

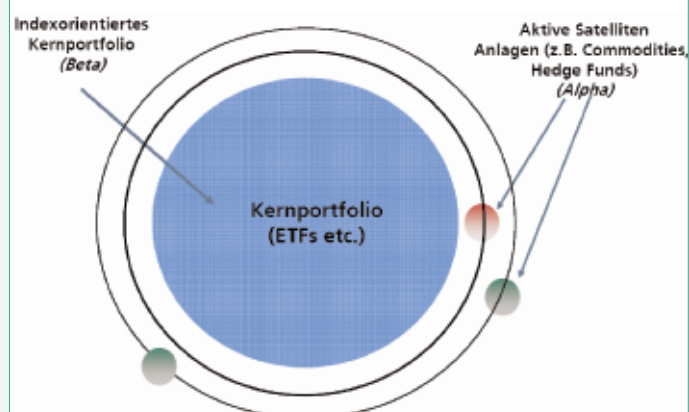
## ELECTRONICALLY TRADED FUNDS

Although ETFs have been around for almost a decade, why have they only gained popularity over the last few years?

Since they were first launched in Europe in April 2000, ETFs have demonstrated impressive annual asset growth rates between 39% and 78%. As with any new financial instrument it requires some time for investors to learn about its benefits for them to invest.

Institutional investors that dominated the ETF market in its early stages appreciate ETFs for their liquidity, transparency and cost-efficiency. UBS Global Asset Management has therefore decided to launch an institutional ETF share classes specifically targeted to meet their needs. More recently, private investors have discovered ETFs as a cost-efficient tool to implement short term tactical shifts and to improve portfolio diversification.

### Core /satellite approach to investing



Source: UBS Global Asset Management

What were the limitations back then and what did it take to thaw the ice?

ETFs combine the mutual fund world with the trading flexibility of stocks. While this structure offers new investment opportunities for investors, it presents certain challenges for the product issuers: European fund regulators had to feel comfortable with a new fund product that investors would typically not subscribe or redeem but purchase and sell like any blue chip stock on an exchange.

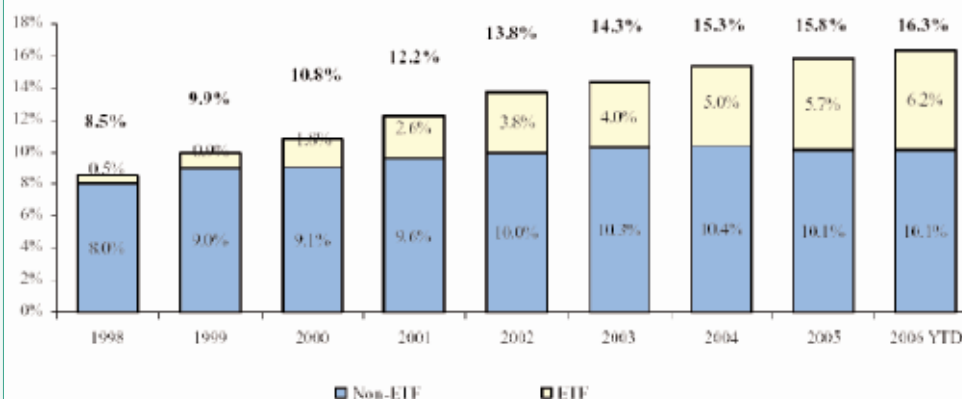
Moreover, it requires an educational process to understand the true liquidity of ETFs. Essentially ETF liquidity is identical to the liquidity of the constituent stocks in the index and not the observed liquidity in the secondary market which is usually a small fraction of the former.

Do you believe there is a recognizable shift in the way assets are being allocated now - i.e. as a percentage - the amount being allocated to "passive" instruments is on the rise? Is this a trend for the near term?

We can observe a general trend towards passive investing in Europe which ETFs and other passive vehicles benefit from.

Compared to the US where around 16% of all equity fund assets are indexed the share in Europe is around 8% and expected to rise.

### As a percentage of total stock wealth in the US...



Source: Morgan Stanley Research, Strategic Insight. YTD = Year-to-date as of 30. August 2006



Dr. Christian Gast is Head UBS Exchange Traded Funds

What are the constraints posed by ETFs and the risks involved?

ETF investors gain exposure to a diversified basket of securities as represented in the underlying index of the ETF. The index provides a diversified portfolio of stocks and thereby reduces the risk compared to investments made in single stocks.

However, the investor is still exposed to the general risk posed by equity investments.

Building on ETFs – what is the next generation of hybrid products an investor can expect? When? What sort of risk reward profile will they have and how affordable will they be?

There is a general trend of ETFs expanding out of the passive space into more active type of investing. Examples are ETFs providing leverage, a capital protection or ETFs based on fundamental indexes.