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Conference Call Transcript

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CORPORATE PARTICIPANTS

Colm Kelleher
Morgan Stanley - EVP, CFO

CONFERENCE CALL PARTICIPANTS

Glenn Schorr
UBS - Analyst

Guy Moszkowski
BAS-ML - Analyst

Michael Hecht
JMP Securities - Analyst

Howard Chen
Credit Suisse. - Analyst

Mike Carrier
Deutsche Bank - Analyst

Mike Mayo
CLSA - Analyst

Roger Freeman
Barclays Capital - Analyst

Jeff Harte
Sandler O'Neill - Analyst

Douglas Sipkin
Pali Capital - Analyst

James Mitchell
Buckingham Research - Analyst

PRESENTATION

Operator

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At this time, I would like to turn the program over to Colm Kelleher for today's call. Please go ahead.

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Colm Kelleher - *Morgan Stanley - EVP, CFO*

Good morning everybody and thank you for joining us. This quarter we continued to show operating improvement as we execute on our strategy. The integration of Smith Barney's on track. Operating results and institutional securities improved. We are improving earnings in core asset management and we continued to invest in talent during the quarter.

For the quarter ended September 30th, Morgan Stanley generated net income of $793 million and diluted earnings per share of $0.38. Negative revenue of approximately $900 million from the narrowing of the firm's debt related credit spreads impacted earnings per share by $0.36. Firm-wide real estate losses declined from last quarter were approximately $400 million. This quarter, we continued to focus on the optimal use of our balance sheet and demonstrated leadership in our businesses including investment banking, credit trading and global wealth management. Following our earlier repayment of TARP capital we repurchased the warrant received with that program as well. We continue to be well positioned in and are capitalizing on the recovery in global capital markets while not limited by large loan portfolio or direct consumer exposure.

Now, turning to our consolidated results on page two in our financial supplement, firm-wide revenues of $8.7 billion included the negative impact of approximately $900 million from the tightening of Morgan Stanley's credit spreads on certain long-term debt carried at fair value. Non-interest expenses were $7.5 billion, up 24% from the second quarter, largely driven by compensation as we continue to invest in our people and our talent which I will discuss later. Non-interest expenses also increased due to inclusion of full quarter of both compensation and non-compensation expenses from Smith Barney.

We continue to accrue compensation based on our estimate of full year needs. Non-compensation expenses were $2.5 billion, up 16% from last quarter, primarily driven by impairment on present assets. Excluding expenses related to Smith Barney, Crescent and auction rate securities from both years, our recurring non-compensation expenses were lower by just under $1 billion on a year-to-date basis, well ahead of the $800 million in annual savings we targeted last year.

Turning to page three in the financial supplement, total assets increased to $770 billion at September the 30th, primarily driven by our client financing businesses especially prime brokerage. Of this, $153 billion is our liquidity pool. We continue to keep a significant portion of our balance sheet and cash and equivalents, as we believe maintaining strong liquidity is prudent in the current environment. Our capital ratios demonstrate the strength of our balance sheet. While we are still finalizing our calculations we believe our Tier 1 ratio under BASL1 will be 15.3%. Risk weighted assets are expected to be approximately $300 billion at September 30, and we believe our Tier 1 ratio under BASL1 will be our Tier 1 common ratio to be 8.2%, and finally our tangible common equity to risk weighted asset ratio to be 9.6%. Level three assets were $51 billion at September the 30th, representing approximately 7% of total assets.

Now, let's turn to the businesses. Starting with institutional securities detailed on page five of the supplement. Revenues of $5 billion included the approximately $900 million negative impact from the tightening of credit spreads as discussed earlier. Non-interest expenses were $3.7 billion in the third quarter of 2009, up 13% from the second quarter on higher compensation. Excluding DVA the compensation ratio in the business was 44.4% in the quarter, and 40% year-to-date. The business reported a pretax gain of $1.3 billion.

Specifically turning to investment banking on page six. Our franchise continued to capture market share in the quarter, and delivered a very strong performance. We were number one in announced and completed global M&A, and advised on eight of the top ten announced transactions for the first nine months of the year. We also gained share across capital markets as activity broadened with strength across products, industries and regions. We saw the IPO market fully re-open, particularly in Asia, and we ranked number one in global IPOs.

We led significant deals in the quarter. To name a few, IPOs for China Metallurgical Construction and Wind Macao. Volkswagen's $32.4 billion restructuring and Rio Tinto's $15.7 billion rights offering. We continued committing risk capital to support our clients including the sale of a Swiss government's $5.2 billion stake in UBS, the largest capital committed equity deal post the credit crisis. Barack Gold's $4 billion common stock offering, the largest North American capital committed equity deal ever. And we committed financing for Warner Chilicothe's acquisition of P&G Pharmaceuticals, the first non-investment grade commitment in the market in over a year. Third quarter investment banking revenues of $1 billion were down 7% from the second quarter, on lower fixed income underwriting.

Advisory revenues were up 4% from last quarter and while M&A market volumes remained subdued overall the outlook is clearly improving. Equity underwriting revenues were flat from a strong second quarter, a significant increase in revenues from Asia fueled by China IPOs as well as several large transactions in the Europe, Middle East and Africa areas offset the decline in US activity. Fixed income underwriting activities increased 24% in from the second quarter on lower investment grade and high yield bond issuance.

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Equity sales and trading revenues of $1.1 billion were negatively impacted by $206 million from the narrowing of debt-related credit spreads on firm-issued structured notes. Cash equity revenues were down 7% from the second quarter of this year on seasonally lower market volumes. Derivatives reported lower revenues down 11% sequentially, affected by the end of the dividend season in Europe as well as lower client activity. Prime brokerage revenues were up modestly from last quarter, but our average client balances incrossed 14% from last quarter with growth across our client base. Prime brokerage continues including the return of a number of key franchise clients showing a recapture of market share in line with our objectives as previously laid out.

In fixed income sales and trading revenues of $2.1 billion included losses of $546 million from the narrowing of credit spreads on firm issued structured notes and a net gain of $334 million related to sale of the firm's participating interest in a claim against the derivative participating interest in a claim against the derivative counter party that filed for bankruptcy protection. Excluding DVA, fixed income sales and trading revenues increased 13% from the second quarter of this year. Commodities revenues were up 35% from the second quarter, however, reduced volatility in the commodities market did mute opportunities. Interest rate credits and currency trading revenues combined were down slightly from last quarter on lower activity levels. Interest rate products reported another strong quarter with revenues up slightly from the second quarter.

Credit trading revenues increased 4% sequentially. Within credit trading, credit corporates had another stand-out quarter with revenues surpassing second quarter levels from strong investment grade and distressed trading and a broader increase in market share. Currencies reported 18% higher revenues from the second quarter on strong trading. On a year-to-date basis, we have seen good performance in interest rate and credit trading with revenues up 79% on 114% respectively.

The total of our mortgage related net exposures across residential and commercial mortgages were reduced from $7.9 billion to $7.4 billion during the quarter. We're seeing liquidity return to these markets and are more actively trading in them. Consequently, we have dropped our mortgage related schedules from the financial supplement as changes in our net exposure are also driven by trading activities. Other sales and trading revenues benefited from spread tightening and valuation gains in our lending business which includes leverage acquisition, finance, and relationship lending.

Net mark-to-market gains in the quarter were approximately $500 million. These gains were partially offset by a $98 million impact of tightening credit spreads on Morgan Stanley's debt related to CIC's investment. Total average trading and non-trading VAR increased to $168 million from $154 million last quarter, reflecting increase in both our trading and non-trading VAR and lower diversification benefits. Average trading VAR increased to $118 million from $113 million reflecting increases in foreign exchange and interest rate risk.

Now we turn to page eight of the supplement and our global wealth management business. With a full quarter of results from the Morgan Stanley Smith Barney joint venture consolidated within this segment our comparison to the second quarter were where only one month of Smith Barney is included is not particularly meaningful. Revenues of $3 billion continued to be stable and consistent despite the overall weakness in the retail markets. Non-interest expenses were $2.7 billion and included $65 million of joint venture related integration costs. The business reported a pretax profit of $280 million. Excluding those JV related integration costs, PBG was $345 million, and the PBG margin was 11%.

On page nine, you can see the quarterly productivity metrics of the business. Total client assets increased 8% to $1.5 trillion on higher market levels. The number of FAs declined slightly to 18,160 and attrition, primarily within the lower quintiles have substantially declined since the closing of the joint venture. For comparison, FA turnover within our top two quintiles was at historic lows of under 1%.

Net new asset outflows of $8.8 billion reflect the lag effects from financial advisors that left Smith Barney prior to the closing. We're seeing a significant reduction in outflows compared to the first half of last year. Deposits in our bank deposit program increased to $110 billion, of which, $52 billion is held by Morgan Stanley banks, total firm-wide deposits at quarter end was $62 billion.

Turning to Asset Management, page ten of the supplement. Asset Management recorded a pretax loss of $356 million, primarily driven by real estate losses related to Crescent within merchant banking. Excluding noncontrolling interest, pretax loss attributable to Morgan Stanley was $294 million. Core Asset Management was profitable for the third consecutive quarter. Excluding the SIV gains reported in the second quarter, core Asset Management revenues of $600 million were higher by 18%, driven by an increase in performance and management fees and gains in our alternative investments while pretax profits were up over 80%.

Merchant banking revenues of $98 million were higher in the second quarter due to lower losses in real estate investments. However, due to the crescent impairment the business reported a larger pretax loss this quarter. Non-interest expenses for Asset Management increased 29% from last quarter, entirely due to a $251 million impairment charge related to Crescent within non-compensation expenses.

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Turning to pages 11 and 12 of the supplement you can see the assets under management and asset flow data. Total assets under management increased to $386 billion during the quarter as market appreciation of $33 billion was partially offset by $8.7 billion in net asset outflows. Nearly all of the quarterly outflows were in our core business, primarily from our money market and equity funds. Fixed income in flows were $1 billion, benefiting from improved performance and asset in flows from investment under TALF. Outflows in equity were primarily related to management changes of certain mandate changes. However, we continued to see performance improving with 71% of equity strategies performing above the Morningstar peer median for one year versus 54% a year ago. In addition, we have seen an increase in the number of funds rated 4 and 5 star by Morningstar to 47 from 35 a year ago, and the percentage of four and five star assets increased to 42% from 21% a year ago.

Turning to our firm-wide real estate exposure on page 14 of our financial supplement. Certain real estate funds were consolidated on our balance sheet under accounting standards topic 810, reassessment guidelines. In the second quarter, Morgan Stanley provided financial assistance amid tight liquidity in the funds. The consolidation of these funds was triggered by the continued deterioration of equity in the funds combined with our financial support. This consolidation resulted in a transfer of the applicable portion of the exposure to Morgan Stanley from the real estate fund line to the consolidated interest line on the schedule. Asset Management's income statements with respect to these funds had virtually no P&L impact to Morgan Stanley with the limited partnership interests deducted through the noncontrolling interest line.

Our real estate gross asset exposure as reflected on our statement of financial condition was $4.4 billion at the end of the quarter, down from $4.6 billion at the end of June. Including $1.6 billion of contractual commitments and other arrangements he with respect to these investments, our total exposure would be $6 billion, down from $6.3 billion at the end of June. This exposure excludes assets and investments for the benefit of certain deferred employee compensation or co-investment plans.

This quarter we continued to make progress in our three business segments. Institutional securities, our core business, continues to demonstrate the strength of our leading client franchise. Investment banking continued to gain strength. We are currently ranked number one in both announced and completed global M&A for the year, number two in global equity, number one in global IPOs. We are hiring over 400 people consistent with our strategic goals and are committed to improving the operating performance in our trading businesses. We are more than halfway through this global hiring plan. The majority of which is outside the US as we rebalance and position our trading positions for growth. for example, we are increasing headcount by over 20% in areas like foreign exchange, emerging markets and equity derivatives.

Global wealth management posted solid revenues despite the challenging retail environment and the integration of our joint venture with Smith Barney is on track. We are optimizing the many businesses reported in our Asset Management segment and we are executing our multi-pronged approach. We announced the sale of our retail Asset Management including Van Kampen investments to Invesco while maintaining a minority stake in the combined firm. This will allow the firm to participate in the future growth of retail Asset Management, via its interest in Invesco, while focusing on its institutional client base. More broadly our partnership with MUFG continues to gain strength of we successfully executed an export related deal for the Egyptian General Petroleum Corporation, furthering the collaboration between our two firms in a testament of our leadership in structuring complex transactions.

Finally, a few words on the outlook. Global economic conditions have improved and market conditions continue to normalize. The overall operating environment is clearly better with higher client volumes. The global M&A market is picking up increasing availability of funding and financing markets are open, with investment grade and high yield debt markets rebounding. The cost of funding has declined as financials continue to raise debt and equity. However, it does still remain higher than precrisis levels.

Global equity markets are open across industries and geographies and the IPO market is accelerating with the emerging markets, particularly Asia, leading the way. The securitization markets have shown continued improvement and government programs like TALF have had a meaningful impact. These are all encouraging signs of more normal markets. We expect the industry's cyclical and structural changes to continue through the rest of the year. The regulatory landscape is open involving and we expect significantly higher capital and liquidity requirements across the industry in the future. We believe we are well positioned for this. Housing markets continue to be challenged and although banks have made significant progress in deleveraging, consumer deleveraging will take additional time. However, consolidation and better pricing of risk prevents opportunities for market share gains and higher spreads globally.

In conclusion, near term cyclical challenges do not change our view of long-term secular growth, as we continue to focus on leveraging Morgan Stanley's global brand to grow our franchise's share of the market. Thank you, with that, I'll now take your questions.

QUESTION AND ANSWER

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Operator

(Operator Instructions). We'll pause for a brief moment to compile the Q&A roster. Your first question comes from the line of Glenn Schorr of UBS.

Glenn Schorr - *UBS - Analyst*

Hi, thanks, Colm.

Colm Kelleher - *Morgan Stanley - EVP, CFO*

Hey, Glenn.

Glenn Schorr - *UBS - Analyst*

Maybe just a quick comment on how you view balance sheet size and leverage. A while back you put a 750 cap out there, but obviously equity's grown but you did take leverage up a little bit, or a little bit over that 750 side so just curious on how you're thinking about balance sheet and size.

Colm Kelleher - *Morgan Stanley - EVP, CFO*

Sure. I gave our balance sheet size within the definition at the time of the leverage ratio. That's really what I want to focus on, Glenn, is that the guidance I've given is a 5 to 7% leverage ratio which I believe will probably be the new norm, although I'm prejudging the regulators on this. Which means that you're talking about 14 to 20 times leverage. Obviously, our equity has grown, which allows us to take the balance sheet off. At this level we're 15.7 times levered and that still gives me room for any potential consolidation under 166, 167 which we're obviously keeping a weather eye on.

Glenn Schorr - *UBS - Analyst*

Okay. And then I guess it all fits together but it's -- the unallocated capital is now at $9.7 billion. Interestingly, I think the capital allocated to the institutional business went down. I don't want to read too much into that either, but just your thoughts on as you project forward, your thoughts -- you made the comment specifically on higher capital requirements coming, but where you think you're at in terms of that -- the true unallocated capital.

Colm Kelleher - *Morgan Stanley - EVP, CFO*

I can't prejudge that because where we're at in true allocated capital is where we're at, Glenn. We have unallocated capital, which the businesses can pull. Obviously I'm keeping capital in reserve because as a firm we do believe there will be higher capital charges. At the moment, I think it's fair to say that we've had no holistic response from regulators as to what that answer will be. We've clearly seen things like the securitization framework, which if they were to be applied today, would have a significant effect on capital. You can take mitigating steps. So my view is that I am prepared to keep and the firm believes we should keep our unallocated capital for the time being. The business can use some of it if it makes sense on a risk adjusted basis but clearly we are keeping an eye on the developing regulatory situation.

Glenn Schorr - *UBS - Analyst*

Maybe just one more that ties into it. You have a good table in the Q that shows some of the anti-dilutive securities outstanding. That has the CIC units and MUFG preferred stock and some other option stuff. How are you thinking about share count? There's some things that are like hard time lines and some of them are more stock related. As the call goes on a little further, MUFG will be in the money. So how do you think about future share count and your ability to offset some of that through repurchases?

Colm Kelleher - *Morgan Stanley - EVP, CFO*

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We clearly would like to address those issues but we think it's too early to do that at the moment. I think the market is still not stable enough. Clearly, we will negotiate and deal with our regulators on what is the right time to do either stock buybacks or deal with dividends going forward. I think it's far too early to think about that at the moment but it's certainly something you know that we are very focused on.

Glenn Schorr *- UBS - Analyst*

I guess with 645 of them outstanding, the big difference between using 1.3 or 1.9 in the model. But cool. I appreciate it.

Colm Kelleher *- Morgan Stanley - EVP, CFO*

You understand the conversion times of those securities as well.

Glenn Schorr *- UBS - Analyst*

Yes, absolutely.

Colm Kelleher *- Morgan Stanley - EVP, CFO*

So we have some time there on that scale, Glen.

Glenn Schorr *- UBS - Analyst*

Absolutely. Okay. Cool. I don't want to be a hog. Thank you.

Operator

Your next question comes from the line of Guy Moszkowski of Banc of America.

Guy Moszkowski *- BAS-ML - Analyst*

Good morning, Colm.

Colm Kelleher *- Morgan Stanley - EVP, CFO*

Hey, Guy.

Guy Moszkowski *- BAS-ML - Analyst*

I just want to pursue for a moment the question of the equity allocation to the institutional securities business, which did come down pretty smartly in the quarter as it had the prior quarter as well. Even as you're increasing the human capital component there, as you pointed out and the bar was a little higher. So maybe you could just give us a sense for how to reconcile those two moves.

Colm Kelleher *- Morgan Stanley - EVP, CFO*

I think you reconcile it by what I've been speaking to you about for a while, Guy which is look at risk adjusted returns and clever deployment of capital. We clearly believe that where we have an edge is where we have increased footprint, and we've put capital behind that sort of business. As we increase market share, we get a better ROA. That is capital efficient. We've also been reducing our legacy assets, which obviously soak up

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a lot of better in our economic capital model and so on. So what I'm suggesting you look at is that our strategy is to pursue those businesses that make sense from a point of view and that's really the answer.

Guy Moszkowski *- BAS-ML - Analyst*

Okay. No, that's fair. Let me ask you, since you brought up legacy assets and you explained why you dropped some of those disclosures, which of course makes perfect sense, given where we are in the markets at this point, but I think it would still be useful to get a little bit of an update for where you are in commercial real estate, financing exposure, CMBS, whole loans and what your hedges look like against that.

Colm Kelleher *- Morgan Stanley - EVP, CFO*

Sure. Well, we've given what we think is our relevant commercial real estate exposure. In terms of where we are on some of the other stuff, we're probably down on a net exposure now, September the 30th, [4.0 from 4.0] (corrected by company after the call) so the non subprime are pretty much unchanged. Commercial mortgages, [3.3, 2.1] (corrected by company after the call), we are trading around that. US subprime, pretty much unchanged, slight tick-up on that. Relatively unchanged from where we were last quarter, that's fair. Finance -- What was your legacy book. The last time we showed it was $5 billion or something. We're about $3 billion, that sort of zip code on the legacy book. Clearly we have been doing new trades there.

Guy Moszkowski *- BAS-ML - Analyst*

And you booked a mark back up on some of that, right, during the quarter?

Colm Kelleher *- Morgan Stanley - EVP, CFO*

Yes, we did. But it was split between the relationship lending book where the hedges came back as well as the legacy book. In terms of the marks, where we are, if you want to know where those are.

Guy Moszkowski *- BAS-ML - Analyst*

Yes, please, yes.

Colm Kelleher *- Morgan Stanley - EVP, CFO*

CMBS bonds, [mid 40s] (corrected by company after the call). That would be senior commercial loans, [high 70s] (corrected by company after the call), mez commercial loans, [high 40s] (corrected by company after the call), Alt-As, mid-30s, US and UK residential loans, [high 60s] (corrected by company after the call). Subprime ABS CDO mez low-teens. Leverage finance portfolio, [mid-70s] (corrected by company after the call). Remember, the other thing you've got to talk about, it's on page 14 of the schedule, is the real estate funds where we have the exposure there which really, if you want me to give you a value on that, I would say low 20s.

Guy Moszkowski *- BAS-ML - Analyst*

Okay. That's all real helpful. And then I just have a final question on compensation. I guess year-to-date, as you pointed out, in institutional you recruited about 40%. Given the hiring that you've been doing and are continuing to do, presumably you've got to give some guarantees in many cases, how should we think about that year-to-date accrual rate relative to where we might need to be in the fourth quarter?

Colm Kelleher *- Morgan Stanley - EVP, CFO*

I don't think it changes particularly. Remember, we had attrition. We had people who left. So we have savings from that. We're pretty much targeting it around this sort of level. We will pay competitively and are proving to pay competitively. We're just being much more discriminating about the pay curve itself, Guy.

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Guy Moszkowski - ***BAS-ML - Analyst***

That's very helpful. Thanks very much, Colm.

Operator

Your next question comes from the line of Michael Hecht of JMP Securities.

Michael Hecht - ***JMP Securities - Analyst***

Hi, Colm, good morning, how you doing?

Colm Kelleher - ***Morgan Stanley - EVP, CFO***

Very well, thank you.

Michael Hecht - ***JMP Securities - Analyst***

I guess just a question on fixed income, sales and trading. Can you help us think about how we should think about the opportunity from here, as you added some people, think you're sort of halfway through your hiring plan. Some of those people have come online, some not. How we reconcile that relative to what you're seeing in terms of trading spreads by some of the different trading areas and whether you expect those to narrow or kind of normalize over time?

Colm Kelleher - ***Morgan Stanley - EVP, CFO***

Well, let's begin with trading spreads. It's clear that trading spreads weren't as wide as they were when the market was abnormal or dysfunctional as it were, but it's also our personal belief that with reduced competition and regulatory barriers being high, you will have systemically or secularly wider trading spreads so the game then is one of market share. We have said to you that we feel -- we said this last quarter. We had slipped in market share in certain product areas where we had been dominant before. We believe that we will be able to rebuild that market share. It will take time and what we're doing is showing you steady progression.

It's clear that we've shown you some progression this quarter. Foreign exchange revenue's up quite significantly. Interest rate revenues are up as well. We've held our I think very high market share in investment grade credit and distressed debt. It really is an issue of footprint, Michael. I think Morgan Stanley is very well placed and has all goodwill from clients to step into that breach and have that serve as a footprint.

Michael Hecht - ***JMP Securities - Analyst***

That's fair. As far as can you give us any color on the pace of revenues you saw in trading. Any months stand out as particularly strong or weak?

Colm Kelleher - ***Morgan Stanley - EVP, CFO***

It was more normalized this time around. August a little bit slow as you would expect, more like a traditional August. But nothing unusual in the pace this time. It really feels like the markets are normalizing and things are moving back to where they should be.

Michael Hecht - ***JMP Securities - Analyst***

Okay. And then on the retail Asset Management deal, congratulations, looks like a good transaction. I understand it's not closing until mid 2010 but can you help us understand the impact of book value and the earnings presentation of the IBD stake at closing.

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Colm Kelleher - ***Morgan Stanley - EVP, CFO***

It's a bit early to make impact. We've probably got a pretax gain of about $1 billion but that's dependent on the closing price of the shares on the acquiring Company, and we are taking an equity stake. Think about it in terms of that and then think about what that will mean. It will be accretive for us. In terms of earnings, I don't think it will be significantly material to what we're doing and it will allow us to focus much more keenly on the institutional business and the merchant banking business left within Asset Management.

Michael Hecht - ***JMP Securities - Analyst***

Okay. Fair enough. Thanks a lot.

Colm Kelleher - ***Morgan Stanley - EVP, CFO***

Thanks, Michael.

Operator

Your next question comes from the line of Howard Chen of Credit Suisse.

Howard Chen - ***Credit Suisse. - Analyst***

Good morning, Colm.

Colm Kelleher - ***Morgan Stanley - EVP, CFO***

Hi, Howard, how are you?

Howard Chen - ***Credit Suisse. - Analyst***

Good, thanks how are you. There's been a lot of press about Crescent. Clarify your exposure and maximum loss that could be taken.

Colm Kelleher - ***Morgan Stanley - EVP, CFO***

Look, as previous -- you know, first of all, in terms of the loss, as you know we consolidated this REIT from a bridge and had to take it on to the Company's books so we need to make an impairment assessment each quarter. Based on continued evaluation of the properties including an analysis of our options we took impairment charges based on a combination of fair value of the properties as well as the impairment from sales. We'll continue to make those assessment as for as long as we own the properties. We negotiated a loan extension with crescent's lender during the current quarter. You know the amount of that loan. It's $2.5 billion. No additional payments are made to the lender as part of that extension agreement. While I won't go into a lot of detail, we continue to work closely with the lender towards an orderly transfer of collateral and asset operations as well as other related matters.

Howard Chen - ***Credit Suisse. - Analyst***

Okay. Great. Thanks, Colm. And then on global wealth management, and the full quarter's contribution of the JV, could you just touch on how you thing think about the pacing of synergy realization and one time costs as we think about you integrating that transaction?

Colm Kelleher - ***Morgan Stanley - EVP, CFO***

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Nothing has changed our time line in terms of our expectations, of the realizations we're doing and we will continue to give you more disclosures as we reach those milestones. We've already given you some. So we are very comfortable with the plan we laid out for the integration on the merger, Michael. Howard, sorry.

Howard Chen *- Credit Suisse. - Analyst*

No worries. Final one from me. With respect to prime brokerage, could you wrap some numbers around the rebound that you noted, maybe speak to a bit of the profitability from those clients who left that have now returned vis-a-vis a year ago.

Colm Kelleher *- Morgan Stanley - EVP, CFO*

All I would say is that our balances are up 14% and profitability is coming back. We do think we have pricing power. As I said, we're not targeting a market share strategy, but we want to be a significant player, which we believe we are in that market. The quality of clients is good. The internal funding aspects of the business are much more in line with what we want. So I think that's really all I'm prepared to say rather than go into a line by line item.

Howard Chen *- Credit Suisse. - Analyst*

Okay. Thanks so much, Colm.

Operator

Your next question comes from the line of Mike Carrier of Deutsche Bank.

Mike Carrier *- Deutsche Bank - Analyst*

Thanks. Just another question on the fixed side. When you look at the recent hiring that you've done, kind of across the platform and then as well as the increased level of risk taking, do you view the platform as being where you want it to be and this is really just focused on FIC. Or are you maybe 50 or 75% of the way there. Probably more importantly, when you look at managing risk, given all the recent hires, just relative to the past, just want to get your view on how you're looking at risk just to ensure that if we do run into more volatility, you guys have a grasp on all of the recent hires.

Colm Kelleher *- Morgan Stanley - EVP, CFO*

First of all, we're just about halfway through the hiring that we need to do, so that's not finished. Two -- so we still go and this firm clearly is attracting talent with its strategy and the execution of that strategy which people can see. We clearly will see the benefits of a lot of that hiring coming through in 2010 because of the way people tend to join you with three month notice periods and so on. In terms of risk, it really doesn't change for us. We're talking about looking at things on a risk adjusted return going back to one of the earlier questions and allocation of capital. We will take risk based on the back of our client franchise, which is client flow and trade on the back of that accordingly. The more we have a strong client franchise, increased flows, we will be able to make risk adjusted returns on that business. So I don't think you're seeing anything away from an execution of a strategy that we've outlined.

Mike Carrier *- Deutsche Bank - Analyst*

Okay. And then another question on the wealth management side, when looking at the $8.8 million in outflows, it's tough to compare that to the $2 billion because that was only one month but I think in the slide presentation you guys used a $32 billion of outflow in the second quarter. So one, just wanted to know if that's relatively comparable. And then looks like the revenue in assets is doing well despite some attrition. So when you look out over the next say 12 to 18 months once the full integration is in place, given the scale that you have, is there any reason that -- I guess more structurally, is there any reason why you wouldn't potentially be able to achieve industry leading margins of, say, like 25%?

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Colm Kelleher - ***Morgan Stanley - EVP, CFO***

There's no reason at all why we shouldn't be able to achieve that, in line with the integration itself we've been clear on that. Remember, you had a lot of attrition in the closing days of Smith Barney, and what you're seeing is the tail effect of that with positive recruiting and more productive FAs, we'll see an improvement in those client flows ant clearly improvement in margin.

Mike Carrier - ***Deutsche Bank - Analyst***

Okay. And then just finally on the Asset Management segment, when Invesco gave their presentation, they just mentioned some of the costs that were related to the retail of the business and then they just mentioned some of the I guess revenue or expense sharing divisions across institutional and retail that they weren't taking. So I guess when you look at the Asset Management business and granted it's very early, but I think when you guys can give some color just on the expenses that are related to the institutional business.

Colm Kelleher - ***Morgan Stanley - EVP, CFO***

On the first point we can't speak for Invesco but they believe they can run the business more efficiently than we have in the past. The outlook for the remaining Asset Management we'll have $267 billion of assets under management as of September 30. Remaining Asset Management will be more focused and streamlined, better leverage our strengths, build on our strong relationships, and we believe that we can take the cost out of that going forward. So we feel very comfortable about this.

Mike Carrier - ***Deutsche Bank - Analyst***

Okay. Thanks a lot.

Operator

Your next question comes from the line of Mike Mayo of CLSA.

Mike Mayo - ***CLSA - Analyst***

Good morning.

Colm Kelleher - ***Morgan Stanley - EVP, CFO***

Hey, Mike, how are you?

Mike Mayo - ***CLSA - Analyst***

Good. Just to follow up on the wealth management question, so if the revenues went from $575 million to $698 million, can you give us some apples to apples figures, either take out the Smith Barney impact or from both quarters or throw in a full quarter of Smith Barney in the second quarter? What would have happened to revenues?

Colm Kelleher - ***Morgan Stanley - EVP, CFO***

Mike, I said last quarter I'm not going to do that. We view this as a consolidated business. We're already getting synergies quicker than we thought. It wouldn't be fair to do that. And it wouldn't help us achieve the sort of goals that we're trying to do in that business. In terms of the revenues themselves what I will say, we clearly had a weakening retail environment but net-net we do believe that with those revenues and results that we are on track for the integration plan as laid out.

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Mike Mayo - ***CLSA - Analyst***

Were those revenues weaker than you expected. I saw some numbers out of Schwab that are decent.

Colm Kelleher - ***Morgan Stanley - EVP, CFO***

There's nothing in those revenue numbers that knocks us you away from what we consider to be our plan and execution on the strategy.

Mike Mayo - ***CLSA - Analyst***

Okay. On the Asset Management side, the biggest increase in AUM this quarter was Van Kampen and that's the business you're selling. So it's just a little bit more color, why you chose to sell that and I think --

Colm Kelleher - ***Morgan Stanley - EVP, CFO***

Well, it's the same as I've said to you before is we felt it was a subscale business for ours. We had one of two choices. We think we chose the right choice for a best in breed manager in which we'll have an ongoing equity interest involved. If you look at our core businesses, the performance has improved significantly as we've outlined to you. We do believe those asset outflows will stop in accordance with the, A, improved performance and B, we're clearly getting the operating margins improved as we've taken out cost.

Mike Mayo - ***CLSA - Analyst***

Have you retained optionality with the rest of the asset management at Morgan Stanley. Potential additional joint ventures or sales?

Colm Kelleher - ***Morgan Stanley - EVP, CFO***

No. We're running the business, the institutional business -- if you think about Asset Management, it's two big legs. It's the merchant banking business which is the real estate, infrastructure and private equity funds, predominantly real estate, within the institutional business you have the fund to funds business, which we believe is a big growth business for many reasons, the hedge business which we have, the liquidity business and all of those we feel very well positioned.

Mike Mayo - ***CLSA - Analyst***

And the backlogs in investment banking, how do they look.

Colm Kelleher - ***Morgan Stanley - EVP, CFO***

I'm telling you, they're building up very well. We're looking very healthy now so we feel very good about our pipelines.

Mike Mayo - ***CLSA - Analyst***

Lastly, the marks, you said you wrote down the low 20s the real estate investments. I thought you said real estate funds. Was it for the real estate funds.

Colm Kelleher - ***Morgan Stanley - EVP, CFO***

I said the real estate funds.

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Mike Mayo - ***CLSA - Analyst***

What is it for total real estate investments the $4.4 billion or the $6 billion including the commitments, what are those written down.

Colm Kelleher - ***Morgan Stanley - EVP, CFO***

We don't do that because of the nature of what they are. If you remember we've given you the composition of those. Within that you have the Crescent deal against which there's a $2.5 billion non-recourse loan, you have other investments. We'll either take some combination of fair value or impairment testing. 94% of that book is actually at cost so it's really very much focused on the impairment testing.

Mike Mayo - ***CLSA - Analyst***

All right. Thank you.

Colm Kelleher - ***Morgan Stanley - EVP, CFO***

Thanks.

Operator

Your next question comes from the line of Roger Freeman of Barclays Capital.

Roger Freeman - ***Barclays Capital - Analyst***

Hi, good morning. I guess most of my questions are actually maybe around the Asset Management business, just to sort of flush that transaction out. Colm, can you say how much of the Morgan Stanley Van Kampen run rate production is into the Morgan Stanley/Smith Barney channel and how much of the AUM is Morgan Stanley retail clients?

Colm Kelleher - ***Morgan Stanley - EVP, CFO***

I mean, it's not -- certainly, if you look at retirement products it's absolutely negligible. One of the other issues we had is we were potentially running into regulatory issues through the Morgan Stanley channel which is why this was a neat solution for us. We're already selling retail products to Invesco so what you're seeing in the financial supplement is that summarized by distribution channel anyway. It's hard to pull that out. I think we will be much better placed as a result of this transaction for selling product through the retail channel.

Roger Freeman - ***Barclays Capital - Analyst***

Right. But I mean just in terms of the -- how leveraged has that business been on a percentage basis to Morgan Stanley retail as opposed to out to any other third parties?

Colm Kelleher - ***Morgan Stanley - EVP, CFO***

I'll have to come back to you on that. I mean, it's not something I can answer.

Roger Freeman - ***Barclays Capital - Analyst***

Okay. And then actually, your point on the retirement headwinds, it's a very interesting one. It's kind of -- it's gotten some discussion recently. How much of the -- how much of the retail business is into retirement products that were essentially impacted? I'm trying to figure out how much has that business been revenue impaired or do you think on a run rate basis -- ?

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Colm Kelleher *- Morgan Stanley - EVP, CFO*

You're talking about a broad market question now which I think others can answer. The current amount that we do out of our network, out of Van Kampen is negligible. In the overall market I think other people would probably be able to answer that better than me.

Roger Freeman *- Barclays Capital - Analyst*

Okay. And then I guess on the gain that you were referring to, I know it's early to say, but would that be -- is that coming from writing up the Morgan Stanley brand retail? Seems like the sale price here is pretty close to what you paid for Van Kampen.

Colm Kelleher *- Morgan Stanley - EVP, CFO*

I think Roger, in all fairness I've given you a good idea of what the gain is and I don't want to give the component part.

Roger Freeman *- Barclays Capital - Analyst*

Okay. Last question, I mean, just since they did put some data out on run rate, profitability and it was actual data, they're backing out what they consider to be shared services and corporate overhead. Let me just ask you. How profitable was that business inside of you, fully costed?

Colm Kelleher *- Morgan Stanley - EVP, CFO*

The business was profitable but our core business will remain profitable. Net-net, we are very comfortable with the transaction from every aspect including what's left in core Asset Management.

Roger Freeman *- Barclays Capital - Analyst*

The costs that they're putting essentially back to you, they won't have a revenue string tied to it?

Colm Kelleher *- Morgan Stanley - EVP, CFO*

As I said, I don't want to comment on what they're saying but we're very comfortable with what we're doing.

Roger Freeman *- Barclays Capital - Analyst*

Very last question. Separate topics. Prime brokerage you talk about the improvements there. What percentage of your equity's revenues at this point would you say are prime brokerage.

Colm Kelleher *- Morgan Stanley - EVP, CFO*

We don't give that. I don't particularly want to give that. I also think the model as we explained before is that if you go back to last year you could have spoken about a standalone prime brokerage business. I think prime brokerage business is very much contiguous, an integral part of our equity business now. It would be like trying to strip out one line.

Roger Freeman *- Barclays Capital - Analyst*

Okay. All right. Thanks a lot.

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Operator

Your next question comes from the line of Jeff Harte of Sandler O'Neill.

Jeff Harte *- Sandler O'Neill - Analyst*

Good morning.

Colm Kelleher *- Morgan Stanley - EVP, CFO*

Hey, Jeff.

Jeff Harte *- Sandler O'Neill - Analyst*

You talked about M&A. And I thought maybe a little more optimistically than I was expecting. Can you talk a little bit about how -- we keep hearing about our great conversations with clients are but no one's actually moving through to pull the trigger or moving to the announcement phase. Are we progressing more towards announcements picking up and kind of what -- do you have any kind of time line in mind as to when we could see a pickup.

Colm Kelleher *- Morgan Stanley - EVP, CFO*

You're already beginning to see a pickup. I think we're at the lows at the moment. The real issue has been access to funding markets and whether people can get that funding. With the opening of the funding markets you're seeing that beginning to happen. Low gearing multiple deals getting done, deals being circulated around. Strategically people are looking. They're more comfortable in the funding. We can mention some big names currently in the market. I do think you're seeing the recovery.

Jeff Harte *- Sandler O'Neill - Analyst*

Okay. And looking at wealth management at the Morgan Stanley/Smith Barney, the concept of 20 to 25% pretax margins, a couple of years out, that would be very impressive. Is the key to getting there more scale and pulling out costs or is there some kind of increased revenue productivity?

Colm Kelleher *- Morgan Stanley - EVP, CFO*

The guidance we've given is very much on a plug and play basis. Which is a scale of business and James has been very clear on that. Any revenue synergies will be additive to that.

Jeff Harte *- Sandler O'Neill - Analyst*

Okay. And finally, you might have touched on this earlier. I didn't maybe missed some of the numbers. Some of the let's call them legacy or the mortgage positions that we no longer get specific disclosures on, were there gains on those portfolios this quarter? And I guess I would specifically be interested in commercial mortgages where you have that portfolio very heavily hedged.

Colm Kelleher *- Morgan Stanley - EVP, CFO*

Look, we had gains up and we had losses down. The net effect on the legacy position was pretty much flat. In commercial mortgages, to give you a bit of color, our hedges didn't work as well as they could have done but obviously the exposures were significantly down. Obviously because the hedges are more liquid when the market recovers and it takes time for the instruments to catch up. On the legacy book, it's been pretty much a wash, gains and losses on the quarter.

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Jeff Harte - ***Sandler O'Neill - Analyst***

Okay. Thank you.

Colm Kelleher - ***Morgan Stanley - EVP, CFO***

Thank you.

Operator

Your next question comes from the line of Douglas Sipkin of Pali Capital.

Douglas Sipkin - ***Pali Capital - Analyst***

Thank you and good morning.

Colm Kelleher - ***Morgan Stanley - EVP, CFO***

Good morning.

Douglas Sipkin - ***Pali Capital - Analyst***

Three questions here. First, with respect to retail, global wealth management, what percentage of I guess your Asset Management fees in there are sort of on a lag basis, priced maybe on the beginning of period assets versus sort of an average or an ending. I know you guys reported $1.57 billion this quarter. Can do you have any idea of what percentage of that is sort of lagged?

Colm Kelleher - ***Morgan Stanley - EVP, CFO***

Offhand I don't. I don't, I'm sorry.

Douglas Sipkin - ***Pali Capital - Analyst***

Okay. No problem. And then secondly, any update -- I know Citigroup has sort of flat-out said that they plan on selling the entire position which I don't think is really a surprise and I think you guys have sort of indicated that. Any update on sort of the time line of that, how that phase-in happens, maybe a little bit more detail now that we're several months into the transaction.

Colm Kelleher - ***Morgan Stanley - EVP, CFO***

This is a acquisition with predefined time lines where we control the optionality on that, which suits this firm and its shareholders just fine. Unless there is a compelling reason for us to re-evaluate that we will execute on the time line as laid out at the agreement signed at the time and that's really where we are.

Douglas Sipkin - ***Pali Capital - Analyst***

Okay. That's helpful. Third question. Could you just give a little color on maybe what type of impact the government buying mortgage backed bonds and government bonds is playing on whether it's easier or harder to make money in fixed income trading with that sort of element of concentrated buying in place and what business may look like when that ends in the beginning of next year?

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Colm Kelleher - ***Morgan Stanley - EVP, CFO***

Well, it is clearly provided more liquidity to the market and more liquidity to the market clearly is better for the market so by definition it's better for everybody. What's it's also done is it's kick started trading in the market so to some degree you would expect. That was the intent of what they did. The issue is will the market be robust when that happens, our view is that it will be. Have a lot of liquidity. You have levels still at quite -- spreads still at quite wide levels. You have people coming into the market now and making investments and making returns so I think it's been a very useful exercise and very helpful in this market stabilization.

Douglas Sipkin - ***Pali Capital - Analyst***

Okay. Great. Final question. I was a little surprised not so much on your end but with Invesco, doesn't seem to be any selling restrictions attached to your roughly $1 billion investment and I was just wondering from a partnering standpoint how if at all will this change how you work with Invesco on the retail side of the fence, obviously now having a 9 plus percentage, will that change anything that Smith Barney, Morgan Stanley is doing in terms of selling Asset Management products.

Colm Kelleher - ***Morgan Stanley - EVP, CFO***

I foresee no changes at all. We have a very healthy, constructive relationship with Invesco.

Operator

We have time for one more question and that comes from James Mitchell of Buckingham Research.

James Mitchell - ***Buckingham Research - Analyst***

Good morning.

Colm Kelleher - ***Morgan Stanley - EVP, CFO***

Good morning.

James Mitchell - ***Buckingham Research - Analyst***

Can I just follow up on the comp ratio. You said you expect it to be pretty flat in the fourth quarter. Is that with the 44% in the third quarter on a normalized basis or the 40% year-to-date.

Colm Kelleher - ***Morgan Stanley - EVP, CFO***

I didn't say in the fourth quarter. What I said was year-to-date, you look at the sort of revenue ratios we're giving across the firm, we've been giving you guidance of just under 50%. What I then said was sorry if I didn't make myself clear is that we've been given segments for each segment number and of course what we've given you guidance on XDVA. In the case of GWN there is no DVA because it isn't allocated to that. They're accruing in the low 60s on a comp ratio, now remember that's a grid payment system. Very little subjectivity. Institutional securities, where there's more of a bonus element, what we've been saying is XDVA we're in the low 40s for institutional securities. Traditionally what you do in the fourth quarter as you know is you true up. But that's the guidance we're giving.

James Mitchell - ***Buckingham Research - Analyst***

You're saying low 40s for the full year.

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Colm Kelleher - ***Morgan Stanley - EVP, CFO***

Yes.

James Mitchell - ***Buckingham Research - Analyst***

And then just following up on wealth management, you guys as you pointed out you're 64% comp ratio. If you look back before you did the acquisition in '08 you were doing 60% or below. How much is a function of needing to get through cost saves versus lower revenue environment and do you expect that to get back 60% over time.

Colm Kelleher - ***Morgan Stanley - EVP, CFO***

We expect that to be the trend.

James Mitchell - ***Buckingham Research - Analyst***

One last follow-up on FIC Where have you guys lost the most market share I guess since 2007, early 2008 and where are you concentrating your efforts to recapture that market share the most?

Colm Kelleher - ***Morgan Stanley - EVP, CFO***

Well, I think we are regaining market share as we go on. It really is in the interest rates and foreign exchange area. But we are regaining that market share. We have seen some improvement this quarter.

James Mitchell - ***Buckingham Research - Analyst***

Sure. You're saying that where you saw the most loss was in those areas?

Colm Kelleher - ***Morgan Stanley - EVP, CFO***

Yes.

James Mitchell - ***Buckingham Research - Analyst***

Okay. Thank you.

Colm Kelleher - ***Morgan Stanley - EVP, CFO***

Well, listen, thank you very much everybody. I would like to thank you for your time and the call.

Operator

Ladies and gentlemen, that concludes your conference call for today. Thank you for your participation. You may now disconnect.

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