

Global Perspectives

July 2010 update

At UBS Global Asset Management, we use proprietary models that are founded on insight based upon nearly 30 years of investment experience as the engine behind our valuation of equity and fixed income markets. Investment expectations for all asset classes are derived from passive, index-level information.

Using **US Equities**¹—the first represented asset class listed in the table on this page—as an example, what follows is a step-by-step look at the variables that are used to identify valuation opportunities and how to interpret them, as well as a summary of our current Global Balanced strategy views.

All represented data are as of the most recent available date of June 30, 2010.

¹ Other asset classes may result in the identification of different valuation opportunities and interpretations.

² The relative valuations and investment expectations are for the indices only. The valuations and expected returns of the indices are subject to change at any time. Valuation and three-year expected return estimates are based on normalized earnings and growth rates. They are shown for illustrative purposes only of the valuation research process used by UBS Global Asset Management to identify potential investment opportunities among broad asset classes. They are not intended to predict the future performance of the markets or any UBS Global Asset Management account or portfolio. Please read the “Key to Reading the Asset Class Valuation Model Table” and “Definitions of ‘Asset Class Investment Expectations’ metrics” pages for a fuller understanding of the assumptions and limitations of the asset class valuation model. Some asset classes represented may not be available in some of the portfolios.

³ The price/value discrepancies are in local currency terms. The hedged returns, however, are measures of the market returns that are available to investors, independent of direct currency effects.

⁴ MSCI World Free Ex-US Index.

⁵ MSCI Emerging Markets Free Index (Unhedged).

The Asset Class Valuation Model as of June 30, 2010²

Column:	1	2	3	4	5	6
Asset class benchmarks		Price/Value ³ overvalued (+)/ undervalued (-)	Equilibrium return	Three-year expected return	Secular risk estimate	Normalized price/value
US Equities: S&P 500 Index		-21.6%	8.1%	15.2%	14.6%	-1.5
Global (Ex-US) Equities: MSCI Index ⁴		-27.2	8.3	17.8	15.1	-1.8
Emerging Markets Equities: MSCI Index ⁵		-21.9	9.8	17.8	18.7	-1.2
Global Equities: MSCI All-Country World Index		-24.3	8.3	16.5	14.0	-1.7
Global Securities Markets Index (GSMI)		-13.7	7.4	11.1	10.5	-1.3
Real Estate: NCREIF Property Index		-9.0	6.6	7.3	10.1	-0.9
US Bonds: Citigroup US Gov't Bond Index		6.9	5.5	-0.3	4.6	1.6
Ten-Year Treasury Bonds		12.7	5.9	-0.9	7.0	1.8
High Yield: Merrill Lynch High Yield Master Index		-7.9	6.6	7.3	9.0	-0.9
Global (Ex-US) Bonds: Citigroup WBGI Ex-US		7.2	5.5	0.1	4.7	1.6
Emerging Markets Debt: JP Morgan EMBI Global		3.5	6.9	3.4	10.0	0.4
Treasury Inflation Protected Securities (TIPS)		1.9	5.2	1.1	3.0	0.6
US Cash Equivalents: 3-Month Eurodollar		0.0	4.7	2.5	0.5	0.0

Key to reading the asset class valuation model table

Column 1: Asset Class Benchmarks identifies the indices and, where applicable, the associated asset class.

Example: In the case of US Equities, the prices and underlying cash flows for companies comprising the S&P 500 Index are used to arrive at valuation results for that asset class.

Column 2: Price/Value indicates whether the asset class is under- or overvalued based on its market price relative to our estimate of the intrinsic value of the asset class, as characterized by the associated index.

Example: The Price/Value relationship for US Equities is -21.6% or 21.6% undervalued, which means that the S&P 500 Index June 30, 2010 market price is below UBS Global Asset Management's estimate of intrinsic value.

Column 3: Equilibrium Return describes the passive return any given asset class should provide in a typical investment environment.

Example: In the case of US Equities, this figure is currently 8.1%. These returns do not take into account current capital market relationships, and are thus used as long-term (20- to 30-year) expectations for determining investment policies or custom benchmarks.

Column 4: The Three-Year Expected Return is UBS Global Asset Management's anticipated return for an asset class over each of the next three years. The figure results from the required rate of return (which is calculated based on the current cash rate and the expected path of future cash rates as determined by UBS Global Asset Management), as well as the added (or subtracted) return that would result from the anticipated convergence of market price to intrinsic value in equal measure over each of the next three years.

Example: Because US Equities, as indicated in the table, is below our estimate, the three-year expected return would be higher than the return that would be anticipated from a US Equities investment given current capital market conditions (known as the required return). The Three-Year Expected Return for US Equities is 15.2%.

Column 5: The **Secular Risk Estimate** figure indicates the "forward-looking" expected standard deviation (which is a measure of volatility) for an asset class. A higher Secular Risk Estimate figure implies greater expected risk.

Example: In the case of US Equities, the Secular Risk Estimate is 14.6%.

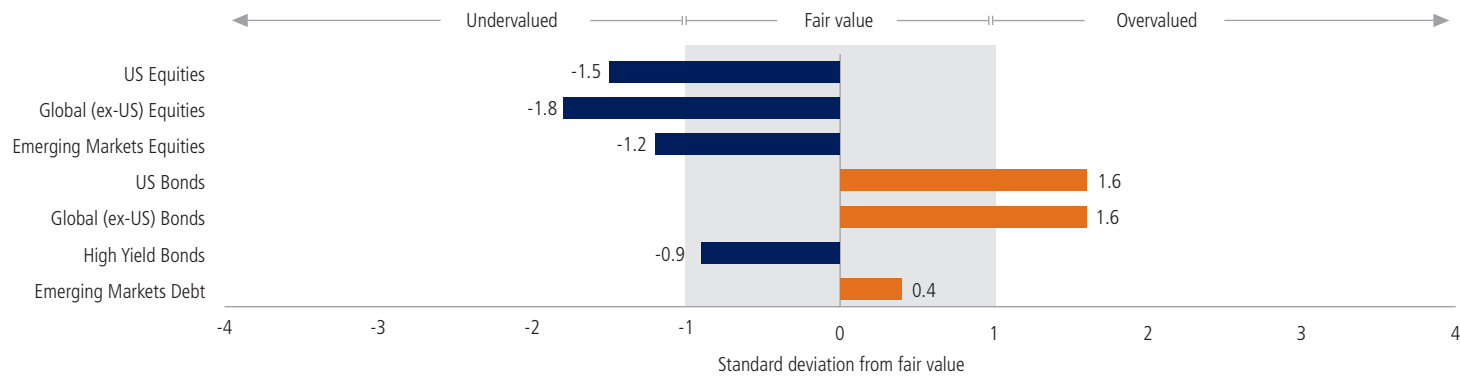
Column 6: The **Normalized Price/Value** figure, which appears in the final column of the table, represents the standard deviation, or dispersion, of the asset class from our estimate of fair value. Normalizing the P/V discrepancy provides a standardized relative comparison across asset classes.

Example: In the case of US Equities, the Normalized Price/Value is -1.5.

Valuations and views

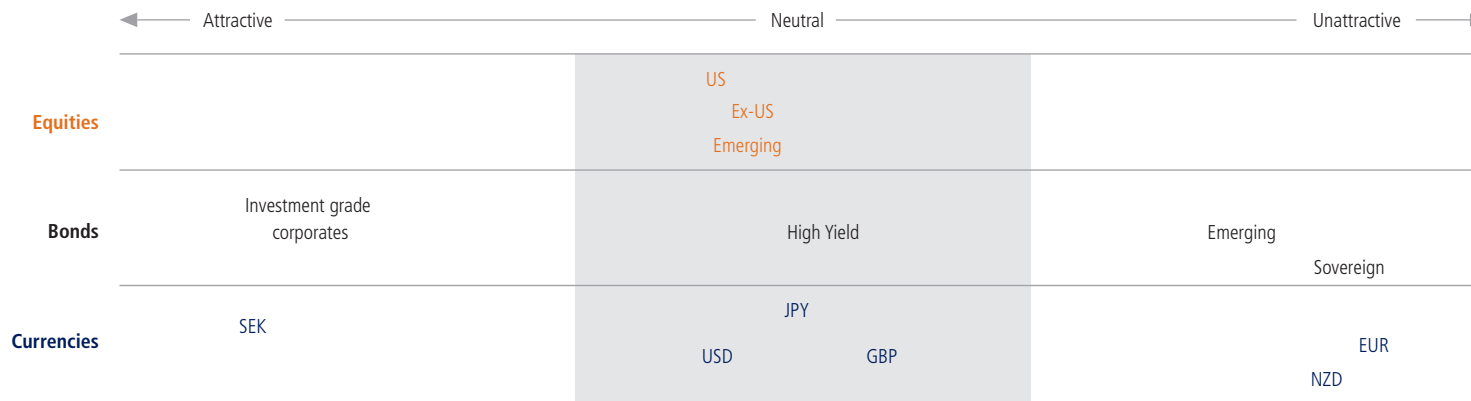
Normalized asset class valuations⁶

Normalizing the price/value discrepancy provides a standardized relative comparison across asset classes



Current views⁷

Asset allocation and currency attractiveness based on fundamental valuation and market behavior



⁶ Source: UBS Global Asset Management. As of June 30, 2010.

⁷ Based on UBS Global Asset Management views. As of June 30, 2010.

Strategy viewpoints as of June 30, 2010

Asset class

UBS Global Asset Management's viewpoint

US Equities

- The US equity market is undervalued by our valuation estimates.
- From a market behavior perspective, market stress remains elevated and has intensified in the recent bout of volatility. Stress indicators like two-year swap spreads and the Volatility Index, which is a gauge of investor sentiment, were in elevated territory.⁸
- Also, we are seeing a good amount of evidence that other fund managers are reducing their equity overweight, which translates into less positive momentum for equities.

Global (Ex-US) Equities

- We believe the developed equity market outside the US is undervalued.
- Weaker economic growth in the eurozone and fiscal deficit concerns in Greece and other peripheral countries still pose a concern.
- We are slightly overweight this asset class.

Emerging Markets Equities

- Emerging markets equities are undervalued by our fundamental valuation estimates.
- Valuations still look attractive; however, earlier in the year, market behavior indicators like mutual fund flows made us cautious.
- We are slightly overweight this asset class.

US Bonds

- US bonds are overvalued by our valuation estimates.
- We prefer investment grade corporate credit to Treasuries. The investment grade corporate bond spread (compensation above comparable Treasuries) is attractive in comparison to previous cycles.
- Healthier corporate balance sheets coupled with stronger corporate profits should benefit credit.

Global (Ex-US) Bonds

- Global (ex-US) bonds are overvalued by our fundamental valuation estimates.
- We are underweight sovereign or government bonds and prefer investment grade corporate credit.
- A recovery in risk-seeking behavior, coupled with a continued recovery of economic growth, should put upward pressure on rates, particularly at the long end of the curve.

High Yield Bonds

- High yield bonds are within fair value range by our fundamental valuation estimates.
- We are somewhat concerned with the potential for a higher default rate environment across lower-quality bonds, which we believe would have negative implications to the high yield debt market.
- While spreads remain relatively wide, we feel that the asset class faces headwinds, such as potential funding issues and a lower, though positive, growth environment compared to previous cycles.

Emerging Markets Debt

- We believe emerging markets debt is within fair value range.
- On a relative basis, we find other asset classes more attractive.
- New issuance has surged and the interest rate premiums over comparable Treasuries are fairly narrow.

Currency

- We believe opportunities to make profits on a weakening euro versus the US dollar have mostly diminished; we do still see opportunities that exist versus other European currencies.
- We are overweight the US dollar versus commodity currencies, such as the New Zealand dollar. We favor non-Japanese Asian currencies based on valuation measures and expectations that global rebalancing will require an upward revaluation of exchange rates in the region.

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⁸ A swap spread is the difference between the negotiated and fixed rates of a swap.

Definitions of “Asset Class Investment Expectations” metrics

1. Asset Class/Benchmark

All investment expectations displayed here are modeled from the discounted cash flows as replicated by the relevant publicly available index. This bears mentioning because these expectations are developed assuming no benefit from active management (i.e., security selection) within the asset classes themselves.

2. Price/Value

An intrinsic value based on the cash flows that an asset class provides—discounted at an appropriate rate of return (the required rate of return)—is identified for each of the asset classes listed. The cash flows would be those that would be expected to pass through to the asset holder; in the case of equities, the relevant cash flows are earnings and nonreinvested earnings (including, though not exclusively, dividends). That intrinsic value is then compared to the market price for the proxy index, and the degree of over- or undervaluation is thereby calculated in percent. As of June 30, 2010, the S&P 500 Index indicated a Price/Value of -21.6%, reflecting our estimate of undervaluation.

3. Equilibrium Return

The equilibrium return represents the return of an asset class in a typical market environment, or one where supply and demand for capital market returns is in ‘equilibrium.’ This is often considered to be the ‘long-term expected asset return’ absent any price/value discrepancy. Equilibrium returns are calculated as the geometric addition of the UBS Global Asset Management estimates of three crucial components:

(a) Real risk-free rate: An estimate of the underlying real rate common to all assets in the global economy, representing the

underlying real interest rate reflects the fundamental ability and willingness of society to expand wealth through savings and investment. The real risk-free rate is currently estimated to be 2.40%.

(b) Inflation premium: The additional return an asset must provide investors to protect them against losses in purchasing power from inflation. The level of long-term inflation is the result of fiscal and monetary policy objectives and actions, as well as the path of overall global inflation. This premium is currently 2.25%.

(c) Asset risk premium: Additional return to compensate investors for the additional systematic risk experienced in an asset class. US equities, carrying more systematic risk to the global investable capital market, thus have higher risk premiums (3.27% for the S&P 500 Index) than US fixed income investments (0.72%). The equilibrium return for US equities, therefore, is $(1.024) \times (1.0225) \times (1.0327) - 1 = 8.13\%$.

4. Expected (Three-Year) Return

Reflects UBS Global Asset Management’s expectations using current market assumptions. There is no assurance that these projections ultimately will be realized. This return is the annualized return expected in an asset class for each of the following three years if market price fully realizes our estimate of intrinsic value. Simply, an asset class should yield its required return in an efficient market, but any mispricing that may occur has the potential to increase (if the asset is currently underpriced) or decrease (overpriced) the asset class return. The three-year period is subjective, but does match the horizon of the AARM strategy-setting: Asset class overweights and underweights taken in anti-

pation of higher or lower expected returns are expected to have a positive impact on market allocation results within a 36-month period of being undertaken.

The calculation is more sophisticated than this, but it helps to conceive of the three-year expected return as follows, for the S&P 500 Index as an example:

The required return for the S&P 500 Index is 5.8% as of the end of June. Since this represents a 21.6% undervaluation, if market price appreciates 7.2% per year relative to the required return for each of the next three years as it matches intrinsic value, the S&P 500 Index can be expected to appreciate overall by $(1.058) \times (1 + 0.072) - 1 = 13.4\%$ for each of the next three years. This imperfect back-of-the-envelope estimate approximates the true expected three-year return of 15.2%. During periods of extreme misvaluation, the expected return estimation is not as close to the actual expected return as it would be during normal times. Any difference results from the process of ‘averaging’ the future 10-year path of required cash returns into a single number for communication purposes. Remember that the required cash return is not a single number per se, but a 10-year process of adjustment.

5. Secular Risk Estimate

These are forward-looking expected standard deviations for the expected returns of the asset classes listed. The secular risk estimate for the S&P 500 Index is 14.6%.

6. Normalized Price/Value

The normalized price/value represents the standard deviation, or dispersion, of the asset class from our estimate of fair value. Normalizing the P/V discrepancy provides a standardized relative comparison across asset classes. The normalized price/value for the S&P 500 Index is -1.5.

