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So Far, So Good

In the months since our last *Investment Quarterly*, we have maintained our view that investors who may have shifted their portfolio weightings to safer assets should consider reevaluating their portfolio allocations based on their long-term investment goals and objectives. Yes, some market concerns have emerged earlier than anticipated, and were reflected by a modest correction in late January and early February—something that many forecasters were anticipating for the second half of 2010. However, fundamentals have generally been improving, with companies showing gains in revenues and profits.

Today, we think that equities have the potential to produce returns in line with historical averages. At the same time, we have ongoing concerns about the economy and the stock market, which we feel could be mitigated through the use of active portfolio management—particularly managers that favor high-quality companies and focus on valuations.

In the last edition of *IQ*, we considered some of the headwinds facing the financial markets, as well as signs of a return to economic growth and accompanying support for an attractive equity market outlook. On the upside, we noted that companies had turned in relatively strong third-quarter results, where a quarter of S&P 500 companies were on track to return to prior peak profitability. Today, firms continue to exhibit strong operating leverage (which measures how incremental growth in revenues increasingly affects growth in operating income), a signal of strength within corporate America. We also noted positive signs of job growth in such metrics as hours worked and temporary employment figures. Throughout 2009, individual investors demonstrated a preference for fixed income—a trend that continued into year-end. We viewed the potential for reallocation to equities as well as the deployment of the considerable cash "on the sidelines" as further support for rising equity values.

On the downside, we noted concerns about relatively limited lending by banks, and the challenges inherent in the balance between encouraging growth and accelerating inflation. Further, the long-term threat posed by growing fiscal deficits and the unpredictable course of "deleveraging" underway both within the financial system and on consumer balance sheets could, we thought, undermine recovery. In retrospect, we believe the market agreed with us on these concerns. However, the "noise" associated with a few widely publicized developments—including concerns about sovereign debt issued by Greece and others, financial regulation and health care reform—overshadowed the robust fourth-quarter 2009 profit reports from companies (see Figure 1). Overall, while these issues are important to monitor, we do not believe that they negate the appeal of an equity allocation—particularly one with a focus on quality and valuation—as an attractive long-term asset class.

FIGURE 1: RECENT HEADLINES OVERSHADOWED A RELATIVELY STRONG 4Q 2009 EARNINGS SEASON

January 11, 2010:	4Q 2009 earnings season begins following Alcoa announcement
January 19, 2010:	Scott Brown elected to Senate
January 20, 2010:	President Obama proposes to limit bank size and trading activities
January 28, 2010:	Senate confirms Ben Bernanke to second term as Fed Chairman
February 8, 2010:	Sovereign debt concerns related to several European countries emerge
February 8, 2010:	S&P 500 declines 8% over 3 weeks
February 12, 2010:	The PBoC increases the reserve ratio requirement
February 18, 2010:	The Fed raises the discount rate by 50 basis points to 0.75%
March 1, 2010:	Fed Vice Chairman Don Kohn intends to resign effective June 23
March 3, 2010:	President Obama proposes reconciliation to pass healthcare legislation
March 9, 2010:	Proposal to create European Monetary Fund draws preliminary support
March 16, 2010:	Greece reports back to EU on progress of its deficit-cutting

Please see important disclosures at the end of this publication.

UNSETTLING EVENTS

Despite a general return to moderate price volatility, the year began with the markets in the throes of anxiety as news emerged around a potential default of Greek sovereign debt. Investors also exhibited concerns about monetary tightening in China and its impact on world economic growth. Meanwhile, the divided U.S. Congress continued to experience a bitter tug-of-war over the key matters of health care and financial reform.

In Greece, alarm over the government's limited ability to fund its high debt levels was not just perceived as important in itself, but as perhaps a precursor of further failures in countries like Portugal, Italy and Spain. This development aggravated the perception of these countries as vulnerable—although all had enjoyed growth prior to the 2008 financial meltdown. Investors continue to weigh Europe's overall growth prospects as they evaluate investment opportunities. The euro has certainly felt the impact of these broader concerns within the region and may remain under pressure until the funding difficulties experienced by Greece and others are resolved. Meanwhile, the Chinese government's move to impose higher capital reserve ratios on banks triggered worries that escalating inflation trends were taking root, leading to concerns about further government actions to contain elevated levels of growth. Investors seemed afraid that such actions could stifle growth at a time when China's strong expansion was so important to the world's overall economic health. Also of interest was speculation as to whether the Chinese government might let its currency appreciate. Such a move could benefit U.S. exporters, but remains entangled in broader tensions around policy and trade relationships.

We believe the stock market experienced the mild intra-quarter sell-off largely due to these fears. A symptom of this was the retrenchment of risk appetite, reflected in a modest widening in credit spreads in the face of improving fundamentals discussed below. Despite the temporary market weakness in late January and early February, equities in general managed to post strong gains in first-quarter 2010: The S&P 500, Russell 2000, MSCI EAFE and MSCI Emerging Markets increased 5.4%, 8.8%, 0.9% and 2.4%, respectively.

POSITIVE DEVELOPMENTS

We believe the equity market demonstrated this resiliency because, as the noise dimmed, fundamental positives seemed to outweigh anxieties. First, Fed Chairman Ben Bernanke was confirmed for another term by the Senate despite some disagreement about his handling of the financial crisis. Second, when the Federal Reserve decided to increase the discount rate (the rate the Fed charges banks for borrowing) earlier than many had expected, the markets took the development in stride. This, in our view, reflects an understanding that the Fed is confident in the current ability of the credit markets to maintain relatively normal conditions without substantial assistance. Third, merger-and-acquisition activity showed signs of life, indicating that companies are again finding uses for cash and that the capital markets are functioning as a source of funding for business growth. Fourth, and perhaps most importantly, company reports for the fourth quarter of 2009 have been strong, reflecting gains in earnings and—a key development—in revenues as well. Of the reporting companies in the S&P 500, 69% beat top-line (revenue) estimates and 73% beat bottom-line (earnings per share, or EPS) estimates. As we head into first-quarter 2010 earnings season, we anticipate profits and revenues will continue on their upward path.

FOR ECONOMY, TWO AMERICAS

In economic news, we continue to see two different stories—one for corporate America and the other for consumers (see Figure 2). In business, we note many reassuring signs. Many companies have emerged from the recession in great shape, with relatively healthy balance sheets

and rebounding profits. CFO surveys indicate significant new optimism by insiders regarding business prospects. Still, we are waiting for more serious demonstrations of investment for the future such as infrastructure and capital spending, which could generate more jobs and lay the groundwork for sustainable expansion.

The consumer, on the other hand, is facing more daunting challenges. Confidence surveys are tepid, as consumers remain weighed down by slow or nonexistent job growth as well as the need to pay down sizable debt levels. On the positive side, consumer spending seems to be rebounding at a decent (but not alarming) rate, shown by retail sales numbers and a decline in savings rates. And although consumer confidence numbers are coming in very low, underlying details indicate that consumers are nervous about the future but admit that they see improved job conditions, at least for now.

In our view, the discrepancy between corporate and consumer indicators can be reconciled to some degree by the notion of leading versus lagging indicators. Business sentiment tends to be a leading indicator in that corporate spending decisions precipitate growth. On the other hand, labor figures are usually a lagging indicator, and consumers are heavily influenced by their employment prospects.

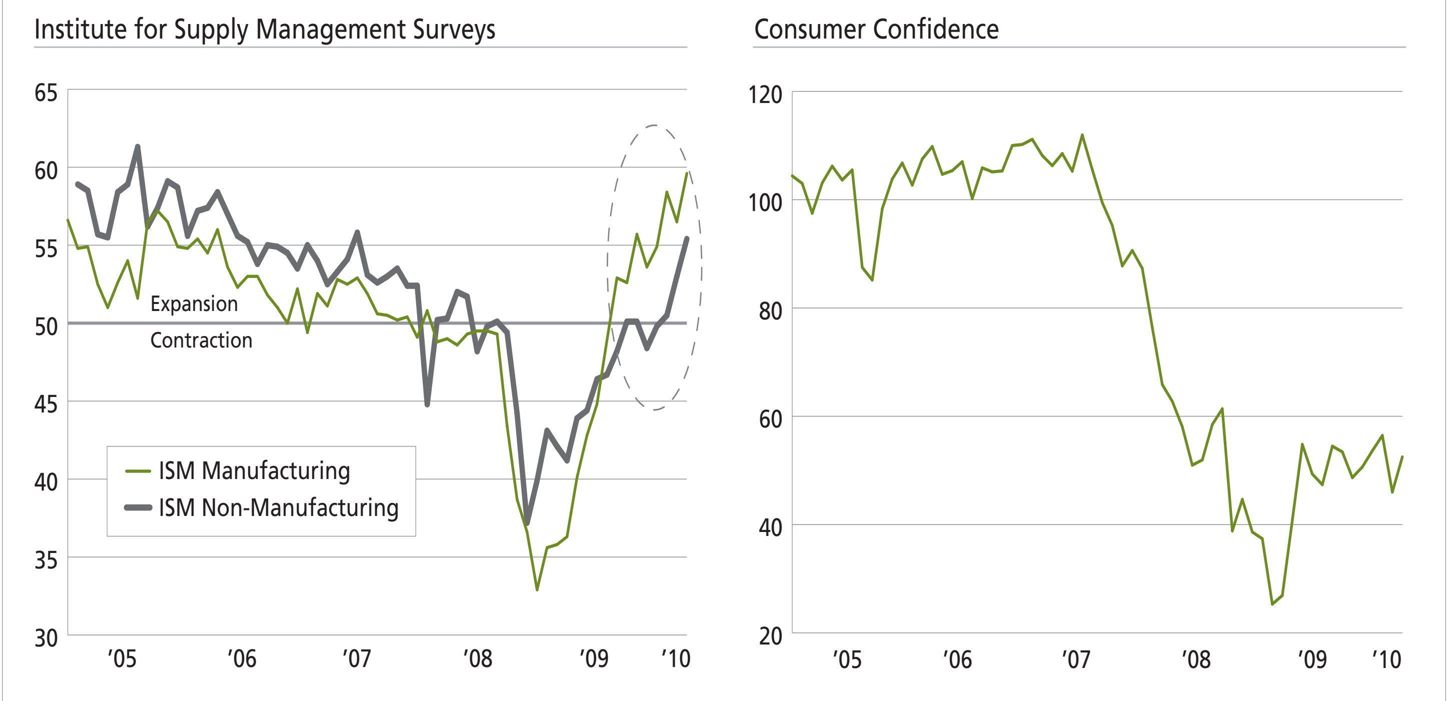
ECONOMIC BACKDROP CONTINUES TO IMPROVE

In terms of specific economic numbers, gross domestic product (GDP) growth came in at a 5.6% annual rate in the fourth quarter of 2009. Although on the high end, the figure was driven by the rebuilding of inventories and government policy-related developments including stimulus spending. As such, we do not expect such a high growth rate to persist in 2010; rather, we foresee a more measured pace of expansion.

Among business activity measures, the Institute for Supply Management's (ISM) manufacturing index moved up sharply last year and although moderating, continues to reflect expansion. The ISM's service index has consistently lagged its manufacturing counterpart since July of 2009. However, it has been picking up and is now showing expansion — a positive for the job outlook, since so much of the U.S. economy is service-based.

Despite ongoing weakness in the labor markets, we are encouraged by the existence of slow but steady improvements. February figures were negatively affected by extreme storms, but not as badly as some feared — leading employment indicators continue to move in the right direction, as evidenced by increased job openings and moderating jobless claims. March's employment report — in which nonfarm payrolls increased by 162,000 — was another strong sign for the labor market. On the housing front, data

FIGURE 2: A TALE OF TWO AMERICAS: WHILE CORPORATE AMERICA IS RECOVERING, U.S. CONSUMER SENTIMENT HAS YET TO IMPROVE



Source: Institute for Supply Management. The ISM Manufacturing and Non-Manufacturing Indexes are monthly composite indexes released by the Institute for Supply Management that are based on surveys of purchasing managers throughout the U.S. in the manufacturing and service areas of the economy. Please see important disclosures at the end of this publication.

have been mixed. Mortgage rates are still low even in the face of the Federal Reserve's decision to wind down its mortgage security purchases, indicating that the market for these assets continues to normalize. Home prices are stabilizing, although foreclosures continue and new and existing home sales have recently shown declines. We anticipate that this element of the economy will continue to experience a rocky recovery.

POLICY DEVELOPMENTS

U.S. policies remain a focal point in the news, although it is unclear how legislation will affect the health care and financial sectors and, by extension, their companies and securities. The election of Scott Brown, a Republican, to replace the late Senator Ted Kennedy, put a temporary roadblock in front of health care reform. The historic health care legislation that was ultimately signed into law after the House of Representatives' use of "reconciliation," which allows for a 51-vote majority, was greeted in the markets with a more positive reaction than many had anticipated. To some degree, the resolution of this substantial uncertainty around policy was surely a relief to many investors.

Financial regulation appears to be gaining steam, with the Fed serving as the potential home to a new consumer protection agency. In terms of Fed monetary policy, Chairman Bernanke and team continue to keep liquidity in the system and are offering reassurances that the accommodative monetary policy will persist for the foreseeable future. We are carefully watching their language for indications of changes as economic conditions improve.

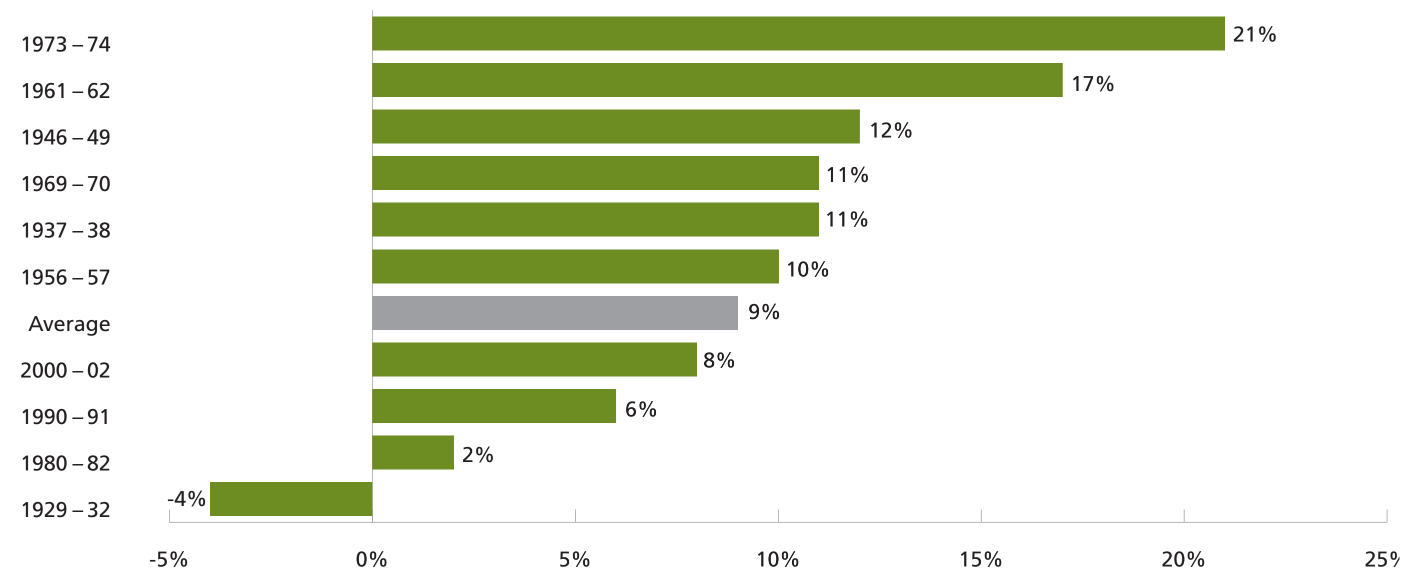
FINAL THOUGHTS

Given what we've all been through over the past two years, it is natural that any period of market weakness could trigger renewed anxiety. Still, it's important to keep things in perspective. Sideways markets and equity corrections are actually quite common — although this period of market stagnation came sooner than many had expected. Moreover, the decline in January and February was quite moderate — less than 10%. Looking at history, since 1929, the market has averaged 3.5 corrections per year of 5% or more, while pullbacks of 10% or more have historically occurred about once a year. While the length and magnitude of any market recovery is unknown, it may be encouraging to note that the second year following the trough of the past ten bear markets (the one-year anniversary of March 9, 2009 recently passed) has tended to be moderately positive with an average gain of 9%, which is in line with the average annual return of equity markets since 1929 (see Figure 3).

In conclusion, our outlook for the equity markets is positive, although, as always, we are keeping an eye on risk. While 2009 experienced the phenomenon of "a rising tide lifts all boats," we think that for the next stage of the markets selectivity could be the key — across stocks, sectors and geographic

FIGURE 3: HISTORICALLY, THE SECOND YEAR OF A MARKET RECOVERY TENDS TO BE IN LINE WITH AVERAGE ANNUAL EQUITY RETURNS

S&P 500 Return: Year 2 After Trough in Bear Market



Data as of March 5, 2010.

Sources: FactSet, BofA Merrill Lynch. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.** See Disclosures section at the end of this material, which is an important part of this presentation.

exposures, as we believe returns are likely to become more differentiated among assets.

To round out this issue of the newsletter, we present two features that I think you will find particularly interesting. First is an article by portfolio managers Richard Levine and Sandy Pomeroy of Neuberger Berman's MLG Group, which discusses the role of portfolio income in today's environment. Absolute yields for many bonds are particularly low these days, and the authors discuss the appeal of using nontraditional sources of income such as real estate investment trusts or convertible bonds. The second piece is a series of brief interviews conducted by Matthew Rubin, director of Investment Strategy, with emerging markets portfolio manager Conrad Saldanha, municipal portfolio manager James Iselin and municipal research head Jeffrey Lipton, and portfolio manager Doug Rachlin, who offers a look at the Master Limited Partnership market. It's a diverse group, but one that provides compelling perspectives on promising areas of the investment universe. ■

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Bear markets defined as 10% reversals in the S&P 500 stock index close. Recessions defined by National Bureau of Economic Research. Past bear markets have often included brief bear market rallies (market increases of over 20%) which were often followed by subsequent declines. Nothing herein constitutes an opinion or a prediction regarding the length or bottom of the current recession and bear market, or any subsequent market or portfolio behavior. The characteristics, including length and recovery time, of past recessions and bear markets have varied significantly and are no indication of the characteristics of the current or future recessions and bear markets.

In Search of Yield

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In today's market, building a portfolio that offers attractive income plus capital appreciation potential can be a challenge — but it's becoming a priority for many who experienced investment losses and high volatility during the credit crisis. Those who turned to the fixed income markets are now faced with historically low interest rates and purchasing power risks for those investments. However, within the equity universe there are a few underutilized sources of yield in addition to the more familiar dividend-paying stocks, such as convertible bonds and preferred stocks, Canadian Income Trusts, Real Estate Investment Trusts (REITs) and Master Limited Partnerships (MLPs), which may provide an alternative for investors seeking a combination of income and the potential for capital appreciation.

THE CONUNDRUM OF YIELDS

In the 10 years ended December 2009, called by many a "lost decade" for equities, the S&P 500 returned -9% cumulatively, an annual average of -0.95%.[1] This slightly negative 10-year average, however, masks the volatility that many investors experienced in the last two years, when the steep falloff in equity values erased the significant market gains of the middle part of the decade. In that extreme market environment, many panicked investors fled the downward spiral of equities in favor of "safe haven" asset classes, notably U.S. Treasuries. Even in the market recovery, retail dollars have continued to flow into lower-risk instruments such as money market funds, CDs and the bond market, demonstrating the ongoing preference for safety and income.

The irony facing income-seeking investors is that just as many shifted to income-generating fixed income assets from equity exposure, the yields on those assets are now extremely low (see Figure 1). Between the flood of dollars into fixed income products and the Federal Reserve's near-zero short-term interest rate, the majority of money market funds are currently yielding less than 0.25%.[2] Further, in addition to the extremely low rates, those asset classes also face interest rate and inflation risk, as the potential for a rising interest rate environment combined with the threat of inflation are raising concerns about the return outlook of fixed income instruments. If inflation picks up over the next few years, as some commentators fear, the inflation-adjusted returns of fixed income investments may be less appealing. Likewise, if interest rates rise, the prices of existing bond issues will likely fall, affecting total return for investors who do not hold bonds to maturity.

FIGURE 1: U.S. TREASURY YIELDS[3]
As of April 20, 2010

3-month Treasury bills	0.14%
6-month Treasury bills	0.22%
1-year Treasury bills	0.40%
2-year Treasury notes	1.01%
3-year Treasury notes	1.62%
5-year Treasury notes	2.54%
10-year Treasury notes	3.80%
30-year Treasury bonds	4.67%

As investors are now faced with low yields and interest rate and inflation risks in fixed income investments, some may be wondering if — despite continued concerns about volatility — the time is right to increase their allocations to equities. A number of factors may support an attractive outlook for the equity markets. Those who believe in the theory of "mean reversion" may think the fact that bonds outperformed stocks in the last decade is a potential signal that the decade ahead could reverse the trend and favor equities. Further, many believe a stabilizing economy and resumption of growth may positively impact the equity markets. Finally, in the face of inflation and despite their higher risk profile, equities may hold more appeal from the standpoint of helping to preserve purchasing power through capital appreciation potential compared with fixed income instruments — a concern that is front-of-mind for many investors in today's environment.

Against this backdrop, many investors seeking current income as well as capital appreciation potential from their investments find themselves in a difficult position: fearful of pure equity exposure yet also concerned about the paltry

[1] Source: Callan Associates.

[2] Source: Bloomberg, as of April 20, 2010.

[3] Source: Bloomberg, yield-to-maturity as of April 20, 2010.

returns of fixed income. It is from this place that we begin the search for yield.

LOOKING TO BONDS, EQUITIES AND BEYOND FOR YIELD

For the last 12 years, Neuberger Berman's MLG Group has managed an Equity Income strategy that seeks to deliver an attractive combination of income and capital appreciation, with less volatility than the U.S. equity market. When constructing portfolios, we look to a broad range of securities including utility stocks, real estate investment trusts, convertible bonds and convertible preferred stocks, as well as other income-oriented equities. Each of these security types on its own can be quite volatile; however, the ability to change portfolio weightings among them, and a rigorous security selection process, has helped us keep our MLG Equity Income strategy's volatility below that of a traditional common stock portfolio as represented by the S&P 500 Index. The strategy has a solid long-term track record over the last three-, five- and ten-year periods, and since inception has outperformed the S&P 500 Index while generating attractive income.

Today's environment poses a number of challenges to investors seeking yield, and certain areas entail more risk than others. Below, we offer our views on the investment landscape, based on a top-down analysis of current themes and in-depth fundamental research. Since many investors turn first to the bond world for income, we begin there.

FIRST STOP: BONDS

Municipal Bonds: Municipal bonds might be a choice for many, but we see some reasons for concern as many states and municipalities are in a difficult phase of the financial cycle. Raising tax rates to generate revenue is often a hard decision—politicians often view it as a way to lose their next election. And cutting government spending has also proven to be difficult. California may be leading the way, but we may see a series of rolling crises around the country. We believe careful selection, thorough analysis of the underlying credit and a bias toward higher-quality municipal bonds is crucial in this environment.

Further, in this interest rate environment, we find shorter-term maturities more attractive. According to Bloomberg, the yield profile for an AA-rated, two-year maturity municipal bond is 1.08%; for a five-year maturity AA-rated municipal bond it's 2.21%.[4] Though the short-term yields are significantly lower, they allow investors to 'roll' into new debt as shorter-dated issues mature, which would be beneficial should interest rates rise in the future—something we discuss below.

Corporate Bonds: In contrast to municipals, we view corporate bonds as a more attractive fixed income alternative right now. The corporate credit cycle is in a different phase. Corporate bonds suffered dramatically in late 2008 and early 2009, when the credit markets essentially dried up. But with liquidity returning and the recession turning to a recovery, many companies are likely to start reporting improved cash flows and earnings; balance sheets are also likely to be on the mend. However, we believe selection will be critical and diversification is warranted.

As a reminder, while bonds have a lower risk profile than equities, all bonds, whether treasury, municipal or corporate-issued, are subject to interest rate risk, something that investors may fail to consider. This risk is more prevalent in longer-duration bonds, but nonetheless, exists for all bonds. In general, when interest rates rise, the price of bonds falls, and vice versa. With interest rates at historic lows we think this favors bond maturities in the one- to five-year range. Shorter maturities could also help mitigate some of the negative price impact of a rising interest rate environment.

FIGURE 2: YIELD COMPARISON: BONDS, EQUITIES AND OTHER ASSET CLASSES[5]

	Yield (%)
Fixed Income	
Barclays Capital Municipal Bond Index	3.47
Barclays Capital Corporate Bond Index	4.47
MLG Equity Income Strategy: Asset Classes	
Convertibles	
Barclays Capital U.S. Convertible Bond Index	3.02
Barclays Capital U.S. Convertible Preferred Index	6.71
REITs	
NAREIT Index	4.34
Utilities	
S&P 500 Utilities Sector	4.53
Other Income-Producing Securities	
S&P 500 Index	1.96
Russell 1000 Index	1.92

For illustrative purposes only. The results are not representative of any Neuberger Berman investment product or service and do not reflect the fees and expenses associated with managing a portfolio. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

BEYOND BONDS: FINDING YIELD IN UNDERUTILIZED SECURITIES

As mentioned earlier, our MLG Equity Income strategy combines a mix of higher-yielding securities in four general categories: Convertible Securities, REITs, Utilities and "Other Income-Producing Securities," which may include common stocks that have attractive dividends and

[4] Source: Bloomberg as of April 20, 2010.

[5] Sources: Neuberger Berman, FactSet. Yields as of February 26, 2010. Fixed income yields quoted on yield-to-maturity. Equity yields quoted on dividend yield.

Canadian Income Trusts. Historically, we have adjusted our MLG Equity Income strategy's weighting to each of the above categories based on the current yield and the upside investment opportunity that our team believes exist within each category and at the individual stock level. However, we have always maintained some exposure to each of the four general categories.

Convertible Securities: Convertible bonds and convertible preferred stocks offer attractive income while providing some opportunity for capital appreciation. Traditionally these are the most conservative of the securities included in the MLG Equity Income strategy.

In general, convertible securities are structured to provide an investor a fixed coupon or dividend for a stated period of time. These securities also give an investor the right to convert that bond or preferred stock into the underlying stock at a fixed ratio which was determined at the time that bond or preferred stock was issued.

The MLG Group focuses on buying convertible securities which have a set par value and a maturity date. This provides us with a level of comfort that, upon the maturity date, we should receive the par value for the bond or preferred stock. When buying convertible bonds for the MLG Equity Income strategy, we tend to focus on selecting bonds which have a near-term (under five-year) maturity date or a "put" feature within five years. A "put" feature enables an investor to give back the bond to the issuing company for the full par value of the bond.

We carefully analyze the credit characteristics of each issuing company to understand the likelihood that the company will be able to pay off the bonds at maturity (or at the put date). We also determine whether we believe there is enough capital appreciation potential in the underlying stock to warrant paying the "conversion premium" embedded in the convertible bond. The conversion premium represents how much the common stock must appreciate before the conversion feature becomes valuable.

We generally view the yield to maturity (or yield to put) on the security as the practical downside scenario for our convertible securities: Even if the underlying common stock does not appreciate as much as we thought, or even if the underlying stock were to go down, we generally would get our "par value" upon maturity or put, as long as the issuing company is still in business and hasn't defaulted on the security.

Like all asset classes, convertible securities tend to go through periods when they are expensive and when they are cheap. We found great value in the convertible securities universe in the most recent down market, but are finding fewer opportunities with the right risk-return tradeoff in the current rallying market environment. In particular, we are wary of the price of the conversion premium in current values, which suggests to us that convertibles may be approaching an 'expensive' phase in the market cycle.

REITs: Companies that own or operate real estate (or real estate securities) are generally exempt from corporate income tax if they meet IRS requirements for distributing their income each year and are organized in the form of a Real Estate Investment Trust (REIT). These companies tend to make larger distributions than traditional common stocks, and can also appreciate in share price if the underlying real estate increases in value. It is now possible to find REITs that specialize in different types of properties (e.g., office buildings, shopping malls, apartment buildings) as well as different parts of the country.

We are currently less enthusiastic about REITs, particularly conventional property REITs based in the U.S. We think it is going to be difficult for many of these companies to grow their distributions over the next few years as, in many cases, their balance sheets are stressed and rents will likely trend lower. In addition, many have debt against their individual properties, which will likely have to be refinanced, potentially on less attractive terms. Thus, the REITs may have to put up additional cash to make the loans compliant, detracting from the cash that is available to shareholders. That being said, we do think there are some attractive areas within the REIT sector. We have been focused on timber REITs, specialty property REITs and international REITs, all of which offer value and have interesting growth potential.

Utilities: Utilities stocks represent a sector of companies that provide essential services such as water, electricity or communications to the public. These companies often have monopoly characteristics and are subject to governmental regulation. Traditionally, utility companies were thought to be relatively 'safe' investments because their business models provided consistent returns over long periods of time.

The utilities sector is another area that has historically offered higher-than-average yields. We are maintaining some exposure to the sector, but are focused on utilities with unique investment stories. As a whole, we believe that many U.S. utilities are facing uncertainty with regard to regulation, both at the federal level through the Environmental Protection Agency (EPA), and at the local level with their local regulatory agencies. At the EPA level, we believe there is risk that large capital expenditure requirements could be forced on individual utilities under the "Clean Air Act" and, at this point, it is not clear that these expenditures would be automatically recovered in the rate base and may instead limit the earnings and dividend growth of many utility companies. Until there is greater certainty in the sector, we anticipate maintaining a lower exposure to the group than we have historically.

Other Income-producing Securities: Currently, we believe the most interesting opportunities lie in the "Other" category. This category may include stocks of U.S. companies with attractive dividends, as well as some foreign stocks. The key characteristic we seek in a company is a business model that appears likely to sustain the dividend payout, and hopefully allow it to grow over time. In the face of a deteriorating economy from 2008 to 2009, many companies cut dividends in an effort to conserve cash. (We were underweight companies in the financial sector, which suffered the most dramatic dividend cuts and eliminations.) Now, as the economy starts to show signs of recovery, we are optimistic that we may be entering a period in which our holdings can resume their history of dividend increases over time.

Our "Other" category also includes securities that avoid the double taxation of corporate income and have the potential to pay out attractive distributions, such as Canadian Income Trusts, business development companies and master limited partnerships. These types of investments tend to be relatively liquid securities that trade on the major global stock exchanges. Additionally, these companies are generally subject to the same financial disclosure as ordinary S&P 500 stocks.

While these alternative yield sources tend to have a higher risk profile than traditional income-producing fixed income asset classes, we think these asset classes present an attractive risk-return profile.

We are optimistic that the global economy is at the start of a recovery period. During the financial crisis and the ensuing recession, many companies aggressively cut costs and capital expenditures. Now many of these companies appear to be positioned for incremental revenue to drop to the bottom line; we see the potential for free cash flow to grow handsomely over the next few years. As mentioned earlier, this would be a positive for dividend-paying securities because we think it is likely that many will increase their dividends as free cash flow grows. Given our outlook for economic growth around the world, we are structuring portfolios that include U.S. and multinational companies that offer international exposure through business operations in foreign markets. We are also buying some foreign companies that we believe have opportunities for growth, that are paying attractive dividends, and that in many cases are trading at discounted multiples compared to their U.S. counterparts.

AVOIDING EQUITIES MAY NOT BE THE ANSWER

The U.S. equity market has underperformed the U.S. bond market over the last 10 years. In fact, bonds have outperformed stocks since the trough in the bond market in 1981. However, this is a highly unusual situation as, historically, over the long term, stocks have tended to outperform bonds due to their capital appreciation potential. Looking ahead, we believe the equity markets have attractive potential and equities, both in the U.S. and globally, do not look expensive to us. In fact, the balance sheets and cash flow prospects of many companies we look at seem to be very attractive. Furthermore, if businesses continue to generate increased cash flow, which is our outlook, we think dividends can increase over time. We believe that high-quality companies that have demonstrated pricing power for their goods and services may be able to sustain their profitability in a rising inflationary environment.

Though we recognize the psychological stress of the volatile market cycle we just experienced, over time we think many investors who decreased or eliminated their allocations to equities will reassess their exposure based on their longer-term investment goals. All told, we believe that investors in search of yield with the risk appetite for the equity markets may want to consider an equity-income strategy. We believe MLG Equity Income strategy is an appealing way to gain exposure to securities with attractive dividend yields, the potential for capital appreciation and, historically, less volatility than the broader stock market.

Richard S. Levine *is a portfolio manager in Neuberger Berman's MLG Group, which manages core equity, equity income, global opportunities and taxable and tax-exempt fixed income strategies. Rich joined Neuberger in 1989 and has 31 years of industry experience.*

Sandy Pomeroy *is also a portfolio manager in Neuberger Berman's MLG Group. She joined the firm in 2005 and has 27 years of industry experience.* ■

This material is intended as a broad overview of the portfolio manager's current style, philosophy and process. This material is presented solely for informational purposes and nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security. No recommendation or advice is being given as to whether any investment or strategy is suitable for a particular investor. It should not be assumed that any investments in securities, companies, sectors or markets identified and described were, or will be, profitable. Any views or opinions expressed may not reflect those of the firm as a whole. All information is current as of the date of this material and is subject to change without notice. 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.**

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Portfolio Manager Perspectives: Looking Beyond U.S. Equities in 2010

MATTHEW L. RUBIN
DIRECTOR OF INVESTMENT STRATEGY
NEUBERGER BERMAN

Here in the Investment Strategy Group, we work with Neuberger Berman clients to provide strategic and tactical asset allocation advice in the context of our market outlook. This quarter, we decided to use the space where we customarily address an investment or allocation topic and instead turned the microphone over to a selection of our Neuberger Berman portfolio managers to get their thoughts on the outlook beyond the traditional U.S. equity universe. The following piece is a result of discussions we conducted with portfolio managers in the areas of emerging market equities, municipal bonds and master limited partnerships (MLPs) about their perspective on the current investment outlook and opportunities within their respective asset classes.

CONRAD SALDANHA
PORTFOLIO MANAGER
EMERGING MARKET EQUITY
NEUBERGER BERMAN

EMERGING MARKET EQUITIES: SEEKING A BALANCE OF RISK AND OPPORTUNITY

As an asset class, emerging market equities experienced an extreme drawdown in the market downturn, though returns rebounded, with the MSCI EM Index up 79.5% for the calendar year of 2009. In the Investment Strategy Group, we encourage our investors to consider an allocation to the asset class where it is appropriate for their risk profile, as companies in developing markets offer the potential for higher growth rates and attendant returns than their counterparts in slower-growing developed economies.

Conrad Saldanha is the emerging market equity portfolio manager for Neuberger Berman's global equity team. The team emphasizes bottom-up, fundamental analysis when choosing stocks from developed and emerging markets and applies clearly defined risk parameters.

MATTHEW RUBIN: *Looking at the emerging markets, what types of indicators are you using to gauge the strength of the economic recovery?*

CONRAD SALDANHA: Within emerging markets, we're monitoring a number of key indicators. The primary focus is on GDP growth. Another important metric is unemployment. In China, for example, where there were 20 million unemployed roaming the countryside, finding jobs for them is an important component of government policy. We also track governments' fiscal policies, particularly in a period of economic recovery whereby an economic stimulus can add to the existing stock of public debt. On the monetary policy side, quantitative easing can potentially manifest itself in higher inflation, which may become an issue in emerging markets. A related issue is the stability of the currency regime, so we do track global currency volatility and are mindful of currency reserve levels.

RUBIN: *There is significant fear in the market today concerning sovereign debt in countries such as Greece, Portugal and Spain. How do you think that will impact the broader financial markets in 2010 and how have you positioned your separate account portfolios?*

SALDANHA: We have been concerned about some of these markets for a while, in terms of their fiscal debt and their ability to finance some of the shorter-term maturities that are coming due. We factored many of these risks into our bottom-up stock selection, which produced an underweight to those countries in our portfolios. However, I anticipate continued volatility in the developed markets due to sluggish economic growth, and the fact that their fiscal deficits, which are already large, are increasing.

In general, emerging markets appear to be in better fiscal shape, barring a few Eastern European countries where we've avoided exposure. The earlier follies like the Asian crisis, the

Russian crisis and even the Latin crisis, have been important lessons for emerging economies, and we think that has contributed to better policies in those economies through the period of market distress.

RUBIN: *What additional concerns do you have about emerging markets today, outside of the sovereign debt issues?*

SALDANHA: A lot of money has entered into emerging markets, and valuations have risen significantly. In late 2008 and early 2009, valuations were two or three standard deviations below the mean from a price-to-book or price-to-cash flow perspective. Today the valuation discounts have almost vanished, but the flip side is that emerging market companies are demonstrating higher growth rates and better returns on capital. As a bottom-up stock picker, this is a consideration.

On a macro level, we're seeing increased inflation in food, oil and wages. The policy response to that is very important, keeping in mind that some emerging markets have a less-than-stellar history of dealing with inflation. By and large, however, most emerging markets during this economic cycle have worked through their policy issues well—and we foresee a continuation of that.

Another concern is the growing trade tensions between developing and developed countries, which could lead to trade wars. In times of economic slowdown, populist moves by politicians can result in protectionism that can disrupt global growth. We continue to watch these issues as they can impact some of the export-oriented emerging economies and their companies.

RUBIN: *What are some key themes you're seeing in emerging markets today?*

SALDANHA: The domestic consumption theme remains compelling within emerging markets. If you combine growth in demographics, low household debt and a high savings rate, it all points to a strong consumption outlook over the longer term.

Infrastructure spending is also important. Outside of China, most emerging markets have underspent on infrastructure for decades. Whether you travel to India, Indonesia, South Africa or Latin America, you see a significant need for increased infrastructure and, importantly, not just replacement infrastructure, but new infrastructure. We anticipate significant capital expenditures by governments in partnership with the private sector for many years to come.

RUBIN: *Which emerging market countries do you find particularly attractive in 2010?*

SALDANHA: We think China offers solid investment opportunities this year. It's a big market that, from a bottom-up perspective, offers quality companies that we can invest in at reasonable valuations. The recent underperformance there has created an opportunity for us.

Longer term, India, Brazil and Turkey are larger markets with attractive investment potential. However, in India, we are cautious about valuations in the market; with both India

THE STRONGEST ECONOMIC GROWTH IS EXPECTED TO COME FROM THE DEVELOPING WORLD

Source: IMF.

and Turkey, the inflation issues are more central and nearer term. How their respective governments deal with them will largely influence our approach.

RUBIN: *What is your general sense of investor sentiment for emerging markets?*

SALDANHA: While emerging markets performed extremely well in 2009, investors still appear very aware that the asset class tends to come in on the higher end of the risk-return spectrum and that the returns of 2009 were really a reversal of the losses of 2008. But last year, inflows into emerging markets—as well as their strengthening currencies—helped drive returns, particularly in commodity-driven markets. I'm optimistic that, longer term, we'll witness a greater decoupling between emerging markets and their developed counterparts. Also I believe that the risk perception may shift and emerging markets could be viewed as less risky from a macro standpoint and, more importantly, a bottom-up stock standpoint. Many of these companies are world class, with strong balance sheets and cash-flow generation. ■

JEFFREY LIPTON
HEAD OF MUNICIPAL RESEARCH
NEUBERGER BERMAN

JAMES ISELIN
PORTFOLIO MANAGER
MUNICIPAL BONDS
NEUBERGER BERMAN

MUNICIPAL BONDS: SIZEABLE DEFICITS AND EXPENDITURE PRESSURES HAMPER STATE AND LOCAL GOVERNMENTS

Many of our clients maintain an allocation to municipal bonds due to the lower risk profile and tax benefits of the asset class. Given the stress on local and state budgets, both in terms of lower revenue generation and higher expenditures, we believe active management will be key to navigating potential minefields. Further, today's low interest rate environment may present challenges and opportunities for fixed income investors going forward, as higher rates in the future can erode prices of existing bonds. Active portfolio managers can position client portfolios with awareness of the creditworthiness of holdings, as well as duration and interest rate exposure.

Jeffrey Lipton and James Iselin are members of Neuberger Berman's municipal investment management team, which navigates this sometimes inefficient marketplace and seeks to preserve capital, maintain sufficient liquidity and deliver competitive tax-efficient returns.

MATTHEW RUBIN: *In the fourth quarter of 2009, we saw GDP growth of 5.6%, a real surprise to the upside. In your view, is this level of economic growth sustainable through 2010?*

JEFFREY LIPTON: We don't believe so. A number of factors converged during the fourth quarter and contributed to that unusually high GDP number. Certainly inventory realignment played a role, as did the spending of federal stimulus money by state and local governments. The Federal Stimulus Plan, which was passed in February 2009, allocated approximately $135 billion of "discretionary aid" to state and local governments. Much of it was distributed in 2009 and 2010. In 2011, we anticipate there will be very little money for the states.

However, while I think we're seeing indications of improvement, states are grappling with very sizeable deficits. Further, we continue to see troublesome unemployment levels. For example, the U.S. Department of Labor shows the California unemployment rate for January 2010 at 12.5%. When combining total unemployed with part-time employment and other marginally employed individuals, the unemployment rate for 2009 in California stood at 21.1%. We have ongoing expectations for revenue dislocation,

both at the state and local levels; in certain states, we are still confronted with real estate dislocation and mounting foreclosures. Given these factors, we're likely to see upcoming GDP numbers coming in below Q4 2009 numbers.

RUBIN: *What are your thoughts on deficits and cash flows at the state and local levels? How are you addressing this within your municipal bond separate account portfolios?*

LIPTON: We closely monitor state and local budget deficits and believe they are likely to persist throughout the near term. Across the board, all types of revenue sources are decidedly down — personal income tax receipts, corporate income tax receipts and sales tax collections, for example. At the same time, expenditure pressures, especially at the state level, continue to grow exponentially, particularly in the areas of social services, corrections, unfunded pension liabilities and other post-employment benefits.

One of the ways we address risk in our municipal bond separate account portfolios is through diversification. Issuer, sector and geographic diversification are imperative. For New York and California residents, there really is no reason to avoid out-of-state municipal securities. For out-of-state bonds, which may be subject to in-state taxation, we seek out bonds in which the yield has the ability to offset or exceed the effects of the state taxation.

Another way we look to diversify risk in today's uncertain municipal marketplace is through bond type. We have increased allocations to prefunded bonds and escrow-to-maturity bonds, which are essentially secured by an irrevocable escrow of U.S. government obligations that is a byproduct of municipal defeasance. When these bonds are properly structured, they can offer triple-A credit quality.

FISCAL YEAR 2010 BUDGET ISSUES FACING U.S. STATE GOVERNMENTS

Number of states that cut 2010 budgets up to 5%:	19
Number of states that cut 2010 budgets more than 5%:	24
Number of states with lower-than-expected 2010 revenue projections:	41
Total U.S. state budget gap for 2011:	$55.4 billion

Source: National Governors Association.

RUBIN: *What are your thoughts on the path of interest rates this year? How are you positioning portfolios given the outlook for a rising interest rate environment?*

JAMES ISELIN: Ben Bernanke testified in front of Congress in mid-March that the Fed will continue its accommodative stance for the foreseeable future. I think it's extremely unlikely that the Fed funds rate will increase in the first half of this year; and any increase in the second half of 2010 will likely be contingent on a material improvement in the U.S. labor markets. The national unemployment rates probably understate the true level of joblessness in this country. With the national average for unemployment hovering around 10% — and significantly higher in certain areas like Michigan and California — there is substantial political pressure on the Fed to be accommodative. Mid-term elections this fall are also likely to be a factor in keeping rates low.

The municipal yield curve is at historic levels of steepness right now and we believe it is unlikely to further steepen. We've been positioning portfolios with a barbell bias in advance of an increase in the Fed funds rate and a flattening of the yield curve. For example, for our Core strategy separate accounts with a 1–15 year maturity focus, we have been overweighting the 1–3 year and 10–15 year parts of the curve and underweighting 5–7 year bonds. A barbell bias doesn't really cost us anything — we're not giving up much, if any, yield as we wait for the curve to flatten.

RUBIN: *Of late, deflation has been a bigger concern than inflation. What are your thoughts on inflation going forward and how are you positioning portfolios should inflation return?*

ISELIN: We're not overly concerned about inflation in the near term, but our investment style could play well in an inflationary environment. Our core strategy targets an overall portfolio duration of roughly four years with a 1- to 15-year maturity focus. This type of duration positioning, in our view, presents a more conservative amount of interest rate risk and has the potential to capture the bulk of the steepness in the current yield curve.

In addition, we are currently taking some precautionary measures in our separate account portfolios in two ways: We currently are avoiding the 20- to 30-year section of the yield curve, where a hyper-inflationary market could cause prices to fall sharply, and are focusing on higher coupon issues in the 10- to 15-year duration range. In the event that rates rise, they could be less likely to trade at deep discounts.

RUBIN: *What is your general sense of investor sentiment for municipal bonds today?*

ISELIN: Municipal bonds tend to be one of the lower risk allocations of an overall investment portfolio, so higher risk allocations tend to go to other asset classes. Given the fact that the Fed has kept interest rates so low, and the yield profiles on money market funds and on the shorter end of the yield curve are at historic lows, some investors could start looking further out on the risk spectrum in order to seek a higher yield profile, perhaps towards lower-quality issues or longer-dated bond maturities with higher interest rate risk. ■

DOUGLAS RACHLIN
PORTFOLIO MANAGER
THE RACHLIN GROUP
NEUBERGER BERMAN

MASTER LIMITED PARTNERSHIPS: CONTINUED OPPORTUNITIES FOR STRONG PERFORMANCE

Master limited partnerships (MLPs) are an unusual asset class with respect to security structure and the resulting tax treatment on distributions, and represent a relatively niche universe of securities with about $140B in total market capitalization at the end of 2009. They tend to have concentrated exposures to certain industries, such as energy and affiliated businesses, and often fall in the range of 'mid-cap' companies. This investment category has historically been on the higher range of volatility, and experienced a severe drawdown followed by a robust recovery in 2009. The asset class also tends to produce higher income than many equity securities as a result of the favorable tax treatment of distribution.

The Rachlin Group's Income Plus Portfolio invests primarily in MLPs and other high-yielding securities, with a focus on companies with the potential to create long-term shareholder value and a history of increasing income distributions each year. The team places a strong emphasis on the potential growth of income among their holdings, a characteristic that may hold appeal for high net worth investors.

MATTHEW RUBIN: *In the last decade, the S&P 500 declined 9%. In your opinion, has anything changed permanently in the investment environment following this unprecedented market decline and recession?*

DOUGLAS RACHLIN: In response to whether the environment has changed "permanently," my answer is no. We do not think that human nature has permanently changed, and that's a driving force behind market behavior. When we entered the last decade, we were still going through the Internet bubble, which began to pop in the spring of 2000. A few years later, we entered the real estate bubble. In essence, during the last decade we lived through two bubbles and the bursting of both, which in itself is unusual. Going further, it should be noted that, from 1982 through the spring of 2000, the S&P was on a tremendous roll and had one of the best-performing near-20-year periods of its history. From that perspective, the fact that the aughts disappointed is not surprising.

The work we do within The Rachlin Group is to seek out attractive investments one security at a time. That has never changed for us. From that perspective, today is no different from any other time. I think you can make the argument that, due to the fact that the market declined over the past decade, there are likely to be some very good opportunities over the course of the next decade.

RUBIN: *The MLP market in general is particularly sensitive to the energy sector. What do you anticipate will happen to demand in the energy space going forward, and how might that impact the outlook for MLPs?*

RACHLIN: We tend to invest in MLPs with very little sensitivity to the price of natural gas or crude oil, and our Income Plus portfolio's correlation to both, going back to 1996, is near zero. That said, we feel natural gas is well-positioned for the next decade or two. In light of this positive outlook, we are investing in the securities of companies that have assets and footprints at or near the development of shale gas territories. We anticipate a significant amount of additional capital will be spent to build pipeline, storage and processing facilities within these regions. An independent trade group for the natural gas industry published a report in October 2009 projecting that between $130 billion and $210 billion of new capital will be spent on natural gas infrastructure over the next 20 years.[1] In the past 18 months, $11 billion was spent on new infrastructure for the natural gas industry, with MLPs accounting for $6.5 billion of that money. We're excited about this additional investment coming into the natural gas sphere and how MLPs in these areas could benefit and participate from this further build-out.

RUBIN: *Are there any sectors in the MLP space that you find particularly attractive today?*

RACHLIN: Beyond our interest in MLPs that engage in the natural gas business, publicly traded general partnerships (GPs) are another focal point for our Income Plus strategy, accounting for over 40% of our portfolios as of mid-March. We look for partnerships with significant growth potential, where the GP interest receives favorable treatment due to its ownership of incentive distribution rights (IDRs). In addition, the GP unit is not diluted as debt/equity financing typically occurs at the limited partnership (LP) level. With our GPs, IDR ownership and lack of dilution can lead to a growth multiple of 2x or more of the anticipated rate of distribution growth of the underlying LP.

We also look for MLPs that are early in their lifecycle and have significant growth potential. We have a strong focus on MLPs with strong parent companies — often with energy-rich MLP-qualifying assets — that are committed to providing the MLP with financial support and to selling them energy assets at accretive multiples over time. This

[1] Source: INGAA Foundation.

'drop-down' model often creates embedded growth within the MLP and leads to visible cash-flow growth.

RUBIN: *MLPs had a difficult year in 2008, followed by phenomenal performance in 2009, with the asset class returning more than 70% for the year as measured by the Alerian MLP Index. What is your outlook for the MLP market in 2010?*

RACHLIN: In 2009 the Alerian MLP Index was up 76% on a total return basis but, in a sense, it was reversing the losses of 2008. Our Income Plus strategy performed quite well in 2009, outperforming both the Alerian MLP Index and the portfolio benchmark, the S&P 500. As of March 2010, the MLP market continued to perform well and I believe there continue to be ample investment opportunities. Today our current valuation range is at the midpoint of our historical metrics, which indicates to us that the market does not appear overbought. We believe the MLP space and the Rachlin Income Plus portfolios continue to present attractive yield and distribution growth potential.

RUBIN: *What is your general sense of investor sentiment for the MLP space?*

RACHLIN: In the MLP space, some investors are beginning to step higher on the risk curve, but only incrementally. ■

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Investing in the stocks of even the largest companies involves all the risks of stock market investing, including the risk that they may lose value due to overall market or economic conditions. Investing in foreign securities involves greater risks than investing in securities of U.S. issuers, including currency fluctuations, potential political instability, restrictions on foreign investors, less regulation and less market liquidity. Master Limited Partnerships (MLPs) are limited partnerships that are publicly traded and which have the tax benefits of a limited partnership and the liquidity of a publicly traded company. As an income-producing investment, MLPs could be affected by increases in interest rates and inflation.

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