited spending by small businesses and consumers, who are particularly dependent on accessing credit. It is important to remember, however, that loan growth has historically lagged improvement in economic conditions.
- **Inflation and Fed Policy.** Another concern is the potential for increased inflation and the impact it could have on Federal Reserve policy. Although we think that excess industrial capacity and consumer weakness could limit inflation early in 2010, commodity prices have shown renewed strength in recent months, suggesting the potential for further gains as the economy accelerates. Thus far, the Fed has maintained exceptionally accommodative policy but, in our view, could become more aggressive with further signs of firming employment. We will be watching carefully for ways to position portfolios if inflation gains momentum.
- **Budget Deficits.** During the crisis, governments worldwide stepped in to absorb much of the risk in the economy and to stimulate economic growth. However, this well of spending is not limitless—something that's obvious from the increasing fiscal deficits of many countries. As time goes on, governments will likely need to devise careful exit strategies to return to sustainable debt levels while avoiding negative impacts on the economy—and the markets.

- **Continued Deleveraging.** Many economists agree that the broad deleveraging of both financial institutions and the consumer were needed corrections in the long term, though the process is certainly a painful one for the markets and consumers alike. Some wonder if the process has yet run its course—ongoing balance sheet risk arising from commercial and residential mortgage exposure could still cause corporate losses, triggering the need for further capital-raising. Consumers face strong headwinds in terms of unemployment, mortgage foreclosures and the need for higher savings rates to repair household balance sheets. It remains to be seen when these trends will have adequately corrected for the long term.

## CONCLUSIONS

Overall, we believe that the positives continue to outweigh the negatives, both in terms of economic fundamentals and the stock market. For businesses, the power of current operating leverage and the benefits of global growth could create sustained earnings power. On the other hand, the domestic consumer continues to face challenges due to employment weakness and the damage done by market and housing losses over the past couple of years. Government intervention has provided invaluable support to the economy and financial institutions, but at some point, there needs to be a transition, such that private enterprise again drives expansion and earnings.

As for the stock market, it has been through a truly remarkable year—extending from sharp early losses to an impressive recovery, to a slowing toward year-end as valuations finally caught up with historical averages. In recent weeks, equities have traded in a narrow range, reflecting natural inertia but perhaps also reflecting some uncertainty as to what comes next.

Against this backdrop, we are beginning to see a change in leadership among equities, as the higher-beta stocks that led the early part of the rally are starting to lose momentum. In their place, we believe that companies with better earnings quality, operating leverage and global reach are poised to stand out from the pack. In general, we feel it is important to focus on valuation and stock-specific fundamentals, but we believe this will be especially crucial as profits should assume more importance in driving market movements during 2010. We believe this environment could favor a smaller number of higher-quality companies and provide fertile ground for active portfolio managers with stock-picking skills who can distinguish between the companies poised to thrive and those that may be left behind.

As an asset manager, we believe that having a variety of viewpoints at our firm strengthens our investment choices by testing the ideas that support them. That's one reason we are able to present such interesting and diverse viewpoints in Investment Quarterly. This time, we present an article written by the Greene Group Small Cap Intrinsic Value team, who provide their perspective on the benefits of investing in small-cap stocks. In addition, Matthew Rubin, Director of Investment Strategy, offers his thoughts on the role international investments can play in a diversified portfolio.

In closing, I would like to thank you for your support in what has been a truly remarkable year for the markets and our firm. We look forward to continuing to serve you in the future. As always, if you have any questions or suggestions regarding future articles in our Investment Quarterly, do not hesitate to contact your Neuberger Berman representative. ■



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# Intrinsic Value Small Cap Investing: Building a Framework to Uncover Value



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Investment managers devise various methods of finding opportunities for returns. The most successful are generally those that can uncover the best opportunities with the greatest consistency. How does one go about finding unusual value before it is broadly exploited? In the field of value investing, many look to earnings multiples, price declines and relative cheapness to uncover opportunities. Unfortunately, these parameters are widely known, and this conventional approach can often yield mediocre performance.

As contrarian investors, we believe the key to identifying opportunities lies in creating a consistent framework to analyze companies, one that avoids the short-term biases of Wall Street and looks at the long-term outlook for a company and its value potential. Similar to a private owner, our approach gets to the core of a business to identify profit potential, the probability of success and the ultimate value of that business to its owner. As we'll discuss here, we believe the universe of small cap value stocks provides an especially compelling opportunity to implement our investment framework.

## **INTRINSIC VALUE INVESTING: A "PRIVATE" APPROACH TO THE PUBLIC MARKETS**

Our Intrinsic Value concept forms the basis of our Small Cap strategy. "Intrinsic Value" represents our team's estimate of a company's true long-term economic worth that may currently be distorted by market inefficiencies. As value investors, we are interested in constructing a portfolio of small cap stocks that trade at a substantial discount to our estimate of their Intrinsic Value.

We use several complementary approaches to triangulate a stock's Intrinsic Value:

**Sum of the parts analysis:** For complex companies with revenue streams coming from diverse lines of business, we evaluate each business line separately, applying valuation multiples of comparable companies to each business. We then sum up the estimated value of each business line,

making the appropriate adjustments for balance sheet assets and liabilities.

**Private market value analysis:** To estimate the value that a company could fetch in a merger, acquisition or leveraged buyout, we estimate the value of each of its businesses based on recent acquisition multiples. We also calculate the ability of the business to support acquisition debt through its future cash flows.

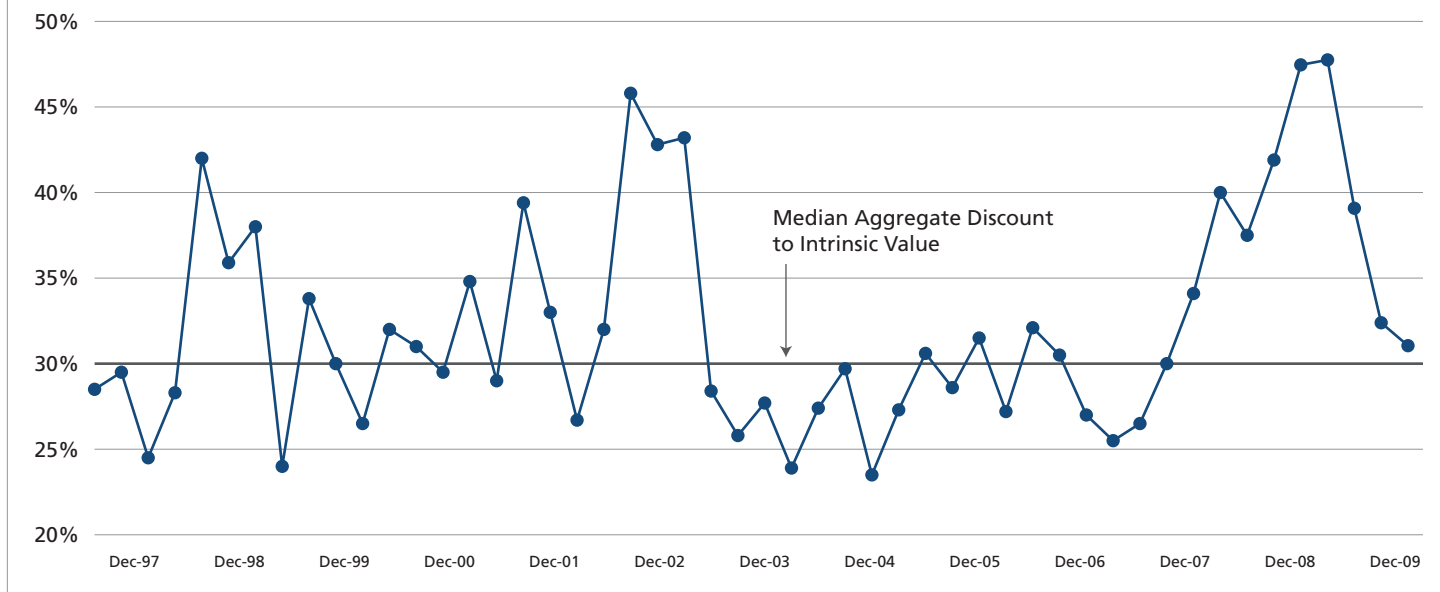
**Normalized earnings power analysis:** Cyclical companies appear to have very low earnings power at cycle troughs. To understand the value of cyclical company, we calculate its *normalized* earnings power, or the level of earnings it can generate on its existing invested capital over the entire cycle. We then apply a through-the-cycle multiple to the normalized earnings number to estimate the value of the company.

**Discounted cash flow analysis:** We model a company's future cash flows based on our understanding of the growth prospects and cyclical drivers of the company's businesses, discounting the future cash flow to a present-day value using a risk-adjusted discount rate.

A key element to our valuation framework is our assessment of a company's management, its strategic and execution abilities, and its direct incentives. We meet with corporate management to discuss its strategic plans, focusing on management's strengths, weaknesses and incentive structures (such as equity ownership and compensation plans) to ensure that they are motivated to realize the company's Intrinsic Value.

After purchasing a stock, we continue to evaluate its stock price versus its Intrinsic Value to determine whether we should maintain the position, add to it, trim it or sell it. We also monitor the average discount to Intrinsic Value of our strategy as a whole, which helps us understand how the attractiveness of our strategy evolves over time.

**FIGURE 1: GREENE GROUP SMALL CAP INTRINSIC VALUE: LONG-TERM DISCOUNT TO INTRINSIC VALUE\***



\*Intrinsic value reflects the team’s analysis and estimates. There is no guarantee that any intrinsic values will be realized; security prices may decrease regardless of intrinsic values.

The portfolio’s aggregate discount to Intrinsic Value tends to spike during times of market distress, indicating to us that our holdings are deeply undervalued. Conversely, the discount to Intrinsic Value tends to fall when markets are returning to a more normal valuation range. The portfolio’s median aggregate discount to Intrinsic Value over the life of the strategy (8/31/1997 inception through 12/31/2009) was approximately 30.6%. Despite a strong recovery for the market and our strategy, the aggregate discount for our Intrinsic Value strategy at the end of 2009 stood at 31.1%, still above historical median levels (see Figure 1.)

**THE INTRINSIC VALUE OPPORTUNITY IN SMALL CAP STOCKS**

Small cap stocks have historically posted strong returns compared with other asset classes.<sup>1</sup> There are unique traits to small cap companies that we believe have contributed to their long-term historical outperformance and provide fertile grounds for our Intrinsic Value investing framework.

**Growth opportunities in small cap companies**

The small cap universe offers numerous opportunities to find stocks with favorable sales and earnings growth characteristics. Smaller companies often operate in nascent markets where the potential for revenue growth is meaningful, as opposed to larger-cap companies that, by nature, operate

in more mature markets. Even within more established markets, there are more relative growth opportunities for small companies starting with smaller shares of the market, compared with large cap companies that frequently already dominate the markets in which they operate.

Further, while many large cap companies focus on harvesting profits from their existing businesses, small companies have historically invested more to grow their business and generate future revenues. Over time, research and development expenditures and capital formation at smaller-cap companies tend to be substantially higher than at large cap companies. Academic studies have documented that higher R&D spending by companies is often underappreciated by the market as investors tend to emphasize current earnings. These studies demonstrate that companies that spend relatively more on R&D have on average exhibited better stock price performance.<sup>2</sup>

**Impact of mergers and acquisitions activity**

We also believe that the mergers and acquisitions market provides a catalyst to propel small company stock prices up toward our Intrinsic Values. Because of their smaller capitalizations, specialized expertise in their markets, growth opportunities and incentivized managements, small companies are more frequently the target of acquisitions than large cap companies. In fact, small caps typically fetch

<sup>1</sup> Based on Ibbotson large cap and small cap asset classes. See Figure 4 for additional information regarding Ibbotson asset classes. 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>2</sup> See for example: Lev, B., B. Sarath and T. Sougiannis, “R&D-Related Reporting Biases and Their Consequences,” Working Paper, New York University, 2000, and Penman, S. H. and X-J. Zhang, “Accounting Conservatism, the Quality of Earnings and Stock Returns,” *The Accounting Review* 77, 2002: 237–264.

higher premiums (in terms of acquisition price relative to pre-offer market price) than larger acquisition targets.

Over the 10 years ended December 2009, there were more than 1,287 announced acquisitions of smaller U.S.-listed companies (with market caps between \$250 million and \$3.0 billion) versus only 358 announced acquisitions of larger U.S.-listed companies. 31% of the small cap acquisition targets fetched premiums of 33% or more, versus only 26% of the large cap targets. The takeover potential for small caps is especially valuable within our Intrinsic Value framework.

### Small cap ownership and governance characteristics

Finally, we believe that the concentrated ownership and governance structure of small cap companies supports value creation and is therefore a key factor in our Intrinsic Value framework. Compared with their large cap counterparts, small cap companies tend to have higher ownership by insiders, often by individuals such as founders who were involved from the earliest stages. Insider ownership can better align management and shareholder incentives. As a result, small cap managements may not be as prone to behaviors that ignore shareholder interests such as “empire building” using large, expensive acquisitions. Simply stated, many small companies exhibit “private owner” characteristics and approaches.

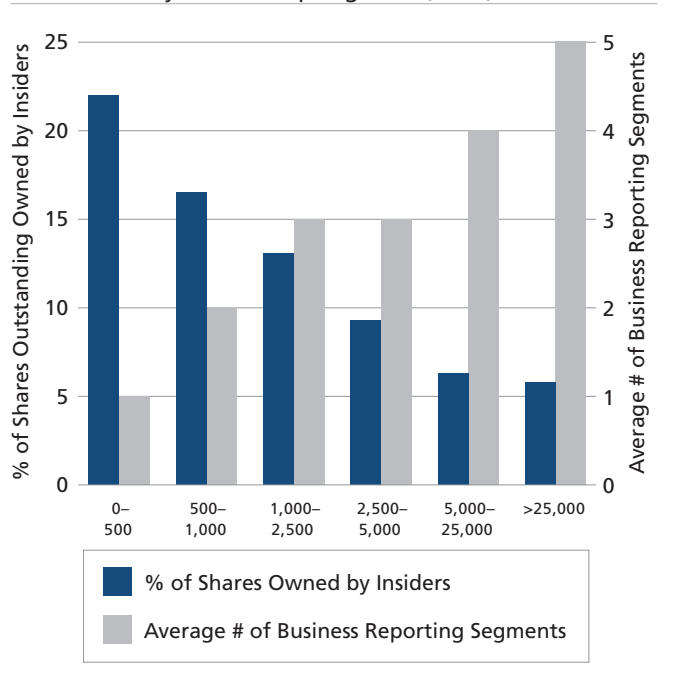
Small cap companies, due to their smaller size, lend themselves to be more easily governed and can avoid the bureaucratic hurdles that hinder larger companies. Unlike large cap companies that often operate along multiple business lines, smaller companies typically operate along a much smaller number of business lines (see Figure 2.) For example, large software companies such as Microsoft or Oracle report along five or more business lines, including consumer, enterprise and hardware, while smaller software companies such as Informatica Corporation and Lawson Software are solely focused on enterprise software. We believe that management teams of smaller companies are able to better focus on their core business, thus creating a competitive advantage.

### OPPORTUNITIES FOR ACTIVE SMALL CAP INVESTING IN TODAY'S MARKET

We believe the small cap market, particularly the value segment, offers the potential for attractive long-term returns. Many investors are questioning whether the strong performance of small cap stocks since the March 9, 2009, market bottom is sustainable. We believe an ongoing recovery

**FIGURE 2: NUMBER OF BUSINESS LINES VS. PERCENT OF INSIDE OWNERSHIP**

Russell 3000 by Market Cap Segment (\$mm)



Sources: FactSet, IBES.

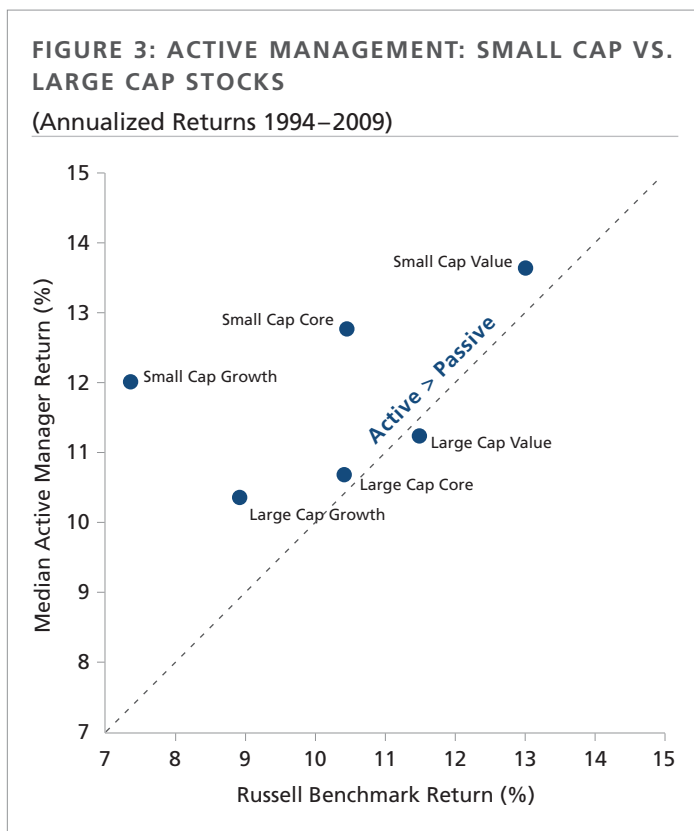
could bode well for small cap companies by providing cheaper capital, lowering raw material, labor and other input costs, and creating end-market dislocations that allow more nimble companies to find new growth opportunity. Between 1945 and 2007, smaller-cap stocks outperformed large cap stocks following the end of recessions, returning an average of 34% within a year after recession ends, and 74% within three years after recession ends (compared with 19% and 48% for large cap stocks).<sup>3</sup> That said, we believe the recovery trade that lifted the small cap sector after last year’s trough certainly could decelerate or end, and we could see a market in 2010 where only a smaller set of companies thrive, spotlighting the attraction of active portfolio management.

Active portfolio managers offer the potential to outperform their benchmarks through a variety of strategies, such as security selection, sector rotation and asset allocation (For more on active vs. passive investing, please see *Investment Quarterly* Edition Seven, available on nb.com.)

<sup>3</sup> Source: Morningstar. **Past performance is no guarantee of future results.** For illustrative purposes only. The results are not representative of any Neuberger Berman investment product or service and do not reflect the fees and expenses associated with managing a portfolio. Cumulative returns of large and small stocks after recessions 1945–2007. Asset class are represented as follows: Large stocks—S&P 500; Small stocks—the fifth capitalization quintile of stocks on the NYSE for 1945–1981 and the performance of the Dimensional Fund Advisors, Inc. (DFA) U.S. Micro Cap Portfolio thereafter (this fund/portfolio includes those companies that have a market capitalization in the largest 4% of the aggregate of NYSE, AMEX and NASDAQ.) Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal.

Due to the inefficiencies in the markets for small cap stocks, such as fewer sell-side analysts covering more companies, less-accurate earnings estimates and thinner trading volumes, we think skillful active managers with a reliable framework for stock selection are especially effective in the small cap universe.

Indeed, we have found that historically, the majority of actively managed small cap strategies have substantially outperformed the passive Russell benchmarks. Between 1994 and 2009, the median actively managed small cap value strategy outperformed the broad benchmark by 1.38% (versus 0.32% underperformance for the median large cap value manager.) Active management in other small cap categories (core, growth) has also been stronger than in the corresponding large cap categories (see Figure 3.)



Sources: eVestment Alliance, Frank Russell.

**Past performance is no guarantee of future results.** For illustrative purposes only. The results are not representative of any Neuberger Berman investment product or service and do not reflect the fees and expenses associated with managing a portfolio. Active Manager returns are based on eVestment Alliance universes. See Disclosures at the end of this piece for universe definitions. The Russell benchmarks for Large Cap Core, Large Cap Value, Large Cap Growth, Small Cap Core, Small Cap Value, and Small Cap Growth are the Russell 1000, Russell 1000 Value, Russell 1000 Growth, Russell 2000, Russell 2000 Value and Russell 2000 Growth indexes, respectively.

Our Intrinsic Value approach identifies three situations in which active small cap managers can take advantage of market inefficiencies:

**Complex companies** have multiple unrelated businesses that belong in different industry segments and/or have different

growth and profitability characteristics. These companies tend to be “chronically undervalued,” often leading management to take remedial, value-creating strategic actions such as takeovers, spinoffs or breakups.

**Cyclical companies’** business ebbs and flows with demand patterns, product cycles or other transient factors. These companies’ stocks can be susceptible to cycles of panic and exuberance, as investors often over-project these normal cyclical changes. As contrarians, these companies can become attractive to us when their business looks to be at its worst and their future recovery potential is ignored. Conversely, these companies are generally unattractive near the peaks of their cycles, where their cyclical nature is forgotten.

**Interrupted-growth companies** are often found in attractive, high-growth markets that have suffered a temporary setback. Sometimes these companies are in transition to a more mature lower-growth mode of operation. These companies are often abandoned by their core-growth investors who dispose of them at depressed prices. Occasionally this selling pressure provides us with an opportunity to buy high-quality businesses at attractive prices.

These pricing inefficiencies are generally due to fairly common, albeit irrational, investor behavior. Using our framework to analyze companies in these situations and identify opportunities by comparing our Intrinsic Value to market prices, our team has been able to generate strong long-term investment returns, outperforming our 1-, 3-, 5- and 10-year Russell 2000 Value and Russell 2500 Value benchmarks.

Some investors worry that small cap value companies are overly concentrated in certain sectors. Indeed, as of December 31, 2009, about 33% of the Russell 2000 Value index of small cap companies was allocated to the financial sector, with the majority concentrated in regional banks and REITs. Moreover, on average, companies in the Russell 2000 Value index derive about 80% of their revenues from domestic sales. We believe investors wary of the U.S. consumer and the health of financial institutions are rightly concerned that these concentrations may overexpose them to smaller banks and their challenges while missing growth opportunities overseas. In our view, an actively managed small cap portfolio can help alleviate some of these concerns. Specifically, our Intrinsic Value strategy has traditionally been underweight the financial sector and overweight manufacturing sectors in favor of global exposure, such as technology, healthcare and industrials.

## **INTRINSIC VALUE SMALL CAP APPROACH VS. PRIVATE EQUITY**

The returns of actively managed small cap value strategies are at times compared to those of private equity strategies. Structurally, private equity and public market investing are different;<sup>4</sup> however, we think the underlying approach taken in assessing company value can be similar. In terms of our valuation process, many aspects of our approach are similar to private equity due diligence. Like private equity investors, we tend to set aside accounting earnings and focus on how much cash a business can generate to support its liabilities and grow equity value. We also look at each component of the business separately, trying to estimate what it would be worth to an outside buyer. Our team visits companies' facilities and engages companies' management in tough and probing discussions about the merits of their strategic plans, their incentive structures, and potential value-driving events to determine if they can operate their businesses to achieve our Intrinsic Value estimates.

Historically, public market returns (as measured by the S&P 500) seem to compare favorably with private equity returns. While information on private equity returns is not as readily available as public market return data, one oft-cited academic study of past private equity returns (1980–1997) shows that on a net-of-fee basis, the average private equity returns were roughly equal to those of the S&P 500. It is worth noting, however, that the data set in that study displayed a wide range of returns, and the authors found significant and persistent return differences based on venture fund/buyout fund distinctions, manager experience, and fund vintage.<sup>5</sup> Another study shows that 1998–2007, arguably one of the best decades for private equity, the median private equity return was below that of

the median small cap value manager.<sup>6</sup> In light of the return studies regarding average private equity fund returns, as well as the investor restrictions and general liquidity and higher cost structures of private equity, we believe our actively managed Small Cap Intrinsic Value strategy could be an attractive, accessible, more liquid alternative to private equity investing.

## **SMALL CAP VALUE INVESTING, RISK AND DIVERSIFICATION**

Small cap value stocks have been more volatile than other equity and non-equity asset classes, particularly in the short run, but they have historically provided attractive longer-term capital appreciation, diversification and inflation-protection benefits (see Figure 4.)

Over the 80 years ended September 2009, cumulative returns for small cap value stocks were nearly eight times greater than the returns for large cap value stocks, and over 40 times greater than the returns for large cap growth stocks. When looking at rolling three-year periods over those 80 years, small cap value stocks outperformed the large cap and small cap growth categories 60% of the time.<sup>7</sup> While small caps have historically been more volatile than large caps, we note that in periods following recessions, small caps have performed well.

Investing in any single small cap company can be highly volatile. A new competitor, a weaker product cycle, or difficulty accessing financing could substantially impact a small cap stock. However, many of these stock-specific risks can be diversified and spread out by investing in a well-constructed portfolio of small cap stocks. The skill of an active small-cap portfolio manager can play an important role in mitigating individual company risks through stock selection and portfolio construction.

From an asset-class risk standpoint, small cap stocks are typically more vulnerable to financial and market risks and uncertainties than large-capitalization stocks. In addition, they may trade less frequently and in lower volume than large-capitalization stocks and thus may be more volatile and less liquid. Some of these risks can be tempered by including a small cap portfolio as part of an overall well-diversified investment program.

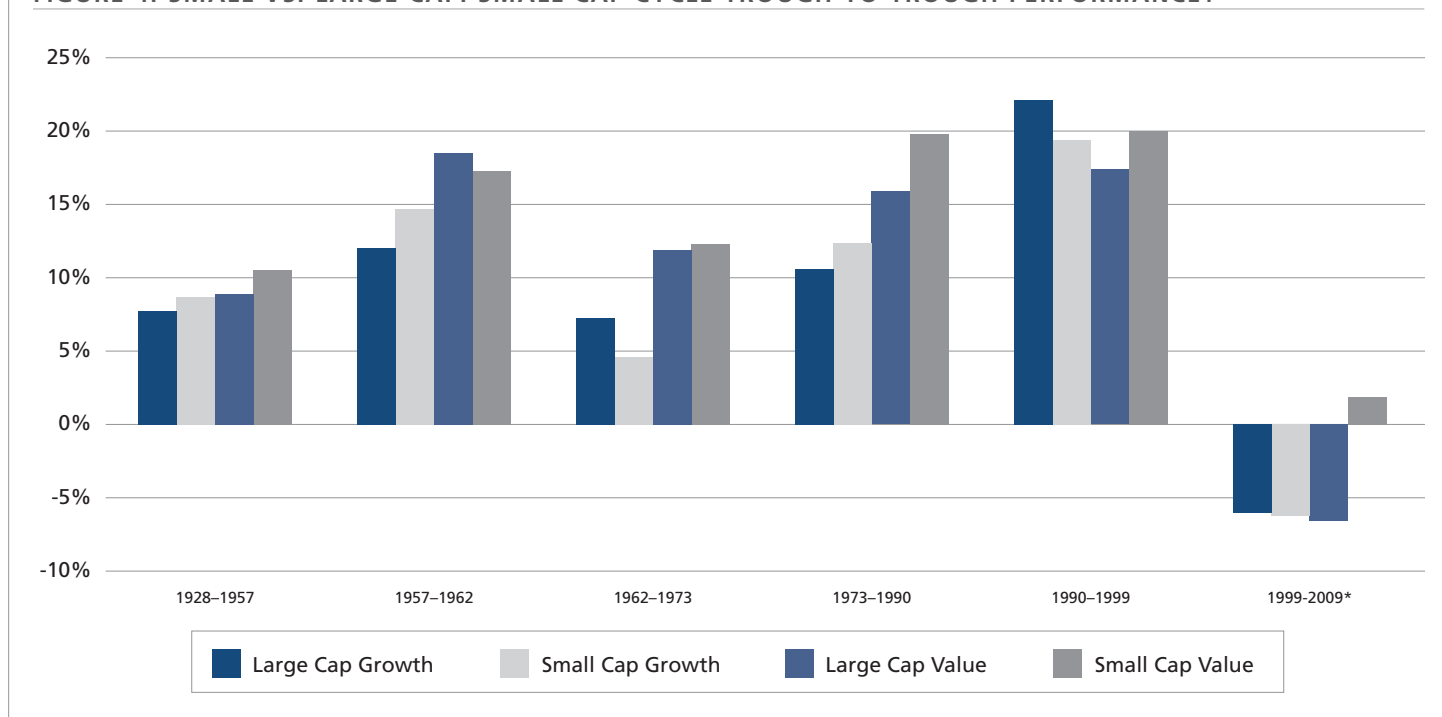
<sup>4</sup> There are material differences between private equity investing and public market investing. Private equity fund investing is subject to investor eligibility requirements, and is generally less liquid, and subject to higher investment minimums and longer commitment periods than small-cap public equity investment. Private equity funds are typically structured as general partnerships with the general partner managing the fund investments and limited partners providing the bulk of the capital. Managers of private equity funds generally engage in privately negotiated transactions to acquire large stakes in companies that may or may not trade on a public exchange, and they also frequently take an active role in company management or operations.

<sup>5</sup> Kaplan, Schoar, "Private Equity Performance: Returns, Persistence, and Capital Flows," 2003. This study calculated a public market equivalent return based on return data for "large liquidated" returns of venture capital and buyout funds and compared it with that of the S&P 500 for the time period 1980–1997. The study indicated that weighted by committed capital, certain private equity fund returns (venture capital funds) outperformed the S&P 500, while other funds (buyout funds) did not. The study indicated that on a gross of fee basis, both types of private equity funds outperformed the S&P 500. Private equity studies and their results are subject to limitations and assumptions based in part on the limited information available regarding private equity returns. No representation is being made regarding the accuracy or reliability of such studies.

<sup>6</sup> Thomson Reuters, "The 2008 Investment Benchmarks Report: Buyouts and Other Private Equity," 2008. This study investigates the performance differences between public and private equity, indicating that average private equity returns, net of fees, are in line with average public equity returns. The study indicates, however, that the top quartile of private equity managers outperforms average private equity returns.

<sup>7</sup> Based on Ibbotson large cap and small cap asset classes. See Figure 4 for additional information regarding Ibbotson asset classes. 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 4: SMALL VS. LARGE CAP: SMALL CAP CYCLE TROUGH-TO-TROUGH PERFORMANCE†**



†Sources: Ibbotson, Morningstar.

Past performance is no guarantee of future results. For illustrative purposes only. Time periods based upon trough-to-trough market cycles as defined by Ibbotson. The results are not representative of any Neuberger Berman investment product or service and do not reflect the fees and expenses associated with managing a portfolio. Asset classes are represented by the following indexes: Large Cap Growth—The Fama—French Large Growth Index; Small Cap Growth—The Fama—French Small Cap Growth Index; Large Cap Value—The Fama—French Large Cap Value Index; and Small Cap Value—The Fama—French Small Cap Index. Indexes are unmanaged and are not available for direct investment. Unless otherwise indicated, returns assume reinvestment of any dividends and distributions. Investing entails risks, including possible loss of principal.

Because small cap returns are not perfectly correlated with large cap returns, an allocation to small cap stocks has some diversification benefits and can potentially *lower* the risk of an overall equity portfolio while *increasing* the return profile of that portfolio. In addition, while small cap value stocks are riskier in the short run, they have the potential to preserve purchasing power over the long term, compared with some other non-equity asset classes. While inflation expectations today remain low, given the budget deficits and structural challenges faced by our economy, we do not think the risk of higher future inflation should be ignored.

### SUMMARY

Small cap companies — and small cap value stocks in particular — have offered compelling risk-adjusted returns over many market cycles. We believe our Intrinsic Value strategy presents a unique and attractive way to enhance the risk/return profile of balanced portfolios and participate actively in the small cap segment.

This material is provided for informational purposes only. Nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security. No recommendation or advice is being given as to whether any investment or strategy is suitable for a particular investor. Any views or opinions expressed may not reflect those of the firm as a whole. 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.**

This material discusses small-capitalization stocks. Small-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-capitalization stocks may not be appropriate or suitable for all investors.

Investments in hedge funds and private equity are speculative and involve a higher degree of risk than more traditional investments. Investments in hedge funds and private equity are intended for sophisticated investors only.

Recession data is from the National Bureau of Economic Research (NBER). The average cumulative returns are calculated from the end of each of the 10 recessions in U.S. history. The National Bureau of Economic Research does not define a recession in terms of two consecutive quarters of decline in real GNP. Rather, it is their opinion that a recession is a recurring period of decline in total output, income, employment and trade, usually lasting six months to a year, and is marked by widespread contractions in many sectors of the economy. The data assumes reinvestment of income and does not account for taxes or transaction costs.

eVestment rankings are based on eVestment Alliance style group universes for the indicated time period and are shown for illustrative purposes only. Unless otherwise indicated, returns reflect reinvestment of dividends and distributions.

## DEFINITIONS

**eA Large Cap Core**—U.S. equity products that invest primarily in large capitalization stocks with fundamental characteristics between growth and value or products that invest in a relatively even mix of growth and value stocks/sectors. The expected benchmarks for this universe would include the Russell 1000, or S&P 500. Managers in this category will typically indicate a “Primary Capitalization Emphasis” equal to Large Cap and a “Primary Style Emphasis” equal to Core.

**eA Large Cap Value**—U.S. equity products that invest primarily in large capitalization stocks with fundamental characteristics showing them to be under-priced or in slower-growing economic sectors. The expected benchmarks for this universe would include the Russell 1000 Value, S&P 500 or the S&P/BARRA Value. Managers in this category will typically indicate a “Primary Capitalization Emphasis” equal to Large Cap and a “Primary Style Emphasis” equal to Value.

**eA Large Cap Growth**—U.S. equity products that invest primarily in large capitalization stocks with fundamental characteristics showing high earnings growth expectations or in fast-growing economic sectors. The expected benchmarks for this universe would include the Russell 1000 Growth, S&P 500 or the S&P/BARRA Growth. Managers in this category will typically indicate a “Primary Capitalization Emphasis” equal to Large Cap and a “Primary Style Emphasis” equal to Growth.

**eA Small Cap Core**—U.S. equity products that invest primarily in small capitalization stocks with fundamental characteristics between growth and value or products that invest in a relatively even mix of growth and value stocks/sectors. The expected benchmarks for this universe would include the Russell 2000. Managers in this category will typically indicate a “Primary Capitalization Emphasis” equal to Small Cap and a “Primary Style Emphasis” equal to Core.

**eA Small Cap Value**—U.S. equity products that invest primarily in small capitalization stocks with fundamental characteristics showing them to be under-priced or in slower-growing economic sectors. The expected benchmarks for this universe would include the Russell 2000, or Russell 2000 Value. Managers in this category will typically indicate a “Primary Capitalization Emphasis” equal to Small Cap and a “Primary Style Emphasis” equal to Value.

**eA Small Cap Growth**—U.S. equity products that invest primarily in small capitalization stocks with fundamental characteristics showing high earnings growth expectations or in fast-growing economic sectors. The expected benchmarks for this universe would include the Russell 2000, S&P 600, or Russell 2000 Growth. Managers in this category will typically indicate a “Primary Capitalization Emphasis” equal to Small Cap and a “Primary Style Emphasis” equal to Growth.

**S&P 500 Index:** Consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value-weighted index (stock price times number of shares outstanding), with each stock’s weight in the Index proportionate to its market value. The “500” is one of the most widely used benchmarks of U.S. equity performance. As of September 16, 2005, S&P switched to a float-adjusted format, which weights only those shares that are available to investors, not all of a company’s outstanding shares. The value of the index now reflects the value available in the public markets.

**Russell 1000 Total Return:** Russell 1000 Index measures the performance of the 1,000 largest companies in the Russell 3000 Index, which represents approximately 92% of the total market capitalization of the Russell 3000 Index. As of the latest reconstitution, the average market capitalization was approximately \$13.0 billion; the median market capitalization was approximately \$4.6 billion. The smallest company in the index had an approximate market capitalization of \$1.8 billion.

**Russell 1000 Growth Total Return:** Measures the performance of those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values. The index is market cap-weighted and includes only common stocks incorporated in the United States and its territories.

**Russell 1000 Value Total Return:** Measures the performance of those Russell 1000 Index companies with lower price-to-book ratios and lower forecasted growth values. The index is market cap-weighted and includes only common stocks incorporated in the United States and its territories.

**Russell 2000 Total Return:** Measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index. The index is market cap-weighted and includes only common stocks incorporated in the United States and its territories.

**Russell 2000 Growth Total Return:** Measures the performance of those Russell 2000 Index companies with higher price-to-book ratios and higher forecasted growth values. The index is market cap-weighted and includes only common stocks incorporated in the United States and its territories.

**Russell 2000 Value Total Return:** Measures the performance of those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values. The index is market cap-weighted and includes only common stocks incorporated in the United States and its territories.

**Russell 2500 Value Total Return:** Measures the performance of those Russell 2500 Index companies with lower price-to-book ratios and lower forecasted growth values. The index is market cap-weighted and includes only common stocks incorporated in the United States and its territories.

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

# Making a Case for International Investing



**MATTHEW L. RUBIN**  
DIRECTOR OF INVESTMENT STRATEGY  
NEUBERGER BERMAN

After the global market downturn in 2008 and early 2009, international equities, particularly emerging markets, staged a dramatic rebound, returning strong full-year 2009 results of 32.5% and 79.0%, respectively, for the MSCI EAFE and MSCI Emerging Markets (EM) indices. It may come as no surprise, therefore, that non-U.S. equities—from developed to emerging markets—drew substantial interest from U.S. investors last year, with fund flows into these areas far outpacing flows into U.S. equities, which were substantially negative in 2009.

Despite this increased interest, many investors in the U.S. remain wary of the potential volatility of international markets. Given the wide range of opportunities available, where you put your investment dollars can make all the difference. ‘International equity’ is a broad category, encompassing investment opportunities ranging from developed markets, such as the United Kingdom or Canada, to emerging markets like China or Brazil, to the so-called ‘frontier’ or pre-emerging markets such as Argentina or Bahrain.

In terms of volatility, developed markets tend to behave similarly to U.S. equity markets, but potentially offer additional diversification opportunities compared with what is available domestically. Emerging markets tend to be more volatile, but in general offer greater growth potential. Many high net worth investors choose to allocate separately to developed and emerging markets, choosing an allocation in line with their overall risk tolerance and investment goals. We believe, however, that one thing is clear: Adding international exposure to a portfolio of U.S. stocks is increasingly essential, both to help promote growth and to ensure sufficient diversification within a broader equity allocation.

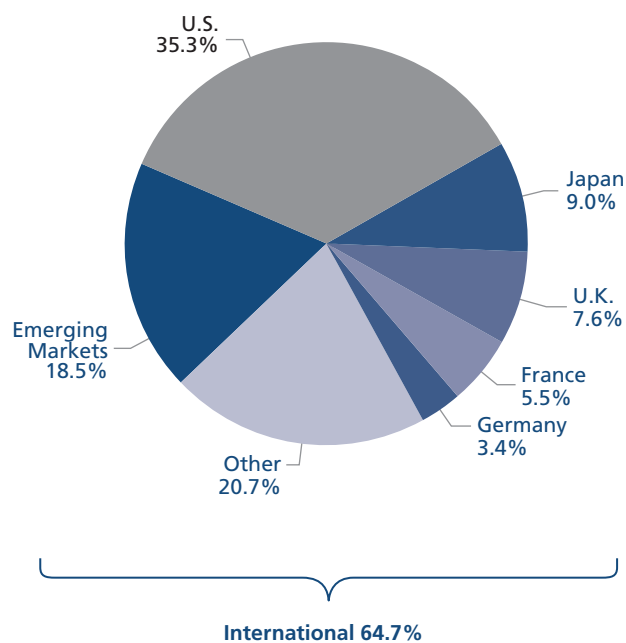
## INTERNATIONAL STOCKS REPRESENT AN INCREASINGLY PROMINENT OPPORTUNITY

In the past, U.S. stocks accounted for the vast majority of global public equity opportunities available to investors. Today, this is no longer the case. After World War II, the U.S. economy

began shifting from a manufacturing-based to a service-based economy. In terms of employment, “goods-producing” or manufacturing jobs as a percentage of total U.S. employment declined from a peak of 44% in 1943 to less than 14% in 2009.<sup>1</sup> While manufacturing in the U.S. waned, other countries gained steam in the sector and developed momentum in other areas. As a result, the opportunity set for investors has evolved. By the end of 2009, for example, nearly 65% of the world’s public stock market capitalization was accounted for by non-U.S. companies in both developed and emerging markets (see Figure 1)—up nearly 15% since 2002.

**FIGURE 1: THE MAJORITY OF EQUITY INVESTMENT OPPORTUNITIES LIE OUTSIDE THE U.S.**

Market Capitalization—December 2009



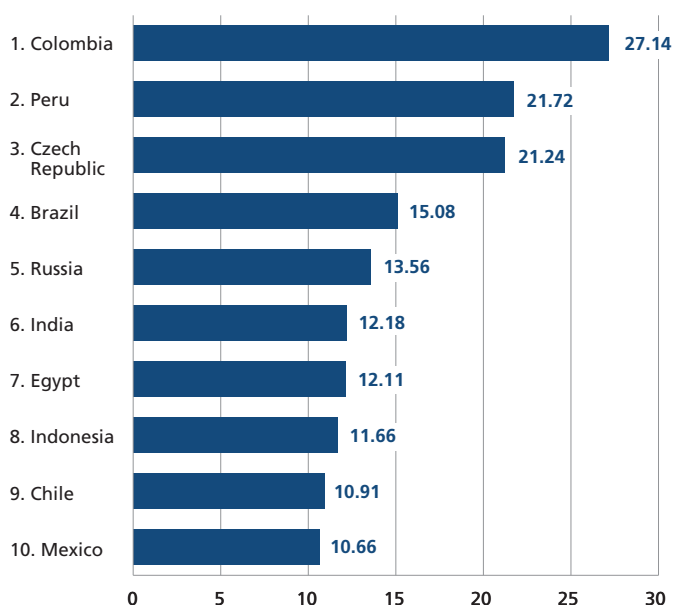
Sources: Rimes Technologies Corporation; FactSet. Based on MSCI All Countries World Index market capitalization.

“Other” includes Switzerland, Canada, the Netherlands, Australia, Italy, Spain, Sweden, Hong Kong, Finland, Belgium, Ireland, Denmark, Singapore, Norway, Greece, Portugal, Austria and New Zealand.

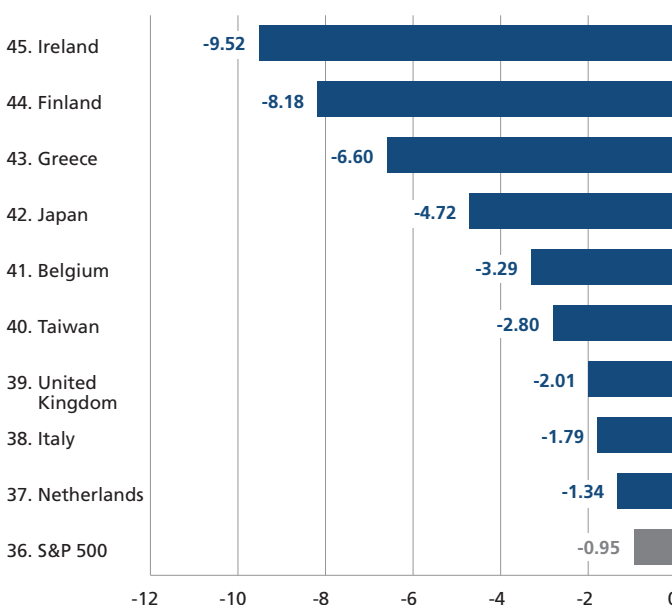
<sup>1</sup> Bureau of Labor Statistics.

**FIGURE 2: INVESTORS WHO LIMITED THEMSELVES TO U.S. STOCKS HAVE HISTORICALLY MISSED TOP PERFORMING MARKETS**

Best-Performing Markets (USD)— 10 Years Annualized Ended December 2009 (%)



Worst-Performing Markets (USD)— 10 Years Annualized Ended December 2009 (%)



Source: MSCI. Indices 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. Please see disclosures at the end of this article, which are an important part of this publication

Within certain sectors the situation is particularly pronounced. Commodity-rich countries, for example, are often the domicile for some of the largest materials-sector companies. Foreign telecom companies that operate in the world’s most populated regions tend to dominate their industry market caps. Further, as sizeable countries like China and India undergo rapid development, companies that are geographically well-positioned to provide them with raw materials, services or consumer goods at the most competitive rates have enjoyed robust growth. Specifically, 86% of the market share in the materials sector and 83% in telecommunications are now represented by non-U.S. companies. More broadly, in seven out of 10 sectors, more than 60% of the opportunities available to investors today lie outside the U.S. For these and other reasons, it has become increasingly difficult to gain access to many sectors without investing abroad and, for investors who prefer to hold the dominant players in each sector, the U.S no longer offers a complete set of options.

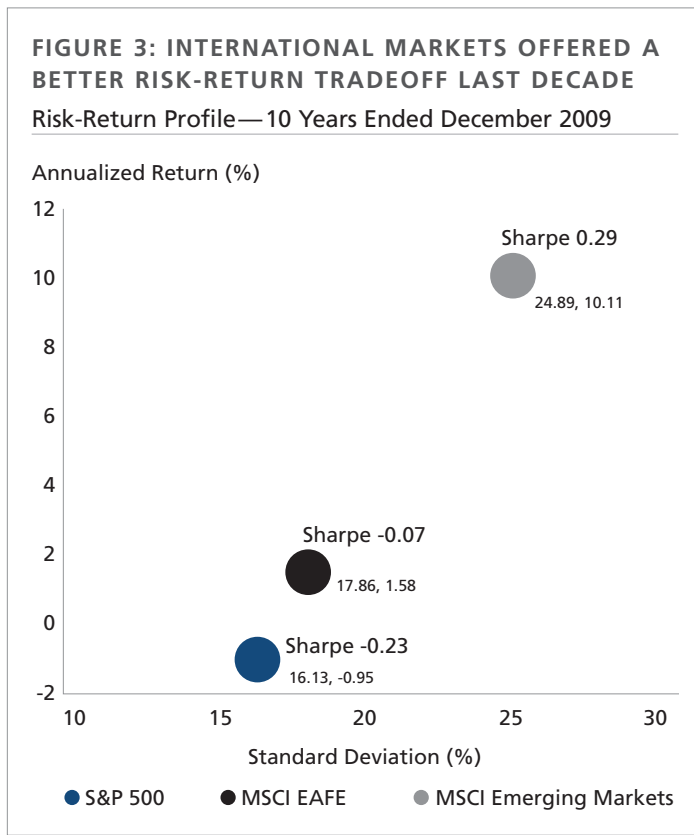
**INTERNATIONAL MARKETS HAVE OUTPERFORMED THE S&P 500**

From a performance perspective, adding an international allocation to a portfolio of U.S. stocks may offer significant benefits. Over the last 10 years ended December 2009, for

example, many international markets offered attractive investment opportunities, while the U.S. lagged. In fact, during that period, all but nine of the 44 international markets (developed and emerging) represented in the MSCI All Country World index outperformed the S&P 500 (see Figure 2.) When you look exclusively at emerging markets during the last 10 years, all countries represented with the exception of Taiwan outperformed the S&P 500, and the MSCI EM index as a whole outperformed by approximately 11.1% annualized. Emerging market outperformance has been even more pronounced in the last five years, led by the BRIC countries (Brazil, Russia, India and China), with the MSCI EM outperforming the S&P 500 by approximately 15% annualized.

One particularly notable characteristic of international markets in the last 10 years is that performance has not been accompanied by a substantial increase in average risk. In fact, the MSCI EAFE and MSCI EM offered higher returns — substantially higher for the emerging markets — with only a slight increase in risk over the S&P 500 (see Figure 3.) We often look to Sharpe ratios to measure how well an investor is compensated in returns for taking on a given level of risk or volatility. A higher Sharpe ratio indicates that an investment offers a more favorable risk-reward balance. Looking at the Sharpe ratio for the S&P 500,

MSCI EAFE and the MSCI EM indices over the last 10 years, both developed and emerging markets came out ahead of the U.S. in terms of risk-adjusted returns.



Sources: Callan; Neuberger Berman. Indices 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. Please see disclosures at the end of this article, which are an important part of this publication.

### CURRENCY: AN IMPORTANT COMPONENT OF RETURNS

Investing abroad typically entails making an investment in a foreign company as well as its local currency. Since the company’s stock is priced in local currency, translating that value back into U.S. dollars entails exposure to foreign exchange rates. As a result, U.S. investors receive two sources of return from the international component of their portfolios: performance of the underlying instrument and fluctuations in the value of the local currency versus the U.S. dollar. Between 2002 and 2009, the U.S. dollar depreciated approximately 32% against a broad currency index.<sup>2</sup> This decline helped further boost returns from international markets, which, as noted above, outperformed the U.S. during that period.

<sup>2</sup> Source: St. Louis Federal Reserve. Note: TWEXMMTH is a weighted average of the foreign exchange value of the U.S. dollar against a subset of the broad index currencies that circulate widely outside the country of issue. Major currency index includes the Euro Area, Canada, Japan, the United Kingdom, Switzerland, Australia, and Sweden. The exchange value was indexed to 100 in 1973.

The table below highlights the impact of currency on investment returns (see Figure 4.) As demonstrated, currency can add to or detract from returns, depending on the direction of the U.S. dollar versus the local currency for an investment. In years in which the dollar declined, currency was a significant contributor to international investment returns. In 2005 and 2008, the two years represented in which the U.S. dollar gained, currency was a detractor. It is important to note, however, that overall returns may not suffer significantly in such years because a strengthening dollar can give foreign companies a competitive advantage by making their goods and services look more attractive on a currency-adjusted basis. In times of a stronger dollar, foreign countries will generally export more and import less, two factors that can help boost the performance of a foreign stock. In terms of timing your investment in international markets, we believe currency trends, which can make sudden moves in the short term, tend to be balanced over longer periods by the offsetting benefits of the export/import relationships among countries. This means there is little advantage to timing your long-term investment around currency moves. While the dollar is currently weak in comparison to a number of foreign currencies, we believe the dollar could appreciate in the medium term once the Federal Reserve exits its extraordinary policy measures and economic conditions return to pre-recession levels.

**FIGURE 4: CURRENCY MAY ADD TO OR DETRACT FROM INTERNATIONAL RETURNS**

	Return %						
	2003	2004	2005	2006	2007	2008	2009
EAFE (Local)	20.78%	13.09%	29.54%	16.94%	3.97%	-39.93%	25.37%
<b>+</b> Currency	18.38%	7.61%	-15.53%	9.92%	7.66%	-3.13%	7.09%
<b>=</b> EAFE (USD)	39.17%	20.70%	14.02%	26.86%	11.63%	-43.06%	32.46%

Sources: MSCI Barra; Neuberger Berman. Indices 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. Please see disclosures at the end of this article, which are an important part of this publication.

While currency can significantly impact performance, it tends to have a relatively minor impact on investment risk. The volatility of the MSCI EAFE is comparable whether returns are measured in local currency or U.S. dollars, with annualized standard deviation measurements for the 10-year period ended December 2009 at 15.74% and 17.86%, respectively. The reason is that currencies do not move in tandem; in fact, there tends to be very little correlation among major global currencies. Additionally,

## ADRS VS. DIRECT INVESTMENTS

When investing in foreign markets, U.S. investment managers have two options available to them. The first choice is to invest directly in the foreign stock, though that choice can sometimes prove cumbersome operationally or require additional compliance with foreign regulations. Another frequently used option is to invest in an alternate form of security, an American Depositary Receipt (ADR). ADRs are certificates issued by U.S. banks that represent a single share or multiple shares of a foreign stock, yet are traded on a U.S. exchange and priced in U.S. dollars. For a small fee, the issuing bank acts as a “middleman” between the actual stock and the owner of the ADR by holding the underlying stock. The bank deals with the operational issues of foreign ownership, as well as distributing its dividends to the owner. In this way, ADRs provide the same exposure to a foreign stock’s performance as well as its underlying currency, despite being traded on a U.S. exchange and being priced in U.S. dollars. However, not every foreign stock is available in ADR form; in particular, emerging and frontier markets are less well represented than developed markets.

currencies and equities tend to move independently, with little correlation between them.

The important contribution of currency to investment returns is one reason we do not recommend U.S.-based multinationals as an exclusive means of gaining international exposure. These multinational corporations operate in foreign markets but their stocks trade in U.S. dollars, offering investors no direct connection to foreign currencies. Further, many U.S. multinationals hedge their currency exposures when operating abroad as a risk management technique. Thus, foreign currency exposure may have a limited impact on a multinational’s performance. Additionally, the changing nature of a U.S.-based multinational’s international exposure can be problematic when attempting to implement an asset allocation with an

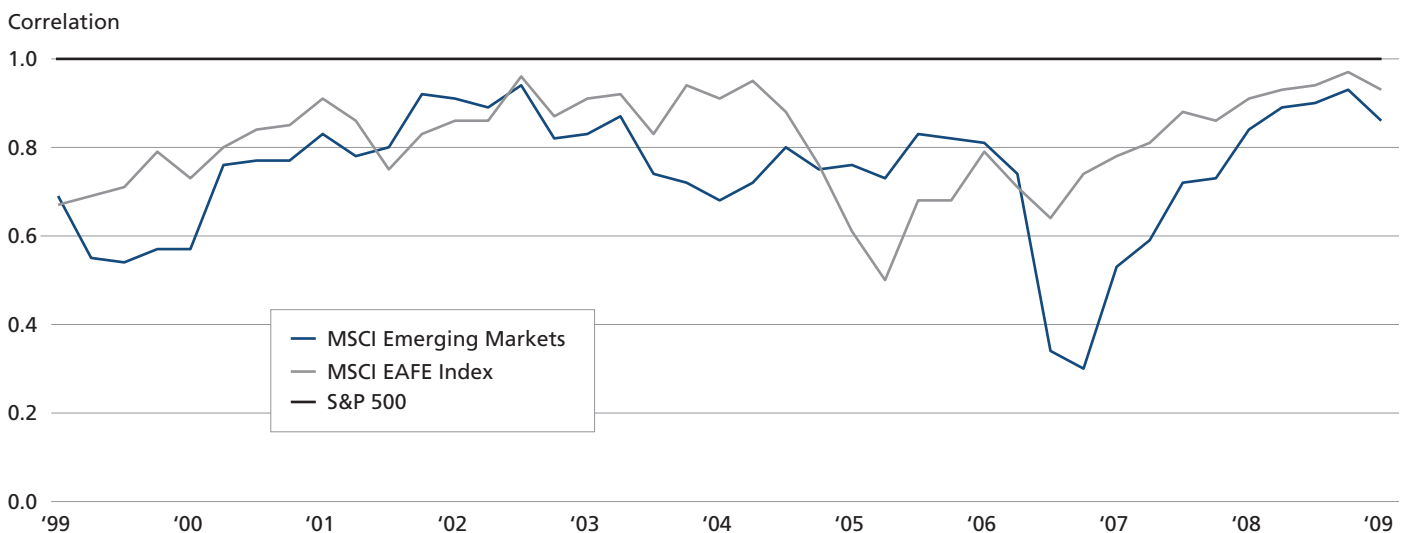
international component. For these reasons, we recommend a dedicated allocation to direct investments in foreign equities, whenever possible, to enhance the international exposure within your portfolio.

## POTENTIAL DIVERSIFICATION BENEFITS OF ADDING INTERNATIONAL TO A PORTFOLIO OF U.S. STOCKS

Given the significant size of the opportunity and the potential for performance from both the underlying asset and currency, there is a compelling argument for allocating a portion of your portfolio to international stocks. Perhaps more important, however, imperfect correlations between foreign and U.S. markets mean that adding international investments to a portfolio of U.S. stocks can help improve diversification and portfolio efficiency.

**FIGURE 5: INTERNATIONAL INVESTING PROVIDES A GOOD SOURCE OF OVERALL DIVERSIFICATION**

Rolling 12-Month Correlation to the S&P 500—10 Years Ended December 2009

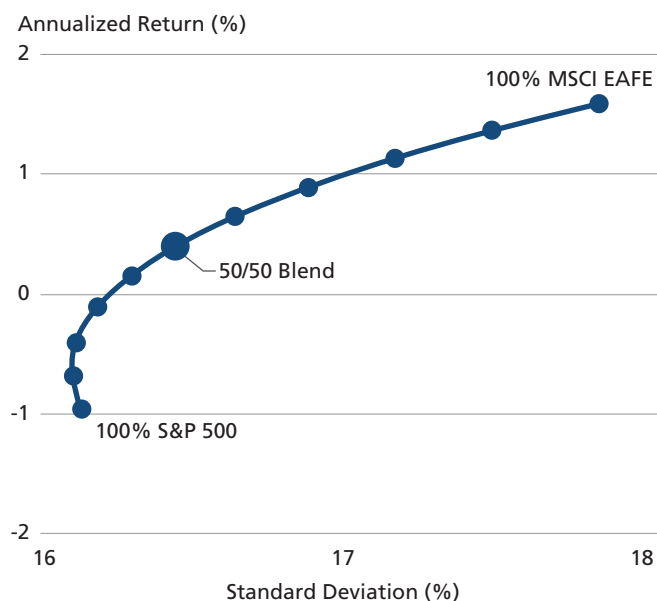


Sources: Callan; Neuberger Berman.

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**FIGURE 6: ADDING INTERNATIONAL TO A PORTFOLIO OF U.S. STOCKS CAN IMPROVE EFFICIENCY**

Portfolio Combinations—10 Years Ended December 2009



Sources: Callan; Neuberger Berman.

Portfolio combinations rebalanced annually. Indices 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. Please see disclosures at the end of this article, which are an important part of this publication.

Correlations between foreign and U.S. markets have followed different trends over time (see Figure 5.) In the emerging markets boom immediately preceding the downturn, many economists had begun to speak of ‘decoupling’ and the lower correlation surfacing between U.S. and foreign market returns. True to the adage, “Nothing goes up in a down market except correlation,” U.S. and non-U.S. stock correlations were much higher in the market tumble of 2008–2009. It remains to be seen how correlations will evolve in this recovery; as growth resumes around the world at different speeds and along different paths, we believe U.S. and non-U.S. returns will resume a lower correlation than they demonstrated in the downturn. This suggests investors can benefit from the diversification of allocating to both U.S. and non-U.S. equities.

Lower correlations between U.S. and international markets explain how combining these asset classes can enhance portfolio efficiency. An efficient portfolio is one that provides the greatest expected return for a given level of risk. Figure 6 demonstrates how the risk-return relationship in a portfolio of U.S. stocks changes as you incrementally add international developed equities. During the 10-year period ended December 2009, adding international to a portfolio of

U.S. stocks (up to 20%) helped increase overall returns while decreasing risk.<sup>3</sup>

## THE NEUBERGER BERMAN APPROACH TO INTERNATIONAL INVESTING

Given the myriad benefits associated with international investing, we may recommend allocating as much as 30% of your equity portfolio, depending, of course, on your specific situation, to a combination of developed and emerging market investments.<sup>4</sup> That exposure can come from a variety of sources. For example, clients can access dedicated international equity managers at Neuberger Berman through separately managed accounts and mutual funds. Additionally, many of our Neuberger Berman portfolio managers actively look abroad for investment opportunities and incorporate them into their predominantly U.S.-focused portfolios. Multinational corporations also offer a degree of exposure although, as discussed earlier, we do not recommend multinationals as a sole source of international exposure.

While there’s certainly no guarantee that international equity markets will continue to outperform the U.S., as they have over the last 10 years, the benefits of including international equities in your portfolio transcend performance. A well-diversified equity portfolio that includes an international allocation has proven over the last decade to produce a better risk-return balance than one that includes only U.S. equities. We believe this potential increase in portfolio efficiency is reason enough to consider a sizeable allocation.

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<sup>3</sup> Sources: Callan and Neuberger Berman

<sup>4</sup> Please refer to Disclosures on back page.

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