

FUNDAMENTALS AND THE STOCK MARKET



MATTHEW RUBIN
DIRECTOR OF INVESTMENT STRATEGY

In the midst of the downturn, many companies cut costs expecting the worst. As a result, they emerged in the current slow-growth environment with dramatically reduced cost structures.

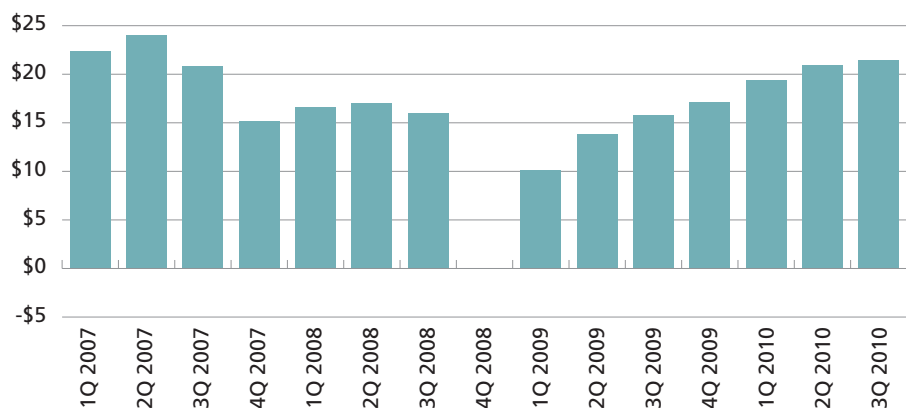
The past decade has not been kind to equity investors, with the S&P 500 posting a roughly flat return over the 10 years ending October 31, 2010. Even with recent market gains, investment flows and price volatility appear to reflect continued risk aversion and skepticism about stocks—something that has prevailed since the credit crisis of 2008.

Is this continued discomfort justified? It can be argued that the economy is relatively weak, and with high unemployment, the weak housing market and a new focus on fiscal restraint, few expect rapid expansion anytime soon—not exactly a bullish sign for an asset class that is supposed to benefit from expansion. However, from a number of vantage points, stocks are displaying what we consider attractive characteristics that suggest the benefits of maintaining substantial exposure to equities in the current environment.

COMPANIES ARE STRONG

In the midst of the downturn, many companies cut costs expecting the worst. As a result, they emerged in the current slow-growth environment with dramatically reduced cost structures which have contributed to strong earnings, with operating profits for S&P 500 companies growing 36% (year-over-year) in the third quarter. In addition, corporate balance sheets are very healthy and in aggregate carry sizable cash positions—nearly \$1 trillion as of September 30, 2010. This provides managements with increased flexibility to increase dividends, buy back stocks or make acquisitions that could fuel growth.

FIGURE 1: S&P 500 OPERATING EARNINGS PER SHARE



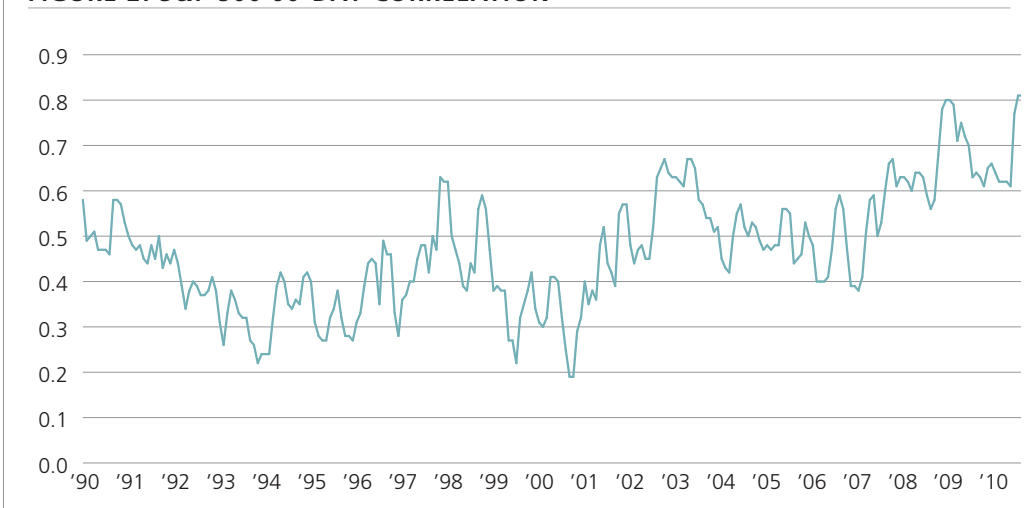
Sources: First Call. Figure for third-quarter 2010 reflects reports by 91% of companies.

We think that it is highly unlikely, given those differences, that stocks will continue, longer-term, to move in lock step, particularly as macro concerns begin to ease.

HIGH CORRELATIONS PROVIDE OPPORTUNITY

Since the onset of the credit crisis in 2008, investors have tended to paint stocks with a broad brush, exiting the asset class on fears of economic and financial weakness and moving back in when conditions appeared to become more stable. The individual fundamentals of particular companies have often mattered less than their tendency to benefit from overall economic growth. As a result, correlations among stocks—even those with widely differing characteristics, business models and levels of management success—have been exceptionally high. We think that it is highly unlikely, given those differences, that stocks will continue, longer-term, to move in lockstep, particularly as macro concerns begin to ease. This, in turn, could create what we believe is an opportunity for active managers to add value to portfolios.

FIGURE 2: S&P 500 60-DAY CORRELATION



Source: Wolfe Trahan. 60-day correlation represents the rolling 60-day performance correlations between each S&P 500 constituent, which are averaged together to create a single correlation figure for the index.

MODERATE VALUATIONS, HEALTHY YIELDS

Even with recent gains, stocks remain inexpensive from a variety of perspectives—including price/earnings, price/cash flow, price/book value and earnings yield. As of October 31, 2010, the P/E of the S&P 500 was about 14.3 times consensus forward earnings estimates—up slightly from last year but far lower than the low-20s levels seen prior to the financial meltdown. Relative valuations are particularly compelling, with the S&P 500 earnings yield at 7.0% compared to the aggregate yield of 4.23% on BBB-rated corporate bonds, for a difference of more than 2.7% compared to the historical average of -0.25% over the 10 years ending October 31, 2010.

Indeed, the valuation relationship between equities and bonds is currently such that many stocks are now relatively powerful income-generating vehicles (although obviously the risks of stocks are generally greater than for bonds). The S&P 500's overall dividend yield is 1.9% as of October 31, 2010, compared to the U.S. 10-year Treasury's 2.6%; and more traditional income-oriented sectors such as Utilities (4.3% yield)¹ and REITs (3.6% yield)² show, in our opinion, particular appeal at a time when many investors are looking for sources of income.

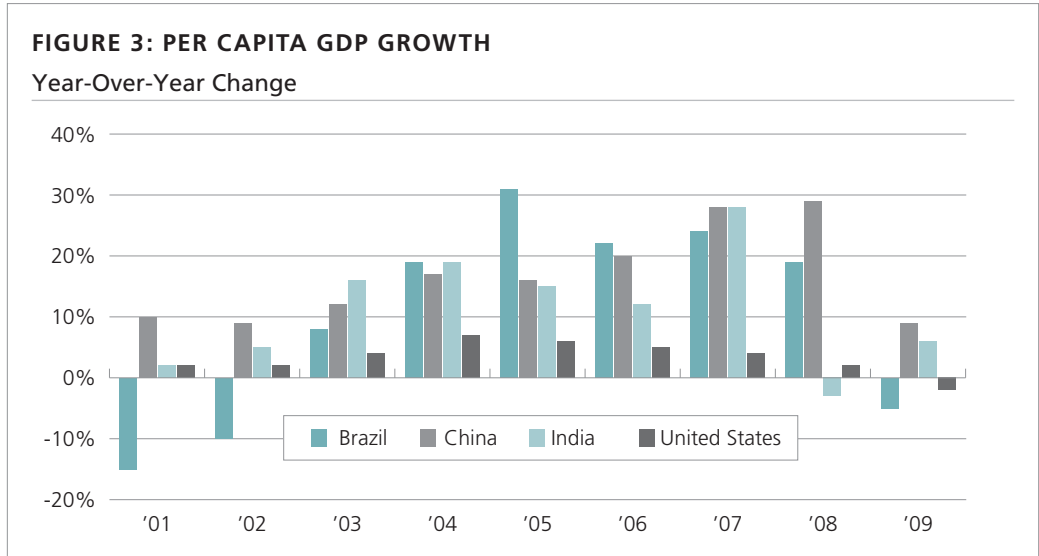
¹ Dow Jones Utility Average.

² FTSE NAREIT Equity REITs Index.

Investing in U.S. and other established market companies with a global presence could be a way to “play” emerging markets growth.

CAPITALIZING ON EMERGING MARKET GROWTH

Although the U.S. and European economies are currently slow, emerging market countries—less burdened by sovereign and personal debt—have shown great resiliency and are expanding at a steady pace. In our view, this suggests that investors should consider the possibility of placing at least a moderate percentage of their portfolios in emerging-markets-focused investments. Less obviously, it also means that investing in U.S. and other established market companies with a global presence could be a way to “play” emerging markets growth. More than 25% of revenues for S&P 500 companies came from non-U.S. sources in 2009. As such, it stands to reason that the earnings base of stock market may expand more rapidly over time than the broader, more tepid U.S. economy, further supporting the case for “domestic” stocks.

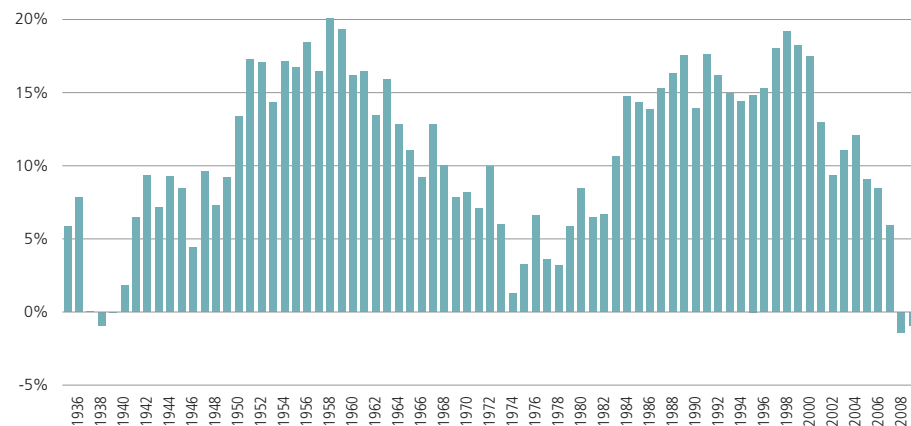


Source: FactSet.

LONG-TERM PERFORMANCE RECORD

The weakness of stocks over the past decade—especially compared to bonds—has undermined the confidence of investors and led many to question the role of equities in investment portfolios. Despite the recent record, however, the long-term performance of stocks has shown them to be a way to create wealth over time. Indeed, the slight declines experienced by stocks over recent rolling 10-year periods (see Figure 4) are highly anomalous—and something that previously had not been seen in roughly 70 years. Past performance does not guarantee future results, but it would stand to reason that in most cases exiting an asset class after a long period of poor results is unlikely to be a formula for success.

FIGURE 4: S&P 500 10-YEAR ROLLING RETURNS
Annualized, 1935–2009



Source: Morningstar Direct.

A MARKET OF STOCKS

In our view, the combined elements discussed above make a compelling case for stocks generally. In addition, more evergreen rationales, such as the usefulness of equities in counteracting the impact of inflation and their important role in maintaining a diversified portfolio, appear convincing as well.

However, we believe that the most compelling argument for stocks is not based solely on their qualities as an asset class, but rather the opportunity set they represent. Even in the current slow-growth environment, our portfolio managers are finding what they consider exceptional companies with good earnings, solid balance sheets and favorable growth prospects. Their ability to differentiate these names from weaker counterparts is a key factor in seeking investment success over the long haul.

We believe that the most compelling argument for stocks is not based solely on their qualities as an asset class, but rather the opportunity set they represent.

The 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.

FTSE NAREIT Equity REITs Index is a free float-adjusted, market capitalization-weighted index that includes all tax-qualified REITs listed in the NYSE, AMEX, or NASDAQ Global Market List which pass FTSE's minimum size and liquidity criteria.

The Dow Jones Utility Average is a price-weighted average of 15 utility stocks traded in the United States.

This material is presented solely for informational purposes and nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation or solicitation to buy, sell or hold a security. This material has been prepared by Neuberger Berman on the basis of publicly available information, internally developed data and other third-party sources believed to be reliable. Neuberger Berman has not sought to independently verify information taken from public and third-party sources and does not make any representation or warranty as to the accuracy, completeness or reliability of the information contained herein. No recommendation or advice is being given as to whether any investment or strategy is suitable for a particular investor. It should not be assumed that any investments in securities, companies, sectors or markets identified and described were, or will be, profitable. 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.

Publications referenced herein are intended solely for your information and should not be construed as an endorsement by Neuberger Berman. Neuberger Berman is not responsible for the content of these publications or Web sites. 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. Data is not representative of any Neuberger Berman investment product or service and does not reflect the fees and expenses associated with managing a portfolio. 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.**

Neuberger Berman LLC is a Registered Investment Adviser and Broker-Dealer. Member FINRA/SIPC.
K0552 11/10 ©2010 Neuberger Berman LLC. All rights reserved.

NEUBERGER BERMAN

Partnering With Clients For Over 70 Years

Neuberger Berman LLC
605 Third Avenue
New York, NY 10158

www.nb.com