



UBS Global Asset Management

Asset Allocation

Since mid 2007 we have seen deterioration in the US housing market and liquidity issues in credit markets cause a slowdown in global economic growth. Uncertainty about the economic outlook going forward has caused many central banks to lower interest rates. At the same time, oil prices (and some other commodity prices) have surged to new highs. This has translated into higher inflation for consumers, causing a predicament for central banks tasked with the dual mandate of full employment and keeping inflation in check.

Uncertainties around subprime and other credit market exposures have escalated. Over the past few months we have seen a flood of bad news from the banking sector with writedowns stemming from losses in subprime and other securitized exposures on balance sheets. This uncertainty in the financial markets coupled with a slowdown in economic growth has become a focus for many market participants, causing investor sentiment to worsen and sending volatility to multi-year highs. Implied volatility in US equity has steadily increased since 2007. This index represents the market's expectation of volatility in the next month, and it is often used as a gauge for investor risk aversion and uncertainty in the market.

The increased volatility has gone hand-in-hand with a reversal in risk-seeking behavior. Risky assets, including equities, investment grade and high yield credit, sold off as risk aversion rose. The equity markets have fallen about 16% from their recent highs in October 2007. Liquidity has dried up in many credit sectors with leveraged investment vehicles feeling the worst of the pain as they struggle to meet short-term commitments and find new sources of financing. Many financial institutions have revealed significant losses on securitized debt holdings, severely impacting their balance sheets. Many of these institutions have been forced to offload positions both illiquid (e.g., lower-rated mortgage-backed

in the credit markets have triggered a flight to quality in developed sovereign bond markets around the globe, not just the US. However, the effect has been greatest in the US where the trigger for the crisis, the US subprime mortgage market, predominantly resides.

Strategy

The recent selloff in equity markets has left equities in more attractive territory from a valuation standpoint. Our analysis points to many equity markets in the area of 20% undervalued, with 3-year forward-looking annualized returns in the low teens. This valuation viewpoint has led us to cautiously increase our developed equity exposure in our multi-asset portfolios. Valuation signals alone would suggest we take

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greater equity overweights and increase relative positions. Cognizant of the current risk aversion in markets and the potential for short-term selling of financial assets, we continue to move cautiously adding to risky asset positions in balanced multi-asset portfolios. While equity valuations are now attractive in many areas, emerging markets remain significantly overvalued; and are most vulnerable to a continuing global economic slowdown.

securities) and liquid positions (including investment grade and high yield bonds). This growing fear of insolvency and illiquidity has led to increased risk aversion globally and a rise in credit spreads across the board. It seems investors have become wary of bonds that could be linked in any way to the ongoing problems in the real estate markets.

Our underweight to government bonds in our global balanced portfolios like those held in the AssetMark Standard Profiles is primarily driven by valuation assessments. We have increased underweight positions (and short positions where appropriate) to bonds as investors have shown increasing propensity in recent months to eschew stocks for the safe haven of government bonds.

The yield on the 10 year Treasury has fallen to a recent-period low of 3.4%, a level seen only once in the past 50 years, when headlines in the summer of 2003 were calling for a deflationary period in the US—a situation quite a bit different from today's. Bond yields have been driven progressively lower since mid-June 2007 as problems

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This increased demand for bonds along with avoidance of some of the risky sectors of the bond market have pushed government bond prices above levels we believe are sustainable. With inflation expectations in the 2.25% range and US 10-year yields around 3.4%, we think the market has gone a bit far with respect to pricing in an elongated recessionary period in the US and globally.

We have selectively added to our high yield and certain investment grade credit exposure in our portfolios (including both DAS as held in the AssetMark Hedged Models and traditional global balanced funds, as prices have become increasingly attractive.) For investors with a longer time horizon, there are significant opportunities today in credit markets. The turmoil in these markets is by and large an outcome of liquidity pressures, rather than credit fundamentals. Lack of liquidity is not the same as credit risk, but this concept seems particularly difficult for the market to digest at the current time. This is most evident by looking at the spreads of certain investment grade credit and lower quality/high yield debt. The drastic spread widening that occurred in the last six months was largely because of liquidity concerns. We used this opportunity to provide liquidity amid market turmoil and growing fear. With spreads near two-year highs, we added investment grade and high yield exposure to our global balanced portfolios.

With spreads at such wide levels, we see very attractive fundamental valu-

ations for investment grade and high yield credit. Valuations in investment grade and lower quality/high yield credit are pricing in a marked pickup in defaults or credit risk. As pointed out above, we believe that liquidity issues have been driving spreads up, rather than fundamentals. The depressed current prices represent an opportunity to generate excess risk-adjusted returns. Accommodative policies by many central banks and the authorities' clear commitment to address liquidity events provide support for such a position.

Overall, our latest strategy changes increase our risk exposure to credit and equity, though we remain conservatively positioned relative to cur-

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rent valuation signals. Overall, risky assets have become more attractive from a valuation standpoint. While our market behavior analysis takes the concerns of the current economic backdrop seriously, our conviction about valuation signals has improved on the back of the aggressive policy responses from the US authorities. We see opportunities in this environment and continue to be a liquidity provider in areas where prices differ significantly from our fundamental value estimates.

Finally, early in the first quarter, with valuations of broad fixed income aggregates becoming stretched, we sold fixed income exposure within both

the Standard and Hedged Profiles. We invested the proceeds in cash within the Standard Profiles and DAS within the Hedged Profiles.

Global Equity

The MSCI World Index was down 8% in the first quarter 2008 in local currency terms. Developed countries posted negative returns with the exception of a few European countries and Hong Kong, the strongest performer by virtue of its association with China.

The worst performing sector was unsurprisingly financials, being directly affected by the sub-prime crisis. The consumer discretionary sector also underperformed as consumer spending was expected to be severely hurt by housing and credit market concerns. Consumer staples, less subject to fluctuations

in income and sentiment, performed well. Utilities, another defensive sector, were the best performer for the quarter.

The portfolio remains overweighted in companies that we believe are most likely to deploy their cash most effectively via dividends, share buybacks and strategic acquisitions at reasonable prices. Sector valuation discrepancies present us with opportunities as the whole market continues the process of recalibrating their approach to risk to a level more appropriate for the later stages of the economic cycle.

Strategy

The strategy is style neutral and its beta is in line with the market. The overall risk policy is an outcome of stock, industry and country decisions. Ex-ante tracking error is at the lower end of the risk spectrum.

Overweights

Pharmaceuticals and biotechnology: This sector is overweighted, driven by positions in the US market, where we find attractive opportunities despite the prospect of health care reform. We continue to prefer companies with unique or noncommodity product concentrations, such as in biologics (e.g., vaccines). Furthermore, we seek to avoid those companies that we believe have too much generic exposure, significant patent expiry risk and weak product pipelines.

Semiconductors and semiconductor equipment: We are overweighted to semiconductors based on individual stock valuations, which are particularly attractive. Companies in this area are beginning to embrace the concept of stock buybacks.

Food and staples retailing: Some large, mainly European, holdings in the sector constitute our overweight position. We believe that market concerns about sugar and wheat prices have been overstated, particularly as the EU recently brought in important measures in order to stabilize the sugar market.

Transportation: We are overweighted in transportation based on positions

in North America. We believe transport companies will maintain pricing power even as materials and energy prices normalize. Long-term demand remains strong and companies have made significant operating improvements.

Media: Our overweight position is comprised of USA and UK companies and based on individual stock analyses. Key thesis points include strong revenue growth projections, increased operating margins and market share gains.

Underweights

Utilities: We are underweight to utilities. The stocks have performed

underweighted in metals and mining with the exception of a few low cost producers and market leaders.

Capital goods: Capital goods stocks have performed well due to demand from emerging economies such as China, and valuations are stretched. We hold a few machinery companies, which are relatively attractive.

Technology hardware and equipment: We believe hardware valuations are stretched and we remain underweighted in this area. We are, however, finding select opportunities, most notably in Japan where the companies are well positioned competitively and have strong cash generative business models.

For investors with a longer time horizon, there are significant opportunities today in credit markets.

well due to their association with the energy sector, low long-term interest rates in the US and Europe and thirst for yield from ageing investors. In addition, bid activity has buoyed up prices. In general, it is an area where we are finding little value outside the US.

Household and personal products: This sub-sector is the least attractive within consumer staples based on valuations. Within the sector, we have a strong preference for food and staples retailing.

Materials: The strategy is underweighted to materials, as most stocks are expensive. We are finding select opportunities, however, in the chemicals space and in paper. We remain

US Core Equities

The US equity market is currently trading at a significant discount to fair value. In addition, we continue to see a wide dispersion of expected returns within the US equity market. This should provide us with a strong alpha opportunity in an attractively priced market. We highlight below where we are finding some of the greatest pricing opportunities.

The first quarter of 2008 was a rough one in the equity markets. Severe downward pressure resulted in US equity market decline of approximately 10%. Within the financial sector, we continued to see volatility. Despite the recent turmoil and the likelihood of future negative announcements, our price to intrinsic value platform believes the sector has been depressed far below fair value. This is not to say

the sector will quickly trend upward. We believe prices may fall further in the short term due to continuing negative news and investor uncertainty. But based on our cash flow analyses and estimates of future write downs, we believe financials will rebound with strong performance once credit concerns diminish.

We continue to find the oil services sector attractive and remain overweight this space. Years of underinvestment and increased capital intensity, combined with heightened demand from emerging markets, is expected to provide above-average earnings and cash flow growth in the energy sector. A shortage of equipment and people to develop, maintain and service rigs, especially in offshore environments, in our view will support a long cycle of pricing power driving a sustainable cycle of worldwide drilling and infrastructure spending.

The Fund's underweight to specialty retailers is consistent with our belief that the consumer sectors may continue to face difficulty in a potential recession. Uncertainty regarding interest rates, fuel prices, the housing market and the near-term health of the economy is weighing heavily on the consumer. A crisis in consumer confidence will further weaken these names.

Oil prices have been volatile. They are near all-time highs, and continue to be well above our normal assumptions. As demand normalizes, non-OPEC supply continues to grow and major capacity expansions in OPEC come

online, we believe concerns over OPEC spare capacity will lessen. Key swing factors will continue to be demand growth in China and the US. We believe that as oil prices normalize at lower levels than where we are today, energy stock prices in general will underperform other segments of the US equity market, which is why we are underweight the sector. In the short-term, there continues to be an incredible amount of speculation on the price of oil and we believe that is what has driven prices up to unsustainable levels. Any type of delevering event in hedge fund space could lead to a quick correction in oil prices, which would benefit our portfolios substantially.

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Currencies

Throughout March, and much of the first quarter, the currency markets experienced the following themes:

- USD consistently remained weak against majority of other currencies, except Asian currencies
- Risk-conscious behavior impacted market movements
- Stagnant global growth with concerning inflationary pressure became a more pronounced theme
- Upward pressure on commodity currencies

An array of weak economic data contributed to the fall in the USD. The March US consumer confidence index fell to a five-year low. The US retail sales rate also slowed in Febru-

ary. Risk seeking behavior retreated and bounced during the first quarter but currency market sentiment was predominately risk averse, producing rallies for "safe haven" currencies such as the JPY and the CHF. The impact of the credit crisis encouraged this behavior. However, aggressive US interest rate cuts and other policy changes acted against this direction. Commodity currencies, such as the AUD, NZD and CAD, strengthened with high commodity prices. Asian currencies, which we regard as mostly undervalued, strengthened, particularly against the weak USD.

USD weakness persisted as market experienced more turbulence

Streams of poor economic news in the US from weak real estate to slow retail sales data drove the slowdown while U.S. interest rate cuts continued at a very aggressive pace. All this contributed to a weakening USD against other currencies. The USD reached record lows against the EUR and the CHF, and weakened below 100 vs. the JPY for the first time since 1995.

Following the depreciation of the USD to more undervalued levels, we increased our exposure in USD as the exchange rate appeared to have priced in significant downside (on the economic front) already. In return, we decreased our overweight in CHF and JPY. However, we have ample risk allowance available to further increase our USD position if it is to continue depreciating.

Risk aversion strongly impacted the currency markets

Risk seeking behavior briefly returned in February only to be reversed by the near-collapse of Bear Stearns, a US investment bank. However, with the help of the Federal Reserve, rescuing this firm from bankruptcy opened the door for policy changes to head off further large disruptions in the market. In other efforts, the Fed increased the scope and size of its securities lending program to attempt to provide much-needed liquidity to stricken institutions, and relaxed the collateral requirements for such borrowing. Still, investors are cautious of risky assets, even affecting commodities somewhat. Notwithstanding risk aversion and economic weakness, commodities overall rose in the three months.

In essence, the risk aversion effects over the quarter resulted in the unwinding of “carry trades” (earlier weakness of low interest rate currencies to fund purchased of high interest rate currencies). The funding currencies in the carry trade, such as CHF and JPY grew stronger against EUR and USD. Our general positioning against the carry trade included short NZD and AUD exposure, and reaped rewards as those currencies depreciated against JPY. CHF strengthening against the EUR further benefited portfolios. As these currencies revert to fair value, we expect to further capture the gains. However, as central banks and governments are keenly interested in alleviating the credit-market distress that has been associated with carry-trade

unwinding, this reversion to fair value may be disrupted as the carry trade is heavily correlated with market’s appetite for risk taking.

Diminished growth rates with increasing inflation

On top of the already large US interest rate cuts, further easing is expected, to take rates below 2% by second quarter, and consensus expectations for GDP growth indicate recession. The U.S. is facing some degree of “stagflation” as CPI inflation is still being reported as rather high. A perception that the Eurozone economy is faring better than that of the US, has not produced similar expectations of rate cuts by the ECB. In other parts of the world,

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such as Singapore and China, increasing inflation continued. In response, China continued to increase its reserve requirement ratio for banks to soak up liquidity. Asian countries and their policy makers tackled inflation by allowing their currencies to slowly appreciate relative to the USD.

Even with appreciation against USD, Asian currencies such as SGD were still falling against most other countries and we still regard most of these currencies as undervalued and attractive.

Commodity currencies were heavily influenced by commodity price and demand

High prices in commodities, influ-

enced by demand from China for oil and grain, supported continuing overvaluations in related currencies, such as AUD and NZD. In the case of the AUD and NZD, these currencies have also been supported by high interest rates due to strong economic growth generally. However, we believe these economies to be in the downward part of the cycle, in particular New Zealand, where the economy has shown signs of slowing.

Fixed Income

U.S. Fixed Income

The prolonged flight to quality and rally in the US Treasury market continued into the first quarter of 2008. Concerns over the slowing US economy, deteriorating real estate market, and the financial health of investment banks and monoline insurers weighed on market sentiment. In response to deteriorating credit and market conditions, the Federal Reserve cut its target lending rate a full 200 basis points during the quarter to 2.25%.

At the beginning of the quarter the two-year Treasury yielded 3.05% and the 10-year Treasury yielded 4.02%. As investors flocked to the safety of the Treasury market, yields plunged and the yield curve steepened. By quarter-end, the two-year Treasury yielded 1.58% and the 10-year Treasury yielded 3.41%.

Swap spreads, a measure of risk premiums for high quality bonds, increased as investors reassessed compensation for risk-taking. In March, the two

year swap spread reached a historic high of 111 basis points, taking out the previous high of 97 basis points established in 1989.

Treasuries continued to be the asset class of choice and benefited from investor risk aversion. Meanwhile all of the spread sectors underperformed in a continuation of the trend in place in the latter half of 2007. For the quarter, commercial-mortgage backed securities (CMBS) and asset-backed securities (ABS) were the worst performing sectors, followed by corporate bonds.

During the quarter we maintained a slightly shorter duration stance relative to the index.

While the relatively weak cyclical outlook for the US economy coupled with disarray in the credit markets

should continue to pressure the markets, longer-term interest rates are approaching historically low levels and in our view have priced in an unduly dire economic outlook. We continued to maintain a steepening bias in portfolios.

Given the market dislocations, we took advantage of new opportunities. For example, we added exposure to high quality municipal bonds where yields reached 110% - 120% of Treasuries. We also added to Treasury inflation-protected securities (TIPS) in 3-year and 10-year maturities at attractive breakeven yields.

In the securitized sectors, we selec-

tively added to high quality "super senior" commercial mortgage-backed securities (CMBS). We also reduced our underweight to the most generic bonds by adding agency MBS, FNMA and GNMA 30-year MBS. In the corporate arena, we increased our exposure and moved closer to a neutral position relative to the index. We focused on longer maturity securities, particularly financials. We also added exposure to defensive subsectors such as pharmaceuticals and healthcare.

U.S. High Yield

The high yield market began 2008 with one of its worst opening quarters in history amidst continued economic uncertainty and volatility. January was

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particularly poor, with negative excess monthly returns that were the worst on record. A modest rally that began in mid March allowed for a flat closing month. For the entire quarter returns were -2.90%. Continuing concerns regarding housing, subprime and the value of various financial assets have had an ongoing negative impact on the economy and financial concerns in particular. It is likely that Federal Reserve actions and fiscal stimulus initiatives will ultimately alleviate some of these stresses, but probably not before we experience recession. The key question to ponder will be how long and deep the recession will be. Against this backdrop, high yield spreads continued to widen hitting an

intramonth high of 840 basis points during March. This compares to a spread of 550 basis points at year end 2007.

During the quarter new issuance virtually ground to a halt as only a handful of deals got placed. Some of the deals that did get placed were leveraged buyout (LBO) deals that came at deep discounts, costing the banks that unloaded them off their balance sheets hundreds of millions of dollars. A large LBO debt calendar still remains for the balance of 2008. This dynamic will continue to strain market liquidity. From an industry standpoint, utilities and steel were the best performers while financial ser-

vices and publishing/printing were the worst. The distressed sector lagged for the quarter as well. From a default standpoint, we

began to see signs of the anticipated uptick as a half a dozen or so credits defaulted. The default rate did not move much due to these defaults and still remains remarkably low.

We entered the quarter with a slightly conservative stance toward the market and became more conservative as the quarter progressed. However, we do have meaningful holdings in short dated (1 year or less) financial paper that, while having ratings that are in some cases investment grade, carry yields that are more in line with stressed high yield. Our thesis for owning these credits is based on our belief that these firms have ample liquidity to weather near-term market

conditions. Overall, as noted earlier, we are less optimistic regarding the US economy and will continue to position our portfolios accordingly.

Emerging Markets Debt

Performing emerging markets debt (EMD) spreads were 325 basis points over equivalent US Treasury yields at the end of the first quarter of 2008, 70 basis points above their level at the end of December. Global liquidity conditions remained poor in the wake of problems related to the US subprime mortgage markets. In addition, the fear of a US recession and its global impact dampened investor confidence and risk appetite. However, major central banks have continued adding liquidity, thus bringing volatility down.

The assessment of economic conditions in emerging markets continues to be positive. The major economies of Latin America continue to grow, with a number of them showing expansion well above expectations. Eastern Europe and Middle East/Africa, important regions for the asset class, have posted solid growth as well. The leading region in terms of economic growth is expected to be Asia, with projected growth rates at around 8%. This provides support for the asset class, despite increased volatility amid uncertainty in global capital markets.

Among the best performing countries for the quarter were Cote d'Ivoire, Pakistan and Iraq. All countries recovered from political crisis and a decline

in violence, a prerequisite for further economic improvements. Among the worst performing countries were Argentina, Venezuela and Sri Lanka. Argentina's problems are unchanged: Macroeconomic policy has followed an unorthodox approach and led to imbalances in the economy amid global market volatility. New farmer protests against taxation on their exports gained attention, and led spreads and yields to widen. Sri Lanka is deteriorating due to the recent increase in violence and the breakdown of all peace agreements. Venezuela

of the reporting period.

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has continued to suffer because of its government's loosening economic policies. The country has generally been sensitive to movements of the asset class, something that has been exacerbated by the heightened level of risk aversion in global capital markets in recent weeks.

Argentina, Indonesia and Serbia were the largest overweight positions in the portfolio throughout the reporting period. Mexico was the largest underweight. The portfolio has continued to seek opportunities in local markets, as fundamentals have been favorable and interest rates relatively high. The US interest rate duration of the portfolio has been lower than that of the emerging markets benchmark. The portfolio incurs additional active risk by investing in local currency-denominated debt, which made up roughly 29% of the total portfolio holdings at the end

UBS Global Asset Management Style Analysis Graph

