A unified managed account, or UMA, allows investors to build a diversified portfolio under a single asset allocation plan that may hold a variety of investments, such as separately managed accounts, mutual funds, exchange-traded funds and even some alternative strategies. UMAs can combine individual securities ownership and account customization with a high degree of investment diversification and operational efficiency, making it possible for investors to consolidate their entire portfolio in a single investment account.
Unified Managed Accounts

Unified managed accounts offer the option to invest in a range of investment types, all within a single account structure.

Through the use of overlay portfolio management, which coordinates all activity in a unified managed account, UMAs may also offer tax-managed trading strategies and portfolio rebalancing to investors. Consolidated performance reports and tax statements often round out these programs.

What follows is a more in-depth look at unified managed accounts. Once we've examined the types of investments that may be included in a UMA, we'll take a look at the investment process, including some issues investors may want to take into account when selecting appropriate investments. We'll also explain the overlay management process and explore some of the additional features UMA programs offer, including tax management and portfolio rebalancing.

INVESTMENTS
Unified managed accounts offer the option to invest in a range of investment types, both actively and passively managed, all within a single account structure. Those investments may include:

• **Separately Managed Accounts.** Often referred to as an SMA, a separately managed account typically consists of a customized portfolio of stocks, bonds or other assets managed on the investor’s behalf by a professional portfolio manager. Because the investor directly owns all the underlying securities in a separately managed account, this type of investment potentially offers the opportunity to manage the timing of future tax liabilities, as well as other services tailored specifically to the investor’s needs.

• **Mutual Funds.** A mutual fund is an investment company that invests in different types of securities, such as stocks or bonds, on behalf of individuals who have similar investment goals (e.g., the fund’s shareholders). A mutual fund generally adheres to a distinct investment objective and investment policies. The assets are managed by a professional portfolio manager hired by the fund, and investors participate by owning shares of the fund rather than the fund’s underlying securities. Traditionally, mutual funds have been used to provide diversification and professional asset management to investors at relatively low account minimums.

• **Exchange-Traded Funds.** More commonly known as ETFs, exchange-traded funds are investment vehicles designed to replicate the daily movement of a particular market index or other benchmark. As the name implies, ETFs are listed and traded on public equity markets. Though some recent ETFs have actively managed components, virtually all exchange-traded funds are passively managed, which tends to decrease their fees and expenses relative to other types of investments. The ETF structure is specifically designed to reduce tracking error—swings in performance relative to the fund’s benchmark—which makes ETFs particularly effective as risk management tools, allowing investors to more closely monitor the overall expected risk in a portfolio.

Note: Investing in the market entails the risk of market volatility. The value of all types of securities, including mutual funds and ETFs, may increase or decrease over varying time periods.
• **Alternative Investments.** Alternative investments generally refer to a diverse set of investment strategies that fall outside of the traditional purchase and sale of stocks and bonds. Some familiar examples of alternative investments include hedge funds, private equity and real estate. For various reasons, the alternative investments typically available to UMA investors are hedge funds and alternative-strategy mutual funds, which employ techniques common to hedge fund investing—such as short selling, leverage and arbitrage trading—within a mutual fund framework. The appeal of alternatives lies in their potential to provide attractive risk-adjusted returns and additional diversification relative to traditional asset classes.¹

**THE INVESTMENT PROCESS**

All investors, regardless of the products in which they ultimately choose to invest, should follow an objective framework for making investment decisions. Although the number of steps may vary, this process should be designed to help investors achieve their objectives, attain portfolio diversification and manage risks over time.

¹Investing in alternative investments is speculative, not suitable for all clients, and intended for experienced and sophisticated investors who are willing to bear the high economic risks of the investment, which can include loss of all or a substantial portion of the investment due to leveraging, short selling or other speculative investment practices; lack of liquidity in that there may be no secondary market for the fund and none expected to develop; volatility of returns; restrictions on transferring interests in the fund; potential lack of diversification and resulting higher risk due to concentration of trading authority with a single advisor; absence of information regarding valuations and pricing; delays in tax reporting; less regulation and higher fees than mutual funds; and advisor risk.

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**FOUR-STEP INVESTMENT PROCESS**

1. **SET FINANCIAL OBJECTIVES**
2. **DEFINE INVESTMENT STRATEGY**
3. **SELECT INVESTMENTS**
4. **ONGOING REVIEW PROCESS**

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**RISK AND RETURN CHARACTERISTICS FOR VARIOUS ASSET CLASSES**

- Large-Cap US Stocks
- Small-Cap US Stocks
- High Yield Bonds
- Intermediate Bonds
- International Stocks
- T-Bills

The above is presented for illustration purposes only and in no way is intended to predict or guarantee the future performance or risk of any particular asset class. Past performance is no guarantee of future results.

With respect to fixed income securities, please note that, in general, as prevailing interest rates rise, fixed income securities prices will fall. High yield bonds are subject to additional risks such as increased risk of default and greater volatility because of lower credit quality of the issues.

There may be additional risks associated with international investing involving foreign economic, political, monetary and/or legal factors. International investing may not be for everyone. The securities of small-capitalization companies may be subject to higher volatility than larger, more established companies.

Data Source: Consulting Group, 30-year period ending 12/31/09
STEP 1: SET FINANCIAL OBJECTIVES

Individuals new to investing often say that all they want to do is “make money.” Since there are many investments that can potentially make money, the issue is actually much more complex. As the graph on the previous page indicates, risk differs among investment types. Certain investments can and do fluctuate dramatically in price, and some investors may not be able to accept a potentially significant short-term decline in the value of their investments. For this reason, appropriate investments should be selected only after an investor has determined his or her financial objectives and tolerance for risk. Of course, there are no guarantees that any investor will achieve all of his or her objectives, even with a long-term time horizon.

Financial objectives—sometimes expressed as part of a client’s investment suitability profile—should begin with a comprehensive review of the investor’s financial resources, liabilities and goals. Ultimately, this process should center on the investor’s return expectations, time horizon and risk tolerance, all of which are interrelated. Higher return expectations, for example, may require that the investor be able to accept higher levels of short-term risk, while the ability to accept such risk is determined in part by the investor’s time horizon.

STEP 2: DEFINE INVESTMENT STRATEGY

Once financial objectives have been clarified, the next step—which Morgan Stanley Smith Barney believes to be by far the most important in the process—is to determine the investor’s investment strategy or asset allocation plan.

Many investors select investments without a clear plan, which often results in a portfolio containing a hodgepodge of unrelated investments. Modern theory on portfolio diversification, however, holds that appropriate asset allocation—the process of systematically distributing funds across different asset classes and investment styles—can create optimized portfolios that produce the highest expected returns for a given level of expected risk (as measured by the volatility of portfolio value over time). Because different asset classes, such as equity and fixed income investments, can respond differently to varying market conditions, portfolio diversification may reduce the exposure to losses caused by a decline in value of one or more of the portfolio’s components.2

Asset allocation models based on this process specify a blend of asset classes with the potential to produce the highest possible long-term returns for various levels of risk tolerance. Because of their long-term outlook, such models are often referred to as strategic asset allocation models. Tactical asset allocation models are based on strategic models, but represent a shorter-term time horizon. Tactical models often attempt to predict which asset classes are likely to outperform or underperform in the upcoming 12 to 18 months, and then adjust asset class exposures accordingly.

For UMA programs, investors may have the option of choosing between strategic and tactical asset allocation models as well as customized asset allocation. While tactical models may offer the opportunity for higher returns in the short term, this

2 Diversification does not ensure against loss. Past performance is not a guarantee of future results.
must be balanced against the possible tax implications of potentially shorter holding periods and higher portfolio turnover, particularly during times of market volatility. A Financial Advisor can provide guidance on what type of model may be most appropriate given market conditions.

**STEP 3: SELECT INVESTMENTS**

Investment selection is the stage at which the expertise and resources available through a Financial Advisor are likely to provide the greatest value to investors. The choice of investment products for a UMA can be influenced by a variety of factors, some as mundane as the minimum investment size for different products and some as complex as the expected risk-return trade-off of a particular type of alternative strategy.

An important consideration in determining investment selection is the choice between active and passive investments for each of the asset allocations in the model.

An actively managed investment relies on the expertise of a portfolio manager to choose the investment’s holdings in an attempt to outperform a predetermined benchmark. A passively managed investment, however, is designed to mimic the holdings of a benchmark in order to match the benchmark’s returns before expenses, not exceed them.

Changing market cycles and the degree of overall market volatility may create simultaneous opportunities for placing assets in both active and passive strategies. Another factor influencing this choice may be differences in market efficiency among asset classes. For less liquid or less researched markets, or at times of extreme volatility, the performance of a skilled active manager may exceed that of an unmanaged product, even once fees have been taken into account.

In addition to the potential cost differences among various types of investments—such as those between SMAs and ETFs—fees associated with investment products within the same type or style of investment can also vary. For instance, the fees charged by two SMA managers may differ by several basis points (one basis point = 0.01%, or 1/100 of a percentage point) despite the fact that both products are invested in the same universe of stocks. The fees of individual products must be evaluated relative to their peers to determine whether a higher fee may be justified by the performance of the investment over time.

Tax consequences may also play a role in investment selection. US investors with fixed income components in their portfolios, for example, may have the option of allocating those funds to municipal bonds, which are typically exempt from federal income tax. Likewise, individuals whose assets are invested in SMAs may have the option of implementing trading strategies that use tax-loss harvesting and other techniques to potentially reduce tax liabilities at the portfolio level.

The final step that an investor may take in the selection process is to compare the holdings of his or her proposed investments with each other. Investment products, even across different investment styles or product types, may hold similar or identical securities in their portfolios. This overlap may lead to overexposure to a specific security, industry or economic sector, undermining the diversification benefits of the proposed asset allocation model. A Financial Advisor has the tools available to assist investors in this analysis.

**STEP 4: ONGOING REVIEW PROCESS**

The investment process doesn’t end with the selection of appropriate investments. All investors should assess the performance of their portfolio periodically to ensure their goals are being met.

With UMAs, performance monitoring occurs on two levels. The first level covers the specific investment products in the account. Each investment product should be reviewed periodically to ensure its performance is in line both with appropriate market benchmarks and with its peers. Where appropriate for actively managed products, this review should also encompass the management firm and the specific portfolio management team handling the product to determine whether the investment strategy is being applied consistently and objectively.

In situations where there is concern regarding a manager’s ongoing ability to successfully meet its mandate, a change in investment product may be necessary. This level of analysis is often carried out by a Financial Advisor or by the firm that provides investment research coverage and support.

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2 This statement does not reflect the possible impact of the federal Alternative Minimum Tax (AMT), which applies to certain taxpayers who have large deductions or sizable amounts of tax-exempt income. Municipal bonds may be subject to state or local taxation. Please consult your tax advisor for more information on these issues and the AMT, and how they may apply to your situation.
The second level at which performance is monitored is that of the investor’s entire portfolio. Comprehensive performance reports on a UMA may display not only the performance of individual products as they compare to their benchmarks, but also the composite performance of the entire portfolio, including the impact of investment fees. Information on the risk-return characteristics of the portfolio, in addition to the asset allocation model, may be included as well.

Reviewing performance reports regularly with a Financial Advisor is an excellent opportunity to ask questions about the account or to review the investor’s overall financial situation. As the investor’s personal or financial situation changes, it is important to determine whether short-term or long-term changes may be needed in the choice of investments or asset allocation models.

OVERLAY PORTFOLIO MANAGEMENT
Unified managed account programs are made possible through the use of overlay portfolio management. An overlay portfolio manager coordinates all activity in a unified managed account, including portfolio construction and implementation, tax-management services (if appropriate) and portfolio rebalancing.

TAX MANAGEMENT
Many investors tend to focus exclusively on before-tax portfolio performance and may not consider the impact that taxes can have on their long-term investment strategy—even though the long-term costs of taxes may outweigh any short-term performance results. Consequently, taxes can be one of the most crucial issues facing investors, particularly in the top federal tax brackets.
Tax-managed investing may use a number of techniques to help manage tax liabilities at the portfolio level. Two of those techniques, loss harvesting and wash sale avoidance, are often standard features in UMA programs. Loss harvesting involves the sale of one or more investments showing a loss in order to offset previously recognized capital gains, while wash sale avoidance is designed to ensure compliance with an IRS rule that voids any tax benefits from the repurchase of securities—or their substantial equivalent—less than 31 days following their sale.

These strategies are integrated into a UMA by the overlay portfolio manager. In addition, for clients above a certain asset threshold, customized tax-management features may be available. Tax mandates may be used to help manage capital gains and tax exposure by limiting gain realization or the overall tax bill, or by taking external tax events into consideration. Additional services may be available for legacy asset transitions or for portfolios with deep embedded gains. A Financial Advisor can help determine what tax-management features may be most appropriate in a unified managed account.

PORTFOLIO REBALANCING
Another key feature of overlay portfolio management is the ability to automate the portfolio rebalancing process. Over time, market forces may cause portfolio allocations to shift in ways that create outsized exposure to a particular asset class or that leave an investor exposed to more risk than he or she is prepared to accept. Through the overlay portfolio manager, a UMA may include an automatic rebalancing feature that periodically corrects for sizable asset allocation shifts, returning the portfolio to the model’s allocation targets.

CONCLUSION
Unified managed accounts allow investors to combine the key components of their portfolio in a single, integrated investment structure. A well-designed UMA program should offer asset allocation advice, a variety of investment options, consolidated performance and tax reporting, portfolio rebalancing and optional features such as tax management.

Unified managed accounts are best utilized as an integral part of a disciplined investment strategy. When developing and implementing such a strategy, each investor should consider his or her individual goals, time horizon and tolerance for risk. Once these have been established, next steps include asset allocation, investment selection and performance monitoring. While each of these steps may benefit from expert guidance, asset allocation and investment selection remain two areas where the advice of an experienced Financial Advisor and the resources available to him or her through Morgan Stanley Smith Barney can provide the most value.

The number and increasing complexity of investment options can make creating and managing a diversified portfolio a difficult process. Finding a way to coordinate and analyze various investment products, their strategies, holdings, account structures, fees, tax statements and performance reports can prove a challenge, even for experts. A carefully constructed UMA program can offer investors the opportunity to simplify their investment lives without compromising the features, diversification benefits or quality of their investment choices.

Consulting Group, the managed money unit of Morgan Stanley Smith Barney, supports unified managed account programs that offer many of the features described above. Talk to your Financial Advisor for more information on Consulting Group’s UMA programs and to determine whether a unified managed account may be suitable for you.

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Tax-management services may adversely impact account performance and do not constitute tax advice or a complete tax-sensitive management program. There is no guarantee that tax-management services will produce the desired tax results.
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In Morgan Stanley Smith Barney unified managed account programs, alternative investments are limited to US-registered mutual funds that seek to pursue alternative investment strategies or returns. Mutual funds in this category may employ various investment strategies and techniques for both hedging and more speculative purposes such as short selling, leverage, derivatives and options, which can increase volatility and the risk of investment loss.

There may be additional risks associated with international investing involving foreign economic, political, monetary and/or legal factors. International investing may not be for everyone. The securities of small-capitalization companies may be subject to higher volatility than larger, more established companies. With respect to the fixed income securities, please note that in general, as prevailing interest rates rise, fixed income securities prices will fall. High yield bonds are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues.

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