Fund-in-Focus

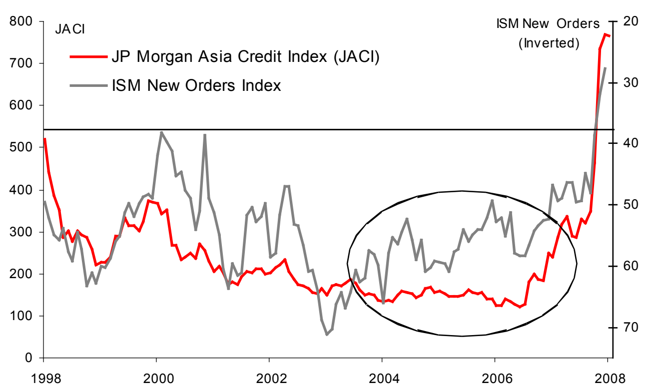
UOB Optimix Asian Bond Fund

1 Which markets does the UOB Optimix Asian Bond Fund ("the Fund") invest in?

The Fund invests in bonds issued by Asian companies and Asian governments, financial institutions and government agencies, including money market instruments. The aim of the Fund is to provide stable current income as well as capital appreciation. The portfolio is invested in securities denominated in both US dollars as well as Asian currencies.

2 2008 was marked by extreme levels of volatility and Asian fixed income markets came under severe pressure along with other risk markets. What is the outlook for Asian fixed income markets as we are faced with the current global recession?

The most common benchmark for the Asian fixed income market is the JP Morgan Asia Credit Index (JACI) while our favourite proxy for the global economic cycle is the US ISM New Orders Index, a component of the wider Institute for Supply Management Manufacturing (ISM) Index. The latter is a leading indicator of economic activity in the US and it is one of the most widely watched figures on the financial markets. The accompanying chart shows the ISM New Orders Index plotted against the JACI, over a period of ten years.



Source: Bloomberg 10 December 2008

There is a relatively good correlation between the two cycles apart from the period circled, from early 2005 to end 2006. Investors will recall that this is the period characterised by the "Asia Decoupling" story when the growth engines in Asia were firing on all cylinders, driven by China's double-digit growth. Then, China's seemingly unstoppable economy appeared able to supplant the US-led growth model of the past and Asian credit spreads remained resilient and 'invincible' - even in the face of poor economic data that came out of the US.

The two cycles however re-coupled in early 2007 when the US sub-prime housing problem first emerged. Asian credit spreads continued to widen in the ensuing period and blew out to unprecedented levels in the final months of 2008 when the crisis on Wall Street reverberated through the global economy and business confidence collapsed. As the ISM New Orders Index plunged, Asian credit spreads reached levels that were even worse than those seen during the Asian Crisis.

However, we believe that the US economy could be starting to find a bottom and if the US ISM New Orders Index does not worsen much from here, the technical pressures resulting in forced selling are likely to abate and we may have seen the peak in spreads, at least in the High Grade credits. In the High Yield space, we expect credit spreads to continue widening.

3 Given your expectations for the global economy, how is the portfolio positioned as we move into the new year? What is the key consideration?

We continue to have an overweight position in High Grade corporate bonds in preference to High Yield corporate bonds. The key concerns are refinancing and liquidity risks. No Asian Single B corporate bond was issued in 2008 and, since the bankruptcy filing of Lehman Brothers Holdings Inc. on 15 September 2008, no Asian sovereign or Asian corporate has been able to tap the bond market. In addition, Asian corporates are facing the risk of rating migration stemming from the possible downgrades in Sovereign ratings and also from the decline in earnings. However, in our view, High Grade investors are being adequately compensated for these downgrade risks given the current credit spreads.

4 The Fund invests in a number of industry sectors in the Asian credit space. In which of these is the Fund holding an overweight position?

We believe the focus of the market is likely to shift from systemic to idiosyncratic risks and this has prompted us to turn positive on the **Financial** sector. We like the corporate bonds of strong and large banks that are closely linked to their sovereigns or those that have strong sponsors. In the capital structure, we prefer Senior debt but have also invested in selective Lower Tier 2 credits. Our investments in the Financial sector include **DBS, OCBC, Public Bank** and **Ambank**.

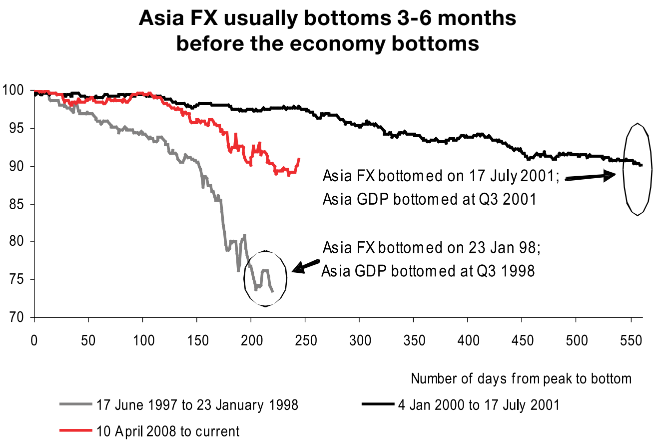
For defensiveness, we continue to stick to the **Telecom** sector. Revenue growth in the Telecom sector has a low correlation with economic activity and while we expect some slowdown in revenue, we do not expect any collapse. Our preferred names in this sector are **KT Corporation, Telecom Malaysia, Excelcomindo** and **SK Tel**.

We have underweight positions in **Industrials** and also the **Retail** space. Among Industrials, we are particularly negative on the export-oriented companies and cyclical industries, such as semiconductors and shipping, given the expected depth of the recession. We are also cautious on companies with huge capital expenditure and aggressive expansion plans as these may add pressure to their credit profile. In the Retail sector, we prefer companies which have a higher proportion of necessities (food and household goods) in their product mix as these products have lower income elasticities – in other words, a decline in household incomes does not typically translate into an equivalent decline in quantity purchased.

5 Asian currencies were weak for much of 2008, especially in the second half of the year. What are your expectations for the Asian currency markets in 2009?

One large reason for the weakness in Asian currencies was the extreme rise in risk aversion in 2008. As investors pulled out of Emerging Markets, including Asia, their currencies came under pressure.

We, however, believe that Asian currencies are likely to have bottomed in the fourth quarter of 2008 and the Asia Dollar Index[1] could strengthen by about 1% in the first quarter of 2009. Asian currencies typically start to turn up three to six months before the region's economy bottoms.

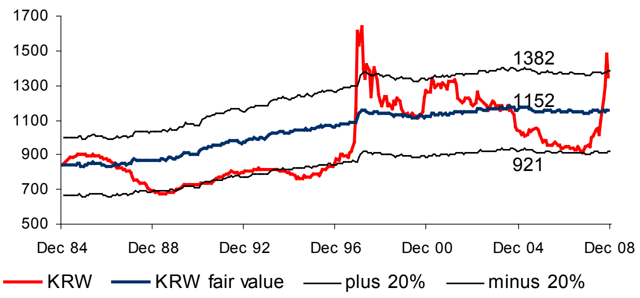


Source: Bloomberg, UOBAM, 23 December 2008

Amongst the Asian currencies, we believe the Korean Won (KRW) has the greatest potential to appreciate. The KRW was one of the hardest hit currencies in 2008, declining 39%[2] against the US dollar. "Overshooting" in currency markets is common and according to our calculations, the KRW is approximately 17%[2] undervalued. One main driver of the currency in the coming months is likely to be Korea's current account. The fall in the price of oil to below US$40/barrel[2] meaningfully affects Korean's trade balance, which swung into surplus in October 2008.

[1] The Asia Dollar Index is a basket of currencies against the US dollar in the following weights: Chinese Yuan 31.5%, Hong Kong dollar 11.3%, Indian Rupee 6.1%, Indonesian Rupiah 3.4%, Korean Won 13.6%, Malaysian Ringgit 6.1%, Philippine Peso 2.4%, Singapore Dollar 11.0%, Taiwan Dollar 9.7% and Thai Baht 4.9%. (Source: Bloomberg, 21 January 2009)
[2] Source: Bloomberg, as at 24 December 2008

KRW is 17% under-valued against the USD according to PPP model. Fair value should be 1152



Source: Bloomberg, UOBAM, 23 December 2008
Note: PPP refers to Purchasing Power Parity

We are mildly negative on the Singapore dollar as we expect a hard landing for the Singapore economy. In our view, the leading indicators are pointing to a steep contraction in the economy on a year-on-year basis in the first half of 2009. This is more than what the market is expecting. In light of this, we expect the Monetary Authority of Singapore to facilitate a depreciation of the Singapore dollar. Unlike most countries, Singapore does not have an interest rate policy and the exchange rate is the main tool for monetary policy.

	December 26, 2008	UOBAM forecast for 1Q 2009	Expected % appreciation/ depreciation
China	6.84	6.86	-0.3
HK	7.75	7.7501	0.0
India	48.51	48.5	0.0
Indonesia	11144	11000	1.3
Korea	1299	1270	2.3
Malaysia	3.48	3.65	-4.7
The Philippines	47.58	48.24	-1.4
Singapore	1.45	1.53	-5.2
Taiwan	33.01	34.0	-2.9
Thailand	34.85	35.00	-0.4

Source: Bloomberg, UOBAM, 26 December 2008

6 A global recession is widely expected and priced into most markets. Nonetheless, it is still likely that 'negative surprises' could emerge. What are the areas of risk that need careful monitoring?

The risks we are most mindful of in the current environment are the following:

1) A rating migration is likely given the deteriorating operating environment. The risk is in the severity of the downgrades, and where they fall. Credit quality will deteriorate as the recession bites and corporate earnings worsen. In addition, due to the large fiscal stimulus packages announced by the various governments in Asia, there is also the potential for downgrades to be seen in Sovereign debt and this will have knock-on effects on the corporates that rely on their support.
2) As mentioned earlier, the credit crunch has given rise to near term liquidity and financing risks. Companies that are unable to roll over their debt would be financially crippled and potentially enter into a state of default.
3) We are also concerned about the level of corporate governance among some of the less developed supervisory bodies.
4) An associated concern is the weak legal infrastructure in some of the countries in which we invest. The lack of transparency in the enforcement and interpretation of laws could push down the recovery values of distressed debt.

7 Looking beyond the current market dislocations and economic downturn, what is the longer term outlook for the Asian fixed income market?

The current crisis is likely to prove to be just a large hiccup in Asia's economic development. Both Asian sovereigns and Asian corporates have so far withstood the current financial meltdown relatively well, especially in comparison to the other emerging regions. We expect Asia to be among the first regions to recover as there is relatively little leverage in Asia's balance sheets (overall debt has been low after the Asian Crisis) and this, we believe, will allow the region to resume its vigorous economic growth in due course.

We also expect Asia Fixed Income as an asset class to continue to grow, in breadth and in liquidity, as the region develops economically and alongside this growth we are also likely to see improvements in corporate governance and transparency.