Special New Year's edition January 2006

UBS research focus

Outlook for 2006

Economy: US growth losing steam

Markets: Adequate returns for stocks and bonds

Investment Strategy: Risks open opportunities for active investors

UBS Wealth Management

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Dear Reader

We are often asked to divulge the real secret behind our investment success. The truth may dissappoint, because it is a far cry from the classic image of the investor whose heroic decisions rely purely on experience and a certain gut feeling. The real key to our investment success, lies in sound research groundwork using state-of-the-art analysis and applying consistently anti-cyclical approach based on a structured and highly disciplined investment process. As we are all aware, the markets are prone to exaggeration and often fluctuate between euphoria and panic. The key to success thus lies in systematically taking advantage of these fluctuations. It is therefore essential to constantly question even the most broadly accepted premises.

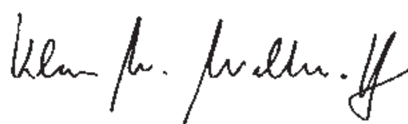
Before we turn our attention fully to the year ahead, it is important to refelct upon what has transpired in the year that just ended. The 2005 financial year has been marked by continuing normalization in economic activity and markets following the downturn at the start of the new millennium and the subsequent rapid expansion. As expected, equities held up well on the back of solid corporate results. Nor did it come as a surprise that the US markets having already factored in a great deal of this upturn, spent the year more or less treading water in an environment of rising short-term interest rates. It was by no means a quiet year, however. The financial markets were shaken in the early part of the year by the crisis in the US automotive industry and in the autumn by higher oil prices resulting from the exceptional hurricane devastation and by flagging consumer sentiment. It was somewhat later in the year, therefore, before interest rates moved up from their historical lows. In spite of this, investors in all asset classes still received slightly higher rewards for the level of risk accepted than we had assumed in our cautiously optimistic scenario a year ago. However, the markets unmistakably moved closer to equilibrium, i.e. fair value, last year.

Experience has shown, though, that neither financial markets nor economies stay in equilibrium for very long. US consumption, the only real engine driving global economic growth, could be on the verge of faltering. The income stream generated by the rise in the price of private residential property is likely to run dry in the near future. Savings activity has also plunged into negative territory, which means that consumption is partly being financed by debt. This not only applies to the average private US household; the whole of the United States is financing a portion of its current expenditure abroad via a sizeable current account deficit. By contrast, savings in Europe remain at a high level, with private consumption still proving to be the economy's Achilles' heel. Even Asia, the world's most dynamic region, will be unable to decouple from the slowdown in the US economy despite the increase in intra-Asian trade.

Given a continuing slowdown in growth, periods of major uncertainty in the financial markets cannot be ruled out during 2006, and recessionary fears may surface in the second half of the year. This could result in higher risk premiums near-term, although price setbacks could certainly present attractive buying opportunities as well. Inflation risks remain limited in this environment of more stable oil prices, signalling that a new interest rate plateau is being reached. While this is likely to exert only moderate pres-

sure on total returns for bonds, we expect equities, based on their fair valuations, to remain relatively resistant, posting normal average returns over the year. By contrast, we are fairly cautious with regard to higher-risk asset classes such as emerging market bonds or high-yield bonds. At the same time, non-traditional investments do not appear to justify a neutral portfolio weighting. We anticipate that commodity prices will remain high due to solid demand and tight supply. Commercial property, the predominant form of indirect real estate investment, has only limited scope for further upward movement, but it benefits from high dividend yields. In this environment of higher risks, hedge funds represent an ideal addition to portfolios.

All in all we expect a turbulent year in the financial markets and hope that we will once again be able to take advantage of this volatility to our clients' benefit. 2006 should present us with particularly promising opportunities to exploit shifts in sentiment and abrupt market movements within our investment strategy.



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Asset allocation requires selective use of risk

Nascent concerns about growth are likely to impact the financial markets as the year progresses, and corresponding positions need to be adopted at an early stage. In view of the fair equity valuations, however, setbacks can also represent worthwhile buying opportunities.

Money-spinners are a rare breed

The slowdown in US consumption, which has been the world's strongest growth engine to date, and the fact that neither Asia nor Europe is in a position to take its place, means we can expect two phenomena on the financial markets. Firstly, late-cyclical phases such as this one generally produce below-average returns. Secondly, it must be assumed that the markets will be on the lookout for signs of a potential slide into recession and will therefore react more sensitively. Large shifts in sentiment are the rule rather than the exception, so it makes little sense to operate with above-average risk positions throughout the entire year. However, waves of panic selling in such periods often represent the best opportunity for bargains and additional returns.

We currently view equities as the most attractive of the risk-bearing asset classes. For one thing, investors have remained more conservative, demanding higher risk premiums once more. Expectations of future earnings trends are also extremely cautious. Valuations are still fair overall, which means that equities remain attractive for investors with a long-term horizon.

Diversification more useful than ever

While we can assume that in this environment fluctuations in risk tolerance are a significant factor across all asset classes, the specific value drivers still vary considerably. It therefore makes sense to base investment strategies on a broadly diversified portfolio in which corporate bonds and emerging market investments are every bit as important as non-traditional investments. In particular, the supply and demand characteristics of segments of the real estate and commodities markets can offer enriching ways to diversify a portfolio. Hedge funds have a largely stabilizing effect over time, and the absolute risk is scarcely any higher than on fixed income instruments.

A flexible investment policy is required

The chart below provides an indication of how a globally diversified portfolio for an investor with a medium risk profile (balanced) and USD as home currency might look. The second chart indicates where tactical overweights and underweights to this benchmark appear advisable based on our current knowledge, and assuming the investor were to make no further changes over the course of the year. This is not the recommended approach for 2006, however, given the expected major fluctuations in market sentiment. Periodic and predominantly anti-cyclical changes in investment strategy are likely to produce above-average returns.

Strategic and tactical asset allocation

The starting point for any investment portfolio is strategic, based on the investor's personal risk capacity and risk tolerance, as determined in a detailed analysis of assets, income, obligations, personal circumstances, etc. A strategic asset allocation then defines the combination of asset classes (benchmark) that offers the highest possible return for the agreed level of market risk based on the long-term risk and return characteristics of the asset classes concerned. In the short and medium term, however, the expected risks and returns may vary considerably from longer-term assumptions due to cyclical or asset class-specific factors. And when the market for a specific asset class displays either excessive caution or exuberance, an informed response my prove to be rewarding. This is achieved through what is known as Tactical Asset Allocation (TAA), which indicates the recommended deviation from the benchmark. The extent and frequency of TAA deviations can be varied depending on the level of activity desired. This is measured using tracking error (TE), which reflects the extent to which returns deviate from the benchmark. The risk budget, for its part, records the proportion of the TE accounted for by a given deviation from the benchmark. The investor then is well equipped to take advantage of sentiment driven market movements.

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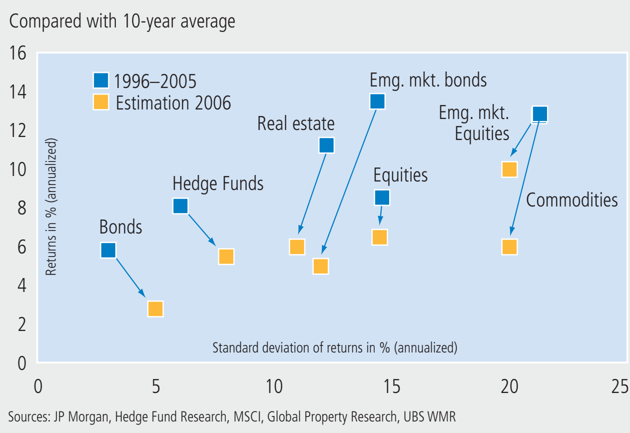
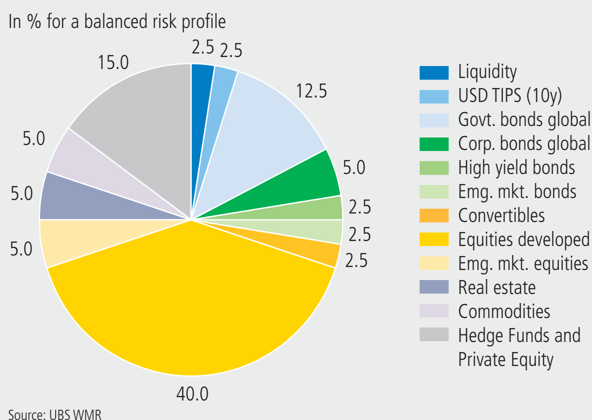
Risk/return profile of asset classes



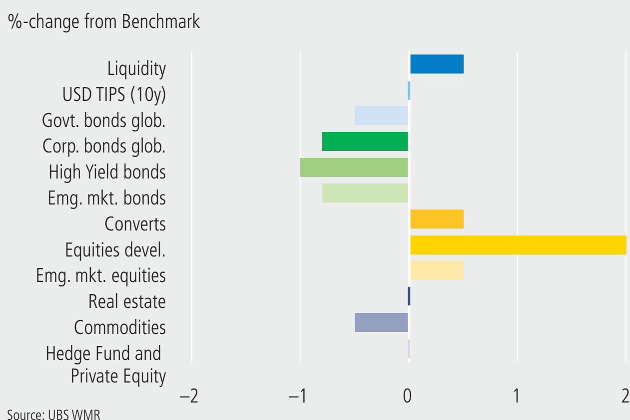
Sources: JP Morgan, Hedge Fund Research, MSCI, Global Property Research, UBS WMR

Benchmark Allocation



Source: UBS WMR

Tactical Asset Allocation



Source: UBS WMR

Transition to weaker growth in the USA

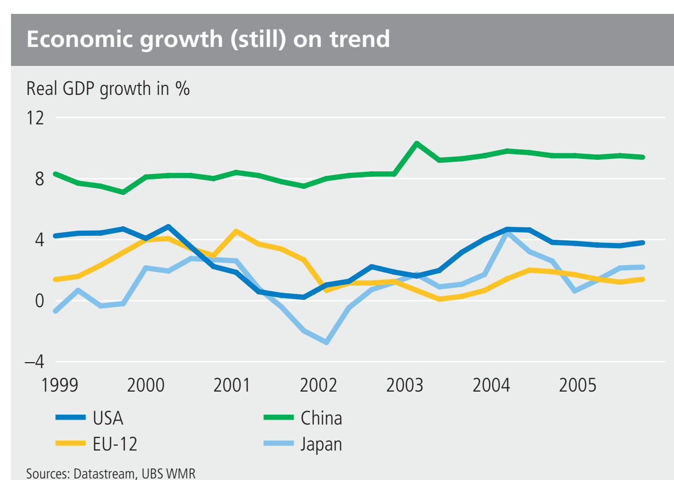
There is little chance of Asia escaping the economic slowdown affecting the USA, and domestic momentum is expected to be weak in Europe.

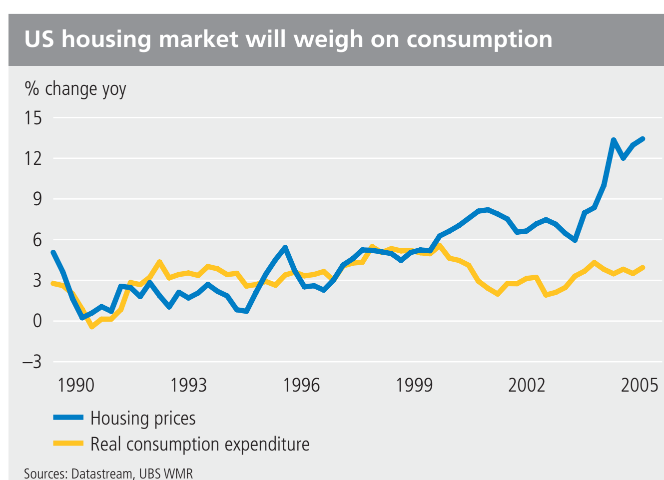
The majority of economies – even those of the major EMU member states – are running close to their trend growth rate of the last ten years. Typically, situations like this do not last long. Given the considerable international imbalances that exist and the rather onesided support to global growth being provided by the US consumer, we see greater risks to the global economic scenario on the negative than on the positive side.

A marked slowdown in store for US consumption growth

Despite the devastation wrought by successive hurricanes, the US economy held up well in 2005, growing at around 3.5%, although slower than in 2004 (4.2%). Consumer spending continued to be the mainstay of growth, keeping pace with the economy as a whole. However, we expect to see precisely this component of demand begin to flag in 2006. Private consumption will be underpinned by solid employment growth combined with a continuing rise in wages and salaries. However, the US household savings rate was already in negative territory by the third quarter of 2005. In other words, personal income was not sufficient to finance consumer spending and, as a result, households were having to dip into their savings. Moreover, a key component of household income – mortgage borrowing – is set to decline in the months ahead as a result of higher interest rates and a gradual weakening of upward price momentum in the residential property market. So-called mortgage equity withdrawals allow homeowners to borrow more when house prices are rising. Last year, this injected liquidity to the tune of more than 5% of disposable income. In the UK and Australia, where mortgage borrowing also accounts for a significant proportion of household income, the end of the property bubble has already taken a heavy toll on the growth of private consumption. In the United States, there will also be little impetus from other components of demand: the ratio of capital expenditure to GDP is at an historically very high level, the construction rate for owner-occupied housing is at an all-time high and the government is continuing to struggle to balance the books. Against this backdrop, we reckon on US growth of 3% in 2006 and just 2% in 2007.

Inflation will continue to creep up at the beginning of the year, before being held in check by a more neutral stance on the part of the Federal Reserve – we expect to see the Fed Funds Rate, the key US policy interest rate, being hiked to 4.5% in January, then remaining at that level until well into the year – combined with more stable or possibly even slightly lower oil prices. On average for the year as a whole, however, inflation is likely to be up slightly relative to 2005, from 3.2% to 3.4%.





German consumer growth remains subdued

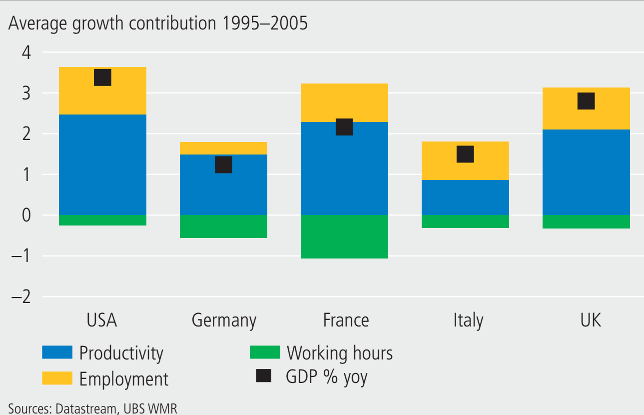
The three biggest EMU countries struggled to gain momentum in 2005. Italy may well end the year virtually stagnant and also Germany will probably only have achieved growth of around 1%. France has fared slightly better, though the economic impact of the unrest in the suburbs last autumn is difficult to assess. Though the news from Germany was more encouraging in the fourth quarter, the better-than-expected economic indicators were confined to industrial production and the export sector. The biggest cause for concern, as far as Europe is concerned, remains the German consumer. In 2005, for the first time in post-war history, Germany saw nominal wage levels fall over the previous year. In other words, neither developments on the employment front nor salaries are fuelling demand. This has its brighter side, however, as unit labour costs are continuing to decline relative to Germany's competitors in the export markets. Since 1999, Italy and France have seen the cumulative growth of their unit labour costs exceed Germany's by more than 15% and 5% respectively. Prior to the introduction of the euro, such imbalances would have been corrected by a depreciation of the relevant currencies against the deutschmark. Even given a global economic slowdown, the export sector will continue to bolster growth in Germany, though not sufficiently to compensate for the lacklustre contribution by the domestic market. We do not anticipate that the forthcoming football World Cup in Germany will have much of an impact, and it is doubtful whether even a victory by the host nation would be enough to lift consumers' spirits. Despite the ongoing political stalemate in which the country finds itself, we expect that the grand coalition under Chancellor Angela Merkel will at least continue the reforms embarked upon by the previous government. Italy faces parliamentary elections in the spring of 2006. As things stand, however, we are somewhat sceptical about the will to reform. The same is true of France, where we think it unlikely that we will see any serious reforms ahead of the presidential elections in the spring of 2007. Overall, the EMU should see growth of around 1.5% for 2006 and 2007.

With slightly better-than-expected economic indicators from the euro zone in the fourth quarter, the European Central Bank has increased its interest rates for the first time in three years. We expect to see an initial tightening of interest rates in the next couples of months. However, there is a risk that a more restrictive stance on the part of the ECB could choke off European growth. Outside of the euro zone, our forecast for the coming quarters is that the UK economy will bounce back and Switzerland will continue to make headway, growing faster than its neighbours again in 2006 as it did in 2005.

Asia is unable to buck the trend – China, though, remains solid

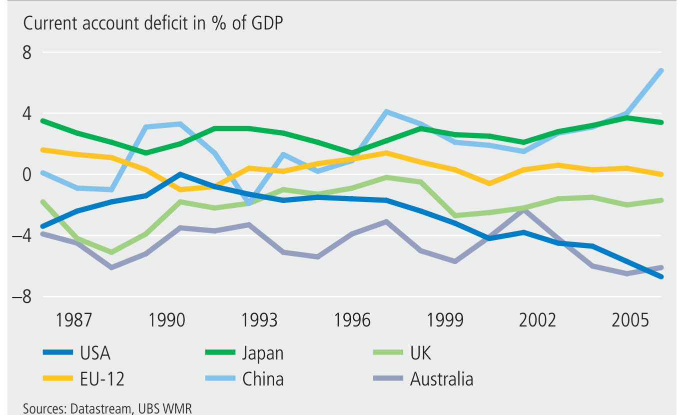
Economic growth in Asia was above the global average trend again in 2005. China once again ended the year with GDP growth of over 9%, whilst Japan – after a shaky start to the year – managed to post growth of 2%. Despite the growing importance of inter-Asian trade, we do not believe that the region will be able to buck the trend and escape the weak growth besetting the US economy. Not least because a large part of this inter-Asian trade is made up of intermediate, not end products. As such, the US slowdown will leave its mark on Asia, too. In China, however, the 11th Five-Year Plan – which also

Different causes of growth lacking in EMU Big 3



Sources: Datastream, UBS WMR

Global imbalances will continue



Sources: Datastream, UBS WMR

includes the 2008 Olympic Games in Beijing – should largely compensate for the slackened growth caused by exports. Japan looks set to gradually put deflation behind it, thus spelling the end of its zero interest rate policy. However, moving away from the ultra-expansionary monetary policy that it has pursued for so long – and getting it right – will be one of the biggest challenges for Japan in the year ahead.

Despite the slight slowdown in the US economy in 2006 and particularly 2007, there are no signs as yet of any correction in the significant international imbalances that exist, namely the high US current account deficit and the correspondingly high surpluses in Asia and the oil-exporting nations. All in all, 2006 is set to be a year of transition on the economic front, with global growth down slightly relative to 2005 but higher than it is likely to be in 2007. On the back of high energy and commodity prices, inflation will reach a new high in the second half of the year before gradually edging back down again. ■

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A word about bird flu

The year 2005 was marked by a number of events which, though not economic in origin, in some instances had serious economic ramifications. Alongside the hurricanes, the persistent instability in the Middle East and the threat of international terrorism – with attacks in London, Sharm el-Sheikh and Bali – comes the spectre of avian influenza or "bird flu". As things currently stand, this presents only a latent risk, as the H5N1 virus has so far only been transmitted from animal to animal or animal to human, not from human to human. Nevertheless, there is a danger that the virus might mutate, causing a pandemic. According to the World Health Organization, it is not a question of if but when that a pandemic will come. Nevertheless, not only the timeframe but also the impact of the mutated virus on human health remains unclear. Possible scenarios range from a harmless infection, to something along the lines of SARS, to a global pandemic claiming two or three million lives. Given that there is no way of knowing when a possible mutation might occur, or what it might mean in terms of human health, it is difficult to say with any certainty what the impact on the global economy might be.

However, the SARS epidemic gives us some idea of how sensitively economies can react to disasters of this kind. With 280 confirmed cases and approximately 40 deaths – all of them in Toronto – Canada's growth fell from 3.1% in the first quarter of 2003 to –1.3% in the second quarter and took six months to recover. Hong Kong, too – with 1,800 or so confirmed cases and 300 deaths – felt the economic effects of SARS in 2003, with growth estimated to have fallen by between 1.5 and 3 percentage points as a result. So even a relatively minor pandemic could hit the global economy extremely hard indeed. But, as noted, it is impossible to assess the concrete implications for economic growth with any certainty based on the information available at the present time.

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WMR Economic forecasts

	GDP growth in %				Inflation in %			
	2004	2005	2006	2007	2004	2005	2006	2007
USA	4.2	3.4	3.0	2.0	2.7	3.1	3.4	2.7
Canada	2.9	2.8	3.0	2.5	1.8	2.0	1.8	1.5
Australia	3.6	3.0	3.0	3.0	2.2	2.5	2.5	2.0
Japan	2.6	2.0	2.0	2.0	–0.1	–0.1	0.2	0.4
EMU	1.7	1.3	1.6	1.4	2.1	2.2	1.8	1.5
Germany	1.6	1.0	1.3	1.4	1.6	1.9	1.5	1.0
France	2.1	1.6	1.7	1.6	2.1	1.8	1.5	1.8
Italy	1.0	0.3	0.9	0.5	2.3	2.1	1.9	1.5
Spain	3.1	3.3	3.0	2.5	3.0	3.3	3.0	2.6
Netherlands	1.7	0.5	1.6	1.9	1.4	1.5	1.3	1.6
UK	3.1	1.7	2.4	2.3	1.3	2.1	2.2	1.8
Sweden	3.1	2.3	2.8	2.6	0.5	0.6	1.4	1.9
Switzerland	2.1	1.9	2.0	1.3	0.8	1.1	0.6	1.1
China	9.5	9.2	8.5	8.2	4.0	2.5	2.3	2.0
Asia[1]	6.0	6.7	6.4	4.5	3.3	3.5	3.5	3.3
Latin America	6.0	4.0	3.8	3.2	7.3	6.0	6.4	5.8
Central/Eastern Europe	6.2	4.9	4.6	4.4	8.6	7.4	7.2	6.5

[1] Excluding Japan

UBS WMR forecasts

Interest rates	3-month LIBOR		10-year govt bond	
	mid 06	end 06	mid 06	end 06
USD	4.50	4.25	4.70	4.50
EUR	2.30	2.30	3.60	3.70
JPY	0.10	0.30	1.80	1.90
GBP	4.60	4.60	4.40	4.40
CHF	1.30	1.25	2.30	2.50
AUD	5.50	5.50	5.50	5.50
CAD	3.60	3.60	4.30	4.50
SEK	2.10	2.40	3.30	3.60

Currencies	vis-à-vis EUR		vis-à-vis USD	
	mid 06	end 06	mid 06	end 06
USD	1.20	1.24	1.00	1.00
EUR	1.00	1.00	0.83	0.81
JPY	137	134	114	108
GBP	0.69	0.69	0.57	0.56
CHF	1.53	1.51	1.28	1.22
AUD	1.58	1.61	1.32	1.30
CAD	1.44	1.41	1.20	1.14
SEK	9.15	9.00	7.63	7.26

US dollar faces challenges

The slowdown in US consumption and the end of deflation in Japan will pose the major challenges in 2006. Both harbor the risk of a weak USD.

The USD is likely to be preassured in 2006 from the substantial current account imbalance between the USA and its trading partners in Asia and the Middle East. The anticipated slowing of US consumer spending, the lack of budget discipline and the concerns about inflation are other factors that will adversely impact the US currency. The USD's weakness will likely benefit the EUR, GBP, AUD, CAD, CHF and other diversification currencies. China's slowly ebbing resistance to a revaluation of the renminbi against the USD favours investments in other safe currency areas. The highlysophisticated Japanese financial market presents additional risks, however, as the end of deflation nears. The process of transition from an expansionary stance in support of the economy to a policy of tighter budget discipline has the potential to trigger some currency fluctuations.

Living with deficits

In the last few years the USA has been running high budget and current account deficits without the USD depreciating sufficiently. In fact, the dollar is massively overvalued against the yen and the renminbi. Its exchange rates against the other G7 currencies are reasonably close to fair value. The keys to this USD strength are a high savings rate abroad, coupled with attractive investment opportunities in the USA. Foreign savings have financed US government and private household consumption, themselves the main engine of growth in the global economy for many years. US treasury securities and bonds issued by the housing agencies (which securitize mortgages) and other financial institutions have therefore dominated USD underwriting. At present, these securities can hardly be beaten in terms of liquidity and quality. Unfortunately, neither lacklustre Europe nor the still relatively closed growth markets of Asia offer comparable investment alternatives.

USD dependent on US consumption

We think US consumption and the US real estate market will cool significantly in 2006. This is likely to negatively impact the liquidity and quality of issuance in US securities. Where investors from Asia and Europe turn as a result, may represent a challenge in 2006. Both regions are enjoying huge inflows of USD thanks to strong exports. If investors increasingly seek alternatives to traditional investments in USD bonds, there will be little to keep the USD from depreciating. The obvious candidates for this correction process are in undervalued Asia. However, Japan, the largest Asian bond market, at present does not provide sufficient security as an alternative to the US market.

Japan's long road to normalcy

The JPY is significantly undervalued against the USD and EUR. Deflation has pushed purchasing power parity so far out of line that today the JPY would have to appreciate approximatively 20–40% to be on par with goods prices in the G3 (USA, euro zone and Japan). The weak JPY is partially a consequence of Japan's extremely expansive monetary and fiscal policies. However, with the expected end of deflation, a more restrictive stance is likely in the cards.

The ample money supply accumulated over the last few years must gradually be scaled back. The Bank of Japan has on various occasions indicated that it expects inflation to rise in the next two years and that it is looking for an opportunity to reduce the large pool of money in circulation. The JPY's performance will depend on how successful this process turns out to be. In the medium term, we think normalization in Japan will lead to a stronger JPY, with the exchange rate reaching fair value against its main trading partners.

The normalization process does involve risks, however, which at least at times will probably result in phases of weakness for the JPY. Japan has learned to live with high and increasing levels of government debt. The end of the zero-rate interest policy now adds a new dimension to the debt situation. Until now, the government deficit could be financed thanks to low interest rates. Any rise in interest rates would, however, markedly increase government outlays. The threat of a regime with a higher tax burden could definitely

encourage capital outflows, which in turn would weaken the JPY – at least temporarily – relative to its current level. The strength of this pressure depends on political decisions, the course adopted by the Bank of Japan and growth prospects. The faster China and the whole region grows, the easier it should be to achieve the transition to an economy with "normal" inflation.

The renminbi as Asia's lead currency
We believe China is likely to maintain the rate of growth posted in the last few years of between 7.5% and 9% per annum. This expansion has been accompanied by a rather leisurely rise in the renminbi, as China wants to protect its export opportunities. The renminbi's appreciation will probably match market expectations at best, but hardly surpass them. Especially if US consumption slows, China is likely to be reluctant to allow too strong an appreciation in the renminbi, as the country's growth is still heavily dependent on exports. In the light of this, the renminbi, potentially Asia's lead currency, will hardly gain significant independence from the USD in 2006. The low level of fluctuation between the CNY and USD underlines the importance of the EUR as a major, independent currency area.

The euro as an unexciting alternative
Unfortunately, there are no currency areas that are free from problems. The USA has a mounting foreign trade deficit, Japan is struggling with deflation and the euro zone is suffering from lethargic economic growth, its over-regulated economies stifling any real upturn. In 2006, this is unlikely to be any different from previous years. However, the euro remains interesting for investors, as it represents a huge capital market. Increasing liquidity and the comparatively good quality of borrowers make the euro attractive for investors wanting to diversify their currency portfolios. It is true that investors seeking high yields and growth opportunities would do better looking at other regions. If, however, the markets expect a phase of uncertainty, because consumption is slowing in the US, economic policy is shifting in Japan and the Asian economic engine starts to falter, then the EUR would provide a haven of relative stability. We therefore expect the euro to post renewed gains against the US dollar in 2006. Together with the euro, the Swiss franc has good upside potential against the USD, and should gain slightly against the EUR, in view of superior economic performance in Switzerland. Despite isolated rate hikes by the Swiss National Bank, Switzerland should continue to stand out internationally as an island of low interest rates.

Alternative currencies still popular
The British pound, the Canadian, Australian and New Zealand dollars, the Norwegian krone and the Swedish krona have performed well in recent years for various reasons. Their economies have remained firmly on a growth path independent of the USA or the euro zone. The UK, Australian and New Zealand currencies have also benefited from high interest rates. International investors looking for alternatives to the USD, EUR or JPY may find attractive opportunities in these currencies. Continuing high commodity prices, stable real estate markets and the problems of the three major currencies referred to above will favour such options. ■

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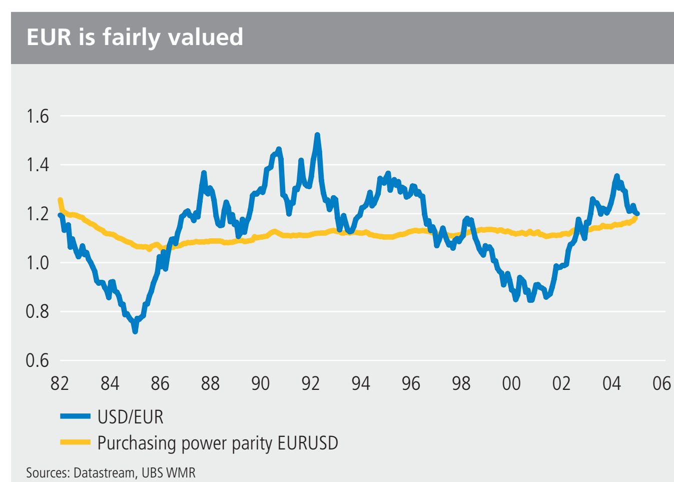
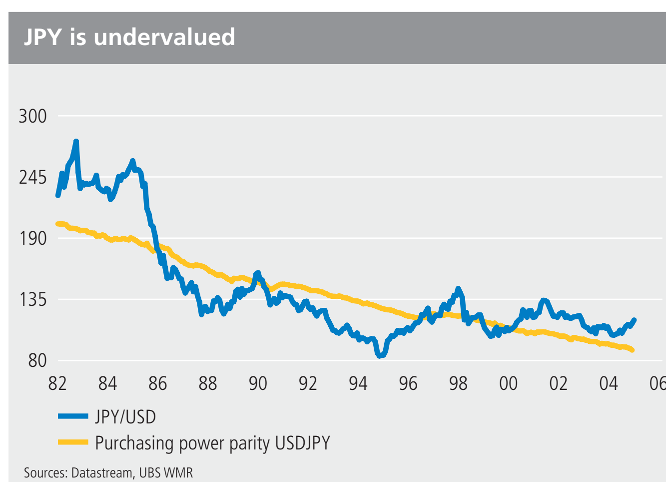
EUR is fairly valued



Sources: Datastream, UBS WMR

JPY is undervalued



Sources: Datastream, UBS WMR

Fair equity valuations provide support

The slowdown in economic and earnings growth in the US poses a risk for stock markets. Fair valuations mean equities remain attractive to longer-term investors.

2005: marked regional divergence

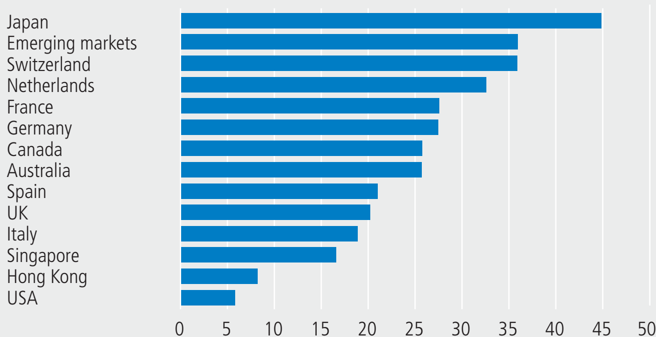
2005 was an excellent year for equities in many areas of the world, with the notable exception of the US. As we expected, the European market has lost some of its valuation advantage over the US. While European equities achieved high double-digit gains, investors were disappointed by the weak annual performance of US stocks. Switzerland led the pack in Europe, followed by the eurozone and the UK. Other regions of the world also gained significant ground on the US. Measured in local currency terms, Japan performed extremely well. Performance in the emerging markets was also very strong, albeit with significant variation between regions and countries. At sector level, the high price of oil pushed the energy sector to the top of the performance rankings. Sector yields were primarily impacted by fluctuating economic expectations as well as the price of oil. Consumer durables such as cars, domestic appliances and computers, which are vulnerable to cyclical shifts, did relatively poorly compared with the more stable consumer staples. Telecoms suffered from uncertainty over the sustainability of the major telecom providers' business models, especially in Europe.

2006: a chill wind blows

This last year saw a slowdown in global growth. We expect this to continue into 2006, particularly in the US. Interest rates are also likely to rise further, while earnings growth will level off appreciably, creating a challenging environment for equities. However, it is important to put this fundamental scenario for equity markets into context. Market participants have already discounted further interest rate hikes by the US Federal Reserve. Similarly, the market is already anticipating slower earnings momentum. Surveys indicate that institutional investors are only expecting corporate earnings to rise in line with overall economic growth, and further margin expansion has been ruled out. As a result, there is limited potential for unpleasant surprises. Our models also confirm that the US equity market is fairly valued, even on conservative assumptions regarding corporate profitability. For example, we assume that current US earnings are roughly 15% above the long-term trend, and that this will be corrected over the next few years. Fairly valued means investors can count on normal returns in the long term, which we would put at around 7.5% for the US. We estimate that valuations for the eurozone and the UK remain favourable, implying even slightly above-average potential returns in the long term. As a result, equities remain an attractive asset class, despite the more challenging cyclical climate. That said, investors will need patience and strong nerves in the face of increased risks. On the other hand, the expected end to US monetary tightening in 2006 may in time cause equity markets to rise.

Equity market performance in 2005

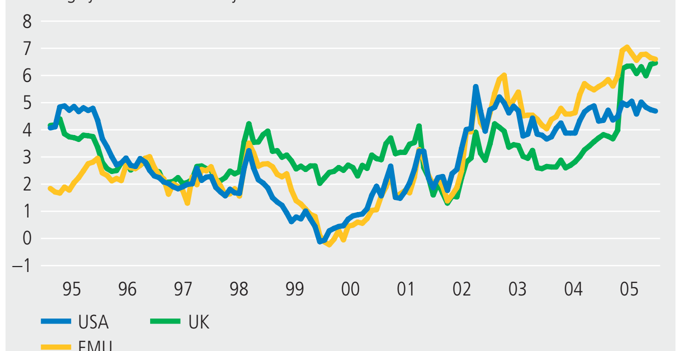
Total return in % and local currency



Source: Datastream

Risk premiums still attractive

Earnings yield less real bond yield



Sources: Datastream, UBS WMR

Japan: valuations pose an obstacle

While the fundamental valuation of the US has improved against other markets, the opposite is true of Japan. The Japanese market has shot up in a short space of time, thanks to increased economic growth, Koizumi's political victory in the context of post office privatization and encouraging corporate earnings. Although the position of Japanese corporations has improved significantly, we still do not believe this warrants a valuation premium of around 20% against the US market. We expect these exaggerations in the Japanese market to be corrected in the course of the year, and that the market will underperform the global equity market. Europe remains the most attractive region. The latest profit indicators continue to show real strength there, and the growth in margins in the eurozone may well persist into 2006 in light of ongoing restructuring at the corporate level. The UK market enjoys a similarly attractive valuation to that of continental Europe, although cyclical earnings risks are higher. Having performed extremely well last year, Switzerland has now lost some of its appeal and may lag behind other European countries in the coming year. We continue to take an optimistic view of the emerging markets in the long term. However, the cooling US consumer demand and higher interest rates may signal increased risk in 2006.

Slowdown favors stable growth sectors

The past year has already shown that investors are increasingly on the look-out for stocks and sectors that will continue to offer stable earnings, despite a tougher macroeconomic environment. As this is likely to intensify further in 2006, we expect that strongly cyclical sectors, such as industrial goods and materials, will experience harsher conditions than sectors which are less susceptible to economic shifts, such as healthcare and everyday consumer goods. We still see good value in the financial sector overall, which should be enough to compensate for increased cyclical and interest rate risks. The key factor for the energy sector will continue to be the price of oil, which we do not expect to drop suddenly. This should help to sustain stock prices, even if structural problems become increasingly evident. Utility companies continued to perform well in 2005 and are now over-valued in our opinion. On the other hand, we see potential in the European telecoms industry, which investors have so far shied away

Large caps vs. small caps: Goliath fights back

In 2005, the strong outperformance of US small caps – stocks with a small market capitalization – against large caps prevalent since 2000 came to a halt, leading to very similar average returns for the two groups. Companies in the middle range (mid caps) still managed to outperform. This year we expect large companies on average to perform better than smaller companies in the US.

This view is based partly on valuations. Smaller cap companies currently have relatively high valuations in the US. Comparison of P/E ratios shows that large companies were relatively expensive during the tech frenzy in the late 1990s. But today their valuations are lower and their multiples are on average more attractive. This change is due to the strong gains made by small companies in recent years, but it is also the result of improved profitability of large companies, which are now producing higher earnings yields than small companies.

Besides valuations, the economic outlook also favors large companies. Interest rates in particular exert considerable influence on the relative appeal of firms. The Federal Reserve has for some time been pursuing a policy of raising rates. The result is that the yield curve in the US has become noticeably flatter. In the past, firms with weak balance sheets and smaller companies have been the first to come under pressure when monetary policy became more restrictive. One reason for this lies in corporate financing. Compared to small companies, large corporations have many avenues available to them for raising funds. They can borrow from the banks or raise capital in the financial markets. By contrast, small companies often have no direct access to the capital markets. Small caps also tend to be focused more heavily on a single sector or region. Overall, their profits are more exposed to the economic cycle than those of large companies.

Although, to improve diversification, it remains worthwhile in the long term to invest part of the portfolio in small and mid-cap indices, the current outlook in the US suggests a tactical overweight of large caps. In Europe, the difference is less marked, due to lower cyclical risks, although, there too, valuations favour large caps.

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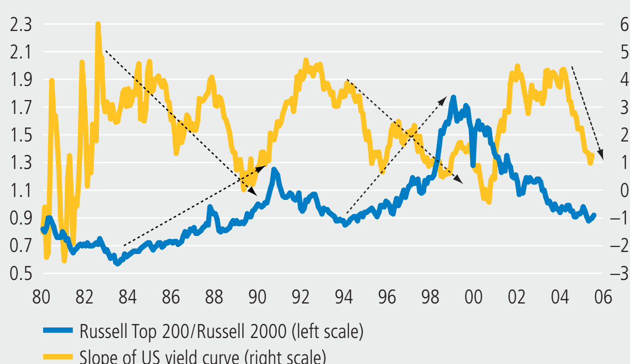
Large firms outperform small as yield curve flattens

An increase in the blue line indicates that large firms are outperforming small firms



Sources: St. Louis Fed, UBS WMR

from despite positive valuation indicators. We believe that concerns over the long-term business outlook are exaggerated and that 2006 may well be the year of recovery. Premium valuations and cyclical risks in the IT sector remain a concern, although relative earnings strength might limit the downside. With regard to investment style, we expect the group of stocks with high market capitalization to outperform small cap companies, notably in the US (see box on page 13). ■

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Leverage has potential to boost return on equity

Return on Equity (ROE) has been one of the key drivers of stock market performance in the last 10 years. Indeed, over long periods of time, once bull and bear markets average out, companies whose return on equity is higher than their cost of capital, generate value. This value generation is, sooner or later, reflected in the form of share price performance. Because we expect 2006 to yield normal share price returns in the area of 6%–8%, we are convinced that, in this environment, an improvement in ROE will be rewarded by the market.

We have separated ROE into the three traditional components of the DuPont analysis, and have concluded that leverage is the area where companies can do most in their attempt to boost ROE. These are the three traditional components of ROE:

- Net margin: Net Income divided by Sales revenues
- Asset turnover: Sales Revenues divided by Invested Capital
- Leverage: Invested Capital divided by Equity

We use one of the typical equations of the DuPont analysis for Return on Equity:

ROE = Net Margin x Asset Turnover x Leverage

If we analyze the drivers of each of these three components, we quickly realize that leverage is the ROE component which can be most easily improved in 2006. Indeed, four years after the burst of the bubble, leverage levels (e.g. Net Debt divided by Total Assets) are low, at only 25%.

Margins are close to all-time highs (the average MSCI World operating margin is at 13.5%, the highest of this decade) and, hence, are difficult to be improved going forward. Macroeconomic growth concerns looming in 2007, coupled with subdued guidance from market leading companies will make sales revenues difficult to grow substantially in 2006.

Finally, as said, leverage is close to all time lows, as free cash flow generation continues to be strong in many sectors. However, current projections suggest that corporate financial leverage could continue improving well into 2006. Given the importance of ROE to valuation, one would think that efficient capital allocation would be a top priority in the corporate world. We are convinced that this is where corporate management teams can surprise the market in 2006.

This should not be a cause for alarm. Adding a limited amount of leverage does not imply that companies take significantly more risk. Market pressure and the increased scrutiny has brought discipline to executive boardrooms. Rather, we have merely run the numbers to see what would happen if, all else being equal, leverage in 2006 would be the same as in 2005. In other words, we have run the numbers for 2006 assuming that the drag from having too much cash in the balance sheet is not further increased. What we have found is that, on average, ROE would increase by more than 15%, from 17.2% to 19.9%. But this growth is not equal across sectors. The sectors which would benefit the most would be: Specialty retail (Consumer Discretionary), Computers and Peripherals (Information Technology), Healthcare Providers and Services (Healthcare), Food (Consumer Staples) and Diversified Financial Services (Financials).

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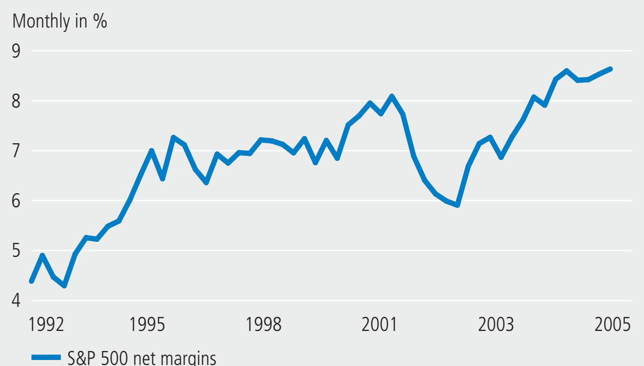
Margins are at historically high levels



Sources: Standard & Poor's and UBS IB

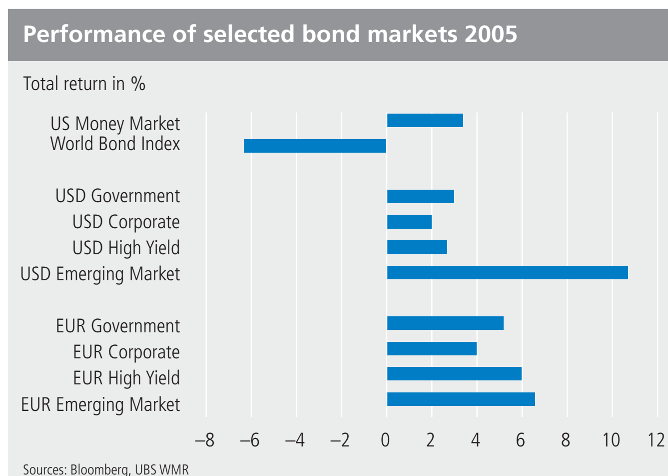
Interest rates remain low

Structural factors may be pointing towards a global rise in interest rates, but the economic slowdown in the USA suggests otherwise.

Short- and long-term rates are at historically low levels throughout much of the world due to modest inflation expectations and low real interest rates. While central banks have generally succeeded in stabilizing inflation expectations, trends in savings and investment over the past few years have driven real interest rates down to an exceptionally low levels. The industrialized countries' investment share of GDP has declined markedly in recent years, and although it has continued growing among the emerging markets, this growth has not been enough to offset the decline in the developed countries. There are both cyclical and structural factors behind this phenomenon. On the structural front, the growing importance of the services sector is presumably reducing investment volumes in the industrialized nations. Production capacities are currently being outsourced to emerging markets, where investment projects are at times running up against capacity restrictions. Among the cyclical aspects worth mentioning are companies' efforts to improve the quality of their balance sheets by reducing debt ratios. In addition, investment was scaled back after an extremely expansionist phase prior to the turn of the century.

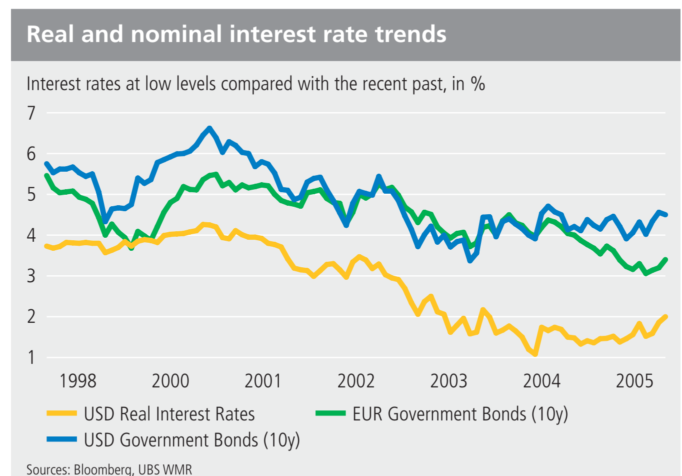
The trend in savings is exactly the opposite, however, with the emerging markets more than making up for declining savings patterns in the industrialized nations. This is due to the desire among the Asian countries, following the Asian crisis and the related capital flight, to build up reserves in foreign currencies. They have therefore kept their exchange rates undervalued and used export surpluses to generate foreign exchange reserves. China too is pursuing an export-oriented growth policy. In the Middle East, the oil-exporting countries also have significant export surpluses at the moment. These trends have increased the amount of savings that, as described above, is currently encountering rather weak investment demand.

Slowdown in growth neutralizes structural interest rate pressure
The influence of these factors will slowly recede in the future. Decision-makers in Asia, for example, with mounting holdings of foreign exchange, will be increasingly ready to allow their currencies to appreciate. A reduction in saving can also be expected in Europe and Japan, as job insecurity declines. Company balance sheets are in the meantime showing significantly reduced gearing ratios. It can therefore be expected that more money is likely to be invested again in the companies concerned. Based on these factors alone, one would expect interest rates to rise moderately in the next few years.



Performance of selected bond markets 2005

Sources: Bloomberg, UBS WMR



Real and nominal interest rate trends

Sources: Bloomberg, UBS WMR

Nevertheless, the anticipated slowing in the pace of US growth does not point to rising yields on the bond market. In particular, the expected increase in private savings in the USA suggests downward pressure on long-term rates. As a consequence, we do not expect long-term interest rates to change significantly to the up- or downside, but to remain within a fairly tight range.

Rates narrow worldwide

For the EUR bond market, we think that the yield spread against the USD should narrow somewhat as growth rates converge, and rates, including in Switzerland, should rise slightly overall. The reverse is true for the SEK and CAD bond markets, however. They have seen a narrowing of yield spreads thanks to significantly lower inflation rates than in their respective reference markets, i.e. the euro zone or the USA. This cyclically driven trend should reverse in the future, resulting in a marginally worse performance for these markets. The Japanese bond market will involve the most risk in 2006. The country's improved economic performance is likely to convince the Japanese central bank to end its zero-rate interest policy either this year or next. The expectations of rising money market rates will probably be coupled with higher long-term interest rates, resulting in a heavier interest burden on the government budget. This in turn could be reflected in a rising risk premium, a potentially unwelcome scenario for bond investors. ■

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The wind is turning against corporate bonds

Corporate bonds delivered more modest returns in 2005 than in the heady days of 2004. Except for European high yield, corporates did not significantly outperform government debt, while the associated risks continued to mount.

Incentives increasing for shareholder-friendly corporate actions

An important reason for the sector's modest returns was the emergence of a trend among companies to pursue shareholder-friendly activities, such as dividend increases, share buybacks and greater M&A. In our view, such steps will be necessary to support return on equity if earnings growth slows as expected. By their very nature, shareholder-friendly actions tend to be detrimental to existing bondholders, due to their likely negative impact on issuers' credit quality and debt levels. This increases the likelihood of defaults in the future.

Slight deterioration in credit quality

Corporate default rates reached a cyclical low in 2005, falling below 2% of the global outstanding high yield bond volume, compared with more than 10% in 2001.

We expect that default rates in the US will begin rising from their low levels as early as the first half of 2006, with the trend reversal in Europe coming later. The proportion of new bond issuance with lower credit ratings has picked up in the last three years, signalling higher default rates in the future. Historically, a rise in high-risk issuance typically results in a higher frequency of defaults, with a lag of around three years.

Credit spreads, i.e. the difference between interest rates on bonds of high and low credit quality, will probably respond to increased defaults with a slight lead. Expectations for spread-widening would likely result in corporate bond returns that are not substantially different from government bonds this year.

A volatile environment for corporate paper

The end of the Fed 's tightening cycle is in sight, harboring potential for more volatile bond markets. Turning points of this kind are typically beset by much uncertainty, as market participants tend to take different views on the exact timing; and the markets are extremely sensitive to news flow on growth and inflation. This is likely to be especially true for corporate bonds, which themselves are at a turning point with regard to credit quality.

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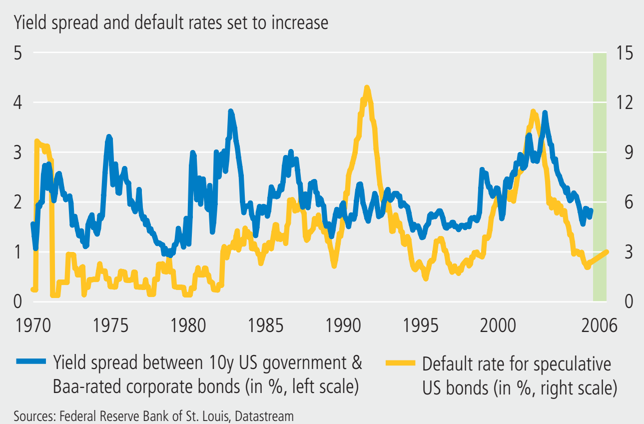
Corporate bonds at a turning point

Yield spread and default rates set to increase



Sources: Federal Reserve Bank of St. Louis, Datastream

Time to be more selective

Emerging markets tend to be sensitive to global risks. In an environment of slower global growth, investors need to focus on the lower-risk markets.

Emerging market investments enjoyed another year of strong performance, as both bonds and equities performed well. This performance took place against a mixed background. On the one hand, economic fundamentals in most emerging markets remained strong. On the other hand, valuations in both bond and equity markets reached new highs, raising questions regarding the degree to which markets may be pricing in an overly optimistic outlook.

Against this backdrop, 2006 is likely to be a more challenging year for emerging market assets. Global liquidity conditions have tightened. Global economic activity is likely to slow, and downside risks are numerous. Historically, this combination of factors has never been the most propitious for emerging markets. However, a number of factors lead us to believe that emerging markets are unlikely to perform poorly. Rather, investors looking into emerging market opportunities will need to be more risk-aware and selective.

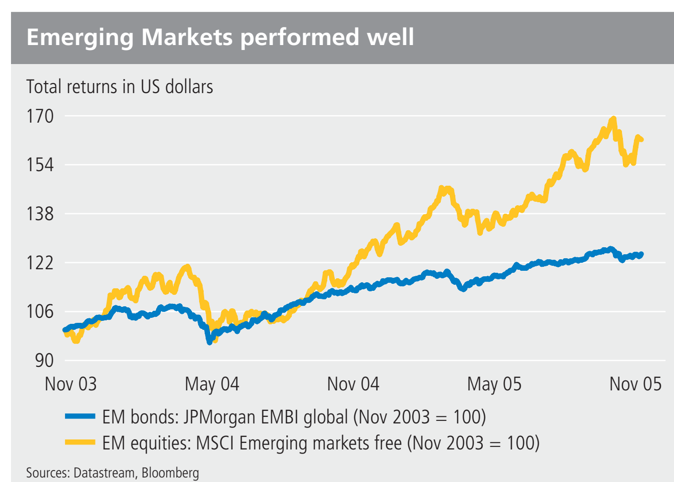
Macroeconomic stability likely to continue …

Over the past few years, most emerging markets have been reasonably successful at attaining a good degree of macroeconomic stability. In Asia, continued rapid integration into the global economy has been accompanied by high rates of economic growth, consistently large current account surpluses, and the accumulation of substantial external reserves. In Latin America, prudent fiscal policies combined with favourable commodity prices have also enabled a similar pattern. Commodity producers elsewhere, notably Russia and South Africa, have also benefited. The only region where current accounts have deteriorated recently is Eastern Europe and Turkey, but this deterioration need not be the cause of too much alarm. This is because new or prospective EU members have been able to attract sufficient foreign direct investment to finance these deficits.

This picture does not imply that emerging markets are immune to a slowdown in the global economy. Indeed, as emerging markets become more integrated into the global economy through trade and financial flows, slower economic growth in industrial countries will certainly take its toll. However, the comfortable balance of payments and reserve positions of most countries provide a cushion that should reduce the risks to investors.

… but reforms may lag

While most emerging markets may have been successful at achieving macroeconomic stability, many countries have lagged in adopting microeconomic reforms designed to enhance economic efficiency.



Sources: Datastream, Bloomberg

Bond returns calculated based on JP Morgan's EMBI Global, Equity returns based on MSCI Emerging Market Free Index.
Source: UBS WMR

In parts of Asia, reforms continue at a measured pace. China is undertaking an important transformation of its banking system. The Philippines is implementing a long-overdue reform of its tax system. Complicated coalition politics, however, have virtually stalled the reform process in India.

In Latin America, microeconomic reforms are particularly necessary, as this remains the region with the lowest investment rates among emerging markets. Little progress can be expected here in 2006, however. There will be 11 elections in the region, including presidential elections in the two largest economies, Brazil and Mexico.

In central and eastern Europe, the outlook for policy reform is mixed. In Poland, Hungary and Russia it is unlikely that economic reforms will be pushed forward. Poland's recent election results have not led to a clear market-friendly mandate. In Hungary, politics ahead of the elections imply that fiscal policy will remain very loose. In Russia, the accumulation of large fiscal surpluses seems to have led to a degree of complacency and reduced the incentives for reform. The only exception in the region is Turkey, where reform momentum remains somewhat positive.

Lagging reforms do not necessarily lead to deterioration in the economic outlook. Without measures that clearly lead to improvements in the medium-term outlook, however, investment returns are likely to be modest.

Focus on lower-risk markets

In an environment where risks are more likely to increase than to decline, investors need to focus on two groups of countries, namely countries with relatively high credit ratings and those where sovereign risks are likely to continue to decline. This is relevant not only for bond markets but for equity markets, too, as external bond spreads have an impact on companies' cost of financing.

Emerging market bond spreads have declined to all-time lows. In line with our outlook for all credit spreads, we expect that spreads will begin to rise during the course of the year. In such an environment, bonds from the higher-rated emerging markets such as Chile, China, Korea, and Mexico will outperform. Lower-rated emerging markets such as Ecuador and Venezuela are likely to suffer. In Brazil and a number of other countries, however, spreads are unlikely to change. This is because spreads in these countries remain above the average for similarly rated corporate bonds, while there are good prospects for credit rating upgrades.

Investors also need to be selective in emerging equity markets. Earnings in these markets are not solely dependent on local market developments. Indeed, a substantial number of companies in emerging markets derive their earning from global sales. This is the case in the export-oriented economies of Asia as well as in Brazil, Israel, Russia, and South Africa.

Valuations for emerging market equities, meanwhile, remain relatively reasonable. Valuation multiples such as price-to-earning and price-to-book ratios remain well below those in industrial countries, while return on equity is much higher. Corporate governance, transparency and regulatory standards have also been improving in most countries. At the same time, although global growth may slow, we do not expect a meaningful decline in oil or other commodity prices, an important source of earnings for many emerging markets.

We expect global factors to have less of an impact in equity markets where domestic demand is likely to remain robust, such as China, or where we expect it to rise, such as Korea. In Brazil and Turkey, where real interest rates should continue declining, equity markets should also benefit. Weak fiscal and balance of payments positions in some of the eastern European countries and India, coupled with demanding valuations, are likely to expose these markets to higher risks. ■

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Real estate investments have reached cruising altitude

2005 has seen exchange-listed real estate investments end their steep ascent with double-digit returns and stabilize at cruising altitude with expected annual returns in the mid to high single figures. Turbulence due to the risk of inflation and a possible slowdown in growth in the US may well result in greater market volatility in 2006.

Once again, real estate was a popular choice with investors in 2005, with high dividend yields and attractive diversification characteristics remaining the main incentives to buy. Markets such as Eastern Europe also attracted foreign capital, with high expected returns in excess of 10% on direct investments. In continental Europe and the Asian markets, too, investors were able to earn returns of 20% or more, at least with exchange-listed real estate investments. Structural and regulatory improvements, the undervaluation compared with other major markets at the beginning of the year and the booming economy in Asia, amongst others, all played a part in this development. In the meantime, the majority of real estate investment markets have become somewhat expensive, though they are not absurdly overvalued[1]. Only in the US do we view exchange-listed real estate valuations as overly elevated, with risk premiums below 0.5%, as expressed by the difference between dividend yield and the interest rate on 10-year Treasury bonds.

Direct investments: values rise on the back of surging investment demand

Direct investments in real estate performed well in 2005, thanks in particular to the strong demand for investment property. Rental trends, on the other hand, can best be described as subdued. Only in the Asia-Pacific region, South America and Canada did rents rise significantly in the commercial office market. In the retail space market, rents came under pressure in the Western industrialized nations as a result of the downturn in consumer spending. We expect that trend to continue in the major markets in the coming year. Whereas rents are unlikely to rise significantly due to the slowdown in economic growth and/or strong activity in the construction industry (in certain Asian markets in particular), the market value of direct investments looks set to continue to rise thanks to continuing high levels of demand. Those markets with a demand overhang – Hong Kong, for example – will offer above-average short-term return potential. However, high taxation and transaction costs will generally make it impossible to fully realize these profits.

[1] There are signs of overheating in certain residential property markets. However, these are not considered investor real estate and are not discussed here.

Further regulatory improvements are likely

The introduction of tax-efficient Real Estate Investment Trusts (REITs) based on the US model in certain European and Asian countries should continue to drive professionalization and increase market transparency. However, the much-discussed introduction in the UK and Germany in 2006 may well be postponed once again. The extent of the positive valuation effect on the firms concerned will depend on several factors. Basically, any revaluation should be less pronounced when interest rates are rising than at a time when they are at historic lows. Also, changes to the status of REITs are likely in some countries – Canada and France, for instance – as a result of unexpected shortfalls in tax revenues. Such a move could have an adverse effect on the valuation of REITs in the countries in question.

Fundamentals will be the main drivers of performance

Although certain markets will continue to benefit from improvements in the regulatory framework in the future, the performance of real estate investments in 2006 looks set to be determined primarily by fundamental factors such as supply and demand for floorspace and debt financing costs. Based on our economic forecasts, we expect to see total returns of between 4% and 8% in the direct investment market in 2006, depending on the country, and risk premiums relative to 10-year Treasury bonds of between 1.5% and 2%. Slightly higher returns are likely on exchange-listed investments – though still in single figures – due to the leverage effect of debt financing. The US real estate markets are likely to be the slowest due to rising interest rates, the downward trend in economic growth and high valuations. Inflationary fears could negatively impact the REIT markets and other real estate vehicles with high dividend yields in particular, given that these markets are – to a certain extent – regarded as an alternative to bonds and are interest-rate-sensitive. In general, we expect to see greater price fluctuations in exchange-listed real estate investments than last year.

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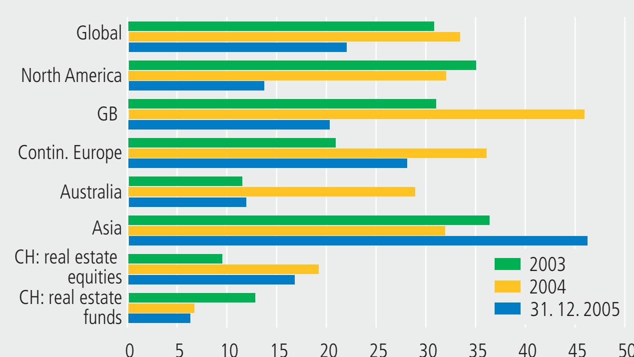
Initial returns on prime commercial office space

Returns are expected to fall further

Source: JLL

Return on exchange-listed real estate investments

GPR250 Index, SWX Real Estate Fund Index



Source: Datastream

Commodity prices remain elevated

Expanding demand combined with supply constraints suggest commodity returns will remain positive even after record performance last year.

China's tremendous economic growth has made it one of the biggest demand factors for commodities, and coupled with solid economic growth from the US and other developed markets, commodities delivered very strong performance in 2005. Supply capacity issues, low inventory levels and uncertainty in global geopolitics have especially supported prices for key strategic commodities such as base metals and energy. Looking ahead, we believe that these factors will continue to influence the performance of commodities in 2006, although slowing economic growth – especially in the US – might pose downside risks.

Fear factors impacted energy markets

With limited OPEC production capacity, the global energy markets became increasingly worried about the influence of geopolitical and weather-related events that might lead to oil supply outages and interruptions in refinery production. Political events like the death of King Fahd of Saudi Arabia or the alleged Iranian nuclear weapon program spurred uncertainty and fear.

In late summer and autumn, the extremely long and violent hurricane season in the Gulf of Mexico took center stage as hurricanes Katrina and Rita hit major oil-producing and refining facilities, leading to significant supply outages. In response to these disastrous impacts WTI crude oil prices hit all-time highs above USD 70/bbl, with the result that the energy market delivered the greatest price performance across all commodity classes in 2005.

Commodities remain well supported in 2006

Going forward, we expect global demand to remain firm during the first half of 2006, but we believe that fears could arise about the stamina of US growth in the latter part of the year.

The energy market is likely to remain volatile as refinery capacity issues resurface in the US, demand from Asia rebounds and supply growth remains meager, especially from non-OPEC producers. Geopolitical fears are unlikely to dissipate any time soon and thus may add short-term volatility to prices. Our 2006 full-year average price forecast for WTI is USD 60/bbl.

The base metal group will continue to be supported by lean inventories, supply deficits and firm demand growth, especially from Asia. Additional supply for metals such as copper and zinc will remain limited in 2006 and high energy costs are likely to impact aluminium smelting capacity, which could lead to the closure of smelters in Europe and the US. Nevertheless, aluminum and nickel prices will still be impacted by excessive Chinese production capacity, but we believe that a government policy to restrict supply could start to have a positive impact during 2006.

Precious metals most attractive

During 2005, gold decoupled from the US dollar and has been driven by high energy prices, increasing inflation expectations and fears of slowing economic growth. The reality is that inflation still remains tame and global growth at present is firm. However, given our base scenario that concerns about slowing economic growth, especially in the US, could increase in the second half of 2006, gold is likely to remain in focus with a shiny future.

Platinum is characterized by favorable fundamentals, which lends support for a higher price. Palladium, meanwhile, is troubled by oversupply, but the likelihood that consumers will start to substitute platinum for the less expensive palladium, especially in the jewellery and catalyst industries, makes us optimistic for the long term. The price trend for silver is likely to continue showing a correlation to the price of gold and copper.

Consolidating current levels

High oil prices and increasing interest rates in the US remain a concern that could dampen economic growth, especially in the US. Nevertheless, the continuation of firm growth from Asia will offset lower demand and thus remain a support for commodity prices. In this environment of higher uncertainty compared to 2005, we expect the asset class to deliver more moderate, yet still positive returns. In general one has to keep in mind that commodity investments tend to have equity-like risk characteristics, but will still represent an attractive portfolio diversifier in 2006 due to their differing return drivers.

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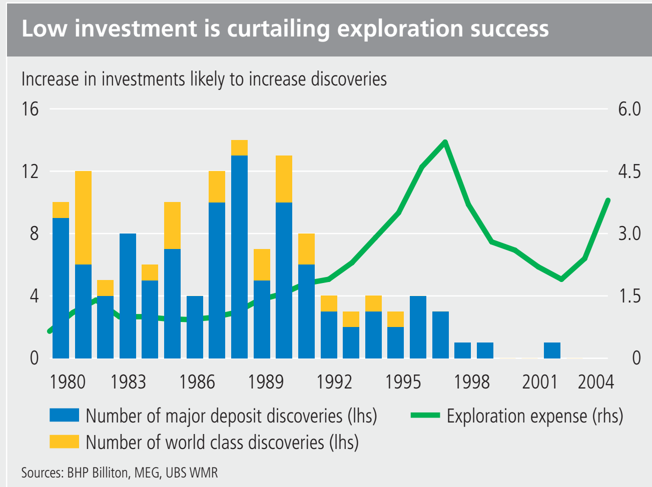
Low investment is curtailing exploration success

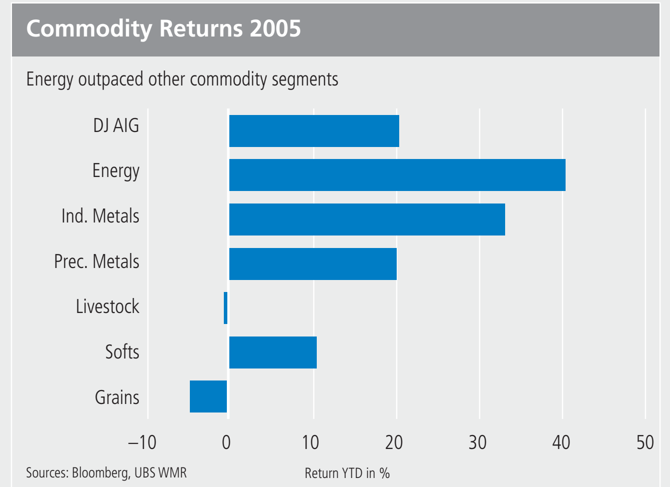
Increase in investments likely to increase discoveries



Sources: BHP Billiton, MEG, UBS WMR

Commodity Returns 2005

Energy outpaced other commodity segments



Sources: Bloomberg, UBS WMR

Solid results for hedge funds

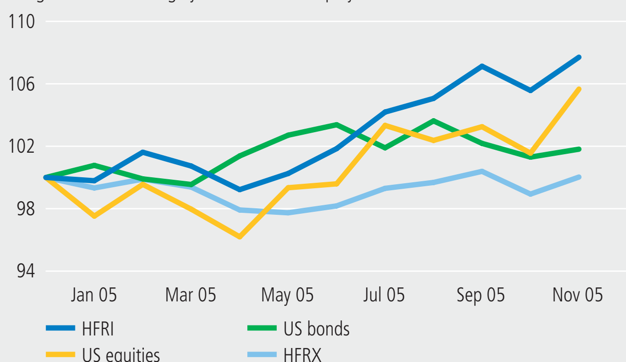
Despite a difficult environment, hedge funds have posted good returns in 2005 as well. Choosing the right fund manager and strategies were again the crucial factors.

On average, hedge funds performed well in 2005. With a return in excess of 7% (in USD), they have outperformed both US bonds and US equities (see graph). This is all the more remarkable given that the US dollar has made strong gains against almost every other currency over the past year. As a result, foreign currency investments made by hedge funds have tended to lose value, which represents a considerable handicap. For CHF or EUR investors, performance has generally been slightly lower if the currency risk of the mostly USD-denominated hedge funds is eliminated by means of currency hedging. As far as risk is concerned, hedge funds have managed to keep the fluctuations in monthly returns within the parameters of bond market risk. Thus, the fear that the strong growth of assets under management might adversely affect the performance characteristics of hedge funds has so far proved unfounded. Even the impact of specific events, such as the downgrading this spring of the credit ratings of the two big US car makers or the news in October that an American financial services firm was filing for bankruptcy, seems to have been confined to individual funds.

With regard to the different styles employed (see graph), it appears that emerging market strategies – which have benefited from the improved fundamentals in these countries – are once again the top performers. However, strategies whose performance depends on skillful market timing have also generated good returns. Arbitrage strategies, on the other hand, rank more towards the bottom end of the performance ranking, though the returns on these investments tend to fluctuate less, making them lower risk. Arbitrage strategies seek to exploit pricing anomalies between one financial instrument and another. Strategies that benefit from upheavals caused by extraordinary corporate events such as bankruptcy have tended to generate less favorable returns compared to last year. However, there have been few opportunities for funds in this category over the past year. Worldwide, firms have posted very good earnings and, as a result, relatively few have found themselves in financial difficulties. It is interesting to note that the performance rankings for the various investment styles have followed a similar pattern over the past two years. There have been no major surprises of late.

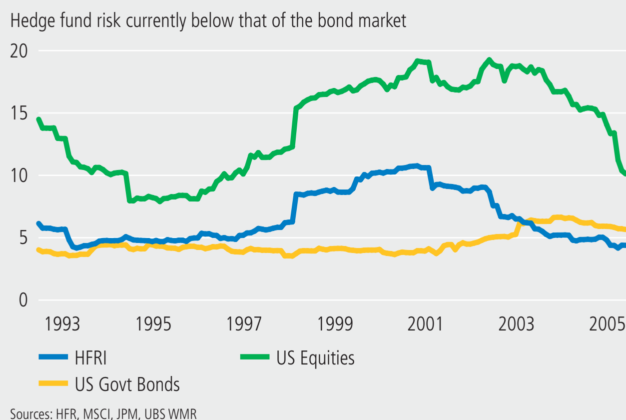
Performance of hedge funds

Hedge funds move roughly in line with the equity market



Sources: HFR, MSCI, JPM, UBS WMR

Volatility of the various asset classes (3-year rolling)



A comparison of the performance of liquid funds, i.e. those that are open for new investors (see the HFRX line on the graph), with that of more illiquid funds, i.e. those that are partly closed for new investors (see the HFRI line on the graph), shows clearly that the latter have performed far better. This confirms that there is a price to be paid for higher liquidity, which takes its toll on performance of the very liquid funds. On the other hand, the difference indicates that most successful funds are often closed. Capacity bottlenecks thus remain a problem, despite the fact that the growth in this asset class has slowed slightly overall. There are several reasons for the latter. For one, equity market performance has clearly stabilized since the crisis years 2000 to 2002. For another, hedge funds are now a feature of many portfolios.

The fear of poor performance remains the biggest concern for investors and hedge fund managers alike. And with good cause: every year, a large number of these funds close due to inadequate performance, though this may not necessarily mean that investors lose their capital. In general, return expectations remain extremely high. Surveys indicate that around 50% of investors expect double-digit returns over the next three years. In our view, such high expectations provide considerable scope for disappointment and should be toned down somewhat. However, the best way to avoid poor performance remains to choose the right fund manager. Therefore, for private investors, it is vital to obtain professional advice about the quality and reliability of the hedge funds selected from a partner who can also facilitate access to the right managers if required.

Another way of minimizing the risk of poor performance is to diversify across several different strategies and fund managers. So-called "funds of funds" are one easy and convenient means of achieving this, providing investors with a source of returns that has only a limited correlation with traditional investments. As a result, hedge funds improve the risk/return characteristics of almost any portfolio.

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Financial markets: past performance and expected returns

		in local currency (in %)				in USD (in %)				Exp. return[2]	Risk[3]
		2005	last 3 years[1]	last 5 years[1]	last 10 years[1]	2005	last 3 years[1]	last 5 years[1]	last 10 years[1]	next 12 months	last 5 years
Equities											
Markets	**World**	16.3	21.2	1.4	11.7	10.0	23.4	2.8	10.6	6.5	14.5
	USA	5.7	17.1	0.6	13.9	5.7	17.1	0.6	13.9	6.5	15.1
	Japan	44.7	32.4	6.1	1.4	25.6	32.7	5.2	0.0	0.0	16.1
	EMU	26.3	24.2	–1.2	20.3	9.6	31.6	3.6	16.6	9.0	20.3
	UK	20.1	20.2	1.5	10.5	7.4	24.0	4.7	12.6	9.5	14.1
	Switzerland	35.8	24.7	1.1	17.3	17.1	28.0	6.0	13.9	3.0	15.5
	Emerging markets	35.8	43.9	26.5	19.5	34.5	55.0	28.6	9.6	10.0	18.9
Sectors	**Consumer discretionary**	7.7	19.0	1.6	8.9	1.5	20.7	2.5	7.9	0.0	18.2
	Consumer staples	12.2	12.1	3.6	12.6	6.3	13.6	5.1	11.9	8.5	9.5
	Energy	36.1	32.7	13.2	29.4	29.4	37.4	17.0	28.4	7.0	16.6
	Financials	19.1	25.4	4.1	14.4	12.1	28.5	6.0	12.9	10.0	15.6
	Health care	14.6	12.5	–0.9	17.2	9.4	13.5	0.0	16.2	9.0	10.9
	Industrials	18.8	27.9	3.8	10.2	12.5	29.4	4.6	8.6	5.5	15.9
	IT	8.6	19.1	–6.4	12.7	5.0	19.9	–6.1	11.7	2.0	31.6
	Materials	29.3	30.5	13.9	11.3	19.8	36.0	17.9	10.7	6.0	17.6
	Telecom	–1.2	9.2	–6.8	3.3	–9.2	11.7	–5.6	2.8	8.5	22.7
	Utilities	22.4	27.9	3.5	13.2	13.9	30.5	5.2	11.3	6.0	12.8
Fixed Income											
Money market	**USD**	3.4	2.1	2.8	5.2	3.4	2.1	2.8	5.2	4.5	0.5
	JPY	0.1	0.1	0.1	0.3	–12.8	0.2	–0.4	–0.9	0.2	0.0
	EUR	2.2	2.4	3.2	4.3	–11.0	6.6	8.4	3.5	2.7	0.3
	GBP	4.9	4.7	5.1	7.3	–5.3	7.2	8.2	8.4	4.6	0.2
	CHF	0.8	0.6	1.4	1.8	–12.4	2.5	5.9	0.6	1.4	0.3
Gov. bonds	**USD**	3.0	3.1	6.2	8.1	3.0	3.1	6.2	8.1	4.3	5.6
	JPY	0.6	0.4	1.7	3.3	–12.2	0.6	1.1	2.1	–0.5	2.1
	EUR	5.2	5.8	7.0	8.0	–8.0	10.1	12.1	7.2	2.5	3.4
	GBP	8.0	5.8	6.5	11.1	–2.2	8.3	9.6	12.1	4.5	4.3
	CHF	4.9	3.9	6.1	5.9	–8.3	5.8	10.7	4.7	1.0	3.6
Corporate bonds[4]	**USD**	2.0	5.4	8.4	8.9	2.0	5.4	8.4	8.9	4.5	5.1
	EUR	4.0	6.4	7.6	8.4	–9.2	10.7	12.8	7.7	2.3	2.7
	GBP	8.8	8.3	9.3	–	–1.4	10.8	12.4	–	3.5	4.5
High yield	**in USD**	2.7	15.3	9.9	8.9	2.7	15.3	9.9	8.9	4.3	8.7
	in EUR	6.0	18.8	5.5	–	–7.3	23.1	10.7	–	2.5	13.1
TIPS[5]		2.8	7.0	10.4	–	2.8	7.0	10.4	–	4.0	6.3
Emerging markets	**EMBI Global**	–	–	–	–	10.7	18.6	15.6	23.9	5.0	9.4
	Asia	–	–	–	–	11.3	9.7	14.5	15.3	5.2	5.2
	EMEA[6]	–	–	–	–	10.9	16.7	33.7	42.6	4.4	9.6
	Latin America	–	–	–	–	10.8	22.5	11.3	20.8	5.0	13.2
Non traditional asset class											
Hedge funds	**HFR Composite Index[7]**	–	–	–	–	7.5	13.4	8.9	18.9	5.5	5.2
Real estate[8]	**GPR 250**	21.9	37.6	24.7	19.5	16.0	41.8	27.9	18.4	6.0	10.6
Commodities	**GSCI**	–	–	–	–	24.2	24.9	11.6	14.7	6.0	22.2
Currencies		vs EUR				vs USD				vs USD	
	USD	15.2	–3.8	–4.1	0.9	–	–	–	–	–	–
	JPY	0.4	–1.1	–1.4	–1.1	–12.8	0.2	–0.6	–1.2	10.2	9.5
	EUR	–	–	–	–	–13.2	4.3	5.1	–0.8	5.7	9.2
	GBP	3.5	1.1	2.1	1.1	–10.2	2.5	3.1	1.1	4.9	7.6
	CHF	0.0	0.5	3.5	–1.1	–13.2	1.9	4.5	–1.2	8.4	9.5

[1] Average total returns per year (geometric average) [2] Expected returns are in local currency and reflect valuation considerations and our main economic scenario. [3] Volatility (standard deviation) of returns, i. e. expected scope of return fluctuation [4] Investment grade quality bonds [5] TIPS: Treasury Inflation-Protected Securities [6] EMEA: Eastern Europe, Middle East and Africa [7] Performance until end of December 2005 [8] Real Estate Investment Trusts

Sources: MSCI, JP Morgan, Merrill Lynch, HFR, GPR, Bloomberg, UBS WMR

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