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INTERNATIONAL EQUITIES: BLUEPRINT FOR A DIFFERENTIATED MARKET ENVIRONMENT

International equity market returns have started diverging—at regional, country and market-cap levels—as investors adjust to changing monetary policy, a subdued growth environment and a muted return outlook overall. We believe that this reflects a new reality in markets, in which top-down, country or even sector views may not be enough to achieve favorable risk-adjusted returns. In this paper, we explore the case for including the flexibility to invest across market caps, regions and sectors, as well as the appeal of a quality bias and fundamentals focus, as part of a disciplined investment process.

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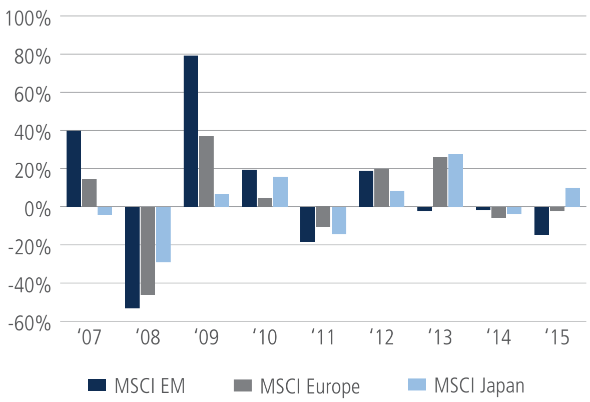
GROWING DIVERGENCE IN THE MARKETPLACE

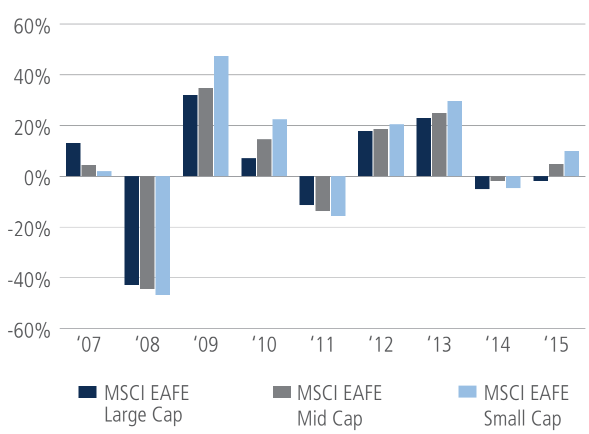
For much of the period since the 2008 market crisis, aggressive monetary policy and macro-related issues have tended to dominate international markets, which has contributed to high correlations of returns among regions and market-cap ranges. However, over the past two years, shifting policy issues and varying growth rates have prompted more diverse return patterns (see Figures 1 and 2).

FIGURE 1: ANNUAL RETURNS BY REGION, COUNTRY



Source: FactSet. Indexes are unmanaged and are not available for direct investment. Unless otherwise indicated, returns reflect reinvestment of dividends and distributions. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

FIGURE 2: ANNUAL RETURNS BY MARKET CAPITALIZATION



Source: FactSet. Large cap: median market capitalization of USD 14 billion; mid-cap: median of USD 4 billion; small cap: median of USD 0.5 billion. Indexes are unmanaged and are not available for direct investment. Unless otherwise indicated, returns reflect reinvestment of dividends and distributions. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

We believe this trend is likely to continue. Economies and policies are diverging, potentially exposing fundamental differences among markets, sectors and stocks. U.S. interest rates may have troughed, while the ECB and Bank of Japan continue to lower interest rates to levels below zero. At the same time, lower profitability at brokerage firms is forcing them to provide less individual stock research coverage—in particular for smaller companies where the daily value traded is low. For investors who look beyond the largest companies (in particular the roughly 900 constituents of the MSCI EAFE Index), this could potentially translate into opportunities to generate alpha among the more than 10,000 actively traded developed market stocks outside the U.S.

IMPLICATIONS FOR INTERNATIONAL EQUITY INVESTORS

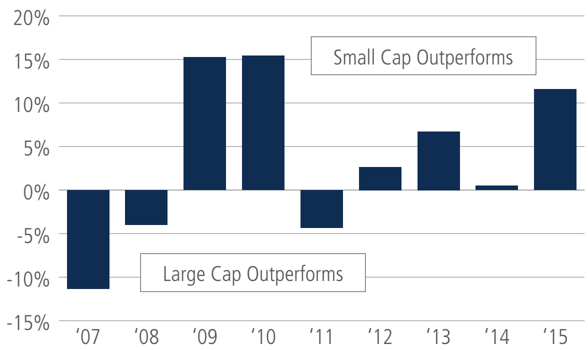
How can this more differentiated environment affect the task of investing in international markets? We believe that potential lies in a powerful nexus between active investing, flexibility and quality. Environments in which market-cap ranges and regions traded within tight bands of one another (such as the 2011-12 period) have been challenging for active managers. However, greater return dispersion can often favor flexible strategies that can be opportunistic, with weightings based on bottom-up fundamental analysis rather than overly narrow investment guidelines.

WHY MARKET-CAP FLEXIBILITY?

The ability to invest away from dominant names in large-cap indices may offer opportunities to generate alpha. In assessing the entire value chain in various industries, we are often led to mid- and small-cap companies with niche businesses that are not well known or well understood. These specialized firms are often more profitable, faster growing or less risky than their larger peers. An investment portfolio that can include these companies at attractive valuations could potentially perform well relative to large-cap oriented peers and indices. As shown in Figure 3, in recent years, small-cap stocks have often outperformed large-cap stocks, so it can be useful to have the flexibility to invest there if a bottom-up opportunity is identified. Small and mid-caps can also suffer underperformance, however, so valuation discipline and risk management are key.

FIGURE 3: INTERNATIONAL SMALL CAPS: AN APPEALING SOURCE OF STOCKS

Annual Return Difference Between MSCI EAFE Small Cap and EAFE Large Cap



Source: FactSet. Indexes are unmanaged and are not available for direct investment. Unless otherwise indicated, returns reflect reinvestment of dividends and distributions. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

INVESTING BEYOND THE BENCHMARK

We believe the notion of flexibility can apply to countries as well, as individual opportunities in a given market may be disproportionate to the overall size of the market itself. MSCI data shows that a country's representation in the index often does not reflect its underlying economic weight. For example, the U.K. represents 19.6% of the MSCI EAFE Index, while economically it is only 8.6% of the revenues generated by MSCI EAFE Index constituents. Moreover, given the dominant presence of multinationals, the MSCI EAFE Index has 24% underlying exposure to emerging markets, even though emerging markets are not explicitly represented. In other words, it is important to understand the underlying exposure of the company, rather than just the country domicile of the stock. The flexibility to invest outside the countries that make up the EAFE Index—like Canada or emerging markets, or even foreign-domiciled U.S.-listed firms—need not add meaningfully to portfolio risk, whether risk is measured by absolute volatility or by tracking error relative to benchmark.

Regarding emerging markets in particular, we know that many developed market companies have revenue exposure to emerging markets. Where we believe this exposure can be additive to returns and growth—and where the multinational has a strong and defensible position relative to local competitors—we are happy to have this exposure. Moreover, where one can identify an emerging markets-based firm that is outperforming its global peers in the global or local marketplaces, we believe it could be an attractive holding for portfolios. Rather than country of domicile, in our view, the key is the underlying exposure, quality of the enterprise, and valuation.

THE IMPORTANCE OF DISCIPLINE

Especially when including companies that are not part of the index, it is important to monitor risk closely. For example, an investor can combine several narrowly focused industrial firms to replicate the risk profile of a much larger conglomerate. It's possible to substitute a multinational with emerging markets exposure for smaller firms that operate and are listed in emerging markets themselves. And one can focus attention on smaller caps with very little debt, and so mitigate the risks associated with larger firms that may have taken advantage of low interest rates to make acquisitions. Thus, a differentiated portfolio need not be a more risky one—whether risk is measured by beta or absolute standard deviation.

In addition to mitigating risk via diversification, we also believe that portfolio volatility can be reduced by a focus on quality—which for us is largely determined by return on capital. Companies with high returns tend to generate strong cash flow, enabling them to weather tough economic conditions more effectively than their peers. Smaller caps and emerging markets firms tend to be more volatile than their large-cap multinational peers, so a focus on quality can help mitigate the risks associated with investing in niche names.

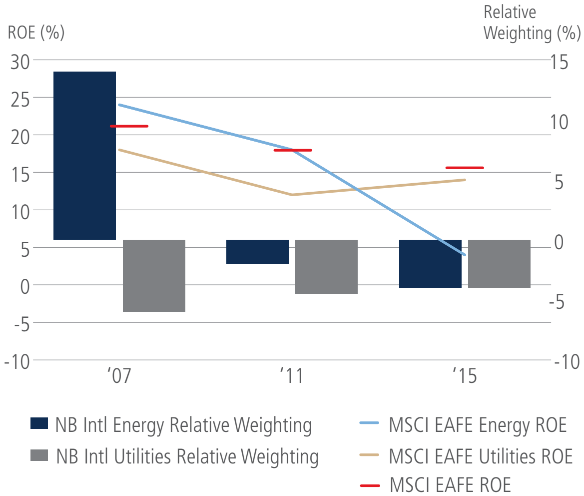
HOW QUALITY CAN SHAPE A PORTFOLIO

An orientation toward quality and fundamentals does have an influence on the overall weightings of a portfolio, and the effects will vary over time. Using a very simplified example, we looked at our International Equity strategy's top sector overweight and underweight as of 2007 (before the global financial crisis) and then followed those sectors through to the current market.

FIGURE 4: FUNDAMENTALS CAN DRIVE EXPOSURE

NB International Equity Strategy: Energy and Utility Sector Weightings and Sector RoE over Time

Evolution of Initial-Period Top Overweight (Energy) vs. Top Underweight (Utilities)



Source: Neuberger Berman, FactSet. Benchmark is the MSCI EAFE Index. Weightings and RoE are as of December 31 of the respective years. Representative portfolio information (characteristics, holdings, weightings, etc.) is subject to change without notice. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.** See additional disclosures at the end of this paper, which are an important part of this material.

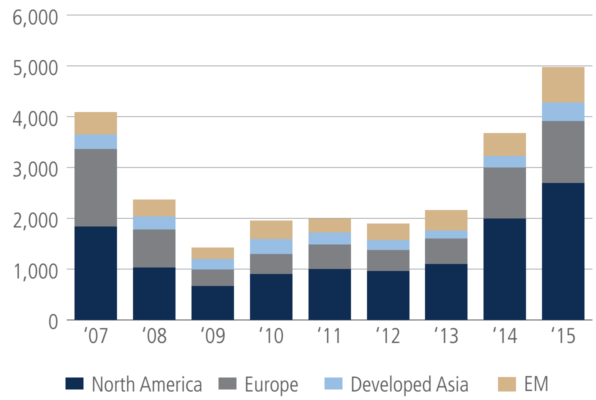
Figure 4 above shows that, in 2007, the energy sector enjoyed a return on equity (RoE) above that of the index before the crisis, as demand for oil and gas drove up prices, allowing for the development of new geographies, like offshore Brazil and Africa, and giving rise to independent energy explorers and differentiated oil service providers. This led to more individual opportunities for us, and the sector was our largest overweight, driven by bottom-up analysis that identified many attractive companies. Several of these firms, however, were acquired in the M&A boom that ensued, which eliminated some of the most exciting and profitable names from the universe, and dragged down the returns of larger remaining acquirers (even before the price of oil declined). As a result, our energy exposure declined. The utilities weighting tells a very different story: Sector returns have never matched the RoE of the overall index, as the sector's RoE is designed to be in line with the cost of capital, which explains our consistent underweight.

SECONDARY BENEFITS

Other factors can drive relative returns: Consider mergers and acquisitions. M&A activity has been accelerating globally as many companies with large cash holdings seek to grow revenues but are loathe to expand capacity. At the same time, accommodative monetary policy from central banks has kept interest rates very low. U.S. firms may be looking to use the strong dollar to make acquisitions abroad, while companies based in emerging markets may be looking to gain expertise and technology from companies in the developed world. Prospects for a continued increase in activity appear strong.

FIGURE 5: GLOBAL DEAL VOLUME BY TARGET'S REGION

USD Billions



Source: Bloomberg.

However, the benefits of M&A are unlikely to be shared universally. We believe that fundamentally strong businesses trading at attractive prices tend to be the more appealing candidates for acquisition. Another look at our International Equity strategy provides some insight: In 2014, the larger-cap MSCI EAFE Index had 32 names targeted for acquisitions that detracted -0.15% from overall index return, as compared to 11 securities targeted for acquisition in our strategy that contributed positively to overall strategy return. In 2015, the index had 45 names targeted that detracted -0.28% from the overall index return, as compared to six securities targeted in our strategy that contributed positively to overall strategy return. The overall MSCI EAFE Index generated negative returns in both 2014 and 2015, so the value added via M&A—specifically, being invested in acquired firms—was significant.

Exposure to small-cap stocks can add potential for portfolio acquisitions. While the percentage of total M&A value is skewed to larger companies, the number of transactions is skewed to smaller deals. For example, in 2015 there were USD 5 trillion worth of deals globally, but the average size of the transaction was just USD 179 million.[1] Purchasing a smaller firm puts less capital at risk for the acquirer, which adds to the attraction of smaller caps.

[1] Source: Bloomberg.

FIGURE 6: POST-GLOBAL FINANCIAL CRISIS – HOW FUNDAMENTALS CAN DRIVE STOCK PERFORMANCE

Period 1: Post-GFC Recovery (Mar 2009 – April 2011)

Market Factors	% Change
Change in P/E	-10%
Change in Earnings	+89%
Annualized Returns	
MSCI EAFE	+34%

Period 2: Euro Crisis (May 2011 – May 2012)

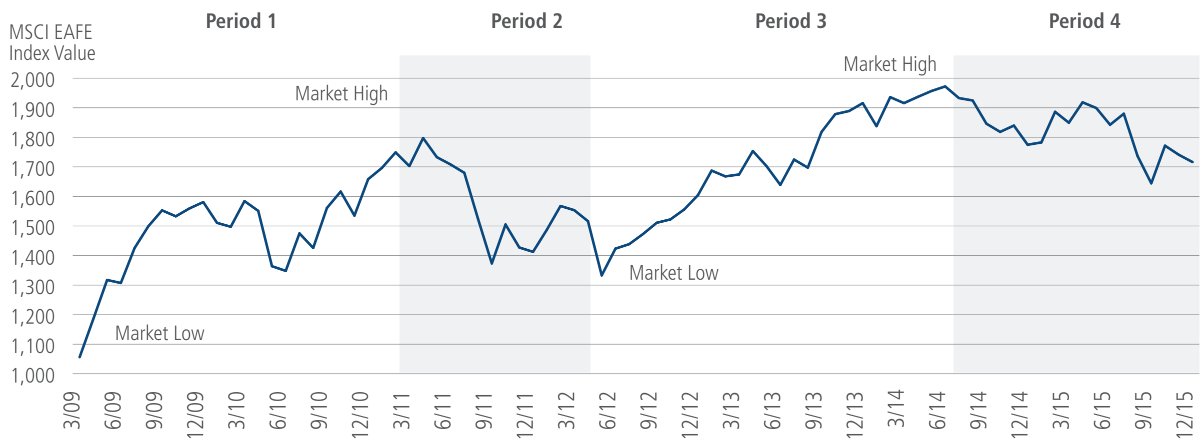
Market Factors	% Change
Change in P/E	-16%
Change in Earnings	-12%
Annualized Returns	
MSCI EAFE	-21%

Period 3: Monetary Policy Rally (June 2012 – June 2014)

Market Factors	% Change
Change in P/E	+45%
Change in Earnings	+2%
Annualized Returns	
MSCI EAFE	+25%

Period 4: Growth Slowdown (July 2014 – Dec 2015)

Market Factors	% Change
Change in P/E	-2%
Change in Earnings	-12%
Annualized Returns	
MSCI EAFE	-6%



Source: Bloomberg and Neuberger Berman.

P/E is Bloomberg compilation of forward earnings estimates for next four quarters. Earnings is calculated based on the MSCI EAFE index price change divided by P/E change. Neither figure is annualized. Light blue shading indicates influential factor for the relevant period.

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QUALITY: AN OPPORTUNE TIME FOR A SECULAR CHOICE

As we have observed, the current market environment is characterized by return dispersion among regions, sectors and market-cap segments—one that we believe bodes well for a quality-driven all-cap approach. While we believe all-cap quality is a solid long-term philosophy, it may perform better in some periods than in others; in particular, it has often done well when fundamentals drive markets.

Looking at performance periods after the global financial crisis (see Figure 6), the rally of mid-2012 to mid-2014 presents an example of a monetary policy-driven market. It was a period characterized by the launch of both "Abenomics" in Japan, and the ECB's quantitative easing, which lifted valuations far more than it did corporate profits (which barely moved during the period). With current valuations in line with long-term averages, we believe we could be entering a period where fundamentals are a key driver of returns.

CONCLUSION

Following a period of increasing correlations, we believe we are now in a period of divergence for international equity markets. As a result, we believe that active management—focusing on specific areas of opportunity—can outperform a broader approach. In particular, we believe a flexible approach that focuses on quality—one that includes medium- and small-cap as well as the largest firms, includes companies in emerging as well as developed markets, and includes all sectors where economic value can be created—while closely monitoring risk, can generate attractive long-term returns.

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