

# Investmentfocus

February 2010

## Commodities: Friend or Foe?

### Executive Summary

In the investment business, I have come to appreciate that there are always opposing views on markets, sectors, styles and stocks. What has made this “rite of passage” a little more interesting for me is that, while my background is in financial services, my oldest brother’s professional pursuits are linked to real estate and energy investing (i.e., hard assets). No doubt, I have generally been on the losing end of this debate in recent years, as hard assets have massively outperformed financial assets for the better part of a decade. Making matters worse is that he has had the good sense to master his craft in beautiful Charlottesville, Virginia, while I continue to grind it out in Manhattan!

Given that the drumbeat surrounding hard asset investing seems to grow louder each day, we are increasingly being asked by our clients whether there is still time left to meaningfully commit capital to commodities at this point in the cycle. Our answer is, we think so, but it is certainly not the no brainer that we expected when we started our deep dive into the commodity arena (please note that we are using the GSCI as a proxy in this analysis). Our conclusions are as follows:

- We believe that commodities’ greatest strength in terms of portfolio allocation is their role as an inflation hedge. This characteristic is even more compelling relative to other asset classes such as real estate if one believes that interest rates are going to rise.
- Commodities can also act as an important diversifier in many instances, particularly during periods of heightened geopolitical tension.
- Commodities do have some notable shortcomings, including their performance during periods of economic weakness. They have also become increasingly correlated to a subset of the equity markets. In addition, commodity investments can also add significant volatility to a portfolio.
- In the current “contango” environment, the negative roll feature of commodities can act as a significant drag on overall performance.

Looking at the big picture, commodity performance during the last decade has been so outsized relative to past cycles that it does makes us wonder whether the lion’s share of absolute returns in the asset class have already been achieved. As such, if suitable, we believe that commodities should represent around 5-7% of overall investment portfolios for large institutional accounts and that allocations should be tactical in nature, given such strong performance from November 2001 through February of this year.<sup>1</sup>



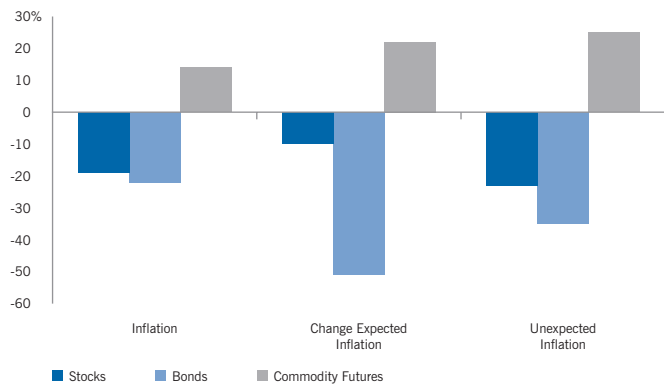
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<sup>1</sup>Data from November 6, 2001 through February 2, 2010.

### Commodities: *The Premier Inflation Hedge*

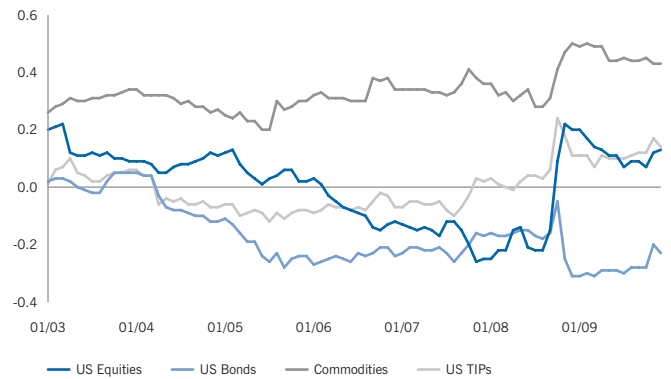
Karl Marx once said, “A commodity appears at first sight an extremely obvious, trivial thing. But its analysis brings out that it is a very strange thing, abounding metaphysical subtleties and theological niceties.” Mr. Marx certainly did not dabble in macro investing or asset allocation, but I think he was onto something. Specifically, we believe one of the great virtues of commodities is that they can help serve as inflation hedges. One can see this feature clearly in *Exhibit 1*. It shows that commodities historically performed well in periods of high inflation, rising inflation or inflation shocks. During these same periods, both equities and bonds showed disappointing performance and hence failed to serve as effective short-term inflation hedges.

**Exhibit 1: Correlation of asset classes with inflation**



Inflation: YoY% CPI. Expected inflation: T-bill rate as proxy. Unexpected inflation: Inflation - Expected inflation. Data is quarterly from July 1, 1959 to December 31, 2004. Past performance is no guarantee of future results. Source: Gorton & Rouwenhorst, Facts and Fantasies about Commodity Futures. Draft: February 28, 2005.

**Exhibit 2: Rolling five-year correlations with change in inflation**



Data from January 1, 2003 to December 31, 2009. Past performance is no guarantee of future results. The asset classes shown are based on the S&P 500, Ibbotson Corporate Bond Index, S&P GSCI and Barclays Global Inflation Linked Bonds - US TIPS, respectively. Source: MSIM, Bloomberg, Datastream

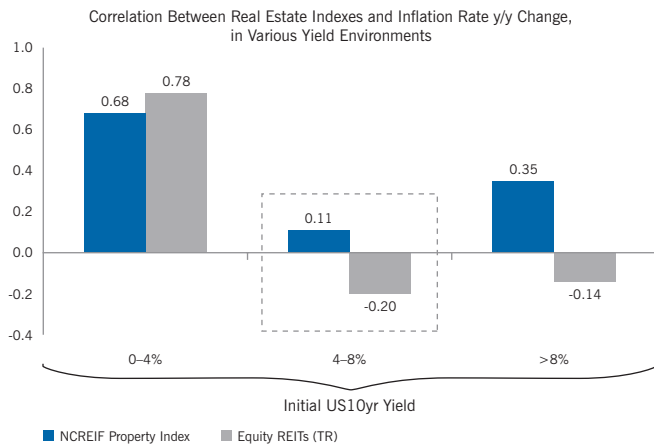
We believe the inflation-hedging feature of commodities remains potent, even in today’s volatile markets. As shown in *Exhibit 2*, on a rolling five-year basis, commodities stand out as a better inflation hedge than equities, bonds or TIPS. Importantly, commodities’ relationship with inflation has generally stood the test in periods of both rising and falling inflation, even through times when other markets actually failed as inflation hedges.

### More Effective Short-Term Hedge than Real Estate, Particularly in Moderate Rate Environments

Asset allocators we speak with often lump commodities and commercial real estate (CRE) together under the broad category of “inflation hedges.” We cannot argue against the fundamental logic that both hard asset classes can potentially provide inflation protection over the long term, but for investors who also keep their eyes on a shorter time horizon (say, 6-12 months), we think bucketing commodities and CRE together is something of an oversimplification.

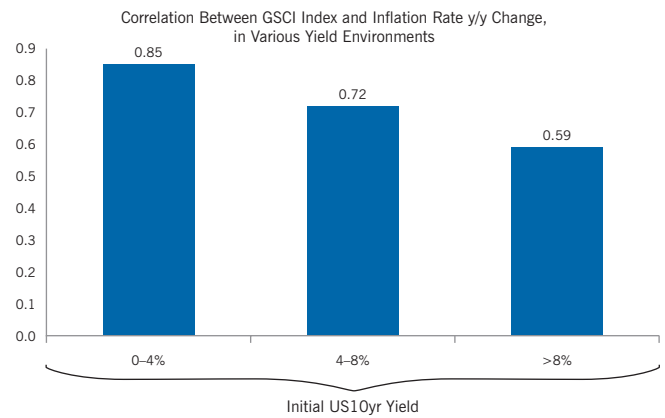
A key distinction is that CRE investors typically purchase their assets using long-term financing, which adds a critical element of interest-rate sensitivity to their investment decisions. *Exhibit 3* shows that in moderate interest-rate environments (4-8% 10-year Treasury yields), there is little correlation between real estate assets and changes in inflation rates. This observation applies for both REIT (as measured by the NAREIT Equity REIT Index) and direct real estate (as measured by the NCREIF Index) performance. Only in ultra-low interest-rate environments (0-4% 10-year Treasury yields)—where deflation is typically the predominant risk being priced in by the market—does CRE show a compelling positive correlation with inflation rate trends. By comparison, we found that the GSCI commodity index exhibited a strong positive correlation with short-term inflation (*Exhibit 4*) across essentially all rate environments.

**Exhibit 3: Short-term inflation-hedging power of real estate is often compromised by its interest-rate sensitivity...**



Inflation rates measured by US CPI. Data from December 31, 1978 to December 31, 2009. Past performance is no guarantee of future results. Source: Bloomberg, MSIM

**Exhibit 4: ...But the inflation-hedging power of commodities has been strong across various yield environments**

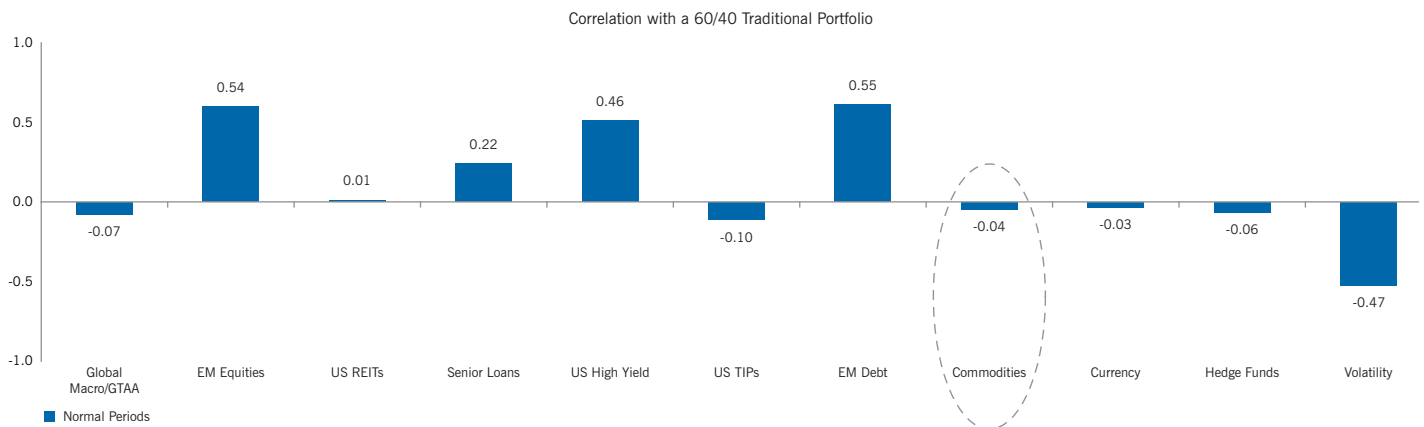


Inflation rates measured by US CPI. Data from December 31, 1978 to December 31, 2009. Past performance is no guarantee of future results. Source: MSIM, Bloomberg

**A Good Diversifier in Many Market Conditions...**

Besides acting as a strong inflation hedge, commodities can potentially add diversification benefits to most portfolios during normal markets conditions. *Exhibit 5* underscores this view, as we show commodities have essentially been uncorrelated to a 60/40 equity/bond portfolio during non-stress periods in the global capital markets. Not surprisingly, commodities have also performed well when there has been rising geopolitical tension. For example, in the periods leading up to the First Gulf War, the Second Iraq War and the 2008 Middle East uncertainty, commodities shined, particularly relative to stocks (*Exhibit 6, next page*).

**Exhibit 5: Commodities have been weakly correlated to a traditional equity/bond portfolio during normal market conditions**

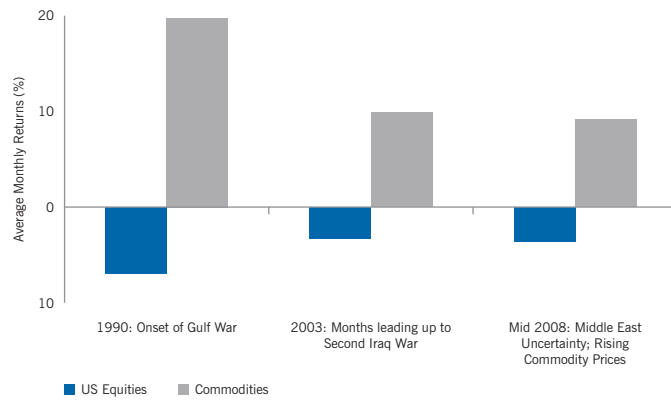


Data from January 1, 1990 to December 31, 2009. Past performance is no guarantee of future results.

The 60/40 Traditional Portfolio in this paper consists of 60% equities (30% S&P 500, 30% MSCI World ex USA) and 40% bonds (20% Barclays US Aggregate, 20% JPM Global Gov't Bond ex USA). The asset classes shown are based on the HFRX Macro Index, JPM EMBI Global, FTSE / NAREIT Equity REITs Index, S&P/LSTA Leveraged Loan Index, Barclays US Corporate High Yield Index, Barclays Global Inflation-Linked Bonds - US TIPS, MSCI EMF Gross Index (Local), S&P GSCI, Barclays Trader Indexes Currency, HFRI Fund of Funds Composite Index and CBOE SPX Volatility Index, respectively.

Source: MSIM, Bloomberg

**Exhibit 6: Geopolitical risk tends to drive divergence between commodity and equity performance**



Onset of Gulf War data from July 31, 1990 to August 31, 1990; Months leading up to Second Iraq War data from December 31, 2002 to February 28, 2003; Middle East uncertainty data from May 31, 2008 to June 3, 2008. Past performance is no guarantee of future results.

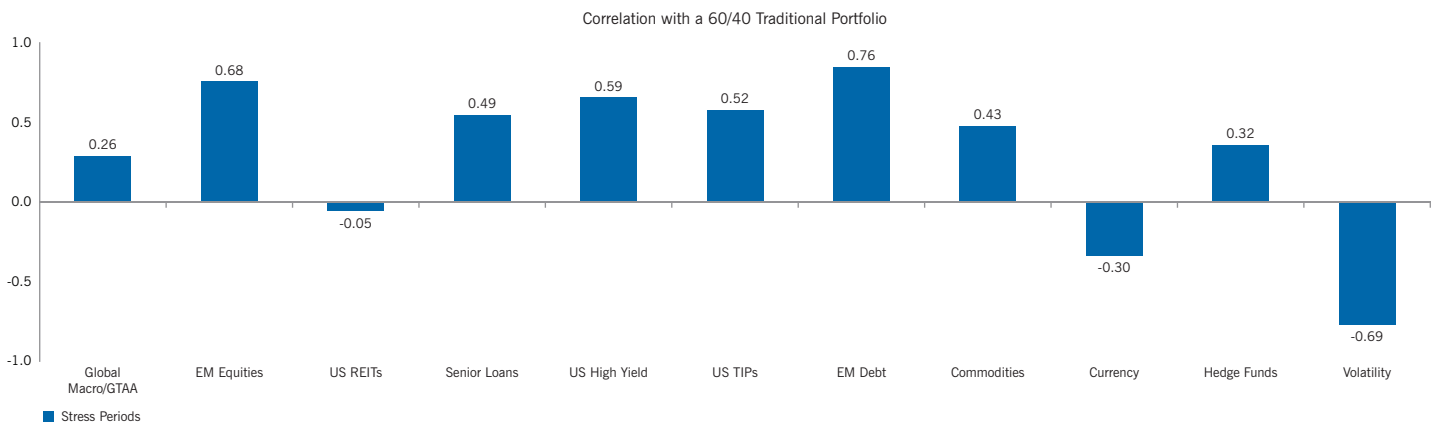
The asset classes shows are based on the S&P 500 Index and S&P GSCI, respectively.

Source: MSIM, Bloomberg, Datastream

**...But Not a Protection Agent During Economic Downturns**

If there is an Achilles Heel to commodity investing, however, it has to be that commodities have not been good diversifiers in a downturn. As *Exhibit 7* shows, correlation with a traditional 60/40 equity/bond portfolio has jumped from negative 4% to a startling 43% during periods of market stress. This lack of diversification is a big deal (see our note, “Managing Risks: Back to Basics,” December 2009), and certainly dispels any notion that diversification benefits occur by just adding more investment classes to a portfolio. The reason for the GSCI’s adverse correlation with other assets during stress periods, we believe, is that financial crises are often associated with declining inflation, which is anathema for commodity performance (*Exhibit 8*).

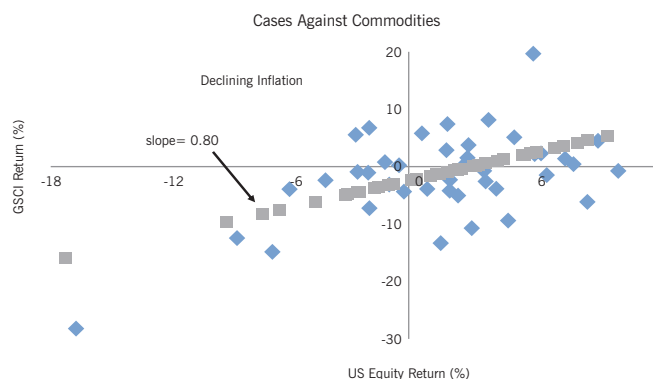
**Exhibit 7: When markets are in turmoil, commodities may not serve as a good diversifier to a traditional portfolio...**



Data from January 1, 1990 to December 31, 2009. See *Exhibit 5* footnotes for details on the indices representing these asset classes. Past performance is no guarantee of future results.

Source: MSIM, Bloomberg.

### Exhibit 8: Commodities have not performed well in declining inflation environments, which are usually led by equity market downturns



Data from January 1, 1990 to December 31, 2009. Past performance is no guarantee of future results.

US equity return as measured by the S&P 500 Index.

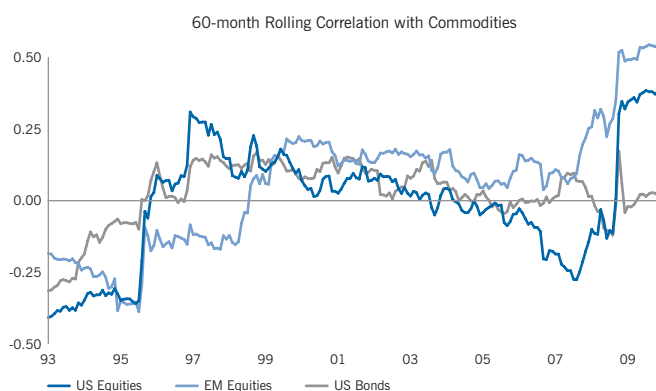
Source: MSIM, Bloomberg

### Correlations Are Rising

We believe that commodities have traditionally served as excellent diversifiers to traditional equity/bond portfolios, as they demonstrated negative correlations to both equities and bonds. Over time, however, the correlations of commodities to equities and bonds have increased. In particular, correlations skyrocketed over the past two years (*Exhibit 9*).

We link this surge to, among other things, the following: low interest rates, greater liquidity, lower friction costs and their increased connection to emerging markets.

### Exhibit 9: Commodities are now increasingly correlated to equity markets, especially emerging market equities



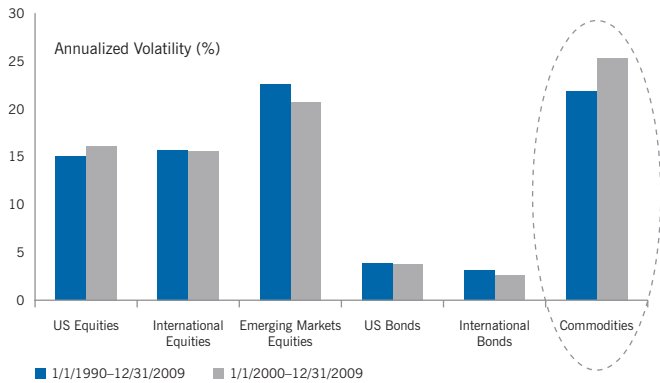
Data from January 1, 1993 to December 31, 2009. S&P 500, MSCI EMF Gross Index (local) and Barclays US Aggregate Bond Index were used for this correlation, respectively. Past performance is no guarantee of future results.

Source: MSIM, Bloomberg

### Higher Volatility Investment

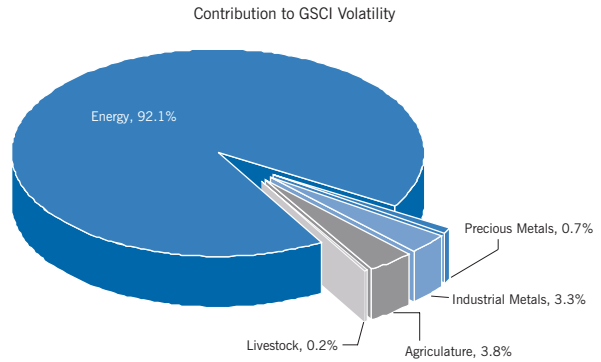
Another key consideration to commodity investments is their potential impact on overall portfolio volatility. *Exhibit 10 (next page)* shows that the GSCI has demonstrated significantly higher volatility than equities and bonds, especially for the past decade. Energy has been a key driver of the elevated volatility, contributing more than 90% of the variance in the GSCI, while accounting for only about 70% of the index weight (*Exhibit 11, next page*)

**Exhibit 10: Annualized volatilities of various asset classes**



Data as of December 31, 2009. Past performance is no guarantee of future results. The asset classes shown are based on the S&P 500 Index, MSCI World ex-US, JPM EMBI Global, Barclays US Aggregate, JPM Global Government Bond ex-US and GSCI, respectively. Source: MSIM, Bloomberg

**Exhibit 11: Energy sector has accounted for most of the GSCI volatilities**



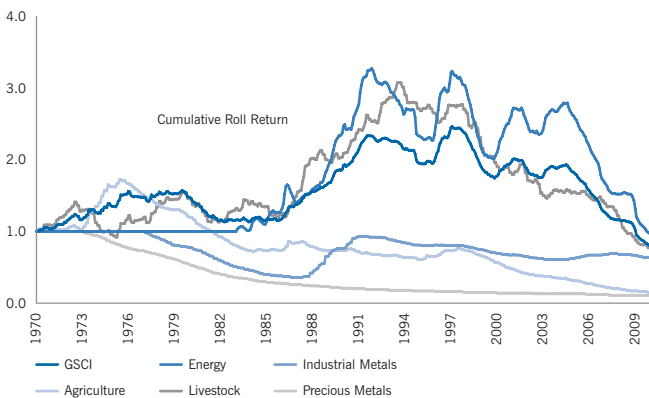
Data from January 1, 2000 to December 31, 2009. Past performance is no guarantee of future results. Asset class based on GSCI. Source: MSIM, Bloomberg

**Potential Drag from the Contango Market**

In addition to the dynamics of the commodity spot markets, one must be aware that the liquid investment instruments used by investors to gain exposure to commodities are commodity futures. Since the most liquid commodity futures have maturities of no more than a few months, one must roll an expiring contract to the next one on the term structure. If the futures curve is backwardated (downward sloping), one would profit from selling the expiring contract at a higher price and buying the incoming contract at a lower price. If the curve is in contango (upward sloping), on the other hand, one would experience a loss by simply rolling the futures contracts forward.

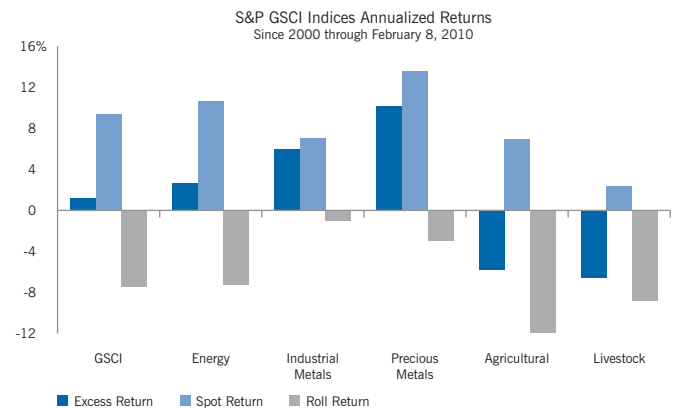
As shown in *Exhibit 12*, the GSCI experienced positive roll returns in the 1980s and 1990s, driven primarily by backwardated energy markets. Since the early 2000's, however, the roll return has become a significant drag to the overall GSCI performance. As shown in *Exhibit 13*, the GSCI has earned an annualized spot return of 9.3% since 2000. However, the roll return has been so negative that the excess total return of the index has been just 1.2%. In fact, the roll return drag was so severe for the agricultural and livestock groups that excess returns were significantly negative during this period.

**Exhibit 12: Cumulative roll returns from GSCI and its sub-components**



Data from January 1, 1970 to January 31, 2009. Past performance is no guarantee of future results. Source: MSIM, Bloomberg

**Exhibit 13: Roll returns from 2000 have been a drag in every commodity sector**



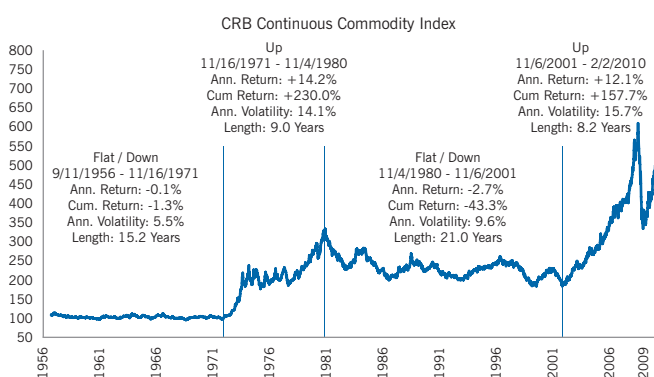
Data from January 1, 2000 to February 8, 2010. Past performance is no guarantee of future results. Source: MSIM, Bloomberg

## Late to the Party?

While commodities have provided substantial returns over the past decade, we are beginning to wonder if the most recent bull market in the asset class may be beginning to plateau. If history is any guide, then the answer is certainly yes. As *Exhibit 14* illustrates, commodities historically have experienced nine-year periods of strong returns, followed by long, largely sideways movements in the asset class for an additional 15 to 20 years. For example, commodities appreciated 230% in nine years from 1971 to 1980, before trading in a range for 19 years during the 1980-2001 period.

We find it noteworthy that we may be approaching this “do-nothing” stage, given that we are already more than eight years into the current bull market for commodities, the cumulative return in commodities has already reached 158%—or more than 70% of prior cycle peak returns—and the asset class’ relative strength versus stocks (*Exhibit 15*) now appears to be waning on the margin.

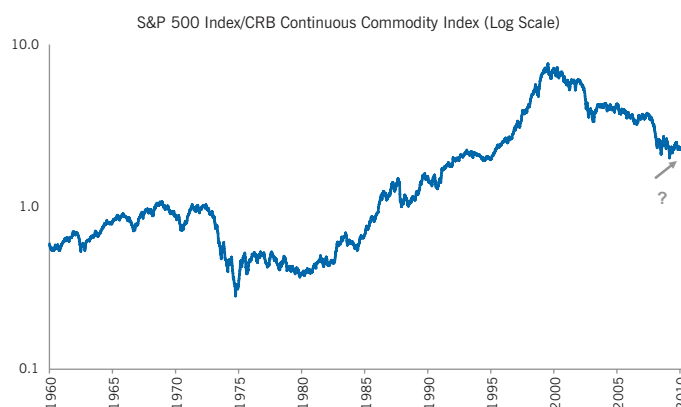
### Exhibit 14: Commodity bull market possibly close to an end?



Data from January 1, 1956 to February 2, 2010. Past performance is no guarantee of future results.

Source: Bloomberg, MSIM

### Exhibit 15: Commodity relative strength against stocks also weakening



Data from January 1, 1960 to February 2, 2010. Past performance is no guarantee of future results.

Source: MSIM, Bloomberg, Datastream

## Conclusion: So How Much Is Enough?

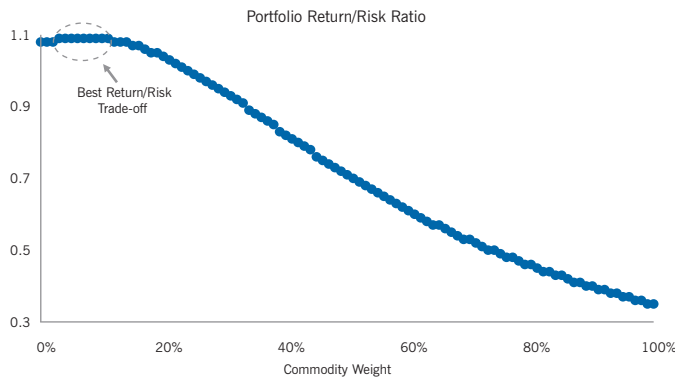
Despite some of the aforementioned shortcomings, we do think it makes sense to have commodities in a portfolio these days, particularly given the substantial monetary stimulus injected into global economy. The question then becomes: How much is enough?

Our basic recommendation is that, all else being equal, 5-7% is probably a reasonable number to target (*Exhibit 16*). We base this recommendation on the following:

- 1) Since commodities tend to have higher volatilities than other markets, adding them to a portfolio often results in a higher risk for the investment. While adding 5-7% of commodities to a traditional 60/40 portfolio would not have a major impact on the portfolio’s volatility, adding 10% or more of commodities to the portfolio is a different story (*Exhibit 17*). No doubt, one must balance the potential value-added from commodities with the higher risk that they bring to the portfolio. This view is consistent with that of our colleague Hussein Allidina, who heads Morgan Stanley’s commodity research effort (please see his full report, “Benefitting from Normalcy,” July 2009, for more insights related to underlying commodities and their role in the investment/asset allocation process).
- 2) The second critical criterion for inclusion in a portfolio allocation is that the asset class should add diversification benefits. As discussed earlier in this paper, commodities in general have demonstrated weak correlations with major markets—which is good news. The bad news is that in recent years they have become increasingly correlated to emerging market equities, and their correlations with developed equities have increased significantly during market downturns.

Going forward, we do not expect these return/risk features to change drastically for commodities relative to other major markets. Thus, an allocation of 5-7% is appropriate to us, as we believe the following: a) commodities deserve a place in a multi-asset strategic benchmark, for their diversification and in particular inflation-hedge features; and b) commodities should not account for a large portion of a strategic portfolio due to their highly volatile features and deteriorating diversification benefits.

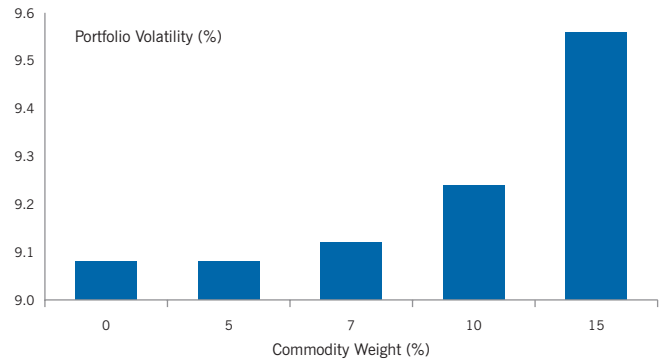
**Exhibit 16: Adding 5-7% commodities to a 60/40 portfolio has historically improved risk-adjusted returns...**



Data from January 1, 1980 to December 31, 2009. See *Exhibit 5* footnotes for details on this hypothetical portfolio. Past performance is no guarantee of future results.

Source: MSIM, Bloomberg, Datastream

**Exhibit 17: ...Although they add volatility to the portfolio as well**



Data from January 1, 2000 to December 31, 2009. See *Exhibit 5* footnotes for details on this hypothetical portfolio. Past performance is no guarantee of future results.

Source: MSIM, Bloomberg

## Disclosures

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# Morgan Stanley Investment Management Publications

Following are recent thought-leadership papers covering a range of investment issues

## 2010: Meaningful Mean Reversion

January 2010—As we move into 2010, investors face questions about many of the key drivers of the recent market rally. In his latest article, Henry H. McVey argues that, unlike 2009, many of the greatest opportunities in the new year will not be the obvious, secular long-term opportunities. Rather, he believes, 2010 will be about taking advantage of less-crowded, cyclical mean-reversion trades.

## Institutional CIO Confidence Index

January 2010—Morgan Stanley Investment Management is proud to introduce its Institutional CIO Confidence Index. Developed through a partnership with Greenwich Associates, the Index measures how confident chief investment officers are in meeting return targets for their portfolios over the next 12 months. As a result, we believe that the Index provides an accurate gauge of the post-crisis sentiment among CIOs at US public funds, corporations, endowments and foundations.

## 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.

### **Accessing Investment Opportunities in a Real Estate Recession**

May 2009—We believe that the most severe economic crisis since World War II is creating the most compelling commercial real estate opportunities in a generation. In this paper, we examine the causes of the ongoing market correction, quantify the impact of the crisis to date, and compare the current real estate recession to past market downturns. Due to the unique combination of events that precipitated the current slowdown, investors could have the chance to purchase the debt and/or equity of real estate at what we view as historically attractive terms.

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