

DOES ECONOMIC GROWTH IN EMERGING MARKETS DRIVE EQUITY RETURNS?

CONRAD SALDANHA, CFA
 PORTFOLIO MANAGER
 EMERGING MARKET EQUITIES

August 2010

Conventional wisdom suggests that a country's economic growth should help the performance of its stock market. Thus, with emerging market economies posting substantially higher growth rates, many investors are increasingly attracted to the potential of emerging equity markets. Our research shows, however, that equity returns tend to be driven more by earnings growth than GDP growth. Returns are also influenced by other factors such as a country's financial market structure, fiscal and monetary policies and legal standards. We believe the complex and dynamic nature of emerging markets suggests that a bottom-up, fundamental investment approach can capitalize on these differences and help identify attractive investment opportunities.

While we believe emerging markets equities and economies have the potential to outperform moving forward, we believe that using GDP growth rates as a proxy for stock market behavior in these countries may be overly simplistic.

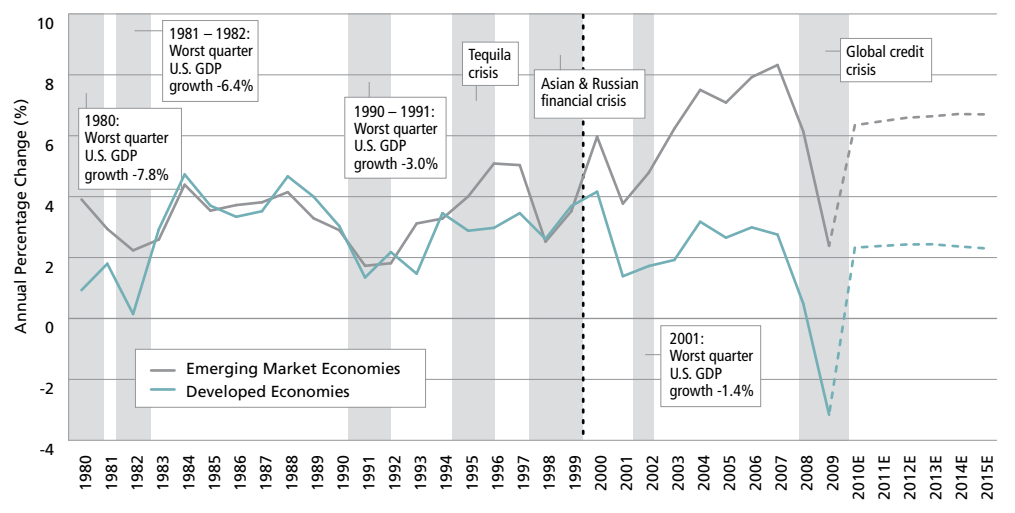
GDP GROWTH IN EMERGING MARKETS

While not always determinative, at the very least, economic growth generally provides an underpinning to a country's equity market. Companies operating in a weak or contracting economy may face obstacles to earnings growth, making valuation changes and price appreciation more difficult. Similarly, companies operating in a rapidly expanding economy may enjoy a tailwind.

As Figure 1 illustrates, emerging market countries' gross domestic product (GDP) growth rates have followed a high growth trajectory, outperforming their developed markets counterparts—particularly since the Asian and Russian financial crises. Given favorable demographic factors and healthy balance sheets, we believe this trend is likely to continue, which could make emerging markets an attractive asset class for investors that view GDP growth as a positive equity market indicator.

It is also important to note that from a long term perspective, the average correlation between GDP growth rates for developed and emerging markets is low; this value was 0.24 from 1980 to 2009. While we believe emerging markets equities and economies have the potential to outperform moving forward, we believe that using GDP growth rates as a proxy for stock market behavior in these countries may be overly simplistic.

FIGURE 1: REAL GDP GROWTH



Sources: International Monetary Fund, World Economic Outlook Database, April 2010; and National Bureau of Economic Research. GDP percentage change based on chained 2000 dollars. Chained 2000 dollars represents real dollar amounts adjusted over time for inflation. Values are computed with 2000 as the base year.

Demographic, macroeconomic and fiscal factors are driving the potential of emerging markets to capture greater global stock market representation over time.

CONTINUING GROWTH AND MARKET EXPANSION

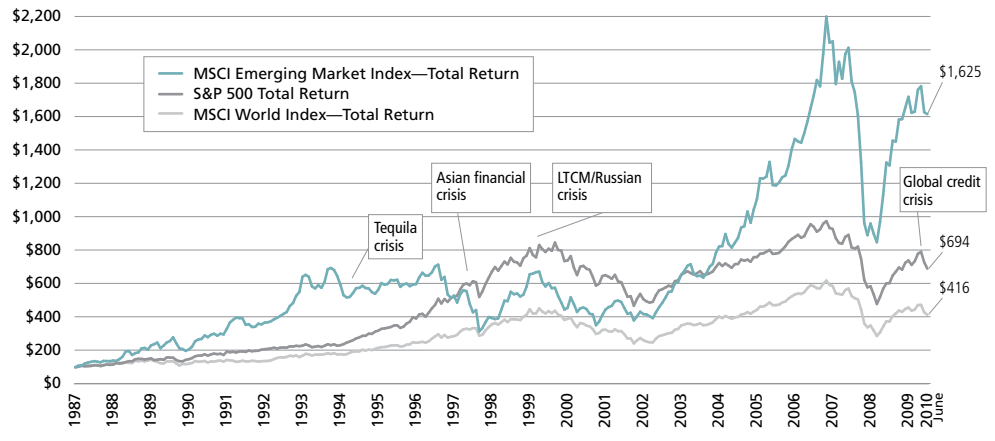
Demographic, macroeconomic and fiscal factors are driving the potential of emerging markets to capture greater global stock market representation over time. Currently, 83% of the world's population lives in emerging market countries. However, these same countries comprise approximately 25% of the world's market capitalization. As credit becomes more readily available and household income rises, consumer spending is likely to increase. Evidence suggests that this could expand GDP and market capitalization in these countries. It is important to note that such increases would likely come from equity issuance as well as market appreciation.

Reduced inflation is another important source of economic and financial market strength. In contrast to the hyperinflationary period of the 1990s, we now see much more stable regimes with inflation projected at levels barely above those of developed markets. Historically, the weakening U.S. dollar, especially since 2002, has also increased asset flows into emerging markets, further bolstering performance. Most importantly, from a fundamental perspective, market gains have been supported by very strong earnings growth, a topic we will revisit in more detail (see Figures 2 and 3).

From a fundamental perspective, emerging market gains have been supported by very strong earnings growth.

From a fiscal perspective, emerging market economies are in relatively strong positions relative to developed nations. Since the Mexican, Asian, Russian and Long-Term Capital Management crises in the late 1990s, emerging market economies have demonstrated much greater stability, as exemplified by their ability to weather the global financial crisis of 2008–2009.

FIGURE 2: HYPOTHETICAL GROWTH OF \$100 (12/31/1987–6/30/2010)

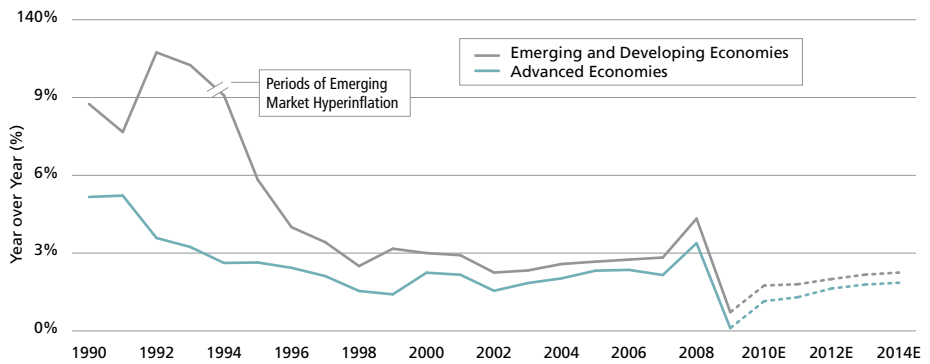


Source: FactSet. Data as of June 30, 2010.

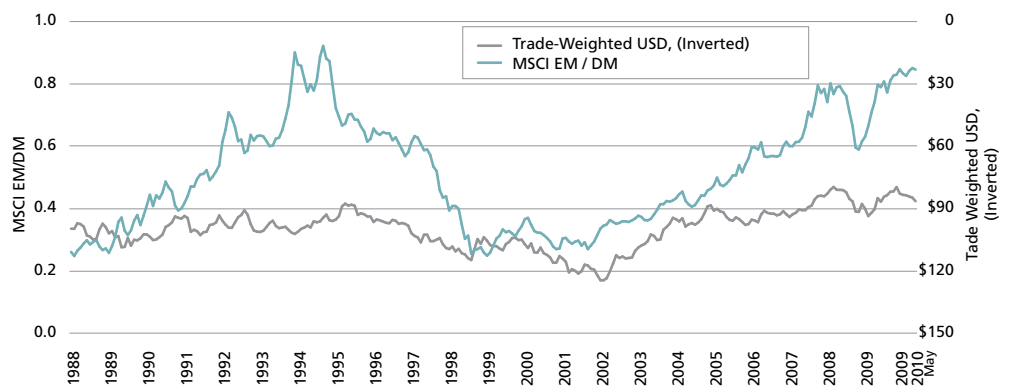
The chart illustrates the results of a hypothetical investment in the indexes over the time periods indicated and assume reinvestment of any dividends and distributions. Results shown are hypothetical and do not represent the returns of any particular investment. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. Past performance is no guarantee of future results.

FIGURE 3:

Real Inflation Rates¹



EM Performance vs. U.S. Dollar²



¹ Sources: International Monetary Fund, World Economic Outlook Database, October 2009.

² Source: Bank of America Merrill Lynch.

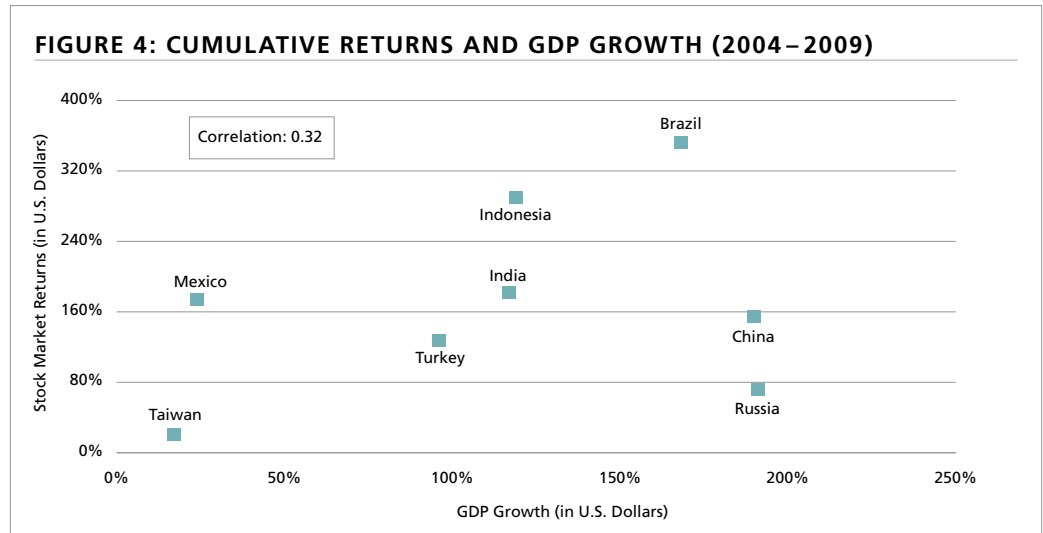
Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. Past performance is no guarantee of future results.

While GDP growth in emerging markets has been accompanied by strong stock market returns since 1990, the highest GDP growth countries have not always produced the highest stock market returns from either a real or nominal perspective. Figure 4 shows the disparity between GDP growth rates and five-year cumulative returns for select emerging market countries.

GDP GROWTH DOES NOT DIRECTLY TRANSLATE

While GDP growth in emerging markets has been accompanied by strong stock market returns since 1990, the highest GDP growth countries have not always produced the highest stock market returns from either a real or nominal perspective. Figure 4 shows the disparity between GDP growth rates and five-year cumulative returns for select emerging market countries.

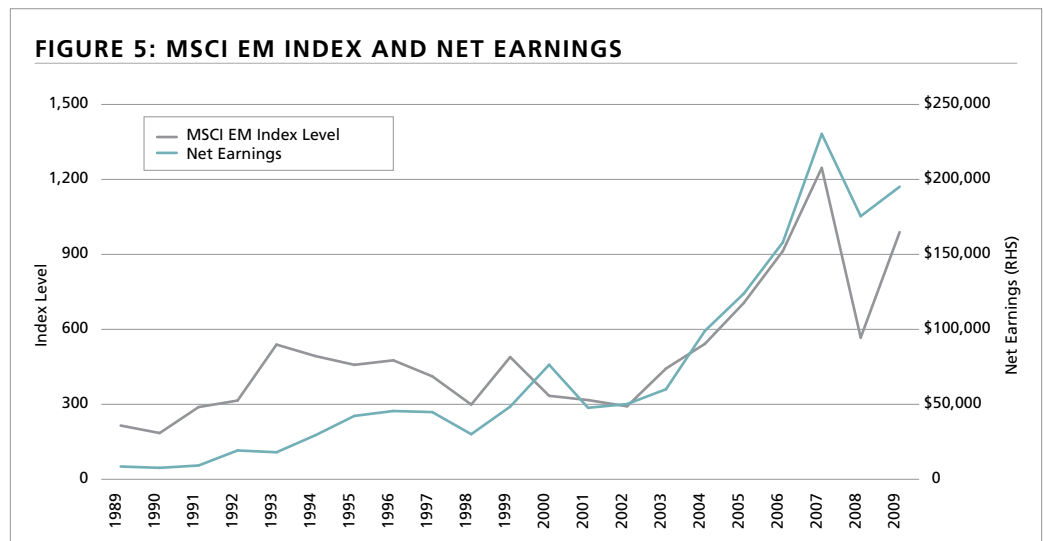
In U.S. dollar terms, the highest nominal GDP growth countries, China and Russia, did not produce the best stock market returns. Mexico, however, outperformed both countries with only about a sixth of their GDP growth.



Source: MSCI. Data from December 31, 2003–December 31, 2009.

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.

The impact of GDP growth on stock market performance varies with each country and is influenced by other factors. We believe that earnings growth can be a better indicator of stock market performance than GDP growth (see Figure 5). We also believe the size of the domestic economy, stock market structure, and valuations affect stock market returns.



Source: JP Morgan. Data as of December 31, 2009.

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.

Our findings show that the impact of EPS growth (earnings to shareholders) and re-valuation (the price investors are willing to pay) had much larger impact on stock market returns than GDP growth.

ANALYSIS IDENTIFIES KEY FACTORS BEYOND GDP GROWTH¹

In order to understand stock market performance better, we disaggregated U.S. dollar price returns (excluding dividends) and isolated the factors that we believe are the key drivers of performance. As shown in Figure 6, we started with the change in GDP growth (as a proxy for sales growth), and multiplied that by the change in earnings per share divided by the change in GDP growth (a proxy for a change in profitability). The impact of multiplying these two variables leads to EPS growth. We then compounded this by the change in price/earnings to represent the change in valuation.

In our analysis, we used MSCI Emerging Markets Index data over a six-year time period (2003–2009), which coincides with one of the biggest bull markets in emerging markets history. Our findings show that the impact of EPS growth (earnings to shareholders) and re-valuation (the price investors are willing to pay) had much larger impact on stock market returns than GDP growth, as we discuss in detail in the next section.

FIGURE 6²:

$$\text{Stock Market Returns} = \Delta \text{ GDP} \times \underbrace{\left(\frac{\Delta \text{ EPS}}{\Delta \text{ GDP}} \right)}_{\text{Profit Impact of Economic Growth}} \times \underbrace{\frac{\text{P/E 2009}}{\text{P/E 2003}}}_{\text{Change in Valuation}}$$

REAL WORLD EVIDENCE

When we looked at the disaggregated factors identified in our model against real world data, the results were determined on a country-by-country basis. As can be seen in Figure 7, Brazil and Indonesia, the best performing markets over the time period examined, were helped most by having achieved much greater P/E expansion than their counterparts — our disaggregated “change in valuation” factor. Part of this expansion can be explained by the period’s commodity run.

China, as previously discussed, showed the strongest GDP growth. However, this did not translate into meaningful profits or returns. In fact, Chinese profits/change in GDP declined during this period. As a result, returns for the Chinese stock market were mediocre, and were surpassed by countries like Mexico, which had significantly lower GDP growth but had corporate profits that increased substantially. Many of the companies listed on the Mexican equities overall enjoyed very high returns and growth rates over the period.

Russia, another GDP growth leader, also underperformed. Russia enjoyed an increase in valuation, but the market’s profitability collapsed due to an increase in the state ownership component within the benchmark. India made steady progress and improved its profitability, although it did not enjoy a significant shift in valuation. Turkey’s performance benefitted from strong economic growth. Taiwan underperformed due to lackluster macroeconomic drivers and was the weakest of the countries we examined in terms of both GDP growth and market return. Taiwan, which is highly dependent on technology export, was also negatively impacted by weak external demand during the period.

¹ Model analysis is shown for illustrative purposes only. The use of tools, such as model based programs, cannot guarantee performance. Investing entails risks, including possible loss of principal.

² Price to Earnings Ratio (P/E): The Price to earnings ratio is calculated by dividing the price of the security by the earnings per share. The higher the PE ratio the more the investor is willing to pay for earnings. A higher PE ratio would imply that earnings will grow higher in the future.

While the correlation between GDP growth and equity returns in emerging markets is relatively low, the correlation between change in earnings and returns is dramatically higher, at 0.75.

FIGURE 7: FACTOR DISAGGREGATION MODEL (2003 – 2009)

	Δ GDP	Δ EPS / Δ GDP	P/E Multiple	Cumulative Stock Market Returns
Brazil	168%	-5%	77%	352%
China	190%	-17%	6%	155%
India	117%	16%	12%	182%
Indonesia	119%	2%	74%	290%
Mexico	24%	80%	23%	174%
Russia	191%	-75%	137%	72%
Taiwan	17%	-5%	9%	21%
Turkey	96%	2%	14%	128%

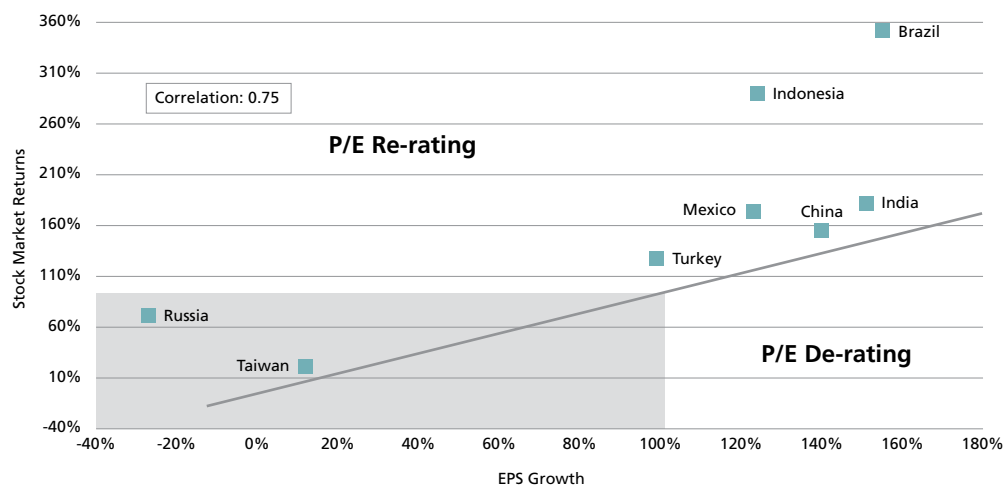
Sources: MSCI and Neuberger Berman.

Results based on data from December 31, 2003–December 31, 2009. Stock market price returns are based on USD and nominal GDP. Model analysis is shown for illustrative purposes only. The use of tools, such as model based programs, cannot guarantee performance. 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.

EARNINGS PER SHARE GROWTH AND VALUATION MATTER MOST

While the correlation between GDP growth and equity returns in emerging markets is relatively low, the correlation between change in earnings and returns is dramatically higher, at 0.75. Figure 8 compares stock market returns to changes in EPS growth. None of the countries listed below witnessed a de-rating and the countries with the largest returns over this period — as represented by the countries farthest above the line — were those that saw the most significant change in their P/E multiple. As we see, Brazil and Indonesia, the best performers over the period, had the most significant change.

FIGURE 8: CUMULATIVE STOCK MARKET RETURNS VS. CUMULATIVE EPS GROWTH



Source: MSCI. Data from December 31, 2003–December 31, 2009.

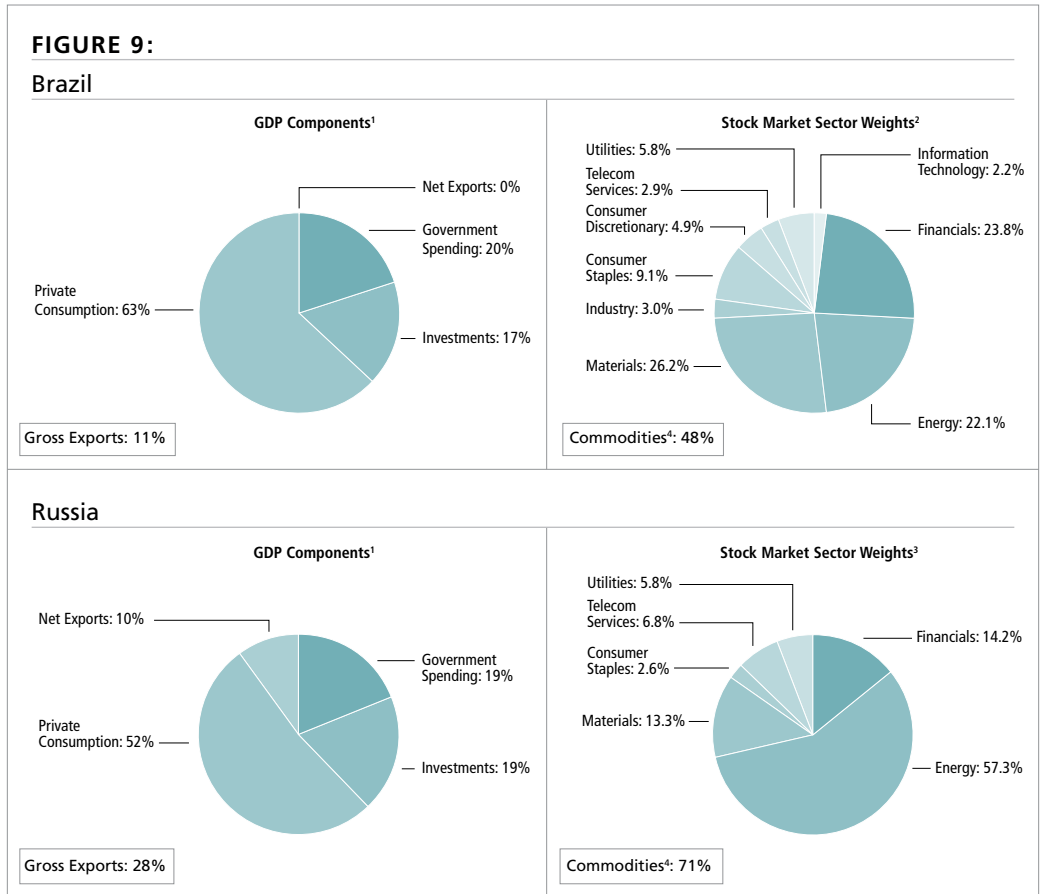
Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. Past performance is no guarantee of future results.

It appears that benchmark exposure (i.e., via an index fund) may not always be representative of the local economy, a factor which we think is important for investors to consider.

BROAD MARKET EXPOSURE IGNORES FUNDAMENTALS

We believe that changes in profitability and valuations are more significant determinants of return than expected GDP growth rates. Furthermore, index or ETF investing may not capitalize on stock-specific factors that contribute to the underlying economy’s performance.

To determine why some of the markets we evaluated did not appreciate significantly, or why their profitability did not increase as much as their peers, we examined two commodity-driven markets with vastly different experiences—Brazil and Russia. In Brazil, private consumption is 63% of the domestic economy. By sectors, however, Materials and Energy comprise 48% of MSCI Brazil Index, and the consumer sectors, especially when excluding Financials, are much less significant. As such, it appears that benchmark exposure (i.e., via an index fund) may not always be representative of the local economy, a factor which we think is important for investors to consider. Russia further exemplifies the disconnect between a country specific index and the underlying economy. In Russia, private consumption is 52% of GDP, while commodities—which are largely exported (i.e., Energy and Materials)—constitute approximately 70% of the index (see Figure 9).



¹ Sources: Neuberger Berman, Merrill Lynch, Credit Suisse. Estimates for 2010. Represents a percentage of GDP.

² Sources: MSCI. As of June 30, 2010, MSCI Brazil Index.

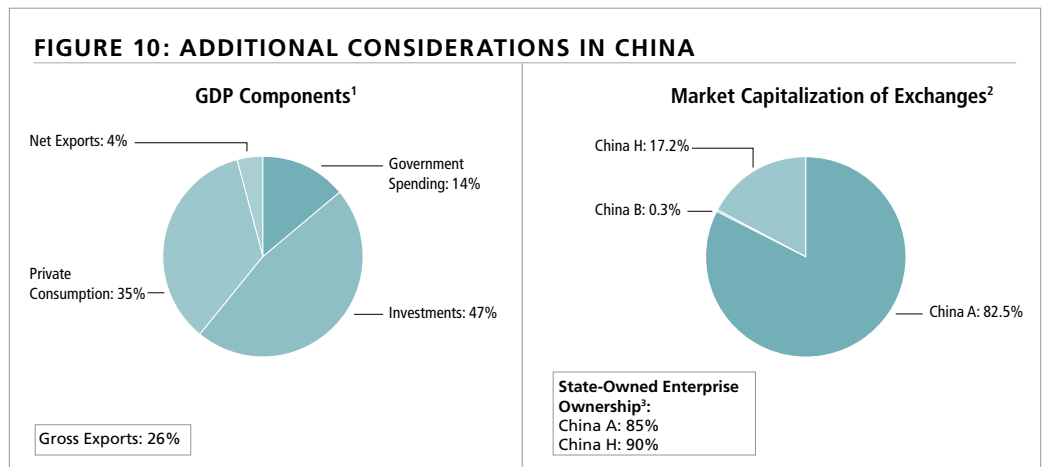
³ Sources: MSCI. As of June 30, 2010, MSCI Russia Index.

⁴ Commodities includes Energy and Materials.

China presents a different scenario altogether. China’s GDP is significantly more trade-oriented, with gross exports approaching 30% of the economy. In addition, the government controls a large part of Chinese GDP, with influences in both areas of government spending (14%) and investments (47%). Chinese private consumption has

Based on our research, while it appears economic growth in emerging markets will likely be strong going forward, we are not of the view that broad equity market outperformance is likely to follow GDP growth in lockstep.

not moved above 35% of the economy, which may explain the limit on profitable growth at the stock level. Additionally, state-owned enterprises dominate China’s corporate sector (85% to 90% of market capitalization) which, in our opinion, probably limits efficiency, thus leading to lower returns. All told, we were not surprised to see Chinese returns disappoint over the time period, as profitability declined relative to strong GDP growth. One additional and important inefficiency in China is this: Chinese market capitalization is dominated by the restricted QFII (Qualified Foreign Institutional Investor) A share market. In contrast, the investable H share market represents only 17.2% of market cap, and is heavily geared toward Financials (see Figure 10).



¹ Sources: Neuberger Berman, Merrill Lynch, Credit Suisse. Estimates for 2010. Represents a percentage of GDP.

² Sources: MSCI. Represents MSCI China A Index, MSCI China B Index and MSCI China H Index. As of December 31, 2009.

³ Source: Deutsche Bank. As of December 31, 2009.

ADVANTAGES OF BOTTOM-UP STRATEGIES

Based on our research, while it appears economic growth in emerging markets will likely be strong going forward, we are not of the view that broad equity market outperformance is likely to follow GDP growth in lockstep. We believe profitability and change in valuation are important considerations in evaluating stock market performance given that they are more closely correlated with market returns than GDP growth.

We also believe that, in many cases, broad indexes are not a proper representation of the underlying economy due to the skewing caused by factors such as sector representation and market structure. This discrepancy may explain why markets (as represented by their MSCI indexes) did not perform in line with their economic growth rates.

By design, bottom-up fundamental active strategies are able to evaluate investments based on multiple considerations, including valuation and profitability metrics.

Across the emerging markets, we believe the most attractive risk/reward opportunities will be found in companies with unique assets, differentiated business models and access to secular growth markets—companies (and opportunities for returns) that may otherwise be overlooked. In our opinion, a bottom-up investment approach focusing on domestically oriented companies can provide attractive total return and diversification potential.

In our opinion, a bottom-up investment approach focusing on domestically oriented companies can provide attractive total return and diversification potential.

RISK DISCLOSURES

Investing in foreign securities involves greater risks than investing in securities of U.S. issuers, including currency fluctuations, potential political instability, restrictions on foreign investors, less regulation and less market liquidity. Governments of emerging market countries may be more unstable and more likely to impose capital controls, nationalize a company or an industry, place restrictions on foreign ownership and on withdrawing sales proceeds of securities from the country, and/or impose burdensome taxes that could adversely affect security prices. These countries may also have less developed legal and accounting systems. Securities issued in these countries may be more volatile and less liquid than securities issued in foreign countries with more developed economies or markets. Changes in currency exchange rates bring an added dimension of risk. Currency fluctuations could erase investment gains or add to investment losses. From time to time, the Fund may hedge against some currency risks; however, the hedging instruments may not always perform as the Fund expects and could produce losses. Suitable hedging instruments may not be available for currencies of emerging market countries. The risks involved in seeking capital appreciation from investments primarily in companies based outside the United States are set forth in the prospectus.

An investor should consider Neuberger Berman Emerging Markets Equity Fund's investment objectives, risks and fees and expenses carefully before investing. This and other important information can be found in the fund's prospectus, which can be obtained by calling 877.628.2583. Please read it carefully before making an investment. The prospectus contains a more complete discussion of the risk of investing in the Fund.

This material is presented solely for informational purposes and 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. Readers should not assume that any investments in securities, companies, sectors or markets identified and described were or will be profitable. Information is obtained from sources deemed reliable, but there is no representation or warranty as to its accuracy, completeness or reliability. All information is current as of the date of this material and is subject to change without notice. Any views or opinions expressed may not reflect those of the firm as a whole. Third-party economic or market estimates discussed herein may or may not be realized and no opinion or representation is being given regarding such estimates. Certain products and services may not be available in all jurisdictions or to all client types. Unless otherwise indicated, returns shown reflect reinvestment of dividends and distributions. Indexes are unmanaged and are not available for direct investment. The use of tools, such as model based programs, cannot guarantee performance. Investing entails risks, including possible loss of principal. Past performance is no guarantee of future results.

MSCI Emerging Market a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of June 2006 the MSCI Emerging Markets Index consisted of the following 25 emerging market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

MSCI World a free float-adjusted market capitalization index that is designed to measure global developed market equity performance. As of June 2006 the MSCI World Index consisted of the following 23 developed market country indices: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom and the United States.

©2010 Neuberger Berman Management LLC, distributor. Member FINRA. All rights reserved.

K0447 09/10