Preferred Securities Update

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

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 preferrets’ 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 preferrets 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.
## Ratings Actions and Rationale

### Ratings Downgrades

<table>
<thead>
<tr>
<th>Issuer</th>
<th>Symbol</th>
<th>Next Call Date</th>
<th>Strip Price</th>
<th>Current Yield (CY)</th>
<th>Moody’s/ S&amp;P Pfd Rating</th>
<th>WMR Preferred Rating</th>
<th>Rationale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Leh Bros Hldgs Cap Tr III 6.375% 3/15/52</td>
<td>LEH pr K</td>
<td>03/15/08</td>
<td>11.35</td>
<td>14.07</td>
<td>A2/BBB+</td>
<td>Marketperform</td>
<td>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 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 A/Watch – 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.</td>
</tr>
<tr>
<td>Leh Bros Hldgs Inc. 6.5% Perpetual</td>
<td>LEH pr F</td>
<td>08/31/08</td>
<td>11.11</td>
<td>14.63</td>
<td>A3/BBB+</td>
<td>Marketperform</td>
<td></td>
</tr>
<tr>
<td>Leh Bros Hldgs Cap Tr IV 6.375% 10/31/52</td>
<td>LEH pr L</td>
<td>10/31/08</td>
<td>11.15</td>
<td>14.32</td>
<td>A2/BBB+</td>
<td>Marketperform</td>
<td></td>
</tr>
<tr>
<td>Leh Bros Hldgs Cap Tr V 6% 4/22/53</td>
<td>LEH pr M</td>
<td>04/22/09</td>
<td>11.33</td>
<td>13.27</td>
<td>A2/BBB+</td>
<td>Market</td>
<td></td>
</tr>
<tr>
<td>Leh Bros Hldgs Cap Tr VI 6.24% 1/18/54</td>
<td>LEH pr N</td>
<td>01/18/10</td>
<td>11.24</td>
<td>13.91</td>
<td>A2/BBB+</td>
<td>Market</td>
<td></td>
</tr>
<tr>
<td>Leh Bros Hldgs Inc. 7.95% Perpetual</td>
<td>LEH pr J</td>
<td>02/15/13</td>
<td>12.36</td>
<td>16.08</td>
<td>A3/BBB+</td>
<td>Market</td>
<td></td>
</tr>
</tbody>
</table>

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**

<table>
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<tr>
<th>Terms and Abbreviations</th>
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<tr>
<td><strong>Abbreviation</strong></td>
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<td>Symbol</td>
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<td>UBS ID</td>
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<td>Next Call Date</td>
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<tr>
<td>Strip Price</td>
</tr>
<tr>
<td>CY/YTM</td>
</tr>
<tr>
<td>YTC</td>
</tr>
<tr>
<td>UBS WMR Parent Credit Rating/Trend</td>
</tr>
<tr>
<td>Moody’s / S&amp;P Credit Rating</td>
</tr>
<tr>
<td>OAS</td>
</tr>
<tr>
<td>Dur.</td>
</tr>
<tr>
<td>Spread Volatility</td>
</tr>
<tr>
<td>Safety of Income</td>
</tr>
<tr>
<td>UBS WMR Rating</td>
</tr>
<tr>
<td>Liquidity</td>
</tr>
<tr>
<td>Sector</td>
</tr>
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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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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)

<table>
<thead>
<tr>
<th>Rating</th>
<th>% of companies under coverage</th>
<th>% for which IB services have been provided</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buy</td>
<td>27%** (51%*)</td>
<td>68</td>
</tr>
<tr>
<td>Hold</td>
<td>62%** (55%*)</td>
<td>65</td>
</tr>
<tr>
<td>Sell</td>
<td>2%** (47%*)</td>
<td>100</td>
</tr>
</tbody>
</table>

* 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 Prefered Stock Ratings: Definitions and Distributions

<table>
<thead>
<tr>
<th>UBS Financial Services Rating</th>
<th>Definition and Criteria</th>
<th>Corresponding Rating Category</th>
<th>% of companies under coverage with this rating</th>
<th>% for which IB services have been provided</th>
</tr>
</thead>
<tbody>
<tr>
<td>Outperform</td>
<td>Securities have potential for outperformance relative to peer group, and the company is likely to meet dividend payment.</td>
<td>Buy</td>
<td>26</td>
<td>68</td>
</tr>
<tr>
<td>Market Perform</td>
<td>Securities are likely to perform in line with peer group, and the company is likely to meet dividend payment.</td>
<td>Hold</td>
<td>73</td>
<td>65</td>
</tr>
<tr>
<td>Underperform</td>
<td>Securities have the potential for underperformance relative to peer group, and the company is likely to meet dividend payment.</td>
<td>Sell</td>
<td>1</td>
<td>100</td>
</tr>
<tr>
<td>Sell</td>
<td>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.</td>
<td>Sell</td>
<td>0.0</td>
<td>n.m.</td>
</tr>
</tbody>
</table>

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

Global Rating History

- LEH pr L (USD)

- LEH pr K

- 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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