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5 April 2006

Media release

Demographics: a coming of age

The world's population is aging. Families are having fewer children, medical science is extending people's lives, and the baby boom generation is entering retirement. These trends are not new. They have already been discussed in numerous studies, which, indeed, often arrive at quite somber conclusions. UBS Wealth Management Research projects, however, that countervailing forces will mitigate the negative impact of population aging on overall economic growth per capita. Even a rising transfer to older generations will leave the per capita income growth rate of the working age population at a surprisingly solid level. Demographics will also have only a mild impact on financial markets – fundamentals matter more. But the widespread demographic change through the middle of this century will have a profound impact on the products and services people demand and consequently the health and prosperity of the industries affected and their attractiveness for financial investments.

Zurich/Basel, 5 April 2006 – A new report released by UBS Wealth Management Research analyzes how the aging of the population in developed countries will impact economic growth projections, financial market performance, and industry trends.

In particular, the new report highlights the following:
- Trend rate of global economic growth to slow; income distribution more important as countries age
- Mild, yet mixed, impact on financial markets; outcome depends on pensions and regional exposure
- Building demand for new tailor-made products; projected industry innovation and evolution

Trend rate of global economic growth to slow

One of the consequences of aging is that fewer people will enter the labor force, while at the same time, more people will enter their retirement years. This creates two potential economic challenges, according to UBS. The first result is that a shrinking labor force and lower rates of saving will slow the trend rate of economic growth in several developed countries. Increasing workforce participation rates, the retirement age, hours worked, and immigration may help to mitigate the growth slowdown, but are unlikely to fully remediate the effect of aging on developed country economies.

Secondly, countries will have to distribute economic output, or income, among a larger group of people who are retired and a smaller group of people who are working. Certain government policies, such as the provision of healthcare and

public pension programs, for example, will act to redistribute income between age groups. However, even the most ingenious financing schemes cannot bypass the fact that we can only consume what is produced. This report shows that countries most affected by aging demographics will need to find ways to transfer economic production from workers to elderly generations in order to prevent an absolute decline in the living standards of the elderly. Even if transfers are large enough to keep the per capital income growth of the elderly constant at 1.0% per annum, the income growth of the working age population in developed countries would still rise between 1.1% per annum in Switzerland and 1.8% in Japan.

Demographic projections point to continued growth in the working age populations of many developing countries, as fertility rates remain well above the replacement rate. The UBS report shows that this demographic trend should continue to support economic growth rates in developing countries when accompanied by important institutional reforms, improvements in productivity, and greater participation in the world's economic system.

A mild, yet mixed, financial market impact
Slower economic growth rates and lower savings rates in developed countries, brought about by an aging population, do not automatically translate into weaker financial market conditions, according to the new report from UBS. Demographic shifts will likely be overshadowed by other fundamental trends, such as the geographic diversity of earnings, the integration of global capital markets, and shifts in institutional pension plan holdings. On the earnings side, as corporations invest abroad and increase the geographic diversity of their sales and cost structure, earnings will increasingly decouple from home country economic growth rates.

Meanwhile, real interest rates (i.e., inflation adjusted), will increasingly be set by the global interplay between the demand for investment and the supply of savings. In industrial countries, any reduction in saving brought about by the drawdown in financial wealth during retirement should exert upward pressure on real rates, while the opposite should occur in developing countries. However, increasingly integrated bond markets will ensure that these effects are limited. In particular, capital flows from thrifty emerging markets into low-saving developed countries will likely constrain upside pressure on real rates in developed countries.

Where the impact of demographic trends on financial markets may be more apparent is through shifts in pension plan holdings. Under a reduced investment horizon, pension plans will likely seek to shift their asset allocation toward bonds and away from equities, and may even begin to shift their debt holdings to shorter-maturity bonds as plan participants age. Overall, the described shift in portfolio composition should negatively affect equities and support bonds (i.e., help maintain low bond yields).

However, as this effect is expected to originate from pension plans rather than from individual investors, we expect it to be most noticeable in countries with a well-developed pension system. Prime examples are the Netherlands, the UK, the US and, to a somewhat lesser extent, Switzerland. In some rapidly aging countries that heavily rely on pay-as-you-go public pension programs, forces will be at work that should provide support to financial market performance. The result will be a

strengthening of the equity culture, a deepening of financial markets, and a greater demand for financial assets. Countries that are the most likely to experience this effect include Germany, France, and Italy.

Building demand for new tailor-made products

Finally, the report identifies shifts in demand for products and services as a result of aging, both positive and negative, as well as how labor shortages can impact selected industries. Specifically, UBS discusses the effect of the aging demographic trend on the healthcare, consumer cyclical & consumer discretionary, technology, and financial industry sectors. According to UBS, the impact of demographic change on industries and companies will be far-reaching, requiring a thorough understanding of the key issues facing each particular sector. In some sectors, such as food manufacturing and auto assembly, production centers will likely shift to regions with less expensive labor. In others, such as orthopedics and banking, products and services will change to meet the demands of an aging customer base. New industries, such as robotics and household medical equipment devices, will emerge to address labor shortages and meet the needs of elderly consumers.

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