UBS House View

Monthly Letter

28 July 2022
Chief Investment Office GWM
Investment Research

Narrative shift

Market concerns have shifted from inflation onto the risk of overtightening and recession.

Long-term is brighter

Near-term uncertainty remains high, but this year's sell-off has created investment opportunities for longer-term investors.

Waiting is costly

The risk-reward associated with waiting to invest deteriorates notably over time. The longer one plans to invest for, the harder it is to justify waiting.

Asset allocation

Within equities, we tilt our exposure toward value, defensives, and quality. We move high grade bonds to most preferred from neutral.

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Why invest now?

Central bankers continue to talk tough about inflation, but markets have largely moved on from worries about rising prices as the risk of overtightening and recession has come into greater focus. What does this mean for investors today?

In the near term, we think the risk-reward for broad equity indexes will be muted. Equities are pricing in a "soft landing," yet the risk of a deeper "slump" in economic activity is elevated. Tactically, we therefore advocate selectivity—preferring value, quality income, and healthcare—and optionality. In fixed income, we move high grade bonds, which would likely rally sharply in a "slump" scenario, from neutral to most preferred. In currencies, we keep a most preferred stance on the Swiss franc.

But what about investors with a longer-term view?

We believe a combination of below-average equity valuations, above-average yields, and post-peak private equity vintages will mean stronger long-term returns for diversified portfolios. After a 26% decline in valuations over the past 12 months, the S&P 500 is now trading at levels consistent with annualized returns in a healthy 7–9% range over the next decade (see page 3). Yields available in bond markets have improved significantly this year. And in alternatives, growth funds created following public market sell-offs have historically delivered better returns than those from prior vintages. In this context, from a longer-term perspective, many clients appear underdiversified and underinvested.

Investors often try to reconcile a constructive long-term view with a more challenging short-term outlook by simply waiting. But this approach also entails risks: The potential savings from waiting tend to be limited, but the potential opportunity costs can be much larger. And, while the near-term outlook for equities might be uncertain, we believe diversified portfolios should deliver more stable outcomes over the coming months, given the potential market scenarios we face.

By buying, or committing to buy, diversified portfolios today, we believe investors can both mitigate near-term risks and position for long-term performance, without running the risk of being left, potentially indefinitely, on the sidelines.

In this letter, we share our latest views on the short-term outlook for the market, then detail why we think the longer-term outlook has improved this year, and analyze how longer-term investors should think about the trade-off between waiting and investing.

Near-term uncertainty remains

Since our last letter, there have been two main developments relevant to our 2H outlook.

Central banks are reducing fears of longer-term inflation.

First, central banks are reducing fears of longer-term inflation. Although recent inflation data has surprised to the upside, markets have priced in a more front-loaded rate hiking cycle by the Federal Reserve, and this appears to be reducing long-term inflation fears. In the July University of Michigan survey of consumers, long-run inflation expectations fell to 2.8% per annum, down from 3.1% in June, and US 10-year breakeven inflation rates have declined from a peak of 3.1% in April to 2.46%. Core CPI has also now declined for three consecutive months.

Concerns about recession are rising.

Second, concerns about recession are rising as growth indicators have continued to fall. In the US, second-quarter GDP contracted 0.9% on an annualized basis, the second consecutive quarterly decline. S&P Global's flash composite PMI dropped to 47.5 in July from 52.3 in June, indicating contraction. In the Eurozone, the composite PMI for July fell to 49.4 from 52 in June, also pointing to a contraction in business activity. In China, mortgage payment boycotts in response to suspended and delayed housing construction and the resurgence of COVID-19 in several cities have brought into focus potential headwinds to a second-half economic recovery.

To account for these developments, we have reduced the probability we assign to our "stagflation" scenario—in which fears of inflation running out of control drive both equities and bonds lower—from 20% to 10%. But we have also raised our estimate for our "slump" scenario—in which fears of a deeper recession lead stocks to fall and high grade bond prices to rise—from 30% to 40%.

Where does this leave us?

In our view, there is a 50% probability that broader equity indexes will move lower from here.

In our view, there is a 50% probability that broader equity indexes will move meaningfully lower over the balance of the year. The "reflation" scenario could bring upside, but this would require markets to start to believe that commodity supply challenges will be resolved, COVID-19 concerns in China will dissipate, or US labor force participation will rise significantly. We think this is a lower-probability scenario. As such, for tactical investors, this remains a market in which to stay diversified, defensive, and selective.

Four scenarios that could drive the market

CIO estimates and targets for end-2022

	Current	Soft landing	Slump	Stagflation	Reflation
S&P 500	**4,024**	**3,900**	**3,300**	**3,100**	**4,500**
10-year yield	2.78%	3.25%	1.50%	4.00%	2.75%
Breakeven	2.46%	2.55%	2.00%	3.00%	3.25%
Real	0.32%	0.70%	–0.50%	1.00%	0.50%
Equity risk premium	315bps	278bps	426bps	312bps	260bps
Implied forward P/E	16.9x	16.6x	17.4x	14x	17.9x
Forward earnings per share	USD 238*	USD 235	USD 190	USD 235	USD 252
Earnings growth (y/y)		3.5%	–16.3%	3.5%	11%
Probability		**40%**	**40%**	**10%**	**10%**

*12-month forward consensus

Source: Bloomberg, UBS, as of July 2022

The long-term outlook has improved this year

The near-term outlook is challenging. Yet for longer-term investors, the sell-off so far in 2022 can be viewed as creating opportunity.

The S&P 500 now trades at valuations consistent with 7–9% returns over the next decade.

Valuations tend not to be a reliable guide to short-term performance. But they do correlate with long-term returns. Today, after a 26% derating over the past 12 months, the S&P 500 trades at a trailing price-to-earnings (P/E) ratio of 18.3x, a level that since 1960 has been consistent with annualized returns in a healthy 7–9% range over the next decade. The MSCI All Country World Index, meanwhile, trades at a trailing P/E of 15.5x, which since 1988 has been consistent with annualized returns of 6–8% over the next 10 years. Yields available in bond markets have also improved substantially this year.

Government bond yields are close to the highest level since 2018 (and 2008 before that). The starting level of yields has historically proven a reliable guide to longer-term bond market returns, suggesting that the longer-term outlook for fixed income is now stronger than it has been for most of the post-financial-crisis era.

History suggests the outlook for newly created private equity growth funds is attractive.

In alternatives, although it is likely that some existing private equity funds will announce downward revisions to net asset values following the sell-off in public markets, growth funds created following public market sell-offs have historically delivered better returns than those of prior vintages. Cambridge Associates estimates an internal rate of return (IRR) of 18.6% for growth equity investments made one year after a market peak, versus 11.4% for those made one year before a public market peak.

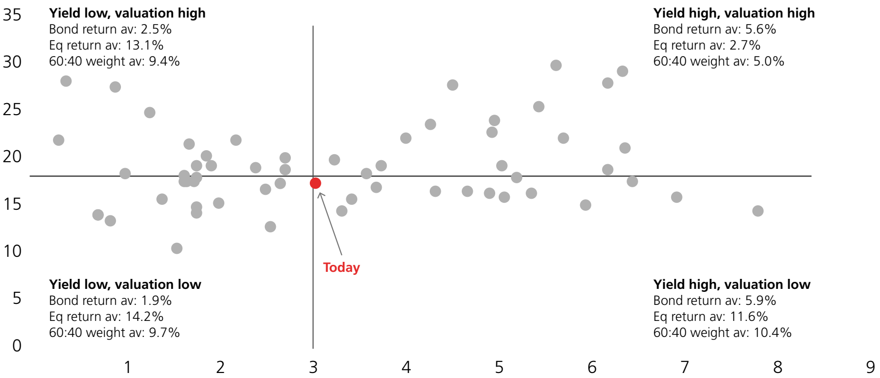
Of course, there are some longer-term risks. Aging populations are likely to limit GDP growth, and the ongoing shift within economies in favor of services can hinder productivity growth. Profits as a percentage of GDP have risen to levels that suggest further gains might come at the expense of consumer spending. And quantitative tightening and higher interest rates imply a different liquidity outlook than has prevailed for the last decade.

However, we don't need to believe that the next decade will be better than the past one to still see a decent outlook for portfolios. Furthermore, innovation and technological advances can promote productivity growth, even in service sectors. The Fourth Industrial Revolution can help drive economic efficiencies, which could help margins remain resilient. And, while central banks are shrinking their balance sheets, elevated levels of government debt mean they will want to keep long-term rates low to keep debt burdens sustainable.

Figure 1

The combination of above-average yields and below-average valuations is rare in recent history

S&P 500 P/E based on trailing earnings, 5-year US Treasury yield in %, semiannual data, past 30 years



Source: Bloomberg, Factset, Datastream, UBS, as of July 2022

Below-average equity valuations and above-average yields point to stronger long-term returns.

It is difficult to know precisely how to balance competing long-term forces when calculating return estimates. But in our view the long-term valuation analysis has merit for its simplicity and track record. In short, we believe a combination of below-average equity valuations, above-average yields, and post-peak private equity vintages will mean stronger long-term returns for diversified portfolios.

Why waiting can be riskier than investing

Waiting before investing comes with risks.

One way that investors often try to combine a constructive long-term view with a more challenging short-term outlook is simply to wait before investing. But waiting comes with risks, too.

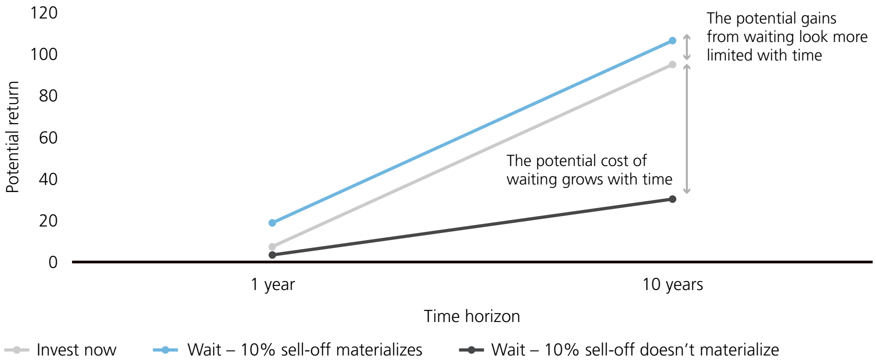
Let's consider two options investors have today: 1) hold cash, and only buy if the market falls by 10% from today's levels; or 2) buy now. How do these options play out over a one-year and 10-year horizon?

Based on our short-term S&P 500 targets and some assumptions about long-term levels for the index, we find that the risk-reward associated with waiting deteriorates notably over time. We offer a full analysis and explanations in the box at the end of this letter. But, to summarize, the longer one plans to invest for, the harder it is to rationally justify waiting.

Figure 2

The longer your time horizon, the harder it is to justify waiting

Time horizon and potential return (%)



Source: Bloomberg, UBS, as of July 2022

The opportunity cost of waiting compounds over time.

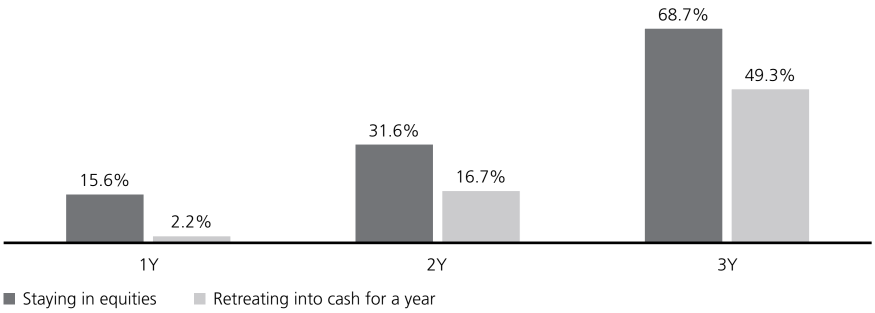
The idea that waiting can be riskier than investing immediately is also borne out in the historical data. Since 1960, a strategy that waited for a 10% correction before buying the S&P 500 and then sold at a new all-time high would have underperformed a buy-and-hold strategy by 80x (yes, eighty). Over the same time period, a strategy of investing immediately after a 20% drop would have delivered an average one-year return of 15.6%. Staying in cash for a year after a 20% drop comes at a significant opportunity cost, and the gap in performance widens over time with the effect of compounding. And strategies investing "all at once" outperformed 12-month phased investment strategies by an average of 4.4% in the first year, considering data since 1945.

The costs associated with attempted market timing are also evident in real-world investor performance data. DALBAR's latest Quantitative Analysis of Investor Behavior report shows that the average mutual fund investor has underperformed the S&P 500 by 3.52% p.a. over the past 30 years, including more than 10 percentage points of underperformance in 2021 alone. For many investors, the more work, time, and stress they add to their lives with market timing, the worse their performance.

Figure 3

Staying invested pays off

Forward returns after a 20% drop: Staying invested in equities vs. retreating into cash for a year before reentering the market, based on monthly data since 1960



Source: Ibbotson, UBS, as of July 2022

In short, we think that by buying, or at least committing to buy, diversified portfolios today, investors can both mitigate near-term volatility and position for long-term performance, without running the risk of being left, potentially indefinitely, on the sidelines.

Investment ideas

Within our asset class preferences, we make two changes this month:

We move high grade bonds to most preferred from neutral.

First, we move the 1- to 10-year segment of high grade bonds, which includes sovereign, agency, quasi-sovereign, and similar types of bonds, to most preferred from neutral. Significant expectations of a front-loaded rate hiking cycle are already priced in; spreads between high grade and sovereign bonds are wide compared to history; and the relatively high carry provides some insulation against volatility—yields would have to rise by 125 basis points in the 1- to 5-year segment and 50 basis points in the 5- to 10-year for the position to become unprofitable over a one-year period.

There is also scope for yields to fall further if fears of a "slump" start to affect markets. This could be particularly beneficial for high grade bonds because, after a sharp sell-off so far this year, many bonds are now trading at a discount to their redemption values. This means a move lower in bond market yields would result in a larger increase in bond prices than a similar-sized move higher in market yields would result in lower prices. This is referred to as "positive convexity."

We move gold to least preferred from neutral.

Second, we move gold from neutral to least preferred. Increases in US interest rates, falling inflation, quantitative tightening, and continued US dollar strength are all likely to weigh on gold, and we expect prices to end the year at USD 1,600/oz, from USD 1,746/oz today. In this context, we do not think gold is well positioned as a hedge against economic slowdown and therefore think investors should either hedge existing gold positions or swap them for other defensive assets, such as high grade bonds, quality-income stocks, the healthcare sector, resilient credits, and the Swiss franc.

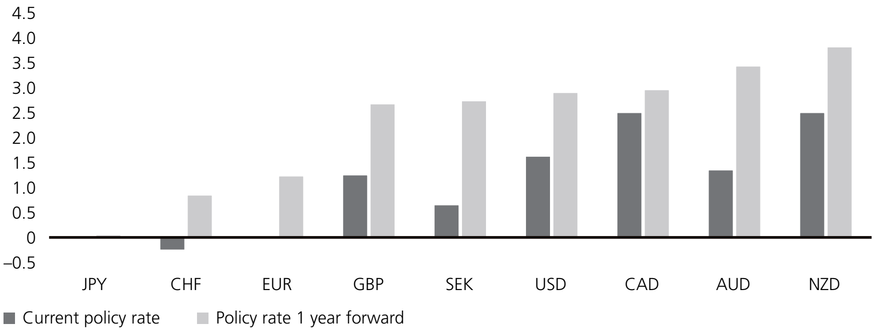
Elsewhere, within equities, we stay most preferred on quality income, value, and the UK and Australian markets, and least preferred on growth. We also prefer the energy and healthcare sectors.

In currency markets, we prefer the Swiss franc, the Australian dollar, and the Canadian dollar and are least preferred on the euro. We also keep a most preferred stance on overall commodities and oil.

Figure 4

Significant expectations of front-loaded hiking cycle already embedded in yield curves

Current policy rate, policy rate one year forward, in %



Source: Bloomberg, UBS, as of 26 July 2022

Overall, to blend an uncertain short-term outlook with long-term opportunities, we continue to focus on ideas that can help investors build a diversified portfolio, navigate varying near-term outcomes, and grow wealth over the long term. These include:

Scenarios	Investment ideas	
Slump / Stagflation (downside)	*Manage a liquidity strategy*	By building a Liquidity strategy—and funding it with cash, bonds, select structured investments, and borrowing capacity to meet the next 3–5 years of cash flow needs—investors can mitigate the risk of forced selling, earn yield, and prepare to capture market opportunities as they arise.
	Diversify with hedge funds	Some hedge fund strategies—especially macro strategies—can perform well in recessionary scenarios, and so far this year they have broadly outperformed equity and fixed income strategies. As a result, they can be effective diversifiers.
	Add defensives and quality	The full impact of higher interest rates and high inflation on corporate profits is not yet clear. By adding exposure to defensive parts of the market (including healthcare and quality-oriented stocks), high grade bonds, and the Swiss franc, we believe investors can improve the resilience of their portfolios. In contrast, we do not see gold as an effective portfolio hedge today.
	Make use of volatility	To mitigate volatility, we think capital protection and dynamic asset allocation are good ways to position more defensively. Meanwhile, we see opportunities to generate yield amid elevated currency, commodity, and equity market volatility.
Soft landing	*Invest in value*	After outperforming for much of the year, value stocks have underperformed in recent weeks amid lower commodity prices and lower bond yields. But we continue to see upside in commodity prices, and, until inflation falls consistently, think value will outperform growth. We favor broad value with a quality tilt, energy stocks, and the UK market.
	Position for the era of security	Amid supply chain challenges, geopolitical uncertainty, and high commodity prices, governments and businesses alike are adapting to an "era of security," in which security is valued more highly than efficiency or price. In the near term, tightness in various commodity markets means we expect higher prices in the months ahead. Over the longer term, we think demand for energy security (carbon-zero), food security (agricultural yield enhancement), and cybersecurity solutions will all be boosted in this new world.
Reflation	*Be selective in longer-term growth*	An alleviation of market concerns about longer-term inflation has supported the recent rally in growth stocks, although we still advocate selectivity at this stage. We see opportunities in select beaten-down stocks, companies linked to the automation and robotics theme, family businesses, and China.
	Invest in private markets	Some private market funds are likely to revise down net asset value estimates in the coming months, as a result of the decline in growth equity valuations this year. But putting fresh capital to work in private markets following declines in public market valuations has historically been a rewarding strategy.

3L disclaimer: Timeframes may vary. Strategies are subject to individual client goals, objectives and suitability. This approach is not a promise or guarantee that wealth, or any financial results, can or will be achieved.

Key scenarios and asset class impact

	Reflation *Strong equity recovery*	**Soft landing** *Limited upside in risk assets*	**Slump** *Equities fall as safe bonds rally*	**Stagflation** *Equities and bonds fall further in tandem*
Probability	**10%** (before: 10%)	**40%** (before: 40%)	**40%** (before: 30%)	**10%** (before: 20%)
Primary triggers	Economic growth surprises positively, while official inflation numbers start to decline ahead of expectations. Inflation fears abate. The Fed and other major central banks reduce accommodation less than the market currently expects.	Corporate earnings remain resilient despite a slowdown in economic growth brought about by tightening financial conditions and rising energy costs. Markets remain resilient despite possible shallow recessions in the US and the Eurozone. Although headline inflation numbers remains strong, core inflation continues to decelerate, and long-term inflation expectations remain anchored as investors gain confidence that inflation is gradually coming under control. The Fed and the ECB raise rates at most in line with market pricing.	The US experiences a recession in the next 12 months as real disposable incomes fall considerably and tight financial conditions disrupt economic activity. Investors start to price in a significant drop in corporate profits. European sovereign spreads rise to a level of concern. The economic downturn is sufficiently deep to send inflation, bond yields, and risk assets sharply lower. The Fed and other central banks consider interest rate cuts and/or other monetary easing measures.	Recessions in the US, the Eurozone, and other regions are not enough to contain inflationary pressure. Inflation continues to rise and stays high throughout 2022. The Fed remains "behind the curve" as wage-price spirals start to form. Long-term inflation expectations rise. The Fed and other major central banks continue to tighten policy aggressively, which further pushes up government bond yields and depresses equity valuations.
Secondary triggers	The flow of Russian gas to Europe resumes to meet European energy demand in full. Energy markets stabilize. COVID-19 epidemic in China subsides; any further major-city lockdowns are limited to seven days or less. Strong policy support lifts growth. The US labor force participation rate improves as high wages attract more workers.	Russia continues to supply gas to Europe at a reduced capacity. Gas rationing in Europe leads to a shallow Eurozone recession in the second half of 2022. The COVID-19 epidemic in China continues, but any further major city lockdowns are limited to 7–14 days. Policy support is gradually ramped up to support growth.	A prolonged cessation of Russian gas supply to Europe causes a deep Eurozone-wide recession. Russia resorts to the use of WMDs in Ukraine, which dramatically increases the risk of direct military involvement by NATO. COVID-19 epidemic in China reaccelerates with more large-city lockdowns extending beyond 14 days. Policy response is delayed and transmission to the economy is slow.	Energy and food prices stay elevated because of persistent supply disruptions caused by the war in Ukraine, sanctions on Russian gas, and Russia's weaponization of energy exports. Reacceleration of the COVID-19 epidemic in China weighs on China's export capacity, exacerbating supply bottlenecks.
What happened?	**Downside risks to growth increased while structural upside risks to inflation receded since last month.** In the US, the June headline CPI beat expectations at 9.1%, while University of Michigan 5-year inflation expectations fell from 3.1% to 2.8% and long-term breakevens declined. The US Treasury yield curve inverted, signaling the Fed's increasing willingness to contain inflation at the expense of an economic downturn. Elsewhere, early signs point to a stronger-than-expected reacceleration in China in the second half of 2022. COVID-related lockdown rules have been adjusted in favor of municipal authorities to make any future lockdowns more targeted. More active policy support is expected to lift growth further and limit the impact on global supply chains. Long-term inflation expectations in the US declined as headline inflation remained high.			

	Spot*	**Reflation**	**Soft landing**	**Slump**	**Stagflation**
S&P 500	4,024	4,500	3,900	3,300	3,100
EuroStoxx 50	3,607	4,200	3,400	3,000	2,700
MSCI EM	990	1,180	1,050	850	800
SMI	11,057	12,200	11,300	9,600	9,400
MSCI AC World	752	830	750	615	570
US 10-year nominal yield	2.78%	2.75%	3.25%	1.50%	4.00%
US 10-year real yield	0.32%	0.50%	0.70%	–0.50%	1.00%
US IG spread**	127bps	45bps	100bps	200bps	135bps
US HY spread**	507bps	300bps	450bps	750bps	650bps
EURUSD	1.02	1.08	0.98	0.98	0.95
Gold	USD 1,746/oz	USD 1,400–1,500/oz	USD 1,600/oz	USD 1,800–1,900/oz	USD 2,000–2,100/oz

* Spot prices as of market close of 27 July 2022
** During periods of market stress, credit bid-offer spreads tend to widen and result in larger ranges. Percentage changes refer to expected total return (t.r.) for the indicated spread levels.

Note: asset class targets above refer to the respective macro scenarios. Individual asset prices can be influenced by factors not reflected in the macro scenarios.

Source: UBS, as of July 2022

Adding up the cost of waiting

Does it make sense to wait before investing? Our analysis shows that, for those with one-year investment horizons, it is rational to wait if you perceive there is a greater-than-30% chance of a greater-than-10% sell-off. For those with a 10-year investment horizon, it is only rational to wait if you perceive a >81% chance of a >10% sell-off.

We assume:
– A 1-year cash return of 3%, based on 1-year US government bond yields.
– A 10-year cash return of 32%, based on compounding the 2.8% annualized yield on 10-year US government bonds.
– A 1-year return on equity of 8%, based on our June 2023 S&P 500 target of 4,200 (4.3% higher than today) and a dividend yield of 1.6%.
– A 10-year return on equity of 82%, based on our estimate of fair value in 10 years' time. If we extrapolate trend earnings, we reach an estimate of S&P 500 earnings per share of USD 382 by 2032 (from USD 227 in 2022). The median P/E ratio on the S&P 500 since 1960 has been 16.1x. This would imply an S&P 500 level in 2032 of 6,150 (16.1 x USD 382), 56% higher than today's level. If we include reinvested dividends, we derive a total return of 82%. (Note that trend earnings analysis can generate different forward returns than our historical P/E analysis).

Next, we consider the potential outcomes for two kinds of strategies that can be employed today: 1) hold cash, and only buy if the market falls by 10% from today's levels; or 2) buy now.
– Returns for the "now" investor, who puts money to work immediately, would simply be in line with the market returns described above.
– Returns for the "wait" investor, who holds cash and only chooses to invest if a 10% sell-off materializes, would vary depending on whether the sell-off materializes, or doesn't.
– For the scenarios in which a 10% sell-off materializes, the "wait" investor would buy in at 10% below the current prices. Thereafter, they would earn returns in line with our assumptions above. Depending on how long they waited in cash, they would also earn some return on cash.
– For the scenarios in which the 10% sell-off doesn't materialize, the "wait" investor would remain in cash for the entire period.

The table below shows the potential outcomes.
– Over a 1-year horizon, "wait" investors would either earn 18–21% (if they bought the dip and the market recovered to our June 2023 target), or 3% (if they remained in cash). "Now" investors would earn 8%.
– Over a 10-year horizon, the "waits" would either earn 92–95% (if they bought the dip and the market delivered returns in line with the above assumptions thereafter), or 32% (if they remained in cash). The "nows" would earn 82%.

There is no one strategy that outperforms in all scenarios. So, how to calculate a rational course of action?
– Of course, much depends on the perceived likelihood of a sell-off. If a sell-off is likely, it is better to wait. If it is unlikely, it is better to invest now. One way to judge a rational course of action is to consider what probability of a sell-off would be required before the expected return from waiting is higher than the expected return from investing.
– Over a one-year horizon, we find we would have to assume a >30% probability of a sell-off before the "wait" investor's expected returns are greater than the "now" investor's return. (In this case, the expected return for the "wait" investor in the first year would be: (>30% x 18.5%) + (<70% x 3%) = >7%).
– Over a 10-year horizon, we would have to assume a >81% probability of a sell-off materializing before the "wait" investor's expected returns are greater than the "now" investor's. (In this case, the expected return over a 10-year horizon would be (>81% x 93.5%) + (<19% x 32%) = >82%).

What does this mean?
– In short, for investors putting money to work with a one-year investment horizon, it is rational to wait if they perceive a >30% chance of a >10% sell-off.
– But for those investing with a 10-year investment horizon, it is only rational to wait if they perceive a >81% chance of a >10% sell-off.
– Simply put, while waiting can be justified for investors with a short-term time horizon, longer-term investors need to be very sure that markets are going to sell off in order to rationally justify waiting to invest.

1-year horizon	**10% sell-off materializes within first year**	**10% sell-off doesn't materialize**	**Probability of the sell-off happening needed for "wait" investor to have higher expected return**
"Wait"	+18–21%	+3%	30%
"Now"	+8%	+8%	
10-year horizon	**10% sell-off materializes within first year**	**10% sell-off doesn't materialize**	**Probability of the sell-off happening needed for "wait" investor to have higher expected return**
"Wait"	+92–95%	+32%	81%
"Now"	+82%	+82%	

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UBS Investor Forum Insights

At this month's Investor Forum, panelists shared their views on market drivers, emerging markets, and investment opportunities.

- On the inflationary outlook, panelists discussed the role of central banks in bringing inflation down to target. The consensus view was that the Fed would likely shift its policy stance once inflation is brought down to about 4%. The global economy is also expected to adjust quickly to the changing environment, with reduced growth starting to impact the labor market as companies reduce their hiring intentions.
- China was the preferred area of investment among emerging markets. While panelists expressed caution over the fragility of the real estate market, they also identified opportunities supported by China's low inflation rate, slightly looser COVID-19 restrictions, and the PBoC's business-facilitating regulations. Beyond China, panelists are looking at how the US dollar will perform when deciding their risk appetite for emerging markets.
- Panelists advocated a defensive portfolio to navigate the uncertain economic environment. Regionally, some panelists identified investment opportunities in European value and high-dividend strategies while also recommending inflation hedges such as gold or real estate. In fixed income, investment grade bonds were seen as a good defensive position, while some participants showed interest in high yield credit, given recent cheaper valuations.

Mark Haefele
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Non-traditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments, there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

Interests in alternative investment funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in an alternative investment fund and should consider an alternative investment fund as a supplement to an overall investment program.

In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

- Hedge Fund Risk: There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, "junk bonds," derivatives, distressed securities, non-U.S. securities and illiquid investments.
- Managed Futures: There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.
- Real Estate: There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.
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