

Preferred Securities Update

USD

Coupons still secure for stronger players but price volatility likely to continue

Lead analyst
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At a glance

- As a subordinated security that allows for coupon deferral, preferred security prices have been punished hard across the financial sector, regardless of the issuer's credit profile. Preferred security prices are at their lowest point in the past 10 years since the market has evolved into one that is dominated by financials. At roughly 550 bps versus Treasuries, financial preferred spreads are at their highest historical level and at close to 200 bps, spreads are also historically wide versus long-maturity financial bonds.
- Since the credit crisis began, there continues to be a strong correlation between equity prices and preferred credit spreads, as risk premiums rise in tandem. While this relationship is likely to continue in the near term, we look for preferreds' credit spreads and subordination premiums to eventually improve over a longer-term 12-18 month horizon as the financial environment stabilizes.
- Financial companies operating as an ongoing enterprise have not historically exercised their right to defer preferred coupons and we look for this practice to continue. In regard to the preferred securities we recommend in our coverage universe, we maintain our view of the coupon payments as secure
- On a security level basis, we favor preferreds issued by those stronger financial companies including Bank of America, HSBC, JPMorgan Chase, US Bancorp, and Wells Fargo which are apt to outperform their sector peers in the current environment. See our *Preferred Security Universe* for specific security information.

Downgrade Lehman preferreds to Marketperform

We downgrade the ratings of the Lehman preferreds from Outperform to Marketperform. This action follows the strong directional correlation that the spreads on Lehman preferreds have experienced with movements in the company's equity prices as their risk premiums have moved in tandem. WMR's Diversified Financials analyst Sandra Goldschneider downgraded Lehman's equity rating from Buy/sector Outperform to Hold/Marketperform. In her view, Lehman's valuation could remain depressed until the environment improves and the real estate market bottoms. Despite the downgrade, we continue to view Lehman's preferred income distributions as secure. Positive company-specific catalysts could include meaningful reduction of mortgage assets or a strategic partnership.

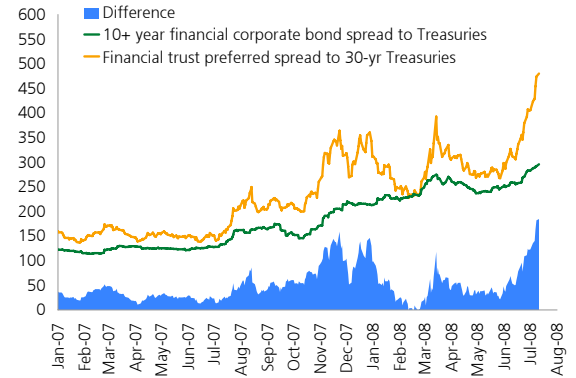
Moody's downgrades Freddie Mac preferreds

Moody's downgraded Freddie Mac's preferred security ratings from Aa3 to A1 citing reduced financial flexibility and an increased risk of suspension in dividend payments. In our view, this risk of skipped dividend payments as been significantly reduced given the Treasury's temporary authority to purchase equity in the two GSEs, which according to Treasury Secretary Paulson, "helps to ensure the GSEs have sufficient capital to continue to serve their mission". In this regard, we continue to view the GSEs preferreds income as secure, however prices will likely remain volatility and vulnerable to headline risk stemming from continued credit related losses that will pressure capital levels.

Asset Class: Preferred Securities

Preferred and financial corporate bond spreads

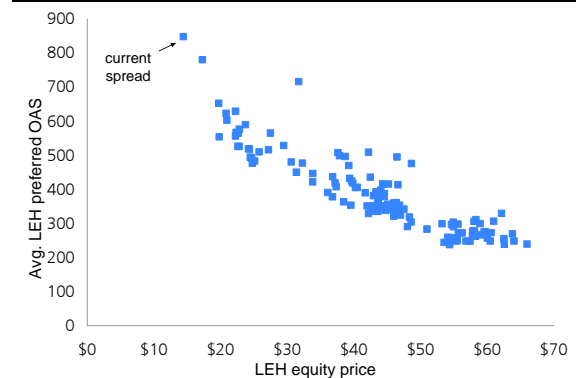
Subordination premiums have risen as securities that rank lower in the capital structure have been impacted most.



Source: UBS WMR, as of 15 July 2008

Lehman preferred spreads and equity price

There has been a strong correlation between Lehman's preferred spreads and equity price.



Source: UBS WMR, as of 15 July 2008

Preferred security downgrades

Symbol	Coupon	Maturity	Strip Price	YTW (%)	WMR Preferred Rating
LEH pr K	6.375	03/15/52	11.35	14.07	MP
LEH pr F	6.500	Perpetual	11.11	14.63	MP
LEH pr L	6.375	10/31/52	11.15	14.32	MP
LEH pr M	6.000	04/22/53	11.33	13.27	MP
LEH pr N	6.240	01/18/54	11.24	13.91	MP
LEH pr J	7.950	Perpetual	12.36	16.08	MP

Source: UBS WMR, as of 15 July 2008; MP = Marketperform

Ratings Actions and Rationale

Ratings Downgrades							
Issuer	Symbol	Next Call Date	Strip Price	Current yield (CY)	Moody's/S&P Pfd. Rating	WMR Preferred Rating	Rationale
Leh Bros Hldgs Cap Tr III 6.375% 3/15/52	LEH pr K	03/15/08	11.35	14.07	A2/BBB+	Market-perform	We downgrade the ratings of the LEH pr K, F, L, M, N, and J preferreds perpetual preferreds to Marketperform from Outperform. There has been a strong directional correlation that the spreads on Lehman preferreds have experienced with movements in the company's equity prices as their risk premiums have moved in tandem. WMR diversified analyst Sandra Goldschneider downgraded Lehman's equity rating from Buy/sector Outperform to Hold/Marketperform and has a Mid AWatch – credit opinion. In her view, Lehman's valuation could remain depressed until the environment improves and the real estate market bottoms. Goldschneider notes that positive company-specific catalysts could include meaningful reduction of mortgage assets or a strategic partnership.
Leh Bros Hldgs Inc. 6.5% Perpetual	LEH pr F	08/31/08	11.11	14.63	A3/BBB+	Market-perform	
Leh Bros Hldgs Cap Tr IV 6.375% 10/31/52	LEH pr L	10/31/08	11.15	14.32	A2/BBB+	Market-perform	
Leh Bros Hldgs Cap Tr V 6% 4/22/53	LEH pr M	04/22/09	11.33	13.27	A2/BBB+	Market	
Leh Bros Hldgs Cap Tr VI 6.24% 1/18/54	LEH pr N	01/18/10	11.24	13.91	A2/BBB+	Market	
Leh Bros Hldgs Inc. 7.95% Perpetual	LEH pr J	02/15/13	12.36	16.08	A3/BBB+	Market	

Source: UBS WMR, financial data as of 15 July 2008

Statement of Risk

Prospective investors should consult their tax advisors concerning the federal, state, local, and non-U.S. tax consequences of owning preferred stocks.

Preferred stocks are subject to market value fluctuations, given changes in the level of interest rates. For example, if interest rates rise, the value of these securities could decline. If preferred stocks are sold prior to maturity, price and yield may vary. Adverse changes in the credit quality of the issuer may negatively affect the market value of the securities. Most preferred securities may be redeemed at par after five years. If this occurs, holders of the securities may be faced with a reinvestment decision at lower future rates. Preferred stocks are also subject to other risks, including illiquidity and certain special redemption provisions.

Appendix

Terms and Abbreviations	
Abbreviation	Description / Definition
Symbol	The preferred security's trading symbol.
UBS ID	The UBS security identification number.
Next Call Date	The next date that the issuer has the option to redeem the security. Once a preferred security's first call date has passed, the issuer can redeem the security at anytime within 30 days notice.
Strip Price	The strip price removes the accrued dividend from a preferred's exchange-traded price to get a better reflection of the underlying value of the security.
CY/YTM	(Current Yield/ Yield to Maturity). In the case of perpetual preferreds, the displayed yield will be the security's current yield as calculated by the annual dividend divided by the strip price. For preferreds with a finite maturity date, the YTM is the internal rate of return that equates the security's strip price with the sum of its total discounted cash flows to the maturity date.
YTC	(Yield to Call). The YTC is the internal rate of return that equates the security's strip price with the sum of its total discounted cash flows to the next call date.
UBS WMR Parent Credit Rating/Trend	The WMR Credit Rating provides an indication of the risk of investing in the senior unsecured debt of the preferred's parent company. The WMR Credit Trend (Improving, Stable, Deteriorating) provides an indication of the direction of credit quality defined in terms of the WMR Credit Rating, which is assessed over a 12-month period.
Moody's / S&P Credit Rating	The credit rating that Moody's and S&P assign to the specific preferred security.
OAS	(Option Adjusted Spread). A measure of a preferred's spread relative to a benchmark curve that adjusts for the security's embedded call option. To determine whether a security is rich or cheap on a relative value basis, we compare the OAS on an individual preferred security with the average OAS of the peer group, adjusting for differences in credit quality and duration.
Dur.	(Effective Duration.) Duration is calculated as the weighted average maturity of a security's total cash flows and is used a measure of the security's price sensitivity to changes in yields. Effective duration takes into account how the preferred's embedded call option will affect the security's future cash flows.
Spread Volatility	(Low, Average, High). A measure of the volatility of an individual preferred's OAS relative to the median OAS volatility of our preferred full coverage universe.
Safety of Income	(Low, Average, High). An assessment of the preferred security's dividend safety. For accounts that are willing to accept the high degree of interest rate risk inherent in preferred securities but that are focused on generating long-term income distributions, our income return classification may be an important, and ultimately overriding, factor in the decision-making process.
UBS WMR Rating	(Buy, Neutral, Reduce). The preferred rating is based on the security's expected total returns relative to its peer group over a three-month time horizon. Securities rated Buy have potential to outperform their peer group, and the company is likely to meet dividend payment. Securities rated Neutral are likely to perform in line with peer group, and the company is likely to meet dividend payment. Securities rated Reduce have the potential to underperform the peer group, or the company is increasingly likely to defer or miss dividend payment.
Liquidity	(Primary or Secondary). Our coverage universe is dividend into primary and secondary groups, according to the volume of shares traded. Although the securities in both groups will be subject to the same valuation process and ratings system, the securities on the primary list are likely accessible to a broader investor base, whereas the securities on the secondary list are more illiquid.
Sector	The preferred security's industry sector.

Appendix

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If the date of this report is not current, the investment opinion and contents may not reflect the analyst's current thinking.

Disclosures (15 July 2008)

Company:

Lehman Bro Hld Cap Trst V 6.0% - 4/22/53 1, 2, 3, 4, 5, 6, 7, 8, 9.

Lehman Brothers Capital Trust VI 6.24% 1, 2, 3, 4, 5, 6, 7, 8, 9.

Lehman Brothers Holdings 6.5% Perpetual 1, 2, 3, 4, 5, 6, 7, 8, 9.

Lehman Brothers Holdings Perpetual 7.95% 1, 2, 3, 4, 5, 6, 7.

Lehman Cap Trst IV 6.375% due 10/31/2052 1, 2, 3, 4, 5, 7, 8, 9.

Lehman Holdings III 6.375% due 3/15/2052 1, 2, 3, 4, 5, 6, 7, 8, 9.

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Appendix

Stock Recommendation System

Analysts provide two ratings: an absolute rating and a relative rating. The absolute rating is based on the current Estimated Fair Value Range (EFVR) for the stock and the stock's recent trading price. The relative rating is based on the stock's total return potential against the total estimated return of the appropriate sector benchmark over the next year.

The EFVR is the price range within which the analyst estimates the stock to be fairly valued. The estimation of the EFVR is based on methods such as a discounted cash flow valuation or a valuation multiples comparison. In the definition of the EFVR, analysts take into account the risk profile (predictability) of the stock.

Absolute Stock Rating System

Buy

We believe the stock is undervalued relative to current market prices.

Hold

We believe the stock's current market valuation is within a fair range.

Sell

We believe the stock is overvalued relative to current market prices.

Under review

Upon special events that require further analysis, the stock rating may be flagged as "Under review" by the analyst.

Suspended

If data is not valid anymore, the stock rating may be flagged as "Suspended" by the analyst.

Restricted

Issuing of research on a company by WMR can be restricted due to legal, regulatory, contractual or best business-practice obligations which are normally caused by UBS Investment Bank's involvement in an investment banking transaction in regard to the concerned company.

Industry Sector Relative Stock View

Outperform (OUT)	Expected to outperform the benchmark
Marketperform (MKT)	Expected performance in line with the benchmark
Underperform (UND)	Expected to underperform the benchmark

Current WMR Global Rating Distribution (as of last month-end)

Buy	27%** (51%*)	Outperform	31%*** (54%*)
Hold	62%** (55%*)	Marketperform	46%*** (49%*)
Sell	2%** (47%*)	Underperform	12%*** (44%*)

* Percentage of companies within this rating for which investment banking services were provided by UBS AG or UBS Securities LLC or its affiliates within the past 12 months. Source: UBS WMR, as of 1 July 2008

** At present, not all securities in WMR's global coverage universe have been assigned an Absolute Stock Rating in a Corporate Report. The Absolute Stock Rating distribution calculation includes only securities that have been assigned an Absolute Stock Rating as of the last month-end.

*** Under our Industry Sector Relative Stock View system, "Outperform" most closely corresponds with a "Buy" recommendation, "Marketperform" most closely corresponds with a "Hold" recommendation, and "Underperform" most closely corresponds with a "Sell" recommendation

UBS Preferred Stock Ratings: Definitions and Distributions

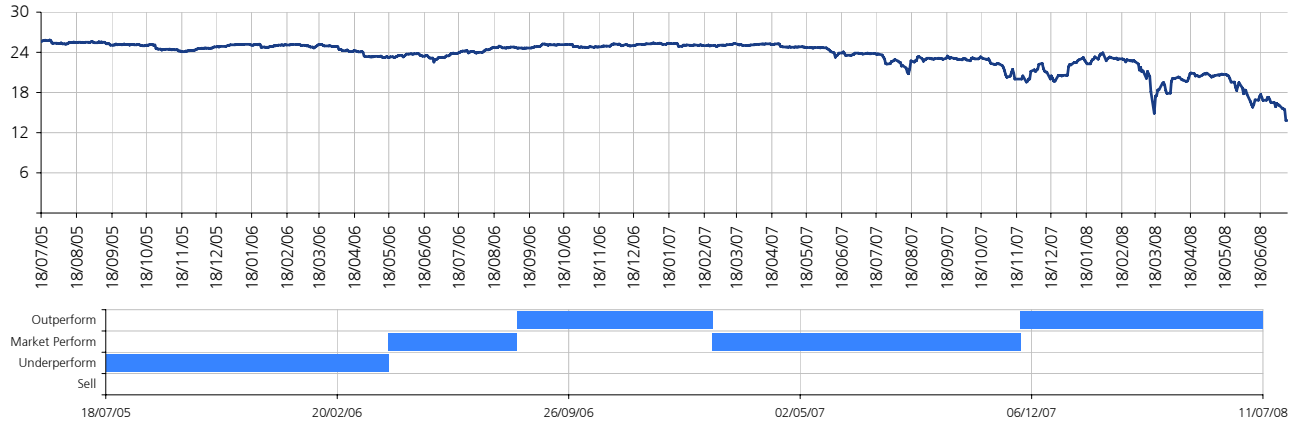
UBS Financial Services Rating	Definition and Criteria	Corresponding Rating Category	% of companies under coverage with this rating	% for which IB services have been provided
Outperform	Securities have potential for outperformance relative to peer group, and the company is likely to meet dividend payment.	Buy	26	68
Market Perform	Securities are likely to perform in line with peer group, and the company is likely to meet dividend payment.	Hold	73	65
Underperform	Securities have the potential for underperformance relative to peer group, and the company is likely to meet dividend payment.	Sell	1	100
Sell	Investors should sell their preferreds in light of substantial downside credit or default risk that raises the likelihood of a deferral or missed dividend payment.	Sell	0.0	n.m.

Source: UBS Financial Services Inc., as of 1 July 2008

Appendix

Global Rating History

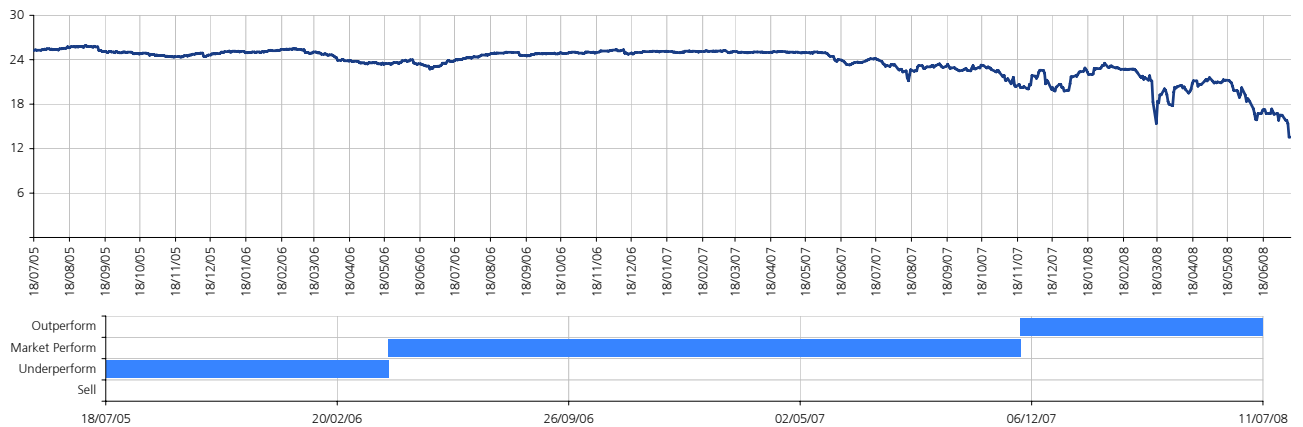
LEH pr L (USD)



Source: UBS WMR, as of 15 July 2008

Global Rating History

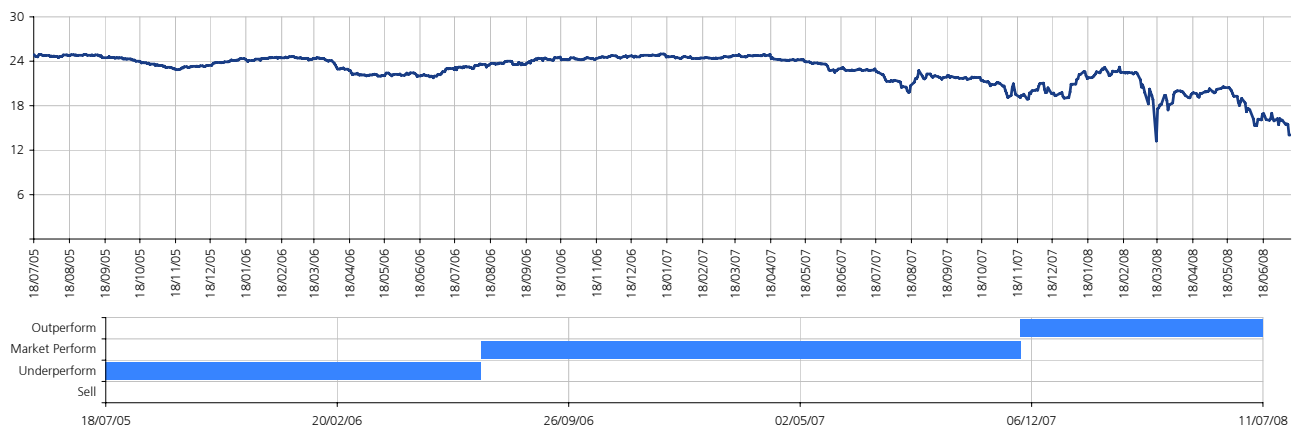
LEH pr K



Source: UBS WMR, as of 15 July 2008

Global Rating History

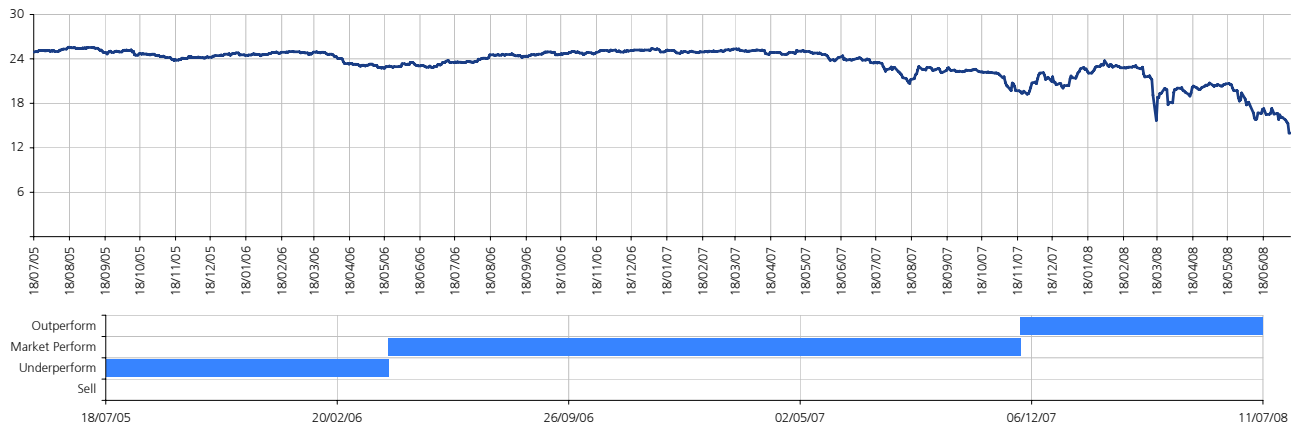
LEH pr M (USD)



Source: UBS WMR, as of 15 July 2008

Global Rating History

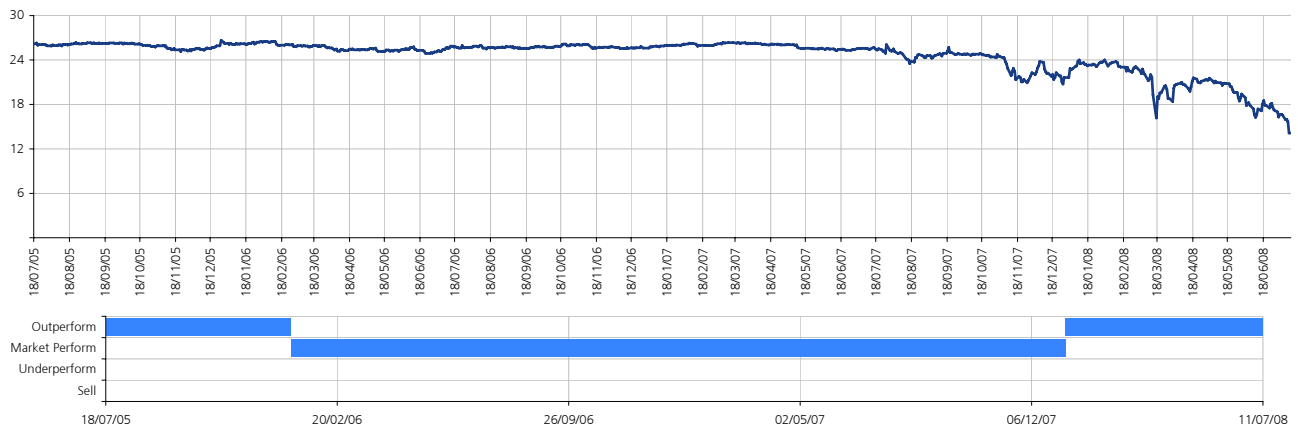
LEH pr N (USD)



Source: UBS WMR, as of 15 July 2008

Global Rating History

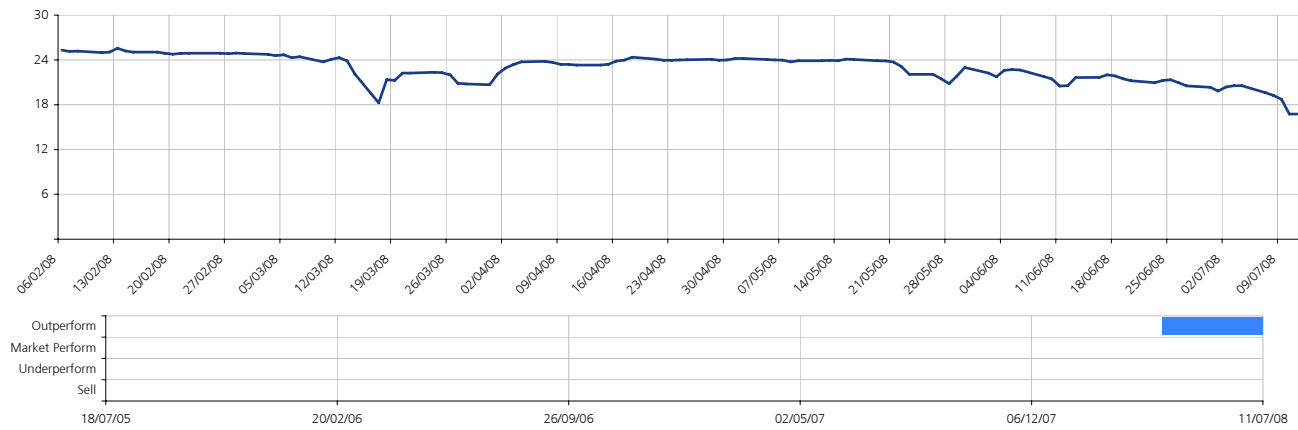
LEH pr F (USD)



Source: UBS WMR, as of 15 July 2008

Global Rating History

LEH pr J (USD)



Source: UBS WMR, as of 15 July 2008

Appendix

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