Top themes

Thematic investment ideas from CIO Wealth Management Research

The Decade Ahead

Second quarter themes
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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

<table>
<thead>
<tr>
<th>Non-traditional</th>
<th>US equity</th>
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<tbody>
<tr>
<td>Commodities</td>
<td>International equity</td>
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<tr>
<td>International fixed income</td>
<td>US fixed income</td>
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</table>

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

Preferred themes are selected based on their timeliness, conviction level, and CIO WMR’s current view on key financial market drivers.

Please contact your financial advisor for copies of reports cited in this publication.

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Dear readers,

This quarter, we are continuing our focus on investment ideas for the Decade Ahead. This is the second installment in the special Top themes: The Decade Ahead series, which highlights long-term thematic opportunities we expect to see unfold across macroeconomic, public policy, technological, and societal lines (see page 2). Specifically in this edition, we introduce two new “decade” themes: Sustainable investing and Beyond benchmark fixed income investing.

First, sustainable investing is emerging as a significant financial industry trend and is increasingly being adopted by institutional as well as individual investors. Concerns about sustainability are rising among consumers, employees, civil society and the investment community. Whether investors seek to align portfolios with personal values, achieve a positive environmental or social impact with their investments, or believe that sustainability considerations affect securities’ values and returns, sustainable investing is on the rise and the number and sophistication of related investment solutions are growing. This theme and its underlying comprehensive report highlight the building blocks for a sustainable investing strategy and provide guidance on how to implement these ideas into a portfolio.

Second, we also launched our first decade theme within fixed income. We argue that a flexible approach that shifts beyond traditional high quality fixed income benchmarks is increasingly needed. In our view, the path toward a normalized growth and interest rate environment will produce headwinds for fixed income investors in coming years. As a result, future bond returns are likely to be more modest, as starting yield levels are typically a strong indicator of future performance. Over longer market cycles, flexible and active fixed income investment approaches as well as broader diversification into credit spread sectors should prove to be two sources of value added.

Sincerely,

Stephen Freedman, PhD, CFA
Head of US Thematic and Sustainable Investing Strategy

Andrea Fisher, CFA
Senior Strategist
Decade Ahead framework

In our January Top themes publication, we introduced a framework for identifying and recommending long-term thematic investment ideas. These “decade themes” are now integrated into our existing thematic universe (see page 8) but are distinctly highlighted given their extended time horizon.

What structural drivers and trends create a multi-year opportunity? In our opinion, those that disrupt the norm and shift consumers’ preferences entirely. Accordingly, our dynamic framework is built upon seven influential sources of change that we expect to play out in the coming decade:

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.

While any attempt to peer into the future must be conducted with a healthy level of humility, we believe looking ahead through this lens can be a helpful tool to cut through the short-term noise of financial markets, plan for the future, and identify attractive opportunities.

Moreover, we also want to ensure our decade themes are germane for investors. We screen each theme to ascertain its relevance and implementability in one of three categories: (1) investment opportunities; (2) financial industry trends; and (3) wealth management strategies. The first ensures that the most important emerging investment themes can be engaged or implemented; the second offers participation in structural shifts within the financial services industry; and the third enables advances in wealth management techniques to be incorporated into portfolio strategies.

This approach ensures that developments, which will have the biggest impact on 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. Overall, the goal of our decade themes is to equip investors with the insights they need to stay in front of the curve.
### Drivers behind Decade Ahead themes

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<th></th>
<th>Resources</th>
<th>Innovation</th>
<th>Demographics</th>
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Stephen Freedman, PhD, CFA

**DECADE THEME**

Sustainable investing (SI) is growing faster than the financial industry at large. The key driver is changing expectations regarding sustainability questions among key stakeholders – consumers, employees, investors and civil society – who are now placing more stringent demands on companies. The Millennials and their idealism are contributing to this shift in attitudes, which is changing the context in which corporations operate and increasingly deserves to be reflected in investment analysis. Interest among investors, in particular among institutional investors, has been catching on and has been driving significant growth in sustainable investment solutions catering to these expanding needs (see Fig. 1).

We define SI as a set of investment strategies that incorporate material environmental, social and governance (ESG) considerations into investment decisions. SI strategies are usually guided by the desire to reach one or several of the following objectives:

1) achieve a positive environmental or social impact alongside financial returns;
2) align investments with personal values; and
3) improve portfolio risk/return characteristics by factoring sustainability into investment decisions

**SI approaches**

There is no uniform way to engage in SI. We distinguish among three basic approaches that can be considered as building blocks of any SI strategy:

1) *Exclusion* is the most traditional approach. Through a process called exclusionary or negative screening, individual companies or entire industries are removed from portfolios if their areas of activity conflict with an investor’s values. Excluded companies are often those with business involvement in areas such as alcohol, weapons, tobacco, adult entertainment or gambling. However, exclusions can be highly customized to investor preferences.

2) *Integration* encompasses various techniques that combine ESG factors with traditional financial considerations to make investment decisions. It can range from the relatively straightforward screening of companies based on sustainability ratings, to the more involved full incorporation of material sustainability factors into the security valuation process through adjustments to inputs such as growth, earnings or discount rates.

3) *Impact investing* explicitly seeks to generate a positive social or environmental impact alongside a financial return. The niche market of impact investing is growing fast. Examples include community investing, microfinance, as well as private equity deals that invest in such sectors as education, healthcare, basic infrastructure and clean energy.

**Unjustified performance concerns**

When considering SI, investors often ask whether such strategies hinder financial performance. Interestingly, evidence gathered in listed markets over the last few decades shows no significant performance difference with conventional approaches. This can be illustrated by comparing the performance of the stock indexes that incorporate SI principles with that of regular stock indexes (see Fig. 2).

Performance differences can occur in specific markets and time periods, but on balance across markets and through full market cycles, a large body of academic
A large body of academic evidence suggests that SI performs no better and no worse than traditional approaches.

Personalizing portfolios with sustainability-themed investing
Sustainability-themed investing identifies themes related to ESG factors, determines which industries and companies are positioned to benefit from these trends, and constructs portfolios that factor in such insights. Examples of such themes include water and waste management, food scarcity, energy efficiency or climate change on the environmental side; supply chain management or access to finance, housing, education and healthcare on the social front; and board diversity or corporate transparency in the area of governance. By directing assets to these themes, investors can pursue return opportunities and express their interests with satellite investments. The thematic angle can also help populate core portfolio investments or inform the selection of impact investing vehicles. When structured as stand-alone investments, such themes can be included even in non-SI portfolios. Note that sustainability-themed investment solutions do not always incorporate more general SI considerations.

From sustainable equities to sustainable portfolios
The trend is for investors to look for SI solutions beyond equities to ensure that their entire portfolio is structured in a way that incorporates ESG considerations. Each asset class presents opportunities, but also limitations that investors must keep in mind. Overall, equities and fixed income lend themselves well to SI. Hedge funds and private markets exhibit a number of implementation hurdles, but interest is growing. Commodity investments are often problematic from a sustainability perspective.

Investors have the option of focusing only on asset classes for which they are comfortable with the SI implementation, and adjusting their asset allocation accordingly. Alternatively, they can maintain a broadly diversified asset allocation and implement asset classes that are more difficult to fulfill with SI by using conventional solutions instead. As SI continues to grow in appeal and sophistication, such challenges will become increasingly easy to overcome.

Fig. 1: SI assets in the US
USD billion

Source: US SIF, as of 2014

Fig. 2: SI and conventional investing perform similarly
April 1990 – February 2015, in %

Source: Bloomberg, as of February 2015
Beyond benchmark fixed income investing

Context
US and non-US fixed income

David Wang; Barry McAlinden, CFA; Leslie Falconio

DECADE THEME

Following the global financial crisis, fixed income investors have found themselves in a difficult environment. The headwinds facing the bond market are numerous and include near-zero rates in short maturity instruments, a longer, drawn-out normalization cycle, and frequent bouts of volatility. Despite the prolonged waiting game, CIO WMR believes that we are on track for a normalized macro environment with the Federal Reserve likely to begin raising rates later this year.

Accordingly, challenging times lie ahead for fixed income investors. Future returns are likely to be modest, as starting yield levels are usually a strong indicator of future annualized returns. An environment where rates are biased higher would exert pressure on principal values and will dampen total returns. Investors’ starting position is disadvantaged by the fact that duration exposure rises as market yields decline, which results in greater price sensitivity to changes in yields. Put simply, fixed income investors will likely have to accept mediocre returns, potentially for several years ahead (see Fig. 1).

The traditional benchmark has flaws
For fixed income investors, the most widely used benchmark for the US taxable fixed income market is the Barclays Aggregate Bond Index (Barclays Agg). Unlike the S&P 500 equity index that offers exposure to a diverse group of industry sectors with multinational exposure, the primary composition of the Barclays Agg comes from government and government-related segments of the bond market, which give the index a very high AA average credit rating.

Investment grade (IG) corporate bonds are represented in the index but high yield (HY) corporate bonds, Treasury inflation-protected securities (TIPS), municipals, and non-agency mortgage-backed securities (MBS) are all excluded. Further, USD emerging market (EM) bonds are represented, but only by a small allocation. As yield levels for traditional segments of the fixed income market have declined, the overall yield level for the Agg sits at 2.2%, near an all-time low. Given that the benchmark exhibits high credit quality and is low yielding, it is understandable that some investors are worried about negative price reactions of bond prices prior to Fed rate hikes.

Price returns contribute less to total return
In seeking higher total returns, we recommend that investors focus on coupon returns which have historically been more important than price returns. This is especially true in today’s environment where the Fed’s quantitative easing programs have led to expensive valuations for many fixed income products. When analyzing the total return contributions of the Barclays Agg over the last 15 years, the coupon return with reinvestments accounted for roughly 90% of the total return. In the broader Barclays Universal Index, coupon return with reinvestment contributed to 92% of the total return over the past 15 years (see Fig. 2). We believe this suggests that investors should consider fixed income investments that have higher coupons rather than chase investments that may have capital gain potential when investing.
Investors can circumvent traditional benchmark shortcomings by increasing exposure to credit spread sectors.

over the long term. Keep in mind that higher coupons and yields often coincide with lower credit quality, so investors should also keep their individual risk tolerance in mind.

Focus on diversification and flexibility
We believe diversifying high-quality bond portfolios and incorporating different types of fixed income asset classes that are not just concentrated in government segments should lead to superior risk-adjusted returns over time. Investors can circumvent traditional benchmark shortcomings by increasing exposure to credit spread sectors, where the additional risk premium can help cushion the effect of higher rates. The often uncorrelated behavior that credit-sensitive fixed income exhibits compared to government bonds can help in the construction of more efficient portfolios that offer greater return potential for a given level of risk. To illustrate this point, we compare the broader-based Barclays Universal Index to the Aggregate Index. The Universal takes the Agg, which comprises 84% of the index, as the starting point, but then adds a mix of high yield bonds (6%), Eurodollar and EM bonds (4%), and private placement 144a bonds (6%). Having exposure to these segments increases the credit sensitivity of the index, but also allows for incrementally greater total returns for similar levels of risk. The credit quality of the overall index drops only marginally to single-A rating equivalent when these additional segments are added, while the Universal index yield level rises to 2.7%.

Further, investors should seek more flexible approaches to managing their fixed income portfolios. Flexible, beyond benchmark investing can be achieved through multiple approaches including those that incorporate active fixed income portfolio management. Investors who deploy high quality fixed income as a buffer for their equity positions, for instance, may consider dialing up the credit exposure a tad to increase the efficiency of the fixed income holdings. Other investors that are open to taking an even greater degree of credit risk and wish to fully participate in a broad variety of fixed income segments may want to utilize a more robust and disciplined asset allocation approach for their fixed income holdings that incorporates a strategic allocation and tactical tilts.

Fig. 1: Long-term trend has been toward lower yields

In %

<table>
<thead>
<tr>
<th>Year</th>
<th>Barclays Aggregate Index yield</th>
<th>10-year Treasury yield</th>
<th>Fed funds rate</th>
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<tbody>
<tr>
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<td>7.5%</td>
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<td>1998</td>
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<td>2015</td>
<td>-0.5%</td>
<td>-1.5%</td>
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Source: Bloomberg, UBS CIO WMR, as of 11 March 2015

Fig. 2: Coupon return contributed the most to total return
Composition of returns for period between 3/16/2000 and 3/16/2015

<table>
<thead>
<tr>
<th>Component</th>
<th>Barclays Aggregate</th>
<th>Barclays Universal</th>
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<tbody>
<tr>
<td>Total Return</td>
<td>128.04%</td>
<td>134.48%</td>
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<tr>
<td>Price return</td>
<td>16.82%</td>
<td>14.55%</td>
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<tr>
<td>Coupon return (with reinvestment)</td>
<td>115.84%</td>
<td>123.93%</td>
</tr>
<tr>
<td>Other return</td>
<td>-4.62%</td>
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Source: Barclays Capital, UBS CIO WMR, as of 16 March 2015
Top themes universe

Our top themes universe represents the full spectrum of investment themes we currently recommend and actively monitor.

**Equities**

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**PREFERRED**  
**Capex rising...finally**

We’ve been arguing that after a period of subpar growth, non-energy capital spending was poised to pick up given the aging stock of existing plant and equipment, an improving global economy, 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.

**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.

**PREFERRED**  
**Eurozone comeback**

Investors looking for something outside of the US to put into their portfolios might find that Eurozone equities are an attractive choice. Recent economic data from the Eurozone has surprised on the upside. We are seeing encouraging signs that the credit crunch is starting to ease, and the European Central Bank’s quantitative easing will provide a tailwind. With support from an economic recovery and a weaker euro, we see great potential for earnings to grow at a robust pace in the years ahead.

**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 a variety of exciting cancer treatments that could represent multibillion-dollar sales potential for the respective developers. We see opportunities in an array of biotechnology and pharmaceutical companies that have novel cancer drugs in development, where their respective stocks are trading at valuations that do not fully reflect these opportunities.
**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 earnings years. Given its 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. In particular, we expect the main beneficiaries to include innovative technology companies, wellness-focused brands, and service-oriented industries.

**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 consumption, and positive ties to industrial activity in the US.

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

Valuations for the highest dividend-yielding 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.

**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.

**North American energy independence: Reenergized**

We see opportunities for investors and advantaged energy consumers across energy infrastructure, chemical and steel manufacturers, transport, auto and utilities. These opportunities are driven by trends in robust drilling activity, infrastructure build-out, and affordable energy supplies. With the cost curve in US shale production declining, US operators are competitively well positioned. We expect to see the US as a net exporter of natural gas, which will benefit select companies in the aforementioned sectors.
Restructurings and turnarounds
Managements rarely aspire to undergo a restructuring, but in some cases, it is the best path when a company has an urgent need to turn around its fortunes, improve its reputation, or restore its competitive position. A well-executed restructuring or turnaround can transform a company into a strong competitor with dramatically improved financial results. Investors can capitalize on this by selecting companies that are currently undergoing restructurings with a high probability of success.

Transformational technologies
We believe there are two areas of technological innovation that will be driving forces behind productivity gains during the next decade. The first is the broad set of business opportunities around the explosion of digital data. 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.

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 provide further stimulus to an improving cyclical outlook.

Water: Thirst for investments
The world's growing population is expected to increase demand for consumer products that 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.
**Beyond benchmark fixed income investing**

Over the next decade, we believe US taxable fixed income investors will find themselves in a challenging market environment characterized by low starting yield levels, bouts of volatility, and a longer, drawn-out normalization cycle. For these investors, the most widely used benchmark is the Barclays Aggregate Index, which suffers from several flaws, in our view. We argue that investors can circumvent benchmark shortcomings by diversifying bond portfolios beyond a traditional benchmark.

**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 portfolio, 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. Considering that US yields are still at historically low levels and WMR forecasts are for them to rise further this year. We continue to believe that it is a compelling time to consider mortgage IOs.

**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 rising rates. Although LIBOR floors prevent coupons from resetting upward immediately, we believe individual investor demand should pick up as the Fed moves closer to raising its target rate. Loan valuations are more appealing than they have been in more than a year, offering an attractive entry point for investments into US loans.

**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, 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.

**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.
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 potentially 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.

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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 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.

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<th>Investment time horizon</th>
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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. We expect higher intra-market return 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.

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Favoring equity hedge strategies

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Financial industry trends & wealth management strategies

**PREFERRED** Adding value(s) to sustainable investing

Concerns about sustainability are rising among consumers, employees, civil society and the investment community. Whether investors seek to align portfolios with personal values, achieve a positive environmental or social impact with their investments, or believe that sustainability considerations affect securities’ values and returns, sustainable investing is on the rise and the number and sophistication of related investment solutions are growing.

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Click for full report
Adding value(s) to sustainable investing

**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 sheet. 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.

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Liability optimization
US CIO Thematic Investment Committee

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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