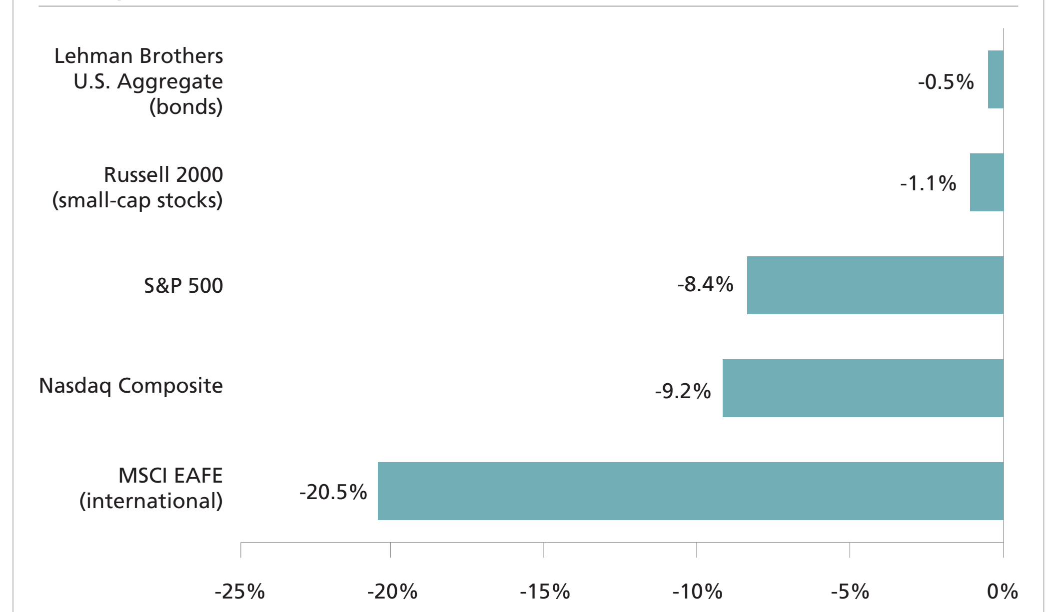
NEUBERGER BERMAN

Third Quarter 2008: Market Commentary

During the third quarter, the performance of equity markets was marked by extreme volatility.

Turmoil in the financial sector, coupled with tight credit and a slowing global economy, tested investors during the third quarter. Efforts by the U.S. government to help ease the financial crisis continued through quarter-end, although the potential impact of the initiatives was still unclear. As in other times of investor confusion and indiscriminate selling, it appeared that a long-term perspective and careful attention to risk would be highly valuable in navigating an uncertain environment.

During the third quarter, the performance of equity markets was marked by extreme volatility. Across industry sectors, market-cap segments, value and growth styles, and U.S. and overseas markets—stocks fluctuated and many suffered significant declines. Underlying this turmoil were serious and interconnected issues—principally worsening stresses on the financial sector on top of the already weak economy and beleaguered consumer.



Source: Lehman Brothers, Russell Investment Services, Standard & Poor's, Nasdaq and MSCI.

See page 8 for index description.

The government's efforts this year to provide liquidity, including interest rate cuts and new lending facilities open to investment banks, have been met with only limited—and temporary—success.

For some time, the U.S. consumer has displayed surprising resilience, but pressures have been building—from high unemployment, rising prices for necessary expenses like food and energy, a lack of available credit, and the devaluation of assets, whether in investment portfolios or home equity. The economy, which has been slow since last year, continued to show weakness, with second quarter Gross Domestic Product revised down to 2.8%, soft corporate profits, and August unemployment rates hitting 6.1%, a five-year high. News from the housing sector generally continued to disappoint, with home prices continuing to decline.

Meanwhile, the financial sector has been under pressure for more than a year, as the scope and depth of the credit crisis has expanded. This quarter saw a crescendo of impacts, with some of the biggest, most venerable names in the financial sector undergoing extraordinary change. During the quarter, the markets reacted strongly to a slew of events, including government takeovers of major banks and a large insurer, the bailout of Fannie Mae and Freddie Mac, bankruptcy, mergers and acquisitions, and restructurings. At this point, the stand-alone investment bank no longer exists, with Morgan Stanley and Goldman Sachs having agreed to become bank holding companies that are subject to regulation by the Federal Reserve.

As has been widely reported, these issues have largely stemmed from system-wide exposure to "toxic assets" including subprime mortgages, and the continued fears of lenders and investors about potential exposures. The government's efforts this year to provide liquidity, including interest rate cuts and new lending facilities open to investment banks, have been met with only limited—and temporary—success, as every new stage in the crisis has brought fresh anxiety. During September, investor fears reached extreme proportions, reflected in short-term Treasury yields, which dipped below zero a few times in a stampede to safety, and a significant jump in the CBOE Volatility Index (VIX).

For much of the month, the Bush administration worked with Congress to pass a rescue plan designed to end the ongoing crisis by purchasing many of the distressed assets that are clogging the balance sheets of financial institutions. The $700 billion plan[1] initially met with stiff resistance and a negative vote in the House of Representatives that sent the S&P 500 down 9% on September 29—its largest single-day decline since 1987. However, stocks rallied the following day (the last of the quarter) on hopes that a deal could be reached, and, indeed, the legislation was passed by the House and Senate a few days later and signed into law.

Among U.S. market sectors, financial stocks garnered the biggest headlines but, overall, did not provide the worst returns for the quarter. As energy prices started to moderate in July, oil and gas stocks retreated, suffering sharp declines over the three-month period. And as worries about housing and economic expansion intensified, basic materials also performed poorly, as did some utilities. In contrast, more defensive consumer issues were modestly positive, while health care issues were stable. In terms of market cap, larger companies suffered the most, while smaller companies generally provided flat returns. For the period, value stocks generally outpaced their growth counterparts.

[1] The rescue plan's ultimate cost could be less, depending on the prices the government could ultimately receive for the purchased assets.

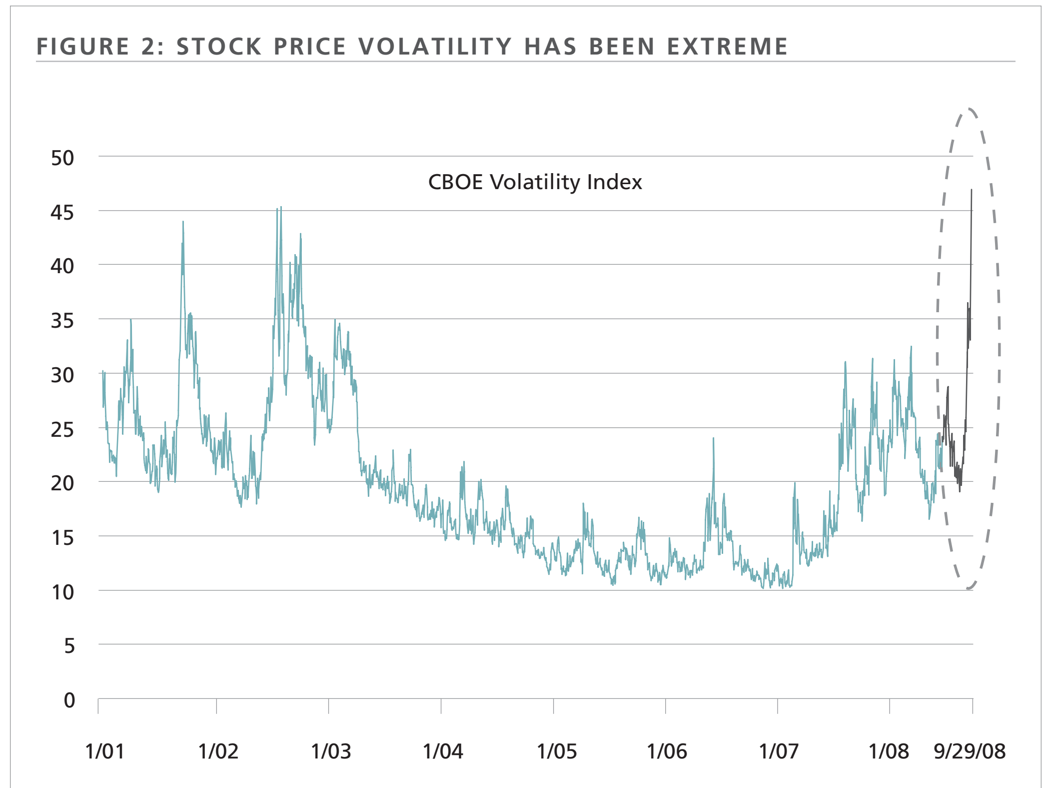
Against this backdrop of decelerating fundamentals, we believe it remains possible to find good stocks that have been unduly punished for the travails of the financial and housing sectors.

ASSESSING THE LANDSCAPE

It is axiomatic that times of market dislocation can create opportunities for those with the capital and knowledge to invest judiciously. For many portfolio managers, the current task may be to sort through major changes in the business and macroeconomic environment, and the prospects and fundamentals of individual securities.

Right now, there is a great deal of concern about the overall economic environment and the impact of tight credit conditions on businesses and consumers. The Fed continues its efforts to lubricate the economy through its lending facilities and coordination with foreign central banks. But much depends on the success of the U.S. government in dealing with the current crisis more systematically and what impact any solution will have on financing business and consumer needs.

FIGURE 2: STOCK PRICE VOLATILITY HAS BEEN EXTREME



Source: CBOE.

The CBOE Volatility Index® (VIX®) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. Since its introduction in 1993, the VIX has been considered by many to be the world's premier barometer of investor sentiment and market volatility.

Against this backdrop of decelerating fundamentals, we believe it remains possible to find good stocks that have been unduly punished for the travails of the financial and housing sectors, or that have been hurt by technical factors that may not relate to their fundamentals. Elsewhere, if one believes as we do that energy supply/demand fundamentals will remain strong over the long term, recent weakness in the sector may offer an opportunity to build exposure. At the same time, many companies that provide basic essentials—such as health care companies—have traditionally held up well in weak economic environments. Of course, there are risks in over-generalizing, as anecdotal reports have recently shown some curbing of health care expenditures to pay for other essentials. Moreover, given the truly historic nature of recent events, it's natural and wise to act with prudence.

Periods like the 1973-74 bear market and the months after the 1987 market crash have subsequently been regarded as times when opportunity was widespread.

Regardless of industry or market segment, however, having a long-term outlook may be especially advantageous at the current time—when so many investors are reacting to news items on a moment-by-moment basis. While it may require patience to allow the economy and financial markets to find their bottom and begin to rebuild, if one is confident in the underlying fundamental prospects of a particular company, it is reasonable to assume that, with time, its value will be revealed.

It's an oft-mentioned sentiment, but the long-term trajectory of the stock market has been upward. Periods like the 1973-74 bear market and the months after the 1987 market crash have subsequently been regarded as times when opportunity was widespread—for those with the insight, patience and skill to capitalize. Experienced portfolio managers who rely on fundamental research and disciplined investment processes may have a decided advantage in seeking to capitalize on volatility.

REAL ESTATE SECURITIES:

A Relatively Stable Quarter

Real estate investment trusts (REITs) were among the few U.S. equity sectors to perform well during the third quarter, rallying as investors sought to reduce risk. Amid general volatility, REITs gained ground after oil began declining from its peak in mid-July, reducing market concerns about inflation. In a low-return environment, their dividend yield, visible earnings, conservative and simple balance sheets, and relatively low leverage helped domestic REITs stand out, as did their historical ability to perform well when interest rates are relatively benign and economic growth is modest.

REITs in overseas markets were a different story, however, as European and Asian real estate securities posted declines. Accelerating fears about a spreading global economic slowdown and dislocation in the U.S. financial services sector appeared to be the primary causes, especially in Europe. In Asia, price appreciation from 2007 and concerns about export-driven economies also affected results.

Neuberger Berman's real estate investment team currently favor REITs in North America, where the U.S. government has been active in trying to solve the financial crisis and minimize the economic slowdown. They believe domestic REIT prices remain attractive, trading at a discount to net asset value. The team also thinks that certain Asian countries with budget surpluses and signs of internal economic growth may have potential. Across the board, it may be appropriate to emphasize defensive real estate sectors such as health care, community shopping centers and self storage, and avoid cyclical areas that are more sensitive to the economic environment.

INTERNATIONAL STOCKS:

Investors "Re-Price" Risk

International markets suffered deep declines during the third quarter due to ongoing uncertainty about the financial system and global economy. Despite the hope for improvement after a year of credit-related anxiety, foreign markets became more challenging as shockwaves from the U.S. financial sector were felt throughout the world. From a sector perspective, energy and materials stocks were laggards, as commodities gave back some of their earlier gains. Health care and consumer-staples stocks fared better but also experienced declines.

The yield difference (or spread) between Treasuries and lesser credits was highly volatile, tightening on positive news and then widening again as uncertainty resurfaced.

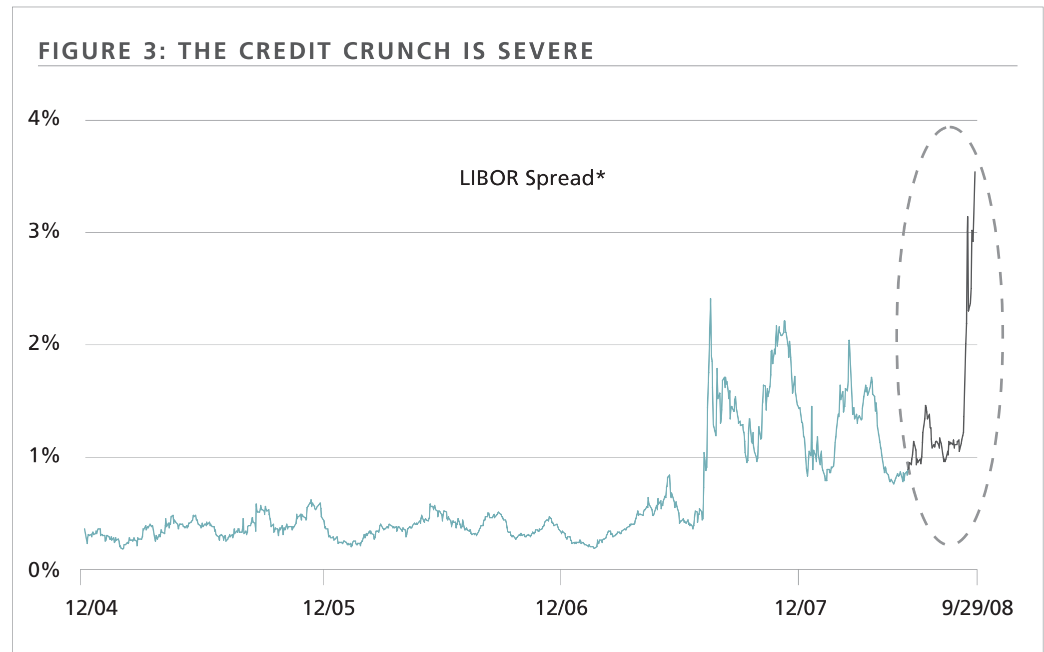
Emerging markets experienced the biggest decline as there was a global repricing of risk. Political worries hampered an already weak Russian market; Brazil and other emerging countries were poor performers as risk aversion caused many investors to abandon riskier assets.

Neuberger Berman's international equity team remains cautious going into the fourth quarter, particularly about financial stocks. In their view, energy's long-term fundamentals remain attractive, but they believe that if the global economy slows—and if government energy subsidies continue to be reduced in various countries—demand could be affected. In contrast, they think that consumer staples and health care stocks may prove more resilient. Particularly in a highly volatile market, they believe that stock selection will be essential to achieving strong returns over the long haul.

FIXED INCOME:
Anxious Period for the Markets

During the third quarter, the fixed income markets saw the same credit-related issues that have hampered them for the past year but, in some cases, with heightened intensity. Missed results at financial companies, bad news from the housing sector and its impact on mortgage-backed securities all were a source of concern for investors. In the municipal market, the ongoing dislocation stemming from issues in the variable rate securities markets and downgrades of municipal bond insurers continued. High commodity prices, although they abated swiftly in the second half of the period, affected the bond market's concerns about the inflation outlook.

FIGURE 3: THE CREDIT CRUNCH IS SEVERE



Source: Bloomberg.

*Difference between 3-month LIBOR and 3-month Treasury Yield.

The LIBOR is an important benchmark interest rate used in global transactions. It is also the base rate used for adjustable rate U.S. mortgages and large corporate loans as well as commercial paper. Separately, the LIBOR is used to determine the price of financial derivatives, including interest rate swaps, which constitute the largest segment of the derivatives market.

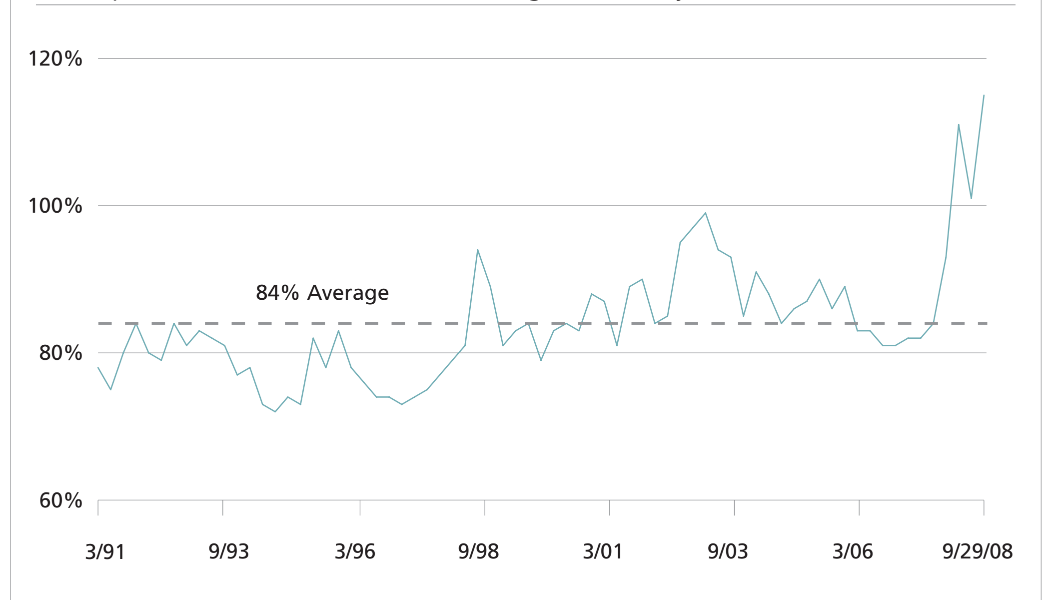
In mid-July, the Treasury and Fed sought to ease market turmoil by announcing in broad terms that they would be addressing issues within Fannie Mae and Freddie Mac.

The yield difference (or spread) between Treasuries and lesser credits was highly volatile, tightening on positive news and then widening again as uncertainty resurfaced, including toward the end of the quarter. Overall, corporate bonds suffered compared to Treasuries while agency securities and agency-backed mortgage-backed securities were helped by the Federal Reserve's takeover of Fannie Mae and Freddie Mac. At the same time, the market became extremely illiquid as banks were unable to hold as much trading inventory due to balance sheet concerns.

In mid-July, the Treasury and Fed sought to ease market turmoil by announcing in broad terms that they would be addressing issues within Fannie Mae and Freddie Mac. Ironically, the lack of detail in the announcement added to volatility until the government revealed that the two mortgage agencies would be placed in conservatorship. Despite the negative impact for stockholders, bond investors benefited as the implied government guarantee behind Freddie- and Fannie-backed debt became explicit.

FIGURE 4: MUNICIPAL BOND YIELDS APPEAR GENEROUS

Municipal Bond Yields, Shown as a Percentage of Treasury Yields



Source: Bloomberg.

Municipal bonds are represented by 10-year AAA General Obligation Bonds. Treasuries are represented by 10-year U.S. Treasuries. See definitions on page 8.

For the overall bond market, however, September saw the credit crunch reach a tipping point, as the bankruptcy of Lehman Brothers Holdings Inc., Bank of America's announced acquisition of Merrill Lynch and the government rescue of insurer AIG caused tremors throughout the financial markets. As part of this trauma, one money market fund announced that its net asset value would "break the buck" or dip below the one-dollar value that is considered an article of faith for investors in such instruments, which are not insured like traditional bank deposits. This caused many investors to worry about the safety of their money market funds, and the Federal Reserve sought to alleviate this problem by offering to temporarily insure the assets in money market funds provided through investment companies that choose to participate.

At times, stocks, bonds and even commodities may move in tandem, but typically and over the long term, these different portfolio components will tend to diverge, smoothing performance patterns and lessening risk.

More broadly, the heightened anxiety forced the Treasury to create a comprehensive rescue plan, which involves floating an unprecedented amount of debt to help take bad investments off financial companies' balance sheets. As noted, although defeated in an initial vote in the House of Representatives, the proposal was modified and passed into law shortly after quarter-end.

Looking forward, given recent market volatility and the numerous credit-related issues that have emerged, exerting extra caution appears advisable. In the corporate sector, this means emphasizing high-quality securities in sectors with relatively stable earnings even in times of economic weakness. In municipals, it means sticking with more conservative securities such as general obligation bonds and favoring state and local issuers that may be more resilient as tax receipts become harder to come by.

At the same time, the wide disparity in yields between Treasuries and other bonds suggests that, in some cases, it may make sense to take on some additional risk to generate income and even capital appreciation. For example, many taxable AAA-rated corporate bonds now trade at levels normally associated with AAs. Discerning which of these credits may actually be bargains requires thorough research. In addition, current volatility requires that investors pay close attention to economic fundamentals and governmental reform efforts, making professional portfolio managers even more valuable in seeking to achieve favorable risk-adjusted returns in a challenging bond market.

MAINTAINING BALANCE

Recent market volatility has been highly disturbing to many investors. Indeed, fears in the credit markets, the weakness among stocks and the ongoing barrage of failures and consolidations in the financial sector have reached remarkable proportions. Clearly, no one has a crystal ball and can say with certainty when and exactly how all of these factors will play out. Our long-term view, however, remains unchanged—that after some period of weakness, economic growth will resume as imbalances in the financial system are worked out.

In the immediate term, it is possible to make smart decisions about what you *can* control, such as maintaining a well diversified portfolio across asset classes and investment styles. Yes, at times, stocks, bonds and even commodities may move in tandem, but typically and over the long term, these different portfolio components will tend to diverge, smoothing performance patterns and lessening risk. Finally, keeping your perspective is certainly advisable, so that your decisions can be rational and consistent with your long-term investment goals.

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The data presented herein represents securities industry market data as of the date specified. It does not represent Neuberger Berman performance nor does it reflect the fees and expenses associated with managing a portfolio.

A bond's value may fluctuate based on interest rates, market conditions, credit quality and other factors. You may have a gain or loss if you sell your bonds prior to maturity. Of course, bonds are subject to the credit risk of the issuer.

Please contact a tax advisor regarding the suitability of tax-exempt investments. If sold prior to maturity, municipal securities are subject to gains/losses based on the level of interest rates, market conditions and the credit quality of the issuer. Income may be subject to the alternative minimum tax (AMT) and/or state and local taxes, based on the investor's state of residence.

This material discusses small- and/or mid-capitalization stocks. Small- and middle-capitalization stocks are typically more vulnerable to financial and market risks and uncertainties than large-capitalization stocks. They may trade less frequently and in lower volume than large-capitalization stocks and thus may be more volatile and be less liquid.

The properties held by REITs could fall in value for a variety of reasons, such as declines in rental income, poor property management, environmental liabilities, uninsured damage, increased competition, or changes in real estate tax laws. There is also a risk that REIT stock prices overall will decline over short or even long periods because of rising interest rates.

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

The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value-weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value. The "500" is one of the most widely used benchmarks of U.S. equity performance.

The Nasdaq Composite Index is a broad-based capitalization-weighted index of all Nasdaq National Market & Small Cap stocks. The index was developed with a base level of 100 as of February 5, 1971.

The MSCI EAFE® Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the U.S. & Canada. As of April 2002, the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom. The index is translated into U.S. dollars.

The Lehman Brothers U.S. Aggregate Index represents securities that are U.S. domestic, taxable, and dollar-denominated. The index covers the U.S. investment-grade, fixed-rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

The Lehman Brothers U.S. Treasury Index is an unmanaged index consisting of U.S. Treasury issues.

The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index. The index is market cap-weighted and includes only common stocks incorporated in the United States and its territories

Treasury Securities are negotiable debt obligations issued by the U.S. government and backed by its full faith and credit.

The CBOE Volatility Index® (VIX®) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. Since its introduction in 1993, VIX has been considered by many to be the world's premier barometer of investor sentiment and market volatility.

Please note that indices do not take into account any fees and expenses of the individual securities that they track, and individuals cannot invest directly in any index.

Diversification does not guarantee a profit or protect against loss.

A copy of our Form ADV Part II is available to our investment advisory clients upon written request.

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