



NEUBERGER BERMAN

Asset Allocation Committee Outlook 4Q20

Bracing for Winter, Looking Forward to Spring

The Asset Allocation Committee notes that an unusually high level of uncertainty, centered on the U.S. election and the path of the coronavirus, may cause elevated market volatility over the coming two to three months. On a 12-month view, however, members broadly favor riskier assets and increasingly seek to reflect a potential cyclical recovery and reflationary forces in their outlook. Doubts nonetheless persist about policymakers' ability to stimulate sustained growth and inflation.

ABOUT THE ASSET ALLOCATION COMMITTEE

Neuberger Berman's Asset Allocation Committee meets every quarter to poll its members on their outlook for the next 12 months on each of the asset classes noted and, through debate and discussion, to refine our market outlook. The panel covers the gamut of investments and markets, bringing together diverse industry knowledge, with an average of 28 years of experience.

COMMITTEE MEMBERS

Joseph V. Amato

Co-Chair, President and Chief Investment Officer—Equities

Erik L. Knutzen, CFA, CAIA

Co-Chair, Chief Investment Officer—Multi-Asset Class

Ashok Bhatia, CFA

Deputy Chief Investment Officer—Fixed Income

Thanos Bardas, PhD

Global Co-Head of Investment Grade

Timothy F. Creedon, CFA

Director of Global Equity Research

Alan H. Dorsey, CFA

Chief Investment Officer of Neuberger Berman Trust Company

Ajay Singh Jain, CFA

Head of Multi-Asset Class Portfolio Management

David G. Kupperman, PhD

Co-Head, NB Alternative Investment Management

Ugo Lancioni

Head of Global Currency

Robert Surgent

Senior Portfolio Manager—Multi Asset Class

Brad Tank

Chief Investment Officer—Fixed Income

Anthony D. Tutrone

Global Head of Alternatives

Market Views

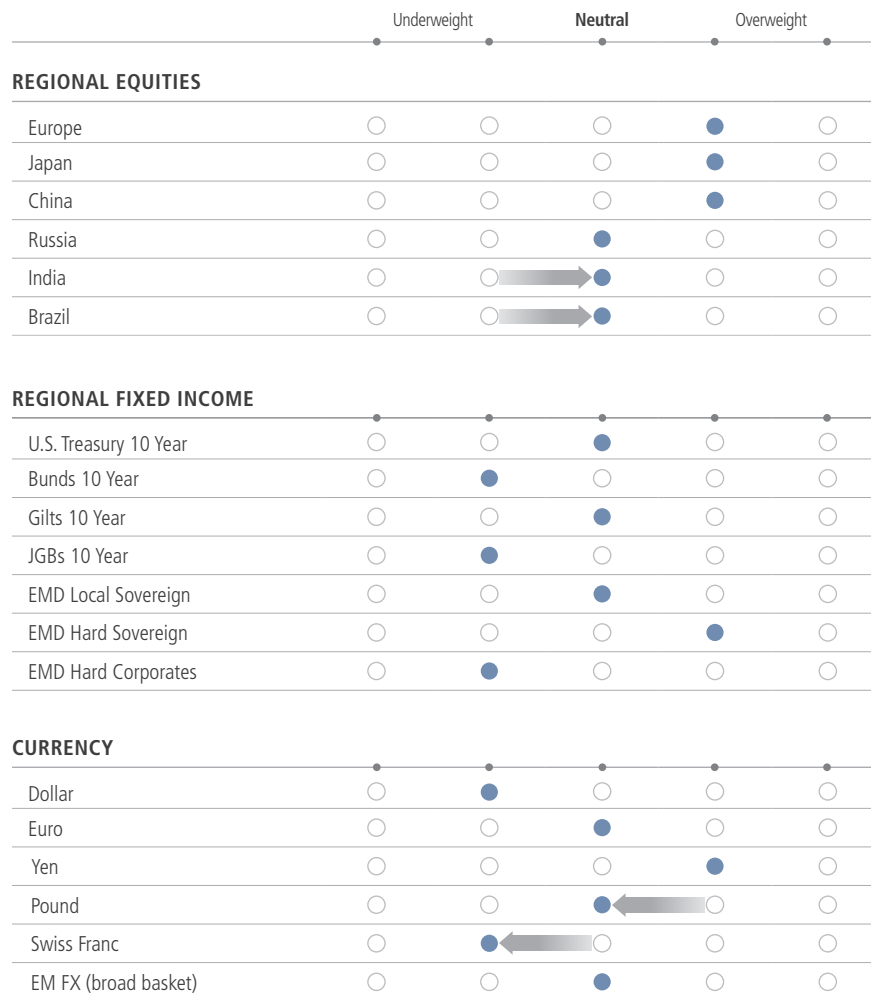
Based on 12-Month Outlook for Each Asset Class



As of 4Q 2020. Views shown reflect near-term tactical asset allocation views and are based on a hypothetical reference portfolio. Nothing herein constitutes a recommendation, investment advice or a suggestion to engage in or refrain from any investment-related course of action. See disclosures at the end of this publication, which include additional information regarding the Asset Allocation Committee and the views expressed.

Regional Focus

Fixed Income, Equities and Currency



“The potential for positive news on coronavirus vaccines in November or December makes the next few months really complex. We have seen investors take some risk off coming into the U.S. elections, but that would likely have been more decisive in the absence of the coronavirus story.”

Brad Tank | Chief Investment Officer—Fixed Income

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"Anticipation of much lower levels of uncertainty in 12 months' time—paired with the after-effects of unprecedented fiscal and monetary stimulus, the potential for another fiscal boost to come, and the Federal Reserve's new, more dovish policy framework—feed into this quarter's changes to our asset class views."

Erik L. Knutzen, CFA, CAIA

Chief Investment Officer—Multi-Asset Class

Bracing for Winter, Looking Forward to Spring

When our Asset Allocation Committee ("AAC" or "the Committee") met this quarter, discussion was characterized by a notable contrast in our views across three different time horizons. All Committee members acknowledge the sheer weight of uncertainty that we face over the next two to three months, centered on the U.S. election and the path of the coronavirus. On a 12-month view, however, there is broad consensus in favor of riskier assets, and an increasing willingness to reflect a potential cyclical recovery and reflationary forces in our outlook. Beyond that horizon, there is less consensus. Doubts persist about policymakers' ability to stimulate a return to sustained growth and inflation. As a result, while anticipated near-term volatility may present opportunities to position for an improvement in sentiment in 2021, AAC members are increasingly debating whether there is any turning back on the road to worldwide "Secular Stagnation."

The next two to three months present an unusually high level of potentially market-moving uncertainty. The long Brexit saga will come to a head. The funds of the innovative and controversial European Recovery Fund will begin to be disbursed. Summer stimulus packages will roll over and decisions will need to be made about whether and how to replace them. The practical implications of the recent changes to the U.S. Federal Reserve's monetary policy framework will begin to clarify. Above all, we face a contentious U.S. election and a resurgence of the coronavirus pandemic as we head into the northern hemisphere winter.

The complexity of this tangle of forces might explain why doubts have only recently crept into markets. Equity indices still appear buoyant even after recent selling. At this quarter's AAC meeting, the strongest consensus was that there is more downside than upside likely for equities and credit over the coming weeks, together with a strong dose of volatility.

Potential Volatility Over Three Months, Stability Over 12

There was, however, almost as broad a consensus that this winter volatility could be an opportunity to add risk, based on more optimistic views for markets over a 12-month horizon. Over this timeframe, most AAC members expect the uncertainties that loom large today to be resolved.

On the virus, even if a vaccine is not moving into production on this timeframe, it seems likely that effective therapeutics will be deployable. Should progress on both these fronts be slower than anticipated, we are still likely to have become more adaptive in our behaviors—more mindful of social distancing, better at shielding the most vulnerable, more efficient in testing, tracking and tracing. We think it improbable that the economies of Europe and North America will be less open this time next year than they are now.

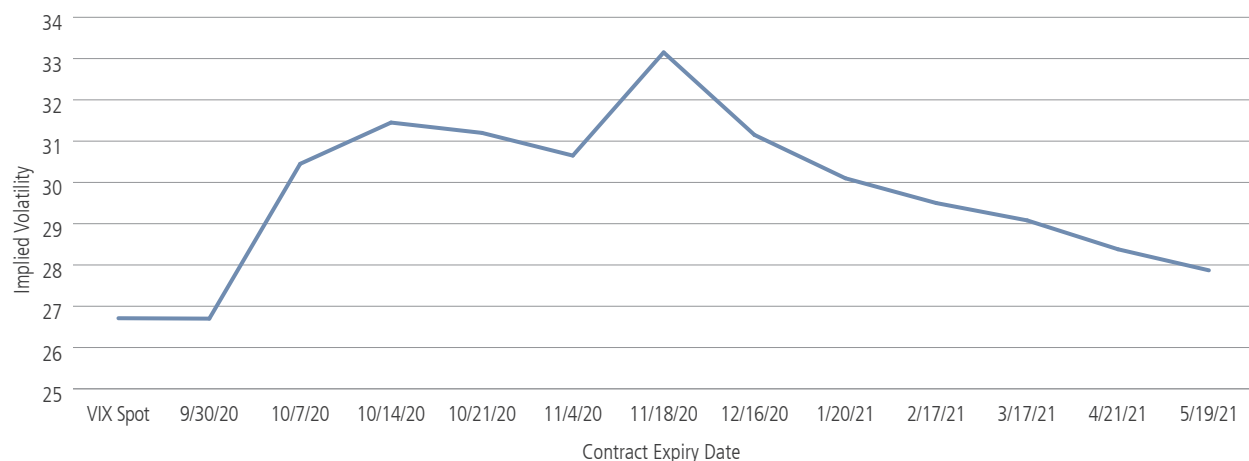
On the election, talk of a delayed or disputed result and a partisan tussle over the next appointment to the U.S. Supreme Court could trigger volatility following the vote on November 3, as it did before

Al Gore conceded to George W. Bush six weeks after the vote in 2000. Barring a major constitutional crisis, however, the result will be settled by January. The AAC notes that the economic impact of the respective probable outcomes would take time to unfold, and that the differences may not be as significant as projected in the short term (see *Up for Debate: How might one position for the U.S. elections?*).

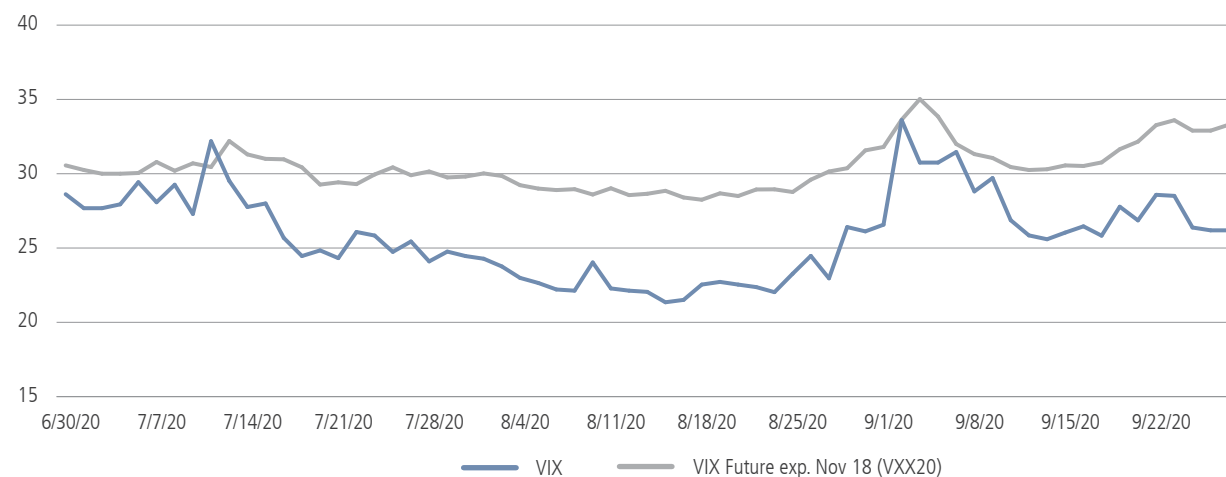
Futures on the CBOE S&P 500 Volatility Index (VIX) have been pricing for an increasingly large spike in implied volatility in the period immediately following the election: while the spot price for the VIX has declined since hitting a high at the beginning of September, the price for the futures contract expiring on November 18 has been climbing again recently. Implied volatility then tails off steadily into the second quarter of next year.

VIX FUTURES PRICING FOR A POST-ELECTION SPIKE IN VOLATILITY

CBOE S&P 500 Volatility Index (VIX) futures contract pricing on September 28, 2020



Pricing of the CBOE S&P 500 Volatility Index (VIX) and the VIX Future expiring on November 18, 2020



Source: FactSet, CBOE. Data as of September 28, 2020.

Getting Ready to Favor Risk

Anticipation of much lower levels of uncertainty in 12 months' time—paired with the after-effects of unprecedented fiscal and monetary stimulus, the potential for another fiscal boost to come, and the Federal Reserve's new, more dovish policy framework—feed into this quarter's modest changes to our asset class views.

We continue to disfavor ultra-low-yielding core government bonds worldwide. We have downgraded our view on investment grade fixed income to neutral as spreads have pulled tighter over the summer. We maintain our more positive view on high yield, particularly higher quality issuers and "fallen angels," which we believe are more attractively valued and are likely to be more sensitive to a recovery in sentiment.

Similarly, we have downgraded our view on U.S. large-cap equity to an underweight following strong performance through August and recent flagging momentum, while maintaining more positive views on the more economically sensitive U.S. small-cap and non-U.S. equity markets.

This is less about advocating a rotation from defensive to more aggressive asset classes than about pulling back where valuations are stretched—particularly defensive-growth stocks and anything perceived as a "COVID beneficiary." Managing risk now may help to preserve dry powder to deploy during the anticipated volatility of the coming two to three months.

A pattern is clear in Committee members' "opportunistic" ideas for this period of anticipated volatility, however. Alongside put option writing to monetize spikes in implied volatility, that list includes: Treasury Inflation Protected Securities (TIPS); cyclical equities versus defensive growth; emerging markets debt and markets with strong organic growth, particularly China; and commodities, with a bias to reflation beneficiaries such as industrial metals, as well as gold and other precious metals as a hedge against devaluation of fiat currencies. We clearly anticipate upgrading our views on reflation-sensitive assets during any sell-offs over the coming months.

The Committee's consensus is not universal. Some members remain more favorable toward large-cap defensive growth, and the debate focused in on the recent performance of financials.

The skeptics ask, if there is a real prospect of a growth and inflation recovery in 2021, with steepening yield curves and rising financial, business and credit activity, why is this not already evident in higher longer-dated yields and stronger performance from bank stocks?

The majority on the Committee counters that there is a significant difference between the move from a closed to a partially re-opened economy and the move from a partially to a fully re-opened economy. They point to strength in the U.S. housing market, which is an important support for local banks. Those working in the private markets point to an unusually full mergers-and-acquisitions deal pipeline for August, indicating that there could be a lot of banking revenue to be won over the next six to 12 months.

Lingering Doubts About Sustained Growth and Inflation

Nonetheless, the skeptics are tapping into deeper concerns that are shared by other AAC members—and many of the clients we work with. The prospect of markets getting a 12-month boost from improving expectations for growth and reflation is different from a return to sustained realized growth and inflation, about which there is considerably more doubt.

On the one side, we have seemingly enormous global disinflationary forces in the form of an aging demographic and ever more rapid technological advances in robotics and artificial intelligence. These forces mean there is not enough demand for businesses to pass on higher prices, and that even near-full employment fails to push up wages. On the other side, there will soon be many trillions of dollars of debt to be inflated away, and fiscal and monetary authorities appear determined to make that happen.

The combined force of fiscal and monetary stimulus, and perhaps even the creative destruction of the COVID-19 shock, means that the last exit off the road to worldwide "Secular Stagnation" may still be ahead of us. Overall, like many other investors, the AAC thinks it may be behind us and currently sides with the disinflationary forces. A decade of lost inflation in Europe and three decades in Japan serve as case studies. Much of this year's huge budget deficit will have been spent on keeping labor away from the workplace. While U.S. market inflation expectations have been edging upwards, they have done so in line with weakness in the U.S. dollar—suggesting that, if inflation does return, it will owe more to the cost-push of debased currencies than to the demand-pull of robust economic activity and consumption.

Commodities, TIPS, hard-currency emerging markets debt: positive views on these exposures would follow from either cost-push or demand-pull inflation. Over the next two quarters of potential volatility, the AAC anticipates opportunities to upgrade its views on these as well as other cyclical, economically sensitive assets, on a 12-month horizon. Whether those views stay in place over a longer timeframe will largely depend upon the ability of our stimulus efforts to get us off the road to Secular Stagnation. We think 2021 may begin to reveal the answer to this critical question.

UP FOR DEBATE:

HOW MIGHT ONE POSITION FOR THE U.S. ELECTIONS?

Looking ahead to the U.S. elections in November, investors have some apparently straightforward questions to ask: What are the probabilities of the various potential outcomes, what is the expected economic impact of each outcome, and to what extent are those priced into markets?

The task is anything but straightforward, of course.

The signals on potential outcomes are very mixed. Equity markets have weakened over the past month or so and the U.S. dollar has been strengthening: these have tended to be signs of a close election to come, but also bad omens for the incumbent—and this time around, it's the incumbent who is trailing in the polls. In swing states, Donald Trump's polling appears to be fluctuating in line with the prevalence of coronavirus cases, while the sudden opening of a Supreme Court vacancy and the President's own COVID-19 diagnosis are unlikely to be the final late developments that could nudge opinion one way or the other.

Still, national polls and, more recently, betting markets have been moving in Biden's favor. When the AAC surveyed sell-side opinion, it found that, on average, Biden is given a 60%-plus chance of winning and that the odds of a Democratic "blue sweep" of the Presidency and both Houses of Congress have been rising rapidly. When we look at some of the economic and market forecasts that follow on from these projections, however, the picture still isn't clear. Some strategists have stated that a Biden win would negatively impact S&P 500 earnings by 10 – 12% and send Treasury yields back up, while maintaining their current S&P 500 Index price forecasts—implying an improbably large jump in valuation multiples from an already high level, or a significant increase in top line growth from cyclical sectors that represent a smaller percentage of the index than they did back in 2016.

In order to simplify the question, we identified what we see as the key fulcrum of the debate—the effect of a large fiscal stimulus versus the effect of higher taxes and tighter regulation—and set out our view of the likely impact on key assets should the market choose to make one or the other the longer-term determinant of prices.

In the event the outcome is seen as stimulus friendly, while that could initially be seen as growth-positive, it could have an adverse impact on equity sectors that have been leading the market recently. The larger initial move may be in underlying sectors. Long-dated U.S. Treasury yields are likely to rise initially, and permanently reset higher in the event of positive developments on a coronavirus vaccine. The dollar would be expected to weaken due to the inflationary impact, but it is possible that the market may regard the stimulus as positive for U.S. growth versus the rest of the world, benefitting the dollar, and therefore we believe a slow decline is more likely. Gold and other commodities are likely to benefit as stimulus is deemed both inflationary and potentially currency debasing over the longer term.

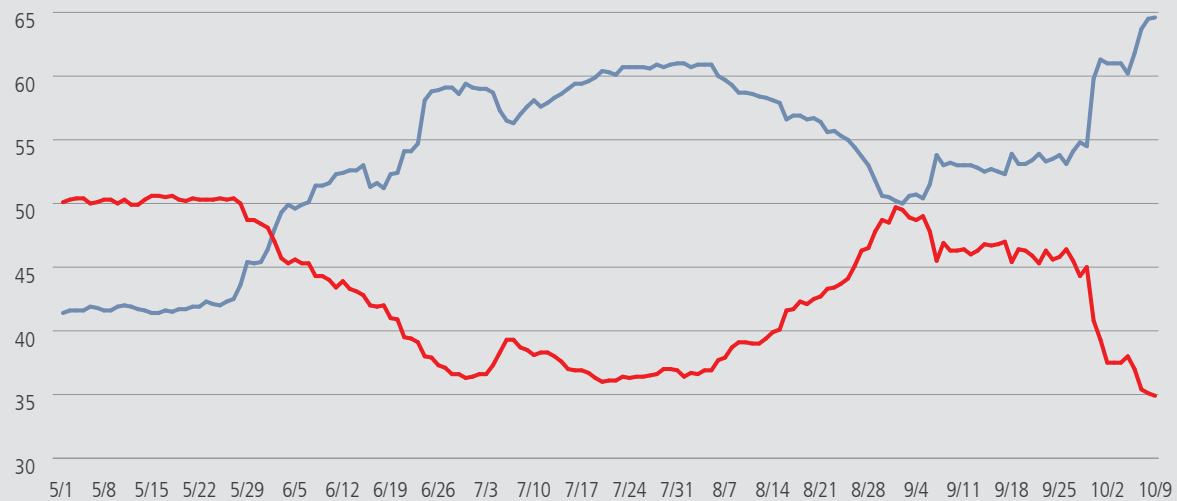
If the market makes tax and regulatory policy the key determinant of prices, growth stocks that have benefitted from accommodative tax policy, particularly tech, could underperform. U.S. equities would likely underperform non-U.S. developed market equities, perhaps quickly adjusting to a new equilibrium based on lower U.S. profitability. Treasury yields would likely remain low and perhaps even go lower, depending on views about how wide the U.S. output gap is, and the dollar is likely to weaken.

In the event of an election result that preserves something like the status quo, we believe that U.S. equities will outperform on relief at the absence of large tax hikes and tighter regulation. Continued outperformance from defensive growth stocks and credit is possible as Treasury yields are likely to remain low. This dynamic is likely to persist until a coronavirus vaccine is developed, at which point the debate will turn to how long cyclical stocks can maintain their outperformance in the face of the longer-term Secular Stagnation trends.

This framework assumes that each scenario occurs independently, whereas it is of course possible that markets price for the effects of stimulus in the shorter term before switching attention to the impact of higher taxes and tighter regulation in the longer term. Overall, it is also important to note that positive developments on a coronavirus vaccine would likely be more significant for markets than almost any election outcome.

BETTING MARKETS BREAK FOR BIDEN

Real Clear Politics Betting Average, May to October



Source: Real Clear Politics. The RCP Betting Average is derived from the online political betting market prices reported by Betfair, Bovada, Bwin, Smarmets, Unibet and Vbet. For illustrative purposes only.

With that in mind, the AAC attempted to pin down some guiding principles for the next two to three, likely volatile, months.

The first is to “stay close to home”—keeping risk levels light, and also recognizing that the efficacy of traditional risk models may be limited during a time of new unknowns. The second principle follows from the first: during sell-offs, we would look to upgrade views on assets we favor on a 12-month horizon, but we would need to see more attractive pricing than under more normal circumstances.

Specifically, a move in U.S. large caps that reflects a 10% decline in earnings per share with a 5% decline in multiples could be enough to move back to a neutral or overweight view. A significant

rise in long-dated Treasury yields could trigger a re-think of our underweight view there: selling Treasury put options might be an interesting way to implement the view, given that the price of interest-rate volatility is tending to rise in lockstep with yields at the moment. Any substantial sell-off in gold following the election could also be an opportunity to upgrade views, if the result is deemed stimulus-friendly.

Finally, while a reflationary environment could be favorable for equities, as we have noted, they are also sensitive to rising rates. As such, an inflation hedge in addition to gold could be useful as long as it can be carried at minimal cost: in our view, selling long-dated Eurodollars could be an option to consider.

FIXED INCOME

Investment Grade Fixed Income

- The Asset Allocation Committee ("AAC" or "the Committee") downgraded its view from overweight to neutral.
- Government bonds still appear very highly valued.
- Interest rates are likely to remain low for a long time and corporates are likely to maintain very conservative balance sheets, leading to a positive view on credit on a 12-month view.
- Spreads have continued to grind tighter over the summer, however, and valuations now appear full compared with high yield.

Developed Market Non-U.S. Debt

- The Committee maintained its underweight view.
- While rates in Europe and Japan are still below those in the U.S., rate cuts from the Federal Reserve have narrowed the differential and rates worldwide are likely to remain low for a long time.
- Positive news on moves toward a common fiscal response to the COVID-19 crisis must now be balanced with evidence of a resurgence of the virus in Europe, and growing risks of Brexit without an E.U.-U.K. trade agreement.

High Yield Fixed Income

- The Committee maintained its overweight view.
- An environment of low rates and conservative management of corporate balance sheets will be supportive of credit markets in general.
- While high yield could be one of the sectors hardest hit by the COVID-19 fallout, our estimate for the default rate over the next 12 months has declined meaningfully as credit markets have re-opened.
- The AAC remains most positive on high quality issuers and particularly "fallen angels."

Emerging Markets Debt

- The Committee maintained its overweight.
- Because emerging markets debt indices are heavily weighted to Latin American countries struggling with COVID-19, the asset class appears to be trading relatively cheaply.
- Emerging markets debt could benefit from U.S. dollar weakness, which we anticipate on a 12- to 18-month view, although caution is warranted in the immediate term.
- The AAC favors China onshore bonds: resilient at the height of the crisis, this market could prove an attractive, high-yielding source of exposure to the recovery.

GLOBAL EQUITIES

U.S. Equities

- The Committee further downgraded its view on U.S. large caps to underweight, while maintaining its overweight view on U.S. small and mid caps.
- U.S. large caps have led the rapid recovery in financial markets and now appear fully valued.
- The AAC believes a tilt toward higher-quality small caps is justified, given their more attractive valuations, and anticipates opportunities to add risk during the potential volatility of the next two to three months.

Non-U.S. Developed Market Equities

- The Committee maintained its overweight view after upgrading last quarter.
- U.S. large caps have led the rapid recovery in financial markets and now appear fully valued, whereas Japanese and European equities remain relatively cheap.
- European equities are also geared to global trade, and while the risk of a no-deal Brexit remains in place and there is evidence of a resurgence of coronavirus across the region, the AAC's view has improved following moves toward a common fiscal response to the crisis.
- Japan may be a source of higher-quality exposure to cyclical stocks and a revival in global trade than riskier emerging markets.
- Caution is warranted over the anticipated volatility of the next two or three months, but the AAC remains positive in its 12-month view.

Emerging Markets Equities

- The Committee maintained its neutral view.
- Many emerging countries still appear vulnerable to the coronavirus.
- There may be regionally specific opportunities such as exposure to China as it recovers from the virus impact ahead of other countries, as well as an opportunity to upgrade our overall view during the potential volatility of the next three months.
- Emerging markets could benefit from U.S. dollar weakness, which we anticipate on a 12-month view, although caution is warranted in the immediate term.

REAL AND ALTERNATIVE ASSETS

Commodities

- The Committee upgraded its view from neutral to overweight.
- While the near-term outlook is disinflationary and likely to be characterized by higher volatility, commodities could provide exposure to a surge in pent-up demand from consumers and manufacturers as uncertainty lifts next year.
- Lower levels of uncertainty and the potential for U.S. dollar weakness next year would likely be a tailwind for commodities.
- The asset class could benefit from higher inflation as a result of the current stimulus efforts—2021 could begin to tell us whether it is possible to stimulate our way to sustained growth and inflation.
- Gold and other precious metals could serve as a haven during volatility as well as a hedge against debasement of fiat currencies as authorities fight to generate inflation.

Hedge Funds

- The Committee maintained its underweight view.
- After providing much-needed ballast for portfolios through the worst of the COVID-19 crisis, liquid alternatives have less of a role to play as the recovery gains a firmer footing.
- Some uncorrelated strategies, such as insurance-linked securities, could still provide useful diversification over the anticipated volatility of the next three months.

Private Equity

- The Committee maintained its overweight view.
- Vintage years raised at the peak of public markets or in the early stages of recession have historically delivered among the best return profiles, albeit with wide dispersion.
- Companies that are highly exposed to coronavirus risk are no longer being transacted, which means that current deals are in robust businesses—the main risk is likely to concern valuations rather than operations.
- There are emerging opportunity sets in co-investments in corporate restructurings, private lending and distressed strategies, and arguably a multi-year opportunity in private equity secondaries.

Currencies

USD

- The AAC maintained its underweight view—but acknowledged the potential for dollar upside during the anticipated volatility of the next two to three months.
- The currency is still overvalued based on purchasing power parity (PPP) metrics.
- U.S. interest rates are likely to remain low for a long time, and the Federal Reserve has adopted a new, more dovish policy framework, which could weaken the dollar as risk appetite recovers.
- The twin deficits that the U.S. runs are likely to be exacerbated by stimulus efforts to counter the economic impact of COVID-19.
- Risks to the view include the continued growth differential with the rest of the developed world, which may rebound slightly as the U.S. re-opens its economy and applies more fiscal stimulus; the potential for risk appetite to deteriorate still further should COVID-19 infections continue to rise or markets position for elevated U.S. political risk; the short position overall that market participants have now adopted; and the currency's historical tendency to rally leading into elections.

EUR

- The AAC maintained its neutral view.
- The rally that met the proposals for a common European fiscal response to the COVID-19 crisis now faces the headwind of all Eurozone countries needing to ratify the plan, and market participants are very long the currency.
- The European Central Bank's very accommodative stance is not supportive.
- The Scandinavian currencies may be a more attractively valued way to gain exposure to improved growth sentiment in Europe.
- However, the euro remains undervalued based on PPP metrics and the currency would likely have positive exposure to any signs of a global cyclical recovery.

JPY

- The AAC maintained its overweight view.
- Japan runs a current account surplus and exposure to the recovery in global trade.
- Both PPP and real exchange rates suggest the JPY is undervalued, which means long yen is likely to remain attractive during any return of risk aversion.
- Very low yields globally make Japan's low rates less discouraging, while hedged foreign investments are at their most attractive levels for years for JPY-based investors.
- Risks to the view include funding stresses within Japan and a decline in demand for havens should sentiment rebound.

GBP

- The AAC downgraded its view from overweight to neutral.
- The GBP appears undervalued based on PPP measures.
- Falling yields globally have improved interest rate differentials in GBP's favor.
- However, there is rising political uncertainty as the Brexit process comes to a head; and high exposure in the U.K. to the downturn in retail, tourism and services due to the COVID-19 outbreak.

CHF

- The AAC adopted an underweight view.
- The Swiss franc is still very overvalued on PPP measures and market participants are very long in their positioning.
- The joint fiscal response in Europe has removed the euro break-up tail risk for the time being.
- The franc is one of the most attractive funding currencies for global carry trades.
- Risks to the view include the currency's status as a potential haven from political uncertainty, particularly around Brexit; a persistent current account surplus and the potential benefit to Switzerland's large pharmaceuticals sector from coronavirus; and low yields globally.

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FIRM HEADQUARTERS

New York
800.223.6448

REGIONAL HEADQUARTERS

Hong Kong
+852 3664 8800

London
+44 20 3214 9000

Tokyo
+81 3 5218 1930

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Neuberger Berman
1290 Avenue of the Americas
New York, NY 10104-0001

www.nb.com