Global Investment Committee Monthly

IN BRIEF

Tactical Asset Allocation Change and August Meeting Summary

MARKETS. We are raising our exposure to risk assets, moving from underweight (UW) to market weight (MW). This change is primarily based on our view that further easing by the major central banks will support risk-asset markets and eventually the global real economy. We now are UW cash, developed-country sovereign debt, inflation-linked securities and global real estate investment trusts; we are MW equities, commodities and both short-duration and high yield bonds; we are overweight (OW) investment grade and emerging market (EM) bonds and managed futures. Within global equities, we continue to OW both the EM and US regions while underweighting other developed markets (DM). Within US equities, our capitalization preference is large caps and our style bias is growth.

ECONOMIES. Europe is in recession and growth is slowing in the US and in most EM economies. Still, we expect global growth to remain positive this year and next. Fundamentals and policy options in EM economies are generally more robust they are in the DM economies. Globally, we expect core inflation to abate.

PROFITS. Expectations for 52-week forward earnings per share (EPS) continue to soften. The S&P 500 forward earnings figure remains below $111, down from nearly $112 in early summer. Forward EPS for global equities has dropped under $28 from more than $30 last summer.

INTEREST RATES. DM central-bank policy rates are likely to remain low at least into 2014. Moreover, the Federal Reserve will probably embark on a third round of Quantitative Ease. We expect that the European Central Bank will further support EU sovereign debt markets and major European banks. Meanwhile, EM central banks have begun easing to offset slower growth.

CURRENCIES. In the short term, we expect US-dollar strength versus the euro. Longer term, major DM currencies will likely decline against several EM currencies.

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Summary of Strategic & Tactical Allocations for Global Investment Committee Asset Allocation Models

The table below summarizes our best thinking on the construction of strategic portfolios and tactical asset allocation. These three portfolios are a sampling of our guidance for investors with more than $20 million of investable assets, which are a subset of the GIC asset allocation models that are shown starting on page 18. The strategic equity allocations in these portfolios are in proportion to their share of global market capitalization. ***The latest changes are marked by arrows.***

EFFECTIVE AUG. 24, 2012

Model	Moderate Balanced Strategic Weight	Tactical Relative Weight	Equity & Alternative Investments Strategic Weight	Tactical Relative Weight	All Bonds Strategic Weight	Tactical Relative Weight
Global Cash	5%	-1% ▼	0%	0%	25%	-1% ▼
Global Bonds	40	1 ▲	0	0	75	1 ▲
Global Equities	32	0 ▲	70	0 ▲	0	0
Global Alternative/Absolute Return Investments	23	0 ▼	30	0 ▼	0	0
Global Bonds						
Investment Grade	30	1	-	-	65	2
Short Duration	5	0 ▼	-	-	10	0 ▼
Government/Government-Related	18	-8	-	-	39	-12
Corporate & Securitized	7	9 ▲	-	-	16	14 ▲
Inflation-Linked Securities	3	-1	-	-	10	-1
High Yield	4	0 ▲	-	-	-	-
Emerging Markets	3	1 ▲	-	-	-	-
Total Bonds	**40**	**1** ▲	**-**	**-**	**75**	**1** ▲
Total Cash & Short Duration Bonds	10	-1 ▼	-	-	35	-1 ▼
Global Equities						
US Large	12	2	24	3	-	-
Growth	6	2	12	4	-	-
Value	6	0	12	-1	-	-
US Mid	2	0	4	0	-	-
Growth	1	0	2	0	-	-
Value	1	0	2	0	-	-
Canada	1	0	3	0	-	-
Europe	6	-2 ▲	14	-6 ▲	-	-
Europe ex UK	4	-2 ▲	9	-4 ▲	-	-
UK	2	0	5	-2	-	-
Developed Asia	3	-2	8	-5	-	-
Japan	2	-2	5	-5	-	-
Asia Pacific ex Japan	1	0	3	0	-	-
US Small	2	0	4	0	-	-
Growth	1	0	2	0	-	-
Value	1	0	2	0	-	-
World ex US Small Cap	2	0	4	0	-	-
Emerging Markets	4	2	9	8	-	-
Total Equities	**32**	**0** ▲	**70**	**0** ▲	**-**	**-**
US Equity	16	2	32	3	-	-
Developed Market ex US	12	-4 ▲	29	-11 ▲	-	-
Developed Market Equity	28	-2 ▲	61	-8 ▲	-	-
Emerging Market Equity	4	2	9	8	-	-
Global Alternative/Absolute Return Investments						
REITs	3	-1	2	0	-	-
Commodities	2	0 ▲	5	0 ▲	-	-
Managed Futures Funds	4	1 ▼	5	0 ▼	-	-
Hedge Funds	11	0	10	0	-	-
Private Real Estate	-	-	3	0	-	-
Private Equity	3	0	5	0	-	-
Total Alternative/Absolute Return Investments	**23**	**0** ▼	**30**	**0** ▼	**-**	**-**

Source: Global Investment Committee as of Aug. 24, 2012

Tactical Asset Allocation Reasoning

Global Bonds	Relative Weight Within Bonds	
Short Duration	Market Weight	With yields extremely low in many markets, relative performance will lag over any reasonable holding period except in an environment of negative returns on risk assets.
Government	Underweight	With interest rates so low, the price of safety is very expensive in perceived safe-haven markets. We see better value elsewhere.
Investment Grade Corporate & Securitized	Overweight	These securities offer an attractive combination of high credit quality and yields that are above those on government bonds.
Inflation-Linked Securities	Underweight	With breakeven rates close to their long-term averages, we see better value elsewhere.
High Yield	Market Weight	The yield spread is close to the long-term average.
Emerging Markets	Overweight	The yield spread is above its long-term trend line.

Global Equities	Relative Weight Within Equities	
US	Overweight	We have a defensive stance that favors large-cap stocks at the capitalization level; at the style level, we favor growth stocks against a backdrop of decelerating earnings growth. Relative-valuation readings also support this positioning.
Developed Markets ex US	Underweight	At the regional level, we have increased our exposure to Europe but remain underweight. We are market weight Canada and the Asia Pacific ex Japan region (predominantly Australia) and underweight Japan, where challenges to economic growth appear to be structural as well as cyclical.
Emerging Markets	Overweight	Policymakers' focus has generally shifted away from containing inflation and toward supporting growth, and there is more scope for policy support than in the developed economies.

Global Alternative/ Absolute Return Investments	Relative Weight Within Alternative Investments	
REITs	Underweight	Given a backdrop of slowing global economic growth, and lacking a relative-valuation advantage, we are inclined to limit exposure to this asset class. For US real estate investment trusts, the dividend yield spread versus the S&P 500 dividend yield is well below its long-term average.
Commodities	Market Weight	Although price declines are possible if the global economy continues to slow, the worst of the declines appears to be behind us for this phase of the cycle.
Managed Futures	Overweight	This asset class often performs well as a hedge against adverse equity market conditions.

Back to Neutral: Boosting Exposure to Risk Assets

With a challenging economic outlook, major central banks are providing liquidity that should support risk-asset markets and the global economy.

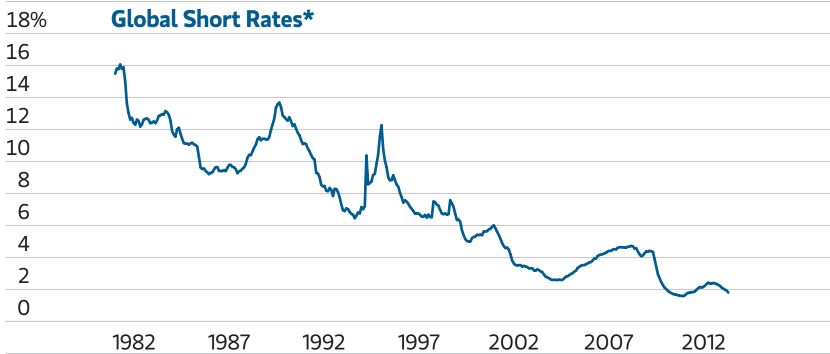
When we reduced the risk exposure in our tactical asset allocation advice last October, the primary driver was that policy disarray on both sides of the Atlantic raised the risk of an economic downturn in Europe and the US, which could have knock-on effects for the global economy and profit growth. We also thought that those fundamentals would create headwinds for risk assets—equities, high yield bonds, emerging market bonds, real estate investment trusts and commodities—until policymakers could catch up with, and move ahead of, market developments.

Ten months later, the Euro Zone has, indeed, slipped into a recession and US growth has slowed considerably. Given strong trade and financial linkages, the pace of growth is slowing around the world. Policymakers—primarily the Federal Reserve, the European Central Bank (ECB) and the People's Bank of China—have committed to more monetary policy stimulus as needed. Indeed, the major global central banks have resumed lowering policy interest rates this year (see Figure 1). In some cases, central banks have engaged in nontraditional steps, such as purchasing billions of dollars in securities and thus expanding their balance sheets—a practice known as Quantitative Ease.

The impact of committed monetary policy is palpable. The MSCI All Country World Index, our proxy for the global equity market, is less than 5% below its mid-March peak, as downbeat economic

Figure 1: Aggressive Easing Pushes Policy Interest Rates to Historic Lows

In their efforts to bolster liquidity and stimulate economic growth, major central banks in both the developed and developing economies have resumed lowering policy interest rates this year.



*Weighted index of policy interest rates, 65% developed market and 35% emerging market
Source: ISI Group of as July 31, 2012

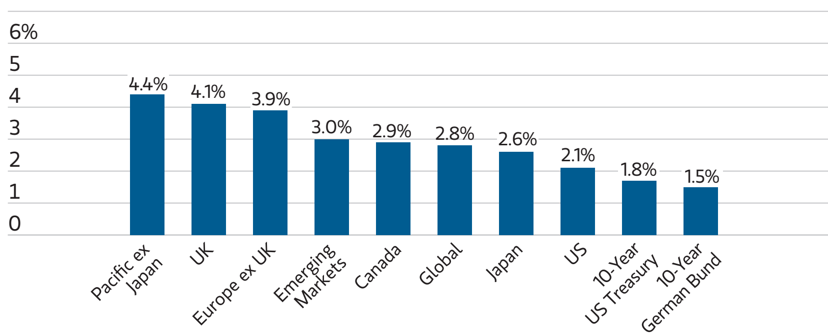
Figure 2: Negative Economic Surprises Bottom Out

Downbeat economic news is not providing as much of a negative surprise to investors as was the case earlier in the year. In recent weeks, the economic surprise indexes improved for the US and China.

Source: Bloomberg as of Aug. 7, 2012

Figure 3: Region by Region, Dividends Trump 10-Year Government Bond Yields

Taken globally, by region or by country, dividends from owning stocks pay more than the interest earned on a 10-year US Treasury or a German bund. This is an important valuation prop for global equity markets.

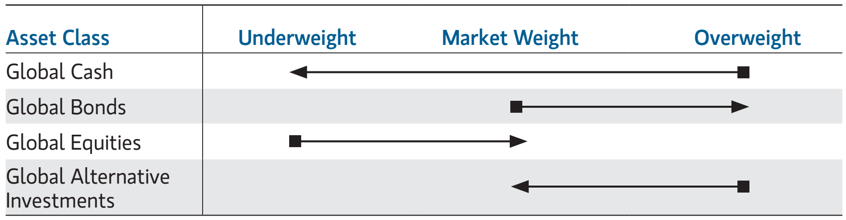


Source: Citi Research, Worldscope, MSCI, FactSet as of Aug. 17, 2012 news is no longer providing as much of a negative surprise as was the case earlier in the year (see Figure 2, page 4). Moreover, with yields on many traditional safe-haven investments at or near their historic lows, the higher dividend yields available on equities are attractive and provide some degree of valuation support (see Figure 3, page 4).

TACTICAL ADJUSTMENTS. Given the robust central-bank stimulus that is likely to remain in place for the foreseeable future, we are adjusting our tactical allocations to broadly eliminate our overweight position in safe havens and our underweight in risk assets (see Figure 4).

We are neutralizing our broad tactical position through several small adjustments at the asset-class level. Specifically, we are modestly increasing our exposure to equities, investment grade corporate bonds, high yield bonds, emerging market bonds and commodities; we are decreasing exposure to cash, short-duration bonds and managed futures. Also, we are reclassifying inflation-linked securities as fixed income instead of an alternative asset (see box). Our changes are explained starting on the next page.

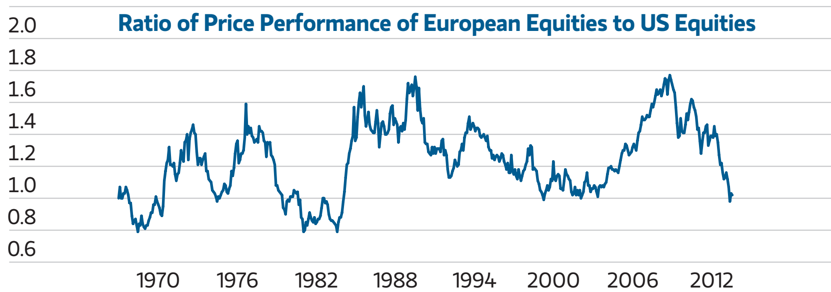
Figure 4: Tactical Changes for Broad Asset Classes



Source: Global Investment Committee as of Aug. 24, 2012

Figure 5: European Equities Have Underperformed US Equities

European equities have underperformed US equities for nearly five years. Now, Europe relative to the US is at levels not seen in about a decade and thus appears less vulnerable to further large declines.



Note: For European stocks, we use the MSCI Europe ex UK Index; for US stocks, we use the MSCI USA Index.
Source: MSCI, Morgan Stanley Smith Barney as of July 31, 2012

Classification of Inflation-Linked Securities as Fixed Income Investments

Inflation-linked securities, such as US Treasury Inflation Protected Securities, better known as "TIPS," possess some of the features of conventional fixed income securities, including specific maturity dates, periodic coupon payments and the payment of principal at maturity. Inflation-linked securities also have the unique feature of having principal adjustments tied to an inflation index, which results in lower correlations of returns with conventional fixed income securities.

The Morgan Stanley Smith Barney Global Investment Committee Asset Allocation Models, until now, have included inflation-linked securities within the Global Alternative/Absolute Return Investments category. Given there is no clear industry consensus on classifying inflation-linked securities, and upon further examination, the Global Investment Committee has decided to group them within global fixed income to encourage more clients to consider the beneficial diversification properties of inflation-linked securities.

This change in classification has no bearing on the strategic or tactical allocations to inflation-linked securities in our asset allocation models, as they remain the same.

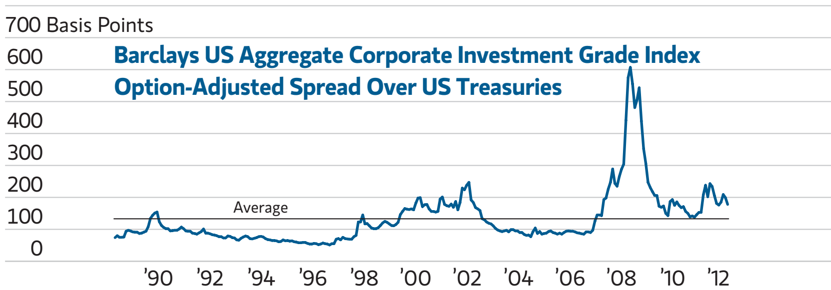
For more information about inflation-linked securities, please refer to the following report: *Inflation-Indexed Securities* (May 21, 2012).

Equities

Valuation indicators generally suggest market prices are already incorporating a below-average economic outlook. After an extended period of underperformance, the European market looks a bit less vulnerable to further large declines (see Figure 5, page 5). We also note the Market Timing Indicator maintained by the Morgan Stanley European Equity Research team has nearly returned to its September 2011 low, and several of their other valuation and risk indicators have issued buy signals. In consideration of this, as well as indications that the ECB intends to step up its efforts to mitigate the fallout from the sovereign debt morass, we are increasing exposure to the Europe ex UK region. *This change shifts our overall position in equities to neutral from slightly underweight and reduces the size of our underweight position in European equities.*

Figure 6: Above-Average Spread for Investment Grade Bonds

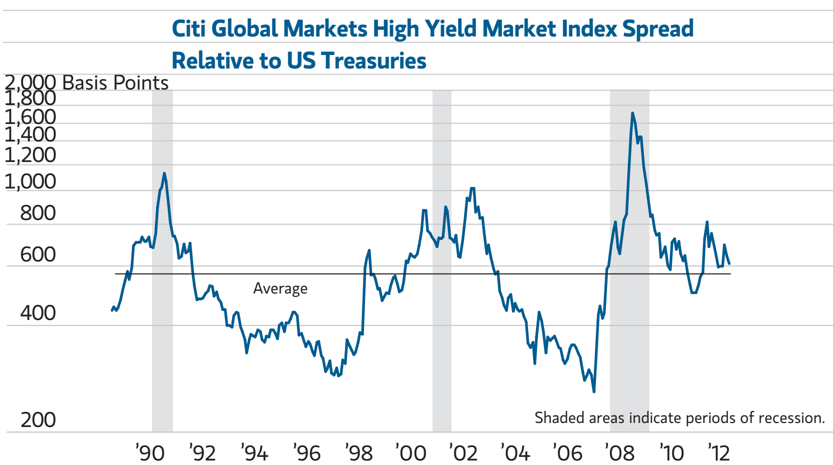
Even though yields on investment grade corporate debt are quite low, the spread relative to US Treasuries is still above average. In this sector, investors can get bonds of high credit quality that top the yields on Treasuries.



Source: FactSet as of July 31, 2012

Figure 7: Spread Makes High Yield Bonds Attractive in a Low-Yield World

High yield bonds' spread over US Treasuries is somewhat above the long-term average, offering an attractive level at which to increase exposure, especially in light of low yields elsewhere.



Note: The above chart is drawn on a logarithmic scale.
Source: Citigroup Global Markets, FactSet as of July 31, 2012

Investment Grade Corporate Bonds

In the US, this asset class continues to offer the attractive combination of yields that are higher than those of Treasuries (see Figure 6) and relatively high credit quality. *This tactical change increases the size of our overweight position.*

High Yield Bonds

In the US, the spread on high yield bonds over Treasuries is somewhat above its long-term average (see Figure 7), offering an attractive level at which to increase exposure, especially in light of low yields elsewhere. History suggests that spreads would widen significantly, at least initially, if the US economy were to slip into a recession. Even though this is not our base-case assumption, recession risks remain uncomfortably high and, as such, we are not ready to adopt an overweight position. *This change shifts our position in high yield bonds to neutral from slightly underweight.*

Emerging Market Bonds

The emerging market bond yield spread over Treasuries is above its long-term trend line (see Figure 8, page 7). For this asset class, we believe the spread's declining trend line is a more meaningful indicator than the long-term average spread, because it better reflects the rerating that this asset class has been experiencing as the underlying credit quality of the issuers has improved. More than 60% of the Citi Emerging Sovereign Bond Index now has an investment grade credit rating, compared with only about 30% a decade ago.

We recommend that investors access this asset class mainly through vehicles that offer local-currency-denominated, unhedged exposure; we believe that, over time, currency appreciation should augment performance. To be sure, currency exposure is likely to entail additional volatility, which is why we consider emerging market bonds to be risk assets. *This change in our tactical allocation shifts our position in emerging market bonds to slightly overweight from neutral.*

Commodities

Aside from a recent weather-induced spike within the agricultural sector and geopolitical concerns lifting oil prices, commodities have declined amid slowing global economic growth. Additionally, commodities have been among the worst-performing asset classes during the past year. Although additional price drops are possible should the economy continue to slow, the worst of the declines appear to be behind us for this phase of the cycle. We note that the Economic Surprise indexes for the US, Euro Zone and China have stabilized, indicating that economic expectations may have reached at least an interim bottom (see Figure 2, page 4). *Our commodities position shifts to neutral from slightly underweight.*

Cash and Short-Duration Bonds

Central banks in developed countries are holding short-term rates at exceptionally low levels, in large part to induce investors to shift into riskier, higher-yielding assets. Thus, holding an overweight allocation in these defensive instruments is the equivalent of "fighting the Fed." With yields at nearly zero—and negative in real (inflation-adjusted) terms—the relative performance on these instruments for any reasonable holding period only becomes attractive in an environment of large negative returns on other investment options. Such an outcome seems less likely to us now than it did last autumn. *Our position in cash moves to underweight from overweight, and in short-duration bonds our position goes to neutral from overweight.*

Managed Futures

We adopted a tactical overweight position in managed futures last October, primarily because this asset class tends to be an effective hedge during extended periods of adverse equity market conditions. *We now see a reduced likelihood of such an outcome, so we have trimmed the size of our tactical overweight position.*

RISKS AHEAD. Although we are increasing our exposure to risk assets, we recognize that the next several months are not without risks. For instance, we note the continued focus on fiscal austerity in Europe, a downward bias in global corporate-earnings revisions, uncertainty over how the US Congress will navigate the approaching fiscal cliff and the possibility that a financial market crisis may be required to induce a decisive and appropriate central-bank policy response—one that gets ahead of the curve rather than just reacts to the latest events.

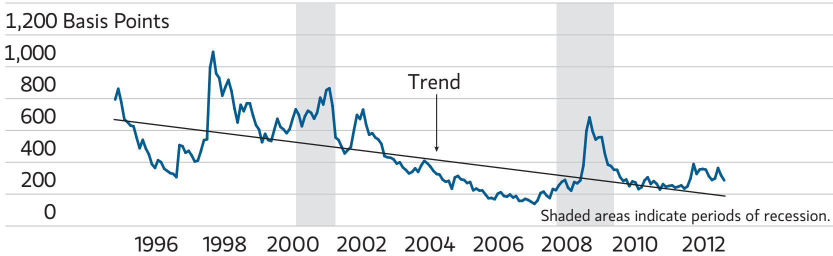
YIELD ESTIMATES. For portfolios with an allocation to fixed income, the overall portfolio yield will be higher as a result of paring cash and short-duration bond exposure and increasing allocations to investment grade corporate, high yield and emerging market bonds (see Figure 9).

IN CONCLUSION. As new challenges and opportunities appear, we continue to evaluate our risk exposure and tactical positioning. Our analysis suggests a neutral risk posture is warranted. ■

Figure 8: Emerging Market Bond Spread Is Above Its Long-Term Trend Line

Emerging market bonds' spread over US Treasuries is above its long-term trend line. We believe that the trend line is a better indicator than the average spread because it better reflects the bonds' improving credit quality.

Citi Global Emerging Market Sovereign Bond Index, Spread Relative to US Treasuries



Source: Citigroup Global Markets, FactSet as of July 31, 2012

Figure 9: Estimated Yields on the Cash and Fixed Income Portion of GIC Asset Allocation Models Before and After Change

	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
Level 1						
Before	1.02%	1.43%	1.71%	2.13%	2.56%	3.75%
After	1.14%	1.59%	2.00%	2.50%	3.05%	4.60%
Level 2						
Before	1.14%	1.48%	1.82%	2.15%	2.63%	3.63%
After	1.25%	1.66%	2.14%	2.55%	3.16%	4.54%
Level 3						
Before	1.21%	1.56%	1.82%	2.15%	2.63%	3.63%
After	1.32%	1.75%	2.14%	2.55%	3.16%	4.54%

Source: FactSet, Morgan Stanley Smith Barney as of July 31, 2012

Economic Outlook

Cutting Forecasts

With the market's attention split between the continuing debt saga in the Euro Zone and the looming fiscal cliff in the US, other economic developments around the globe have gotten a bit lost. Growth potential within the emerging market (EM) universe is beginning to feel the ill effects as well. As a result, Morgan Stanley economists revised their global growth forecasts downward for the second time this summer. The current global GDP estimate now stands at 3.2% for this year and 3.5% for 2013, reflecting a a drop of 0.3 percentage points for both estimates (see Figure 10). This time around the downward assessments were due mostly to lower readings from the EM group, where GDP now is expected to be 5.2% and 5.8% for 2012 and 2013, respectively.

CHINA SLOWING. A key player in this mix is China, as the latest news points to the potential for slower growth for the remainder of this year and 2013. Indeed, just last week, Morgan Stanley economists reduced the outlook for China, projecting 8.0% GDP growth this year versus the prior estimate of 8.5%; they also lowered the 2013 GDP forecast to 8.6% as compared with the earlier reading of 9.0%. The impetus for the downward assessment on China is two-fold: stronger headwinds from external demand and a delay in action on the fiscal policy front.

Against this backdrop, investors have witnessed another disappointing run of economic data in July, which revealed a sharper-than-expected slowdown in exports, imports, industrial production, retail sales and fixed investment. While it is expected that fiscal policy moves could boost growth prospects, Morgan Stanley economists believe that the rebound could come slightly later and be smaller in scale than originally envisioned.

US PROBLEMS. It has become apparent that the US can't escape some of the fallout from the ongoing Euro Zone difficulties—and we still face uncertainty from the fiscal cliff. At these levels, the US economy has little resilience and will continue to be vulnerable to external shocks, such as a potential "Grexit"—Greece's departure from the Euro Zone. Morgan Stanley and Citi economists estimate US GDP growth at slightly above 2% in 2012 and less than 2% in 2013.

The US' problems do not all originate abroad. Stagnant personal-income growth remains a constraint. Notwithstanding the positive July retail-sales report, the prior three months produced consecutive declines. The link between real consumer spending and real disposable income is relatively tight from a historical perspective (see Figure 11, page 9). With subdued wage growth, it is difficult to envision a sustained upswing in spending any time soon. In fact, Morgan Stanley economists see real consumer spending struggling to reach 2% in the near future.

Figure 10: Morgan Stanley and Citi Global GDP and Inflation Forecasts

(year-over-year percent change)

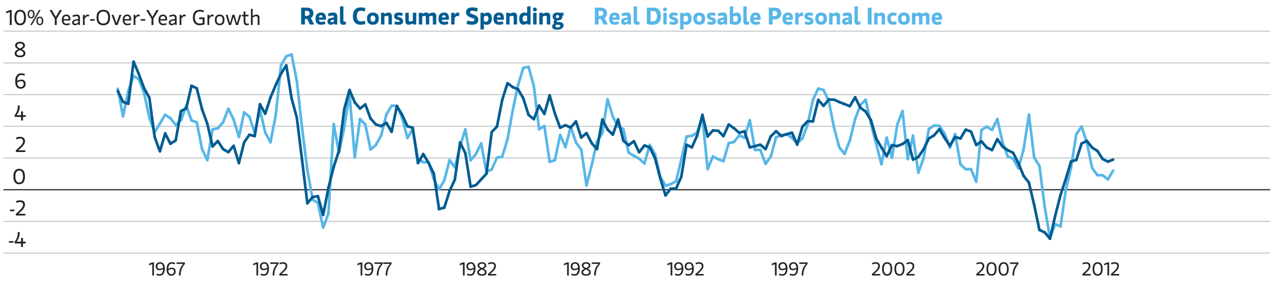
Morgan Stanley	2011	2012	2013	% Contribution to Growth 2012
Global GDP	**3.9**	**3.2**	**3.5**	
Developed Economies	**1.4**	**1.2**	**1.0**	**20**
US	1.8	2.1	1.4	14
Euro Zone	1.5	-0.5	0.0	-2
UK	0.8	-0.5	1.0	0
Japan	-0.8	2.5	1.0	5
Developing Economies	**6.5**	**5.2**	**5.8**	**80**
Brazil	2.7	1.6	3.2	2
Russia	4.3	4.2	3.7	4
India	7.5	5.7	6.5	11
China	9.2	8.0	8.6	38
Global Consumer Prices				
Global Inflation	4.4	3.4	3.1	
Developed Economies	2.6	1.9	1.4	
Developing Economies	6.2	4.9	4.7	
US Core*	1.7	2.3	2.2	
US CPI	3.1	2.2	1.9	

Citi	2011	2012	2013	% Contribution to Growth 2012
Global GDP	**3.7**	**3.0**	**3.2**	
Developed Economies	**1.3**	**1.3**	**1.0**	**23**
US	1.8	2.2	1.9	15
Euro Zone	1.5	-0.6	-1.0	0
UK	0.7	-0.6	0.5	-1
Japan	-0.8	2.7	1.8	6
Developing Economies	**6.0**	**4.7**	**5.5**	**77**
Brazil	2.7	1.4	3.9	1
Russia	4.3	3.5	4.0	4
India	6.5	5.4	6.2	12
China	9.2	7.9	8.0	40
Global Consumer Prices				
Global Inflation	4.1	3.2	3.2	
Developed Economies	2.3	1.7	1.6	
Developing Economies	6.0	4.6	4.7	
US Core*	1.4	1.9	1.6	
US CPI	2.4	1.8	1.9	

Note: Global forecasts are GDP-weighted averages, using Purchasing Power Parity estimates, which give greater weights to developing economies.
*Personal Consumption Expenditures
Source: Morgan Stanley Research, Citi Research, Morgan Stanley Smith Barney as of Aug. 22, 2012

Figure 11: Disposable Personal Income and Consumer Spending Struggle to Stay Positive

From a historical perspective, the link between real consumer spending and real disposable income is relatively tight. With subdued wage growth, it is difficult to envision a sustained upswing in spending any time soon.



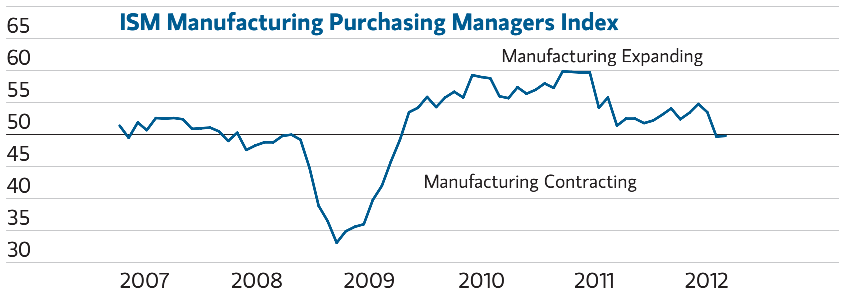
Source: Haver Analytics, Citi Research, Morgan Stanley Smith Barney as of June 30, 2012

MANUFACTURING WEAKENS. Also troubling is the US manufacturing sector, which, for the last three years, has been one of the supports of the economic recovery. The ISM Manufacturing Purchasing Managers Index, a closely followed barometer, has dropped below the critical line for the second month in a row (see Figure 12). It is now at 49.8, and anything below 50.0 is considered contraction. The manufacturing sector likely is feeling the ill effects of a weaker domestic economy, fallout from the Euro Zone crisis, slowing EM activity and a stronger dollar.

CLARITY ON JOBS. The latest employment report beat expectations, but job gains continue to fall short of what it will take to significantly lower the unemployment rate, which ticked up one-tenth of a percentage point, to 8.3%, in July. The civilian labor-force participation rate fell by one-tenth of a percentage point to 63.7%. If nothing else, the latest jobs report did provide some clarity. Conventional wisdom led investors to believe that the first quarter's 226,000 average monthly reading was too high due to unseasonably mild winter weather, while the second quarter's reading of only 91,000 per month was payback for unusually high growth earlier in the year (see Figure 13). The average of the two quarters is around 159,000, which is close to the 172,000 jobs gained in July for private employment. Perhaps that figure is closer to underlying US jobs growth. ■

Figure 12: Purchasing Managers Index Falls Below Critical Level

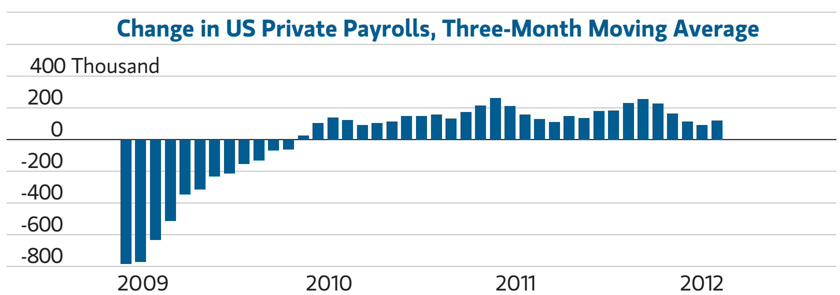
When this purchasing managers' index falls below 50, the manufacturing sector is considered to be contracting. The index has been slightly below 50 for two consecutive months.



Source: Bloomberg as of July 31, 2012

Figure 13: US Jobs Creation Slows

Private-sector jobs growth improved in July after slowing in previous months. Still, at this pace, it will be hard to materially lower the unemployment rate.



Source: US Bureau of Labor Statistics, FactSet as of July 31, 2012

Figure 14: Earnings Forecasts for the Standard & Poor's 500, MSCI All Country World and MSCI Emerging Markets Indexes

S&P 500				
	Morgan Stanley		Citi	
	Operating EPS	YOY Change	Operating EPS	YOY Change
2012	$100.00	2%	$103.25	6%
2013	$98.70	-1%	$108.00	5%

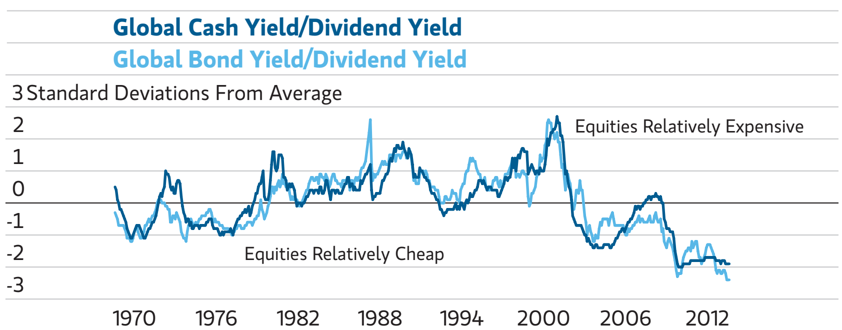
Consensus of Wall Street Analysts						
	S&P 500		MSCI All Country World		MSCI Emerging Markets	
	Operating EPS	YOY Change	Operating EPS	YOY Change	Operating EPS	YOY Change
2012	$103.39	8%	$25.50	7%	$90.91	8%
2013	$115.46	12%	$28.68	12%	$102.49	13%
52-Week Forward	$110.62		$27.62		$98.63	

Note: Citi estimates are before write-offs.

Source: Citi Research, Morgan Stanley Research, Thomson Financial, Datastream as of Aug. 22, 2012

Figure 15: Global Equities Still Appear Inexpensive Relative to Cash and Bonds

The gaps between the equity dividend yield and those on cash and government bonds are at least two standard deviations below their long-term averages. That makes equities attractive relative to bonds and cash.



Source: MSCI, Thomson Financial as of July 31, 2012

Equities Outlook

Tug-of-War Pulls Us Back to Neutral

Prospects for global economic growth are already modest, to say the least, and every revision these days seems to be downward. In like manner, corporate-earnings estimates for this year and the next are melting away (see Figure 14). Neither trend indicates an ideal environment for investing in equities. Nonetheless, we believe that central banks' efforts to ease financial conditions will continue to provide a lift to a global equity market that is already attractively valued relative to cash and bonds (see Figure 15). Indeed, the gaps between the equity dividend yield and those on cash and government bonds are at least two standard deviations from their long-term averages. Amid this tug-of-war, we believe that a neutral allocation to equities is appropriate.

A LITTLE MORE EUROPE. Within equities, European stock valuation appears to be particularly attractive (see Figure 16, page 11). The Market Timing Indicator, which the Morgan Stanley European Equity Research team maintains to inform three-to-six-month forward trading strategies, continues to be in buy territory. That backdrop, combined with European Central Bank President Mario Draghi's recent pledge to do "whatever it takes" to maintain the currency union, is the primary driver of our decision to increase our exposure in this region. Even so, we maintain a tactical underweight position. After all, with the continued emphasis on fiscal austerity and the distinct possibility that Greece may exit the monetary union, potential pitfalls remain. So, we continue to prefer emerging markets and the US at the regional level.

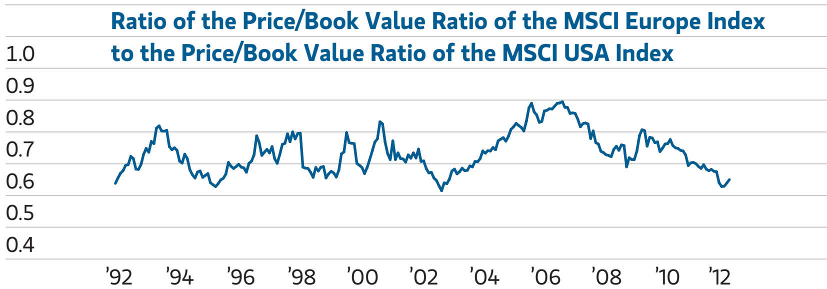
OVERWEIGHT EMERGING MARKETS. The primary factor for our tactical overweight to emerging markets is that, by and large, emerging market (EM) policymakers have much more latitude to make adjustments that support economic growth than those in developed economies. Indeed, with inflation generally moderating, many already have shifted their focus away from fighting inflation—a stance that hindered EM equity market performance during the better part of 2011. Still, companies based in emerging economies need to improve their ability to turn premium GDP growth rates into premium earnings-per-share growth.

US FAVORITES. Within US stocks, we continue to favor large caps. We initiated a tactical preference for large caps in April 2011 largely based on relative valuation, which had reached extreme readings. The valuation advantage is still evident, although it is no longer extreme (see Figure 17).

At the style level, value stocks continue to appear expensive relative to growth stocks, especially in the large-cap sector, but not nearly to the degree that existed a couple of years ago when we initiated our tilt toward growth. We are retaining this preference in light of the valuation advantage—albeit reduced—and in consideration of decelerating corporate-earnings growth. Under such conditions, growth stocks—companies that have the ability to deliver relatively stable earnings growth regardless of the economic backdrop or those expected to post above-average earnings growth—typically outperform. ■

Figure 16: European Equities Show Low Valuation Relative to US Equities

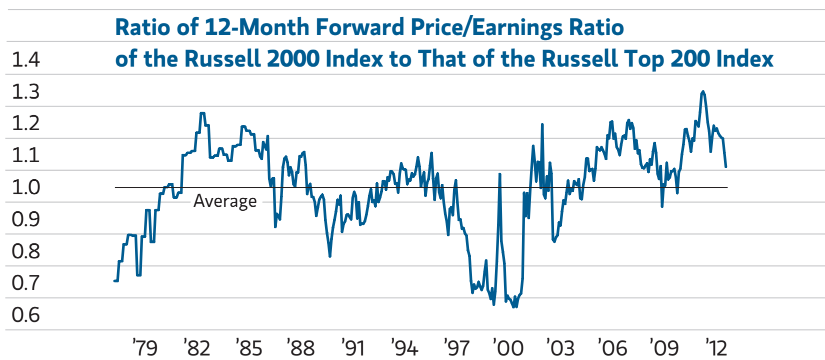
A comparison of price/book value ratios for the MSCI Europe and MSCI USA indexes indicates that European stocks are at their lowest valuation relative to US stocks in nearly a decade.



Source: FactSet as of July 31, 2012

Figure 17: Valuation Shows Large-Cap Stocks Attractive Relative to Small-Cap Stocks

Sixteen months ago, we initiated a tactical preference for large caps largely based on relative valuation, which had reached extreme readings. The valuation advantage is still evident, although no longer extreme.



Source: Thomson Financial, FactSet as of July 31, 2012

Fixed Income Outlook

Coordinated Action Redux

If one were using an Olympic scorecard to mark this month's central-bank action, the first two spots on the podium would have been left empty due to lack of participation. Expectations were building that the Federal Reserve, the European Central Bank (ECB) and the Bank of England (BOE) would take additional action and ease policy further, and it was only a matter of which would move first. However, those expectations were dashed, as no new initiatives were announced.

Still, we expect all three to resume their easing measures later this year, perhaps as soon as September's policy meetings. While such moves would be welcome, they would probably offer only near-term relief. The Global Investment Committee believes that the central banks will ultimately enact measures that have market-moving potential, especially the ECB. Thus, another round of coordinated action by the Fed, the ECB, the BOE and the People's Bank of China (PBOC)—at each central bank's respective policy meeting—seems to be a probable scenario.

Of the aforementioned central banks, the PBOC could prove to be the most problematic. Morgan Stanley economists had been expecting two more rate cuts this year, but now foresee only one 25-basis-point move, as the PBOC appears to have become more concerned about inflationary pressures.

Within the Euro Zone, the ECB is apparently working on a two-pronged policy approach: unconditional efforts and conditional efforts. The former category seems reserved for additional rate cuts. The current refi rate of 0.75% actually allows the Euro Zone policymakers to implement another cut or two before hitting zero (see Figure 18). The conditional policy option seems reserved for sovereign debt purchases or the resumption of the Securities Market Programme. According to the ECB, this option would only be taken if a sovereign nation, such as Spain or Italy, asked for official assistance.

JAWBONING RATES LOWER. There is no doubt that one of the more scrutinized policy speeches occurred in London on July 26, when ECB President Mario Draghi delivered his "whatever it takes" remarks. In his comments, Draghi essentially put the money and bond markets on notice when he stated, "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro—and believe me, it will be enough."

Following the latest policy meeting, Draghi provided a bit more in the way of details, especially regarding the potential for sovereign debt purchases. Based upon statements from the subsequent press conference, it appears that ECB purchases would focus on shorter maturities, essentially providing relief on the funding front for Spain and Italy. The natural question is whether the mere mention has had any impact, and the answer thus far is in the affirmative. Spain and Italy each saw their respective two-year yields hit recent peaks of 6.77% and 5.03% on July 24, just two days before the Draghi speech (see Figure 19, page 13). Now, the Spanish two-year yield is at 3.55%, while the Italian two-year yield is at 2.99%.

BACK TO JACKSON HOLE. Fed policymakers did not provide any additional accommodation at their recent meeting, but the language in the postmeeting policy statement—such phrases as "will provide" and "closely monitor"—has been used in the past to signal that the bar for further action has been lowered. While a change in interest rate guidance, a cut in the interest paid on excess reserves or another round of Quantitative Ease remain on the table, the better-than-expected July jobs report dampens the urgency of making a move.

Figure 18: Morgan Stanley and Citi Policy Rate and Government Bond Yield Forecasts

Morgan Stanley	Current Rate	4Q12	4Q13
Policy Rate (%)			
US	0.00–0.25	0.15	0.15
Euro Zone	0.75	0.25	0.25
Japan	0.10	0.05	0.05
UK	0.50	0.25	0.25
China	6.00*	5.75*	5.75*
10-Year Government Bond Yield (%)			
US	1.70	2.05	1.85
Germany	1.46	1.00	1.70
Japan	0.82	1.00	1.20
UK	1.63	1.40	1.90

Citi	Current Rate	4Q12	4Q13
Policy Rate (%)			
US	0.00–0.25	0.25	0.25
Euro Zone	0.75	0.25	0.25
Japan	0.10	0.10	0.10
UK	0.50	0.50	0.50
China	3.00**	2.75**	3.25**
10-Year Government Bond Yield (%)			
US	1.70	1.65	2.60
Germany	1.46	1.20	1.80
Japan	0.82	0.95	1.30
UK	1.63	1.40	2.25

*Morgan Stanley's current and forecast policy rates use the one-year lending rate.
**Citi's current and forecast policy rates use the one-year deposit rate.
Source: Morgan Stanley Research, Citi Research as of Aug. 21, 2012

Nevertheless, the uptick in the unemployment rate to 8.3% will not be welcomed by the voting members and provides the Fed with good reason to implement further easing, perhaps as soon as the two-day meeting that starts on Sept. 12. Thus, as we have seen the past two years, Chairman Ben Bernanke could use the platform of the Jackson Hole symposium to telegraph any moves that may be forthcoming when he speaks there on Aug. 31.

A Reluctant Rally in Credit

Investor faith in monetary policy is a remarkable thing. Over the past two months, global and domestic economic data have generally come in weaker than expected—the US July jobs report excepted—and the European sovereign debt crisis has officially engulfed Spain. Yet, a speech by European Central Bank (ECB) President Mario Draghi at the end of July, as well the Aug. 1 statement from the Federal Open Market Committee meeting, has left the impression that monetary policymakers will not let market conditions deteriorate further. This, combined with strong technical factors, has allowed spreads to grind tighter despite stretched valuations and weak macro fundamentals.

Since the end of June, the investment grade spread over US Treasuries has tightened by 28 basis points, to 171, putting it within striking distance of the 12-month low of 163 basis points. The yield on the Barclays Capital US Aggregate Investment Grade Index is hovering around 3%, slightly above its all-time low (see Figure 20). High yield spreads have narrowed by 88 basis points since June 30. The current spread on the Barclays Capital US Aggregate High Yield Index is 565 basis points, only six basis points north of the 12-month low. The yield is 6.76%, slightly above the all-time low, and the price of the high yield index is around 102, just short of its all-time high (see Figure 21, page 14).

LOW RATES FORCE MOVES. The most obvious explanation for the spread rally is that the low-interest-rate environment is forcing investors to reach for the higher yields generally found in the credit markets. Since 2009, cumulative net inflows to investment grade and high yield mutual funds are more than $200 billion (see Figure 22, page 14). That, coupled with low net issuance, redemptions and coupon income, has left many funds with excess cash to invest. Factor in that many investment funds are adding credit risk to achieve yield bogeys they cannot otherwise get in traditional safe-haven assets, and you are left with a market that looks unusually strong given the macro risks. In effect, monetary policy is working—in that it is forcing investors to take on more risk; it is, essentially, a reluctant rally.

We believe risk-asset rallies can be self-defeating, in that they essentially let policymakers off the hook. Recent history suggests that policymakers will act only when market pressure forces them to do so. Thus, the odds of sovereign bond purchases by the ECB and/or another round of Quantitative Ease by the Fed increase if risk assets sell off.

EUROPEAN ACTION PLAN. The ECB has essentially provided the markets with a plan of action in the event that Spain and Italy need assistance. As he has done in

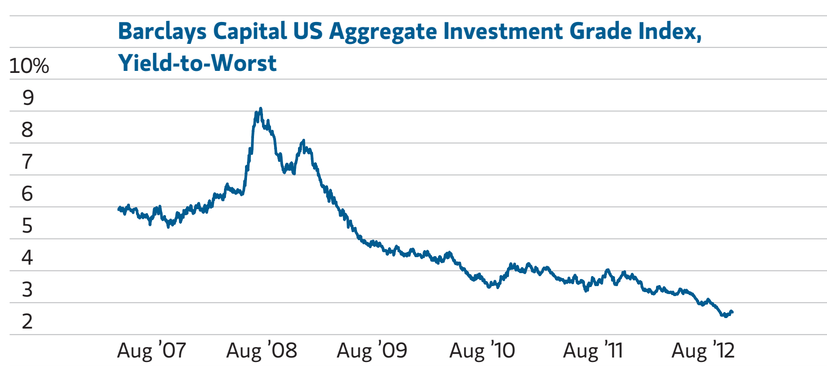
Figure 19: Yields for Spanish and Italian Two-Year Notes Fall but Remain Elevated

In late July, European Central Bank President Mario Draghi indicated that the bank would purchase securities of countries struggling with their debt. Since then, yields on Spanish and Italian two-year notes have come down significantly.

Source: Bloomberg as of Aug. 22, 2012

Figure 20: Record-Low Yield for Investment Grade Bonds

The yield on investment grade bonds is near a record low. Still, it is higher than US Treasury yields, and, with their excellent credit quality, these bonds make a good choice for fixed income investors.



Source: FactSet as of Aug. 14, 2012

the past, and perhaps to try to appease German opposition, Draghi has asked for a quid pro quo for assistance. He wants Spain and Italy to "request assistance" before the ECB will commit to sovereign bond purchases. This would put the country requesting assistance into a "troika" program similar to the programs governing the fiscal reforms of Ireland, Portugal and Greece.

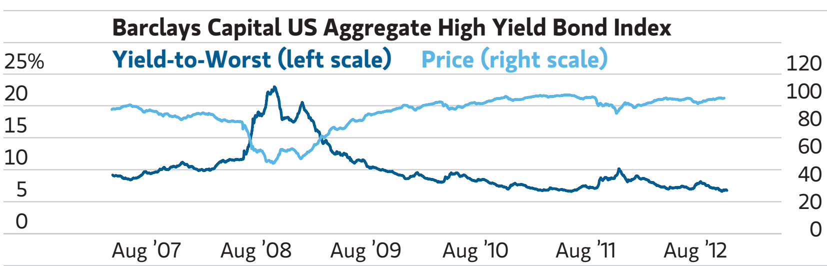
Draghi's plan is a positive step in that it reduces the chance of a larger tail-risk event occurring, in our view. Yet it does come with some potential negative knock-on effects. For one, mandated austerity programs may actually worsen the economic outlook for Spain and Italy and perhaps the entire Euro Zone. In addition, some important legal issues need to be addressed—namely, whether the European Stability Mechanism can be counterparty to the ECB and if ECB-purchased bonds are senior to bonds purchased by others.

HIGHER YIELD, LIMITED UPSIDE. In our view, high yield is more at risk than investment grade. With the price of the Barclays Capital High Yield Index around 102, investors have very limited upside price potential, as roughly 70% of the high yield market is callable at either par or 101. While investors may be attracted to the coupon income the high yield market offers relative to other fixed income assets, we believe the upside potential is limited to coupon income while downside potential exists. Based on this assessment, we continue to focus on Ba1-rated credits with shorter maturities. The higher quality and lower duration should provide some price protection, as well as the ability to clip a relatively attractive coupon.

The yield on investment grade credit is historically low. Yet, the spread on the index, at 171 basis points, remains wide of the long-term average of roughly 136 basis points, providing some cushion. Of the two asset classes, investment grade is apt to remain more stable than high yield in a risk-off environment, and we believe investors will continue to seek the yield pick-up of investment grade corporates over risk-free assets. During the next 12 to 18 months, we see investment grade credit as one of the most attractive investment opportunities, on a risk-adjusted basis, across asset classes. In a low-growth, low-yield world, we believe investors will be attracted to the additional income of investment grade credit versus Treasuries and the lower volatility of returns versus equities and high yield.

Figure 21: Yields Fall and Prices Rise for High Yield Bonds

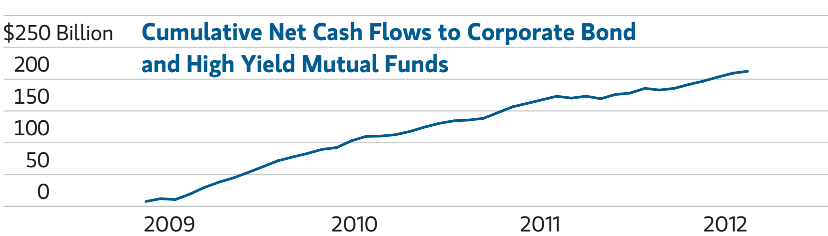
The long slide in interest rates has left the yield on high yield bonds only slightly above its all-time low and the prices only slightly below the all-time high.



Source: FactSet as of Aug. 21, 2012

Figure 22: In a Period of Falling Interest Rates, Investors Stash Cash in Bond Funds

As interest rates declined during the past three years, investors put more than $200 billion in net cash into corporate bond and high yield bond funds. Those flows helped to lift prices and drive rates lower.



Source: Investment Company Institute as of June 30, 2012

Tighter Range for Emerging Market Bonds

Emerging market (EM) bonds participated in the summer risk rally with spreads tightening, too. The Barclays Capital Emerging Markets (US$) Index is trading around 340 basis points higher than US Treasuries. This represents about a 65-basis-points-tighter spread since June 30, and it is 114 basis points tighter for the year to date.

Still, we believe that the likelihood of a pronounced sell-off in EM bonds is very low because any renewed market weakness would likely prompt central banks, both in the developed and developing economies, to boost liquidity.

BETTER MACRO FUNDAMENTALS. Despite the recent slowdown in growth, macro fundamentals, such as fiscal and trade balances, are stronger in EM economies versus their developed-market peers, in our view. We believe this positions EM economies to benefit from an eventual rebound in global growth sometime in the coming year—growth that may be driven by coordinated monetary policy easing.

A Delicate Balance in Municipal Bonds

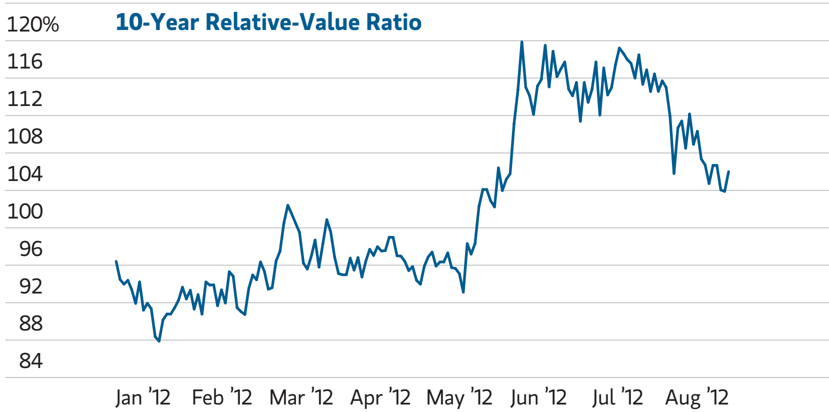
As the vacation season draws to a close, we find the municipal bond market to be maintaining a delicate balance. Mutual fund inflows have continued to be robust, while proceeds from maturing bonds and coupon payments, which are typically heavy in June and July, kept buyers engaged—even as yields have declined to uninspiring levels. Elevated levels in municipal-to-US Treasury comparisons—also known as the relative-value ratios—generally show that investors can buy top-quality tax-exempt securities that pay at least as much as, if not more than, comparable taxable government bonds.

RISK ON. More recently, the market's appetite for risk has increased mildly, driving the muni-to-Treasury ratios sharply lower and weakening the outsized relative-value pillar that helped support the muni market for most of the summer. As of Aug. 21, the 10-year relative-value ratio stood at 106% (see Figure 23). To veteran municipal bond buyers, this ratio looks pretty compelling, and we agree. However, versus a three-month average of 113% and the recent high of 120%, it pales in comparison.

The reason for the decline is simple: The benchmark 10-year US Treasury yield rose by a striking 40 basis points during the last month, while its counterpart, the 10-year Aaa-rated muni yield, climbed just 25 basis points. The long-term average for the relative-value ratio is 84%, but we expect 95% to be the near-term resistance level.

Figure 23: Relative-Value Ratio Falls, but Is Still Above Average

A few months ago, the relative-value ratio for 10-year municipal bonds approached 120%. That has since come down to near 100%, but it is still well above the long-term average of 84%.



Source: Thomson Reuters as of Aug. 21, 2012

INVESTOR CONCERNS. A confluence of recent and pending developments may soon impact the market. These include a decline in bond redemptions, growing new-issue supply, lower relative-value ratios, low absolute yields, occasional credit mishaps and still-rampant downgrades. In addition, Mitt Romney's choice of Paul Ryan as a running mate is raising concerns that, within tax reform, the federal tax exemption for muni bonds is at risk—a correct view, we believe. With these factors in mind, we are adjusting our outlook for the asset class to "cautiously neutral" from the "constructively neutral" stance adopted May 11.

HOLDINGS REVIEW. Now may be an opportune time to review portfolios—first, with an eye toward limiting overexposure to issuers experiencing, or perceived to be experiencing, credit stress; and, secondly, as a review of maturity concentrations. The municipal marketplace has performed well thus far, but weaker demand, renewed tax uncertainties and seasonally heavier supply could weigh on investor sentiment and trigger greater price volatility. We continue to advocate six-to-14-year maturities via a blend of bonds rated mid-tier A or higher, essential-service revenue bonds and general-obligation issues. State-level general-obligation bonds and appropriated paper also appear compelling, given generally improving credit quality. ■

Global Alternatives/ Absolute Return Investments Outlook

Heat and Drought Raise Commodity Prices

Commodities posted a solid gain during July, outperforming most other risk assets. The Dow Jones-UBS Commodity Total Return Index, our benchmark, increased about 6.5%. The grains sector, which surged nearly 20% amid searing heat and drought conditions in key US growing areas, provided about two-thirds of the index's gain. At the individual-commodity level, corn prices posted the largest increase, at 28%.

Aside from the recent weather-induced spike within the agricultural sector, prices for many commodities have dropped amid slowing global economic growth, a decline that has made commodities one of the worst-performing asset classes during the past year. Although nonagricultural prices could continue to slide if the economy continues to slow, we believe that the worst of the declines probably are behind us for this phase of the cycle. We note that the Citi Economic Surprise indexes for the US, Euro Zone and China have stabilized, indicating that economic expectations may have reached at least an interim bottom. Consequently, we have shifted our tactical allocation position in commodities from slightly underweight to neutral.

GOLD SPARKLES. As for gold, Hussein Allidina—head of commodity strategy at Morgan Stanley and a member of the Global Investment Committee—continues to rank it among his favorite tactical commodity picks. He forecasts an average price of $1,727 per ounce for the rest of this year and $1,816 for 2013, as compared with the current price of about $1,615. He believes investment demand for gold is likely to remain strong amid sustained low real interest rates and heightened risk aversion stemming from uncertainty surrounding the Euro Zone's sovereign debt crisis.

Hedge Funds Prove Positive in July

Hedge funds posted gains in July, with the HFRI Fund of Funds Composite Index closing up 0.73%. Overall, the majority of strategies generated profits; macro funds produced the biggest gains, while relative-value managers added to their already solid year-to-date performance (see Figure 24).

EQUITY RETURNS. The performance of long/short equity funds was muted—the HFRI Equity Hedge Index was up 0.37% relative to long-only benchmarks, due to the underperformance of their consumer-discretionary holdings and an earnings season that proved difficult to navigate. Although both the S&P 500 and MSCI World Index returned around 1.4% in July, market breadth was poor and key sectors were weak. In addition, small caps underperformed large caps. Regionally focused funds experienced mixed results, with the continuing recession and debt problems in the Euro Zone, economic slowing in China and a stalled recovery in Japan all contributing to the drag.

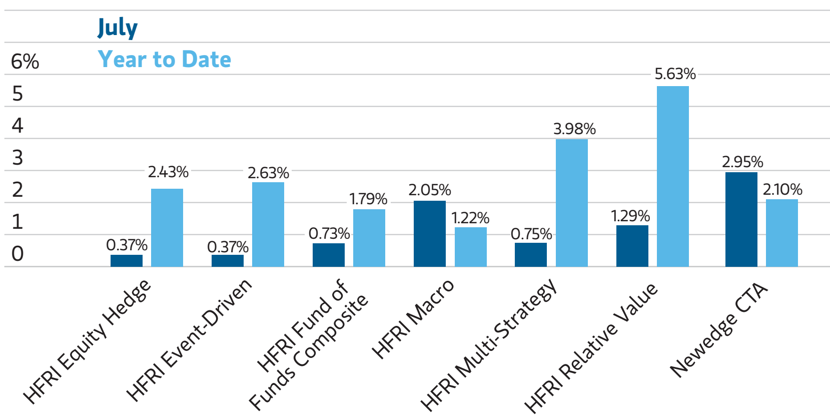
DISCRETIONARY MACRO. Discretionary macro funds exhibited strong performance, benefitting from volatility and strong trending behavior across multiple asset classes. Commodity-focused funds performed well, with contributions from the agricultural and metals sectors, while currency-focused funds posted gains due to short positions in the euro. Funds with long positions in developed-market interest rates also generated noteworthy returns. Performance among emerging market (EM) macro funds was mixed, with longs in EM interest rates driving profits and shorts in the Australian dollar accounting for the largest share of losses.

SYSTEMATIC MACRO. Most systematic macro funds generated positive returns, with the Newedge CTA Index up 2.95% in July. The rally in grains and fixed income, as well as the decline in the euro, drove gains for many medium- and long-term technical strategies. Short-term strategies benefited from the same trends, but returns were more muted as a result of losses stemming from reversals in equity and currency markets.

RELATIVE VALUE. In aggregate, relative-value funds, as measured by the HFRI

Figure 24: Modest Total Returns for Hedge Funds So Far This Year

Judged by the HFRI Fund of Funds Composite Index, hedge funds have produced modest returns so far this year. Funds following relative-value strategies have been the best performers for the year to date.



Source: Hedge Fund Research, BarclayHedge as of Aug. 21, 2012

Relative Value Index, returned 1.29%, taking year-to-date results to 5.63%. Within the strategy, dedicated mortgage funds returned approximately 2.0%, with mortgage credit being a leading contributor to returns. Prices on mortgage-backed securities rallied on improving US-housing fundamentals, as well as strong technical factors, as investors searched for yield. Dealer activity was also supportive, as inventories were rebuilt. Elsewhere, merger arbitrage was additive even though deal volume remained subdued. Credit and convertible-arbitrage strategies were positive in July, with funds benefiting both from directional and relative-value trading opportunities. Funds also generated returns from interest, currencies and bonds.

LOOKING AHEAD. We continue to maintain a cautiously optimistic outlook for quantitative equity strategies. These strategies historically have been able to withstand abrupt reversals in market sentiment as a result of their tight risk-management policies that limit market, sector and style exposures. Our concerns are prompted by the increased number of new entrants, particularly in strategies that do not have high analytical barriers to entry and, more recently, by lower market volumes and liquidity.

Among credit funds, we favor more-liquid credit strategies. Although high yield spreads have compressed, a low default forecast, improving credit metrics and robust investor demand for high yield securities are likely to be supportive for event-driven credit funds. Diminished market liquidity, as evidenced by the lowest level of broker-dealer corporate credit inventory since 2001, could keep volatility high and benefit the more nimble fund managers.

POSITIVE ON MACRO FUNDS. We are positive on macro funds as well—particularly on those engaging in more tactically oriented trading that also are able to reposition quickly to capitalize on market volatility. We also see superior opportunities for the fund managers most capable of accessing and sizing up opportunities in both commodities and the emerging markets. Similarly, we see opportunity in mortgage strategies, especially those wherein loss-adjusted yields continue to significantly exceed other fixed income categories. However, our focus is on the most credit- and/or prepayment-sensitive segments, wherein the potential to generate excess return is greatest given the high analytical barriers to entry for more-complex securities, coupled with less-efficient markets. ■

Global Investment Committee Asset Allocation Models

The Global Investment Committee (GIC) is made up of senior professionals from Morgan Stanley LLC Research, Morgan Stanley Smith Barney, Citi Investment Research & Analysis and outside financial market experts. The committee provides guidance on investment allocation decisions through the creation and maintenance of various model portfolios.

The GIC's Asset Allocation Models shown on the following pages represent its best thinking on strategic and tactical asset allocation. In these portfolios, the strategic equity allocations are in proportion to their share of global market capitalization based on the MSCI All Country World Investable Market Index. As such, the strategic allocation to non-US stocks is more than 50% of the total equity allocation.

There are three sets of models designed to provide guidance for investors with less than $1 million (Level 1), between $1 million and $20 million (Level 2) and more than $20 million in investable assets (Level 3). Accordingly, the portfolio sets have varying levels of allocations to traditional asset classes, liquid alternative investments and illiquid investments. The GIC constructs each set of portfolios on a scale of increasing risk—that is, expected volatility—and expected return. Each set consists of eight risk-tolerance levels. In each case, model 1 is the least risky and is composed mostly of bonds. As the model numbers increase, the models introduce higher allocations to equities and thus, become riskier. Alternative/absolute return investments are present in all models and provide increased asset-class diversification.

The GIC has also created and maintains strategic and tactical allocations for several other model portfolios used in various advisory programs. Most of these model portfolios incorporate a home-country bias toward the US. Under this subjective constraint, the strategic equity allocations have a 70%/30% split between US and non-US markets, and the strategic fixed income allocations have an 80%/20% split.

Global Investment Committee Asset Allocation Models for Investors With Less Than $1 Million in Investable Assets (Level 1)

Tactical Changes Effective Aug. 24, 2012

Model Portfolios	Global Bonds		Global Bonds, Global Equities and Alternative/Absolute Return Investments										Global Equities and Alternative/Absolute Return Investments			
	Model 1		Model 2		Model 3		Model 4		Model 5		Model 6		Model 7		Model 8	
	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical
Global Cash	30%	29%	15%	14%	10%	9%	8%	7%	5%	4%	3%	2%	-	-	-	-
Global Bonds																
Investment Grade	60	62	55	57	42	44	30	32	21	23	6	8	-	-	-	-
Short Duration	15	15	15	15	10	10	7	7	5	5	2	0	-	-	-	-
Government/ Government-Related	32	24	28	20	22	16	16	10	11	5	3	0	-	-	-	-
Corporate & Securitized	13	23	12	22	10	18	7	15	5	13	1	8	-	-	-	-
Inflation-Linked	10	9	3	2	3	2	3	2	3	2	2	1	-	-	-	-
High Yield	-	-	2	2	3	3	5	5	6	6	8	8	-	-	-	-
Emerging Markets	-	-	-	-	2	3	4	5	5	6	6	7	-	-	-	-
Total Bonds	**70**	**71**	**60**	**61**	**50**	**52**	**42**	**44**	**35**	**37**	**22**	**24**	**-**	**-**	**-**	**-**
Total Cash & Short Duration Bonds	45	44	30	29	20	19	15	14	10	9	5	2	-	-	-	-
Global Equities																
US Large	-	-	6	8	12	14	16	18	18	21	22	26	30	34	26	30
Growth	-	-	3	5	6	8	8	11	9	13	11	16	15	20	13	18
Value	-	-	3	3	6	6	8	7	9	8	11	10	15	14	13	12
US Mid	-	-	2	2	2	2	2	2	4	4	4	4	6	6	6	6
Growth	-	-	1	1	1	1	1	1	2	2	2	2	3	4	3	4
Value	-	-	1	1	1	1	1	1	2	2	2	2	3	2	3	2
Canada	-	-	1	1	1	1	2	2	2	2	3	3	4	4	3	3
Europe	-	-	4	4	8	4	9	4	11	5	14	7	18	12	15	9
Europe ex UK	-	-	3	3	5	2	6	2	7	2	9	4	12	8	10	6
UK	-	-	1	1	3	2	3	2	4	3	5	3	6	4	5	3
Developed Asia	-	-	2	1	5	2	5	2	6	2	8	3	10	3	9	2
Japan	-	-	1	0	3	0	3	0	4	0	5	0	6	0	6	0
Asia Pacific ex Japan	-	-	1	1	2	2	2	2	2	2	3	3	4	3	3	2
US Small	-	-	2	2	2	2	4	4	4	4	4	4	6	6	8	8
Growth	-	-	1	1	1	1	2	2	2	2	2	2	3	4	4	5
Value	-	-	1	1	1	1	2	2	2	2	2	2	3	2	4	3
World ex US Small	-	-	1	1	2	2	2	2	3	3	4	4	5	5	7	7
Emerging Markets	-	-	3	3	4	9	5	11	6	13	9	17	11	20	16	25
Total Equity	**-**	**-**	**21**	**22**	**36**	**36**	**45**	**45**	**54**	**54**	**68**	**68**	**90**	**90**	**90**	**90**
Total US Equity	-	-	10	12	16	18	22	24	26	29	30	34	42	46	40	44
Total Developed ex US Equity	-	-	8	7	16	9	18	10	22	12	29	17	37	24	34	21
Total Developed Market Equity	-	-	18	19	32	27	40	34	48	41	59	51	79	70	74	65
Total Emerging Market Equity	-	-	3	3	4	9	5	11	6	13	9	17	11	20	16	25
Global Alternative/Absolute Return Investments																
REITs	-	-	2	1	2	1	3	2	4	3	4	3	5	5	5	5
Commodities	-	-	2	2	2	2	2	2	2	2	3	3	5	5	5	5
Managed Futures	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Hedge Funds	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Private Real Estate	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Private Equity	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Total Alternative/ Absolute Return Investments	**-**	**-**	**4**	**3**	**4**	**3**	**5**	**4**	**6**	**5**	**7**	**6**	**10**	**10**	**10**	**10**

Global Investment Committee Asset Allocation Models for Investors With $1 Million to $20 Million in Investable Assets (Level 2)

Tactical Changes Effective Aug. 24, 2012

	Global Bonds		Global Bonds, Global Equities and Alternative/Absolute Return Investments										Global Equities and Alternative/Absolute Return Investments			
Model Portfolios	Model 1		Model 2		Model 3		Model 4		Model 5		Model 6		Model 7		Model 8	
	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical
Global Cash	25%	24%	13%	12%	8%	7%	5%	4%	3%	2%	2%	1%	-	-	-	-
Global Bonds																
Investment Grade	65	67	55	56	40	41	30	31	20	21	6	7	-	-	-	-
Short Duration	15	15	12	12	7	7	5	5	2	2	3	0	-	-	-	-
Government/ Government-Related	35	26	30	22	23	15	18	10	13	6	2	0	-	-	-	-
Corporate & Securitized	15	26	13	22	10	19	7	16	5	13	1	7	-	-	-	-
Inflation-Linked	10	9	3	2	3	2	3	2	3	2	2	1	-	-	-	-
High Yield	-	-	2	2	3	3	4	4	5	5	6	6	-	-	-	-
Emerging Markets	-	-	-	-	2	3	3	4	4	5	4	5	-	-	-	-
Total Bonds	**75**	**76**	**60**	**60**	**48**	**49**	**40**	**41**	**32**	**33**	**18**	**19**	**-**	**-**	**-**	**-**
Total Cash & Short Duration Bonds	40	39	25	24	15	14	10	9	5	4	5	1	-	-	-	-
Global Equities																
US Large	-	-	6	7	10	11	12	15	14	16	20	24	26	29	22	25
Growth	-	-	3	4	5	6	6	9	7	10	10	14	13	17	11	15
Value	-	-	3	3	5	5	6	6	7	6	10	10	13	12	11	10
US Mid	-	-	-	-	2	2	2	2	2	2	4	4	4	4	4	4
Growth	-	-	-	-	1	1	1	1	1	1	2	2	2	2	2	2
Value	-	-	-	-	1	1	1	1	1	1	2	2	2	2	2	2
Canada	-	-	1	1	1	1	1	1	2	2	2	2	3	3	3	3
Europe	-	-	4	4	5	3	7	3	9	4	12	6	15	10	12	6
Europe ex UK	-	-	3	3	3	2	4	2	6	2	8	3	10	8	8	4
UK	-	-	1	1	2	1	3	1	3	2	4	3	5	2	4	2
Developed Asia	-	-	2	1	3	1	4	1	5	2	6	2	8	2	7	2
Japan	-	-	1	0	2	0	3	0	3	0	4	0	5	0	4	0
Asia Pacific ex Japan	-	-	1	1	1	1	1	1	2	2	2	2	3	2	3	2
US Small	-	-	-	-	2	2	2	2	4	4	4	4	6	6	8	8
Growth	-	-	-	-	1	1	1	1	2	2	2	2	3	4	4	5
Value	-	-	-	-	1	1	1	1	2	2	2	2	3	2	4	3
World ex US Small	-	-	1	1	2	1	2	1	2	2	3	2	4	4	5	5
Emerging Markets	-	-	2	3	3	7	5	10	6	12	7	14	9	17	14	22
Total Equity	**-**	**-**	**16**	**17**	**28**	**28**	**35**	**35**	**44**	**44**	**58**	**58**	**75**	**75**	**75**	**75**
Total US Equity	-	-	6	7	14	15	16	19	20	22	28	32	36	39	34	37
Total Developed ex US Equity	-	-	8	7	11	6	14	6	18	10	23	12	30	19	27	16
Total Developed Market Equity	-	-	14	14	25	21	30	25	38	32	51	44	66	58	61	53
Total Emerging Market Equity	-	-	2	3	3	7	5	10	6	12	7	14	9	17	14	22
Global Alternative/Absolute Return Investments																
REITs	-	-	2	1	2	1	3	2	4	3	4	3	5	5	5	5
Commodities	-	-	2	2	2	2	2	2	2	2	3	3	5	5	5	5
Managed Futures	-	-	2	3	4	5	4	5	4	5	5	6	5	5	5	5
Hedge Funds	-	-	5	5	8	8	11	11	11	11	10	10	10	10	10	10
Private Real Estate	-	-	-	-	-	-	-	-	-	-	-		-	-	-	-
Private Equity	-	-	-	-	-	-	-	-	-	-	-		-	-	-	-
Total Alternative/ Absolute Return Investments	**-**	**-**	**11**	**11**	**16**	**16**	**20**	**20**	**21**	**21**	**22**	**22**	**25**	**25**	**25**	**25**

Global Investment Committee Asset Allocation Models for Investors With $20 Million or More in Investable Assets (Level 3)

Tactical Changes Effective Aug. 24, 2012

Model Portfolios	Global Bonds		Global Bonds, Global Equities and Alternative/Absolute Return Investments										Global Equities and Alternative/Absolute Return Investments			
	Model 1		Model 2		Model 3		Model 4		Model 5		Model 6		Model 7		Model 8	
	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical
Global Cash	25%	24%	13%	12%	8%	7%	5%	4%	3%	2%	2%	1%	-	-	-	-
Global Bonds																
Investment Grade	65	67	55	56	40	41	30	31	20	21	6	7	-	-	-	-
Short Duration	10	10	7	7	7	7	5	5	2	2	3	0	-	-	-	-
Government/ Government-Related	39	27	34	24	23	15	18	10	13	6	2	0	-	-	-	-
Corporate & Securitized	16	30	14	25	10	19	7	16	5	13	1	7	-	-	-	-
Inflation-Linked	10	9	3	2	3	2	3	2	3	2	2	1	-	-	-	-
High Yield	-	-	2	2	3	3	4	4	5	5	6	6	-	-	-	-
Emerging Markets	-	-	-	-	2	3	3	4	4	5	4	5	-	-	-	-
Total Bonds	**75**	**76**	**60**	**60**	**48**	**49**	**40**	**41**	**32**	**33**	**18**	**19**	**-**	**-**	**-**	**-**
Total Cash & Short Duration Bonds	35	34	20	19	15	14	10	9	5	4	5	1	-	-	-	-
Global Equities																
US Large	-	-	6	7	8	10	12	14	14	16	18	22	24	27	20	23
Growth	-	-	3	4	4	6	6	8	7	10	9	13	12	16	10	14
Value	-	-	3	3	4	4	6	6	7	6	9	9	12	11	10	9
US Mid	-	-	-	-	2	2	2	2	2	2	4	4	4	4	4	4
Growth	-	-	-	-	1	1	1	1	1	1	2	2	2	2	2	2
Value	-	-	-	-	1	1	1	1	1	1	2	2	2	2	2	2
Canada	-	-	1	1	1	1	1	1	2	2	2	2	3	3	3	3
Europe	-	-	4	4	6	4	6	4	8	4	11	5	14	8	12	6
Europe ex UK	-	-	3	3	4	2	4	2	5	2	7	2	9	5	8	4
UK	-	-	1	1	2	2	2	2	3	2	4	3	5	3	4	2
Developed Asia	-	-	2	1	3	1	3	1	5	2	6	2	8	3	7	2
Japan	-	-	1	0	2	0	2	0	3	0	4	0	5	0	4	0
Asia Pacific ex Japan	-	-	1	1	1	1	1	1	2	2	2	2	3	3	3	2
US Small	-	-	-	-	2	2	2	2	2	2	4	4	4	4	6	6
Growth	-	-	-	-	1	1	1	1	1	1	2	2	2	2	3	4
Value	-	-	-	-	1	1	1	1	1	1	2	2	2	2	3	2
World ex US Small	-	-	1	1	1	1	2	2	2	2	3	3	4	4	5	5
Emerging Markets	-	-	2	3	3	5	4	6	5	10	6	12	9	17	13	21
Total Equity	**-**	**-**	**16**	**17**	**26**	**26**	**32**	**32**	**40**	**40**	**54**	**54**	**70**	**70**	**70**	**70**
Total US Equity	-	-	6	7	12	14	16	18	18	20	26	30	32	35	30	33
Total Developed ex US Equity	-	-	8	7	11	7	12	8	17	10	22	12	29	18	27	16
Total Developed Market Equity	-	-	14	14	23	21	28	26	35	30	48	42	61	53	57	49
Total Emerging Market Equity	-	-	2	3	3	5	4	6	5	10	6	12	9	17	13	21
Global Alternative/Absolute Return Investments																
REITs	-	-	2	1	2	1	3	2	2	1	2	1	2	2	2	2
Commodities	-	-	2	2	2	2	2	2	2	2	3	3	5	5	5	5
Managed Futures	-	-	2	3	4	5	4	5	4	5	5	6	5	5	5	5
Hedge Funds	-	-	5	5	8	8	11	11	11	11	10	10	10	10	10	10
Private Real Estate	-	-	-	-	-	-	-	-	2	2	2	2	3	3	3	3
Private Equity	-	-	-	-	2	2	3	3	4	4	4	4	5	5	5	5
Total Alternative/ Absolute Return Investments	**-**	**-**	**11**	**11**	**18**	**18**	**23**	**23**	**25**	**25**	**26**	**26**	**30**	**30**	**30**	**30**

Endnotes

1. The strategic allocation refers to the long-term investment weightings for the major asset classes that best fit an investor's specific circumstances, a risk profile including their ability and willingness to tolerate risk, and return objectives, and that take into account the asset returns, standard deviations of returns, and correlations of returns under varying economic and financial conditions.

2. The tactical allocation incorporates active decisions to overweight or to underweight asset classes in the near-term relative to their strategic allocation based on: (i) the current and projected financial and economic environment; (ii) evaluations of risk in global asset markets; and (iii) other fundamental, valuation, and psychological, technical, liquidity factors.

3. The eight portfolios displayed in the accompanying matrix are arranged from left to right in a general progression from conservative through moderate to aggressive risk profiles.

4. A conservative asset allocation risk profile tends to encompass: (i) relatively lower, or in some cases zero, levels of exposure to equities and to investments outside the investor's home country and currency; and (ii) relatively higher levels of exposure to cash, fixed income, and investments inside the investor's home country and currency. A conservative asset allocation risk profile style may generally be expected to exhibit lower price volatility as measured by the standard deviations of annual returns from the portfolio and generally seeks to generate a somewhat greater proportion of its returns from income as compared with capital gains.

5. A moderate asset allocation risk profile tends to encompass: (i) relatively moderate levels of exposure to equities and to investments outside the investor's home country and currency; and (ii) relatively moderate levels of exposure to cash, to fixed income and investments inside the investor's home country, and to currency. A moderate asset allocation risk profile may generally be expected to exhibit moderate price volatility as measured by the standard deviations of annual returns from the portfolio and generally seeks to generate a somewhat balanced proportion of its returns from income as well as from capital gains.

6. An aggressive asset allocation risk profile tends to encompass: (i) relatively higher levels of exposure to equities and to investments outside the investor's home country and currency; and (ii) relatively lower, or in come cases zero, levels of exposure to cash, to fixed income and investments inside the investor's home country, and to currency. An aggressive asset allocation risk profile may generally be expected to exhibit higher price volatility as measured by the standard deviations of annual returns from the portfolio and generally seeks to generate a somewhat lower proportion of its returns from income as compared with capital gains.

7. The cash/cash equivalent asset class may include US dollar-based short-term investments as well as non-US dollar-based short-term investments, and/or Exchange-Traded Funds (ETFs) or other instruments dedicated to US and/or to non-US cash and cash equivalents. In a rising US dollar environment, the return to US dollar-based investors from unhedged non-US dollar investments will be lower than US dollar returns. In a falling US dollar environment, the return to US dollar-based investors from unhedged non-US dollar investments will be higher than US dollar returns.

8. Fixed income holdings may be either taxable or tax exempt, depending on the instrument and/or the investor's current and future tax status. As a matter of practice, many investors tend to hold certain types of investments in their taxable accounts, such as: (i) tax-exempt municipal bonds; and (ii) assets that generate a significant proportion of their total return from long-term capital gains. Similarly, many investors tend to hold certain other types of investments in their tax-deferred, tax-exempt, or low-tax accounts, such as: (i) taxable bonds; (ii) assets that generate a significant proportion of their total return in the form of dividends, taxable interest income, accredited income and/or short-term trading profits. It may thus be helpful for investors to mentally and/or computationally combine the assets held in their taxable and their tax-exempt accounts to gain perspective on the overall asset allocation of their investments.

9. Duration is a measure of the average cash-weighted term-to-maturity of a bond. It is a frequently used measure of the sensitivity of a bond's price and the present value of its cash flows relative to interest rate movements. The specific desired duration of investment grade, high yield and emerging markets bond holdings will usually be influenced by the investor's interest rate expectations. In a rising interest rate environment, investors may choose to generally shorten the duration of their fixed income holdings, and in a falling interest rate environment, investors may choose to generally lengthen the duration of their fixed income holdings.

10. Depending on the interest rate environment and other factors, certain fixed income securities, such as preferred stocks and convertible securities trading near their bond equivalent value, may be included within the fixed income asset category.

11. Global investment grade bonds include: (i) US dollar denominated or non-US dollar denominated US Treasury securities; (ii) US dollar denominated or non-US dollar denominated US Federal Agency and other Government-related securities; (iii) many US dollar denominated or non-US dollar denominated securitized and/or mortgage-backed securities carrying investment grade quality ratings from the major credit rating services; (iv) US dollar denominated or non-US dollar denominated corporate and/or municipal bonds carrying investment grade quality ratings from the major credit rating services; and (v) certain other US dollar denominated or non-US dollar denominated instruments. For tax-related and/or other reasons, some investors may implement their investment grade bond exposure through tax-exempt securities. In periods of deteriorating credit conditions, investors may choose to improve the credit quality of their bond holdings by focusing on higher-rated sectors of the global investment grade bond universe, and in periods of improving credit market conditions, investors may choose to lessen the credit quality of their bond holdings by focusing on a broader range of credit ratings, possibly including lower-rated issues, within the global investment grade bond universe. Non-US dollar Fixed Income Securities holdings are considered to be hedged into US dollars, unless otherwise noted. In a rising US dollar environment, the return to US dollar-based investors from unhedged non-US dollar investments will be lower than US dollar returns. In a falling US dollar environment, the return to US dollar-based investors from unhedged non-US dollar investments will be higher than US dollar returns.

12. Short duration investment grade bonds are considered here to be fixed income instruments with a Moody's/Standard & Poor's credit quality rating of Baa3/BBB- or higher with duration of two years or less. Duration is a measure of the average cash-weighted term to maturity of a bond and is a frequently used measure of the sensitivity of a bond's price and the present value of its cash flow relative to interest rate movements.

13. Certain equity industry groups and their specific component companies may entail exposure to the forces and factors affecting alternative/absolute return investments, including: (i) real estate and/or energy infrastructure assets, such as pipelines and storage facilities; (ii) commodities (including energy, agriculturals, base metals, and precious metals); and (iii) direct ownership in timber and/or oil and gas properties. Such equity industry groups may be included within the equity asset category.

14. For investors with investable assets greater than $1 million, the absolute equity weighting, as well as the relative degree of tactical versus strategic equity exposure, may be somewhat lower than total equity weightings for those investors with investable assets of less than $1 million. This is primarily due to the

greater degree of accessibility that investors with investable assets greater than $1 million may have to the alternative/absolute return investments asset classes, which tend to be characterized by high investment minimums, possibly lower liquidity, and special capital entry and exit provisions.

15. Currency exposure for the non-US equity and non-US alternative/absolute return investments asset classes is generally not hedged into US dollars unless otherwise noted. In a rising US dollar environment, the return to US dollar-based investors from unhedged non-US dollar investments will be lower than US dollar returns. In a falling US dollar environment, the return to US dollar-based investors from unhedged non-US dollar investments will be higher than US dollar returns.

16. As an alternative to investing in specific non-US countries, investment styles, market capitalization levels and companies, investors with investable assets of less than $1 million may choose to implement non-US equity asset class exposure through investment vehicles linked to a non-US broad market index. In a rising US dollar environment, the return to US dollar-based investors from unhedged non-US dollar investments will be lower than US dollar returns. In a falling US dollar environment, the return to US dollar-based investors from unhedged non-US dollar investments will be higher than US dollar returns.

17. For some investors, small percentage allocations to certain asset classes may entail inefficient considerations of cost, monitoring and liquidity; in such cases, investors may choose to aggregate these small-percentage allocations with similar asset classes within the same asset category.

18. The alternative/absolute return investments asset category is considered here to include asset classes that tend to respond to a range of influences in addition to and/or instead of the fundamental underlying forces such as interest rates, economic conditions, and corporate profitability affecting equities, fixed income securities, and cash asset categories. Such influences include: (i) supply-demand considerations for the underlying asset(s); (ii) investor preferences relating to store-of-value considerations; (iii) unconventional investment techniques involving short selling, the borrowing or lending of securities and/or investment capital; (iv) the use of swaps, options, futures and other derivatives; and/or (v) investment manager skill. Within an asset allocation context, alternative/absolute return investments are intended to provide some degree of exposure to returns and standard deviations of returns that tend generally not to be highly correlated with the investment performance of the equity, fixed income and cash asset categories. Due to the fact that many alternative/absolute return investments may have, compared to conventional asset classes: (i) less liquidity; (ii) higher investment vehicle minimums; (iii) unconventional frequency and methodology of pricing; (iv) extended investment timeframes and/or lockup periods; (v) unusual risk/reward profiles; (vi) less predictable timing for capital inflows and outflows; (vii) higher fee structures; (viii) greater or fewer regulatory, tax reporting, and/or compliance requirements; and (ix) more leverage, investors should consider the asset allocations set forth here in light of: (a) their own specific circumstances, risk profile including their ability and willingness to tolerate risk, and return objectives; (b) their short-term and long-term investment outlook; and (c) the universe of investments that are suitable for and appropriate to their investment temperament and wealth level.

19. Owing to the characteristics of alternative/absolute return investments, many asset classes within this asset category may not be available to investors at all wealth levels. Asset classes that may generally be unavailable to certain investor wealth levels because of minimum investor asset requirements and/or minimum instrument purchase requirements have blank percentage allocation weightings.

20. The global real estate investment trust (REIT) asset class, which tends toward investment exposure to commercial real estate properties (including, but not limited to, office buildings, apartment buildings, hotels and shopping centers), may also include publicly traded companies engaged in the ownership, development and/or management of real estate, and is considered here to exclude an investor's primary residence(s).

21. Real estate investment exposure may be achieved through private equity real estate interests. The private equity real estate asset class may involve special investment considerations, including: (i) investor net asset minimum criteria; (ii) investment vehicle entry and exit conditions; (iii) regulatory, tax reporting and/or compliance requirements; (iv) suitability guidelines; and (v) other risk factors.

22. The commodities asset class is considered here to include precious metals, base metals, agriculturals, energy and/or partnership or direct ownership interests in oil-, gas- and timber-related properties. Commodities exposure may also be implemented through holdings of Equity securities of precious metals-, base metals-, agricultural-, energy- and/or oil-, gas- and timber-related companies.

23. The US Treasury form of inflation-linked securities (known as Treasury Inflation-Protected Securities, or TIPS) is generally exempt from state and local income taxes. Each semiannual interest payment, including: (i) the coupon; and (ii) the accrued inflation adjustment amount, is subject to federal taxes on ordinary income each year. Ordinary income taxes are due on the inflation adjustments of the principal component of the security, even though the inflation adjustment portion is not realized until maturity or until the security is sold. The taxation of this "phantom income" may cause a misalignment between the investor's tax liabilities and actual cash coupon payments received from the investment. Morgan Stanley Smith Barney does not offer tax advice for investors. Investors should consult their tax counsel for specific advice regarding tax matters. Investment exposure to US or to non-US inflation-linked securities can be implemented on an individual instrument basis and/or through Exchange-Traded Funds (ETFs) specializing in such assets.

24. The private equity asset class is considered here to include several subcategories, such as: (i) leveraged buyout and management buyout activity; (ii) direct ownership of equity stakes in privately held firms; and (iii) venture capital investing. For the private equity asset class, special investment considerations may include: (i) investor net asset minimum criteria; (ii) investment vehicle entry and exit conditions; (iii) regulatory, tax reporting and/or compliance requirements; (iv) suitability guidelines; and (v) other risk factors that may vary by private equity subcategory.

25. Managed futures funds typically are operated by commodity trading advisors utilizing commodity and financial (equity, interest rate, foreign exchange) futures contracts, forwards, and options. For the managed futures asset class, special investment considerations include: (i) investor net asset minimum criteria; (ii) manager fees; and (iii) regulatory, tax, reporting and/or compliance requirements. Managed futures funds may not be appropriate for all investors. In view of the relatively high standard deviations of returns that may be associated with any single managed futures manager, investors may choose to implement their allocation to managed futures using a fund of funds approach and/or a broadly diversified group of managed futures managers and strategies.

26. For the hedge funds asset class, including funds of hedge funds, special investment considerations include: (i) investor net asset minimum criteria; (ii) investment vehicle entry and exit conditions; (iii) regulatory, tax reporting and/or compliance requirements; (iv) suitability guidelines; and (v) other risk factors that may vary by investor category. Hedge funds may not be suitable for all investors. In view of the potentially high standard deviations of returns that may be associated with any single hedge fund manager, investors may choose to implement their allocation to hedge funds using a fund of funds approach and/or a broadly diversified group of hedge fund managers and strategies. Funds of funds generally have higher fee structures than single hedge fund manager strategies. Certain FX/currency managers that employ a fundamentally driven investment process may be viewed as a subset of the hedge fund (global macro) asset class. Certain FX/currency managers that employ trend-following, quantitatively-driven techniques may be viewed as a subset of the managed futures asset class.

Index Definitions

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

MSCI USA INDEX This is a free-float-adjusted, market-capitalization-weighted index that is designed to measure large- and mid-cap US equity market performance.

MSCI EUROPE INDEX This is a free-float-adjusted, market-capitalization-weighted index that is designed to measure the equity market performance of the developed markets in Europe. It consists of the following 15 country indexes: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden and Switzerland.

BARCLAYS CAPITAL US AGGREGATE CORPORATE INVESTMENT GRADE INDEX This index represents securities that are investment grade, SEC registered, taxable and dollar denominated.

CITI GLOBAL MARKETS HIGH YIELD MARKET INDEX This index captures the performance of below-investment-grade debt issued by corporations domiciled in the United States or Canada. It 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.

CITI GLOBAL EMERGING MARKET SOVEREIGN BOND INDEX This index includes Brady bonds and US-dollar-denominated emerging market sovereign debt issued in the global, Yankee and Eurodollar markets, excluding loans. The ESBI offers diversification benefits with respect to the geographical and asset-class dimensions. It comprises debt in Africa, Asia, Europe and Latin America.

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.

MSCI EMERGING MARKETS INDEX This index measures the performance of equities issued by companies domiciled in the emerging markets.

RUSSELL 2000 INDEX This index measures the performance of the 2000 smallest companies in the Russell index universe. It represents approximately 10% of US market capitalization.

RUSSELL TOP 200 INDEX This index measures the performance of the largest-cap segment of the US equity universe. It includes approximately 200 of the largest securities based on a combination of their market cap and current index membership and represents approximately 68% of US market capitalization.

BARCLAYS CAPITAL US AGGREGATE CORPORATE INVESTMENT GRADE INDEX This index represents securities that are investment grade, SEC registered, taxable and dollar denominated.

BARCLAYS CAPITAL US AGGREGATE CORPORATE HIGH YIELD INDEX The index includes publicly issued US-dollar-denominated non-investment grade, fixed-rate, taxable corporate bonds that have a remaining maturity of at least one year, are rated high yield using the middle rating of Moody's, S&P and Fitch, respectively, and have $600 million or more of outstanding face value.

DOW JONES-UBS COMMODITY INDEX This index comprises futures contracts on 19 physical commodities. They include energy, industrial metals, precious metals and agricultural commodities.

HFRI EQUITY HEDGE INDEX Equity hedge strategies maintain positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of the levels of net exposure, leverage, holding period, concentrations of market capitalizations and valuation ranges of typical portfolios of market capitalizations and valuation ranges of typical portfolios.

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

HFRI EVENT DRIVEN INDEX This is an index of strategies that maintain positions in companies currently or prospectively involved in a wide variety of corporate transactions including but not limited to mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance or other capital structure adjustments.

HFRI FUND OF FUNDS COMPOSITE INDEX This is an equal-weighted index of 650 hedge funds with at least $50 million in assets and 12 months of returns. Returns are reported in US dollars and are net of fees.

HFRI MACRO INDEX These funds trade a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard currency and commodity markets. Managers employ a variety of techniques, both discretionary and systematic analysts and combination of top-down and bottom-up analyses.

HFRI MULTI-STRATEGY INDEX Multi-Strategy strategies employ components of both discretionary and systematic macro strategies, but neither exclusively both. Strategies frequently contain proprietary trading influences, and in some cases contain distinct, identifiable substrategies, such as equity hedge or equity market neutral, or in some cases a number of substrategies are blended together without the capacity for portfolio-level disaggregation.

HFRI RELATIVE VALUE INDEX This index tracks managers who maintain positions in which the investment thesis is predicated on realization of a valuation discrepancy in the relationship between multiple securities. Managers employ a variety of fundamental and quantitative techniques to establish investment theses, and security types range broadly across equity, fixed income, derivative or other security types.

NEWEDGE CTA INDEX This index calculates the daily rate of return for a pool of commodity trading advisors as selected from the larger managers that are open to new investments.

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International investing entails greater risk, as well as greater potential rewards compared to US 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, funds of hedge funds, private equity, and managed futures funds, are speculative and entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds and risks associated with the operations, personnel and processes of the advisor.

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

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

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.

A taxable equivalent yield is only one of many factors that should be considered when making an investment decision. Morgan Stanley Smith Barney and its Financial Advisors do not offer tax advice; investors should consult their tax advisors before making any tax-related investment decisions.

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 US Treasuries in times of low inflation.

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.

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.

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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.

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

Principal is returned on a monthly basis over the life of a mortgage-backed security. Principal prepayment can significantly affect the monthly income stream and the maturity of any type of MBS, including standard MBS, CMOs and Lottery Bonds. Yields and average lives are estimated based on prepayment assumptions and are subject to change based on actual prepayment of the mortgages in the underlying pools. The level of predictability of an MBS/CMO's average life, and its market price, depends on the type of MBS/CMO class purchased and interest rate movements. In general, as interest rates fall, prepayment speeds are likely to increase, thus shortening the MBS/CMO's average life and likely causing its market price to rise. Conversely, as interest rates rise, prepayment speeds are likely to decrease, thus lengthening average life and likely causing the MBS/CMO's market price to fall. Some MBS/CMOs may have "original issue discount" (OID). OID occurs if the MBS/CMO's original issue price is below its stated redemption price at maturity, and results in "imputed interest" that must be reported annually for tax purposes, resulting in a tax liability even though interest was not received. Investors are urged to consult their tax advisors for more information.

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.

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

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.

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