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Notes on graphics

The visual aids below are used throughout this publication to help categorize themes in the context of portfolio integration and investment time horizon.

Portfolio context

- Non-traditional
- Commodities
- International fixed income
- US fixed income
- International equity
- US equity

Investment time horizon

- Short term: Less than 6 months
- Medium term: 6 to 12 months
- Multi-year: Decade themes
- Long term: Greater than 12 months

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With the start of the New Year, we’re excited to announce a number of fresh changes to Top themes. First, on a quarterly basis throughout 2015, we will incorporate a longer-term perspective into our ongoing thematic discussion as we present our views for the Decade Ahead. In doing so, we will highlight long-term thematic investment opportunities based on changes we expect to see unfold across macroeconomic, public policy, technological, and societal lines. We have categorized these as “decade” themes, since they rely upon favorable multi-year structural drivers that are expected to persist over time. Our Chief Investment Strategist, Mike Ryan, expands upon this framework in the feature article, The Decade Ahead: In front of the curve (see pg. 2).

This brings us to the second important change to Top themes. Going forward, a subset of themes will be selected as “preferred” as a way of conveying to readers which ideas are particularly timely in light of conviction levels and our WMR Chief Investment Office’s view on key financial market drivers. While this represents a departure from our previous practice of calling certain ideas “top themes,” it allows us to have a more dynamic and flexible thematic framework that incorporates decade themes as well as portfolio strategy recommendations. In each publication, we will highlight which recommended decade themes currently provide an attractive entry point in the near term, given financial market conditions (starting on pg. 12).

Finally, another key change this month is the addition of thematic ideas that go beyond the traditional investment landscape. We believe it’s important not only to seek out opportunities in an investment context but also to consider attractive wealth management strategies. Accordingly, we will periodically feature recommended ideas on how to save, invest, plan, spend, give, and bequest. We debut the first of these “planning” ideas on page 10 with a decade theme on optimizing liabilities from Michael Crook, Head of Portfolio and Planning Research.

Stephen Freedman, PhD, CFA
Head of Cross Asset Strategy

Andrea Fisher, CFA
Investment Strategist
THE DECADE AHEAD

In front of the curve

Mike Ryan, Chief Investment Strategist

We seek to identify long-term investment opportunities that cut across macroeconomic, public policy, technological, and societal lines.

When we first introduced the Decade Ahead series back in February 2011, the world was still reeling from the aftershocks of the global financial crisis and associated recession. Financial institutions were attempting to rebuild their capital base following trillions of dollars in losses, global growth prospects remained in a precariously fragile state, the normal governing process in some countries had broken down entirely, and central bankers around the world had embarked upon the greatest experiment in the history of monetary policy. It’s therefore not surprising that investors experienced a level of anxiety and apprehension about the future not seen since the dark days of the Great Depression and World War II. We therefore thought it essential to put the events of the prior three years into their proper context and offer some perspective on what the future might hold. Hence, the inspiration behind the Decade Ahead series.

But much has changed since we wrote that initial report. The fortunes of the world are no longer held hostage to the whims of elected officials, nor are they completely dependent upon the largess of policymakers. The financial system has healed to the point where credit creation is normalizing, while the real economy continues in the recovery process – albeit in a halting and uneven manner. That initial sense of foreboding has given way to a more sober assessment of the future that, while remaining wary of the risks and challenges ahead, is also open to the potential rewards and opportunities before us. It therefore seems like the perfect time to hit the reset button on the Decade Ahead.

Keep in mind, of course, that any attempt to peer into the future is apt to be as humbling as it is enlightening. Events often unfold in ways that simply cannot be anticipated even by the very wisest and most insightful among us. Disruptive innovations and changing consumer preferences will give birth to entirely new industries – while at the same time planting the seeds for the destruction of others. Shifting political
and geopolitical dynamics ensure that events on the world stage will remain fluid, volatile, and largely unpredictable. Meanwhile, the manner in which we choose to exploit and utilize the globe’s resources will be altered by both technological changes and public policy choices. Finally, traditions will be shattered and new ones will emerge as societal norms and cultural mores continue to shift.

A dynamic and flexible framework…
We therefore seek a framework to identify long-term investment opportunities that is robust enough to incorporate all the potential sources of change in the coming decade. This operating model must include drivers that cut across macroeconomic, public policy, technological, and societal lines in order to identify the most relevant themes and trends. But the model must also be flexible enough to determine which of these drivers will emerge at any one time to give shape to the critical events of the day. The coming decade will be defined by the following drivers: (1) technological innovation; (2) demographic changes; (3) sources and uses of natural resources; (4) trends in globalization; (5) government policy choices; (6) economic normalization; and (7) societal and cultural shifts.

But we should remember that the coming decade must always be viewed dynamically as part of a continuum rather than statically with discrete beginning and end points. After all, each and every sunrise marks the dawn of a new decade. History never plays itself out in such neatly, well-defined and clearly delineated periods. So while it may be convenient to reference decades based upon the ten digits of a calendar year (e.g., 1961, 1962, 1963…1970), a decade actually denotes any arbitrary and continuous ten-year period. What’s
The decade themes we are focusing on for the first quarter of 2015 touch upon multiple drivers and are immediately actionable.

more, such simplistic labels as “the roaring ’20s” or “the dirty ’30s” fail to capture the richness and complexity of each period, and are therefore just as apt to be misleading as they are descriptive.

…for germane and relevant outcomes
To make sure that these themes and trends are germane for investors, we are determined to screen each for relevance through one of three categories: (1) investment opportunities; (2) financial industry trends; and (3) wealth effects. The first ensures that the most important emerging investment themes will be exploitable, the second allows for transformational changes within the financial services industry to be identified, and the third enables advances in wealth management to be incorporated into portfolio strategies. This approach assures that events that will have the biggest impact upon the financial well-being of our clients – whether they emanate from changes in Federal Reserve Policy, advances in endowment management approaches, or shifts in the way that investors conceptualize risk – can each be addressed appropriately.

In a departure from our initial Decade Ahead approach, and in accordance with our new more dynamic framework, new decade themes will be introduced throughout the year based upon the drivers already identified. While some effort will be made to balance these themes across the three broad categories for relevance, we will rely upon the dynamics within the real economy, geopolitical stage, financial markets, and society in general to help determine our choices and guide our assessments. These themes will be introduced and incorporated into our *Top themes* publication and updated quarterly as new themes and trends are introduced.

The first three themes
The decade themes we are focusing on for the first quarter of 2015 touch upon multiple drivers and are immediately actionable. They include: the emergence of transformational technologies, the rising influence of the Millennial generation, and the opportunity for individual investors to optimize and refinance liabilities on their household balance sheets.

In our view, innovations in the areas of digital data, automation, and robotics will be critical drivers of productivity growth and should create a variety of investable opportunities in the years to come. Further, the Millennial generation is rising as a dominant population cohort in the US, and its consumption and lifestyle preferences will have a lasting impact on various segments of the economy. Lastly, currently low interest rates are poised to gradually rise, which means that now is an excellent time for individuals to lock in attractive financing conditions and to optimize their liabilities.

On a final note, there are several themes we’ve previously discussed in this publication that are multi-year in nature and fit within our new *Decade Ahead* framework. This includes: North American energy independence: Reenergized, e-Commerce, and Water: Thirst for investments. In our view, these themes represent long-term opportunities that are also being driven by a number of the structural drivers we have highlighted.
### Drivers behind Decade Ahead themes

<table>
<thead>
<tr>
<th>Q1 focus themes</th>
<th>Resources</th>
<th>Innovation</th>
<th>Demographics</th>
<th>Globalization</th>
<th>Government</th>
<th>Normalization</th>
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<td>✓</td>
<td></td>
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<td></td>
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<tr>
<td>The rising Millennials</td>
<td></td>
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<tr>
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<td>independence: Reenergized</td>
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<tr>
<td>Water: Thirst for investments</td>
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</table>
Ever since the Industrial Revolution, technological progress has been a key driver of economic growth and corporate profitability. Accordingly, understanding where technological progress will most likely occur and make a material difference is a worthwhile activity for investors, as it can help identify investment opportunities. We focus on two broad areas of technological innovation that we believe will drive productivity gains over the next decade. The first is the explosion of digital data, which should create a broad set of business opportunities. The second is automation and robotics. Both have the potential to profoundly transform the structure of our economy, disrupt existing business models, and create substantial growth opportunities for those well positioned to participate.

Digital data growth is set to explode in the coming years (see Fig. 1) based on several drivers. The first is rising internet penetration, which currently averages only 38% globally, whereas individual developed economies have achieved rates in excess of 80%. We expect internet penetration in emerging markets to surge as broadband becomes more widespread and smart devices turn more affordable. Second, we expect increased data usage in EM, particularly among the younger generation. This should be driven by increasing e-Commerce and mobile phone usage. Third, changing global consumer digital lifestyles, in particular the increasing use of smart devices, should be an important driver of growing data traffic. Finally, the emerging Internet-of-Things network of connected devices such as sensors, controllers and communication units should be another long-term driver of data growth.

Given strong volume growth in data, we believe digital data offers a very good long-term investment opportunity through two broad channels. The first group to participate in the digital data wave is data enablers, or companies that promote the creation and growth of data, including internet, enterprise-application and smart-device companies. The second group is data infrastructure providers, which mainly include companies that store, carry and analyze data. They often belong to broader sector groups like semiconductors, networking, hardware, software and services. In particular, opportunities should arise with enterprise and consumer data storage and within “big data” analytics.

Despite the growth in recent years, we believe smart automation is still in its early stages. We estimate that automation only has a 1% share of the manufacturing industry’s total global revenues (equivalent to USD 150bn). If our expectation is correct that automation revenue growth in the mid-to-high single-digit rates will significantly outperform normal manufacturing revenues, the share could almost double to 2% over the next ten years. From an investment perspective, smart automation represents one of the fastest-growing segments within the broader industrial and IT sectors over the next decade. Secular trends that we expect to drive such growth include: an increasing reliance on robotics in emerging markets due to demographic challenges and rising wages; rising IT penetration in the manufacturing sector (industrial software); and the North American shale gas revolution, as the cheap access to energy it provides could stimulate investments in the chemical industry for years to come. Areas that should benefit the most from the automation and robotics revolution include...
Smart automation represents one of the fastest-growing segments in the industrial and IT sectors over the next decade.

Factory automation, process automation, industrial software, and 3D printing.

Factory automation generally applies to assembly processes such as the use of robots in the automotive industry, but it is also used for other processes in general manufacturing, packaging, and semiconductors, to mention a few. The automotive industry remains the largest end-market for factory automation. We see a strong potential for greater robot penetration in emerging markets, with China currently at levels comparable with Japan in the 1970s (see Fig. 2).

Process automation refers to continuous production processes that transform raw materials into final products (such as the mixing of liquids, gases, and electricity). Usually, a high degree of measurement, timing, and precision is important. The automation part involves a central computer that interacts with valves and sensors to run the process smoothly. Typical process automation end-markets are the oil-and-gas, refining, chemical, and power-generation industries.

Industrial software currently represents 8% of the broader software industry but is emerging as one of its fastest-growing subgroups, as manufacturers increasingly leverage the benefits of digitalization in product manufacturing. These benefits include the ability to solve design complexity and improve time-to-market.

3D printing involves “print heads” depositing slices or layers of a powder or filament very precisely according to the digital instructions. In a quickly changing business environment with complex manufacturing processes, the need to create products with faster time-to-market has led many companies to revisit their product development strategies and turning to new and quicker processes. 3D printing provides an optimal solution, as it facilitates rapid prototyping by accelerating development cycles, detecting and fixing design flaws earlier, saving significant rework expenses, and improving product quality.

Despite the long-term nature of these themes, we believe that overall the transformational trends in digital data, automation, and robotics present actionable investment opportunities that can be accessed today.
The rising Millennials

Andrea Fisher, CFA; Jon Rather

DECADE THEME

Millennials, also known as Generation Y, are a unique and important segment of the US population. Due to its sheer size, this cohort – currently consisting of individuals between the ages of 16 and 35 years old – is poised to have an outsized impact on the US economy. By 2025, Millennials will account for more than 25% of the US population while the older half of this generation will be just entering their peak earning years. Accordingly, we believe companies would be well advised to align their business models with this generation’s consumption needs and preferences, as Millennials will likely be a significant growth driver for years to come. In particular, we expect certain innovative technology companies, wellness-focused brands, and service-oriented industries to benefit from the rising Millennial population.

Though today’s young adults exhibit some behavioral traits in common with past generations, different social influences and economic circumstances distinguish them. The bursting of the housing bubble and the Great Recession, for example, have negatively impacted their household balance sheets and redefined perceptions of risk. On the other hand, this generation is tech-savvy, health-conscious, on track for record levels of educational attainment, and more racially diverse than preceding generations.

Digital natives
To identify the types of companies that should experience a growth tailwind from the growing spending power of the Millennials, we must first consider this is a generation of “digital natives,” having grown up with cable TV, internet and mobile phones. Millennials desire connectivity at all times and online social interaction, while exhibiting fluency in incorporating technology and different digital platforms into nearly every facet of their lives, from personal banking to online dating (see Fig. 1). Accordingly, we believe the companies best positioned to attract Millennials’ dollars will offer a strong mobile platform, be successful at attracting internet traffic through multi-platform digital strategies and social media engagement, and provide an interactive online customer experience.

As their usage of mobile technology and online networks continues to grow, the possible range of beneficiaries is wide, in our view, and includes electronic companies as well as those providing cloud computing, mobile payments, and high-tech videogaming. Social media hubs, in particular, could become a digital marketplace for a host of online activities, from TV streaming to serving as a gateway for e-Commerce via personalized advertising.

Informed consumers
Furthermore, greater use of mobile technology and social media is providing Millennials with greater and easier access to a variety of products, company information, consumer reviews, and pricing comparisons. This dynamic has altered the way this generation forms brand opinions and ultimately makes spending choices, leading to potentially more informed consumption decisions (see e-Commerce: Beyond Amazon for related theme). Companies that are successful at attracting this generation’s spending dollars will need to take an innovative, omni-channel approach to marketing and branding, while providing a seamless, service-oriented customer experience.

In addition, we believe access to a wide range of information online (research, news, testaments from personal
connections) has created a greater awareness among Millennials surrounding the impact of healthy food choices and the benefits of regular exercise. Living healthy has become somewhat of a ritualized lifestyle choice, frequently promoted on social media via exercise and food photos. This cultural shift clearly supports health and wellness-focused companies. Winners will likely include organic and natural food companies as well as those consumer staple companies revamping their product offering to match this healthier change in consumer tastes. According to Euromonitor, an independent research company for consumer markets, the global health and wellness food market is estimated at USD 932bn in 2014, and is expected to grow to USD 1.1tn by 2019. Given this generational shift, we also expect more Millennial spending dollars to flow into digital fitness gadgets and trendy athletic apparel.

The renting generation
Finally, Millennials are also distinguishing themselves from a lifestyle perspective through lower household ownership and preferring to live closer to metropolitan areas. Currently, the rentalship rate among individuals under 35 years old is a lofty 63% while housing rental vacancy rates in the US have been on a multi-year downward trend (see Fig. 2). From a cyclical perspective, elevated unemployment rates, lackluster income growth, tighter lending conditions, and soaring education costs among young adults are playing an influential role.

Putting these economic headwinds aside, evidence still suggests the trends toward greater rentership, later life-cycle events (e.g., marriage, children), and an overall preference for urban settings with convenient services should continue. Since 2000, the number of 25- to 34-year-olds with a four-year degree living in close-in neighborhoods in the nation’s largest metro areas has increased by 25%. From an investment perspective, we believe these trends favor real estate companies that own and manage multi-family rental dwellings. In our view, “sharing economy” businesses also stand to benefit, as they tend to flourish in metropolitan areas by utilizing the internet and mobile devices as a means of conveniently providing services and goods on demand without any ownership commitment.

By 2025, Millennials will account for more than 25% of the US population.
Liability optimization

Context – Planning

Michael Crook, CAIA

DECADE THEME

We view the current market environment as an opportune time for investors to “optimize” their liabilities in order to add potential alpha to their balance sheets. In general, we find that there are no specific rules of thumb for liability allocation. It’s a custom household decision that has to be made within the context of the factors discussed below, including tax situation, time horizon, and asset allocation. Additionally, the current tactical environment is the catalyst for the near-term opportunity, but liability optimization has the potential to significantly impact a household’s net worth at all times as the benefit is accrued and compounded over years and decades – enhancing returns and thereby enabling households to better meet their objectives.

Market context

The main monetary policy response to the financial crisis of 2007-2008 was clear and direct in its intention to reduce interest rates by the dual mechanisms of lowering the fed funds rate and quantitative easing (QE). Such policy action appears to have been successful in the US, as economically and financially, recovery continues. Unemployment has declined below 6%, the Federal Reserve has ended QE, credit spreads have compressed significantly, and equity market valuations have returned to pre-crisis levels.

In fact, the last remaining vestige of the financial crisis can be seen in the levels of prevailing interest rates. Short-term Treasury rates remain near zero, long-term rates are near historical lows, and yields on Treasury Inflation Protected Securities (TIPS) imply inflation will average only 1.7% for the next 10 years. From the asset perspective, the low rate environment highlights the problem of low bond portfolio returns and the risk of negative returns as rates normalize. For the same reasons, we believe these conditions present an excellent opportunity on the liability side of the balance sheet to lock in low borrowing costs, express views on interest rates and inflation, and generally take action that will likely lead to higher net worth in the future relative to inaction.

Debt as a tool

Debt serves many purposes on a balance sheet. For some households, debt is simply a resource for making large purchases (e.g. house, airplane, boat) that could otherwise not be afforded. Others use it for convenience, but not as a necessity, when making purchases. Those are common and straightforward ways of understanding debt usage, but they certainly don’t apply to the Summers, Buffet, and Bernanke households.

Why might they advocate debt usage? One reason is that debt can also be used to add leverage to a balance sheet – an action that would increase the net worth of the household when the return on investment assets is expected to exceed the cost of the debt. This is essentially the rationale that Larry Summers is alluding to from a firm’s perspective. It’s equally applicable to households.

Another reason, as Warren Buffett points out, is to express an investment view. Adding debt or refinancing longer-term debt obligations actually decreases the duration exposure of the overall balance sheet. If interest rates increase or inflation is higher than expected, such an action could result in a higher overall balance sheet value versus doing nothing.
Any rational chief financial officer in the private sector would see this is a moment to extend debt maturities and lock in low rates. *Larry Summers, 2012*

You would think that people would be lining up now to get mortgages to buy a home. It’s a good way to go short the dollar, short interest rates. It is a no-brainer. *Warren Buffett, 2014*

**Historical perspective**
Borrowing costs are primarily driven by prevailing interest rates. Currently, short- and long-term interest rates are at or near historically low levels, particularly once inflation is included in the analysis. As of 19 December 2014, the current yield on the US 10-year Treasury bond was 2.2%. Treasury yields have only been lower 8% of the time since 1990 (see Fig. 1). Real bond yields are quite depressed as well. The current yield on the 10-year Treasury Inflation Protected Security is only 0.5% – meaning that investors are content with a real return of 0.5% annually for 10 years for holding these securities.

Market expectations for rates going forward are equally subdued – at least on the long end of the curve. Due to labor market pressure and a continued economic recovery, we believe the Federal Reserve will begin raising short-term interest rates in mid-2015. At the same time, longer-maturity yields should increase as well – albeit at a much slower pace (see Fig. 2). The result is a flattening of the yield curve that drives up borrowing costs to more normal levels.

Although borrowing costs are low from an absolute perspective, it’s the relationship between the cost of debt and the expected return on assets held on the asset side of the balance sheet that drives the decision between using debt and not using debt for most investors. A simple way of making this decision is to look at the expected return on a portfolio relative to the cost of the debt. During some periods, that spread is actually negative – implying that it wouldn’t make sense to use debt except out of necessity or for convenience. However, the opposite is true today. Many investors who hold balanced or growth portfolios will find that the spread is likely fairly sizable and that the time is opportune to utilize borrowing from an investment standpoint.

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**Fig. 1: Interest rates continue to decline**
Treasury rates, 1990–2014, in %

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<th>Year</th>
<th>10-year Treasury</th>
<th>10-year TIPS</th>
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<td>1991</td>
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<td>2014</td>
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Source: Bloomberg, UBS, as of 19 December 2014

**Fig. 2: Treasury curve will likely flatten**
Market expectations based on the Treasury forward curve, in %

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<th>Maturity</th>
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<th>December 2016</th>
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<td>0</td>
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<td>30</td>
<td>1.7%</td>
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Source: Bloomberg, UBS, as of 19 December 2014
Top themes universe

Equities

Investment time horizon

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<tr>
<th>Short</th>
<th>Medium</th>
<th>Long</th>
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**Preferred**  
**Transformational technologies**

We believe there are two areas of technological innovation that will drive productivity gains over the next decade. The first is the explosion of digital data, which should create a broad set of business opportunities. The second is automation and robotics. Both have the potential to profoundly transform the structure of our economy, disrupt existing business models but also create substantial growth opportunities for those well positioned to participate.

[Full report: “Transformational technologies”]

**Preferred**  
**The rising Millennials**

By 2025, Millennials will account for more than 25% of the US population, with the older half of this generation just entering their peak working and earning years. Given their size and spending potential, we believe companies would be well advised to align their business models with this generation’s unique consumption needs and preferences. We expect the main beneficiaries to include innovative technology companies, wellness-focused brands, and service-oriented industries.

[Full report: The rising Millennials]

**Preferred**  
**Capex rising...finally**

We’ve been arguing that after a period of subpar growth, capital spending was poised to pick up given the aging stock of existing plant and equipment, an improving global economic backdrop, strong company balance sheets, and greater fiscal clarity. Indeed, it is becoming clear that corporations are gaining confidence in the economic outlook and beginning to reinvest in their businesses. We expect to see this trend to continue and disproportionately benefit select technology, industrial, and financial companies.

[Full report: Capex rising...finally: an update]

**Preferred**  
**e-Commerce: Beyond Amazon**

As consumers of traditional retail shift their shopping and spending online, opportunities abound for true omni-channel retailers and related companies. We believe long-term positive drivers of digital growth, including the rapid adoption of mobile devices, will continue to hasten market-share shifts online. We recommend taking a look at select opportunities in consumer-focused industries that take an omni-channel approach and utilize digital marketing strategies to complement their online efforts.

[Full report: e-Commerce: Beyond Amazon – an update]

**Preferred**  
**Major advances in cancer therapeutics**

A new wave of advanced cancer therapeutics is rapidly emerging. Within the next two years, we expect to see a number of pharmaceutical and biotech companies introduce several exciting cancer treatments that could represent multibillion-dollar sales potential for those developers. We see an opportunity in an array of biotechnology and pharmaceutical stocks that are conducting cutting-edge research, have drugs in development, and are trading at valuations that do not fully reflect this opportunity.

[Full report: Major advances in cancer therapeutics]
**Benefit from reform in Mexico**

We believe the passage of structural reforms in Mexico will increase the country’s long-term growth potential which has not been fully priced in by the markets. In the coming months, we expect to see an adjustment as foreign direct investments begin to flow into energy-related infrastructure projects and economic momentum picks up. We expect higher GDP growth in 2015, driven by higher government spending, consumption, and positive ties to industrial activity in the US.

*Full report: “Benefit from reform in Mexico”*

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**Dividend investing – don’t overpay for yield**

Valuations of the highest-dividend-yield stocks remain elevated and vulnerable to rising rates, while equities with moderate yields but historically high and consistent dividend growth are much more attractively valued. Investors should note that although 84% of S&P 500 companies pay shareholders some form of recurring dividend, the payment relative to share price and earnings strongly varies across industries and companies, as does the growth rate of the dividends per share paid.

*Full report: Update: Dividend investing – don’t overpay for yield*

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**Equal-weight investing**

Cap-weighted index funds have become a standard holding in many investment portfolios. While these funds have some attractive properties, such as low turnover, they also have some drawbacks, such as the tendency to hold overvalued stocks. As an alternative, investing according to an equal-weight approach has shown to exhibit attractive long-term risk and return properties. Moreover, the small-cap bias embedded in such a strategy aligns favorably with our current tactical equity views.

*Full report: Equal-weight investing*

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**Financials – on the road to recovery**

Banks’ balance sheets are expected to grow as a result of improvements in the US housing market and a pickup in construction activity. Rising interest rates should generate a nice tailwind for banks, along with resolution of regulatory lawsuits. We expect capital markets and M&A to improve as consumer confidence continues to recover. Further, long-term improvements in bank profitability remain on track, reflected by better-than-expected cost control and capital-market activity in the fourth quarter.

*Full report: US financials: On the road to recovery*

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**North American energy independence: Reenergized**

We see opportunities for investors and energy consumers across industries including energy infrastructure, chemical and steel manufacturing, transportation, auto, and utilities. These opportunities are driven by robust drilling activity, infrastructure buildout, and affordable energy supplies. As the costs of US shale production decline, US operators become more competitively positioned. We expect to see the US as a net exporter of natural gas, which will benefit select companies in the aforementioned sectors.

*Full report: North American energy independence: Reenergized*

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**US technology: Secular growth, on sale**

The US technology sector is attractively valued given its solid long-term earnings growth, improving cyclical outlook, accelerating cash distributions to shareholders, and exposure to secular growth drivers. In the short term, we expect rising demand for IT equipment to drive growth, while in the long term we look to cloud computing and e-Commerce, among others. Continued labor market gains and rising capacity utilization are further symptoms of an improving cyclical outlook.

*Full report: US technology: Secular growth, on sale*
**Water: Thirst for investments**
The world’s growing population is expected to increase demand for consumer products which require substantial amounts of water as an input for production. Therefore, we see tremendous revenue and profit growth potential in exposed companies due to long term trends in industrialization, climate change, and rising living standards. We recommend global industrials that benefit from higher capex in the US, as roughly half of the water exposed stocks are industrials.

[Full report: Water: Thirst for investments]

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**Fixed income**

**Prefered**

**Mortgage IOs: Positive returns when rates rise**
Agency interest only (IOs) are a mortgage-backed securities product that offer investors the opportunity to add yield to their fixed income portfolios, while at the same time mitigating potential losses in a rising rate environment. When added to a diversified fixed income portfolio, the negative correlation to other bond holdings can limit risk and enhance return. With US yields at pre-taper-tantrum lows, we believe now is a compelling time to consider mortgage IOs.

[Full report: Benefits of investing in mortgage IOs]

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**Prefered**

**US senior loans**
Due to their floating-rate character, senior loans are an attractive alternative to more traditional fixed income segments in an environment of stable or rising rates. Loan coupon rates reset regularly based on 3-month USD LIBOR, which has historically allowed loans to perform well in such an environment. Although total returns in 2014 underwhelmed expectations, we think valuations are more appealing than they have been in more than a year, offering an attractive entry point for investments into US loans.

[Full report: Senior loans: preparing for higher US interest rates]

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**Opportunities in capital securities**
In our view, financial sector capital securities will continue to outperform the broader investment-grade bond market in the coming months, boosted by attractive yields and improving issuer fundamentals. Banks, insurers and large-cap diversified financials are holding record levels of equity capital and liquid assets and employing less leverage. Further, the broader capital securities market will benefit from stricter capital requirements, as outstanding issues will be called and replaced with compliant securities.

[Full report: An update on the capital securities theme]

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**Yield pickup with kicker bonds**
Municipal kicker bonds are callable, high-coupon munis that sell at a premium and are priced to a specific call date. However, the actual yield realized will “kick up” if the call is not exercised by the borrower in a timely manner. If rates do rise, kicker bonds are less likely to be called, thereby increasing the duration as the effective maturity is extended beyond the investor’s expectation. We observe a yield opportunity in 5% coupons versus AAA non-callable bonds with comparable redemption dates.

[Full report: Municipal Market Guide: At a crossroads]
Non-traditional and commodities

Diversify bond portfolios into credit alternatives
Given our expectation for interest rates to gradually rise from current low levels, we expect investors to be faced with a multi-year period of unsuitably low bond returns. As a complement to fixed income portfolios, credit alternatives present an opportunity to diversify away some interest rate risk and outperform investment-grade sovereign and corporate bonds. Credit alternatives are actively managed strategies that can go long and short a variety of fixed income instruments.

Full report: Update: Diversify bond portfolios into credit alternatives

Exploring the benefits of equity event-driven strategies
Executives are under pressure to stimulate organic growth prospects through M&A and other significant corporate events in order to promote shareholder value after a sustained period of multiple expansion. Accordingly, we find special situation investing and merger-arbitrage strategies as attractive ways to capitalize on these corporate transactions. Opportunities for special situation investing include corporate events such as spin-offs, breakups, tender offers, and asset disposals, among others.

Full report: Exploring the benefits of equity event-driven strategies

Favoring equity hedge strategies
We think the current environment is conducive for stock picking and it is likely to remain in place for the foreseeable future. Higher interest rates in the future, for example, should support increased intra-stock dispersion, which is positive for this style, enabling managers to generate excess returns. Further, we expect performance to increasingly be dictated by company-specific fundamentals and developments, rather than broad market movements and shifts in risk perception.

Full report: Favoring equity hedge strategies

Wealth management strategies

Preferred Liability optimization
The current market environment presents an opportune time for investors to “optimize” their liabilities in order to add potential alpha to their balance sheets. Liability allocation is a custom household decision to be made within the context of tax situation, time horizon, and asset allocation. Liability optimization can potentially impact a household’s net worth as the benefit is accrued and compounded over years and decades, thereby enhancing returns.

Full report: Balance sheet optimization
US Thematic Investment Committee
The themes selected for the top themes universe are selected and actively monitored by the US Thematic Investment Committee (TIC).

Members of the US Thematic Investment Committee
All members are analysts or strategists working for CIO Wealth Management Research Americas (CIO WMR):

Michael Crook
Sally Dessloch
Mike Dion
Leslie Falconio
Andrea Fisher
Stephen Freedman (Chair)
David Lefkowitz
Barry McAlinden
Tom McLoughlin
Brian Nick
Mike Ryan
Jon Woloshin
Jeremy Zirin

Top themes universe
CIO Wealth Management Research actively recommends and monitors a range of investment themes that we believe an investor should consider in light of current or anticipated financial market trends. Thematic drivers include but are not limited to emerging growth opportunities, misvaluations in capital markets or foreseeable developments in public policy, demographics, society, environment, and technology.

All themes originate from analysts within CIO Wealth Management Research. Among the top themes universe a subset is deemed ‘preferred’. Themes with the ‘preferred’ designation may change from month to month and are determined based on factors such as conviction, timeliness, implementability, and our current WMR Chief Investment Office’s view on key financial market drivers.
Emerging Market Investments
Investors should be aware that Emerging Market assets are subject to, among others, potential risks linked to currency volatility, abrupt changes in the cost of capital and the economic growth outlook, as well as regulatory and sociopolitical risk, interest rate risk and higher credit risk. Assets can sometimes be very illiquid and liquidity conditions can abruptly worsen. WMR generally recommends only those securities it believes have been registered under Federal U.S. registration rules (Section 12 of the Securities Exchange Act of 1934) and individual State registration rules (commonly known as “Blue Sky” laws). Prospective investors should be aware that to the extent permitted under US law, WMR may from time to time recommend bonds that are not registered under US or State securities laws. These bonds may be issued in jurisdictions where the level of required disclosures to be made by issuers is not as frequent or complete as that required by US laws.


Investors interested in holding bonds for a longer period are advised to select the bonds of those sovereigns with the highest credit ratings (in the investment grade band). Such an approach should decrease the risk that an investor could end up holding bonds on which the sovereign has defaulted. Sub-investment grade bonds are recommended only for clients with a higher risk tolerance and who seek to hold higher-yielding bonds for shorter periods only.

Nontraditional Assets
Nontraditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments; there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

Interests in alternative investment funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in an alternative investment fund and should consider an alternative investment fund as a supplement to an overall investment program.

In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

• Hedge Fund Risk: There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, “junk bonds,” derivatives, distressed securities, non-US securities and illiquid investments.
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