

FIXED INCOME MARKET REVIEW AND OUTLOOK

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Although the fixed income markets in 2008 were characterized by fear and risk aversion, 2009 could best be described as the year that risk appetite returned to the markets—in abundance. The end result: the spread sectors (non-Treasuries) significantly outperformed equal-duration Treasuries and rewarded investors who took a leap of faith in the midst of the credit crisis. On the following pages, we discuss the dramatic shift in investor sentiment in 2009, the impact on the fixed income markets during the year, and the implications for 2010.

EXECUTIVE SUMMARY

- The longest recession since the Great Depression appeared to end during the third quarter of 2009.
- The 2008 meltdown in the financial markets gradually gave way to more normal conditions.
- Treasury yields, which had fallen sharply in 2008, reversed course and rose across the curve.
- In 2008, virtually every spread sector lagged equal-duration Treasuries; the polar opposite occurred in 2009, as the spread sectors generated superior relative results.
- Risk-taking was rewarded during 2009, as the fixed income asset classes that performed the worst the prior year generated stronger returns.
- While credit spreads significantly narrowed from pre-crisis levels, we believe opportunities remain in a number of sectors in 2010.

2009 ECONOMIC RECAP

The trough of the U.S. economic recession, which occurred during the first quarter of 2009, gradually gave way to “less negative” news, followed by stabilization and renewed growth during the second half of the year.

There was little optimism surrounding the economy as the year began—and for good reason. The continued fallout from the bursting of the housing bubble and the severe repercussions from the September 2008 bankruptcy of Lehman Brothers had essentially frozen the credit markets. The new year began with the U.S. Department of Commerce announcing that fourth-quarter 2008 GDP had contracted 5.4% following a 2.7% decline during the previous three months. Economic weakness intensified during the first quarter of 2009, as GDP declined 6.4%.

In the second quarter, the economy began to show some signs of bottoming. The term “green shoots” was coined by policymakers and economists to describe early signs of improvement in the quarter. While “less bad” economic news was the norm in the

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spring and early summer, some data showed actual improvement. For example, existing home sales moved higher in July and the S&P/Case-Shiller Home Price Indices indicated that prices rose on a quarterly basis for the first time since 2006. Increased investor confidence in the economy was validated when second-quarter GDP was shown to have contracted only 0.7% due, in part, to more modest declines in both exports and business spending. While some data, most notably conditions in the labor market, remained weak, economic data by and large surprised on the upside during the third quarter. This prompted Federal Reserve Chairman Ben Bernanke to note in September that the recession was "very likely over." Indeed, GDP expanded 2.2% during the third quarter—its first positive reading in a year—and an impressive 5.7% in the fourth quarter, driven by higher auto sales, an upturn in home sales due to stabilizing prices and the homebuyer tax credit, and a reduction in inventory liquidation.

2009 FIXED INCOME OVERVIEW

The spread sectors rewarded investors who assumed greater risks in 2009. The best results came from lower-quality bonds and the most beaten-down sectors of 2008.

In many ways, the fixed income markets in 2009 reflected a complete reversal of what was experienced the previous year. Looking back, 2008 was characterized by periods of extreme risk aversion as investors were confronted with numerous shocks, including the demise of storied financial institutions, forced selling into liquid markets, frozen credit conditions and a rapidly weakening global economy. Collectively, this led to heightened risk aversion, plunging Treasury yields and unprecedented widening in the spread sectors.

Twelve months later, the economy appears to be on the mend, the financial markets are largely functioning in a normal manner and risk aversion has been replaced by robust risk appetite. Treasury yields moved higher during the fourth quarter as they did for much of the year, and the yield curve steepened to near-record levels. While Treasury prices weakened in 2009, credit spreads meaningfully tightened—in some cases, to pre-crisis levels. Not only did the spread sectors substantially outperform Treasuries, but in sharp contrast to 2008, lower-quality securities outperformed their higher-rated counterparts.

No single event triggered this dramatic change of fortune in the fixed income markets. Certainly contributing to the turnaround was the U.S. government's aggressive attempt to avert an all-out meltdown in the financial markets and a repeat of the Great Depression. As economic data transitioned from deteriorating to showing signs of stabilization, investor sentiment improved and supported the significant tightening in the spread sectors. In our view, this performance validated the conviction that we had expressed at the end of 2008: "... we believe the prudent action is to stay the course and earn the enormous income advantage offered by these spreads. When we look back a year from now, we believe that the best performing portfolios will have been those with no Treasuries (except possibly a TIPS component) and a maximum exposure to the spread sectors."

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REVIEW OF INTEREST RATES AND CURRENCIES

In a reversal from 2008 when Treasury yields fell across the curve, yields backed up in 2009. Despite a rally toward the end of the year, the U.S. dollar weakened versus most major currencies.

When 2009 began, it appeared to us likely that Treasury yields were unsustainably low and, barring a complete economic catastrophe, would move higher over the course of the year. This proved to be the case as yields rose across the curve during 2009. As economic conditions improved, the steepening of the yield curve intensified during the fourth quarter. While short-term rates moved less, given the Federal Reserve's expectations that economic conditions would "warrant exceptionally low levels of the federal funds rate for an extended period," longer-term rates moved sharply higher as inflationary concerns moved to the forefront. Whereas two-year and 10-year Treasury yields fell 229 and 190 basis points, respectively, in 2008, they rose 36 and 159 basis points, respectively, in 2009.

After peaking in March, the U.S. dollar weakened during much of the remainder of 2009. While there were periods of volatility, the overriding theme was a declining dollar as the global carry trade continued. Given low short-term rates in the U.S., traders borrowed dollars and used the proceeds to purchase currencies from nations with higher rates. In December, there was some reversal of this trend as some better-than-expected payroll data led to expectations that rates in the U.S. would rise sooner than previously expected. However, this was not enough to overcome the dollar's previous weakness and the currency fell 2.53% versus the euro in 2009. Over the year, the dollar gained 2.6% versus the yen after declining in 2008 and 2007.

TREASURY MARKET YIELDS — 2009

Maturity	Yield Levels		
	12/31/09	12/31/08	Change (b.p.)
Fed Funds	0.25%	0.25%	0
Two-year	1.14	0.78	+36
Five-year	2.68	1.56	+112
10-year	3.84	2.25	+159
30-year	4.64	2.29	+235
10-year TIPS	1.43	2.20	-77

CURRENCY MARKET SUMMARY — 2009

FX	12/31/09	12/31/08	Change (%)
EUR/USD	1.43	1.40	-2.53
GBP/USD	1.62	1.46	-10.00
USD/JPY	93.01	90.65	+2.60

Source: Bloomberg.

As economic conditions steadily improved and demand for riskier (and higher yielding) securities increased, spreads narrowed.

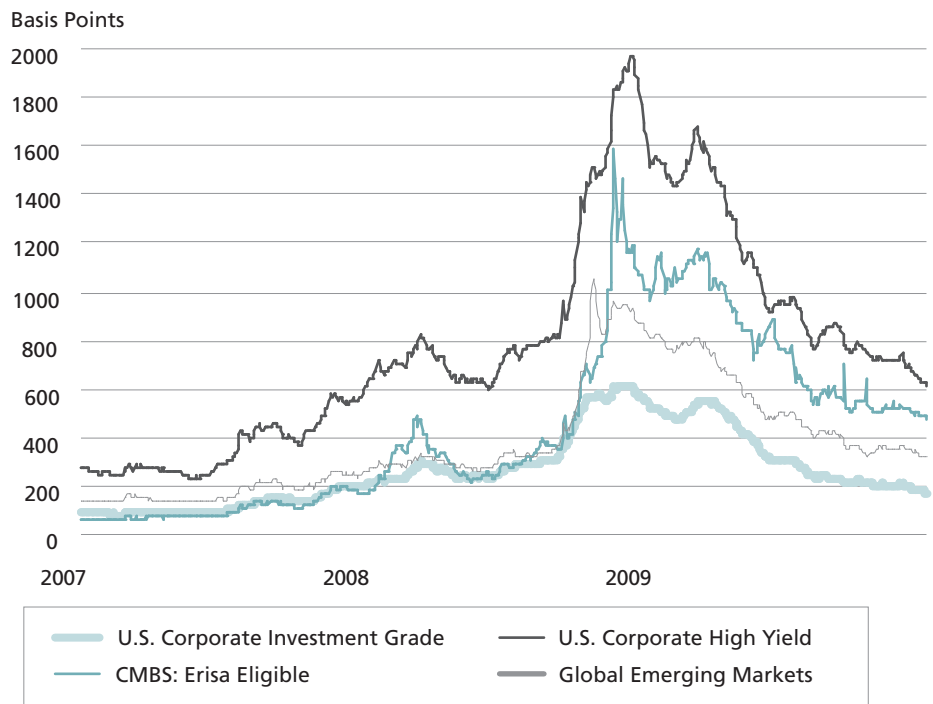
2009 SECTOR RETURNS

Every spread sector outperformed equal-duration Treasuries in 2009, with the best performance coming from the lowest-quality areas of the market.

The overall bond market, as represented by the Barclays Capital U.S. Aggregate Index, generated a 5.93% total return in 2009. Although the bond market outperformed the overall stock market by 37.0% in 2008, as measured by the S&P 500® Index, it lagged stocks by 17.52% in 2009. The primary driver of the bond market’s return was narrowing credit spreads, which more than offset the negative impact of rising Treasury yields.

When the year began, spreads in many sectors were pricing in worst-case scenarios. For instance, investment-grade corporate bond spreads reflected default rates that were several times higher than had ever occurred, even during the Great Depression. As economic conditions steadily improved and demand for riskier (and higher yielding) securities increased, spreads narrowed. This reversed much of the underperformance of the past two to three years, while, we believe, still leaving room for continued improvement in 2010.

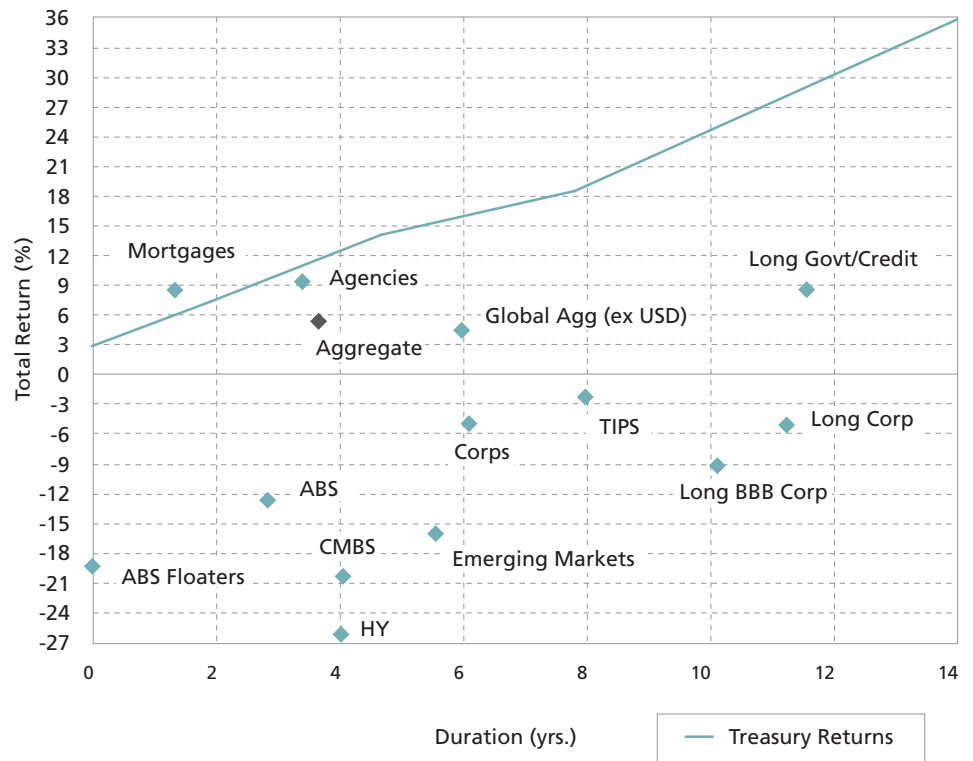
CREDIT SPREADS: FROM “UNCHARTED WATERS” TO NORMALIZATION
Option-Adjusted Spreads



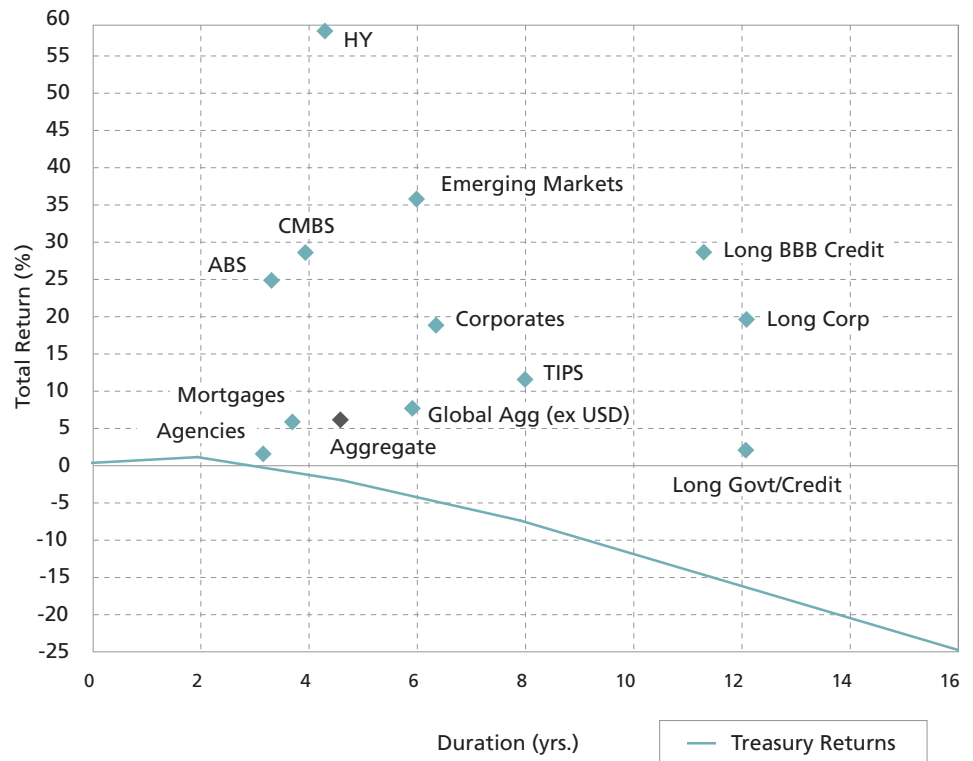
Source: Barclays Capital. See Index Definitions on page 11. Data as of December 31, 2009.

Perhaps there is no better way to illustrate the contrast between the performances in the fixed income markets during the past two calendar years than by looking at the charts on the following page. As you can see, in virtually every case Treasuries outperformed the spread sectors in 2008. In 2009, the exact opposite occurred.

FIXED INCOME MARKET RETURNS 2008



FIXED INCOME MARKET RETURNS 2009



Source: Barclays Capital. See Index Definitions on page 11.

We anticipate that the U.S. economy will continue to recover in 2010.

Although the amount of monetary stimulus has been unprecedented, inflation should remain moderate due to excess capacity and weak labor markets.

2010 MARKET OUTLOOK

Economic Activity

While uncertainties remain regarding the economy, we expect to see continued, albeit modest growth in 2010, with little likelihood of a double-dip recession.

We anticipate that the U.S. economy will continue to recover in 2010. Both the consensus and our view is for sub-trend growth, as we believe overall GDP in 2010 is going to be highly dependent on the future economic policy actions out of Washington. On the monetary side, we will be closely watching the timing and methods of quantitative easing removal. The fiscal side is still very murky due to the pending finalization of the health care bill and tax policies.

That said, a number of challenges remain that will influence longer-term economic growth as many families, homeowners, and businesses still face severe financial pressure. Real estate foreclosures are increasing and unemployment is high. Concerns remain that the shadow inventory of foreclosed homes held by banks will eventually hit the market and that the increased supply may dampen the recent improvement in prices. In addition, businesses are still cautious in the face of uncertainty about the strength of the recovery. As a result, they are deferring capital expenditures and delaying hiring plans until more certainty exists regarding sustainable improvement in revenues.

Interest Rates: Inflation, Real Rates and Fed Policy

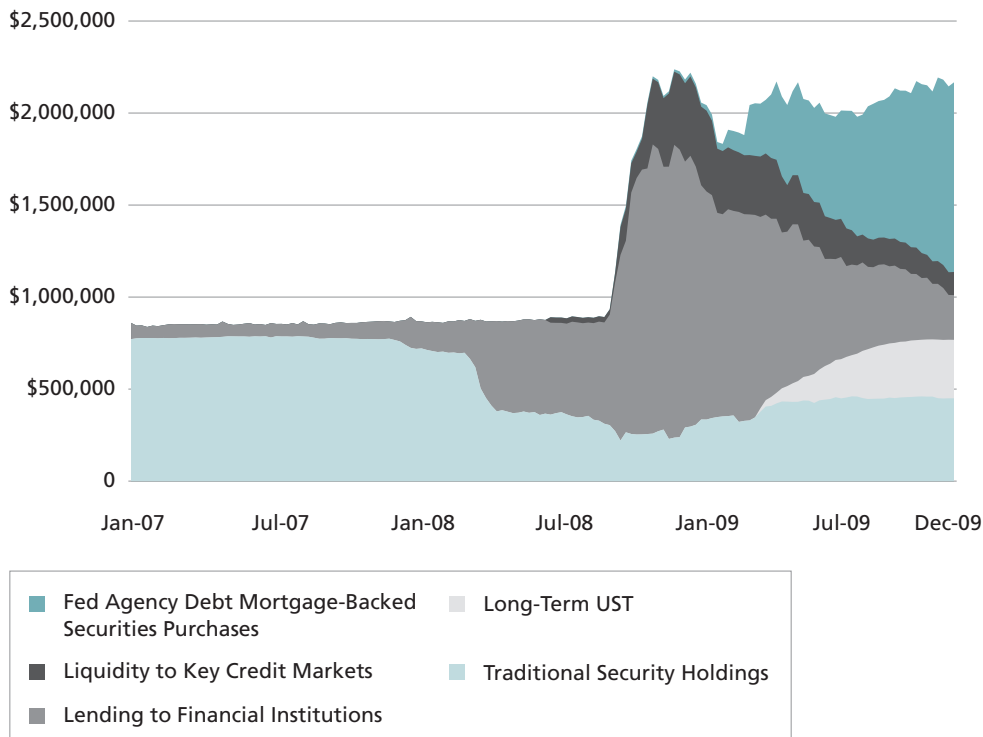
Despite continued economic growth, we expect to see inflation remain muted, while rates should trend higher as the Fed unwinds its stimulus programs.

We evaluate the components that determine the level of nominal interest rates: inflation expectations and real rates. On the inflation front, we focus on the core reading (nominal less food and energy) and anticipate that it will move higher in 2010 as economic growth improves. While headline inflation was negative for the first time since the 1950s, market expectations for core inflation have increased significantly in recent months to return to historically normal levels. Although the amount of monetary stimulus has been unprecedented, inflation should remain moderate due to excess capacity and weak labor markets.

Regarding the Fed Funds rate, we believe it will likely remain between 0 and 0.25% during the first half of 2010. We feel that stabilization of the unemployment rate will be the key for the future path of the Fed's policy decisions. The Fed balance sheet has expanded dramatically since the beginning of 2007 especially to accommodate the newer programs.

FED BALANCE SHEET EXPANSION AS OF DECEMBER 31, 2009

Date	12/16/09	12/31/08	01/03/07
Traditional security holdings	\$ 454,473	\$ 296,299	\$771,569
Securities lend to dealers	9,046	179,662	7,347
Repurchase agreements	0	80,000	40,857
Other fed assets	85,284	44,558	39,609
Currency swaps	56,756	553,157	0
Term auction credit	178,379	450,219	0
Primary/other broker-dealer	0	38,476	0
Primary credit	27,977	86,550	180
Secondary credit	503	18	0
Seasoned credit	117	4	54
Maiden lane 1	26,199	26,974	0
Maiden lane 2	14,675	20,059	0
Maiden lane 3	20,556	27,990	0
ABS CP	79	23,797	0
CP	41,928	332,410	0
Other credit	0	\$0	0
AIIG credit	38,306	38,924	0
MBS	692,196		
Agency	130,050	20,266	0
Term asset-backed securities	42,854		
Long-term U.S. Treasuries	302,609		
Total	\$2,121,987	\$2,219,363	\$859,616



Source: Federal Reserve of Cleveland.

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As the year progresses, uncertainty could escalate about the Fed's ability to remove stimulus (i.e., quantitative easing, the Fed Funds rate and other programs) without triggering a market disruption. We will closely monitor this situation and think the status quo will remain until economic activity turns positive in a sustainable fashion.

The U.S. Treasury is expected to sell more debt in 2010 than the \$2.1 trillion last year and yields may need to rise to entice buyers. By the end of 2010, we expect to see rates moving higher by 50 to 100 basis points. The expectation of the future rate of Fed Funds currently priced into the market is 300 basis points of increases over the next three years, which implies a slow but steady tightening.

SPREAD SECTORS

We believe that additional spread tightening could occur in various market segments in 2010.

Mortgages: Our view of the agency MBS market is somewhat negative. The Fed recently announced its target to complete the MBS purchasing program by the end of first quarter of 2010. While this program successfully lowered mortgage rates in 2009, there are uncertainties as to who will replace the government as the marginal buyer. In addition, given current low interest rates, we believe it makes sense to avoid lower-coupon Agency MBS, as we believe they are not sufficiently compensating investors for their underlying risks.

In our opinion, non-Agency RMBS markets remain fundamentally undervalued in spite of the large amount of individual issue variation. Poor liquidity and rating agency downgrades remain the headline risks. Most non-Agency and residential MBS are now viewed as being below investment grade and, consequently, opportunities are limited for investment-grade portfolios. That said, it seems to us that some bonds are attractive versus other below-investment-grade sectors, such as emerging market debt and high yield bonds. To succeed in this environment, we feel that each deal needs to be evaluated independently to properly assess valuation.

The strong credit rally in 2009 was driven by the removal of the systemic risk premium, optimism regarding the economy, and stronger-than-anticipated corporate earnings.

- **Investment Grade Credit:** The strong credit rally in 2009 was driven by the removal of the systemic risk premium, optimism regarding the economy, and stronger-than-anticipated corporate earnings. Going forward, we believe that corporate balance sheets, overall, are well-positioned for the improving economic environment. In light of this, we believe that spreads are likely to tighten further, especially in financials and BBB-rated industrials.
- **High Yield Bonds:** We remain positive on the outlook for high yield bonds as we believe spreads will further tighten in 2010. In our opinion, supporting the sector will be continued economic growth, very strong market technicals and better-than-expected recovery rates. In addition, we anticipate that defaults in 2010 will be approximately 4%, whereas the market is currently pricing in a higher 6.5% default rate. Finally, a combination of continued par pay-downs, driven by refinancing in the high yield market, asset sales, and improved free cash flow generation, could help high yield spreads move lower.

To successfully navigate this environment, we feel it is paramount to differentiate potential holdings by their deal structure.

In our opinion, growth of the U.S. economy is likely to outpace growth in other developed markets due to more proactive fiscal and monetary policy.

- **Asset-Backed Securities:** We expect to maintain our ABS underweight as most subsectors, such as credit cards, have substantially recovered and are now believed to be fairly valued. Given this, we think other sectors provide higher return potential with comparable risk attributes.
- **Commercial Mortgage-Backed Securities:** We have a positive outlook for CMBS as we believe investors are being rewarded for accepting the underlying risks. We agree with the consensus that delinquency rates will move higher from current levels (roughly 5%) and commercial real estate prices are likely to fall further. We do not expect to see significant underperformance because current pricing continues to imply a very pessimistic outcome. This view is based on our analysis of the underlying collateral and level of subordination. In addition, we believe that the Term Asset-Backed Securities Loan Facility (TALF) and Public-Private Investment Program (PPIP) programs have helped improve liquidity. Even though rating agency downgrade risk remains, it will be nowhere near the 2009 experience in RMBS. To successfully navigate this environment, we feel it is paramount to differentiate potential holdings by their deal structure. For example, we believe that super senior CMBS provide attractive returns, even under extremely negative commercial property market environments.
- **Treasury Inflation-Protected Securities (TIPS):** We have a positive outlook for TIPS in 2010. While the breakeven spread has improved, it is still below average. In our view, this implies further outperformance for TIPS if the economy expands and nominal Treasury interest rates move higher.
- **Emerging Market Debt:** We believe that structural improvements in the fundamentals for emerging market countries will drive long-term excess returns for the asset class. Volatility has declined since the events of the mid- to late-1990s without reducing the opportunity for emerging market debt. We expect to see a convergence of BRIC (Brazil, Russia, India and China) and European Union entrants to the major developed markets as the global economic recovery gradually unfolds. We also anticipate emerging market GDP growth to surpass other regions in 2010.
- **Non-Dollar:** We have an overall negative view regarding un-hedged non-dollar securities as we believe that the dollar may be close to a cyclical low. In our opinion, growth of the U.S. economy is likely to outpace growth in other developed markets due to more proactive fiscal and monetary policy actions. In particular, we expect to see the dollar strengthen versus the euro and yen as economic conditions gradually improve. However, there are certain major economies that are ahead of the U.S. in returning towards trend growth rates and countries such as Australia and Norway have already started their interest rate hiking cycle as a result. In our view, differences between major central banks' indications on monetary policy are likely to provide attractive opportunities to invest in 2010.

CONCLUSION

The last two years have been both exasperating and exhilarating. While less volatility and drama would generally be welcome for many investors, it is during those very periods that compelling opportunities often present themselves. We believe that such occasions play to the strengths of active investment managers. Given their experience and resources, they can look beyond the market “noise” and hone in on the underlying fundamentals of individual securities. It is our belief that such an orientation will be instrumental in the year ahead given the uncertainties regarding the economy and the Fed’s actions to remove its stimulus programs.

INDEX DEFINITIONS

ABS—This index is the ABS component of the Barclays Capital U.S. Aggregate Index. The index includes pass-through, bullet, and controlled amortization structures. The ABS Index includes only the senior class of each ABS issue and the ERISA-eligible B and C tranche.

Agencies—The Barclays Capital U.S. Agency Bond Index measures the performance of the agency sector of the U.S. government bond market and is comprised of investment-grade native-currency U.S. dollar-denominated debentures issued by government and government-related agencies, including the Federal National Mortgage Association (“FNMA” or “Fannie-Mae”). The Index includes both callable and non-callable agency securities that are publicly issued by U.S. government agencies, quasi-federal corporations, and corporate and foreign debt guaranteed by the U.S. government.

Aggregate—The Barclays Capital U.S. Aggregate Index covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-Related, Corporate, MBS (agency fixed-rate and hybrid ARM passthroughs), ABS, and CMBS sectors. The U.S. Aggregate Index is a component of the U.S. Universal Index in its entirety. The index was created in 1986, with index history backfilled to January 1, 1976.

CMBS—The Barclays Capital Commercial Mortgage-Backed Securities (CMBS) Index family consists of four components: CMBS Investment-Grade Index, CMBS High-Yield Index, CMBS Interest-Only Index, and Commercial Conduit Whole Loan Index (all bond classes and interest-only classes). The CMBS Investment-Grade Index is further subdivided into two components: The U.S. Aggregate-eligible component that contains bonds that are ERISA-eligible under the underwriter’s exemption and the non-U.S. Aggregate-eligible component that consists of bonds that are not ERISA-eligible. The CMBS Indices were launched on January 1, 1997.

Corporates—The Barclays Capital Investment Grade Credit Index is publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered.

Emerging Markets—The Global Emerging Markets Index consists of the fixed and floating-rate USD-denominated U.S. Emerging Markets Index and the primarily EUR- and GBP-denominated fixed-rate Pan-European Emerging Markets Index and includes emerging markets debt from the following regions: Americas, Europe, Asia, Middle East, and Africa. For the index, an emerging market is defined as any country that has a long-term foreign currency debt sovereign rating of Baa1/BBB+/BBB+ or below using the middle rating of Moody’s, S&P, and Fitch. The index does not overlap with the U.S. Corporate High-Yield Index or the Pan Euro Corporate High-Yield Index, but may overlap with other investment-grade Aggregate Indices if the securities meet their index eligibility rules. The Global Emerging Markets Index was launched on August 1, 2001.

Global Agg (ex USD)—The Global Aggregate Index provides a broad-based measure of the global investment-grade fixed-rate debt markets. The Global Aggregate Index contains three major components: the U.S. Aggregate Index (USD 300 million), the Pan-European Aggregate Index (EUR 300 million), and the Asian-Pacific Aggregate Index (JPY 35 billion). In addition to securities from these three benchmarks (94.9% of the overall Global Aggregate market value), the Global Aggregate Index includes Global Treasury, Eurodollar (USD 300 million), Euro-Yen (JPY 35 billion), Canadian (USD 300 million equivalent), and Investment-Grade 144A (USD 300 million) index-eligible securities not already in the three regional aggregate indices. The Global Aggregate Index family includes a wide range of standard and customized subindices by liquidity constraint, sector, quality, and maturity. The Global Aggregate Index is a component of the Multiverse Index. The Global Aggregate Index was created in 1999, with index history backfilled to January 1, 1990.

HY—The Barclays Capital U.S. Corporate High-Yield Index covers the USD-denominated, non-investment-grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody’s, Fitch, and S&P is Ba1/BB+/BB+ or below. The index excludes Emerging Markets debt. The index was created in 1986, with index history backfilled to January 1, 1983. The U.S. Corporate High-Yield Index is part of the U.S. Universal and Global High-Yield Indices.

Long BBB Credit—This is the long component of the Barclays Capital U.S. Credit Baa Index. The index includes publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered. The U.S. Credit Index is the same as the former U.S. Corporate Investment Grade Index, which has been renamed as the U.S. Credit Index. The name change is effective as of 6/1/00 (for statistics) and as of 7/1/00 (for returns).

Long Corporates—The Barclays Capital U.S. Long Credit Index includes investment-grade corporate and non-corporate credit bonds that are dollar-denominated and have a remaining maturity of greater than or equal to 10 years. As of December 31, 2008, the Index included 965 issues with an average dollar-weighted maturity of 24.39 years.

Long Govt/Credit—The Barclays Capital U.S. Long Government/Credit Bond Index measures performance of U.S. dollar denominated U.S. Treasuries, government-related, and investment-grade U.S. corporate securities that have a remaining maturity of greater than or equal to 1 year. In addition, the securities have \$250 million or more of outstanding face value, and must be fixed rate and nonconvertible.

Mortgages—The Barclays Capital Mortgage Backed Securities Index is an unmanaged index of mortgage pools of the Government National Mortgage Association, Federal Home Loan Mortgage Corporation and Federal National Mortgage Association.

TIPS—The Barclays Capital U.S. Treasury Inflation Protected Securities (“TIPS”) Index measures the performance of intermediate (1–10 year) U.S. Treasury Inflation Protected Securities.

S&P/Case-Shiller Home Price Indices—The S&P/Case-Shiller Home Prices Indices measures the residential housing market, tracking changes in the value of the residential real estate market in 20 metropolitan regions across the United States.

S&P 500® Index—The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value-weighted index (stock price times number of shares outstanding), with each stock’s weight in the Index proportionate to its market value. The “500” is one of the most widely used benchmarks of U.S. equity performance.

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