

# On the Markets

## MICHAEL WILSON

Chief Investment Officer  
Morgan Stanley Wealth Management

## Volatility Can Lead to Opportunity

When 2014 began, one of our most strongly held views was that this year would bring more volatility to the markets than what we saw in 2013. That's because whenever the Federal Reserve begins to tighten monetary policy, higher volatility has historically followed. While higher volatility is normal at this stage of the recovery, it does not mean the end of the recovery. Instead, it usually provides opportunities to invest new capital at better prices. The mid-January/early February stock market correction is likely to be the first of what we think will be several of these opportunities during the year. Were you ready for it? Most equity markets have recouped all their losses and are approaching or making new highs.

As equities declined, bonds rallied sharply—typical behavior when markets fear growth is slowing. However, unlike equities, bonds have not reversed these moves. Bond yields remain close to the lows for the year and, conversely, bond prices are at their highs. Should we be worried about this divergence of bonds and stocks? Are bonds telling us that that trouble is still looming and growth will disappoint? We don't think so.

Instead, we think bonds are still benefitting from the portfolio rebalancing that is a result of the 34% outperformance of equities over bonds last year. In addition to this rebalancing from stocks to bonds, there are many large defined benefit pension plans engaging in “liability defeasance.” This is also the result of equities' 2013 returns, which left many of these plans fully funded for this first time in years. Thus, many fiduciaries are deciding to “lock in” their funding status. This maneuver can be done by investing in very long-term US Treasury bonds with all of the plan assets. While defeasance creates strong demand for bonds and drives yields lower, we think this is a temporary source of demand that will eventually run its course. Therefore, do not be complacent; instead, take advantage of this bond rally to shorten maturities if you haven't already done so.

Finally, with volatility and bond yields expected to rise this year, we think it is a good time to reconsider alternative investments in one's portfolio. As stocks and bonds rallied strongly during the last five years, alternatives were not a good choice. At this stage of the recovery, we believe that alternatives can help reduce the volatility in a portfolio while providing better returns than fixed income as interest rates normalize. ■

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# Consensus Bulls and Contagious Complacency

ADAM S. PARKER, Ph.D

US Equity Strategist  
Morgan Stanley & Co.

It is hard for us to think we are not consensus bulls. We know that the consensus is right a lot, so that doesn't in and of itself necessarily make us worried. So what are the risks we hear about?

One of the main questions we have tried to address with investors over the past several weeks is whether contagion from the emerging markets can impact US equities. So far we have been pretty dismissive. Why? Because complacency has become a learned behavior in the minicrises that have periodically popped up since the summer of 2011. After all, every dip in the S&P 500 caused by Greece, Cypress, Italy, Spain or Portugal was a dip to be bought. Every monetary policy decision, or fear of a hard landing, or Washington standstill, was an opportunity to load up. So, why should a "little" cocktail of Turkey and Argentina cause sustained fear?

**EARNINGS APPEAR SOLID.** What really matters is that the dream of growth stays alive, and that the bear case in US corporate earnings doesn't form. Without significant fear of an earnings pullback, the market really has never gone down more than 10% historically. Sure, you want to avoid stocks that pull a double-digit percentage of their earnings from, say, Argentina, but in aggregate corporate earnings from these countries just aren't substantial enough to instill meaningful fear that there could be an earnings recession. We guess the complacency we learned from the core of Europe is contagious to the emerging markets,

meaning we will dismiss fears from some of the smaller emerging market (EM) countries until big US multinationals tell us their earnings are meaningfully impaired.

At the end of the day, we are really saying that we aren't particularly worried about the emerging markets. Turkey is the world's 17<sup>th</sup> largest economy, and we have learned never to focus on the 17<sup>th</sup> most important thing. So, to us, the main risks to the S&P 500 remain a US or China growth slowdown. After all, these are the two largest economies in the world and could grow enough this year to simply add GDP about the size of Turkey.

**RECOVERY RISK.** The US recovery is the biggest risk to our bullish outlook. If we hit a sustained soft patch in the US economy, with weak Institute for Supply Management and job reports, my sense is that by late spring this could cause a sizeable market correction. After all, how can we earnestly say that lower growth and lower liquidity is "fine" for US

equities? However, Morgan Stanley & Co.'s base case for the US economy calls for slightly higher growth this year than last. Lending growth seems to be picking up, and we suspect lending growth will improve as credit standards are slowly relaxed. So our base case is that the dream of growth is still alive.

China is a major risk, too. We've been wondering whether a slightly lower China economic trajectory is already embedded into the US stock market. Is that a preposterous thought given the S&P 500 is basically at its all-time high? Not really, as a basket of US equities with China exposure trades well below the 2007-to-2011 average and, after the recent correction, at only a modest premium to the 2013 level. Our guess is that low-to-mid single-digit downside to the market is all that's probable from a China slowdown.

**BELOW CONSENSUS ON CHINA.** Why? Our house view on the China economy, while below consensus, is not one where we see a high probability of a hard landing. We've seen in the last 18 months in the US that a mediocre and below-consensus base case with a low probability of a bear case is just fine for equity market multiples. Our guess is that this scenario for the Chinese economy might not be bad for equity market multiples, too.

## MS & Co.'s 10 Fastest-Growing Industries

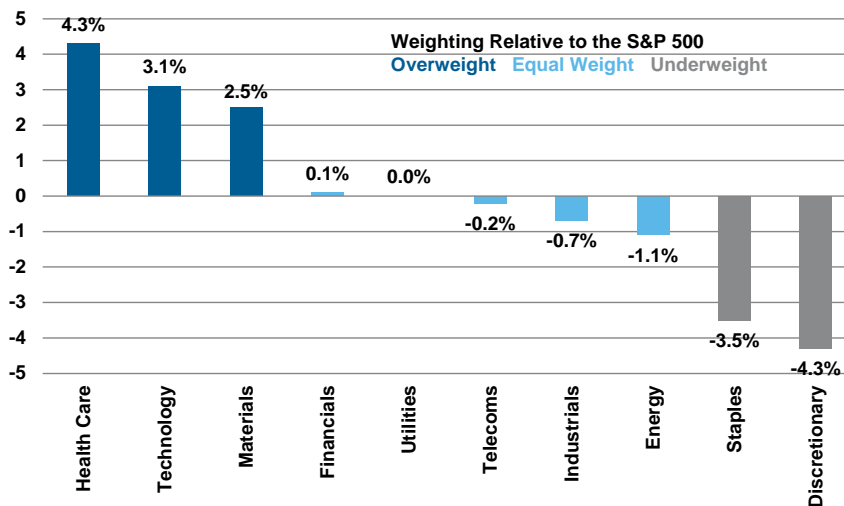
	Revenue (\$ billion)		YoY Growth (%)	
	2013	2014E	2014E	2015E
Biotechnology	54	65	19.2	20.5
Internet & Catalog Retail	110	131	18.9	17.3
Internet & Software Svcs.	110	130	18.4	18.1
Airlines	136	158	16.0	4.9
Transportation Infrastructure	1	1	15.1	13.5
Life Sciences Tools & Svcs.	43	48	12.8	6.7
Real Estate Mgmt. & Dvlpmnt.	19	22	12.7	0.7
Health Care Technology	6	6	12.5	14.0
Construction Materials	7	7	12.0	14.7
Wireless Telecomm Svcs.	69	77	11.4	2.2

Source: Thomson Reuters, Morgan Stanley & Co. Research as of Feb. 24, 2014

On the margin, we think weakness in China could be bad for industrials, old technology (think hardware), machinery, and metals and mining. Our suspicion is that health care, new technology (big data, analytics, software, Internet) and US chemicals will be relatively less affected by a China or EM slowdown.

**WEAKER DOLLAR, STRONGER PROFITS.** Much of the headline news in currencies over the past few months has been on EM currencies and the yen. Maybe somewhat quietly then, the dollar has weakened versus the euro to levels really never seen outside of the euro crisis and its unwind in 2011. The euro is 57.6% of the trade-weighted currency basket, and a weak dollar versus the euro is quite helpful to US corporate earnings. Our prior work shows that each 10% the dollar weakens against the euro over a full year helps S&P 500 earnings by about 6%. So, compared with, say, the stronger dollar in the middle of 2012, today's earnings have been helped by about 1.5% per quarter due to the weak dollar/euro alone. Overall, this should be supportive for technology, health care and consumer staples—making the recent downward revisions in

## How MS & Co.'s Sector Recommendations Line Up



Source: Thomson Reuters, Morgan Stanley & Co. Research as of Feb. 24, 2014

consumer staples even more disappointing. Consumer staples revisions have been the worst of any sector in the market, and owning expensive defensives that miss their earnings targets isn't prudent.

In the end, we believe investors who want to have exposure to growth should consider investing around some themes such as: the rerating of the research & development pipeline, either through biotechnology or

select pharma; Internet and software; and airlines (see table, page 2). By sectors, we are overweight health care, technology and materials; market weight utilities, financials, telecoms, industrials and energy; and underweight consumer staples and consumer discretionary (see table, above). ■

ON THE MARKETS / ECONOMICS

# Turnin' Up the Heat

## ELLEN ZENTNER

Senior US Economist  
Morgan Stanley & Co.

## JOHN ABRAHAM

US Economist  
Morgan Stanley & Co.

Severe weather can disrupt economic activity and, according to the National Oceanic and Atmospheric Association, the current winter season is shaping up to be one of the coldest—and snowiest—on record. Weather-related distortions have clearly been captured in data releases such as the January Institute for Supply Management manufacturing index, motor-vehicle sales and overall retail sales. Housing activity also shows the effects of extreme weather in parts of the country; freight-transportation companies, which are some of the best indicators of overall economic activity, are seeing a material impact on volume and costs.

**HEATING HITS SPENDING.** With the cold weather comes the need to heat homes and, of course, the attendant energy

expenses. We find that natural gas prices affect more than 80% of households that turn up the heat. As a result, outsized increases in natural gas prices this winter have cut into household spending by an above-trend \$34.7 billion. Although depressed gasoline expenses have offset some of the energy cost for consumers, the ambit of natural gas prices extends well beyond the purchase of the actual commodity: “Marginal generation” pricing by utilities, which use natural gas to generate power for needs above the typical base load, can spread the price increases to other energy sectors. This leads us to believe that the true impact of this year's severe winter on home heating costs may currently be understated.

Here's how the heating bill is shaping up. Based on seasonally adjusted consumption patterns of natural gas in 2013, the annualized cost to households of a 10-cent price increase is approximately \$1.5 billion. This winter, from November through January, natural gas prices ran

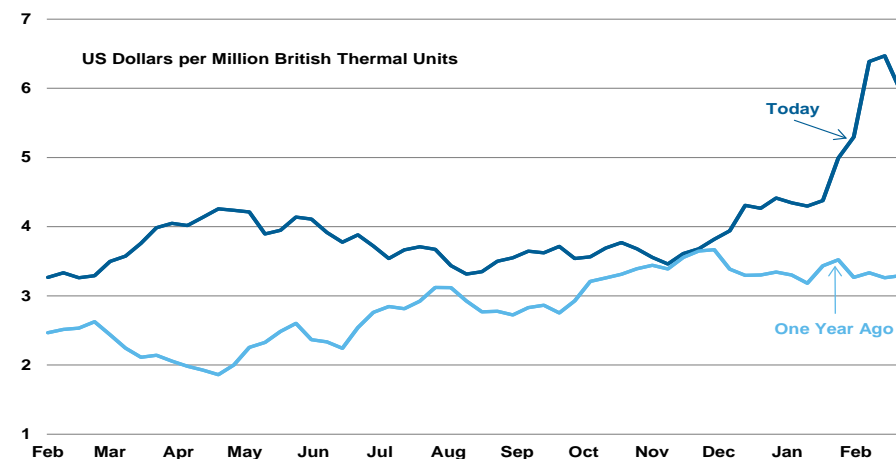
about \$2.30 higher than during the same period one year ago, suggesting an additional burden to households of roughly \$34.7 billion (see chart). While \$34.7 billion is a small share of total disposable personal income (about 0.3% in 2013), higher natural gas prices this winter are an added burden on US households that rely on natural gas for home heating.

**GASOLINE PRICE RELIEF.** Gasoline prices, however, are providing a modest offset, standing about 7.5 cents per gallon lower from November through January when compared with the same period last year. Americans devote a much larger share of income to gasoline than natural gas, and every 10-cent increase/decline in gasoline prices costs/saves US households about an annualized \$10.4 billion. This suggests that households are currently saving nearly \$8 billion at the pump over these cold months. Taken together, the net additional burden to households this winter, from higher natural gas prices less lower gasoline prices, is about \$27 billion.

Depending on how long the big chill lasts, it may be some time before we see “clean” data on the US economy—data that has not been abnormally affected by the weather. Such weather-related impacts on data are largely viewed as transitory through the lens of the Fed.

Moreover, these short-term disruptions tend to be reversed in the following quarter, which means the second quarter is likely to play catch-up. Our current GDP tracking estimates suggest that fourth-quarter real GDP growth will be revised downward to 2.5% from the originally reported 3.2%. We see the first quarter tracking at 0.7%, which builds in a drawdown in inventories, weak January retail sales results and lagging construction activity. If recent weakness is in fact weather related, however, we could see a strong rebound in the second quarter. In fact, our models show that the growth trajectory for the second quarter is in excess of 4%. ■

## What a Difference a Year Makes for Natural Gas Prices



Source: EIA as of Feb. 21, 2014

# Emerging Markets Out of Sync?

**PATRYK DROZDZIK**

*Economist  
Morgan Stanley & Co.*

**MANOJ PRADHAN**

*Economist  
Morgan Stanley & Co.*

What do the US, Brazil and South Korea have in common? Not much, as it turns out. In fact, economic recovery, the stance of monetary policy and the level of complacency among policymakers are all out of sync with each other. What's more, they could become even more out of sync rather than converge.

To get a better understanding of what's happening in the emerging markets, we view many emerging market (EM) countries as members of either the "double deficit club" or the "safe haven club." The double deficit club is a collection of EM economies with current-account and budget deficits that raise concerns about macro instability. This cohort includes Brazil, India, Indonesia, South Africa, Turkey and Ukraine and, to a lesser extent, Mexico and Thailand. The safe haven group—and this a relative term—includes more mature EM economies, such as Chile, Korea and Taiwan, and those with sound macro stability, such as China, Colombia, Peru, the Philippines and Poland. It's important to note that memberships are fluid and can switch depending on changing fundamentals. To that end, India and Indonesia are making progress toward an exit from the double deficit club, while Russia may soon be knocking at the clubhouse door.

**GROWTH TRAJECTORY.** So why are these economies apt to become even more out of sync? For instance, look at growth (see chart). The trajectory of growth in the

US, China and the EM double deficit and safe haven clubs is going in different directions, while in the US growth appears to be transitioning to a more sustainable phase. In China, where summer stimulus has rolled over and financial tightening is starting to bite, economic activity is already moderating.

That's not all—the growth profile is also varied throughout the emerging markets. For the double deficit economies, growth is only bottoming or in the very early stages of expansion. In India, recovery in domestic demand may be difficult in the near future given macrostability headwinds, and growth recovery will likely depend mostly on an improvement in exports. Growth in Brazil is driven by a robust consumer, while the supply side of the economy is lagging. In Turkey, recent interest rate hikes and business conditions are likely to slow momentum going forward. In Indonesia,

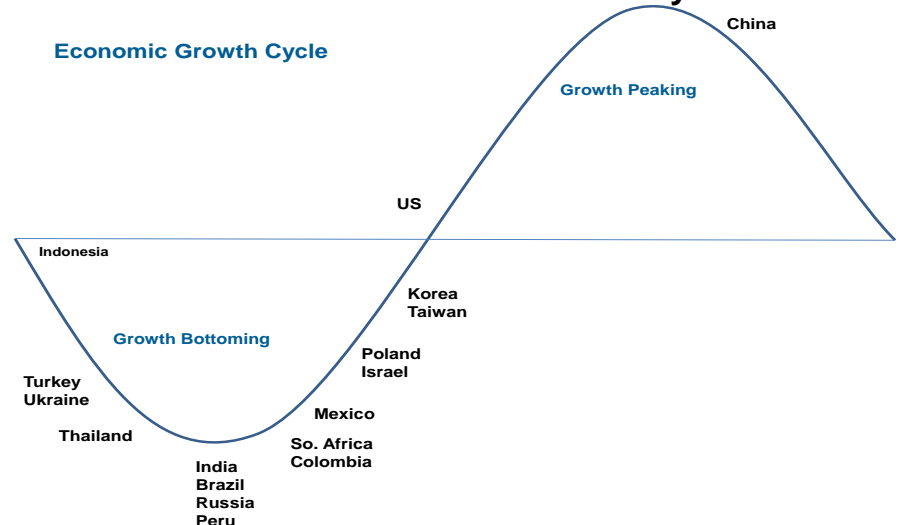
growth is slowing from a high level due to a slowdown in domestic demand and robust net exports. These economies remain sensitive to changes in external demand and monetary conditions. Rising real interest rates, thanks to improvements in the US economy, are likely to continue to represent an exogenous tightening of monetary conditions for these economies, keeping sustained downward pressure on growth.

## **FEWER ADJUSTMENTS NECESSARY.**

On the other hand, recovery appears more advanced in the safe haven countries because of stronger fundamentals and lower external exposure. Unlike the double deficit club, EM safe haven economies have less internal adjusting to do. In turn, this means that higher global interest rates could put less pressure on them.

Will the trajectory of growth between these two clubs converge or diverge? Double deficit countries could see better prospects for growth if stronger external demand materializes. For this, the US recovery needs to be driven by consumption in order to generate greater demand for EM consumer-oriented exports. Still, if a recovery is led by the business sector, we believe that the benefit to the emerging markets will be smaller

## Who's Where in the Economic Growth Cycle

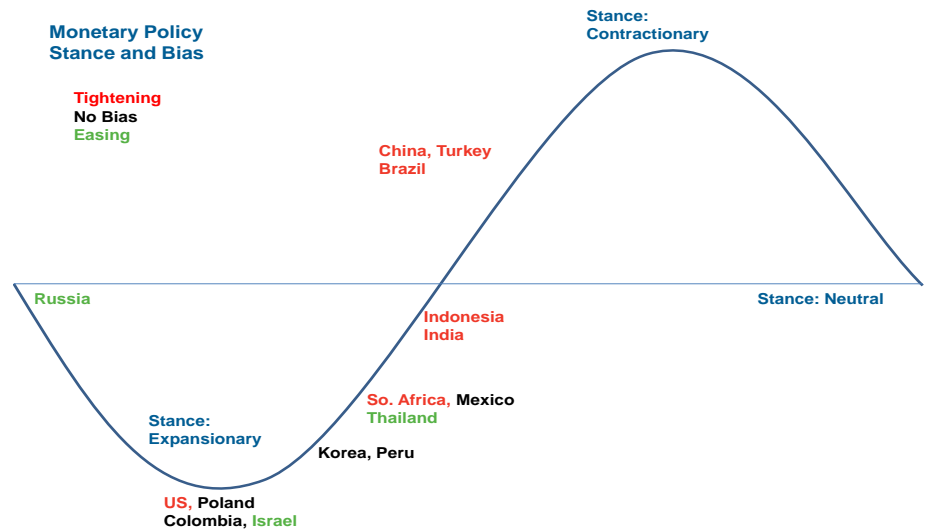


Source: Morgan Stanley & Co. Research as of Feb. 14, 2014

while downside risks to an already subpar and vulnerable recovery will grow. Growth prospects could also be enhanced if: The downside risks to growth in China recede; if the EM economies see better external demand and stable commodity prices; and EM policymakers themselves enact appropriate reforms. On the other hand, safe haven club economies still face the prospect of contagion from the double deficit economies, while the likes of Korea and Taiwan could suffer if China's downside risks were realized.

**MONETARY POLICY.** Monetary policy is out of sync as well. The Quantitative Easing tapering saga has left monetary conditions mostly unchanged in the US but has caused a pronounced tightening in monetary conditions in the double deficit club but less so in the safe haven club (see chart). For instance, policy is mildly restrictive in Brazil and Turkey, neutral in India and mildly expansionary in South Africa. The result: A wedge between the monetary stance of both clubs and consequent downward pressure on the tenuous recovery in the double deficit economies. Finally, there is a change in the level of activity among policymakers. A minicrisis has pushed the double deficit club economies out of complacency into action. They have recently begun dealing with the external imbalances, but most seemingly remain complacent about dealing with their domestic imbalances.

## Who's Where in the Monetary Policy Cycle



Source: Morgan Stanley & Co. Research as of Feb. 14, 2014

The safe haven economies have seen their monetary policy stance come under some stress but remain mostly unaffected by the same events that have tightened monetary policy in the double deficit economies. As a result, the gap between the monetary policy stance in the safe haven and double deficit economies has widened. In turn, this could widen the gap between the growth profiles of these two clubs.

EM economies are out of sync with the US and within the EM universe, too. Should growth in the US strengthen and invite policy renormalization, it will likely

tighten monetary conditions in emerging markets and put downward pressure on growth in the more exposed economies. While a right policy combination of structural reforms and external and domestic rebalancing could ease growth concerns, complacency in addressing domestic imbalances implies that we are not there yet. ■

ON THE MARKETS / EQUITIES

# EM Exodus Creates Pockets of Value

**HERNANDO CORTINA, CFA**

Senior Equity Strategist  
Morgan Stanley Wealth Management

Investors are fleeing emerging market (EM) stocks in droves. Globally, dedicated EM equity funds have suffered a record 18 consecutive weeks of outflows that amounted to \$41 billion, or about 5% of fund assets under management. Since the inflow peak about a year ago, more than \$70 billion has been withdrawn, all but fully reversing the cumulative inflows that had taken place since December 2011.

In our view, investors are moving their money because slow growth in developed economies has uncovered weaknesses in many export-focused EM economies. Furthermore, the tapering of the Federal Reserve's Quantitative Easing has made funding some emerging markets' external deficits more challenging.

Consistent with the Global Investment

Committee's (GIC) underweight EM equity stance, we are underweight, too, in the Strategic Equity Portfolios (STEP) that may invest in EM stocks. We don't think it would be appropriate to be completely out of the asset class, for three main reasons. First, the vulnerability of different EM countries varies widely, with some countries such as China, Korea, Mexico, Taiwan and Chile appearing sound from a stability perspective. Next, from a valuation and performance perspective, EM equities lagged developed market stocks by 29% in 2013—the largest gap since the 1998 Asian/Russian crisis—and now trade on a single-digit forward price/earnings multiple (P/E), which makes it the cheapest major equity grouping worldwide (see chart). Finally, from a bottom-up perspective, we believe there are some quality individual companies, even in the more vulnerable

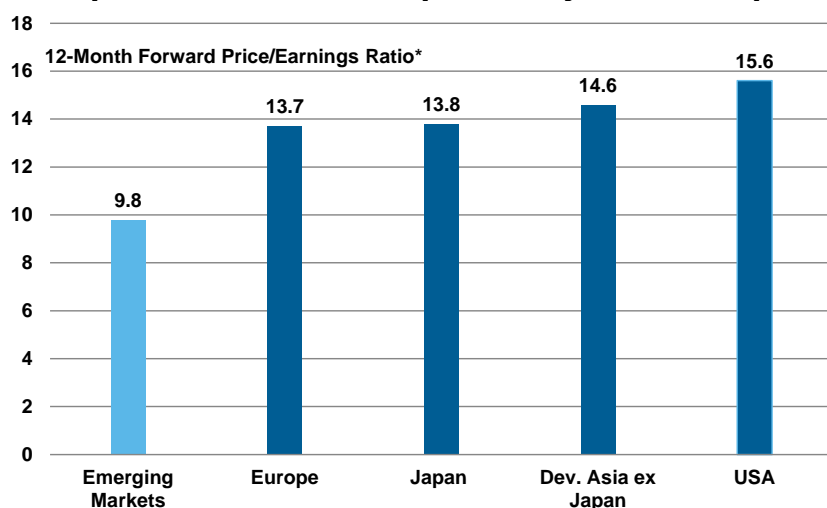
emerging markets, that are well placed to withstand some macro volatility and provide attractive long-term growth.

**SINGLE-DIGIT VALUATION.** Many investors understand that the most significant driver behind last year's stellar 32% S&P 500 total return was P/E expansion, not earnings growth. As a result, the S&P 500 now trades at about 15.6 times 12-month forward earnings, its highest valuation since 2005. Other developed markets such as Europe, Japan and the developed Asian markets now trade at about 14 times forward earnings. In sharp contrast, EM equities trade at less than 10 times forward earnings (see chart).

**INVESTMENT OPPORTUNITIES.** With the large differences among EM economies, and the additional differences between companies exposed to exports versus domestic markets, we believe that a selective, active approach to portfolio construction makes the most sense. At a broad level, within the STEP portfolios we have exposure to "minimal volatility" optimized funds that generally overweight those more stable markets mentioned above, as well as more defensive domestically oriented sectors such as consumer staples, health care and telecoms. At a country level, we concur with the GIC's preference for China and Mexico.

At the stock level, we are invested in the consumer discretionary sector, particularly media, which we believe offers a long runway of growth into the expanding middle class as advertising budgets and media consumption in Mexico and other Latin American countries accelerate. We favor select, high-quality private banks in India that have a track record of generating attractive return on equity. While India faces macro challenges, the authorities are starting to respond, growth is troughing and this year's general elections could be a positive catalyst. ■

## EM Equities Trade at Comparatively Low Multiple



\*Based on consensus estimates for the MSCI indexes  
Source: MSCI, Bloomberg as of Feb. 24, 2014

ON THE MARKETS / FIXED INCOME

# Interest Rates Chill Out

## KEVIN FLANAGAN

Chief Fixed Income Strategist  
Morgan Stanley Wealth Management

## JOHN DILLON

Chief Municipal Bond Strategist  
Morgan Stanley Wealth Management

## JONATHAN MACKAY

Senior Fixed Income Strategist  
Morgan Stanley Wealth Management

Coming into 2014, US economic data were consistently surprising to the upside, and the US Treasury market reacted appropriately. From a low of 2.50% on the benchmark 10-year US Treasury bond in late October, the yield worked its way higher, nudging 3.0% at the turn of the year (see chart).

Since then, more often than not economic data have been softer than expected. Certainly, the last two jobs reports underscored this point, but this data series has not been alone, as a whole host of reports released into February have also been disappointments. Given the headlines surrounding this winter's unusually harsh weather, the natural

question is: Have these inclement weather conditions been playing a restraining role, or is economic activity just taking a breather from the solid 3.3% pace of last year's second half? Unfortunately, it may take months before we know for sure (see page 4).

**EMERGING MARKET IMPACT.** Softer-than-expected economic data only explains about half of the latest drop in yields. No doubt, negative headlines emanating from the emerging markets led to a flight to safety, which ultimately brought the 10-year yield down to 2.58% from its 3.03% near-term high. Emerging market (EM) concerns surely have stoked volatility in the fixed income market, too, but we don't envision those concerns having an impact on monetary policy. The minutes of the January Federal Open Market Committee revealed that policymakers are wrestling with how to adjust their "enhanced rate guidance" with the unemployment rate on the doorstep of their 6.5% threshold. Look

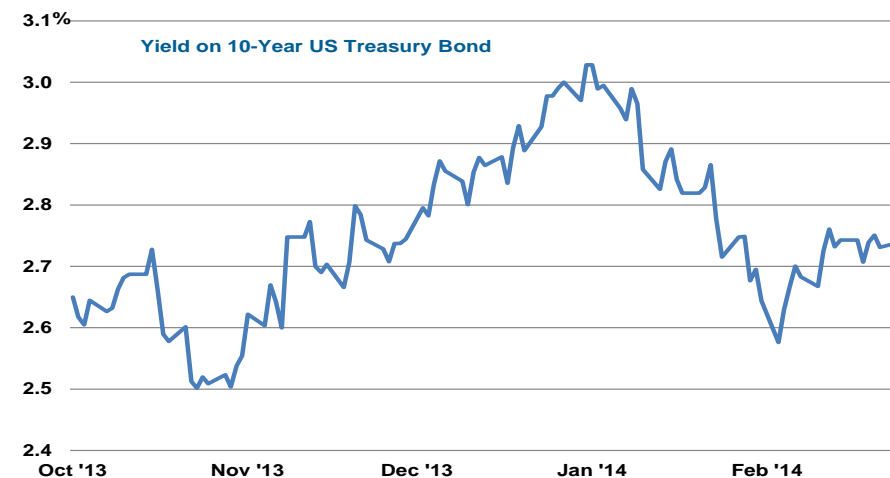
for this to become a focus at the March 18 and March 19 gathering. Unless there is a significant shift in the Fed's economic outlook, it appears as if \$10 billion tapering per meeting is almost on cruise control.

Absent an EM meltdown, we feel future rate trends will be driven more by domestic economic considerations. While EM-related concerns did not go away, they're not in the headlines either. Thus, the US Treasury market focus has shifted back to the domestic fundamentals, and it appears as if the market has discounted the weather effect. If the economy does rebound in the second quarter, as we believe it will, we look for the 10-year Treasury yield to make a move back toward the 3.0% threshold.

**ECHOES IN CREDIT.** The pullback in Treasury yields has reverberated in the credit sector, too. Tracking the flight to quality, investment grade credit outperformed high yield; long-duration\* bonds outperformed short-duration bonds; and noncyclical sectors outperformed cyclical ones. We still believe that this year, short-duration credit will outperform long duration and high yield will have a modestly better performance than investment grade—albeit with more downside risk. A change in strategy may occur when we see rates above 3% but, for now, a defensive approach is still warranted, in our view.

Even if the lower yields in the US are short-lived, they should be a welcome break for the EM bond market. This market has been under pressure since last summer, when rising rates in the US exposed the funding vulnerabilities of the many EM countries that were running large current-account deficits. Coupled with slowing growth in China, many EM economies are now faced with the triple threat of slower growth, less foreign direct investment and, in some cases, rapidly rising inflation. Central-bank intervention

## Surprising Decline in US Treasury Bond Yield



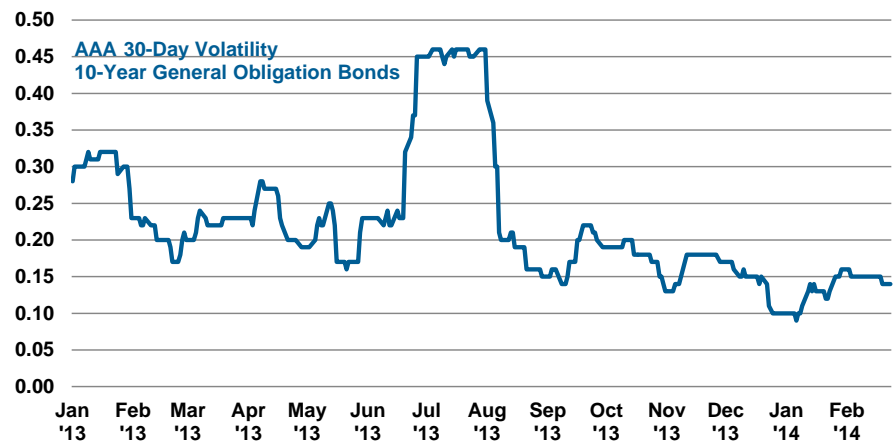
Source: Bloomberg as of Feb. 24, 2014

through rate hikes—Turkey, Brazil, India and South Africa have all raised rates in the last three months—has stopped the bleeding to some degree, but quite a few countries also need to undergo significant structural changes to stabilize their economies.

**BE SELECTIVE.** The Global Investment Committee has an underweight in EM debt and recommends a selective approach instead of investing in a broad-based index. Let's take a "good, bad and ugly" approach to Latin American debt to show why such selectivity is necessary. The good countries are Mexico, Peru, Colombia and Chile, all of which have a combination of stronger relative growth, lower inflation, stable currencies, strong or decent funding profiles and little opposition to progressive structural reforms. In the bad category is Brazil, which faces rising inflation, a weakening currency, slower growth, high interest rates, high debt levels and a national election later this year. Finally, in the ugly bucket, we placed Argentina and Venezuela, both of which face rampant inflation, declining currencies, weak fiscal and funding profiles and rising opposition to the current political establishment.

**MUNIS' BUSY MONTH.** Much has transpired in the municipal market during the past month. The three largest credit ratings agencies—Standard & Poor's, Moody's and Fitch—cut Puerto Rico's bond rating to below investment grade. The Commonwealth, one of the largest municipal bond issuers, had already made plans to sell bonds in the new-issue market. In colder climates, Detroit's much-awaited "plan of adjustment" was presented to the US Bankruptcy Court. If

## Muni Market Volatility Remains Subdued



Source: TM3, MSWM Muni Strategy as of Feb. 24, 2014

approved, holders of the city's general-obligation bonds may recover much less than the high recovery rates the market has historically experienced.

What has yet to occur, and perhaps may not, is a systemic market reaction that hinders liquidity and raises yields throughout the market. Market volatility has been flat and substantially lower than last summer, when the market was rocked by rising interest rates (see chart). Mutual fund flows, which have typically been negative in periods of bad news, were actually positive at \$320 million in the week ending Feb. 21. That the muni market can absorb this news with nary a hiccup could be more important than the events that have transpired.

**TROUBLED HISTORY.** The municipal market has a troubled history when it comes to negative news: the demise of the bond insurers; the mayhem after an analyst's now unfulfilled call for rampant defaults; and last summer's rate-driven bond rout with acute pressure for muni

bonds. While a spike in volatility can make some investors uncomfortable, it can also unlock value for others, presenting an opportunity to purchase high-quality bonds at attractive levels.

If there is ultimately no discernible impact from the Puerto Rico and Detroit situations, it indicates to us that investors are increasingly differentiating between various credits. It would also support the notion that credit spreads for mid-range investment grade municipals are simply too wide and should continue to tighten over time.

Since the advent of the financial crisis, we have believed that the municipal market is transitioning toward a credit-based market more akin to US corporates, from a rate-driven market similar to US Treasuries. To us, the events—or should we say nonevents—of the past month support that view. ■

\*Duration, the most commonly used measure of bond risk, quantifies the effect of changes in interest rates on the price of a bond or bond portfolio. The longer the duration, the more sensitive the bond or portfolio would be to changes in interest rates. Generally, if interest rates rise, bond prices fall and vice versa. Longer-term bonds carry a longer or higher duration than shorter-term bonds; as such, they would be affected by changing interest rates for a greater period of time if interest rates were to increase. Consequently, the price of a long-term bond would drop significantly as compared with the price of a short-term bond.

# An Outcomes-Oriented Approach to Alternatives

**LISA SHALETT**

Head of Investment and Portfolio Strategies  
Morgan Stanley Wealth Management

The Global Investment Committee (GIC) view has long been that properly selected alternative asset classes and investment strategies can add diversification, provide some measure of downside resilience and, thus, should be incorporated, when suitable, in investment portfolios. To that end, we have explored lower-cost alternative investment formats and below outline a fresh approach to asset allocation that incorporates them alongside traditional products.

**MINIMIZING VOLATILITY.** The first principle of wealth management is to create and maintain portfolio diversification through effective asset allocation. The power of this principle lies in the role that compounding returns plays in wealth accumulation and preservation. To that end, we manage risk in an effort to mitigate large portfolio drawdowns and minimize volatility. When we minimize volatility over the typical multiyear investment horizon, we increase the probability that we achieve our goals. Allocations of bonds and cash have been the primary risk-management tool in portfolios, but the end of a 30-year bull market for bonds—combined with the impending unwinding of historic central-bank intervention in markets and the likely rise in bond volatility—raises the question of how effective these traditional assets alone will be in managing risk during the next three to five years.

The GIC believes that, as investors navigate this historic period of interest rate normalization, alternatives will be an even

more important tool for portfolio diversification. In the past, bringing alternative investments into portfolios was challenging, in large part because liquidity, tax efficiency, transparency and affordability resulted in complexity and, therefore, limited access. Now, through alternative mutual funds and alternative exchange-traded funds (ETFs), some of these barriers are falling (see table).

## TRANSFORMATIVE DEVELOPMENT.

The GIC believes that this development is transformative for asset allocation and portfolio construction. Specifically, this development enables the transition from a pure accessibility-driven framework to a more precise risk-management and suitability-driven approach from which even the most conservative investor with a basic stock-and-bond mix could benefit.

Easier access alone is not sufficient to attract investors. Skepticism around

alternatives is high, in part resulting from disappointing performance during the financial crisis. In addition, there has been confusion about how and when to use alternatives, given that they range from all flavors of hedge funds to private equity, real estate and commodities. Alternatives' lack of clear benchmarks, naming conventions and performance standards has further hindered their use.

**A NEW FRAMEWORK.** New products and new packaging are not going to create better outcomes for investors. What is needed is a more robust, refined and disciplined approach to asset allocation and portfolio construction—one that includes categorizing products and strategies by clearly defined investment characteristics, benchmarks and how they serve investors (see table, page 11).

Our framework brings asset classes and strategies into one of five goal-centric/risk-management categories: real assets, total return assets, equity hedge assets, equity return assets and opportunistic assets. In our analysis, each of these types of investments, when added to a standard stock/bond portfolio, would lower the aggregate correlation with equities, potentially reduce volatility and

## Comparing Features of Alternative Investments

		Alternative Mutual Funds and ETFs	Private Offerings
Investment	Style	Varies by Strategy	Varies by Strategy
	Flexibility	Limited Investment Flexibility	Greater Investment Flexibility
	Derivatives	Limited Use of Derivatives	Greater Ability to Use Derivatives
	Leverage	Limited Use	Greater Ability to Use Leverage
	Transparency	High	Generally Low
	Correlation	Generally Higher to Traditional Investments	Generally Lower to Traditional Investments
	Minimum	Low Minimum Investment	High/Private Investor Qualifications
Operations	Fees	Typically Asset-Based Management Fees	Typically Management and Performance Fees
	Tax Reporting	IRS Form 1099	Typically IRS K-1
	Redemptions	Generally Daily (ETFs trade on an exchange)	Limited Opportunity
Regulatory	Oversight	1940 Act Restrictions	Limited SEC Oversight
	Diversification Requirements	Position Sizes, Sector Exposure, etc.	None—Diversification Varies Widely

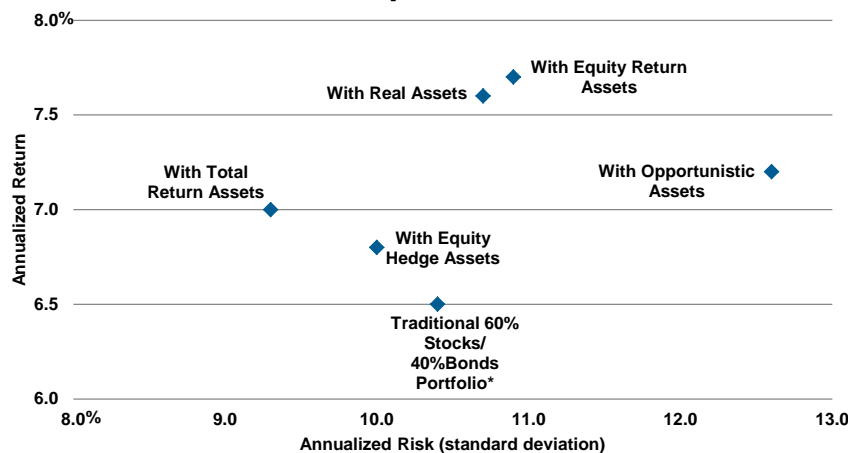
Source: Morgan Stanley Wealth Management GIC

**Our New Outcomes Framework**

Client Goals	Primary Traditional Assets	Alternatives' Portfolio Main Purpose	Alternative Assets	Client Goal Suggested Benchmark
Capital Preservation	Cash, Money Market Funds, Short-Duration Bonds	Inflation Protection	Real Assets	CPI Plus
Income	Bonds, High Yield Equity, Convertibles, Preferred Stock	Income/Cash Flow Preservation	Total Return Assets	T-Bill or LIBOR Plus
Balanced Growth	60%/40% Equities/Bonds	Volatility Reduction	Equity Hedge Assets	Risk-Adjusted 60/40
Market Growth	S&P 500 Plus	Equity Diversification	Equity Return Assets	Risk-Adjusted S&P 500 Plus
Opportunistic Growth	80% Plus Equities	Growth Amplification	Opportunistic Assets	Customized

Source: Morgan Stanley Wealth Management GIC

**How Alternatives Can Impact Portfolios**



\*60% S&P 500/40% Barclays Capital US Aggregate Bond Index  
 Note: Annualized return and annualized risk are for 2000 through 2013. Alternatives mentioned above are drawn from the New Outcomes Framework table at the top of this page.

Source: Morgan Stanley Wealth Management GIC as of Dec. 31, 2013

produce portfolios that have markedly different performance characteristics depending on the current economic climate (see chart, left).

In categorizing alternatives, we break apart the broad category heretofore known as hedge funds or hedged strategies and align substrategies to their different underlying drivers. Relative-value strategies, for example, fall under income preservation/total-return assets, while global-macro strategies are volatility management assets and event-driven strategies are market growth assets. With this categorization, we also propose clear performance metrics and benchmarks that should create a framework for comparing alternative mutual funds/exchange-traded funds and private offerings.

This new framework acknowledges that alternatives is not a singular asset class to be allocated to but a collection of diverse strategies and asset types that can be used specifically as tools to aid portfolio construction. Finally, investors require a structured approach to navigating the sea of choices in a framework that better links potential solutions to their long-run goals. That is why it is important to establish such a construct for Financial Advisors and clients. ■

*For a full copy of the white paper, "An Outcomes-Oriented Approach to Alternatives," please contact your Financial Advisor.*

# Dividends Have Room to Run

Investors spooked by the Great Recession still approach stocks warily, but there has been no lack of love for equities that produce dividends. In fact, the strong performance of some stocks in high-dividend sectors such as consumer staples and utilities has been driven more by investors' desire for yield than the fundamental value of the equities, says Jim Boothe, chief investment officer at Santa Barbara Asset Management.

Boothe believes that payouts will continue to rise, however, as companies feel more confident in their ability to return money to shareholders. In a recent conversation with Morgan Stanley's Tara Kalwarski, Boothe explains how his dividend strategy fits into the current market environment. The following is an edited version of their conversation:

**TARA KALWARSKI (TK):** Dividends have increased in popularity over the past few years amid the low interest rate environment. Can you tell me a little bit about how this has evolved?

**JIM BOOTHE (JB):** In 2003, when the tax laws changed and the tax on dividends was reduced to 15%, we began to see more interest in the category. A few years later, dividends became truly compelling. Interest rates were so low that dividend stocks became more attractive relative to US Treasury bonds or other fixed income securities because the income component was very competitive.

In the last couple years, there has also been more attention paid to dividend growth stocks, which aren't necessarily the highest yielding stocks. Still, it's mostly

the interest rate environment that's making these strategies so compelling.

**TK:** What's your outlook for dividend stocks for the next few years?

**JB:** There are many factors that indicate that dividends are going to continue to do well. First, I expect rates to stay low for at least the next year. Five years out, while rates may rise somewhat from where we are today, I don't think they're going to spike. So while they might start to seem high relative to where we were two or three years ago, I think they will still be near historical lows.

There's also very clearly a lot of room for dividend growth. Payout ratios are 32% right now. The long-term average is closer to 55%. By definition, we don't see this being fully played out until we're at least at the average.

Looking at it another way, a few years ago about 300 out of the S&P 500 stocks paid a dividend. As of Dec. 31, it was 417, the highest it has been in about 20 years. I believe it will continue to increase because companies have the cash and they're just starting to reward shareholders that way. There's also been a change in the way dividends are viewed by companies. Previously if you were a growth stock and you started to pay a dividend it was a red flag that your growth was over with. I think that mindset is changing.

Finally, from a demographic standpoint, with the Baby Boomers, these types of strategies will still be in demand because they provide both an income and growth component. Investors are starting to understand that just having fixed income in your portfolio is probably not going to

be a good strategy if you want to keep ahead of the cost of living.

**TK:** Are you finding opportunities these days? Are dividends a crowded trade?

**JB:** In general, it's more difficult to find stocks that have a compelling absolute yield. We used to be able to find stocks with 4% or 5% yields; a 3% yield in today's environment would be very compelling if the fundamentals were attractive as well. There's still good runway for dividend growth because the payout ratios are pretty low for the amount of cash companies are generating.

As far as crowding, yes, there is crowding in certain sectors, like utilities and consumer staples where money has gravitated based solely on the yield [and] not the fundamentals.

**TK:** What have been the biggest challenges over the past couple of years?

**JB:** We typically thrive when the market is volatile. In the last year and half, if you look at the VIX [volatility index], you can see it's come down dramatically. In addition, we've seen a momentum market and a rally in lower-quality securities. So that's been a challenge for us, because we typically have a higher-quality portfolio and momentum stocks that don't pay dividends. We can't invest in them at all.

**TK:** What has been the biggest surprise?

**JB:** I have been surprised to see lower-quality banks do so well. They were a bad place to be during the past five years and they're still the only sector that hasn't reached 2007 levels. Then in the middle of last year there was an inflection point where the banks started to fully participate and even lead the market. We didn't anticipate, however, that regulators would limit the payout ratio on the banks. Right now they're targeting a 30% payout ratio, but some of the stronger banks that came out of the financial crisis actually have the ability to pay more than that. So the capital ratios for all the banks are just accumulating. They're quite high right

now. Maybe that will go away when people's memories of the financial crisis eventually fade.

**TK:** What does your current positioning look like from a regional sector perspective?

**JB:** A few years ago we focused more on the companies that had international and global sales, but the last couple years we've brought our focus to domestic exposure because we think the US economy currently has better prospects than the rest of the world.

**TK:** How are dividends treated differently in the US versus globally?

**JB:** The most obvious difference is that outside the US absolute yields are more attractive, probably at least another 1% higher. So there's a lot more opportunity there. Some stocks have 5% or higher yields, but even the average stock pays a little bit more.

On the downside, the dividend policy is a little different. In the US, companies pay quarterly and they pay the same amount. Outside the US, they typically pay twice a year—an interim dividend and a final dividend—and those payouts are not the same amount. International firms are also less reluctant to cut the dividend than ones in the US. So you have to roll up your sleeves a little bit more, because a high dividend today might not be a high dividend tomorrow. And in Europe, due to the crisis, the dividend environment is still

worse than in the US. For example, while banks in the US have begun paying dividends, the European banks haven't started paying again at all yet.

**TK:** As you mentioned, you come at this strategy from a growth perspective. What are your thoughts on growth versus value right now in the dividend space?

**JB:** The market rally over the last year and a half has been bifurcated; there has been speculative money going into both value stocks like banks and momentum stocks like biotechs. I think we're going to have a transition in the market where more regular growth stocks will do well.

**TK:** Do you think the kinds of earnings growth rates we're seeing are sustainable?

**JB:** No. Last year, the market was up 30%, but the earnings didn't really justify the market multiple. So my expectation is that for the next few years we're not looking at double-digit returns. High single-digit returns will likely be the norm.

**TK:** Given how correlations aren't as tight anymore, do you think that there will be more opportunities going forward for active investors to add value?

**JB:** It seems like the active/passive thing goes in cycles. In the last few years there's been more interest in passive strategies, partly because of all the exchange-traded funds, but I expect active management will come back into vogue.

**TK:** Do you think we'll see a "great rotation" back into equities? Or were

investors permanently spooked by the bear markets and will continue to stick with larger amounts of bonds and cash?

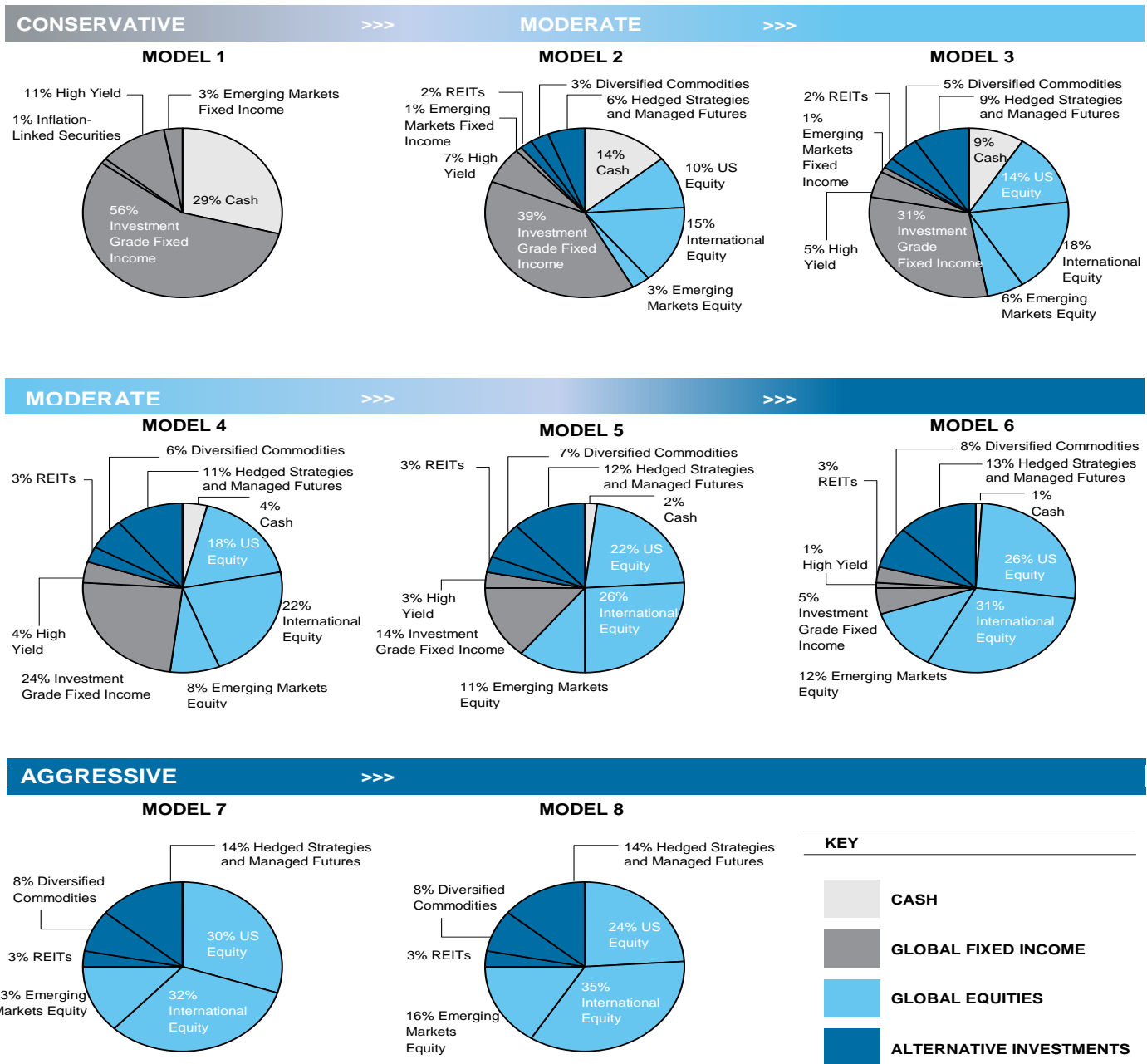
**JB:** That's a great question. I remember being surprised by how spooked investors were by the "flash crash" a few years ago. It seems like a lot of investors think the market is rigged or it's like a casino. Clearly people's confidence in the market needs to improve from where it is today. The financial crisis and Great Recession were pretty bad so it will probably take a while for investors to get that confidence back. With that said, there's always fear and greed. At some point, greed comes back.

I think right now we are in somewhat of an unloved equity market. Stocks have been going up, but a lot of people still have their doubts. We know the typical investors' asset allocations; they're very much geared and tilted towards fixed income. They need a way to get involved with the equity market without necessarily swinging for the fences. ■

*Jim Boothe is not an employee of Morgan Stanley Wealth Management. Opinions expressed by him are solely his own and may not necessarily reflect those of Morgan Stanley Wealth Management or its affiliates.*

# Global Investment Committee Tactical Asset Allocation

The Global Investment Committee provides guidance on asset allocation decisions through its various model portfolios. The eight models below are recommended for investors with up to \$25 million in investable assets. They are based on an increasing scale of risk (expected volatility) and expected return. Hedged strategies include hedge funds and managed futures.



## Tactical Asset Allocation Reasoning

<b>Global Equities</b>	<b>Relative Weight Within Equities</b>	
US	Equal Weight	While US equities have done exceptionally well since the global financial crisis, they still offer attractive upside potential, particularly relative to bonds. We believe the global economy continues to heal from the financial crisis, making recession neither imminent nor likely in 2014. This is constructive for stocks.
International Equities (Developed Markets)	Overweight	We maintain our bias for Japanese and European equity markets given the political changes taking place in Japan and the improving economic outlook in Europe. Japan outperformed the US last year and Europe was very strong in the second half. We believe that Japan and Europe will continue to perform well in 2014 because of their more nascent economic and earnings recoveries.
Emerging Markets	Underweight	Emerging markets have been disappointing. Policy remains too tight in major countries, both voluntarily (China) and involuntarily (India and Brazil). The tapering of Quantitative Easing (QE) is also likely to have a disproportionately negative impact on emerging market equities.

<b>Global Fixed Income</b>	<b>Relative Weight Within Fixed Income</b>	
US Investment Grade	Overweight	We have recommended shorter-duration (maturities) since March given the potential capital losses associated with the rising interest rates from such low levels. Yields have risen since then, but not enough for us to change that advice. Within investment grade, we prefer BBB-rated corporates and A-rated municipals over US Treasuries.
International Investment Grade	Equal Weight	Yields are low globally, so not much additional value accrues to owning international bonds beyond some diversification benefit.
Inflation-Linked Securities	Underweight	We have been underweight inflation-linked securities since March, given negative real yields across all maturities. Recently, these yields have turned modestly positive but remain unattractive in our view, due to the longer-duration characteristics of TIPS.
High Yield	Equal Weight	Yields and spreads are near record lows. However, default rates are likely to remain muted as the economy recovers slowly, keeping corporate and consumer behavior conservative. We prefer shorter-duration and higher-quality (B to BB) issues and vigilance on security selection at this stage of the credit cycle.
Emerging Market Bonds	Underweight	We reduced our weighting to equal weight from overweight in March due to record-low spreads and yields. Similar to emerging market equities, we recently moved to underweight on the basis that tapering of QE will likely be a disproportionate headwind for emerging market debt relative to other debt markets.

<b>Alternative Investments</b>	<b>Relative Weight Within Alternative Investments</b>	
REITs	Equal Weight	Rising interest rates explain most of the poor performance since May. At current levels, we believe REITs are fairly valued and offer select opportunities. The industrial and commercial segments tend to outperform at this stage of the recovery. International REITs should also be favored relative to domestic REITs at this point in the cycle.
Commodities	Equal Weight	Commodities performed poorly this past year as: real interest rates rose; China maintained tight monetary and fiscal policies; and the US dollar strengthened. Recent stabilization in China and new growth initiatives may help near-term performance. Commodities provide some ballast to a traditional equity/bond portfolio.
Hedged Strategies (Hedge Funds and Managed Futures)	Equal Weight	This asset class can provide uncorrelated exposure to traditional risk-asset markets. It tends to outperform equities when growth slows and works well in more challenging financial markets.

*Note: Hedged strategies consist of hedge funds and managed futures.*

## Index Definitions

**AAA 30-DAY VOLATILITY 10-YR GO INDEX** This index measures price volatility of 10-year AAA-rated municipal bonds. It is calculated by taking the standard deviation of the log of the percentage yield change. Then it is multiplied by the square root of the number of business days in the year to annualize the figure.

**BARCLAYS CAPITAL US AGGREGATE BOND INDEX** This index represents securities that are SEC-registered, taxable and dollar-denominated. The index covers the US investment grade fixed-rate bond index, with index components for government and corporate securities, mortgage pass-through securities and asset-backed securities.

**MSCI DEVELOPED ASIA EX JAPAN INDEX** This index captures large- and mid-cap companies in two of three developed market countries (excluding Japan) and eight emerging market countries in Asia. With 609 constituents, the index covers approximately 85% of the free-float-adjusted market capitalization in each country.

**MSCI EMERGING MARKETS INDEX** This index captures large- and mid-cap representation in 21 emerging equity markets, amounting to about 85% of the free-float-adjusted market capitalization.

**MSCI EUROPE INDEX** This free-float adjusted capitalization-weighted index is designed to measure equities' performance in 16 developed markets in Europe.

**MSCI JAPAN INDEX** This free-float adjusted capitalization-weighted index, with 320 constituents, is designed to measure the performance of large- and mid-cap segments of the Japanese stock market.

**MSCI USA INDEX** This index is designed to measure the performance of the large- and mid-cap segments of the US market. With 586 constituents, the index covers approximately 84% of the free-float-adjusted market capitalization.

**MSCI WORLD INDEX** This index captures large- and mid-cap representation across 23 developed market countries. With 1,610 constituents, the index covers approximately 85% of the free-float-adjusted market capitalization in each country.

**S&P 500 INDEX** Regarded as the best single gauge of the US equities market, this capitalization-weighted index includes a representative sample of 500 leading companies in leading industries of the US economy.

**VIX** This is the trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 index options. Often referred to as the fear index or the fear gauge, it represents one measure of the market's expectation of stock market volatility over the next 30-day period.

## Risk Considerations

**International investing** entails greater risk, as well as greater potential rewards compared to U.S. investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economies.

**Alternative investments** which may be referenced in this report, including private equity funds, real estate funds, hedge funds, managed futures funds, and funds of hedge funds, private equity, and managed futures funds, are speculative and entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds and risks associated with the operations, personnel and processes of the advisor.

**Managed futures investments** are speculative, involve a high degree of risk, use significant leverage, have limited liquidity and/or may be generally illiquid, may incur substantial charges, may subject investors to conflicts of interest, and are usually suitable only for the risk capital portion of an investor's portfolio. Before investing in any partnership and in order to make an informed decision, investors should read the applicable prospectus and/or offering documents carefully for additional information, including charges, expenses, and risks. Managed futures investments are not intended to replace equities or fixed income securities but rather may act as a complement to these asset categories in a diversified portfolio.

Risks of **private real estate** include: illiquidity; a long-term investment horizon with a limited or nonexistent secondary market; lack of transparency; volatility (risk of loss); and leverage.

**Investing in commodities** entails significant risks. Commodity prices may be affected by a variety of factors at any time, including but not limited to, (i) changes in supply and demand relationships, (ii) governmental programs and policies, (iii) national and international political and economic events, war and terrorist events, (iv) changes in interest and exchange rates, (v) trading activities in commodities and related contracts, (vi) pestilence, technological change and weather, and (vii) the price volatility of a commodity. In addition, the commodities markets are subject to temporary distortions or other disruptions due to various factors, including lack of liquidity, participation of speculators and government intervention.

**Physical precious metals** are non-regulated products. Precious metals are speculative investments, which may experience short-term and long term price volatility. The value of precious metals investments may fluctuate and may appreciate or decline, depending on market conditions. If sold in a declining market, the price you receive may be less than your original investment. Unlike bonds and stocks, precious metals do not make interest or dividend payments. Therefore, precious metals may not be suitable for investors who require current income. Precious metals are commodities that should be safely stored, which may impose additional costs on the investor. The Securities Investor Protection Corporation ("SIPC") provides certain protection for customers' cash and securities in the event of a brokerage firm's bankruptcy, other financial difficulties, or if customers' assets are missing. SIPC insurance does not apply to precious metals or other commodities.

**Bonds** are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

**Bonds rated below investment grade** may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk and price volatility in the secondary market. Investors should be careful to consider these risks alongside their individual circumstances, objectives and risk tolerance before investing in high-yield bonds. High yield bonds should comprise only a limited portion of a balanced portfolio.

**Interest on municipal bonds** is generally exempt from federal income tax; however, some bonds may be subject to the alternative minimum tax (AMT). Typically, state tax-exemption applies if securities are issued within one's state of residence and, if applicable, local tax-exemption applies if securities are issued within one's city of residence.

**Rebalancing** does not protect against a loss in declining financial markets. There may be a potential tax implication with a rebalancing strategy. Investors should consult with their tax advisor before implementing such a strategy.

**Treasury Inflation Protection Securities' (TIPS)** coupon payments and underlying principal are automatically increased to compensate for inflation by tracking the consumer price index (CPI). While the real rate of return is guaranteed, TIPS tend to offer a low return. Because the return of TIPS is linked to inflation, TIPS may significantly underperform versus conventional U.S. Treasuries in times of low inflation.

An investment in an **exchange-traded fund** involves risks similar to those of investing in a broadly based portfolio of equity securities traded on an exchange in the relevant securities market, such as market fluctuations caused by such factors as economic and political developments, changes in interest rates and perceived trends in stock and bond prices. Investing in an international ETF also involves certain risks and considerations not typically associated with investing in an ETF that invests in the securities of U.S. issues, such as political, currency, economic and market risks. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established

markets and economics. For specifics and a greater explanation of possible risks with ETFs, along with the ETF's investment objectives, charges and expenses, please consult a copy of the ETF's prospectus. Investing in sectors may be more volatile than diversifying across many industries. The investment return and principal value of ETF investments will fluctuate, so an investor's ETF shares (Creation Units), if or when sold, may be worth more or less than the original cost. ETFs are redeemable only in Creation Unit size through an Authorized Participant and are not individually redeemable from an ETF.

***Please consider the investment objectives, risks, charges and expenses of the fund(s) carefully before investing. The prospectus contains this and other information about the fund(s). To obtain a prospectus, contact your financial advisor. Please read the prospectus carefully before investing.***

**Equity securities** may fluctuate in response to news on companies, industries, market conditions and general economic environment.

Companies paying **dividends** can reduce or cut payouts at any time.

**Asset allocation and diversification** do not assure a profit or protect against loss in declining financial markets.

**REITs investing** risks are similar to those associated with direct investments in real estate: property value fluctuations, lack of liquidity, limited diversification and sensitivity to economic factors such as interest rate changes and market recessions.

Because of their narrow focus, **sector investments** tend to be more volatile than investments that diversify across many sectors and companies.

**Asset-backed securities** generally decrease in value as a result of interest rate increases, but may benefit less than other fixed-income securities from declining interest rates, principally because of prepayments.

**Investing in foreign emerging markets** entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks.

**Investing in foreign markets** entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks. **Investing in currency** involves additional special risks such as credit, interest rate fluctuations, derivative investment risk, and domestic and foreign inflation rates, which can be volatile and may be less liquid than other securities and more sensitive to the effect of varied economic conditions. In addition, international investing entails greater risk, as well as greater potential rewards compared to U.S. investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economies.

**Value investing** does not guarantee a profit or eliminate risk. Not all companies whose stocks are considered to be value stocks are able to turn their business around or successfully employ corrective strategies which would result in stock prices that do not rise as initially expected.

**Growth investing** does not guarantee a profit or eliminate risk. The stocks of these companies can have relatively high valuations. Because of these high valuations, an investment in a growth stock can be more risky than an investment in a company with more modest growth expectations.

**Yields** are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

**Credit ratings** are subject to change.

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