

# An Outcomes-Oriented Approach to Alternatives

**Global Investment Committee**

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“Alternatives” - They are...

**Expensive**

**Risky**

Riskier than traditional  
Investments

**Not Widely  
Accessible**

**Complex**

**Illiquid**

That's something  
to avoid

**... OR ARE THEY?**

What constitutes “Alternatives Investments”?

Private Equity

Hedge Funds

Currency

Structured Investments

Real Estate

Commodities

REITs

Collectibles

Venture Capital

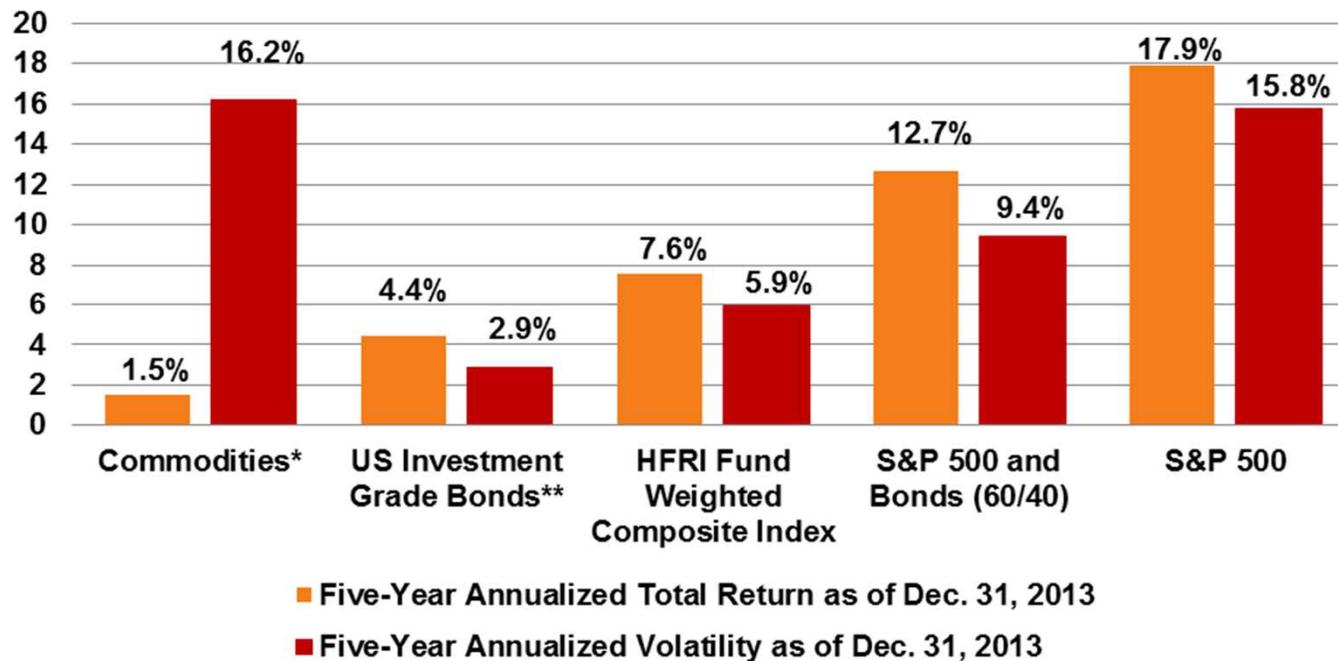
Master Limited Partnerships (MLPs)

## Why Consider Alternatives?

- 1 Alternatives asset classes are designed to provide better risk-adjusted performance than traditional long-only products
- 2 Alternatives asset classes aim to generate returns with **low correlations to everything else the client owns** (their traditional investments), adding diversification and lowering portfolio volatility

## Why Consider Alternatives?

### The Recent Past Is Not Prologue



\*Dow Jones-UBS Commodity Total Return Index \*\* Barclays Capital US Aggregate Bond Index  
Source: Bloomberg as of Dec. 31, 2013

## Why Consider Alternatives *Now*?

1. With interest rates rising and bond volatility increasing, bonds are not likely to be an “anchor to windward”

### As GDP Picks Up, Interest Rates Likely to Follow



Source: Morgan Stanley Wealth Management GIC as of Jan.31, 2014

### Equities Have Already Begun This Year More Volatile

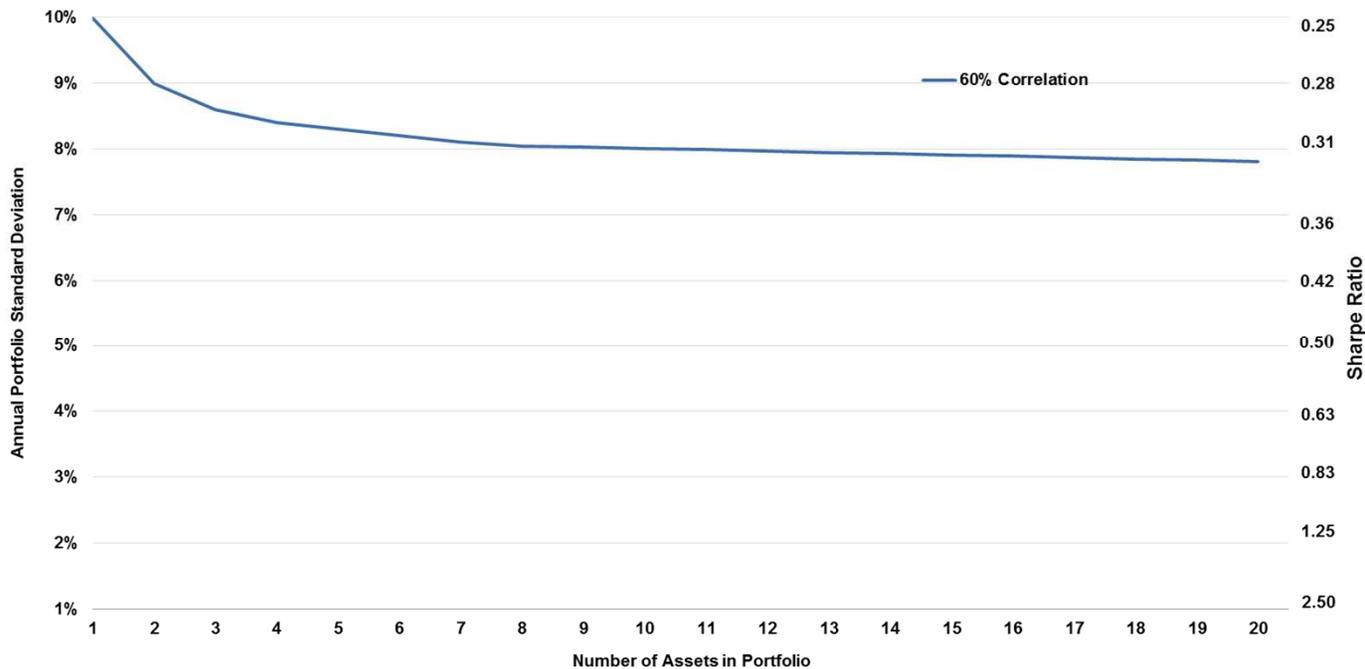


Source: Morgan Stanley Wealth Management GIC as of Jan.31, 2014

## Why Consider Alternatives *Now?*

### 2. Diversification and volatility management really matter to outcomes

#### We Reduce Volatility by Adding Uncorrelated Assets

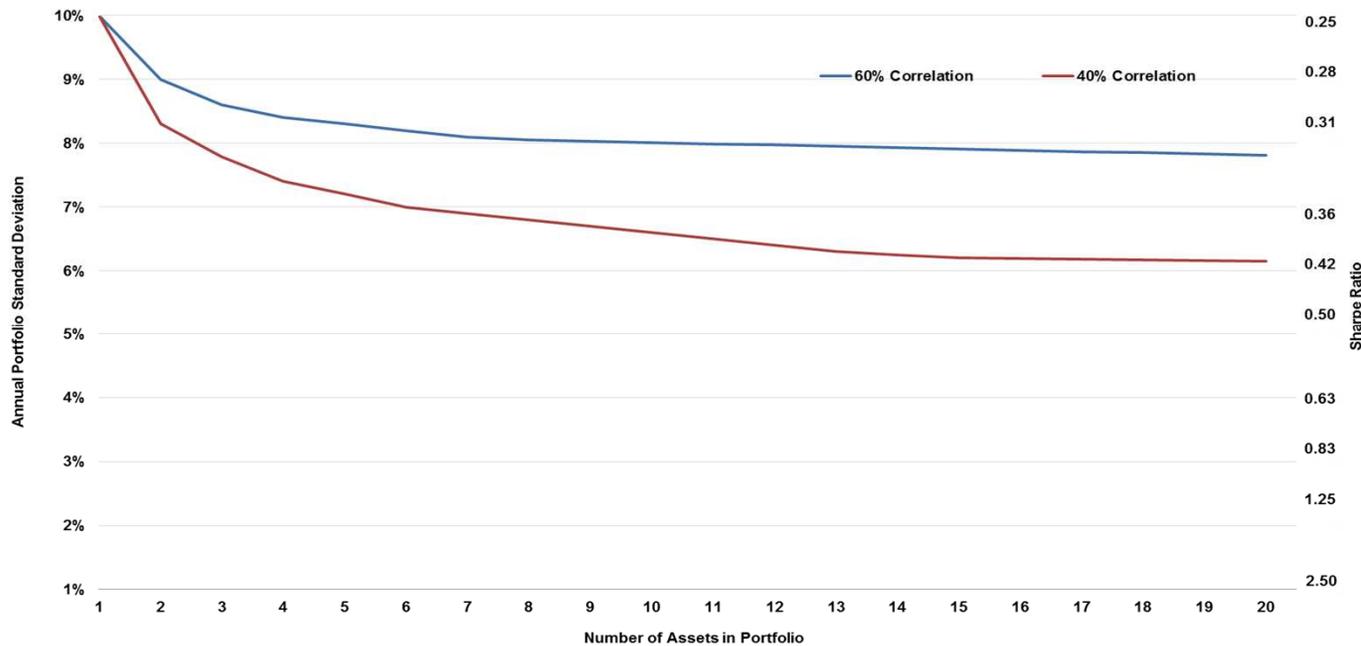


Source: Morgan Stanley Wealth Management Alternative Investments Advisor Research

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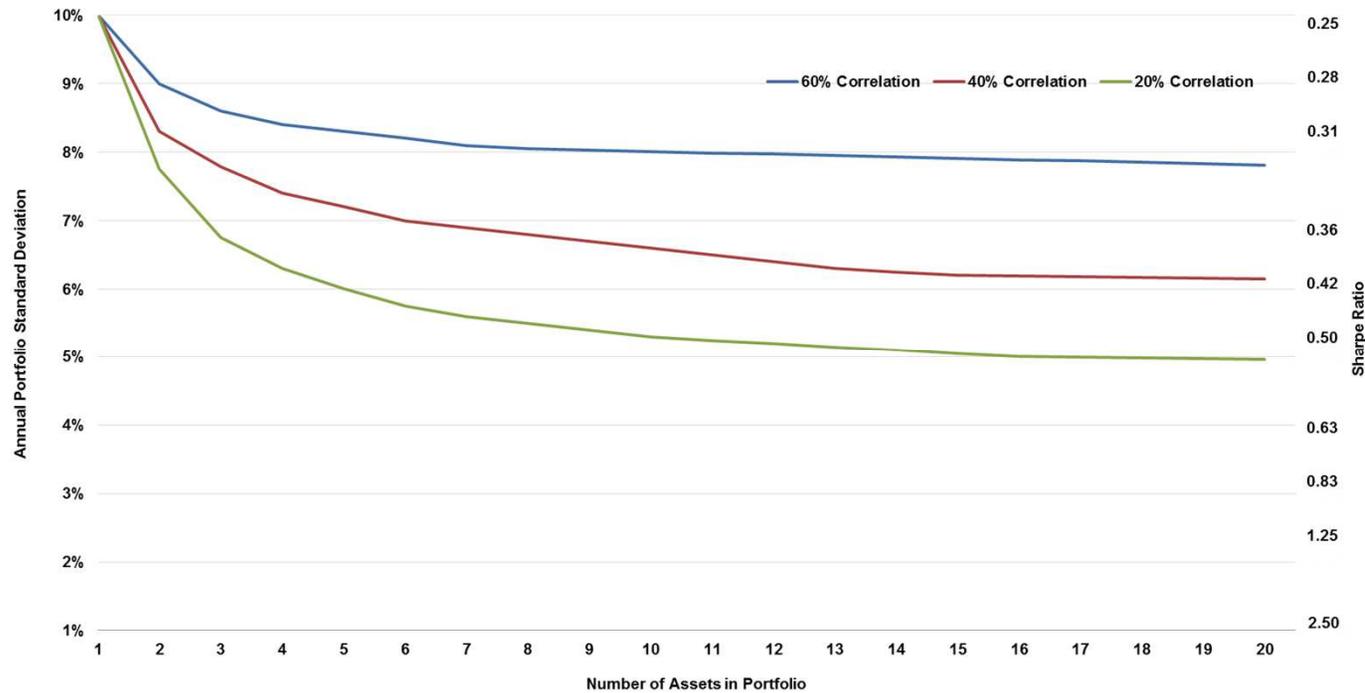


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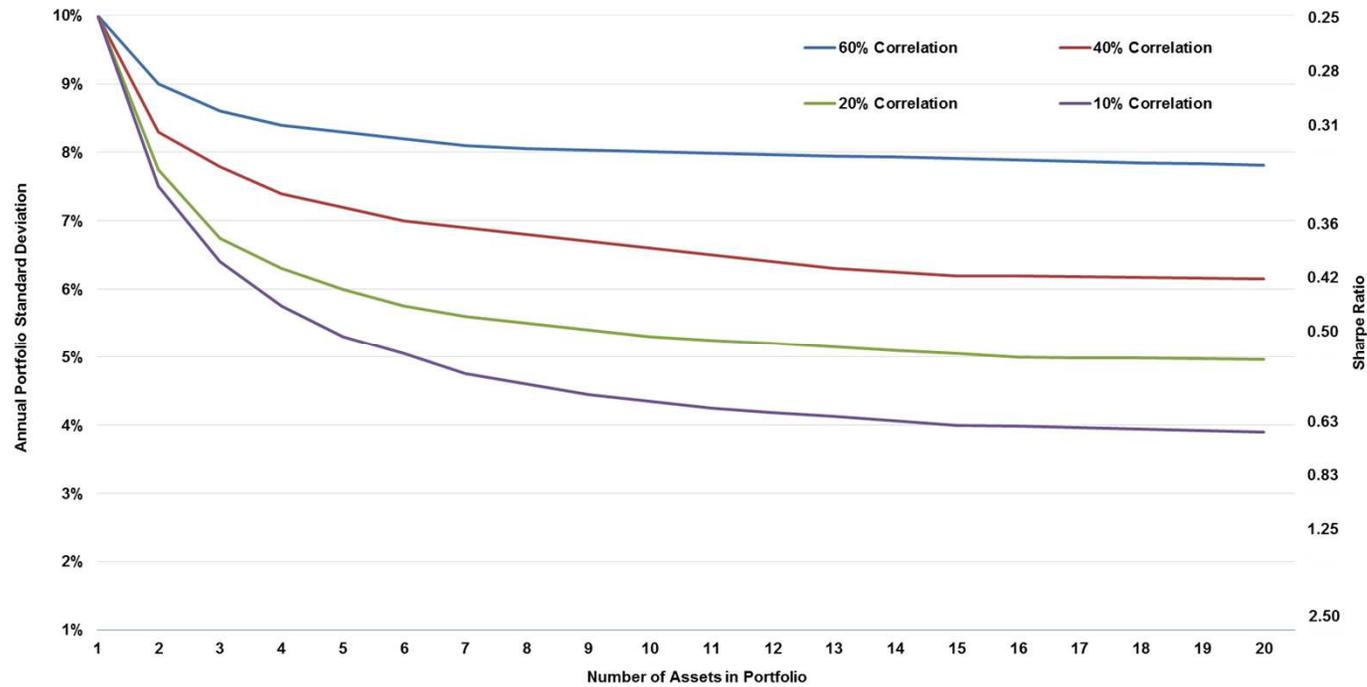


Source: Morgan Stanley Wealth Management Alternative Investments Advisor Research

## Why Consider Alternatives *Now*?

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The GIC Reduces Volatility by Adding Uncorrelated Assets

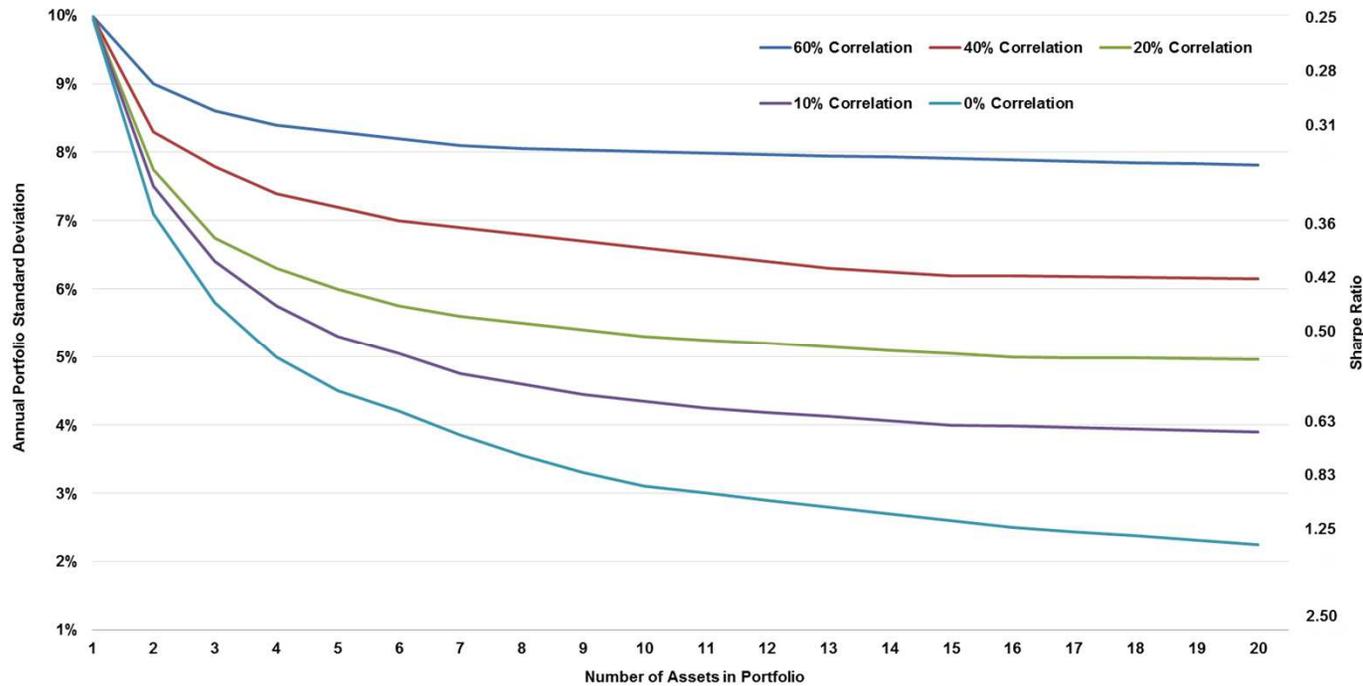


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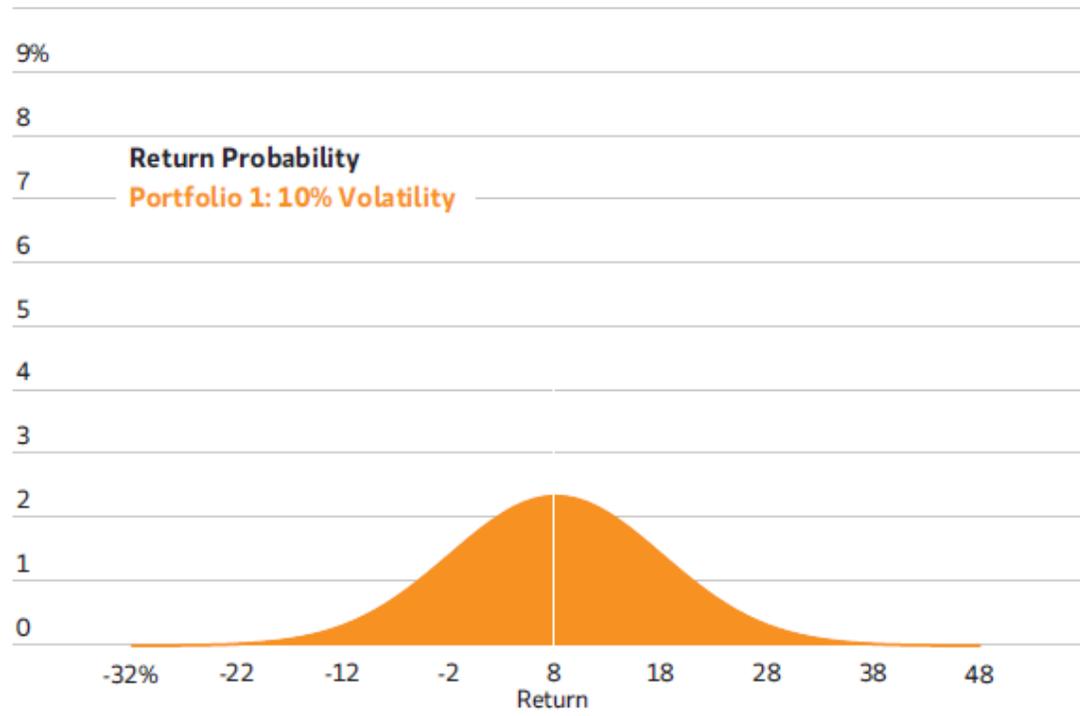


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## Why Consider Alternatives *Now*?

### 2. Diversification and volatility management really matter to outcomes

Reducing Portfolio Volatility Increases Probability of Reaching Goals

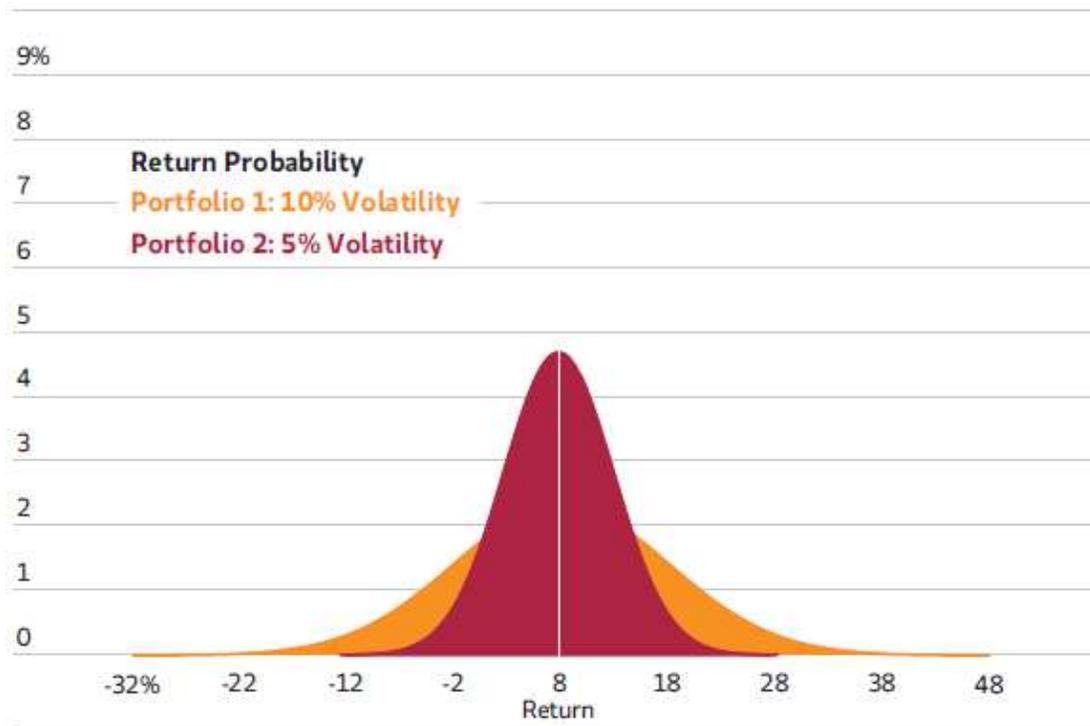


Source: Morgan Stanley Wealth Management GIC

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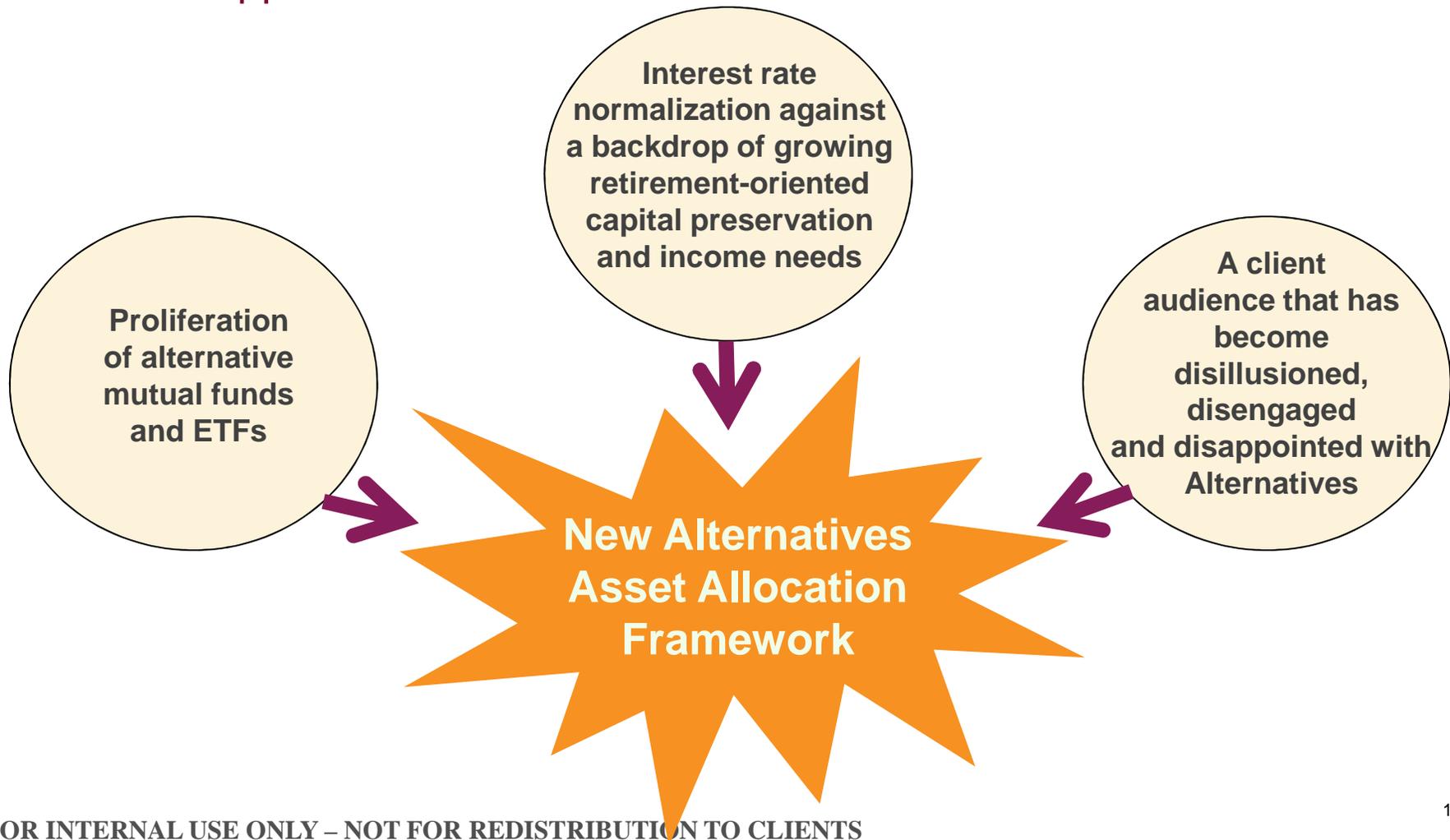
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#### Reducing Portfolio Volatility Increases Probability of Reaching Goals



Source: Morgan Stanley Wealth Management GIC

Three forces are now colliding, requiring us to revisit our asset allocation approach to alternative investments



## The GIC's Framework Has Three Ambitions:

- 1 Create a disciplined approach to Alternatives based on investment characteristics
- 2 Improve ease of selecting Alternatives by aligning categories with client goals
- 3 Set performance goals by establishing market-based benchmarks

## How Do We Select the Proper Strategies?

### Hedge Strategies' Diversification Properties Are Not Homogeneous

Alternative Strategies	Performance Since 1990, Annualized (%)	Annual Volatility, 25-Year Average (%)	Long-Run Correlations		25-Year Sharpe Ratio	Maximum Drawdown (%)
			S&P 500	Barclays Capital Global Aggregate Bond Index		
Equity Long/Short	12.7	9.2	0.73	0.10	1.02	-30.6
Event Driven	11.6	6.8	0.70	0.10	1.21	-24.8
Hedge Fund of Funds Composite	7.3	5.2	0.62	0.13	1.21	-27.5
Relative Value	10.1	4.4	0.53	0.10	1.56	-18.0
Equity Market Neutral	6.8	3.2	0.32	0.10	2.10	-9.2
Convertible Arbitrage	8.6	6.6	0.50	0.20	1.31	-25.3
Global Macro	11.6	7.5	0.33	0.30	1.12	-10.7
Distressed Credit	12.1	6.5	0.52	0.51	1.85	-27.4
Managed Futures	6.7	11.6	-0.10	0.18	1.00	-16.2
<b>S&amp;P 500 Index</b>	9.5	14.9			0.39	-50.9
<b>Barclays Capital Global Aggregate Bond Index</b>	6.5	3.7			0.88	-5.1

\*Average since 1990

\*\*Barclays Capital US Aggregate Bond Index

†Average since 1990

Please reference the index definitions beginning on page 39 for the indexes used to describe the alternative strategies in the exhibit above.

Source: Hedge Fund Research, Morgan Stanley Wealth Management GIC as of Dec. 31, 2013

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Source: Hedge Fund Research, Morgan Stanley Wealth Management GIC as of Dec. 31, 2013

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## The GIC's new Alternative Assets / Categories

### Real Assets

Commodities ex Precious Metals Precious Metals/Gold, MLPs, Global REITs

### Total Return Assets

Equity Market Neutral, Relative Value Strategies including Credit Long/Short

### Equity Hedge Assets

Global Macro, Managed Futures, Hedge Fund of Funds, Multi-Strategy Alts

### Equity Return Assets

Equity Long/Short, Event Driven

### Opportunistic Assets

Private Equity, Private Direct Real Estate, Early Stage Venture, Distressed Lending, Direct Lending, Impact Investing, Timberland, Water, Collectibles, etc.

## Which Alternatives Asset Classes You Add to the Portfolio Matters



Note: Annualized return and annualized risk are for the period 2000 through 2013. \*60% S&P 500/Barclays Capital US Aggregate Bond Index.  
 Alternative asset classes mentioned above are drawn from the framework on slide 22.  
 Source: Morgan Stanley Wealth Management GIC as of Dec. 31, 2013

## Comparing Alternative Mutual Funds and Private Offerings

		<b>Alternative Mutual Funds and ETFs</b>	<b>Private Offerings</b>
<b>Investment</b>	<b>Style</b>	Varies by Strategy	Varies by Strategy
	<b>Flexibility</b>	Limited Investment Flexibility	Greater Investment Flexibility
	<b>Derivatives</b>	Limited Use of Derivatives	Greater Ability to Use Derivatives
	<b>Leverage</b>	Limited Use of Leverage	Greater Ability to Use Leverage
	<b>Transparency</b>	High	Generally Low
	<b>Correlation</b>	Generally Higher to Traditional Investments	Generally Lower to Traditional Investments
<b>Operations</b>	<b>Minimums</b>	Low Minimums	High/Private Investor Qualifications
	<b>Fees</b>	Typically Asset-Based Management Fees	Typically Management and Performance Fees
	<b>Tax Reporting</b>	IRS Form 1099	Typically IRS Form K-1
	<b>Redemptions</b>	Generally Daily	Limited Opportunity to Redeem
<b>Regulatory</b>	<b>Oversight</b>	1940 Act Restrictions	Limited SEC Oversight
	<b>Diversification Requirements</b>	Position Sizes, Sector Exposure, etc.	None—Diversification Varies Widely

Source: Consulting Group Investment Advisor Research as of April 29, 2013

## The GIC's New Framework Employs an Outcomes-Oriented Approach to Using Alternatives Investments

Client Goals	Primary Traditional Assets	Alternatives' Portfolio Main Purpose	Alternative Assets	Client Goal Suggested Benchmark
Capital Preservation	Cash, Money Market Fund Short-Duration Bonds	Inflation Protection	Real Assets	CPI Plus
Income	Bonds, High Yield Equity, Convertibles, Preferred Stock	Income/Cash Flow Preservation	Total Return Assets	T-Bill or LIBOR Plus
Balanced Growth	60%/40% Equities /Bonds	Volatility Reduction	Equity Hedge Assets	Risk-Adjusted 60/40
Market Growth	S&P 500 Plus	Equity Diversification	Equity Return Assets	Risk-Adjusted S&P 500 Plus
Opportunistic Growth	80% Plus Equities	Growth Amplification	Opportunistic Assets	Customized

## Our New Outcomes-Oriented Framework for Alternatives

CLIENT PRIMARY GOALS	PRIMARY ROLE OF ALTERNATIVE INVESTMENT	NEW ALTERNATIVE ASSET CATEGORY	CLIENT PRIMARY BENCHMARK	INVESTMENT CHARACTERISTICS			GIC STRATEGIC RETURN EXPECTATIONS†
				ANNUAL VOLATILITY (%)	CORRELATION WITH GLOBAL EQUITIES	CORRELATION WITH US INV. GRADE BONDS	
Capital Preservation	Inflation Protection	<b>Real Assets</b>	<b>Real Return; CPI Plus</b>	<b>10 – 20</b>	<b>0.40 – 0.60</b>	<b>0.10 – 0.20</b>	<b>4 +</b>
		Commodities ex Precious Metals		15 – 20	0.30 – 0.45		5 – 6
		Precious Metals/Gold		15 – 20	0.10 – 0.20		7 – 8
		Master Limited Partnerships*		10 – 15	0.60 – 0.70		7 – 8
		Global REITs		10 – 15	0.60 – 0.70		4 – 5
Income	Real Return Enhancement/ Preservation	<b>Total Return Assets</b>	<b>Libor Plus; 3-Month US T-Bill Plus 300 bps</b>	<b>3 – 7</b>	<b>0.30 – 0.50</b>	<b>0.00 – 0.10</b>	<b>2 – 4</b>
		Equity Market Neutral		3 – 5	< 0.20	0.00 – 0.10	2 – 4
		Relative Value Strategies Including Credit Long/Short		5 – 7	0.50 – 0.60	0.10	2 – 4
Balanced Growth	Volatility Management	<b>Equity Hedge Assets</b>	<b>Total Return; 60% Stocks/40% Bonds</b>	<b>6 – 8</b>	<b>&lt; 0.50</b>	<b>0.20 – 0.30</b>	<b>3 – 5</b>
		Global Macro		8 – 10	0.20 – 0.30	0.20 – 0.30	4 – 6
		Managed Futures		10 – 15	± 0.10	0.20 – 0.30	2 – 4
		Hedge Fund of Funds; Multistrategy Alts.		5 – 7	0.40 – 0.60		2 – 3
Market Growth	Equity Diversification	<b>Equity Return Assets</b>	<b>S&amp;P 500</b>	<b>10 – 20</b>	<b>0.65 – 0.90</b>	<b>0.00 – 0.10</b>	<b>4 – 8</b>
		Equity Long/Short		10 – 15	0.70 – 0.90	0.00 – 0.10	4 – 6
		Event Driven		10 – 15	0.80 – 0.95	0.00 – 0.10	4 – 6
Opportunistic Growth	Growth Amplification	<b>Opportunistic Assets</b>	<b>Mandate Specific</b>	<b>NM**</b>	<b>NM**</b>	<b>NM**</b>	<b>8 +</b>
		Private Equity		10 – 20	0.85 – 1.00		
		Private Direct Real Estate		10 – 15	0.65 – 0.85		
		Early Stage Venture, Distressed Lending, Direct Lending, Impact Investing, Timberland, Water, Collectibles					

“If it walks like a duck...”

Our disciplined approach means many funds previously categorized as “Alternatives” will now be classified as “Other”

The Global Investment Committee’s Outcomes Framework for Alternatives is not provided as part of an investment advisory service offered by Morgan Stanley Wealth Management, is not available to be directly implemented as part of an investment advisory service and should not be regarded as a recommendation of any Morgan Stanley Wealth Management investment advisory service. Estimates of returns are in US dollars. The Outcomes Framework for Alternatives does not reflect the investment or performance of actual portfolios. Estimates of returns are gross figures, and as such, do not take into account fees and other expenses, the deduction of which, when compounded over a period of years, would decrease returns. Returns for periods of longer than one year are annualized. Investment characteristics are derived from indexes published by Hedge Fund Research, Inc. See the index definitions starting on page 39. Estimates of future performance are based on assumptions that may not be realized.

\*For more information about the risks to Master Limited Partnerships (MLPs) see Risk Considerations beginning on page 42.

\*\*NM = Not meaningful; †Corresponds to capital market assumptions as published in the GIC’s Strategic Asset Allocation Capital Markets Update, March 8, 2013

Source: Morgan Stanley Wealth Management as of Dec. 31, 2013

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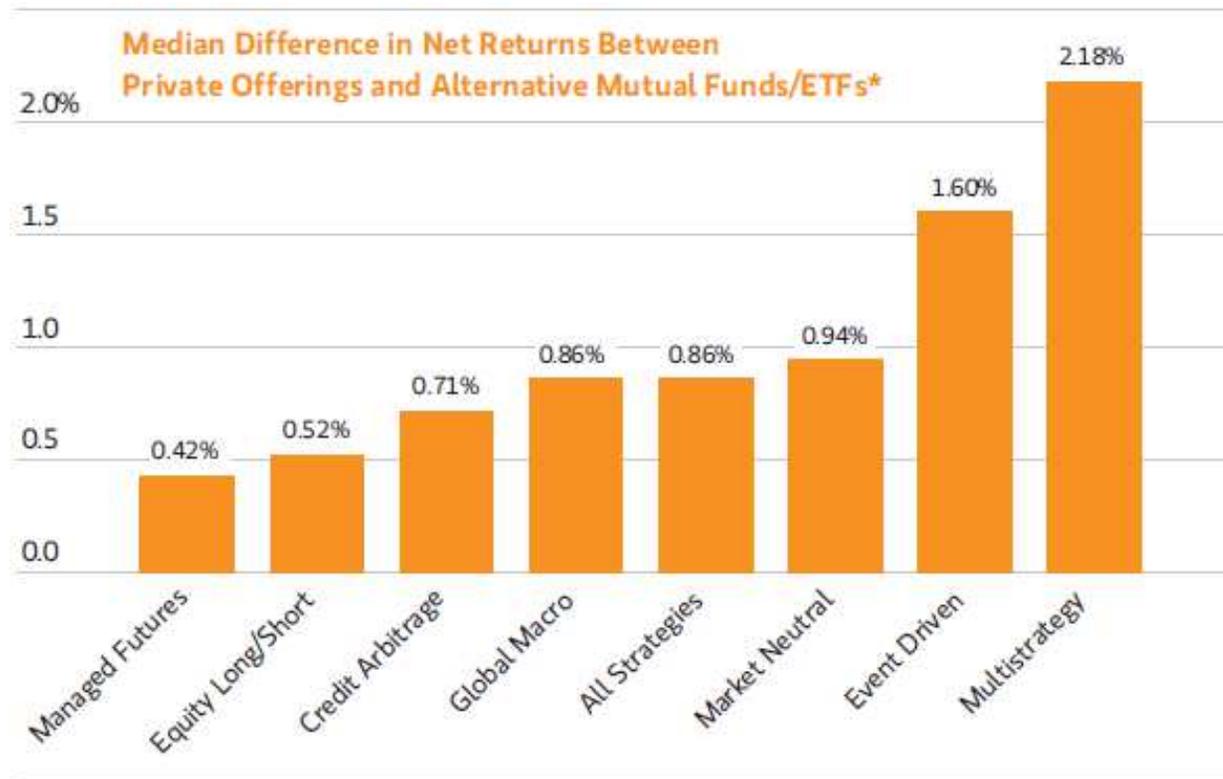
# The Increased Availability of Alternatives Mutual Funds/ETFs Transforms Our Approach to Asset Allocation

Business Consideration	Traditional Private Offerings	Alternative Mutual Funds/ETFs
Target Client Segment	Institutions; UHNW; Accredited and Qualified	All
Asset Allocation Approach	Strategic	Strategic and Tactical
Role in Portfolio	Opportunistic Growth; Volatility Mitigation	Goal Achievement and Tactical Risk Management
Tax Considerations	K-1; Opaque and Delayed	Annual 1099; ETF Cost-Basis Accounting
Fee Considerations	Potential for Layering	Transparent
<p>Accessibility – and Liquidity-Driven Approach</p>		<p>Goal Based; Suitability-Driven Approach</p>

Hybrid alternatives solutions may commingle traditional private offerings and alternative mutual funds/ETFs

## Keep in Mind Liquidity Has a Price. Is Liquidity Overvalued by Investors?

Investors Pay a Performance Price for Liquidity



\*Based on Cliffwater study of managers who manage both private and alternative mutual funds/ETFs, which examined 149 pairs in June 2013  
 Source: Cliffwater LLC as of June 2013. Performance data shown represents 10 years ending March 2013.

## Talent Differences also can Impact performance realization

### Investors Pay a Performance Price for Liquidity

#### Performance Comparison - Traditional Hedge Funds vs 40 Act Mutual Funds

As of December 2013

Index/Funds	Number of Funds	3 Year Performance (Overall*)	3 Year Performance Difference (Overall*)	3 Year Performance (Top 25%)	3 Year Performance Difference (Top 25%)	3 Year Performance (Top 10%)	3 Year Performance Difference (Top 10%)
Morningstar Long/Short Equity	117	5.68%		9.60%		16.50%	
HFRI Equity Hedge Index	1889	4.04%	-1.64%	9.10%	-0.50%	18.00%	1.50%
Morningstar Market Neutral	64	1.38%		3.00%		6.30%	
HFRI EH- Equity Market Neutral Index	195	2.44%	1.06%	6.50%	3.50%	11.20%	4.90%
HFRI Relative Value Index	726	5.82%	4.44%	12.90%	9.90%	18.20%	11.90%
HFRI ED: Merger Arbitrage Index	44	3.02%	1.64%	5.30%	2.30%	7.90%	1.60%
Morningstar Multialternative	104	2.16%		4.70%		7.80%	
HFRI FOF Composite	1134	2.43%	0.27%	4.70%	0.00%	9.32%	1.52%
Morningstar Managed Futures	29	-5.78%		-3.30%		1.80%	
Barclay CTA Index	530	-2.10%	3.68%	1.50%	4.80%	8.20%	6.40%
Morningstar Multicurrency	44	-0.99%		0.10%		1.60%	
HFRI Macro Index	881	-1.50%	-0.51%	6.10%	6.00%	11.90%	10.30%
Morningstar Bear Market	66	-23.55%		-17.70%		-1.20%	
HFRI EH: Short Bias Index	92	-11.31%	12.24%	-6.10%	11.60%	2.40%	3.60%
<b>Average Performance Difference</b>			<b>2.65%</b>		<b>4.70%</b>		<b>5.22%</b>

Source: Partrac and Morningstar

\* Morningstar performance numbers are simple averages of the reported fund returns.

## Conclusions

1. Alternatives are ***not necessarily what you think they are***
2. The GIC believes that ***now is the time*** to seriously consider Alternatives
  - Cyclical reasons (Rates, Volatility)
  - Secular reasons – ***new solutions are available to all***
3. The GIC's has a new Alternatives Asset Allocation Framework
  - Alternatives are ***not a single asset class***
  - Success is about aligning solutions with goals
4. The GIC believes ***not including Alternatives Strategies is a risk***
  - Alternatives plus traditional investments improve performance and risk management