

Global Investment Committee

10 Investment Ideas for 2013

STRATEGY

AUTHORS

The highly accommodative policy stance being pursued by the Federal Reserve, the European Central Bank (ECB) and other central banks should continue to bolster financial markets in 2013 despite fiscal policy drag and another year of subpar growth in the global economy. The Global Investment Committee (GIC) believes that this backdrop is generally good for equities and other risk assets.

The Fed is engaged in an open-ended round of Quantitative Ease (QE), purchasing longer-term Treasury securities and mortgage-backed securities in an effort to hold down interest rates and improve financial conditions and thus foster a stronger economic expansion. The ECB has put in place another type of unconventional program called Outright Monetary Transactions (OMT) designed

to backstop European nations' sovereign debt markets. Although the program has not been activated, its existence has significantly reduced the threat of sovereign debt defaults and a disruptive breakup of the euro monetary union.

Meanwhile, to bolster local growth, several other central banks have eased in recent months.

By holding interest rates at exceptionally low levels, central banks are inducing investors to shift into riskier, higher-yielding assets. With policy rates at nearly zero—and negative in real (inflation-adjusted)

terms—the returns from traditional safe-haven investments for any reasonable holding period will only be attractive if there are outright declines in other investment options. While such declines are always a possibility, we do not assign a high probability to them this year.

We tap the global resources of Morgan Stanley to formulate the best investment ideas for the coming year.

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Figure 1: Our Best Ideas for 2013

Given our view that this year will be a good one for risk assets in general and equities in particular, here are our best investment ideas and the benchmarks we will use to track them.

- 1 **Commodities and Gold**
50%/50% split between the Dow Jones-UBS Commodity Total Return Index and the spot price of gold
- 2 **Emerging Markets Bonds**
JP Morgan Emerging Market Bond Index, local currency, unhedged
- 3 **US Large-Cap Growth**
Russell 1000 Growth Index
- 4 **Dividend Aristocrats**
S&P 500 Dividend Aristocrats Index
- 5 **Global Gorillas**
S&P Global 100 Index
- 6 **Emerging Markets Equities**
MSCI Emerging Markets Index
- 7 **Investment Grade Credit**
Barclays Capital US Aggregate Corporate Index
- 8 **High-Quality Municipal Bonds**
Barclays Capital AMT-Free Intermediate Continuous Municipal Index
- 9 **Water**
ISE Water Index
- 10 **Master Limited Partnerships**
Alerian MLP Index

Consequently, the tactical recommendations in the GIC's Asset Allocation Models, which have a 12-month time horizon, overweight risk assets. These tactical positions inform our 10-best investment ideas for 2013. Indeed, five of our ideas come from our tactical positions. We also have looked outside of our standard asset allocation framework for investment opportunities that offer attractive attributes fitting to the times.

The 10 Ideas for 2013

In light of the exceptionally low interest rate environment, several of our investment ideas once again target high-quality income generation: "dividend aristocrats," investment grade corporate bonds, high-quality municipal securities and master limited partnerships (MLPs). Three ideas are designed to capitalize on the superior growth prospects in emerging economies: emerging market (EM) equities, local currency EM bonds, and "global gorillas." We continue to favor the investment prospects for water—a finite resource that is not always available where it is needed. We also have retained US large-cap growth stocks. Finally, in light of the liquidity that central banks are pumping into the banking system, we have added commodities and gold to our list.

Here is a discussion of each idea. The order is not indicative of preference. We start with the new additions to the list:

COMMODITIES AND GOLD. Against a backdrop of slowing growth in most EM economies, broadly speaking, the performance of commodities has significantly trailed that of other risk assets during the past year. Looking forward, growth in EM

economies seems likely to accelerate in response to policy-easing steps taken during the past several months. Economic activity in EM economies tends to be more resource intensive than in developed economies, so a pickup in EM growth bodes well for commodity demand.

With regard to gold, the accommodative policy stance of the world's major central banks seems likely to continue to fuel concerns about future inflation and currency debasement. This, in turn, should spur investment demand for gold.

We also note that previous rounds of QE appear to have given a lift to commodities, particularly gold and other precious metals; QE3 should do the same. Our benchmark for this investment idea is a 50/50 split between the Dow Jones-UBS Commodity Total Return Index and the spot price of gold.

EMERGING MARKET BONDS. The potential for high total returns from fixed income securities in 2013 seems limited in light of the low starting level of interest rates. That said, EM bonds are one of the more attractive bond sectors. This asset class has undergone a rerating during the past several years because of improvement in the underlying credit quality of the sovereign issuers. Indeed, more than 60% of the issues in the Citi Emerging Sovereign Bond Index carry an investment grade rating, compared with only about 30% a decade ago. Consequently, yield spreads over comparable Treasury securities have been trending downward. Current spreads are a bit above that declining trend line. We encourage investors to seek vehicles that provide exposure to local-currency-denominated bonds (unhedged), as we expect currency

appreciation to provide a boost to total return. Our benchmark is the JP Morgan Emerging Market Bond Index (local currency, unhedged).

Here are the eight ideas that carry over from 2012:

DIVIDEND ARISTOCRATS. With money-market interest rates and traditional safe-haven bond yields likely to remain near record lows, dividend-paying equities should continue to provide an attractive alternative for income-seeking investors. We prefer large-cap, blue-chip companies that have consistently raised dividend payouts for several years. Our benchmark is the S&P 500 Dividend Aristocrats Index.

INVESTMENT GRADE CREDIT. The persistence of low interest rates and rising stock values has further strengthened corporate balance sheets. Thus, investment grade corporate bonds continue to offer an attractive combination of yields that are higher than those on traditional safe havens, such as US Treasuries, and

high credit quality. Our benchmark is the Barclays Capital US Aggregate Corporate Index.

HIGH-QUALITY MUNICIPAL BONDS. The return of the 39.6% US income tax rate should underpin demand for tax-exempt municipal bonds. In light of the outlook for subpar economic growth, which will continue to strain state and local government finances, we favor “high quality” (rated A or better) general-obligation and essential-service revenue bonds rated BBB or better with maturities of five to 11 years. In addition, prerefunded muni bonds selling at yields higher than corresponding US Treasuries are also compelling. Our benchmark is the Barclays Capital AMT-Free Intermediate Continuous Municipal Index.

MASTER LIMITED PARTNERSHIPS. Master limited partnerships—limited partnerships that trade on a securities exchange—offer the tax benefits of the limited-partnership structure and the liquidity of publicly traded securities. MLPs are concentrated

in natural-resource industries such as oil, natural gas and minerals extraction. They are attractive to income-seeking investors, as they typically offer dividend yields that are considerably above those on conventional equity investments. As with real estate investment trusts, MLPs have a special status in the US tax code: To avoid state and federal corporate income taxes they must generate and pay out 90% of their income from producing, transporting and/or processing natural resources. Our benchmark is the Alerian MLP Index.

EMERGING MARKET EQUITIES. Emerging market economies are on much better footing than their developed-market counterparts, due to growing middle-class consumer sectors that support domestic demand. Many EM countries do not face the debt overhangs that are limiting policy flexibility in many developed countries. Indeed, policymakers in many EM countries have been gradually utilizing their latitude to make both

2012 Performance Review

Despite persistent markdowns in the estimates for economic growth and corporate earnings, risk assets performed surprisingly well during 2012, as increasingly accommodative monetary policy facilitated a decoupling from the challenging fundamental backdrop. Our top performer for 2012 was one of our thematic ideas: water (up 27.8%—all performance is on a total return basis). Our equity-related ideas generally posted strong gains led by emerging markets equities (up 19.1%), dividend aristocrats (up 16.9%), US large-cap growth (up 15.3%), and global gorillas (up 13.4%).

Three of our ideas designed to provide high-quality income generation in a low interest rate environment delivered solid results: investment grade corporate bonds (up 9.8%), high-quality municipal bonds (up 6.8%) and master limited partnerships (up 4.8%).

Our laggards were the more defensive ideas that reflected our concern in early 2012 that policy disarray on both sides of the Atlantic had tipped the Euro Zone in to a recession, with the US soon to follow: short duration bonds (up 1.4%) and managed futures (down 2.1%).

Note: These performance results are based on benchmark indexes, actual performance may have varied based upon the specific investment vehicles employed. All returns are reported as of Dec. 31, 2012 in US dollars, except for managed futures, which is reported for the 12 months between Nov. 30, 2011 and Nov. 30, 2012 (See Figure 2, page 4).

fiscal and monetary policy changes that bolster domestic demand. Looking forward, growth in EM economies seems likely to accelerate in lagged response to the policy-easing steps taken during the past several months. Our benchmark is the MSCI Emerging Markets Index.

GLOBAL GORILLAS. We believe that investing in large, DM companies with outsized exposure to the emerging markets—we call them “global gorillas”—is another way to capture the growth from economies that expect to account for about 80% of global growth this year. One way to capitalize on that growth is via established multinationals that have strong businesses in countries with a rapidly expanding middle class—such as China, India and Brazil, all of which are likely to experience rapid growth in consumer spending in the next several years. Our benchmark is the S&P Global 100 Index.

US LARGE-CAP GROWTH STOCKS. This idea incorporates our preferences within US equities in terms of market capitalization and style. As with the global gorillas, large-cap stocks are better-positioned to benefit from established sales channels in emerging markets. Moreover, from a valuation perspective, large-cap stocks appear historically cheap relative to mid-and small-cap stocks. Similarly, by historical standards, growth stocks appear cheap relative to value stocks.

Furthermore, during periods when corporate earnings growth is scarce, growth stocks—companies that can deliver relatively stable earnings growth regardless of the economic backdrop or those that can generate above-average earnings growth—typically outperform. Our benchmark is the Russell 1000 Growth Index.

WATER. Water may be the most important commodity story of the 21st century as declining supply and rising demand combine to create the “perfect storm.” Current global water-usage levels are unsustainable. While the scarcity of freshwater is most acute in Africa and western Asia, scarcity also has become an economic constraint in major economies such as China, India and Indonesia, as well as in the commercial centers of Australia and the western US. Indeed, urbanization may cause the demand for water to increase five-fold beyond the essential water requirement needed for personal hygiene, cooking and cleaning. Moreover, this does not include water used in power generation or other industrial activities that typically accompany urbanization. Finally, climate change is shrinking the available supply. In the face of progressively growing demand for water, companies are investing in ways to increase water availability. Our benchmark is the ISE Water Index. ■

Figure 2: A Recap of 2012's Best Ideas

Results may vary depending on the strategies used. From Dec. 31, 2011 through Dec. 31, 2012, the total return on the MSCI All Country World Index was 16.8%; the Barclays Capital Global Aggregate Bond Index, 4.0%; and US Treasury bills, 0.8%.

	Total Return (%)*
1 Water ISE Water Index	27.8
2 Emerging Markets Equities MSCI Emerging Markets Index	19.1
3 Dividend Aristocrats S&P 500 Dividend Aristocrats Index	16.9
4 US Large-Cap Growth Russell 1000 Growth Index	15.3
5 Global Gorillas S&P Global 100 Index	13.4
6 Investment Grade Credit Barclays Capital US Aggregate Corporate Investment Grade Index	9.8
7 High Quality Municipal bonds Barclays Capital AMT-Free Intermediate Continuous Municipal Index	6.8
8 Master Limited Partnerships Alerian MLP Index	4.8
9 Short-Duration Bonds Barclays Capital Global Treasuries 1 to 3 years Index	1.4
10 Managed Futures CASAM CISDM CTA Equal-Weighted Index	-2.1**

*Dec. 31, 2011 to Dec. 31, 2012

**Nov. 30, 2011 to Nov. 30, 2012

Source: Bloomberg as of Dec. 31, 2012

Index Definitions

DOW JONES-UBS TOTAL RETURN COMMODITY INDEX

This index comprises the total return from futures contracts on 19 physical commodities. These include energy, industrial metals, precious metals and agricultural commodities.

JP MORGAN EMERGING MARKET BOND INDEX

This index includes local-currency bonds from 27 emerging market countries.

S&P 500 DIVIDEND ARISTOCRATS INDEX

This equal-weighted index measures the performance of large-cap, blue-chip companies within the S&P 500 Index that have followed a policy of increasing dividends every year for at least 25 years.

BARCLAYS CAPITAL US AGGREGATE CORPORATE INVESTMENT GRADE INDEX

This index represents securities that are investment grade, SEC-registered, taxable and dollar-denominated.

BARCLAYS CAPITAL AMT-FREE INTERMEDIATE CONTINUOUS MUNICIPAL INDEX

This is a market-value-weighted index designed to replicate the price movements of medium-duration bonds with a nominal maturity of six to 17 years.

ALERIAN MLP INDEX

This index is a float-adjusted, capitalization-weighted index of the 50 most prominent energy master limited partnerships.

MSCI EMERGING MARKETS INDEX

This is a free-float-adjusted, market-capitalization index designed to measure equity market performance in the global emerging markets.

S&P GLOBAL 100 INDEX

This market-capitalization-weighted index includes 100 large-cap companies whose businesses are global in nature and that derive a substantial portion of their operating income, assets and employees from multiple countries.

RUSSELL 1000 GROWTH INDEX

This index measures the performance of the Russell 1000 companies with higher price-to-book ratios and higher forecasted growth rates.

ISE WATER INDEX

This index comprises securities that derive a substantial portion of their revenues from the potable water and wastewater industry. The index uses a modified market-capitalization-weighted methodology to create a more uniform weight distribution.

MSCI ALL COUNTRY

WORLD INDEX This is a free-float-adjusted market-capitalization index that is designed to measure equity-market performance in the developed and emerging markets.

BARCLAYS CAPITAL GLOBAL AGGREGATE BOND INDEX

This index measures a wide spectrum of global governments, government-related agencies and corporate and securitized fixed income investments.

BARCLAYS CAPITAL GLOBAL TREASURY 1-3 YEARS INDEX

This index tracks the fixed-rate local currency government debt of investment grade countries.

CASAM/CISDM CTA EQUAL WEIGHTED INDEX

This index reflects the average performance of commodity trading advisors (CTAs) reporting to the CISDM Hedge Fund/CTA Database. In order to be included in the equally weighted index universe, a CTA must have at least \$500,000 under management and at least a 12-month track record. The index, which goes back to 1980, is calculated using net performance and net asset value.

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Alternative investments which may be referenced in this report, including private equity funds, real estate funds, hedge funds, managed futures funds, and funds of hedge funds, private equity, and managed futures funds, are speculative and entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds and risks associated with the operations, personnel and processes of the advisor.

Investing in commodities entails significant risks. Commodity prices may be affected by a variety of factors at any time, including but not limited to, (i) changes in supply and demand relationships, (ii) governmental programs and policies, (iii) national and international political and economic events, war and terrorist events, (iv) changes in interest and exchange rates, (v) trading activities in commodities and related contracts, (vi) pestilence, technological change and weather, and (vii) the price volatility of a commodity. In addition, the commodities markets are subject to temporary distortions or other disruptions due to various factors, including lack of liquidity, participation of speculators and government intervention.

Physical precious metals are non-regulated products. Precious metals are speculative investments, which may experience short-term and long term price volatility. The value of precious metals investments may fluctuate and may appreciate or decline, depending on market conditions. If sold in a declining market, the price you receive may be less than your original investment. Unlike bonds and stocks, precious metals do not make interest or dividend payments. Therefore, precious metals may not be suitable for investors who require current income. Precious metals are commodities that should be safely stored, which may impose additional costs on the investor. The Securities Investor Protection Corporation ("SIPC") provides certain protection for customers' cash and securities in the event of a brokerage firm's bankruptcy, other financial difficulties, or if customers' assets are missing. SIPC insurance does not apply to precious metals or other commodities.

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Bonds rated below investment grade may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk and price volatility in the secondary market. Investors should be careful to consider these risks alongside their individual circumstances, objectives and risk tolerance before investing in high-yield bonds. High yield bonds should comprise only a limited portion of a balanced portfolio.

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.

Interest on municipal bonds is generally exempt from federal income tax; however, some bonds may be subject to the alternative minimum tax (AMT). Typically, state tax-exemption applies if securities are issued within one's state of residence and, if applicable, local tax-exemption applies if securities are issued within one's city of residence.

Treasury Inflation Protection Securities' (TIPS) coupon payments and underlying principal are automatically increased to compensate for inflation by tracking the consumer price index (CPI). While the real rate of return is guaranteed, TIPS tend to offer a low return. Because the return of TIPS is linked to inflation, TIPS may significantly underperform versus conventional U.S. Treasuries in times of low inflation.

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