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SOLVING

Market Insights and Outlooks from Senior Investors at Neuberger Berman

FOR 2015

Serious Investing™
Since 1939

Neuberger Berman

is a 75-year-old private, independent, employee-controlled investment manager. The firm manages equities, fixed income, private equity and hedge fund portfolios for global institutions, advisors and individuals. With offices in 17 countries, Neuberger Berman's team includes more than 2,000 professionals. Tenured, stable and long-term in focus, the firm fosters an investment culture of fundamental research and independent thinking.

More Complexity, More Opportunity

Change is constant in the markets, for better or worse.

Certain opportunities, once deep and rich, mature as money flows in, while new, developing circumstances may not be well understood or readily accessed, creating attractive entry points for investors. Meanwhile, underlying fundamentals can deviate—incrementally or all at once—upsetting the apple cart and requiring fresh assessments of the market landscape.

Today, investors are grappling with multiple dynamics that may complicate the search for risk-adjusted return: The divergence of central bank policies, the precarious state of the European economy, the weakness of oil prices and the strength of the dollar are just a few key examples. They have been accompanied by myriad political complications—from Russia to Iran to China to Brazil—that may or may not have broad ramifications for the markets.

The good news is that this array of influences reflects the opportunities created in the current global landscape, underscoring the importance of research and analysis and contributing to a growth in investment choices. Despite the seeming end of the secular bull market in bonds, for example, investors can now seek yield potential through private markets or the growing emerging markets debt sector. Although equity markets have enjoyed a three-year advance, increased volatility should provide additional opportunities for active investors. And while China's equity market until recently disappointed, earnings growth and political reforms may set the table for continued resurgence. We see many situations like these in the current markets.

As portfolio managers, our historical grounding in fundamental research and ideas-driven investment analysis make us well-equipped to assess rapid global changes, and to seek opportunities across asset classes on a global basis. *Solving for 2015,* our annual market outlook, reflects this broad orientation, providing our views on equities, fixed income and alternatives. I hope you find the publication to be a valuable resource as you consider investment strategies for the coming year.

Sincerely,

Joseph V. Amato
President and Chief Investment Officer
Neuberger Berman

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Investors' Roundtable:

GLOBAL REBOOT FOR THE INVESTMENT LANDSCAPE

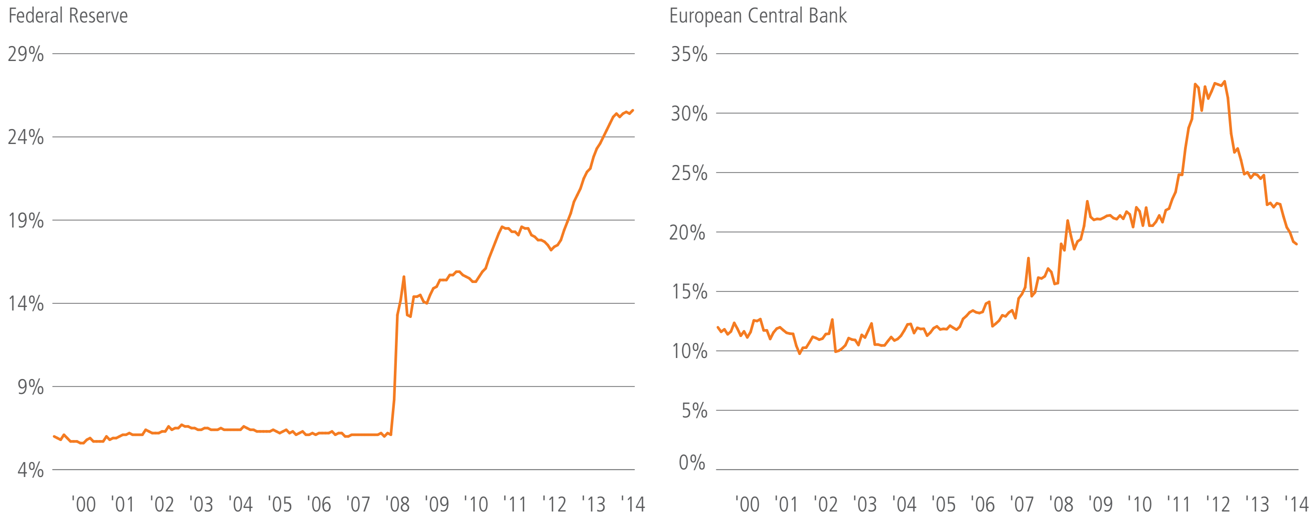
In many ways, 2014 has been a year of surprises for the capital markets. Initial consensus views on global growth and the upward path of interest rates have largely been revised; geopolitics have weighed heavily in price volatility; and regional markets have tended increasingly to go their own way. In this shifting environment, Neuberger Berman's senior investment leaders gathered to discuss key themes for 2015, including current challenges faced by investors, and prospects for generating returns and managing risk in the year ahead.

Erik L. Knutzen, Chief Investment Officer—Multi-Asset Class: In the current climate, a key issue that many investors must deal with is the generally low return outlook across markets. Low interest rates are behind pessimism about bonds, while slow economic growth—a key component in corporate earnings—is tempering enthusiasm for equities. However, an interesting aspect of this is that, regionally, economic prospects are quite diverse: The U.S. and U.K. appear to be leading developed markets, Japan is on the cusp, and Europe is struggling; meanwhile, emerging markets are running the gamut, with China being a key question mark.

Joseph V. Amato, President and Chief Investment Officer: We are moving from a period in which policy across the developed world was aggressively accommodating, and quite synchronized in Europe, Japan and the U.S. Now things are starting to diverge. The U.S. has begun to pull back, and we think rates will likely increase in the second half of next year or the first quarter of 2016. This transition contributes to sloppiness in the markets, which we've witnessed in 2014.

THE ECB HAS SOME CATCHING UP TO DO

Central Bank Balance Sheet Assets as % of GDP



Source: Bloomberg, data through October 2014.

All Eyes on the ECB

Knutzen: The European policy situation is obviously quite different from the U.S. and a key story for 2015.

Brad Tank, Chief Investment Officer—Fixed Income: In some ways, the Fed is old news at this point. Whether it raises rates in June of 2015 or the following January is not as interesting to the markets as whether the ECB is on an effective path that prevents deflation. Currently, you've got small-scale quantitative easing being embraced in Europe, but the market expectation is that ultimately you'll need larger scale QE. There are practical issues, such as what assets will work best for QE purchases, so it will take a long time to engineer. But it will be crucial in the first half of 2015 and everyone will be watching.

Knutzen: How will the monetary picture affect equity markets? More broadly, do you like the fundamental picture for stocks?

Amato: Earnings and interest rates drive markets. Short-term psychology does have an impact on P/E ratios, but over time, equity markets tend to follow corporate profits. We believe rates are going to stay low for a while, and on earnings the consensus for the S&P 500 next year is high-single-digit growth. Margins for U.S. large caps are at very high levels due to a lack of wage pressure, low energy costs and low rates. All of these conditions are likely to remain in place, which means that margins are unlikely to go down—and could even improve a bit from these levels, contributing to earnings. Although dollar strength is in general positive for U.S. financial assets, it may tend to cut into exporter profits and reduce the value of non-U.S. earnings at multinationals. Moreover, economic weakness outside the U.S. may prove a headwind against this group as well.

Knutzen: What about small caps? They've really trailed in 2014 but are also more levered to U.S. domestic growth.

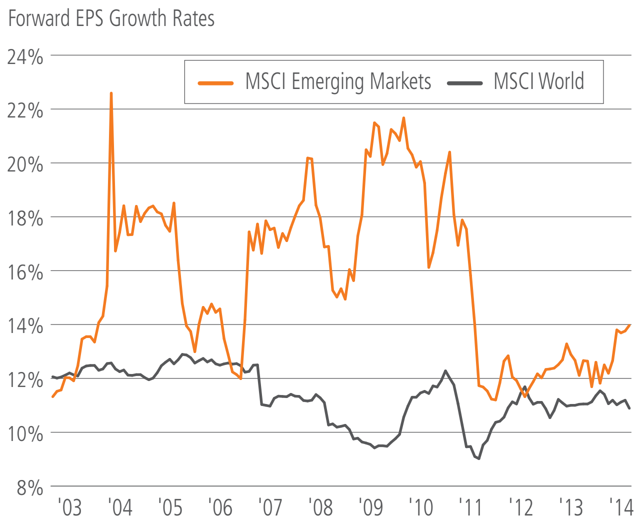
Amato: We've seen the biggest gap between small- and large-cap performance since the late 1990s. Although they're still at a premium to larger companies based on price/earnings, small caps are at a discount on an EBITDA basis. Also, small caps are not at historically high margin levels like large caps, so they have room to improve from a profits perspective. If you believe the U.S. is a safe haven today, small caps are an appealing way to gain exposure to that theme.

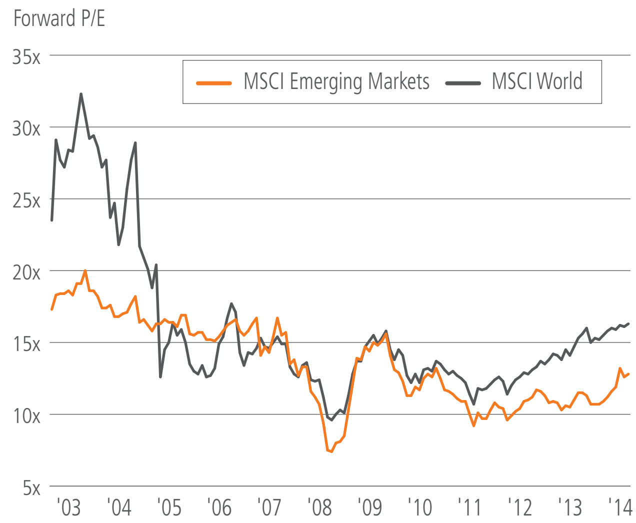
Knutzen: European equities face a more challenging environment. What's your view there, and in other global markets?

Amato: Europe is a different story, and we're not very sanguine on equities there because of the economy. The weaker euro could help exports, but there remain difficult structural problems that need to be addressed. That said, we believe that there are a number of multinational companies with good prospects. And if the ECB gets much more aggressive, stock prices stand to benefit.

In emerging markets, a general theme is reform. This past year has had several important elections; for example, in India, where a reformist took office and in Brazil, where the status quo has been maintained. The market reaction in these cases has been quite distinct, with Indian stocks generating sharp gains and Brazilian stocks trading down from when it became apparent that President Dilma Rousseff was headed for victory. We believe the willingness to introduce meaningful change will make a difference in economic prospects—which is what these two markets have been reflecting. More broadly, we think emerging market valuations are pretty reasonable in light of growth rates, though you have to be mindful of the sector weightings that go into the averages.

EMERGING MARKET EQUITIES: ATTRACTIVE GROWTH/VALUATION COMBINATION





Source: MSCI, FactSet, RIMES, data through October 2014.

Knutzen: What about China? That's a question mark for many investors.

Tank: There's been a lot of skepticism about China, which has been reflected in poor market performance over the last few years. However, we think the government is taking constructive steps in transitioning the economy toward a more sustainable domestic consumption orientation. In the past, the government might have simply reduced interest rates to spur growth, but they're looking at other ways to support the economy that won't lead to further asset bubbles.

Amato: On the equity side, we believe investors are overly discounting the potential for economic weakness there, and so we're constructive on the Chinese market. Valuations remain reasonable, and the market has discounted the potential impact of lower growth.

Geopolitics: An Ongoing Factor

Knutzen: Geopolitics have been a major presence in the markets, and should remain so, given the multiple flashpoints around the world. However, I think it's very important to parse the risks that create headlines but don't drive underlying fundamentals, from those events that actually affect the economy. For example, the Israeli-Palestinian conflict is a human tragedy but may not affect broad market pricing. In contrast, Russia-Ukraine has implications for energy supplies in Europe and the health of the Russian economy.

Amato: For investors, the challenge of geopolitical issues is their unpredictability. Germany appeared willing to tolerate Russian assertiveness—until separatists shot down a commercial airliner, which drastically changed political viewpoints there. And it's hard to discount the potential success of ISIS in disrupting oil flows. Although the Ebola virus isn't "political," it is another wildcard that could have very little—or potentially significant—impacts.

Impact of Low-Cost Energy

Knutzen: The impacts of low oil prices are probably a bit easier to gauge. Just from a cost standpoint, they should tend to support consumer demand globally and generally contribute to corporate margin expansion. But so many emerging market countries are levered to commodities. What will the impact be there?

Tank: Energy prices are clearly a huge issue for next year. Declines are hurting some countries that are already down and out, such as Venezuela and Russia. For many countries in Asia and much of Eastern Europe, they should be a positive, leaving aside whether they will prompt more erratic behavior from Russia. A related issue is weakness in soft commodities generally, which is hurting a number of Latin American countries. More generally, there is some concern that low oil prices are a sign of potential deflation. So, clearly this bears watching.

Drilling down (so to speak), it's important to consider the impacts on company fundamentals. A number of energy companies that issue high yield debt become profit-challenged if oil trades below $65 on a sustained basis. If the price gets far below that level and stays there, you could see some failures, which would affect the overall high yield default rate.

Knutzen: Clearly low oil prices are negative for many producers. But MLPs and other companies that are geared toward volume may not be as impacted. Private markets, which we haven't touched on yet, may offer opportunities that are relatively insulated from current conditions. Tony?

Anthony D. Tutrone, Global Head of Alternatives: We think the energy sector is well suited to private equity. Many energy companies need capital but the public market and the banks cannot fill the funding gap due to regulatory pressures and technical reasons. Oil prices have an impact on exit values, but most deals we've seen are predicated on an oil price of $60 or lower, so the underlying economics work. A key aspect of the energy story to us is underdeveloped infrastructure. Whether it's shale operations in the U.S. or deep-well drilling elsewhere, they all require services, transportation and equipment.

Navigating Private Equity

Knutzen: What about the picture for private equity more generally? How are valuations?

Tutrone: You always have to make the distinction between the market at large and the opportunities you can find. In general, prices are higher, but we feel there are plenty of attractive investments out there. In buyouts, for example, the model for success remains the same. You buy companies at fair prices and create value by improving them through margin and operational improvements, acquisitions and changing revenue models. In this way, you have the potential to add value during ownership and then sell to a larger industry player or exit through an IPO later on. With higher prices you just have to be more selective. As a result, we believe there should be a focus on private equity firms that have strong deal flow and discipline.

It's a similar story in other areas. The secondary market is growing due to selling tied to regulation as well as its increased acceptance as a way to manage private equity portfolios. Looking at venture capital, late-stage prices are probably too high but early-stage deals are more reasonable. Although recent market volatility suggests that the distressed sector could provide more opportunities in the future, it could take some time.

What About Yield?

Knutzen: Something we've only touched upon is the issue of investment yield, given low rates and, in the U.S., the potential for Fed tightening.

Tank: Generating yield is clearly a challenge. Simply extending duration or moving down the quality scale provides limited additional return at this point, and increases risk. So we think it's better to think in opportunistic terms, drawing on the array of sectors that are available, including high yield and emerging markets debt, as well as strategies like private debt, distressed and long/short credit. Having the ability to go short in duration could also be quite valuable as we enter a period of gradually rising rates. All of this broadens the manager tool kit at a key inflection point. Although sticking close to major indices was a winning strategy for a long time, in our view that math no longer works in your favor.

Knutzen: Are there sectors you'd point to in particular as potentially rewarding?

Tank: We definitely like emerging markets debt (EMD) and believe it provides real secular opportunity. People have long thought that EMD did poorly when the Fed raised rates, but the reality is more tempered than that. These are truly varied markets, with their own growth and yield cycles. And frankly, their credit quality is much higher than yields suggest. So you get a premium there. Long-term, we think developed market investors will be increasing allocations to the asset class as they come to understand it better.

Knutzen: What about high yield bonds? The market experienced periods of extreme volatility in 2014.

Tank: There's been spread widening in the sector, but we think that it's technical in nature, not based on fundamentals, as we believe that defaults aren't likely to increase for a couple of years. So we believe that makes high yield relatively attractive. That said, we're cognizant of the risks. European weakness is a pressure point, though we think the fundamentals of high yield issuers there are often stronger than the general economy. Overall, you just have to be vigilant.

Knutzen: One way that investors are coping with low yields is to move into more illiquid areas—for example, the private debt market.

Tutrone: In our view, there's a secular opportunity in many segments of this large and growing area. Many banks are talking about a new "asset-lite" model, and have reduced allocations across much of their loan portfolios. This has allowed other investors to step in to fill the void. So there's been a big increase in private debt financing, including mezzanine, second liens and real estate loans. Our team believes the trend is likely to continue in 2015.

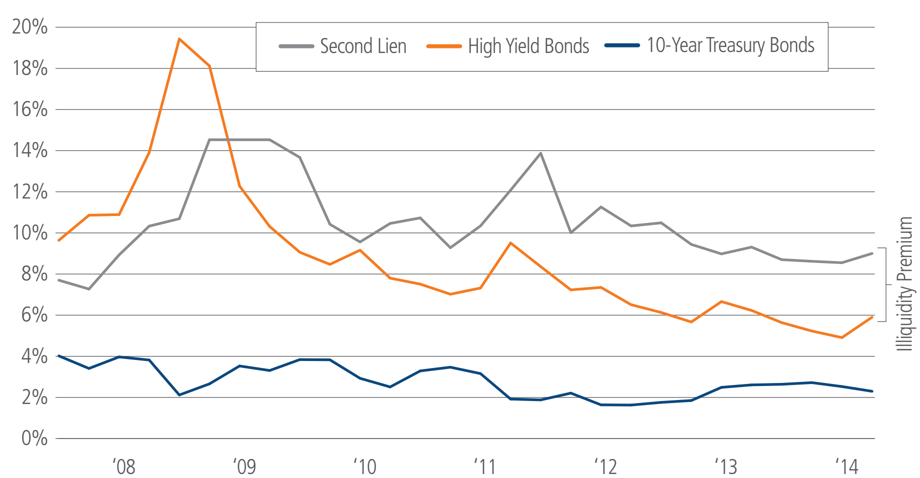
Can Hedge Funds Bounce Back?

Knutzen: Let's talk about hedge funds. They've had a challenging year.

Tutrone: Yes, a number of trends have moved against hedge fund managers in 2014. With all the geopolitical noise and concerns about growth in Europe and Asia, market-wide sentiment has tended to overwhelm specific company fundamentals, making it a very difficult market for many hedge fund strategies. The collapse of a few key large merger transactions hurt many event-driven managers, and policy decisions by central banks and governments have trumped economic data in moving markets, which has hampered macro-driven strategies.

PRIVATE DEBT OFFERS SIGNIFICANT ILLIQUIDITY PREMIUM

Fixed Income Yields



Source: Bloomberg, Credit Suisse, Barclays and S&P LCD; data through September 2014. U.S. Treasury: U.S. Government Generic 10 Year Index; high yield: Barclays Corporate High Yield Bond Index; second lien: Average New-Issue Spread from S&P LCD (includes LIBOR floor and upfront fee).

In general, we think these are temporary headwinds, and we're fairly constructive on certain areas. For example, we think that lower correlations and the gradual shift toward higher U.S. interest rates, which tend to differentiate companies, should provide a fertile environment for long/short equity managers. Notwithstanding this year's weakness, we believe robust M&A activity will help event-driven managers.

One of the big stories in hedge funds is the proliferation of activist funds. Even with relatively small positions, they've been able to get even large companies to make changes by simply rattling the cage—which in certain circumstances has resulted in changing out boards of directors, and prompted divestitures, buybacks and spinoffs. This has the potential to create favorable outcomes for shareholders and is very encouraging from an investor perspective.

An Eye on Risk

Knutzen: As we wrap up here, I just wanted to emphasize the potential importance of risk management going forward. This past year has seen many twists and turns, and that will likely be the case for 2015. Moreover, both equities and bonds have had a very strong run over the past few years. So, having a solid risk-based asset allocation framework can be quite valuable, as is the notion that you should be flexible in the asset classes, countries and sectors that you draw from on both a secular and tactical basis. That can help provide diversification and add to your opportunity set.

Tank: I agree that risk will be a key factor for investors moving forward. The ultimate impacts of stimulus, and what will happen as it starts to be withdrawn, are large unknowns. While Abenomics in Japan has generally been a boost to confidence and financial market performance to date, from here things could get more challenging. Aggressive QE against the backdrop of an outsized public debt market relative to GDP requires close watching. At the same time the potential return cushion from bond yields, or from undervaluation on the equity side, are relatively limited. Fortunately, as we've discussed, there are many pockets of opportunity if you have a broad enough canvas to work with.

Knutzen: Thanks, everyone, for your time and insights. We'll be keeping investors informed on our views on the markets as 2015 progresses.

Asset Allocation:

VIEWS ON PORTFOLIO POSITIONING IN THE COMING YEAR

As investors look toward 2015, the major economies are diverging, and along with them the monetary policies of central banks. Many financial assets carry fuller valuations than a year ago, while geopolitical events are more frequent and attention-grabbing, contributing to periods of elevated volatility. Such a backdrop highlights the benefits of effective diversification and risk management, in our view.

For the coming year, our long-term preference for equities over fixed income remains intact. Modest changes at the margin include a recent upgrade to a slightly overweight view for U.S. all-cap and large-cap equities as well as emerging markets equities. We have also adjusted our view of developed market non-U.S. equities, moving toward a neutral position.

Some additional details at the asset-class level are below.

Fixed Income

Global: Yields have moved lower as investors price in an outlook of subdued global growth, low (and in some places falling) inflation and generally supportive central bank postures. Although we anticipate possible stronger growth in the United States, the potential for European stagnation and ongoing stimulus from the Bank of Japan could keep global rates low for an extended period. We view the segment as an underweight as it offers paltry yields and appears expensive.

High Yield: We are neutral on the asset class, but see recent, largely technically driven spread widening as a buying opportunity. Fundamentals remain favorable, with U.S. defaults likely to remain near just 2% for the next few years. Average issuer leverage is moderate while interest coverage is strong. In addition, we see a modest maturity schedule over the next two years and attractive valuations as positive factors.

Emerging Markets: We are constructive due to still generally favorable valuations, supportive global market conditions and improving fundamentals. Though the asset class could be vulnerable to a rise in U.S. Treasury rates, we think the impact would be less severe than in prior episodes given higher local yields, less crowded positioning and broad current anticipation of Treasury yield increases.

Equity

United States: We favor U.S. equities, believing that earnings will be a primary driver of returns going forward. Although valuations are somewhat elevated relative to longer-term averages, we believe they are appropriate given current macro conditions and strong company fundamentals. Still, we recognize that prospects for rising rates and any short-term earnings disappointments are risks. Continued strength in M&A and positive leading economic indicators also support our optimism.

Europe: We recently moved to a neutral position, based on current fears about growth and deflation, with German bunds and CPI hovering at extremely low levels. We believe the European Central Bank's rate cuts and credit-easing measures reflect its commitment to supporting the economy, while the weakened euro should help exporters. We are watching stock markets closely as moderate valuations and the prospects for monetary stimulus vie with economic risks and the potential for Ukraine/Russia-related shocks.

MARKET VIEWS BASED ON ONE-YEAR OUTLOOK FOR EACH ASSET CLASS

Asset Class	Below-Normal Return Outlook			12-Month Forecast in Line With 5-7 Year Annual Return Outlook			Above-Normal Return Outlook	Change From A Year Ago
FIXED INCOME	–			O			+	
Global Fixed Income		■						O
U.S. Investment Grade Fixed Income		■						O
U.S. Government Securities	■							▼
Investment Grade Corporates		■						O
Agency MBS		■						O
CMBS / ABS		■						O
Municipals			■					▼
U.S. TIPS		■						O
High Yield Corporates				■				O
Emerging Markets Fixed Income					■			O
EQUITY								
Global Equities					■			O
U.S. All-Cap Core					■			▲
U.S. Large Cap					■			▲
U.S. Small Cap				■				O
Master Limited Partnerships				■				O
Developed Market—Non-U.S. Equities				■				▼
Emerging Markets Equities					■			O
Public Real Estate				■				O
REAL AND ALTERNATIVE ASSETS								
Commodities			■					O
Lower Volatility Hedge Funds					■			▲
Directional Hedge Funds				■				O
Private Equity				■				O

▲ Return outlook higher than last year ▼ Return outlook lower than last year O Return outlook essentially unchanged

Views expressed herein are generally those of Neuberger Berman's Asset Allocation Committee and do not reflect the views of the firm as a whole. Neuberger Berman advisors and portfolio managers may make recommendations or take positions contrary to the views expressed. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. See additional disclosures at the end of this material, which are an important part of this publication.

Japan: Abenomics has helped reverse Japan's deep deflationary trend, largely due to the Bank of Japan's aggressive balance sheet expansion. However, recent growth has been very weak, hampered by an early 2014 consumption tax increase, and investors have become more skeptical of prospects for long-term structural reform. As the effects of currency devaluation wane, achieving wage growth will be pivotal to improving economic growth.

Emerging Markets: We see attractive valuations and the potential for improving fundamentals. There are risks from rising rates, choppy growth (particularly in China) and geopolitical flare-ups. Moreover, the strong U.S. dollar, weak commodity prices and local conditions could create a variety of "winners and losers" in the asset class. Overall, we think there are opportunities as earnings growth appears to be improving. Declining correlations between emerging and developed market equities could make the asset class a better diversifier going forward.

Alternatives

Private Equity: This is a neutral position, largely due to the long-duration nature of the asset class. With the uptick in mergers and acquisitions activity, the market for exits is currently strong. Credit is readily available across the board and we have seen a lot of activity in the energy space. Within the venture capital market, valuations are slightly overheated, while private debt remains attractive due to strong credit quality and coverage ratios.

Lower Volatility Hedge Funds: We have upgraded this segment to a slight overweight position as we believe it provides a solid risk-adjusted return profile with many traditional asset classes trading near historical highs and fuller valuations. Strategies within this space should be well positioned to take advantage of declining stock correlations and a reaccelerating M&A environment, as well as navigate a backdrop of rising interest rates.

Constructive but Careful

We remain generally positive on equity markets but continue to monitor risks that could disrupt our outlook. Potential monetary policy missteps are one concern, should the U.S. Federal Reserve tighten too fast or the ECB fail to act forcefully enough. To date, we believe these central banks are providing an appropriate level of accommodation. Geopolitics are also an issue but should not overly impact markets if underlying economic fundamentals are not affected. Although we are not out of the woods yet, we believe the low interest rate environment and supportive global central banks should contribute to an extension of the current economic cycle, which should lend support to financial assets over the next year.

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. The panel covers the gamut of investments and markets, bringing together diverse industry knowledge, with an average of 23 years of experience.

Erik L. Knutzen, CFA, CAIA
Chief Investment Officer—Multi-Asset Class

Multi-Asset Class Portfolios:

MANAGING RISK IN AN INCREASINGLY COMPLEX WORLD

Investors generally recognize the importance of asset allocation and risk management. Over the long term, asset allocation mix tends to drive the majority of an investor's return and risk outcomes. Many institutional investors currently find themselves facing the twin challenge of a lower market return outlook, given rock-bottom government interest rates and modest global economic growth prospects, and increased demands on their investment funds, whether to meet increased spending needs or to close a liability funding gap. At the same time, the global market landscape has become far more complex, with myriad potential risks and a proliferation of investment strategies.

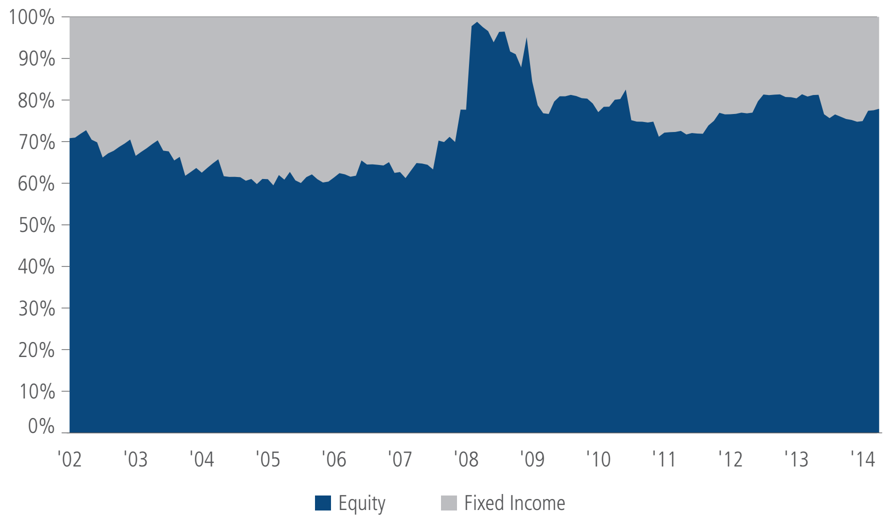
What approach to allocating capital and managing risk across multi-asset portfolios do we favor in the currently challenging environment? We believe an appealing method is to implement a risk-balanced strategic asset allocation, while retaining the flexibility to adjust portfolio exposures and to make opportunistic investments in markets that present attractive expected risk-adjusted returns.

Risk-Balanced Allocation: A More Informed Choice

The traditional method of portfolio analysis often involves allocating capital based on a client-defined target return objective. In a risk-balanced approach, risk is allocated among asset classes to fill out a risk target or budget. The most commonly cited insight generated by risk-balanced asset allocation is regarding the 60% stock/40% bond portfolio. In the capital allocation framework, this common weighting scheme appears broadly diversified. Yet an analysis of the contribution to risk from the two component asset categories shows that, on average, equities contribute an outsized portion of the risk to the portfolio. Furthermore, the contribution to total risk of the two components varies significantly over time.

60/40 STOCK-BOND MIX CONCENTRATES PORTFOLIO RISK

% of Portfolio Volatility Attributed to Stocks



Source: Bloomberg.

For illustrative purposes only. Stocks are represented by the MSCI World Index and bonds are represented by the J.P. Morgan Global Government Bond Index. 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.**

The display above shows the relative contributions to risk of the 60/40 portfolio over the last 12 years, and indicates that, at any given time, equities drove between 59% and 99% of risk (as measured, in this case, by volatility), hitting a high point in the midst of the financial crisis of 2008 – 2009. At that point, equities accounted for the majority of risk at a time when that exposure was most volatile. In contrast, an investor with a risk-balanced portfolio compares capital allocations—that is, how much of the portfolio's assets are allotted to each category—to the risk from those investment categories, to generate a more diversified outcome.

In our view, allocating according to risk relationships, as opposed to return expectations, represents a more informed way of building a portfolio. While it is true that the future risks of asset classes are unknown, relative risk levels tend to be stable over time even as forecasting returns can be extremely challenging. To illustrate, let's consider stocks, bonds and cash over a five-year forecasting horizon. While it is quite possible that bonds or cash will outperform stocks, it is far more likely that, over that same time horizon, stocks will be more volatile than bonds, which will be more volatile than cash. As a result, a risk-balanced approach allows a better understanding of the sources of the portfolio's risks, and the relative benefits of diversification of other asset categories. For example, exposure to commodities—a relatively volatile asset category—may reduce overall risk and consume very little of a program's risk budget due to low expected correlations to equities and other components of a strategic asset allocation policy. Moreover, allocating assets according to risk contribution leads to a varying of the capital allocation over time in response to changing market environments (see display on page 14).

A unique application of a risk-balanced approach to asset allocation is what has commonly become known as the risk parity portfolio. This represents a collection of risky assets which are each expected to have a positive long-term return premium, but which are not perfectly correlated. In this context, the three broad categories of persistent return premia appear to be associated with stocks, bonds and inflation-sensitive assets. Historically, these categories have had similar Sharpe ratios, or long-term returns per unit of risk. Therefore, a portfolio constructed of an equal risk weight of each of these three categories appears highly efficient at a given level of risk, as well as being broadly diversified across market environments. One challenge associated with this approach is that bonds and inflation-sensitive assets often have low return expectations relative to equities, given their lower expected and realized risk levels; as such, a simple portfolio of equal risk-weighted allocations to the three categories often may have a return profile that is lower than a client's established target return objective. A solution to this challenge may be the application of leverage to raise the target return.[1] Although such an approach may not be appropriate for many investors across their entire investment program, incorporating an allocation to a risk parity strategy in an investment program can potentially have a beneficial effect on the overall risk/return profile.

Flexibility and Opportunistic Investing

A risk-balanced approach to strategic asset allocation can be an appealing way to help clients seek to achieve their long-term objectives at appropriate risk levels. But we believe it is important to take an additional step: incorporating flexibility into an investment program. One of the lessons of the great financial crisis was that capital market relationships are always changing and that a "set it and forget it" approach to asset allocation can lead to challenges. As shown in the display on page 14, a risk-balanced approach can reflect varied levels of risk in the marketplace by adjusting strategic allocations over time to keep total risk levels constant. This is in contrast to a constant asset allocation, in which risk will vary significantly.

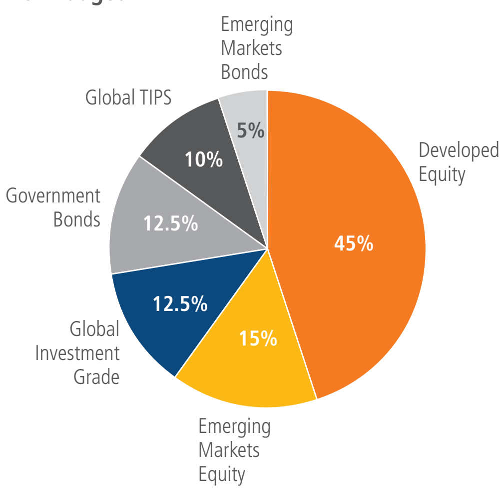
In addition, market prices change on an ongoing basis. While many short-term market movements can be characterized as "noise," often securities prices move far enough away from fair value to present trading opportunities. Within asset classes, such divergences from fair value can be pursued by active managers within those categories. But opportunities may also present themselves across asset categories and major markets including equities, fixed income, currencies and commodities. To seek to take advantage of market inefficiencies at this level, incorporating a global tactical asset allocation strategy in an investment lineup can make sense.

[1]For a more in-depth discussion of risk parity, see Wai Lee, "Risk Parity: Common Fallacies," Neuberger Berman, June 2014.

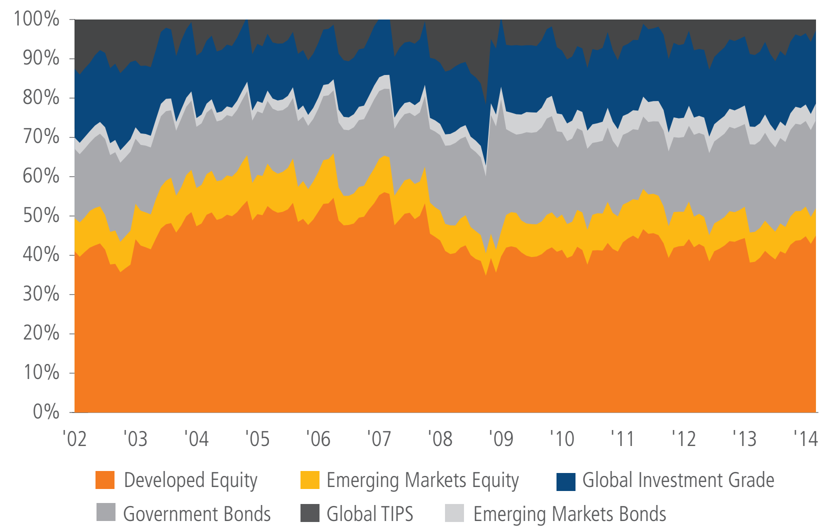
IN RISK-BALANCED APPROACH, RISK DETERMINES WEIGHTINGS

Hypothetical: Portfolio Risk Budget and Weightings over Time

Risk Budget



Portfolio Weight



Source: Bloomberg, Neuberger Berman.

Indices are as follows: developed equity, MSCI World Index; emerging markets (EM) equity (ex-China), MSCI EM Index excluding Chinese securities; government bonds, J.P. Morgan Global Government Bond Index; EM bonds, J.P. Morgan EMBI Global Investment Grade Index; global investment grade, Barclays Global Aggregate Bond Index; global Treasury inflation protected securities (TIPS), Barclays Global Inflation-Linked Index. In the example above, risk was assessed across multiple dimensions, including volatility, correlation and tail risk, as well as less quantifiable risks such as regulatory and liquidity risk. Once the hypothetical risk profile was determined, in conjunction with proprietary risk forecasts, optimization tools were used to select asset class weights in order to achieve the desired risk profile.

Occasionally, major capital markets dislocate so much as to merit a dedicated opportunistic allocation over a medium-term (e.g., two- to three-year) time horizon. Such a dislocation occurred in large segments of the credit market during the crisis of 2008 – 2009. An allocation made to credit at that time would have added significant value to investment portfolios, as credit market segments later rebounded—many even more robustly than equity markets. A more current example is found within the global banking sector. Post-crisis regulatory changes, including Dodd-Frank and Basel III, are forcing many banks to de-lever balance sheets and change their business mixes, in many cases ceasing long-standing activities. In our view, this represents a secular opportunity for investors with the ability to lock up capital over time. On a global basis, buying assets from bank balance sheets and/or providing liquidity to borrowers across the corporate, real estate and asset-backed segments appears to present attractive long-term risk-adjusted return potential.

Of course, it is true that market dislocations are not always present. In fact, one of the challenges of the current environment is that most liquid asset categories appear to be at or above fair value. While this could persist for some time (and markets could get even more expensive), history suggests that dislocations eventually emerge. To be prepared for opportunities when they arrive, we think it is important for investors to have a flexible investment policy, and a component of their asset mix which is liquid and a potential source of funds at such times. A key benefit of a risk-balanced approach is the ability to maintain exposures to investment categories with the potential to do well across a variety of investment environments. This includes asset classes such as Treasuries and other sovereign bonds with the potential to perform well and (importantly) remain liquid in stressed environments. Irrespective of their currently low yields, they can provide "dry powder" to take advantage of attractive opportunities when they arise.

A Fresh Look

The currently challenging environment highlights the appeal of taking a fresh look at asset allocation and risk management. Return outlooks for most asset classes are low and the risk backdrop appears increasingly complex—at the same time that investors are hoping that their money can "work harder." In such a context, we think that balancing the risks across a portfolio provides a highly efficient and effective approach to strategic asset allocation—which can be a key driver of long-term results. Complementing this approach with the flexibility to take advantage of short-term market movements and occasional significant dislocations can add an important component to long-term returns, as well as risk management. While the future is unknown—and no investment approach can change that humbling reality—a flexible and dynamic risk-balanced approach to investing can help investors chart a course toward their long-term goals.

This article draws on papers written by the author while an employee at NEPC LLC, as well as the work of Wai Lee, Chief Investment Officer of Neuberger Berman's Quantitative Investment Group, and his team. The author wishes to thank both his former employer and his past and current colleagues for their insights and support, as well as access to these materials.

Matthew L. Rubin
Director of Investment Strategy

Personal Strategy:

LOOKING BEYOND RATES TO ASSESS FINANCIAL CONDITIONS

After several years of loose financial conditions, guided heavily by accommodative monetary policy, the tide appears to be turning as the U.S. Federal Reserve winds down its quantitative easing operations and outlines a path to policy normalization. The Fed has stated that it will keep rates low for a considerable time, but we are already beginning to see an inflection point in the National Financial Conditions Index (NFCI), which tracks underlying conditions across risk, credit and leverage. Although still below average, the NFCI has increased steadily and was recently at its highest level in over a year. While many investors are focusing on the timing of the first Fed Funds rate hike, we believe that attention should also be paid to the implications of tighter financial conditions as represented by the NFCI—for the economy, asset classes and portfolio positioning.

Economic Implications

The housing sector has been an important part of the economy, which has benefitted from low interest rates making homes more affordable to buyers. Yet, despite the decline of mortgage rates throughout 2014, home prices have cooled—with the annual price gain for the S&P/Case-Shiller U.S. National Home Price Index slowing for eight consecutive months through August. We think this trend will continue in 2015 as higher mortgage rates, combined with already tight housing credit conditions, act as a headwind against more robust home price gains. That being said, employment growth has steadily improved and the supply of homes remains constrained, all of which should keep the housing recovery moving forward in 2015, even if at a slower pace. The U.S. consumer could encounter similar headwinds with the onset of tighter financial conditions, the brunt of which could be felt across mortgages, credit cards, auto loans and student debt. However, the significant decline in energy prices for much of 2014 should provide a meaningful counterbalance for consumers. As a result, we anticipate a continued modest economic expansion in the United States despite the potential for tighter financial conditions.

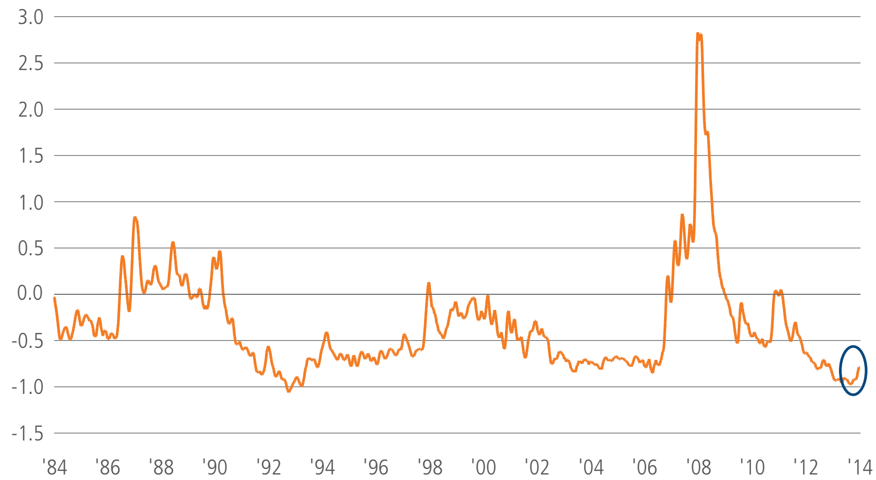
Asset Class Considerations

From an asset class perspective, we anticipate a more nuanced impact from tighter financial conditions. Over the past five years, lower quality (characterized by low return on invested capital), higher leverage and non-earning companies have been among the strongest performers in the U.S. small-cap universe. As monetary policy and interest rates normalize, we believe we may see a change in market leadership and a reversal of many of these performance trends that have persisted in recent years. After a disappointing 2014 on an absolute basis and relative to U.S. large caps, we believe small-cap equities may be poised for a stronger period of performance over the next year. In our opinion, U.S. economic growth will continue to diverge from the rest of the world and small-cap equities (as represented by the Russell 2000 Index) offer the greatest exposure to that trend, with over 80% of index revenues derived within the U.S.

High yield fixed income is another asset class that tends to display sensitivity to financial conditions. When the NFCI spiked to historical highs in 2008, for example, high yield corporate bonds sold off sharply. From 2003 to 2006, an extended period of loose financial conditions, non-investment grade bonds provided attractive returns. Although we are cognizant of the impact that tighter financial conditions can have on non-investment grade fixed income, we maintain a constructive view on high yield corporates over the next year. Default rates should remain low in 2015 and market technicals (supply and demand) continue to be supportive of the asset class, with only $41 billion of high yield bonds outstanding expected to mature in 2015. In our view, high yield corporate bond spreads also offer attractive value at current levels and could help buffer against interest rates moving higher sooner or more sharply than anticipated. In the meantime, the asset class provides the potential for attractive income in what continues to be a yield-starved investment landscape.

ALTHOUGH STILL LOOSE, U.S. FINANCIAL CONDITIONS ARE TIGHTENING

National Financial Conditions Index



Source: FactSet, data through October 31, 2014. The NFCI is constructed to have an average value of zero and a standard deviation of one over a sample period extending back to 1973. Positive values of the NFCI indicate financial conditions that are tighter than average, while negative values indicate financial conditions that are looser than average. The index captures volatility and funding risk in the financial sector, credit conditions, and debt and equity measures. Increasing risk, tighter credit and declining leverage are consistent with tightening financial conditions.

Constructive in the Face of Tighter Conditions

As our constructive views on U.S. small-cap equities and high yield corporates suggest, tighter financial conditions need not be a bad thing. It is important to remember that the Fed is removing its accommodative support and financial conditions are potentially tightening because the economic backdrop in the U.S. continues to improve, even as growth in much of the world has come under pressure. Active management has been challenged in recent years, but we believe a backdrop of normalized monetary policy and tighter financial conditions could lead to a regime change. With the specter of rising interest rates only increasing as we head into 2015, we believe managing duration in fixed income portfolios will take on even greater importance. We also anticipate more differentiated performance among individual equity securities going forward, so stock selection could be a key driver of returns. Overall, we believe 2015 could turn out to be another positive year for the economy and financial markets despite the Fed and broader financial conditions moving closer to a tightening posture.

SOLVING FOR 2015

Global Equities

Joseph V. Amato
President and Chief Investment Officer

Overview:
TWO STEPS FORWARD, ONE STEP BACK

Since the advent of the financial crisis in 2008, central bank monetary policy has been quite synchronized across developed markets. This highly accommodative policy has helped with the economic healing, but the depth of weakness has resulted in an inconsistent level of recovery across global economies. In 2015, we see central banks and growth rates of the major developed economies moving in different directions. Although the long-term trend for global growth appears positive, reflecting a recovery from deep post-crisis levels, we anticipate an inconsistent environment in the coming year, as investors come to terms with new economic realities across global markets. This will likely result in increased volatility and investor uncertainty. Yet, as is typical during these periods, opportunities will undoubtedly abound.

Key Juncture for Developed Markets

Among global headwinds, Europe's economic weakness could be particularly challenging for equities in 2015. European Central Bank President Mario Draghi famously said that he would do "whatever it takes" to protect the euro, but slow growth and near-deflationary conditions in Europe are proving hard to overcome. These conditions have prompted the central bank to intensify easing policy, with the intent to expand its balance sheet by €1 trillion over the next two years. We believe the central bank is on the right track. Recent weakness in the euro currency should also help stimulate European exports and marginally raise inflation rates.

Japan's economy is also at an inflection point. After several quarters of encouraging expansion, the impact of Abenomics has stalled amid lower inflation and slow job growth. The Bank of Japan has introduced a fresh round of quantitative easing with a "shock and awe" approach involving increased bond buying and the potential purchase of Japanese equities. The initial market reaction has been positive, but we continue to wait for meaningful structural reforms to solidify any short-term benefits. As in Europe, currency depreciation could provide a short-term boost for exports.

In contrast, improving U.S. economic growth prompted the Federal Reserve's decision to end its quantitative easing late in the fall (contributing to dollar strength versus the euro and yen), and markets generally expect actual rate hikes to occur in mid- to late 2015. Manufacturing activity and consumer confidence remain strong, while lower energy prices should provide a boost to consumer spending. On the downside, we worry that the strong dollar, although supportive of investment flows generally, will pressure earnings growth rates for U.S. multinationals.

Reform Highlighted in Emerging Markets

Elsewhere, China and the rest of the emerging markets have shown meaningful dispersion, reflecting a variety of characteristics and prospects. The Chinese government's success in maintaining a soft landing has been questioned, but we think GDP growth there is likely to expand by around 7.2% in 2015, while earnings growth has been healthy. Moreover, the government is seeking subtler ways to influence growth that avoid contributing to bubble conditions, and seems committed to economic reform and further opening of its equity markets.

More broadly, the issue of reform is central to long-term prospects in emerging markets. Investors reacted favorably to the elections of reform candidates in India and other countries, but a key will be actual execution to overcome structural obstacles. In the meantime, country (and company) positioning relative to energy and the availability of earnings growth could be crucial to differentiating among securities.

Key Themes for 2015

Interest rates: Overall, rates will be a major part of the 2015 story, with the potential to meaningfully impact equity markets. Rather than inflation, we believe the main threat perceived by developed market central banks is the potential for deflation—in Europe and Japan in particular—such that policy-induced low interest rates and quantitative easing are likely to continue supporting equity valuations. Conditions in the U.S. are healthier (albeit without robust job growth associated with recoveries), suggesting the likelihood of at least modest tightening, which is a traditional headwind against financial assets.

Energy Prices: The price of oil is now more than 25% lower than its three-year average, due largely to expectations for softer demand growth coupled with increased supply and the reluctance of some producers to trim output. Our analysts believe that oil prices are likely to remain at moderate levels for the next 12 months. Overall, this should have a positive effect on GDP growth and earnings, while containing inflation, but could also hurt countries such as Russia and Venezuela that are highly dependent on energy revenues.

Currency: The U.S. dollar has enjoyed a surge in valuation relative to the euro and yen, which should help the competiveness of exporters in Europe and Japan (and hamper multinationals in the United States). This reflects not only the tighter stance of the Federal Reserve, but also the "safe-haven" status of the U.S. as other regions deal with economic uncertainty and political turbulence. Given the diverging trajectories of major economies, we are likely to see ongoing currency volatility moving forward, which could affect securities valuations on a global basis.

Geopolitics: Political and military conflicts, which have garnered so much attention in 2014, are likely to continue distracting markets on a periodic basis. Recent flashpoints have included the conflict between Russia and Ukraine, the advance of ISIS in Iraq and Syria, and pro-democracy demonstrations in Hong Kong. The Ebola virus, while not political, has been another potential wildcard. Among these issues, Russia-Ukraine appears to have the more serious implications should energy flows to Europe be disrupted. ISIS, although notable, has yet to meaningfully impact oil prices or markets. Overall, we believe it will be important to distinguish between issues of real economic significance and those that, no matter how tragic or frightening, are unlikely to broadly affect economic fundamentals.

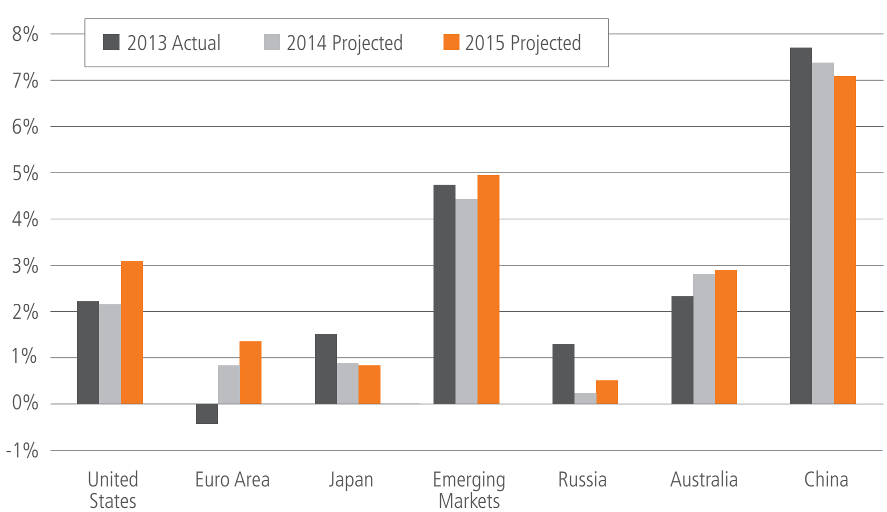
Caution with a U.S. Bias

2014 has proven unpredictable for investors, characterized by shifting growth trends and geopolitical surprises. Through November, U.S. equity markets have rebounded from a sharp downturn associated with anxiety over European and Chinese growth, but the MSCI EAFE Index remains down year-to-date in U.S. dollar terms (though up modestly in local currency), and emerging markets are slightly positive. Looking ahead, we are generally cautious given the U.S. interest rate cycle and uncertainty in Europe.

On a relative basis, however, we are confident in the prospects for U.S. equities, on the back of sustained economic improvement, steady earnings prospects and still-reasonable valuation levels. U.S. inflation remains modest, with wage growth kept in check by technology and the forces of globalization. Europe remains weak, with opportunities evident in more global companies on a case-by-case basis. Emerging markets provide a mixed landscape, with wide differences in country valuations tied to industry sector weightings, exposure to energy and prospects for reform. Finally, China is valued near historical lows, and ongoing moves toward openness coupled with earnings expansion, in our view, add to its attractive opportunity set. In general, based on our outlook for global economic growth and interest rates, we have a preference for equities over other asset classes.

GLOBAL ECONOMIC GROWTH IS DIVERGING

GDP Growth Rates



Source: International Monetary Fund, data through October 31, 2014.

U.S. EQUITIES: STANDOUT ON THE GLOBAL LANDSCAPE

Investors began 2014 with relatively benign expectations for U.S. equities. A slowly improving U.S. economic picture coupled with a turn in eurozone growth and fundamental gains in emerging markets suggested that U.S. companies could enjoy steady earnings expansion. That, aided by continued loose monetary policy, seemed to support another year of market gains for U.S. stocks. The reality turned out to be far more complex.

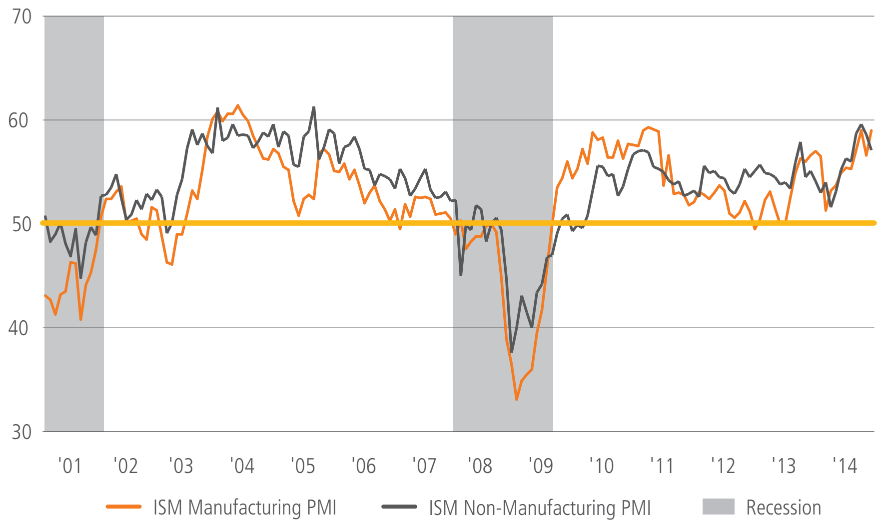
After a weak first quarter, due in part to the distorting impact of severe weather, second-quarter GDP came in much stronger, and helped drive a steady advance for U.S. equity indices. Gradual improvement in unemployment statistics, housing strength and decent consumer sentiment supported markets, along with renewed mergers and acquisitions activity and minimal pressure on corporate margins from wage inflation.

Bond market volatility around the Federal Reserve's tapering of quantitative easing had little impact on stocks, as it appeared to imply economic recovery and earnings strength that could offset the cost of potentially higher rates. Even the steady drumbeat of geopolitical distractions (primarily in Ukraine and Iraq) did not, surprisingly, have a meaningfully negative impact on equity markets.

By late summer and fall, however, the weaker fundamental picture in Europe began to erode confidence in risk assets, including U.S. stocks. Eurozone growth came in at continued low levels, while inflation was well below the ECB's comfort zone. This led market observers to downgrade their expectations for global GDP growth, which, in turn, resulted in a month (October) of wild swings in the markets. Eventually, market sentiment improved with new easing measures in Europe and China, as well as constructive earnings news in the U.S., helping domestic equities regain lost ground.

U.S. BUSINESS ACTIVITY REMAINS STRONGLY POSITIVE

Manufacturing and Non-Manufacturing Indices



Source: Institute for Supply Management, data through October 2014. Figures above 50 represent expansion and below 50 represent contraction.

Constructive Fundamental Conditions

The U.S. economy continues to show reasonable, sustained strength. Growth remains on a steady path, with an estimated GDP increase of 3.9% in the third quarter of 2014 and, in our view, a long-term growth trajectory of around 2% – 3%. Housing starts, while less robust than anticipated at the beginning of the year, have strengthened recently, while PMI surveys have been recorded well into positive territory, reflecting expansion in both the industrial and service sectors of the economy.

MLPs: Looking Past Price in Energy

Douglas A. Rachlin and **Yves C. Siegel, CFA,** Portfolio Managers—The Rachlin Group

North America's energy infrastructure continues to enjoy healthy growth, and in our opinion should continue to expand over time. Predicated on the vital role that master limited partnerships are playing in this trend, we believe that the sector's long-term prospects are also favorable—a view that has not changed with 2014's weakness in crude oil prices.

In our opinion, many U.S. oil fields should remain economically attractive to drill even if oil prices fall further. And, as domestic oil and natural gas production continues to proliferate, we believe that significant capital investments will be required to bring the burgeoning supply to market.

Midstream MLPs, our focus, provide the infrastructure necessary to process, transport and store natural gas, crude oil and their by-products. They have little direct commodity price risk because they typically do not take title of the product they transport. These MLPs should continue to be meaningful participants in the infrastructure build-out, as they typically enjoy a relatively low cost of capital and have the potential to earn attractive rates of return on their investment.

MLP investors typically receive a competitive average current yield of 5% to 6% plus the potential for growing distributions that are reflective of the shale "revolution" in the United States. In our view, the opportunity for MLPs should lead to further increases in distributions to unit holders over time.

Employment statistics continue to paint a mixed picture. The labor participation rate has dropped to a 36-year low, in part due to demographics (retiring baby boomers) and a shift in disability policy, but it is also indicative of structural issues including accelerated use of labor-saving technologies. However, the unemployment rate continues to fall, from its 10% high in 2011 to 5.8% in October. In our view, continued improvement should further bolster consumer confidence levels. Moreover, positive sentiment could encourage more use of consumer credit, which in turn could help accelerate overall growth prospects.

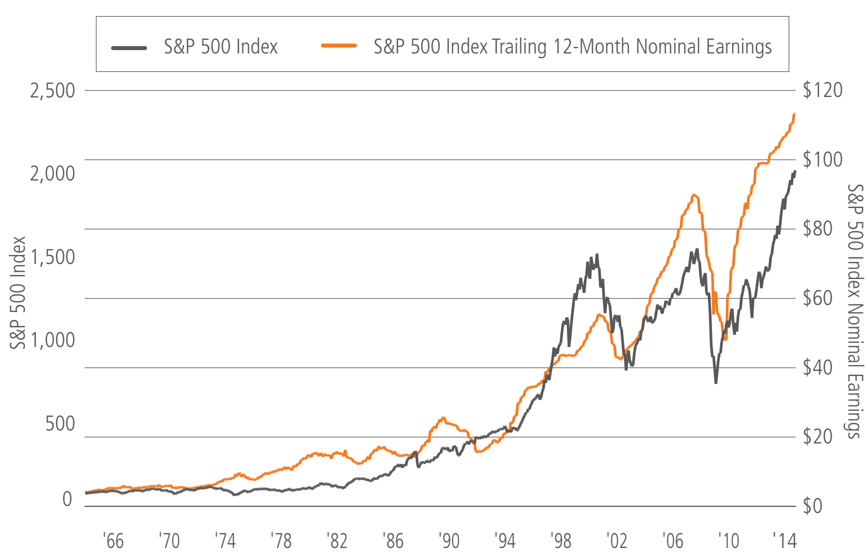
With this relatively favorable backdrop, companies continue to demonstrate the ability to grow earnings, supported by decent revenue expansion and tight controls on cost. Telecom, materials, industrials and health care companies have been among the stronger earners, while consumer discretionary and energy companies have lagged.

EARNINGS GROWTH CONTRIBUTIONS TO THE S&P 500 INDEX

Sector	Trailing 12-Month Earnings Growth	Weight in Index (Beginning of Period)	Contribution
Health Care	10.9%	12.8%	1.4%
Industrials	12.7%	10.8%	1.4%
Financials	5.7%	15.7%	0.9%
Information Technology	4.2%	17.8%	0.8%
Consumer Staples	6.4%	11.0%	0.7%
Materials	16.2%	3.5%	0.6%
Telecom	21.3%	2.4%	0.5%
Energy	4.7%	10.4%	0.5%
Consumer Discretionary	2.5%	12.5%	0.3%
Utilities	6.7%	3.1%	0.2%
S&P 500	7.3%	100%	7.3%

Source: Bloomberg, data through October 31, 2014.

U.S. PROFITS ARE AT RECORD LEVELS BUT DEPEND ON MARGINS, MONETARY POLICY
S&P 500 Index and Earnings



Source: Bloomberg, data through October 2014.

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.**

Small-Cap Equities: Making a Quality Play

Judith M. Vale, CFA, and **Robert W. D'Alelio**
Portfolio Managers—Small Cap Value Equity

With a U.S. bull market that's now half a decade long, investors are wondering whether they could see volatility or even declines next year, driven in part by the prospect of higher U.S. interest rates and an uneven recovery abroad. We think a key question today is what sort of stocks could outperform in such an environment.

Our small-cap investment universe is truly varied, in terms of growth fundamentals, quality, cash flows and valuation. And such difference can be a benefit or a curse depending on the stocks you choose. During the current long-term bull market, "the stocks to own" have largely been of the low-quality, high-debt sort, which have benefited from an initial bounce-back from crisis-level lows and a very forgiving near-zero rate policy. Old-fashioned, profitable, steady growth businesses—in ironic contrast—have lagged.

We think that is likely to change. With higher rates, the vulnerabilities of lesser companies should become more apparent, as they face higher interest costs down the road. Moreover, if weakness in Europe, Japan and elsewhere seeps into U.S. growth figures, quality stocks may be better able to ride out the storm. Whatever the case, we believe that earnings should eventually be the driving force behind individual small-cap stock returns. The key will be time horizon—letting short-term sentiment pass so that the markets ultimately recognize underlying fundamentals.

Although profit margins have generally been near historical highs, we do not expect a meaningful change. Interest rates are likely to remain generally low, keeping financing expenses down, while energy prices have dropped and wage pressures remain limited. Also, some form of corporate tax reform could be a possibility due to the power shift in Washington, D.C. Assuming that moderate economic conditions remain intact, we think that revenue growth and stable margins could contribute to high-single-digit earnings growth for the S&P 500 Index next year. This, combined with currently moderate valuations, should prove supportive for U.S. stock prices overall.

Wildcards and Sectors to Watch

Even with constructive U.S. fundamentals, various factors could cause greater volatility in stock market performance. Although geopolitical developments have had generally limited cumulative impact on markets in 2014, they have certainly contributed to price volatility. And given the number of hotspots around the world, the potential for further incidents, of varying significance, seems elevated. Dollar strength is also a concern. Although reflective of U.S. stability and potentially favorable to U.S. financial assets, it also may cut into profits at some multinational U.S. companies. Wage inflation in the U.S. has been relatively contained, but historically has begun to trend upward with an unemployment rate of 5.5%—not far below recent levels. Potential global economic weakness could also undermine results, as the U.S. economy can only "diverge" so far before being affected by weaker conditions in Europe and elsewhere. Most significant, however, is the outlook for interest rates. The consensus suggests that the Fed will raise rates in mid- to late 2015. While we anticipate some increase next year or early in 2016, we remain of the view that rates will stay low for an extended period of time. Nonetheless, shifts in Fed policy have typically led to increased uncertainty and volatility in the capital markets. We expect the driver for rate hikes is the Fed's important desire to, at some point when the U.S. economy is on a sustainable growth trajectory, return rate policy to "normalcy." This should be positive for equities in the long run, in our view.

A key recent development in the global economy is lower energy prices, which dropped sharply amid slowing demand growth and stable supply aided by increased production in North America. Overall, we believe low oil prices are positive for most U.S. companies. However, they are clearly a negative for energy businesses whose profits are directly tied to commodity price levels. That being said, many companies in the North American shale industry are profitable at current or lower oil price levels. In addition, midstream energy companies (including MLPs), which concentrate on the storage and distribution of oil and natural gas, are somewhat insulated from price swings.

Among sectors generally, we favor cyclical areas, which are valued moderately compared to consumer durable shares. Defensive stocks (such as utilities) seem fully priced. And financial stocks are generally a mixed bag, given prospects for tightening and new pressures on some institutions due to greater capital requirements and the elimination of some business lines since the 2008 credit crisis.

From a market-cap perspective, small company stocks have had a difficult 2014 thus far, deeply underperforming large-cap issues. Small caps had enjoyed a strong run since 2009 and were at extended valuations a year ago. However, now they are closer to long-term averages and reasonably priced on an EBITDA basis versus larger counterparts. Given that more of their earnings are from U.S. sources, they may provide a favorable way to leverage U.S. relative economic strength in 2015 and mitigate some risk tied to the rising U.S. dollar.

Cautious in Near Term, Still Constructive Over Long Term

After nearly three years of strong U.S. equity returns, we have a relatively cautious near-term outlook, while remaining constructive on the asset class over the long term. Economic weakness in other developed markets and slowing growth in China will have some impact on the U.S. We are more concerned, however, about the pressure generated by an upward bias in U.S. interest rates and the dollar. This will likely create periodic market headwinds, in particular since interest rates have been so low for so long. We do think rates will remain relatively low, as mentioned, since U.S. economic growth is structurally slower than in past cycles. Over the longer term, we also expect U.S. companies to continue to generate decent earnings growth, which could help continue to drive returns. As the Federal Reserve reduces its involvement in the economy and rates normalize, company and industry fundamentals should once again be the dominant factor in stock valuations—a welcome development to us.

Global Orphans Deliver on Dividends

Tony M. Gleason, CFA
Portfolio Manager—The MLG Group

A key challenge for investors these days is that, with yields at ultra-low levels, there's very little "income" in traditional fixed income. In addition, U.S. dividend-paying companies have enjoyed solid returns over the past couple of years, trimming the effective yield they provide for each dollar of investment. Now, however, we believe that income generation may be entering a new phase as many investors are expanding their horizons to non-U.S. stocks in the search for alternative sources of yield.

As we look across the global landscape—whether in Europe, Asia or Latin America—equity dividend yields are generally elevated both relative to history and to the U.S. market. The FTSE 100 Index, for example, provides a 4.8% yield versus the S&P 500 Index's 1.9%,[1] which becomes more impressive when you consider that European government bond rates are lower than U.S. counterparts.

Looking beneath the surface, we see a whole "orphanage" of companies with good fundamentals and dividend yields above the market average, but which have failed to gain notice from many investors or have traded in sympathy with sluggish markets. For many global investors, the presence of such stocks may be intriguing, but for many U.S. investors, who have traditionally looked abroad for growth but not income, they may be a revelation. Over time, we anticipate that global income-producing names will garner more attention and support from the investment community at large.

[1]As of October 31, 2014.

DEVELOPED INTERNATIONAL MARKETS: SLUGGISH BACKDROP BUT OPPORTUNITIES REMAIN

Benjamin Segal, CFA, Portfolio Manager and Head of Global Equity Team

Developed international markets have lagged for much of 2014 for reasons that in our view are, for the most part, not surprising. Continued economic weakness in the eurozone, fading of enthusiasm around "Abenomics" reforms in Japan, and the resurgence of the U.S. dollar—though it arrived later in the year than we had anticipated—have all kept pressure on developed international equities. Political uncertainty in Russia and the Middle East has created another pressure point for the asset class.

Just as we were skeptical about growth heading into 2014, we see nothing on the macro horizon to give us greater optimism as we look forward to 2015. Importantly, however, from a bottom-up perspective, we believe significant, albeit select, opportunities continue to exist on a country, sector and company basis. As in 2014, we think the ability to identify differentiated companies that have the potential to execute in a lackluster environment will be key to generating alpha in the coming year.

Eurozone: Pressure Points Shift, Sanctions Hurt

2014 has seen economic improvement in the peripheral European economies that were long a focus of concern. But while those troubled markets may have the worst behind them, fundamentals in the core of the continent have deteriorated somewhat. France has stalled, Italy is weak, and the sanctions aimed at Russia are an incremental negative affecting many European companies. Thus, from a macro perspective, the eurozone seems in no better shape for the coming year than it was going into 2014.

Non-Eurozone: Brighter Spots, with Caveats

In our opinion, prospects for the U.K. continue to be brighter than for the eurozone, especially now that the uncertainty of the Scottish independence vote has been resolved. However, as many U.K.-listed names tend to be global corporations, gaining meaningful exposure to domestic growth is a challenge. Further, the U.K. economy is concentrated in London and the Southeast, which is significantly driven by financial services and real estate. Monitoring these sectors is therefore critical, especially as property affordability remains at a low. Still, together with the Nordic nations and Switzerland, the U.K. may again be among the healthiest European economies in 2015.

Japan: Abenomics' Luster Lost

We've long held the view that Japan faces serious structural challenges. Positive sentiment around Abenomics-related policies and the potential they represented drove Japanese equities in 2013. Since then, optimism has faded, pressuring Japanese shares, as investors continued to await material change.

We believe that the fundamentals behind the yen, which has declined in 2014, and the Japanese economy remain weak. If this is correct, locally oriented businesses will likely continue to struggle. However, a sharply weaker yen could present investment opportunities among exporters, which have long been some of the most innovative companies in Japan.

Appeal of Multinationals

With the U.S. maintaining its status as the strongest developed market economy, we believe that multinational corporations based outside the U.S. but with significant operations in North America are attractive—with such companies likely to benefit from both economic and currency gains (see display).

Similarly, we believe that companies with exposure to select emerging markets offer the prospect of better growth. Though emerging markets had a slow start in 2014, a series of elections—most significantly that of Prime Minister Narendra Modi in India, but also results in Indonesia—could mean more market-friendly reform and less political uncertainty going forward. The outlook appears most promising in India, but we are concerned that sharply higher share prices there could mean that valuations are vulnerable to any delays in implementation. While many countries appear to be firmly on the reform track, the outlook in other markets—notably Russia, Brazil and South Africa—is much less clear.

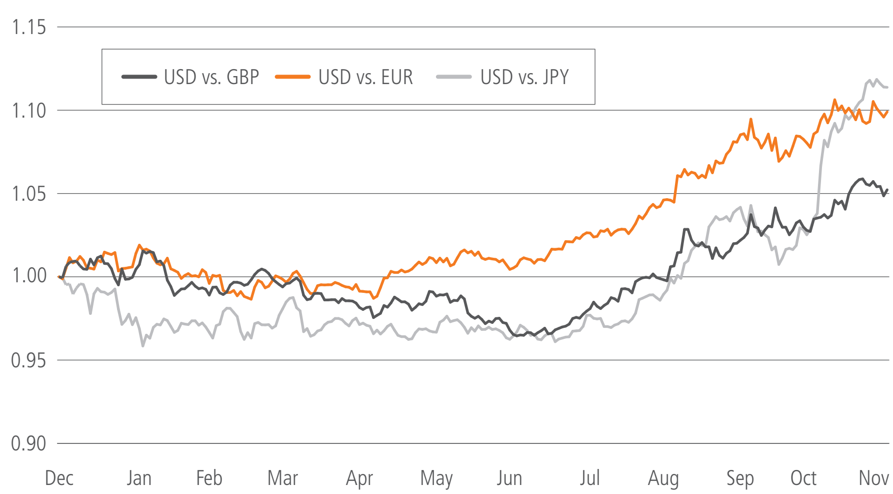
Identifying Real Growth Potential

In a world of uninspiring growth, we are focusing on businesses with strong cash flows and recurring revenue streams, many of which can be found in segments of the industrials and information technology sectors. Sectors dependent on global growth, such as energy and raw materials, could struggle again in 2015. We are also wary of companies reliant on government contracts or assistance. Public sector budgets are likely to remain under pressure.

With interest rates having reached their lower bound in most developed markets, we favor companies that should benefit from higher rates, or at least those that are interest-rate agnostic. Highly leveraged companies—in

RECENT U.S. DOLLAR STRENGTH SEEMS LIKELY TO CONTINUE IN 2015

(Dec 31, 2013 = 100)



Source: Bloomberg, data through November 2014.

Fundamental Analysis, ESG and Effective Due Diligence

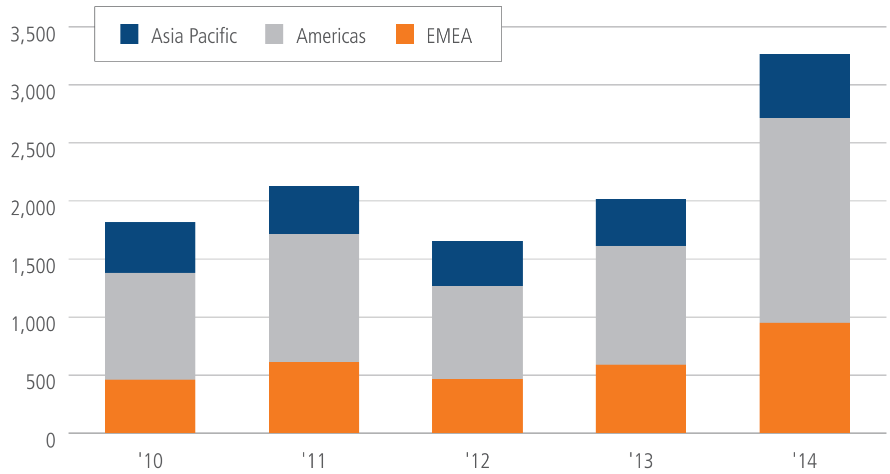
Ingrid S. Dyott and
Mamundi (MG) Subhas, CFA
Portfolio Managers—Core Equity/Socially Responsive Investing

As portfolio managers, we look at many top-down risks as we assess bottom-up company fundamentals. In the coming year, we think that global economic and geopolitical uncertainties could influence business and consumer decisions, as well as market performance. Beyond these key factors, however, we believe that one should not ignore the influence of environmental, social and governance (ESG) issues in assessing the investment environment and prospects for individual securities.

Trends in ESG can foster new markets and investment opportunities. In the case of climate change, consumers have become more conscious of energy efficiency and emissions, supporting businesses with viable solutions in these areas. Companies that recognize the importance of attracting and retaining talent combined with incentive compensation structures that align employees with business objectives mindful of all stakeholders are competitively advantaged.

Fundamental due diligence, in our view, should incorporate such factors along with specific business and macro considerations. The analysis may extend to impact on liability, regulation, supply chains, consumer demand and market growth, all of which can make for a more complete picture of company prospects. We believe this should enhance the potential to identify thoughtfully managed companies that are well positioned to both grow and navigate evolving risks.

GLOBAL M&A VOLUME HAS BEEN ELEVATED
USD billions – First 9 Months of the Year



Source: Bloomberg, data through September 30, 2014.

particular those reliant on shorter-term funding such as banks and utilities—could struggle as investors anticipate a rate rise. With rates having remained low for several years already, businesses with strong balance sheets haven't been rewarded—a situation that could change as rates move higher.

Vulnerable M&A-Based Valuations

During 2014, merger and acquisition activity has been much higher than in prior years, which has resulted in a modest takeover premium in certain European companies' share prices in our view (see display). Acquisitions have been partially driven by "inversions," whereby a U.S.-domiciled company seeks to purchase a foreign company and re-domicile in the target company's market—lowering its tax burden in the process. With the U.S. Treasury Department crafting legislation designed to limit this practice, we think valuations based on M&A prospects are vulnerable.

Higher Quality at a Discount

While the MSCI EAFE Index has declined in U.S. dollar terms so far this year, many international markets are up in 2014 in local currency terms. However, earnings expectations haven't increased as much as share prices. As a result, and in particular for those areas of the market most sensitive to low interest rates, valuations have become more demanding entering 2015 than they were at the beginning of 2014.

However, for many of the highest-quality international companies with stronger balance sheets, more consistent earnings profiles, and less economically sensitive revenue streams, fundamentals have improved in line with share performance. Thus, valuations for the businesses we favor are no richer—and in some case are cheaper—now than they were a year ago. As we look to 2015, quality companies offer what we consider attractive return potential if markets remain strong, and lower risk should markets consolidate. As such, we remain constructive for the year ahead.

EMERGING MARKETS: REFORMS REMAIN CENTRAL TO PERFORMANCE

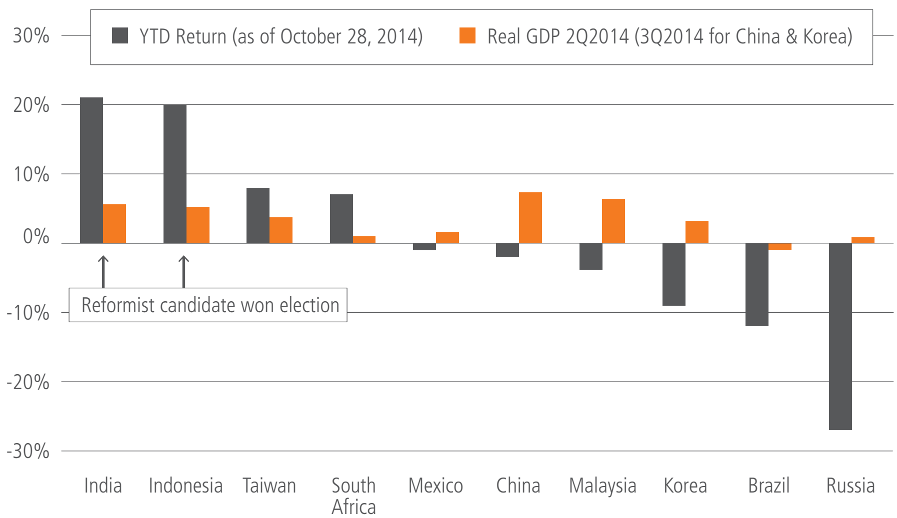
Conrad A. Saldanha, CFA, Portfolio Manager—Emerging Markets Equities

At the beginning of 2014, emerging markets seemed poised for improved performance on the back of the apparent end of a downward earnings revisions cycle, coupled with supportive valuations. Still, these tailwinds competed with a potential rise in U.S. interest rates and growing geopolitical tensions, offset by quantitative easing in Japan and Europe. All of these factors led us to suggest that investors avoid thinking of emerging markets as a homogenous asset class but rather as a divergent set of opportunities and risks requiring country, sector and stock level analyses.

For much of 2014, our improved expectations were borne out. After a rocky start (driven in our opinion by U.S. Federal Reserve tapering and Russia's annexation of Crimea), the MSCI Emerging Markets Index saw a period of outperformance relative to developed international markets. Investors appeared to chase better valuations and growth prospects—and the best performing markets were those with both reformist political change *and* strong domestic growth (see display). Overall, there has been tremendous disparity between the best and worst performing markets. As we look toward 2015, we anticipate another differentiated year across markets, where reforms—and their impact on economic growth—will be a key factor.

REFORMS AND GROWTH HAVE DRIVEN RETURNS

Market Performance and GDP Growth



Source: Bloomberg.

From Intent to Action

In our view, the structural growth imperative for emerging markets continues to be reform. In 2014, we have seen investors reward countries that have started to address their own issues. This has been most notable in India and Indonesia, where investors have applauded what they considered positive central bank actions and reformist election wins.

Greater China: Skepticism Should Wane

Frank Yao, PhD, Senior Portfolio Manager—Greater China Investment Team

Investor sentiment toward China has been improving gradually, as concerns over a potential hard landing have dissipated. Although China's growth is slowing, we believe this is a positive sign of the Chinese government's focus on transitioning its economy to quality (not quantity) expansion. Meanwhile, meaningful reforms persist, from cleaning up state-owned enterprise reforms, to interest rate liberalization and the easing of capital controls. Overall, we anticipate GDP growth of around 7% for this key market over the next few years.

From a valuation standpoint, Chinese equities remain at record lows, with the MSCI China Index trading at about nine times forward earnings versus its historical average of 13, and the CSI 300 Index trading at 10x compared to the historical 17x.[1] Meanwhile, company earnings continue to stabilize. Based on a sample of over 1,400 China A-shares companies, net profit growth has been at 10%, 8% and 11% for the fourth-quarter 2013, first-quarter 2014 and second-quarter 2014, respectively.[2]

In our view, this combination of reforms, low valuations and earnings strength makes Chinese equities very appealing. Moreover, we are optimistic that Chinese A-shares will soon become part of the MSCI indices, which could increase demand as investors increase their allocations to be in line with index weightings. Obviously, Chinese equities have been disappointing in recent years. Looking into 2015, we believe that short-term market volatility should persist. However, we believe that investor skepticism should gradually ease as the Chinese business climate shows steady progress.

[1]Source: Bloomberg, as of September 30, 2014. Forward 12-month P/E ratios for the MSCI China Index and CSI 300 index were not available until January 2006.

[2]Source: WIND Information Co. Ltd., as of June 30, 2014. Net profit growth year-over-year takes a constant sample of 1,442 China A-share companies that have started reporting quarterly financials since 2008.

We think the work ahead for reformist governments is going to be harder. It is one thing for a country to commit to reform, but another entirely to overcome obstacles and execute. It's for this reason that we question how quickly share prices in Indonesia have already risen on the promise of structural change tied to President Joko Widodo's election. Even under ideal circumstances, it could take a few quarters before the effects of promised reforms are felt by the businesses and sectors they are meant to benefit.

Outlook Varies by Region, Country, Sector

While we believe reform may be the most significant long-term driver of value, as has occurred in the past year, we see a range of intermediate-term opportunities and risks at the country and sector level. With our expectation that GDP growth will remain scarce in the coming year—both in developed markets and in some of the larger emerging economies—we believe markets where earnings growth could surprise on the upside will be favored. India is one example, especially should the reforms under Prime Minister Narendra Modi continue.

By contrast, we anticipate slower growth for the larger North Asian markets, specifically Korea and Taiwan, due to weak export end-markets and competitive pressure from Japan, where the yen has weakened. In policy-driven China, decisions by the government should continue to be the predominant driver of stock market performance. A series of reform measures aimed at opening up China's capital markets could dominate both the Hong Kong and Shanghai exchanges.

In Latin America, the Brazilian market tracked pre-election polls, hoping for the populist incumbent to lose, which ultimately did not happen. That leaves the Brazilian economy suffering from anemic growth and high inflation expectations, with a volatile currency and little prospect for reform. In Mexico, by contrast, investors with high expectations for reform have been disappointed in 2014. However, we continue to see the potential for positive longer-term benefits from the execution of reforms there, especially in the energy sector, which up to now has been sacrosanct.

Russia offers tremendous value (see display at right). However, even at compelling valuations, the lack of policy transparency makes it a high-risk locale for stocks, in our view. We believe this economy, which was slowing prior to the start of sanctions, will continue to see significant headwinds. We also feel that it's too early to fully determine the impact of sanctions on companies on the U.S. and European sanctions lists. While in the longer term, investors could realize even higher discount rates for investing in Russia in 2015, there could be some pain in the nearer term.

In nearby Central and Eastern Europe, lackluster growth and deflationary forces in developed Western Europe continue to pose a challenge to local economic growth.

With geopolitical risk remaining elevated, it seems likely to continue to add volatility to markets and investment flows. For example, energy-related stocks may remain volatile with tensions in the Middle East and Western sanctions against Russia and diminishing supply, balanced against falling global energy demand that has led to recent oil price softening. Importantly, cheaper oil benefits most of the consumer-driven economies in emerging markets, including India and Turkey, through lower inflation and reduced current account deficits. This affords policymakers additional monetary and fiscal flexibility.

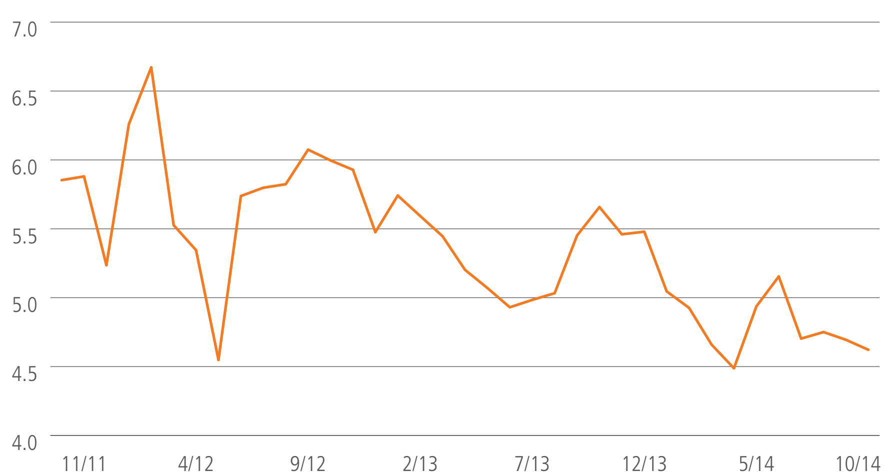
We also saw a market rotation toward lower quality, state-owned businesses across emerging markets at times during 2014. In our view, this shift was driven by expectations for reform and political change, as well as by supportive valuations and inflows from ETFs—as some of these companies, particularly in the energy, telecommunications and financial sectors, represent large weightings in their respective benchmarks. For these gains to be sustainable, we think earnings at these companies will need to catch up to their share price appreciation—something that so far has proven to be elusive.

Identifying Real Beneficiaries

While we see 2014 as a year of transition, we view 2015 as a year of execution. Rather than focusing solely on promising election results, the emphasis now is on follow-through with respect to policy reforms. As investors, we believe the key task is to identify the countries that are able to execute and the individual companies that stand to benefit. Ultimately, we believe companies that exhibit strong earnings growth and superior returns will be rewarded in the current global low-growth environment.

RUSSIAN VALUATIONS ARE VERY LOW—BUT REFLECT ELEVATED RISK

MSCI Russia: Forward Price/Earnings



Source: Bloomberg.

SOLVING FOR 2015
Global Fixed Income

Overview:

SHIFTING TRAJECTORIES CONTRIBUTE TO UNCERTAINTY

The global economy and fixed income markets have provided their share of surprises in 2014—from growth disappointments to concerns about deflation to repeated distractions due to events in Ukraine, Iraq and elsewhere. Given extensive uncertainties around the globe today, assessing the year ahead is arguably more difficult than at times in the past. However, we do see a number of key themes, including increased divergence among economies, elevated market volatility and the value of looking across markets and assets in search of return.

Brad Tank
Chief Investment Officer—Fixed Income

When 2014 began, it was widely assumed that interest rates would trend higher during the year and generate a headwind against global fixed income markets. As is often the case, the unknowns trumped the consensus, as rates generally declined given several bouts of risk aversion, at times triggered by escalating geopolitical issues and concerns about global growth. Against this backdrop, volatility returned to the markets, causing sovereign yields to fall and credit spreads to reverse course and widen.

As we look toward 2015, we anticipate a world in which economies function in different gears. We believe the U.S. and U.K. economies should expand at solid, if unspectacular growth rates, while the eurozone and Japan could experience a far slower pace of expansion. In terms of monetary policy, the U.S. Federal Reserve and Bank of England (BoE) appear likely to take their first steps toward policy normalization. Meanwhile, the quantitative easing baton will be passed on to the European Central Bank and the Bank of Japan (BoJ) as they seek to stimulate growth and inflation. Emerging markets, meanwhile, represent a true kaleidoscope of economic profiles, though more subdued growth and lower inflation should be the norm, in part due to commodity weakness. This should induce easy monetary policy in many developing countries.

While our base case scenario calls for a continuation of the global recovery, we caution investors to expect a bumpy ride. With the Fed's future actions being data-dependent, asset prices should be more responsive to upside and downside surprises, resulting in increased spread volatility. Meanwhile, other potential sources of risk are visible across the landscape. Geopolitical tensions have been pervasive in 2014 and are likely to remain a threat in 2015. To date, China has proved its skeptics a bit wrong by executing a smooth downshift in growth but certainly bears close watching. Markets expect an expansion of quantitative easing in Europe and a failure to deliver by the ECB would expose their markets to further volatility and downside risk. Abenomics in Japan has been impactful thus far but now must include meaningful structural reform to deliver sustained momentum.

With this backdrop, we are finding pockets of opportunity across the fixed income marketplace. As was the case at times in 2014, markets often exaggerate or misread developments, making it possible for investors to capitalize and generate value. We believe making fluid choices, picking your spots and basing decisions on economic realities should be especially valuable in the year ahead.

In the pages that follow, my Global Fixed Income colleagues provide further details on our views across sectors and markets.

DEVELOPED MARKETS FIXED INCOME

GLOBAL ECONOMY AND SPREAD SECTORS: A TALE OF MANY MARKETS

Andrew A. Johnson, Chief Investment Officer—Global Investment Grade Fixed Income
Thanos Bardas, PhD, Senior Portfolio Manager—Global Investment Grade Fixed Income and Head of Interest Rates
Jon Jonsson, Senior Portfolio Manager—Global Fixed Income

Global macroeconomic dynamics in 2014 have continued to highlight the very unusual nature of the ongoing recovery from the financial crisis. To repair the trauma induced by dislocations associated with deleveraging and a protracted recession, policymakers have remained reliant on exceptionally accommodative monetary policy and other non-traditional measures. Within the G4, a noticeable theme has emerged. While the U.S. and the U.K. have steadily picked up velocity, Japan, whose recovery initially looked promising, and the eurozone are struggling to tread water. We could see a repeat of these trends in 2015.

ECONOMIC/RATES VIEW

U.S. Should Continue to Accelerate

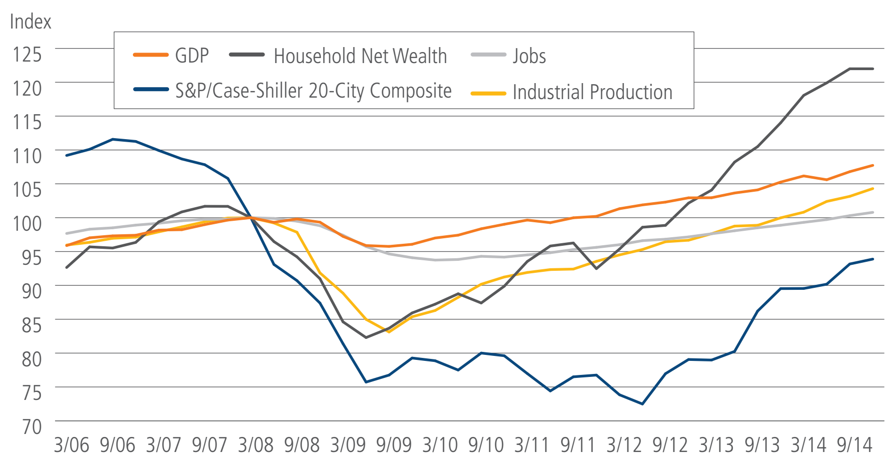
After surprisingly weak activity early in 2014, the U.S. economy quickly recovered and behaved more like we had anticipated—with modest growth and benign inflation in our view likely for the year as a whole.

While pockets of weakness persist, we think the U.S. will likely remain on solid footing in 2015. The labor market has steadily improved, with unemployment moving closer to the Fed's target. If that continues, it could have a positive knock-on effect on consumption, the housing market and other areas of the economy. Lower energy prices should provide a further boost to consumer spending in 2015.

The display (at right) shows the evolution of key macroeconomic variables in the U.S. economy. GDP and net worth have recovered strongly post-crisis, while the economy has finally recovered all the jobs lost during the recession. While house prices remain well below pre-crisis levels, the rebound from post-"bubble" levels has been impressive. Easy lending conditions and the improving labor market should allow the recovery to persist. All told, we forecast real GDP growth of 2.7% +/– 0.3% in 2015.

While quantitative easing ended in October, we think the Fed's monetary policy will be accommodative in 2015. Economic data will drive the timing of policy normalization. Along those lines, improvements in the labor market have yet to trigger wage inflation, while the Fed is closely monitoring weakening growth overseas. We doubt the Fed would rush rate hikes and jeopardize the recovery, especially in light of recent modest inflation prints. Under these conditions, we think the Fed will be patient and its initial rate hike could occur in the second half of 2015 with some probability

EVOLUTION OF KEY U.S. MACROECONOMIC VARIABLES, POST-CRISIS
Indexed from 2007



Source: Bloomberg, Neuberger Berman calculations.

that it occurs in the first quarter of 2016. In our view, the Fed Funds rate could be between 0% – 0.25% and 0.75% by the end of 2015.

Turning to Treasury yields, they seem likely to move higher in 2015. But given global uncertainties and the Fed's measured approach, we do not expect a sharp upward move. Rather, our outlook for the 10-year Treasury yield is for a gradual increase in its trading range, toward 2.6% – 3.3%, by the end of 2015. We anticipate that steady growth should lead to somewhat higher inflation, though lower energy prices have kept price pressures contained in 2014. At the same time, service and shelter inflation continue to show strength. For 2015, wage pressures will likely resurface as economic growth becomes more entrenched and the unemployment rate drops below the Fed's target. All told, we think inflation is likely to be about 2.0% +/– 0.5%.

Eurozone: What Stagnation Looks Like

While 2014 began with more optimism about the eurozone, dislocations suffered in recent years have continued to pose major challenges. As shown, the region has yet to recoup its economic losses from the credit crisis. At the same time, a key issue for policymakers is the wide economic divergence between Germany and other eurozone members.

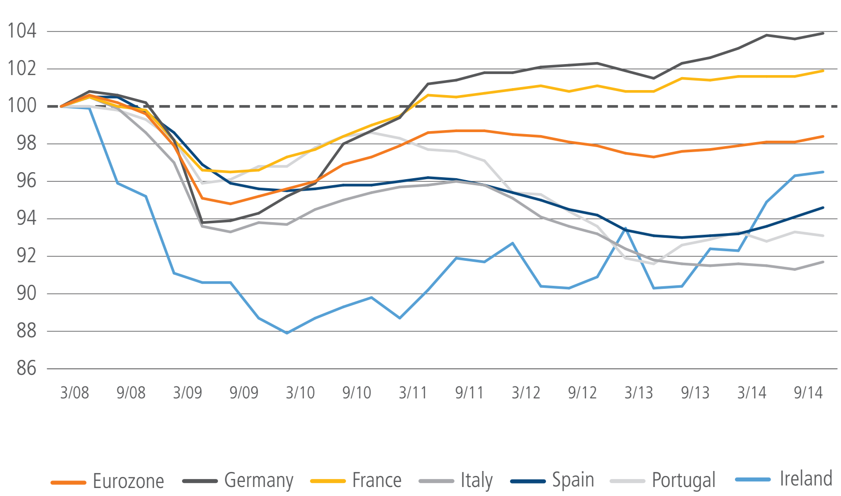
Lackluster growth and very low inflation have spurred the ECB to action. In September, the ECB lowered its refinance and deposit rates to 0.05% and –0.20%, respectively. The ECB also introduced its long-term refinancing operation (LTRO) using cheap, targeted loans to encourage banks to lend. Most importantly, the ECB has pledged to expand its balance sheet by 50% (about €1 trillion), with sovereign purchases becoming a growing possibility.

The geopolitical landscape remains a key risk. The Russia-Ukraine conflict has weighed on already fragile confidence due to Europe's heavy reliance on Russian energy as well as Russia's role as a key export market. Also, euro skepticism remains active in highly indebted nations, while Germany and other creditor nations are becoming increasingly disenchanted with the proliferation of bailout machinery to prop up less fiscally disciplined countries.

Due to the length of the debt crisis, the need for further deleveraging and a sharp rise in structural imbalances, we think the eurozone could gain only gradual traction in 2015. We anticipate real GDP growth to be around 0.75% +/– 0.5%, with headline inflation of around 0.6% +/– 0.5%. With an aggressive ECB, our yield outlook on 10-year German bunds is 1.5% +/– 0.5%, with the likelihood of peripheral spreads continuing to tighten. Given the slow economic activity and the formidable problems that confront the eurozone, we expect the ECB to refrain from hiking rates before the maturity of the LTROs in September 2018. This, in turn, would also support the ECB's quest to thwart appreciation in the euro. Looking at the European bond market, it is currently pricing in a very weak economic outcome, such that positive economic surprises could impact asset prices.

EUROZONE 'GROWTH' STORY HAS BEEN MIXED

GDP, December 2007=100



Source: Bloomberg, data through September 2014. Third quarter number for Ireland is a Neuberger Berman forecast.

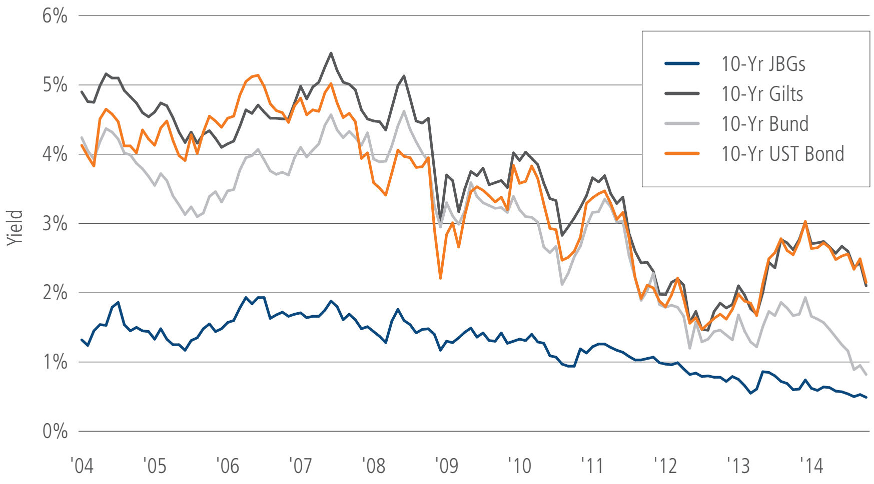
Japan: Stimulus Initially Helped – Now What?

After a protracted downturn, the Japanese economy expanded for some time at an above-trend pace on the back of Abenomics-fuelled growth. Through the BoJ's aggressive purchases and pursuit of its 2% inflation target, monetary policy succeeded over the short term in reversing the country's deep deflationary trend. However, more recent data suggest that economic momentum is faltering, driven in part by a consumption tax hike introduced in April and sluggish wage growth. As a result, the BoJ has increased the magnitude of quantitative easing and a second planned tax increase has been postponed. For Abenomics to prove successful in the medium to long term, we think serious structural reforms will have to be implemented and take hold. Also, we believe the central bank's inflationary target is unlikely to be achieved without higher wages and, by extension, a pickup in consumption. We forecast real GDP growth of 1.25% +/– 0.5% in 2015 and headline inflation of 2% +/– 0.5%. Our outlook is for the Japanese 10-year government bond to end the year at 1.0% +/– 0.3%.

United Kingdom: Slow Path to Normalization

The U.K. economy has accelerated in 2014, but the recovery overall remains the U.K.'s slowest on record. Significant tightening was priced into the front end of the yield curve in the first half of the year, as the market began to increase expectations for rate hikes. However, this has partially reversed, as the BoE has tempered expectations due to moderating inflation, little wage growth and weak industrial production. We anticipate real GDP growth of 2.4% +/– 0.4% for the country in 2015, with headline inflation of 1.7% +/– 0.5%. Unlike the market consensus, we expect the central bank to be very slow in withdrawing monetary accommodation. As in the U.S., we believe policy normalization will start in the second half of 2015 or the first quarter of 2016. Against this backdrop, our outlook for U.K. 10-year yields is in the range of 2.5% +/– 0.4%.

GOVERNMENT BOND YIELDS REMAIN EXCEPTIONALLY LOW



Source: Bloomberg, data as of October 15, 2014.

SECTOR VIEWS

U.S. Investment Grade Credit: Coupon Clipping

We anticipate a largely coupon-clipping environment for U.S. investment grade credit in 2015, with potential for modest spread tightening. Credit quality has likely peaked, but we do not anticipate any meaningful deterioration. Fundamentals remain strong overall, with corporate balance sheets that are often flush with cash. This suggests that default rates should remain well below their longer-term average. The impact of any Fed rate hikes will likely be limited, in our view.

In 2014, we saw an increase in shareholder-friendly actions, such as share buybacks and mergers and acquisitions activity. We remain watchful for signs of increasing event risk, especially if growth in the U.S. surprises to the upside. Conversely, if U.S. growth disappoints, or if growth overseas remains weak, this may lead to more conservative corporate fiscal policy and a decline in balance sheet leveraging.

In terms of sectors, we continue to favor financials. Their fundamentals are generally improving, partially due to increased capital requirements, and U.S. names tend to be domestically oriented and thus somewhat insulated from overseas risks. Conversely, we are wary of the health care and pharmaceutical sectors, as we feel investors are not adequately compensated for event risks.

Non-U.S. Investment Grade: Pockets of Opportunity

Despite multiple uncertainties, we anticipate select opportunities in the non-U.S. developed credit markets. The European credit cycle is more nascent than that of the U.S. and deleveraging remains the norm. As a result, we think event risk (share buybacks and M&A activity) is less of a factor. While we do not know if additional QE will provide the same tailwind for European credit as it did in the U.S., it could be an important theme as 2015 unfolds.

Drilling down further, we are generally constructive on European bank credits. Their valuations are attractive, especially as we anticipate strengthening balance sheets due to regulatory scrutiny. Banks would also likely benefit indirectly from more aggressive ECB actions. The central bank's asset purchase program has also shone a positive spotlight on European asset backed securities (ABS).

In the U.K., we feel credit spreads are generally attractive and could provide further opportunities in 2015. Although less liquid, we think U.K. spreads should be closer to those in the U.S., as investors are more than adequately compensated for this risk.

Currency: Will Volatility Trigger Opportunity?

Ugo Lancioni, Portfolio Manager—Global Fixed Income and Currency

Currency markets were range-bound in the first half of 2014 but later saw increased volatility due to signs of diverging growth, as well as expectations for a bifurcation of monetary policy between the U.S. and other major economies. The net result was a sharp rally in the U.S. dollar.

Looking ahead, FX opportunities could be driven by the effects of the greenback's advance, including lower commodity prices and their potential impact on global inflation. We anticipate continued, albeit less dramatic, gains for the dollar in 2015, as the fundamental story of superior growth and monetary tightening remains intact. On the yen, we believe that its valuation has become very cheap versus other G10 countries; and although the BoJ should continue expanding its balance sheet, we don't think the yen is likely to fall much more. The British pound has declined since the 2014 Scottish referendum. With more subdued inflation, expectations for the first BoE rate hike have been pared back substantially. However, U.K. growth prospects remain solid and the pound could rebound if current disinflationary concerns do not materialize.

Elsewhere, the euro's valuation seemingly has approached more reasonable levels. To some extent, growth in the eurozone is a wildcard for 2015. Expectations are now so low that we could see an upside surprise during the year, especially if looser financial conditions start feeding through to the real economy. Finally, our view generally is that the commodity-based currencies, including the New Zealand and Australian dollars, corrected from overvalued conditions. They could have further to fall if commodity prices remain weak.

In sum, we anticipate periods of continued volatility for the currency markets in 2015, creating plentiful opportunities for investors.

MBS and RMBS: Contrasting Outlooks

We have a fairly negative outlook on the agency mortgage-backed securities (MBS) sector. Over the last 20 years, current-coupon MBS spreads have averaged around 145 basis points over Treasuries. Today, they're at roughly 100 basis points. In the past, there has been a governmental entity acting as a marginal pricer for MBS, whether Fannie Mae, Freddie Mac or the Fed. The former two are winding down as institutions, while the Fed has recently ended its MBS purchases and will at some point stop reinvesting principal payments from its MBS holdings. Whoever emerges to set pricing in this sector will likely want to be compensated accordingly, which implies wider spreads. Finally, as the Fed slowly moves to normalize monetary policy, interest rate volatility should rise—another potential headwind for MBS.

We are more positive on non-agency residential mortgage-backed securities (RMBS). Projected loss-adjusted yields are now around 4% – 4.5%, in our view making them among the more attractive segments of the fixed income market. A number of clouds over non-agency RMBS have dissipated, including regulatory uncertainty and lawsuits related to mortgage originators and servicers. While housing activity has moderated, it remains relatively firm. Also, the floating rates on most RMBS help to limit their interest rate risk. One potential risk would be the knock-on effect of significant spread widening in credit markets. But we think its magnitude in non-agency RMBS would be muted due to their lower correlation to corporate credit, a decreasing inventory of outstanding bonds and solid demand from yield-seeking investors.

ABS: Opportunity from ECB Buying

In Europe, central bank purchases are contributing to the appeal of ABS. The ECB and the BoE view the asset class as an important tool for banks to extend credit to the real economy, and ultimately for stimulating growth. The ECB began buying in the fourth quarter of 2014 and we think this may create some opportunities in the European ABS market, but this will largely depend on whether the ECB is successful at reigniting new issuance. While the ABS sector offers a yield advantage over sovereigns, its risks include illiquidity and macro issues.

In the U.S., we have fairly benign expectations for ABS in 2015. Traditional AAA-rated issues, such as credit card, auto and student loans, have historically been fairly stable, with relatively muted volatility. We see spreads as now being fairly tight, but with low risk of substantial widening.

CMBS: Fairly Valued

Commercial mortgage-backed securities (CMBS) generally appear fairly valued to us. After significant tightening since 2008 – 2009, their spreads should stay in a fairly narrow 25-basis-point range in 2015. While volatility will likely be muted overall, we do anticipate many trading opportunities. One risk is the credit quality of underlying loans. With new issuance up significantly, we've recently seen credit quality deteriorate somewhat, with more highly levered loans. Fundamental analysis and a clear understanding of the underlying collateral will be critical for success in 2015.

TIPS and Linkers: From Constructive to Cautious

Inflation-linked bonds have bounced back after disappointing performance in 2013. In the U.S., we anticipate relatively stable inflation in 2015 as the housing component of CPI continues to strengthen along with improvement in the labor markets, while weakness in energy prices is feeding through to consumer prices. In our view, a decoupling of the U.S. economy from a slower Europe and Japan will cause U.S. break-even inflation rates to adjust modestly higher. Risks to our outlook include a further significant slowdown in China that could cause additional volatility in commodity prices, and further U.S. dollar strength.

Elsewhere, real yields have moved lower across countries, with European Union peripherals posting the strongest performance. Break-even inflation rates have generally been lower due to worries about potential for European deflation and further slowing of growth in emerging markets. We are cautious on European inflation-linked securities, although aggressive actions by the ECB and a sharp increase in its balance sheet could lead to an improved outlook for break-even inflation. In the U.K., despite stronger economic data, subdued energy and food prices continue to reduce headline inflation. In Japan, the dampening effects of a consumption tax hike and weaker oil prices should moderate inflation expectations. Elsewhere, break-even inflation in the commodities bloc should remain steady but may shift a bit higher as currency weakness feeds through to prices.

MORE ROOM TO RUN?

James L. Iselin, Head of Municipal Fixed Income

After generating strong results into the fourth quarter of 2014, some investors are questioning whether the municipal market can continue to rally into 2015. While the backdrop for the market will likely look quite different in 2015, we believe there's reason for continued optimism.

First, we believe fundamentals for many municipalities should remain stable at current, albeit lower than optimal, levels. Second, while the municipal yield curve has flattened, it remains steep from a historical perspective. In particular, we feel investors targeting the intermediate portion of the yield curve should be fairly compensated in 2015. Third, we expect technicals to remain strong overall. U.S. tax rates are the highest in recent memory and the municipal market provides one of the few opportunities to shield investment income.

More Volatility Ahead

What will look different in 2015? In contrast to the smooth ride in 2014, we expect the municipal market to see higher volatility, consistent with the overall fixed income market. This would be partially driven by the Fed and shifting expectations as to the timing and magnitude of rate hikes. While it's logical to assume that interest rates will increase in 2015, we expect them to drift modestly higher—a far cry from the spike we saw in 2013 when "tapering" became a household word.

We also believe supply will be higher in 2015, after subdued new issuance in 2014. With the November midterm election behind us, there could be an upswing in bond deals. Refinancing activity could also increase as municipalities look to lock in relatively low rates. Still, we think new supply will be well absorbed. And an increase in issuance should mean greater opportunities to exploit mispriced securities.

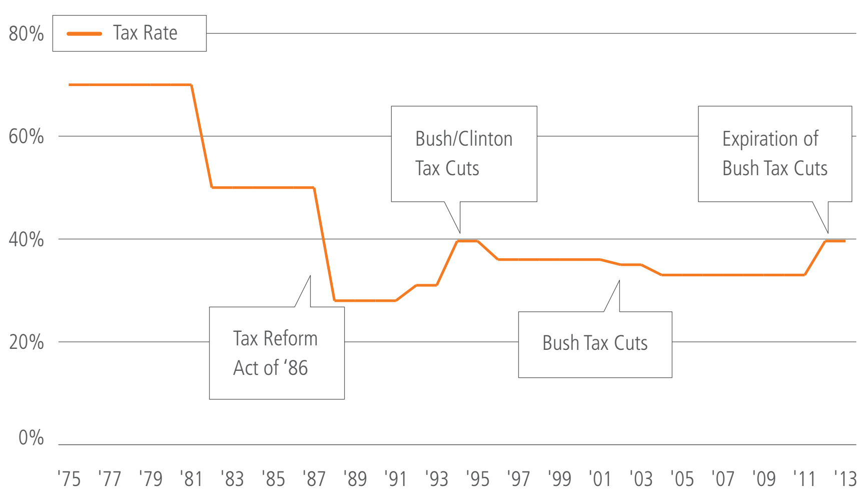
As for risks, many are the same as we mentioned in last year's outlook. Headlines regarding credit issues in Puerto Rico, Detroit's bankruptcy and other municipal downgrades could rattle investors from time to time. Still, if 2014 is any indication, investors have become better equipped to handle this type of market noise. Finally, while we'd give it a fairly low probability, a sharp spike in rates would negatively impact the municipal market.

Importance of Selection

In summary, we find municipal valuations to be fair to attractive, especially when compared to Treasury yields and in light of our expectation for overall strong demand. However, given the changing backdrop, we believe security selection will be increasingly important in 2015, as the difference between "bond pickers" and "risk takers" increases.

CONTINUED HIGH TAX RATES ARE REINFORCING DEMAND FOR MUNICIPAL BONDS

U.S. Personal Income Tax – Highest Marginal Rate



Source: Internal Revenue Service. Figures do not include the 3.8% Medicare tax.

HIGH YIELD AND SENIOR FLOATING RATE LOANS

CORPORATE FUNDAMENTALS REMAIN SUPPORTIVE

Thomas P. O'Reilly, CFA, Portfolio Manager—High Yield
Joseph P. Lynch, Portfolio Manager—Senior Floating Rate Loans

We believe generally solid fundamentals should lend support to the U.S. and European high yield markets, as well as floating rate loans, in 2015, albeit with some volatility.

United States: Growth and Low Defaults

In our view, the U.S. economic recovery should remain on track, with modest inflation. Such an environment should, in our view, be conducive to corporate profit growth. Also, given extensive refinancing activity, many companies have reduced their borrowing costs and extended maturities on their debt. Many issuers have a "balance sheet buffer," with ample cash on their balance sheets and only moderate leverage. Against this backdrop, we think it's unlikely that defaults will increase much in 2015. Should defaults stay around 2%, as we anticipate, it would represent only about half of their long-term average.

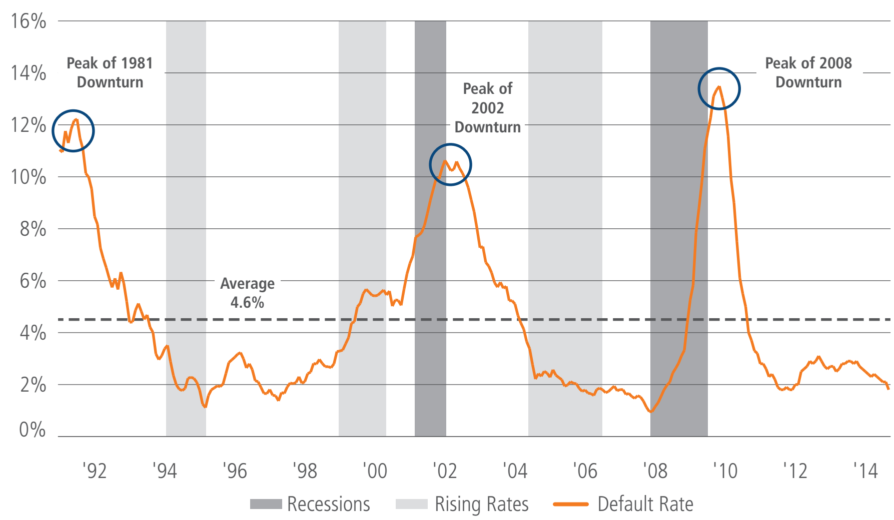
Still, we are cognizant of the risks—many of which are not directly tied to market fundamentals—that could adversely affect investor sentiment and pressure spreads. We've seen increased signs of economic slowdowns in Europe, Japan and China which, if they continue, could be a headwind for U.S. growth. Numerous geopolitical issues are also not likely to be resolved in the near term, which could trigger flights to quality, such as experienced in July through October.

Finally, we could see volatility tied to shifting expectations for future Fed rate hikes. While we believe rates could move higher in 2015, we feel this would be gradual. It's also important to point out that a rising rate environment is not necessarily negative for the high yield and senior floating rate loan markets. Rising rates would likely be driven by improving economic growth, which could result in higher corporate profits and improving fundamentals—traditional supports for the non-investment grade market.

All told, we could see some modest spread tightening from today's levels, with total returns largely coming from coupon income.

DEFAULT PICTURE FOR HIGH YIELD REMAINS POSITIVE

Global Speculative-Grade 12-Month Rolling Default Rate



Source: Moody's Investors Service, data through September 2014.

Europe: Strong Corporate Fundamentals and Low Defaults

We are constructive on the European high yield market in 2015. While economic growth in Continental Europe will likely remain weak, credit quality is at historically high levels. This has resulted in continued low levels of defaults, which we expect to continue in 2015. In light of moderate economic growth, management teams have remained conservative, which should limit shareholder-friendly event risks in Europe, favoring bond holders. We also anticipate that market technicals will remain supportive in 2015, driven by low interest rates and continued rapid expansion of the European high yield market. These two factors, we believe, provide an attractive investment opportunity and the ability to be more selective in security selection. As in the U.S., we are likely to see periods of elevated volatility in 2015. Still, we believe credit spreads remain attractive in light of this risk. As such, we believe that in 2015 the European high yield market has the potential for attractive total returns in line with long-term averages.

ECONOMIC STRENGTH SHOULD OFFSET LIQUIDITY WITHDRAWAL

Rob Drijkoningen and **Gorky Urquieta**, Co-Heads—Emerging Markets Debt Team

2014 has been a year of recovery for emerging markets debt (EMD) after a turbulent 2013. The adjustments forced by Federal Reserve tapering in 2013 led to rate hikes by emerging market (EM) central banks, which slowed domestic demand in many countries. Cheaper EM currencies helped restore competitiveness and, in combination with increasing growth in developed markets, current account imbalances receded, providing a healthier position to kick off 2014.

The year began poorly as spreads and yields widened materially in January. However, given the extent of the underperformance of EMD relative to developed market sovereigns and credits, the value appeal of EMD assets became more evident, causing EMD markets to stabilize and then rally until July. This dynamic was shared across EM sovereign, corporate and local currency government bond markets alike, with the latter again demonstrating its higher beta status with currency movements compounding yield shifts up or down. Among the three groups, EM sovereigns and corporates outperformed local currency bonds, supported by a surprisingly benign U.S. Treasury market and adjustments made in emerging countries, including interest rate increases and improvements to various imbalances.

In this context, growth in EM may still be regarded as subpar as compared to the last 10 years, but at least the composition of growth has cyclically improved, given the rebalancing away from domestic demand to more export-led growth. Also, EM currencies have adjusted downward to the less favorable terms of trade due to commodity weakness.

Later in the year, headwinds against EM were created by continued strong growth in the U.S., along with a rally of the U.S. dollar, supporting the notion of a reduction of previously buoyant liquidity; this led to an increase in risk premia across developed and emerging markets alike.

Conflicts, Reforms and Elections

Geopolitical events are typically never far away, but 2014 has had more than its fair share. The Ukraine-Russia conflict has been the most impactful, given the importance, size and proximity of Eastern Europe as part of the EMD universe, with spillovers into the European Union. It still looks like the conflict, in whatever shape or form, will remain a drag on the region for some time. Overall, EMD has been relatively resilient in the face of frequent headline-producing developments, though ongoing tensions bear watching.

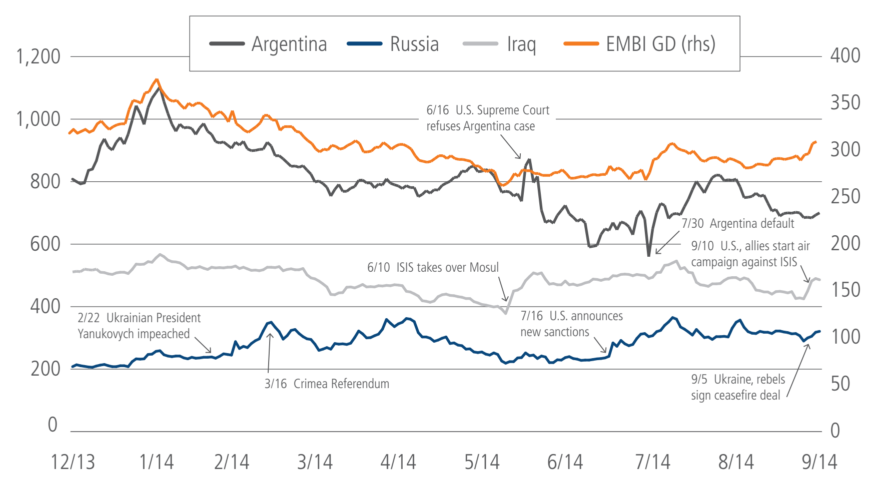
Over the course of the year, election uncertainties have largely proven to be opportunities for structural improvement. The outcomes in Indonesia, India and Ukraine ushered in reform-minded governments, though domestic hurdles from political opposition to reforms remain. In India, the Modi government has already fully liberalized fuel subsidies, while Indonesia, under President Joko Widodo, is likely to move in that direction. In August, Prime Minister Narendra Modi made some changes to India's Labour Laws Act, Factories Act and Apprenticeship Act to ease paperwork, trim transaction costs, and generally reduce the intrusive nature of the state. Together with reforms already set in motion in Mexico and continuing in China, the productivity catch-up theme in EM could have further legs after years of subdued progress on this front.

Next year's election schedule is certainly less heavy, with Argentina (general elections) and Venezuela (legislative elections) in Latin America, and Nigeria and Ivory Coast in Africa providing the key races. In the case of Argentina, regime change and the promise of less unorthodox policies are likely, as the current president is not eligible to run. In Venezuela, the picture is less clear as the midterm elections could turn into a powerful catalyst for change if the opposition is successful, but the cycle for the removal of the current administration is still distant. In Africa, Nigeria's elections could create volatility given the north/south divide, while in Ivory Coast the current president is clearly the market's favorite, creating potential downside if another candidate is elected.

For the broader emerging universe, China remains a bellwether. Its restructuring toward a more consumption-driven economy appears underway as shown by the rise in its services trade deficit. However, investors will likely need to navigate the short-term pain of economic

EMD HAS PROVEN RESILIENT DESPITE FREQUENT GEOPOLITICAL EVENTS

Spread over U.S. Treasuries (basis points)



Source: J.P. Morgan. Stripped spread for EMBI Global Diversified Index and Argentina, Russia, Iraq subcomponents.

rebalancing. Weaknesses in real estate activity and manufacturing investment are never far away from concerns about a hard landing. We think the chance of one is fairly low given that the country's public balance sheet appears strong enough to prevent any systemic fallout from the property market. The new leadership tends to refrain from substantial easing measures whenever economic activity slows, preventing a repeat of the mistake which led to the rapid buildup of credit in the past. The government has shown determination in its push against corruption and has kick-started reforms for fiscal, state-owned enterprise and land policies. In addition, exports should help to offset some of the weakness in domestic demand.

Multiple Drivers Ahead

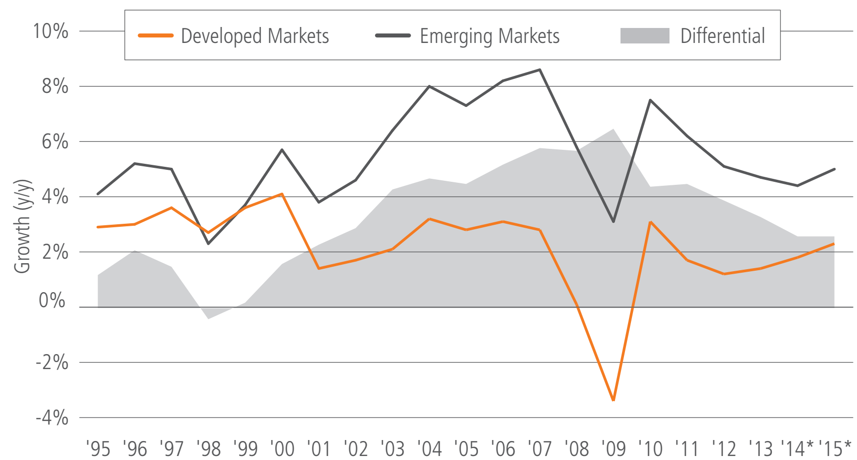
Going forward, given their enormous economic and political diversity, there is no single driver determining the outlook for emerging markets. Rather, various perspectives will likely be important in deciding on the potential winners and losers. In general, with our assumption of continued—if only moderate—growth in developed markets, EM countries that are sensitive to the global cycle are likely to benefit most. In our view, commodity exporters are less well positioned than commodity importers. This is due to structural (supply-side) increases in energy sources and more subdued demand globally, which to some degree is due to a shift in growth toward service-oriented activities and therefore less energy-intensive uses, as in the case of China.

At the same time, subdued growth (although stronger than in developed markets—see display top, right) and lower inflation in emerging markets (the latter due to low commodity prices including in agriculture) should enable relatively easy monetary policies and support consumer demand in EM, possibly with the exception of those countries that continue to have structural or cyclical funding gaps such as Turkey and South Africa. These remain more vulnerable to volatility, risk aversion and/or funding pressures emanating from the probable upcoming tightening cycle in the U.S.

In this context, the relative strength of the U.S. dollar could remain with us for some time. However, we believe that global economic growth won't be derailed, feeding into EM growth, which remains stronger than in developed markets. This could—with a lag—translate into EM currencies and spreads generating total return in U.S. dollar terms. Within the asset class, EM sovereigns' longer duration than EM corporates but modestly lower yields could offset each other.

While, in our view, the exceptionally low volatility we saw in mid-2014 is not likely to return, history has demonstrated that after the initial rate rise or liquidity withdrawal, risk premiums tend to recede again, capitalizing on the growth that ensues. With that in mind, we believe the generally solid economic fundamentals and carry advantage of EMD should make them competitive versus other fixed income asset classes in the year ahead.

GROWTH ADVANTAGE CONTINUES IN EMERGING MARKETS

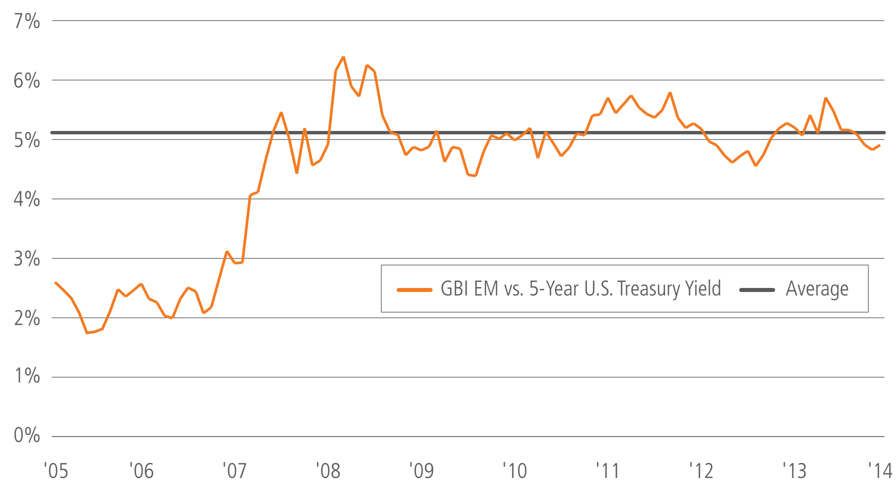


*Forecast.

Source: IMF World Economic Outlook, data through October 2014.

EMD HIGH NOMINAL YIELDS PROVIDE CARRY TRADE APPEAL

Spread over U.S. Treasuries



Source: J.P. Morgan. J.P. Morgan Government Bond Index-Emerging Markets compared to 5-year U.S. Treasury.

SOLVING FOR 2015
Alternatives

Private Equity:

OPPORTUNITIES ACROSS THE ASSET CLASS

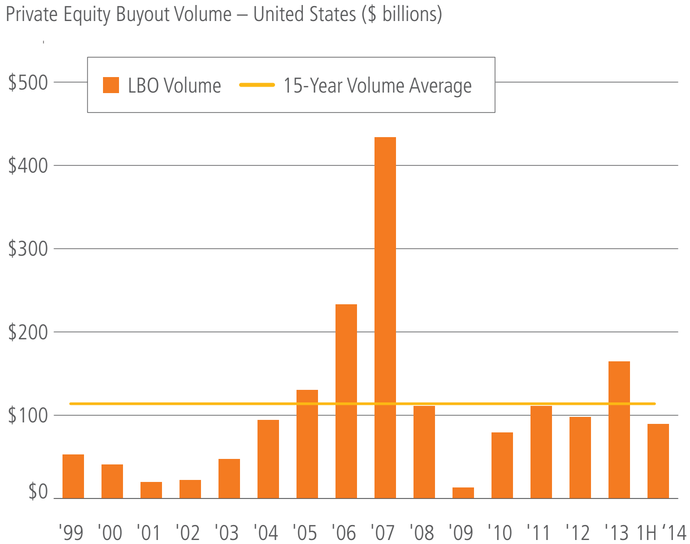
Anthony D. Tutrone
Global Head of Alternatives

The private equity market continues to experience robust conditions in many areas. At the same time, higher valuations and the current economic climate pose challenges and reinforce the value of careful due diligence and attention to risk in making investment decisions. Over the next year, we believe that traditional buyout firms can continue to leverage market conditions to achieve realizations through multiple avenues. Operational turnarounds, in our view, represent attractive opportunities within special situations in a potentially challenging and slower-growth environment. Venture capital managers should continue to see a strong exit market, and the growth equity sector remains underserved and thus offers attractive return potential, in our opinion. Finally, the secondary market seems likely to continue its long-term growth trend.

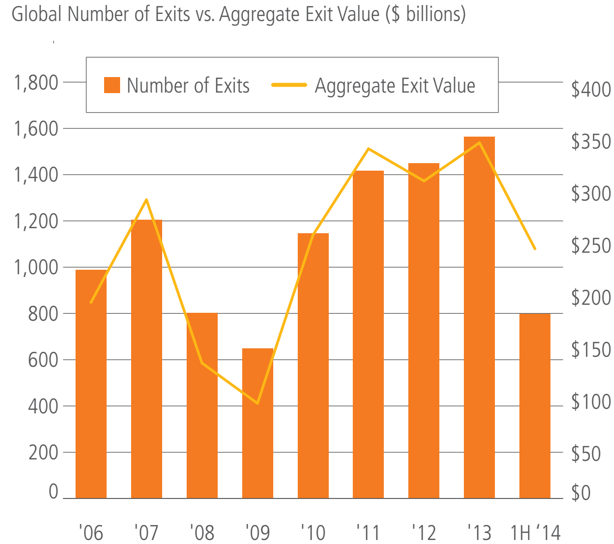
Buyouts: Focus on Realizations and Operations

During 2014, buyout activity has continued at a healthy pace, albeit down from 2013 levels. Private equity firms have become increasingly cautious as the year has progressed due to rising valuation multiples driven by a rising stock market, low interest rates and robust debt markets with borrower-friendly terms available to purchasers. As a result, there have been a significant number of realizations through dividend recapitalizations, initial public offerings and merger and acquisition sales. In 2015, we believe that firms will continue to be focused on generating cash realizations. One trend to watch is the U.S. Federal Reserve's increasing scrutiny of leverage levels offered by regulated banks to finance transactions. We think large banks will be selective in, but not abandon, providing levels of financing that may attract the attention of the regulators. While this is likely to negatively affect the absolute level of credit availability, we do not believe the impact will be material as the funding gap should be filled by non-regulated financial institutions and elements of the "shadow banking" system.

PRIVATE EQUITY BUYOUT VOLUME AND EXIT ACTIVITY



Source: S&P Leveraged Buyout Quarterly Review and Thomson One.



Source: Preqin.

Optimism for accelerating economic growth has waned, with several international markets, including Europe, potentially challenged. We think that private equity firms will be opportunistic moving forward, and capitalize on transactions resulting from any dislocations driven by below-expected levels of global economic growth.

We also anticipate the increasing prevalence of structured transactions such as preferred stock investments to help reduce the debt burden of overleveraged companies or to facilitate financing of M&A transactions for strategic acquirers that do not have the financial means to fund the deals independently.

In the context of generally slow economic growth, we believe firms can continue to create value in existing portfolio companies by controlling costs, seeking initiatives to accelerate organic revenue and pursuing accretive acquisitions to augment existing capabilities or to provide an entry into new product areas and new geographies.

We believe that private equity firms will increasingly partner with sophisticated co-investors in their transactions to fund equity requirements both at transaction inception and during the portfolio company holding period. Private equity firms have recognized the benefits of co-investors which allow them to complete transactions too large for their funds, manage portfolio composition and foster stronger relationships with their investors.

Special Situations: Turnarounds Appear Particularly Strong

Special situations encompass a variety of equity and debt strategies, including operational turnaround investments, distressed debt purchases and distressed asset purchases. In the year ahead, we believe that a potentially challenging and slower-growth environment, continued deleveraging, potential for globally destabilizing events, market volatility and a focus by companies on their core operations should provide ample opportunities for special situations investors.

Operational Turnarounds: Over the past five years, an attractive supply of opportunities has emerged from two main sources. The first is standalone companies that are undermanaged, deeply distressed and/or misunderstood. These out-of-favor private and public companies can be purchased outright at attractive entry prices, operationally rehabilitated, and then exited at traditional market valuations, creating the potential for high multiples of invested capital. The second source is orphaned business units within larger companies that suffer from minimal management attention, suboptimal resources and a lack of capital. A similar opportunity exists where these business units can be carved out at attractive entry prices, made to operate as standalone companies, and then exited at traditional market valuations for potentially high returns. We consider the operational turnaround opportunity to be "evergreen" in the sense that poor management and neglect are not cyclical, leading to opportunities throughout market cycles.

Distressed Debt: Over the past two to three years, distressed debt strategies have found reduced opportunity due to significant market liquidity, low interest rates, a generally improving economic environment and low default rates. However, even under these circumstances, there has been significant potential on a case-by-case basis in various geographies and sectors around the world. For example, while the opportunity in the United States has been relatively modest, Europe has seen a more robust supply of corporate distressed debt opportunities. Going forward, we believe the outlook for distressed debt is relatively attractive, although the timing remains unclear. Since 2009, loan volume and leverage levels have steadily increased to pre-crisis levels while there has also been continued increased issuance of low-rated debt. Further, the global economic outlook appears challenged and there is potential for multiple destabilizing events. Thus, while current default rates and distressed debt levels remain relatively low, we anticipate a more robust opportunity in the future.

Distressed Assets: We believe an ongoing driver of this strategy is the need for banks to clear nonperforming assets off their balance sheets to satisfy regulators, improve capital ratios and generally appease investors. As banks improve earnings and capital ratios, their willingness to sell bad and non-core assets at market-clearing prices continues to increase. Although heightened competition has increased asset prices and reduced return potential, we believe this opportunity will continue for many years given bank provisioning levels, particularly in Europe. In addition to distressed financial asset strategies, there are a variety of ongoing distressed hard asset strategies, including aircraft, shipping and energy. These strategies tend to be niche-oriented and have considerable barriers to entry that often create the potential for attractive returns.

In sum, while the opportunity for special situations is especially strong today within operational turnarounds, we believe that the environment for distressed debt could become increasingly attractive in the future.

Venture Capital/Growth Equity: Robust Activity, Select Opportunities

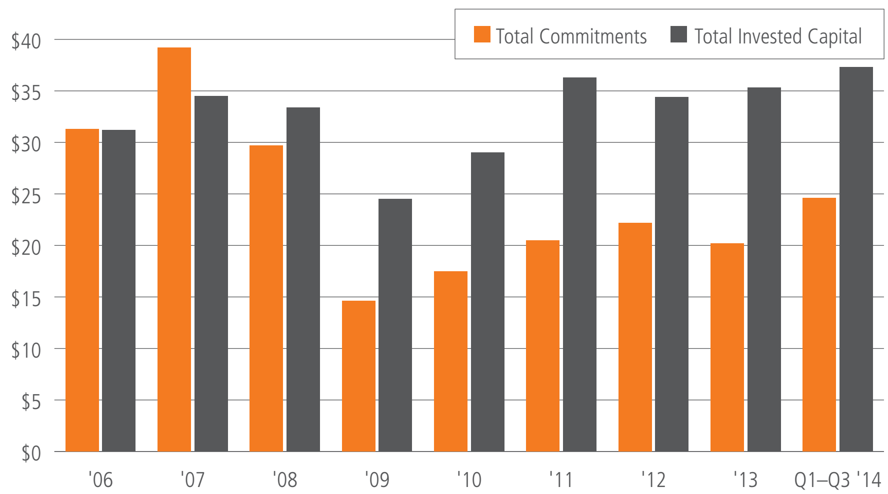
In 2014, the venture capital sector has seen accelerated momentum, with a very strong exit environment, increased levels of fundraising, robust investment activity and rapidly rising valuations in late-stage, exit-ready companies.

Capital raised by venture capital firms has generally lagged capital deployed since 2007, highlighting additional elevated activity on the part of many non-traditional investors. This is particularly true in late-stage venture-backed companies, with hedge funds and mutual funds using these rounds to build positions in companies that are expected to be taken public. Venture capital fundraising has been robust in 2014 with 20% more money raised in the first three quarters of the year than in the whole of 2013. The larger amount of capital targeted at the sector has led to an increase in both the median check size per financing round and median pre-money valuations. However, this data is skewed by later-stage rounds; early-stage pricing has generally remained at reasonable levels while late-stage companies' valuations have often soared once they have achieved some measure of success. Indeed, the median valuation of late-stage companies in the first three quarters of 2014 increased to 2.5 times what was seen in 2013—leaving valuations, in many cases, at what we believe are unsustainable levels.

In 2015, we believe these trends are likely to continue. Late-stage valuations for the most high profile and successful companies will remain elevated as long as exit markets are robust and the strong funding environment at this stage continues. However, should a significant market correction or economic event occur in 2015, it is possible that recent investments in certain late-stage companies will see a sharp decline in value. As such, we continue to believe that early-stage companies generally offer one of the most attractive risk/return opportunities in this market segment.

VENTURE CAPITAL DEPLOYED OUTPACES CAPITAL RAISED

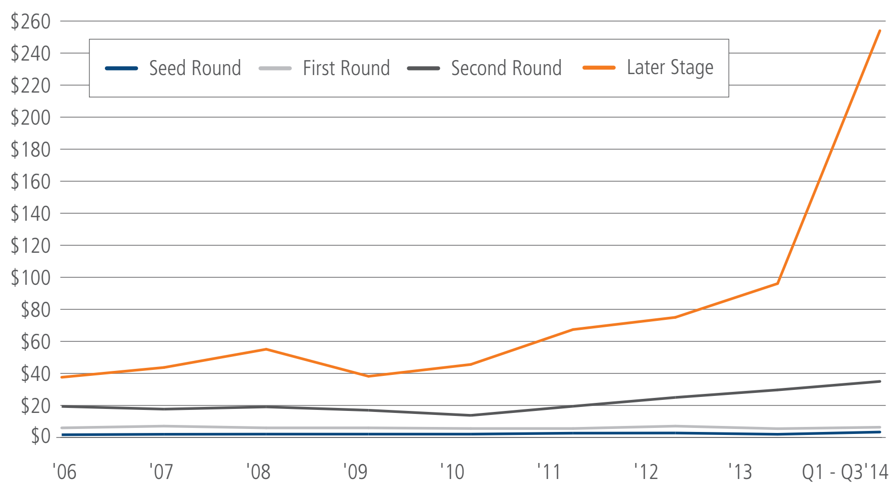
Fundraising and Investment Pace ($ billions)



Source: Dow Jones VentureSource, Q3 2014 Venture Capital Industry Overview.

MEDIAN PRE-MONEY VALUATIONS SOAR FOR LATER-STAGE INVESTMENTS

Median Pre-Money Valuations by Year and Stage ($ millions)



Source: Dow Jones VentureSource, Q3 2014 Venture Capital Industry Overview.

As U.S. stock markets have steadily risen to record highs, the venture-backed initial public offering market has become increasingly active. During the first three quarters of 2014, 85 VC-backed IPOs were completed, 11 more than in all of 2013. A busy pipeline of filed IPOs remains, and this activity is expected to continue at a steady pace into 2015. In comparison, M&A exits have been steadier. As long as equity markets remain buoyant, yields stay low and a steady supply of exit-ready companies continues, we think that recent trends in M&A exits and public offerings will persist. However, because of the volatility of the IPO market, we believe small and midsized M&A exits are more appealing as we believe they offer less volatile return potential over time.

The growth equity segment in the U.S. and Europe continues to be an attractive marketplace to deploy capital, as it has over the past several years. Situated between venture capital and small-cap buyout, we believe it is underserved, with a relatively low profile as a standalone asset class. As the number of firms focused on this asset class is small relative to the number of opportunities, we think the ability of investors to be highly selective could prove beneficial to returns. Also of importance, the availability of capital for many smaller companies continues to be scarce relative to larger counterparts, creating opportunities for providers of equity capital to serve those seeking funds for growth. We see a similar opportunity in emerging markets, in particular in Latin America, where growth capital and, just as importantly, the guidance of an experienced professional investor, can help to differentiate a company and could lead to attractive returns. Although somewhat muted by the small size and illiquidity of these types of companies, valuations in Latin America are trending upward as entrepreneurs look to public counterparts and highly publicized large acquisitions as exit metrics for their own companies' valuations. Still, we continue to believe that this is an attractive asset class as market inefficiencies persist.

Secondaries: Growing Force in Private Equity

In our view, 2014's strong activity in the private equity secondary market is likely to continue in 2015. Growth drivers of recent years, namely the expansion of the universe of sellers, changing regulation of financial institutions, more active portfolio management and the growth in private equity generally are, in our opinion, sustainable, long-term trends that we believe will continue to drive supply over time.

In addition, the secondary market continues to grow in sophistication and, today, offers what we believe are creative and customized liquidity solutions to both limited partners and general partners globally. As the private equity asset class continues to mature, one trend we believe will continue in 2015 is the secondary market's ability to provide viable solutions for mature, end-of-life private equity funds where limited partners desire liquidity, but their interests are not necessarily well-aligned with those of the general partner.

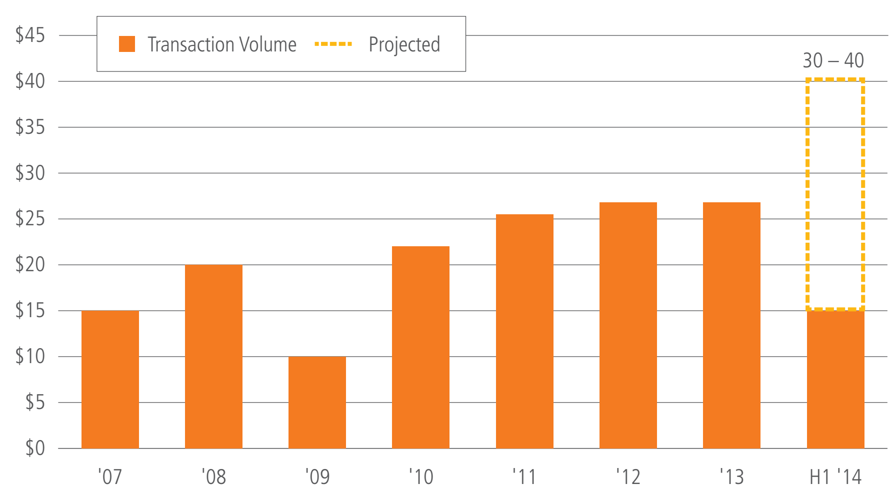
The secondary market can be volatile and has demonstrated a tendency to change quickly in response to public market conditions and distribution activity from underlying portfolios. According to UBS, a leading secondary market advisor, deal volumes increased to about $15 billion in the first half of 2014. This was more than double the roughly $7 billion in transactions we witnessed in the first half of 2013, when the market saw its lowest level of activity since 2009. In our opinion, such rapidly changing market conditions can provide attractive opportunities for value-oriented buyers and sellers who have an understanding of the underlying fundamentals and are well positioned to capitalize on potential market dislocations.

Conclusion

We believe private equity can continue to be an attractive asset class in 2015, with the potential to generate attractive returns with low correlations to other investments. In an environment that will likely be as active as in 2014, we see potential opportunities across a variety of strategies of the asset class, as financing for transactions is readily available and the public markets are receptive to companies backed by both buyout firms and venture capital investments. Distressed managers are still finding opportunity, particularly in operational turnarounds. Finally, secondary volume should continue to be strong as the space continues to evolve and adapt to current market conditions. Over time, the relative attractiveness of these areas is likely to shift, but in our view, the diverse nature of the asset class will continue to offer multiple ways to generate value for investment portfolios.

SECONDARY MARKET TRANSACTION VOLUME REMAINS STRONG

Secondary Transaction Volume ($ billions)



Source: UBS and publicly available data. Estimated secondary transaction volume based on Neuberger Berman estimates.

Jeff Majit, CFA and **David Kupperman, PhD**
Co-Heads, NB Alternative Investment Management

Hedge Funds:

VARIED FUNDAMENTALS, LOW CORRELATIONS COULD PROVE SUPPORTIVE

The financial markets continue to be supported by accommodative central bank policy, but heightened geopolitical risks, uncertainty around future interest rate policy in the United States, and government intervention in the merger space have conspired to make 2014 a challenging year for many hedge funds. A number of strategy-specific factors have also contributed to mixed results in the industry. For long/short equity managers, sell-offs among growth and small- to mid-cap stocks and a sharp sector rotation in the spring contributed to selling pressure in many popular hedge fund long positions. For event-driven managers, a handful of large deal "breaks" have led to broad weakness in event-driven situations as managers have de-risked their portfolios. For macro managers, volatility-suppressing stimulus and quantitative easing programs have challenged their opportunity set. In our view, these headwinds may only be temporary and we are constructive on the opportunities for each strategy going forward.

We believe that factors such as persistently low correlations among stocks, strong underlying company fundamentals and reasonable valuation levels are supportive of long/short equity strategies. In our view, the environment for corporate activity is also highly favorable as cash on corporate balance sheets remains at near-record levels and the pipeline for new deals continues to be robust. Finally, as economic growth across the world's major economies continues to diverge, we anticipate that the resultant decoupling of monetary policy cycles could lead to higher levels of volatility in fixed income and currency markets, and could create a greater number of cross-market trading opportunities for macro managers.

Looking toward 2015, we discuss these developments in more detail below, and consider their potential impact on long/short equity, event-driven and macro strategies.

Long/Short Equity: Potential Beneficiary of Divergence

We believe long/short equity may provide a compelling investment opportunity in 2015, as fundamentals remain strong, correlations are low and increased volatility may lead to higher dispersion, which has generally been positive for the strategy. We believe that some of the challenges faced by the strategy in 2014—a sell-off in growth-oriented stocks and the relative underperformance of mid-caps versus large caps—are all temporary phenomena.

Beyond these general tailwinds, today's market environment has certain characteristics that we believe may make long/short equity particularly interesting. Over the past year, the paths of the largest economies in the world, including the U.S., the European Union, Japan and China, have started to diverge. At the same time, and at least partially in reaction to this, central banks are starting to vary in their policy approaches. These differences have increased volatility in interest rates, currencies and commodities. Large moves in these asset classes have the potential to create dispersion among equities in different geographies and sectors. For instance, changes in currency valuations could hurt exporting companies in some regions and help those in others, while companies which have had access to capital markets only because of extremely low interest rates may be hurt when some central banks increase them. High dispersion and low correlation, which has persisted this year, often present fertile ground for long/short equity managers.

Given the current backdrop, we have a positive view of the general U.S. long/short equity landscape. However, we see particular potential in two sectors—health care and energy.

Health Care: Change Breeds Opportunity

The U.S. health care landscape has undergone tremendous change in the last few years and will likely continue to do so. Approximately 14% of the U.S. population, or 44.5 million people, are 65 and over, while 10,000 more Americans are turning 65 every day. Although health care spending represents 17% of total U.S. GDP and is expected to reach 20% in the near future,[1] health care companies represent only 13% of U.S. equity market capitalization.[2]

Perhaps the most important and dramatic change for the sector in recent years is the Affordable Care Act (ACA), which has thus far resulted in 10 million Americans gaining health insurance for the first time, with an additional 25 million expected to sign up in the future. We believe that the effects of the implementation of the ACA have only just begun to be felt by companies and their investors. Earlier this year, we received the first look at the law's incipient effects on utilization rates and health care spending, and what they mean for various subsectors including hospitals, insurance companies, pharmaceutical companies and medical equipment makers. Already, the ACA has proven to be a positive catalyst for some stocks, particularly hospital issues.

While health care is generally a defensive sector and has demographic trends working in its favor, thus calling for a net-long bias, the changes mentioned above could produce a fair amount of dispersion, both among subsectors and among stocks within subsectors, reinforcing the appeal of a long/short approach to the space.

Energy: Capitalizing on Shale's Knock-On Effects

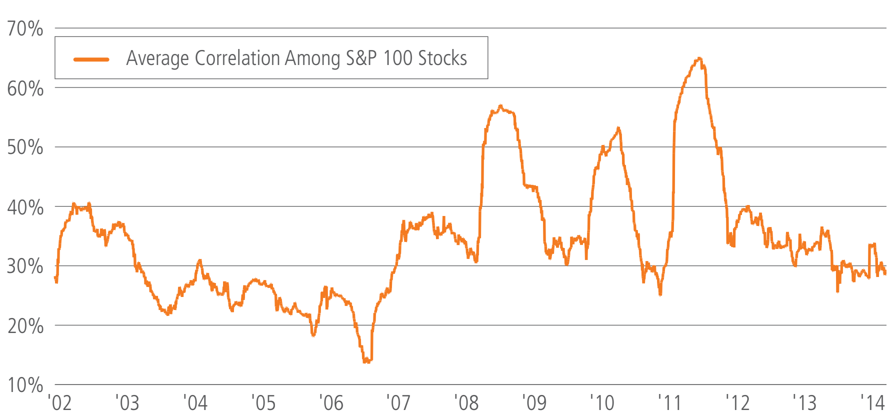
Energy-focused long/short equity funds are among the most popular in the sector-focused long/short world. This is largely due to the size of the energy market, the yield orientation (as opposed to value orientation) of the major investor base and the generally high dispersion among subsectors. Two particular trends are unfolding that, in our view, present interesting opportunities specifically for energy-focused long/short equity managers.

Due to unconventional drilling methods, the U.S. has been the world's fastest-growing oil and gas producer in recent years, a trend that we think could continue until at least 2020. Among the beneficiaries have been oil and natural gas exploration and production (E&P) companies. However, the U.S. shale energy "revolution" has produced various winners and some notable losers, largely tied to geography and cost structure.

Recently, additional knock-on effects of this revolution have started to appear. The dramatic increase in production, combined with America's historical position as a net oil importer, has required massive changes in the ways energy is stored, transported and shipped. As investment in energy infrastructure continues and the U.S. increases its oil and gas exports, we believe that we may see increased dispersion among energy subsectors and individual stocks which could benefit long/short managers.

NORMALIZED CORRELATIONS COULD FAVOR LONG/SHORT EQUITY STRATEGIES

Stock Correlations: Rolling 120-Day Averages



Source: Bloomberg, data through September 30, 2014.

[1]Centers for Medicare & Medicaid Services (CMS).
[2]Russell 3000 Index.

Moreover, the increase in production and slowing demand growth from China and other countries have contributed to a material decrease in the price of oil. Only time will tell if this move is temporary or longer lasting, but sustained low oil prices have the potential to reveal further differences among companies. For instance, low-cost producers with lean cost structures and/or low costs of capital may be able to gain market share from higher-cost producers which are forced to trim production.

Event-Driven: Accelerating Activity Could Benefit Managers

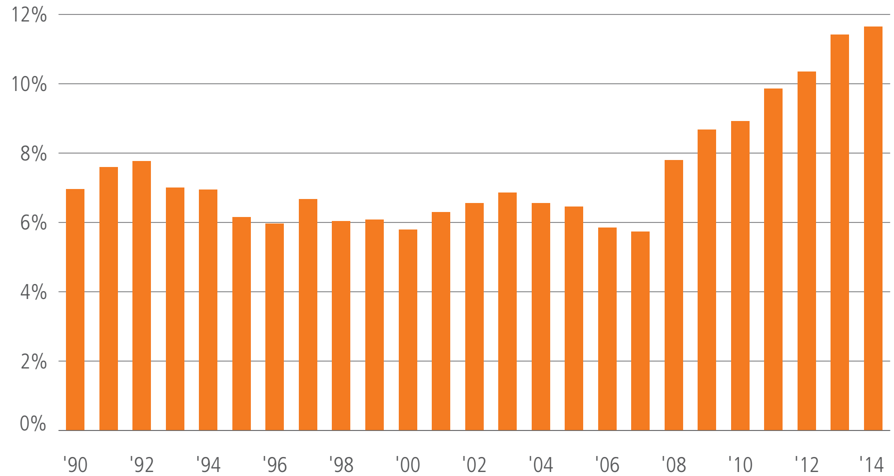
Following the global financial crisis in 2008, many companies decided to employ conservative strategies by cutting costs and hoarding cash. The result was a sharp decline in corporate activity, including mergers and acquisitions, share buybacks, dividend increases and spinoffs. Even after the 2007 – 2009 recession, economic growth was relatively slow and companies struggled to grow organically. Many investors believed that the combination of high corporate and private equity fund cash balances and anemic growth could soon spur the next upswing in corporate activity, but may have underestimated how defensive these companies had become. Through 2013, the number and volume of announced M&A and spinoffs did not come close to the pre-crisis peaks in 2006 and 2007.

Finally, in 2014, the pace of corporate activity has begun to accelerate. In addition to the factors we have noted, we have found that corporate executives' confidence seems to be on the rise for the first time in several years and the prospect of potentially higher interest rates has provided impetus for companies to secure cheap financing for deals before rates rise.

In addition to these drivers, companies in the U.S. have begun to employ creative measures to dampen the effects of high U.S. corporate tax rates. The energy sector has seen a wave of MLP conversions; many real estate-related companies (from outdoor advertising to data storage companies) have converted to real estate investment trusts. Finally, U.S. companies with large cash holdings in overseas subsidiaries have been employing tax-inversion mergers to gain access to that cash without triggering U.S. taxes.

AMPLE DRY POWDER FAVORS M&A ACTIVITY

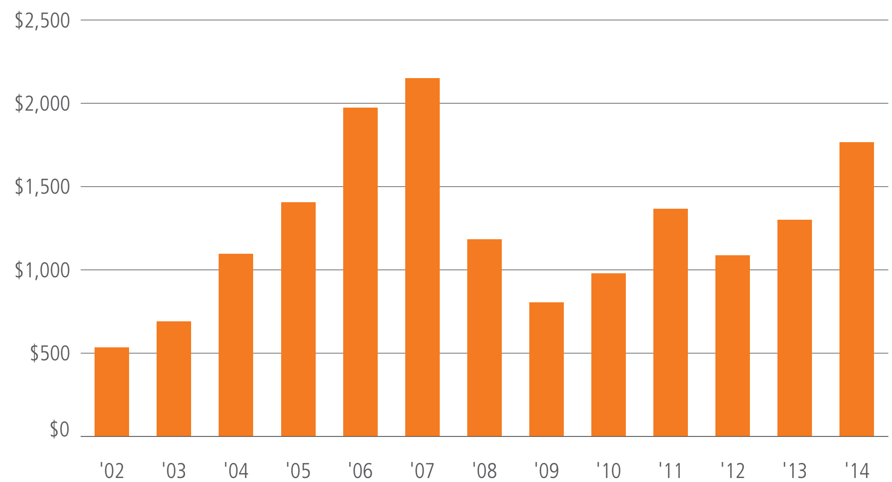
S&P Companies: Cash/Total Assets



Source: Bloomberg, data through September 30, 2014.

M&A VOLUME HAS FINALLY SURGED

U.S. M&A Volume ($ billion)



Source: Bloomberg, data through September 30, 2014.

While this has all been helpful in providing event-driven managers with a broad set of opportunities, the strategy has faced several headwinds, the largest of which have been regulatory/legislative in nature. Specifically, in August, three large deals fell apart, leading to speculation about tighter antitrust regulations and potential actions by the U.S. Congress or Treasury against tax-inversion mergers. This in turn led to a sharp decline in positions directly affected by the news and a broad sell-off in unrelated event-driven situations as managers reduced their risk exposures.

In September, the Treasury did in fact implement new rules to make it more difficult to complete tax-inversion mergers, which led to fresh weakness across the event-driven landscape. Finally, in early October, hedge funds suffered from an adverse ruling regarding legislation tied to Fannie Mae and Freddie Mac, followed by an unexpected deal break in one of the large ongoing tax-inversion mergers. This led to yet another extensive decline in event-driven trades.

Despite these headwinds, we believe event-driven managers have relatively attractive prospects moving forward. Even with the already high volume of announced deals, corporate cash balances remain near record levels. Also, we believe the current low-growth economic environment should persist, which could inhibit organic revenue growth and highlight the need for corporate activity. In addition, a rising interest rate environment may be imminent, which could further pressure corporate executives to secure cheap financing to complete deals sooner rather than later. From a more technical vantage point, higher interest rates may lead to wider merger arbitrage spreads, which present the potential for greater total return without increasing risk. At the same time, assets under management for activist hedge funds are now well over $100 billion, creating considerable dry powder to challenge company managers to accelerate corporate activity. Finally, periods with elevated spinoff activity, as is occurring currently, have historically been precursors to a healthy amount of M&A.

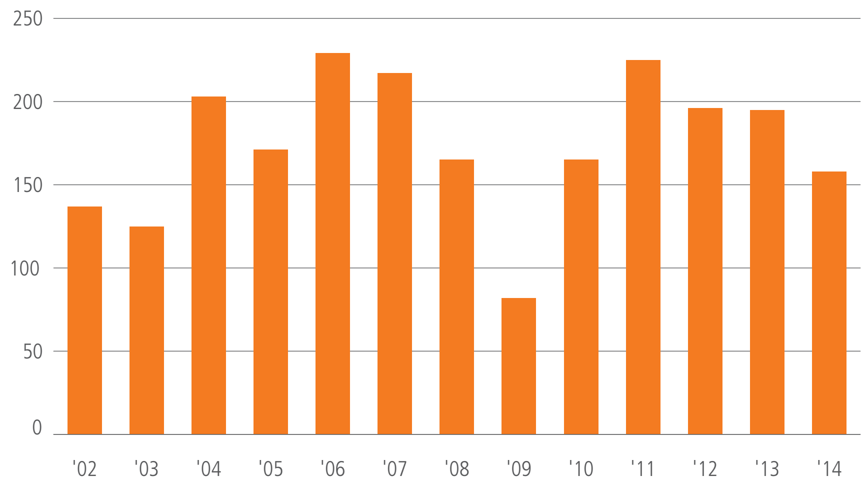
Macro: Policy and Volatility Could Open Doors

Global macro strategies have generated several years of relatively uninspiring performance. A combination of factors, including globally coordinated central bank activity, which has contributed to a lack of realized volatility and sustained trends across many markets, overly bearish positioning stemming from fresh memories of 2008, and trades which managers have simply gotten wrong, are all to blame, and in varying proportions.

In our opinion, however, the prospects for macro managers appear better going forward. The effectiveness of global coordinated central bank policy and massive QE can be debated, but the impact of suppressing interest rates and volatility, and inflating equity markets, is largely undisputed. Given the continued signs of strength from the U.S. economy, the market is anticipating that the Federal Reserve will begin to raise interest rates sometime in mid- to late 2015. In our view, this could be an important catalyst to improve the environment for macro hedge funds. Interest rate hikes could help support the U.S. dollar and cause price declines for intermediate to long-term bonds. As currency and fixed income have long been the preferred domain for most macro hedge funds,

SPINOFF ACTIVITY COULD LEAD TO MORE M&A

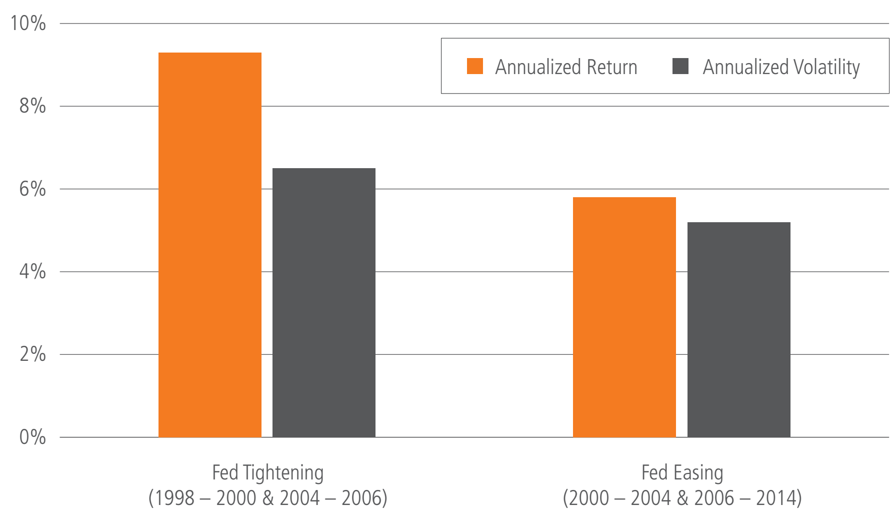
Number of Global Spinoffs



Source: Bloomberg, data through September 30, 2014.

MACRO CAN EXCEL WHEN THE FED RAISES RATES

HFRI Macro Performance During Most Recent Interest Rate Cycles (1998 to Present)



Source: HFR, Bloomberg. For illustrative purposes only. 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.**

the trends created by Fed activity could lead to attractive opportunities for managers. A rising rate environment has often been positive for hedge fund managers. The display above shows the performance of macro hedge funds during the last two Fed tightening cycles, relative to more benign rate environments.

In addition, we believe the growing economic divergence among some of the world's largest economies could lead to increased differentiation in central banks' policies over the short and intermediate term. We anticipate that this could increase volatility and create a greater number of cross-market opportunities for macro managers to exploit as they take bets on the different economic trajectories and monetary policy paths of various economies. The display on the following page shows the market's forecasts for short-term rates in some of the world's major economies. Growth in the U.S. and U.K. appears strong enough that short-term rates could begin to rise

Volatility, Creative Destruction: Constructive in 2015

Charles C. Kantor, Senior Portfolio Manager—Long/Short

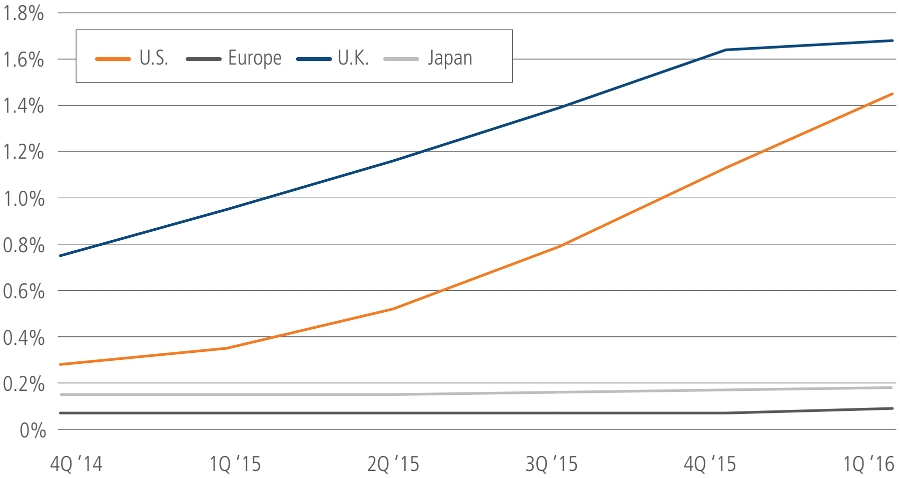
As long/short managers, we find that opportunity often emerges in transitions—changes in macro and liquidity conditions and in fundamentals among individual stocks. Today, we have plenty to work with, given a constructive U.S. economy coupled with increased market volatility and meaningful changes (both good and bad) at many companies.

In our view, the current economic expansion should last longer than many expect, characterized by slow growth and low inflation. Also, moderate earnings growth expectations and increased accountability on the part of corporate managers are likely to lend support to equity valuations. Driven by globalization and technology, we are seeing an acceleration of "creative destruction" across industries, providing opportunities both long and short. We believe that strong management teams operating in healthy end markets with the ability to effectively allocate capital will be leaders in creating shareholder value while those slow to adapt will find it more challenging to deliver their business and financial objectives.

Volatility across asset classes reappeared in the second half of 2014 as markets digested the potential removal of central bank support. The extreme turbulence should continue at times as the recovery in global growth remains uneven. Taken together with the unprecedented challenge of removing liquidity from the U.S. financial system, the implication for asset values has yet to be formalized. While dispersion among regions, market capitalizations and sectors created headwinds for many active managers in 2014, we believe it represents a favorable backdrop in 2015 for fundamental long/short strategies that seek to achieve favorable risk-adjusted returns through rigorous bottom-up security analysis.

RATE FORECASTS REFLECT MONETARY DIVERGENCE

3-Month Rate Forecasts (%)



Source: Bloomberg.

in 2015. On the other hand, zero-interest-rate policies seem likely to persist in Europe and Japan as the European Central Bank grapples with a stagnating economy and the Bank of Japan looks to stimulate growth and close the book on two decades of deflation. Every party ends at some point, and, in our view, the upcoming Fed tightening cycle will be a major catalyst that ends the easy-money, low-volatility trend that has fueled risk assets over the last several years. We believe there will be more divergent central bank policy and an increase in currency and fixed income volatility and, as a result, an improved backdrop for the macro funds that make it their business to trade in those markets.

A New Year, a New Market

Volatility and difference—in valuations, economic prospects and company fundamentals—are crucial drivers of hedge funds' ability to generate attractive risk-adjusted returns. The past few years have seen central banks pursue expansive policies to cure broad financial ills and return their economies to a path of growth. Whether they have succeeded is still an open question, but the universal path of developed market economies and monetary policy is changing into something more diverse and reflective of regional fundamentals. We believe this divergence may augur well for many hedge fund strategies, and thus we are optimistic about the year ahead.

SOLVING FOR 2015
About the Authors

About the Authors

Joseph V. Amato | President, Chief Investment Officer
Joseph V. Amato is president of Neuberger Berman Group LLC and chief investment officer, as well as a member of the firm's Board of Directors and its Audit Committee. He joined the firm in 1994 and has 29 years of industry experience. Joe received his Bachelor of Science from Georgetown University.

Thanos Bardas, PhD | Managing Director, Portfolio Manager
Thanos Bardas, managing director, is a senior portfolio manager on multiple fixed income strategies and global head of Sovereigns and Interest Rates. He is also a member of the fixed income investment team setting overall portfolio strategy, specializing in LDI and inflation strategies. Thanos joined the firm in 1998 and has 16 years of industry experience. He graduated with honors from the Aristotle University, Greece, and earned his MS from the University of Crete, Greece. Thanos also earned a PhD in Theoretical Physics from the State University of New York at Stony Brook.

Robert W. D'Alelio | Managing Director, Portfolio Manager
Robert W. D'Alelio, managing director, is a portfolio manager on the Small Cap Value team. He joined the firm in 1996 and has 35 years of industry experience. Bob earned a BA from the University of Massachusetts and an MBA from Babson College.

Rob Drijkoningen | Managing Director, Co-Head of the Emerging Markets Debt Team
Rob Drijkoningen, managing director, is a lead-portfolio manager and co-head of the Emerging Markets Debt team. He joined the firm in 2013 and has 24 years of industry experience. Rob earned a Macroeconomics degree from Erasmus University in Rotterdam and is DSI-qualified.

Ingrid S. Dyott | Managing Director, Portfolio Manager
Ingrid S. Dyott, managing director, is an associate portfolio manager of the Core Equity strategy and the co-manager of the SRI strategy. She joined the firm in 1997 and has 19 years of industry experience. Ingrid earned a BA from Bowdoin College and an MBA from Columbia University.

Tony M. Gleason, CFA | Managing Director, Portfolio Manager
Tony Gleason, managing director, is a portfolio manager for the MLG Group. He joined the firm in 1999 and has 27 years of industry experience. Tony holds a BS in Organic Chemistry from Stockton State College and an MBA from Fairleigh Dickinson University. He holds the Chartered Financial Analyst designation.

James L. Iselin | Managing Director, Head of Municipal Fixed Income
James L. Iselin, managing director, is head of the Municipal Fixed Income team and a senior portfolio manager. Jamie joined the firm in 2006 and has 20 years of industry experience. He holds a BA in Philosophy from Denison University.

Andrew A. Johnson | Managing Director, Chief Investment Officer—Global Investment Grade Fixed Income
Andrew A. Johnson, managing director, is chief investment officer and global head of Investment Grade Fixed Income and lead portfolio manager for multiple active and custom bond portfolios. He is also a member of Neuberger Berman Fixed Income LLC's Board of Directors. Andy joined the firm in 1989 and has 24 years of industry experience. He earned BS and MS degrees in Electrical Engineering at the Illinois Institute of Technology and his MBA from the University of Chicago.

Jon Jonsson | Managing Director, Portfolio Manager
Jon Jonsson, managing director, is a senior portfolio manager for Global Fixed Income strategies and is a member of the Investment Grade Fixed Income Senior Portfolio Management Strategy Team. He joined the firm in 2013 and has 16 years of industry experience. Jon received a BSc in Applied Mathematics from the University of Iceland and a Master's degree in Financial Engineering from New York University.

Charles C. Kantor | Managing Director, Portfolio Manager
Charles C. Kantor, managing director, is the founder and senior portfolio manager of the Kantor Group, which manages Neuberger Berman's Long/Short strategy. He joined the firm in 2000 and has 20 years of industry experience. Charles earned a Bachelor of Commerce in Accounting and Economics from the University of Cape Town, South Africa and an MBA (with honors) from Harvard University Graduate School of Business.

Erik L. Knutzen, CFA, CAIA | Chief Investment Officer—Multi-Asset Class
Erik L. Knutzen, managing director, is Multi-Asset Class chief investment officer. He drives the asset allocation process on a firmwide level, and engages with clients on strategic partnerships and multi-asset class solutions. He joined the firm in 2014 and has 25 years of industry experience. Erik holds a BA from Williams College and an MBA from Harvard Business School. He holds the Chartered Financial Analyst and Chartered Alternative Investment Analyst designations.

David Kupperman, PhD | Managing Director, Co-Head of NB Alternative Investment Management (NBAIM)
David Kupperman, managing director, is a portfolio manager and co-head of NBAIM. He is also a member of the Investment Committee for hedge fund strategies. He joined the firm in 2011 and has 16 years of industry experience. David holds an MA and a PhD in Physics from The Johns Hopkins University and a BA and an ME from Cornell University.

Ugo Lancioni | Managing Director, Portfolio Manager
Ugo Lancioni, managing director, is a currency and global fixed income portfolio manager and heads the Currency team responsible for developed markets FX strategies. Ugo is responsible for managing active currency overlay portfolios and is a member of the Investment Grade Fixed Income Senior Portfolio Management Strategy Team. He joined the firm in 2007 and has 18 years of industry experience. Ugo received a Master's degree in Economics from the University "La Sapienza" in Rome.

Joseph P. Lynch | Managing Director, Portfolio Manager

Joseph P. Lynch, managing director, serves as a portfolio manager for Senior Floating Rate Loans portfolios. Joe joined the firm in 2002 and has 19 years of industry experience. He earned a BS from the University of Illinois and an MBA from DePaul University.

Jeff Majit, CFA | Managing Director, Co-Head of NB Alternative Investment Management (NBAIM)

Jeff Majit, managing director, is a portfolio manager and co-head of NBAIM. He is also a member of the Investment Committee for hedge fund strategies. He joined the firm in 2000 and has 14 years of industry experience. Jeff graduated Phi Beta Kappa from Amherst College, earning a BA with concentrations in Economics, and Asian Languages and Civilizations. He holds the Chartered Financial Analyst designation.

Thomas P. O'Reilly, CFA | Managing Director, Portfolio Manager

Thomas P. O'Reilly, managing director, is a portfolio manager for High Yield and Blended Credit strategies, and sits on the firm's Partnership and Asset Allocation committees. He joined the firm in 1997 and has 25 years of industry experience. Tom earned a BS in Finance from Indiana University and an MBA from Loyola University. He holds the Chartered Financial Analyst designation.

Douglas A. Rachlin | Managing Director, Portfolio Manager

Douglas A. Rachlin, managing director, is the senior portfolio manager and founder of the Rachlin Group. He joined the firm in 1996 and has 28 years of industry experience. Doug earned a BA from Tufts University and an MBA from the Stern School of Business at New York University.

Matthew L. Rubin | Managing Director, Director of Investment Strategy

Matthew L. Rubin, managing director, is director of investment strategy at Neuberger Berman, chief investment officer of the Neuberger Berman Trust Company and a member of the firm's Retirement Services Committee. Matt joined Neuberger Berman in 2007 and has 14 years of industry experience. He graduated summa cum laude with a BA from the State University of New York at Stony Brook.

Conrad A. Saldanha, CFA | Managing Director, Portfolio Manager

Conrad A. Saldanha, managing director, is a portfolio manager for Neuberger Berman's Global Equity team and is responsible for emerging markets equities. He joined the firm in 2008 and has 20 years of industry experience. Conrad earned a B.Com from St. Xavier's College, Calcutta, and an MBA from Virginia Polytechnic Institute. He also holds the Chartered Financial Analyst designation.

Benjamin Segal, CFA | Managing Director, Head of Global Equity Team

Benjamin Segal, managing director, is a portfolio manager and head of Neuberger Berman's Global Equity team. He joined the firm in 1998 and has 21 years of industry experience. Benjamin earned a BA from Cambridge University, an MA from the University of Pennsylvania, and an MBA from the University of Pennsylvania, the Wharton School. He holds the Chartered Financial Analyst designation.

Yves C. Siegel, CFA | Managing Director, Portfolio Manager

Yves C. Siegel, managing director, is a portfolio manager for the Rachlin Group. He joined the firm in 2012 and has 29 years of industry experience. Yves received both a BA and MBA from New York University and holds the Chartered Financial Analyst designation.

Mamundi (MG) Subhas, CFA | Senior Vice President, Portfolio Manager

Mamundi (MG) Subhas, senior vice president, is an associate portfolio manager of the Core Equity and SRI strategies. He joined the firm in 2001 and has 35 years of industry experience. MG earned a BS and an MBA from the University of Pittsburgh. He holds the Chartered Financial Analyst designation.

Brad Tank | Managing Director, Chief Investment Officer—Fixed Income

Brad Tank, managing director, is chief investment officer and global head of Fixed Income. He is also a member of the firm's Senior Management Committee and Asset Allocation Committee. Brad joined the firm in 2002 and has 34 years of industry experience. He earned a BBA and an MBA from the University of Wisconsin.

Anthony D. Tutrone | Managing Director, Global Head of Alternatives

Anthony D. Tutrone, managing director, is global head of Alternatives, which includes both private equity and hedge funds. Tony joined the firm in 2002 and has 27 years of industry experience. He earned a BA in Economics from Columbia University and an MBA from Harvard Business School.

Gorky Urquieta | Managing Director, Co-Head of the Emerging Markets Debt Team

Gorky Urquieta, managing director, is a portfolio manager and co-head of the Emerging Markets Debt team. He joined the firm in 2013 and has 20 years of industry experience. Gorky obtained a BA in Business Administration from the Bolivian Catholic University in La Paz, Bolivia, and a Master's degree in Finance from the University of Wisconsin.

Judith M. Vale, CFA | Managing Director, Portfolio Manager

Judith M. Vale, managing director, is a portfolio manager on the Small Cap Value team. She joined the firm in 1992 and has 34 years of industry experience. Judy earned a BA from Yale University. She holds the Chartered Financial Analyst designation.

Yulin (Frank) Yao, PhD | Managing Director, Senior Portfolio Manager

Yulin (Frank) Yao, managing director, is vice chairman—Asia and senior portfolio manager for the Greater China Investment team, based in Hong Kong and Shanghai. He joined the firm in 2008 and has 21 years of industry experience. Frank received a BS at Fudan University, an MS at Georgia Institute of Technology and an MBA in Finance from the Stern School of Business at New York University, where he was honored as a Stern Scholar. Frank also conducted a PhD study in Engineering at Columbia University.

We are investors.

We take seriously the responsibility our clients place in us to provide portfolio solutions that meet their specific needs. Whether investing for institutions and their constituents, or alongside advisors and their clients or investing directly for private individuals, Neuberger Berman is singularly focused.

We are long on independent, original thinking and short on top-down house views. This is the passionate investment culture that we hope is conveyed in this set of forward-looking essays.

We encourage you to learn more about Neuberger Berman and how we can work together.

Please contact your Neuberger Berman representative or visit www.nb.com.

GLOBAL HEADQUARTERS

New York, New York
800.223.6448

REGIONAL HEADQUARTERS

Hong Kong, China
+852 3664 8800

London, United Kingdom
+44 20 3214 9000

Tokyo, Japan
+81 3 5218 1930

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Zurich, Switzerland

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Neuberger Berman LLC
605 Third Avenue
New York, NY 10158-3698
www.nb.com