Morgan Stanley

Why Managed, Why Now

A Market Made for Managed Fixed Income

MANAGED FIXED INCOME IN TODAY'S MARKET

Volatile markets can be challenging for both equity and fixed income investors, but with volatility comes opportunity. Yields have reset upward, volatility is set to remain heightened, and after a year where stocks and bonds moved together, bonds are starting to act like themselves again—bringing defensive diversification back into investor portfolios.

A TRANSFORMED LANDSCAPE

While the fixed income markets again offer significant opportunities, the landscape has become more complex as insurance has disappeared, sourcing inventories have fallen and transaction costs have risen. Generating tax alpha, accessing inventory and gaining the full benefits of bonds requires more specialized expertise than ever.

In this market, active managers may be better positioned to provide alpha through a several advantages.

Why managed fixed income?

- **Generate** tax alpha through tax-loss harvesting
- **Benefit** from extensive credit teams that are proactive, not reactive
- **Access** primary and secondary inventory
- **Leverage** size and scale for improved pricing
- **Reduce** potential cash drag and stay fully invested
- **Improve** flexibility, efficiency and ease of rebalancing
- **Customize** your portfolio with options to help add alpha and yield via a separately managed account strategy

Why now?

- The investment landscape has become more complex, with increased volatility, uncertainty and risk
- Yields are higher, making fees a smaller percentage
- Muni dealer inventories have decreased significantly, from $51BN in 2007 to $12BN in 2022*
- No AAA-rated bond insurers remain**
- BBB corporate bonds constitute 47% of the index, compared to only 13% in 1980***
- Volatility can make execution more expensive, with wider bid/ask gaps

PUTTING THE INCOME BACK INTO FIXED INCOME

We believe that the fixed income markets are at a better entry point than we've seen in quite some time, with yields higher, valuations cheaper and credit durable. An active manager can help you take advantage of the current market.

Where markets have been hit hard by volatility, don't overlook the opportunities to harvest losses to help lower your capital gains tax bill. These tax losses never expire and can be used to offset possible tax gains in the future.

*CreditSights, Federal Reserve and MSRB, 4Q2022. **Fixed Income Solutions, Second Quarter August 10, 2022 ***Federated Hermes: Why Professional Managed Fixed Income, August 2022

BENEFITS OF MANAGED FIXED INCOME: TAX-LOSS HARVESTING AND TAX ALPHA

As inventories shrink and the fixed income markets grow more complex, active management can offer significant advantages. During times of high volatility, one benefit stands out: the power of tax-loss harvesting.

TAX-LOSS HARVESTING

In a nutshell

Taxes can be a substantial drag on your progress toward financial growth. Tax-loss harvesting is a powerful tool for turning investment losses into tax assets.

When done correctly, investors can offset capital gains with capital losses they've incurred during this tax year or carried over from a prior year—so they can benefit from volatility and potentially generate better after-tax results.

In fixed income

While sophisticated equity investors have long appreciated the benefits of active tax-loss harvesting, some managed fixed income strategies are now also taking advantage of tax-loss harvesting.

Volatility and market liquidity have created tax-loss harvesting opportunities in fixed income that we haven't seen in decades.

In Total Tax 365

Tax-harvesting opportunities ebb and flow with the fluctuations of the market and not with our fiscal calendars.

Select managers and strategies in Total Tax 365 incorporate tax-sensitive investing into daily trading activity in order to capitalize on today's volatility and potentially yield better after-tax results.

CONSIDER TRANSITIONING ASSETS TO A PROFESSIONAL MANAGER

Many of the fixed income Separately Managed Accounts (SMAs) available on our platform can be funded with cash or in-kind securities. A professional bond manager can use size and scale to enhance portfolios, innovative technology to allow for better tax efficiencies, and tax-loss harvesting to help you keep more of what you earn.

THE VALUE OF A PROFESSIONAL BOND MANAGER	HYPOTHETICAL PERFORMANCE*
Access. Professional managers often have broader access to both the new issue and secondary markets, with pricing and diversification advantages. During periods of volatility, the benefit may be pronounced in the secondary market.[1]	10 bps**
Oversight. Extensive credit teams create the potential to quantify emerging risks, capture new opportunities and increase yield by moving into A- and even BBB-rated municipal bonds, reflecting a significant difference in average spreads.[2]	56 bps
Price. By trading in institutional blocks, professional managers may be able to avoid retail markups and pass the savings on to clients.[3]	15 bps
Tax-loss harvesting. When offered by a bond manager, active, year-round tax-loss harvesting seeks to reduce the impact of capital gains taxes and may elevate after-tax return potential.[4]	33 bps
Reduced cash drag. Professional managers may be able to trade with more flexibility, rebalance holdings more easily and source attractive bonds more efficiently when they mature or are called in order to keep client accounts fully invested.[5]	28 bps
Total:	**142 bps**

*Parametric Value of a Professional Muni Bond Manager, June 2022. See last page footnotes 1-5. The hypothetical performance illustrated is gross of fees and would be reduced by the fees clients pay in an advisory program.
**bps: basis point, one hundredth of one percent

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• Performance derived from model portfolios, which are typically constructed using individual securities (stocks and bonds), ETFs, mutual funds or other investment products, and can be developed with the benefit of hindsight and without actual money at risk
• Performance that is back-tested by the application of a strategy to data from prior time periods when the strategy was not actually used during those time periods—back-testing attempts to demonstrate how an investment strategy might have performed if it had been implemented historically
• Targeted or projected performance returns of a portfolio that is based on assumptions about investment returns and market behavior
• Performance during certain simulated market scenarios that measure the potential impact of discrete market events on a portfolio using a multifactor statistical risk model
• Performance during certain simulated historical scenarios that measure the profit and loss impact of instantaneous market movements between two specified dates based on risk factors in a portfolio

Hypothetical performance illustrations:
• May include investment products that you currently may not own, or may not own in the same quantities
• May appear similar to your current portfolio—but you would not necessarily have obtained the same results even if you had held the same products in the same allocation for the same time periods
• Are not designed to maximize performance returns or other rewards
• Do not reflect the personal performance experience of your actual securities or account(s)

Hypothetical performance results have inherent limitations, including the following:
• There can be large differences between hypothetical and actual results
• These illustrations do not account for certain risk factors, including the ability to withstand losses or to adhere to a particular trading strategy in the face of trading losses
• The hypothetical results do not represent actual results and are generally designed with the benefit of hindsight
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[1]Source: Parametric. Parametric Value of a Professional Muni Bond Manager. 10bps: The average differential spread to MMD in the primary and secondary market, broken out by credit buckets, AAA, AA and A in the 5 to 15 year maturities. Data is from 1/1/2021 to 4/30/2022.

[2]Source: Parametric. The AAA, A, AA, and BBB tax exempt municipal yield curves are calculated using a basket of bonds created using the following rules based criteria. Interest is exempt from Federal Income tax. Maturity size of $1,000,000 or greater. The issue date is within 5 years from today's date. Fixed rate coupons between 3% and 5%. Bonds are non-callable, or have a call date that is 7, 8, 9, or 10 years from today's date. Maturity date is 1 to 20 years from today's date. Each bond selected has at least one rating from either Moody's, S&P or Fitch. 5/23/22.

[3]Source: MSRB Report on Secondary Market Trading in the Municipal Securities Market, 12/31/2019.

[4]Based on historical model testing, the average simulated tax alpha for a 1-10 year national ladder was 33 basis points. It is important to note that not every year contained opportunities to add value through tax loss harvesting due to market dynamics.

[5]Source: Morningstar Direct and Parametric Laddered Interest Rate Scenario Tool as of 5/23/22. Assumes Tax Free Money Market Yield of 0.37%, the average yield of the Morningstar Tax Free Money Market Fund Category. Category contains 179 funds. Parametric Ladder yield based on a 1-14 Year BBB National Sample with a gross yield of 3.22%. This material is presented for informational and illustrative purposes only as the views and opinions of Parametric as of the date hereof. It should not be construed as investment advice, a recommendation to purchase or sell specific securities, or to adopt any particular investment strategy. Actual client results may differ significantly from those stated, depending on factors such as changes in securities or financial markets or general economic conditions. Forecasts and estimates and certain information contained herein are based upon proprietary research and not be to relied upon as advice or interpreted as a recommendation. This information is not to be construed as an estimate or promise of the experience or results a client may achieve. This material has been prepared on the basis of publicly available information, internally developed data and other third-party sources believed to be reliable. However, no assurances are provided regarding the reliability of such information and Parametric has not sought to independently Parametric is a part of Morgan Stanley Investment Management, an affiliate of Morgan Stanley Smith Barney LLC.

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