

# STEP Commentary

## CIO Spotlight

This CIO Spotlight report focuses on Mike Wilson, Chief Investment Officer for Morgan Stanley Wealth Management.

The report has three key elements:

- Highlights from Mike's 22-year career at Morgan Stanley & Co. as well as his thoughts on leveraging his experience and connectivity at the firm to provide investment themes and resources to Wealth Management.
- Mike's key insights behind the rationale for the Global Investment Committee's tactical and strategic views on global equities and fixed income.
- What do the Fab Five, Winston Churchill, and John Wooden have in common? Not much. But they are all mentioned inside.

Our goal remains to highlight some of the boldest, highest-conviction thinking from Morgan Stanley Wealth Management in a reader-friendly format.

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## CIO Spotlight: Michael Wilson

*Michael Wilson is chief investment officer, chair of the Global Investment Committee and head of research for Morgan Stanley Wealth Management. He has been employed at Morgan Stanley & Co. for 22 years, mostly within its Institutional Securities Group. Mr. Wilson started his career in Morgan Stanley & Co. investment banking in 1989, and transitioned to the Institutional Equities Division in 1995. During this time, he started and managed the trading desk analyst effort while also serving as a technology sector specialist for nine years. In 2009, Mr. Wilson became Morgan Stanley & Co.'s head of content distribution for North American Equities, managing the "Alpha Team" and producing thematic ideas for the firm's institutional clients. During 2012, he assumed his current roles at Morgan Stanley Wealth Management. He has a BBA from the University of Michigan and an MBA from the Kellogg Graduate School of Management.*

**Dan:** Mike, let's kick off here and talk about your background at the firm. You've been with Morgan Stanley & Co. over 20 years, with most of that time spent in the Institutional Equity Division (IED). Can you provide some of the highlights from your previous roles at the firm?

**Mike:** Sure. I started at Morgan Stanley right out of undergrad in 1989. My academic training is pretty narrow. I have a BBA with a background in accounting and finance, and a little bit of marketing in there as well from the University of Michigan. I got my MBA subsequently at the Kellogg school at Northwestern University also in finance, marketing and strategy. I have a pretty deep understanding of accounting. When I first started at the firm I was in investment banking. We did a lot of bottom-up analysis of companies, focusing on corporate governance issues and M&A. Coming out of the recession in 1991 there was quite a bit of activity.

That was my introduction to Morgan Stanley, performing bottom-up analysis of companies, and industries. I spent a lot of time in the energy sector in those first four years. I got a pretty good grounding there.

I switched over in '95 to institutional equities in sales and trading and spent the next 15 years in a myriad of roles, everything from sales—I spent a couple years doing that—and then moving into a specialized role following the technology industry as a desk analyst, doing proprietary trading, and working very closely with capital markets completing a tremendous number of IPOs. I did the whole gamut of roles within technology and I also started what we call the sector specialist group, the desk analyst group, a cross-sector effort within Institutional Equities.

So we had at one point about 20 desk analysts covering various industries and I oversaw that group while still remaining a specialist in technology. That was a very good experience because

it allowed me to continue to develop my bottom-up abilities while forcing me to think cross-sector as well. Because of these different roles, I had to understand the short-term as well as intermediate-term investment horizons and why capital moves in and out of sectors.

My last role in institutional equities brought all of these experiences together. I was head of product development, product marketing and what we called content distribution. Essentially, what that means is filtering any kind of content that's valuable to the institutional client—and that could be equities, fixed income, or anything across the capital structure to our salespeople so they could deliver it effectively to clients. We built a couple businesses on top of that, most notably the custom basket trading business.

Custom baskets is just a fancy way of saying trying to find investment themes within the equity and fixed income markets that you could take advantage of by buying baskets of securities that represent those ideas. I think my background is one reason why I was asked to come over here to Wealth Management and there are a couple of reasons why the fit resonated for me. I had all this connectivity to the firm across a lot of different areas, and part of our role in wealth management research and, quite frankly, even in the asset allocation role is tapping into those resources to provide the best advice to our FAs, and ultimately, to our clients in a way that they can digest.

**Dan:** If you think back over different market environments, particularly when you were in IED, you've had a chance to get to know many great investors. What are some of the common traits of the investors that impress you the most and any key investing lessons that you've learned from them over time or from any of the investment-oriented roles that you've held?

**Mike:** I think the biggest lesson by far is humility. I've been fortunate enough to interact with some very successful investors. The thing I've noticed about the most successful ones is that they are very humble. The reason why they're humble is because the markets have taken them to the wood shed many times and that's a very humiliating experience.

One major thing that I've learned—and it was hard for me to learn initially when I was younger—is that working harder than everyone else doesn't necessarily translate into making winning investments. While that's part of the equation, the other part is understanding why things are doing what they're doing and what's wrong about your thesis.

So humility by far is number one.

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**Dan:** Transitioning now to your role as the chief investment officer for Wealth Management running the Global Investment Committee, what do you envision as some of the opportunities in this new role and perhaps discuss utilizing the resources here at Morgan Stanley as you alluded to earlier.

**Mike:** I think far and away the biggest challenge we have is simplifying what we do so that it can reach more people. Quite frankly, asset allocation is a focus area because if it's not the most important thing for an individual investor it's one of them. It's the foundation behind being diversified, and making sure that you're not making excessively large bets in certain types of risk. A good number of our financial advisors follow some asset allocation process, but still fewer than I would like.

I think some of that is, quite frankly, because they're confused by it. Asset allocation can be a little bit technical in the sense that there are a lot of unique terms and words. I don't think anybody would disagree that he would like to embrace it, so the biggest challenge and opportunity is simplifying it, bringing it to people in a way they can understand and appreciate the potential benefits.

**Dan:** You've traveled around the country over the past couple of months getting to know advisors and management within the wealth management division. Any initial impressions or surprises about our business that you've had so far during your travel?

**Mike:** No surprises at all, Dan. I think there's been a lot of surprises, some positive and some not so positive. Probably the biggest pleasant surprise is that we're dealing with real people on this side, right? On the institutional side of the business we're dealing with professional investors, and professional investors are not very interesting. They tend to be narrow and focused on the markets with everything they do and what it means for their portfolios. Over here, I've had the opportunity to meet some very interesting financial advisors, and clients who run real businesses. That's a breath of fresh air for me.

Another benefit from my new interactions is that people are generally not so wrapped up in the day-to-day actions of the market. They are focused more on their lives and businesses as opposed to the gyrations of stock and bond prices. That balance is, actually, I think a very healthy thing not only in terms of your work life but also in terms of how you think about the markets. You get this other viewpoint of the economy and markets from people involved in small businesses and other facets of the world.

I would say, if I can, on the less positive side is how little of the resources people use. We have tremendous resources that have been developed here long before my arrival. There are tremendous things that have been developed within Wealth Management Research. I'll just talk about the STEP program as an example. There's still a large number of FAs who don't even know it exists. The Center for Investment Excellence and all the bells and whistles that are provided there are also under utilized in my view

as is the third-party research that's available or even the individual company research or how to find certain types of reports.

We've got to make it easier for our FAs to navigate what I've called the "Moroccan bazaar" of resources and infrastructure here. We need to get them a better map.

**Dan:** Segueing to some of your key macro views, as you outlined in your initial *Positioning* report, different countries in the developed world have responded to the financial crisis of '08 with varying policy approaches over the last couple of years. While the U.S. has leaned towards stimulus, Europe has leaned towards austerity, and yet both regions are still stuck with sluggish growth, and high unemployment. So to kick off, can you address some of the key economic issues driving this environment in the developed world? What are some of the key asset allocation implications?

**Mike:** That's a big question. I think I would boil it down to something I'm writing about right now, which is that I think people generally—not just investors but the average person on the Street—believe that markets are directly correlated to economic growth. When I say "markets" I'm talking about equity and bond markets. The way I think about it is that bond markets are much more attuned to economic growth and equity markets are much more attuned to earnings growth. I believe that normally works in sync, meaning positive economic growth syncs with positive earnings growth and vice versa.

The way that we came out of the financial crisis, different regions, as you suggested, decided to deal with that crisis in different ways. The United States was without question the most aggressive—well, the Chinese were more aggressive than the United States, but perhaps too aggressive and they had to curtail their stimulus.

At any rate, consistently over the last four years the United States has been the most aggressive in monetary policy and to some degree fiscal policy, too, given the size of our budget deficit that continues to persist. As a result, the earnings growth in the US has been far superior not only to the rest of the world but far superior to the economic growth of this country. That has resulted in the United States equity market doing much, much better than other regions.

So I think the way to think about it going forward is that if this recovery is going to persist there has to be a rebalancing of that, meaning the United States has to take a bit of a backseat in terms of the rate of change on policy. We're seeing it now, with Japan being the most acute example, as Japan is now taking the lead on policy and being much more aggressive. And what's happened? Japanese earnings growth has really taken off and the stock market has taken off. In fact, Japan has been the best-performing market by far for the last four or five months, even

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currency adjusted. I think that's going to continue and that's a healthy development, quite frankly, for the global economy.

**Dan:** Focusing in on the U.S. for a bit specifically, companies have arguably recovered more strongly than consumers following the crisis. Corporate balance sheets are flush with cash, margins are near peak levels, yet we've had the weakest personal income growth this cycle of any post-war recovery. The question is, can you explain maybe some of the reasons that are behind that disconnect between the consumer and corporations?

**Mike:** I think it's very simple. There's been a move toward capital and away from labor, and it's been going on for 30 years. It's just been more acute here in the last four years simply because there's more pressure for companies to drive the bottom line through cost cutting.

**Dan:** As a related question, earnings have rebounded tremendously, as you alluded to earlier, since '09, yet are now starting to slow down in the U.S. We have no real indications of an official economic recession. Is it possible to have an earnings recession and not an economic recession? Is there any precedent for that historically?

**Mike:** We just had one. In fact, I predicted an earnings recession without an economic recession last year.

**Dan:** How would you define an earnings recession?

**Mike:** Two quarters of negative growth year-over-year, and we got that in the third and fourth quarter last year. The fourth quarter was marginally positive, but generally speaking, no growth. I think the first quarter this year will be negative. We have an earnings recession today in the United States. It doesn't feel like that considering the market rally. We have had an example like that in history. The most interesting earnings recession was in, I believe, 1966 – '67 and the stock market didn't correct, something I should have considered when I made the prediction that stocks would sell off more broadly with an earnings recession.

Generally speaking, markets can only go so far if earnings don't start to reaccelerate again. The good news is that our model suggests that the earnings growth recession could be ending after this quarter. I think the bigger question is what does the reacceleration look like? I think the market has sniffed out that potential second half 2013 reacceleration. It's one of the reasons why the stock market continues to do well. It was anticipating the bottoming of earnings revisions and growth in the first quarter.

I wouldn't be surprised if earnings continued to disappoint, however, relative to expectations. So right now consensus expectations are 8% to 10% growth for the next two years on average in the United States. As you know, MS Chief US Equity Strategist Adam Parker expects closer to flattish or low-single-digit earnings for this year, and I think that he's going to end up being correct. The market didn't care about disappointing earnings for

the last year, year and a half, but I think from here, because we've had this massive multiple expansion, it suggests that the United States might be a laggard market—not necessarily a negative market but a laggard market—relative to other regions if the earnings growth is better overseas.

**Dan:** The Fed has obviously been very accommodative for four years. If you could just touch on some of the risk to that story, obviously people are now starting to discuss an eventual Fed exit. Related to that, you have a tactical underweight in equities and you haven't fully positioned in that higher strategic equity allocation just yet. What are some of the drivers of your tactical view on the equity market? Is it earnings disappointment? Is it negative economic surprises out of Europe?

**Mike:** Let's take a step back. When we made our asset allocation changes in March we took our strategic weighting up by 10% in equities globally. That was a big change. If you go from point A to point B, you'd actually increase your global equity exposure, although we didn't go completely into the higher equity weight on a tactical basis.

There are two reasons why we did not move all the way to our strategic equity weights. One, a 10% move would be difficult for people to digest initially, so we were trying to get people from point A to point B in a safe way and to make that move in one fell swoop would have been a little too aggressive for the system of 17,000 FAs and four million clients. We didn't think that it was appropriate.

The second reason was that we have some models that take into account sentiment, fundamental factors, and positioning. Over time, they have worked quite well and were suggesting from a tactical standpoint, particularly in the U.S., we were due for some sort of correction or at least consolidation. That model may actually get back into a buy zone just by going sideways. Our plan is to put the cash to work with a more favorable reading.

**Dan:** Regarding additional topics that come up frequently with advisors, a lot of folks are focused on flows. What do you think is ultimately going to be the catalyst to drive more retail investors back to equity funds? We've had a decade of poor returns, flash crashes, and policy uncertainty in our more recent memory. What will it take in your view to drive a "Great Rotation," if you will? Is it compromise in D.C.? Is it just simply seeing negative returns on a statement regarding fixed income holdings?

**Mike:** I think it's mostly just "time." We have a demographic issue in the entire developed world where people are simply getting older and shouldn't necessarily be owning more equities. That's been the single biggest driver of these persistent flows into fixed income. By the way, even within equities where there have been strong flows this year it's gone into high dividend-paying stocks. So, bond-like equities.

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I do think that we will see this “Great Rotation” at some point, but it’s not going to be from bonds to stocks. It’s going to be from cash to stocks. Let me put it into context. In the United States, I don’t think that people are under-invested in equities. Based on the Fed’s flow of funds data, 38% of household financial assets are in equities currently. Historically, the range has been 15% to 50%, with 50% of course being the 2000 peak during the tech bubble and 15% was the end of the secular bear market in 1982.

Now, I don’t know if we could get back to 15%, but the point is that the average over the last 55 years has been 30%. It’s hard to sit here and argue that U.S. households are under-invested in equities particularly when one considers the aging demographic. I don’t know if they need to get under-invested to the degree they were in 1982, but I’m not convinced that they need to be piling in more. I think people will continue to take risks more prudently than what the pros or the media are talking about or expecting.

Before I leave this topic, by contrast, in Japan, where they’ve been in a 22-year secular bear market and have had deflation and equities have been a terrible place to be, the comparable numbers are 7% in equities and 55% in cash. You know, that’s a pretty stark contrast. If you’re looking for a real great rotation it could be there, but there has to be more structural change. For that money to really move, it’s going to take years, but that could be a very interesting development.

**Dan:** We have focused a lot on equities so far. Can you remind us what your key positioning is in fixed income right now and your expectations for interest rates over the medium term?

**Mike:** Let’s start with the second question first, which is what’s our expectation for interest rate normalization? I don’t think that this is tremendously out of consensus, but I still think most of our clients don’t understand this concept, which is that rates are abnormally low at zero percent for Fed Funds, and 1.7% for ten-year treasuries. Unless you think that we’re going to be in this deflationary environment for the next ten years, you have to assume that there’s going to be some rate normalization – and I’m optimistic that there will be, I just think it will be slower than what people expect.

I guess if I had to think about it, I believe that the highest probability scenario is that at least at the fed funds level we stay sort of flattish for the next year or two. When the market starts to anticipate higher rates, it’ll probably happen very fast. We could see a 200-, 300-basis-point increase in fed funds over the course of 12, 18 months. It’s the way it happened in 1994, and it’s the way it happens when things have been compressed for so long.

We could be wrong. It could be faster, it could be slower. I don’t really know the answer, but what I do know is that over seven years, which is the time that things tend to mean revert, we should be back towards a normal level of 3%, 4% on fed funds, which would then argue sort of 5%, 6% on ten-year treasuries. That’s not

a very good outcome if you’re long duration. We’re not smart enough to know exactly when it’s going to happen, but we do think that people need to start moving out of duration today in anticipation of that eventually happening.

Why it’s different today than, say, a year ago is there was still actually some value in owning duration. Today, it’s very hard to argue that there’s much value left because of all of the activity by the fed. So we think being short duration and long credit is the right strategy. When I say long credit I mean long credit in an active way; having managers who are taking specific credit risks because there is still opportunity in that. Owning credit passively through indices is not a great way to do it. Instead, I would suggest either using active managers or picking individual credits on your own.

**Dan:** Last question regarding the U.S. It relates to the housing market, which a lot of bulls point to as a key driver of a potential continued recovery here for the economy. I see two key risks and would be curious for you to address these. One, the obvious issue is that housing on a relative basis is a much smaller percentage of the overall economy than it was pre-crisis. So perhaps the wealth effect is somewhat limited.

Two, clearly we’ve seen a lot of investor-related, non-traditional buyers in the housing market. I’m also concerned that the typical housing recovery wealth effect may be limited because of the nature of the bidders. It’s not really the traditional families and the like that are benefitting from the price recovery.

Can you just address those key risks with regard to the housing market?

**Mike:** The housing market is healing. There’s no doubt. I mean, housing took a pretty good hit. It took a 30%, 40% correction, which in a market that big and that important is devastating, as we learned the hard way. I don’t think that housing is expensive. I think it’s very cheap given where rates are, but I’m probably more concerned in terms of the rate of recovery from here based on the fact that household formation remains below trend and rates will eventually normalize. What it really gets back to is real personal income growth and the jobs market.

It’s going to take time. I think that the housing market in certain areas is ahead of itself. For example, homebuilder stocks to me seem like they’re expensive relative to maybe other areas to play the housing recovery, like RMBS, which may provide more value.

**Dan:** And regarding the expectations for a wealth effect, if housing is a smaller part of the economy and there are so many non-traditional buyers supporting the market, does that limit a potential wealth effect and its overall impact on the consumer and the economy?



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**Mike:** Yes, I think that the wealth effect has been overstated in the past. I don't think that's a healthy way to grow an economy anyways. So I'm not overly concerned about it.

Look, I think housing is no longer a drag, which is a positive, but I don't think it's going to be the primary growth engine either, nor should it be.

**Dan:** We're going to wrap up the fundamental part of the conversation with two final questions, and they're regarding overseas markets. On a strategic time horizon you continue to favor international equities, including EM, Japan and Europe over the U.S., which you alluded to earlier, due to relative value support. Can you remind us of your rationale there? Importantly, the U.S. has still continued to run in the first couple months of '13. What's really the catalyst to drive rotation into those international equities?

**Mike:** I wouldn't say we favor international markets on a strategic basis as a huge overweight. It's really that we believe people are perhaps too home-country biased. The movement we made, if you actually look at our strategic weightings they're pretty similar to, say, the MSCI All Country World Index. They're not that dissimilar from where the benchmarks are.

However, we do think that over a seven-year timeframe, and we've done the work on this, that the expected returns look greater for certain international markets. There's a lot of empirical data in our analysis to support that view.

We know—and I'm the first guy to forget this, by the way—that the single biggest predictor of what our expected returns or eventual returns are going to be is what we pay. So relative valuation is perhaps the single most important determinant of where you put your money when you're looking at seven-year investment horizons on a strategic basis. Of course, on a one- to two-year basis, it probably means very little.

**Dan:** Last macro question. One topic that comes up frequently with FAs and clients is China. Given the significant transition going on there from an export model to consumer model, what are your expectations for that transition? What are some of the potential investment implications?

**Mike:** China is obviously a very powerful story as they continue transitioning from a rural to an urban economy. They are also transitioning from an export economy to a domestic consumption economy. We've seen it happen in history many times. I mean, the United States was an exporting country that turned into a domestic growth economy 150 years ago. So it's part of the inevitable cycle of any developing nation. China just happens to be a very large developing nation, so it's had a massive global impact. I believe the Chinese have genuinely tried to be responsible about the credit cycle but the shadow banking system has gotten away from them. In many ways, China is going through its own deleveraging cycle, which is weighing on global demand. They're now starting to let

the renminbi appreciate a bit and I think that's part of the transition to a domestically oriented economy. So I would look for China to continue to add growth to the global economy. I think the transition towards a consumer-driven and domestically driven economy is going to take longer than people would like, but they'll ultimately be successful.

**Dan:** Transitioning to the always-fun personal section of these conversations, the NCAA championship outcome was a tough one for you and fellow Michigan grad Adam Parker, although with such a young team it's likely that you guys are going to get another shot at it. Now, I'm sure you did your best to root on the Wolverines, but I did, however, want to test how dedicated of a Michigan fan you are with a lightning round of trivia. These questions will get progressively harder. First question, name all five members of the original fab five.

**Mike:** That would be Juwan Howard, Jalen Rose, Stacy King, Ray Jackson and, Chris Webber.

**Dan:** Well, you passed the first round. Round two. The famous victor's fight song was written by a University of Michigan student following a thrilling last-minute victory over what school in 1898? As a hint, UM doesn't play these guys anymore, thank god.

**Mike:** Brown, perhaps?

**Dan:** That's funny, it wasn't Brown, although I'll have you know Brown was in the Rose Bowl in the early 1900s.

**Mike:** Yea, that's because there were only four teams in the country back then.

**Dan:** It was actually the University of Chicago, which as I mentioned, luckily they don't play anymore.

Now, the most difficult Michigan trivia question. Do you know the origin of why Michigan has the yellow winged helmet design?

**Mike:** It was so that the quarterback could actually see his receivers. It was designed by Fritz Crisler.

**Dan:** Very good, Mike. You got the hardest one. Now, beyond all things Michigan sports, we're sure you're interested in other topics. If you could have dinner with any two people from history or from the present day, who would they be and why?

**Mike:** Excellent question. I need a second to think about this one. I think there are so many choices, but I would say Winston Churchill has to be one of them. The main reason for Winston Churchill is because I feel like he understood the average person and how they fit into society, which is why he was such a great leader. I would also like to talk to him about his experiences and how he made his advancement without changing his personality. He was always this gruff guy who spoke his mind, yet it didn't

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seem to hurt his popularity. He was brilliant and had some very interesting habits. I just think you could learn a lot from him in terms of how to carry yourself personally to be successful. He's always been a figure that I've admired and I think it'd be very interesting. I'm sure it'd be entertaining as well.

Another person I would like to have dinner with is John Wooden. We've all read his books and probably memorized some of his numerous quotes but I think it is fair he is one of the greatest teachers in history. Not just because he won so much but because he got players to perform at their highest level individually and on a consistent basis. I am a believer in the idea that if you can teach something well, then you are a master of the topic. I would like to understand his secrets to being a great teacher.

**Dan:** Great. You know, it's funny, Mike, I could have sworn you were going to say Chris Webber, to ask him what he was thinking when he called that time out!

Now, you've been very generous with your time. Last question, all jokes aside, you've been with the firm for 22 years. What does Morgan Stanley mean to you in three or four words?

**Mike:** Three or four words? Opportunity, respect, educational.

**Dan:** Mike, thanks very much for your time. We look forward to your contributions to Wealth Management going forward.

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

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

Principal is returned on a monthly basis over the life of a mortgage-backed security. Principal prepayment can significantly affect the monthly income stream and the maturity of any type of MBS, including standard MBS, CMOs and Lottery Bonds. Yields and average lives are estimated based on prepayment assumptions and are subject to change based on actual prepayment of the mortgages in the underlying pools. The level of predictability of an MBS/CMO's average life, and its market price, depends on the type of MBS/CMO class purchased and interest rate movements. In general, as interest rates fall, prepayment speeds are likely to increase, thus shortening the MBS/CMO's average life and likely causing its market price to rise. Conversely, as interest rates rise, prepayment speeds are likely to decrease, thus lengthening average life and likely causing the MBS/CMO's market price to fall. Some MBS/CMOs may have "original issue discount" (OID). OID occurs if the MBS/CMO's original issue price is below its stated redemption price at maturity, and results in "imputed interest" that must be reported annually for tax purposes, resulting in a tax liability even though interest was not received. Investors are urged to consult their tax advisors for more information.

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