Morgan Stanley

Exchange Funds

An Important Alternative for Your Asset Allocation

Introduction

Can the expression “too much of a good thing” apply to your investment portfolio? It can, if you own concentrated stock positions that represent a disproportionate percentage of your overall wealth.

Corporate executives often accumulate such positions throughout their careers as a result of stock option plans and other equity compensation programs, but they are not the only ones to rely too heavily on an individual stock. Some investors inherit their positions; some receive them when the businesses they own go public or are acquired by a publicly owned firm. Others simply build their positions over time because they become overly enamored with a particular company.

To protect yourself or to diversify your holdings against market declines that can slash the value of not only your position, but also your entire portfolio, you have generally had three alternatives available to you:

1. You could sell all or part of your position and reinvest the proceeds in a diversified portfolio — realizing that you might incur substantial capital gains liability.
2. You could borrow against your position and use the proceeds to purchase a diversified portfolio — realizing that securities-based lending requires you to make interest payments and only enables you to borrow a portion of your stock’s market value.
3. You could employ a hedging strategy such as an equity collar or variable delivery forward contract — provided your employer allows such strategies and realizing that hedges like these are only a short-term solution. These strategies have also become increasingly expensive over time and entail unique risks of their own.

However, there is another alternative to consider — Exchange Funds — which may enable you to achieve the following:

Diversify Your Holdings

Avoid Borrowing and Use the Full Value of Your Position

Gain Potential Tax Advantages

How Exchange Funds Work

Exchange funds are limited partnerships sponsored by banks, brokerage firms or investment management organizations. The limited partnership structure enables them to take advantage of a provision in the tax law that allows investors to participate by contributing their single stock position(s) without actually selling it. By doing so, although your rights to the stock position(s) are given to the exchange fund, you receive partnership units in a diversified portfolio of stocks initially contributed by investors like you, but ultimately managed to pursue specific goals like long-term growth.

Some exchange funds seek to outperform or match the returns of the overall market as measured by the S&P 500 Index or the S&P 1500 Composite Index, while others seek to outperform or match the returns of the Russell 1000 or other market indexes. All exchange funds, however, have one thing in common: to comply with the tax code provision that allows tax-free transfers of stock, they must invest 20% of their gross assets in qualifying assets. Most exchange funds currently satisfy this requirement by purchasing real property typically held through indirect subsidiaries of the funds. Other similarities include:

DIVERSIFICATION

By participating in an exchange fund, you are essentially swapping your concentrated stock position(s) for a diversified portfolio of stocks selected by professional managers. There is no guarantee that the portfolio will outperform your original stock position(s), but diversification can reduce portfolio volatility. In addition, the 20% of exchange fund assets that must be invested in illiquid securities provides further diversification, often in an asset class that has historically provided returns with a low correlation to those generated by equities.

SEVEN-YEAR COMMITMENT

Exchange funds remain open to new transfers of stock until they reach what their management considers to be target size. Each investor receives a share of partnership units commensurate with his or her contribution. The fund then employs its strategy and at the end of seven years, you have the option to redeem your units. When you do, you typically receive a pro rata share of some or all of the stocks in the fund's portfolio, depending on the policy of the individual fund. You can also stay invested in the partnership on a tax-deferred basis.

TAX-DEFERRED GROWTH

Most funds reinvest all dividends and capital gains earned by their portfolios. These reinvested earnings are taxed at your individual tax rate. However, when you elect to redeem your units after seven or more years and receive your distribution, you pay tax only when you sell any of the shares you receive. Your cost basis is the same as the aggregate cost basis of the employer stock shares you originally contributed.

ESTATE PLANNING BENEFITS

Exchange fund units qualify for the same step-up in cost basis offered by other investments transferred to heirs upon their original owner's death. This could result in a considerably smaller tax bill for heirs when they eventually redeem their exchange fund units and sell their distributed shares.

What Else Should You Know Before You Invest?

Exchange funds are designed for long-term investors, but in the event you run into unforeseen expenses that require you to alter your strategy, you are generally offered a degree of liquidity. Many exchange funds offer the opportunity to redeem your units on a monthly or quarterly basis. Some even offer daily redemptions. However, redemptions before the seven-year period has elapsed typically trigger additional fees that can be as high as 2% of assets, under certain circumstances. By redeeming early, most investors will most likely end up receiving their original shares, instead of a diversified grouping of stocks.

Other exchange fund characteristics of which you should be aware include:

FEES which, for funds offered through Morgan Stanley, can typically range from 0.85%-0.95% for the annual client fee. There is also a one-time upfront client fee of up to 1.5% depending upon your investment amount.

MINIMUM INVESTMENT REQUIREMENTS which, for funds currently offered through Morgan Stanley, range from $500,000-$1 million in stock(s). No cash will be accepted.

ACCEPTANCE POLICIES may differ from fund to fund; however, they generally include a list of defined stocks in their investable universe that are approved for investment. Each of the stocks listed in the "approved stock list" may be driven by capacity constraints subject to the fund's availability. Some accept only stocks of established companies with large market capitalization and a history of profitability, while others are open to mid-cap or small-cap positions. Restricted stocks are eligible for acceptance, but check to determine whether the windows in which you're allowed to sell your restricted holdings match up with the time period in which your fund is accepting shares.

Seeking to Identify Superior Exchange Fund Managers

Morgan Stanley offers access to exchange funds through leading third-party managers, all of whom have significant experience managing exchange funds. Most funds selected for your consideration are uniquely designed to provide broad diversification and have passed the in-depth scrutiny necessary for their addition to our product suite. Specifically, we employ a rigorous due diligence process that focuses on investment expertise and operational capabilities. That process includes:

QUANTITATIVE AND QUALITATIVE ANALYSIS

How have funds performed over time, in various market cycles and versus their peer groups? How much risk did managers assume to achieve their returns? Morgan Stanley research professionals visit managers on-site to interview key personnel and conduct in-depth reviews of investment approaches, portfolio composition, risk management techniques and capacity constraints, as well as organizational depth and stability.

OPERATIONAL REVIEW

What risks do funds pose outside of their investment processes? Our experts review each manager's infrastructure, controls and business practices to determine whether they meet our demanding criteria. Managers can be eliminated from consideration if our analysis reveals failure to supervise, improper valuation practices, a lack of checks and balances or inadequate risk and liquidity controls.

APPROVAL OF NEW FUNDS

Should we see a demand for a new exchange fund offering, the Alternative Investments Product Development team, in conjunction with our Global Investment Manager Analysis team, will work with the fund to negotiate terms and seek the necessary approvals from Morgan Stanley's Actively Managed Product Review Committee. This group consists of senior professionals from such diverse disciplines as legal, compliance, risk and investments. Funds that pass their scrutiny are made available to qualified Morgan Stanley clients.

ONGOING MONITORING

Once a fund is selected for inclusion on our platform, it is reviewed and evaluated on an ongoing basis to help ensure it continues to meet Morgan Stanley's investment and operational standards. Events that could change a fund's status include persistent underperformance, style drift, significant changes to key staff and inadequate operational resources.

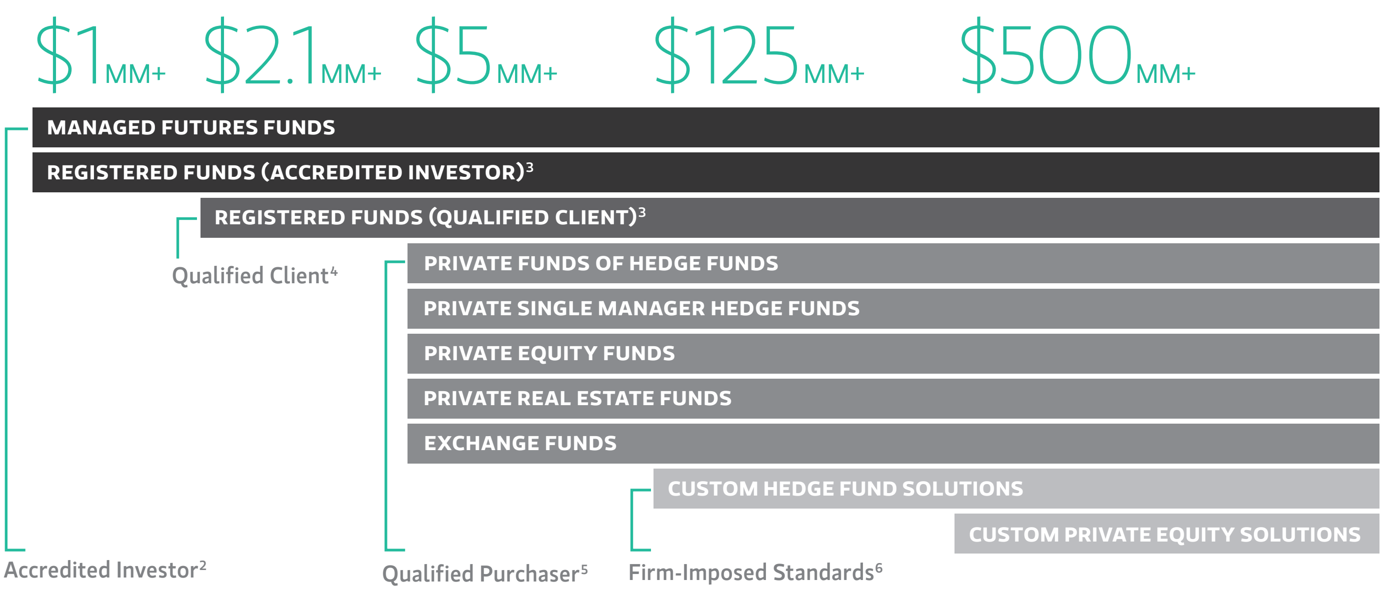
A Word About Eligibility

Investors participating in alternative investments offered through Morgan Stanley must meet certain SEC and/or state standards depending on the structure of the fund or service. Morgan Stanley may impose a qualification standard that is higher than those required to meet SEC/state standards. Additionally, individual funds or services may have their own investment minimum and eligibility criteria.

Alternative Investments Eligibility

Alternative investments are offered only to qualified investors. Client eligibility[1] to purchase alternative investments is typically based on the client's net worth, or as applicable, net investable assets, as shown in the chart below.

Client Net Worth/Net Investable Asset Minimums



[1] Eligibility does not imply suitability. Speak with your Financial Advisor or Private Wealth Advisor to help determine if alternative investments may be appropriate for you. Please see the Important Disclosures at the end of this publication for additional information.

[2] Funds that rely on an Accredited Investor standard generally require a minimum net worth of $1 million for an individual (excluding primary residence), and $5 million for an entity.

[3] The specific Registered Fund structure will determine eligibility standards. Funds that rely on an Accredited Investor standard include Registered Funds of Hedge Funds; funds that rely on a Qualified Client standard include Registered Single Manager Hedge Funds and Registered Private Equity Funds.

[4] Funds that rely on a Qualified Client standard require an individual or entity to have a minimum net worth of $2.1 million, exclusive of primary residence, or have at least $1 million invested under management with the manager of the fund.

[5] Funds that rely on a Qualified Purchaser standard must meet Accredited Investor standards, and require minimum net investable assets of $5 million for an individual, and $25 million for an entity.

[6] In addition to meeting Accredited Investor and Qualified Purchaser standards, these funds are subject to firm-imposed higher eligibility standards.

When Is the Right Time to Invest?

If you're a corporate executive, you already look to your employer for salary and benefits. By concentrating too much of your overall wealth in the stock of your employer, you could become undiversified and subject yourself to excessive risk. If you've inherited your position, built it yourself over time or acquired it through a business transaction, you should ask yourself whether it's prudent to concentrate such a substantial portion of your assets in any investment. To determine whether exchange funds represent a viable solution for you, contact your Morgan Stanley Financial Advisor or Private Wealth Advisor.

Appendix

RISK CONSIDERATIONS

Investing in alternative investments can involve a high degree of risk. These are speculative securities. Diversification does not assure a profit or protect against loss in a declining market. **Before you decide to invest, carefully consider a fund's investment objectives, risks, charges and expenses. This and other information can be found in a fund's confidential offering memorandum or prospectus, which you should read carefully before investing.**

ALTERNATIVE INVESTMENTS

Valuation Risk Certain alternative investment funds often trade in esoteric and/or illiquid securities. In normal markets, it is sometimes difficult to price these instruments, causing managers to estimate market values. In stressed markets, this problem may be magnified, leaving investors with an imprecise understanding of a portfolio's net asset value. Valuations for investments for which market quotations are not available may at times be estimates, which may affect the amount of the management and incentive fees.

Specialized Trading Special investment techniques such as leveraging, short selling and investing in derivatives, including options and futures, may result in significant losses.

Manager Risk Investing in a fund exposes investors to risks particular to that fund manager. These risks can include poor decision-making, key personnel departures or fraud, among others. In the case of a fund of funds, although the investment manager selects managers it believes are prudent and reliable, managers could perform poorly or reach capacity.

Liquidity Risk Interests in certain alternative investment funds are generally not readily marketable and not redeemable. Interests in a fund generally are not transferable except in limited circumstances. Accordingly, investors have to bear the risks of investing for the full duration of the lock-up period.

Investment Process/Model Risk The investment manager's investment process may be heavily dependent on the investment manager's analysis of historical data. No assurance can be given that these analyses will accurately predict future results.

Market Risk The value of securities, commodities and currencies may fluctuate, reflecting a variety of factors, including changes in investor outlook and political and economic environments.

Strategy Risk Investments in diverse and sometimes complex strategies are affected in different ways and at different times by changing market conditions. Strategies may at times be out of market favor for considerable periods, with adverse consequences for the portfolio.

Incentive Compensation Managers will, in general, receive performance compensation, which may give the managers incentives to make investments that carry greater risk or are more speculative than might be the case if no performance compensation were paid.

GLOSSARY OF TERMS

Alternative Investments Alternative investments include hedge funds, public and private offerings, low expense and high expense, liquid and illiquid, long-only and long-short investments such as master limited partnerships ("MLPs"), commodities, real estate, private equity, collectibles and venture capital. Various alternative investment strategies are being utilized by investment managers in other vehicles such as mutual funds and managed accounts.

Correlation A measure of the degree to which two variables move in the same direction with the same impact on performance, measured in a range of -1.0 to 1.0. A correlation of -1.0 implies that the variables move inversely with one another while a correlation of 1.0 implies that the variables move in exactly the same manner. A correlation of zero implies that there is no relationship between the movements of the variables (therefore implying perfect diversification).

Diversification Spreading investment risk by constructing a portfolio that contains different investments whose returns are relatively uncorrelated. Risk levels can be reduced without a corresponding reduction in returns.

Qualitative Analysis An analysis of the qualities of a company that cannot be measured concretely, such as management quality or employee morale.

Quantitative Analysis A mathematical analysis of the measurable figures of a company, such as the value of assets or projected sales. This type of analysis does not include a subjective assessment of the quality of management.

REFERENCED INDEXES

Russell 1000 Index Measures the performance of the 1,000 largest U.S. companies based on total market capitalization.

S&P 1500 Composite Index A broad-based capitalization-weighted index of 1,500 U.S. companies and comprises the S&P 400, S&P 500 and the S&P 600.

S&P 500 Index Tracks the performance of 500 widely held, large-capitalization U.S. stocks.

Notes

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Alternative investments often are speculative and include a high degree of risk. Investors could lose all or a substantial amount of their investment. Alternative investments are suitable only for eligible, long-term investors who are willing to forgo liquidity and put capital at risk for an indefinite period of time. They may be highly illiquid and can engage in leverage and other speculative practices that may increase the volatility and risk of loss. Alternative investments typically have higher fees than traditional investments. Investors should carefully review and consider potential risks before investing. Certain of these risks may include, but are not limited to:

- Loss of all or a substantial portion of the investment due to leveraging, short-selling or other speculative practices;
- Lack of liquidity in that there may be no secondary market for a fund;
- Volatility of returns;
- Restrictions on transferring interests in a fund;
- Potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized;
- Absence 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 manager.

As a diversified global financial services firm, Morgan Stanley Wealth Management engages in a broad spectrum of activities including financial advisory services, investment management activities, sponsoring and managing private investment funds, engaging in broker-dealer transactions and principal securities, commodities and foreign exchange transactions, research publication, and other activities. In the ordinary course of its business, Morgan Stanley Wealth Management therefore engages in activities where Morgan Stanley Wealth Management's interests may conflict with the interests of its clients, including the private investment funds it manages. Morgan Stanley Wealth Management can give no assurance that conflicts of interest will be resolved in favor of its clients or any such fund.

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Indexes are unmanaged and investors cannot directly invest in them. Composite index results are shown for illustrative purposes and do not represent the performance of a specific investment.

Past performance is no guarantee of future results. Actual results may vary. Diversification does not assure a profit or protect against loss in a declining market.

Any performance or related information presented has not been adjusted to reflect the impact of the additional fees paid to a placement agent by an investor (for Morgan Stanley Wealth Management placement clients, a one-time upfront Placement Fee of up to 3%, and for Morgan Stanley Wealth Management Consulting Clients, an annual advisory fee of up to 2.5%), which would result in a substantial reduction in the returns if such fees were incorporated.

Alternative investments involve complex tax structures, tax-inefficient investing, and delays in distributing important tax information. Individual funds have specific risks related to their investment programs that will vary from fund to fund. Clients should consult their own tax and legal advisors as Morgan Stanley Wealth Management does not provide tax or legal advice.

Interests in alternative investment products are offered pursuant to the terms of the applicable offering memorandum, are distributed by Morgan Stanley Smith Barney LLC and certain of its affiliates, and (1) are not FDIC-insured, (2) are not deposits or other obligations of Morgan Stanley or any of its affiliates, (3) are not guaranteed by Morgan Stanley and its affiliates, and (4) involve investment risks, including possible loss of principal. Morgan Stanley Smith Barney LLC is a registered broker-dealer, not a bank.