

Investment Viewpoints

Banking on the future

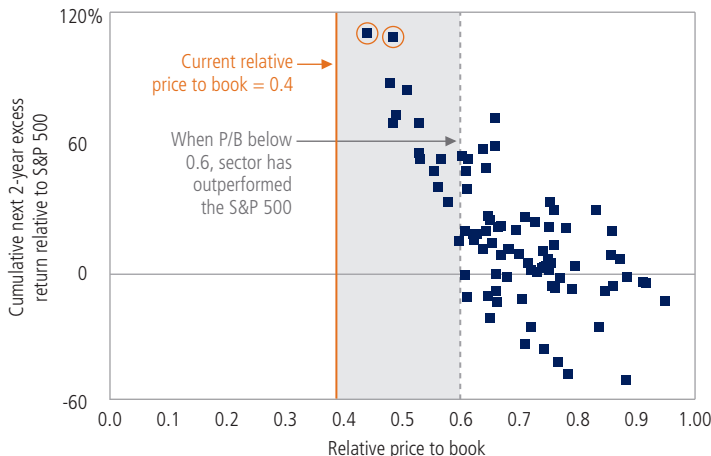
June 2008

Investment Viewpoints is designed to provide a closer look at elements that factor into UBS Global Asset Management's market or strategy views. This issue presents our perspective on one area of the US equity market—financials—as represented in our Core and Value US Equity portfolios.

The recent turmoil in the credit markets has shaken the financial sector. Massive write downs have resulted in billions of dollars in losses. As the financial firms see their balance sheets hurt, earnings power continues to weaken. Without clarity into the breadth and depth of future write downs—a near certainty for the sector—many investors are abandoning financial companies altogether.

Financials appear likely to outperform

Median P/B relative to S&P 500 vs. next 2 years relative performance



Financials excluding insurance and real estate. Quarterly from December 31, 1984 – March 31, 2008

Source: Factset, UBS Global Asset Management

Past performance is no guarantee of future results.

Despite the recent turmoil and the likelihood of future negative announcements, our price to intrinsic value platform believes the sector has been depressed far below fair value. This is not to say the sector will quickly trend upward. In fact, we believe prices may continue to be volatile in the short term, due to continuing negative news and investor uncertainty. However, based on our cash flow analyses and estimates of future write downs, we believe financials will rebound with strong outperformance once credit concerns diminish.

Within our core and value US equity strategies, we have cut the long-term profitability estimates of companies that we believe are directly exposed to credit risks. While this reduced what we saw as their fair value, current market prices continue to fall far short of our value estimates. After all of the write offs—and our estimates of future write offs—we believe share prices today look very attractive.

Historical perspective

To put the current valuations in perspective, we can take a look at the historical price-to-book (P/B) ratios¹ of the financial sector during the past 23 years (see chart at left). Along the x-axis, we plotted the historical P/B for the financial sector, excluding insurance and real estate, relative to the P/B for the S&P 500 Index (the "Index"). The y-axis shows the percent of cumulative excess returns of the financial sector, excluding insurance and real estate, relative to the Index. The numbers represent rolling two-year periods.

The chart illustrates for the period shown that when the price-to-book falls below a relative P/B of 0.6—nearly half that of the typical S&P 500 company—the sector has, over the course of the next two years, outperformed the S&P 500 by 20% or more. The two "bulls eye" dots that are shown in the upper left-hand corner of the dot cluster are from

¹ A ratio used to compare a stock's market value to its book value. It is calculated by dividing the current closing price of the stock by the latest quarter's book value per share.

September and December of 1990, the nadir of the savings and loan (“S&L”) crisis. From these periods, when the relative price-to-book ratios were at their lowest, the relative outperformance was more than 100% for the following two years.

At the end of March 2008, the relative price-to-book ratio was 0.4—an unprecedented low during the past 23 years. During that time span, there has never been a period when financials did not outperform when the relative P/B fell below 0.55. It should be noted that the current low, in part, is exacerbated by new mark-to-market accounting rules that have been implemented. However, even with this taken into account, we believe the P/B is still at a remarkably low level, estimated to be near the low that was hit during the S&L crisis.

Opportunities

In our view, not all opportunities within the financial sector are equal. We are currently avoiding monoline lenders, mortgage companies, homebuilders, or firms that appear overly dependent on short-term liquidity. That said, we continually monitor the price/value relationships of these companies, recognizing that a time may come when we do want to add

opportunistically to these areas. We currently see strong opportunities among large diversified financial companies.

While these companies have been exposed to their share of headline risk, we believe they have strong established balance sheets. Also, we believe many of these companies are likely to come through this crisis better positioned than before, as we anticipate that some of their smaller competitors will fail. Furthermore, in our opinion, companies with solid underwriting cultures will weather the current storm much better than others.

Lastly, a drop in the short-term rate, which has steepened the yield curve,² is another positive consideration for banks. As a result of this drop, banks can borrow short term, and lend long term. As the spread between shorter-term and longer-term rates grows, banks should improve their net interest margins, which can have a dramatic effect on earnings. For these reasons, we believe financials, **especially the large diversified kind**, will eventually see strong performance, thus rewarding our current position.

² The yield curve is the relation between the interest rate (or cost of borrowing) and the time to maturity of the debt for a given borrower in a given currency.

The views expressed are as of June 16, 2008, and are those of UBS Global Asset Management. These views are subject to change at any time in response to changing circumstances in the markets, and are not intended to predict or guarantee the future performance of any individual security, asset class, the markets generally, nor are they intended to predict the future performance of any UBS Global Asset Management account, portfolio or fund. The information contained herein does not constitute a distribution, an offer to sell or the solicitation of an offer to buy securities or funds.