



A Fresh Approach to **Core Equity** Investing in the Emerging Markets

As the emerging markets asset class has expanded over the past thirty years, so has investor interest in this area, triggering a proliferation of investment options, including index-tracking and style- and factor-focused products. Lazard's Emerging Markets Core Equity team has evaluated these approaches and questions their validity. On the one hand, passive products can neglect a significant subset of emerging markets stocks and are restricted by index construction rules. Investing by timing styles or factors, on the other hand, is prone to cycles that can result in undesirable patterns of performance. The team proposes a core portfolio that transcends style considerations, instead relying on fundamental stock selection and risk management relative to the benchmark.

Emerging-market equities have become an important component of global portfolios, due to their long-term performance potential. However, this asset class is prone to oscillations in performance leadership, whether by style (growth versus value) or factor (including high beta versus low beta and high price-to-earnings [P/E] ratio versus low P/E ratio). By its nature, investing with a style or factor¹ focus can result in undesirable patterns of performance, especially during periods of elevated volatility when stocks with a shared orientation tend to move in tandem (more on this later). This can be problematic for investors in search of more predictable excess returns. The concept of core investing has come about as an alternative to style-driven approaches. The average core strategy addresses issues of size (market capitalization) and style (growth and value). We believe this definition is too narrow and that an emerging markets core equity offering should include a consideration of other characteristics in an effort to improve investment outcomes.

Fundamental stock selection is central to Lazard's Emerging Markets Core Equity strategy. Our portfolio construction process extends beyond style to include a cyclical (aggressive) versus defensive perspective and a consideration of a portfolio's volatility relative to its benchmark. We also monitor factors such as interest rates and commodity price movements in order to isolate any unintended positions. As a result, we expect portfolio performance to be driven to a greater extent by company-specific instead of style-specific factors resulting in lower volatility of excess returns relative to the benchmark (what we call "lower volatility of alpha"). This could be especially attractive to the risk-aware emerging-market investor seeking a more stable pattern of relative performance. In our view, this framework can serve as a central solution for emerging-market equity investing.

Looking Deeper into Patterns of Performance

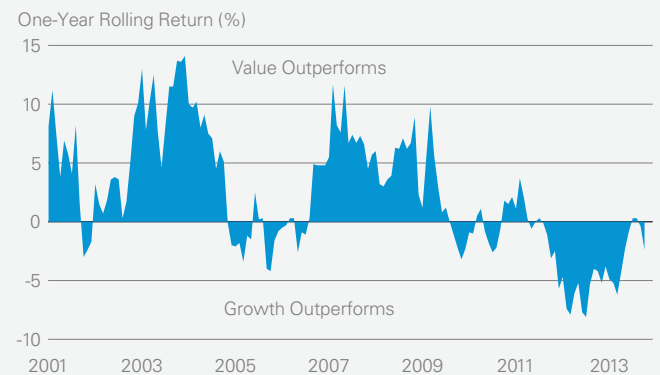
By evaluating the core style of investing from different angles, including growth versus value and cyclical (aggressive) versus defensive, and also by disaggregating the portfolio's volatility relative to the index, style biases can be mitigated to result in a portfolio driven by stock-specific factors. We illustrate how a given characteristic can be in or out of favor for extended periods.

Using the MSCI Emerging Markets Value and Growth indices, we computed the rolling one-year excess return of the value index over the growth index from December 2001 to September 2014. Exhibit 1 shows that value outperformed growth most of the time, decisively and for long stretches. However, a portfolio's cyclical or defensive tilt has been an important contributor to excess returns over this period regardless of its growth or value bias.

In order to compare the performance of cyclical stocks versus defensive stocks, we created custom indices based on the Global Industry Classification Standard (GICS). The Cyclical Index includes consumer discretionary, information technology, industrials, financials, materials, and energy stocks, while the Defensives Index includes consumer staples, health care, telecom services, and utilities stocks. For both indices, sectors were weighted utilizing the corresponding month-end sector weights of the MSCI Emerging Markets Index.

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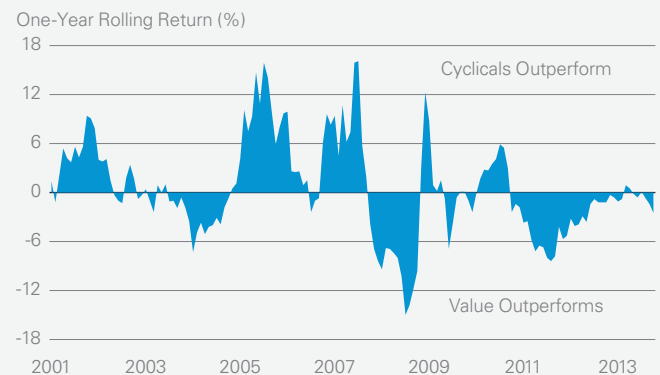
Exhibit 1
Value versus Growth



As of 30 September 2014

Data are based on the MSCI Emerging Markets Value and Growth indices. This information is for illustrative purposes only. The performance quoted represents past performance. Past performance is not a reliable indicator of future results. This information is not intended to reflect the performance of any strategy or product managed by Lazard. Indices are unmanaged and have no fees. One cannot invest directly in an index. Source: MSCI

Exhibit 2
Cyclicals Index versus Value



As of 30 September 2014

Data are based on the Cyclical Index² and the MSCI Emerging Markets Value Index. This information is for illustrative purposes only. The performance quoted represents past performance. Past performance is not a reliable indicator of future results. This information is not intended to reflect the performance of any strategy or product managed by Lazard. Indices are unmanaged and have no fees. One cannot invest directly in an index.

Source: MSCI, Lazard

The Active versus Passive Debate³

Passive investing has gained popularity across virtually every asset class, including emerging markets equities. Among emerging-market index trackers, the MSCI Emerging Markets Index is the most widely imitated.

While it holds a certain appeal, passive investing in practice does not lend itself very well to the emerging markets due to liquidity issues, as well as the relatively higher cost of trading locally.⁴ Moreover, those funds tracking popular emerging-market benchmarks are by extension limited to a narrow subset of emerging-market companies. A decade ago, this may not have been as problematic, as the MSCI Emerging Markets Index included slightly more than one-half of all companies in the opportunity set, defined here as the MSCI Emerging Markets Investable Market Index (IMI). By contrast, at the end of 2013 this figure dwindled to approximately one-third as the number of listed companies increased (824 stocks in the MSCI Emerging Markets Index relative to approximately 2,600 stocks in the MSCI Emerging Markets IMI).

Other drawbacks of benchmark investing include large-cap bias and sector and country concentration. Consider this: The largest 75 constituents of the roughly 800-stock MSCI Emerging Markets Index—or just 9% of all constituents—account for nearly one-half of the index's total capitalization. Another quirk of capitalization-weighted benchmarks means that any gains, however large, in smaller-cap constituents would generally have a negligible impact on an index fund's performance, which is wasted opportunity.

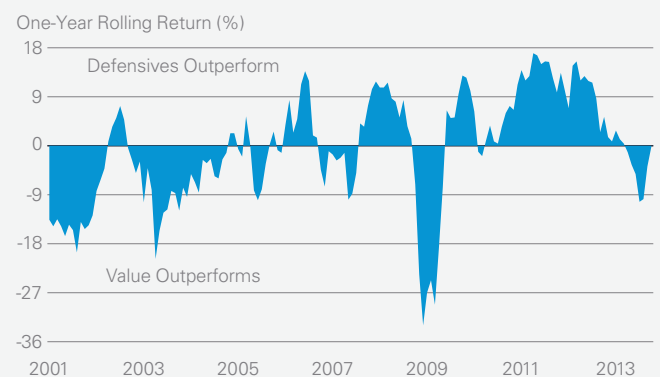
The MSCI Emerging Markets Index is also dominated by financials, information technology, and energy stocks as many of the companies in these sectors are large- or mega-cap. Together, these constitute 54% of the index. The largest four country constituents (China, Brazil, South Korea, and Taiwan) represent 56% of the benchmark, with many of the countries with smaller weights having a negligible impact on index performance.

In our view, these flaws can be addressed through active management, which allows for a much more thoughtful approach to investing in the emerging markets, with portfolio positions that are driven by best ideas as opposed to index composition.

As Exhibit 2 illustrates, maintaining a cyclical exposure was a key contributor to excess returns from June 2005 to June 2008. Specifically, the Cyclical Index rose 177.5% versus returns of 121.3%, 104.1%, and 112.5% for the MSCI Emerging Markets Value, Growth, and Standard indices respectively. From this we conclude that while particular market conditions can benefit a particular style (i.e., value or growth), other factors such as a portfolio's sector positioning should also be considered when seeking to outperform in different market environments.

Shifts in sector leadership can also be sudden, violent, and long-lasting. Exhibit 3 illustrates a rotation to defensive sectors that began in October 2009. From November 2009 to September 2014, the Defensives Index advanced 62.7% compared to 18.2%, 29.8%, and 24.0% for the MSCI Emerging Markets Value, Growth, and Standard indices, respectively. Exhibit 4 maps the returns of the value and growth indices as well as our custom cyclical and defensives indices at different points in time. From this it is evident that certain styles and sector orientations have done better than others at one time or another, but that none has done so in any way that could be useful to a value or growth investor. Given our analysis thus far, we believe that taking a one-sided view in a portfolio is risky and can potentially lead to sustained periods of underperformance. For example, some inves-

Exhibit 3
Defensives Index versus Value

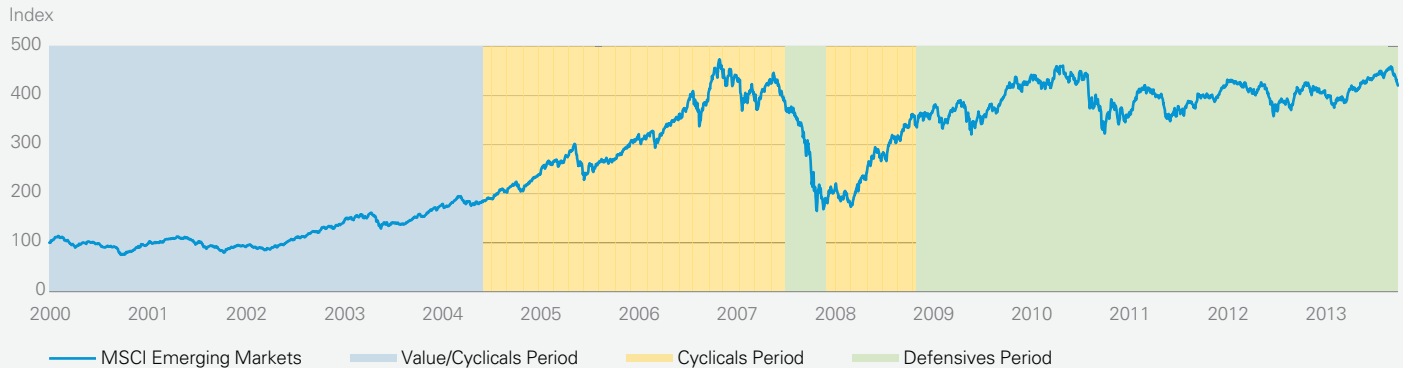


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Source: MSCI, Lazard

Exhibit 4 Performance Leadership Timeline



Returns	December 2000 to May 2005	June 2005 to June 2008	July 2008 to November 2008	December 2008 to October 2009	November 2009 to September 2014
MSCI Emerging Markets Index (%)	83.3	112.5	-50.9	77.5	24.0
MSCI EM Value Index (%)	109.4	121.3	-49.1	79.5	18.2
MSCI EM Growth Index (%)	59.9	104.1	-52.8	75.5	29.8
Cyclicals Index ² (%)	109.6	177.5	-61.1	89.2	5.1
Defensives Index ² (%)	52.7	112.3	-35.0	46.2	62.7
Number of Months	54	37	5	11	59

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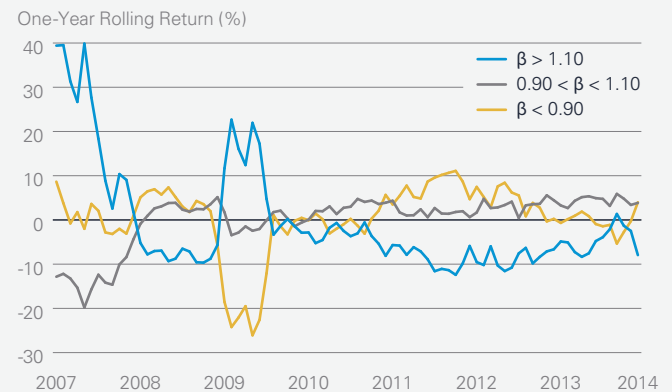
Source: MSCI, Lazard

tors are convinced that instances of sector dominance are structural. However, in mid-2005 through mid-2008, this view was applied to cyclical companies and was no longer valid as of the fourth quarter of 2008. In fact, what is frequently believed to be a “structural” phenomenon often breaks down at some point, and it usually does so quickly and dramatically.

Taking the prior analysis one step further, we investigated the impact that a stock’s systematic risk can have on returns. With this in mind, we classified equities into three different beta categories and calculated their one-year returns relative to the benchmark. As one would expect, and as Exhibit 5 shows, the performance of beta groups we regard as “aggressive” (beta greater than 1.10) or “defensive” (beta less than 0.90) is more susceptible to market shocks than stocks of a more “neutral” nature (beta between 0.90 and 1.10).⁵ In addition, each of these groups has led at one time or another.

These comparisons suggest that investors with concentrated style or factor exposure are vulnerable to fluctuating returns with pronounced peaks and valleys. While we have furnished some examples here, more exist, including for market-cap cycles (Exhibit 6). As emerging markets investors, we believe there are ways to mitigate dispersion of returns relative to the benchmark while preserving return potential, as we discuss next.

Exhibit 5 Performance by Beta Groups in Emerging Markets



As of 30 September 2014

Data are based on the MSCI Emerging Markets Index. The chart shows beta group performance relative to the MSCI Emerging Markets Index. This information is for illustrative purposes only. The performance quoted represents past performance. Past performance is not a reliable indicator of future results. This information is not intended to reflect the performance of any strategy or product managed by Lazard. Indices are unmanaged and have no fees. One cannot invest directly in an index.

Source: MSCI, FactSet

Accessing Emerging-Market Equities through an Active, Core Approach

The evidence suggests that timing any single style or factor is a difficult, if not futile exercise. We believe that it is more effective to rely on bottom-up stock selection to build a portfolio with relatively uncorrelated styles and factors in order to generate more consistent alpha over a market cycle. Accordingly, stock-specific factors should drive portfolio performance.

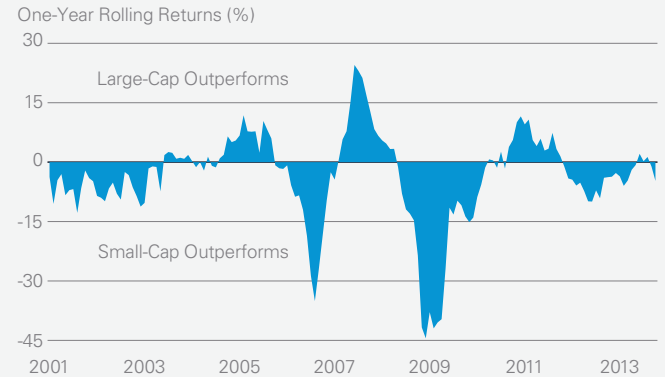
We also believe that there are opportunities to invest in companies at any stage of development, as depicted in Exhibit 7. However, to identify those mispriced opportunities our choice of valuation metrics varies depending on our assessment of a company's stage of life. This concept, which we refer to as flexible valuation, allows for standardized and disciplined company analysis and allows the team to identify those they believe are the best companies regardless of style, size, or geography.

Risk management is another distinguishing feature of the Lazard Emerging Markets Core Equity strategy. In managing the portfolio's risk relative to the benchmark, we seek to diversify across styles and factors without explicitly neutralizing any two opposing traits at any point in time. Over the long term, this can help to dampen the volatility of excess returns relative to the benchmark (i.e., lower tracking error) as well as to improve risk-adjusted performance measures, such as the information ratio.

We believe the emerging markets remain an attractive source of mispriced equity opportunities. Active management appears best suited to exploit these inefficiencies given the drawbacks of passive and single-style or factor investing. Our style-unconstrained approach not only widens the opportunity set, but can also reduce unintended biases that can lead to extended periods of underperformance. As stock pickers, our goal is to derive outperformance primarily from stock selection, but also maintain lower volatility of alpha.

In our view, all of these features make Lazard's Emerging Markets Core Equity strategy well-suited for investors seeking a comprehensive emerging markets equity solution.

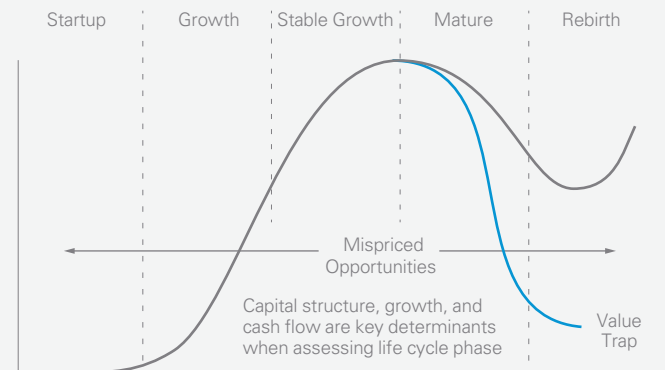
Exhibit 6
Large Cap versus Small Cap



As of 30 September 2014

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Exhibit 7
Seeking to Identify Winners at All Stages of the Company Life Cycle



This information is for illustrative purposes only.

About the Lazard Emerging Markets Core Equity Team

The Emerging Markets Core Equity team believes that investing across the style spectrum minimizes potential underperformance from style-specific risks by reducing such biases. The team seeks to invest in companies viewed as mispriced relative to their assessment of fair value, without any prejudice as to a company's stage of development. Based on this philosophy, the team seeks to construct a portfolio of attractively priced companies with asymmetric upside.

The team has worked together in various forms since 1999 and adhered to a consistent investment philosophy throughout its history. On average, its members have eighteen years of experience in the emerging markets equity asset class, with the majority of the team having worked together since January 2009. The entire team joined Lazard Asset Management over the course of 2010 and 2011 and has integrated fully into the firm's renowned emerging markets platform.

Notes

- 1 A factor is defined as the underlying risk exposure that is the theoretical driver of an asset's return (i.e., elements such as volatility, inflation, economic growth, or company size). In factor-based investing investors choose among a multitude of factors rather than asset classes in order to construct their portfolios.
- 2 The Cyclical Index includes consumer discretionary, information technology, industrials, financials, materials, and energy stocks, while the Defensives Index includes consumer staples, health care, telecom services, and utilities stocks. For both indices, sectors were weighted utilizing the corresponding month-end sector weights of the MSCI Emerging Markets Index.
- 3 Data in this section are as of 30 September 2014 unless indicated otherwise. Source: MSCI
- 4 For the three-years ended on 30 September 2013, a sample of emerging-market index funds and ETFs shows higher tracking error (1.82%) than US funds (0.68%), and comparable to developed-market ex-US funds (1.81%). Additionally, this sample of emerging-market index funds and ETFs has underperformed (-0.72%) its benchmark by a greater amount than US (-0.19%) or developed-market ex-US funds (-0.03%). Funds were selected based on Morningstar's classification of index or enhanced index funds with at least a three-year track record. The sample is composed of 21 emerging-market funds, 187 US funds, and 49 developed-market ex-US funds. Source: Morningstar.
- 5 Within each beta group, stocks are weighted by market capitalization and the risk model for beta is the Northfield Information Services Global Model.

Important Information

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