

2011 OUTLOOK: INTERNATIONAL AND EMERGING MARKET EQUITIES

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The past year has been turbulent for financial markets, with sovereign debt issues and economic uncertainty driving volatility. Despite this negativity, relatively healthy economic growth in developing countries and exceptional levels of liquidity in developed markets have helped drive gains in many equity markets, particularly in the emerging world. Looking ahead, we believe what appears to be a generally moderate economic recovery will remain on track, although sovereign debt issues and associated austerity measures in Europe, as well as increasing protectionist tendencies in emerging markets, pose risks. In the pages that follow, we share perspectives on the investment climate and our outlook for 2011.

EXECUTIVE SUMMARY

- We anticipate modest but positive global economic growth in 2011.
- Economic growth in emerging markets should benefit developed-market firms with global reach as well as emerging-market companies.
- Issues we are closely watching: the potential for currency/trade wars, asset bubbles and inflation in the emerging markets, increasing regulation and possible negative impacts of monetary tightening.
- Many overseas corporations are profitable and healthy, with cash available for M&A, higher dividends and other corporate activities.
- Valuations generally remain compelling in relation to longer-term growth rates and cash flows.
- Bottom-up stock selection combined with a macro perspective could be effective in the year ahead.

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INTERNATIONAL DEVELOPED MARKETS

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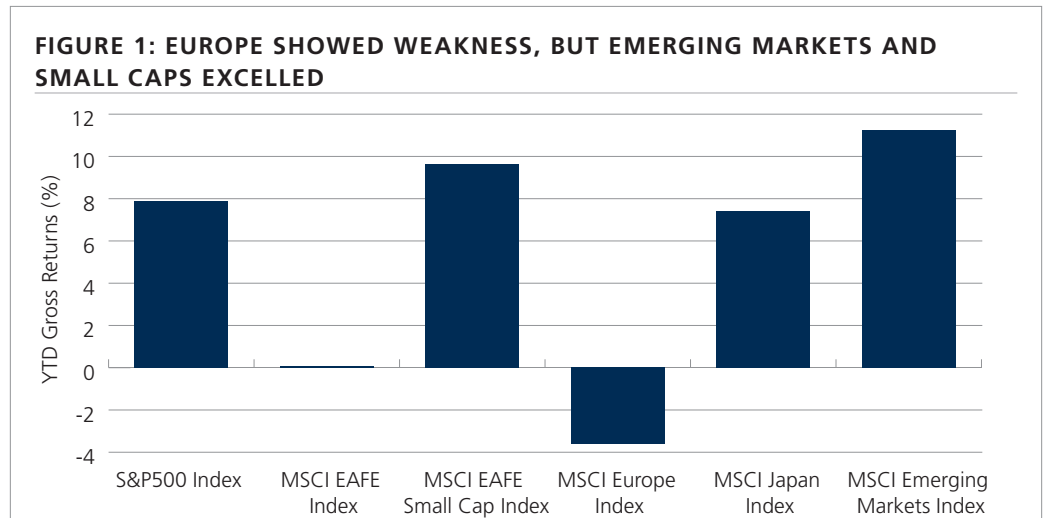
In 2010, Confidence Offset Headline Risk

While international developed markets saw some dramatically negative headlines in 2010—including sovereign debt issues in Greece and similar concerns for the debt of Portugal, Ireland, Italy and Spain—these factors were largely offset by improving earnings and investor sentiment. Investor confidence stemmed from the belief that governments and central banks globally had stabilized the global economy and that much uncertainty had been removed.

In developed economies, governments and central bankers—the U.S. Federal Reserve in particular—bolstered improved confidence in a global expansion as they took steps to stop any hint of deflation. Largely positive economic news from strong engines of growth in the emerging world, particularly China, but also Brazil and India, also helped international markets, given the increasing importance of exports to these regions.

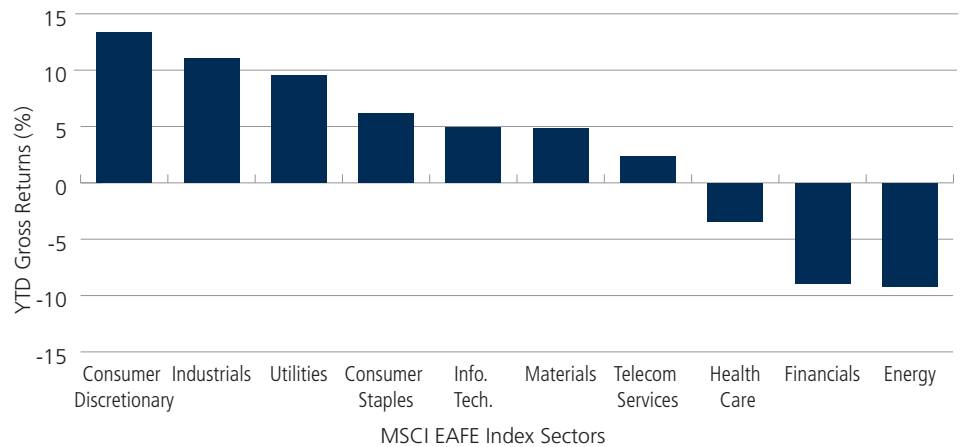
The MSCI EAFE Index was up through October but later faced headwinds as concerns increased once again over the debt crisis in Ireland and other European nations. Through the end of November, the EAFE index was up slightly for the year, with performance varying widely by country and much of the returns driven by currency with the Japanese yen holding firmer than the euro. The markets most closely associated with the debt crisis fared worst while more resilient northern European countries—and Germany in particular—performed better, as a weaker euro helped boost exports. From a sector perspective, Consumer Discretionary and Industrials did best, given improvement in the global economy overall. However, difficulties expanding production affected the Energy sector while regulation and possible sovereign debt exposure risk held back Financials. Overall, the EAFE index trailed both the S&P 500 and the MSCI Emerging Markets indices for the period. Internationally, smaller-cap names outperformed their larger-cap peers both because of more attractive sector composition—more Consumer Discretionary and Industrials, and less Financials and Energy—and strong performance in their sectors, given improved investor risk appetite.

FIGURE 1: EUROPE SHOWED WEAKNESS, BUT EMERGING MARKETS AND SMALL CAPS EXCELLED



Sources: FactSet, MSCI. Data through November 30, 2010. For illustrative purposes only. Indexes are unmanaged and are not available for direct investment. Investing entails risk, including possible loss of principal. Past performance is no guarantee of future results.

FIGURE 2: CONSUMER STRENGTH OFFSET BY WEAK FINANCIALS, ENERGY



Sources: FactSet, MSCI. Data through November 30, 2010. For illustrative purposes only. Indexes are unmanaged and are not available for direct investment. Investing entails risk, including possible loss of principal. Past performance is no guarantee of future results.

LOOKING AHEAD, GROWTH CONCERNS PERSIST

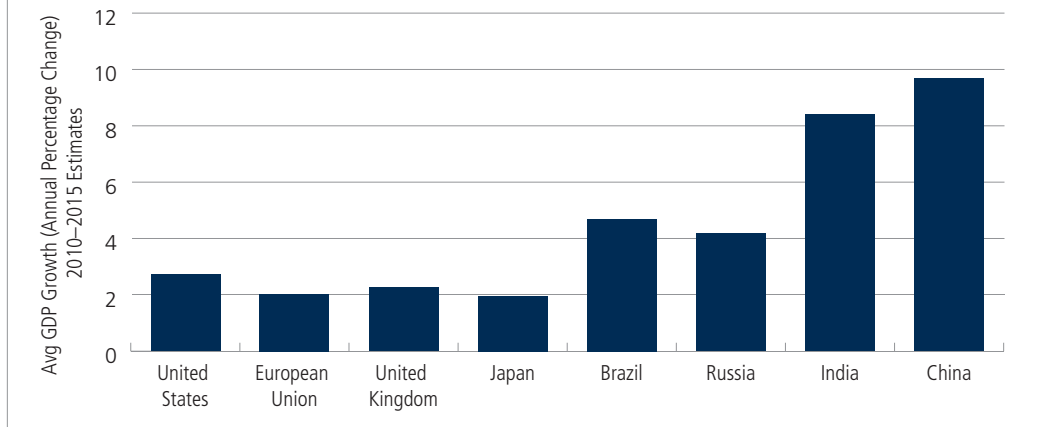
While a modest recovery appears to be underway, we believe the macroeconomic backdrop is likely to remain challenging for many developed international markets.

While a modest recovery appears to be underway, we believe the macroeconomic backdrop is likely to remain challenging for many developed international markets. Many of the weaker European economies are struggling with a relatively strong currency as well as high levels of sovereign and/or private debt. Similar to the U.S. situation, the U.K., Japan, France and Italy are struggling both to stimulate their economies and to control fiscal spending, while bond markets are forcing governments to reduce their fiscal deficits. Although debt reduction is essential for the long-term economic health of these nations, austerity measures are likely to reduce aggregate demand and limit the strength of the rebound. Moreover, while the market seems to believe that private sector spending—which is currently stable—will make up for the public shortfall, we think that remains to be seen.

In particular, countries that are struggling with debt—such as Greece, Italy, Ireland, Portugal and Spain—as well as an inability to devalue their currencies are likely to experience weak or negative growth. Meanwhile, Japan also continues to suffer from a high public debt level. We believe Japan’s economic growth will remain challenged because of its aging population as well as the ongoing risk of deflation. In contrast, Germany has been a bright spot for growth due largely to the strength of its export sector. Similarly, countries that are more geared to natural resources, such as Australia and Canada, should continue to expand at a faster rate, given ongoing demand for their commodity exports from emerging markets. In summary, economic growth is likely to vary widely in the year ahead, with emerging markets continuing to show the brightest prospects.

Despite tepid economic growth, the picture for many individual companies is positive. Balance sheets at many firms have been repaired to pre-crisis levels, cash flow generation is strong, and new capital expenditures and working capital have been cut back.

FIGURE 3: ECONOMIC GROWTH IS STRONGEST OUTSIDE DEVELOPED MARKETS



Source: International Monetary Fund, World Economic Outlook Database, October 2010.

Real GDP estimates begin after 2009. European Union composed of 27 countries: Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Romania, and United Kingdom.

Corporate Strength

Despite tepid economic growth, the picture for many individual companies is positive. Balance sheets at many firms have been repaired to pre-crisis levels, cash flow generation is strong, and new capital expenditures and working capital have been cut back. Excluding certain countries such as Singapore, Hong Kong and Australia where employment is strong, high levels of unemployment are limiting upward pressure on wages. With some uncertainty about the economic environment, companies remain reluctant to add new employees or make capital expenditures, keeping cash flows at high levels. As a result, currently strong profits are being converted very effectively into cash flows and strengthening balance sheets. On many cash flow-based valuation measures, international markets appear very attractively valued.

Real Estate: A Known Risk

Real estate weakness continues to have a significant impact on economic growth in the developed markets. The property sector grew dramatically through 2007 for countries including the United States, the U.K., Ireland and Spain in what is now generally acknowledged to have been an investment bubble. During this time, real estate accounted for a significant share of economic and job growth, adding as much as two to three percentage points to GDP. Today, however, the market is working through a sizable inventory of properties, which we believe will reduce the overall rate of economic growth by a similar figure until the inventory is absorbed. Over time, we believe housing demand will regain momentum, helped by factors including new household formation, increased living standards, replacement of aging stock in rural areas and a shortage of quality housing in urban areas.

Emerging Opportunities

In our view, another support for many developed market firms is the stronger growth in emerging markets, which has implications across a variety of sectors. For example, infrastructure, manufacturing and distribution needs in the emerging markets have put a market premium on those companies within Materials and Industrials best suited to meet

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demand from developing economies. Both sectors performed well for much of 2010 and we believe their prospects should remain positive as long as emerging markets growth and cyclical local demand continue—something that is consistent with our expectations given demographic trends.

At the individual stock level, we note that many global firms listed in the developed markets have recently underperformed emerging market counterparts. As a result, these companies, in areas such as Consumer Staples and Energy, now tend to trade at lower valuations than their local peers, and often with considerably less risk. In our view, there are numerous “best of breed” companies in this category—global firms with significant emerging markets exposure, long track records, strong management teams, and exceptional transparency—that provide a real opportunity for discerning investors.

In contrast, we are wary of financial stocks, which have generally underperformed over the past year for reasons including sovereign debt exposure, balance sheet concerns and uncertainty about pending regulatory reforms. Looking ahead, we continue to see a risk to profits from increasing regulation, including the Basel III accord, which is meant to stabilize the banking sector but will raise capital requirements. Balance sheets have improved, but not to the point where we have complete confidence in them; and we think European sovereign paper—particularly that of Spain and Greece—is going to struggle over the long term. As such, many institutions will likely need to raise more capital to weather these potential economic storms. In short, banks have been trying to sell credit while both businesses and consumers have worked for the past 18 months to reduce debt. All of these factors are putting pressure on profitability, and we think that financial sector returns are generally going to be constrained.

Excelling in a Soft Economy

With expectations for a slower-growth economy in the developed markets, we do not anticipate much of a tailwind for stocks. Indeed, we see two main macroeconomic risks to stock performance—first, the possibility that lower government spending could constrain expansion and, second, that emerging market growth could slow, which would challenge the outlook for many countries and sectors.

As such, from an investment standpoint, we believe a close eye should be kept on macroeconomics in assessing potential opportunities. In some cases, developed markets outside the EAFE index that are not suffering the same weakness as EAFE counterparts may be worth considering. For example, Canada is largely geared toward natural resources, which would be positive given continued growth in the emerging markets. Obviously, this could be considered a risk should emerging market economies slow. Moreover, these countries’ currencies have recently appreciated and any currency pullback from here would hamper their returns for U.S. dollar-based investors.

Of course, investment strategies may differ by country. In Europe and Japan, where we have concerns about sovereign debt and government belt tightening, we believe a focus on companies operating on a global basis with emerging markets exposure is appealing. We also see broad opportunity in companies selling efficiency and productivity solutions to the corporate sector. We believe that companies with innovative products or services within growing markets—whether sector-based or geographic—will see good growth in the coming year, but that the rest of the market may see less expansion.

Looking ahead we think that individual company prospects could prove to be more impactful than their capitalization size.

Considering Market Cap

One factor that may have less of a general impact in the coming year is market capitalization. In the early stages of a rally, investors have historically tended to focus on larger-cap stocks first and then migrate to smaller names. At the end of 2009, we suggested there was opportunity in smaller issues, a fact that was borne out in 2010 as those stocks excelled. Looking ahead, however, we think that individual company prospects could prove to be more impactful than their capitalization size.

In some industries, scale really matters, as witnessed in global food production and distribution. In Energy and Materials, smaller names with more targeted businesses may be advantaged in important niche subsectors. As such, we believe an opportunistic, flexible approach to market capitalization makes sense. In short, where size is correlated with quality, profitability and the ability to execute and grow, we favor larger companies; however, in small niche industries, the leading player may be a well-managed, profitable smaller business. In either case, we believe relative valuation will remain an important component of investment decisions.

Overall, we believe many opportunities exist on a company-by-company basis and that a research focus will be the key to identifying potential opportunities. From our perspective, the most attractive prospects in this environment are companies with consistent earnings and cash flows, indicating an ability to operate even in a mediocre environment and the potential to use that cash for the benefit of shareholders.

EMERGING MARKETS

In light of a slow global economy and few opportunities for outsized returns, the superior growth rates of emerging economies continued to attract investors in 2010. Although we believe prospects in the emerging markets remain strong, valuations, along with country-specific infrastructure problems and inflation, may be important issues to watch as the coming year unfolds.

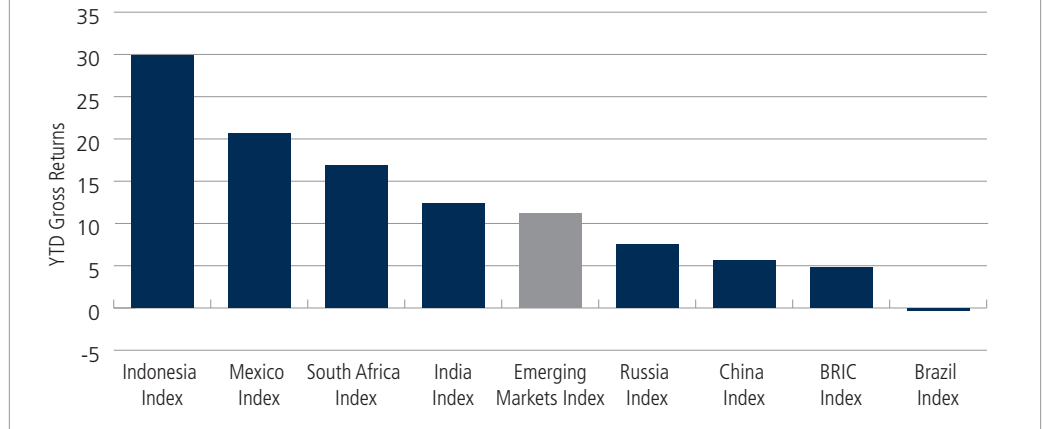
In 2010, Fast Growth Attracted Capital

Emerging markets provided exceptional gains over much of 2010, supported by evidence that emerging economies continued to expand rapidly while much of the developed world saw stagnant growth. Through November, the MSCI Emerging Markets Index had surpassed both the MSCI EAFE and the S&P 500 indices.

Among the emerging markets, Asia performed slightly ahead of other regions, but results varied widely among countries. Some of the strongest performers through November were smaller markets, such as Thailand, which appeared to have attracted capital due to relatively favorable valuations, while Peru and Chile were also very strong. Among the poorest performing markets through November were the Czech Republic, Hungary and Brazil. Growth in Eastern Europe is fairly dependent on Western Europe, and the underperformance of the Czech and Hungarian markets reflected the weakness of developed Europe. Brazil, which was down modestly, was impacted by the overhang from issues at Petroleo Brasileiro (or Petrobras), the national oil company, and one of the largest issues in that country.

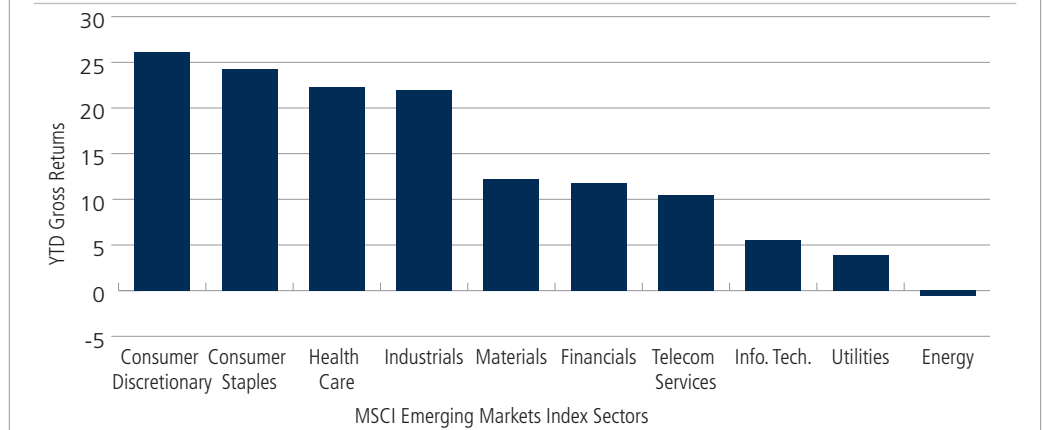
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FIGURE 4: EMERGING MARKETS SAW BROAD-BASED GAINS



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FIGURE 5: CONSUMER STOCKS LED, WHILE ENERGY TRAILED



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Given our view that the strong current economic growth in the emerging markets is largely due to positive demographic trends and increasing secular demand, it was not surprising to us that Consumer Discretionary stocks were the best performing sector year-to-date through November 2010. The emerging markets’ domestic sectors are more insular and less correlated with the West, and the consumer base is underleveraged, with high savings rates and income growth. In our view, all of these positives provide consumer stocks with a potentially strong long-term outlook. By contrast, sectors with more exposure to developed markets (such as Information Technology, Energy and Materials) and/or the risk of adverse regulation (Financials and Telecom) lagged.

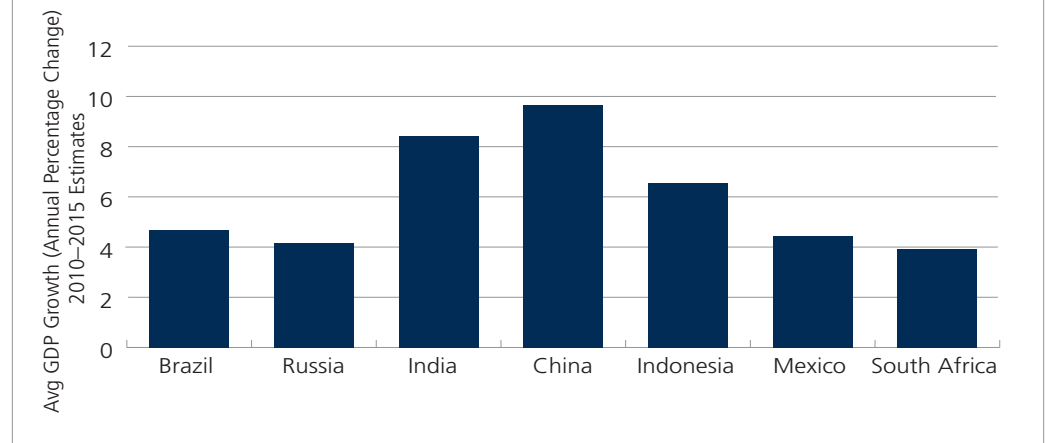
Forecasts Could Prove to Be Conservative

While we view the emerging markets from a bottom-up perspective, at a macro level, economic growth continues to look strong to us, driven again by domestic sectors. Heading into 2011, we actually feel that current forecasts for economic growth in the developing world could prove overly conservative. From the standpoint of strong demographics—growing, young populations with more access to products on an individual level, and the fact that balance sheets look good both on an individual and country basis—we see the propensity

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to spend. We believe individuals in these regions not only have the ability but also a strong desire to spend money to improve their lives. At the same time, we believe governments have the capacity and will to develop infrastructure, and need to do so if strong growth is to continue. In addition, businesses need to spend on productivity to meet all this growing demand—creating multiple, interrelated drivers for expansion.

FIGURE 6: ASIAN GROWTH FORECASTS ARE PARTICULARLY STRONG



Source: International Monetary Fund, World Economic Outlook Database, October 2010.

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Beyond their growth potential, the other recent tailwind for developing markets has been a liquidity infusion, with quantitative easing in the developed markets providing additional capital to higher yielding assets such as emerging markets equities. Unfortunately, a downside of this additional cash is the potential for an asset bubble—a concern for both recipient countries and investors. Inflation is a related and substantial worry. In China, where rising prices pose a threat to the Communist party and its mandate of stability, the government has sought to cool its economy and lessen inflationary pressures through monetary tightening. India and numerous other countries have sought to rein in inflationary pressures and loose monetary conditions as well.

In addition, supply constraints are contributing to inflationary pressures in many countries and could also have negative implications for long-term growth. Many infrastructure bottlenecks exist today, as roads, airports and other facilities have not kept pace with years of expansion. We believe that governments will need to spend significant capital to address these deficiencies. At the company level, businesses need to increase capacity as well as enhance efficiency and productivity—especially given wage increases across regions. Higher wages can be beneficial as they put more money into the hands of the emerging middle class, but they can also lead to rising inflation.

A countervailing force, to some degree, is that easy liquidity policies in the West have strengthened many emerging markets currencies. This tends to hurt their exports, which is why a number of countries have introduced policy measures designed to keep currencies competitive. For example, Brazil has imposed a tax on new foreign inflows into fixed income and equity securities. Overall, there is significant near-term risk of trade-related tensions as Western governments seek to stimulate demand through lower interest rates and currency devaluation while China and others maintain informal dollar pegs for their currencies, artificially capping their value and worsening trade imbalances.

We think stock selection will continue to be a key driver of investment returns going forward.

Stock Selection Is Key

In evaluating emerging market equities, we separate pure economic growth potential from measures of profitable growth, having found that profitability is more closely correlated with market returns than is a particular country’s GDP growth rate. As such, and particularly after a period of strong inflows, we think stock selection will continue to be a key driver of investment returns going forward.

Current valuations underscore that point. As of November 30, 2010, emerging market equities in general had a trailing price/earnings ratio (P/E) of 14.5, but as investors have focused on Consumer Staples names, inflows have driven those valuations up to the point where the sector appears quite expensive—with a P/E of 19. Such rich valuations do not appear to factor in any possible risks, such as an increase in the cost of wheat or other raw materials. The Financials sector is another good example. Numerous private sector financial stocks in emerging markets are currently trading at significant premiums—as high as three or four times book value. In our view, valuations such as these provide limited upside potential, even if all goes well.

FIGURE 7: IN SOME SECTORS VALUATIONS APPEAR HIGH

MSCI Emerging Markets Index Sectors: Price to Earnings



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In balancing what we consider the compelling opportunities provided by emerging markets equities with the greater relative risks of the asset class and high valuations in certain sectors, we believe focusing on quality businesses with strong and sustainable returns is an attractive approach.

In balancing what we consider the compelling opportunities provided by emerging markets equities with the greater relative risks of the asset class and high valuations in certain sectors, we believe focusing on quality businesses with strong and sustainable returns is an attractive approach. We see particular value in domestically (or home country) oriented names. Such companies enjoy greater exposure to positive local demographic trends and should also see less earnings volatility against an uncertain global backdrop. These companies tend to be relatively small in terms of market capitalization so we believe extensive research is valuable.

Among domestically oriented stocks, we think the consumer sectors are already pricing in much of their potential upside. In our view, Health Care companies offer good consumer-type exposure, with good cash flow generation; and while the overall valuation of the sector is high, we believe that numerous companies trade at relatively reasonable multiples. The other domestic sector we favor is Industrials, which stands to benefit from the ongoing effort to upgrade infrastructure in the developing world.

Overall, we continue to believe that the emerging markets are reasonably valued, especially considering their relatively high growth rates, which are generally expected to be 3–6% more than those of developed markets.

Opportunities by Country

While we prefer bottom-up analysis, there are some generalizations we can make regarding the opportunities found on a country basis. In this vein, we see potential growth and value in Thailand, Turkey and the Philippines over the coming year. In our view, India and Brazil still offer interesting opportunities in the mid-cap market, and we think that Brazil could start to perform well now that Petrobras has completed an historic deal to drill for oil offshore and as the country benefits from what we expect will be a continuation of favorable business policies under President-Elect Dilma Rousseff. We are more cautious about export-driven, technology-oriented markets such as Korea and Taiwan but we do find select opportunities there.

In our opinion, China may be a “contrarian play,” with select opportunities among domestically oriented companies. There has been considerable policy noise coming from China as the government seeks to address rapidly rising property prices and wage increases. While we feel there is some potential for a property bubble in China—as well as the chance of excessive policy measures—we think the risks have been overstated in the market. Longer term, we believe China does need to rebalance its economy and that, over time, consumption and GDP growth should rise from the mid-30% range toward 50%, which would still be well below the 60–70% of the developed world. With mounting U.S. pressure on the Chinese to revalue the renminbi, we also note the strong danger of trade-conflict escalation.

Overall, we continue to believe that the emerging markets are reasonably valued, especially considering their relatively high growth rates, which are generally expected to be 3–6% more than those of developed markets. We believe that bottom-up fundamental analysis within a macro perspective—on economic data, currencies, interest rates and policy changes in major economies—can seek to help investors capture the opportunity these markets represent while mitigating exposure to the risks inherent in the asset class.

APPEAL OF GLOBAL EXPOSURE

As political gridlock and a slow economic recovery continue to create headwinds in the U.S., we believe the developed international and emerging markets equities may offer opportunity. In both cases, they can provide an additional entry to the superior growth potential of emerging economies and their populations and, as always, they provide investors with attractive diversification potential. However, given our relatively moderate outlook for 2011, we believe a focus on stock selection is likely to be key. We believe that fundamentals, valuations and the ability of companies to execute their strategies will be the key to enabling certain equities to separate from their peers in the coming year.

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Investing in the stocks of even the largest companies involves all the risks of stock market investing, including the risk that they may lose value due to overall market or economic conditions. Small- and mid-capitalization stocks are more vulnerable to financial risks and other risks than stocks of larger companies. They also trade less frequently and in lower volume than larger company stocks, so their market prices tend to be more volatile. Investing in foreign securities involves greater risks than investing in securities of US issuers, including currency fluctuations, interest rates, potential political instability, restrictions on foreign investors, less regulation and less market liquidity.

The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-valueweighted 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.

The MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the US & Canada. As of June 2006, the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom

The MSCI Emerging Markets Index is 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

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