

## Global Advisor Research (GAR)

2008 - 2009

### What Do I Do Now?

#### *Investing Insights from Industry Veterans*

Fall 2008 will be remembered as one of history's worst market periods. The Dow Jones Industrial Average (DJIA) fell more than 26% between September 1, 2008, and October 10, 2008 — and that was not the worst of it. The devastating market collapse was global, as evidenced by the decline of the Standard & Poor's 500 and Dow Jones World ex-US Indices, which dropped 33% and 41%, respectively, from September 2, 2008, through October 26, 2008. During this eight-week period, the yield of the two-year U.S. Treasury Bond slid more than 66%, from 2.25% to a low of 1.34%. Meanwhile, the Volatility Index (VIX)

increased to greater than 80%, representing the highest level of stock market volatility ever measured.

Fear and panic spread, as what began as a U.S.-centric subprime mortgage crisis extended to various asset classes around the world. Bear Stearns, Lehman Brothers and AIG collapsed. Merrill Lynch was bought out by Bank of America and Wachovia was acquired by Wells Fargo.

The United States Government and the Federal Reserve Board stepped in to help protect the markets and bolster the largest of the financial services companies. Perhaps, it was too little, too late. De-leveraging

became — and remains — the mantra for most investors.

Investment management firms were unable to shield investors from this maelstrom. With the exodus from hedge funds and mutual funds persisting — and even intensifying — through early October, there was nowhere to hide. The strongest companies, with the tightest balance sheets, were being sold off as the market continued to plummet.

This market turmoil is like nothing we have seen in at least a generation, but that does not mean we should ignore our investment strategies, convert all assets to cash, or abandon the sound principles of in-

vesting. In fact, many of the industry's most respected money managers consider this an opportune time to invest. It is time to stop looking back to the last five days, five week or five months; it is time to start looking forward, to the next five years.

In early November 2008, Global Advisor Research (GAR), the due diligence arm of the Consulting Services Group of Morgan Stanley, contacted some of the Firm's most successful partners for further insight. The money managers interviewed represent in excess of \$3 trillion in assets under management and are among the most respected in the industry.

We asked 15 Chief Investment Officers (CIOs) and Senior Portfolio Managers:

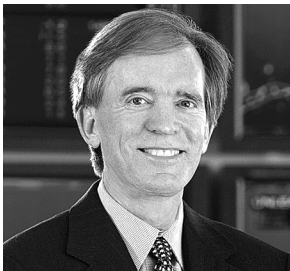
- How do you view the market today?
- What, if anything, are you buying?
  - What are you avoiding?
- What advice do you have for long-term investors?

The consistency of their views amazed us.

Irrespective of investment philosophy, they all said that this is an historic opportunity to invest.

## The Real Economy: Our Biggest Challenge

In short time, a financial (liquidity and solvency) crisis expanded into an economic crisis and, according to Bill Gross of the Pacific Investment Management Company, LLC (PIMCO), the economy will get worse before it gets better.

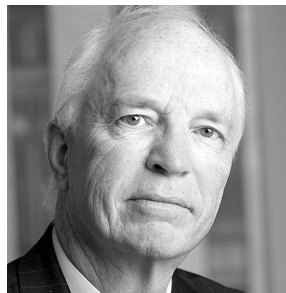


**Bill Gross**

Indeed, PIMCO believes that while current and future extraordinary policy responses will help to mitigate the effects of a slow-down, real improvements in liquidity and economic growth may not occur until 2010.

Although the real economy is facing its big-

gest threat since the Great Depression, and there is legitimate cause for concern, it is important to note that today's environment is different in many ways from that of the 1930s. William Priest of Epoch Investment Partners, Inc. noted that, during the 1930s, governments around the world were fragmented due to competing socio-economic ideologies that spanned from free-market capitalism to near-extreme communism or fascism.



**William Priest**

Today, this is not the case, and we can expect the governments and countries to continue to act in support.

For Robert Turner of Turner Investment Partners, Inc., this means Government support in reigning in wide credit spreads and re-instilling confidence in our banks and banking system.



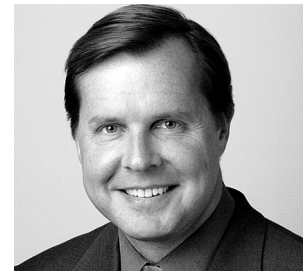
**Robert Turner**

The Government will continue to use its balance sheet, said Gross, and investors should be positioned to capitalize on this support.

Of course, questions remain as to how and where to capitalize on this support. As the U.S. appears to be nearing the end of its volatile phase, the European and BRIC (Brazil, Russia, India and

China) countries are only now beginning to feel the effects of the credit crisis and global market slow-down. This is evidenced by China's unprecedented November 12 move to stimulate its market by infusing domestic investments with \$586 billion in government funding.

Thomas Galvin of Columbia Management Group, LLC (U.S. Trust)



**Thomas Galvin**

predicted that the developing nations would be next to feel the devastating effects of the crisis, while the U.S., the first to face it, will be the first to escape it.

## Views on the Market: The Time to Get In

*We will probably be looking back to this time and think, "Why didn't I buy more?"*

– **Robert Doll, BlackRock Investment Management**

Although there are characteristics of the recent market activity that have never been observed before, most of the managers we interviewed agreed that the market collapse can be traced back to sub-prime mortgages, excessive leverage and/or a crisis of investor confidence — and they all agreed that this is

an opportune time for appropriate investors to invest.

Turner, a growth investor, pointed to the destabilization of the housing sector as the spark that started the market downturn; but, he added, the effort to stabilize the housing sector, along with other aggressive actions taken by governments

globally, will help turn the market around. Turner said he is bullish in the short and intermediate terms.

Joe Deane of the municipal bond team of the Western Asset Management Company believes that a significant impetus for the market decline has been the unwinding of leverage, which he traced to

a period earlier this decade when rates were kept "too low for too long."



**Joe Deane**

Christopher Davis of Davis Advisors argued that our present situation is like that of other boom-and-bust cycles that have come before it, including the Nifty 50, the commercial real estate boom and the tech bubble.



**Christopher Davis**

However, because of such contributing factors as leverage, securitization and

mark-to-market accounting, today's crisis has proven to be more severe.

Robert Doll of BlackRock agrees. He said the market "lost its footing" in October 2008. Like Davis, he referred to the Nifty 50 and the tech bubble, pointing to the recent 50% drop in equity prices. "The market is in the process of building a bottom," he said.



**Robert Doll**

"As an investor, you need to focus on companies with free cash flow and earnings."



**Richard Freeman**

Richard Freeman of Legg Mason-affiliate ClearBridge Advisors, LLC also said we may be close to a "generational bottom," with October 10, 2008, marking a "climactic low." The previous bot-

tomms were in 1973-1974, when the DJIA hit an "ultimate low," and in August 1982. In each case, he recalled, the bottoms helped launch prolonged bull markets.

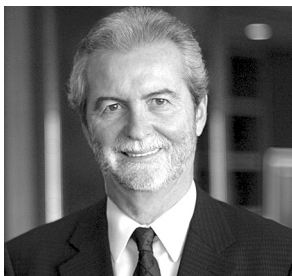
According to Freeman, there are at least three traits of today's market that indicate there is opportunity for investing success:

1. Historic levels of investor pessimism.
2. Record levels of cash in money markets.
3. A Federal Reserve Board accommodative to working with companies and providing liquidity.

*It is time to start buying...*

*There are typically a couple of times for each generation, and this is one of those times.*

*– David Dreman, Dreman Value Management, LLC*

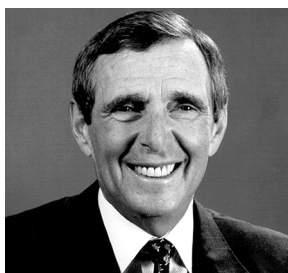


**John Calamos**

John Calamos of Calamos Investments noted that growth stocks and convertibles, his Firm's specialties, have taken a beating despite the clean balance sheets of the non-financial companies. However, he said: "Growth is priced as if it's never going to grow again. Unless you think that we are going into a 1930s-style depression, growth stocks

are priced as value stocks. Keep in mind, even in the 1970s, even with the high interest rates and increasing inflation, the market snapped back more than 40%."

In fact, the market has not been this cheap, from a valuation perspective, since the 1970s, added David Dreman, a deep value manager.



**David Dreman**

"We are starting to see generational values," he said. "Stocks that historically trade at multiples in the mid-teens are now trading at four, five and six times expected earnings.



**David Iben**

David Iben of Tradewinds Global Investors, LLC, also a value investor, is as positive on the market as he has been in years. It will be a

while before we see positive news about the real economy, he said, but he remains as bullish today on the market as he was in 1991-1992 and 2002. Equity valuations are attractive and other options, such as T-Bills, are expensive, said Iben. "This is the time to get in."

Priest, a global value investor, noted that equity earnings yields are between 2% and 4% above those of treasuries. "It's time to start putting cash back to work," he said. "The stock market has discounted a lot of bad news, and market values for equities are at 75% to 80% of real values."

Galvin said he expects the Federal Reserve's recent actions to be felt by year end. The markets have priced in some of the worst economic possibilities, and with the credit spreads decreasing, which is historically a leading indicator,

there is reason to be bullish, he said.

Jon Bosse of NWQ Investment Management Co., LLC agreed, pointing to the growing number of companies with no debt and extensive free cash flow, as well as increasingly low

investor expectations, as indications of opportunity in the market. "Emotion and investing success are contrary to each other," he said. "Investors should fight emotion, maintain perspective and seek out opportunities."



Jon Bosse

## Your Investment Advice

*My definition of an investor is one who thinks long term.*  
— Charles Brandes, Brandes Investment Partners, L.P.

Despite the worldwide panic that erupted over the market downfall of 2008, most managers are optimistic about the future, but that does not mean that they recommend a stock shopping spree. Patience and strategy are key, Freeman said. "The market does not turn on a dime," and volatility will likely continue because the market still "needs to breathe a bit."

Furthermore, government spending, unemployment and inflationary pressure are on the rise, as a new administration prepares to enter the White House. Uncertainty prevails regarding financial oversight, taxation and economic legislation, and how any changes would affect global competition. Additionally, with stocks already deeply discounted, it is difficult to predict how negative earnings reports might affect the market.

Yet, the managers we interviewed predicted a positive tilt to take place soon. "Market disloca-

tions and low expectations provide opportunities to relocate to equities," said Bosse. Turner agreed, adding, "This is an opportunity to buy stocks, maybe in an aggressive way."

Tom Marsico of Marsico Capital Management, LLC went even further.



Tom Marsico

He said: "We believe stock prices of good, even excellent companies have been marked down to what could be considered 'fire-sale' valuations, or levels not seen in decades."

However, Doll suggests making calculated moves — from non-risky to riskier assets, such as from treasury bills to high-yield corporate bonds and equities. "Focus on high-quality companies with

secure balance sheets, strong free cash flow and limited need to access the capital markets," he said. These are "good indicators of a firm's future strength."

William Danoff of Fidelity Investments agreed that the sharp decline in prices has pushed stocks to a level offering new opportunity — and he, too, warned, while stocks are now cheap, they could become even cheaper before prices rise again.



William Danoff

"We don't know when this cycle will pass, but we are confident that it will pass," said Marsico. "And we don't know what event will serve as the catalyst for the market recovery, but we are confident that that there will be such an event, or

maybe more than one."

Brandes's Charles Brandes, a disciple of Benjamin Graham, who is considered the father of the value investing approach, offered a prediction.



Charles Brandes

He said, "The recession will be major, but in another three to five years, good companies will be worth much more."

The CIOs and Portfolio Managers we interviewed agreed:

*Long-term investors should **not** try to time the market. Instead, upgrade your portfolio by purchasing/holding shares in companies with the potential for significant growth in the next few years.*

## What the Professionals are Buying

The 15 interviewees represent a total of 441 years of experience (YOE), or an average of nearly 30 years in the industry. Their firms manage a total of almost \$4 trillion — an average of approximately \$265 billion in assets under management (AUM) per manager.

While most of the interviewees agree that *now* is the time to invest, their specific recommendations vary...

### **Jon Bosse**

CIO / Co-President - 22 YOE

**NWQ**

\$37.4 Billion AUM

- Seeking opportunities in energy, materials and financials.
- Across sectors, seeking companies that may act as consolidators within their industries.
- Focusing on companies that have the strongest balance sheets and the least leverage.
- Focusing on bottom-up fundamentals and attractive valuations.

### **Charles Brandes**

Chairman / Founder - 40 YOE

**Brandes**

\$112 Billion AUM

- Favoring telecommunications and pharmaceuticals.
- Watching technology.
- Internationally, increasing weight to Japan on stock-specific basis.
- In the credit markets, focusing on high-yield bonds.

### **John Calamos**

Chairman / CEO / CIO / Founder - 31 YOE

**Calamos**

\$41.2 Billion AUM

- Seeking value in convertibles and growth stocks.
- Favoring large cap, quality companies over small cap companies.

### **William Danoff**

Vice President / Portfolio Manager - 22 YOE

**Fidelity**

\$100 Billion AUM

- Focusing on healthcare (e.g., biotech), financials (i.e., firms with large capital positions), and consumer staples.

### **Christopher Davis**

Portfolio Manager - 19 YOE

**Davis**

\$105.2 Billion AUM

- Taking advantage of the generational buying opportunity in global leaders.
- Upgrading the quality of financial holdings, but not increasing the portfolio weight to the sector.
- Focusing on improving portfolio quality.

### **Joe Deane**

Portfolio Manager - 39 YOE

**Western**

\$630 Billion AUM

- Focusing on adding the highest quality names expected to have the most liquidity.
- Purchasing longer, higher-yielding, high-quality bond issues such as housing (e.g., state housing finance agency paper) and healthcare.
- Adding positions in strongest state and local general obligation bonds, as well as essential service revenue issues with the best sources of revenue.
- Selling pre-refunded bonds and short-maturity positions.

**Robert Doll**

Vice Chairman / Global CIO, Equity - 28 YOE

- In equities, focusing on energy, materials, and financials (i.e., multi-nationals with predictable earnings and domestic companies that will benefit from government stimuli).
- Moving away from T-Bills and municipal bonds toward high-yield corporate bonds.
- Outside the U.S., overweighting Japan; underweighting European equities.

**BlackRock**

\$1.4 Trillion AUM

**David Dreman**

Chairman / CIO / Founder - 31 YOE

- Maintaining a five year-plus view.
- Buying tobacco and oil companies.
- Looking for blue chip companies with strong finances.
- Increasing weight to real estate as an inflation hedge.

**Dreman**

\$18.4 Billion AUM

**Richard Freeman**

Managing Director / Senior Portfolio Manager - 32 YOE

- Focusing on biotech, energy and cable companies.

**ClearBridge**

\$116.3 Billion AUM

**Thomas Galvin**

President / CIO, Growth Equity - 20 YOE

- Increasing weights to the financial and consumer goods and services sectors.
- Decreasing health care exposure.
- Remaining cautious on technology.
- Looking for the companies that will emerge as leaders from the de-leveraging process and/or grow market share.

**Columbia**

\$390.7 Billion AUM

**Bill Gross**

Co-CIO / Founder - 39 YOE

- Watching agency-backed mortgages that provide positive risk/return balance.
- Hedging portfolios against inflation with Treasury Inflation-Protected Securities (TIPS) and commodities.
- Outside of fixed income, favoring international and emerging market equities.

**PIMCO**

\$800 Billion AUM

**David Iben**

CIO / Portfolio Manager - 27 YOE

- Favoring equities over bonds.
- Within fixed income, favoring high-yield corporate bonds.
- Holding little to no cash.
- Focusing on emerging markets, Japan and Korea.
- Increasing weights to energy and materials.
- Remaining cautious on consumer-related U.S. companies.

**Tradewinds**

\$35.1 Billion AUM

**Tom Marsico**

Chairman / CEO / CIO / Portfolio Manager - 28 YOE

- Increasing investments in financial, consumer discretionary and information technology companies with sustainable-cost leadership structure, necessary products/services, and positioning to gain market share after economic downturn.

**Marsico**

\$62.8 Billion AUM

## William Priest

CEO / CIO / Founder - 36 YOE

- Focusing on individual companies, without significant overweights to any sector.
- Avoiding consumer discretionary and retail.
- Avoiding financials, materials and commodities for now.
- Using free cash flow and dividends as investment indicators to select companies across the globe.

## Epoch

\$100 Billion AUM

## Robert Turner

Chairman / CIO / Co-Founder - 27 YOE

- Buying early-cycle stocks, such as financials (e.g., banks without credit issues).
- Looking for new leaders that have lagged for some time, such as consumer-oriented (e.g., retailers with unique positioning or niche) and housing (e.g., home builders) stocks.
- In technology, focusing on semiconductor companies.
- In healthcare, focusing on biotech companies.
- In the credit markets, focusing on distressed debt and high-grade corporates.

## Turner

\$29.1 Billion AUM

## What to Do Now

While the market is in constant flux and the short-term economic outlook remains bleak, it is imperative that we practice investment discipline and maintain our long-term strategy. There will likely be more unfavorable news to come, but the economy and markets will, eventually, recover. Now is the time to examine each company's fundamentals and long-term growth/value prospects. It is also the time to evaluate your long-term asset allocation and consider strategic and tactical adjustments to your portfolio. From our interviews it is clear: the industry thought leaders are confident the market has produced some attractive opportunities. It is up to you to work with your Morgan Stanley Financial Advisor or Investment Representative to discover those opportunities that may be suitable for you.

*You make most of your money in a bear market. You just don't realize it.*  
– Shelby Cullom Davis, legendary Wall Street investor

**For additional information, or to discuss your investment strategy, please contact your Financial Advisor or Investment Representative.**

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## **Risk Information**

**International Investing:** International investing involves risks not associated with domestic investing, including political, economic, currency and liquidity risks as well as differences in accounting and limited available information.

**Equities:** Investors should be willing and able to assume the risks of equity investing. The value of a client's portfolio changes daily and can be affected by changes in interest rates, general market conditions and other political, social and economic developments, as well as specific matters relating to the companies in which securities the portfolio holds.

**Sectors:** Portfolios that invest primarily in securities of companies in one industry or sector are subject to greater price fluctuation and volatility than portfolios that invest in a more broadly diversified portfolio.

**Fixed Income Securities:** Fixed Income Securities are subject to interest rate risk, credit risk, prepayment risk, market risk, and reinvestment risk. Fixed Income Securities, if held to maturity, may provide a fixed rate of return and a fixed principal value. Fixed Income Securities prices fluctuate and when redeemed, may be worth more or less than their original cost.

**Emerging Markets:** Investing in the securities of such companies and countries involves certain consideration not usually associated with investing in developed countries, including political and economic situations and instability, adverse diplomatic developments, price volatility, lack of liquidity and fluctuations in the currency exchange.

**High Yield Bonds:** High Yield Fixed Income Investments, also known as junk bonds, are considered speculative, involve greater risk of default and tend to be more volatile than investment grade fixed income securities.

**Commodities:** 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.