On the Markets

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Starting the New Year on a High Note

Here we are again at the beginning of a new year and typically a time for promising to kick bad habits and committing to new behaviors in hopes of better health or richer relationships. From an investment standpoint, the close of the year often finds us regretting bad decisions from the past and vowing to not make those same mistakes again. Since stocks outperformed bonds by a record 34 percentage points in 2013—and the S&P 500 and the Dow Jones Industrial Average hit new highs—many investors are likely lamenting that they didn't own enough equities or that they owned too many bonds or alternative investments like commodities and real estate investments trusts.

While we believe stocks will trump bonds again in 2014, we do not think the outperformance will be nearly as dramatic, and there will likely be periods during which stocks underperform bonds and alternatives. In other words, this is not a time to abandon one's asset allocation and portfolio diversification. Just as a doctor would not recommend an unbalanced crash diet to make up for bad eating habits last year, we think it's important to stay disciplined with one's investment approach in order to maintain good financial health.

Nevertheless, 2014 could pick up right where 2013 left off, as growth appears to be accelerating. Some of this has to do with the fact that we are now five years into the recovery from the financial crisis and the economy may finally be achieving some self-sustaining momentum. We are also reaching the one-year anniversary of the economic headwinds from the payroll tax hike and fiscal sequestration, or mandatory government spending cuts, we experienced last year. As a result, there is a good chance the US economy reaches real GDP growth of more than 3% during the first half of 2014. This is why stocks ended 2013 on such a high note while bonds weakened further; markets were looking forward and discounting such an outcome.

The challenge will come if rates move higher too quickly and equity investors start to anticipate a slowdown, which we think could occur later in the year but not in the near term. Therefore, we maintain our healthy appetite for equities as we begin the new year—but still in the context of a well balanced and diversified diet. ■

Five Tricky Transitions

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For the final months of 2013, the global economy and policymakers largely followed the script we laid out in September. Global GDP growth accelerated to an annualized pace of 3.8% in the third quarter, up from 2.5% in the first quarter and 3.5% in the second quarter. When the fourth quarter is tallied, we expect GDP to run in the same high-3% range. Central banks continued to provide monetary accommodation as the US Federal Reserve decided to postpone tapering in September, the European Central Bank cut its refinancing rate in November and several other developed market (DM) central banks managed to push out expectations of their first rate hikes through dovish talk.

We think that our narrative comprising economic acceleration in the developed markets, stabilization in the emerging markets and continued central-bank accommodation will continue to play out in early 2014. According to recent surveys and hard data, the global trade and manufacturing cycles are on the up, suggesting decent growth momentum as we start 2014. The Fed decided to begin tapering ahead of expectations in December but, with its reassurance that the near-0% policy rates will continue, the markets responded positively. As for the European Central Bank (ECB), anticipate a cut to its refinancing rate yet again in the first quarter. This all suggests a fairly benign near-term economic and policy outlook over the next few months.

Looking at the broader picture, 2014 will mark year five of a postcrisis global economic expansion that has seen bumpy, below-par and brittle growth. The first four years of this expansion have been characterized by deleveraging and balance sheet repair in the financial, household and corporate sectors of many developed market economies, massive support from central banks through conventional and unconventional means; swelling public-sector debt; a full-blown debt crisis in Europe; and rising leverage and volatile inflation in the many emerging markets that benefitted from abundant global liquidity and the commodity supercycle.

If all goes well, 2014 could mark the transition to a sounder, safer and more sustainable second half of this expansion. That means a DM expansion that is less dependent on monetary and fiscal stimulus, instead driven by private consumption and capital expenditures and supported by a normalization of the credit mechanism. It also means an EM expansion that is helped by structural reforms aimed at more sustainable growth models.

However, for the expansion to embark on a sounder, safer and more sustainable second half, we believe policymakers around the globe will have to master five crucial and tough transitions this year.

The Fed: Second Time Lucky?

The Fed, under the new leadership of Janet Yellen, still has to manage the tapering process and create credible forward guidance on interest rates to avoid a replay of the unpleasant experience last summer, when the markets almost completely disregarded the Fed's "tapering isn't tightening" talk and pushed market rates significantly higher.

Japan: Crunch Year for Abenomics

This year will be difficult for Japanese GDP growth as the planned corporate tax cuts are unlikely to fully offset the drag from the consumption tax hike in April. Also, our Japan team does not expect to see major progress on structural reforms that could boost growth in the short term. Still, we expect the economy to muddle through. We forecast additional easing measures by the Bank of Japan in the course of the year in the form of increases in the amount of asset purchases, as well as the potential introduction of US-style forward guidance. Over time, this should support the transition from deflation to moderately positive inflation.

Europe: From Financial Fragmentation to Banking Union

The Euro Zone is facing a crucial transition in 2014, where we see below-consensus GDP growth of only 0.5% (see table, page 3). The comprehensive balance sheet assessment, planned ahead of the ECB taking over as single supervisor in the fourth quarter, will combine an asset quality review (AQR) and a bank stress test. This process will likely unify and cleanse the banking system, reduce fragmentation and unclog the lending channel—preconditions for a more sustainable recovery and for allaying what we view as a major risk: "Japanification" and deflation. To support the banking sector and to sustain expectations of lower rates, we expect the ECB to cut the refinancing rate one more time, most likely in the first quarter. Europe will also have to transition from financial fragmentation to a credible banking union.

China: A Delicate Turn Toward Reform-Driven Growth

China will have to transition from growth driven by leverage and state-owned enterprises to reform-driven growth. Financial liberalization and easing of personal and social freedom can improve the quality of resource allocation beyond what rebalancing to consumption-led growth could accomplish. However, the near-term task of implementing reforms is far more challenging, thanks to China's starting point of financial market prices that don't reflect fundamentals, capital misallocation and deleveraging. If financial liberalization is pushed through earlier than social reforms, the movement of market prices toward their fundamental levels could clash with deleveraging, creating downside risks to near-term growth. Our China economics team expects a slow and steady implementation of reforms, with the beneficial impact of the changes likely felt in 2015. Thus, our forecast for 2014 growth is 7.2%, but we expect 2015 growth to clock in at 7.4%.

Other EM Countries Transition to New Growth Models

Investors and policymakers agree that structural reforms and not cyclical responses are the way forward. Yet, we believe that EM policymakers either have shied away from reforms, are on the wrong track or have near-term headwinds. The 2014 landscape is likely to remain difficult for several EM markets:

Mexico. The reform process has struggled with a watered-down fiscal package and uncertainty about the critical energy package. However, ambivalence over reforms may be the catalyst that pushes policymakers to do more. We believe that reform and Mexico's US ties will lead to better growth, but perhaps not in the near term; our Mexico team expects growth of 3.3% in 2014.

India. Investment-oriented reforms, which saw positive momentum in late 2012 and early 2013, have all but disappeared. To improve the current account deficit, in our view, India needs higher real rates to encourage savings, along with a better investment climate. Both are missing at the moment.

Indonesia and Turkey. These two nations have indicated they will seek tighter monetary policy, which is encouraging. However, their commitment is yet to be seen and the risks of a tightening cycle for credit and fiscal deterioration need to be kept in mind.

Brazil and Russia. Russia's new central-bank governor is focusing on the structural frailties of the country's growth model. If she refrains from easing policy to support growth, the administration may face pressure to pass structural reforms. Brazil, however, appears to be continuing along a more risky path of balancing rate hikes with strong credit growth.

An important aspect of this transition will be dealing with higher real rates. While current and capital-account pressures are creating upside risks for real rates in the emerging markets, central banks themselves will play a role. We see 13 EM central banks raising rates in 2014. Since it is the relatively smaller EM central banks, we do not think that this will constitute a major turn in EM liquidity. Such a move is more likely in 2015, when we expect both DM and EM central banks to lift policy rates.

However, the trickiest EM transition comes from the US. The risk is a triple cocktail of: (1) US growth reaching its inflection point; (2) much of the growth coming from capital expenditures; and (3) a failure of the Fed's strategy to move from QE to forward guidance. Even the failure of the Fed's transition by itself is a dangerous environment. The vulnerable EM economies, in our view, are hostage to a successful transition at the Fed. ■

Morgan Stanley & Co. Sees Stronger Global Growth in the Years Ahead

Real GDP			2014E			2015E			2016-2018E
	2012	2013E	Bear	Base	Bull	Bear	Base	Bull	Base
Global	3.2%	2.9%	2.7%	3.4%	4.1%	3.0%	3.7%	4.5%	3.8%
G10	1.5	1.1	1.1	1.8	2.5	1.4	2.0	2.7	2.0
US	2.8	1.6	2.0	2.6	3.2	2.2	2.7	3.5	2.5
Euro Zone	-0.6	-0.5	-0.5	0.5	1.3	0.6	1.1	1.5	1.3
Japan	1.9	1.8	0.5	1.3	1.8	-0.2	1.1	1.7	1.0
UK	0.1	1.4	1.6	2.5	3.4	1.2	2.2	3.4	2.3
Emerging Markets	4.9	4.7	4.2	5.0	5.7	4.5	5.3	6.1	5.4
China	7.7	7.6	6.9	7.2	7.6	7.2	7.4	8.0	7.0
India	5.1	4.7	4.2	5.1	6.0	5.0	6.0	6.8	6.8
Brazil	0.9	2.3	1.0	1.9	2.8	0.0	1.5	2.5	2.8
Russia	3.4	1.6	1.5	2.7	3.5	1.4	2.6	3.5	2.5

Source: Morgan Stanley & Co. Research as of Dec. 13, 2013

Better US Growth: Delayed, not Derailed

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Chief US Economist
Morgan Stanley & Co.

The political machinations surrounding the federal budget battle in October have left a notable imprint on real GDP in the fourth quarter of 2013 and the first quarter of 2014. Most of this, however, is not economics but arithmetic, as hours not worked by furloughed government workers took a toll on the previous quarter but will reappear early this year. Taken together, we believe the pickup that seemed to be on track for late 2013 and into 2014 was delayed by one quarter, but not derailed.

PRIVATE-SECTOR RESILIENCE. Amid all these gyrations, the incoming data suggest the private sector has been resilient. Final private domestic demand accelerated after shutdown and likely grew at an annual pace in excess of 3.5% in the final quarter of 2013. Consumer confidence data reveal US households are the most upbeat on labor market conditions in the past five years. Moreover, after being significantly impacted by the sequester and federal budget cuts that constricted nominal GDP to the tune of about 1.75 percentage points in 2013, US manufacturers are busy again and plans for capital expenditures are on the rise.

All told, we expect 2014 to be the breakout year when real GDP rises above the 2% growth channel that it's been stuck in since the recovery began and expands at a pace above 2.5% (see chart).

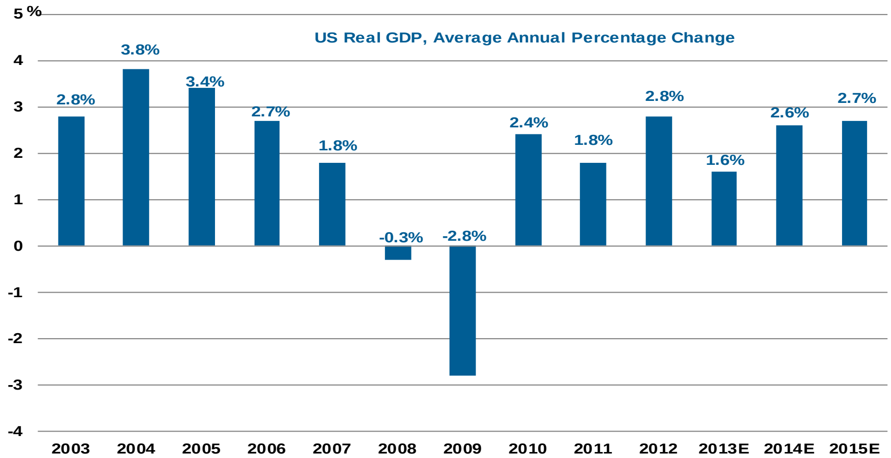
FOUNDATION OF PERFORMANCE. Four fundamentals build the foundation for this performance. The financial crisis took an enormous toll on the level of economic activity. With this adjustment mostly having run its course, the drag on growth is lifting. Similarly, fiscal consolidation at the federal level should continue as background noise, but we think it will reverberate at nowhere near the volume of the tax increases and sequester-driven swoon of the first half of last year. More importantly, a two-year budget deal has removed a good deal of uncertainty over fiscal policy, at least for now.

Meanwhile, considerable wealth has accumulated, driven by the run-up in major equity indexes and gains in home prices. That is an important determinant in household spending, particularly that of affluent households. In the Federal Reserve's Financial Accounts, net worth as a percentage of disposable income is poised to soar further when the 2013 figures are complete. Adding this fuel to sales, firms should feel a need to increase capital spending. Supportive of this spur, businesses have been underinvesting for some time and have ample cash on hand, implying a reason and an ability to invest. In our view, business investment is apt to jump above 6.0% this year; business investment growth for 2013 and next as compared with 2013 is tracking in at about 2.5%.

WINDING DOWN. The Federal Reserve's Dec. 17 announcement that it will start to wind down longer-term asset purchases beginning in January—a bit earlier than March, as we had anticipated—indicates the central bank has acknowledged the better incoming data and outlook. At the same time, the Federal Open Market Committee delivered strong forward guidance, saying that "it likely will be appropriate to maintain the current target range for federal funds well past the time that the unemployment rate declines below 6.5%."

The latest unemployment rate is still half a percentage point above this threshold and inflation is running well below the Fed's 2% target rate. This suggests that the Fed will have ample time to continue to provide its extraordinary policy accommodation. We do not expect to see the first policy tightening until early 2016. ■

US Economic Growth Starts to Look Better



Source: Federal Reserve, Morgan Stanley Research as of Dec. 2, 2013

Bullish, Especially on the Developed Markets

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The macroeconomic environment forecast by our economists for this year should prove positive for equities, given expectations for a moderate pickup in global GDP growth and central-bank policy that is likely to remain highly accommodative. While equity valuations have risen materially in the developed markets over the past year, we do not believe they are overextended. What's more, the relative valuations compared with other asset classes remain compelling.

Still, our 2014 equity market scenario-weighted base-case forecasts are modest (see table). They are 9% each for the US, Europe and Asia Pacific ex Japan and 7% for Japan. The emerging markets, the only region to have negative returns in 2013, has an 8% upside price target.

MORE BALANCED RETURNS. The composition of stock market returns is likely to become more balanced between multiple expansion—the primary driver of returns in the US and Europe in 2013—and earnings-per-share (EPS) growth (see chart, page 6). Outside the US, we expect profit growth to be the primary driver of market returns as we forecast only a small further rerating of the price/earnings ratio (P/E) in Europe and flat multiples in Asia, the emerging markets and Japan. We are forecasting further multiple expansion in the US, perhaps our most contrarian bullish call within equities. The most likely macro catalyst to prevent significant further multiple expansion this year is higher bond yields, reflecting both a pickup in global GDP growth and the Federal Reserve's decision to start tapering, or cut back on asset purchases. Even though overall global monetary policy should remain highly accommodative this year, we believe tapering could cause some volatility and uncertainty across global asset markets and help push global bond yields higher.

While the Fed is trying hard to differentiate between tapering and tightening, the gradual reduction in Quantitative Easing (QE) represents something of an inflection point in global monetary policy. We note that global equity valuations have historically tended to roll over ahead of the first Fed rate hike of a new cycle. However, the probability of a long and slow reduction in QE from the Fed, coupled with the potential for further policy easing from the Bank of Japan and the European Central Bank (ECB) and continued low global inflation trends, means that outright multiple contraction is unlikely during 2014. Other factors such as a continued asset allocation rotation into stocks and a likely pickup in mergers-and-acquisitions activity in 2014 should further support equity valuations.

During the past year, the key call across global equity markets has been to overweight developed market (DM) equities relative to emerging market (EM) equities. While the relative performance and valuations of the former are now becoming quite elevated, we believe it is too soon to rotate back into emerging markets and, hence, we reiterate our existing recommendation to overweight the developed markets and underweight emerging markets.

EM VULNERABILITY. The main reason we continue to underweight Asia Pacific ex Japan and emerging markets is the EM's vulnerabilities, which include its own subdued growth, a stronger US dollar and increases in the global cost of capital. These factors are of particular concern for Brazil, Turkey, South Africa, India and Indonesia, all of which also have parliamentary and/or presidential elections in the May-through-October period. While elections offer an opportunity for much needed structural reform, the intersect between political campaigning and Fed tapering during the second quarter suggests a period of volatility in these markets such as we saw in the summer of 2013. Further, our interest rate and foreign exchange colleagues see structural

Morgan Stanley & Co.'s 2014 Global Equity Targets

Region/Index	Base Case Price Target*	% Upside	Bull Case % Upside	Bear Case % Downside
Japan/TOPIX	1,390	7	41	-34
US/S&P 500	2,014	9	31	-18
Europe/MSCI Europe	1,480	9	40	-26
Asia Pacific ex Japan/ MSCI Asia Pacific ex Japan	545	9	40	-40
Emerging Markets/ MSCI Emerging Markets	1,080	8	41	-40

*Scenario-weighted
Source: Morgan Stanley & Co. as of Dec. 31, 2013

weakness and upward pressure in these regions that we believe will have a negative impact on P/E multiples.

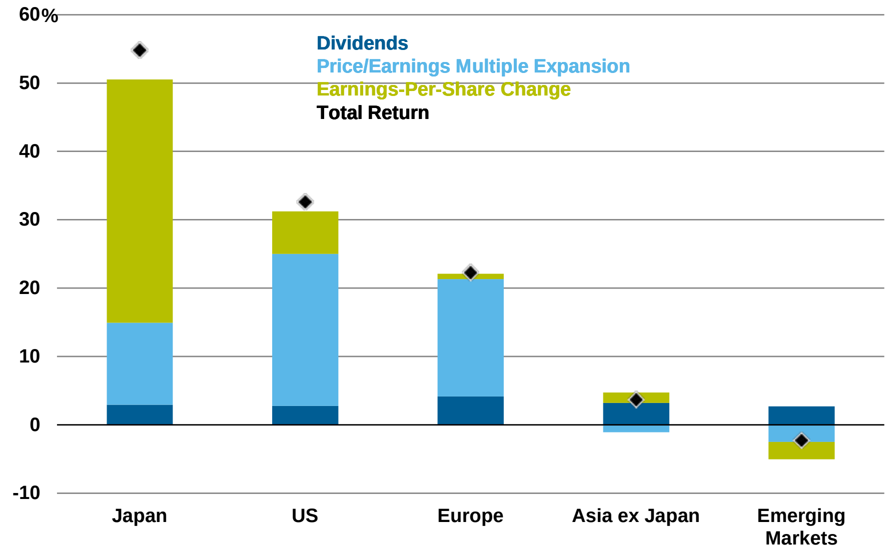
Within Asia Pacific ex Japan and the emerging markets, we have a strong preference for Australia, China, Hong Kong and Korea, which have stronger sovereign balance sheets and more resilient growth. For China there is the added dimension of the Third Plenary's reform agenda. This has surprised market expectations on the upside, most notably in relation to *hukou* permits for regional migration and one-child policy reform, as well as commitment to the deregulation of energy, water, telecom and other sectors. We therefore expect the discount in valuation between the MSCI China and MSCI Asia Pacific ex Japan /Emerging Markets indexes to narrow.

In our view, profitability will continue to be important for industry selection within EM and Asia Pacific ex Japan in 2014, given the uncertain macro and political environment. However, we think the tradeoff between EPS growth and valuation will become more important. In particular, we like EM firms with DM exposure, given our house forecast of DM growth acceleration.

BEST EARNINGS GROWTH. Japan is likely to post the strongest EPS growth in 2014 and show a return on equity that is normalizing toward the global mean. Given this, we expect further rerating. Japan is also likely to be the equity market least affected by any Fed tapering, given its own QE program. On the flip side, we have some concern over the pace of Third Arrow reform, which appears to be slowing in areas such as medicine and corporate governance. Japan's economy also has to negotiate the 3% consumption tax hike in the second quarter, highlighting potentially greater downside risks to the market than we see in the US.

Since last March, we have been sanguine on US equities. Our logic has been driven more by the lack of a bear case than the strength of the base case (see *2,014 in 2014*, page 7). We have seen three turns (to 15.1 from 12.0) of multiple expansion in the past two years—only the fourth such period over the last four decades. Obviously, a sample size of three isn't statistically significant, but the prior three periods were all followed by a continued rally for another 12 to 24 months, as momentum typically lasts longer than people expect.

Deconstructing 2013's Global Equity Market Returns



Source: MSCI, IBES, Morgan Stanley & Co. Research as of Dec. 31, 2013

FRAGILE RECOVERY. A weak and fragile economic recovery suggests that Europe is perhaps most vulnerable to any significant increase in global bond yields this year.

However, the region's return on equity is close to a 20-year low relative to global equities and hence may have the greatest operational leverage into an improving global macro backdrop. A better top-line environment, coupled with the first margin increase in three years, should finally see European EPS start rising again. If our 2014 top-down forecast of 10% EPS growth for Europe is correct, this is likely to be the first time in five years that European EPS growth exceeds that seen in the US.

In addition, there is scope for Europe's perceived risk premium to fall further as the ECB embarks on its push toward greater banking union and as global investors reallocate funds to the region. The liquidity associated with the latter is putting downward pressure on peripheral bond yields and bank funding costs, which in turn increases the perception that Europe is healing. As a result, we are raising our base-case 12-month P/E target to 13.6 from 12.5; the current reading is 13.1. Within Europe, we are overweight financials as they offer the lowest normalized valuations across the market. We are also overweight the technology and pharmaceuticals sectors. We are underweight consumer staples, energy, materials and utilities. At the country level we prefer Spain over Italy and Germany over France. ■

Our S&P 500 Forecast: 2,014 in 2014

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US Equity Strategist
Morgan Stanley & Co.

Our 2014 forecast for the S&P 500 Index is 2,014 (see table). That may look like a big number, but it doesn't take a giant leap to get there. It represents 9% potential upside from the 2013 close, driven by our estimate of 6% operating earnings growth, net 3% share repurchases and modest expansion of the forward price/earnings (P/E) multiple. Relative to our prior view, this represents about a 0.8 turn more in the P/E multiple—and there is potential for more. The low dispersion of price/forward earnings and higher company-specific risk lead us to conclude that a more concentrated portfolio will be prudent this year.

MULTIPLE EXPANSION. Since last March, we have been sanguine on US equities. Our logic has been driven more by lack of a bear case than the strength of the base case. We have seen three turns of multiple expansion in the last two years as the P/E moved to 15.1 from 12.0—only the fourth period with this level of expansion over the past 40-plus years. Obviously, a sample size of three isn't statistically significant, but the prior three periods were followed by a continuation of the rally for another 12 to 24 months, as momentum typically persists. The only thing people are worried about currently is that no one is worried about anything, which isn't a real worry.

In order to time the impossible—the inflection point—we remain focused on what could cause fear about a materially lower earnings trajectory, or even what could introduce volatility into the earnings estimates. The answer: not much right now. We need to see more capital spending, hiring, inventory and mergers-and-acquisitions activity in order to be more fearful of a material earnings decline as these costs get put in place and turn out to be imprudent. We would look for backlog extensions from the technology and industrials companies or increases in book-to-bill ratios as signs demand is improving and spending is imminent. The most pronounced risks remain: demand weakness in the emerging markets, which has been indicated by some large US multinationals; a policy error from the Federal Reserve; and a strengthening dollar, which can be a drag on profits earned overseas by US companies.

Morgan Stanley & Co.'s 12-Month US Equity Targets

Earnings Landscape	Probability of Scenario	2013E	2014E	2015E	P/E Ratio	Target	Upside/ Downside
Bull Case	20%	$111.50	$122.60	$134.90	17.9	2,414	30.6%
Growth		*8%*	*10%*	*10%*			
Base Case	60%	$109.40	$116.00	$122.90	16.4	2,014	9.0%
Growth		*6%*	*6%*	*6%*			
Bear Case	20%	$107.30	$102.00	$102.00	14.9	1,519	-17.8%
Growth		*4%*	*-5%*	*0%*			
S&P 500						1,848	

Source: Thomson Reuters, Morgan Stanley & Co. as of Dec. 31, 2013

ABOVE CONSENSUS. With a 2% dividend yield, a 3% net buyback and mid-single-digit earnings growth, a big down market is akin to calling for a double-digit contraction in the market multiple. We don't think that's likely. We are still optimistic and wouldn't be surprised to see the S&P 500 remain robust. Our target for 2014 will likely be above Wall Street's consensus. The dream of a steeper yield curve, a belief that the Fed can distinguish between tapering and tightening and the lack of a credible bear case in earnings could drive further multiple expansion. Upside from economically stronger China and Japan could also help. In fact, it isn't preposterous to say that we could be in an environment of synchronous global economic expansion in 2014 that isn't fully in today's prices.

At the sector level, we are upgrading materials to overweight from equal weight, a move driven by chemicals. We are also downgrading industrials to equal weight from overweight and lowering energy to underweight from equal weight. In addition, our strategy recommendations include a preference for small caps over large caps and we recommend a barbell-like approach, holding both cyclical and defensive companies. We prefer health care to consumer staples, technology to consumer discretionary and chemicals to industrials and energy. Within financials, we prefer capital-market-sensitive banks and asset managers over insurers and regional banks. ■

Trading Less Often May Return More

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Investors should be quite pleased with their recent gains as the S&P 500 delivered a 32% total return (price appreciation plus dividends) in 2013, the index's best performance since 1997. Over the past three years, the S&P has gained 56%, which is about 16% on an annualized basis. Yet, studies have shown that individual investors' results often lag market averages due in good part to poor market timing—or coming into and going out of the market at the wrong times—management fees and taxes.

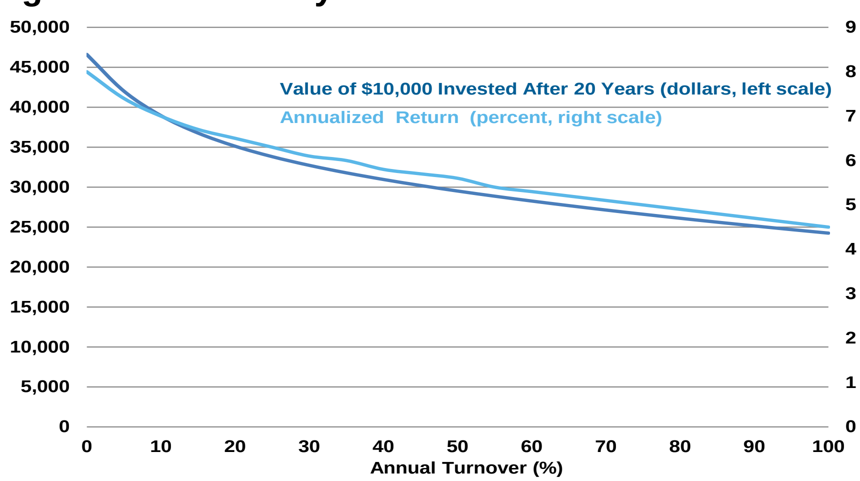
That's why it's important to think about aftertax returns. For instance, in our Strategic Equity Portfolio (STEP) Program, we emphasize "buy and hold" investing rather than frequent trading, thus reducing the realized capital gains, particularly the short-term capital gains rate on investments held for less than a year, which can be a significant drag on performance. In a taxable account, every trade is potentially a taxable event.

HIGHER TAX RATES. You may not realize it until you file your taxes, but tax rates on investments did increase meaningfully last year for households earning more than $250,000. (The 2014 rates are unchanged, though the brackets crept up due to cost-of-living adjustments.) Taxes can absorb a significant portion of investor gains, particularly short-term gains. Thus, limiting portfolio turnover—the percentage of a portfolio that changes over in a year—can significantly enhance outcomes for investors, in our view.

Turnover can be an issue with mutual funds. Over the past 20 years, the asset-weighted annual turnover rate for US equity mutual funds has averaged 62%, according to the Investment Company Institute. That rate implies an average 19-month holding period for a stock. Some mutual funds experience turnover rates of 80% or 100%, or even higher. In contrast, equity STEP portfolios have averaged 37% turnover since inception, and just 31% or so over the past two years. The implied average holding period for each stock is a little more than three years.

TURNOVER'S IMPACT. It is difficult to estimate how much a given client's aftertax performance can be enhanced by a lower-turnover strategy because such a calculation would depend on specific circumstances such as the timing of client cash flows and individual returns, but we believe it could be meaningful over time. For instance, the chart at left simulates the 20-year aftertax return of a strategy returning 8% per year before taxes, adjusting for varying annual turnover rates. Based on a hypothetical $10,000 investment, we estimate that with 60% annual turnover, the investment would grow to $28,300 after 20 years. That's a 5.3% average annual return. Cut the turnover in half, and the $10,000 becomes $32,700—a 6.1% average annual return. In other words, the results are 15% greater, illustrating why maintaining moderate turnover is one of our key investing principles. ■

Higher Turnover May Produce Lower Returns



Note: This chart shows the aftertax impact of turnover on a hypothetical portfolio that earns 8% per year over 20 years, a 23.8% long-term capital gains tax rate and a 43.4% short-term capital gains tax rate. The higher the turnover, the more capital gains taxes investors pay.
Source: Morgan Stanley Wealth Management

Federal Capital Gains Tax Rates for 2013*

Family Income ($000)	Short-Term Capital Gains	Long-Term Capital Gains & Dividends
< $250	33.0%	15.0%
$250 - $398	36.8%	18.8%
$398 - $450	38.8%	18.8%
> $450	43.4%	23.8%

*For couples filing jointly. Rates include the 3.8% Medicare surtax on modified adjusted gross income greater than $250,000.
Source: Tax Foundation

"A Much Better Feel About Europe"

Evidence is increasing that economic conditions in Europe are improving, according to Stephen Peak, portfolio manager of the Henderson European Focus Fund. "There's a much better feel about Europe," he explains. "People can see the macro developments," which Peak believes is helping to reverse the flow of assets. What's more, those buyers who are returning to the region are finding opportunities to own stocks at more reasonable valuations—especially in economically sensitive sectors. Peak recently discussed his outlook with Morgan Stanley Wealth Management's Tara Kalwarski. The following is an edited version of their conversation.

TARA KALWARSKI (TK): What is your outlook for European stocks?

STEPHEN PEAK: (SP): One thing that seems certain is: Things are "less worse." If you want to spin that another way, you can say they're getting better. We've been through a period in which people, including American investors broadly, have sort of given up on Europe. They saw the headlines: Greek crisis, turbulence in the Euro Zone, etc. We're all human; we see these things and it gives us a natural aversion. What we've seen in the last few years is that investors have either sold down their European positions or, in some cases, sold out completely. They felt that Europe was unsuitable for investment and they couldn't possibly have any money there. "It's over. Let's go somewhere else." That is in the process of changing. I think the change has been triggered by the headlines changing from crisis to recovery.

Europe is still a big market. It's two-thirds of the international market by capitalization. Investors are now starting to scratch their heads and say: "You know what? We've been out of this market. We've been low in this market. We had really good US returns during the last few years, with the market reaching all-time highs. Maybe we should go back and think about Europe again." Things are past the worst. European markets are nowhere near their highs. If you look at index levels, European stocks would need to rise approximately 30% to get back to their all-time highs. That doesn't mean they will, but it's an interesting contrast to the US.

TK: What do valuations currently look like versus US stocks?

SP: Price/earnings ratios (P/Es) in Europe are lower, but you need to adjust for the economic cycle. The cycle in the US has been more extended, while Europe is in a depressed state. You need to adjust for that in terms of your earnings prognosis. We think the US is trading roughly at, or just above, its long-term average in cyclically adjusted P/Es. Pretty much all the markets in Europe are trading at distinct discounts to their long-term P/Es. If you map them relative to the average US P/E of the past 30 years, the line goes from top left to bottom right, so we are trading in heavily discounted territory.

Based on the ratio of price to book value, broadly speaking, it's the same shape of curve. Go back 30 years and the chart in relative price to book values, in Europe versus the US, goes from top left to bottom right. That doesn't mean the line will go up, but this should give investors some comfort. They're not paying top dollar. They're getting something at a discount, with the potential for the discount to narrow. In terms of the risk/reward dynamic, you're not buying something that's just traveled and been world's best. You're buying something that's moved off its low but whose valuation metrics offer appeal and should have a margin of safety.

The other factor that I think is relevant is the asset flows, or the process of people reassessing their portfolios and looking at Europe and saying that it has become suitable for investment again. People have been underweight or absent, and they're starting to rectify that. We see that in our business and we think the process is not complete. There is more to come. We think the flows into Europe mutual funds are likely to continue. On a demand/supply basis, that probably adds fuel to the potential upside of the markets.

TK: Can you discuss your strategy and how you go about identifying attractive opportunities?

SP: I'm very much a bottom-up investor, and I'm agnostic about style and market capitalization. When I'm looking at stocks, I'm looking to paint a picture of potential upside. I'm looking for an outlook for business that I believe in, that I think is mispriced, whether it's on a multiple basis or a growth basis or whatever it may be. I'm looking to imagine and work out the potential in the stock over the next 12 to 24 months. If there's sufficient upside in which I have conviction, then that company's a clear candidate for the fund.

TK: Can you tell me about your current positioning?

SP: There are no deliberate concentrations in particular sectors or regions but, if you do a snapshot of our holdings right now, the biggest allocation is to the UK. That doesn't mean that I think the UK economy has the best outlook, just that most of the best ideas that I can find are companies listed in London. Second up is Germany. Third up is Spain right now. It's quite a diverse mix. I'm looking to have a range of exposures geographically rather than having all of my eggs in one basket.

I think what people tend to struggle with sometimes is that they think that if they're investing in a Europe fund, they're investing in European gross domestic product. That is clearly not the case. We're investing in the shares of European companies, which may be exposed to a number of European markets or to global markets—particularly in the example of multinationals.

TK: What sectors look appealing, and which are you avoiding?

SP: I have been building up exposure to the financial sector over the last 12 months. We think that European recovery has started and will gradually get stronger and more stable. As happened in the US, the European financial sector is recuperating. It's going through a healing process. In tandem with a better macro outlook, it seems likely that the financial sector is going to respond.

Another area that I like is consumer discretionary, which is also a play on recovery as, perhaps, employment prospects get better across the region.

Areas that I don't like, which is just as important to consider, include consumer staples, a sector that has done well in the last few years, primarily because some of the bigger companies have very little to do with Europe. They have exposure to emerging markets, which have grown faster, but conditions there have become more difficult and some of the consumer staples companies are finding it more difficult to grow their earnings; their multiples have expanded and they look expensive to me. I'm very light in that area and prefer companies elsewhere. I've probably tilted the portfolio in the last six to nine months to focus more on the European economy in the expectation that companies exposed to Europe will have a slightly better time of things, certainly versus recent history. We've been adding industrials and financials in Europe, but also companies that may be global but have a predominant emphasis on Europe.

TK: What developments might indicate that your thesis about European recovery is incorrect?

SP: I believe that we're starting to see pockets of recovery, but if that's wrong and Europe stagnates and slips back into recession, the argument of financial recuperation would be damaged. That would be one thing I would watch very closely. The other thing we need to watch very closely is best described as regulatory risk. Regulators around the world have been demanding that banks have more of a buffer and improve their capital ratios. If they make further demands for banks to be better capitalized and then even more capitalized beyond that, that's got some potential negative ramifications because it means they need to issue equity, and that's dilutive. The bad combination would be we're wrong on economic progress and regulators are more harsh and demanding and companies need to issue more paper.

TK: What do you think could surprise on the upside?

SP: The big surprise could be at the corporate level. We don't buy GDP, we buy shares of companies. My suspicion is that Europe's GDP is not going to boom; it's just going to get better. If that's right, in terms of the earnings prognosis for companies, you'll have that specter of operating leverage coming through. In other words, if a company can grow its top line by 1%, then earnings per share will grow by more than 1%.

Generally speaking, I think analysts tend to underestimate the inflection point and they tend to underestimate the potential for earnings per share because they misconstrue or are overly conservative on operating leverage. That would mean the earnings prognosis for Europe at the company level is actually better than we currently think. We don't think it will be very dramatic over all, but in certain instances it will be. That's one of the things that I'm looking at in terms of my stock selection: companies with operating leverage. ■

Stephen Peak is not an employee of Morgan Stanley Wealth Management. Opinions expressed by him are solely his own and may not necessarily reflect those of Morgan Stanley Wealth Management or its affiliates.

Ready for Higher Rates and Higher Volatility

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With the lion's share of postshutdown economic data reported and the Federal Open Market Committee (FOMC) finally pulling the trigger on tapering, we believe the US Treasury bond market will be mainly influenced by how the US economy is faring as compared with expectations about its performance.

Globally speaking, Morgan Stanley & Co. economists have characterized 2014 as "sounder, safer and more sustainable" as compared with 2013's "bumpy, below par and brittle." From a US vantage point, recent data have suggested the shutdown/debt ceiling saga had no lingering effects and that the private sector seems to be building momentum. On balance, the recent budget deal appears to be positive, as it reduces some fiscal drag in 2014 and removes future uncertainty by funding the government for two years. Easing fiscal restraint appeared to be a factor that led the Fed to start tapering.

FED COMMUNICATIONS. With new leadership at the Fed imminent, the markets got a glimpse of a new policy twist at the December FOMC meeting: enhanced rate guidance. This communication tool is meant to be a more powerful policy instrument and provide a better map to the timing of the first increase in the federal funds rate. That addresses a major problem in last year's "taper talk:" The markets linked reduced asset purchases to a pushed-up timetable for hiking rates. Looking at the recent behavior of short-term US Treasuries, it appears as if the Fed has had more success in separating tapering from tightening than it did earlier in the spring and summer. Still, the Fed will have a tough job if new economic data surprises to the upside.

As for interest rates, our base case sees the yield on the 10-year US Treasury rising above 3.00% and moving to 3.25%. Our base case sees a slight increase in the two-year US Treasury yield, heading north of the September high of 0.52%. Overall, however, we envision the US Treasury yield curve modestly steepening.

CREDIT LIKELY OUTPERFORMS. We still believe curve positioning will continue to be a key driver of returns and that shorter maturities will outperform longer maturities for at least the first half. We also believe corporate bonds will continue to outperform rate-sensitive products as investors look for income opportunities. For now, investors will be using last year's playbook, given the ongoing dual headwinds of rising rates and relatively rich valuations.

Speaking of valuations, spreads in investment grade and high yield credit markets were tighter by 27 basis points and 119 basis points, respectively, in 2013. The Citi US Broad Investment Grade Corporate Index is currently trading with a spread of 113 basis points over similar-duration Treasuries, while the Citi High Yield Market Index is trading with a spread of 414 basis points over Treasuries; these are the lowest spreads we have seen since 2007.

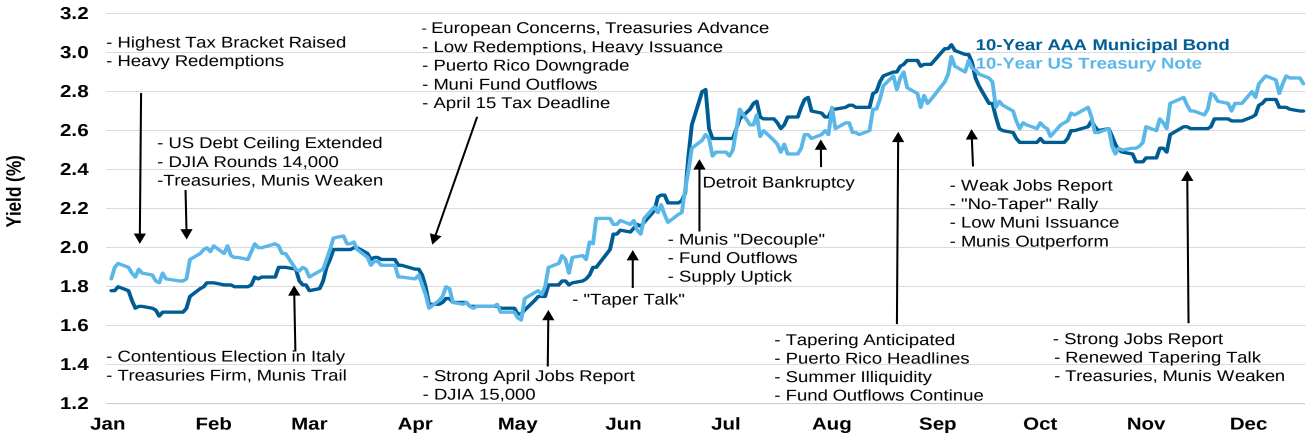
LIMITED UPSIDE. Based on these valuations, we believe there is limited upside in both asset classes. To estimate just how much, we considered possible returns under base, bull and bear scenarios (see table).

Our Fixed Income Scenarios for 2014

	Base Case	Bull Case	Bear Case
Two-Year US Treasury Yield (%)	0.55	0.25	1.00
10-Year US Treasury Yield (%)	3.25	2.25	4.00
	Total Return (%)		
US Treasury			
One-to-Five Years	0.71	1.62	0.25
10-Plus Years	-4.03	14.28	-11.65
US Govt.-Sponsored			
One-to-Five Years	0.80	1.76	0.33
10-Plus Years	-1.24	10.90	-6.62
Credit			
One-to-Five Years	1.48	2.58	0.93
10-Plus Years	-0.84	12.92	-6.23
High Yield			
One-to-Seven Years	4.99	6.28	4.24
10-Plus Years	3.18	12.69	-1.17

Source: Morgan Stanley Wealth Management as of Dec. 17, 2013

In 2013, Volatility Increased in US Treasuries and Municipal Bonds



Source: Thomson MMD as of Dec. 17, 2013

Under the base scenario, the yield curve goes through a modest bear steepening—yield curve moves higher but the move is greater in long-term yields than in short-term yields—the yield on the 10-year rises to roughly 3.25% while the two-year Treasury moves up to 0.55%, which is only 17 basis points above the current level. In the bull scenario, the yield curve undergoes a bull flattening—the yield curve moves lower but the move is greater in the long-term yields than in the short-term yields—as the 10-year drops to 2.25% while the yield on the two-year drops to 0.25%. Finally, in the bear scenario the 10-year rises to 4.0% and the two-year moves up to 1.0%, causing a sharp bear steepening. In all scenarios, both short- and long- duration* investment grade and high yield generally outperform Treasuries and government-sponsored debt.

This analysis helps inform our view that investors will be able to generate better returns at the short end of the yield curve and credit will likely outperform. We believe this year the broad investment grade and high yield markets will generate returns of roughly 0% to 1% and 3% to 4%, respectively, based on coupon income and modest spread tightening offset by rising yields and falling prices.

MUNI VOLATILITY. During the past year, municipal bond investors, like those in the taxable market, faced interest rate volatility—something that is likely to continue in 2014 (see chart). However, as with taxable bonds, prudent positioning on the yield curve and coupon structure helped mitigate some of the pain from rising rates.

The increased market volatility unlocked value. Credit spreads for both A-rated and BBB-rated bonds remain distended. That said, we think it is still worthwhile to play defense for those concerned about price volatility and selective offense for those with the patience to target value and see it through. For now, investors should lock in short-to-intermediate muni bonds in the four-to-nine-year maturities.

MARKET IMPROVEMENTS. The best news for muni investors is that we see continued improvement in credit quality, state revenues and housing prices. True, some high-profile issuers have legacy credit hurdles and some defaults may surface, but we view these as important but isolated events in an improving environment. Outflows from muni mutual funds persisted for most of 2013, and we expect this trend to continue until rates rise, perhaps in the 3.0%-to-3.25% range.

Finally, the risk of tax reform will likely continue. We place the odds of an adverse development for munis at no more than 20%. Recall that the top federal tax rate reverted back to 39.6% in 2013, many states have increased tax rates in recent years and municipal bonds are not subject to the 3.8% Medicare surtax. When prudently executed, the case for tax-exempt municipal bonds remains strong. ■

*Duration, the most commonly used measure of bond risk, quantifies the effect of changes in interest rates on the price of a bond or bond portfolio. The longer the duration, the more sensitive the bond or portfolio would be to changes in interest rates. Generally, if interest rates rise, bond prices fall and vice versa. Longer-term bonds carry a longer or higher duration than shorter-term bonds; as such, they would be affected by changing interest rates for a greater period of time if interest rates were to increase. Consequently, the price of a long-term bond would drop significantly as compared with the price of a short-term bond.

Investing With Impact: Social, Environmental and Financial Values

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Many investors may be familiar with the term "socially responsible investing (SRI)," an approach to investing that encourages responsible environmental, social, consumer, human rights and diversity policies. SRI strategies typically involve negative screening to weed out companies in select industries, such as alcohol and tobacco. Within Morgan Stanley & Co.'s "Investing With Impact" framework, SRI falls under the Values Alignment category. The other categories are Environmental, Social and Governance (ESG) Integration; Sector Exposure; and Impact Investing.

So, what is different here? Historically, SRI investing has been a way for investors to avoid certain industries or companies that were not aligned with their values. The ESG Integration framework, for instance, takes things a step further by potentially allowing investment managers to more effectively identify important drivers of longer-term risks and returns. As a result, some investment managers have begun looking toward ESG Integration as a way to more fully evaluate companies and potentially find attractive investment opportunities. The sector-exposure category is more focused, targeting specific themes or niches, such as solar energy or clean-water technologies. Impact investing is the most direct way of trying to effect positive social or environmental change, but that channel is typically addressed through private equity or hedge funds.

The Investing With Impact framework is part of the investment industry's embrace of socially responsible investing. The industry's increasing commitment to such goals is evidenced by the growing number of signatories to the United Nations Principles for Responsible Investment. Globally, approximately $34 trillion is managed or advised by these signatories. According to a 2012 report from the United States Forum for Sustainable and Responsible Investment, about $3 trillion of professionally managed assets in the US investment marketplace are managed "responsibly."

Each individual investment process is different and performance results will vary by strategy. However, we find that indexes with ESG guidelines have generally performed well versus broad market indexes like the S&P 500 (see table, page 14). ESG is not as developed on the fixed income side; in looking at recently created indexes that incorporate ESG guidelines, there is some evidence suggesting ESG Integration can help mitigate losses in challenging market environments, while overall returns were fairly similar to non-ESG index returns.

ESG Integration

ESG Integration has particular significance to the investment industry. A number of managers are employing the technique as both a means of aligning values and a way to potentially identify more attractive investment opportunities, and the proper management of ESG issues can significantly affect company profitability and thus share price. Although it is still an evolving area of investment management, a study by the Global Sustainable Alliance estimates there are nearly $14 trillion in assets managed using ESG globally, or around 20% of the assets managed in the regions covered by the study.

Investors utilizing ESG Integration methodologies have traditionally focused on public equities, but utilizing ESG factors can help identify risks that could have a material impact on bond issuers. Examples of these risks include those that are credit related, liquidity related, regulatory, legal and even reputational. ESG principles also can potentially help investment managers construct lower-risk bond portfolios and preserve client capital. While traditional stock and bond research and analysis is generally effective in identifying shorter-term risks, longer-term risks associated with high impact and low frequency events are much more difficult to model and forecast.

Increasing numbers of investment managers are creating specific ESG-branded investment products, and some traditional money managers have begun incorporating ESG principles into their investment processes as well. For example, PIMCO became a signatory to the UN PRI, which was formulated by the investment community and takes the view that ESG issues can affect financial returns and therefore should be considered when making investment decisions. According to the PRI Association, there are currently more than 1,200 signatories to the principles.

ESG Index Returns

Index	Return* (%) 3-Yr.	5-Yr.	Risk**
MSCI USA Large Cap ESG	15.0	9.3	17.9
S&P 500	5.0	10.0	18.1
Return Difference	10.0	-0.7	
MSCI USA Mid Cap ESG	18.0	14.1	21.5
Russell Mid Cap	17.5	13.0	21.7
Return Difference	0.5	1.2	
MSCI USA Small Cap ESG	18.4	12.2	24.2
Russell 2000	18.3	11.2	24.0
Return Difference	0.2	1.0	
MSCI EAFE ESG	9.8	7.7	22.1
MSCI EAFE	9.0	6.9	22.2
Return Difference	0.8	0.9	
MSCI World Ex USA ESG	9.3	7.5	22.1
MSCI World Ex US	8.4	6.6	22.1
Return Difference	0.9	0.9	

*Average annual **Standard deviation
Source: Morningstar, Consulting Group Investment Advisor Research as of Sept. 30, 2013

Environmental

Public companies can benefit from operating in an environmentally friendly manner or, in the case of carbon-related industries, from making a concerted effort to reduce the environmental impact of their products and mitigating operational risk. Companies in the oil and gas sector, especially those in higher-risk operations such as offshore drilling, benefit from embracing stringent safety standards that may exceed federal regulations, as the damage caused by oil spills and related accidents expose these companies to substantial financial costs and lower equity valuations.

In response to demand from consumers seeking to reduce their environmental footprint and in pursuit of profit growth, auto companies continue to develop a wide range of alternative-fuel vehicles. Makers of consumer products, concerned over limited water resources, work to educate their customers and also change their manufacturing processes to better manage water use.

The environmental management of bond issuers is relevant to bond investors as it has direct value implications. A study by the European Centre for Corporate Engagement found that regulatory, legal and reputational risks associated with environmental incidents lead to increased financing costs and lower credit ratings. Conversely, companies with a history of practicing proactive environmental policies were associated with a lower cost of debt.

The costly fines, awards and clean-up that go along with environmental violations can threaten the financial viability of issuers. In addition, in the event of default, bond holders may find their claims are subordinated by an issuer's environmental liabilities due to US legal and regulatory law.

Social

Aspects of social-management policies that can increase risk include workplace issues related to diversity, health, safety and labor relations. Class-action lawsuits stemming from these issues not only result in costly litigation and potential awards but can also damage brand reputation.

Community impact is another area of which investors need to be conscious. Negative impact can damage brand loyalty and possibly affect the ability of an issuer to operate in the manner they are accustomed to should new rules and regulations be imposed.

Governance

Strong corporate governance has now become a common risk factor that many investment managers use in stock selection. Company management teams are usually the first to be credited when the company does well—and vice-versa. Having senior leadership that is transparent, shareholder friendly and risk focused has been shown to be positive for share prices. Some investment managers will invest in a company due to their familiarity and confidence in the corporate governance.

Bond issuers that practice strong corporate governance implement appropriate rules around corporate actions such as mergers and acquisitions, and they generally emphasize a culture of strong risk management, shareholders' rights, transparency and responsibility to employees and stakeholders.

Some believe that stronger corporate governance could have helped mitigate the severity of the financial crisis in 2008. Although corporate governance did not directly cause the crisis, lax control mechanisms may have contributed to excessive risk taking. Companies with strong corporate governance are typically managed in a more sustainable manner. Thus, individual-company bankruptcy risks (default risk) may be reduced, as well as overall systemic risks.

The Investor Responsibility Research Center highlights 24 provisions of corporate governance with relative importance for the benefit of management, which may be valuable to shareholders. A study by Bebchuk, Cohen and Ferrell published in Harvard Law School's *Review of Financial Studies* identifies six of those provisions as having the most meaningful impact and correlation with lower firm valuations and returns. Those provisions are: staggered boards, limits to shareholder amendments of the bylaws, supermajority requirements for mergers, charter amendments, poison pills and golden-parachute arrangements. When screening for only these six provisions, companies that ranked highly for corporate governance outperformed those ranked worst by more than 12%. ■

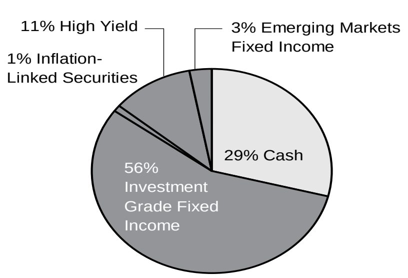
**Standard deviation is a measure of the dispersion of a set of data from its mean. The more spread apart the data, the higher the deviation. Standard deviation is applied to the annual rate of return of an investment to measure the investment's volatility. Standard deviation is also known as historical volatility and is used as a gauge for the amount of expected volatility.

Global Investment Committee Tactical Asset Allocation

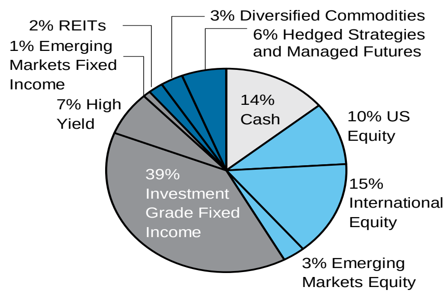
The Global Investment Committee provides guidance on asset allocation decisions through its various model portfolios. The eight models below are recommended for investors with up to $25 million in investable assets. They are based on an increasing scale of risk (expected volatility) and expected return. Hedged strategies include hedge funds and managed futures.

CONSERVATIVE >>> MODERATE >>>

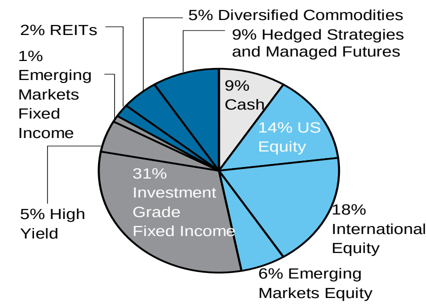
MODEL 1



MODEL 2

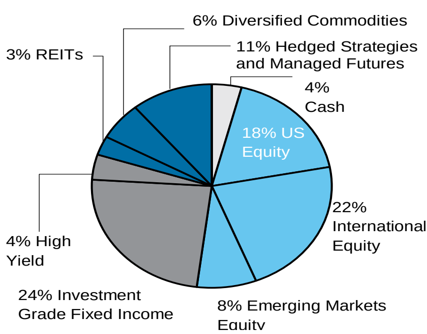


MODEL 3

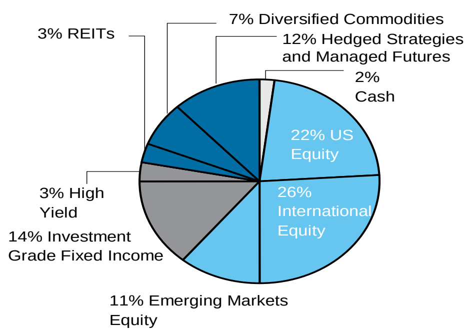


MODERATE >>> >>>

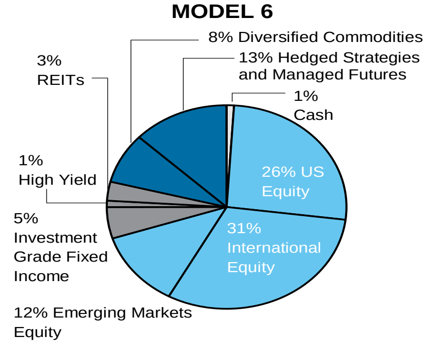
MODEL 4



MODEL 5

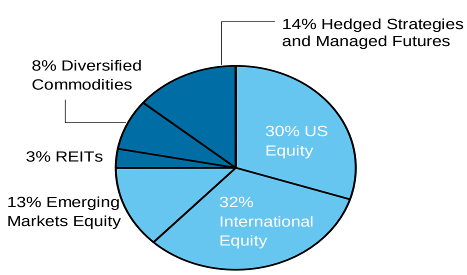


MODEL 6

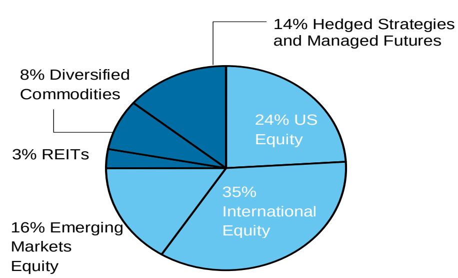


AGGRESSIVE >>>

MODEL 7



MODEL 8



KEY

- CASH
- GLOBAL FIXED INCOME
- GLOBAL EQUITIES
- ALTERNATIVE INVESTMENTS

Note: Hedged strategies consist of hedge funds and managed futures.

Tactical Asset Allocation Reasoning

Global Equities	Relative Weight Within Equities	
US	Equal Weight	While US equities have done exceptionally well since the global financial crisis, they still offer attractive upside potential, particularly relative to bonds. We believe the global economy continues to heal from the financial crisis, making recession neither imminent nor likely in 2014. This is constructive for stocks.
International Equities (Developed Markets)	Overweight	We maintain our bias for Japanese and European equity markets given the political changes taking place in Japan and the improving economic outlook in Europe. Japan outperformed the US last year and Europe was very strong in the second half. We believe that Japan and Europe will continue to perform well in 2014 because of their more nascent economic and earnings recoveries.
Emerging Markets	Underweight	Emerging markets have been disappointing. Policy remains too tight in major countries, both voluntarily (China) and involuntarily (India and Brazil). The beginning of Quantitative Easing (QE) is also likely to have a disproportionately negative impact on emerging market equities.

Global Fixed Income	Relative Weight Within Fixed Income	
US Investment Grade	Overweight	We have recommended shorter-duration (maturities) since March given the potential capital losses associated with the rising interest rates from such low levels. Yields have risen since then, but not enough for us to change that advice. Within investment grade, we prefer BBB-rated corporates and A-rated municipals over US Treasuries.
International Investment Grade	Equal Weight	Yields are low globally, so not much additional value accrues to owning international bonds beyond some diversification benefit.
Inflation-Linked Securities	Underweight	We have been underweight inflation-linked securities since March, given negative real yields across all maturities. Recently, these yields have turned modestly positive but remain unattractive in our view, due to the longer-duration characteristics of TIPS.
High Yield	Equal Weight	Yields and spreads are near record lows. However, default rates are likely to remain muted as the economy recovers slowly, keeping corporate and consumer behavior conservative. We prefer shorter-duration and higher-quality (B to BB) issues and vigilance on security selection at this stage of the credit cycle.
Emerging Market Bonds	Underweight	We reduced our weighting to equal weight from overweight in March due to record-low spreads and yields. Similar to emerging market equities, we recently moved to underweight on the basis that tapering of QE will likely be a disproportionate headwind for emerging market debt relative to other debt markets.

Alternative Investments	Relative Weight Within Alternative Investments	
REITs	Equal Weight	Rising interest rates explain most of the poor performance since May. At current levels, we believe REITs are fairly valued and offer select opportunities. The industrial and commercial segments tend to outperform at this stage of the recovery. International REITs should also be favored relative to domestic REITs at this point in the cycle.
Commodities	Equal Weight	Commodities performed poorly this past year as: real interest rates rose; China maintained tight monetary and fiscal policies; and the US dollar strengthened. Recent stabilization in China and new growth initiatives may help near-term performance. Commodities provide some ballast to a traditional equity/bond portfolio.
Hedged Strategies (Hedge Funds and Managed Futures)	Equal Weight	This asset class can provide uncorrelated exposure to traditional risk-asset markets. It tends to outperform equities when growth slows and works well in more challenging financial markets.

Index Definitions

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.

DOW JONES INDUSTRIAL AVERAGE A widely followed indicator of the stock market, the Dow is a price-weighted average of 30 blue-chip stocks that are generally the leaders in their industries.

TOKYO STOCK EXCHANGE INDEX (TOPIX) This free-float-adjusted index tracks all domestic companies of the exchange's First Section.

MSCI EUROPE INDEX This free-float adjusted capitalization-weighted index is designed to measure the performance of 16 developed European markets.

MSCI ASIA PACIFIC EX JAPAN INDEX This is a free-float-adjusted, market-capitalization weighted index that is designed to measure the markets in the Asia Pacific regions except for Japan.

MSCI EMERGING MARKETS INDEX This is a free-float-adjusted market-capitalization index that is designed to measure equity market performance in the global emerging markets.

CITI US BROAD INVESTMENT GRADE CORPORATE INDEX This index is designed to track the performance of US dollar-denominated bonds issued in the US investment grade bond market. The index includes institutionally traded US Treasury, government-sponsored, mortgage-backed, asset-backed and investment grade securities.

CITI HIGH YIELD INDEX This index captures the performance of below-investment-grade debt issued by corporations domiciled in the US and Canada. This index includes cash-pay and deferred-interest securities. All the bonds are publicly placed, have a fixed coupon and are nonconvertible. Bonds issued under Rule 144A are included in their unregistered form.

MSCI USA LARGE CAP INDEX This free-float adjusted capitalization-weighted index consists of the 300 largest US stocks by market cap.

MSCI USA MID CAP INDEX This free-float adjusted capitalization-weighted index consists of the next 450 largest US stocks by market cap.

MSCI USA SMALL CAP INDEX This free-float adjusted capitalization-weighted index is designed to measure the performance of the small-cap segment of the US equity market. It has approximately 1,750 stocks.

MSCI EAFE INDEX This free-float adjusted capitalization-weighted index is designed to measure the equity market performance of the developed markets outside of the US and Canada.

MSCI WORLD EX US INDEX This free-float adjusted capitalization-weighted index, which excludes the US, captures the large-cap and mid-cap representation across 22 developed markets.

RUSSELL MID CAP INDEX This capitalization-weighted index measures performance of 800 companies with an average market capitalization of $6.7 billion.

RUSSELL 2000 INDEX This capitalization-weighted index measures the performance of the 2000 smallest companies in the Russell 3000 Index. The average market capitalization is $1.3 billion.

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International investing entails greater risk, as well as greater potential rewards compared to U.S. investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economies.

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.

Managed futures investments are speculative, involve a high degree of risk, use significant leverage, have limited liquidity and/or may be generally illiquid, may incur substantial charges, may subject investors to conflicts of interest, and are usually suitable only for the risk capital portion of an investor's portfolio. Before investing in any partnership and in order to make an informed decision, investors should read the applicable prospectus and/or offering documents carefully for additional information, including charges, expenses, and risks. Managed futures investments are not intended to replace equities or fixed income securities but rather may act as a complement to these asset categories in a diversified portfolio.

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.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

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.

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.

Value investing does not guarantee a profit or eliminate risk. Not all companies whose stocks are considered to be value stocks are able to turn their business around or successfully employ corrective strategies which would result in stock prices that do not rise as initially expected.

Growth investing does not guarantee a profit or eliminate risk. The stocks of these companies can have relatively high valuations. Because of these high valuations, an investment in a growth stock can be more risky than an investment in a company with more modest growth expectations.

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.

Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

Investing in smaller companies involves greater risks not associated with investing in more established companies, such as business risk, significant stock price fluctuations and illiquidity.

Stocks of medium-sized companies entail special risks, such as limited product lines, markets, and financial resources, and greater market volatility than securities of larger, more-established companies.

Interest income from taxable zero coupon bonds is subject to annual taxation as ordinary income even though no interest payments will be received by the investor if held in a taxable account. Zero coupon bonds may also experience greater price volatility than interest bearing fixed income securities because of their comparatively longer duration.

Investing in foreign emerging markets entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks.

REITs investing risks are similar to those associated with direct investments in real estate: property value fluctuations, lack of liquidity, limited diversification and sensitivity to economic factors such as interest rate changes and market recessions.

Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

The indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment.

The indices selected by Morgan Stanley Wealth Management to measure performance are representative of broad asset classes. Morgan Stanley Wealth Management retains the right to change representative indices at any time.

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

Asset-backed securities generally decrease in value as a result of interest rate increases, but may benefit less than other fixed-income securities from declining interest rates, principally because of prepayments.

Credit ratings are subject to change.

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