

Positioning

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Re-Positioning

It is with strong feelings of responsibility and humility that I assume the role of chief investment officer and chair of the Global Investment Committee (GIC). It is my goal to earn your trust and respect. With that in mind, I look forward to meeting as many financial advisors and clients as possible, welcoming questions, discourse and debate.

I want to assure everyone there will be significant continuity with the prior asset allocation process and reports with which you are familiar. I recognize the unease associated with organizational change and want to make this as smooth a transition as possible.

Working with me on the GIC will be some familiar faces, namely David M. Darst, our chief investment strategist, and Andrew Slimmon, who heads Morgan Stanley Wealth Management's Applied Equity Advisors. Now joining us on the core team will be Martin L. Leibowitz, director of Morgan Stanley's global strategy team and Adam S. Parker, Morgan Stanley's chief US equity strategist. Together, our team brings a wealth of investment knowledge and asset allocation experience. Once you get to know the new members and their work, I am confident you will agree.

Our objectives are to provide you with asset allocation advice and investment insights for what is likely to be a challenging but exciting environment. Finally, we plan to reintroduce the popular *On the Markets* publication shortly, along with other periodicals, including future editions of this monthly essay.

The Road Ahead

No doubt, the past decade has been trying for investors. With two 50% corrections in US equities, bubbles in everything from technology stocks to housing and a central bank that continues to push the envelope on policy, it is no surprise that individual investors have decided to reduce the risk in their portfolios. Compounding these concerns is the fact we are getting older as a society and have less time to absorb any nasty surprises. The reality is that the past 10 years has not been that different from other periods in history. Such a period just hasn't happened in most investors' lifetime or cognitive memory. While every difficult period is unique, there are similarities that can be used to our advantage when thinking ahead.



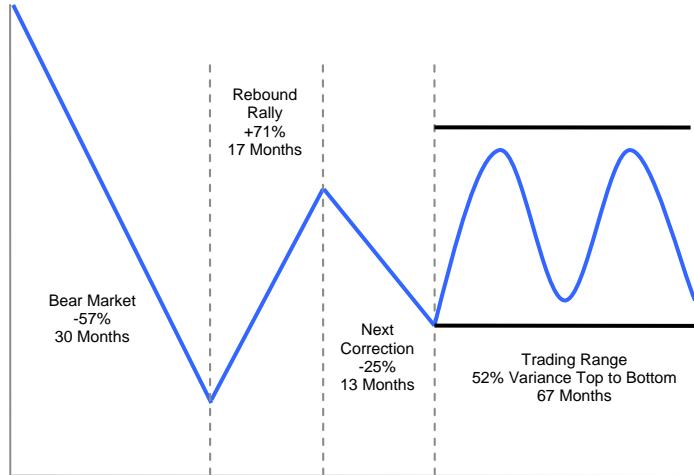
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Specifically, Morgan Stanley Research has looked at other post-financial-crisis periods and has discovered a distinctive pattern followed by equity markets (see Exhibit 1). Since this has been a truly *global* event, I looked at how *global* equity markets have fared following this crisis.

Exhibit 1. Four Stages of a Typical Secular Bear Market and Its Aftermath

The chart below represents the typical secular bear market pattern based on our sample of 19 such bear markets.



Source: Morgan Stanley Strategy Research as of Sept. 5, 2012

Unsurprisingly, the MSCI All Country World Index has followed the expected pattern (see Exhibit 2). Nevertheless, it is remarkable to see just how closely the index's path has resembled the predicted outcome. The good news is that we are probably past the worst of this crisis, even though we are likely to experience a trading range market for at least a few more years.

In order to move forward, we need to understand where we have been. First, the reality is that the developed world is in a major deleveraging cycle, something that happens approximately every 80 years. This deleveraging cycle is the natural result of the capitalist system, and historical data suggest it is right on schedule.

Deleveraging can take several different paths depending on how society chooses to deal with it: write-downs, or outright defaults; spend less and tax more, or austerity; increasing GDP faster than debt, or growth; and monetization of the debt, or inflate. Obviously, some of these choices are politically unacceptable or difficult to achieve. Therefore, the choice is typically some combination of all the above.

While each country has chosen a slightly different approach to deleveraging, most skew toward monetization or inflating their way out, if they can. Clearly, the US has been the most

aggressive in this regard while Europe has enacted more of a mix of the four options.

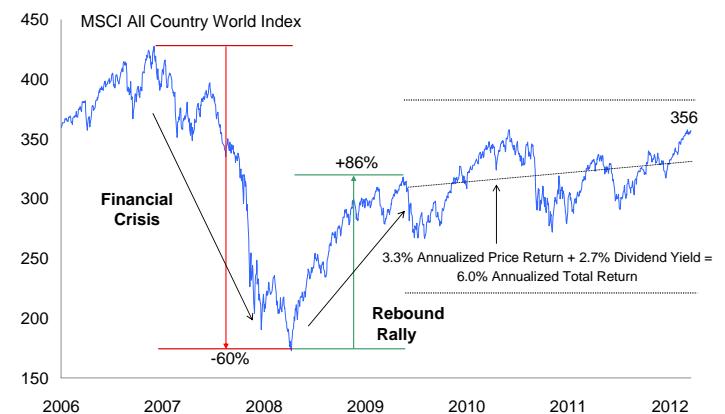
For example, France has chosen the tax route while Greece, Ireland, Spain and Italy have taken the austerity and/or default route, mostly involuntarily. Given the seemingly better outcome achieved thus far in the US, others are starting to steer further toward monetization. In fact, this is exactly what the European Central Bank's commitment last summer to do "whatever it takes" was all about. Some economists call this monetization "financial repression." I call it "print and spend."

No matter what you call it, the idea is simple. There is too much debt in the world, and if we allowed markets to take their natural course, the economic consequences would be politically and socially unacceptable to most. Therefore, central bankers and government authorities have chosen a path they believe is more desirable, given what they believe to be the alternative—a second Great Depression.

It is not my intent to make a political statement or judgment about these choices. Rather, it is my goal to understand what choices have been made and if these choices will continue. In other words, it doesn't matter what I think our leaders *should* do to deal with the deleveraging cycle. What matters is what I think they *will* do. As of now, a clear choice has been made. Most countries have decided to adopt some degree of financial repression as a means to deal with the deleveraging.

Exhibit 2. Global Equities Track Bear Market Pattern

It is remarkable to see just how closely the MSCI All Country World Index resembled the pattern in Exhibit 1. This suggests that while the worst has likely passed, we likely still face a trading range for a few more years.



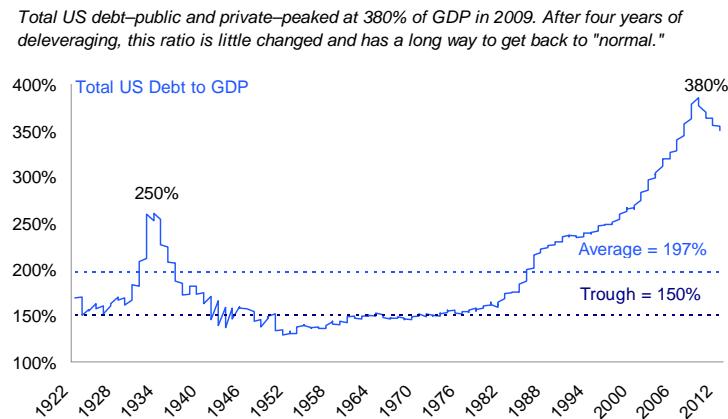
Source: Bloomberg as of Feb. 14, 2013

What Does It Mean?

Judging by the price and volatility of most risk assets during the past few years, markets have become increasingly comfortable with financial repression. Corrections have become less frequent and shallower than just a few years ago when investors were still struggling to understand this new regime. A smart investor once told me, “There are many things that can affect asset prices in the short term, but there are only two things that affect them in the long run: growth and interest rates.” These are hard words to live by when one is getting whipsawed by hurricanes, fiscal-cliff deliberations and sovereign-debt crises. Still, they provide a great compass as we navigate the ups and downs we expect to continue.

While the deleveraging is an accepted fact by most, it is not well appreciated how far we have to go. For example, the US debt-to-GDP ratio shows we are still in the early innings (see Exhibit 3). Assuming we can proceed at the same pace of the past three years, the US should be back to somewhere between that point at which the last deleveraging ended and the average—debt to GDP in the 150%-to-200% range—in 10 to 15 years. And remember, the US is the farthest along among the developed countries.

Exhibit 3. Deleveraging Has a Long Way to Go



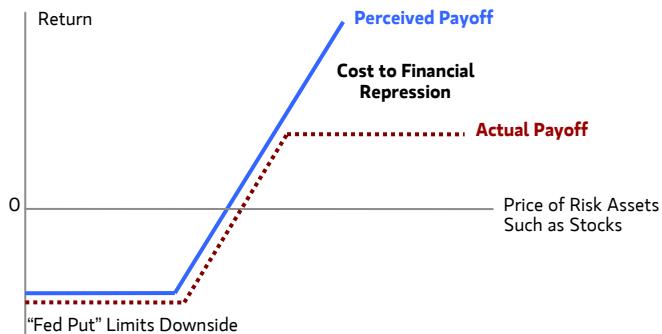
The key takeaway is that the combination of deleveraging with financial repression is a recipe for low growth and low interest rates. Furthermore, this combination is not necessarily a bad backdrop for risk assets.

Despite the negative connotation of financial repression, it has actually led to good results for risk takers. In addition to monetizing the debt, financial repression also creates something known as the “Fed Put” for investors. In essence,

financial repression provides a support level for risk asset prices, essentially mimicking the behavior of a put option (see Exhibit 4). This “free” downside support has allowed astute investors to assume more risk than they would otherwise and capture the upside during the past three years.

Exhibit 4. Financial Repression Can Limit Returns

While the “Fed Put” affords some downside support for risk assets, the same policies can limit the upside returns as well.



Source: Morgan Stanley Smith Barney LLC as of Feb. 20, 2013

The only caveat with this framework is that it assumes there is no cost to financial repression. Unfortunately, there are significant costs with any policy, especially extraordinary ones. While the benefits might outweigh these costs, I believe the real payoff structure of financial repression suggests gains may be limited, too. This is due to my belief that financial repression and extraordinarily low rates suppress future growth. The implication of such a realization is that returns are likely to be lower than expected. This is not the end of the world, but it is an important observation when considering one’s wealth management.

Another way to think about the return outlook is that most risk assets earn some premium to cash. We know that financial repression means real interest rates are close to zero or negative. Holding cash is undesirable under such circumstances. We also know that financial repression is unlikely to end anytime soon. Investors have wisely figured this out and moved a significant chunk of assets from cash to bonds. However, with bonds trading at such low yields, it’s getting harder to make this simple trade, particularly for longer-duration and/or lower-credit securities. The natural progression for investors has been to move even further out the risk curve toward equities in search of higher yields and/or better total returns. This migration is likely to continue so long as the real return on cash is close to zero or negative.

Taking this a step further, expected returns are a function of three things: the risk-free rate; “beta,” the payoff for taking a

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given level of risk; and “alpha,” which is the additional return from security selection. Don’t get bogged down by the Greek terms; they simply mean there is no free lunch and everything builds upon the risk-free rate, which today is 2%, the yield on a 10-year US Treasury note. Tack on a 4% equity risk premium, and maybe some alpha, and a typical 0.60 beta portfolio will get you an “expected” 4%-to-5% *nominal* return. Subtract the central banks’ targeted inflation of 2% and you’re left with a 2%-to-3% expected *real* return. Not horrible, but definitely not the glory days either.

Taking Control

There has been a giant movement toward passive investing over the past decade as investors have come to realize that most active managers underperform their benchmarks, particularly after fees.

As illustrated above, a completely passive approach may not yield the results investors need to meet their objectives or obligations. Therefore, a more active approach could be required to achieve financial goals.

Using the beta/alpha framework discussed above, returns can be achieved in three ways:

• **Strategic Asset Allocation/Risk Tolerance.** Every investor is willing to accept some level of risk, depending on his or her situation. This is the strategic asset allocation process. For a given level of risk, or beta, we know what to “expect.” In the past, when returns on traditional 60% stocks/40% bonds portfolios regularly exceeded 8% to 9%, most investors were satisfied and stopped here.

• **Tactical Asset Allocation.** This provides additional return through opportunistic risk-taking. The Global Investment Committee (GIC) has provided these tactical tilts and added between 50 and 100 basis points of additional return per annum during the past three-and-one-half years, depending on the model selected. To address an environment in which expected passive returns are quite modest, the GIC will become more active going forward, with larger and more frequent tactical tilts. As a result, this portion of one’s return could become more significant relative to the total.

• **Manager/Security Selection and Alternatives.** Alpha is the holy grail of the investment business because it is the return earned above what is expected from an assumed level of risk. The most common way to do this is through superior manager or security selection.

Alternative investments are another source of alpha. Long/short hedge funds are probably the best example of an

alpha strategy. Other alternatives, like REITs or commodities, add potential value to a portfolio because they are uncorrelated to traditional asset classes such as equities and fixed income. Therefore, one of the key benefits of owning alternatives is that it allows one to own more higher-risk, higher-return assets while keeping the *portfolio* risk constant.

The good news is that after two years during which correlations between equity securities remained historically high, they are starting to decline. Adam Parker wrote about this in a recent report (see *Searching for Alpha: Top Ideas in Sectors with High Potential Generation*, Feb. 12, 2013). High correlations mean the market is treating all stocks the same and not differentiating their unique underlying fundamentals. A high-correlation environment, such as experienced in 2011 and 2012, is difficult for active portfolio managers, whose expertise is stock selection. If recent declines in correlations persist, active management should benefit.

Matthew Rizzo, an analyst in our Consulting Group Investment Advisor Research unit, has also discussed the changing trend in correlations in a recent report for our investment advisor clients (*Active Versus Passive: Emerging Optimism for Active Management*, Feb. 14, 2013). He highlights separately managed accounts and mutual funds with significant “active share”—how much it varies from its benchmark index—that are on Investment Advisor’s Focus List. Choosing from this list could be a way to add alpha to your portfolio.

Perhaps one of the most overlooked opportunities for individual investors to add alpha to their portfolios is in fixed income. With passive returns in fixed income so low at this point, any additional alpha can increase the total return significantly. Yet, I have never had anyone ask me for my favorite bond. In many ways, we are still an equity culture.

The bottom line is this: Investors need to take a more active approach in both stocks and bonds if they *expect* to earn something more than a 4%-to-5% nominal return over a realistic investment horizon. This includes more active tactical asset allocation, manager/security selection and a higher percentage of alternative investments. I recommend considering all three for those who require or would like to achieve a greater return than 4% to 5% nominal.

In addition to more active management of one’s assets, there are other ways to try to enhance expected returns. One possible strategy is selling call options on stocks in your portfolio, or covered-call writing. This tactic makes sense—especially if you agree we are likely to remain in a trading range, albeit an upward sloping one.

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Studies have shown¹ how a systematic strategy of covered-call writing has the potential to add yield to a typical equity portfolio while partially reducing the volatility, or risk. That sounds a lot better to me than going further out on the credit or duration curve for a few extra basis points, or paying rich valuations for certain high-dividend-yielding defensive stocks.

Exhibit 5. Covered Calls Could have Added to Investors' Total Returns

A strategy of writing covered calls—that is, selling 2% out-of-the-money call options every month added about 1.2% per annum to the S&P 500's total return while also lowering its volatility. This strategy makes sense in a trading-range environment.



Source: Bloomberg as of Feb. 15, 2013

Recent history suggests covered-call writing enhances relative performance (see Exhibit 5). During the past six years, a strategy of writing 2% out-of-the-money calls every month added approximately 1.2%* per annum to the total return (see Exhibit 5). While that's not a home run, 120 basis points per year would be a 20%* increase to our forward expected returns on equities, while at the same time it would partially reduce the risk of the portfolio by the premium received. Now that's what I call taking control.

*The assumed return rates in this analysis are not reflective of any specific investment and do not include any fees or expenses that may be incurred by investing in specific products. The actual returns of a specific investment may be more or less than the returns used in this analysis.

Conclusion

The 2008-2009 period was one we all wish to forget and hope to never experience again. While we believe such a financial crisis is unlikely to occur again in the near term, there are lasting impacts from the Great Recession we must consider when thinking about how and where to invest. First, we think the deleveraging cycle is far from completion. Second, because we have decided to deal with this deleveraging by implementing financial repression, we should expect interest rates and economic growth to remain lower for longer. Based on previous post-financial-crisis periods, we believe the deleveraging could last a minimum of two-to-three more years. Third, a period of low interest rates and low economic growth may not be a bad time in which to take investment risk. In fact, the past three years have been quite attractive. Nevertheless, our analysis suggests the next seven years are likely to bring disappointing nominal returns of just 4% to 5% for investors with passive portfolios consisting of 60% equities and 40% fixed income. We plan to publish more on this in the near future.

To deal with these lower expected returns, we suggest implementing a more active approach that includes a traditional strategic asset allocation process married to more frequent tactical tilts. Within asset classes, investors should also consider managers who are willing to deviate from their passive benchmarks as a means to add alpha. I also believe writing covered calls could be an attractive way to add yield to a portfolio. Finally, I think alternatives should be part of every portfolio since they allow investors to hold higher-returning assets while keeping the total risk of the overall portfolio constant. I hope you found this inaugural issue of *Positioning* useful. My intention is to address topics that affect our clients' financial goals and to provide insights that bring clarity to the complexity of today's investment world.

¹Hill, Joanne, Venkatesh Balasubramanian, Krag (Buzz) Gregory, and Ingrid Tierens, *Finding Alpha via Covered Index Writing*, *Financial Analysts Journal* (Sept.-Oct. 2006); pp. 29-46. Kapadia, Nikunj, and Edward Szado, *The Risk and Return Characteristics of the Buy-Write Strategy on the Russell 2000 Index*, *The Journal of Alternative Investments* (Spring 2007); pp. 39-56.

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Index Definitions

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

S&P 500 INDEX Regarded as the best single gauge of the US equities market, this capitalization-weighted index includes a representative sample of 500 leading companies in leading industries of the US economy.

CBOE S&P 500 2% OTM BUY/WRITE INDEX This is a benchmark index designed to track the performance of a hypothetical 2% out-of-the-money buy/write strategy on the S&P 500® Index. It is a passive total return index based on (1) buying an S&P 500 stock index portfolio, and (2) "writing" (or selling) a near-term S&P 500 Index "covered" call option, generally on the third Friday of each month.

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

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