

April 28, 2006

US Portfolio Strategy

Hedge Funds: It Pays to Have Conviction

Profiting from Hedge Funds. You do not actually need to pay high management and performance fees to get the hedge fund community's best ideas these days. Rather, leveraging the simplicity of FactSet and SEC filings, my colleagues in US Strategy helped me to devise a strategy for exploiting high-conviction ideas from the domestic hedge fund community. Driving our framework is the identification of stocks with high ownership by a select number of hedge funds.

If You Can't Beat Them, Join Them. Using our strategy of buying high-conviction hedge fund ideas, an investor would have realized a cumulative return of 486% since 1999. This return compares with the S&P 500 return of 12% or the Russell 2000 return of 89% during the same period. Our strategy also back-tests well from a consistency standpoint, as it outperformed the S&P 500 return in 20 out of 28 three-month periods.

Small Guard Who Can Play the Big Forward Position. Though it appears we might be approaching a saturation point, hedge funds have massively shifted their portfolios towards smaller-capitalization stocks in recent years. All told, the percentage of hedge fund ownership in mega/large-cap stocks within the Russell 3000 has fallen to 36% from 48% in 1999. Meanwhile, small/mid-cap stocks now account for 64% of total registered long positions versus 51% in 1999.

Taking it to the stock level: Using our High Conviction Idea methodology, the following stocks screen as High Conviction Ideas: AN, JNS, NCR, CC, GD, NOVL, OMX, QLGC, and AZO. See Exhibit 6 for further details.

Morgan Stanley & Co. Incorporated **Henry H. McVey**Henry.McVey@morganstanley.com
+1 (1)212 761 7201**David R. McNellis, CFA**David.McNellis@morganstanley.com
+1 (1)212 761 7991**Frances Lim**Frances.Lim@morganstanley.com
+1 (1)212 761 8059**William M. Smith, CFA**

William.M.Smith@morganstanley.com

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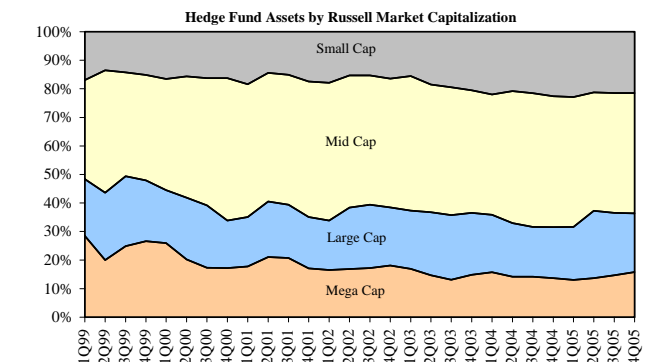
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Hedge Funds: It Pays to Have Conviction

As I travel around and visit with a growing number of Morgan Stanley accounts, it has become clear to me that hedge fund managers — particularly emerging ones with limited assets — are increasingly trafficking in smaller-capitalization US stocks. But it helps to get a second opinion. To this end, my colleague Bill Smith built a database of hedge fund 13F filings. What we found is that hedge fund ownership of mega/large-cap stocks has fallen to 36% in 4Q05 from 48% in 1Q99. Probably more interesting to the typical man on the street, however, is that there is a lot of money to be made by tracking which *specific* stocks hedge funds own.

Don't get me wrong. Not all hedge fund ideas are money makers — far from it. But our work shows that buying stocks with 1) high hedge fund ownership in percentage terms; 2) but owned by only a few select hedge funds (i.e., their highest-conviction ideas) is a great vehicle for generating significant alpha. All told, using our strategy of buying high-conviction hedge fund ideas, an investor would have realized a cumulative return of 486% since 1999. This return compares with the S&P 500 return of 12% or the Russell 2000 return 89% during the same period. Investors should take comfort that we use a conservative approach that assumes positions are not initiated until fully 60 days after the end of each quarter (15 days after 13F files are published). See Exhibit 6 for details, but current high-conviction names that are worth reviewing include AN, JNS, NCR, CC, GD, NOVL, OMX, QLGC, and AZO.

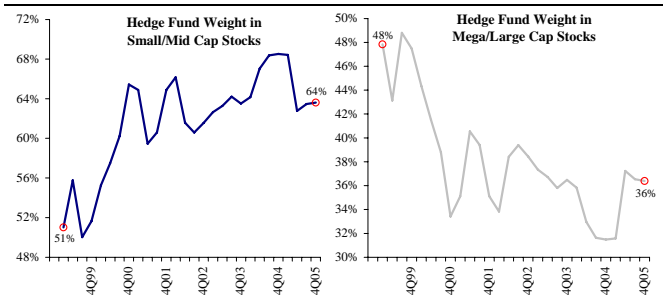
Exhibit 1
Hedge Funds Have Moved Down the Cap Curve



Using the Russell 3000 universe of companies: Mega Cap represented by top 50 by market cap, Large Cap by next 150, Mid Cap by Russell Midcap, and Small Cap by Russell 2000. Source: FactSet Lionshares, Russell, Morgan Stanley Research

Failing to See the Forest? While sell-side houses continue to produce voluminous reports on large-capitalization S&P 500 stocks, the fastest-growing part of their client base is actually shunning the traditional blue chips. As Exhibit 2 shows, the percentage of hedge fund ownership in mega/large-cap stocks within the Russell 3000 has fallen to 36% from 48% in 1999. Meanwhile, small/mid-cap stocks now account for 64% of total registered long positions versus 51% in 1999. This shift in focus makes sense to us for several reasons. For starters, many of the best opportunities in recent years have been in small-cap and international stocks, not domestic large-cap ones. Also, as the business has gotten more competitive, hedge fund investors have transitioned their portfolios away from single-stock ideas towards derivatives, private investments, and swaps. Furthermore, the reduced exposure to mega/large-cap stocks is consistent with the observations of my colleague, Marty Leibowitz. In a recent note, his work outlines the high correlation between long/short hedge funds and small-cap stocks (see his report *Hedge Funds and Small-Cap Betas* dated 3/24/06 for more details). Perhaps his readers were not surprised to find that the MSCI Long Bias Hedge Fund Index recently posted its best quarterly gain since 4Q04, coinciding with a 13.9% gain in the Russell 2000, its best quarter since 4Q04.

Exhibit 2
Shifting Focus to Smaller Stocks



Source: FactSet Lionshares, Russell, Morgan Stanley Research

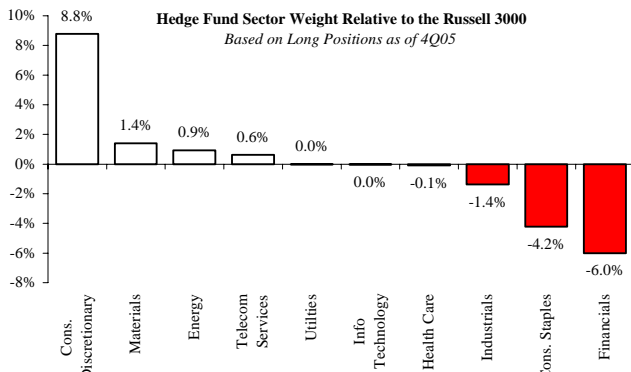
You Can Run, But You Can't Hide. To get a better picture of where hedge fund managers are laying their bets on the long side, we looked at hedge fund holdings of Russell 3000 companies (\$490 billion in assets as of 4Q05). To our surprise, we found that managers are currently most long the Consumer Discretionary sector. Ironically for us, that's our largest underweight. However, hedge fund managers are not bullish on *all* Consumer Discretionary stocks, just a few select names within the sector. In particular, Retailing names like Sears (51.7% hedge fund ownership), AutoZone (41.8%), OfficeMax (32.2%), and AutoNation (30.9%) rank highest by

April 28, 2006
Strategy

hedge fund ownership. Wendy's (30.3%) and Circuit City (30%) round out the top six.

Exhibit 3

Hedge Funds: Long the US Consumer?



Source: FactSet Lionshares, Russell, Morgan Stanley Research

On the other hand, their biggest underweight positions are in the Financials and Consumer Staples sectors. I take some comfort that we are out of consensus on our Financials call. Both hedge funds and long-only clients have been fighting our thesis to buy financial intermediaries with global exposure since we implemented it last August. I acknowledge that we are 50% of the way through the trade at this point, but I still am of the mindset that the brokers will beat numbers for the next three quarters, delivering record or near-record return on equity. As for Consumer Staples, we recently reduced our underweight to equal weight as we think that sentiment is negative, earnings are bottoming, and valuations are now within the realm of reason.

Acting on Activism. Using our strategy of buying high-conviction hedge fund ideas, an investor would have realized a cumulative return of 485.6% since 1999. That's not too bad compared with the S&P 500 return of 12.1% or the Russell 2000 return of 89.4% during the same period. Our strategy also back-tests well from a consistency standpoint, as it outperformed the S&P 500 return in 20 out of 28 three-month periods, with an average excess return of 6.5%. The ability to outperform consistently results from the strategy's positive skew — only five of the 28 periods were negative on an absolute return basis.

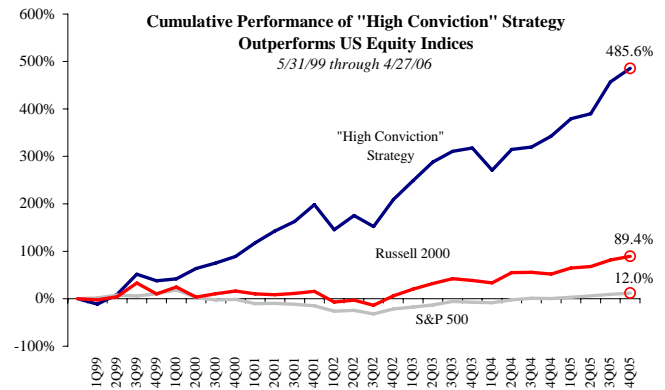
Now that I have your attention on the performance front, let me bore you with the details about how the 'plumbing' of this strategy works. Using SEC 13F filings, we first rank the top 25 stocks within the S&P 500 by percentage of hedge fund ownership (i.e., hedge fund shares owned as a percent of shares outstanding). We then screen these stocks in search

of those positions only owned by a select number of hedge funds — choosing the ten stocks with the smallest number of hedge fund owners. The process was repeated four times a year following the quarterly 13F filings. For those who are sticklers for the "rules," we want you to know that we modeled a 60-day waiting period between the end of each quarter and the initiation of our positions. This allows a generous window for both reporting (institutions have 45 days to file) and for an investor to build a meaningful position in the stocks.

There are at least two factors that make this strategy successful, we think. First, we are buying companies where hedge fund conviction is highest, i.e., high ownership, but low participation. In an era where hedge fund companies can charge 200 basis point management fees to support deep-dive research on a select number of stocks, our premise is that it probably makes sense to pay attention to where the "smart money" is making its Big Bets. Second, we think that by identifying the positions with the fewest owners, coupled with high percentage ownership, we can focus on the stocks where more activist shareholder measures may be contemplated to bolster value (e.g. new board, divestitures).

Exhibit 4

Buying High-Conviction Hedge Fund Ideas Is a Powerful Alpha Generating Strategy



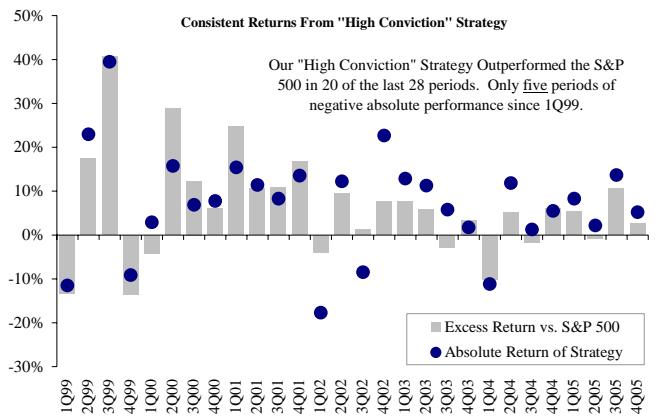
Note: Returns are market cap weighted.
Source: FactSet Lionshares, Morgan Stanley Research

Missing Links. Perhaps the biggest risk to our strategy — and the one that contaminates most back-tested strategies — is survivorship bias. Our historical 13F database contains information only on companies *that remain going concerns today*, so we are not able to gauge the impact of owning companies that failed or were de-listed. Put another way, we received a 'get out of jail free card' for the small number of companies that hedge fund managers continued to champion as they went belly up. This impact was probably most profound during the 2001/2002 period. An important offset is

April 28, 2006
Strategy

that we also do not get the benefit of take-outs related to M&A. This is a big deal, as hedge funds, especially event driven and merger arbitrage types, traffic heavily in speculative names that often get acquired. Unfortunately, our methodology does not account for these 'take-outs' because there is a change of control, which is not picked up in our data and would likely skew our results *higher*, if you can imagine that.

Exhibit 5
Not Bad: Our Strategy Outperforms 72% of the Time



Source: FactSet Lionshares, Morgan Stanley Research

See Footnote A. Like any glossy annual report, there are footnotes to which all readers should pay attention. For starters, our 13F database (i) only represents long positions and does not include ADRs, ETFs, or derivatives, (ii) only institutions with assets under management of more than \$100 million or a 10,000 share position are required to report; and (iii) the analysis is not limited to one type of fund and may include positions by funds that invest across the capital market spectrum (i.e., convertible arbitrage, macro, statistical arbitrage, etc.). In cases where the number of hedge fund participants results in a tie between two or more stocks, we side with the stock where hedge fund ownership is highest. For example, 39 hedge funds held positions in ODP this period, the same as AZO and MERQ. However, since ODP had the lowest percentage of ownership (vs. AZO and MERQ) we excluded ODP from the strategy. Lastly, it is worth repeating that our database only has history from 1999, and that survivorship bias (i.e., dead companies and dead funds that are no longer available) may have influenced our results.

April 28, 2006
Strategy

Exhibit 6

Top 25 S&P 500 Companies by Hedge Fund Ownership

| "High Conviction" Strategy | Ticker | Company Name | GICS Industry Group | Performance | | Market Value | Hedge Fund % of Shares Outstanding | Number of Hedge Funds w/ Positions | Morgan Stanley Rating |
|--|--------|----------------------------|----------------------------------|---------------|--------------|--------------|------------------------------------|------------------------------------|-----------------------|
| | | | | Price 4/27/06 | From 2/28/06 | | | | |
| | AN | AutoNation Inc. | Retailing | 22 | 5.2 | 5,773 | 30.9% | 22 | O / C |
| | JNS | Janus Capital Group Inc. | Diversified Financials | 20.57 | -6.2 | 4,437 | 18.6% | 26 | U / I |
| | NCR | NCR Corp. | Technology Hardware & Equipment | 39.6 | -1.2 | 7,271 | 11.2% | 29 | E / I |
| | CC | Circuit City Stores Inc. | Retailing | 28.9 | 20.3 | 5,263 | 30.0% | 35 | U / I |
| | GD | General Dynamics Corp. | Capital Goods | 68.28 | 10.8 | 27,490 | 19.1% | 37 | O / A |
| | NOVL | Novell Inc. | Software & Services | 8.42 | -11.5 | 3,242 | 24.8% | 37 | -- |
| | OMX | OfficeMax Inc. | Retailing | 38.49 | 31.2 | 2,725 | 32.2% | 38 | -- |
| | QLGC | QLogic Corp. | Technology Hardware & Equipment | 20.15 | -2.0 | 3,243 | 20.4% | 38 | -- |
| | AZO | AutoZone Inc. | Retailing | 94.24 | -2.5 | 7,231 | 41.8% | 39 | O / I |
| | MERQ | Mercury Interactive Corp. | Software & Services | 35.55 | 0.1 | 3,079 | 21.8% | 39 | U / I |
| | ODP | Office Depot Inc. | Retailing | 40.82 | 14.4 | 12,607 | 11.5% | 39 | -- |
| | AYE | Allegheny Energy Inc. | Utilities | 34.3 | -4.1 | 5,586 | 17.9% | 40 | -- |
| | LPX | Louisiana-Pacific Corp. | Materials | 28.05 | -1.3 | 2,967 | 15.8% | 41 | -- |
| | MYG | Maytag | Consumer Durables & Apparel | 21.33 | 24.0 | 1,710 | 14.6% | 41 | -- |
| | KBH | KB Home | Consumer Durables & Apparel | 62.01 | -7.5 | 5,993 | 14.1% | 44 | O / A |
| | HSP | Hospira Inc. | Health Care Equipment & Services | 38.69 | -2.5 | 6,223 | 11.3% | 46 | E / A |
| | TIN | Temple-Inland Inc. | Materials | 46.08 | 8.0 | 5,172 | 11.0% | 50 | O / A |
| | CTX | Centex Corp. | Consumer Durables & Apparel | 55.7 | -17.6 | 7,116 | 17.6% | 53 | -- |
| | KMG | Kerr-McGee Corp. | Energy | 99.49 | 1.8 | 11,540 | 11.8% | 55 | E / I |
| | WEN | Wendy's International Inc. | Consumer Services | 62.5 | 7.9 | 7,265 | 30.3% | 58 | U / I |
| | PD | Phelps Dodge Corp. | Materials | 81.86 | 18.6 | 16,626 | 21.0% | 62 | O / I |
| | X | United States Steel Corp. | Materials | 66.18 | 21.4 | 7,504 | 21.7% | 62 | E / C |
| | WMB | Williams Cos. | Energy | 22.16 | 2.7 | 12,698 | 11.7% | 66 | O / I |
| | SHLD | Sears Holdings Corp. | Retailing | 146.05 | 21.3 | 23,511 | 51.7% | 73 | U / I |
| | GDT | Guidant Corp. | Health Care Equipment & Services | 80.1 | 4.4 | 26,706 | 20.3% | 88 | NAV |
| "High Conviction" Strategy Average | | | | 4.42 | | 6,975 | 0.25 | 34 | |
| "High Conviction" Strategy Weighted Average | | | | 5.19 | | | | | |
| Top 25 Average | | | | 5.43 | | 8,919 | 0.21 | 46 | |
| Top 25 Weighted Average | | | | 10.02 | | | | | |
| S&P 500 | | | | 2.53 | | | | | |
| Russell 2000 | | | | 4.40 | | | | | |

Note: Data based on 13F filings as of 12/31/05. Stock Rating: O = Overweight; E = Equal-weight; U = Under-weight; NAV = Not Available; Industry View: A = Attractive, I = In-Line, C = Cautious. Source: FactSet Lionshares, Morgan Stanley Research

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April 28, 2006
Strategy

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|--------------------------|-------------------|------------|----------------------------------|----------------|----------------------|
| | Count | % of Total | Count | % of Total IBC | % of Rating Category |
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| Equal-weight/Hold | 879 | 44% | 300 | 47% | 34% |
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| Total | 1,978 | | 643 | | |

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April 28, 2006
Strategy

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1585 Broadway
New York, NY 10036-8293

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Europe

25 Cabot Square, Canary Wharf
London E14 4QA

United Kingdom

Tel: +44 (0) 20 7 425 8000

Japan

4-20-3 Ebisu, Shibuya-ku
Tokyo 150-6008

Japan

Tel: +81 (0) 3 5424 5000

Asia/Pacific

Three Exchange Square
Central

Hong Kong

Tel: +852 2848 5200