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Tax-Managing Portfolios Across Public and Private Investments

More than ever, investors appear to understand the benefits of focusing on after-tax rather than pre-tax returns across public and private market exposures. As a result, we have seen increased demand for tax-efficient investment structures and strategies to help seek portfolio growth over the long term. In this paper, we consider a range of opportunities that may offer value to investors that are grappling with tax challenges, including tax-efficient Separately Managed Accounts, strategies for concentrated stocks and specialized insurance products.

In our view, two significant trends have helped to shape the investment landscape over the past decade: First, investors have increasingly moved their public equity dollars to low-cost, passive investments. Second, we've seen a growing allocation to private markets. A common theme across both trends has been a desire by investors to improve tax efficiency. Within public markets, select investors have taken the quest for tax-efficiency to new levels through custom, tax-managed Separately Managed Accounts (SMAs), strategies for concentrated stock positions and, in private markets, by allocating capital to portfolios within insurance vehicles. In this paper, we explore the benefits of tax-efficient SMAs, management of low-cost-basis single-stock exposure, and the characteristics of Private Placement Life Insurance (PPLI) policies and Private Placement Variable Annuities (PPVA) in seeking to achieve investment goals.

Public Market Exposure Through SMAs

SMAs, which allow investors to directly invest in a portfolio of individual securities rather than use commingled products like mutual funds or ETFs, unlock the potential for improved after-tax returns and tailored investment solutions to aid families with generational wealth planning. Their ability to capitalize on market volatility by opportunistically realizing capital losses can offset gains generated elsewhere in a portfolio, reducing investor tax liabilities and supporting greater potential compounding of capital over time.

Let's take a step back to examine differences between commingled investment vehicles such as mutual funds or ETFs and custom SMAs:

Customization. Mutual funds and ETFs cannot be customized given that they are commingled, or pre-packaged, investment vehicles. SMAs allow investors to customize their portfolios according to their specific needs and risk tolerance. This includes the ability to take into account the tax implications of specific trades or exclusions of certain securities.

In-Kind Funding. Commingled investment vehicles such as mutual funds and ETFs must be funded with cash. For someone already invested in the market, this may require selling an existing investment and realizing associated tax gains before reinvesting, potentially reducing the amount available for compounding over time. Custom SMAs can accept existing securities, potentially reducing the transition tax cost and keeping more dollars invested after the transition.

Tax-Loss Harvesting. SMAs can take advantage of tax-loss harvesting of individual stock holdings, providing the ability to offset capital gains tax liability. This is more difficult with ETFs because they are structured as a single security, and losses realized by the portfolio manager in selling the underlying stocks cannot be passed through to the investor.

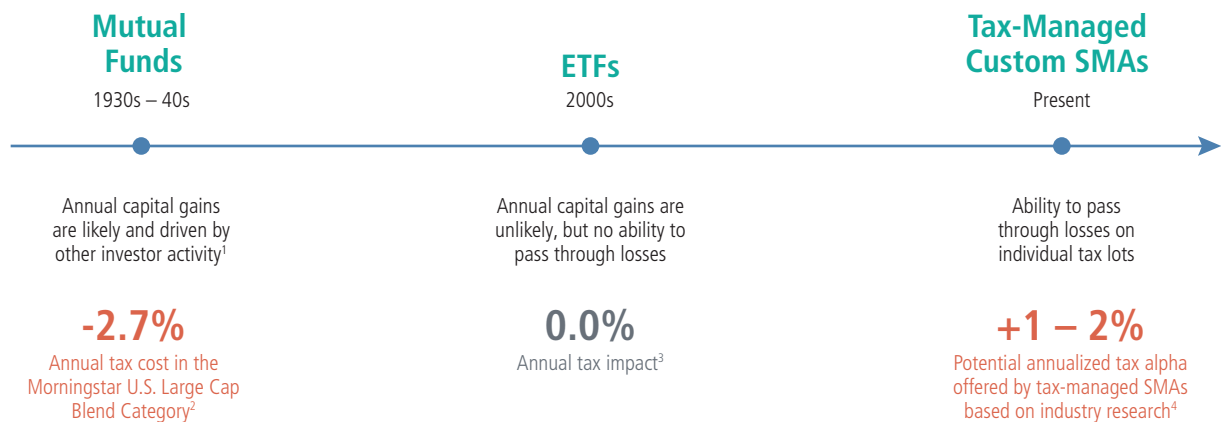
Avoidance of Capital Gains Distributions. Whereas mutual funds and ETFs may pass through capital gains in a given calendar year based on the decisions of the portfolio manager or trades from other investors in the vehicle, gain distributions from SMAs can be controlled by the investor.

How can you quantify the difference between these investment vehicles? Morningstar now publishes data to help taxable investors understand what we believe truly matters: after-tax returns. We looked at the 10-year annualized "tax drag" of the U.S. Large Cap Blend category for mutual funds, which shows the difference between after-tax and pre-tax return. We found the average annualized tax drag of U.S. Large Cap Blend mutual funds to be -2.7%. ETFs generally benefit from what is called "creation/redemption," allowing for shares at a gain to be removed without realization, so it is reasonable to assume 0% tax drag.

As mentioned above, custom tax-managed SMAs are able to both defer gains and pass through excess realized losses based on each investor's guideline. This method of tax management in SMAs has been shown to result in potential "tax alpha" of 1 – 2% annualized.

EVOLUTION OF INVESTMENT VEHICLES

Directly holding individual stocks in an SMA can provide investors greater control over their after-tax outcomes.



Source: Morningstar, Neuberger Berman. As of June 30, 2023.

¹ Cost basis is commingled with other investors, and trading/redemptions can cause securities to be sold at a capital gain, after offsetting capital losses, which is then passed through to all investors.

² Average annual tax cost, which is calculated as the difference between after-tax and pre-tax returns within the Morningstar U.S. Large Cap Blend category over the last 10 years. The U.S. Large Cap Blend category was selected because it is the largest Morningstar category by AUM.

³ ETFs typically avoid gain realization due to the favorable security creation/redemption process of ETFs, resulting in zero impact on taxes.

⁴ Shomesh E. Chaudhuri, Terence C. Burnham and Andrew W. Lo., 2020, "An Empirical Evaluation of Tax-Loss-Harvesting Alpha," *Financial Analysts Journal* 76:3, 99–108. This is an independent industry resource; Neuberger Berman has no affiliation. There is no guarantee that tax management of client assets will result in increased after-tax returns; results will differ based on individual investor circumstances.

See additional disclosures at the end of this paper.

Tax management has two key components: tax-loss harvesting and the deferral of gain realization. The value of loss harvesting is relatively straightforward. Assuming there are capital gains to be offset, the total amount of losses can be multiplied by the investor's tax rate to determine the tax savings. The value of deferring capital gains can be a bit more nuanced, but we believe it is equally important: Every dollar of taxes not paid in the current year remains invested in the market and compounds over time. Consider below the value of \$50,000 tax savings compounding over time with the market.

VALUE OF COMPOUNDING

Annualized Market Return	\$50,000 Tax Savings Invested in the Market Over	
	10 Years	20 Years
5%	\$81,445	\$132,665
7%	\$98,358	\$193,484
10%	\$129,688	\$336,375

Source: Neuberger Berman.

Maximizing the Benefits of Tax Management

If you have already introduced tax management to your equity portfolios, we would offer a few ideas for maximizing its benefits:

Frequency of loss harvesting. Whether trading positions once a year, or systematically on a more frequent basis, we believe there is value to be had in tax-loss selling. That said, we think that investors can benefit from an approach that seeks to systematically realize losses every two weeks, with daily review of portfolios to capitalize on higher volatility when it occurs within the two-week period. This approach balances the desire to realize losses and maximize after-tax wealth with the impact of wash-sale restrictions that such trading can create, potentially leading to dispersion from the target benchmark.

Tax-loss harvesting is not limited to down markets; it thrives in upward-trending markets with stock performance dispersion. As discussed in our publication, "[Hidden Value: Tax-Loss Harvesting in Up Markets](#)," even in strong years like 2024, individual stock volatility can provide opportunities for tax savings.

Expanding to active. Many investment managers have limited the scope of systematic tax-loss harvesting to core equity exposures, in what is often referred to as direct indexing. While this can be valuable, investors may also wish to employ tax management when implementing fundamental or quantitative active-equity portfolios. Consider that the reason for using an active portfolio manager is often to identify stocks that can increase in value and then be sold at a gain, which inherently creates tax costs that can reduce after-tax investment returns. A manager who considers cost basis and tax rates when trading an active equity portfolio can seek to protect, or even enhance, pre-tax alpha on an after-tax basis.

Optimized charitable giving. Rather than donating cash, the investor can make charitable donations go further by gifting appreciated stock positions. Such gifting removes a potential tax liability while the charity benefits from receiving the full value of the security. If securities are gifted in lieu of cash, using the latter to purchase new positions in the tax-managed portfolio can afford new opportunities for tax-trading in the future.

Long/Short extensions. A long/short investment portfolio takes long positions in securities expected to appreciate and short positions in securities anticipated to decline in value. An example of a long/short portfolio may be structured as 130% long equity and 30% short equity.

The primary objective of a long/short portfolio is to seek improved pre-tax performance. However, there is also the potential for significant after-tax benefits. By combining long and short positions, these strategies create increased opportunities for tax-loss harvesting regardless of market direction.

This approach may be particularly suitable for investors with substantial capital gains to offset, such as those preparing for a business sale or receiving large private equity distributions, and those looking to renew tax benefits of an appreciated portfolio. However, it is important to consider the trade-offs, including higher costs, increased complexity and additional risks from the use of leverage.

Concentrated Stock Strategies

Dealing with outsized, low-basis stock positions is a common challenge for families. Such positions can be a significant contributor to portfolio risk, but often remain in place due to the potential tax consequences of selling or for sentimental reasons (e.g., if company stock generated the family's wealth). In many cases, you see a combination of both. With a top U.S. long-term capital gains rate of 23.8% (including the ACA investment surtax), and upwards of 37.1% for those in the highest taxing state (California), taxes associated with a sale can be an imposing hurdle to overcome, leaving only 63 – 76% of initial assets to reinvest after the taxes are paid.

Historically, few effective investment solutions have been available to address the tax hurdle associated with selling single-stock positions. "Staged selling" is the most common approach, in which the family sells only the amount for which it is comfortable paying taxes in a given year and repeats the process annually. This limits the amount of tax owed, but also limits the degree of diversification achieved by the sales.

Exchange funds are another industry tool used to address concentrated stock positions, accepting different stocks from multiple investors to create a more diversified portfolio over time. Each contributor receives a partnership interest in the fund without incurring immediate tax consequences. Such funds, however, are only a tax-deferral vehicle, as eventually the original stock, or a basket of stocks, will be returned to the investor with their original cost basis.

An alternative approach is to simply pay down the tax bill, eliminating the future tax liability, and diversify into a broader equity portfolio. However, using the sale proceeds to pay the tax can reduce the capital available to reinvest. By the same token, in a higher interest rate environment, borrowing or employing margin to pay the taxes has become less appealing.

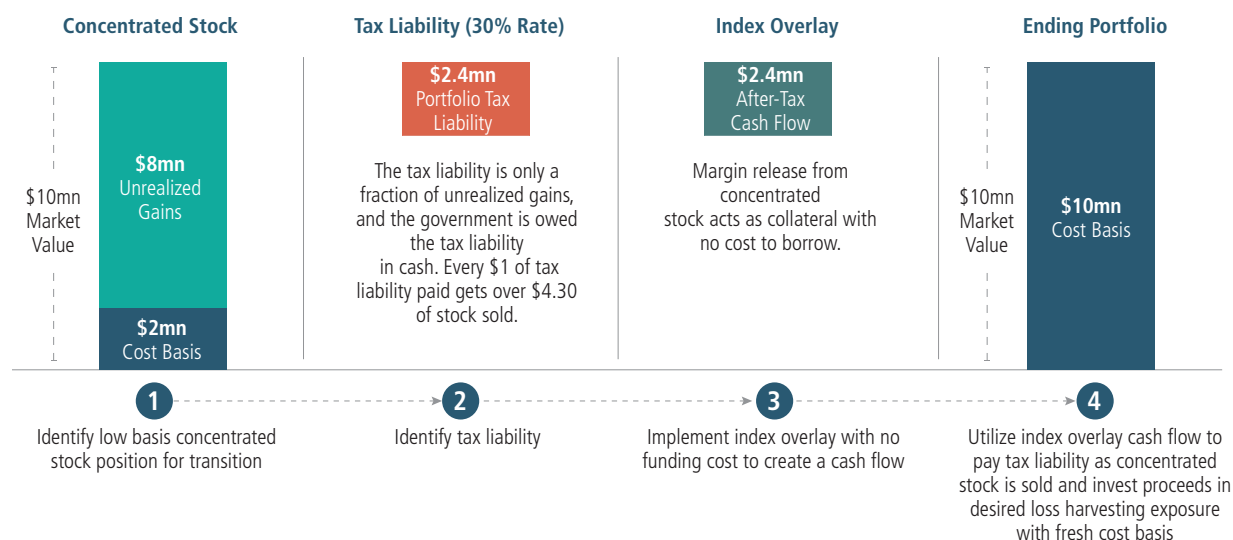
Margin Release

To create a cash-generating investment, you can instead access an underutilized feature of a concentrated stock position: “margin release,” but without actually going “on margin.” Margin release is akin to borrowing power, but unlike the regular utilization of margin, it has no direct associated costs.

Using margin release to collateralize an investment that requires no cash funding (i.e., an overlay) is a capital-efficient way to generate income that can be used to pay the tax bill from selling the stock. Even in the most extreme scenario of having a zero-cost-basis position, every dollar of margin release-backed income can pay the tax bill associated with selling approximately \$3 – \$4 of stock. A higher cost basis and/or lower tax rates create a smaller tax liability, allowing for an even greater ratio of stock sold to tax liability paid.

This process can effectively convert a dormant asset on the family balance sheet to a productive investment allocation. When coupled with investing the proceeds from selling the concentrated stock into a tax-managed equity portfolio, the timeline to exiting the position can become shorter due to enhanced opportunities to harvest losses that can offset taxable sales. At Neuberger Berman, we call this combined solution Dynamic Concentrated Stock Management (DCSM), the structure of which is outlined below.

ILLUSTRATIVE EXAMPLE: UTILIZING MARGIN RELEASE



Source: Neuberger Berman.

DYNAMIC CONCENTRATED STOCK MANAGEMENT: KEY STEPS

Step 1: Open Index Overlay Account

Family utilizes margin release from its stock position to start writing index put options.

Step 2: Generate Cash Flow From Overlay

Options generate income to pay the tax bill from selling down concentrated stock; when options are not profitable, the family has a realized loss that can be used to sell down the position. The income from index options is relatively tax-efficient, at 60% long-term and 40% short-term capital gains.

Step 3: Transition to Diversified Portfolio

Proceeds fund a tax-managed equity portfolio, which then seeks to opportunistically realize losses to further offset tax liabilities from the sale of the concentrated stock.

Steps 1 – 3: Repeat

...until the family has exited the stock position to the desired extent.

Outcome:

The family has a diversified equity portfolio without having to pay for taxes or funding out of pocket. By our estimate, the approach can help transition about 50% of a zero-basis stock position within four to eight years.

In addition to no-cash funding and the elimination of the tax liability, benefits of this approach include flexibility around the timing of sales and the type of equity exposure funded with the proceeds. Active or passive, U.S. or international, large cap or small cap, investors can control and adjust the resulting exposure while maintaining a systematic tax loss harvesting overlay that helps offset the tax liabilities they face.

In our view, holding a concentrated stock position with low-cost basis is a “good” problem to have: It means the family has benefited from holding a stock purchased at an opportune time and/or representing a successful company. That said, markets are unpredictable, and diversification has shown to be a prudent way to protect and grow wealth over the long term. The DCSM approach is meant to serve as a way to remove key hurdles, such as taxes, that stand in the way of aligning the family investment portfolio with long-term wealth objectives.

Private Markets Exposure Through Life Insurance

Private markets have gained significant traction among investors seeking attractive return potential with relatively low correlation to traditional public market assets. However, as with public investments, taxes can pose challenges, reducing the returns that fully reflect the economic success of the underlying investments. For taxable investors, asset location plays a critical role in optimizing returns. Specialized insurance products, such as Private Placement Life Insurance (PPLI) and Private Placement Variable Annuities (PPVA), can offer meaningful advantages for qualified investors, making them powerful tools in a tax-efficient investment strategy.

ILLUSTRATIVE EXAMPLE: TAX EFFICIENCY OF PPLI AND PPVA

The following table highlights the potential tax efficiency of PPLI and PPVA compared to taxable accounts. As you will see, a taxable investor with assets generating a 10% per annum return will only have a net after-tax investment income of roughly 4.5% in a high income-tax state such as New York or California. These solutions enable a taxpayer to compound returns on either a tax-deferred or tax-free basis, depending on the structure.

	Taxable Investor			PPLI	PPVA
	California	NYC	Texas/Florida		
Gross Investment Return	10.00%	10.00%	10.00%	10.00%	10.00%
Federal Tax Rate	(4.08%)	(4.08%)	(4.08%)	0.00%	(2.04%)
State/City Income Tax	(1.33%)	(1.35%)	0.00%	0.00%	
Annualized PPVA/PPLI Fees	0.00%	0.00%	0.00%	(0.58%)	(0.50%)
Net Investment Return	4.59%	4.57%	5.92%	9.42%	7.46%

Source: Winged Keel Group. Net level annual rate of return of 10%. See the assumptions and disclosures at the end of this paper, which are an important part of this display.

Private Placement Life Insurance: A Tax-Efficient Solution

PPLI is an advanced insurance product tailored to wealthy individuals seeking to combine the benefits of life insurance with access to private market investments. Unlike traditional life insurance policies, which primarily focus on providing a death benefit, PPLI policies enable policyholders to invest in a broad range of complex assets, including private equity, private credit, hedge funds and real estate.

The structure of PPLI is designed to maximize tax efficiency. The policyholder contributes premiums to the insurance policy, which are then allocated to Insurance Dedicated Funds (IDFs) or Separately Managed Accounts (SMAs). These investment vehicles are managed by professional investment managers to align with the policyholder's objectives.

The PPLI structure typically provides the following advantages:

Tax-free growth. Investment returns, including dividends, interest and capital gains, grow on a tax-free basis. This means that policyholders do not incur taxes on the growth of the investments while the policy remains in force, providing the potential for enhanced capital compounding over time. PPLI is particularly advantageous for assets that would otherwise generate high levels of income taxable at ordinary income rates such as private credit or hedge funds because the tax-free structure shields their earnings from annual income taxes. Private equity, which typically benefits from capital gains rates, can also achieve more tax efficiency when held within a PPLI policy. The higher the returns of the underlying assets, the greater the compounding benefit.

Estate planning benefits. PPLI policies can be integrated into a broader estate plan. Upon the policyholder's passing, the death benefit is paid out to beneficiaries on a tax-free basis. This feature not only preserves wealth, but can also provide liquidity to help indirectly offset estate taxes, ensuring a smooth transfer of assets to heirs.

Tax-free withdrawals. Policyholders can access tax-free liquidity up to certain levels by making withdrawals up to their cost basis and taking loans against the policy's cash value, provided the policy remains in force. This flexibility enhances the utility of PPLI policies as part of a broader financial plan.

Investment flexibility. Policyholders can customize their investment strategies by selecting from a wide range of IDFs and SMAs, which include both traditional and alternative asset classes. This flexibility enables investors to align their portfolios with their long-term goals while accessing top-tier private markets managers and strategies, the number of which has grown over the past five years. This stands in contrast to the relatively limited investment options offered by traditional insurance products. In addition, assets within a PPLI account may be reallocated without triggering income tax liability.

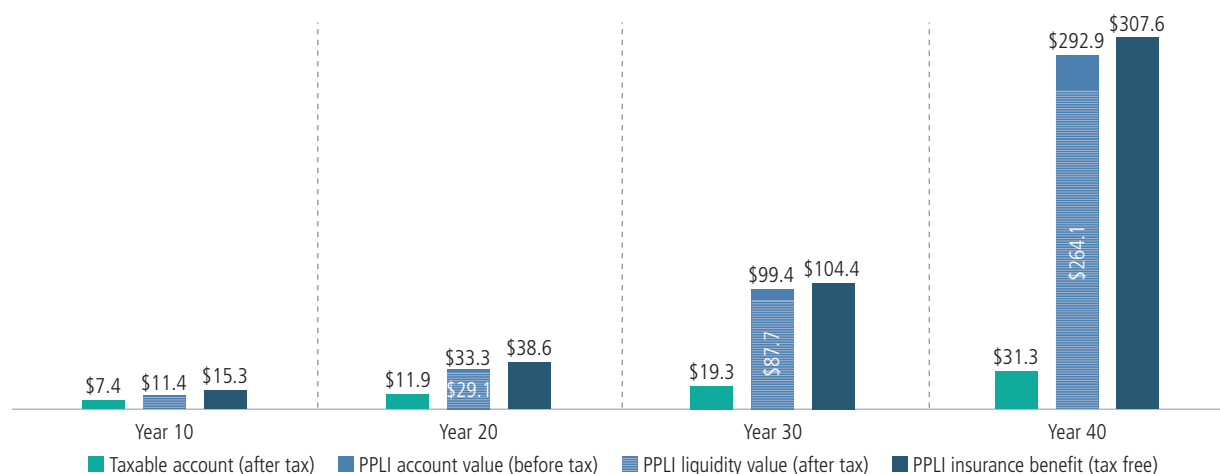
Simplified tax reporting. Unlike many traditional private market investments, PPLI policies do not generate Schedule K-1s, which are commonly associated with partnerships and can complicate tax filings. By eliminating the need for K-1s, PPLI simplifies tax reporting for investors.

Over the long term, the returns generated within a PPLI policy should be expected to significantly outperform those of an identical portfolio in a taxable account, even after accounting for additional fees.

The following display illustrates the potential compounding benefit of a PPLI account purchased by a 50-year-old male with an initial \$5 million value that grows at a 12% annualized rate of return. By year 10, the account value inside the policy would be \$11.4 million (with a \$15.3 million death benefit) compared to \$7.4 million for a taxable account. By year 30, the account value inside the policy would be \$99.4 million (with a \$104.4 million death benefit) compared to \$19.3 million for a taxable account.

ILLUSTRATIVE EXAMPLE: COMPOUNDING BENEFIT OF PPLI

Long-Term Growth of \$5 million assuming 12% annualized rate of return



Source: Winged Keel Group. Net level annual rate of return of 12%. See the assumptions and disclosures at the end of this paper, which are an important part of this display.

Private Placement Variable Annuities: A Complementary Tax-Deferred Strategy

Similar to PPLI, PPVA offers a tax-advantaged structure for individuals and families. However, there are key differences in how PPVA policies work and the benefits they provide.

A PPVA is an annuity contract where the investment component grows on a tax-deferred basis. Annuity holders contribute premiums to the annuity, which are then invested in IDFs or SMAs. The growth of these investments is not subject to annual income taxes, providing a significant compounding advantage over time. Similar to PPLI, assets within a PPVA account may be reallocated without recognizing income tax. Unlike PPLI, PPVA does not include a death benefit, but instead focuses primarily on the tax-efficient accumulation of wealth.

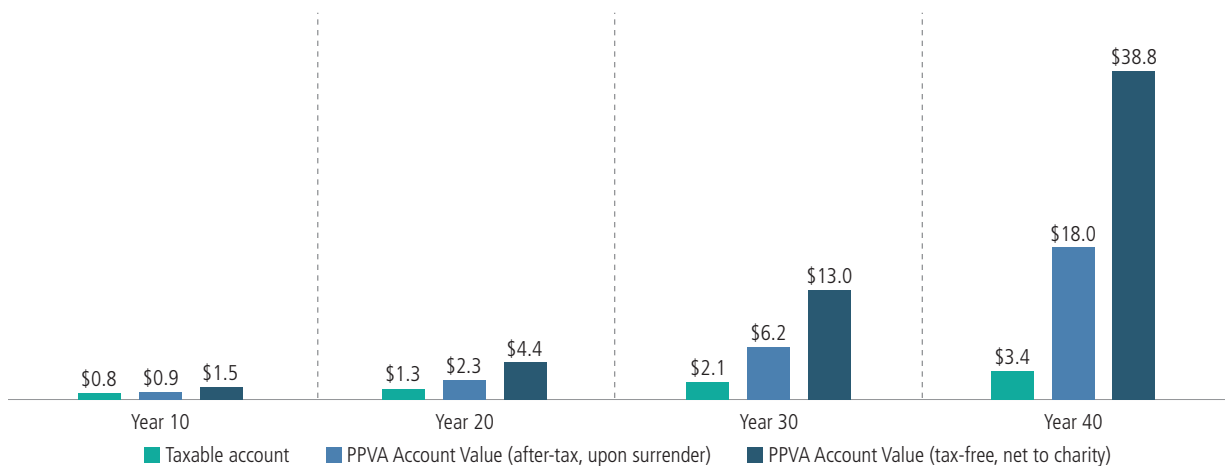
One of the distinguishing features of PPVA is the withdrawal structure: Distributions are taxed as ordinary income at the time of withdrawal, but the deferred tax growth allows for potentially higher returns over the life of the annuity.¹ For philanthropically inclined investors, we believe PPVA is particularly compelling. Policyholders can designate a charitable organization as the beneficiary of the annuity thereby eliminating taxation and helping to satisfy philanthropic objectives.

¹ There is an early withdrawal tax of 10% on the gain element of withdrawals taken before age 59½. Additionally, no withdrawals are required until age 95.

As shown below, a \$500,000 investment in a PPVA that generates a 12% annual rate of return would grow to \$1.3 million (after tax) by year 20 in a taxable account, \$2.3 million in a PPVA account (after tax, upon surrender) and \$4.4 million (tax-free) for charitable recipient, with return benefits continuing to grow over time.

ILLUSTRATIVE EXAMPLE: COMPOUNDING BENEFIT OF PPVA FOR INDIVIDUAL OR CHARITABLE BENEFICIARY

Long-term growth of \$500,000 Initial Investment, assuming 12% annualized rate of return (\$mn)



Source: Winged Keel Group. Net level annual rate of return of 12%. See the assumptions and disclosures at the end of this paper, which are an important part of this display.

KEY DIFFERENCES BETWEEN PPLI AND PPVA

While PPLI and PPVA share similarities in their tax-advantaged structures and their ability to invest in private markets, their purposes and mechanics differ, as shown below.

Feature	PPLI	PPVA
Primary Purpose	Combines life insurance with investment capabilities for tax efficiency and estate planning.	Focuses solely on tax-deferred investment growth, often used as a retirement or philanthropic tool.
Death Benefit	Includes a tax-free death benefit for beneficiaries.	Does not include a death benefit; instead, provides distributions during the annuity holder's lifetime.
Tax Treatment	Investment growth and death benefits are tax-free.	Investment growth is tax-deferred; gains are taxed as ordinary income when withdrawn.
Estate Planning	Designed to transfer wealth to heirs efficiently; can indirectly provide liquidity for estate taxes.	Less focused on estate planning; more oriented toward income generation and philanthropy.

How Neuberger Berman Fits In

Both PPLI and PPVA provide policyholders with access to IDFs, which allow investors to participate in strategies across private equity and private credit, potentially offering a high degree of customization and access to leading investment managers. Neuberger Berman has extensive experience in this space and manages \$3.2 billion in IDF assets as of September 30, 2024.

Considerations When Using PPLI or PPVA

While PPLI and PPVA may offer compelling benefits, they are not without complexities. Key considerations include:

Cost and complexity. These policies often involve higher fees, including mortality and expense charges, and require careful planning to ensure alignment with investor objectives.

Liquidity constraints. Private market assets are typically less liquid than public market securities, which may limit the investor's ability to quickly access funds within a PPLI or PPVA policy.

Regulatory risk. Changes in tax laws or insurance regulations could affect the benefits and flexibility of these products.

Above all, the effectiveness of these policies depends on proper structuring and compliance with tax regulations. In our view, collaborating with experienced financial advisors, insurance brokers, tax professionals and legal experts is essential to ensure alignment with investor goals and legal requirements.

Making the Right Choice

PPLI and PPVA offer unique opportunities for individuals and families to access private markets in a tax-efficient manner. While PPLI is often better suited for those seeking a combination of estate planning and investment growth, PPVA can be ideal for investors focused on long-term tax deferral and philanthropic objectives. By leveraging the investment flexibility, tax advantages and structural benefits of these products, investors can align their portfolios with their broader financial goals.

Conclusion

Developing a tax-efficient investment program is a multifaceted process that involves both straightforward and complex elements. For many investors, tax-efficient Separately Managed Accounts (SMAs) can serve as a foundational tool to optimize after-tax return potential. These vehicles can address critical objectives such as mitigating single-stock risk and maximizing active alpha.

When integrated with income-generating option strategies, SMAs can also play a pivotal role in offsetting taxes on realized gains, forming a key component of a comprehensive diversification strategy. In addition, leveraging the structural benefits of Private Placement Life Insurance (PPLI) products can provide tax-efficient access to private markets, further enhancing portfolio efficiency.

It is important to recognize that these strategies are highly sophisticated and require close collaboration with trusted advisors to tailor solutions to your unique circumstances. At Neuberger Berman, our professionals are available to consult with you on these and other considerations that may influence your investment portfolio.

Note on assumptions used in the displays on pages 7, 8 and 9: Over the trailing five, 10-, 15-, and 20-year periods, the Burgiss Global Private Equity Index generated annualized returns of 13.8%, 13.7%, 14.3% and 12.6% (pooled horizon IRR). The hypothetical examples presented show outcomes based on returns lower than those of the index to provide plausible yet conservative outcomes. These figures are not representative of Neuberger Berman's historical or projected returns. 100% of realized gains are taxed as short-term capital gains/ordinary income, and 0% of realized gains are taxed as long-term capital gains. Federal tax rate on short-term capital gains/ordinary income is 40.8% (37% plus 3.8% Medicare surtax). California state income tax rate is 13.30%. New York State and New York City combined income tax rate is 13.53% (9.65% state tax plus 3.88% city tax). PPVA is fully surrendered (or paid out) in 40 years, at which point deferred gains are subject to income tax at ordinary rates; assumes NYC resident is the annuitant. PPLI assumes the insured to be a 50-year-old male with a life expectancy of 40 years; the insured is classified as a standard nonsmoker life insurance risk. The analysis assumes tax rates do not change during the time period. Actual results would be subject to a number of economic, market, regulatory, and other factors that could materially affect this analysis, and potentially negatively affect returns. The assumptions are hypothetical in nature and there can be no guarantees that the historical performance of an investment, portfolio or asset class will have a direct correlation with its future performance. The benchmark performance is presented for illustrative purposes only to show general trends in the market for the relevant periods shown. The investment objectives and strategies of each fund in the benchmark may be different than the investment objectives and strategies presented herein, and may have different risk and reward profiles. A variety of factors may cause this comparison to be an inaccurate benchmark for any particular strategy and the benchmarks do not necessarily represent the actual investment strategy of a fund. It should not be assumed that any correlations to the benchmark based on historical returns would persist in the future.

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