



Investment Theme **STRATEGIC CALL**

Corporate Bonds

Asset Class: Fixed Income, Credit

Credit where credit is due

Lead analysts

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As individual recommendations of this Strategic Call may change, we advise you to always check our latest updates.

At a glance

Part I: Strategy

- We believe that investors with a longer term investment horizon should consider purchasing Investment Grade corporate bonds.
- Corporate credit spreads have widened significantly over the past 12 months due to the spillover from the subprime mortgage crisis, increased pessimism on economic growth and concerns about deteriorating fundamentals.
- While corporate credit fundamentals have deteriorated since last year, they started from a very strong initial position. Thus, we think companies should largely weather the economic slowdown and banks' more restrictive lending practices.
- Long-term valuations of investment grade (IG) corporate bonds in USD and EUR are attractive and, we believe, generously compensate for corporate default risk even under a pessimistic scenario.
- Thus, in our view, current credit spreads reflect an excessive increase of the risk premium.
- IG corporate bonds should be able to post solid performance, beyond that of government bonds, over the next two years.
- While we do not think that spreads will return to the levels seen before the subprime crisis, we expect that credit spreads will narrow substantially over the next two years.

Part II: Recommendations

- To implement our strategy, we recommend issuers in sectors that offer value and that remain well-positioned to face the expected deterioration in corporate credit quality over the next quarters.

What is a Strategic Call?

A Strategic Call seeks to exploit investment opportunities among a wide range of asset classes. The calls are based on long-term trends and themes, and have a corresponding investment horizon and holding period assumption of greater than 12 months. Consequently, the views expressed in a Strategic Call can at times diverge from our shorter-term tactical recommendations.

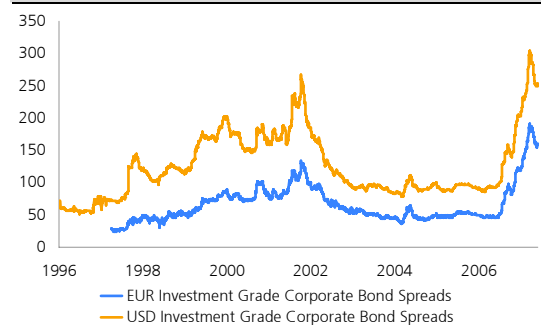
Recommendations: at a glance

Long-short	Expected annual return over 3 years
Buy basket of USD and EUR Investment Grade corporate bonds that are well-positioned to face deteriorating credit trends	We expect our basket to outperform government bonds by an average of 3% per annum.
Short a duration-matched government bond index to offset interest rate risk	
Long only	Expected annual return over 3 years
Buy basket of USD and EUR Investment Grade corporate bonds that are well-positioned to face deteriorating credit trends	We expect our basket to generate returns of an average of 5.9% per annum.

Source: UBS WMR, as of 30 May 2008

Fig. 1: IG corporate credit spreads exceeded peak of previous credit cycle

IG credit spreads over government bonds



Sources: Merrill Lynch, UBS WMR, as of 30 May 2008

Part I: Strategy

Corporate credit: from complacency to excessive caution?

Corporate credit markets have been on a rollercoaster ride for the last 12 months. Credit spreads – the difference between the yields on corporate bonds and government bonds – reached historic lows during May 2007. Investors had pursued higher yields through complex leveraged products, thereby driving valuations to very high levels. With risk appetites flourishing, valuation considerations seemed to take the backseat a year ago.

A harsh wake-up call hit investors during the summer of 2007, when it became apparent that the soaring US housing market was indeed a bubble ready to burst. The subsequent collapse of the subprime mortgage market sent tremors through other risky asset classes such as corpo-

Past performance is no indication of future performance. The market prices provided are closing prices on the respective principle stock exchange. This applies to all performance charts and tables in this publication.

This report has been prepared by UBS AG

ANALYST CERTIFICATION AND REQUIRED DISCLOSURES BEGIN ON PAGE 9.

rate credit. Since then, credit spreads have climbed to cyclical highs, significantly exceeding levels experienced in 2001-02 in the previous credit cycle. It is only recently, following substantial central bank and government interventions and the successful recapitalization of various financial institutions, that market sentiment has improved and corporate credit spreads have started to decline (see Fig. 1).

Market prices now reflect an anticipated sharp deterioration in credit quality and substantial uncertainty about the future. It is our thesis in this Investment Theme that the correction has gone too far and that a normalization of corporate bond markets creates opportunities for patient investors.

Credit losses and risk premiums drive credit spreads

The performance difference between corporate bonds and government bonds results from changes in credit spreads, which are the extra yields that investors demand for holding corporate rather than government bonds. Credit spreads, in turn, represent a compensation for two different types of risk.

First, spreads are a protection against credit losses. Corporate issuers may default with some degree of probability and such events typically lead to losses for bond investors. The credit spread is demanded to compensate for this risk of loss. As Fig. 2 shows, credit spreads and corporate default rates are positively related over longer time periods. The graph also shows that current spreads appear excessively high in relation to current default rates.

Second, credit spreads carry an additional risk premium, beyond expected credit losses, to compensate investors for the volatility associated with corporate bonds compared to government bonds, as well as their possible lack of liquidity.

Historically, the compensation for credit losses is a substantial portion of the credit spread on High Yield corporate bonds, while it represents only a small fraction of the spread on IG corporate bonds (Fig. 3). In other words, liquidity and volatility concerns determine the credit spreads for IG bonds.

Investment-grade corporates are attractively valued

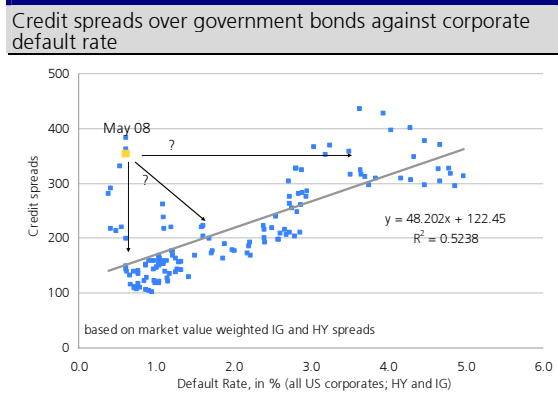
Based on WMR's long-term valuation model, we believe that IG corporates are attractively valued relative to government bonds (Fig. 4). Our analysis assumes some deterioration in corporate credit quality and therefore rising credit losses. It also assumes that the risk premium converges rapidly to its long-term average.

It is important to note that valuations of IG corporates are attractive not just because of the correction in Financials. As Fig. 5 illustrates, credit spreads have widened substantially since last summer among Industrials and Utilities, though to a lesser degree than among Financials. Therefore, while the problems in the financial system clearly caused the recent spread-widening, other sectors were affected as well and are also attractively valued.

Asserting that IG corporates are attractively valued reflects our view that the current risk premium (beyond expected credit losses) is excessive. The following calculations illustrate this.

The default risk for IG companies (rated 'BBB' / 'Baa' or better) exists but is generally very low. Fig. 6 shows the probability of default over a ten-year period for 'A'-rated companies, which is about the average

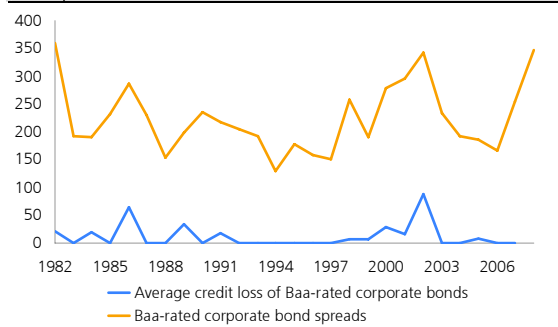
Fig. 2: Credit spreads misaligned with underlying risk



Sources: Moody's, Merrill Lynch, UBS WMR, as of 30 May 2008

Fig. 3: IG corporate bond losses are historically small

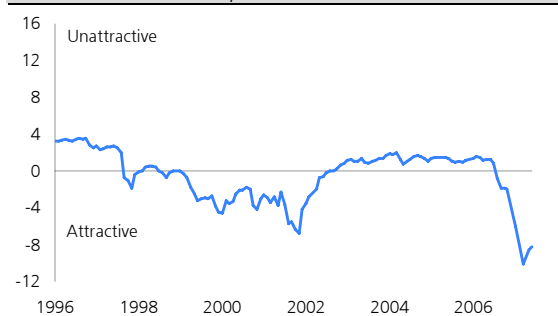
Losses based on annual default rates and recovery rates, in basis points



Sources: Moody's, UBS WMR, as of 30 May 2008

Fig. 4: Attractive long-term valuation

Deviation from fair price of US IG corporate bond index relative to US Treasuries, in %



Note: based on expected default compensation and risk premium of 110 basis points

Sources: Merrill Lynch, Moody's, UBS WMR, as of 30 May 2008

rating for the US IG corporate index. On average, only 1.6 out of 100 'A'-rated companies default over a decade. This contrasts sharply with the speculative grade segment, where 34 out of 100 default in that time frame (for 'B'-rated companies).

For IG companies, investors basing their credit-loss expectations on average long-term default and recovery experience would demand roughly a 9-basis point credit spread per year as compensation for this default risk. This assumes that investors can recover 40% of value in the case of default. For the extremely low recovery value of just 10%, required default compensation moves up to roughly 13 basis points. Given the current spreads of about 250 basis points, investors are now demanding a risk premium of more than 230 basis points. By comparison, the average risk premium has been 110 basis points in the past. Therefore, investors are well-compensated for default risk and are receiving a generous risk premium as well.

Corporate bond outlook

Will corporate bonds underperform despite attractive valuations? As valuation alone is often a poor predictor of near-term performance, it is important to analyze whether there is a significant chance that the drivers of credit spreads may work against corporate bonds in next few quarters. We address this dynamic in sections A and B, below.

A) Corporate defaults to rise, but risk overstated by the market

We start our analysis with a question: is it possible that the current disconnect between credit spreads and default rates (see Fig. 2) will be resolved by a dramatic increase in default rates rather than a meaningful decrease in spreads?

We believe that default rates are set to rise in coming quarters, but we do not expect them to increase beyond their historical average over the next 12 months. In contrast, we think the market appears to anticipate an increase in defaults above historical peaks.

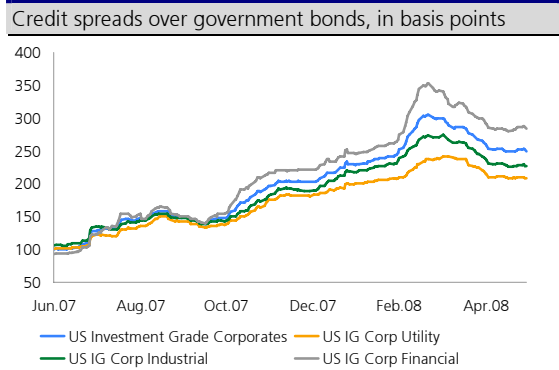
■ Long-term economic drivers of corporate defaults

Default rates and the general economic environment are closely related, tending to move inversely to each other. Corporate failures decline during periods of economic expansion as companies take advantage of economic growth and strengthen their financial position. In contrast, during tougher economic times, and especially during recessions, the operating environment becomes more difficult for corporates as earnings decline and financing grows less available. As a consequence, defaults tend to increase (see Fig. 7). In this cycle, the fact that many banks are constrained in their ability to lend to companies may also contribute to rising defaults. While WMR expects slower economic growth in the US well into 2009, we do not expect to see corporate defaults increase to a degree that would justify the current risk premium.

■ Corporate balance sheets and income statements suggest no massive deterioration in credit quality

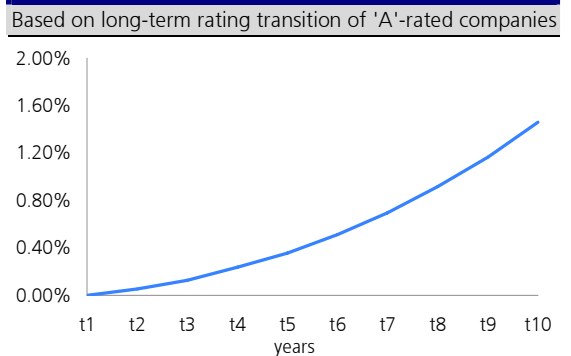
We think corporations are generally well prepared for the more challenging times ahead. Many companies have taken good advantage of the favorable financing and earnings conditions of recent years. Strong corporate earnings growth and prudent financial management have put companies in a better position to weather the current slowdown. For instance, the interest-rate coverage ratio – a measure of a company's ability to pay interest on existing bonds – remains at multi-year high (see Fig. 8). The second important credit metric, financial leverage, however, has deteriorated some-

Fig. 5: Spread-widening has affected all sectors within IG corporates



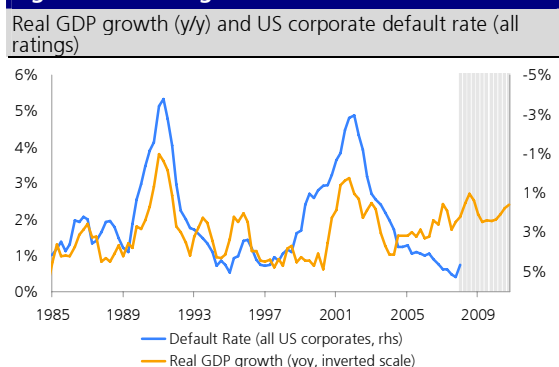
Sources: Merrill Lynch indices, UBS WMR, as of 30 May 2008

Fig. 6: Cumulative default probability for IG companies



Sources: Moody's, UBS WMR, as of 30 May 2008

Fig. 7: Economic growth and default rates



Note: Shaded area indicates UBS WMR forecast

Sources: Bloomberg, Moody's, UBS WMR, as of 30 May 2008

what over the last two quarters, slipping from quite healthy levels, which indicates that companies are using more debt financing (see Fig. 9).

The gradual deterioration of corporate balance sheets is also reflected in credit rating changes. Fig. 10 shows that rating agencies have downgraded more companies than they have upgraded in recent months. Corporate bond investors should be aware that an IG-rated bond today can migrate into the speculative rating segments over the holding period. Historically, this risk is very low for bonds rated 'AA' or higher, while this risk is highest for bonds close to the speculatively rated segment, namely, 'BBB'-rated bonds. (see Appendix for more details.)

■ Low debt refinancing needs should help limit defaults

Without doubt, financing has become more difficult for corporates over the last 12 months. However, companies generally exploited the favorable environment of the previous years that prevailed until the summer of 2007 to refinance their debt, and also secured lower interest payments. Thus, we think companies have a limited need to come to the market for refinancing for the next two years.

Certainly, companies with weak balance sheets that need short-term financing will run into difficulties. This is accentuated by the fact that obtaining bank credit is becoming more difficult at the same time. Financial institutions were hit hard by the weakness in the US housing and mortgage market and the subsequent write-downs, provisions and charge-offs. These credit losses limit their ability to extend credit to companies today. Recent bank lending surveys in the US and also Europe underscore these developments.

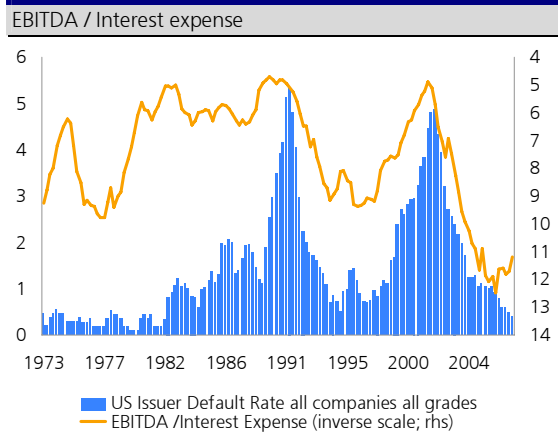
B) Risk premium – normalization likely

Low corporate default risk, only slowly deteriorating balance sheets and limited refinancing needs in an environment of slower economic growth and more restrictive bank lending have to be seen along with historically high IG credit spreads. The risk premium on top of default risk should compensate the investor, in our view, for the uncertainty about the future and other factors such as reduced liquidity.

Fig. 11 shows a normalized risk premium. Many instances of elevated risk premiums over the past two decades can be linked to specific events, like the Latin American debt crisis in the early 1980s or the LTCM crisis in 1998, or the current subprime crisis. During all these periods, investors demanded a significant premium for vanishing liquidity. In addition, uncertainty about the potential outcome of such crises leads to a higher risk premium. As new information becomes available, the outlook becomes clearer and liquidity starts to return to financial markets. The risk premium recedes and underlying fundamentals again become more important.

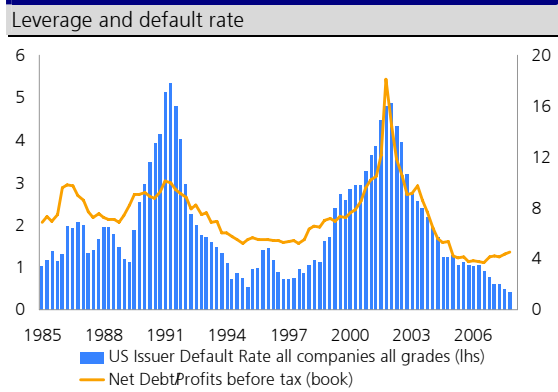
After first-quarter earnings results from the major financial institutions, there is now greater transparency regarding future write-downs. At the same time, recapitalization and central bank interventions have improved market liquidity and strengthened confidence in the markets. We expect that the risk premium on investment-grade corporate bonds will continue to decline over the coming quarters and investors will refocus on fundamentals. Although the underlying fundamentals are expected to slowly deteriorate over the coming quarters, current spread levels more than compensate for that development. We expect that spreads will substantially decrease over the next two years and IG corporate credit should deliver attractive returns.

Fig. 8: Interest coverage ratio remains high



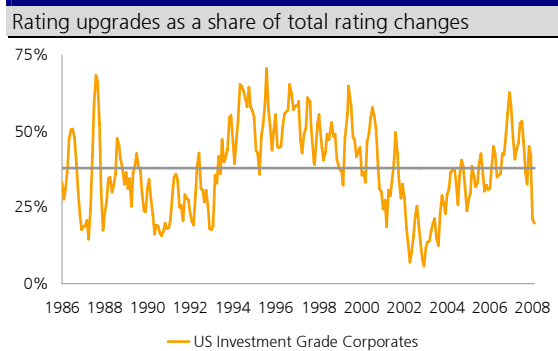
Sources: Bureau of Economic Analysis, UBS WMR, as of 30 May 2008

Fig. 9: Financial leverage on the way up



Sources: Bureau of Economic Analysis, Moody's, UBS WMR, as of 30 May 2008

Fig. 10: Credit rating trends deteriorate



Sources: Moody's, UBS WMR, as of 30 May 2008

European IG corporates also attractive

While most of our analysis in this note has focused on the US corporate bond market, we believe the main conclusion, namely that IG corporates are an attractive investment over the next two to three years, also applies to Eurozone corporates.

As the credit spreads in Fig. 1 indicate, the dislocation in corporate bond markets that started last summer hit EMU corporate bonds at least as severely as their US counterparts. EMU corporates are significantly undervalued and the underlying credit trends look more solid to us than do those in the US.

Risk factors to our Strategic Call

There clearly are factors that pose a risk to our Strategic Call for Investment Grade corporates to outperform government bonds, or which could at least delay such outperformance. We note the following factors that could hurt market sentiment and cause credit spreads to spike temporarily:

- A high-profile default by a well-known company in the High-Yield segment
- High volatility in commodity or foreign exchange markets
- Disappointing corporate earnings
- Ongoing heavy supply of longer-dated corporate bonds due to lower availability of bank credit and short-term refinancing

These considerations highlight the longer-term nature of our view and the possibility of short-term setbacks.

Part II: Recommendations

Our view that Investment Grade corporate bonds are attractively valued relative to government bonds must be seen in the context of a trend toward deteriorating corporate credit quality and fragile sentiment. The question, thus, arises how to best invest in Investment Grade bonds given this trend.

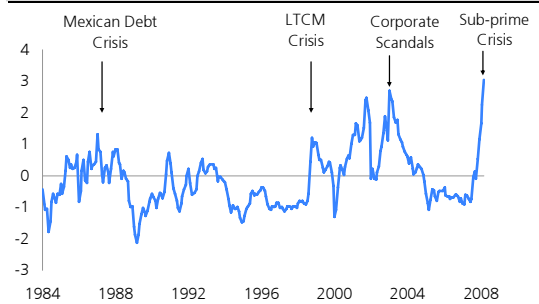
Investors should be selective in their investment approach, as we expect markets to be increasingly driven by credit fundamentals going forward. We have screened our investment-grade universe against various risk drivers and below we list our most and least preferred sectors and issuers. Given the ongoing turmoil in the financial sector, and its considerable diversity, we are not providing sector recommendations for financials at this time. For a successful implementation of this WMR Strategic Call, investors should have a long-term time horizon, ideally holding a bond until maturity.

For specific bond recommendations, please refer to our Bond Top List, which is updated daily.

A) Financials

Banks and Brokers - Banks and Brokers are the hardest hit sector from the credit crisis. They had to bear substantial valuation losses on structured mortgage products and other structured credit investments that amounted to nearly USD 300bn in 2007 and the first quarter of 2008. Since then, prices for structured credit products have stabilized and in some areas even recovered somewhat. We think that the phase of large-scale write-downs on such assets is almost over; however, we do not see the end of the credit crisis yet. Particularly those banks with

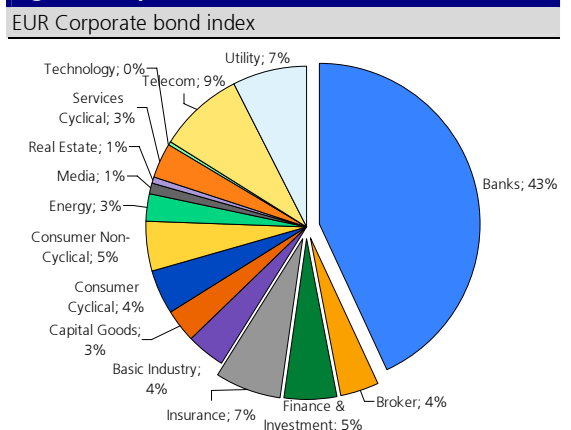
Fig. 11: Risk premium jumps in stress periods
'Baa'-spread minus average credit loss (normalized)



Note: Risk premium is derived as the z-score of IG credit spread minus credit loss.

Sources: Moody's, UBS WMR, as of 30 May 2008

Fig. 12: Corporate bonds sector distribution



Sources: Merrill Lynch, UBS WMR, as of 30 May 2008

large lending books that include consumer credit, commercial real estate and corporate credit to small and medium-size enterprises should face increased loan-loss provisioning and rising loan losses as well, in our view.

Banks have successfully recapitalized following the wave of write-downs, but we think it will take several years for them to fully restructure their balance sheets. Therefore, we expect the financial industry's overall credit trend to deteriorate and we think that further rating downgrades for banks less successful in restructuring lie ahead.

After noting all these negatives, we still consider the current valuation of the senior bonds of many banks attractive, as we think that bond risk premiums are overstating the default risk at present. Many investors continue to be cautious on banks and the many large new bond issues exert pressure on credit spreads.

We favor large global banks with an ample deposit base and significant importance to the financial industry, as these are most likely to receive support in case of financial distress. On the other hand, we remain cautious on small and medium-sized banks and financial services companies that do not attract deposits.

Insurance - The insurance sector is less affected by the credit crisis than banks, with some few exceptions, like AIG. We remain cautious on US and UK insurers, noting the latter's exposure to a souring UK housing market. The larger insurers from continental Europe are in rather good shape, in our view, but their bonds also offer significantly lower risk premiums than banks and brokers do.

Recommended US Financials¹: **Bank of America**, Citigroup, **Goldman Sachs**, J.P. Morgan Chase, Lehman Brothers, Merrill Lynch, Morgan Stanley, **Wells Fargo**.

Recommended non-US Financials: **Australia & New Zealand Banking Group**, Barclays Bank, **BNP Paribas**, Commonwealth Bank of Australia, **HSBC Holdings**, **Lloyds TSB Bank**, National Australia Bank, Royal Bank of Scotland, Société Générale.

Avoid: Allied Irish Banks, AIG Group, BBVA, Banco Santander, Bank of Ireland, Bradford & Bingley, Countrywide Financial, Fortis, Northern Rock, Swedbank, Wachovia, Washington Mutual.

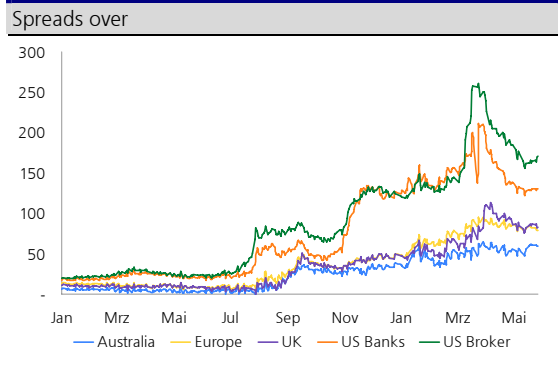
B) Non-financial corporates

Outperform sectors

Telecommunications - The Telecom sector is well-protected from a cyclical downturn, in our view. Financial leverage remains low while we think current valuations look attractive. However, in Europe, consolidation activity is likely to increase over the coming years. While we highlight the risk of increasing M&A activity, we also believe that credit deterioration is likely to be limited and that major participants are strongly committed to a rating of at least 'Mid BBB'. Telecom bonds could thus be particularly attractive for buy-and-hold investors, whereas we would generally prefer issuers less likely to play an important role in the next consolidation phase. Our preferred issuers in this sector are Telecom Italia and Telefonica. We would also consider in-

¹ top picks in bold

Fig. 13: Regional differences of risk premia of bank bonds



Sources: Bloomberg, UBS WMR, as of 30 May 2008

Fig. 14: Non-financial sector assessments

	exposure to economic cycle	exposure to resource prices	exposure to currency risks	financial policy	valuation	overall
Automobiles & Parts	--	--	--	-	-	--
Construction & Materials	--	-	=	=	-	-
Food & Beverage / Food retail	=	-	-	=	=	=
Healthcare	=	=	=	-	-	=
Media	-	=	-	=	-	-
Non-Food Retail	--	-	-	=	-	--
Oil & Gas	=	+	-	=	-	=
Specialty Chemicals	--	-	-	=	-	--
Telecommunication	=	=	=	-	++	+
Tobacco	=	=	=	=	+	+
Utilities	=	+	=	=	-/+	=/+

Source: UBS WMR, as of 30 May 2008

vesting in Vodafone bonds, although the valuation is less attractive and the company may be among the consolidators. We are, however, currently avoiding France Telecom and Deutsche Telecom, for which we may see large and potentially transforming M&A transactions over the coming months. (We would consider adding exposure though after the announcement of a major transaction.) With the exception of Telecom Italia, we expect new issuance to be high in the coming months. We would therefore generally recommend building exposure via newly issued bonds.

Recommended issuers²: **Telecom Italia**, **Telefonica**, Vodafone, AT&T
Avoid: Deutsche Telekom, France Telecom and Portugal Telecom

Utilities - Despite ongoing regulatory pressures, we expect earnings and cash flows to be more resilient among Utilities than for the general corporate sector. European utilities enjoy strong pricing power and, as we expect power prices to remain high, we believe that most European utilities will be able to cope well with the increased resource prices. Valuations are, however, relatively tight and we also expect continued strong volumes of primary issuance. Here again, we advise selectively adding exposure via newly issued bonds. Our preferred issuer list includes Endesa, for which we believe the market is currently overestimating supply and rating risks.

Recommended issuers: **Endesa**, Enel, Suez, EDP
Avoid: EDF, GDF, RWE, Vattenfall, ENBW

Tobacco - Due to its inelastic demand, we believe the Tobacco sector to be well-protected from lower consumer spending. Following the string of acquisitions last year, we expect credit profiles to remain stable or to improve; therefore, we like current valuations. Although tobacco companies should maintain their shareholder focus, we believe that issuers are generally committed to strong balance sheets.

Recommended issuers: **BAT**

Marketperform sectors

Consumer products / Food & Beverages / Food Retail - Although we see this segment as largely non-cyclical, we believe that resource price inflation could increasingly pressure margins. We therefore generally prefer diversified issuers with well-known brands and the strong pricing power to pass on increased costs. As a result of the recent M&A activity among brewers, we expect increased bond issuance in this sub-sector and therefore recommend building exposure via new issues.

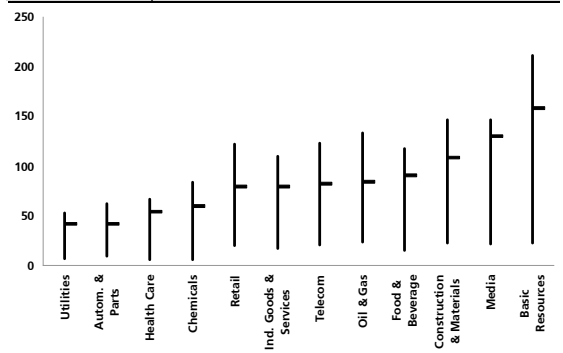
Recommended issuers: Danone, **Diageo**, **Heineken**, McDonalds, Unilever, Tesco, Wal-Mart
Avoid: Carrefour

Healthcare - Though the rating trend for Pharma companies is likely to be negative due to the strong shareholder focus, patent expirations and struggling pipelines, most companies in this sector should remain solidly positioned in the 'A'-category or above. These companies enjoy strong liquidity and cash flows regardless of the economic environment.

Recommended issuers: Glaxo

Fig. 15: Spread Development Non-Financials

Spread ranges since beginning of credit crisis (Summer 2007); in basis points



Sources: UBS Delta / WMR, as of 30 May 2008

² top picks in bold

Issuers in various other sectors - Apart from the listed industries, we would currently also consider adding exposure to the following issuers:

Total, BP - The issuers, under WMR coverage in the Oil & Gas sector, have clearly benefited from the currently high resource prices, which we expect to persist. Although valuations are already reflecting the strong cash flow generation, we would – depending on individual bond valuations – selectively add exposure.

Fiat - Following the upgrade to investment grade by all major rating agencies, we still like current valuations and see further potential for Fiat. Due to our negative stance on the European auto sector and the issuer's still relatively low ratings, we would, however, expect volatility to remain high.

Underperform sectors

Our least preferred sectors include several exposed to the economic cycle, high raw material prices or the currently low USD. We would therefore not currently add exposure to:

Autos and Auto Parts - While we are currently avoiding the European auto sector in general, we are currently particularly negative on Continental, Porsche, Peugeot and Renault. As noted, above, we are more positive on Fiat for valuation reasons.

Paper Sector - Earnings and credit metrics are likely to remain under pressure, in our view, as companies will have difficulties to pass on increasing costs. We are currently particularly negative on UPM and Stora Enso (no longer WMR-covered, we note).

Specialty Chemicals - Due to the low pricing power and decreasing demand, we continue to be negative on Ciba and Clariant.

Non-Food Retail - Due to the expected consumer slowdown and the prolonged sub-trend economic growth, we are avoiding non-food retailers like, for example, Marks and Spencer.

Fig 16: Recommended issuers

Issuer	Industry	WMR Rating
AT&T	Telephone-Integrated	Mid A
ANZ BANKING GROUP	Comm. Banks Non-US	Low AA
BANK OF AMERICA	Super-Regional Banks-US	Low AA
BARCLAYS BANK	Comm. Banks Non-US	Mid AA
BNP PARIBAS	Comm. Banks Non-US	Mid AA
BP	Oil Comp-Integrated	High AA
BRITISH AMERICAN TOBACCO	Tobacco	High BBB
CITIGROUP	Finance-Invest. Bank/Broker	Mid AA
COMMONWEALTH BANK AUSTRALIA	Comm. Banks Non-US	Low AA
DIAGEO	Beverages-Wine/Spirits	Low A
ENERGIAS DE PORTUGAL SA	Electric-Integrated	Low A
ENDESA	Electric-Integrated	Low A
ENEL	Electric-Integrated	High A
FIAT	Auto-Cars/Light Trucks	Low BBB
GLAXOSMITHKLINE	Medical-Drugs	High A
GOLDMAN SACHS GROUP	Finance-Invest Bank/Broker	Low AA
GROUPE DANONE	Food-Misc/Diversified	Low A
HEINEKEN	Brewery	Low A
HSBC	Comm. Banks Non-US	Mid AA
J.P.MORGAN CHASE	Finance-Invest Bank/Broker	Low AA
LEHMAN BROTHERS	Finance-Invest Bank/Broker	High A
LLOYDS TSB	Comm. Banks Non-US	Mid AA
MCDONALDS	Retail-Restaurants	Mid A
MERRILL LYNCH	Finance-Invest Bank/Broker	High A
MORGAN STANLEY	Finance-Invest Bank/Broker	Low AA
NATIONAL AUSTRALIA BANK	Comm. Banks Non-US	Low AA
ROYAL BANK OF SCOTLAND	Comm. Banks Non-US	Low AA
SOCIETE GENERALE PARIS	Comm. Banks Non-US	Low AA
SUEZ	Electric-Integrated	Low A
TELECOM ITALIA	Telephone-Integrated	Mid BBB
TELEFONICA	Telephone-Integrated	High BBB
TESCO	Food-Retail	High A
TOTAL SA	Oil Comp-Integrated	High AA
UNILEVER NV	Food-Misc/Diversified	High A
VODAFONE	Cellular Telecom	Low A
WAL-MART	Retail-Discount	Mid AA
WELLS FARGO	Super-Regional Banks-US	Mid AA

Source: UBS WMR, as of 30 May 2008

Appendix

Statement of Risk

Bond market returns are difficult to forecast because of fluctuations in the economy, investor psychology, geopolitical conditions and other important variables.

Corporate bonds are subject to a number of risks, including credit risk, interest rate risk, liquidity risk, and event risk. Though historical default rates are low on investment-grade corporate bonds, perceived adverse changes in the credit quality of an issuer may negatively affect the market value of securities. As interest rates rise, the value of a fixed coupon security will likely decline. Bonds are subject to market value fluctuations, given changes in the level of risk-free interest rates. Not all bonds can be sold quickly or easily on the open market.

Prospective investors should consult their tax advisors concerning the federal, state, local, and non-U.S. tax consequences of owning any securities referenced in this report.

Terms and abbreviations			
Abbreviation	Description	Abbreviation	Description
IG	Investment Grade	EBITDA	Earnings before interest, tax, depreciation and amortization
HY	High-Yield	EMU	European Economic and Monetary Union
rhs	Right hand scale	lhs	Left hand scale
GDP	Gross domestic product		

Probability of holding a "fallen angel"					
	1 Year	2 Years	3 Years	4 Years	5 Years
Aaa	0.00%	0.02%	0.05%	0.08%	0.12%
Aa1	0.00%	0.04%	0.10%	0.17%	0.27%
Aa2	0.00%	0.07%	0.18%	0.31%	0.48%
Aa3	0.18%	0.32%	0.51%	0.76%	1.05%
A1	0.00%	0.42%	0.86%	1.34%	1.85%
A2	0.25%	0.91%	1.69%	2.56%	3.52%
A3	0.27%	1.59%	3.05%	4.61%	6.22%
Baa1	1.47%	3.89%	6.39%	8.87%	11.27%
Baa2	1.10%	5.80%	10.08%	13.90%	17.30%
Baa3	4.22%	14.27%	21.47%	26.75%	30.74%

Cumulative probability of rating downgrade to Ba1 or below;
based on historical rating transition matrix (1983 - 2007) from Moody's Investors Service

Appendix

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Appendix

Credit Issuer/Bond Recommendation Definitions				
Recommendation	Time Horizon		WMR Terminology	Definition
WMR Credit/Bond* Rating	Longer Term	Investment Grade	AAA	Issuer / Bonds have exceptionally strong credit quality. AAA is the best credit quality.
			High AA	Issuer / Bonds have very strong credit quality.
			Mid AA	
			Low AA	
			High A	Issuer / Bonds have high credit quality.
			Mid A	
			Low A	
			High BBB	Issuer / Bonds have adequate credit quality. This is the lowest Investment Grade category.
			Mid BBB	
		Low BBB		
		Non-Investment Grade	High BB	Issuer / Bonds have weak credit quality. This is the highest Speculative Grade category.
			Mid BB	
			Low BB	
			High B	Issuer / Bonds have very weak credit quality.
			Mid B	
			Low B	
			High CCC	Issuer / Bonds have extremely weak credit quality.
			Mid CCC	
Low CCC				
CC	Issuer / Bonds have very high risk of default.			
C				
D	Obligor failed to make payment on one or more of its financial commitments. This is the lowest quality of the Speculative Grade category.			
WMR Credit Trend	Review within a couple of months	Improving	The WMR Credit Trend reflects the analyst's expectation as to how the company's credit fundamentals will change.	
		Stable		
		Deteriorating		
	Review within a couple of months	Watch +	Increased likelihood of UBS WMR Credit Rating upgrade(s).	
		Watch -	Increased likelihood of UBS WMR Credit Rating downgrade(s).	
Recommendation	WMR Terminology		Definition	
Bond Recommendation	Outperform (OUT)		The bond is expected to earn a higher total return than a liquid bond benchmark representing a comparable level of risk.	
	Marketperform (MKT)		The bond is expected to earn a total return in line with a liquid bond benchmark representing a comparable level of risk.	
	Underperform (UND)		The bond is expected to earn a lower total return than a liquid bond benchmark representing a comparable level of risk.	
	Sell (SELL)		In light of substantial downside credit or default risk, and the expectation of a lower total return than a liquid bond benchmark representing a comparable risk, investors should sell these bonds.	

*The Bond Rating reflects WMR's opinion of the credit quality of a bond. The WMR Bond Rating is derived by adjusting the WMR Credit Rating of the issuer for any collateral-type and capital structure considerations specific to that bond. This may result in the bond having a different risk profile, and therefore a different rating than the issuer, as well as other bonds of the issuer.

Appendix

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