

2010 OUTLOOK: INTERNATIONAL AND EMERGING MARKETS EQUITIES

BENJAMIN SEGAL, CFA
 HEAD OF GLOBAL EQUITIES TEAM
 PORTFOLIO MANAGER,
 INTERNATIONAL EQUITIES
 NEUBERGER BERMAN LLC

CONRAD SALDANHA, CFA
 PORTFOLIO MANAGER,
 EMERGING MARKETS EQUITIES
 NEUBERGER BERMAN LLC

Both international developed markets equities and emerging markets equities enjoyed a significant rebound in 2009, once the indiscriminate selloff from the financial crisis abated. With the MSCI EAFE Index up roughly 75% and the MSCI Emerging Markets Index up 107% between March and December 2009, investors may question whether valuations have risen ahead of fundamentals. Below, Benjamin Segal, head of Neuberger Berman’s global equities team and portfolio manager for International Equities, and Conrad Saldanha, portfolio manager for Emerging Markets Equities, share their insights and outlook for 2010. They discuss the markets in detail—where they have been, where they may be headed, and where they believe opportunity and uncertainty lie.

NON-U.S. INVESTING¹

Potential Long-Term Benefits

- Portfolio diversification and expanded opportunity set
- Under-researched names, especially in mid- and smaller-caps
- Higher domestic growth prospects in emerging markets
- Expanded access to natural resources and commodities markets

Key Near-Term Risks

- Slower-than-expected global growth
- Potential for reversal in recent dollar weakness
- Increases in interest rates, especially if rapid
- Increased government regulation (e.g., trade protectionism) and intervention

TABLE 1: PERFORMANCE OVERVIEW

| | 1 Yr | 3 Yr | 5 Yr | 10 Yr |
|-----------------------|--------|--------|--------|--------|
| MSCI EAFE | 32.46% | -5.57% | 4.02% | 1.58% |
| MSCI Emerging Markets | 79.02% | 5.42% | 15.88% | 10.11% |
| S&P 500 | 26.46% | -5.63% | 0.42% | -0.95% |

Sources: MSCI, Standard & Poor’s. As of December 31, 2009.

Index data is 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.

¹Foreign Investment Risk

Investing in foreign securities involves greater risks than investing in securities of US issuers including currency fluctuations, interest rates, potential political instability, restrictions on foreign investors, less regulation and less market liquidity.

As risk appetite and raw material and commodity prices increased and stock markets began to rise, the willingness of investors to look overseas also increased.

Government debt-to-GDP in Japan is currently twice that of the U.S. and, in our view, will remain a concern over the next several years.

INTERNATIONAL MARKETS

International Markets Benefited as Investors Sought Higher Returns

As risk appetite and raw material and commodity prices increased, stock markets rose and investors became increasingly eager to look overseas for returns. This benefited stock prices in both emerging and developed overseas markets during 2009. For U.S.-based investors, the currency factor also added to underlying returns.

Among developed markets—where Gross Domestic Product per capita tends to be higher, regulation of the markets tends to be tighter, and growth rates tend to be slower and steadier—Norway, Australia, Singapore, Sweden and Belgium were top performers for the full year, while Japan, Ireland and Finland, although positive, lagged significantly.²

Looking deeper, generally speaking, the stocks, sectors and markets that suffered most during the downturn performed best in the rally. From a quality perspective, the rally—at least initially—was driven primarily by lower-quality names. Markets with the highest correlation to global recovery, those where governmental stimulus has been most proactive, and those whose currency was most punished during the downdraft from mid-2007 through March 2009 were the markets that bounced back most significantly between March and year-end. The MSCI EAFE Index was up over 32% in dollar terms for 2009, slightly ahead of the S&P 500's full-year performance of 26.46%. Some of this return came from currency, as the dollar depreciated by approximately 4% over the course of the year.

Western Europe Showed Strength; Japan Lagged

The international developed markets are dominated by Europe, which in general was strong for the year, with the U.K. and Nordic markets performing well in dollar terms. The British pound and Swedish krona both appreciated strongly against the U.S. dollar after poor performance in 2008. Japan is the only major market that lagged significantly, up only 6.39% for 2009, with the yen weaker for the year than the U.S. dollar.²

In contrast with many Western governments that had taken supportive stances following the financial crisis, Japan had less of an acute problem, and consequently less of a policy response. Since its lows were less low, Japan's bounce was less significant when the markets rebounded. Beyond that, the Japanese government's capacity to stimulate the economy appears constrained after nearly 20 years of incurring budget deficits to prop up the domestic economy. Government debt-to-GDP in Japan is currently twice that of the U.S. and, in our view, will remain a concern over the next several years. Finally, in elections this year, the Democratic Party of Japan government replaced the Liberal Democratic Party, which had dominated the government since the 1950s, leaving some uncertainty around the macroeconomic and regulatory backdrop for Japanese firms.

² All individual markets mentioned in this article are represented by the relevant MSCI Country Indices.

**TABLE 2: ANNUALIZED PERFORMANCE FOR SELECT DEVELOPED MARKETS
(FOR PERIODS ENDED DECEMBER 31, 2009)**

| | 1 Yr | 3 Yr | 5 Yr | 10 Yr |
|----------------|--------|---------|--------|--------|
| UNITED KINGDOM | 43.37% | -7.05% | 2.42% | 1.38% |
| JAPAN | 6.39% | -10.25% | -0.70% | -3.54% |
| FRANCE | 33.26% | -4.52% | 5.45% | 2.64% |
| AUSTRALIA | 76.77% | 4.71% | 12.33% | 12.76% |
| GERMANY | 26.56% | -2.12% | 7.23% | 1.91% |
| SWITZERLAND | 26.61% | -2.00% | 7.17% | 5.25% |

Source: MSCI Indexes. As of December 31, 2009.

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We anticipate that any outperformance in 2010 would likely be driven by individual stock selection rather than overall market movements.

Valuations: Still Reasonable After Rally, but Stock-Picking May Drive Future

Today, from a valuation perspective, European markets still trade at a modest discount to the U.S., roughly in line with the historic average. With profitability probably slightly higher in the U.S. versus Europe, growth in the U.S. probably somewhat higher, an American population that is increasing versus flat-to-declining in Europe, and with a more rigid labor market in Europe plus a relatively strong euro, we believe the valuation discount is appropriate. While, with the benefit of hindsight, international and particularly emerging markets were cheap earlier this year, we would argue that valuations are now roughly in line with fundamentals. As such, we believe that any outperformance in developed markets in 2010 would likely be driven by individual stock selection rather than overall market movements.

Currency Pressures Likely to be Less a Factor

From a currency perspective, the fundamentals behind the U.S. dollar seem adverse, which could benefit returns on international stocks. However, many of the negative factors that apply to the dollar could also apply to the euro. Consequently, we believe much of the dollar's decline versus the euro is likely behind us, and we do not anticipate currency playing a significant role going forward.

From a sector outlook point of view, we had a period of extremely high commodity prices during the economic boom from 2005 to 2007. Oil is the best example, with steel and precious metals also participating. Prices pulled back significantly during the downturn, particularly in highly economically sensitive areas like iron ore, oil and gas, but they have bounced back in recent months. Similarly, while large swaths of the financial sector needed to be rescued from the precipice, the outlook for 2010 appears to be more stable.

In Natural Resources sectors, M&A is often an expedient way for large companies in the sector to grow their reserves and production quickly.

In Consumer Staples, companies with strong brands and established markets that executed effectively in the downturn continue to do so.

SECTOR OUTLOOK: DEVELOPED MARKETS

M&A Activity and Price Movements Positive for Natural Resources

We currently anticipate that natural resources prices will likely move up incrementally over the next three to five years, which we believe is supportive of a modest overweight in energy stocks and raw materials. While we are fairly positive on raw materials as a group, we highlight copper and uranium as particularly attractive.

We also believe continued consolidation and M&A activity in these areas is likely. Most natural resources are relatively hard to come by, and acquisition is often an expedient way for large companies in the sector to grow their reserves and production quickly. We anticipate that any consolidation would likely lead to positive developments and a potential source of outperformance, as a consolidating group of producers could have the ability to exert greater pricing power, with the smaller- and mid-cap acquisition targets potentially benefiting from this.

High Valuations and U.S. Domination in Technology

In Information Technology, we see select opportunities but, in general, believe the U.S. has an ongoing and enduring competitive advantage. International companies tend to operate in a less fertile environment for entrepreneurs and technology, with a less flexible labor force and more rigid education system. Further, it appears that the expectation for technology spending to likely increase has already been priced into much of the sector, so it may be difficult to find well-priced opportunities.

Fundamentals Falter in Telecom

Telecommunications has benefited from substantial growth recently, and we think the fundamentals have become less compelling over time as a significant amount of capital investment appears to be needed to upgrade networks for increasing data usage. Other potential negatives include competition from cable, revenue-sharing agreements with recent entrants like Apple, market saturation, and an overall declining ability to increase prices.

Consumer Sectors Look Promising

In Consumer Staples, companies with strong brands and established markets that executed effectively in the downturn continue to do so. Many of these firms are at what we consider to be low valuations, as investors may have focused further out on the risk spectrum. We believe there is significant opportunity in this sector, especially among firms with a strong international and emerging markets footprint. In Consumer Discretionary stocks, a more heterogeneous sector, we think companies delivering innovation or a differentiated experience and those benefiting from a benign regulatory framework, such as gaming or media, appear well-positioned and have attractive return potential.

Special Situations in Financials, Health Care and Utilities

At over 25% of the MSCI EAFE Index, Financials is a huge sector. As the deleveraging of corporations continues, the appetite for credit has declined. Even given the amount of capital these companies have taken on, we believe they may struggle. Accordingly, we have a pessimistic return outlook and believe a cautious approach is warranted. Companies with strong global or local footprints and low-cost positions, and with an ability to innovate and manage risk, appear better positioned in our view.

If rates rise too early, this could choke off the recovery before it gains full momentum.

Given our overall global outlook, we think strong stock-picking skills could be the key driver of international portfolio returns in the coming year.

Health Care is another sector with a dominant U.S. component, but there are several companies in Europe with interesting drug pipelines and innovations, and where near-term patent expiration is not a risk to revenues.

Finally, Utilities tend to be highly regulated, low-growth, highly leveraged and capital-intensive operations, so we think power generation, with a few exceptions, may be a difficult area in which to find attractive opportunities. As we think about the movement toward alternative energy, however, we believe suppliers of key components may offer interesting opportunities.

Keeping an Eye on Risk

A key risk we see facing international developed market investing is currency. Near-term, international returns could be enhanced by a weak dollar or undermined by a strong one. Another risk we see is the possibility of a pullback in the global economy. Right now, the world's growth engine is in the East. If that should moderate at the same time that a recovery in the developed West falters, there is a risk of slippage back into a weaker economic environment, which could negatively impact the equity markets. Similarly, interest rates today are at an all-time low, and we feel that central banks globally would like to see higher rates. If rates rise too early, this could choke off the recovery before it gains full momentum. Increased government regulation across a number of industries may be a significant risk to some corporations but, at the same time, a narrow group of companies will likely be positioned to benefit from the changes.

International Mid- and Small-Cap Stocks

Although the correlation among the various developed markets has increased,³ we believe international investing continues to offer attractive diversification benefits within the framework of an overall portfolio. Particularly within the international mid-cap universe, we believe there are opportunities to find companies that are both undervalued and have the potential for returns that are uncorrelated with the U.S. equity market. In our view, it is possible to find high-quality smaller-cap companies that trade at significant discounts solely because of their size. We believe investors may start looking beyond size and focus on growth and valuation.

As mentioned, we do not anticipate currency playing a significant role going forward, nor do we see international markets having a significant advantage from a valuation standpoint relative to the U.S. Moreover, we believe there is unlikely to be a significant differential between export-driven companies and those focused on their domestic markets. Given our overall global outlook, we think strong stock-picking skills could be the key driver of international portfolio returns in the coming year. We believe identifying those companies that can succeed even in a tougher environment will be a key factor. We also think that balancing a mix of companies with those that could suffer from a weak dollar with others that could benefit also makes sense, as this could help neutralize the impact of currency moves on an overall portfolio.

³ According to Callan and Neuberger Berman, over the 10 years ended December 31, 2009, the 12-month rolling return correlation between the S&P 500 and the MSCI EAFE Index rose from 0.47 to 0.93, with 1.0 representing synchronized movement.

In terms of countries, Brazil, Indonesia, India, Russia and Turkey performed best, turning in triple-digit returns for the full year.

The crisis caused indiscriminate panic selling despite the fact that most emerging markets economies were in good shape.

EMERGING MARKETS

Remarkable Year in Emerging Markets

Emerging markets, where prices tend to be more volatile, growth rates higher, and Gross Domestic Product per capita lower than in more developed markets, saw dramatic results in 2009, closing up 79.02% as measured by the MSCI Emerging Markets Index. In terms of countries, Brazil, Indonesia, India, Russia and Turkey performed best, turning in triple-digit returns for the full year. During 2009, Eastern European markets such as the Czech Republic and Poland were among weaker performers.⁴

TABLE 3: ANNUALIZED PERFORMANCE FOR SELECT EMERGING MARKETS (FOR PERIODS ENDED DECEMBER 31, 2009)

| | 1 Yr | 3 Yr | 5 Yr | 10 Yr |
|--------------|---------|---------|--------|--------|
| CHINA | 62.63% | 9.96% | 23.83% | 9.60% |
| BRAZIL | 128.62% | 21.83% | 32.86% | 20.01% |
| KOREA | 72.06% | 0.83% | 12.89% | 9.56% |
| TAIWAN | 80.25% | 2.11% | 6.66% | -0.06% |
| INDIA | 102.81% | 7.48% | 20.87% | 14.11% |
| RUSSIA | 104.91% | -12.53% | 12.64% | 15.58% |
| SOUTH AFRICA | 57.82% | 5.01% | 12.36% | 12.76% |

Source: MSCI Indexes. As of December 31, 2009.

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Indiscriminate Sell-Off

The financial crisis started in the Western world in 2008, driven by countries with high consumer leverage geared to home equity prices. The crisis was manifested through derivative products and other financial instruments, which leveraged the situation further, impacting the financial system in these countries significantly. As many hedge funds sought liquidity and investors' fears increased, the crisis led to indiscriminate panic selling across global markets, with emerging markets being particularly susceptible.

This selling took place despite the fact that the economies of these countries, particularly the larger ones, were in general financially strong heading into the crisis, during the crisis, and coming out of it. The countries within emerging markets that were impacted most were those that had either high budget and current account deficits or generally high debt levels without sufficient foreign reserves to back them up. This effect was seen primarily in central and eastern European countries during the crisis—and many of them are not yet out of the woods. Companies and markets with more commodity-driven currencies, like Brazil and Russia, also suffered.

A Resurgence That Beat Even Optimistic Projections

In 2009, emerging markets found the bottom in March. Quantitative easing on a global basis and the announcement and deployment of fiscal stimulus packages made the markets more comfortable, and many investors moved out on the risk spectrum looking for higher return potential. This triggered a rally in commodities and the

⁴ All individual markets mentioned in this article are represented by the relevant MSCI Country Indices.

Strategic investors had the ability to add well-positioned, financially strong companies to portfolios at meaningful discounts.

With valuations no longer artificially depressed, it is not as easy to find good companies at attractive prices, but in our view, there are still significant opportunities in these markets.

If this cycle were to change, a shift in risk preference could have a negative effect, just as it did during the financial crisis.

emerging markets that lasted throughout 2009, led initially by the highest-beta countries, currencies and stocks. With relatively strong GDP growth announced in China and India, however, the fundamentals of emerging markets appear squarely back in focus.

For bottom-up stock investors, like us, 2009 provided a great environment. Strategic investors had the ability to add well-positioned, financially strong companies to portfolios at meaningful discounts. This, coupled with the overall rise in the MSCI Emerging Markets Index, helped the market climate. Considering the tremendous run-up in emerging markets this year, the heavy discounts seen during the crisis—a two-standard deviation event in terms of valuation against the mean—are for the most part gone. Russia, Turkey and Thailand are among the least expensive markets at this time, while more secular growth stories such as India, China and Indonesia are at the higher end of the spectrum. With valuations no longer artificially depressed, it is not as easy to find good companies at attractive prices, but in our view, there are still significant opportunities in these markets. In our opinion, valuations are still attractive and growth prospects remain compelling.

Thinking bigger picture, 80% of the world lives in emerging markets countries, but these markets account for just over 12% of the world's market capitalization—so we see a tremendous underrepresentation relative to the population and to their GDP. Emerging markets countries have a large consumer base, demographics that are favorable—with younger populations on average than the aging population of the developed world—and consumers who are less leveraged, with high savings rates, and consequently the potential to spend. This is combined with the fact that many emerging markets governments are fiscally strong, and have substantial reserves to be able to stimulate economic growth.

Risks in the Current Environment

A key risk we see at this time would come from a reversal of the unprecedented monetary easing and injection of liquidity into the global financial system and economy. If this cycle were to change, while fundamentals would still look attractive, a shift in risk preference and investor sentiment could have a negative effect on emerging markets equities, just as it did during the financial crisis. Tightening is both an external and internal risk. If China, a big importer of natural resources, tightened, for example, it could impact the price of commodities worldwide.

Another noteworthy risk we see at this time comes from the West. If the developed world fails to fully recover from the recession and enters a prolonged environment of slow global growth, it could impact the export-oriented economies of the emerging markets. However, even in this case, we think that the more domestically focused emerging economies could continue to perform well.

Another factor to watch is trade tensions and protectionism, which can happen in an environment of slower growth. Tariffs and trade wars would likely damage the global economy. And finally, some emerging markets countries' currencies have appreciated quickly as large amounts of foreign funds flowed into their economies. If currencies appreciate too quickly, countries may consider employing devices to slow inflows, such as taxes on foreign investors. This happened in Brazil, and other countries may be evaluating similar programs.

High-Quality Companies, Secular Stories Compelling

We believe the longer-term structural imperative for emerging markets is very much there. At this stage in the rally, in terms of valuation, we think particularly compelling opportunities lie in the more domestically focused sectors, where we see a sustainable secular story. We think a focus on high-quality companies, and away from the highest-beta sectors is appealing, and see reason to be cautious about those companies and sectors whose prospects are tied more closely to the health of the global economy and/or dollar weakness than their underlying fundamentals.

Fundamental Research, Macro Perspective

While both developed and emerging overseas markets recovered impressively from the damage they sustained during the financial crisis, ongoing world economic issues continue to loom in counterbalance to fair valuations, strong fundamentals and optimistic prospects. In our opinion, hands-on research and careful screening and stock-picking could be advantageous in a flat- to up-market—but if the global economy and markets begin to slip, assets perceived as riskier may suffer first. In addition to exhaustive fundamental research, we believe in the importance of keeping a close watch on economic data, currencies, and interest rates, as well as policy changes in major economies such as China.

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The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. As of June 2007, the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom. The index is translated into U.S. dollars.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. As of June 2009 the MSCI Emerging Markets Index consisted of the following 22 emerging market country indices: Brazil, Chile, China, Colombia, the Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Morocco, Peru, the Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

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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