NEUBERGER | BERMAN

# SOLVING

**Market Insights and Outlooks from Senior Investors at Neuberger Berman**

# FOR 2014

Serious Investing®

# Neuberger Berman

is a 75 year-old private, independent, employee-controlled investment manager. The firm manages equities, fixed income, private equity and hedge fund portfolios for global institutions, advisors and individuals. With offices in 16 countries, Neuberger Berman's team is approximately 2,000 professionals and was named by *Pensions & Investments* as a 2013 Best Place to Work in Money Management. Tenured, stable and long-term in focus, the firm fosters an investment culture of fundamental research and independent thinking.

# A Changing Climate, A Varied Landscape

As we begin 2014, fundamentals are shifting once again.

Economic growth, which for so long was stagnant, is gradually reappearing, even at moderate, varying levels across the world. Meanwhile, the ultra-loose monetary policy that played a key part in recovery post-2008 seems to be continuing, but with the beginnings of a policy shift in the U.S.

Clearly, how these related trends play out has major implications for investors. Last year, the mere contemplation of Federal Reserve tapering caused setbacks in fixed income markets and among emerging countries perceived as vulnerable to capital flight. However, stocks in developed markets were less impacted and seen as benefiting from the growth triggering the apparent change in policy.

As the Fed and other central banks adjust their approaches, investors should remain alert. Fortunately, inflation trends are moderate and we do not expect a radical uptick in rates this year. But the shift in backdrop merits close attention as investors look to adjust investment portfolios to capitalize on the dual environment of improved (moderate) growth and somewhat tighter monetary conditions.

One key factor today is the sheer variety of investment potential. Emerging markets were once seen as a single portfolio allocation, but are becoming more recognized for diverse characteristics across countries, credits and businesses. And while developed markets have often moved together, the United States, Europe and Japan are all at different stages of their economic cycles, changing the investment calculus within each market.

At Neuberger Berman, we are opportunistic in our approach, believing that fundamental research and security selection are an effective way to help clients achieve their investment goals. As the investable universe has grown—across borders and asset categories—our focus has broadened as well.

*Solving for 2014,* our third annual market outlook, reflects that diversity. It provides our views on equities, fixed income and alternatives, all on a global basis, and all capitalizing on the fundamental research of our portfolio managers and analysts. This publication provides a clear window into our thinking.

I hope you will find *Solving* useful as you consider your investment strategy for the coming year.

Sincerely,

Joseph V Amato

Joseph V. Amato
President and Chief Investment Officer
Neuberger Berman

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# SOLVING

## Perspective and Outlook

# FOR 2014

Joseph V. Amato
President and Chief Investment Officer

Alan H. Dorsey, CFA
Head of Investment Strategy and Risk

Anthony D. Tutrone
Global Head of Alternatives

Brad Tank
Chief Investment Officer—Fixed Income



# Investors' Roundtable:

## THREADING THE NEEDLE ON RATES AND GROWTH

As 2014 begins, investors are seeing a more stable global economy, but also stagnant growth, low (although potentially rising) fixed income yields and the potential for policy disruptions—whether from central banks or political leaders. Within this landscape, a number of quandaries lie ahead, among them: where to find attractive capital appreciation potential, what to expect from interest rates, and how to generate meaningful investment income—all implicating the task of solving for investment objectives and needs in the coming year and beyond.

Neuberger Berman's senior investment leaders met recently to discuss these and other key issues. Alan H. Dorsey, CFA, Head of Investment Strategy and Risk, moderated a panel including Joseph V. Amato, President and Chief Investment Officer; Brad Tank, Chief Investment Officer—Fixed Income; and Anthony D. Tutrone, Global Head of Alternatives. Together, they considered various potential influences on the markets over the coming year, explained some misconceptions about market behavior, and noted possible sources of return for 2014.

**Alan Dorsey:** The knock on this recovery has been its meager growth rate, but that's gradually improving, is it not?

**Joseph Amato:** From an economic perspective, things are definitely looking up across regions. Despite all the political issues, U.S. growth continues to grind forward at a reasonably steady pace. Europe is actually showing signs of life, China has stabilized—although it won't exhibit the kind of growth we saw over the last decade. Finally, "Abenomics" in Japan has led to stronger economic activity. Equity performance in developed markets has reflected this, but we still feel quite constructive on their prospects for the coming year. Emerging markets have been laggards on slower economic growth rates, but things are getting better and we feel that valuations make them attractive at this point.

**Dorsey:** The flipside of growth is tapering and the potential for higher rates. Last year showed how disruptive even the threat of a shift in monetary policy can be. Brad, what do you expect of rates in the coming year?

**Brad Tank:** Coming out of the last downturn, we thought we might be returning to an environment where economic cycles would be much shorter than had occurred since the 1980s. But now, it looks like we'll have more of the same. In my view, we're probably in the middle innings of this growth phase in the U.S. Things are getting better, but not rapidly. So we do anticipate that rates are poised to rise again, just at a fairly moderate pace.

## Rates and Their Impact

**Dorsey:** That has different implications for different asset classes. What could it mean for stocks?

**Amato:** Conventional wisdom would suggest that if rates go up, price/earnings ratios should come down given the arithmetic relationship between equities and rates, and the impact of higher financing costs. At the same time, as rates go up they're typically driven by stronger economic activity—which suggests that you'll see earnings growth as well. In fact, P/E multiples have historically expanded as 10-year Treasury yields have increased—up to around 5% – 5.5%, at which point the impact of higher rates starts to become negative. The relationship of earnings and rates is a key influence on the direction of stocks.

**Dorsey:** Do you see any signs that margins are under pressure?

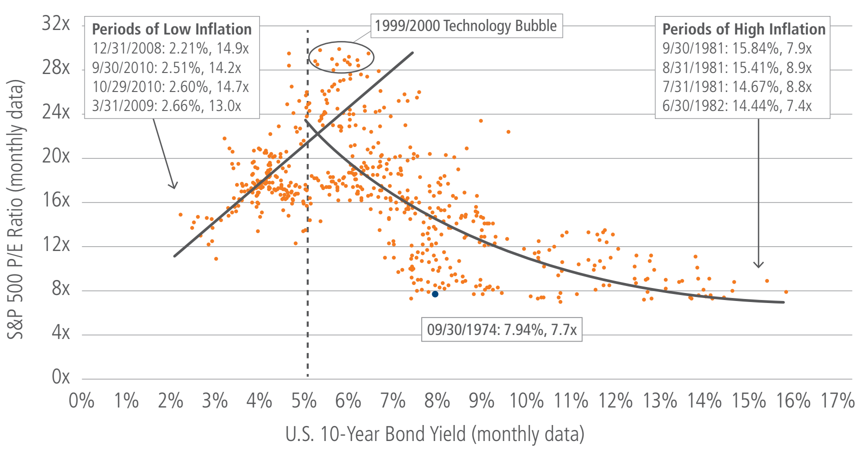
**Amato:** Margins have been the subject of much debate. They've been close to record levels for the S&P 500, which is a function of cost cutting and higher efficiencies post-2008. Small-cap company margins, however, are at historical averages. What will happen from here? Labor is a key issue, and we don't see a lot of pressure there, nor do we see any pressure tied to raw materials or other components of the cost structure. That said, we don't expect margins to grow significantly.

**Dorsey:** So, if that's the case, what could drive stock returns in 2014?

**Amato:** You'll probably see modest earnings growth this year—perhaps around 10%, tied to modest operating leverage as the economy picks up. Buyback activity is quite strong and could also help. But, beyond that, the key driver of U.S. stocks will probably need to be multiple expansion. That may be a function of investment flows, as investors continue to pull back from bonds—what's being called the "great rotation." M&A may also play a part. Activity has been very weak, but with a more stable economy and less uncertainty, you could see companies putting their excess cash to work in acquisitions.

**STOCKS CAN RISE WITH INTEREST RATES**

Relationship Between Bond Yields and P/E Multiples




Sources: Bloomberg, RBC Capital Markets, Neuberger Berman. S&P 500 P/E ratio is the trailing 12-month price-to-earnings ratio for the S&P 500 Index provided by Bloomberg. Monthly data, January 1962 to February 2011. U.S. 10-year bond yield is the yield for generic on-the-run 10-year U.S. government bond index.

**Dorsey:** Companies are in strong shape financially. Naturally, that has implications for fixed income as well.

**Tank:** Yes, the news is generally quite good. Over time, corporate balance sheets have gotten better, leverage ratios have generally declined, and companies have become much more diversified from a geographical perspective, which has broadened their sources of cash flow and earnings. Since the financial crisis, they've been quite cautious with respect to leverage and business risk. Although there's been an uptick in borrowing over the past 18 months, it's been relatively modest. Of course, all of this supports the continuation of low default rates—which are a key to maintaining narrow spreads.



**Dorsey:** Wouldn't a meaningful shift in rates change the situation?

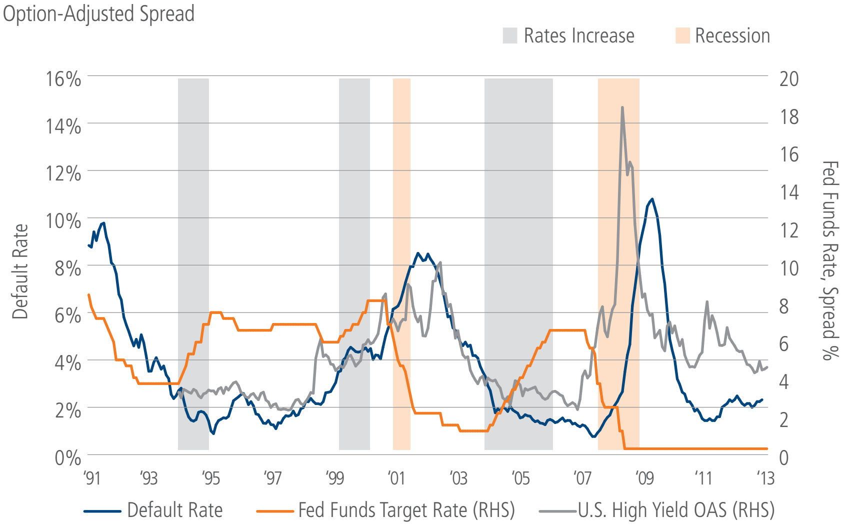
**Tank:** It would, but keep in mind that tightening cycles tend to have a delayed impact on default rates, which are often tied to economic acceleration and earnings strength. Since high yield bonds, for example, tend to trade based on the economy and default rate, it can take two or three years from the outset of a tightening cycle before their spreads widen meaningfully. This dynamic is helpful to corporate credits generally, but particularly constructive for the non-investment grade bond market.

**Dorsey:** This idea of sensitivity to rates versus economic fundamentals is an interesting one. Tony, do you find that it's relevant in the private equity universe?

**Anthony Tutrone:** Absolutely. We've found that buyout activity has generally increased during tightening cycles. This seems counterintuitive, since anywhere from 50% – 75% of buyout financing typically came from debt in the last cycle. But, ultimately, I think interest costs have little impact on returns. What matters more is the prospect for earnings growth.

**DEFAULTS HAVE HISTORICALLY LAGGED INTEREST RATES**

Global Speculative-Grade 12-Month Rolling Default Rate vs. the Federal Funds Target Rate and U.S. High Yield Option-Adjusted Spread






Sources: Moody's Investors Service, Bloomberg. Third-party economic or market estimates discussed herein may or may not be realized and no representation is being given regarding such estimates. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

Low interest rates typically occur in weak environments, when it's difficult to have confidence in earnings prospects for particular companies or to secure financing. Bid-ask spreads tend to be fairly high as well, because of the difficulty in estimating company value. This happened post-2008.

Later, as the economy starts to recover, rates go up, but you also have better visibility on earnings, bid-ask spreads narrow, and financing becomes easier. So, to me, tying higher rates to buyout activity is kind of like blaming the thermometer for cold temperatures.

Dorsey: During these upswings of buyout activity, interest coverage has usually declined and leverage ratios have increased. Doesn't that add to risk?

Tutrone: It does add to financial risk, no question. But for private equity firms, this is usually outweighed by stronger earnings visibility. Of course, private equity is a cyclical business, and at the end of the cycle, you tend to see excesses. So, historically, it has generally been better to invest in the early stages of an expansion, when you can benefit from economic growth and to achieve liquidity before conditions deteriorate. At this point, we haven't gotten to a major acceleration in buyouts, but as the economy improves, we believe deals will begin to pick up.

## 'What Works' in Today's Environment?

Dorsey: Part of the challenge of today's market is that investment dynamics are changing, so you need to be attuned to what will or won't work moving forward.

For example, although hedge funds overall have tended to perform well in periods of rising rates, we may encounter a bifurcation ahead. Managed futures strategies have had a hard time navigating policy-driven markets, and without the tailwind of secular interest rate declines, it's not yet clear whether they can identify and benefit from future trends. At the same time, long/short managers stand to benefit as higher rates make it easier to differentiate among companies based on their capital structures; and event-driven managers may be able to capitalize on increased corporate activity as the economy strengthens.

More broadly, a key issue is where you can achieve incremental return—whether through capital appreciation or additional yield—mindful that return outlooks have gradually shifted downward while interest rates remain extremely low. Alternatives are one key area that's gained traction, but another that we think is particularly important from a portfolio allocation standpoint is emerging markets. Joe, would you like to elaborate a bit?

Amato: For much of the past two years, emerging markets equities didn't have much of a cheering section. Obviously they tend to be more volatile, and slowing earnings and events like the tapering scare sent many investors to the exits. But, for a lot of reasons, I think emerging markets should be on everyone's radar. First, they make up a huge chunk of world GDP, but account for only a small portion (less than 10%) of capital markets assets—so investors are structurally underweight. Beyond that, even though emerging markets growth has slowed, it is still much faster than in the developed markets. Our Greater China team, for example, thinks that China could grow by more than 7.5% this year, while the U.S. could expand at around 2.5%. Obviously, growth by itself is less important to equity returns than earnings, but a high topline certainly helps.

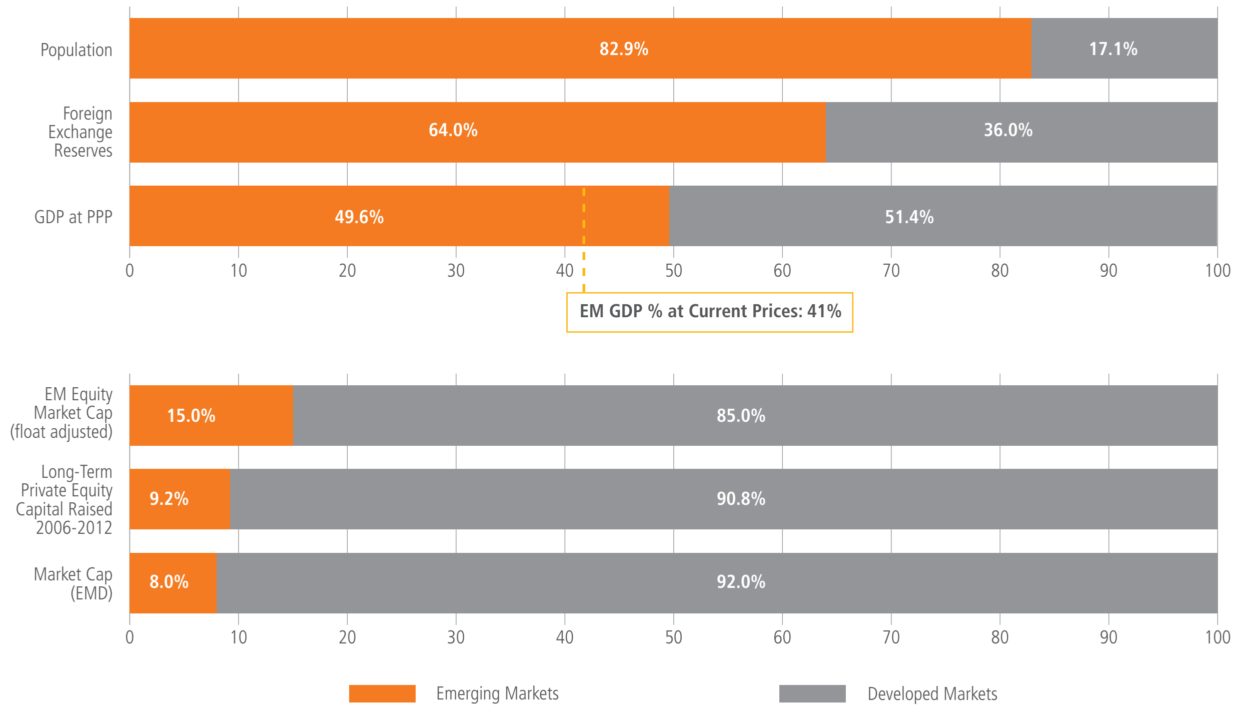
Tank: Another consideration is the quality of emerging market issuers. Over the years, many countries have been successful at reforming their fiscal and monetary policy, reducing debt and increasing their current accounts. In many ways, they've done a better job than developed countries. Looking at the debt market, this has led to a gradual upgrading of emerging markets debt issuers, and today more than two-thirds of debt outstanding is investment grade. This market has also become much deeper and more varied. While once we had just hard currency sovereigns, today there is a well-developed corporate market, while local currency bonds are dominant in terms of market cap share.

Dorsey: We've talked about emerging markets in terms of publicly traded securities. Tony, is there anything to add on the private equity side?

Tutrone: If you think about how private equity works, the ideal situations are often where fund managers can come in and help improve the way a company does business. Emerging markets have a lot of these opportunities, where you may have family-owned enterprises that are just reaching the next level and can benefit from modernization. And in some regions, deal prices can be quite cheap. At the same time, private equity markets may be underdeveloped, so dispersion of performance among managers is quite significant. You have to be careful, but the upside potential is there.

**EMERGING MARKETS OPPORTUNITY: DEMOGRAPHICS AND HEALTHY BALANCE SHEETS DRIVE FUTURE POTENTIAL**

Emerging Economies as % of Total World




Sources: World Bank (population as of 2010, EME market capitalization as of 2012), CIA World Factbook (FX reserves as of 2012), IMF World Economic Outlook (GDP at PPP as of 2012). EMD figure: JP Morgan as of September 2013. Private Equity figure: Bain 2013 Global Private Equity Report and EMPEA.

## Waiting Can Be Rewarding

Dorsey: Obviously, illiquidity is a key characteristic of private equity—both a risk and an opportunity.

Tutrone: If you look at buyouts, having a lockup allows general partners to do their job and limit the influence of short-term pressures you get in the public markets, which can work to the benefit of investors. At the same time, you have to be willing to wait, which is a key reason for the additional return potential. Secondary markets provide some middle ground. There's still a lot of deal flow coming from forced selling by banks due to regulatory changes, so you're able to get what we think are quality assets that have a shorter half-life than if you were to invest at the launch of a standard private equity investment.

Dorsey: Overall, it seems there are solutions out there if you look for them. One key theme we haven't talked about is political risk. Anyone care to comment?

Tank: This past year, we saw how politics can disrupt the markets. The conflict over the shutdown and debt ceiling was a major distraction, and you saw investors get increasingly anxious as key deadlines approached. The question is, do issues like this matter for long-term investors? On the one hand, no one really believes that the U.S. is going to give up its status as the world's premier credit, whether it's AAA or AA+. On the other hand, if these fiscal games of "chicken" are repeated (despite some positive recent developments), then there is potential for lower market and business confidence, and that could have a more lasting effect.

That said, there's always going to be political risk from a variety of sources. So you have to build that into your investment assumptions and forge ahead.

# Asset Allocation:

## VIEWS ON PORTFOLIO POSITIONING FOR THE COMING YEAR

As market expectations shift to slowly improving global growth and a bias toward rising interest rates, prospects for asset classes—and their impact on portfolio positioning—are evolving as well. Neuberger Berman's Asset Allocation Committee, made up of senior strategists and portfolio managers from across investment disciplines, meets regularly to evaluate data and share outlooks for various market segments.

For 2014, we believe that more stable growth trends should favor risk assets—particularly equities in non-U.S. markets but also including some areas of fixed income that suffered periods of volatility last year.

### Equities: International, Emerging Appeal

In equities, we have a positive view of both developed international and emerging markets (EM), based on an improving economic outlook and depressed valuations. With stronger readings for manufacturing and generally positive GDP growth figures, Europe appears to be coming out of its debt-driven recession with commitment to monetary union and more maneuvering room for financially pressured peripheral nations. Meanwhile, China's slower but more sustainable economic path, signs of a trough in EM earnings, and generally low valuations should lend some support to emerging markets in the coming year. Still, we believe that selectivity will be important in both segments, as improvement may not be evident across all sectors and markets.

In the U.S., recent market gains are keeping our return outlook in line with historical averages. However, we have a generally favorable outlook for equities (particularly large caps) given prospects for continued, moderate earnings gains, stable profit margins and potential for multiple expansion as the recovery gains momentum. Interest rate increases could eventually become a headwind but should be moderate and gradual in the near term.

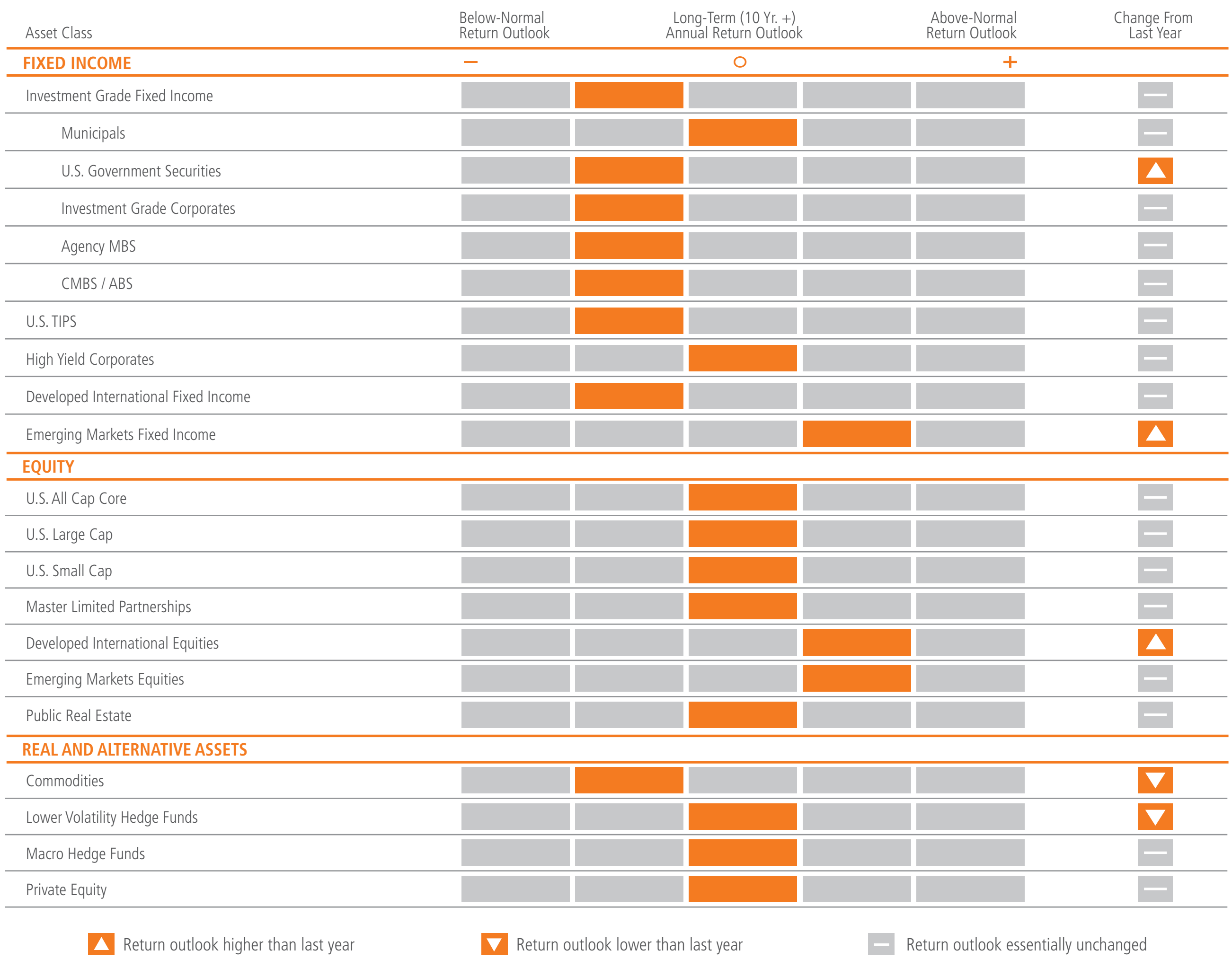
## Fixed Income: Spread Sectors Could Outperform

Although yields backed up after initial tapering discussion by the Federal Reserve, we have maintained a below-normal return outlook for U.S. investment grade credits given weak supply/demand dynamics and valuations ahead of reduced monetary accommodation. Among sectors, we see relative value in municipal bonds, as higher rates have diminished the supply of new issuance, while a steepened yield curve offers return potential at the middle range of the duration spectrum. Moving out on the risk curve, we see continued (though somewhat tempered) valuation appeal in high yield bonds, which stand to benefit from low current default levels and the potential for an extended economic cycle.

Across the global fixed income landscape, we believe emerging markets debt (EMD) offers an attractive risk/return relationship over the next year. The sector underperformed for much of 2013, particularly in the wake of discussions around Fed tapering, prompting a shift in investment flows away from the asset class. In our view, this was a market overreaction which created pockets of opportunity in the near term, especially given signs of economic improvement across regions. From a secular perspective, we favor EMD credits over time due to solid fiscal performance, more favorable economic prospects, and higher risk premiums than developed market counterparts.

**FOR 2014, EMERGING ASSETS SHOW POTENTIAL**

Market Views Based on One-Year Return Outlook for Each Asset Class




This material is provided for informational purposes only and nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security. The views expressed herein are generally those of Neuberger Berman's Asset Allocation Committee which comprises professionals across multiple disciplines, including equity and fixed income strategists and portfolio managers. The Asset Allocation Committee reviews and sets long-term asset allocation models, establishes preferred near-term tactical asset class allocations and, upon request, reviews asset allocations for large diversified mandates and makes client-specific asset allocation recommendations. The views and recommendations of the Asset Allocation Committee may not reflect the views of the firm as a whole, and Neuberger Berman advisors and portfolio managers may recommend or take contrary positions to the views and recommendation of the Asset Allocation Committee. The Asset Allocation Committee views do not constitute a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. This material may include estimates, outlooks, projections and other "forward-looking statements." Due to a variety of factors, actual events may differ significantly from those presented. Please see disclosures at the end of this publication, which are an important part of this article.

### Alternatives: Despite Pricing, Private Equity Seems Attractive

Over the past year, we have moderately reduced our outlook for a number of alternative segments. Commodities prices face continued headwinds from China's more moderate growth. Lower-volatility hedge funds also face rate pressure but stand to benefit from a potential increase in mergers and acquisitions, meriting our neutral weighting.

Private equity, like public market counterparts, has seen healthy appreciation. As such, some larger, high-quality assets may be overextended on valuation—something implied by an increased ratio of exits to purchases. However, business fundamentals generally remain strong, while financing is still readily available, albeit at a moderately higher cost. We believe that smaller, more complex companies currently offer better valuations. Given private equity's long duration and imbedded illiquidity premium, we believe it is an important strategic component of a diversified asset allocation.

The display on page 9 shows our views on various asset classes for the coming year.

Matthew L. Rubin
Director of Investment Strategy



# Personal Strategy:
## REVISITING PORTFOLIOS AS RATES RISE

Warnings about the potential for rising interest rates have been frequent in recent years, as forecasters anticipated a retreat from the 30-year bull market in bonds and the eventual end of accommodative monetary policy. From May to September 2013, investors got a preview of such a reversal, as the 10-year Treasury yield rose nearly 140 basis points on tapering fears, only to pull back somewhat when the Federal Reserve later postponed slowing its regular purchase of bonds on the open market. Now, as tapering appears set to begin in earnest, investors are contemplating how to invest in an environment that could include a bias toward steadily increasing rates—a marked departure from recent history.

### Balancing Income Needs

For many investors, income generation is an important investment objective, but one that has been complicated by historically low yields across most segments of fixed income. Therefore, the search for higher income in bonds has led many investors to look further out on the credit risk spectrum into areas like high yield corporates or extend the duration of their bond portfolios. However, we're all too familiar with the relationship between yields and bond prices—as yields move higher, bond prices fall (and vice versa) and longer duration bonds are most exposed to the negative impact of rising interest rates.

There are, however, other sources of income that do not have this same kind of relationship to interest rates. In fact, yields in many of these alternative income-producing investments are not related to interest rates at all. Equity dividend yields, for example, tend to stay fairly consistent over the years. This is because stock prices may go up and down, but dividends can also be adjusted over time, so the yield (dividend/stock price) can stay relatively stable. Real estate investment trusts (REITs) and master limited partnerships show a less consistent yield pattern, but again, they follow their own dynamics rather than being driven primarily by interest rates. These investments, while more volatile than traditional fixed income assets, may offer a more attractive risk/return tradeoff to certain investors.

## Rates and REITs, Bank Loans

While other, non-traditional income-producing asset classes may not have as much sensitivity to interest rates over the long term, returns for certain asset classes, such as REITs, have often suffered during the initial selloff period immediately following a sharp rise in interest rates. For example, from May to August of last year, REITs experienced double-digit losses.[1] However, over the long term, REITs have typically stabilized and recovered in the six to 12 months following an initial rate-related selloff and have outperformed the equity markets (represented by the S&P 500 Index) over such periods.

Another asset class that has typically provided some rate stability is bank loans, which generally have durations of less than a year. Due to the floating rate feature of bank loans, whose yields reset every 30 – 90 days, the current income derived from the asset class has the potential to increase along with rates. As a result, bank loans held up relatively well last year and should continue to provide a potential hedge against rising rates going forward.

## A Gradual Path Higher

The good news is that the path toward higher interest rates may be more gradual than the sharp increase witnessed in the middle of last year—for several reasons. First, we anticipate stronger and more consistent economic growth in 2014, helped by a much smaller fiscal drag (as federal tax rates and sequester-related spending cuts are likely to remain fairly constant). Also, we should see continuity at the Federal Reserve under the direction of new Chairman Janet Yellen, who appears likely to follow Ben Bernanke in openly communicating the Federal Open Market Committee's (FOMC) outlook and thresholds for future action. Finally, we expect to see less political brinksmanship with midterm elections looming at the end of this year. Taken together, there should be better clarity on government policy in 2014 and a more stable interest rate backdrop.

## Hawkish Turn?

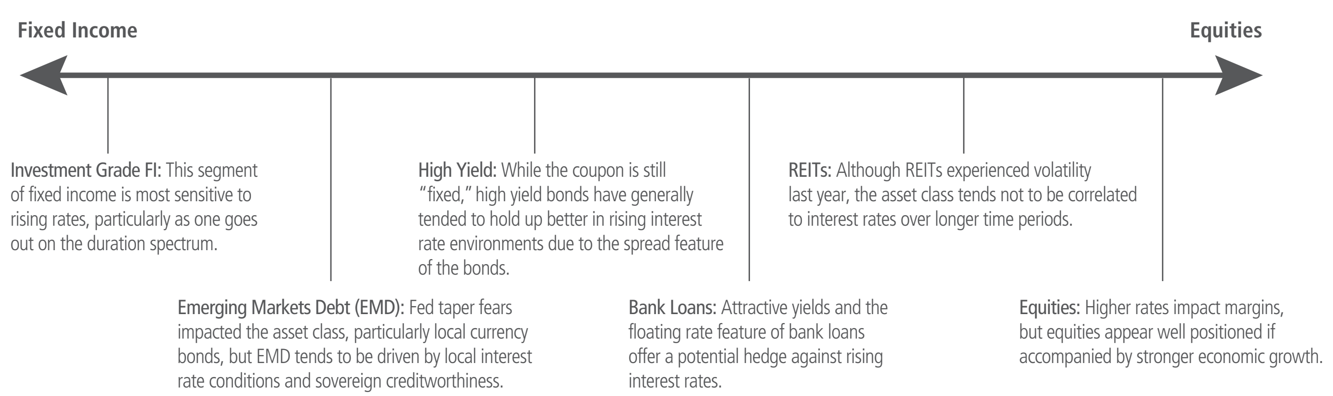
One development to keep in mind is the makeup of the FOMC, which is likely to turn more hawkish with a fresh rotation of voting members. Two of those returning in 2014 are Dallas Fed President Richard Fisher and Philadelphia Fed President Charles Plosser, both of whom have been critical of the central bank's accommodative policies and expanded balance sheet. Chicago Fed President Charles Evans, who has supported more quantitative easing, is now an alternate member. Although Fed Chairman Janet Yellen and New York Fed President William Dudley are proponents of maintaining easy monetary policy, pressure to taper asset purchases is likely to mount throughout 2014, particularly as the negative effects of the government shutdown begin to fade. Longer-term, we think the Fed will keep the Fed Funds rate low well into 2015, if not longer. That being said, longer interest rates could begin to move well before a watershed decision by the Fed to raise rates.

## Putting the Pieces Together

From a portfolio positioning standpoint, we continue to see value in several asset classes that we believe are relatively insulated from the negative effects of rising interest rates. Within fixed income, our preference is for high yield corporate bonds, which currently have attractive underlying fundamentals and tend to hold up relatively well as rates increase, given the action of their spreads and their shorter durations due to higher coupons. We also favor certain hedge fund strategies that can offer similar volatility characteristics to fixed income but may be better able to navigate periods of rising rates. Finally, we believe equities could be attractive in this context. Higher short-term rates can have a negative impact on corporate profit margins, but stocks can still generate attractive returns if revenues grow and/or price/earnings multiples expand. Aside from our views on allocating to these asset classes, we believe that being nimble and tactical will be an important part of dealing with the opportunities and risks associated with rising interest rates.



**RISING RATES: HOW MIGHT ASSETS REACT?**




[1]FactSet. Represented by the FTSE NAREIT All Equity REITs Index.

# SOLVING
## Global Equities
# FOR 2014

Joseph V. Amato
President and Chief Investment Officer



# Overview:

## BETTER GROWTH, LESS UNCERTAINTY COULD SUPPORT STOCKS

The global equity markets saw a clear divide in 2013, as many developed markets performed well on positive economic news, while emerging markets suffered from headwinds of earnings weakness and, later, concerns about monetary policy. As we look ahead, global growth should improve, with acceleration in the U.S., Europe and Japan, as well as shift to more sustainable growth levels in China.

We believe this synchronized pickup in global growth should lend support to equity markets and underscores our longstanding constructive view of the asset class. Still, the tenuous condition of some economies could result in setbacks, making selectivity and risk management essential in 2014.

In the United States, last year's strong equity market returns were generally the result of improving fundamentals, supported by continued ultra-low interest rates. The housing market exhibited strength and consumers were resilient as unemployment eased modestly. Earnings rose at a healthy 10% clip. Despite the headline-grabbing debt-ceiling debate and concerns about the the Federal Reserve's tapering, government policy was actually a positive. The U.S. budget deficit declined and the Fed ultimately maintained near-zero rates but, at year-end, signaled a gradual reduction in its bond-buying program.

While there has been a considerable advance since 2009, we see significant fundamental support for U.S. stocks in 2014. Economic activity should improve, relieved of the fiscal drag associated with last year's federal spending cuts and supported by healthy consumer demand, resurgent housing and, increasingly, the cost-efficiency of many manufacturing companies. This latter group is benefiting from limited wage pressure, low borrowing costs and relatively cheap energy prices—a long-term competitive advantage that is encouraging managers to maintain or add to capacity in North America.

More broadly, given the current combination of slow-but-improving growth and moderate inflation, we believe that interest rates could gradually shift upward, but without the shocks experienced last year. With this backdrop, we think U.S. earnings should grow by around 10%, with modest multiple expansion, which should also lend support to the U.S. equity market.

### Moving Beyond Monetary Policy

In Europe, last year's equity market advances were more a function of relief than economic strength, as investors reacted to accommodative actions by the European Central Bank, lower rates and reasserted commitment to monetary union, along with a return to (barely) positive growth numbers. This year, Europe's economy should continue to improve, supported by reduced fiscal tightening and the ongoing constructive policies of the ECB.

In Japan, equity markets have cheered the initial impacts of "Abenomics," which have helped stimulate growth and improve competitiveness via a cheap yen. However, while monetary policy has been effective thus far, and fiscal stimulus is ongoing, the "third arrow" of structural reforms has not yet occurred. We believe this will be difficult to achieve, but such change will be needed to return Japan to long-term economic health.

### Encouraging Signs, Low Valuations

Elsewhere, Chinese equities generally languished last year, not only due to Fed-related risk aversion but also concerns over softening Chinese growth and skepticism about government policies. Recently, however, prospects have become brighter. The Xi administration appears committed to economic change, particularly in its pledge to give markets a "decisive" role in resource allocation, and in plans to reform state-owned enterprises and implement fiscal reforms. China appears likely to achieve GDP growth of more than 7.5% this year—less than the past but more sustainable and, importantly, far higher than growth in developed markets. Meanwhile, valuations of Chinese equities remain very low on a historical basis.

Finally, other emerging markets saw corporate earnings weaken early in 2013 at the same time that developed market profits were improving—a situation that has typically hurt EM equities. Later, with the Fed's initial tapering announcement, emerging markets with current account deficits saw particularly strong outflows. Eventually, the asset class recovered based on the Fed's subsequent statements and more encouraging news on economic growth trends. In 2014, we believe that appealing valuations and more solid growth prospects set the stage for improved equity performance in emerging markets. Still, last year's performance dispersion suggests the importance of selectivity—not only by country, but by sector and security as well.

Overall, we believe that fundamentals will be the key driver for equities this year, especially as the Fed begins to pull back on longstanding easing policies. In particular, we think that synchronous global growth should lend support to stocks in 2014. On the following pages, our portfolio managers provide more detailed views on their outlook for each region's equity markets.

## U.S. EQUITIES: BUILDING ON RECENT STRENGTH

**Leah Modigliani**, Multi-Asset Class Strategist

Despite ongoing dysfunction in Washington, D.C., the United States experienced a solid economic recovery, healthy earnings growth, and continued monetary stimulus in 2013. This helped drive the U.S. equity market substantially higher, with the Dow Jones Industrial Average and the S&P 500 Index achieving new all-time highs for the first time in five years. As we start 2014, the U.S. economic backdrop appears hospitable to equities, with "goldilocks" inflation (not too hot and not too cold) and modest GDP growth expected for the coming year. Given recent equity price appreciation and our expectation for higher interest rates, we believe stocks could face periodic headwinds. Still, with reasonable valuations and positive momentum in the global economy, we have an upbeat 2014 outlook for the U.S. equity market.

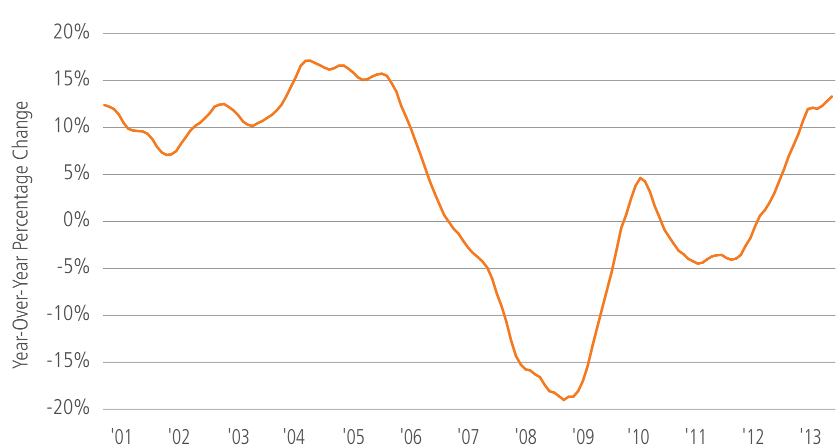
### A Dramatic Shift

A year ago, the global economic landscape was mired in uncertainty. The United States was about to go off the "fiscal cliff," Europe was in recession, China's economy was showing signs of fatigue, causing fears of a "hard landing," and Japan was trapped in a cycle of deflation. Valuations reflected the general unease, however, and U.S. stocks traded well below historical norms.

Today's environment is far less uncertain, as economies around the world seem to have put the worst of the global economic crises behind them. In the U.S., business activity in both the manufacturing and services sectors has shown steady growth for much of the past year. Auto and retail sales have been brisk on the back of improving consumer confidence. Unemployment, while still elevated, has continued to ease—from 7.8% at the start of 2013 to 7.0% late in the year. Housing, in particular, has strengthened, with median home prices advancing at double-digit rates (see display).

**HOUSING HAS EXPERIENCED AN IMPRESSIVE RECOVERY**

S&P/Case-Shiller Composite-20 City Home Price Index




Sources: Bloomberg, Case-Shiller. Data through September 2013.

The real estate market has served as a potent force for the economy, with a 1% increase in median home prices typically contributing over $150 billion to domestic consumer wealth, and supporting increased spending. Although existing home sales dipped when mortgage rates increased at midyear, we believe that even modest economic growth and improving employment should keep the housing recovery on track, along with the rest of the economy.

Another support for U.S. growth is increased domestic energy production. Technological breakthroughs in extraction methods (termed "fracking") have allowed drillers to access abundant oil and natural gas reserves that are still in the early stages of utilization. While environmental and public safety concerns have gained some momentum, we expect this windfall to have a powerful, ongoing impact as lower energy prices should result in broad cost savings and job creation.

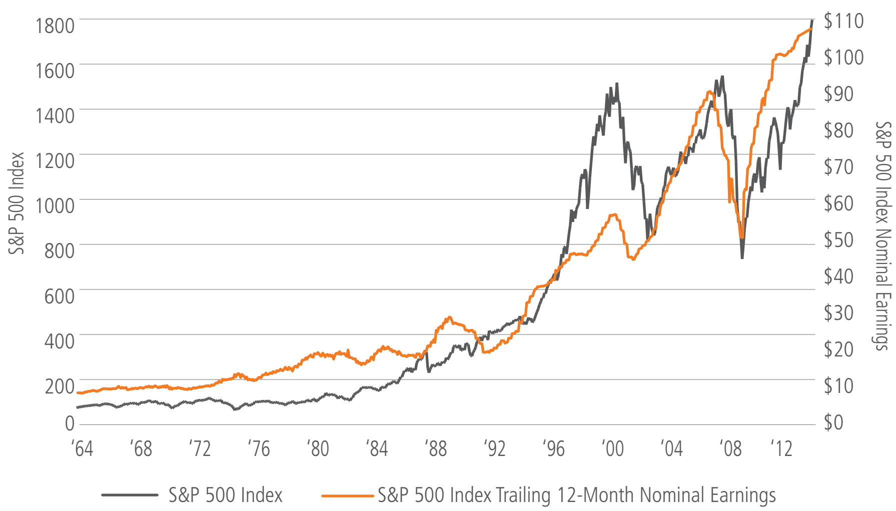
Corporate earnings came in stronger than most analysts had expected for 2013. Despite sometimes dire predictions, profits for S&P 500 Index companies grew at an estimated annual rate of roughly 10% in 2013 and are projected to grow at about the same pace for the next two years. With profit margins near record highs, we don't expect them to expand much further. On the other hand, we see little pressure on margins coming from higher costs. Furthermore, topline increases, which have been scarce in the current recovery, could become more robust if economic and policy uncertainty recede further, as we expect.

Increased corporate activity could also prove beneficial. Reflecting sizable cash balances, share buybacks and dividends have increased at a rapid clip—and we think this is likely to continue. Meanwhile, assuming that management teams can become more comfortable with the macro environment, we could also see a much-awaited increase in mergers and acquisitions.

## Policy, Disrupted

Despite all these positives, government policymakers recently caused considerable upheaval in the markets. The U.S. government averted the fiscal cliff at the start of the year, only to return to crisis-based management with a disappointing 16-day government shutdown in September, followed by a dangerous flirtation with sovereign default shortly thereafter. The spectacle soured business and consumer sentiment, and exposed flaws in the U.S. political system for all the world to see.

**WILL CORPORATE EARNINGS CONTINUE TO SUPPORT U.S. EQUITIES?**




Source: Bloomberg. Data through November 2013. 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 Federal Reserve had its missteps as well. Its statement in May that it would soon "taper" quantitative easing caused considerable disruption, driving up interest rates and risk aversion, only to be recanted, leaving investors relieved but also shaking their heads.

Beyond these distractions, the overall fiscal picture has become significantly more balanced. With sequestration policies, federal spending has decreased, while tax receipts have surged, drastically reducing the federal budget gap. Although this does tend to put growth at risk, the benefit is that the fiscal deficit is projected to be close to just 3% of GDP at the end of 2013.

Unfortunately, some issues remain. While we believe that Congress' two-year budget deal is a positive development, the U.S. debt ceiling will need to be addressed again in the first quarter. Moreover, Washington, D.C., is still quite polarized, which we think poses an ongoing threat to business confidence, investment spending, and, by extension, reductions in unemployment.

As for monetary policy, the Fed now plans to slow the pace of its QE bond purchases by $10 billion per month (from $75–$85 billion per month at the start of the year), which could put upward pressure on interest rates. Still, it has reaffirmed its highly accommodative stance and intention to hold target interest rates near zero "at least as long as" unemployment exceeds 6.5%, and the inflation outlook remains no higher than 2.5%. Clearly, the Fed thinks that the economy is likely to be strong enough to handle this change, and we agree.

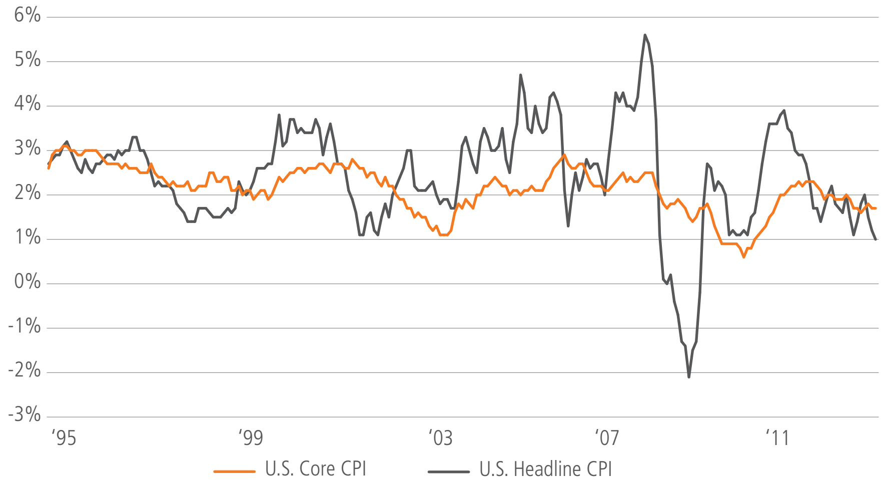
## Valuation and Market Prospects

At this point, U.S. equities are closer to what we consider fair value than they were at the start of 2013, but remain well within the range of historical norms. Over the past 50 years, the average price-to-earnings multiple of the stock market has been around 15.5 times forward earnings. In our view, profits should continue to improve. This, combined with low inflation and a reduction in global economic uncertainty, could facilitate earnings multiple expansion—perhaps even above long-term averages, despite modest headwinds in the form of rising rates and some already-scheduled federal spending cuts due to sequestration.

Drilling down a bit, we favor select energy, industrial and technology stocks, especially those which are trading below their long-term average P/E multiples. We also think pockets of cyclical stocks, including airlines, are appealing. Given recent industry consolidation, and both operational and financial leverage imbedded in airlines, we believe the sector is poised to benefit from a pick-up in both U.S. and global economic growth. We are less

## INFLATION REMAINS CONTAINED, EVEN WITH FED LIQUIDITY

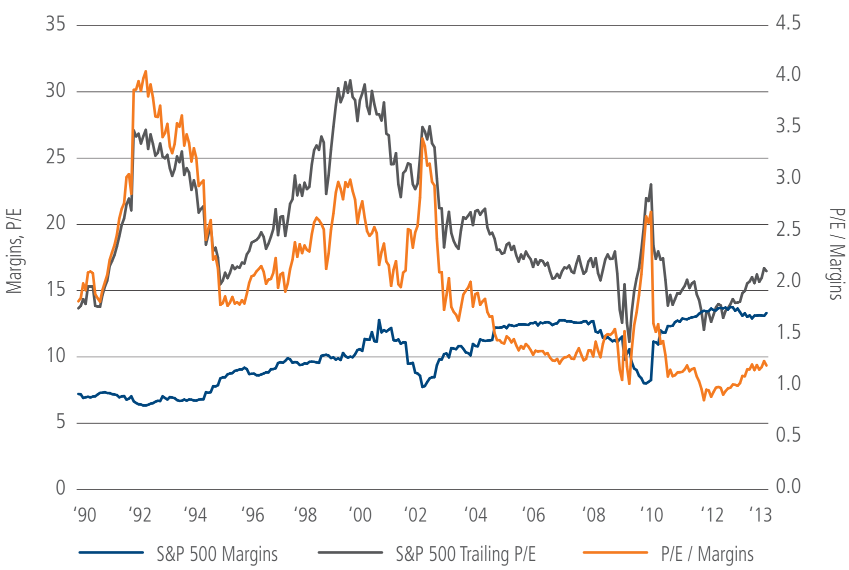
U.S. Core and Headline Consumer Price Index




Sources: Bloomberg, Bureau of Labor Statistics. Core CPI is the U.S. CPI Urban Consumers Less Food and Energy Year-Over-Year NSA Index. Headline CPI is the U.S. CPI Urban Consumers Year-Over-Year NSA Index. Data through October 2013.

## RECORD PROFITS, MODERATE MULTIPLES

U.S. Profit Margins, Price-to-Earnings, P/E-to-Margins




Sources: Bloomberg, FactSet. Third-party economic or market estimates discussed herein may not be realized and no representation is being given regarding such estimates. Indices are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. Data through November 2013.

effusive on defensive sectors, such as health care and utilities, which seem expensive relative to historical norms.

As for company size, we don't have strong preferences as stocks across the size spectrum seem fairly valued on a relative basis. In our view, small-cap stocks could provide better leverage to a U.S. recovery, but large caps stand to benefit more from burgeoning global economic strength over the coming year.

### Will No News Be Good News?

As we look ahead, many issues that recently concerned investors have dissipated. The U.S. economy is growing, corporate profits are healthy, balance sheets are solid and energy costs are declining. Overseas, Europe has emerged from recession, China has successfully transitioned to slower, but presumably more stable growth, and Japan's economy is expanding meaningfully for the first time in recent memory.

Still, the potential for a reversal of some or all of these trends remains tangible, and much responsibility is in the hands of policymakers, to further reduce uncertainty and by extension build business confidence that could lead to more investment, hiring and, ultimately, stronger growth. Assuming they can follow an approach akin to the physicians' pledge of "first do no harm," we believe the current environment sets the groundwork for another constructive—if perhaps not exceptional—year in U.S. equities.

# DEVELOPED INTERNATIONAL MARKETS: FUNDAMENTAL OPPORTUNITIES IN A LOW GROWTH WORLD

**Benjamin Segal, CFA,** Portfolio Manager and Head of Global Equity Team

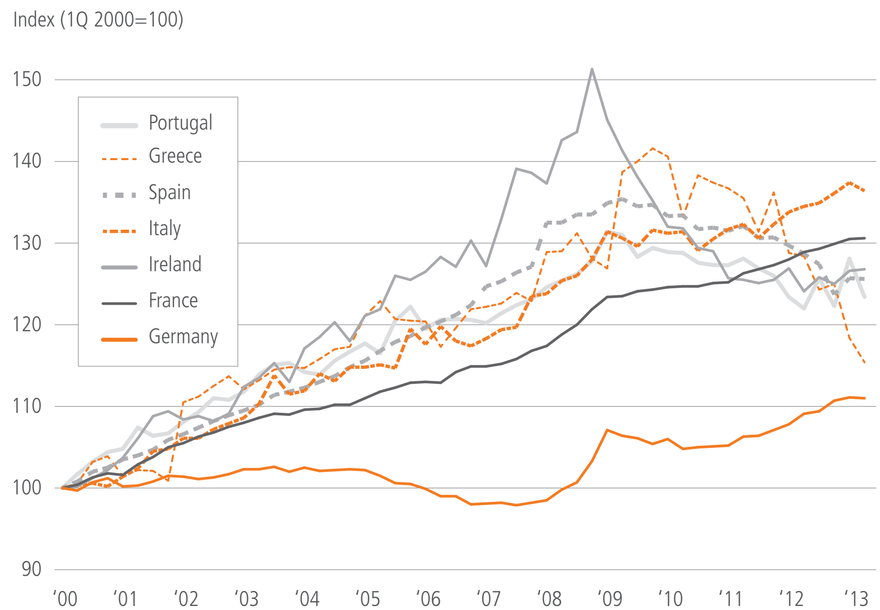
Advances in international equity markets during 2013 were, in our opinion, significantly driven by central bank policy and a reduction in perceived risk. Economically challenged parts of the eurozone, such as Greece and Spain, saw the biggest gains as economic conditions stabilized and sentiment improved; an initial positive response to "Abenomics" fostered an improvement in Japan. On the other hand, slower growth in China and other emerging markets negatively impacted Canada and Australia—commodity export-oriented economies driven by demand from the developing world. Looking ahead, we believe the macro environment in the developed markets will incrementally strengthen but remain lackluster, with Europe registering minimally positive GDP figures and Japan struggling to maintain its 2013 momentum. With such a backdrop, we believe that paying close attention to individual company fundamentals will be key to generating alpha.

### Europe: Improvement, at a Slow Pace

Over the past year, European equity markets have generally benefited from improving data out of troubled "peripheral" nations. Spain, Portugal, Greece and others have been supported by European Central Bank policies and the commitment of Germany and other core nations to keep the eurozone intact, offering the periphery more fiscal flexibility as they seek to execute needed reforms. Following a period of significant wage deflation, unit labor costs have declined significantly (see display), such that these countries are now far more competitive versus the rest of the eurozone.

**EUROZONE PERIPHERAL COUNTRIES ARE ADDRESSING COMPETITIVENESS**

Unit Labor Costs




Sources: National statistics, Haver Analytics, GS Global Investment Research. Data through June 2013.

Furthermore, much-discussed potential for a banking union across the European Union could lower the cost of capital for companies operating in many of these markets.

Still, Europe continues to face major growth constraints tied to fiscal deficits and poor long-term demographics, and we think it will grow slowly, lagging the U.S. expansion. The International Monetary Fund's 2014 GDP euro area current forecast is 1.1%. Although the ECB has continued to be proactive, consumer and business activity remain relatively subdued in most of the continent. The euro has been relatively strong versus other major currencies, which is not helping the competitiveness of exporters. Even as companies across Europe have benefited from the stabilizing economic environment—with balance sheets in much better shape than three to four years ago—most management teams we meet are focused on controlling costs and restraining investment. Like their peers in the U.S., companies remain relatively conservative, adopting a wait-and-see approach until the economic outlook becomes clearer. Meanwhile, businesses most exposed to slowing emerging markets, especially in the materials and energy sectors, have done poorly—a trend we believe is likely to continue.

### Japan: The Impact of Abenomics

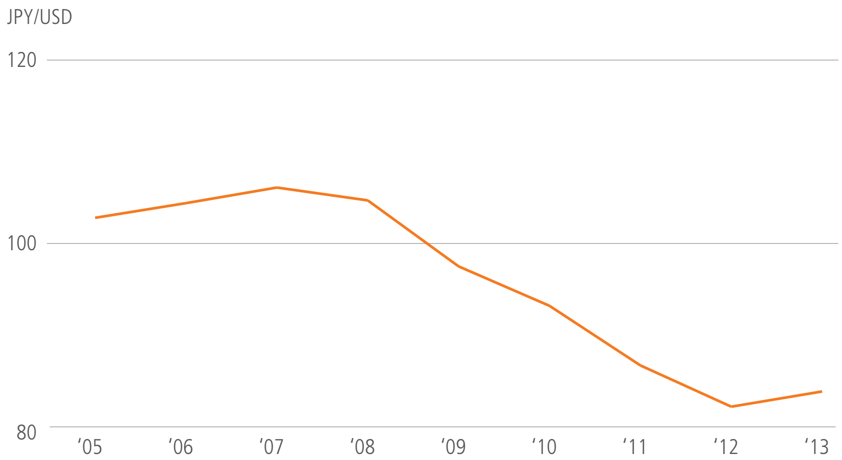
Prime Minister Shinzo Abe's policies have drawn an initial positive response from investors, but face challenges in 2014. The three key elements of Abenomics are monetary expansion, fiscal expansion and structural reform. In our view, the most significant impact thus far has been on the monetary front, as Japan has been generating fiscal deficits for many years now, and the details regarding structural reforms remain unknown.

The Bank of Japan's quantitative easing has caused the yen to weaken since the fourth quarter of 2012, strengthening the competitive position of Japanese exporters—especially with manufacturers improving their operations to lower the "breakeven" yen/dollar exchange rate in recent years to levels below the current yen 95 – 100/U.S. dollar range (see display on page 19).

QE has also given investors confidence that deflation—which has plagued the Japanese economy over the last 20 years—could be coming to an end. Higher inflation expectations have boosted share prices of names geared to asset prices, such as real estate and financial institutions. Select domestically driven companies and sectors, and those benefiting directly from better global growth, have also done well.

**WEAKER YEN HAS HELPED JAPAN'S EXPORTERS**

Japanese Manufacturers' Breakeven Yen/U.S. Dollar Exchange Rate




Sources: Annual Survey of Corporate Behavior conducted by Economic and Social Research Institute (ESRI), Cabinet Office (Japan).

While the market is likely to continue to cheer reforms in Japan, we believe economic growth and policy announcements will disappoint expectations. The weaker yen has been a positive for exporters, but has also resulted in higher prices for inputs such as imported raw materials and products. Investors hoping that a return of inflation will spur consumer spending may be disappointed, as individuals are squeezed between stagnant disposable incomes and higher fuel, food and utility costs. While the government would like to see wages rise, this would cut into corporate profits, undermining the returns that investors are hoping to see from the Japanese equity market.

In order to address Japan's chronic fiscal deficit—which has resulted in the country's 230% gross public debt to GDP ratio—the government plans to increase the consumption tax from 5% to 8% in April. While this could pull demand forward into the first quarter, the tax will tend to weaken spending on a structural basis. While a reduction in the corporate tax rate—which, at 38%, is among the world's highest—would be a major positive for corporate profits, we do not believe it will accelerate Japan's weak economic growth trajectory.

### Proven Performers and Niche Opportunities

Much of the appreciation in international equity prices over the last year has been driven not by a significant improvement in earnings, but instead by multiple expansion. Thus, the forward price/earnings ratio for the MSCI EAFE Index has risen from 12.5 at the end of 2012 to its current 14.7. With higher investor expectations, we believe the market is likely to be more vulnerable to disappointing news from companies or policymakers.

We therefore favor a focus on those companies that are most likely to execute well in the low growth environment. Companies that have a strong track record in tough economic times, solid balance sheets and steady cash flow may, in our opinion, be advantaged. In addition, we are seeing opportunities to own such companies at valuations that offer potential upside, even based on conservative expectations.

At the same time, we are focusing on avoiding certain areas of concern: for example, companies that would struggle without government policy support, those operating with a thin capital base, and those facing declining revenues for structural or demographic reasons. In contrast, companies with a unique product offering—whether or not protected by patents—should maintain pricing power and the ability to generate free cash flows. We also believe niche operators may have advantages over conglomerates, especially in businesses such as industrials, manufacturing, branded consumer goods, health care and technology.

Despite the recent strength in international markets, we continue to see excellent bottom-up opportunities in select areas. In our view, businesses with proven management teams and execution strategies, value-added services addressing niche markets, and which are managed with an emphasis on cash flows, have attractive performance potential.



## EMERGING MARKETS: DIFFERENTIATION AND REFORMS COULD PROVE DECISIVE

**Conrad A. Saldanha, CFA,** Portfolio Manager—Emerging Markets Equities

After a relatively difficult 2013 for emerging markets (EM) equities, we are seeing areas of opportunity in the asset class. In our view, improved global economic conditions, potential economic reforms and currently attractive valuations merit attention from investors. As fundamental stock pickers, however, we are less swayed by such macro conditions than by the quality and valuation of individual companies. We continue to see what we consider strong, differentiated companies beyond the typical, popular names found in market indices, that have the potential to prosper on their own merits in the coming year.

## Pressing Issues: Earnings and Current Account Deficits

Coming into 2013, earnings forecasts continued to decline for emerging markets, driven by slower GDP growth and, more importantly, by downward earnings revisions in cyclical sectors. This was followed by "tapering" fears in the U.S., which drew considerable attention to countries with current account deficits. The result was sharp currency depreciation in such countries, including Brazil, India, Indonesia, South Africa and Turkey, as many foreign equity and bond investors reduced their exposures.

Subsequently, as the Federal Reserve postponed its tapering of asset purchases, emerging markets saw the return of foreign funds and some relief in an otherwise tough year. Atypically, 2013 saw a slowing in EM growth while developed market growth accelerated, albeit from very low (U.S.) or recessionary (Europe) levels. This led to export-oriented EM countries and companies outperforming their domestically oriented counterparts in mid-2013, temporarily reversing what we consider the long-term benefits of focusing on local consumption.

In our view, the key to future sustainability for emerging markets—and high current account deficit countries in particular—is structural reform. We think this entails considering a view beyond that of a "homogeneous" EM asset class, toward the divergent opportunity and risk that exists at the country, sector and company levels.

At the same time, the secular long-term drivers of emerging markets are worth repeating here: Specifically, demographic and secular momentum in EM countries—including a growing middle class with rising levels of disposable income and consumerism—continues to underpin what we see as an opportunity unequaled in the developed world. More immediately, following recent performance, EM stocks are trading at discounts relative to historical levels and other equities, providing potentially attractive entry points.

## The Challenge of Change

If there's an overarching theme in emerging markets for the upcoming year, we think it is how well—or poorly—countries are going to address structural reform. For example, in countries with large current account deficits, governments will need to continue to employ "strong medicine," including higher interest rates and tighter liquidity (which will continue to be a short-term drag on GDP growth rates) to fight inflation and support their currencies.

In our view, both a challenge and opportunity for 2014 is that a number of these countries—Brazil, India, Indonesia, Turkey and South Africa—are going into election cycles. While economic realities and the need to bring imbalances into check might dictate unpopular remedies, populist vote-seeking programs could stand in the way of near-term reform.

In our view, however, there is real potential longer-term upside in the possibility of pro-business and reform-minded politicians taking the helm after the election cycle. Regardless of somewhat slower GDP growth, we think that markets would cheer moves toward more sustainable growth, reform, good governance, increased competitiveness and the removal of infrastructural bottlenecks.

## Asian Markets: Slower Growth, With Exceptions

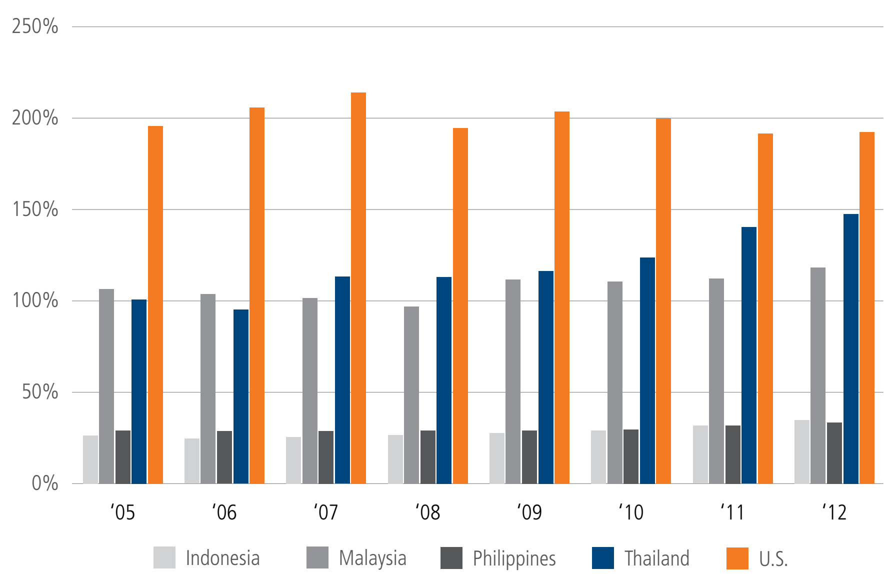
From a regional perspective, the most significant change since early 2013 is that investor focus has moved away from concerns about Chinese growth. As investors' worst fears about China were not realized—and its GDP growth rate subsequently revised upward—focus has moved to the slowing growth and adverse current accounts found among some export-oriented countries such as Indonesia within the Southeast Asian (ASEAN) region. Still, other countries including the Philippines have proved more stable, aided by steady overseas foreign working remittances and credit expansion, among other factors.

Although credit penetration (as a percentage of GDP) is significantly lower in ASEAN countries than in developed markets (see display), its recent growth has been something of a concern, as we have yet to see the "seasoning" of their loan book. As ASEAN nations work to address their deficits and currency depreciation, we expect to see higher interest rates and tighter liquidity—which could slow credit and GDP growth in the near term but help move the region to more sustainable, consistent expansion over time.

In China, meanwhile, the current government now has more than a year under its belt, and investors appear to be more constructive on near-term economic growth. We think this positive sentiment, combined with attractive valuations, could be supportive for Chinese equities. Currently, China is experiencing overcapacity in capital-intensive sectors, such as steel and cement, suggesting potentially lower structural returns for these sectors.

**ASEAN CREDIT: TIGHTENING COULD SLOW ITS EXCESSIVE GROWTH**

Private Sector Credit (% of GDP)

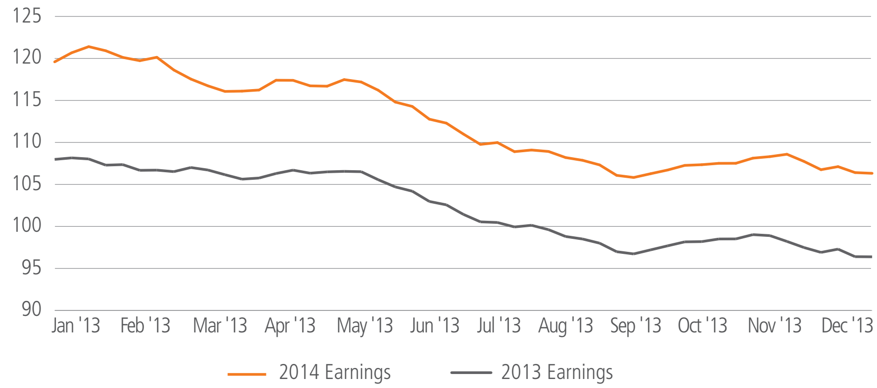



Source: World Bank.

Longer-term, we expect Chinese growth to be more reliant on domestic consumption than fixed asset investments. The new administration's focus during its first 12-plus months has been to root out corruption within the party's rank and file. We expect to see opportunities emerge from those initiatives, in the reallocation of future spending toward environmental initiatives, addressing imbalances between rural and urban populations, and promoting consumption.

**EM EARNINGS EXPECTATIONS APPEAR TO HAVE TROUGHED**

Change in MSCI EM Index Earnings Estimates for 2013 and 2014




Source: Bloomberg. Shows the change during 2013 in analysts' earnings estimates for 2013 and 2014 for all MSCI EM Index companies. Data through December 6, 2013.

## EMEA and Latin America: Diverse Opportunities

The Central European markets of Poland, the Czech Republic and Hungary have seen a positive knock-on effect from the better economic data coming out of Western Europe. Meanwhile, the Middle East and North Africa have experienced generally improving relations with Iran, which have been largely offset in the markets by the ongoing crisis in Syria. This balance may particularly impact neighboring Turkey, which suffered from volatility in the past year due to current account deficits and internal strife. Elsewhere in the region, Qatar and the United Arab Emirates (but also Greece) will enter the MSCI EM Index this year, which we think will provide greater visibility and support to the region and its markets, at least via increased index and ETF investment weightings. Finally, resilient commodity prices are providing a positive backdrop for Russia. The country's increased hydrocarbon trade with China could also provide an incremental source of growth, reducing its reliance on Europe.

Looking to South Africa, the market has continued to struggle, as the rand was particularly hard hit when investors grew concerned about its current account deficit situation. Concerns about consumer indebtedness and the resulting slowdown in consumer spending have also had a negative impact.

In Latin America, we think Brazil, like Russia, may benefit from strengthening commodity prices. It also offers opportunity tied to the development of its "pre-salt" oil discoveries, but we believe the government needs to adjust its domestic oil-pricing regime to gain traction in this area. In Mexico, the other Latin American giant, growth has been affected by a focus on structural reform measures; however, we believe the country continues to have strong long-term growth prospects, through regained competitiveness in manufacturing and potential reform of its hydrocarbon sectors.

## Structural Positives, Accentuated Through Research

While investors' near-term focus has been on the cyclical recovery in developed markets, we continue to see positives in structural domestic growth prospects within emerging markets. Beyond superior growth potential, and even as structural reforms are now needed in many countries, we have seen significant improvements in political stability, macroeconomic and fiscal policies, governance and inflation levels over the past 10–15 years. Thus, in our view, the volatility caused by 2013's global liquidity movements provides an attractive entry point for long-term investors.

As we've noted, however, investors should no longer view emerging markets as one homogeneous unit, but rather as an investment category containing divergent trends. We believe emerging markets are close to the cyclical bottom in terms of earnings revisions (see display).

As a result, we think future market performance may be more closely tied to the successful implementation of structural reforms on a country-by-country basis, as well as how individual companies operate in this slower domestic growth environment. Therefore, we believe the ability to identify and fully understand the differences between the prospects for individual companies, within their respective sectors and in each specific EM market, may be the key differentiator in seeking to achieve attractive investment results.

# GREATER CHINA: APPROACHING A NEW, 'MORE SUSTAINABLE' PHASE

**Frank Yao,** Senior Portfolio Manager—Greater China Investment Team

We have previously made the case that, as the world's second-largest equity market, China is significant and unique enough to be approached as an independent asset class. Of course, it also shares various characteristics with other emerging markets (EM), including (on the positive side) higher GDP growth rates and supportive demographic and consumer trends, and (less positively) a tendency toward volatility based on worldwide investor sentiment.

The latter characteristic was evident in 2013. In broad terms, investors contemplated the possibility of the U.S. Federal Reserve "tapering" its quantitative easing program—prompting risk aversion and negative investor flows throughout EM. Within China, specifically, they reflected skepticism about economic growth, policies from the new government and—most concretely—a temporary liquidity crisis. Balancing these perceived risks, however, were consistent signals that economic growth and corporate profitability would firm, and perhaps become more stable for the long term—something that helped Chinese equities recover toward the end of the year.

## New Stability

Looking ahead, we are relatively sanguine about China's economic backdrop. China is likely to record growth of over 7.5% this year, reflecting the government's successful efforts at curbing, without suffocating, the Chinese economic engine. From a variety of vantage points, China's financial condition is stronger than many other EM countries, with subdued inflation, favorable current account and FX reserves, and a low unemployment rate.

**CHINA'S STABLE BACKDROP**

| | China | Brazil | India | Indonesia | Russia | South Africa |
|---|---|---|---|---|---|---|
| Current Account Balance as % of GDP | 2.6 | -2.4 | -5.0 | -3.3 | 2.6 | -6.4 |
| Forex Reserves as % of GDP | 41.2 | 15.6 | 16.2 | 12.8 | 26.6 | 13.2 |
| Inflation | 3.1 | 5.5 | 10.6 | 6.0 | 6.4 | 5.6 |
| Unemployment | 4.1 | 6.0 | N/A | 6.1 | 5.5 | 25.7 |

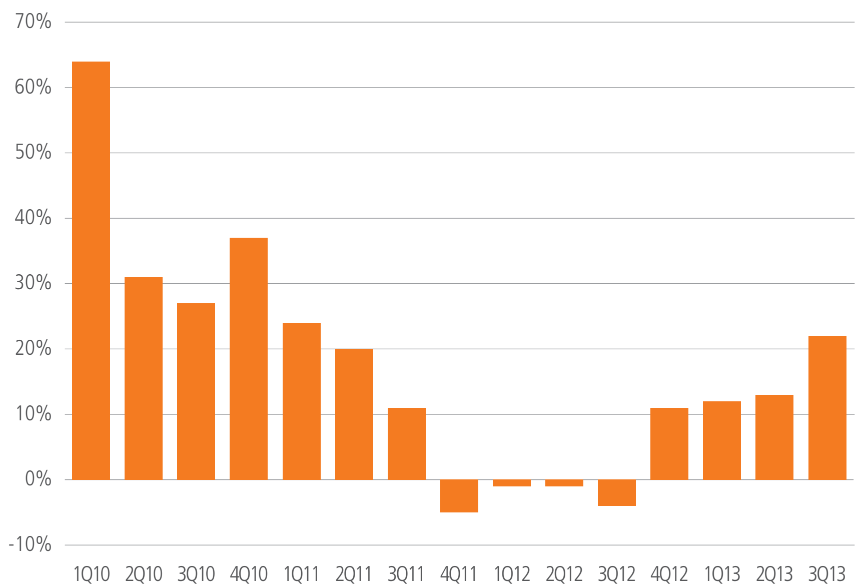
Sources: IMF World Economic Outlook as of April 2013 and China's State Administration of Foreign Exchange (SAFE). All figures are 2013 estimates, except Forex Reserves as % of GDP, which were calculated using the amount of foreign exchange reserves/GDP as of December 31, 2012 for each country.

At the corporate level, profitability appears to be improving for many businesses, and we believe that earnings and returns on equity are likely to continue the healthy growth experienced toward the end of last year.[1] For example, recent data have shown that companies in China's A-share market (shares trading on mainland exchanges) are stabilizing. Based on a sample of over 1,400 A-share companies, net profit growth has been steadily improving since 2012: net profit growth rates for the first, second and third quarters of 2013 were 12%, 13% and 22%, respectively (year over year).[2]

Many observers may attribute Chinese companies' growth to the financial sector. However, even if companies representing this sector are removed, the outcomes are still compelling, with revenue and net profit growth at 9% and 11% for the second quarter, and 10% and 24% for the third quarter of 2013, respectively. In addition, margins and profitability ratios have been recovering for this group, as shown by net profit margins, operating margins and return on equity, which for the second quarter were 4.2%, 5.3% and 10.2%, and for the third quarter were 4.2%, 5.8% and 10.1%, respectively.[3] We believe these signs of financial improvement may be the catalyst to turn Chinese equity markets around.

**PROFITABILITY IS GRADUALLY IMPROVING**

China A-share Companies' Quarterly Net Profit Growth YoY (%)[2]




Source: Wind Information Co. Ltd., as of September 30, 2013.

[1]Goldman Sachs Strategy Research.

[2]WIND Information Co. Ltd., as of September 30, 2013. Net profit growth is based on a constant sample of 1,442 China A-share companies that have started reporting quarterly financials since 2008.

[3]WIND Information Co. Ltd., as of September 30, 2013. Based on a constant sample of 1,401 China A-share companies (excluding those in the Financials sector) that have started reporting quarterly financial results since 2008.

## Change in Direction

Longer-term trends appear positive as well. Over the next three to five years, China is likely to represent the only major economy to sustain real GDP growth of more than 7%, the government's current target. As this unfolds, we believe the country will gradually become less reliant on exports and investment in favor of domestic consumption—as part of the government's new emphasis on sustainable, quality economic expansion rather than growth for growth's sake.

The priorities of the current regime are evident from the themes articulated at the Third Plenary Conference of the 18th Communist Party Congress, held in November, which focused on market-driven resource allocation and financial reforms. Among the ideas being contemplated: encouraging state-owned banks to loan money to local borrowers, establishment of the Shanghai Free Trade Zone, liberalizing interest rates, reforming state-owned enterprises and opening up more industries—including banks, insurance and even defense—to the private sector. Much depends on the details, but we think China's leadership is focusing exactly where it should be.

## Compelling Valuations

Despite more stable conditions, China's equities now trade near historical lows—reflecting their poor market performance since the 2008 financial crisis. Onshore equities are valued at just 10.6 times forward earnings, compared to the historical average of 17.3.[4] Meanwhile, the offshore market also appears inexpensive, with a forward P/E of around 10.2, versus the historical average of 13.2.[4] Price to book value is at a historical low as well.

## Assessing the Opportunity

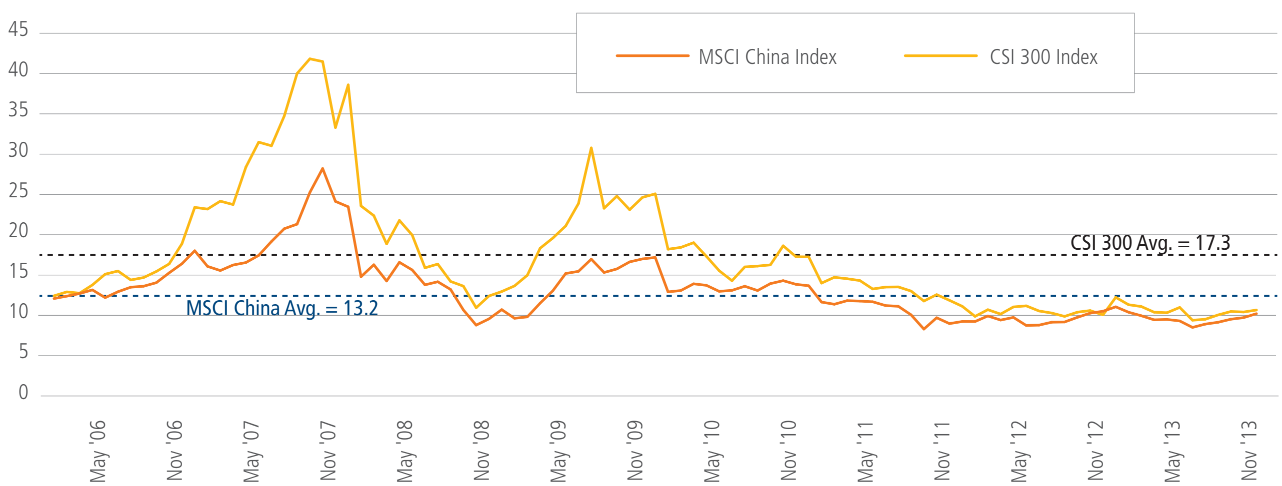
What we've said in the recent past seems even more evident today: In our view, there is a historic opportunity in Chinese equity markets, given low valuations, solid company fundamentals for many businesses, and encouraging macroeconomic trends compared to other markets. With its rapidly expanding equity market—the second largest in the world—we think China is vastly underrepresented in global equity indices. Indeed, MSCI has been contemplating a recalibration of its global indices to increase China's weighting. Should this happen, foreign inflows to the market could increase, providing a new support for the Chinese market.

Further, we believe the Chinese equity markets provide many investment opportunities for stock pickers. The market's size, growth and lack of analyst coverage can lead to inefficiencies that can be exploited by those who can overcome the complexity of company access, have knowledge of the regulatory environment, and understand the market at a fundamental level. This knowledge, coupled with a deep cultural understanding and an "on-the-ground" presence are, to us, highly important in seeking alpha in China.



**CHINESE EQUITY VALUATIONS ARE NEAR HISTORICAL LOWS**

Foward Price/Earnings




Source: Bloomberg, data through November 30, 2013. Forward 12-month P/E ratios for the MSCI China Index and CSI 300 Index (representing Shanghai and Shenzhen-traded stocks) were not available until January month-end 2006. Forward P/E ratios are based on forecast earnings that may be underestimated or overestimated, and are uncertain. Therefore, no reliance should be placed on these forecasts.

[4]Bloomberg, as of November 30, 2013. Historical average represents the period from January 2006 to October 2013, as forward 12-month P/E ratios for the MSCI China Index and CSI 300 Index were not available until January month-end 2006. Forward P/E ratios are based on forecast earnings that may be underestimated or overestimated, and are uncertain. Therefore, no reliance should be placed on these forecasts.

# SOLVING

## Global Fixed Income

# FOR 2014

# Overview:

## BALANCING PERCEPTION AND REALITY IN BONDS

In the fixed income market, perception sometimes trumps reality, or in some cases, actually becomes reality. Back in 2012, when investors were skeptical of European financial stability, they drove local bond yields upward and pushed peripheral countries to the brink.

Brad Tank
Chief Investment Officer—Fixed Income

In May of 2013, when the Federal Reserve initially announced its intention to taper bond purchases, market pricing inferred not just tapering but accelerated rate hikes as well. And when U.S. politicians flirted with default in October, investors became increasingly agitated—despite the extremely low risk that the country's market-leading status was actually threatened. Questions of fact, fairness and truth mattered only up to a point—and woe to the investor who moved the other way on these trades.

Another matter of perception faces us today, tied to the path of interest rates and prospects for fixed income in 2014 and beyond. Clearly, the 30-year tailwind of declining market rates seems to be behind us, and bond investors must deal with the notion that U.S. rates will have an upward bias from here. However, the severity and pace of those increases is subject to dispute. Indeed, we believe that the Fed is likely to be measured in its approach, while growth and inflation trends suggest that the 10-year Treasury is near fair value.

The ramifications of this are subtle but significant. It means that yields in some spread sectors have the potential to make up for—or at least soften—the impact of moderate increases in rates. And it suggests that Treasury price action should have a less disruptive influence on non-U.S. debt markets and currencies.

For the coming year, we anticipate a relatively benign growth environment, with continued momentum in the U.S., a modest acceleration in Europe and an "Abenomics"-driven recovery in Japan offsetting China's slower (if more sustainable) growth trajectory. Global monetary policy is gradually diverging, with a stable to tighter bias in the U.S., aggressive accommodation in Japan, and fresh loosening of policy in Europe. Healthy growth in some emerging markets is prompting tightening in some countries, which should prove supportive of their currencies.

Ordinarily, an improving economic landscape leads to higher interest rates. But given the fragility of many economies and still moderate global inflation, we think rates will generally stay in a narrow range this year. In the U.S., valuations in spread sectors remain more attractive than pre-"taper talk" levels, while solid fundamentals and a positive technical backdrop could support investment grade and high yield credits. In Europe, improving growth could result in pockets of opportunity in credit markets. And, after downward pressure for much of 2013, valuations in emerging markets debt, particularly hard currency sovereign and corporate issues, appear relatively attractive.

As we look toward 2014, low fixed income yields remain a key challenge for global investors. At the same time, the array of investment choices has never been broader. In our view, a key to getting the most out of the current environment is to draw readily from these disparate elements, to be open to new solutions and opportunistic in seeking returns. In the pages that follow, my colleagues provide further details on our views across the global fixed income landscape.

## DEVELOPED MARKETS FIXED INCOME

# U.S. ECONOMY AND SPREAD SECTORS: MODEST EXPECTATIONS IN A POSITIVE ENVIRONMENT

**Andrew A. Johnson,** Chief Investment Officer—Investment Grade Fixed Income

**Thanos Bardas, PhD,** Portfolio Manager and Global Head of Sovereigns and Interest Rates



The U.S. fixed income market was volatile at times in 2013, often driven by uncertainties regarding a shift in Federal Reserve monetary policy. With rates rising given expectations that the Fed would start paring its asset purchase program, most areas of the fixed income market generated disappointing results. While its December meeting provided clarity, questions remain concerning the timing and pace of the Fed's future actions. This notwithstanding, we're generally more optimistic about U.S. fixed income in 2014. Spreads and valuations are more attractive than their 2013 pre-taper discussion levels, and technicals should be supportive overall for positive, albeit generally modest gains in 2014. That being said, we expect volatility to persist, as monetary policy slowly transitions from accommodation to normalization. While it could be at least two years and possibly longer before the Fed moves from its zero interest rate policy, this eventually would likely be priced into the market well beforehand.

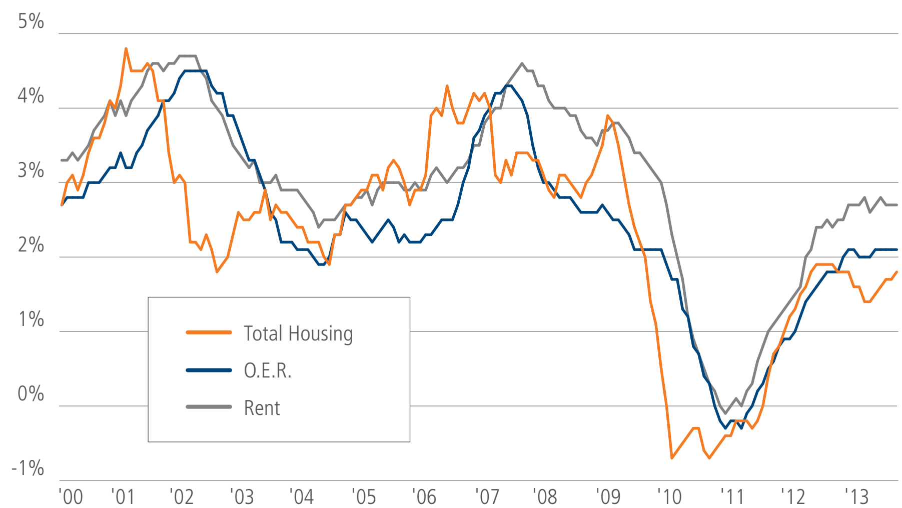
### U.S. Economy, Rates and Inflation

As has been the case since the end of the "Great Recession," U.S. economic growth for 2013 was below trend, with consumption, fixed investment and government spending below pre-2008 rates. Although we expect some economic improvement in 2014, GDP growth will likely be far from robust—at roughly 2.5% (+/- 0.5%), up from around 2.0% in 2013.

Consumers have de-levered and their balance sheets have improved significantly, creating potential pent-up demand for large-ticket items. The ongoing housing recovery is also positive for the economy, as relatively low mortgage rates support near-record levels of housing affordability. Importantly, this should feed into other sectors of the economy. On the corporate front, respectable earnings and past balance sheet consolidation have positioned many companies to capitalize on investment opportunities that are likely to increase amid the growing economy. Finally, while the fiscal drag from the federal

**HOUSING IS NOW A KEY SUPPORT FOR THE U.S. ECONOMY**

Housing Inflation (year over year)




O.E.R. is "Owners' Equivalent Rent of Primary Residence," and represents the amount a homeowner would pay to rent, or would earn from renting, his or her home in a competitive market.

Sources: Bloomberg, U.S. Bureau of Labor Statistics. Data through October 2013.

government will continue, it should be less burdensome as sequestration-mandated spending cuts start to fade.

Our outlook for U.S. interest rates is naturally tied to the future actions of the Federal Reserve. We expect to see a fairly seamless transition to Janet Yellen as Fed chair and a continuation of Bernanke-era policies. The Fed's decision in December to taper modestly, and at the same time continue its forward guidance, should serve to clarify its intentions in the future. In his statement and Q&A, Bernanke went to great lengths to stress that the Fed's tapering actions are not intended to be a removal of accommodation, and certainly not a tightening of monetary policy.

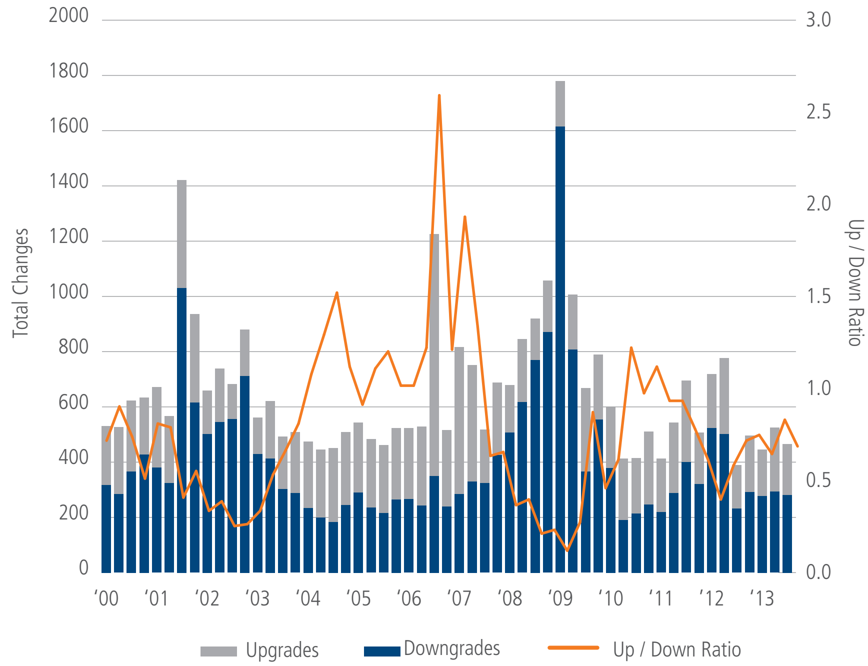


Given its view of the labor market, low inflation and lack of fiscal stimulus, we feel the Fed will be very measured in further tapering, and will make good on its implicit promise to be accommodative through much of 2015. However, as always, Fed policy will respond to the level of economic activity. In terms of rates, we expect the 10-year Treasury yield to trade in a range of 2.2% to 3.5% in 2014, or around its position as of late 2013.

While far from an issue, we believe inflation will continue to drift higher in 2014, partially triggered by steady increases in the housing sector, which accounts for more than 30% of the Consumer Price Index (CPI). Rents have been particularly strong since the bursting of the housing bubble. We anticipate inflation to end the year at 1.8% (+/- 0.3%).

**U.S. CREDIT CONDITIONS REMAIN STRONG**

Moody's U.S. Corporate Credit Ratings (by quarter)




Sources: Bloomberg. Neuberger Berman. All Moody's Corporate Ratings for United States; includes companies on credit watch, as of third-quarter 2013.

## U.S. SECTOR VIEWS

### Investment Grade Credit

Rising rates and interest rate volatility were headwinds for longer-term investment grade credit in 2013, but that was largely balanced by strong fundamentals and technicals. We expect to see more favorable results in 2014. In our view, there are a number of factors that will support the market. We believe technicals will be largely positive, as demand for the asset class should be fairly robust given their higher yields and the possibility that credit spreads will be negatively correlated to Treasury rates. We also see supply as being very manageable.

From a fundamental perspective, corporate balance sheets are largely cash-rich and profits should remain fairly solid. Valuations remain attractive given current spread levels compared to other periods of historically strong fundamentals and stable economic growth. While fundamentals could moderate somewhat during the year, they will be doing so from a very high level. In particular, we are wary of unfriendly bond owner actions, such as share repurchases. All told, we expect to see a coupon-clipping environment, along with moderate spread tightening in 2014.

In terms of sectors, we favor financials in particular. In our view, their fundamentals have improved in recent years and the technical backdrop is favorable, as new issuance should be relatively modest. We also expect to see volatility-driven opportunities in the metals/mining and health care sectors. Elsewhere, cable/media companies continue to produce high and largely stable cash flows. However, we feel event risk, in the form of increased M&A activity, could negatively impact the sector in 2014.

### Mortgage-Backed Securities

We have a generally positive outlook for agency mortgage-backed securities (MBS) for 2014. Valuations seem reasonable and risk has decreased, as the average MBS price is lower than it was entering 2013. Given higher rates, prepayment risk has moderated, making future cash flows easier to anticipate. Technicals, in our view, remain positive as well. We expect the Fed to remain a buyer of agency MBS for most of 2014, albeit at reduced levels. But this must be taken in context with expected reduced levels of issuance. In addition, the Fed continues to own a large portion of outstanding MBS, a situation that could be in place for quite some time and support the market. As was the case during the second half of 2013, less refinancing activity should dampen the level of new supply during the year. A key question for the MBS market is: Who will step up and be the next marginal pricer when the Fed leaves the table? While this is a risk, we don't foresee it being a significant issue until perhaps late in 2014.

We remain positive regarding prospects for the non-agency residential mortgage-backed securities (RMBS) market in 2014. Despite their strong run since the credit crisis, non-agency RMBS continue to offer a yield advantage relative to most fixed income instruments. We currently project loss-adjusted yields around 5% for the sector in 2014. In addition, most of these securities are floating rate in nature, which helps to limit their interest rate risk. In summary, the absence of new supply, a dwindling inventory of outstanding bonds and generally strong demand should support the non-agency RMBS market in 2014.

### Asset-Backed Securities

We have a muted outlook for the asset-backed securities (ABS) market for 2014. We feel demand will be generally positive for this high-quality/low-volatility asset class. At the same time, new supply will be fairly limited. While we do not anticipate a lot of risk in the ABS market, neither do we see an abundance of compelling opportunities given relatively benign spread volatility.

### Commercial Mortgage-Backed Securities

Commercial mortgage-backed security (CMBS) spreads appear to be reasonably attractive heading into 2014. CMBS spreads remain wider than their pre-taper discussion levels in May 2013, with room for some spread compression in 2014. We also think the technical backdrop will be supportive. New issuance, largely in the form of refinancing activity, was robust in 2013 and generally met with strong demand—two trends we expect to continue in 2014. Despite these positives, we do see the potential for specific issue risk. Sharply higher commercial real estate prices since their trough could lead to refinancing activity by certain sponsors who received loan modifications during the crisis. As such, we feel individual security selection will be key in 2014.

### Inflation-Protected Securities

U.S. Treasury Inflation-Protected Securities (TIPS) generated disappointing performance in 2013, as they exhibited higher beta than nominal bonds in the selloff that occurred during the late spring and summer months. In our view, weak retail investor demand and interest rate adjustments by leveraged risk parity funds were largely to blame for this outcome, while confusion regarding future Fed monetary policy added fuel to the fire. Looking ahead, U.S. inflation appears to have stabilized and all indications suggest a steady and slow increase. We believe this will be triggered by stronger U.S. growth dynamics, coupled with synchronized global growth acceleration. In addition, with the Fed's concern about rising rates, we expect breakeven inflation to be supported in the near to medium term. Risks to this outlook include political gridlock that could dampen growth and labor momentum.

## MUNICIPAL BONDS: SOME ENCOURAGING SIGNS

**James L. Iselin,** Head of Municipal Fixed Income

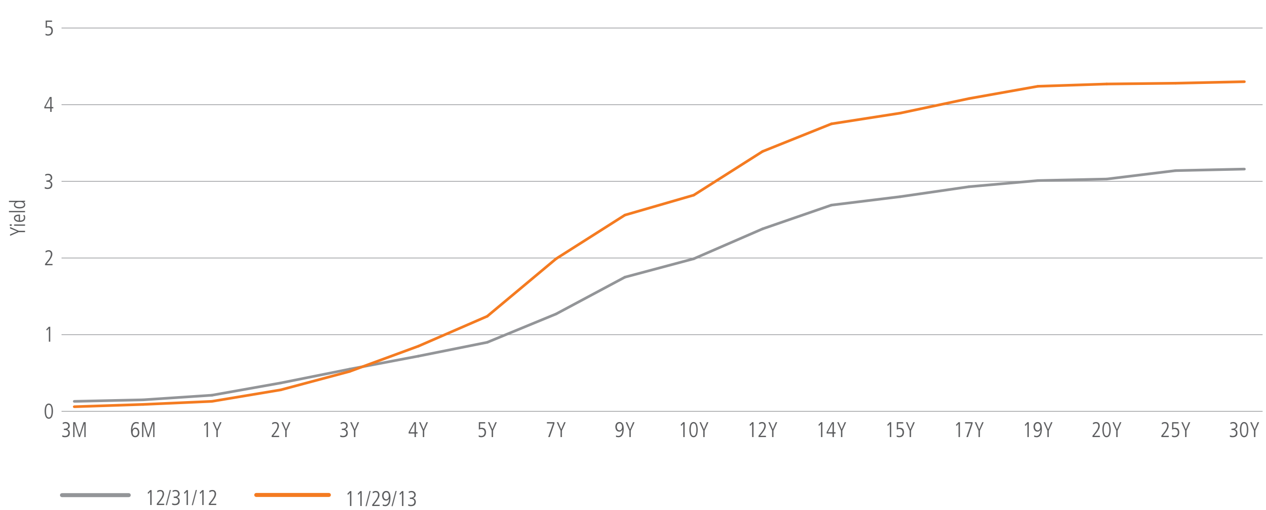
While headline risks remain, we have a fairly positive outlook for the municipal market in 2014. The municipal yield curve is steep from a historical perspective, even more so than at the beginning of 2013 given the back-up in rates. In addition, with the economy gaining some traction, the trend of rising state tax revenues should remain in place, helping to strengthen state balance sheets. Should the real estate market show further improvement, local tax revenues, which have been challenged, could increase as well. We are also encouraged by budget cuts by many municipalities, although there's additional work to be done on this front.



We are also cautiously optimistic about the technical backdrop. Retail demand for municipal securities was weak during the second half of 2013. Given higher tax rates and attractive valuations versus equal-duration Treasuries, we're anticipating somewhat better demand for this high-quality asset class in 2014. This may also be a fertile backdrop for crossover buyers, such as institutional investors and pensions. At the same time, we expect supply to moderate in 2014 given less refinancing activity, a major driver of new municipal issuance in recent years.

**MUNICIPAL YIELD CURVE HAS BECOME STEEPER**

U.S. AAA General Obligation Municipals




Source: Bloomberg.

Despite these positives, there are several risks. News about Detroit's bankruptcy, credit issues in Puerto Rico and the likelihood of other municipal downgrades could negatively impact retail demand and put pressure on the market. While we expect the Federal Reserve to remain largely accommodative, it's reasonable to assume that rates will move moderately higher in 2014. This too could be a headwind for the municipal market.

Despite the improved economic backdrop, municipal credit is mostly idiosyncratic, not systemic. Therefore, we believe that extensive credit research and individual security selection will be keys to help mitigate periods of volatility in the marketplace.

## HIGH YIELD BONDS AND BANK LOANS: CONTINUED OPTIMISM FOR 2014

**Ann H. Benjamin,** Chief Investment Officer—Non-Investment Grade Fixed Income

While spreads have meaningfully tightened in recent years, we believe there are many reasons to remain optimistic about high yield bonds and bank loans in 2014. Fundamentals continue to be supportive, in our view, given generally healthy balance sheets, ample liquidity and cash flows that allow most issuers to handily meet their debt obligations. In addition, many corporations have aggressively capitalized on the low interest rate environment to reduce their borrowing costs and extend their maturities. Against this backdrop, the default rate in 2013 will likely be south of 2%, less than half its long-term average of approximately 4%. We believe this trend will continue for several years to come.

We are similarly positive about the technical environment. Despite some temporary setbacks, investor demand was robust in 2013. Given what we expect to be relatively low interest rates, we anticipate overall strong demand in 2014, albeit punctuated by periodic flights to quality. We also believe that demand will be adequately met by new supply. As has been the case for several years, this will largely be driven by refinancing activity by higher quality B-rated and BB-rated companies. Despite concerns about a significant increase in CCC-rated leveraged buyout activity, this did not occur in 2013. Furthermore, there has been a relatively low amount of aggressive new structures being introduced in the marketplace which, in our opinion, is positive for the market going forward.

The inherent risks of owning below-investment grade securities cannot be overlooked, but we feel they'll be manageable in 2014. Aside from negative one-off corporate events that inevitably occur, political dysfunction in Washington, D.C., is a potential issue. Should further partisan conflict result in weakening confidence, it could potentially dampen growth and trigger an uptick in unemployment. In addition, the Fed has decided to begin tapering modestly this month, which will likely push rates somewhat higher. That being said, the Fed has chosen to taper due to an improving economic environment, which we feel will be beneficial for the overall high yield and bank loan markets. Furthermore, with the yield on the 10-year Treasury now trading around what we consider to be fair value, we do not expect rates to spike significantly higher and crimp refinancing activity.

## NON-U.S. DEVELOPED MARKETS: SIGNS OF PROGRESS AND OPPORTUNITY

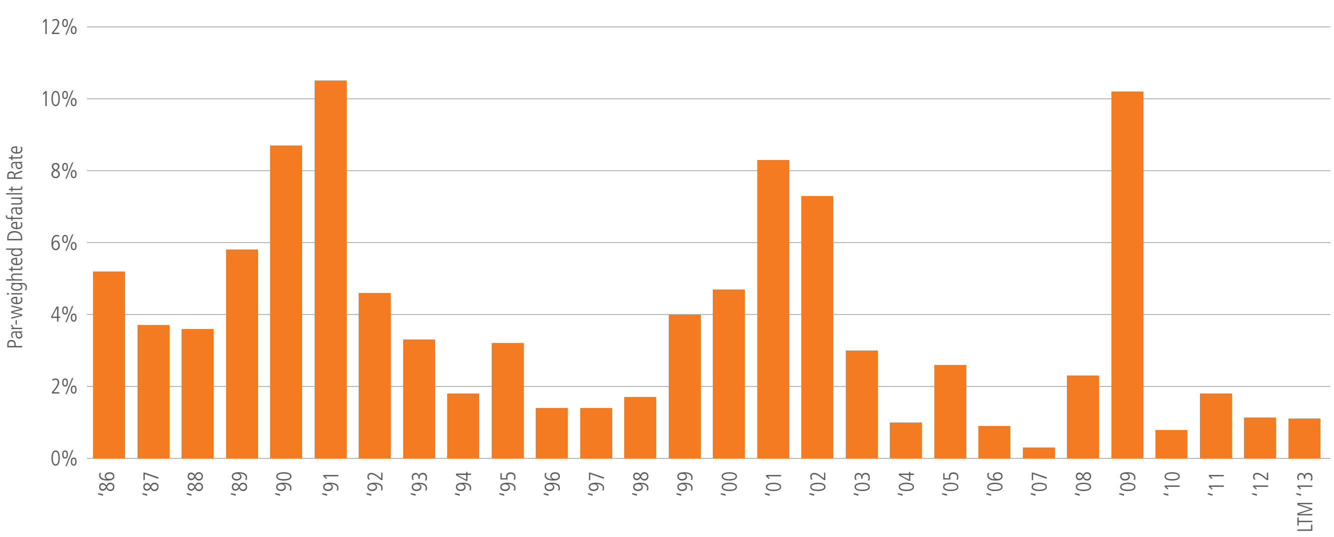
**Thanos Bardas, PhD,** Portfolio Manager and Global Head of Sovereigns and Interest Rates

**Jon Jonsson,** Senior Portfolio Manager—Global Fixed Income

During 2013, the world's developed economies maintained a delicate balance between achieving structural change and sustaining budding recovery. With growth on a firmer footing, we believe the G4 economies (U.S., eurozone, UK and Japan) will expand together in 2014—the first year of simultaneous growth since 2010. Still, these countries are at different stages in the business cycle, which should prompt market



**HIGH YIELD DEFAULTS REMAIN VERY LOW**




Source: JP Morgan Default Monitor, as of October 31, 2013. Figures are for last 12 months.

divergence in economic policy, with the Federal Reserve gradually reducing stimulus and weaker economies keeping especially accommodative monetary supports.

## Eurozone

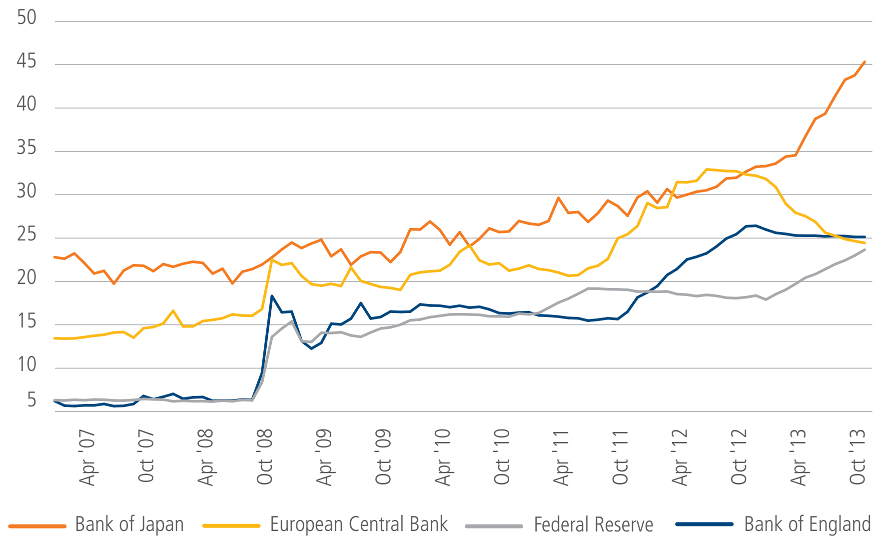
The economic environment in the eurozone remained sluggish in 2013, due to fiscal consolidation and household deleveraging. Although GDP growth turned positive at midyear, output remained more than 2% below its pre-crisis levels, while growth (or a lack of it) varied markedly between core and peripheral countries.

While leading indicators suggest the eurozone is on the cusp of a recovery, we expect the numbers to be moderate, with the lack of credit growth representing a key problem. Although other major central banks have expanded their balance sheets to promote recovery, the European Central Bank has been much more conservative in initiating non-standard tactics. While the Fed is planning to reduce quantitative easing in 2014, we expect the ECB to add stimulus given the considerable slack in the economy and the fact that the central bank's primary mandate, maintaining price stability, is at risk due to burgeoning deflationary pressures. The ECB already moved away from its longstanding policy of never "pre-committing," by providing forward guidance that its key rate would remain at "present or lower levels for an extended period of time"—an acknowledgement of the severity of the output gap in the region.

Against a backdrop of accommodative policy and an improving global growth environment, we think eurozone GDP should grow about 1% (+/- 0.5%) in 2014. Supporting the expansion, in our view, will be the depreciating euro and a corresponding boost in exports. We believe unemployment should stabilize at around 12% in 2014. Inflation, which was around 0.7% last year, should be somewhat higher at 1.5% (+/-0.3%) this year, given our expectation for a weaker euro. We anticipate modest peripheral spread compression in 2014, while the bellwether 10-year German yield should rise modestly to 2.1% (+/-0.6%).

**ECB HAS MORE ROOM FOR STIMULUS**

Central Bank's Balance Sheet as % of GDP




Sources: Bloomberg, Neuberger Berman, as of October 2013.



## Japan

Last year, the Bank of Japan (BoJ) and the Liberal Democratic Party of Japan implemented aggressive policies aimed at stimulating growth and ending the country's longstanding deflationary cycle. In April, the BoJ unveiled a "quantitative and qualitative monetary easing program" that largely exceeded market expectations. The central bank also pledged to double its monthly purchases, an undertaking that would lead to a significant expansion of its balance sheet. Although it is very early in Prime Minister Abe's latest tenure, we believe the results of "Abenomics" have thus far been encouraging.

While we expect a modest drop in the pace of expansion this year, we believe Japan will post solid GDP growth of 1.5% (+/- 0.5%) and that inflation should increase to 1.25% (+/- 0.5%). Overall, we view the Japanese bond market as overvalued given improving economic momentum. Our expectation for 10-year yields is an increase from late 2013 levels of around 0.6% to roughly 1.2% (+/- 0.4%). As the pick-up in inflation is currently being driven by yen depreciation, a shift toward currency strength would undermine our forecasts.

## Investment Grade Credit

With a backdrop of modestly improving growth in the eurozone and the UK, we have a generally positive view of developed market credits for 2014. Accelerating growth and continued monetary policy accommodation, in our view, should help support corporate fundamentals. We also feel that technicals will remain strong overall, as investors look for incremental yield in a low-interest rate environment.

In our view, opportunities among peripheral eurozone credits should generally surpass those in core countries. On average, investment grade non-financial peripheral bonds trade at spreads more than 1.5 times larger than their core counterparts; among senior financial credits, peripheral spreads are almost twice the level of core spreads. Finally, covered bonds appear more attractively valued than senior bonds, once the additional security is taken into account. This differential is particularly pronounced in Spain.

Last year, peripheral corporates' premiums tightened relative to those of core securities. However, given that they started the year at extremely wide levels, we feel there is more to go, particularly if economic conditions in the euro area continue to improve. Among the key events affecting systemic risk this year, the ECB is poised to take over the supervision of the eurozone's banks. In particular, we see the ECB's upcoming bank stress tests (formally known as the "asset quality review," or AQR) as critical to improving sentiment for the region.

Other risks to our outlook include potential missteps by the ECB in implementing monetary policy and the AQR, as well as outflows from the credit markets in general, should rates move meaningfully higher.

### Inflation-Linked Bonds

We have a mixed outlook for non-U.S. inflation-linked securities (linkers) in 2014, with a negative view of eurozone core linkers and better expectations for the periphery. Despite recent momentum in the UK economy, anemic wage growth, a stronger currency and subdued commodity prices could hamper growth, limiting UK linker's performance in 2014. Elsewhere, Japanese linkers posted strong returns in 2013 given high accommodative fiscal and monetary policy and, in our view, should maintain their upward trend in the medium term in 2014. Finally, commodity bloc linkers (Australia, New Zealand and Canada) generated weak results in 2013. We anticipate better performance from Australian and New Zealand linkers over the next year. But, with economic slack weighing on inflation expectations and lackluster economic growth, we think Canadian linkers could show weakness.



## CURRENCY: TIMING OF TAPERING AND RELATIVE GROWTH ARE KEYS FOR 2014

Ugo Lancioni
Portfolio Manager—Global Fixed Income and Currency

In our view, the extent of Europe's recovery and the pace of U.S. Fed tapering will likely remain focal points for currencies in the coming year. Over the last three years, the currency markets have been distorted by an unprecedented level of economic policy uncertainty (see display). The reduction of such uncertainty could be one of the key themes to emerge in 2014—translating into a greater focus on relative currency fundamentals and, by extension, greater opportunities for active currency investors.

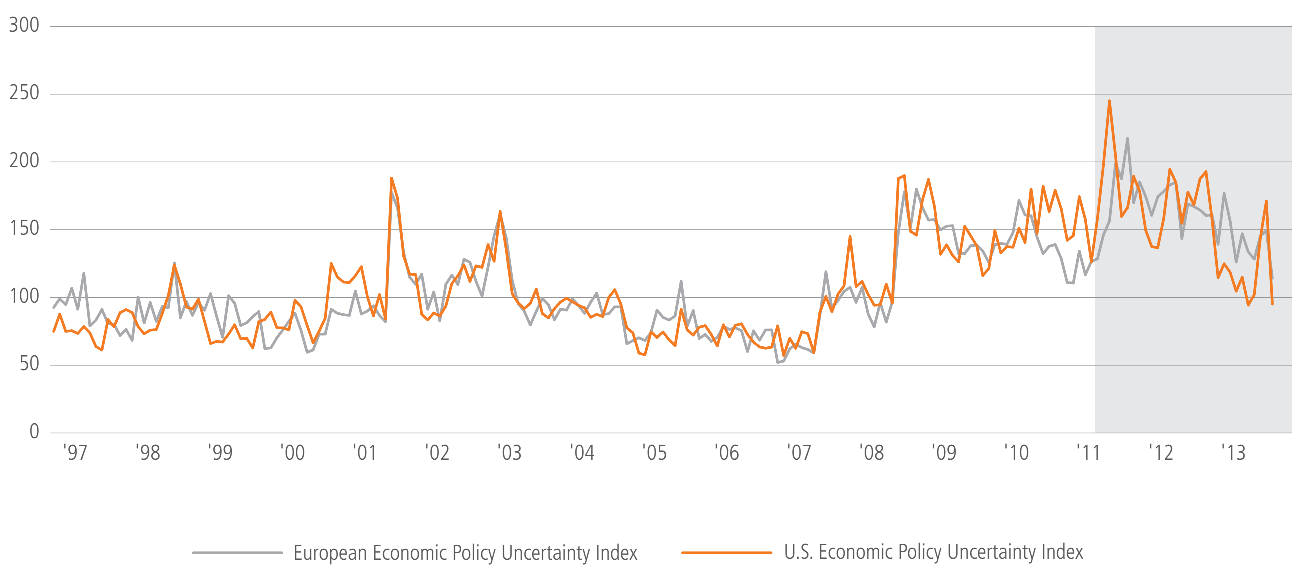
The euro's appreciation in mid-to-late 2013, associated with demand for European assets due to fading risks to the monetary union, appears inconsistent with existing growth and employment numbers and, in our view, could threaten the fragile recovery. If growth softens and disinflationary risk increases, the ECB could be forced to ease more aggressively. As such, despite renewed optimism in the eurozone, it is difficult to see a significantly stronger euro in 2014. However, we believe it is important that policymakers continue to foster the recent optimism, as a stronger Europe would provide welcome help to global growth overall.

Elsewhere, U.S. cumulative growth has outpaced other developed countries in recent years, while Japan's economic activity and business confidence have improved. Despite this, both countries are currently enjoying competitive currencies relative to other major economies. We anticipate that pressure on the U.S. dollar and yen will persist only as long as their central banks continue to inject enormous amounts of liquidity into the system. As such, the pace of Fed tapering will likely be the most important factor for currency investors in 2014 and could result in periods of higher volatility for currency markets.

Overall, we believe the U.S. dollar and the British pound are currently the most attractive currencies among developed countries, while the Canadian dollar, Swiss franc and euro remain expensive. The greenback could benefit from improving underlying growth dynamics, although any shortfalls in data could cause the Fed to put tapering on hold and trigger periods of downside dollar risk.

Similarly, recent economic momentum should support the pound, although Britain's uptrend in domestic activity appears somewhat fragile. In our view, among other European currencies, the Norwegian krone offers among the best risk/reward opportunities, while unattractive valuation and improvements in European sentiment could gradually take the shine off the Swiss franc.

**POLICY UNCERTAINTY APPEARS TO BE EASING**




Source: Economic Policy Uncertainty. Data through November 2013.

## EMERGING MARKETS DEBT

# OVERVIEW:
# CALMER SEAS AND COMPELLING VALUATIONS

**Rob Drijkoningen and Gorky Urquieta,** Co-Heads—Emerging Markets Debt Team

2013 proved a very turbulent year for emerging markets debt (EMD), as a combination of pessimism about growth in emerging economies and expectations of the Federal Reserve's tapering of asset purchases triggered concerns about capital outflows, which dominated performance in the asset class.

As it has often been the case, the initial market reaction was drastic and largely indiscriminating, bringing total returns for an already difficult year into deeply negative territory through the end of the third quarter. Later, fears were alleviated by early evidence of a trough in growth, helped by better data out of China. Markets then became more discerning about fundamentals, continuing to punish those countries with current account deficits and major funding needs. With tapering risk pushed off at the Fed's September FOMC meeting against market expectations, a healthy rebound followed which undid much of the damage inflicted in the summer.

As we enter 2014, many elements remain ambiguous but others have become clearer. As the recovery in the developed world gains traction—with the eurozone's emergence from recession and U.S. resilience in the face of fiscal headwinds—we believe that prospects for the emerging world are also growing more favorable. A stronger global economy, even one led at the margin by the industrialized world, is a net positive for emerging economies. And although China's ability to engineer a "soft landing" of its economy remains important, given its dominance as a commodity consumer, we have already witnessed some recovery in many emerging economies, especially those geared to exports into developed markets. Overall, while the emerging market/developed market growth differential appears to have bottomed at around 3%, what's more important is that both segments are on a positive uptick, which also improves prospects for supportive commodity prices.

### Global Economy: Below Trend but Improving

We are optimistic that emerging economies could experience a resurgence in 2014. With its decision to start tapering in January, the Fed has signaled the "beginning of the end" of ultra-easy monetary policy. Still, prospects for global growth should continue to improve, albeit at below trend, given global interest rates that remain at close to historical lows due to a lack of inflationary pressure and weakness in the labor market. Such an investment environment could prove more conducive to risk-taking in EMD than has been the case in the recent past.

However, differentiation across countries (not all emerging markets are created equal) will likely prove decisive in seeking to capture positive returns in 2014. Last summer's steep selloff revealed vulnerabilities in various emerging economies, but in many instances, it also prompted overdue fiscal and monetary policy initiatives. Longer-term structural improvements such as reduced indebtedness, large international reserve buffers, fiscal flexibility and the ability to deploy monetary stimulus have helped rebuff the notion of a crisis in emerging countries.

### What Else to Expect: Uncertainty

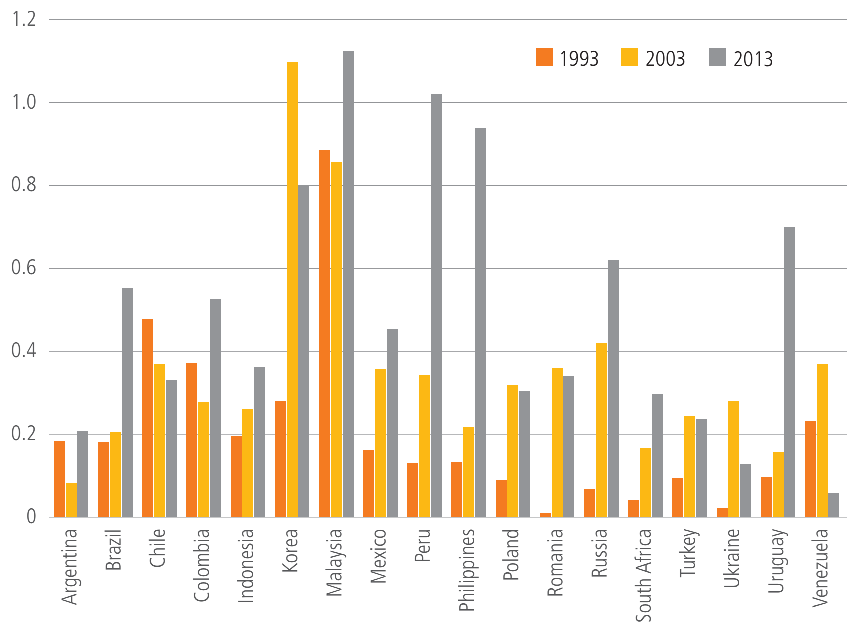
We can expect that things won't go as scripted. Having already received a preview of the potential impacts of Fed tapering, emerging markets are likely to remain hostage to the risk of rising developed market interest rates choking off capital flows. Also, the U.S. could yet generate another fiscal and debt ceiling showdown, which could derail expectations once again. Data from China have been improving consistently, but its transition from an economic growth model reliant on exports and investments to one led by domestic consumption is fraught with uncertainty, especially at a time when lending and credit

**EMERGING MARKETS GROWTH AND INFLATION PICTURE IS GENERALLY BENIGN**


Sources: Bloomberg, Neuberger Berman, as of December 9, 2013. Data shown in percentage points. See countries key on page 36.

**EMERGING MARKETS' STRUCTURAL SHIFTS HAVE REBUFFED THE NOTION OF 'CRISIS'**

Reserves/External Debt




Source: International Institute of Finance, as of October 31, 2013.



growth are already elevated. And while the eurozone has successfully defused risks of a breakup, bloated balance sheets and structural impediments to growth, as well as political risk (particularly in the periphery), remain issues that are not without risks.

### Implications for Emerging Markets Debt

In emerging markets, we believe that below-potential growth will lead monetary authorities to remain accommodative, putting downward pressure on rates. The risk is that depreciation will persist, at least for countries with a vulnerable balance of payments. Also, a common denominator of the correction in local markets last summer, aside from the perception of external-account-related vulnerability, was that the five countries that suffered most in the selloff (Brazil, India, Indonesia, Turkey and South Africa) all will conduct general elections in 2014. Since political uncertainty tends to reduce the likelihood of meaningful reform, these markets remain at risk should volatility return.

Overall, as rates and spreads have backed up in the hard debt markets, the valuation argument has swung back in favor of both sovereigns and corporate EM credits, where we believe spreads in absolute terms and relative to developed world counterparts look compelling.

### Long-Term Story Largely Unimpaired

Over time, emerging markets debt has enjoyed a gradual upgrading of perceived credit quality, such that more than two-thirds of the asset class is now investment grade. In our view, this rerating is on pause but has not reversed. Reserve accumulation was only temporarily derailed last year, and reserves are still ample by any standard, with current account deficits largely funded by foreign direct investment in most cases. In general, we have not seen—nor do we expect—a deterioration of public sector balance sheets and fiscal dynamics, while credit growth is decelerating, which has reduced concerns about household leverage.

Investment flows into the asset class were weak but still positive in 2013. More importantly, outflows were confined to retail investors, while institutional strategic allocations remained largely undisturbed. The latter speaks to what we consider the underrepresentation of EMD in global portfolios. In our view, institutional investors will gradually increase their allocations, which should provide a long-term tailwind for the asset class.

## HARD CURRENCY SOVEREIGN DEBT: COUNTRY SELECTION WILL BE CRUCIAL

**Bart van der Made, CFA**
Lead Portfolio Manager—EMD Hard Currency

The cyclical downturn in emerging markets that seemingly bottomed in 2013 exposed the difference between resilient investment-grade countries that had improved their credit quality and vulnerable countries where excessive fiscal and current account deficits had developed in the last few years without a clear policy response to cure them.

The composition of our investment universe changed as new countries entered, taking the index from 55 to 61 countries. These new countries, which issued U.S. dollar-denominated bonds, are generally "frontier" markets from Central America and Africa, whose bonds are below investment grade. Together, they have increased the diversification available within the hard currency debt market.

In the wake of the recent correction, valuations among hard currency sovereigns have moved from the rich side of fair value to the bargain side. In January 2013, spreads over U.S. Treasuries hit around 240 basis points, equal to the level of April 2010 and their tightest position since 2007. In the spread-widening that followed, investment grade names underperformed and their spreads moved from rough equality with U.S. BBB credits to significantly higher levels.

Looking ahead, we believe that valuations are generally attractive among investment grade bonds, which represent some two-thirds of the index. The addition of new issuers, some with relatively little return history or research coverage, could provide new opportunities for investors. Still, a number of countries have shown rapid deterioration in fundamentals—characterized by underwhelming growth, and large and widening fiscal/current account deficits—which could potentially trigger balance-of-payments crises.

On the whole, the current landscape supports a fairly positive view of the asset class, though we believe that country selection will be particularly important in the year ahead.

**VALUATIONS HAVE BECOME MORE APPEALING**

EM Hard Currency vs. U.S. Investment Grade Yields (spread)


Source: JP Morgan. U.S. represented by the JP Morgan U.S. Liquid Index (JULI); EM represented by the JP Morgan EMBI GD Investment Grade Index. Data through December 12, 2013, shown in percentage points.

## HARD CURRENCY CORPORATE DEBT: RELATIVE VALUE, IMPROVING FUNDAMENTALS

Nish Popat
Co-Lead Portfolio Manager—EMD Corporates

Jennifer Gorgoll, CFA
Co-Lead Portfolio Manager—EMD Corporates

Our outlook on EM corporates is fairly constructive, as we believe that strong credit fundamentals will generally remain intact during 2014. The currently expected reduction in liquidity due to Fed tapering has, in our view, largely been priced into the market. However, anticipation of the Fed's measures, combined with the potential for further conflict over the U.S. budget and debt ceiling, could conceivably impact the corporate market and impair investor sentiment going forward.

In general, EM companies have not only improved their credit profiles since 2008, but continue to maintain ample liquidity, making them well-positioned to weather setbacks in economic growth. That being said, we believe that EM growth will accelerate this year, translating into a very supportive environment for businesses.

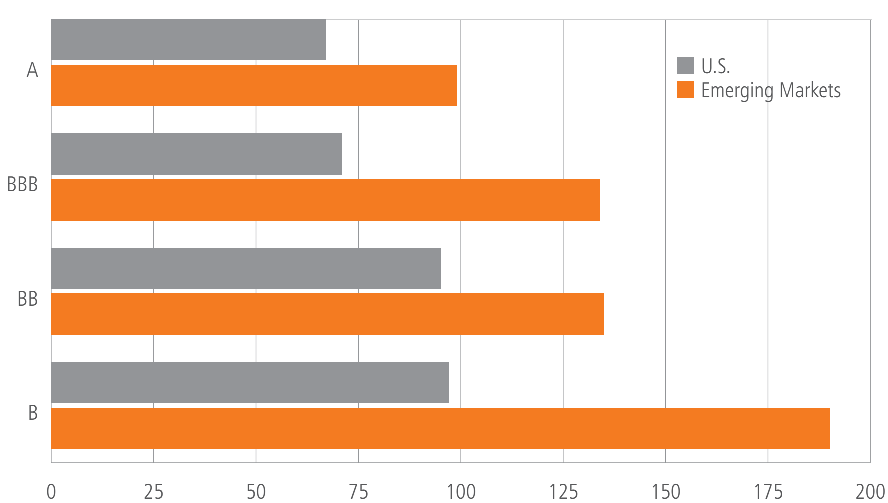
As the corporate universe continues to expand and diversify geographically with the uninterrupted growth of debt issuance, we believe that investors will increasingly look at credit with a more global perspective. At the time of this writing, EM investment grade corporates offered a pickup of roughly 130 basis points over U.S. counterparts.[1] The segment's high yield sector (single B-rated) appears to us even more attractive, with a 185-basis-point advantage over single B-rated U.S. issues.[2] We believe these differences will narrow over time as investors re-evaluate underlying credits in emerging markets versus the U.S. and other developed economies, as well as provide investors with ample carry.

EM corporate defaults rose in 2013, particularly in Latin America. However, this is due largely to idiosyncratic situations in the Mexican homebuilder sector and among Brazilian oil and gas companies, rather than a systemic issue. Although defaults should remain low from a historical perspective in 2014, we believe that bottom-up fundamental analysis will continue to be crucial in identifying attractive opportunities and avoiding defaults.

Going forward, we see pockets of opportunity, but are cognizant that sector and country selection will be very important. Mexico is one

**EMERGING MARKETS CORPORATES PROVIDE BETTER VALUE THAN U.S. COUNTERPARTS**

Spread per Turn of Leverage (basis points)




Source: BofA Merrill Lynch. Financial data as of June 30, 2013; spread data as of September 30, 2013.



[1]JP Morgan. Emerging market corporates represented by the JP Morgan CEMBI Diversified Index; U.S. credits represented by the JP Morgan JULI Index.

[2]JP Morgan. EM high yield represented by the single-B component of the JP Morgan CEMBI Diversified Index; U.S. high yield represented by U.S. domestic high yield single-B issuers.

market we find attractive, given the country's recently strong pace of reform and our expectation for further advances, particularly on the energy front. While positive for the sovereign, Mexican corporates should also benefit given an expected pickup in economic growth, particularly as the U.S. economy recovers.

We also see good relative value opportunities in Asia, particularly within China, where the property, oil and gas, and financial sectors appear attractive. Globally, the metals and mining sectors generally underperformed in 2013 and continue to appear weak—but could surprise on the upside should global growth prove stronger than expected.

## LOCAL CURRENCY DEBT: REAL RATES, GROWTH COULD PROVE SUPPORTIVE

**Raoul Luttik**
Lead Portfolio Manager—EMD Local Currency

With their export sensitivity to developed markets, EM economies appear well positioned to expand more rapidly this year. Indeed, export growth is already broadening beyond externally focused Asian economies to benefit more domestically oriented markets such as Turkey and India. Demand is coming not only from a resurgent U.S., but from Europe and Japan as well.

With this in mind, we think there is scope for EM currencies to appreciate this year—with some caveats. One is that existing slack in some economies could open the door to limited easing, reducing the attractiveness of carry in these markets, especially in combination with higher U.S. interest rates. Second, while current account deficits in some EM countries are starting to move toward more sustainable levels, there is some way to go—especially if one assumes that portfolio flows to these markets will remain limited. These deficits are partly due to structural factors (e.g., in South Africa and Turkey) and partly due to excessively buoyant domestic conditions. Although the latter are being addressed by tighter monetary and/or fiscal policies, structural issues are seeing less progress given the elections scheduled in many EM countries for this year.

Our generally positive view on EM currencies is also due to the recent depreciation of real effective exchange rates (REERs), especially those in the so-called "Fragile Five" nations (Turkey, South Africa, India, Indonesia and Brazil). These valuations are now "fair to cheap," as REERs are now close to levels last seen during the extreme weakness of 2008.

Turning our discussion to EM country yields, they are clearly sensitive to potential increases in U.S. Treasury yields, even though we see limited scope this year for the 10-year rate to move much higher given U.S. economic conditions. Overall, we expect essentially range-bound movements in local yields, while high-yielding issuers have some scope for the compression of embedded risk premiums.

Economic softness (noted above) and already tightened policy rates in some markets could limit downside, especially with limited inflationary pressure and moderate growth expectations for China and other commodity-intensive countries.

Geographically, we think Central and Eastern Europe should see a modest uptick in growth. With supportive balance-of-payment conditions and generally subdued domestic demand, these regions should experience a fairly benign fixed income environment. In Latin America, we believe Brazil is attractive from a yield perspective, while Mexico should make economic headway due to its structural reform efforts. (See more on Asia on the following page.)

Looking at the big picture, given already high yields, steep curves, reasonable valuations and generally supportive currency dynamics, we believe the EM local currency bond market has relatively favorable prospects for the coming year.

**2013 SELLOFF SHOWED THAT COUNTRY SPECIFICS MATTER**

Weaker fundamentals (as represented by CSS) were closely linked to currency declines.


Sources: Bloomberg, Neuberger Berman. The EMD investment team's Currency Stability Score (CSS) captures trends in variables that have been important in key turning points of a currency regime. Variables fall into four broad categories: competitiveness, economic, financial system health and political. A CSS is internally derived for each country in the universe from 0 to 25, with a "0" being the strongest score.

Currencies, countries: ARS, Argentina; BRL, Brazil; CLP, Chile; CNY, China; COP, Colombia; CZK, Czech Republic; HUF, Hungary; IDR, Indonesia; ILS, Israel; INR, India; KRW, South Korea; MXN, Mexico; MYR, Malaysia; PEN, Peru; PHP, Philippines; PLN, Poland; RON, Romania; RUB, Russia; SGD, Singapore; THB, Thailand; TRY, Turkey; TWD, Taiwan; UYU, Uruguay; ZAR, South Africa.

# ASIAN DEBT: IMPROVING RISK-REWARD DYNAMICS

**Prashant Singh, CFA**
Lead Portfolio Manager—EMD Asia

Going into 2014, we are generally enthusiastic about the strength in Asian sovereign balance sheets, and the general stability and sustained macro improvements in the region. With all its prominent economies now rated investment grade, Asian fixed income will likely retain relatively low volatility characteristics. Given attractive carry and the potential for both a pickup in global growth and the compression of Asian spreads, we believe the asset class looks increasingly compelling from a risk-adjusted return perspective.

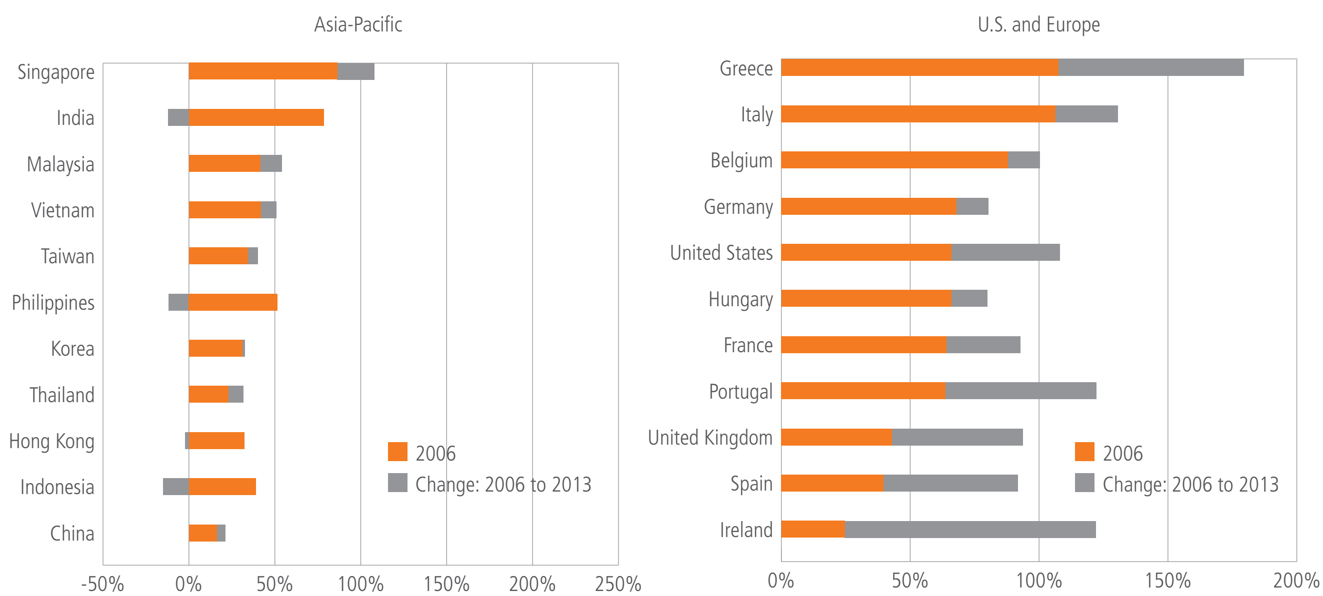
We believe that Asian growth should pick up modestly in 2014 with performance varying among countries. Manufactured goods exporters such as Korea, Taiwan and Singapore are likely to be the key beneficiaries of an expected cyclical rise in exports. The Philippines should continue to benefit from strong investment spending, fueled by accommodative monetary policy and unprecedented political stability. However, the need for tighter financial conditions and/or fiscal consolidation may constrain growth in India, Indonesia and Malaysia. Further, upcoming general elections in India and Indonesia may result in much-needed structural reforms being put on hold. However, positive election results could lead to a significant reduction in political risk premiums for both of these economies. Barring an unexpected and meaningful pickup in commodity prices, regional inflation should be range-bound this year. We expect the degree of monetary accommodation to be greater in higher-yielding markets than in their lower-yielding counterparts, and thus expect higher-yielding local sovereign bonds to outperform.

In our view, recent improvements in the Chinese economy will likely continue. Announced infrastructure projects, an improved housing market and a recovery in exports should keep growth stable at around 7.5%. Meanwhile, ongoing reforms focusing on governance, finance, fiscal policy and land use will also move ahead. This benign environment should allow for policymakers' increased tolerance of currency appreciation, such that the renminbi could appreciate further in 2014—reinforcing a strengthening bias in Asian FX. Regionwide, we favor currencies of economies with positive basic balances,[3] such as China and South Korea.

For Asian corporate bonds, a few headwinds should persist, including higher interest rates and pockets of high leverage. That said, the accumulated savings of Asian economies and scaling back of capex plans should help companies gradually work off excess capacity that resulted from a surge in credit growth since 2008. Although banks could face slower loan growth and margin compression, banking systems remain very healthy given the strict and preemptive stance of regulators coupled with ample liquidity. Overall, we anticipate a balanced upgrade-to-downgrade ratio in Asian corporate debt, with default rates remaining low through 2014. With a potentially heavy new issue pipeline, we favor lower beta corporates with strong balance sheets and quality managements. From a risk/return perspective, this seems far more reasonable than moving down the credit quality curve to pick up yield.



**ASIAN SOVEREIGN BALANCE SHEETS REMAIN STRONG**
Sovereign Debt/GDP




Sources: IMF, Neuberger Berman estimates.

[3]Combining current account and foreign direct investment.

# SOLVING
## Alternatives and Multi-Asset
# FOR 2014

# Private Equity:
## DIVERSE OPTIONS IN A KEY ASSET CLASS

In 2014, we anticipate a continuation of many of the trends present in 2013. Traditional buyout firms are underwriting companies within a framework of a more favorable economic environment aided by readily available low-cost leverage. Special situations managers are encountering an extended opportunity set tied to residual effects of excessive borrowing prior to the 2008 financial crisis, including companies that are struggling operationally and sellers that continue to divest non-core and orphaned assets. Venture capital managers continue to see a strong exit market. The growth equity opportunity still remains attractive, with demand for capital greater than supply for smaller companies. Finally, we believe that the secondary market will maintain a long-term growth trend as the universe of sellers continues to expand.

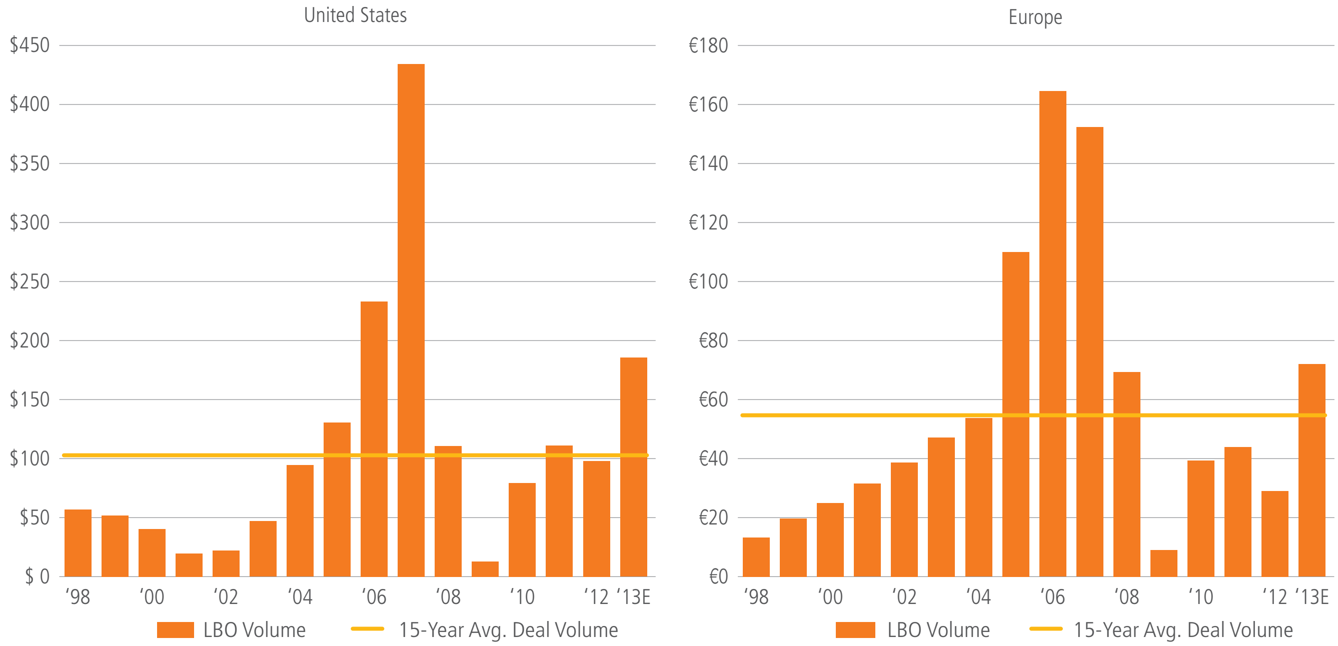
**Anthony D. Tutrone**
Global Head of Alternatives

### Buyouts: Strong Activity Should Continue

The buyout market was healthy during 2013, although volumes were still below the peaks achieved prior to the financial crisis. As the year progressed, valuations moved higher largely as a result of a surging stock market, although average buyout multiples were lower than overall public market valuations. Looking to 2014, we believe many existing trends should continue. New deal activity should remain robust, although many private equity firms are currently biased toward cash realizations from existing portfolio companies. Regarding exit strategies, outright sales of portfolio companies to private equity buyers and cash-rich strategic acquirers should remain the standard approach. However, stable credit markets and low interest rates should facilitate dividend recapitalization transactions in which proceeds from new debt are paid out to private equity owners. We believe that public stock market investors will continue to have a healthy appetite for private equity-backed IPOs.

**BUYOUT ACTIVITY SHOULD REMAIN ROBUST**

Buyout Volume (billions)




Source: S&P Q3 2013 Leveraged Buyout Quarterly Review.

From an economic perspective, many buyout firms believe that global growth will slowly improve during 2014 but will remain sluggish by historical standards. As such, with organic revenue growth frequently difficult to achieve, value creation strategies will likely focus less on improving operations, cutting costs and expanding through acquisitions. Compared to larger companies, such initiatives are relatively easier to implement in the small- to mid-cap market, where companies tend to be managed less professionally, and there are more "add-on" acquisition candidates with the potential to significantly increase a company's size and growth rate.

To help fund new transactions as well as finance add-on acquisitions, while maintaining a controlling ownership, we believe private equity firms will continue to seek co-investors that have sufficient capital and expertise to help facilitate the execution of the value creation strategy. The companies and industries that have shown resilience through the post-financial crisis period should continue to command premium purchase price multiples. As another strategy, some private equity firms are becoming more willing to make more aggressive cyclical bets in industries such as shipping. We also expect increasing activity in international markets, primarily Asia and Latin America. In these geographies, we think a local presence and strong GP relationships are essential to navigating the cultural and regulatory idiosyncrasies of each market.

## Special Situation Strategies Show Appeal

Special situations encompass a variety of strategies: operational turnarounds (including value buyouts of undermanaged companies), distressed assets and distressed debt. In the year ahead, we believe that a mixed operating environment, continued deleveraging, continued potential for destabilizing events, volatility and a focus by companies on their core operations should provide ample opportunities for special situation investors.

Currently, we believe there is a large global supply of orphaned business units within public and private companies that suffer from suboptimal resources and a lack of capital and attention. When companies focus on core assets, they are often eager to sell non-core businesses at attractive prices. As such, orphaned divisions can represent a rich opportunity set for operational turnaround investors with specific expertise in corporate carve-outs. Another supply driver of operational turnarounds is poor management, a phenomenon which is not cyclical and presents an evergreen opportunity to purchase struggling companies at highly attractive prices. Poorly managed companies often face a number of interrelated challenges including loss of talent or market share, competitive weakness and limited access to capital markets. In today's low-growth but highly competitive marketplace, we believe such businesses are especially at risk and represent a rich opportunity set for operational turnaround investors who have specific expertise in acquiring, restructuring and rehabilitating struggling companies.

Private equity firms specializing in distressed financial assets purchase non- or sub-performing loan pools at a deep discount, typically from financial institutions. They then work in-house and/or with a servicer to collect, modify and restructure these loans. Currently, we believe an ongoing driver of this strategy is banks' ongoing need to clear nonperforming assets off their balance sheets to satisfy regulators, improve capital ratios and generally appease investors. However, the carrying values of these assets are frequently higher than third parties have been willing to pay. As banks improve earnings and capital ratios, their willingness to sell bad and non-core assets at market-clearing prices continues to increase. Although heightened competition for these assets has increased pricing, we believe the opportunity will continue for many years given bank provisioning levels, particularly in Europe. In addition to distressed financial asset strategies, there are a variety of ongoing distressed hard asset strategies, including those within aircraft, shipping, energy and other sectors. These strategies tend to be niche oriented and have considerable barriers to entry that often create the opportunity for outsized returns.

Distressed debt strategies seek to acquire corporate loans and bonds of underperforming companies, at prices meaningfully below par, to restructure the companies or trade their securities. Currently, distressed debt strategies are finding limited opportunity in the marketplace due to the strong rally in credit markets, persistently low interest rates, significant refinancing activity and a generally improving economy that has lowered default rates. Still, we believe there is significant potential on a case-by-case basis in various geographies and sectors around the world. Overall, for example, Europe has a more robust supply of distressed corporate debt opportunities than the U.S.



## Venture Capital/Growth Equity: A Robust Environment

In 2013, the venture capital environment picked up where it left off in 2012, with steady fundraising, robust investment activity and increasing valuations in late-stage companies. Perhaps the most notable development of the year was in the exit market and, in particular, the increasingly receptive IPO market in the U.S.

Capital raised by venture capital firms continues to lag capital deployed. Over the past five years, invested capital has exceeded fundraising by over $50 billion. Investment patterns are directly related to fundraising, and consequently, the check size per financing round contracted in 2013, as did the median pre-money valuation, to a level last seen in 2005. Early-stage valuations have generally remained at reasonable levels, while mid- and late-stage valuations have seen a dramatic increase. In many cases, we believe these valuations are at unrealistic levels, with the median valuation of later stage investments nearly double that of late 2012.

We expect these trends to continue in 2014, with healthy (but not unreasonable) levels of fundraising driving a thriving seed and early-stage market. Late-stage valuations for the most high-profile and successful companies should remain elevated as long as exit markets remain robust and capital continues to flow into the space. Should a market correction or economic shock occur in 2014, recent investments in certain late-stage companies may experience a sharp decrease in value.

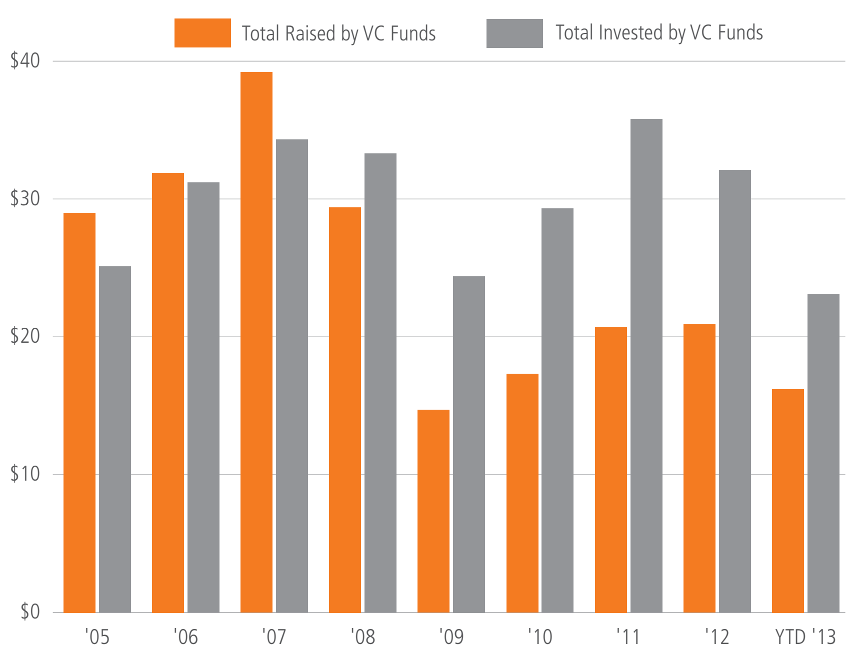
As U.S. stock markets continue to set record highs, the strength of the venture-backed IPO market also builds. With interest rates remaining near record lows, some investors are turning to growth-oriented investments for returns, even if the company exhibits little or no revenue, and uncertain profitability. A number of recent high-profile purchases illustrate the ongoing search for significant acquisitions and the willingness to acquire companies based on user numbers and "eyeballs" rather than financial metrics.

A busy pipeline of filed IPOs remains, and we expect it to remain robust in 2014. Although successful IPOs can yield outsized returns, they are far less prevalent than M&A exits and have a longer timeline. The period from formation to IPO has increased sharply, from about three to four years in 2000 to seven years today, compared to a current average of approximately five years for an M&A exit. Assuming equity markets remain buoyant, yields stay low and the steady supply of exit-ready companies continues, we expect recent trends in M&A exits and public offerings to persist in 2014. However, the fragility of the IPO market is well-documented, so we favor opportunities with the expectation of small and mid-sized M&A exits, which we believe can drive more consistent returns over time.

Turning to growth equity, we believe the segment remains attractive in both the U.S. and Europe. Situated between venture capital and small-cap buyout, its niche is relatively low profile as a standalone asset class and, in our view, remains underserved. As the number of firms focused on this asset class is small relative to the number of opportunities, investors are able to be highly selective. Equally, the availability of capital for many smaller companies continues to be scarce compared to larger companies, creating opportunities for providers of equity capital to those seeking funds for growth. We see similar potential in

**VENTURE CAPITAL: INVESTMENT HAS OUTPACED FUNDRAISING IN RECENT YEARS**

Fundraising and Investment Pace (billions)




Source: Dow Jones VentureSource Q3 2013 Venture Capital Market Overview.

emerging markets, particularly Latin America, where many companies are at a stage at which new capital and related management guidance could support new efficiencies and growth potential.

## Secondary Market Rebound

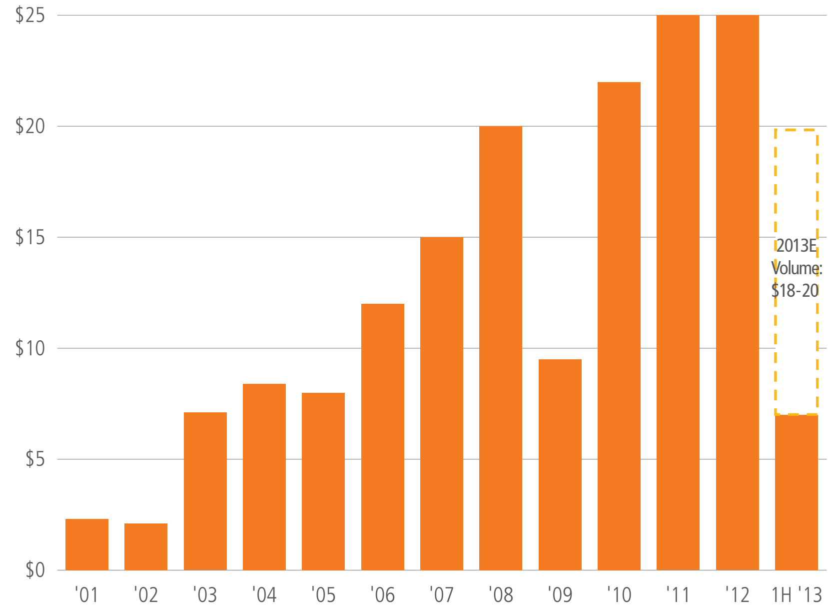
In our view, secondary market transaction volumes should improve in 2014. After several years of record activity, the first half of 2013 demonstrated lagging volumes for secondary buyers. According to Cogent, a leading secondary market advisor, transaction volume was roughly $7 billion in the first half of 2013, representing the lowest level of activity since 2009.

Many observers had expected 2013 to be another record year, but robust distributions from underlying portfolios, coupled with strong global equity markets, caused many would-be sellers to postpone potential transactions. However, we believe this trend has started to abate. The secondary market growth drivers of recent years, namely the expansion of the universe of sellers, changing regulation of financial institutions, more active portfolio management and the growth in private equity generally are, in our opinion, sustainable, long-term trends that we believe will continue to drive supply in 2014 and beyond.

In addition, the secondary market continues to grow in sophistication and, today, offers creative and customized liquidity solutions to both limited partners and general partners globally. As the private equity asset class matures further, one trend we expect to continue this year is the secondary market's ability to provide viable solutions for mature, end-of-life private equity funds where limited partners often want liquidity and interests are sometimes not well aligned with general partners. Finally, with secondary dry powder at rational levels, we believe 2014 will provide attractive secondary investment opportunities for experienced secondary investors.

**DIP IN SECONDARY ACTIVITY COULD PROVE TEMPORARY**

Secondary Transaction Volume (billions)




Sources: Neuberger Berman and secondary market advisor research.

## Conclusion

With the current environment of low interest rates and a slowly improving economy, we believe private equity continues to be an attractive asset class with the potential to generate favorable returns with low correlations to other investments. Financing for new transactions and dividend payments is readily available and the public markets are receptive to companies backed by both buyout firms and venture capital investments. Despite the improving economy, distressed managers are still finding opportunity in operational turnarounds and purchases of non-core assets. Finally, secondary volume should benefit from sellers seeking more complex and sophisticated solutions to manage their private equity portfolios.

Jeff Majit, CFA
David Kupperman, PhD
Ian Haas, CFA
Fred Ingham, ACA, CFA
Eric Weinstein
–Portfolio Managers, Hedge Fund Solutions Group



# Hedge Funds:
## AMID CHANGING MARKETS, NEW LEADERSHIP?

In the wake of the 2008 financial crisis and subsequent European sovereign debt issues, markets have largely been driven by macroeconomic concerns, policymaker actions and sharp shifts in investor sentiment. This dynamic has made it difficult for those who seek to predict or follow market trends to find reliable sources of return. For managers seeking to capitalize on differences among individual securities, higher correlations driven by macro-focused markets have generally made alpha generation more challenging.

Today, with the tapering of quantitative easing beginning and the potential for interest rate increases down the road, the implications are mixed. Hedge funds have generally done well in tightening cycles. However, trend followers—specifically, commodity trading advisors (CTAs)—who benefited from the secular decline of rates over the last 20 years, may be left adrift as they search for the next "long-term trend." On the other hand, higher rates should help drive increased performance dispersion among companies—something that could help long/short equity and other fundamentals-focused investors.

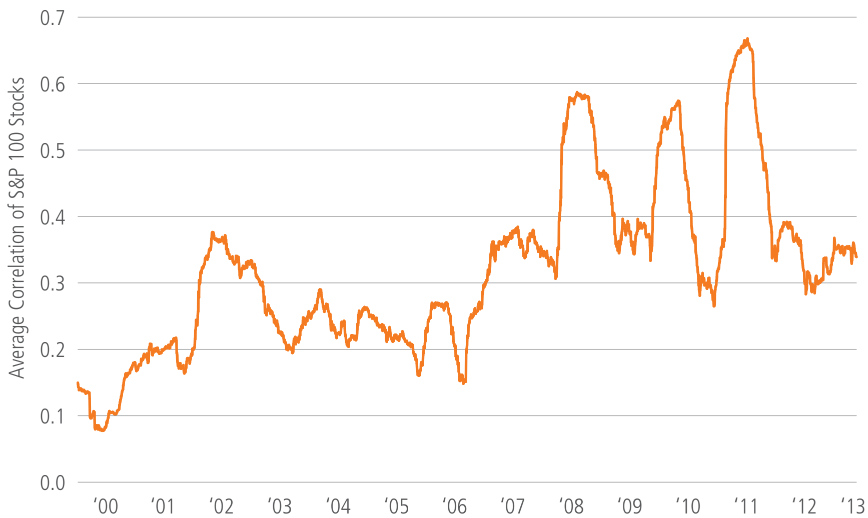
As we begin 2014, we discuss some of these developments and their ramifications for key segments of the hedge fund universe.

### Long/Short Equity: Navigating Correlation Shifts

With the exception of 2013, the last few years have been challenging for long/short equity hedge funds. Persistently high correlations across stocks have created headwinds for managers seeking to generate alpha by having long positions rise and their shorts decline in value. Higher correlations in 2011 and much of 2012 reflected stock performance that was less a function of company-specific fundamentals than it was of macroeconomic developments and changes in market sentiment (i.e., with "risk on, risk off" price movements). In our view, long/short equity managers are typically better at analyzing company-specific factors than timing frequent market

**LOWER CORRELATIONS: A BOON FOR STOCK PICKERS?**

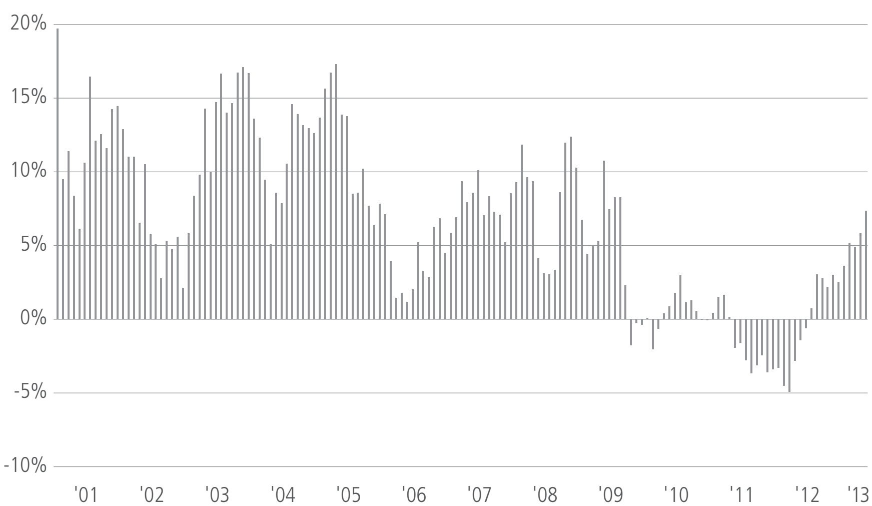
U.S. Equity Correlations: Rolling 120-Day Average




Source: Bloomberg. Data through September 2013.

**LONG/SHORT EQUITY HAS SEEN A RESURGENCE**

Rolling 12-Months Outperformance of Hedge Fund Long Holdings vs. S&P 500 Index




Source: FactSet. Data through September 2013.

shifts. As a result, they typically struggle during these types of periods. However, conditions began to change in the second half of 2012 as European policymakers made it clear that they would take action to preserve the monetary union and the stability of the continent's financial markets. These assurances helped lessen market fears about Europe, and subsequently, correlation levels generally declined and have remained at moderate levels.

Lower correlations, and the implied increase in the significance of fundamentals to stock performance, would seem to be a more conducive environment for long/short equity managers. Indeed, after previous weakness, hedge fund managers' long positions resumed outperforming the market for much of 2013.

Given a more benign macroeconomic landscape and a commitment by global policymakers to avoiding negative economic and capital market tail risk scenarios, we believe 2013's moderate correlations are likely to persist in 2014. This environment should, in turn, be beneficial to long/short equity hedge funds.

## Fundamental Trends Affecting Long/Short Equity

Although individual stock selection is central to long/short equity performance, broader market trends and the fundamentals that drive them are also important—especially since most long/short equity managers have a modest net long bias. To that point, while equities have made significant gains since the trough of March 2009, we see various reasons to be constructive on equities going forward. Positive, albeit slow, global economic growth, significant corporate activity driven by high corporate and private equity cash balances (but also by difficulty generating organic earnings growth), and a friendly environment for capital market financing could prove supportive to equity markets in 2014.



At the same time, the degree of recent equity market gains suggests the potential for pullbacks. In such an environment, we believe that long/short equity managers with meaningful, active short books could offer some insulation, and potentially outperform simple index hedges, given their focus on identifying individual, company-specific shorts. In addition, short exposure has historically helped reduce volatility and offered investors a smoother return stream and better risk-adjusted performance over time.

In our opinion, another relative advantage for long/short equity is the potential for higher interest rates. As the Federal Reserve tapers its quantitative easing program and eventually reduces its balance sheet, rates are likely to increase. To the extent short rates normalize from their current near-zero levels, managers with substantial short exposure (and who do not employ leverage in their long books) should benefit from larger "short rebates" on related cash collateral holdings. In addition, higher rates would increase the cost of capital, potentially widening performance differences among companies based on capital structure and operating margins—which eventually would likely be reflected in stock prices. Also, the Fed has indicated that tapering and rising interest rates will need to be concomitant with an improving (and therefore stock-friendly) economic landscape. Finally, as investors seek to reallocate a portion of their fixed income holdings in the face of rising rates, some of those assets should flow into stocks, providing additional support for the equity markets.

## Global Macro: A Mixed Bag

Macro-focused investing is broadly defined as seeking to profit from market-price changes that arise from a variety of factors, including turning points in macroeconomic cycles, changes in outlook for growth or inflation, and price reactions stemming from the actions of policymakers. Global macro hedge funds have a broad investment universe that includes the trading of commodities, currencies, fixed income and equities, across all regions.



The investment strategies that global macro managers employ have become increasingly diversified and include dedicated sub-strategies which may focus on a specific region or a narrower universe of asset classes and instruments. We divide the global macro space into three broad categories: commodity trading advisors ("CTAs" in this text but including both CTAs and managed futures managers), systematic macro and discretionary macro.

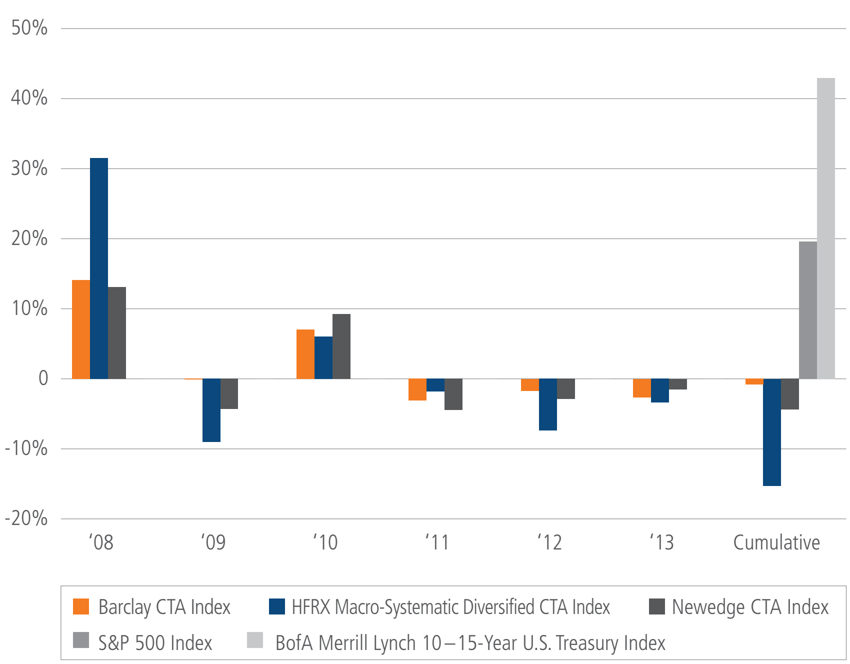
Among these categories, we believe that discretionary macro funds are the best positioned heading into 2014, while we are less constructive on CTAs.

CTAs were popular at one time for their performance and lack of correlation to the credit and equity markets. Broadly speaking, CTA managers develop trading algorithms using historical pricing data. Their close cousins, managed futures managers, are generally trend followers (by our estimate over 75%). Trend followers perform poorly when markets trade sideways or when trends are frequently interrupted by government policy or geopolitical events that result in sharp turns in the markets. Unfortunately, this is precisely the type of environment we have seen in recent years. Indeed, after delivering strong performance in the challenging environment of 2008, CTA returns have since been lackluster (see display).

While much of the concern around potential systemic risks in various economies and financial markets has been moderated by the actions and commitments of policymakers (thereby facilitating lower correlations among equities), policymaker influence on markets is likely to remain significant in the near to medium term.

**HAVE CTAS LOST THEIR TOUCH?**

Annual and Cumulative Returns, 2008 to October 2013




Sources: Bloomberg, HFRX.

As such, the number of persistent, smooth market trends available to CTAs may continue to be limited in 2014.

Besides overall performance, the other key benefit of investing in CTAs historically has been their low-to-negative correlations to equity and credit markets. Particularly over the last decade, CTA returns have been flat or positive in difficult months for the broader markets. However, upon closer examination, a significant factor potentially driving this return pattern was large gains due to net long positions in fixed income. The long rally in U.S. Treasuries since 1980 has been one of the most prominent trends in tradable markets. However, going forward, developed nations are likely to experience a secular period of rising rates. Many CTAs have already made the adjustment from being long to short government bonds. With that positioning, when market volatility leads to a flight to quality, CTAs may no longer be negatively correlated to traditional asset classes. As such, we do not think that CTAs can necessarily provide the same diversification benefits on a consistent basis going forward.

On the other hand, we believe that discretionary global macro managers are better suited to generate profits in the current market environment because their playbook is much broader than that of CTAs. This makes them better-suited to find ways to generate returns in a world that will continue to be heavily influenced by policy actions. We observe several ways they could generate returns in the current market:

- Momentum Trades: Predicting the direction of an asset class and taking long or short positions to generate returns while that momentum lasts. This is similar to a CTA trend-following strategy but the macro manager overlays more discretion as to which trends to follow and can actively risk-manage positions to seek to avoid losses from trend reversals. CTAs, on the other hand, tend to be purely systematic and are therefore less able to assess the increasingly important qualitative context and market positioning around potential trades.

- **Carry (or anti-carry) Trades:** These include borrowing from a low-interest-rate currency to fund the purchase of high-yielding currencies or assets. Managers can find similar trades in the fixed income and commodities markets as well.
- **Relative Value Trades:** The manager sets up trades to profit from the normalization of related currency, commodity, equity and/or fixed income securities, which often trade at spreads to each other that can fluctuate due to short-term news, events or technical factors.
- **Mean Reversion Trades:** Identifying dislocations across markets based on top-down fundamental analysis and asset class valuation.

In the parlance of macro practitioners, top-down analysis results in trading themes, which managers seek to exploit through security selection and the timing of trades. We believe that discretionary macro funds have a number of themes to take advantage of in 2014, setting up a robust opportunity set for managers with demonstrated expertise, trade structuring acumen and risk management discipline. These themes include, among others, uncertainty and differing expectations around the timing and magnitude of Fed tapering, Japan's monetary easing program, the increasing divergence of policies across central banks, developed market term-structure trades and emerging market currencies.

### ABS/Niche Credit: Select Opportunities

Since 2009, spreads have tightened significantly across the asset-backed securities universe, leading investors to question whether there is value left in this trade heading into 2014. Last year, the space continued to attract investor demand, with hedge funds dedicated to the asset class receiving estimated inflows of $5.1 billion.[1] Although recent returns have been solid, they have slowed from 2012, when the HFRI Fixed Income Asset Backed Index was up nearly 16%. In addition, managers within this space experienced varying results in 2013. Those focused on agency mortgage-backed securities underperformed due to interest-rate volatility and other factors, while those with broader overall exposure to the asset class did well.

In our view, select strategies in the ABS/niche credit space should continue to offer attractive risk-adjusted return potential in 2014. For example, mortgage put-backs refer to investors forcing originators to repurchase mortgages due to breaches in the representations and warranties made by the originator about the underlying pool of mortgages when the mortgage-backed securities were sold. Hedge funds employing this strategy bought select residential mortgage-backed securities at significant discounts following the collapse in the housing market, with the view that they would be able to recover substantially more value by putting qualifying mortgages back to their originators. Court rulings and announced settlements in 2013 helped confirm the value of put-back claims, and we believe that value realization is likely to occur within the next 6 – 18 months, based on the outcome of a few key events.

TARP preferred securities represent a niche credit area where we anticipate attractive return potential in 2014. These investments were made into banks by the U.S. Treasury in 2008 – 2009 as part of the Troubled Asset Relief Program, and were structured as perpetual preferred stock with cumulative dividends. The initial coupon was set at a 5% fixed rate for the first five years but most coupons are set to step up to 9% in 2014.

In May 2012, the Treasury announced that it would begin to conduct auctions for all of its preferred stock as part of an effort to wind down bailout programs. Banks are not typically allowed to bid on their own TARP preferred shares as regulators prefer that they continue to conserve capital. This factor, coupled with a lack of natural and eligible buyers, has brought about limited demand and thus material discounts for these securities. Moreover, given the additional interest costs to borrowers from the rate step-up, we believe many of these securities are likely to be called before their step-up dates in 2014, providing an extra premium to investors. The underlying fundamentals are also supportive of this as bank balance sheets continue to improve, mitigating downside risk and providing banks with the flexibility to redeem their TARP shares.

### Keeping Flexible and Managing Risk

As history has shown, the dynamics driving hedge fund results and opportunities can shift over time, and with little warning. Risk aversion, economic growth, interest rates or earnings fundamentals may be key factors, along with more technical issues like bank capital requirements and constraints on the use of leverage or illiquidity. No doubt, 2014 will hold its own surprises. However, we believe that by carefully selecting managers, with various tailwinds at their backs, and by broadly diversifying across strategies, investors can achieve a comfortable balance of potential return and risk that hedge funds are well suited to provide.



[1] eVestment.

**Wai Lee, PhD**
Chief Investment Officer and Director of Research—
Quantitative Investment Group



# Multi-Asset Class Portfolios

## 'MICRO' FLEXIBILITY SHOULD COMPLEMENT MACRO DECISIONS

The relative importance of asset allocation policy, often labeled as the set of macro decisions, versus that of security selection, considered the micro perspectives, has gone through three decades of debates, interpretations and clarifications. It now seems to be a settled proposition that both can be important in determining performance of a multi-asset class portfolio.[1] Still, given that the macro tends to get more attention these days, we thought it would be worthwhile to share some ideas on how micro factors can influence broad portfolio decision making.

### Extending Analysis Across Multiple Dimensions

By now, it is well accepted that investing is a global endeavor. No longer can an asset or region be isolated when analyzing the drivers of its performance and prospects for the future. For example, when discussing the price/earnings ratio of the S&P 500 Index, often factors are cited such as economic cooling in China potentially limiting inflationary pressures in the U.S. It can be increasingly difficult for investors to stay abreast of all these developments day in and day out, let alone to effectively integrate the information contained within these trends into actionable investment decisions.

Despite the challenges, multi-asset class solutions have continued to gain traction. As institutional investors expand their global exposures, they are increasingly looking to providers who can partner with them in this exercise—to help them develop an overarching view across a wide range of asset classes and effectively translate it into an asset allocation framework. It is thus natural to be somewhat predisposed toward focusing on similarly high-level perspectives—that is, the "macro"—as a first step in this process: perspectives such as return forecasts for individual asset classes, forecasts for global economic growth, geopolitical events, monetary or fiscal policies, and of course the risks that may be lurking to topple these views.

[1]Ibbotson, Roger G., "The Importance of Asset Allocation," Financial Analysts Journal (March/April 2010, pp. 18 – 20), provides a summary of more recent findings.

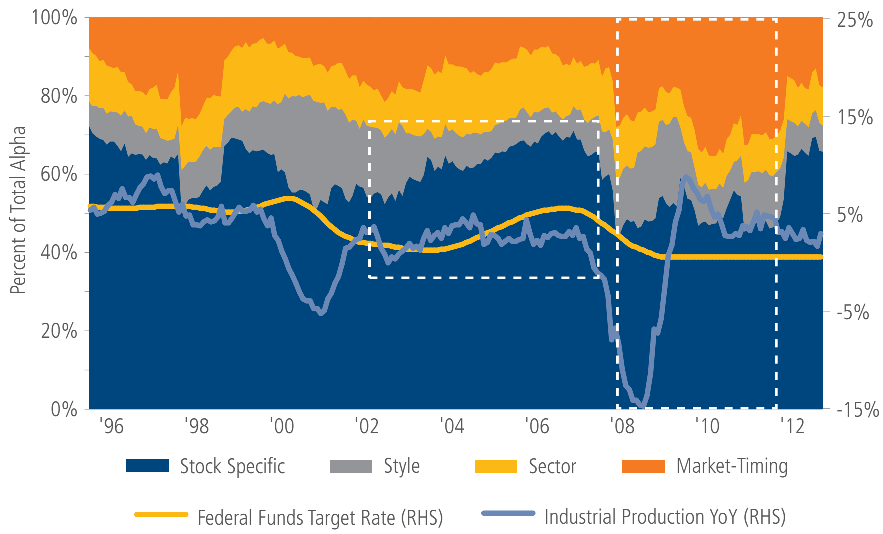
To be sure, these are all important, if not critical, considerations in approaching a multi-asset class portfolio. However, we believe it is also extremely important to consider the "micro." By this, we mean the information that is contained within individual securities, particularly when considered in the aggregate, as an asset class is by construction an aggregate of its underlying constituents. We believe that such bottom-up analysis contains important information related to the future direction of the overall economic and market environment, which may even shed light on the potential reaction of monetary policy. As we will also discuss, the relative size of the alpha opportunities within a particular asset class from the macro versus micro can change with different economic regimes. For example, in the period following the 2008 financial crisis, being correct on the market's overall direction was one of the most significant investment decisions to be made in managing equity, given that assets had largely migrated into being either "risk on" or "risk off" assets.

As we look ahead to 2014, the balance appears to be shifting once again toward stock-specific factors having a greater impact on returns when managing equity asset class exposures. Thus, we think one of the key takeaways for investors who seek effective multi-asset class portfolios is to incorporate an approach that allows for dynamic movement amongst these different components as well as the drivers of their returns.

## Assessing the Micro/Macro Relationship

For any asset class, there are multiple sources of security returns. The relative weight that each alpha source provides will typically shift over time, and we believe an experienced investment manager may be able to assist investors in navigating these changing waters. To use the equity market as an example, the returns of individual stocks may be driven by such factors as whether a particular style is in favor (e.g., value vs. growth, or large cap vs. small cap), whether the stock's sector is performing well, how exposed that stock is to the overall market (beta), and of course stock-specific risk. The display above decomposes the alpha opportunities of stock selection within this universe into different sources.[2]

**THE OPPORTUNITY SET: ALPHA SOURCES OF RUSSELL 1000 STOCKS**




Sources: Market QA, MSCI Barra, Neuberger Berman's Quantitative Investment Group. Data through August 2013.

As shown, stock-specific risk has historically been the most dominant driver of stock selection alphas.[3] Focusing on the highlighted period of mid-2008 to 2012, however, it is apparent that the impact of market timing was at an all-time high, meaning that the ability to time the market—and to identify whether the "risk on" or "risk off" environment was currently prevailing—was very impactful to the success of stock selection.[4] This type of environment is one of the hardest in which to pick individual stocks, evident not only empirically from the chart, but anecdotally from the cacophony in recent years around whether active management could still add value. Moving on to the most recent period in the chart, including late 2012 and 2013, there appears to be a return to fundamentals, where focusing on stock-specific factors once again wields more impact.

Let's now focus on another series shown in the display above, the target for the Fed Funds rate, as one proxy for macro conditions. Following the 1990s growth bubble, alpha opportunities attributable to stock-specific risks contracted from mid-1999 through much of 2001, preceding Federal Reserve easing between 2000 and 2003. A similar leading relationship between the importance of stock-specific fundamentals and Fed action can be seen around the global financial crisis from late 2007 through 2009. It is also interesting to note what happened when the Fed tightened, as in the 2004 to 2007 period; at such times, stock picking was actually becoming *more* productive.

Other macro variables offer similar insights. For instance, looking at industrial production growth, one notices that, from 2002 to 2006, the opportunity set from stock picking was actually increasing while economic growth was sustained rather than accelerating. This is similar to current conditions, where industrial production growth has been relatively flat since 2012, while stock selection has regained importance.



[2]All variables in this chart, except year-on-year industrial production growth, are smoothed by taking 12-month averages for ease of illustration.

[3]By construction, stock-specific risk is truly unique to each stock and cannot be captured by any other factors. As a result, given the 1,000 constituents in this universe, it is not surprising that stock-specific risk is always the most important component of stock-selection alpha.

[4]Lee, Wai, "Risk On/Risk Off," Journal of Portfolio Management (Spring 2012, pp. 28 – 39), provides the derivation why alpha opportunity shrinks significantly in a "risk on, risk off" environment.

How does this relate to multi-asset class portfolio management, which includes both macro and micro elements? Clearly, the risk-budgeting decision between macro and micro can drive investment performance over time, depending on what types of risks are more productive. To this end, we hypothesize that stock-selection alpha can become limited when investors focus more on perceived systemic risks that can have an impact on a broad universe of individual stocks. These periods tend to coincide with economic downturns.

### Implications for Multi-Asset Class Portfolios

While these observations are interesting, they beg the question of whether there is causality and, more importantly, whether there is any utility for portfolio management. One of the challenges of managing a multi-asset class portfolio is that there are so many moving parts, including but not limited to, objectives, framework, implementation, asset class decisions and security selection. Because of this, we believe it is prudent to remain diversified not only across asset classes and individual securities, but also among the underlying drivers of decisions regarding these components of a multi-asset class portfolio.

To that end, we believe one should not limit the scope of investment decision catalysts to a discrete macro or micro silo. Rather, we prefer to diversify the inputs to the decision-making process to include factors based on the interplay between these macro and micro concepts. While the broad-based nature of such signals almost by definition precludes their efficacy in forecasting specific inflection points in individual securities or asset classes, we believe that such signals can be effective tools for guiding risk taking within a multi-asset class portfolio. For example, an observation that stock-specific opportunities are on the rise again, as is currently the case, might suggest that higher alpha is potentially achievable from security selection for a given level of active risk. Similarly, if sector allocation is wielding a greater relative impact in determining returns, such as during the growth bubble and the 2004 to 2006 period, a manager may wish to spend more time on these more macro decisions given the higher potential advantage they may bear.

Drilling down to more actionable steps, one can implement a number of indicators that span the line between macro and micro, hopefully providing insight into the potential opportunity set from each domain. For example, analyzing the dispersion in earnings estimates across a broad swath of stocks in a particular market or region has been shown to have forecasting value for the future direction of that market as a whole, with increasing dispersion potentially indicating more negative conditions for stocks going forward. Another related indicator is the relative occurrence of upgrades versus downgrades for securities in a given market; an increasing ratio of upgrades to downgrades may imply more favorable stock market performance going forward.

A final point to highlight is that effectively managing this relationship between micro and macro views can actually lead to another important, albeit arguably indirect, source of return for the overall portfolio—risk stabilization. We believe that pulling in diversifying components, such as both micro and macro factors, can help mitigate volatility, potentially clear some of the headwinds to return compounding over time, and may ultimately lead to better performance.

### Focus on Flexibility

On some level, none of what has been discussed thus far may be particularly surprising. In fact, the decades-old efficient market hypothesis claims that the market is the best reflection of all available information and, by extension, must collectively reflect the market participants' combined views for the future. As with many concepts of investment theory, however, the biggest challenge is often in the details of implementing an effective strategy to reflect these views. For investors with multi-asset class portfolios, we believe flexibility remains the critical ingredient to achieving success. Whether it's the ability to move nimbly from one asset class to another as opportunities present themselves, or having a dynamic research process that recognizes when certain drivers of returns may be more or less important, the common denominator is flexibility in one's approach.

# SOLVING

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# FOR 2014

# About the Authors

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Joseph V. Amato is president of Neuberger Berman Group LLC and chief investment officer, as well as a member of the firm's Board of Directors and its Audit Committee. He joined the firm in 1994 and has 29 years of industry experience. Joe received his Bachelor of Science from Georgetown University.

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