



Global Investment Committee Monthly

IN BRIEF

July Meeting Summary

MARKETS. Our cautious tactical asset allocation remains in place, given the still inadequate policy response to both the European recession and slower US growth. We are overweight (OW) cash, short-duration bonds, investment grade bonds and managed futures. We are underweight developed-country sovereign debt, high yield bonds, equities, commodities, global real estate investment trusts and inflation-linked securities. We are market weight emerging market (EM) bonds. 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 tilt 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. The policy options to promote growth in DM economies are variously limited, politically unlikely or too little, too late. Moreover, fiscal policy is tightening in Europe and is likely to tighten in the US as the fiscal cliff approaches. We expect the

cliff to be addressed after the election. By contrast, fundamentals and policy options in EM economies are generally more robust. Globally, we expect inflation to abate.

PROFITS. Expectations for 52-week forward earnings per share (EPS) are mixed. The S&P 500 forward earnings figure is now above \$112, up from a low of \$107 last autumn. However, 52-week forward EPS for global equities has dropped to about \$28, down from more than \$30 last summer.

INTEREST RATES. DM central-bank policy rates are likely to remain low at least into 2014. The Federal Reserve has extended Operation Twist, given continued tepid US growth; a third round of Quantitative Ease is likely. The European Central Bank (ECB) policy rate is now below 1%. Moreover, the ECB now indirectly supports the 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, and are a subset of the GIC asset allocation models that are shown starting on page 19. The strategic equity allocations in these portfolios are in proportion to their share of global market capitalization.

EFFECTIVE JAN. 20, 2012

Model	Moderate Balanced Strategic Weight	Tactical Relative Weight	Equity & Alternative Investments Strategic Weight	Tactical Relative Weight	Bond & Alternative Investment Strategic Weight	Tactical Relative Weight
Global Cash	5%	2%	0%	0%	25%	2%
Global Bonds	37	0	0	0	65	-1
Global Equities	32	-2	70	-4	0	0
Global Alternative/Absolute Return Investments	26	0	30	4	10	-1
Global Bonds						
Investment Grade	30	1	-	-	65	-1
Short Duration	5	2	-	-	10	2
Government/Government-Related	18	-8	-	-	39	-12
Corporate & Securitized	7	7	-	-	16	9
High Yield	4	-1	-	-	-	-
Emerging Markets	3	0	-	-	-	-
Total Bonds	37	0	-	-	65	-1
Total Cash & Short Duration Bonds	10	4	-	-	35	4
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	-4	14	-10	-	-
Europe ex UK	4	-4	9	-8	-	-
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	-2	70	-4	-	-
US Equity	16	2	32	3	-	-
Developed World ex US	12	-6	29	-15	-	-
Developed Market Equity	28	-4	61	-12	-	-
Emerging Market Equity	4	2	9	8	-	-
Global Alternative/Absolute Return Investments						
REITs	3	-1	2	0	-	-
Commodities	2	-1	5	-1	-	-
Inflation-Linked Securities	3	-1	-	-	10	-1
Managed Futures Funds	4	3	5	5	-	-
Hedge Funds	11	0	10	0	-	-
Private Real Estate	-	-	3	0	-	-
Private Equity	3	0	5	0	-	-
Total Alternative/Absolute Return Investments	26	0	30	4	10	-1

Source: Global Investment Committee as of Jan. 20, 2012

Tactical Asset Allocation Reasoning

Global Bonds	Relative Weight Within Bonds	
Short Duration	Overweight	Given the heightened risk of recession in many developed economies, we favor this safe-haven asset class.
Government	Underweight	With yields near historical lows in perceived safe havens and an unusual degree of uncertainty about additional credit downgrades and default risk in some countries, we see better value elsewhere within the bond market.
Investment Grade Corporates	Overweight	These bonds offer relative safety and quality. In the US, yield spreads versus Treasuries are above average.
High Yield	Underweight	If the “growth scare” continues, yield spreads are likely to widen.
Emerging Markets	Market Weight	Attractive yield spreads are offset by a desire to limit exposure to riskier asset classes.

Global Equities	Relative Weight Within Equities	
US	Overweight	We have a defensive stance that favors large-cap stocks at the capitalization level and growth stocks at the style level. Relative-valuation readings also support this positioning.
Developed Markets ex US	Underweight	At the regional level, we are market weight to Canada and the Asia Pacific ex Japan region (predominantly Australia) and underweight to Europe and Japan, where challenges to economic growth appear to be structural as well as cyclical.
Emerging Markets	Overweight	Fundamental factors such as economic and earnings growth, government balance sheets and indebtedness remain relatively favorable. 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.
Commodities	Underweight	Demand for many commodities will be negatively affected by the slowing in global economic activity.
Inflation-Linked Securities	Underweight	With breakeven rates close to their long-term averages and the threat of inflation subdued, we see better value elsewhere.
Managed Futures	Overweight	This asset class often performs well as a hedge against adverse equity market conditions.

Open Door Policy

Central banks around the world have left the door open to further easing if growth continues to disappoint.

As economic data have largely continued to disappoint, it is increasingly clear that the direction of financial markets for the remainder of the year depends upon both the actions and rhetoric of policymakers across the globe. The potential for and vulnerability to shocks remains high, with the Euro Zone debt crisis and the US fiscal cliff looming large. This does not create an attractive backdrop for bold changes in investment strategy. Accordingly, our broad strategy must remain cautious and mindful of the elevated nature of fat tail risks.

A modest improvement or even stabilization of economic data in the US might be a positive catalyst for sentiment, but neither scenario seems probable in the short term. New orders have fallen sharply of late, income growth is struggling and the June US jobs report was weak for the third time in a row (see Chart 1). In our view, these trends point to a GDP growth rate of about 2%. Since such a slow growth rate is too feeble to materially lower the elevated unemployment rate, we believe that the Federal Reserve will respond this summer with a third round of Quantitative Ease. Unfortunately, we do not think that action will do much to boost lackluster GDP growth.

Given weaker growth, the Federal Reserve decided late last month to extend Operation Twist through Dec. 31. The extension allows the Fed to keep purchasing Treasury securities with maturities of six to 30 years and selling

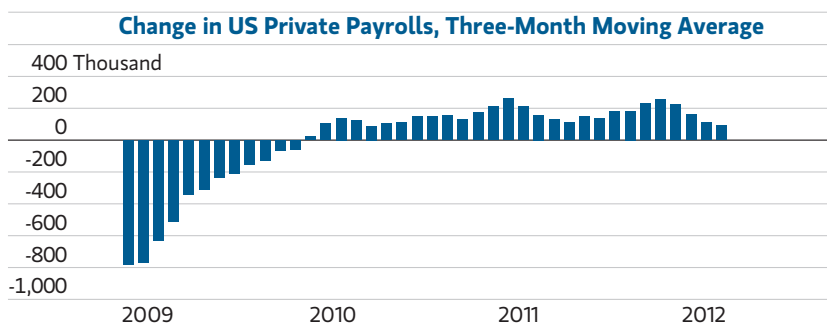
securities with maturities of three years or less, thereby putting downward pressure on long-term interest rates. The Fed's balance sheet will remain largely unchanged but, thanks to two previous rounds of Quantitative Ease, it is still nearly \$2 trillion larger than it was before the financial crisis and recession. Indeed, all the primary central banks—the Fed, the People's Bank of China (PBOC), the European Central Bank (ECB), the Bank of Japan and the Bank of England—have dramatically increased their balance sheets (see Chart 2). In aggregate, these

five central banks' balance sheets have grown to nearly \$13.6 trillion from about \$6.5 trillion in a little more than four years. That's equivalent to nearly 20% of global GDP, and it is the key reason that the financial crisis didn't tip the global economy into recession.

However, growing their balance sheets isn't all that central banks have been up to. The ECB recently cut its main interest rate 25 basis points to 0.75%, and the PBOC lowered rates for the second time in a month. A global easing cycle is under way, and central bankers have left the

Chart 1: US Job Creation Slows Down

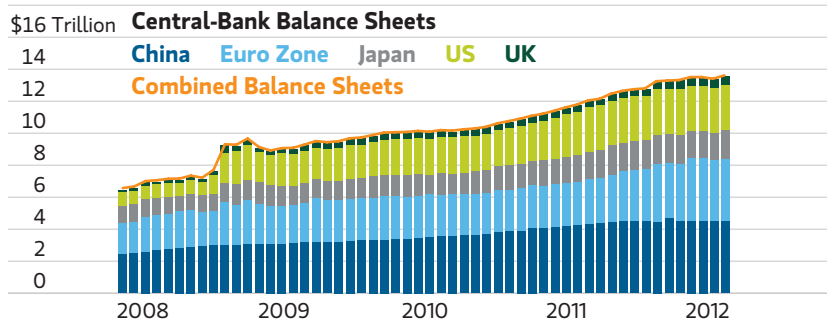
Private-sector jobs growth has slowed. At this pace, it will be hard to materially lower the unemployment rate.



Source: US Bureau of Labor Statistics, FactSet as of June 30, 2012

Chart 2: Global Easing Swells Central-Bank Balance Sheets

The world's five main central banks have dramatically increased their balance sheets during the past four years. In aggregate, they have more than doubled to nearly \$13.6 trillion, which is nearly 20% of global GDP.



Note: The January 2008 and June 2012 values in US dollars for each of these central banks are as follows: People's Bank of China, \$2.41 trillion and \$4.50 trillion; European Central Bank, \$1.97 trillion and \$3.89 trillion; Bank of Japan, \$1.05 trillion and \$1.81 trillion; Federal Reserve, \$865 billion and \$2.81 trillion; and the Bank of England, \$185 billion and \$561 billion. The totals for the five are \$6.48 trillion and \$13.57 trillion.

Source: Federal Reserve, European Central Bank, Bank of Japan, People's Bank of China and Bank of England as of June 30, 2012

door open to taking further action. Fed Chairman Ben Bernanke recently said, “We are prepared to do what’s necessary,” and ECB President Mario Draghi remarked, “We are not running short of policy options.”

Risk-asset markets, however, have had a muted response to the latest efforts by the central banks, suggesting that investors are suffering from incremental policy fatigue and awaiting more-decisive responses to the problems besetting the global economy. For now, global equities have yet to recover to their pre-Great

Recession highs: The MSCI All Country World Index is 27% below its all-time peak in October 2007. On a year-over-year basis, the total return for global equities is -1.7%. However, the total return for US equities is 6.9%, which is especially important for US households; equities, along with residential real estate, account for nearly half of US household assets (see Chart 3). They also represent more-liquid sources of wealth than other household holdings such as pension fund reserves, privately owned businesses and life insurance

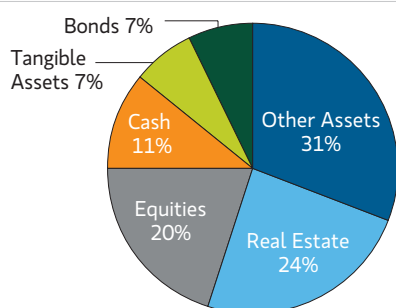
contracts. Higher home and equity prices would also help to further deleverage household balance sheets.

HALFWAY DELEVERAGED. Households have done some deleveraging already. Lower interest rates have helped to drive down the financing costs as a share of income in recent years. Debt service, as a percentage of disposable income, is at its lowest level in 18 years—about 11% (see Chart 4). The financial obligations ratio, which adds automobile lease payments, rent on tenant-occupied properties, homeowners’ insurance and property taxes to debt service as a percentage of disposable income, stands at 16%—also the lowest level since 1994. Based on the aftermath of previous debt crises, Morgan Stanley Chief US Economist Vincent Reinhart estimates US households are about halfway through the deleveraging cycle.

RAIN IN SPAIN. Of course, getting sustainable growth again partly depends on what happens in Europe. The EU summit in late June produced a crucial break in the negative feedback loop between Spanish banks and Spanish sovereign debt by proposing that the €500 billion European Stability Mechanism could inject cash directly into Spanish banks—once the ECB can install a Euro Zone banking supervisor. Regarding the specifics, “That

Chart 3: What Do US Household Assets Comprise?

Equities and residential real estate make up nearly half of US households’ assets. With prices in both asset classes struggling, it is difficult for households to rebuild their balance sheets.

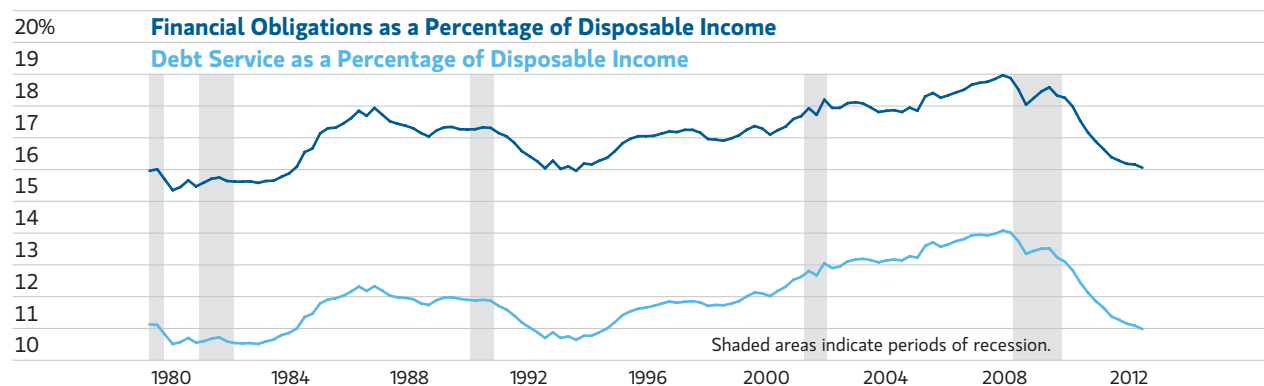


Note: Other Assets includes noncorporate business equity, pension fund reserves, life insurance reserves and security credit. Tangible Assets includes consumer durable goods, equipment and software.

Source: Federal Reserve Board, Morgan Stanley Smith Barney as of June 30, 2012

Chart 4: Lower Interest Rates Help to Drive Down Debt Service

Lower interest rates have helped to drive down households’ debt service as a percentage of disposable income to the lowest level since 1994. The same can be said for the broader financial obligations ratio. Both are measures of household deleveraging.



Note: The financial obligations ratio adds automobile lease payments, rent on tenant-occupied properties, homeowners’ insurance and property-tax payments to the debt service ratio.

Source: Bureau of Economic Analysis, Federal Reserve as of March 31, 2012

will take time. It's complex. That's not easy to create, but we will work on it," said Wolfgang Schauble, Germany's finance minister.

In our view, European policymakers still face roadblocks in trying to preserve the euro and improve the EU economy. The tough challenges include establishing full fiscal policy union, recapitalizing the banking system, creating a European deposit-insurance program, creating a Eurobond market and empowering the ECB to operate as a true lender of last resort.

Given the recession in Europe, we believe that the ECB will further ease monetary policy by taking short-term interest rates to zero and engaging in additional securities purchases. Elga Bartsch, Morgan Stanley's European economist, foresees no GDP recovery until 2014. Europe thus faces an extended period of growth challenges, harkening back to Japan's two "lost decades" since 1990. Alongside this process, we expect the euro to continue to soften, especially against the US dollar. The euro has already declined 17% in the past 15 months.

In contrast with developed-market (DM) policymakers, emerging market

(EM) policymakers have a more robust tool set to deploy to offset the impact of slowing growth. In addition to the PBOC, other EM central banks in Russia, India, Turkey and Brazil have eased of late. We also expect China to engage in fiscal stimulus targeting infrastructure and welfare spending, as well as to introduce measures to support the property market.

The global economy is in its weakest state since the recovery started. Nevertheless, because of the incremental growth generated by EM economies, we still expect positive global GDP growth of nearly 3.5% in 2012. That growth, however, will be uneven, with about 80% coming from the EM economies. The US economy should be able to muddle through, barring a big shock.

FISCAL CLIFF. One potential shock is the \$525 billion fiscal cliff—some 3% of GDP—that the economy faces next year unless Congress extends tax cuts and benefit programs and curbs the spending mandates that are due to take effect on Jan. 1. Little is likely to happen before the November elections, and it will be up to a postelection lame-duck session of Congress to find a solution. With

those political decisions being election dependent, uncertainty about how the cliff will be navigated is likely to cause increasing market concern toward the end of this year. Failure to defer the changes could result in enough fiscal drag to cause a recession, according to the Congressional Budget Office. Postelection, we think that there will be an agreement to mitigate and/or delay the fiscal cliff.

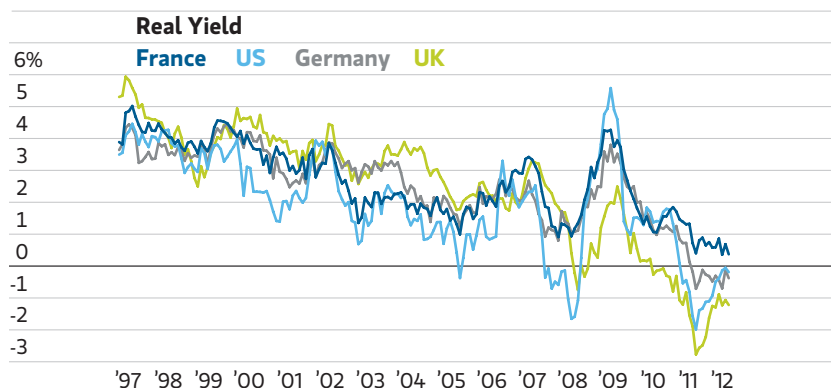
TACTICAL ASSET ALLOCATION. We remain slightly underweight in our allocation to risk assets—equities, real estate investment trusts (REITs), commodities and high yield bonds. In global equities, we hold 2% less exposure in our balanced tactical models than we do in our comparable strategic models. Conversely, we are overweight safe havens—cash, short-duration debt and investment grade bonds—as well as managed futures. At a more detailed level, our positioning does take tactical risks. For example, we remain overweight EM equities, for which dividend yields, valuations and relative growth prospects remain favorable; this is also where more policy flexibility exists.

Within DM equities, we favor the US over Europe and Japan, both of which face daunting cyclical, structural and political headwinds. Within US equities, we continue to favor large-cap stocks. Those stocks typically outperform during adverse market conditions and currently offer a relative-valuation advantage. At the style level, we prefer growth stocks to value stocks. During periods of decelerating corporate earnings, growth stocks—companies that have the ability to generate relatively stable earnings growth regardless of the economic backdrop or those expected to post above-average earnings growth—often hold up better. Moreover, value stocks appear somewhat expensive relative to growth stocks on a historical basis.

ALTERNATIVE INVESTMENTS. Among the alternative/absolute return investments in our model portfolios, we are maintaining slight underweight tactical allocations to commodities and REITs. We believe it is prudent to limit exposure to these economically sensitive asset classes in

Chart 5: Real Yields in Stronger Countries Are Negative or Almost So

Real yields on US, UK and German government bonds are negative, which means investors lose money after inflation. The real yield on French bonds is barely positive. This situation is one reason we have an underweight asset allocation in developed-market government bonds.



Note: The real yield is calculated by subtracting each respective country's headline consumer price index (CPI) rate from its 10-year sovereign bond yield. For Germany, CPI is as of June 29, 2012. For the US, UK and France, CPI is as of May 31, 2012.

Source: Bloomberg as of July 10, 2012

light of slowing global growth, the recession in Europe and vulnerabilities in the US. In managed futures, we have a tactical overweight position. This asset class has low historical-return correlations with other asset classes, thereby providing a considerable degree of portfolio diversification. Moreover, as was the case in May of this year, managed futures have historically performed well during adverse equity markets.

CASH AND FIXED INCOME. It is difficult to make a compelling valuation case for cash and short-duration bonds when their yields generally fall short of inflation and

appear expensive relative to equities and other risk assets. However, given the cyclical risks we foresee, the defensive properties of these asset classes should provide ballast to a diversified portfolio during periods of market turbulence; thus, we are modestly overweight in cash and short-duration debt. Within bonds, we remain significantly underweight in DM sovereign debt, as real yields on US, UK and German government bonds are negative and those on French bonds are barely positive (see Chart 5, page 6). In prioritizing safety and quality over wide spreads, we are limiting our exposure to

high yield corporate bonds and emerging market debt, while favoring exposure to investment grade corporate bonds.

IN CONCLUSION. As new challenges and opportunities appear, we continue to evaluate our risk exposure and tactical positioning. Our analyses suggest many safe havens would have less vulnerability in the likely challenging economic period ahead. As a result, at a high level, our asset allocation models remain overweight to global cash, market weight in global bonds and alternative/absolute return investments and underweight in global equities. ■

While both Citi and Morgan Stanley economists envision Germany muddling through with roughly a 1% growth rate this year and next, Citi projects that France and the Netherlands will be in the negative column throughout that period. Furthermore, the EZ tentacles seem to be branching out

across the oceans. Indeed, recent purchasing managers' reports for the US and China have revealed a slowing in manufacturing activity (see Chart 6). In the case of the US, the purchasing managers' gauge fell below 50, which is a key threshold, for the first time since July 2009.

Economic Outlook

Euro Zone Ripple Effect

From an economic vantage point, nothing has changed for the better in the Euro Zone (EZ) in the last month. True, the late-June EU summit, at which leaders agreed to help ailing Spanish banks, cheered some—but the details are still lacking and, in any case, that action is unlikely to have much impact on EZ growth prospects this year or in 2013. The baseline scenario still calls for recessionary conditions throughout the currency union, with the periphery countries faring the worst.

The negative repercussions are flowing through the core countries as well.

Chart 6: Purchasing Managers Indexes Indicate Manufacturing Slowdowns

While manufacturing in the Euro Zone has declined significantly, recent purchasing managers indexes for the US and China have also revealed a slowing in that sector. The US index is at its lowest level in three years.



Source: Bloomberg as of July 10, 2012

Table 1: Morgan Stanley and Citi Global GDP and Inflation Forecasts

(year-over-year percent change)

Morgan Stanley				% Contribution to Growth	Citi				% Contribution to Growth
	2011	2012	2013	2012		2011	2012	2013	2012
Global GDP	3.9	3.5	3.8		Global GDP	3.6	3.0	3.2	
Developed Economies	1.3	1.3	1.4	20	Developed Economies	1.3	1.2	1.0	21
US	1.7	2.1	1.6	13	US	1.7	2.1	2.0	14
Euro Zone	1.5	-0.3	0.9	-1	Euro Zone	1.5	-0.7	-0.8	0
UK	0.7	0.5	1.8	0	UK	0.6	-0.4	0.6	0
Japan	-0.7	2.3	1.0	4	Japan	-0.7	2.7	1.4	6
Developing Economies	6.4	5.6	6.1	80	Developing Economies	6.0	4.9	5.5	79
Brazil	2.7	2.7	3.4	2	Brazil	2.7	2.3	4.5	3
Russia	4.3	5.0	4.0	5	Russia	4.3	3.5	4.0	4
India	7.1	5.7	6.5	10	India	6.5	6.4	6.9	14
China	9.2	8.5	9.0	38	China	9.2	7.8	7.9	39
Global Consumer Prices					Global Consumer Prices				
Global Inflation	4.4	3.4	3.1		Global Inflation	4.2	3.2	3.1	
Developed Economies	2.6	1.9	1.4		Developed Economies	2.3	1.7	1.3	
Developing Economies	6.2	4.8	4.8		Developing Economies	6.1	4.7	4.8	
US Core*	1.7	2.3	2.2		US Core*	1.4	1.8	1.6	
US CPI	3.1	1.9	1.5		US CPI	2.5	1.7	1.5	

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 Investment Research & Analysis, Morgan Stanley Smith Barney as of July 18, 2012

CHINA'S LANDING. Neither Citi nor Morgan Stanley economists are calling for a hard landing—generally understood to be GDP growth below 7%—for China, but both firms acknowledge the possibility does exist. Thus far, the Morgan Stanley estimate for Chinese GDP remains unchanged, at 8.5% this year and 9.0% in 2013. Citi, however, recently lowered its China growth targets yet again, to 7.8% this year and 7.9% next year (see Table 1, page 8). In each instance, the forecasts represent a notable slowing from the 9.2% pace of last year and the 10.4% rate seen in 2010, but they remain indicative of a soft landing.

Still, as long as there is no end in sight for the EZ's woes, growth projections for China, and also the emerging market (EM) universe as a whole, are subject to downside risk.

US ECONOMIC DOWNGRADE. Due to deteriorating economic conditions and rising uncertainty surrounding the fiscal cliff, Morgan Stanley economists recently lowered their US economic forecasts for 2012 and 2013. While the actual amounts are not necessarily newsworthy, they confirm the Global Investment Committee's concerns around potential downside risks to the US economy's outlook. Specifically, Morgan Stanley

now expects GDP growth of 2.1% this year and only 1.6% in 2013; the estimates are down 0.2 percentage points and 0.4 percentage points, respectively, from their prior forecasts.

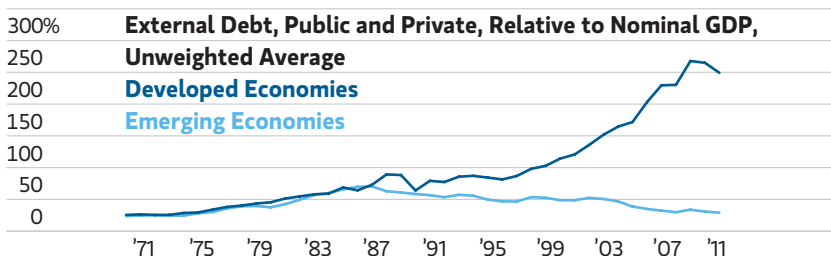
The stubbornly sluggish growth setting is not so surprising from a historical view. Vincent Reinhart, Morgan Stanley's chief US economist, has noted that in the previous 15-worst financial crises of the latter twentieth century, deep recessions resulted—with shallow recoveries. In addition, historically, real GDP per capita was 15% lower after 10 years than that predicted by the prior trend, and the unemployment rate never returned to its precrisis low in 10 out of 15 cases.

DELEVERAGING'S IMPACT. Why does growth tend to remain so anemic in the wake of a financial crisis? The answer, most likely, lies in the deleveraging process. Judging by the data, the leaders in the global deleveraging race are nonfinancial businesses and EM governments, followed by US financial intermediaries, US households and, lastly, EZ financial institutions and governments. By the measure of debt relative to nominal GDP, the DM economies still have a long way to go as compared with their EM counterparts (see Chart 7). Deleveraging is a slow-going process for US households, too, which are getting no help from the real estate or equity markets. Those two asset classes account for about half of US household assets. As long as households are still trying to repair their balance sheets, it is difficult to envision any forthcoming boost to GDP growth from this sector. Also, keep in mind that, at some point, US government balance sheet repair will need to occur, which may dampen rather than boost growth prospects.

HOUSING HEAD FAKE? The improvement in US housing-related data of late has begged the question of whether this important sector can provide sustainable support to the economy. In terms of its contribution to real GDP, residential fixed investment has been a positive—albeit modest—force over the

Chart 7: Developed Economies Have Far to Go in Deleveraging

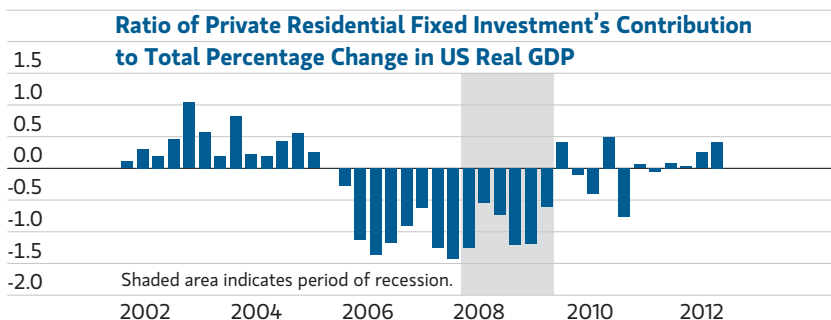
By the measure of debt relative to nominal GDP, the developed-market economies still have a long way to go in deleveraging as compared with their emerging market counterparts.



Source: Carmen M. Reinhart, Vincent Reinhart and Kenneth Rogoff, "Debt Overhangs: Past and Present," National Bureau of Economic Research as of April 2012

Chart 8: Residential Construction No Longer a Drag on Economic Growth

In terms of its contribution to real GDP, residential fixed investment has been a positive force over the past four quarters, marking its longest span of back-to-back positive results since 2005.



Source: US Department of Commerce, FactSet as of March 31, 2012

most recent four quarters, marking its longest span of back-to-back positive results since 2005 (see Chart 8, page 9). While this is certainly welcome news, it may not be telling the whole story. The more likely reason for this recent uptrend has more to do with the fact that housing has had to dig itself out of

a very large hole. Thus, on a comparative basis, the further away we get from the 2008-to-2009 experience, the more likely it becomes that modest upticks in construction and home improvements will not seem as positive.

In addition, there is still a shadow-inventory issue. Once home prices begin

to rebound on a more sustainable basis, the improved market is apt to draw properties that owners had wanted to sell but didn't offer because of the poor prospects. The drawing down of this shadow inventory could lead to a supply imbalance, producing an oversupply that limits price gains. ■

Equities Outlook

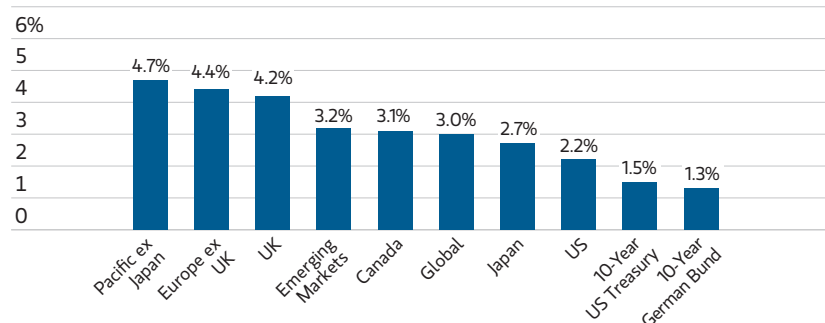
Liquidity Likely to Limit Downside

We are maintaining our modest tactical underweight position in global equities, with a continued preference for the emerging markets and the US at the regional level. Despite a challenging macroeconomic backdrop, one of the primary reasons we have not cut back to an even larger underweight position in stocks is that central banks have significantly expanded their balance sheets in recent years (see Chart 3, page 5). That ample liquidity must find a home and, with yields on many safe-haven investments at historic lows, the search for yield seems likely to lead many investors to the stock market.

Indeed, equity dividend yields in some key countries and regions are higher than yields on US and German government 10-year notes (see Chart 9). Essentially, equity markets offer a positive real—or inflation-adjusted—yield, while these government bonds do not. The valuation differential in this metric is a major factor in our large tactical underweight

Chart 9: Region by Region, Dividends Trump 10-Year Bond Yields

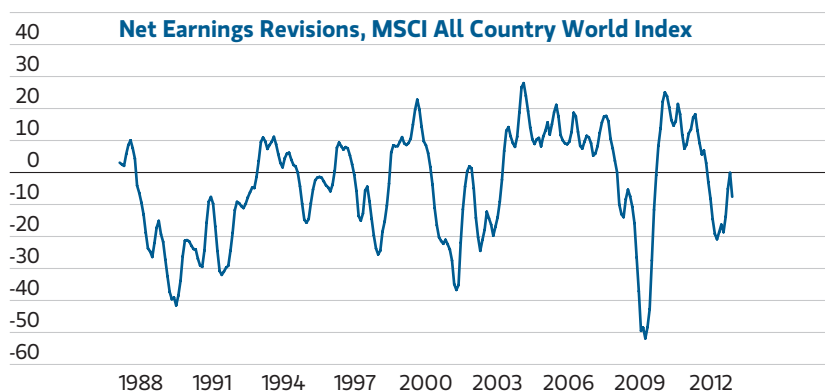
Taken globally, by region or by country, dividends from owning stocks pay more than interest on a 10-year US Treasury or a German bund. This is an important valuation prop for global equity markets.



Source: Citi Investment Research & Analysis, Worldscope, MSCI, FactSet as of July 13, 2012

Chart 10: Earnings Revisions Index Turns Downward

In a potentially ominous development heading into another quarterly corporate earnings reporting season, analysts' earnings revisions for global stocks have rolled over. Revisions had been climbing since late last year.



Note: Net earnings revisions are based on individual-company analysts' forecasts for the next calendar year and are calculated as the number of upgrades minus the number of downgrades divided by the total number of revisions using a three-month sliding window.

Source: FactSet, Morgan Stanley Smith Barney as of June 30, 2012

Table 2: Earnings Forecasts for the Standard & Poor's 500, MSCI All Country World and MSCI Emerging Markets Indexes

	S&P 500				Consensus of Wall Street Analysts					
	Morgan Stanley		Citi		S&P 500		MSCI All Country World		MSCI Emerging Markets	
	Operating EPS	YOY Change	Operating EPS	YOY Change	Operating EPS	YOY Change	Operating EPS	YOY Change	Operating EPS	YOY Change
2012	\$100.00	2%	\$103.25	6%	\$105.70	8%	\$26.19	9%	\$93.75	11%
2013	\$98.71	-1%	\$108.00	5%	\$118.60	12%	\$29.48	13%	\$104.71	12%
52-Week Forward					\$112.54		\$28.14		\$100.15	

Note: Citi estimates are before write-offs.

Source: Citi Investment Research & Analysis, Morgan Stanley Research, Thomson Financial, Datastream as of July 18, 2012

position in government bonds. The last time the global equity dividend yield was above the yield on the 10-year US Treasury note was a brief period during the throes of the financial crisis.

DOWNWARD REVISIONS. In a potentially ominous development heading into another quarterly corporate earnings reporting season, analysts' earnings revisions for global stocks have rolled over (see Chart 10, page 11). For the US market, analysts modestly lowered their earnings expectations for the second quarter during June, bringing them to

a level that would constitute year-over-year growth of about 5%; this would be a sequential decline from the 9% increase made during the first quarter (see Table 2, page 11).

The primary factor supporting our tactical overweight position in emerging market (EM) equities is that, by and large, EM policymakers have much more latitude to ease policy, both monetarily and fiscally, than those in developed economies. Indeed, with inflation generally moderating, many policymakers already have shifted their focus toward supporting

economic growth, rather than fighting inflation—a stance that hindered EM equities for the better part of 2011. Policy advantages aside, it is incumbent upon the companies based in emerging economies to improve their ability to turn premium GDP growth rates into premium earnings-per-share growth.

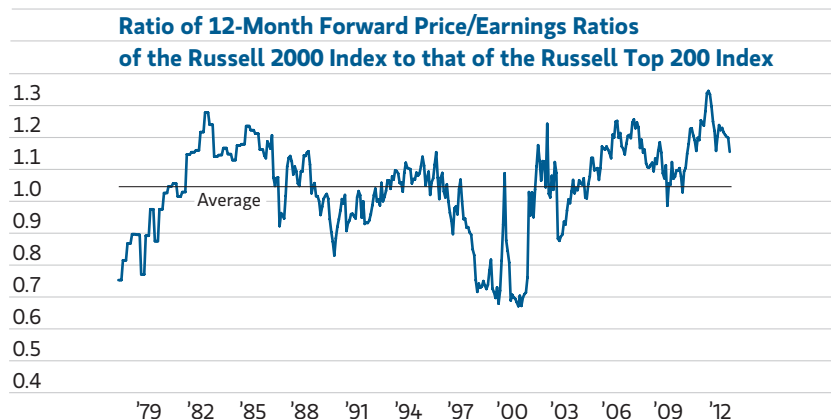
FAVORING US EQUITIES. Among developed markets, we expect investors to continue to favor the US—at least until there is a sense that Europe and Japan are overcoming structural headwinds that augur extended periods of subpar economic growth, or until valuations become more compelling. With regard to valuation, we note that the Market Timing Indicator, which is maintained by the Morgan Stanley European Equity Research team, has generated a short-term buy signal for a three-to-six month window. That said, we are not inclined to pursue short-term trading opportunities, preferring to wait until we perceive a more durable change in market trends.

Within US stocks, we continue to favor large caps in keeping with our current defensive bias. Fifteen months ago, we initiated a tactical preference for large caps largely based on relative valuation, which had reached extreme readings. After the recent annual reconstitution of the Russell indexes, the valuation advantage is still evident, although no longer extreme (see Chart 11).

Similarly, 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 stocks (see Chart 12). We opted to retain our preference for growth in light of the valuation advantage, albeit reduced, and in consideration of the backdrop of decelerating corporate earnings growth. During such periods, 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. ■

Chart 11: Valuation Shows Large-Cap Stocks Attractive Relative to Small-Cap Stocks

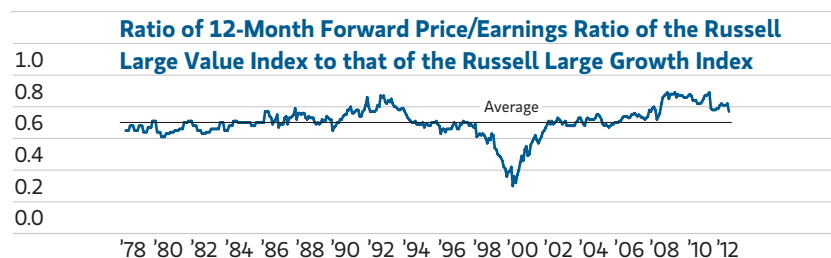
Fifteen months ago, we initiated a tactical preference for large caps largely based on relative valuation, which had reached extreme readings. The valuation advantage is still evident, although no longer extreme.



Source: Thomson Financial, FactSet as of June 30, 2012

Chart 12: Large-Cap Growth Stocks Remain Attractive Relative to Large-Cap Value Stocks

Large-cap value stocks continue to appear expensive relative to large-cap growth stocks, but not nearly to the degree that existed a couple of years ago when we initiated our tilt toward growth.



Source: Thomson Financial, FactSet as of June 29, 2012

Fixed Income Outlook

Coordinated Action

For the past month or so, we believed that global central bankers appeared ready for some coordinated monetary policy action and, on this front, they did deliver—with an exclamation point: The People's Bank of China implemented its second rate cut in the last month, the European Central Bank lowered its key lending rates and the Bank of England boosted its Quantitative Ease (QE) program by another £50 billion. These actions followed the Federal Reserve's June 27 announcement that it would extend Operation Twist through the end of the year—giving us the anticipated Operation Twist 2 (OT2).

From an economic vantage point, we have believed for some time that further easing, especially from the Fed, would have little impact on economic growth. The outcome has been the utter lack of enthusiasm for OT2 and the other central-bank moves seen from

the financial markets, other than the predictable lowering of interest rate forecasts (see Table 3). In our opinion, the muted response to central bankers' actions underscores the point that the global investment community has seen this act before—and is unimpressed.

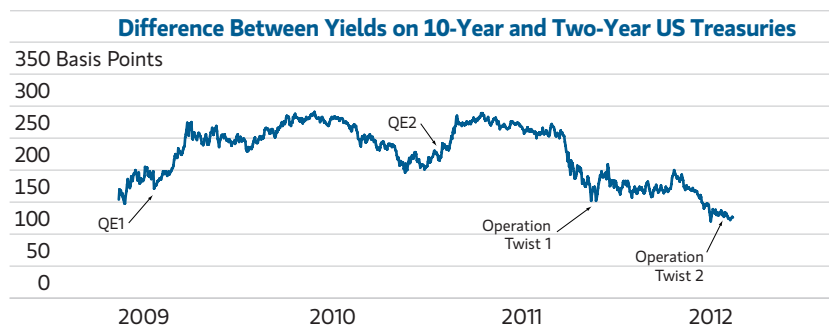
YIELD CURVE FLATTENS. Even interest rates have not behaved as would be expected in the face of further monetary ease. Typically, the market response to easier monetary policy is higher long-term rates, and thus a steepening of the yield curve. Indeed, following the Fed's announcement of QE1, QE2 and, to a lesser degree, OT1, the US Treasury

yield curve—as defined by the difference between the 10-year and two-year Treasury yields—became steeper, then later flattened as the economy started to slow (see Chart 13). However, in the aftermath of the Fed's latest action, there was barely any steepening at all.

OPTIONS FOR EASE. Is the bond market asking for more monetary stimulus? Fed Chairman Ben Bernanke has long held that the central bank is prepared to take further action when necessary. Besides another OT continuation, the options would include a third round of Quantitative Ease focusing on mortgage-backed securities or interest rate guidance

Chart 13: US Treasury Yield Curve Keeps Flattening

After the announcements of Quantitative Ease (QE1), QE2 and, to a lesser degree, Operation Twist 1, the US Treasury yield became steeper. However, in the aftermath of the Fed's latest action, there was barely any steepening.



Source: Bloomberg as of July 18, 2012

Table 3: Morgan Stanley and Citi Policy Rate and Government Bond Yield Forecasts

Morgan Stanley	Current Rate	4Q12	4Q13	Citi	Current Rate	4Q12	4Q13
Policy Rate (%)				Policy Rate (%)			
US	0.00–0.25	0.15	0.15	US	0.00–0.25	0.25	0.25
Euro Zone	0.75	0.75	1.00	Euro Zone	0.75	0.50	0.50
Japan	0.10	0.05	0.05	Japan	0.10	0.10	0.10
UK	0.50	0.50	1.25	UK	0.50	0.50	0.50
China	6.00*	6.06*	6.06*	China	3.00**	2.75**	3.25**
10-Year Government Bond Yield (%)				10-Year Government Bond Yield (%)			
US	1.48	1.90	1.85	US	1.48	1.80	2.60
Germany	1.20	1.75	2.50	Germany	1.20	1.25	2.00
Japan	0.75	1.00	1.20	Japan	0.75	1.10	1.30
UK	1.48	2.20	3.20	UK	1.48	1.65	2.50

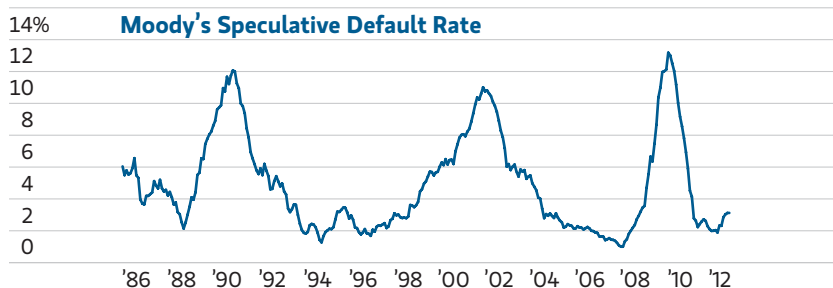
*Morgan Stanley's current and forecast policy rates use the one-year lending rate.

**Citi's current and forecast policy rates use the one-year deposit rate.

Source: Morgan Stanley Research, Citi Investment Research & Analysis as of July 17, 2012

Chart 14: Low Default Rate for High Yield Bonds

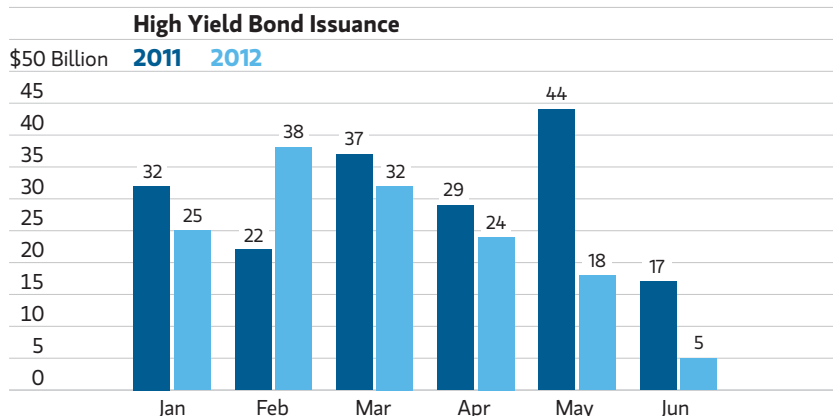
Despite slowing global growth, the default rate on high yield bonds is close to an all-time low. Moody's expects the speculative-grade default rate to remain near the current level for the next 12 months.



Source: Datastream, Federal Reserve Bank of St. Louis, Bloomberg as of June 30, 2012

Chart 15: 2012 High Yield Issuance Lags Behind 2011

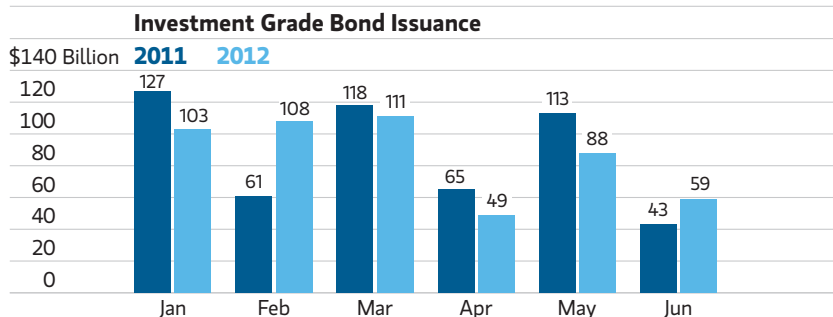
The issuance of high yield bonds this year has lagged behind 2011 in every month except February. Total issuance is down about 22% through June 30.



Source: Bloomberg as of June 30, 2012

Chart 16: Investment Grade Issuance Remains Close to 2011's Level

In contrast with the high yield sector, issuance of investment grade bonds this year is nearly the same as last year. While the month-by-month counts vary, total issuance for the year through June 30 is \$518 billion versus \$527 billion for the first six months of 2011.



Source: Bloomberg as of June 30, 2012

through the federal funds communication statement. Still another option would be to lower the rate for interest on excess reserves.

Unless the US economy were to take a decisive turn for the worse, Morgan Stanley economists believe that the Fed will avoid a headline-making QE3 move and keep policy on hold until at least December. In fact, the June Federal Open Market Committee minutes appeared to reinforce the notion that the voting members do not yet have the appetite for more aggressive action. However, as we have witnessed throughout the first half of 2012, Fed thinking is an ever-evolving process and can shift depending on the state of events at home and abroad.

Credit: A Tale of Two Quarters

The first half of the year has been a tale of two quarters. In the first quarter, a combination of better-than-expected economic data and two massive liquidity injections from the European Central Bank helped high yield bonds outperform investment grade corporates. In the second quarter—as economic data started coming in lower than expected, both domestically and globally, and the European credit crisis spread further—investors embraced investment grade bonds. The very strong first quarter gave high yield a 7.12% return, versus 4.60% for investment grade, for the first half of 2012. We believe the second half will look more like the second quarter, with investors opting for quality rather than risk; thus, we retain our preference for investment grade credit over high yield for the remainder of the year.

POSITIVE FUNDAMENTALS. In our view, the biggest downside risk for the credit market is the ongoing crisis in Europe. In addition, slowing global growth and the looming fiscal cliff in the US are risks likely to intensify in coming months. Offsetting these macro issues to some degree are strong micro fundamentals: US companies have dramatically improved their balance sheets over the past three years and are better positioned to withstand lower economic growth rates. In addition, the rate of defaults on high yield bonds is close to the all-time low,

and Moody's expects it to remain near the current level for the next 12 months (see Chart 14, page 14). Finally, credit investors have high levels of cash due to fund inflows, coupon payments and redemptions with low levels of new issuance (see Chart 15, page 14 and Chart 16, page 14). In all, we believe these pillars of support will help mitigate the level of spread widening that might otherwise be seen amid the increasingly negative macroeconomic backdrop.

SMALL STEPS IN EUROPE. Recent news out of Europe that policymakers agreed to move toward a sole European-banking regulator and allow the European Stability Mechanism to capitalize banks directly is a positive step, in our view. Yet, some of the technical details of the agreement are still lacking. In addition, the policy-makers' summit did nothing to address the rising trajectory of debt burdens and lack of growth for the peripheral European countries, nor did it address the possibility of joint European debt issuance. Though, admittedly, a two-day meeting may be too short to work out these complex issues, the markets are begging for action—as evidenced

by Spanish 10-year yields, which are hovering around 7%.

SPREAD WIDENING. Because we believe that the situation in Europe is likely to worsen over the coming months, we expect to see both high yield and investment grade spreads at wider levels before the year's end. The spread widening in high yield will likely be due to investors reducing risk, while the widening in investment grade will more likely come from a further drop in risk-free rates.

The spread on the Barclays Capital US Aggregate Corporate Investment Grade Index is currently 191 basis points, roughly 41 basis points tighter for the year to date. With the drop in risk-free rates during the past month, the yield-to-worst return for the index is 3.05%, an all-time low. The spread on the Barclays Capital US Aggregate High Yield Index is currently 611 basis points, which is 88 basis points tighter for the year to date. The yield-to-worst on the index is 7.12% and, with the index at a dollar price of \$101.25, there is little room for capital appreciation. From a longer-term perspective, high yield credit is

trading closer to its long-term average spread as compared with investment grade credit (see Chart 17). Thus, at current levels, we see more downside risk in high yield and more value and stability in investment grade.

QUALITY COUNTS. To take advantage of this environment, we suggest that credit investors continue to move up in quality by taking profits in lower-quality credit and reinvesting primarily in higher-quality high yield and lower-quality investment grade. 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, investment grade credit offers higher income than Treasuries and a lower volatility of returns relative to high yield and equities.

Long-Term Potential, Near-Term Volatility in Emerging Market Bonds

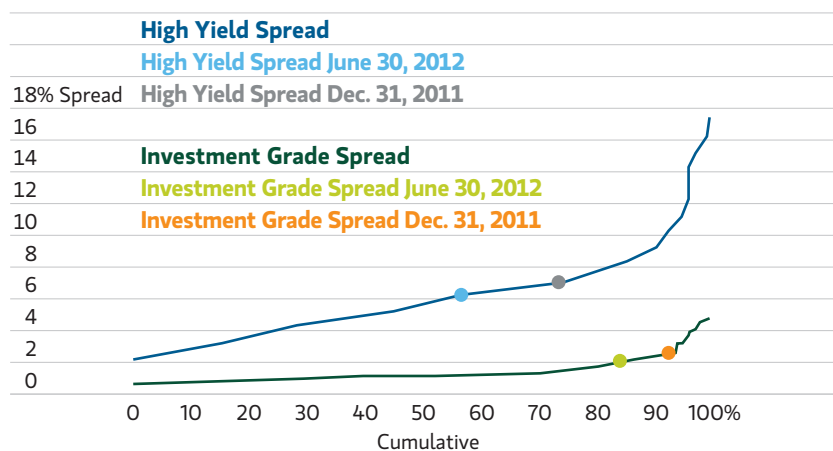
Similar to other risk assets, emerging market (EM) bonds did significantly better in the first quarter of this year than in the second. Spreads widened roughly 69 basis points between April 1 and June 30, versus close to 100 basis points of tightening between Jan. 1 and March 31. The Barclays Capital Emerging Markets (US\$) Index is currently trading around 398 basis points over US Treasuries—about 55 basis points tighter since the beginning of the year. Although current valuations are attractive relative to long-term averages, they remain well short of the highs we experienced last October when spreads reached 526 basis points.

Slower growth in the EM economies and ongoing weakness in Europe are apt to be headwinds for these bonds, but those negatives can be offset to some degree by EM central-bank easing. Central bankers in Brazil, China and India have all reduced lending rates in the last year in response to slowing GDP growth. If this easing is effective, it may serve to bolster economic growth going into 2013.

BETTER FUNDAMENTALS. Despite the recent slowdown, macro fundamentals such as fiscal and trade balances are

Chart 17: Spreads Favor Investment Grade Over High Yield

This chart shows that global high yield spreads have been higher 58% of the time. On the other hand, global investment grade bond spreads have been higher only 15% of the time. By this analysis, investment grade is the better valued of the two sectors.



Note: For high yield, the benchmark index is the Barclays Capital Global High Yield Index (hedged). The Citi High Yield Index is used prior to August 2000. For investment grade, the benchmark index is the Citi World Broad Investment Grade (BIG) Corporate Index (hedged).

Source: FactSet, Yield Book as of June 30, 2012

likely to remain decidedly stronger in EM economies versus their developed-market peers. We believe that this positions EM economies to benefit from an eventual rebound in global growth sometime in the coming year. This anticipated growth may be driven by coordinated monetary policy easing in both the developed and emerging markets.

Based on current spread levels, we view EM fixed income as fairly valued for a slower-growth environment. Despite our positive view on the long-term growth potential of these economies, we expect higher EM spread volatility relative to investment grade credit and, thus, we recommend a market weight exposure to EM bonds.

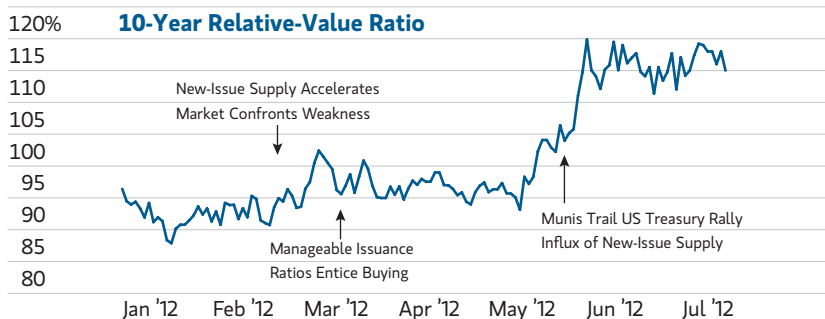
Muni Market Subdued for the Summer

A confluence of bullish and bearish factors leads us to conclude that municipal market price activity will remain relatively subdued for the summer, with yields likely to be range bound. As a result, we remain constructively “neutral” toward this asset class.

Seasonal factors play a positive role. For instance, muni bond issuance tends to decline in the summer. Since 2000, the months of July, August and September have averaged approximately \$28 billion, \$29 billion and \$26 billion in monthly new-issue supply, respectively. In contrast, the post-2000 average for April through June is more than \$34 billion, and for the October-through-December period it's nearly \$33 billion. In terms of demand, June and July are among the busiest months for bond redemptions on the muni calendar. As a result, many investors will have additional cash positioned for deployment.

Chart 18: Municipal Relative-Value Ratio Remains Elevated

For a variety of reasons, the relative-value ratio for 10-year municipal bonds is well in excess of 100%. This means tax-exempt municipal bonds are delivering higher yields than taxable US Treasury bonds.



Source: Thomson Municipal Market Data as of July 17, 2012

ATTRACTIVE RELATIVE VALUE. Atop these positive factors is attractive relative value. Municipals have underperformed the broader US Treasury market, in part because munis do not benefit from the same global flight-to-quality flows that Treasuries do. As a result, relative-value ratios have spiked, resulting in a 115% relative-value ratio for 10-year munis (see Chart 18). This elevated valuation level—with the long-term average being 84%—could mitigate any muni-specific market weakness.

With relative value sharply higher, why haven't muni bonds outperformed? The answer is that absolute yields are historically low—with 10-year benchmark munis trading at less than 2%. Current valuation levels may continue for some time, and adverse global events could accelerate the flight to Treasuries, possibly pushing ratios even higher. On the other hand, positive developments in the domestic or global economy could trigger a flight from Treasuries, with

falling bond prices eventually transmitting to the muni arena.

WHAT TO DO. As noted, we remain constructively neutral and view any interim price declines as opportunistic entry points. Meanwhile, we would also suggest keeping some cash on hand. The anticipated uptick in supply in the autumn months may present some buying opportunities. Currently, we advocate investing in six-to-14-year maturities via mid-tier A-rated or higher general-obligation bonds and essential-service revenue bonds. As local governments continue to face significant fiscal headwinds, investors should not be relaxing their credit-quality parameters at this time. In contrast, state credit quality is improving, making general-obligation and appropriated paper at the state level compelling. For those seeking short-duration investments, prerefunded municipal securities, also at 113% of corresponding Treasuries, appear attractive as well. ■

Global Alternatives/ Absolute Return Investments Outlook

Commodities Struggle With Slower Global Growth

Amid a general pullback in risk assets during the second quarter, commodities experienced a somewhat smaller decline than global equities. The Dow Jones-UBS Commodity Total Return Index, our benchmark, was down about 4.5%, whereas the MSCI All Country World Index declined more than 5%. For the 12 months ended on June 30, commodities have significantly underperformed most other risk assets, posting a decline similar to that of emerging market stocks (see Chart 19).

We continue to limit exposure to this economically sensitive asset class in light of the ongoing recession in the Euro Zone and its likely negative spillover effects on other regions. The demand for many commodities is negatively affected by a downturn in economic activity. For example, Hussein Allidina, head of commodity strategy at Morgan Stanley and a member

of the Global Investment Committee, lists certain base metals—namely zinc, lead, aluminum and nickel—among his least-favored commodities from a short-term, tactical perspective, primarily because of their ties to industrial activity.

BEARISH ON OIL. Allidina takes a bearish view of crude oil, too. He estimates that the per-barrel price of Brent crude oil—now about \$105—will average about \$97 for the remainder of the year. In his view, the path of least resistance for oil prices remains downward amid slowing global economic growth. A cutback in OPEC production seems necessary to prevent an above-normal inventory buildup in the months ahead.

Of course, not all commodities are as sensitive to the economic cycle. Allidina points out that many commodities within the agriculture sector are taking their cues from weather conditions. In particular, record heat and low precipitation in the US have generally been adverse for the supply side of the equation, pointing toward higher prices.

BULLISH ON GOLD. Gold remains among Allidina's favorite tactical commodity picks. He forecasts an average price of \$1,719 per ounce for the rest of this year and \$1,816 for 2013, compared with the current price of about \$1,600. The forecast is based on strong investment demand for gold amid a sustained low real interest rate environment and heightened risk aversion stemming from the debt crisis in the Euro Zone.

Hedge Funds at the Halfway Point

Global equity markets rallied 4% in June (in local-currency terms), largely on the hopes that coordinated, global central-bank stimulus would lead to a pickup in economic activity, but hedge funds did not take advantage of that. The HFRI Fund of Funds Composite Index finished the month down 0.4% and wrapped up 2012's first half only 1.1% in the black. The composite had been up 3.3% in January and February, but has since given back a good chunk of the gains.

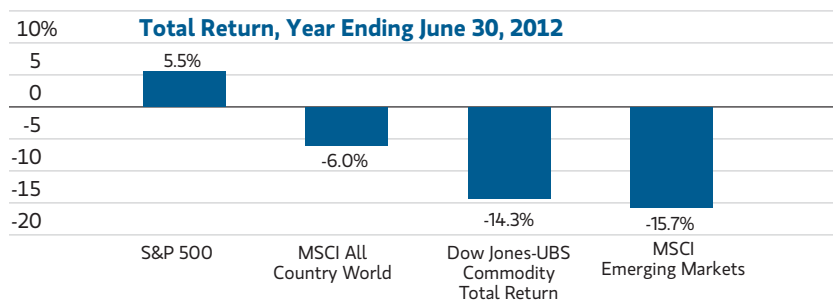
EQUITY HEDGE. The HFRI Equity Hedge Index was up 0.9% in June. Managers in this style sector started the month with low net market exposure due to continued economic weakness and uncertainty relating to policy response, and, as a result, they did not benefit much from the rising markets. In addition, their long positions underperformed the market, while short investments proved challenging. Sector rotation was significant within the market and investments that had generated good returns in prior months gave back gains. Portfolio hedges also detracted from performance. Medium-term quantitative equity funds generated modest and mixed performance. Value factors rebounded in the risk-on environment, reversing some of their year-to-date losses. Funds with strategies based on price momentum and quality factors generally lost ground.

Leveraged credit markets recovered in June, benefiting from optimism regarding the European sovereign debt crisis. The Credit Suisse High Yield Index gained 1.9%, as credit spread tightening more than offset a modest rise in Treasury yields. Lower-quality credits outperformed somewhat, and so the Credit Suisse High Yield Distressed Securities Index advanced 2.0%. With this backdrop, distressed funds with higher net exposure posted the largest gains.

DISCRETIONARY MACRO. Discretionary macro funds generally experienced difficulties, as many held large short positions in the euro, which rallied 2.4% in June. The popular long volatility trade also negatively affected the

Chart 19: Commodities Underperformed in the Past Year

The 12-month period that ended June 30 was tough for all risk assets, but especially for commodities. Their performance fell well behind US and global equities. Only emerging market equities fared worse.



Source: FactSet as of June 30, 2012

strategy, as volatility declined through the month. All told, the HFRI Macro Index lost 1.6%. Emerging markets (EM) macro funds exhibited mixed performance, as the rally in EM interest rates led to gains for several funds, while large market reversals led to losses in developed-market hedges.

Managed-futures funds experienced negative performance in aggregate, as the Newedge CTA Index declined 1.7%. Losses were broad based, impacting strategies operating at both short- and long-term forecast horizons. The last trading day of the month resulted in significant losses for many long-term momentum strategies as the rally worked against their generally bearish positioning.

RELATIVE VALUE. Relative-value funds gained 0.9% as measured by the HFRI Relative Value Index. Cash nonagency residential mortgage-backed securities provided a slight positive contribution, as prices ended the month flat to marginally lower, while carry was additive. Asset-backed securities exhibited greater correlation with risk assets and traded higher, with tranches improving by 2% to as much as 8%

during the month. Regarding mortgage derivatives, agency interest-only exposure had a marginally positive impact on returns. In addition, the latest S&P/Case-Shiller 20-City Home Price Index data exhibited signs of stabilization. The index displayed a non-seasonally adjusted 1.3% month-over-month increase in April, the index's latest report. It was the largest monthly improvement since May 2010.

Also in the relative-value space, strengthening high yield corporate credit and leveraged loan markets provided slightly positive contributions to performance. In addition, funds benefited from convertible bond arbitrage exposure, as valuations richened relative to hedges. Merger arbitrage also provided profits, as the majority of spreads on outstanding deals tightened.

PLANNING AHEAD. Moving forward, we advise maintaining a balance in hedge fund portfolios. Given the up-and-down nature of the markets for the year, we believe that taking concentrated bets within hedge fund portfolios may be ill advised. Specifically, to deal with volatility, we continue to maintain

global macro strategies of all stripes. The buffer they provide in down markets, such as happened in May, are attractive compensation for occasional underperformance during rallies, such as we saw in June.

Within macro, we believe investors should maintain their relative strategic weights between discretionary and systematic strategies—given the dispersion in performance at the manager and substrategy level; making active tactical calls within the macro style may add risk without accompanying benefit. We also continue to overweight mortgage-based strategies, as loss-adjusted yields on the credit side and returns to prepayment risk on the agency side are attractive. In addition, the opportunities arising in commercial mortgages have provided hedge funds with more fodder for returns. Notably, given potential policy action after the presidential election that could affect mortgage values, an active approach employing experienced managers may allow investors to not only gain the current benefits but also effectively manage the coinciding risks. ■

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)

Effective Jan. 20, 2012

Model Portfolios	Global Bonds and Inflation-Linked Securities		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%	32%	15%	17%	10%	12%	8%	10%	5%	7%	3%	5%	-	5%	-	5%
Global Bonds																
Investment Grade	60	59	55	59	42	46	30	34	21	25	6	10	-	-	-	-
Short Duration	15	18	15	18	10	13	7	10	5	8	2	2	-	-	-	-
Government/ Government-Related	32	24	28	20	22	16	16	10	11	5	3	0	-	-	-	-
Corporate & Securitized	13	17	12	21	10	17	7	14	5	12	1	8	-	-	-	-
High Yield	-	-	2	1	3	2	5	4	6	5	8	7	-	-	-	-
Emerging Markets	-	-	-	-	2	2	4	4	5	5	6	6	-	-	-	-
Total Bonds	60	59	57	60	47	50	39	42	32	35	20	23	-	-	-	-
Total Cash & Short Duration Bonds	45	50	30	35	20	25	15	20	10	15	5	7	-	5	-	5
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	1	8	2	9	2	11	3	14	5	18	8	15	5
Europe ex UK	-	-	3	0	5	0	6	0	7	0	9	2	12	4	10	2
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	19	36	34	45	43	54	52	68	66	90	86	90	86
Total US Equity	-	-	10	12	16	18	22	24	26	29	30	34	42	46	40	44
Total Developed ex US Equity	-	-	8	4	16	7	18	8	22	10	29	15	37	20	34	17
Total Developed Market Equity	-	-	18	16	32	25	40	32	48	39	59	49	79	66	74	61
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	1	2	1	2	1	2	1	3	2	5	4	5	4
Inflation-Linked Securities	10	9	3	2	3	2	3	2	3	2	2	1	-	-	-	-
Managed Futures	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Hedge Funds	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Private Real Estate	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Private Equity	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Total Alternative/ Absolute Return Investments	10	9	7	4	7	4	8	5	9	6	9	6	10	9	10	9

Global Investment Committee

Asset Allocation Models for Investors

With \$1 Million to \$20 Million in Investable Assets (Level 2)

Effective Jan. 20, 2012

Model Portfolios	Global Bonds and Inflation-linked Securities		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%	27%	13%	15%	8%	10%	5%	7%	3%	5%	2%	4%	-	-	-	-
Global Bonds																
Investment Grade	65	64	55	56	40	41	30	31	20	21	6	7	-	-	-	-
Short Duration	15	17	12	14	7	9	5	7	2	4	3	1	-	-	-	-
Government/ Government-Related	35	26	30	22	23	15	18	10	13	6	2	0	-	-	-	-
Corporate & Securitized	15	21	13	20	10	17	7	14	5	11	1	6	-	-	-	-
High Yield	-	-	2	1	3	2	4	3	5	4	6	5	-	-	-	-
Emerging Markets	-	-	-	-	2	2	3	3	4	4	4	4	-	-	-	-
Total Bonds	65	64	57	57	45	45	37	37	29	29	16	16	-	-	-	-
Total Cash & Short Duration Bonds	40	44	25	29	15	19	10	14	5	9	5	5	-	-	-	-
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	1	5	1	7	1	9	2	12	4	15	6	12	2
Europe ex UK	-	-	3	0	3	0	4	0	6	0	8	1	10	4	8	0
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	14	28	26	35	33	44	42	58	56	75	71	75	71
Total US Equity	-	-	6	7	14	15	16	19	20	22	28	32	36	39	34	37
Total Developed ex US Equity	-	-	8	4	11	4	14	4	18	8	23	10	30	15	27	12
Total Developed Market Equity	-	-	14	11	25	19	30	23	38	30	51	42	66	54	61	49
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	1	2	1	2	1	2	1	3	2	5	4	5	4
Inflation-Linked Securities	10	9	3	2	3	2	3	2	3	2	2	1	-	-	-	-
Managed Futures	-	-	2	5	4	7	4	7	4	7	5	8	5	10	5	10
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	10	9	14	14	19	19	23	23	24	24	24	24	25	29	25	29

Global Investment Committee

Asset Allocation Models for Investors

With \$20 Million or More in Investable Assets (Level 3)

Effective Jan. 20, 2012

Model Portfolios	Global Bonds and Inflation-Linked Securities		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%	27%	13%	15%	8%	10%	5%	7%	3%	5%	2%	4%	-	-	-	-
Global Bonds																
Investment Grade	65	64	55	56	40	41	30	31	20	21	6	7	-	-	-	-
Short Duration	10	12	7	9	7	9	5	7	2	4	3	1	-	-	-	-
Government/ Government-Related	39	27	34	24	23	15	18	10	13	6	2	0	-	-	-	-
Corporate & Securitized	16	25	14	23	10	17	7	14	5	11	1	6	-	-	-	-
High Yield	-	-	2	1	3	2	4	3	5	4	6	5	-	-	-	-
Emerging Markets	-	-	-	-	2	2	3	3	4	4	4	4	-	-	-	-
Total Bonds	65	64	57	57	45	45	37	37	29	29	16	16	-	-	-	-
Total Cash & Short Duration Bonds	35	39	20	24	15	19	10	14	5	9	5	5	-	-	-	-
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	1	6	2	6	2	8	2	11	3	14	4	12	2
Europe ex UK	-	-	3	0	4	0	4	0	5	0	7	0	9	1	8	0
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	14	26	24	32	30	40	38	54	52	70	66	70	66
Total US Equity	-	-	6	7	12	14	16	18	18	20	26	30	32	35	30	33
Total Developed ex US Equity	-	-	8	4	11	5	12	6	17	8	22	10	29	14	27	12
Total Developed Market Equity	-	-	14	11	23	19	28	24	35	28	48	40	61	49	57	45
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	1	2	1	2	1	2	1	3	2	5	4	5	4
Inflation-Linked Securities	10	9	3	2	3	2	3	2	3	2	2	1	-	-	-	-
Managed Futures	-	-	2	5	4	7	4	7	4	7	5	8	5	10	5	10
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	10	9	14	14	21	21	26	26	28	28	28	28	30	34	30	34

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 some 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, accreted 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

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)

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 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.

S&P 500 INDEX Widely 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.

RUSSELL LARGE VALUE INDEX This index measures the performance of the large-cap value segment of the US equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth rates.

RUSSELL LARGE GROWTH INDEX This index measures the performance of the large-cap growth segment of the US equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth rates.

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.

CITI HIGH YIELD INDEX This index captures the performance of below-investment-grade debt

issued by corporations domiciled in the US 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 WORLD BROAD INVESTMENT GRADE CORPORATE INDEX (HEDGED) This index comprises investment grade securities with minimum ratings of Baa3/BBB-. The securities have a minimum maturity of one year and a fixed coupon. Currency exposure is hedged to the US dollar.

BARCLAYS CAPITAL EMERGING MARKETS BOND (US\$) INDEX This index measures the performance of emerging market sovereign bonds denominated in US dollars.

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 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 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.

CREDIT SUISSE HIGH YIELD INDEX This index is designed to mirror the US-dollar-denominated high yield debt market. The index frequency is weekly and monthly. Issues must be rated no higher than Baa1/Baa2 by Moody's or BB+ or BBB+ by S&P.

CREDIT SUISSE HIGH YIELD DISTRESSED SECURITIES INDEX This index measured the performance of distressed securities within the Credit Suisse High Yield Index.

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 analysis and combinations of top-down and bottom-up analyses.

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.

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.

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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.

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

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.

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