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INVESTMENT MANAGEMENT

Built for Change

Shifting From Beta to Alpha

FIXED INCOME | GLOBAL FIXED INCOME TEAM | INVESTMENT INSIGHT | 2018

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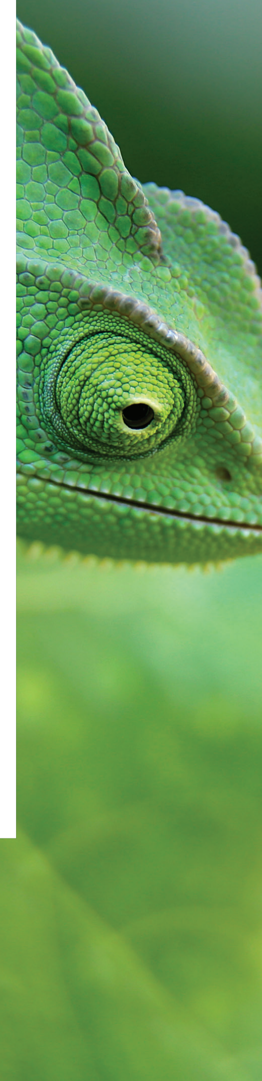
A fundamental shift is underway in fixed income. The new era of rising interest rates is causing fixed income managers across the world to rethink how they invest. Investors should consider active managers who focus on generating alpha to help drive returns and create diversification benefits from owning fixed income in a portfolio.[1]

In the last 10 years, sustained monetary stimulus—lower interest rates aimed at keeping economies afloat after the global financial crisis—made it easy for fixed income managers to earn returns. The systemic effect throughout the market (beta) overwhelmed contributions by idiosyncratic factors (alpha). As yields fell, bond prices across the board rose. Simply being invested in the bond market was enough to earn decent returns.

That has all changed. Today, markets have mostly normalized, and it is no longer enough to just be in the market. Making active choices around duration, credit and yield curve positioning is more important than ever, and getting it wrong can lead to missed opportunities and potential losses.



[1] Diversification does not eliminate the risk of loss.

The beta avalanche is ending

The stimulative policies that drove fixed income returns indiscriminately across entire markets (the beta avalanche) are being dismantled. But it is an uneven process, and the ripple effects across markets are hard to predict.

We believe the one certainty is that asset valuations will eventually normalize, migrating to levels that are in line with their idiosyncratic fundamental merits. This return to normalcy means that, to earn competitive returns, managers will need to identify and capitalize on those merits. Going forward, in-depth analysis of individual bonds and market segments (alpha-generating activities) will most likely take center stage as the driver of fixed income returns.

The era of beta dominance actually goes back much further than the financial crisis of 2007-2008. For close to four decades, declining yields have been a primary support for fixed income returns. In fact, from 1989-2017, the Bloomberg Barclays U.S. Aggregate Bond Index averaged a 6.4% annual return. Of that, 95% was derived from duration, the beta effect of falling yields across fixed income markets.[2]

So we think the shift from beta to alpha as the dominant driver of returns truly marks the beginning of a new era in fixed income. By early 2018, most major central banks had either ended or were starting to end their stimulative monetary programs. By comparing index returns so far this year to those during the 10 years of monetary stimulus (2008-2017), we see a new era unfolding: The cessation of stimulus has slowed down the beta engine that had fueled returns in earlier years *(Display 1)*.

Just being in the market (beta) is no longer enough. Going forward, to generate healthy returns, we believe fixed income investors will need to engage active managers who have the potential to outperform the broad market through alpha-generating strategies.

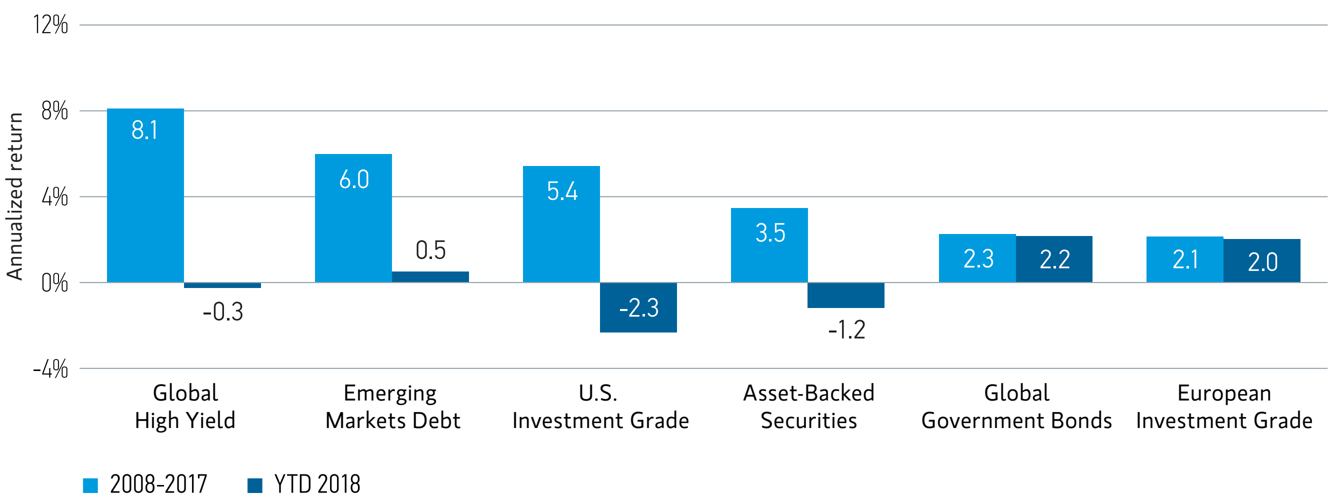
In the new era, fixed income retains its role as a diversifier

As the shift to alpha-driven returns unfolds, investors may be tempted to question the validity of bonds as diversifiers. Some research shows that negative stock-bond correlations, which are suggestive of strong diversification benefits, are associated with accommodative monetary policy.[3] Given that the era of accommodative monetary policy is nearing an end, it would be logical for investors to question the diversification benefits of fixed income going forward.

Our answer, unequivocally, is that bonds will continue to play a vital role in portfolio diversification—both in

DISPLAY 1

The end of stimulus marks a new era in fixed income



Source: Morgan Stanley Investment Management. Data as of 3/31/2018. The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** Returns for less than one year are cumulative (not annualized). See Disclosure section for Risk Considerations and index definitions.

Investing involves risks including the possible loss of principal. In general, fixed income investments are subject to credit and interest rate risks. High yield investments may have a higher degree of credit and liquidity risk. Foreign securities are subject to currency, political, economic and market risks. The risks of investing in emerging market countries are greater than investments in foreign developed countries. Investors should carefully review the risks of each asset class prior to investing.

[2] Data from Bloomberg Barclays U.S. Aggregate Bond Index (1989-2017)

[3] Systemic Risk and Systematic Value: "The correlation of equity and bond returns" http://www.sr-sv.com/the-correlation-of-equity-and-bond-returns/

DISPLAY 2

Not the same without a yield cushion

A-RATED CORPORATE BOND INDEX	1990s	TODAY
Yield	7.4%	3.7%
Estimated total return after a **50 bps** rise in Treasury yield	4.9%	0.2%
Estimated total return after a **100 bps** rise in Treasury yield	2.2%	-3.5%

Source: Bloomberg Barclays A-rated Corporate Bond Index. Data as of June 13, 2018. Data shown for the 1990s is an average from 1990-1999. This interest rate sensitivity analysis is spread neutral.

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the new era and throughout changing market cycles for many years to come. In our view, though, skilled active management will be crucial to producing positive returns and creating those diversification benefits.

Challenge: There is little yield cushion

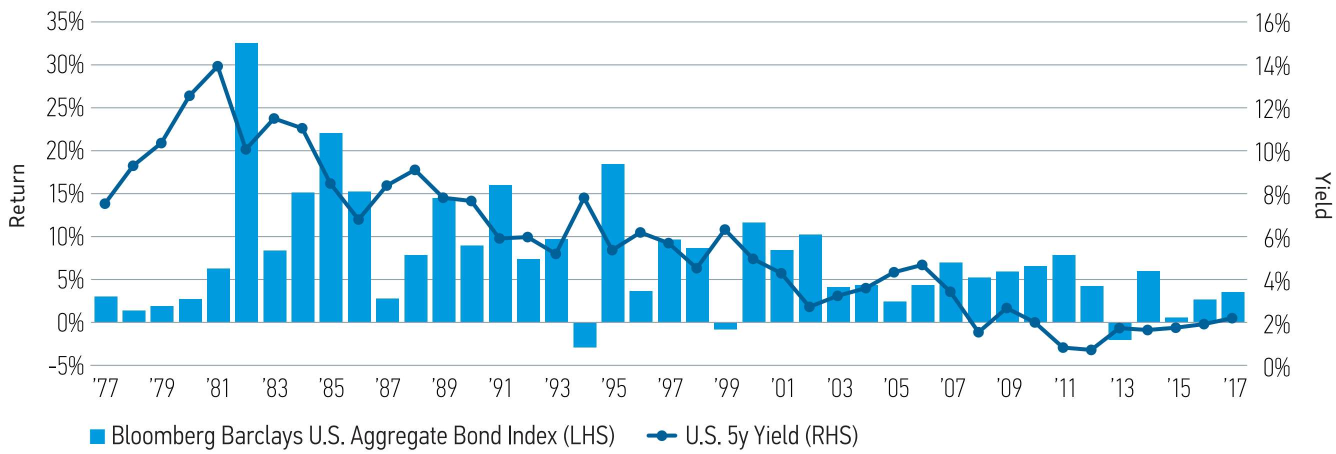
We believe it will be possible to earn competitive returns from fixed income, but it will require greater skill than in years past. One of the biggest challenges will be to manage interest-rate risk when there is virtually no yield cushion to buffer the effects of rising rates.

A comparison here is useful. In the pre-crisis period, when interest rates were higher—and even going back as far as the 1980s—a generic allocation to investment grade fixed income provided both return and diversification properties because bond yields were much higher. In the 1990s, for example, an investor could buy A-rated corporate bonds with yields averaging over 7%. Such bonds could absorb an approximately 130-basis point rise in U.S. Treasury yields before incurring an absolute return loss. That sort of yield cushion does not exist today. In fact, a rise of just over 50 basis points in U.S. Treasury yields could trigger an absolute return loss in today's market, all else being equal *(Display 2)*.

We are not suggesting that yields are going to spike higher anytime soon, but we are suggesting that we are near an inflection point. As we see it, the secular decline in yields is coming to an end, and bond yields may bounce along the bottom and trend higher in the years to come *(Display 3)*.

DISPLAY 3

At an inflection point?



Source: Bloomberg, Morgan Stanley Investment Management. Data from 1977 through 2017. The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See Disclosure section for index definitions.

Shift toward alpha requires change in strategy

In this environment, where market beta adds little value or even detracts from returns, it becomes fundamentally important to tap into other return sources (alpha).

This is where investors need to make choices, and there is a spectrum of strategies from which to choose.

Indexed strategies generally rely heavily on beta as a source of returns. Non-indexed strategies have the potential to also generate alpha through in-depth analysis on duration, sectors, credit spreads and yield curve structure *(Display 4)*.

In our view, only by taking advantage of these more idiosyncratic opportunities in global markets can investors achieve alpha. Given today's market conditions, we think that returns from alpha-oriented decisions have the potential to exceed returns from beta (market exposure). For this reason, it may be time for investors to consider increasing their allocations to alpha-focused fixed income strategies.

DISPLAY 4

Adding alpha

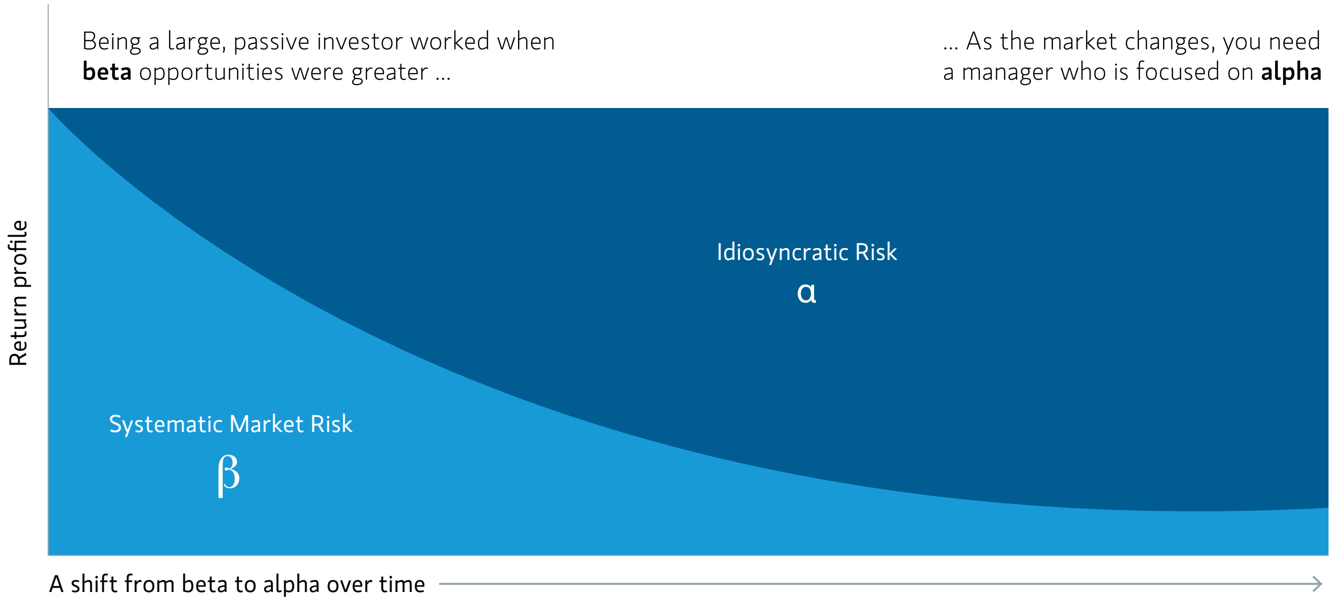
	PASSIVE INDEXED	ACTIVE INDEXED	PASSIVE NON-INDEXED	ACTIVE NON-INDEXED
Description	Asset allocation determined solely by an index without active decision-making by a manager	Asset allocation determined by an index, with some flexibility	Portfolio is established without regard to an index, and passively held (buy and hold strategy)	Active investment decisions are made independent of an index; risk characteristics in this category can vary widely
Goal	Perform in line with the index	Modest outperformance of index by capitalizing on select beta and alpha opportunities	Outperform an index by capitalizing on beta opportunities and generating alpha through a set period that ends with the maturity of the bonds in the portfolio	Outperform an index by capitalizing on beta opportunities and generating alpha through changing markets
Investment Approach	Derives returns mainly from changes in yields, especially in the current low rate environment For indexes that include credit, spread widening or tightening will contribute	Derives returns mainly from changes in yields and, for strategies that include credit, general changes in credit spreads Active positioning in duration, credit, security selection and yield curve exposure can contribute to a lesser degree	Derives returns from a combination of market factors (beta) plus active decisions in asset allocation and security selection (alpha)	Derives returns from a combination of market factors (beta) plus active and ongoing positioning decisions in duration, credit, yield curve exposure and security selection (alpha)
Sources of Return	β	$\beta + \alpha$	$\beta + \alpha$	α

Increasing Alpha-Generation Potential →

Source: Morgan Stanley Investment Management, May 2018
This is for illustrative purposes only and is not exhaustive.

DISPLAY 5

Shifting from beta to alpha



This chart is for illustrative purposes only.

The right alpha-producing conditions

Market beta is easy to come by, but alpha is a scarce commodity. Producing alpha is a delicate art and science: Managers need to have the right analytical resources and infrastructure to support their ability to find alpha.

Large asset managers may struggle to generate alpha because they may not be able to secure enough individual bonds to fill their needs. To compensate, they may frequently rely on derivatives to gain synthetic exposure. These derivatives usually behave like indexes and thus are largely beta-driven, defeating the purpose of active alpha-seeking strategies. Reliance on derivatives can also be costly, and it is no substitute for a durable portfolio of actual securities. *(Display 5)*

In general we advocate owning a bond fund over individual bonds because it reduces concentration risk. The reason is that a fund has the advantage of diversification across a wide range of sectors. It is difficult to replicate these diversification benefits by owning a series of individual bonds or a ladder strategy, which holds individual bonds of different maturities.

Conclusion: A new era requires a focus on alpha

Today, fixed income markets are at an inflection point. The beta forces that dominated in the past are diminishing as central banks withdraw monetary stimulus and interest rates inch higher. The diversification benefits of fixed income remain intact, but investors can no longer rely on passive strategies with simple market exposure (beta) to earn competitive returns.

This new era requires a new mindset in our opinion. More than ever, investors will need to explore alpha-focused strategies in an effort to achieve competitive performance. These strategies should be overseen by skilled active managers who have the latitude to dynamically adjust their portfolios in an effort to extract value from duration positioning, credit analysis, yield curve exposure and security selection. The choices fixed income investors make today will have significant implications for performance and diversification benefits going forward.

Risk Considerations

There is no assurance that a Portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the Portfolio will decline and may therefore be less than what you paid for them. Accordingly, you can lose money investing in this Portfolio. Please be aware that this Portfolio may be subject to certain additional risks.

Fixed-income securities are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In the current rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. **Longer-term securities** may be more sensitive to interest rate changes. In a declining interest-rate environment, the portfolio may generate less income. **Mortgage- and asset-backed securities** are sensitive to early prepayment risk and a higher risk of default and may be hard to value and difficult to sell (liquidity risk). They are also subject to credit, market and interest rate risks. Certain **U.S. government securities** purchased by the strategy, such as those issued by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of the U.S. It is possible that these issuers will not have the funds to meet their payment obligations in the future. **High-yield securities ("junk bonds")** are lower-rated securities that may have a higher degree of credit and liquidity risk. **Public bank loans** are subject to liquidity risk and the credit risks of lower-rated securities. **Foreign securities** are subject to currency, political, economic and market risks. The risks of investing in **emerging-market** countries are greater than risks associated with investments in foreign developed countries. **Sovereign debt securities** are subject to default risk. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. **Restricted and illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk).

INDEX DEFINITIONS

The **Bloomberg Barclays Euro Aggregate Corporate Index (European Investment Grade)** is an index designed to reflect the performance of the euro-denominated investment-grade corporate bond market.

Bloomberg Barclays Global Aggregate Hedged USD Index provides a broad-based measure of the global investment grade fixed-rate debt markets. Total Returns shown is hedged USD.

The **Bloomberg Barclays Global High Yield Corporate Index (Global High Yield)** is a multi-currency measure of the global high yield corporate debt market. The benchmark name changed from Barclays Global High Yield – Corporate Index to Bloomberg Barclays Global High Yield – Corporate Index on 24 August 2016.

The **Bloomberg Barclays U.S. Corporate Index (U.S. Investment Grade)** is a broad-based benchmark that measures the investment grade, fixed-rate, taxable, corporate bond market.

The **Bloomberg Barclays U.S. Mortgage-Backed Securities Index (Asset-Backed Securities)** tracks agency mortgage-backed pass-through securities (both fixed-rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA) and Freddie Mac (FHLMC). The index is constructed by grouping individual TBA-deliverable MBS pools into aggregates or generics based on program, coupon and vintage. Introduced in 1985, the GNMA, FHLMC and FNMA fixed-rate indexes for 30- and 15-year securities were backdated to January 1976, May 1977 and November 1982, respectively. In April 2007, agency hybrid adjustable-rate mortgage (ARM) pass-through securities were added to the index.

EM Debt – Represented by a Blended Index of equal-weighted (1/3%) of JP Morgan EMBI Global, JP Morgan CEMBI Broad Diversified and JP Morgan GBI-EM Global Diversified Index. The **JP Morgan Emerging Markets Bond Index Global** tracks total returns for traded external debt instruments in the emerging markets and is an expanded version of the EMBI+. As with the EMBI+, the EMBI Global includes U.S. dollar-denominated Brady bonds, loans and eurobonds with an outstanding face value of at least $500 million. The J**P Morgan Corporate Emerging Markets Bond Index Broad Diversified Index** is a global, liquid corporate emerging markets benchmark that tracks U.S.-denominated corporate bonds issued by emerging markets entities. The **JP Morgan Government Bond Index-Emerging Markets Global Diversified Index** is a market-capitalisation-weighted, liquid global benchmark for U.S.-dollar corporate emerging market bonds representing Asia, Latin America, Europe and the Middle East/Africa.

JP Morgan Global Government Bond Index (Global Government Bonds) is a market value weighted fixed income index comprised of government bonds in developed countries.

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