

# UBS AST 3 Global Real Estate (ex CH)

Quarterly Report 2Q16

UBS Investment Foundation 3



# Contents

|   |    |
|---|----|
| Executive summary .....                                       | 3  |
| Key facts .....   | 3  |
| Fund summary.....   | 3  |
| Performance summary.....                                      | 3  |
| Quarterly highlights.....                                     | 3  |
| Outlook.....  | 3  |
| Performance review.....                                       | 4  |
| Performance in CHF (hedged, as at June 30, 2016).....         | 4  |
| Portfolio review.....   | 6  |
| Portfolio update.....   | 6  |
| Positioning pre-UK Referendum on EU membership.....           | 6  |
| Positioning post-Brexit.....                                  | 6  |
| Portfolio allocations.....                                    | 7  |
| Capital deployment.....                                       | 7  |
| Actual & target allocations vs. investment restrictions ..... | 8  |
| Leverage .....  | 9  |
| Foreign exchange exposure.....                                | 9  |
| Underlying funds summary.....                                 | 10 |
| Property views.....   | 10 |
| Underlying funds summary.....                                 | 10 |
| Individual underlying fund summaries.....                     | 10 |
| Market review and update.....                                 | 11 |

# Executive summary

## Key facts

|                       |  |
|-----------------------|--|
| Fund name             | UBS AST 3 Global Real Estate (ex CH) (AST 3 GRE)   |
| Fund structure        | Investment Foundation, eligible for the 2 <sup>nd</sup> pillar of the Swiss Pension System according to BVV2 |
| Fund Manager          | UBS AG, UBS Asset Management   |
| Fund Inception        | June 30, 2011  |
| Liquidity             | Quarterly liquidity with a 12-month notice period  |
| Net Asset Value (NAV) | Net Asset Value (NAV) of CHF 1,990 million (as at June 30, 2016) <sup>1</sup>                                |
| Base currency         | CHF denominated. Foreign currency exposure is hedged back to CHF.  |
| Leverage              | Maximum of 33.3% on a look-through weighted average basis. No additional leverage at the AST 3 GRE level.    |
| Subscription          | Quarterly  |
| Redemption            | Quarterly (with a 12-month notice period)  |
| Valoren               | I-A0:12355878, I-A1:12355881, I-A2:12355883, I-A3:12355885, I-X:12355889                                     |
| Share class NAV       | I-A0: CHF 1,291.82, I-A1: CHF 1,292.87, I-A2: CHF 1,294.58, I-A3: CHF 1,221.44, I-X: CHF 1,255.99            |

<sup>1</sup> Excludes capital inflows of CHF 221.3 million received at the end of 2Q16. Unless otherwise stated, all figures, performance estimates and charts include the additional capital inflows received and the forward investment activities made in anticipation of these capital inflows at the end of 2Q16.

## Prospectus and subscription process

The foundation board and the supervisor have approved the current prospectus, which was published on May 28, 2015, and can be downloaded at [www.ubs.com/ast](http://www.ubs.com/ast). The next cut-off date to subscribe to AST 3 GRE is August 31, 2016, with an allocation date of no later than November 30, 2016, and a value and trade date of December 22, 2016, and December 30, 2016, respectively.

## Fund summary

UBS AST 3 Global Real Estate (ex CH) (AST 3 GRE) holds 22 core real estate funds in its portfolio and has committed 95.0% of its available capital. During the quarter, AST 3 GRE accepted inflows of CHF 221.3 million, which the Manager has already allocated as described in the following Quarterly highlights section.

## Performance summary<sup>2</sup>

The performance of AST 3 GRE during 2Q16 was 1.02% Quarter-on-Quarter and 7.25% Year-on-Year (hedged, in CHF for the I-A2 share class). Following the strong performance in 1Q16, AST 3 GRE's returns moderated as a result of slowing capital gains in the US and Europe, the write down of a UK fund to a redemption price, and the negative impact of a holding in a closed-end APAC fund that was diluted by new commitments ahead of the fund's final closing. Over the medium-term (three to five years), the Manager expects returns to moderate to a range of 5-6% p.a. (net in CHF, for I-A2 share class), driven by income return as capital value growth normalizes and FX hedging costs remain high.

## Quarterly highlights

The UK Referendum and eventual Brexit result were key considerations for AST 3 GRE's recent investment activity especially in 2Q16.

During 2Q16, the Manager made three investments in the US and Europe and placed a redemption request for its entire holding in one UK fund.

In the US, the Manager made top-up investments into two US Balanced Funds which will both be fully drawn by July 2016.

In Europe, the Manager completed a new investment into a European Logistics Fund, providing AST 3 GRE exposure to a diversified portfolio of prime income producing logistics assets. The Manager believes the investment complements AST 3 GRE's existing portfolio and will serve as a solid foundation to a sector that is expected to continue to benefit from the domestic consumption-led European recovery.

Post Brexit, on June 30, 2016, the Manager submitted a redemption request for AST 3 GRE's entire holding in a UK Balanced Fund. The Manager currently estimates the full redemption proceeds to be funded in 1Q17.

## Outlook

AST 3 GRE remains overweight in the US and continues to selectively act on opportunities to increase the Continental European exposure to a neutral weight. Post Brexit, the Manager has moved quickly to execute an underweight position in the UK. Even after completing multiple APAC investments in 1Q16, AST 3 GRE's weighting in APAC remains near the bottom end of the strategic range, primarily due to the region's limited investment options. The Manager expects AST 3 GRE to move to a more neutral position in the medium-term as more suitable products come to market.

<sup>2</sup> Expected performance is no guarantee for future results

# Performance review

## Performance in CHF (hedged, as at June 30, 2016)

The positive Quarter-on-Quarter performance of 1.02% and Year-on-Year performance of 7.25% (for the I-A2 share class) were lower than in previous quarters, as capital growth moderated in the US and Europe. Notably, however, stable income distributions, supported by favorable income growth, contributed an increased share of the portfolio's total return Quarter-on-Quarter.

The best performer within the portfolio during the quarter was a Japanese Industrial Fund, whose total return of 6.9% was driven by strong valuation uplifts and stable income distributions.

The weakest performers this quarter were a UK Balanced Fund and a Balanced Asian-Pacific Fund, whose total returns were -4.4% and -4.0%, respectively. The Manager wrote down the UK Balanced Fund's holding value to the redemption price after placing a redemption request for AST 3 GRE's entire stake. This write down reflects the actual expected proceeds from this Fund over the coming quarters and builds in the underlying manager's expected valuation falls. The weak performance by the Balanced Asian-Pacific Fund, a closed-end fund, was substantially attributed to AST 3 GRE's holding being diluted by new commitments ahead of the fund's final closing. Holding for this one-off negative dilution impact, the Balanced Asian-Pacific Fund actually recorded positive underlying real estate valuation gains during the quarter and is expected to perform well over the medium-term.

The US funds continued to perform well and were led by two US Balanced Funds which delivered quarterly total returns of 2.6% and 2.4%, respectively. Total returns for the US funds ranged from 1.4% to 2.6%, reflecting moderating capital growth and more balanced contributions from income distributions. The Manager expects capital value growth to continue normalizing over the next three years and returns be driven increasingly by market rent growth.

In the UK, the Brexit result did not immediately impact returns. One UK Balanced Fund delivered a strong total return of 2.8%, attributed mainly to capital growth, while another Balanced UK Fund achieved a total return of 1.9% primarily from income distributions. In fact, if the UK Balanced Fund mentioned above was not written down to the redemption price, the 2Q16 performance would have been 1.4%. Going forward, the Manager does expect the uncertainties surrounding Brexit to result in weaker overall performance in the UK, particularly in City of London offices.

The Pan-European funds delivered mixed results ranging from 0.1% to 1.6%, net of the impact of look-through FX hedging. Of the Pan-European funds, two Balanced European Funds have meaningful exposure (34% and 21%, respectively) to the UK. While the Manager expects the UK holdings in those funds to experience valuation pressure over the coming quarters, the outlook for the Continental European properties remain positive and should offset the expected weakness from the UK exposures. Although capital value growth moderated in 2Q16, income growth was a common feature across all of AST 3 GRE's Pan-European holdings. The improving outlook for income-led returns lends support for the Manager's initiative to actively seek investment opportunities expected to benefit from the continued recovery of domestic consumption in Continental Europe.

In APAC, as mentioned above, the Japanese Industrial Fund was AST 3 GRE's best performing fund this quarter, while the Australia Office Fund recorded a 4.0% return from strong capital appreciation and consistent income distributions. With the exception of the mentioned Balanced Asian-Pacific Fund, the returns for the remaining APAC funds ranged 2.0% to 2.8% net of the impact of look through FX hedging.

On balance, we believe our disciplined investment process will keep AST 3 GRE on track to deliver attractive returns to investors.

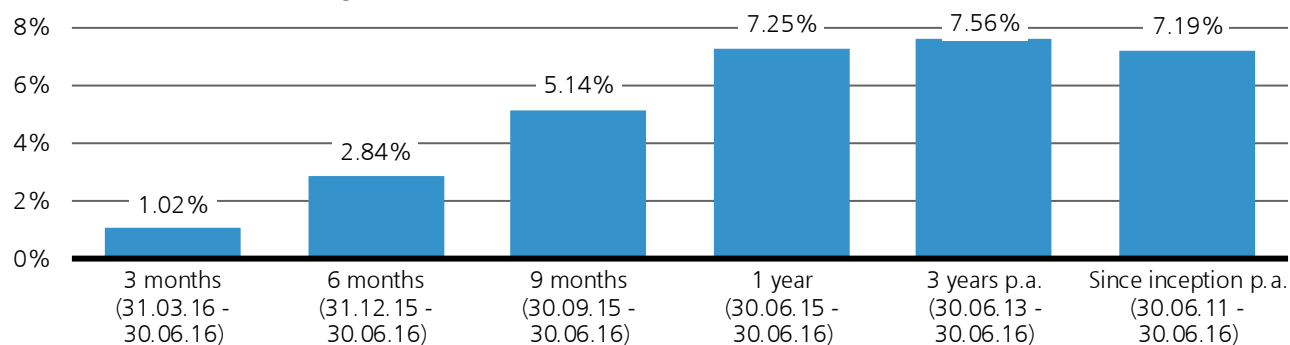
## Total returns (in CHF, hedged)<sup>3</sup>

|      | 3 mths | 6 mths | 9 mths | 1 yr | 3 yrs<br>(p.a) | SI<br>(p.a) <sup>4</sup> |
|------|--------|--------|--------|------|----------------|--------------------------|
| I-A0 | 0.96   | 2.71   | 4.94   | 6.99 | 7.32           | 6.96                     |
| I-A1 | 0.99   | 2.77   | 5.02   | 7.10 | 7.41           | 7.05                     |
| I-A2 | 1.02   | 2.84   | 5.14   | 7.25 | 7.56           | 7.19                     |
| I-X  | 1.17   | 3.16   | 5.62   | 7.89 | 8.14           | 7.57                     |
| I-A3 | 1.05   | 2.90   | 5.22   | 7.36 | 7.65           | 7.19                     |

<sup>3</sup> Total returns performance includes distributions to June 30, 2016. Performance may differ across share classes due to distributions, fees, and expenses. Past performance is not a reliable indicator of future results.

<sup>4</sup> Since inception. Since inception date for I-A0, I-A1, I-A2 was June 30, 2011. Since inception date for I-X was December 31, 2011. Since inception date for I-A3 was March 31, 2012. Since inception returns are annualized for all share classes with since inception dates over one year.

**Total returns for I-A2 (in CHF, hedged)<sup>5,6</sup>**



<sup>5</sup> Total returns performance includes distributions to June 30, 2016. Performance may differ across share classes due to distributions, fees and expenses. Past performance is not a reliable indicator of future results.

<sup>6</sup> Since inception date for I-A2 was June 30, 2011. 3-year and since inception returns are annualized.

# Portfolio review

## Portfolio update

To date, approximately 95.0% of AST 3 GRE's available capital has been committed to 22 underlying core real estate funds, providing exposure to over 2,100 properties in 23 countries over six sectors. The look-through occupancy of the portfolio is 92.9%, with a diversified pool of over 11,000 tenants and a weighted average lease expiry of circa 5.6 years. Current look-through leverage stands at 24.0% and refinancing risk should remain low with a healthy staggered maturity schedule.

## Positioning pre-UK Referendum on EU membership

AST 3 GRE invests across all the major developed markets through institutional unlisted property funds where a neutral allocation to the UK is around 12%. At the start of 2016, AST 3 GRE had an overweight position (c. 16%) to the UK given its strong actual and relative performance over the last few years. In 1Q16, however, the Manager started the process of moderating the UK exposure to a more neutral position, consistent with the Manager's pre-UK Referendum forecasts for expected UK returns in 2016 and 2017.

In addition, AST 3 GRE's look-through exposure to the higher-risk, City of London offices segment was minimal (< 0.3% of the overall portfolio), while none of the UK funds had significant leverage or vacancy issues. The majority of the UK holdings are in defensive sectors such as industrial and high-quality retail.

The total UK exposure at the end of June 2016 is 12.4%, which still reflects the UK Balanced Fund holding ahead of the redemption being realized.

## Positioning post-Brexit

The Manager has moved quickly to target an underweight position in the UK and submitted a redemption request to the UK Balanced Fund mentioned above on June 30, 2016. Once fully redeemed, AST 3 GRE's overall exposure to the UK is forecast to decrease to 9.7%, reflecting an underweight

allocation. On a look-through basis AST 3 GRE's exposure to City of London offices will decline further to c. 0.1% and remain more heavily weighted to the defensive UK sectors of industrial and dominant retail.

AST 3 GRE will maintain its overweight position to the US core market over the near-term as the US remains the deepest and most liquid investible market, and the Manager does not expect the US real estate market to be impacted by Brexit. Based on this rationale, AST 3 GRE completed top-up investments into a US Balanced Fund, one of the Manager's most preferred US funds, and another US Balanced Fund, which offers a defensive profile and an attractive distribution yield.

In Europe, AST 3 GRE completed a new investment into a Balanced European Fund, which provides AST 3 GRE exposure to a diversified portfolio of prime income-producing logistics assets. This investment complements AST 3 GRE's existing European portfolio and increases exposure to a sector that is expected to continue to benefit from the domestic consumption-led European recovery.

After making multiple investments in APAC in 1Q16, the Manager did not make any further investments in 2Q16. The Manager, however, believes certain sectors in APAC remain relatively attractive such as the Japanese industrial sector and the Australian office sector (particularly in Sydney). In Japan, monetary conditions remain accommodating and continue to support real estate pricing. In Australia, particularly in Sydney, the occupier market outlook continues to improve as a result of demand from finance, insurance, technology, media and telecommunications sectors and limited new supply.

AST 3 GRE aims to balance both the geographical and sector exposures by investing globally with a focus on the traditional sectors and markets with strong in-place income and rental growth potential.

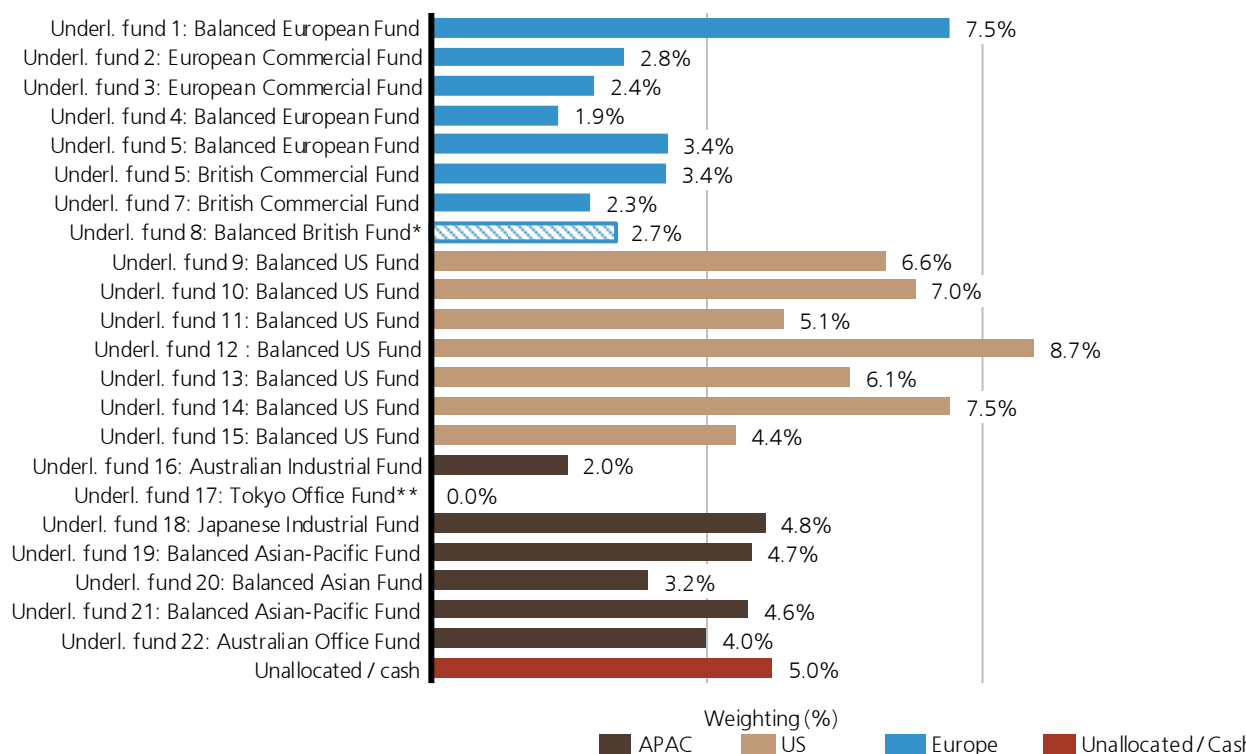
## Portfolio statistics

|  |         |
|--|---------|
| Value of underlying real estate (CHF billion) <sup>7</sup> | 108.8   |
| Number of underlying real estate funds                     | 22      |
| Number of properties <sup>7</sup>                          | 2,100+  |
| Number of tenants <sup>7</sup>                             | 11,000+ |
| Portfolio occupancy (%) <sup>7</sup>                       | 92.9    |
| Leverage (% gross asset values) <sup>7</sup>               | 24.0    |
| Weighted average lease expiry (years) <sup>7</sup>         | 5.6     |

<sup>7</sup> Based on committed and invested capital and forward investment activities made in anticipation of the confirmed 2Q16 capital inflows. Information based on underlying funds' last available report.

## Portfolio allocations

(Based on the value of the underlying funds plus outstanding commitments (including Investment Committee-approved forward investments made in relation to 2Q16 capital inflows) as of June 30, 2016



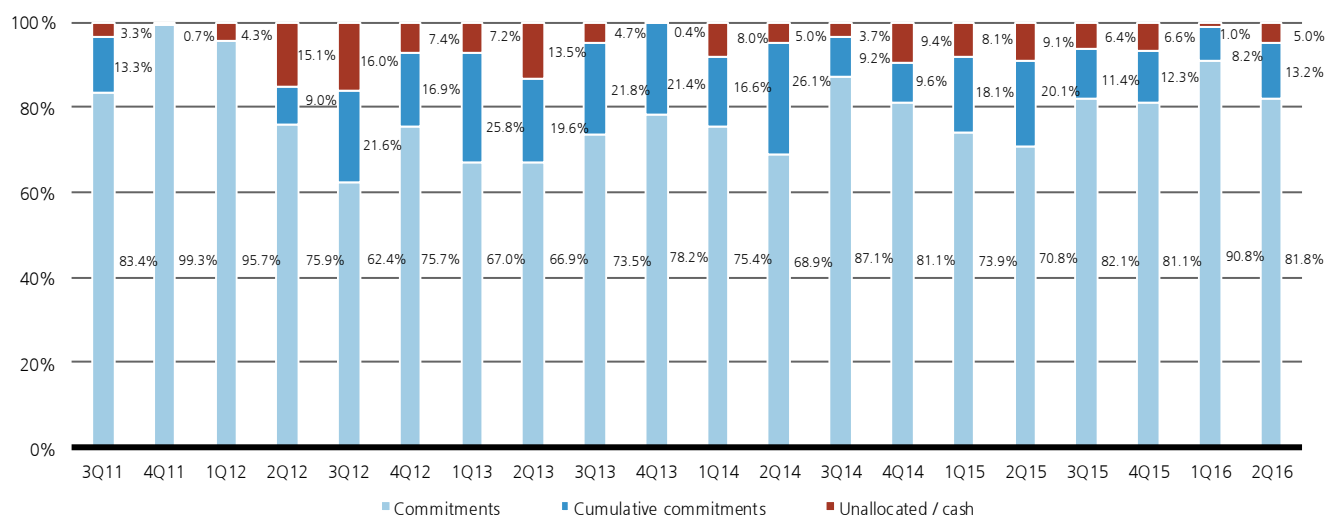
Note: Weights are based on committed and invested capital to underlying funds. The weights include forward investments activities made in anticipation of the confirmed 2Q16 capital inflows. The figures may not add up to 100% due to rounding differences.

\* On June 30, 2016, the Manager submitted a redemption request for AST 3 GRE's entire holding in this UK Balanced Fund. Unless otherwise stated, all figures and charts in this report still include this Fund's holding.

\*\*The fund has liquidated its investments and is winding down the fund entities

## Capital deployment<sup>8</sup>

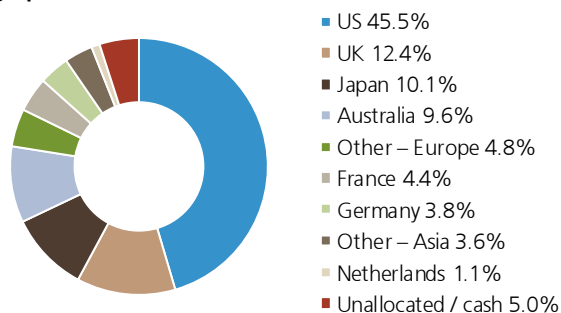
The below chart depicts when commitments were made into underlying funds



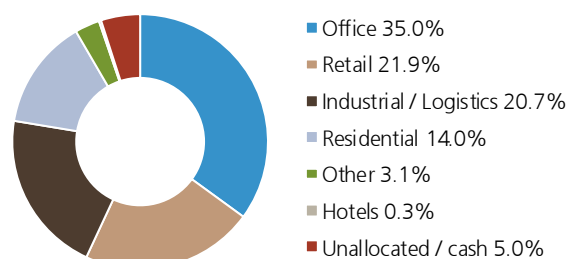
<sup>8</sup> Look-through on NAV as of June 30, 2016; NAV is based on total commitments to underlying funds. The weights include forward investment activities made in anticipation of the confirmed 2Q16 capital inflows.

## Actual & target allocations vs. investment restrictions<sup>9</sup>

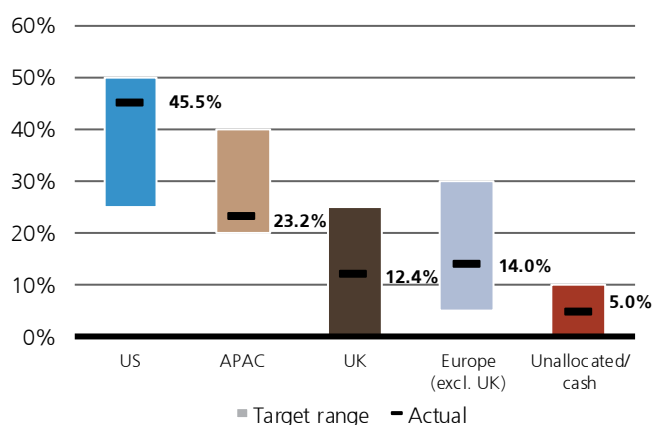
### Geographic allocation



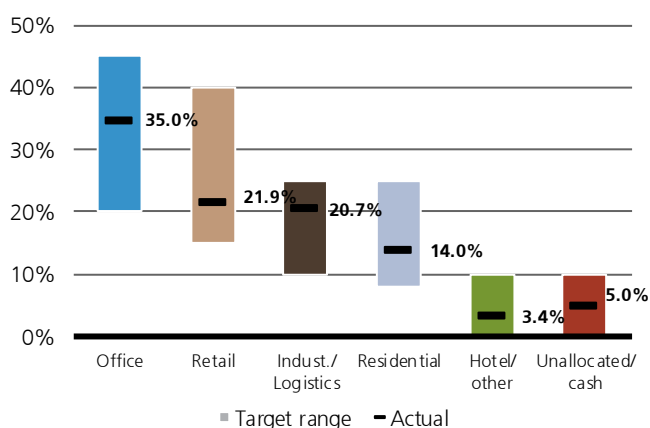
### Sector allocation



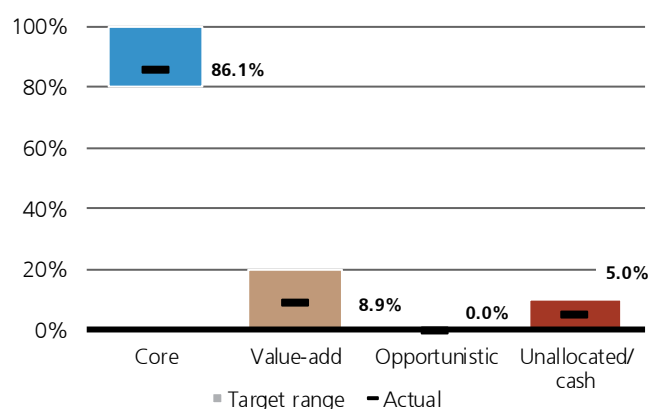
### Regional allocation



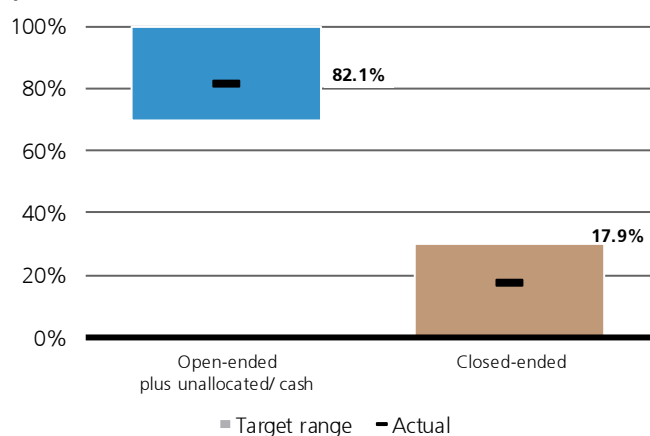
### Sector allocation



### Risk allocation



### Open-/ closed-ended allocation

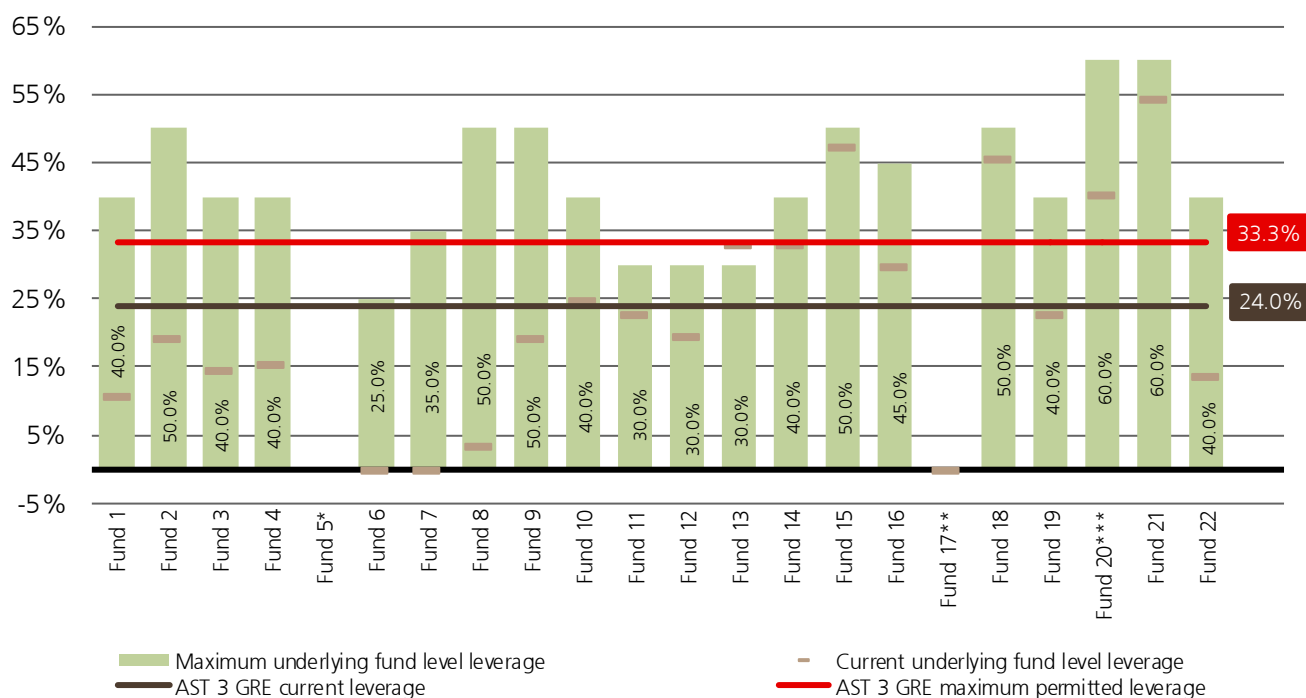


<sup>9</sup> Look-through on NAV as of June 30, 2016; weights are based on invested and outstanding commitments to underlying funds. Includes forward investment activities made in anticipation of the confirmed 2Q16 capital inflows. Charts may not add up to 100% due to rounding differences.



## Leverage<sup>10</sup>

AST 3 GRE is not leveraged at the portfolio level but the underlying core real estate funds do possess leverage

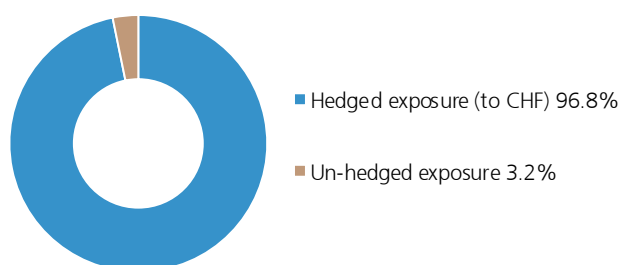


\* Due to certain confidentiality agreements with the fund, specific information relating to the portfolio may not be disclosed.

\*\* The fund has liquidated its investments and is winding down the fund entities

\*\*\* As the fund is in its ramp-up phase, the fund is able to increase gearing up to 60% at the property level when it is advantageous to do so. However, the fund's intention is not to take on excessive leverage and it has to adhere to the maximum leverage of 40% at the fund level after the ramp-up phase

## Foreign exchange exposure<sup>10</sup>



<sup>10</sup> As at June 30, 2016

# Underlying funds summary

|  | Currency | Year of initial commitment | Underlying fund currency (million) |            |                |                          |
|--|----------|----------------------------|------------------------------------|------------|----------------|--------------------------|
|  |          |                            | Real estate value                  | Commitment | Capital called | 2Q16 value <sup>11</sup> |
| Underl. fund 1: Balanced European Fund                     | EUR      | 2013                       | XX                                 | 147.62     | 147.62         | 153.43                   |
| Underl. fund 2: European Commercial Fund                   | EUR      | 2011                       | XX                                 | 53.65      | 53.65          | 57.33                    |
| Underl. fund 3: European Commercial Fund <sup>12</sup>     | EUR      | 2011                       | XX                                 | 47.53      | 47.53          | 48.54                    |
| Underl. fund 4: Balanced European Fund                     | EUR      | 2015                       | XX                                 | 37.70      | 0.00           | 0.00                     |
| Underl. fund 5: Balanced European Fund                     | EUR      | 2016                       | XX                                 | 70.00      | 0.00           | 0.00                     |
| Underl. fund 6: British Commercial Fund <sup>12</sup>      | GBP      | 2011                       | XX                                 | 54.02      | 54.02          | 57.84                    |
| Underl. fund 7: British Commercial Fund <sup>12</sup>      | GBP      | 2013                       | XX                                 | 36.37      | 36.37          | 39.37                    |
| Underl. fund 8: Balanced British Fund <sup>12</sup>        | GBP      | 2014                       | XX                                 | 44.02      | 44.02          | 45.42                    |
| Underl. fund 9: Balanced US Fund                           | USD      | 2011                       | XX                                 | 120.59     | 120.59         | 149.38                   |
| Underl. fund 10: Balanced US Fund                          | USD      | 2011                       | XX                                 | 129.24     | 129.24         | 159.16                   |
| Underl. fund 11: Balanced US Fund                          | USD      | 2011                       | XX                                 | 97.07      | 97.07          | 115.93                   |
| Underl. fund 12: Balanced US Fund                          | USD      | 2013                       | XX                                 | 175.63     | 175.63         | 198.17                   |
| Underl. fund 13: Balanced US Fund                          | USD      | 2015                       | XX                                 | 126.85     | 126.85         | 137.79                   |
| Underl. fund 14: Balanced US Fund                          | USD      | 2013                       | XX                                 | 164.20     | 97.00          | 103.35                   |
| Underl. fund 15: Balanced US Fund                          | USD      | 2015                       | XX                                 | 98.00      | 57.15          | 59.47                    |
| Underl. fund 16: Australian Industrial Fund <sup>12</sup>  | AUD      | 2011                       | XX                                 | 46.28      | 46.28          | 60.24                    |
| Underl. fund 17: Australian Office Fund                    | AUD      | 2016                       | XX                                 | 120.00     | 120.00         | 122.04                   |
| Underl. fund 18: Tokyo Office Fund <sup>12,13</sup>        | JPY      | 2013                       | XX                                 | 1,418.6    | 1,418.6        | 12.87                    |
| Underl. fund 19: Japanese Industrial Fund                  | JPY      | 2012                       | XX                                 | 9,942.28   | 4,864.28       | 6,197.37                 |
| Underl. fund 20: Balanced Asian-Pacific Fund <sup>12</sup> | USD      | 2013                       | XX                                 | 104.30     | 104.30         | 105.41                   |
| Underl. fund 21: Balanced Asian Fund                       | USD      | 2014                       | XX                                 | 62.57      | 62.57          | 71.80                    |
| Underl. fund 22: Balanced Asian Fund <sup>12</sup>         | USD      | 2015                       | XX                                 | 98.90      | 76.02          | 81.46                    |

\*Due to certain confidentiality agreements with the fund, specific information relating to the portfolio may not be disclosed.

## Property views

Property details cannot be disclosed in this report due to confidentiality agreements. Existing investors in UBS AST 3 Global Real Estate (ex CH) will have full access to this section.

## Individual underlying fund summaries

Individual underlying fund summaries cannot be disclosed in this report due to confidentiality agreements. Existing investors in UBS AST 3 Global Real Estate (ex CH) will have full access to this section.

This section will include the following information for each target fund:

- Current Net Asset Value
- Current Gross Asset Value
- Number of assets
- Fund occupancy
- Regional and sector allocation
- Target net returns

<sup>11</sup> Excludes distributions and based on last available information

<sup>12</sup> (Partial) subscription costs/premiums/accrued distributions were payable for these funds.

<sup>13</sup> The fund has liquidated its investments and is winding down the fund entities

# Market review and update

By Paul Guest, Lead Real Estate Strategist

## Macroeconomic overview

The global economy is relatively healthy, despite the fact that in most major economies domestic demand is expanding at a rate below its 10-year (or longer) average. This is nothing to get excited about, but in the US, in Europe, and in China, household demand is expanding at a steady rate and inflation expectations are picking up. This trend is led by the most flexible economies that first started to expand – the US, the UK – while those advanced economies more tightly linked to commodities like Australia and Canada are lagging. Emerging markets with home-grown challenges like Brazil and Russia are exceptions. Japan continues to struggle with low real wage growth and anemic retail sales growth. Regardless, the virtuous circle of job creation – wage growth – consumer spending – more job creation is becoming embedded in a broader swathe of economies, particularly in Europe. This is a positive dynamic for real estate.

Research by UBS' global economics group suggests that for much of 2014 and 2015 in the US and the Eurozone, at least, the revised economic data is stronger than the initial releases (see Chart 1). This does not tend to get captured in the news nor by financial markets, yet in a majority of cases both growth and inflation data are revised upwards post-release. This corroborates the broader evidence of a steady pickup in demand growth – nothing explosive, but also not as weak and as prone to reversal as central bank activism might suggest.

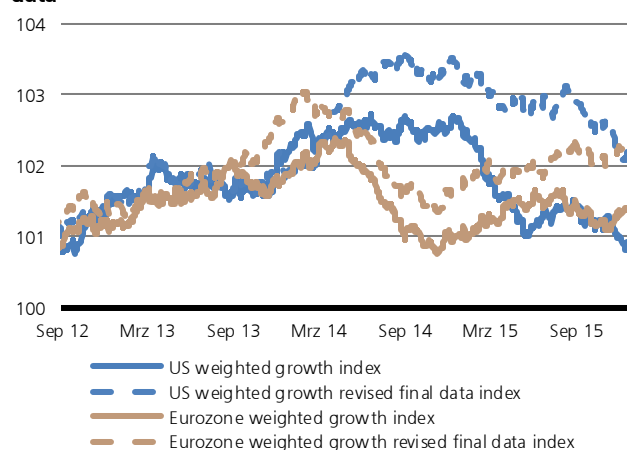
This is not to say that there are no challenges. Market sentiment is still fragile, as hinted at by the sudden and sharp swing from 'risk off' in 1Q16 to 'risk on' since March. Asset markets were highly volatile in the January quarter, triggered by a range of concerns ranging from China to US monetary policy to geopolitics. Volatility has been tamed in recent months, with such measures as the VIX below their long-term averages. But event risk, defined as the possibility of a rare, unanticipated event causing a sharp change in market values, is very much present. The European Union (EU) referendum in the UK is just one aspect of the institutional challenges facing the EU, while in the US the presidential race is always a source of headlines if not always direct market moves.

Monetary policy is a further uncertainty. The discontinuity between the world's major central banks has eased with the US Federal Reserve's decision to postpone tightening due to global volatility and uncertainties. Nevertheless, the Fed will ultimately need to tighten as core inflation and wage growth are both up in the US and are expected to remain ahead of the curve. Meanwhile, in both the Eurozone and Japan there is plenty of non-traditional easing still underway. Communication from the Bank of Japan, in particular, has been unclear.

Market reaction to recent actions and statements from both Tokyo and Frankfurt suggests central bank activism has reached its limits. This raises a key question: if growth weakens anew, what stimulative policies are left to enact?

Overall, the combination of a modest strengthening in domestic demand and a pickup in inflation is supportive of income growth in good quality commercial property. This will be necessary as the sector makes the shift from capital value growth-led to income growth-led total returns.

**Chart 1: UBS weighted economic surprise indices, initial vs. final data**



Source: UBS global economics group, Bloomberg, April 2016

## Capital markets

The long-standing appeal of property's higher-yielding characteristics in a low-yielding world persisted in 1Q16. Despite the correction in equity markets during the quarter, which has since reversed, and the re-pricing in high yield corporate bond markets, good quality commercial property continues to offer an attractive risk-adjusted income yield relative to other asset classes. Having said that, investment performance indices for the first quarter are still being released and amongst those available there is some indication that property's shine has started to diminish (see Chart 2).

While US and UK commercial property were amongst the world leaders in total returns in 2015, in 1Q16 the period of double-digit capital value growth had already entered its coda. The AREF/MPD UK Quarterly Property Fund Index reported a headline total return of 0.9% in 1Q16, or 10.2% year-on-year (YOY). This is down from 12% YOY in 4Q15. In fact, total returns in March IPD's monthly property index (which is asset level, rather than fund level as is AREF) fell month-to-month for the first time since June 2009. This was directly the result of changes to taxation rather than deteriorating performance, but combined with other indicators it is one facet of a broader cool-down. In the US, NCREIF's Open-End Diversified Core

(ODCE) index returned an annualized 8.7% in 1Q16, down from 13.4% and 13.6% the previous quarter and a year before, respectively. In both markets, income return has been broadly stable and it is capital growth which is slowing.

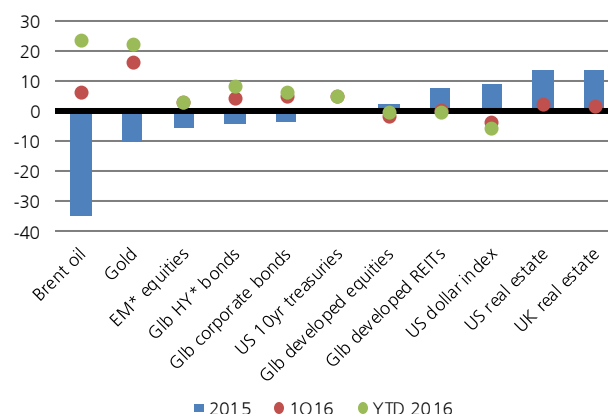
The reduction in returns is reflected in transaction markets. Volumes are highly seasonal, but in 1Q16 RCA's European commercial transaction volumes fell 36% YOY, 40% if you include development land. The exact percentage varies depending on your source, but all agree on a sizeable, broad-based retreat in the pace of new investment. In the US, volumes were down 20% with all sectors except multi-family (+12%) showing a drop. RCA data for Asia-Pacific is not yet available, but extrapolating from JLL's figures it too probably saw a small decline, led by Tokyo. Interestingly, cap rates, as measured by transaction rather than valuation, were broadly unchanged, which together with the performance data above suggests that prices have been stable despite the drop-off in transaction activity.

There are two ways of looking at this: first, a pause for reflection based on tight historical pricing and the view that prices cannot rise ad infinitum; and second, a pause based on mounting uncertainties as to the outlook. Coverage of the impending EU referendum in the UK would certainly suggest a crisis of nerves, but as noted above the economic outlook is reasonably positive. Furthermore, neither the referendum nor other macro risks (China reform, Fed tightening, etc.) can be the sole trigger when the slowdown in transaction volumes is so widespread and is not accompanied by a fall in prices.

At the same time, debt flows to real estate also appear to be cooling off. In the US, both pricing and new issuance of CMBS declined in 1Q16, while the market in Europe has never really recovered from the 2008 crisis. There is anecdotal evidence of competition amongst lenders and well documented growth from non-traditional lenders such as insurance funds. Timely data on lending to commercial real estate is hard to come by, but certainly for the largest real estate market, the US, the CMBS market corroborates evidence of a pause.

Despite this, new inflows to property investment continue. In 1Q16, Preqin recorded USD 21 billion in new capital for closed-ended real estate funds, on par with the prior quarter and down only slightly from USD 22 billion a year prior. Furthermore, Preqin's 2016 survey of alternative investments found that 29% of respondents intended to increase their allocation to real estate further this year (55% said 'maintain'), while nearly all categories of investors had a persistent gap between their target and current allocations to real estate.

**Chart 2: Total return by asset class (% by time period)**



\*Notes: EM = emerging markets; Glb = global; HY = high yield  
Source: Thompson Reuters Datastream, IPD, NCREIF (as at May 3, 2016)

These surveys do not guarantee inflows. And a particular worry is the view of yield-seeking investors, particularly if interest rates do continue to rise and corporate bond yields continue to move out. Eventually, a portfolio of low investment grade bonds will seem attractive against the relative illiquidity and inherent risks of real estate. Given the long-term nature of many investor groups with high property allocations (e.g. insurance and pension funds, sovereign wealth), much of the recent inflows should prove sticky even as interest rates rise.

## US real estate

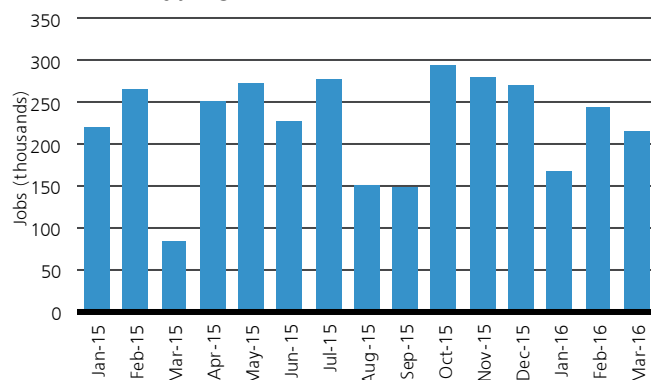
### Economic viewpoint

The fundamentals for US real estate are reasonably solid. The economy is adding new jobs despite weak quarterly economic growth at the start of 2016. It is important to bear in mind that commercial real estate demand has a stronger link to labor market trends than to GDP growth. In total, the US added more than 200,000 jobs per month in five of the past six months (see Chart 4). This is above-trend, despite the fact that during the first quarter 2016, gross domestic product (GDP) growth showed seasonal (likely weather-related) weakness, similar to the beginning of six of the past seven years. Commercial real estate demand is affected more directly by the inherent stability in the job market than by quarterly fluctuations in GDP.

The yield curve flattened during the first quarter, primarily due to decreasing rates on long-term bonds. Rates on 10-year treasuries started 2016 at 2.24% and as of March 31, 2016, had fallen nearly 50 basis points to 1.78%. This unwound some of the increase of 2H15 and is reflective of the change in expectations vis-à-vis the Federal Reserve tightening cycle – further hikes are expected later this year, but not as many or as quickly as before. As we enter 2016, YOY growth in headline consumer price inflation is nearly 1%. Excluding food and energy, YOY inflation exceeded 2% for the fifth

consecutive month during March 2016. This is above the Fed's long-term comfort level and does suggest that further hikes will be forthcoming.

**Chart 3: Monthly job growth**

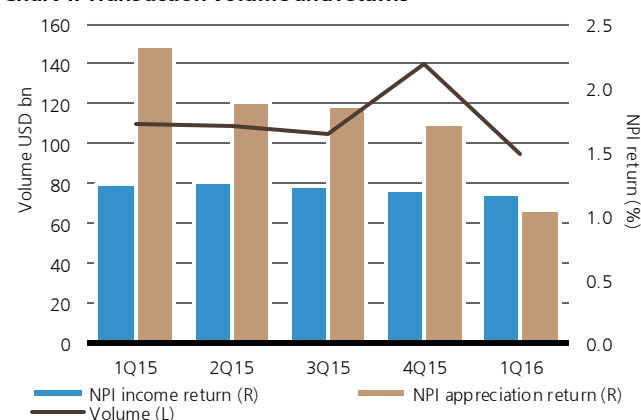


Source: Moody's Analytics as of March 2016

#### Commercial real estate

Performance has been positive though capital appreciation slowed during the first quarter, in line with our expectations for 2016. Looking ahead, conditions remain supportive: interest rates are low; rent growth is well above inflation, and supply growth remains low-to-balanced across the five major property types. This will support further income growth, even as capital appreciation slows. We believe commercial real estate returns are likely to be lower in 2016 than in the previous six years. First quarter NCREIF returns are consistent with this expectation (see Chart 4), although one quarter does not make a trend. During 1Q16, income return exceeded appreciation, the first time this has occurred since 4Q13.

**Chart 4: Transaction volume and returns**



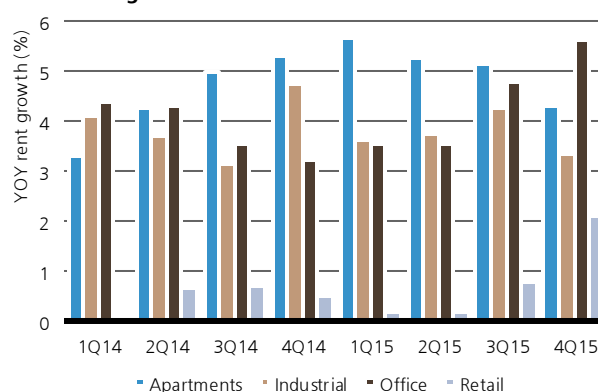
Source: NCREIF Property Index and Real Capital Analytics as of March 2016

Recent headlines brought attention to a slowdown in transaction volume, with RCA reporting commercial real estate investment volumes down 20% YOY during 1Q16. We do not believe this is the beginning a genuine downturn, but rather US transaction volume is likely flattening out at a

high level. Nationally, transaction sales reached an all-time high of USD 463.1 billion for the five major property types during 2015 (excludes entity-level transactions).

The pause in Q1 could be due to rising uncertainties, both domestically and internationally, or to a gathering view that property prices cannot continue to rise ad infinitum. However, the cap rates reported by RCA were stable if not lower over the quarter, so the drop in transaction volumes has not had an impact on prices. Furthermore, as noted above, the outlook for property performance is positive: rent growth is exceeding inflation in all property sectors (see Chart 5). Improving property fundamentals and low interest rates support the demand for commercial real estate even as transaction volumes and returns appear to be moving off of recent highs.

**Chart 5: Rent growth**



Source: CBRE-Econometric Advisors as of March 2016

Note: Apartment, retail and hotel data are not yet available for 1Q16.

#### European real estate

##### Demand

Since the beginning of 2016 global capital and financial markets have been on a roller coaster. On the back of slowing economic growth in Emerging Markets (EM), many European sentiment surveys moved southward suggesting a slowdown in European economic activity as well. However, by the end of the first quarter, sentiment data has stabilized and preliminary data show that in many European economies experience resilient and or even strengthening domestic demand. Encouragingly, the labor market in most European markets is starting to show signs of recovery, with annual full time EU employment expected to rise by 0.8% in 2016.

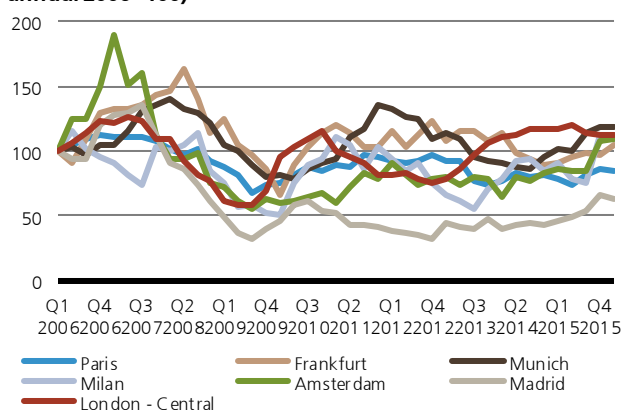
Although overall unemployment generally remains quite high, in undersupplied sectors of the workforce (i.e. technology sector) a tightening of the labor market is starting to place upward pressure on wages. Disposable income is supported further by almost zero inflation, which consumers are feeding back into the economy in the form of very strong retail sales. The domestically driven recovery is having positive implications for European occupier markets, and we expect occupier

demand to continue to improve across the main European markets. However, political uncertainties may send a grey cloud overcasting the recovery in the occupier markets. UK's referendum on EU membership creates uncertainties for occupiers but office take-up numbers have not been affected yet. So far, occupiers have focused their leasing activity primarily in good quality assets in the central business and dominant retail locations.

Traditionally, the first quarter is the quietest quarter of a year and it is difficult to make projections for the whole year. On a rolling annual basis, office take-up in most European office markets was flat in 1Q16. However, some German markets reported the strongest 1Q leasing data since 2009, reflecting the pick-up in employment growth. Despite the political uncertainties in the UK Central London office take-up achieved almost identical results compared to 1Q15. On the other hand, Paris reported the lowest 1Q take-up level since 2004, giving concerns that the economic recovery may not lead to increasing office space demand.

Even though European consumers are supported by low inflation, and in some countries (i.e. Germany, UK, Sweden) increasing wages, retailers remain cautious in their expansionary policies. Retailer's demand focus on dominant high street locations and shopping centres, while tertiary retail destinations are neglected. International retailers from outside Europe are still looking for entering the market but are likely to prefer the most sought-after locations as well.

**Chart 6: European office take-up volumes (indexed rolling annual 2006=100)**



Source: CBRE 1Q16

### Supply

There continues to be significant polarization in the availability of commercial real estate space based on the quality and location of the assets. In the office markets, the aggregate European markets vacancy was largely stable in 1Q16 reflecting the steady level of occupational demand, with the overall level falling by 0.1 percentage points (p.p.). The key office markets generally recorded marginal declines in vacancy, continuing the trend from the previous year.

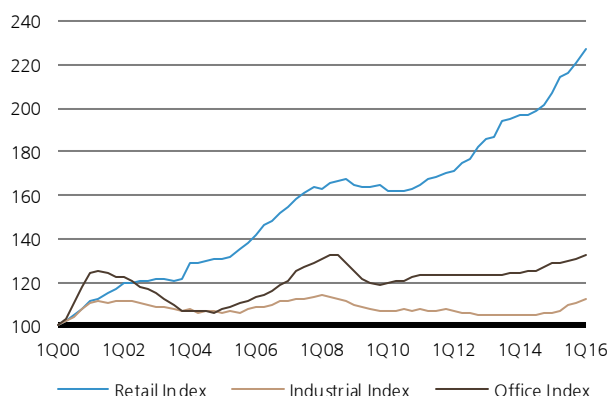
One exception was Central London where availability increased slightly (0.1 p.p.) reflecting the slight slowdown in occupier demand in the run up to the referendum and continuing new supply coming through to the market. In CEE, Warsaw recorded a substantial 1.9 p.p. increase in the vacancy rate as the volume of new supply continues to outweigh demand in the market, a trend which is set to continue.

London and Warsaw are very much exceptions within the European office markets however, most locations continue to see very limited development activity. This is contributing to a continuing polarization of available space in CBD and CBD fringe submarkets, which are now in many cases under-supplied, and the peripheral submarkets which are still suffering from very high vacancy rates from the overhang on development during the previous cycle combined with a weakness in occupier demand for this type of office space. Structural oversupply in these areas is maintaining overall vacancy rates at a high level, and even markets which have seen a strong recovery in demand in 2015 are still seeing vacancy rates in some peripheral sub-markets at above 20%. These include Brussels Periphery (23.0%), Barcelona Periphery (20.2%) and Madrid Periphery (29.4%).

On the flip side, due to the lack of new supply in central locations we are seeing some positive rental growth coming through in the prime segment of the market. The Weighted Average EU-15 Office Market Rent Index rose by 0.8% in 1Q16, taking annual growth to 2.8%. Whilst unexceptional growth compared to previous recovery periods, it is nonetheless encouraging that rents are moving in an upward trajectory after several years of stagnation and decline. With limited signs of a speculative supply response starting across Europe (with a few exceptions) this supply demand imbalance in this segment of the market is expected to continue to drive positive rental growth over the coming years. The outlook for secondary locations and poorer quality buildings is much weaker, however, and with the pace of economic growth not forecast to drive a recovery in demand in some areas, a significant amount of current vacant space may become redundant in its current form.

This polarization in supply and demand is mirrored by the retail, and to a lesser extent, industrial sector. There continues to be strong competition for the very few available units on the prime European high streets, and this has continued to drive strong rental growth for the prime end of the sector.

**Chart 7: Prime rents index (2000 = 100)**



Source: CBRE 1Q16

Prime rents increased by 2.8% in 1Q16 and by 10% on an annual basis. But while the prime retail segment has seen the strongest rental growth of all property sectors, secondary and tertiary retail locations continue to suffer from much higher vacancy which is subduing any capacity for rental growth. These are the locations which are the most affected by the growth in e-commerce, as retailers are typically streamlining their store portfolios, focusing on dominant locations and coming out of secondary areas where they can now rely on their online platform to achieve coverage.

With these changing dynamics it is likely that a reasonable proportion of retailing space across Europe will, over time, be deemed surplus to requirements in its current form.

#### Capital markets

The first quarter of 2016 has seen a sharp deceleration in activity from the exceptionally high levels reached in 2015. Whilst the first three months of the year are traditionally quieter, the EUR 50 billion invested represented an 18% decrease. Nonetheless, the start to 2016 was bound to lie in the shadow of such a busy year and according to CBRE data it was actually the third best Q1 on record, bettered only by 2015 itself and 2007. Sentiment is also still broadly positive, with the majority of respondents to PMA and CBRE's surveys of investor intentions saying they plan to invest more in the next 12 months. Nonetheless, it is highly likely that concerns about the world economy, geopolitical challenges and falling commodity prices have brought about a degree of caution – tellingly, investment from Asia and the Middle East declined in both capital invested and market share.

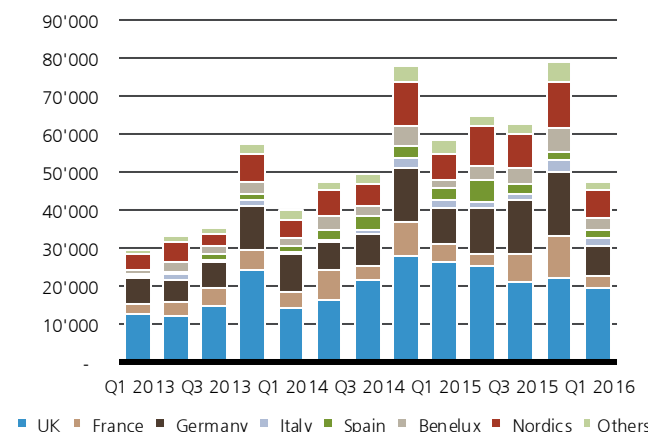
Investment across the core markets decreased markedly as Germany (-14%), France (-37%) and the UK (-25%) all fell back with concerns about pricing and limited availability of core product likely restricting activity. This seemed to benefit the Nordics and Benelux countries however, both of which saw respective increases of 14% and 37%. Portugal also catapulted itself back onto the investment radar seeing an increase in excess of 150% year on year, although this is

coming from a very low base – indeed, the total invested for 1Q16 came to just EUR 569 million. The hot spots of yesteryear Ireland and Spain seem to be cooling off, with investment declining by 51% and 33% respectively. Investment capital targeting more peripheral markets tends to be opportunistic, leading to regular fluctuations in volumes. Of the main asset classes, investment in retail tailed off the most declining by 32% when compared with the same time last year, whilst industrial continued its impressive rise in popularity, showing an increase of 57%. The amount of capital targeting logistics assets is unsurprising as it still offers a near 200 bps premium to offices.

Reflecting the weight of capital targeting European property, average yields moved in for the fourteenth consecutive quarter across all the major asset classes. Investors seem to have an increasing willingness to look up the risk curve for returns and this is reflected in yield movements outside of the core European markets. The biggest shift was seen in high street retail in Sofia which contracted by 200 basis points to hit a record low of 5.5%.

In most European markets, prime yields have now fallen to below, or are very close to record low levels. In some markets, particularly in the UK, we believe we are reaching the peak of pricing in this cycle, although there may be a bit more inward yield shift to come in a few of the peripheral European markets, particularly as the lower for longer outlook for central bank interest rates means the attractive spread between European government bonds and real estate will maintain for at least the next 12 months. Accordingly, Europe's safe haven status will likely continue to attract overseas investors, particularly in the context of low yields in many domestic property markets worldwide.

**Chart 8: European Investment volumes (EUR million)**



Source: CBRE 4Q15

#### Viewpoint

Given the headwinds of market uncertainties due to the UK referendum on EU membership, data from 1Q16 suggests the

market has actually been holding up surprisingly well. Take-up for Central London came in at 3.1 million sq ft, which was on a par with the 1Q levels recorded in 2014 and 2015. Similarly, despite the uncertainty levels, provisional investment volumes indicate figures similar in 1Q16 to 1Q levels in 2014 and 2015 (Q1 is historically the weakest quarter of investment volumes). It appears that the investment demand which is coming to the market has become more focused towards the core property in central submarkets, which would be expected during a period of heightened uncertainty. Indeed, the West End reported a provisional number of GBP 0.7 billion which was larger than the 1Q levels in 2014 and 2015. Some of this may have been driven by deals which were initiated last year completing, and the referendum was not officially announced until half way through the quarter so it may be that the full impact of the uncertainty won't be reflected in the volume numbers until Q2.

Prime yields have been stable in the West End at 3.5% since 2Q15, reflecting a cooling off of investor demand given the various headwinds and the fact that both prime and average yields in the market are at record lows. For March 2016, MSCI IPD reported negative total returns for the first time since June 2009. Valuers have become more cautious again, in particular outside the core segment. As we head closer to the referendum date, we would expect to see the market slow further. Given the timescales involved, few investors would be able to complete transactions before the referendum result so wait-and-see is the most likely outcome. The following months will tell us if only short-term uncertainties have created some volatility or if the UK real estate market has already peaked.

## **Asia Pacific (APAC) real estate**

### *Demand*

Macro conditions have generally stabilized across the APAC region relative to January's low point which was characterized by elevated financial market volatility, falling commodity prices and declining global trade which many Asian economies depend on to support activity and jobs. Importantly, high frequency economic data for China has surprised on the upside in recent months. In particular, manufacturing, exports and housing – key sectors that have weighed on growth over the past 12-24 months – are showing signs of growth on account of further monetary easing measures from the People's Bank of China (PBoC). Renewed efforts by the government to stimulate activity via increased financing of infrastructure spending and widening of the budget deficit for this year including corporate tax cuts and unemployment benefit for workers laid-off during the restructuring process is also supporting activity and jobs.

Unsurprisingly, commodity prices have rallied albeit from low levels on China's better than expected growth. Higher commodity prices are providing some additional support for the region's resource exporters including Australia, Indonesia

and Malaysia via a higher terms of trade which should help to boost household incomes and corporate profits.

Although downside risks remain, particularly around the sustainability of credit in China, slower nominal GDP growth as governments fail to implement structural reforms and concerns that Japan may be reaching its monetary limits, for the moment, at least, better than expected economic activity should support leasing markets and fundamentals in the near-term relative to our views 3-6 months ago.

Overall, net absorption across the key APAC office markets this year is expected to be around 2.4 million sqm this year (2.3% of existing stock) which is slightly above historical averages of around 2.2 million sqm albeit slightly down on 2015 levels. Given the mix of developed and emerging cities that make up the region though, and the varying degrees to which they are exposed swings in global trade, finance and commodities, it is not surprising that key markets are at different stages in their leasing cycles.

In the key developed markets, healthy jobs growth in the services sector is supporting occupier demand, particularly in the CBD markets of Japan (Tokyo and Osaka) and Australia (Sydney and Melbourne) where fundamentals have improved over the past 12 months. In other developed markets, leasing activity remains sluggish relative to historical averages on account of subdued demand from the financial sector, particularly global banking (Hong Kong & Singapore) or stabilizing at very low levels as the mining sector shifts to the production phase which requires less headcount than that needed to underwrite and execute new investments (Brisbane & Perth). In China, the gradual shift to serviced based activity and jobs is supporting leasing markets in the Tier 1 cities where overall net absorption is expected to be around 10-15% higher than 2015 levels, which will offset some of the weakness in other markets across the region.

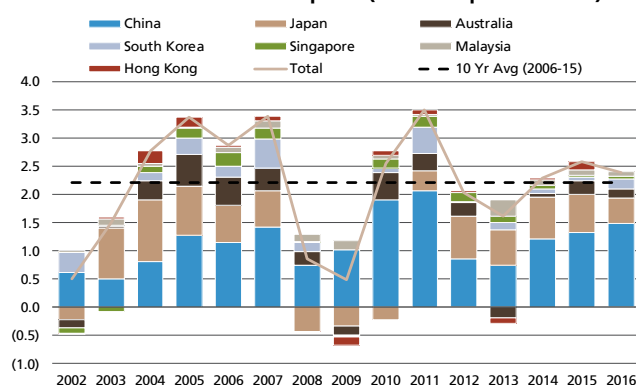
In the retail sector, leasing demand in developed markets (Australia and Japan) remains focused on prime high streets and dominant shopping centers within their catchments and locations that are seeing rising demand from Chinese tourists. These trends are similar to those observed in other markets as households focus their spending habits in locations that can either offer 'alternative' consumer experiences and locations with strong Food & Beverage offerings. On the flip side, retail strips in secondary and tertiary locations with poorer quality retailers will continue to struggle in an environment of rising online sales and limited real wage growth, driving an increasing wedge in the sector with the turnover in dominant assets growing faster than overall national sales growth.

In other developed markets, the prime retail segment in Hong Kong and Singapore remains challenging given the pullback in spending from mainland Chinese visitors and ongoing affordability issues either as a result of high rents and/or restrictions on immigration into Singapore which is limiting labor supply and pushing up wage costs for retailers. Prime



rents in Singapore will remain under pressure on the back of the growth and increasing sophistication of suburban shopping centers.

**Chart 9: APAC net office absorption (million square meters)**



Source: PMA, as at April 2016

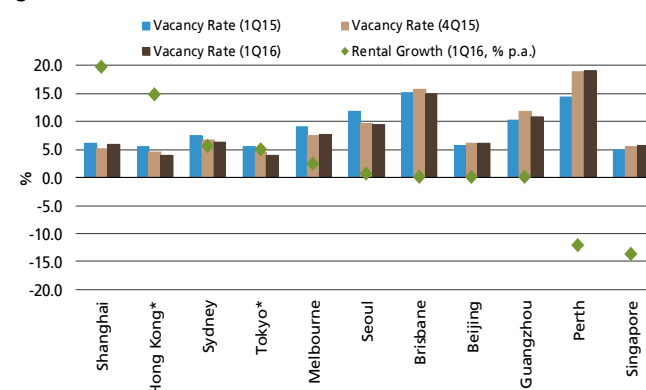
### Supply

Generally, vacancy rates remain tight or tracking lower in the region's key developed cities which is supporting real rent growth in the CBD markets, including Hong Kong, Sydney and Tokyo. Tighter vacancy rates should support further uplifts in rents in 2016 although the pace is likely to slow in Tokyo following relatively healthy uplifts in recent years and as new supply is delivered to the market to match demand. Although the strengthening yen remains a concern for Japanese exports and earnings growth, the overall strength of large corporates remains relatively healthy in an environment of low borrowing costs and healthy sentiment. In the near-term, rents in the Hong Kong market are likely to slow on the back of global macro concerns, financial market volatility and the delivery of new CBD offices to the market. Growth should bounce back over the medium-term given vacancy rates are likely to remain low and stable. The combination of elevated vacancy, new office supply and subdued corporate demand is likely to constrain office rent growth across Seoul's three core submarkets.

Occupancy levels and rents will remain under pressure in markets that are exposed to elevated levels of supply in the near-term alongside weak demand from either the global banking sector (Singapore) or the downturn in mining (Brisbane & Perth). The historical volatility of these markets suggests that rents should pick up once current vacancy and new supply are absorbed given the development pipeline is thin beyond the next 12-18 months. However, with regulatory pressures cutting into the expansionary plans and profits of the global banking sector and China's shifting demand drivers capping demand for commodities, the growth recovery is set to be fairly moderate compared to previous cyclical upswings. Diverging performance continues to characterize China's office markets. Robust demand from domestic financial and tech companies has supported leasing and fundamentals in

Beijing and Shanghai. However, average market wide vacancy rates are set to rise over the next two years as significant amounts of new supply are delivered to the market in decentralized locations. Improving infrastructure connectivity and rental discounts relative to CBD markets are likely to continue to attract occupiers to these decentralized locations. Shenzhen's office sector benefited from favorable Chinese policies such as the Closer Economic Partnership Arrangement (CEPA) Service Trade Agreement between Mainland China and Hong Kong, and the office vacancy rate tightened to below 6% in 2015, although a looming supply influx in on the horizon for 2016. At the other end of the spectrum, lower-tier cities, in general, reported vacancy rates in excess of 18%. These include cities such as Chengdu (37.7%), Chongqing (39.2%), Tianjin (28.3%), Wuhan (24%) and Hangzhou (18.2%). The dire situation of oversupply will further exacerbate the softness in occupancy and rents in 2016.

**Chart 10: CBD office vacancy rates and headline prime rental growth**



Source: CBRE, PMA, as at March 2016

### Capital markets

The regional recovery has generally led the improvement of occupier markets in recent years on account of loose monetary conditions and volatility in listed equities and credit, which has supported a shift to alternative assets, including commercial real estate. However, consistent with the pullback in liquidity seen in other regions in 1Q16, preliminary data suggests that APAC investment volumes fell back over the quarter as investors became more cautious towards trophy assets and portfolio deals, and cross border sentiment slipped on account of global macro concerns and elevated volatility.

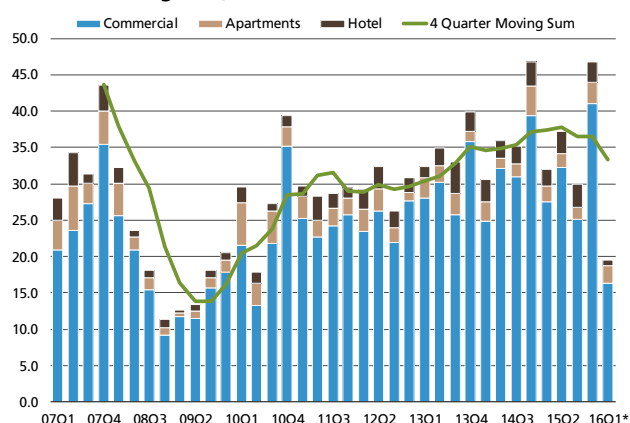
Generally, investor activity remains focused on markets and cities with stronger fundamentals, including China (tier 1 cities), Japan (Tokyo and regional markets) and Australia (Sydney and Melbourne). In Australia, local institutions have been more competitive in recent months with anecdotal evidence suggesting that required returns have been lowered in line with the hurdle rates for foreign investors. The pickup in domestic liquidity has helped to offset the pullback in foreign capital into the Australian market. Tighter lending conditions for foreign investors may also be playing a role at

the margin as local banks refocus their lending strategies towards domestic institutions.

Despite the pullback in liquidity, healthy investor demand for core assets continues to support pricing with prime office yields in key cities grinding lower over the past year. This trend continued into Q1 with prime yields in regional and secondary cities – particularly in developed markets – moving lower as investors look to boost income returns and diversify. Grade B office yields in markets with stronger fundamentals also tracked lower, narrowing the spread between prime and secondary buildings. Often these Grade B assets are located in submarkets that are either being supported by renewed public infrastructure investment or the withdrawal of stock for conversion in residential apartments or other uses.

In most Asia Pacific cities, prime office yields are now close to or below pre-crisis levels driven by strong investor demand for core exposure. There are exceptions, including secondary cities such as Brisbane and Perth where the core pricing recovery has lagged other markets and yields remain elevated relative to pre-crisis levels, reflecting the weaker fundamentals. We believe that we are close to the cyclical peak in terms of core yield pricing, although there may be some further minor compression in the Australian markets, particularly if some recent pricing evidence is reflected in valuations. However, with lending conditions tightening at the margin relative to end 2015 levels and foreign capital flows likely to slow as the AUD strengthens the extent of any further inward yield compression is most likely to be marginal.

**Chart 11: APAC investment volumes (USD billion, quarterly and 12 month rolling sum)**



Source: CBRE 4Q15

#### Viewpoint

Notwithstanding a further downturn in global trade volumes or return of global financial market volatility, macro conditions are holding up relatively better than feared at the beginning of the year. China's recent round of monetary and credit easing has had a positive impact on activity, particularly in those sectors which have been sluggish in recent years.

With most economies across the region operating with a fair degree of spare capacity and core inflationary pressures remaining subdued, further monetary easing will be needed to bring growth back towards trend levels. Fortunately, central banks still have some scope to ease policy, particularly in the region's emerging markets of China and India.

However, the room for extra policy easing – whether fiscal or monetary – is more constrained across APAC compared to pre-crisis levels with interest rates lower, corporate and household leverage higher and fiscal deficits and debts elevated relative to 2007 levels. Limited electoral appetite to increase public spending or cut taxes is constraining the ability of governments to roll out fiscal stimulus. Thus there are limits to the extent to which policy stimulus can boost growth. What's really needed is an overhaul of the growth engine, structural reforms that raise productivity growth over time, but which have so far been only tentatively adopted.

For the APAC real estate markets, current prime yields look expensive compared to both historical averages and pre-crisis levels. However, elevated property spreads and lower (perceived) volatility compared with equities means that real estate investment remains relatively attractive compared to other asset classes which should continue to support capital flows into the sector. Looking ahead, the performance dynamic of real estate is shifting towards income as the key driver of returns. In an environment of slowing capital growth, stock selection, asset management and selective capital expenditure will be key to generating outperformance of individual buildings and portfolios.

In the near-term, we continue to favor the region's key developed markets of Japan (Tokyo and Osaka) and Australia (Sydney and Melbourne) where the CBD markets and value added opportunities continue to be supported by relatively healthy leasing dynamics, jobs growth and credit availability, albeit with borrowing costs gradually tightening in recent months as a result of macro risks (Japan) or regulatory pressures (Australia). Over the medium-term, we prefer strategies that are linked to the rebalancing of China's economy towards serviced based production and jobs.

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