

Institutional CIO Confidence Index

January 2010



In partnership with



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Preface

We are proud to introduce to you our **Institutional CIO Confidence Index**. A result of in-depth interviews with chief investments officers throughout the US institutional spectrum (including public funds, corporations, endowments and foundations), the Index seeks to establish a statistically meaningful measure of how confident these chief investment officers are in meeting return targets for their portfolios in general—and the myriad underlying asset classes in particular—over the next 12 months. The results of our survey indicate that CIOs remain deeply uncertain about the return prospects for their investments in the coming year.

The Index—developed by Morgan Stanley Investment Management (MSIM) in partnership with Greenwich Associates—reflects our firm’s core values and commitment to sharing knowledge and providing informed, educated and innovative solutions to the institutional investment community. We feel that the report you are about to read—which details the findings of the first installment of the Index—accurately captures the post-crisis period within the institutional market, blending both quantitative and qualitative insights to help institutions make better investment decisions.

All of us at MSIM are excited about our work in the institutional arena, and are particularly devoted to the relationships and strategic partnerships we have established with key members of this community. We feel that our global platform, research and long history in the institutional space put us in a unique position to assess risks, recognize investment goals and identify opportunities for institutional investors today. We hope that the results of our survey help clients to benchmark and compare their own expectations for meeting their return targets to an aggregate institutional index.

We are indebted to all the professionals—both at MSIM and Greenwich Associates—who devoted their time and talent to build an Index that is both informative and creative. More importantly, we owe our gratitude to all the chief investment officers who participated in this effort, and generously spent their time with us to make this Index a reality.

Our goal is to follow the insights of this first installment with regular updates, so as to create a long body of research, spark new ideas, and contribute to the ongoing dialogue among investment officials, consultants and asset managers.

Sincerely,



Stu Bohart

Co-Head, Morgan Stanley Investment Management



Executive Summary

Institutional investors are uncertain that their portfolios will meet performance targets over the next 12 months, the inaugural installment of the Institutional CIO Confidence Index shows. A partnership between Morgan Stanley Investment Management (MSIM) and Greenwich Associates (GA), the Index is the result of 50 interviews conducted in a six-week period ending November 1, 2009 with chief investment officers across the institutional community in the United States, including public funds, corporations, endowments and foundations.

(continued on next page)

Executive Summary *(cont'd)*

Ranging from a scale of -100 (not confident) to +100 (totally confident), the first installment of the Index measured aggregate CIO confidence in the surveyed period at a modest 7.6. This score indicates that, even with the markets stabilizing since MSIM's Public Fund CIO Survey was conducted just over a year ago, institutional CIOs remain unsure about the prospects for their portfolios in the coming year.

Responses to our survey, however, were far from monolithic. In fact, we saw a wide gradation in the level of confidence among the multiple constituents of the institutional investing community, with the Index scoring a moderately bullish 20.0 among corporates, a more restrained 10.6 among publics, and a decidedly more bearish -9.4 among endowments and foundations.

Our Index is a statistically meaningful measure of forward-looking institutional investor sentiment. Our goal is to provide an aggregate institutional index that enables clients to benchmark and compare their own return expectations.

Methodologically, it blends quantitative data on institutional investment return targets, 12-month forward return expectations and portfolio asset allocations with CIOs' qualitative assessments of their own degree of confidence that their portfolio returns will lag, meet or exceed targets over the coming year. Individual scores from each participant are in turn combined to generate the final CIO Index score. The 50 participants in the first installment of the Index represent an aggregate \$548.8 billion in assets under management, with an average of \$11 billion per plan.

In addition to this confidence gauge, we sought to capture other measures of expectations among institutional chief investment officers—including 12-month return forecasts for individual asset classes, as well as a series of economic assumptions—in an effort to better contextualize their responses. Additionally, our survey included several qualitative-based questions aimed at furthering our understanding of the participants' points of view, as well as establishing causal effects behind their forecasts.

Just as important, we also asked participants to indicate what—if any—types of adjustments they were planning to make to their asset allocations over the next 12 months. We broke down that question into individual asset classes, and inquired about the reasons prompting any potential change, namely strategic, tactical or

rebalancing. We believe that this combination of quantitative and qualitative metrics coalesced to paint an accurate picture of the general trends and expectations shaping the post-crisis period in the US institutional investing community.

The results in a nutshell show that the 50 participating CIOs expect fixed income to be the main driver of positive investment performance in the coming 12 months, with high-yield and investment-grade corporate fixed income perceived as likely top performers in absolute terms. Conspicuously, these are the only two asset classes that the CIOs expect, in aggregate, to beat the internal return targets set by their institutions. Although the CIOs name US equities as their number-three top performer for the next 12 months, average returns on the asset class are expected to fall short of long-term targets.

The Index results reveal the extent to which institutional portfolios have been affected by both the dramatic drop in asset valuations associated with the global financial crisis and the subsequent recovery in global markets. The CIOs confirm that the need to rebalance portfolios is driving many of the changes to asset allocation currently underway—in both traditional and alternative asset classes. More than 30% of the CIOs plan to reduce allocations to US equities in the next 12 months, and an equal share plan to trim allocations to non-US equities. Less change is expected in fixed-income allocations, with almost two-thirds of the CIOs saying their institutions plan to keep fixed-income allocations stable at current levels. Roughly 80% of the CIOs plan to keep cash allocations steady over the coming year.

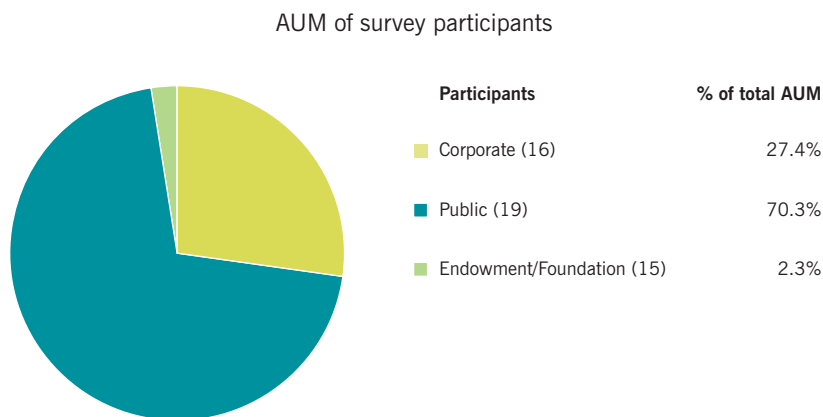
These expected changes in asset allocations—which suggest a degree of continuity with established portfolio strategies, as opposed to any fundamental restructuring—appear to be in keeping with the essentially neutral outlook reflected in the current score of 7.6 on the CIO Confidence Index. That same neutral sentiment can be seen in CIOs' projections for the US economy at large. While the CIOs' predictions of US GDP growth of 2.8% for the next 12 months can be seen as a bullish expectation at this point in the economic cycle, the CIOs participating in the Index expressed concerns about a host of risks that could jeopardize the recovery in the global economy and financial markets in the next year.

We plan to update the Institutional CIO Confidence Index regularly as a means of tracking changes in the institutional community's investment outlook, and to provide clues to future market direction as these trends unfold. ☞

1 | Index Results: *CIOs Lack Certainty on Meeting Portfolio Performance Targets*

The Institutional CIO Confidence Index provides a broad measure of investor sentiment by tracking the degree of confidence among institutional CIOs that returns on their investment portfolios will lag, meet or beat return targets over the next 12 months. The current Index is based on the results of interviews with 50 institutional chief investment officers, broken down as follows: 19 CIOs from public pension funds, 16 from corporate pensions, and 15 from endowments and foundations. The CIOs participating in the Index represent institutions managing \$548.8 billion in assets. The bulk of these assets—approximately 70%—is managed by public pension funds, with 27% managed by corporate pension funds, and 2% from endowments and foundations (E&F). Participating institutions have average assets under management (AUM) of approximately \$11 billion (*Display 1*).

Display 1: Institutions participating in the CIO Confidence Index manage nearly \$550B



Data as of November 1, 2009

Source: Institutional CIO Confidence Index survey

As part of the Index survey, each CIO was asked to give his or her institution's annual return targets for every major asset class, and then to provide expectations for actual returns for the coming 12-month period. In each case, the CIOs were also asked to rate on a five-point scale their qualitative level of confidence in their portfolios' ability to hit target returns in each major asset class. These results were then multiplied by the institution's allocation to create a confidence score for each asset class. These asset-class scores were then aggregated to produce the overall Index score, a statistically significant measure of CIO sentiment.

The result of these calculations is expressed on a scale of -100 to +100, with -100 being the most negative sentiment or level of confidence, and +100 the most positive. Although our participant spectrum includes institutions with varying size of assets under management, the Index itself is not AUM weighted. Since the purpose of the Index is to gauge confidence, our rationale reflects a desire to capture the CIOs' sentiment and future expectations regardless of the size of the portfolio they are managing (a complete description of the technical methodology used in creating the Index is provided in this report's Appendix).

The Index debuts at a score of 7.6, based on CIO interviews conducted between September 14, 2009 and November 1, 2009. This score indicates that CIOs are essentially neutral in their assessments of whether returns on their institutions' portfolios will match or beat their targets, with a slight positive bias. Underlying the average Index score, however, is a wide distribution of confidence scores among the CIOs and a significant variation in outlook among participants from public funds, corporate funds, and endowments and foundations (*Display 2*). Approximately 35% of the CIOs report confidence scores ranging from -10 to +10. Within that group scores are tipped toward the positive, with slightly more than a quarter of all CIOs coming in with scores between zero and 10.

Display 2: The Confidence Index shows institutional CIOs are essentially neutral

Average CIO Confidence Index by channel

	# of Participants	Average CIO Index
Corporate	16	20.0
Public	19	10.6
E&F	15	-9.4
Total	50	7.6

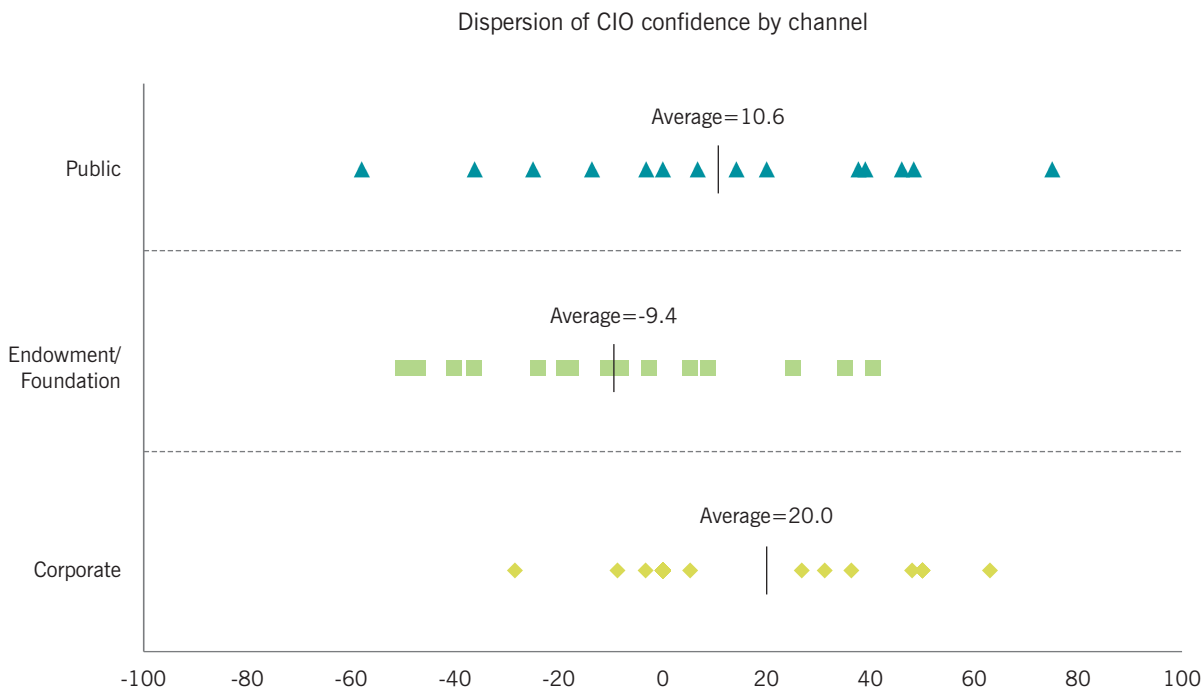
Data as of November 1, 2009

Source: Institutional CIO Confidence Index survey

Display 3 illustrates the distribution of scores from all Index participants. It shows a fairly regular distribution of scores in the negative range, with a tail consisting of a relatively small number of scores indicating strongly pessimistic views, and a larger group scoring in what would best be termed a moderately negative range. The distribution on the right side of the table is less regular, with few CIOs scoring in a range best described as moderately optimistic, but fully 25% of all participants scoring in the more bullish range between 30 and 60. This distribution pattern suggests that a majority of CIOs with a distinctly positive outlook are not just predicting that the investment environment will be favorable; these CIOs expect financial markets to show significant strength in the coming year.

The *Display* also shows that, within the research sample, public pension fund CIOs are generally positive about the prospects of their portfolio returns hitting their targets, while CIOs from endowments and foundations score in negative territory. CIOs of corporate pension funds are by far the most bullish, with an average Index score of 20, followed by public fund CIOs at a positive 10.6. The average Index score among endowment and foundation CIOs is -9.4, a score that likely reflects continuing difficulties stemming from their relatively large exposures to illiquid asset classes going into the 2008 financial crisis. ³

Display 3: Bullish to bearish: Wide variation in CIO confidence



Data as of November 1, 2009

Source: Institutional CIO Confidence Index survey

2 | Index Drivers: *CIOs See Fixed Income Powering Performance*

As we shift to return expectations for individual asset classes in search of causal relationships driving the aggregate Index, the results of the Institutional CIO Confidence Index survey reveal that the slight positive bias reflected in the overall 7.6 Index score is driven primarily by the CIOs' outlook for fixed income, especially high-yield and investment-grade corporate bonds. For all other equity and alternative asset classes, CIOs see their returns falling short of targets in the coming year (*Display 4, next page*).

CIOs expect high-yield fixed income to be the best performer in the next 12 months, with an average expected annual return of 13.5%. That strong expectation tops the CIOs' average 4.4% target for the asset class, generating a positive 9.1 percentage-point differential, as shown in *Display 4*. The CIOs' expected number-two top performer for the coming year is investment-grade corporate fixed income, which they forecast to return 8.2% in the period, besting return targets by a solid 2.8 percentage points.

Perhaps reflective of the powerful rally experienced by the stock market since its trough in March 2009, the third top asset class in terms of expected performance—US equities—is not expected to exceed target returns in the next 12 months. As illustrated in the *Display*, CIOs say that their portfolios have set return targets of 7.7% for US equities, but they expect the asset class to provide returns of only 7.2% in the coming year.

The survey data show that CIOs are expecting negative absolute returns from only one asset class: public REITs. Not only are they expecting a return of -1.2% on this asset class, those returns actually fall short of the -0.2% target set by institutions. “The problems associated with residential, and now commercial, real estate are not going away any time soon. It usually takes years,” the CIO of a large foundation said in response to one of the survey's open-ended questions. “Problems with valuation and oversupply will take a while to get resolved.”

Other asset classes expected by the CIOs to be the worst performers in the next 12-month period include global government bonds, with expected returns of 1.8%; and US mortgage-backed securities (MBS) and US Treasuries, both with return expectations of 3.6%.

Display 4: CIO expectations vary by asset class

Asset class	Number of respondents		Forward 12-month returns		Expectation gap*
	Total	By channel	Expected	Target	
US Equities	41		7.2%	7.7%	-0.5%
Non-US Equities	34		6.9%	9.0%	-2.1%
Public REITs	30		-1.2%	-0.2%	-1.0%
US Treasuries	38		3.6%	4.7%	-1.1%
General US Fixed Income	34		4.5%	4.5%	0.0%
Global Investment-Grade Corporate Fixed Income	31		8.2%	5.4%	2.8%
Global Government Bonds	26		1.8%	2.0%	-0.2%
US Mortgage Backed Securities	29		3.6%	3.6%	0.0%
US High-Yield Fixed Income	27		13.5%	4.4%	9.1%
Hedge Funds	24		5.5%	6.7%	-1.2%
Commodities	27		6.8%	10.1%	-3.3%

■ Public ■ Endowment/Foundation ■ Corporate

*Forward 12-month expected returns minus forward 12-month target returns.

Asset classes are defined using the following indices: US Equities: S&P 500; Non-US Equities: MSCI ACWI ex-US; Public REITs: NAREIT; US Treasuries: 10-year US Treasury Bond; General US Fixed Income: Barclays Capital US Aggregate Bond; Global Investment Grade Corporate Fixed Income: Barclays Global Aggregate Corporate; Global Government Bonds: Citigroup World Government Bond; US Mortgage Backed Securities: Barclays Capital US Mortgage Backed Securities; US High Yield Fixed Income: Barclays Capital US Corporate High Yield; Hedge Funds: Hedge Fund Research Index; Commodities: Goldman Sachs Commodities Index (GSCI).

Number of respondents represents the rounded average of the respondents to both the expected and target return questions.

Data as of November 1, 2009

Source: Institutional CIO Confidence Index survey

Among the main drivers of CIOs' concerns about US Treasuries and other government bonds, two stand out: 1) investors' increasing appetite for risk assets; and 2) what CIOs termed "artificially low" interest rates generated by the continued accommodative policy stance of the Federal Reserve and other central banks around the world. "Nothing constructive is going to happen in US Treasuries over the next 12 months unless news of a new calamity inspires another flight to quality," said the CIO of another large foundation.

The CIO of a large public pension fund was even more direct about his outlook for US Treasuries. "By definition, rates can't go down from zero, so if you're loaded up on short-term Treasuries, you will take a beating," he said. "It's a question of when, not if."

Among all asset classes, CIOs expect actual returns to fall short of targets by the widest margin in commodities. The Index survey results reveal a negative 3.3 percentage point gap between CIOs' target returns of 10.1% on commodities and their 6.8% return expectations for the coming year. However, it should be noted that commodities also ranked as one of the asset classes cited most frequently when CIOs were asked to pick the best-performing asset classes for the coming year. The CIOs mentioning commodities in this context pointed to the devaluation of the US dollar, inflation and an increase in demand spurred by a resurgent economy as factors that will likely contribute to strong performance from the asset class.

In keeping with their overall confidence score of 20, corporate fund CIOs are most bullish about expected returns for US equities. Almost two-thirds of those CIOs reported expected returns between zero and 15% for the S&P 500 next year—a share that equals the average among all survey participants. However, approximately 20% of corporate CIOs say they are expecting returns in excess of 15%, compared to 11% for public funds, and 13% for endowments and foundations.

The CIO of a large corporate pension fund explained why he believes US equities will be the strongest-performing asset class over the next 12 months: "Half of the income (from companies in the S&P 500) comes from emerging markets and other markets outside the US," he said. "Plus, there are the benefits of a multiplier effect coming through a weaker currency. Although it is kind of counter-intuitive, a lot of companies in the S&P 500 are going to do well from a weaker currency."

Endowments and foundations, meanwhile, are most bullish on non-US equities, a universe proxied in our Index survey by the MSCI ACWI ex-US Index. Fully 93% of endowment and foundation CIOs expect non-US equities to generate positive returns in the next 12 months, and 20% expect non-US equity returns to top 15%. "The US stock market is overvalued," said the CIO of a university endowment. "There will be a leveling and a pullback. Outside of the US, markets are trailing. They haven't popped yet."

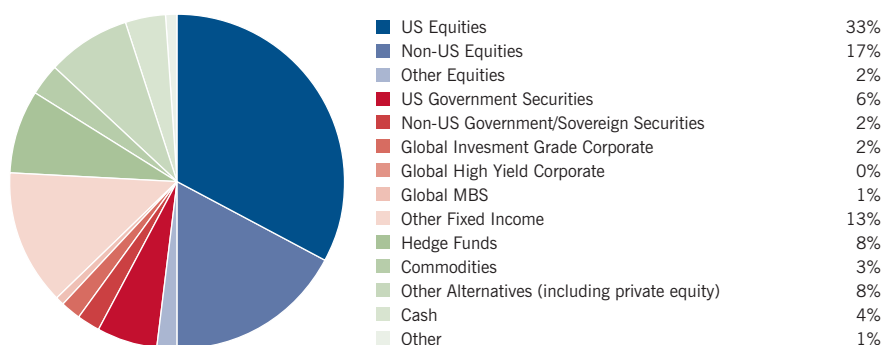
The significant divergence in opinion among institutional CIOs about return expectations for specific asset classes and their portfolios as a whole helps explain the less-than-certain market sentiment expressed in the 7.6 Index score. It also underlines why many of the CIOs expect hedge funds to be the biggest generators of alpha in the coming year. With little confidence in predictions about performance in individual asset classes, a significant number of CIOs said hedge funds' ability to capitalize on volatility and target attractive opportunities in distressed credit will give them a meaningful advantage in the months to come. As the CIO of a large public pension fund noted, "There continue to be dislocations in the market, and hedge funds are nimble enough to go after them." ☞

3 | Asset Allocation: *Strategic Shifts and Portfolio Rebalancing*

The Index survey results reveal the extent to which institutional portfolios have been affected by both the dramatic drop in asset valuations associated with the global financial crisis and the subsequent recovery in global equity markets. These shifts have prompted the CIOs to adjust their portfolios, as part of both rebalancing efforts and broader alterations to investment strategies. A map of the participants’ asset allocations as of the interview time of the Index survey is shown in *Display 5*.

Display 5: Post-crisis portfolio

Average respondent asset allocation



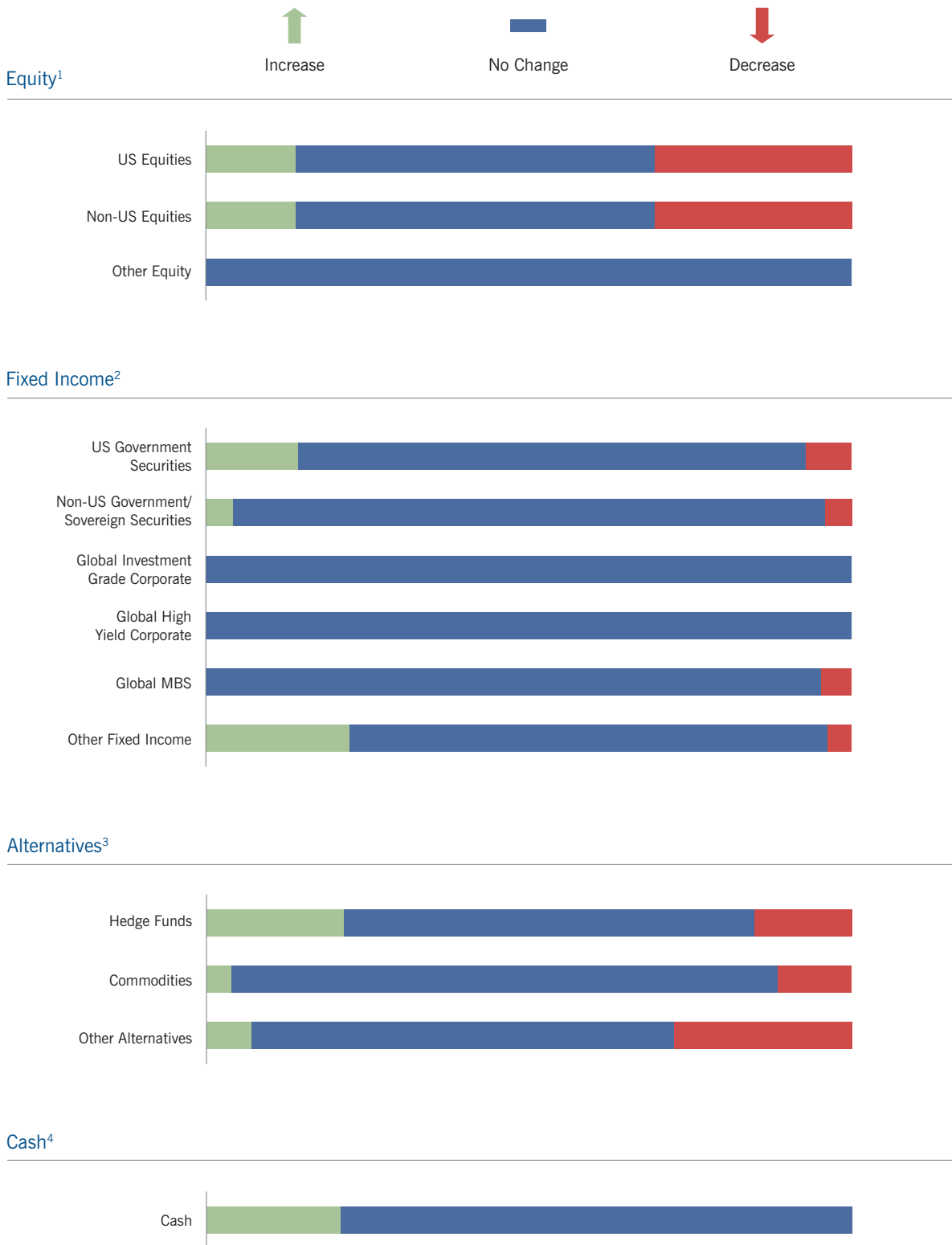
Data as of November 1, 2009

Source: Institutional CIO Confidence Index survey

Using their current allocations as a starting point, CIOs’ intentions to change (or not) their future asset allocation are shown in aggregate in *Display 6 (next page)*. For example, more than 30% of the CIOs participating in the Index survey intend to reduce allocations to US equities in the next 12 months, and an equal share plan to trim allocations to non-US equities. In both cases, slightly less than 15% of the CIOs are planning to increase allocations, and a majority is standing pat. “With equities having run so hard, they are becoming less and less attractive,” said the CIO of a public pension fund. “We were over-weighted in equities coming out of the bottom of this recession, but they are now up 40%, so we’ve become much more neutral.”

Display 6: CIOs are planning to adjust portfolios

Expected change in asset allocation (12-month forecast)



¹Total Participants = 33

²Total Participants = 24

³Total Participants = 29

⁴Total Participants = 30

Data as of November 1, 2009

Source: Institutional CIO Confidence Index survey

CIOs planning to make significant changes to their equity portfolios are evenly divided between those doing so to rebalance and those making a strategic change to their portfolios. One third of the CIOs planning major changes to equity allocations are reducing allocations in order to rebalance to an existing stable target—a move that primarily reflects the strength of the equity market recovery in 2009. Additionally, a total of 16% of CIOs are increasing allocations to rebalance to either a stable target or target range. For another 17% of these CIOs, a planned increase in equity allocations represents a shift in portfolio strategy, as does a planned reduction by more than one third.

CIOs expect less change to fixed-income allocations over the next 12 months. Roughly one third of them are planning to make some change to their overall fixed-income allocations, with the bulk of that share planning cuts. However, almost 80% of participating CIOs plan to hold allocations to US Treasuries stable for the next 12 months, a proportion that increases to between 90% and 100% in global government bonds, investment-grade fixed income, high-yield fixed income and MBS. Slightly more than 20% of CIOs plan to reduce allocations to “other” fixed income,¹ with almost three quarters planning no change, and nearly 5% planning to increase.

Rebalancing is the primary driver for planned changes in fixed income. Seventy percent of the CIOs planning to make changes in these allocations are doing so to rebalance. Among the 30% adjusting fixed-income allocations as a strategic change to their targets, all are planning to add to existing allocations.

Forty-two percent of CIOs plan to increase allocations to alternative investments. Although all of these CIOs said they are increasing alternative allocations in order to rebalance their portfolios, many CIOs expressed considerable optimism about the prospects for hedge funds in the coming year. One CIO explained that the hedge-fund industry today is much stronger than the one that existed at the outbreak of the global crisis. “Hedge funds have been through the misery of 2007 and 2008 and they’ve seen a lot of their capital evaporate,” he said. “The capital that is left is the stickier, smarter money, and a lot of what I call froth is out of the market.”

Meanwhile, the CIOs planning reductions to the alternative sleeves of their portfolios are divided between those doing so as part of a rebalancing, and those making a strategic shift in their allocations. Although only a relatively small share of CIOs plans to reduce allocations to “other” alternatives² and commodities, more than 20% say they expect to cut allocations to hedge funds. Among the CIOs planning reductions, 20% are making a strategic decision to decrease their target range, and the remainder is rebalancing.

After having faced some liquidity concerns as a result of the 2008 financial crisis, almost 80% of CIOs plan to maintain existing cash allocations, which increased significantly among virtually all global institutions last year. Current cash allocations reflect both institutions’ new appreciation for liquidity and a lingering uncertainty about market direction that has prompted many institutions to park assets in cash. The CIO of a large public pension fund, however, made the case that institutions would not be able to maintain large allocations for long, with cash holdings at present earning in the neighborhood of 1.3%. In his view, the cash—when put to work—is likely to find its way into the equity market. “Investors are holding too much cash,” he said, “and when this is redeployed it will push up equity prices.”

In keeping with that sentiment, all of the CIOs expecting to change their cash allocations—slightly more than 20%—are planning reductions. These changes are evenly divided between CIOs increasing or decreasing cash allocations to rebalance, and those making a strategic change to target allocations.

Plans for cash allocations provide interesting insights into the views of institutional CIOs about the durability of the market recovery, the prospects of additional liquidity shortages and the relative attractiveness of investment opportunities at the current point in the market cycle. The CIO of an educational endowment summed up the dilemma facing institutions that are uncertain about market direction in the wake of the historic crisis: “Since March, if you own cash, you own nothing,” he said. “People need to take risks to make money.” ☞

¹“Other” fixed income is defined in our survey as any fixed-income instrument not included in the individual categories shown in *Display 6*.

²“Other” alternatives is defined in our survey as any alternative instrument not included in the individual categories shown in *Display 6*.

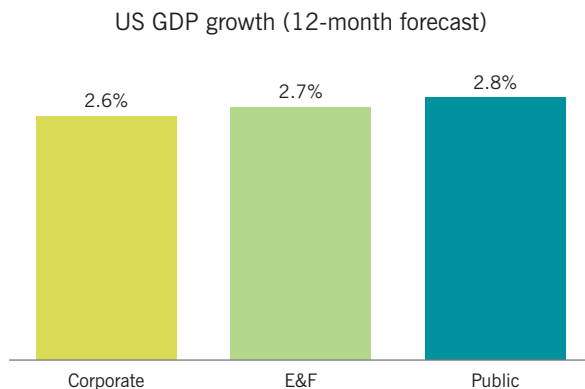
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CIO Outlook: *Risk Factors Temper Optimism on Economy*

The neutral outlook indicated by the current score of 7.6 on the Institutional CIO Confidence Index is also reflected in CIOs' predictions for a variety of important macro-economic indicators for the next year.

The CIOs expect US GDP to grow at an average rate of 2.7% in the coming year (*Display 7*). While 60% of CIOs expect growth to come in between 1% and 3% over the next 12 months, a solid 38% predict an expansion of 3% or more, with 18% looking for growth of 4% or higher. Corporate fund CIOs are the least optimistic. Overall, corporate CIOs predict GDP growth of 2.6%, with one in 10 expecting negative growth in the coming year.

Display 7: Economic growth forecasts are relatively optimistic



Total number of respondents = 40 (Corporate, 11; E&F, 14; Public, 15)

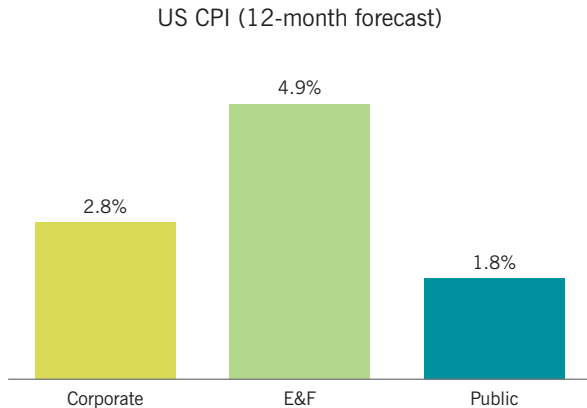
Data as of November 1, 2009

Source: Institutional CIO Confidence Index survey

Despite their rather bullish overall expectations for GDP, many CIOs expressed worries about the sustainability of the current economic recovery in light of global deleveraging, a high unemployment rate, a weak US dollar and the prospect of inflation. As the CIO of a large endowment/foundation noted, “Other than the fact that the unemployment rate will likely be about 10%, the main factor affecting the US economy will be the fact that the US consumer is over-leveraged. The consumer drives GDP, and the government is trying to plug the gap because the consumer is in rehab.”

On average, the CIOs expect US inflation of 3.2% over the next 12 months (*Display 8*), but predictions vary considerably. While some CIOs are basing their forward outlook on the belief that inflation will remain benign and interest rates will remain low, a significant number of CIOs named inflation as the single biggest threat keeping them up at night. About 45% of CIOs predict inflation between zero and 2%, almost 40% expect the inflation rate to fall between 2% and 4%, and almost 20% predict inflation of 4% or higher. CIOs of endowments and foundations are expecting inflation of 4.9% over the next year; public pension fund CIOs predict an inflation rate of just 1.8%.

Display 8: Inflation expectations vary substantially



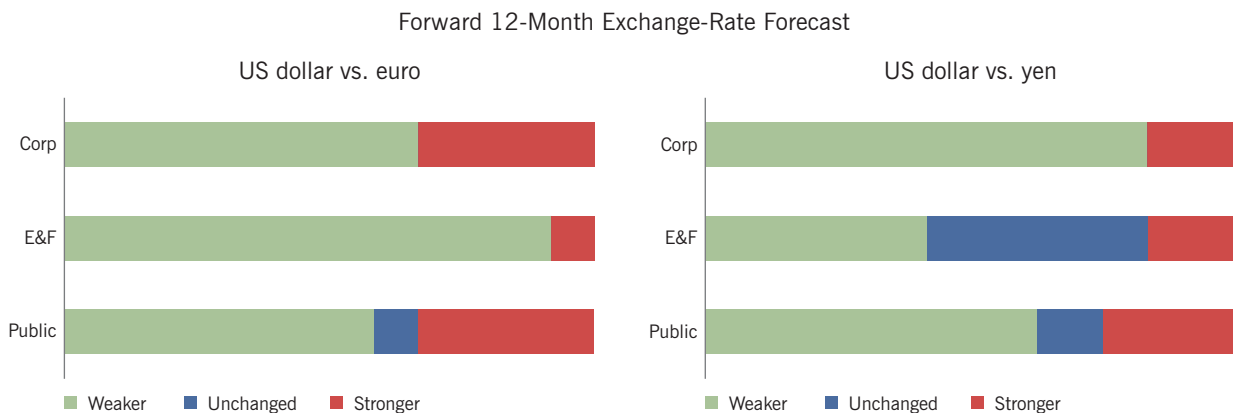
Total number of respondents = 40 (Corporate, 11; E&F, 14; Public, 15)

Data as of November 1, 2009

Source: Institutional CIO Confidence Index survey

Meanwhile, almost three quarters of the CIOs that expressed an opinion on the direction of the US dollar relative to the euro expect continued weakening on the part of the dollar for the next year, and more than 55% of those offering a prediction expect the dollar to continue falling against the yen (*Display 9*). CIOs of endowments and foundations are the most bearish on the dollar: more than 90% of those that expressed an opinion expect the US dollar to weaken against the euro in the coming year. The CIO of a public pension fund summed up the concerns of many Index survey participants by saying, “I am very worried about spending by the federal government... There will be inflation and a weakening dollar that does not bode well.”

Display 9: Respondents see a further weakening dollar

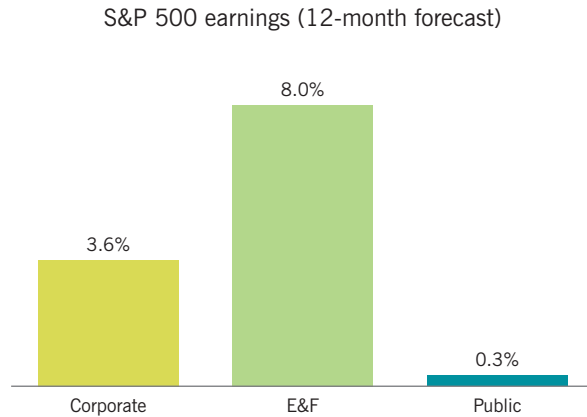


Data as of November 1, 2009

Source: Institutional CIO Confidence Index survey

CIOs were sharply divided in their predictions for earnings growth for the companies in the S&P 500 next year. The average expectation among all Index survey participants is for earnings rate growth of 4.0%. However, that average spans a prediction of just 0.3% growth from CIOs at public pension funds, 3.6% from corporate fund CIOs and a bullish 8.0% from CIOs at endowments and foundations (*Display 10*).

Display 10: Opinions diverge sharply on corporate earnings



Total number of respondents = 31 (Corporate, 10; E&F, 11; Public, 10)

Data as of November 1, 2009

Source: Institutional CIO Confidence Index survey

There is less variance in the expectations for unemployment, but there is also little in the way of optimism. On average, CIOs expect a national unemployment rate of 9.8% for the next 12 months. Many of the CIOs expressed particular concern about the potential negative impacts of such a high level of unemployment on an economy that is still largely driven by consumer spending.

These concerns—along with related worries about inflation, US dollar devaluation and other risk factors—are acting to constrain the level of confidence among CIOs, even in the face of relatively strong expectations for overall economic growth. The end result: The neutral sentiment captured in the first installment of the Institutional CIO Confidence Index. As the CIO of a large endowment sums up: “Consumers need to feel comfortable that they will have jobs, and that things will get better before they start spending. With unemployment at the level it is, and at the level I expect it to be (in the near future), the glass is half empty, at best.” ☞

Conclusion

The results of the Institutional CIO Confidence Index reveal that high levels of uncertainty about the near-term performance of financial markets and the overall economy persist among large institutional investors.

Doubts about overall direction are strong enough that institutions are, in aggregate, agnostic as to whether returns on their investment portfolios will meet their return targets over the coming year, with only a slight bias to the positive. Underlying this uncertainty are expectations that actual investment returns will hit or exceed institutional targets only in high-yield and investment-grade corporate fixed income. Returns on all other asset classes are expected to fall short of targets.

By providing a consistent and statistically valid measure of expectations among institutional CIOs, the Institutional CIO Confidence Index provides the marketplace with a valuable tool for assessing current levels of investor sentiment in historically unpredictable markets. As the Index tracks changes in CIOs' outlook over time, we expect it to produce a robust set of results that will be released regularly and analyzed for forward-looking indications. ☞

Disclosures

This document has been prepared solely for informational purposes and is not an offer, or a solicitation of an offer, to buy or sell any security or instrument or to participate in any strategy. The information does not contend to address the financial objectives, situation or specific needs of any individual investor. Investors should consider such factors as their financial objectives, risk tolerance, and time horizon among other factors prior to investing. A financial professional can help assess investors with their individual situation prior to making any investment decisions.

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Charts and graphs provided herein are for illustrative purposes only. Any forecasts/estimates are based on current market conditions, subject to change, and may not actually come to pass.

All investments involve risks, including the possible loss of principal. Commodities are more volatile than stocks. Commodities and company stocks are more volatile than bonds and are subject to greater risks. Bonds are subject to interest-rate, price and credit risks. Foreign stocks are more volatile than domestic stocks. Emerging Markets country investments entail greater risks than those generally associated with foreign investments. Investments in securities rated below investment grade (commonly known as “junk bonds”) present greater risk of loss to principal and interest than investment in higher-quality securities. REITs are more susceptible to the risks generally associated with investments in real estate.

Appendix:

Research Universe and Technical Methodology

The Institutional CIO Confidence Index is a statistically meaningful measure of institutional chief investment officers' expectations for investment portfolio returns. The Index blends quantitative data on asset allocations, and expected and target return, with qualitative assessments of CIO confidence to create a single composite score.

RESEARCH UNIVERSE

The Index is based on the results of a survey of 50 chief investment officers from US institutions, including 19 CIOs from public pension funds, 16 from corporate pensions, and 15 from endowments and foundations. The CIOs participating in the Index survey represent institutions managing \$548.8 billion in assets, with all CIOs representing institutions with at least \$250 million in AUM. The bulk of these assets, approximately 70%, are managed by public pension funds, with 28% managed by corporate pension funds and 2% by endowments and foundations. Participating institutions have an average AUM of approximately \$11 billion. The Index was conducted by Morgan Stanley Investment Management and Greenwich Associates in a six-week period ended November 1, 2009 using computer-aided telephone interviewing.

METHODOLOGY

The CIO survey consists of 10 questions designed to capture quantitative and qualitative data. Survey participants are asked to give their allocations to each of the major asset classes and to express their qualitative level of confidence that actual returns from each asset class will meet or exceed their institutions' return targets. CIOs are asked to express their degree of confidence on a scale of one to five (five-point semantic ratings scale). The statistical composite of the resulting portfolio allocation data and the semantic ratings of confidence are transformed to the linear scale of -100 to +100. The low end of the scale (-100) indicates extreme bearishness and the expectation that portfolios will not meet their targets; 0 represents inconclusiveness; and +100 indicates extreme bullishness or a high degree of confidence that actual portfolio returns will hit institutional targets. Intermittent points on the scale represent degrees of sentiment between the mid-point and anchors. The Index is designed to be sensitive to changes in both actual asset allocations and CIO perceptions or confidence levels.

MODEL

The table below displays the statistical model used for the Institutional CIO Confidence Index, including the quantitative and qualitative inputs for each asset class along with the mathematic procedures for calculation.

Model	Current Allocation	Multiply	Confidence in Target Return	Scale Equation (-100, 0, 100)	Confidence Index Scores
Equities	%	*	(1-5)	$((\text{Confidence Score} - 1) * 50) - 100 = Y$	= Row
Fixed Income	%	*	(1-5)	$((\text{Confidence Score} - 1) * 50) - 100 = Y$	= Row
Alternatives	%	*	(1-5)	$((\text{Confidence Score} - 1) * 50) - 100 = Y$	= Row
Cash	%	*	(1-5)	$((\text{Confidence Score} - 1) * 50) - 100 = Y$	= Row
Total Confidence Index Score (by CIO respondent)					= Sum of Column (-100, 0, 100)

Morgan Stanley Investment Management Publications

FOLLOWING ARE RECENT THOUGHT-LEADERSHIP PAPERS COVERING A RANGE OF INVESTMENT ISSUES.

Managing Risk: Back to Basics

December 2009—In the wake of the crisis in global capital markets, investors are understandably focused on the issue of risk and the proper management of it. But how exactly should risk be defined and approached? MSIM's Henry McVey argues that an effective risk management process should center around a top-down framework for assessing strategic risk in a portfolio.

Scenario Analysis of Illiquidity Surges

December 2009—For investors holding illiquid assets, 2009's equity market rally poses an interesting dilemma: How do investors manage high growth in illiquid allocations that occur as a result of strong stock market returns? In this paper, we address this and other key questions on portfolio liquidity, and potential illiquidity surges, in periods of stable and extreme equity market returns.

Inflation Outlook: On the Razor's Edge

November 2009—As many investors worldwide fret about potentially rising inflation, MSIM's Henry H. McVey posits that market fears might be misplaced, arguing instead that uncomfortably low inflation is a much bigger risk to global markets in 2010.

Charting the Comeback Trail in Japan via Small-Cap Equities

November 2009—As world economies stay on the path to recovery, Japan remains either forgotten or avoided by most investors. Is this strategy correct? Or are investors risking being underexposed to a potentially significant period of outperformance for Japanese stocks? If so, what presents the most attractive opportunity: large or small caps? In this paper, we tackle these questions, and examine Japanese stocks in general and small caps in particular.

Recovery Myths

October 2009—As the US economy continues to show signs of improvement, many investors have begun to wonder about the sustainability and strength of the recovery. In this research report, Richard Berner tackles this issue, and identifies what he believes are three myths currently fueling this economic debate.

A Changing of the Guard

October 2009—The global equity market recovery has so far been defined by a strong rally in high-beta stocks. But history suggests that these "junk rallies" have typically lasted, on average, about six months from the markets' trough. In this paper, Henry H. McVey argues that we are now on the cusp of a major shift in global equity market leadership.

Investing in a Horizontal World

October 2009—Correlations among world economies and asset classes have increased dramatically as of late. But is this situation sustainable in the long run? In this article, Ruchir Sharma argues that the case for differentiation based on local factors is strong and getting stronger.

The New Landscape for Fixed Income: From Treasuries to TALF

October 2009—As the global credit crisis shows signs of easing, institutional investors confront a crucial issue: How to exploit the new investment landscape to generate the higher potential returns of equities, while striving to maintain the lower volatility often associated with fixed income? In this white paper, we address this question, and propose a framework through which investors can set up opportunistic fixed-income portfolios.

Financials: Less Bang for Your Beta

September 2009—The Great Recession has undoubtedly taken a heavy toll on financials. But now that the downturn has begun to show signs of abating, how can investors best explore potential opportunities within the sector? In this paper, Henry McVey tackles this key issue, and shares his outlook for financials.

Convertible Bonds: Back in the Spotlight

August 2009—While optimism appears to have returned to global capital markets, uncertainty surrounding the timing of the economic recovery has led some investors to remain sidelined until a sustainable recovery process becomes more clearly defined. But how do you determine optimal market entry points? In this paper, we investigate convertible bonds as a potential solution to the current market-timing dilemma.

US Corporate Profitability—Support on the Margin

August 2009—Although US corporate earnings have dropped steeply since the start of the Great Recession, net margins for non-financial firms have been surprisingly resilient compared to previous downturns. What does that mean to equity trading levels? Does this represent a tactical opportunity? Henry McVey provides answers in this article.

Challenges to Rebalancing the US Economy

July 2009—The global financial crisis has exposed the vulnerability of unbalanced US and global growth. The ensuing recession, however, is now helping to rebalance the US economy. The question now is: Will this rebalancing process be benign for economies and markets, or will it be disruptive? In this paper, we tackle this difficult question by examining the challenges ahead for the US economy.

The “Renaissance” of Global Macro Investing

July 2009—In his inaugural article since returning to Morgan Stanley, Henry McVey, MSIM’s Head of Global Macro and Asset Allocation, highlights his current views on the direction of financial markets, and argues that a key upshot of the Great Recession will be an augmented role for the traditional top-down, macro-investing approach.

Operational Improvement: The Key to Value Creation in Private Equity

July 2009—The global financial crisis is reshaping the private equity landscape. While lingering tight credit has increased competition for new deals, opportunities for “home runs” to offset underperforming investments are now limited. As a result, private equity firms have become even more dependent on their ability to improve operational performance in every deal to generate attractive returns. But what is the best way to enhance operations and unlock value from portfolio companies? In this paper, we examine the many approaches firms can take in deploying operational expertise.

Surplus Targets and Percentile Fans

June 2009—While an investment fund’s level of surplus (or deficit) should not, by itself, determine its investment strategy, any informed portfolio decision should take that number into consideration. But even so, questions remain: How can fund managers determine, for example, that the level of equity beta exposure of their portfolios is adequate to their future needs? In this paper, we address this and other issues, providing a framework for understanding beta exposures.

How the Tight Credit Market Is Augmenting the Investment Opportunity for Private Debt Capital

May 2009—The dislocation in the credit markets has set the stage for a widening gap between the supply of, and demand for, capital. What solution could potentially fill this gap? This paper suggests that a combination of traditional and non-traditional sources of debt capital should emerge in response to this imbalance. Specifically, we believe that private credit capital targeting middle-market issuers is likely to be an important focus for investors.

Return Targets and Percentile Fans

May 2009—A portfolio’s beta exposure has traditionally been a key factor influencing the prospects for reaching return targets. But how much beta does one need to increase one’s chances of exceeding the risk-free rate over a one-year period? Conversely, how much beta risk is necessary to satisfy target returns in the long run? In this paper, we address these issues, and provide a compelling framework for understanding beta exposures.

Looking Beyond the Valley: Identifying Cross Asset-Class Opportunities

May 2009—The global economic crisis has taken a heavy toll on asset prices across the investment spectrum, including equities, credit and commodities, creating a number of distressed investment opportunities. Yet, many investors are still wondering how to best assess these opportunities, and how to rebalance their portfolios for optimal potential returns. This paper addresses these questions, and lays out a comprehensive roadmap for investors to gauge the current opportunities and place them in the proper historical context.

The views and opinions expressed within these publications are those of the authors, are based on matters as they exist as of the date of preparation and not as of any future date, and will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date hereof.

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