



## The Benedict-McLoughlin Report 2013 Investment Outlook

By Christopher Benedict, CFA

- The developed economies are still a ways away from getting their respective fiscal houses in order and this process will likely take several years
- Overall, I believe we will experience below average global economic growth and this will translate into below average investment returns across asset classes
- Investors should review their asset allocations and re-balance if necessary in an effort to “squeeze” out any unnecessary portfolio risk

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#### The Benedict-McLoughlin Group

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Global financial markets appear to be starting 2013 where they left off in 2012, namely, in “risk-on” mode. Looking back, global equity markets battled a fair amount of uncertainty to post solid gains in 2012.<sup>1</sup> Concerns surrounding the U.S. elections and the “fiscal cliff”, continuing turmoil in Europe, and the fear of a slowdown in China all could have easily de-railed market momentum. And, with increased clarity on all fronts, albeit without anything necessarily getting solved, investors appear to feel that the worst is over and they continue to embrace equities and other “risk” assets with several prominent forecasters publishing optimistic forecasts for 2013. In the supporting role, global bond markets have remained “conductive” with most central banks providing significant monetary support in terms of low interest rates and, in some cases, outright asset purchases. These policies have kept interest rates in the “stronger” developed economies near record lows and have even enabled modestly lower rates in the “problem child” economies like Greece and Spain, although they remain elevated on a relative basis.

While there currently is a palpable sense of increased optimism, the underlying question remains: Have we really fixed

anything or are we simply treating the symptoms and not the actual illness, namely, too much debt? The U.S. seems to be “solving” its problem by running massive deficits and buying government debt to the tune of \$85 billion per month (which, coincidentally, is approximately equal to our average monthly deficit of the past few years).<sup>2</sup> Europe has also been using more debt to address their issues via their Longer-Term Refinancing Operations (LTRO). And, Japan, with its 200%+ debt-to-Gross Domestic Product (GDP) level, is now employing a “novel” new fix: You guessed it, more debt.<sup>3</sup> It remains to be seen if increasing our debt levels will actually help the global economy over the long run but, I am skeptical. I have always been taught that, when you are in a hole, the first thing you should do is stop digging.

In any case, any potential sustainable solution, in my opinion, is simply a matter of balance. In an effort to balance the budget, governments can attempt to raise revenue (i.e., taxes), they can reduce government spending, or they can do some of both. Furthermore, they can attempt to address the issue immediately or over an extended period of time.

Of course, an optimal period of time may be hard to figure with much precision but, I suspect it is somewhere between five and fifteen years. In other words, those “solutions” that call for either an immediate “bite the bullet” approach on one end of the spectrum or a “the problem will work itself out over time” approach on the other end, should be ignored, in my opinion. I believe a comprehensive and realistic approach that puts us on a sustainable debt-to-GDP path over the next decade, for example, is the most reasonable way to tackle the problem. In parallel, the U.S. government should secure the financing of the “program” by issuing enough medium and long-term debt so as to more closely “match” the average maturity of our federal debt with the average “maturity” or duration of its liabilities, which are longer term in nature (i.e., Social Security, Medicare, etc.). This would help to mitigate the risk of running into a “Greek” problem where the U.S. could face financing problems as the inevitable “hiccups” present themselves along the way. As of May 2012, the average maturity of U.S. Treasury debt outstanding was approximately five years.<sup>4</sup> While this is longer than the all-time low of four years in 2008, it is still a great deal shorter than the average duration of the country’s liabilities and poses a meaningful risk, in my opinion.

### **Why Ben Bernanke Will Likely Not End Up in the Hall of Fame**

With global equity markets up over 100% from the early 2009 lows and economic output at an all-time high (albeit with below trend-line growth), it may appear that we are in the throes of the next structural bull market in global equities. But, in my opinion, much like the writers who vote on who will be inducted into the Baseball Hall of Fame, it is hard to get excited about artificially enhanced performance. The Federal Reserve along with many of the central banks around the world have essentially provided “performance enhancing” monetary policy to the global economy and, while this was appropriate as we were exiting the “Great Recession” of 2008/2009, the continuation of it for such an extended time period introduces a number of risks. Whether it is a home run hitter taking illegal substances or a central bank providing easy money to spur economic growth, it is often easy to be blind to the

longer-term consequences as the short-term “benefits” are being enjoyed. Although, in this example, there may also be some hoping that there might never be any sort of “payback” in the future. Unfortunately, hope is not a strategy as we recently witnessed the all-time home run leader fail to garner enough votes (by a long shot) to get into the Baseball Hall of Fame due to his cheating. Interestingly, except for two others, the rest of the top 10 all-time home run leaders are either in the Hall of Fame or are still active players. The two exceptions were also shunned in the recent Hall of Fame voting because of their use of performance enhancing substances. And, while I’m not a conspiracy theorist, it’s a bit coincidental that the three on this list that will likely never reach the Hall all have repeating initials, just like the current head of the Federal Reserve...hmmm.

At some point, I believe, there will be a tipping point where investors begin to put more weight on the long-term risks of continued deficits and the accompanying rising debt levels vs. the often ephemeral benefits of artificially low interest rates. Importantly, empirical evidence has shown that ever-increasing monetary easing has diminishing returns. Bill Gross, the founder of the world’s largest fixed income manager, points out that, in the 1980s, it took four dollars of new credit to generate \$1 of real GDP. Over the last ten years it has taken ten dollars and since 2006, it has taken twenty dollars to achieve the same incremental \$1 of real GDP.<sup>5</sup> Furthermore, Carmen Reinhart and Kenneth Rogoff have shown that economies with high debt-to-GDP levels grow more slowly than their less levered counterparts. In fact, utilizing data from 1790 – 2009, they show that when debt-to-GDP levels are above 90%, economies grow at roughly half the pace of those economies with less debt.<sup>6</sup> That highly indebted economies grow at a slower pace than less levered economies does make some intuitive sense. At such high debt-to-GDP levels, an economy’s debt trajectory has, of course, three potential future paths: Continue to increase, stabilize, or decline. In the first scenario, investors would likely eventually begin to require higher interest rates to compensate for an increased risk of default and higher funding costs typically slow down economic growth. In the latter two scenarios and especially the last one, the implication is that some fiscal consolidation/austerity would take place to allow the

deleveraging to occur. Of course, this could involve cuts in government spending, higher taxes or a combination of the two and history has shown that both actions reduce economic growth at the margin. In fact, this is exactly what happened in the U.S. in the fourth quarter where a decline in defense spending reduced GDP by 1.55 percentage points.<sup>7</sup> I expect more of the same.

So, it would seem that we can either endure some economic pain now or maybe a great deal more pain at some point in the future, depending on the ultimate path that the U.S. and other highly indebted countries decide to take. As mentioned above, I believe some pain in the short and intermediate term in an effort to avoid significant pain at some point in the indeterminate future is the sober choice. I strongly believe that it is time to face the reality that the U.S. (Europe and Japan as well) has been spending beyond its means. There are approximately 127 million people who receive government transfers or payments in the U.S. (including welfare, Social Security and Medicare) and only 115 million full time jobs.<sup>8</sup> This means that there are effectively 1.1 government dependents for every full time worker in the U.S. Demographics imply that this ratio will get worse. Easy monetary policy and low interest rates have allowed us to continue deficit spending and, in my opinion, has potentially created a structural imbalance where it will be increasingly difficult to reign in these government programs and other government spending. Remember the “47%” number that became such an issue during the Presidential campaign? The losing candidate was referring to the percentage of people that do not pay any federal income tax in the U.S. How can this country perform at its best if half of the citizens do not have any “skin in the game”? To be sure, any incremental revenue that would come by making these 47% pay at least something in federal income tax would be small; however, it is the mindset that matters, in my opinion. A truly free and dynamic capitalistic society should have everybody participating. On the other side of the spectrum, taxing the top 1% of the earners at a 50% rate, for example, would bring in only \$50 billion per year which barely puts a dent into our deficit and debt situation.<sup>9</sup> I guess the tax rate could be increased even further on the highest earners, however, taxpayers do have legs and can end up in areas of the world that are less “taxing”.

Admittedly, while I have been focusing on all of the risks of monetary policy, an argument can be made that the U.S. (and other select developed nations with historically low rates) has a competitive advantage because we can borrow at such low interest rates. I agree with this notion. We should absolutely take advantage of these low interest rates but, in order for it to become a sustainable competitive advantage, these rates need to be locked in for the long-term just as many homeowners have re-financed into long-term mortgages at these historically low rates. Yes, borrowing at an average rate of 1.9% (the current yield of the 10-Year U.S. Treasury Note) is more expensive than borrowing at 0.74% (the current 5-Year yield), however, 1.9% is a lot cheaper than 5%, which is where we were on the 10-Year as recently as 2007 (see graph on p. 10) and could easily be where we end up (or worse) if the market starts pricing in default risk on U.S. debt, not to mention inflation. The numbers are indeed staggering. The U.S. spent \$220 billion in net interest expense in 2012, which made it the fourth largest expense of the federal budget.<sup>10</sup> If 5-Year interest rates simply reverted back to where they were prior to the Great Recession, interest costs would catapult to the top expense to the tune of \$1 trillion per year. As a reference point, we spend less than \$100 billion on education. I think it is time to “lock and load”.

## Asset Allocation <sup>11</sup>

Of course, before any investor begins to analyze specific markets or securities, a proper asset allocation strategy should be established. Unfortunately, asset allocation often takes a back seat to specific securities or sectors in investment research reports and the financial media. This is a bit counterintuitive as the asset allocation decision is often described as one of the most important decision an investor has to make. Every investor has unique objectives and risk tolerances and constructing an allocation strategy based on these unique characteristics can help minimize unnecessary risk given a certain return objective or, similarly, help maximize the expected return given a certain risk level. The fact that different asset classes and sub-asset classes are not perfectly correlated enables what amounts to be the closest thing to a “free lunch” in the investment world as overall portfolio risk may be reduced by combining asset

classes that are uncorrelated. Therefore, it is my contention that a proper asset allocation strategy implemented and managed in a disciplined fashion by a qualified investment professional can add significant value. However, it is important to note that even proper diversification does not guarantee a profit or protect against a loss, as 2008 and early 2009 so vividly demonstrated.

I essentially address asset allocation strategy at three levels; long-term (strategic) target allocation ranges, short/intermediate-term (tactical) adjustments within target ranges, and periodic re-balancing. For example, considering a hypothetical investor with a strategic target allocation of 50% stocks and 50% bonds (for the sake of simplicity, ignore other asset classes for the moment), I would target strategic ranges of 35 – 65% for stocks and 35 – 65% for fixed income as opposed to actual fixed-point targets of 50% each. Once a strategic range is established, I then tactically determine where in the range we should be. The more attractive I believe equities are, for example, the higher the allocation within the range. Of course, these ranges also apply to sub-asset classes like small versus large capitalization equities, for example (see table below). Finally, a re-balancing review is done at least annually or following significant market moves.

The philosophical underpinning of my approach to asset allocation is rooted in the belief that the core of an investment portfolio should be strategically positioned for the long-term, given the specific objectives and risk tolerance of the investor. To be sure, wholesale market-timing calls (i.e., shifting entire allocation into all stocks or all cash, for example) have historically proven difficult to execute consistently. However, by allowing subtle, tactical shifts within the strategic ranges, skilled portfolio managers are generally able to take advantage of relative value discrepancies while still leaving room for error. For example, in early 2003, I moved my equity exposure to the high end of strategic ranges because I believed the relative risk/return tradeoff between stocks and investment-grade fixed income significantly favored stocks. Although that turned out to be correct, if equities had continued their downward slide following the Internet bubble and 9/11, an investor's long-term plan should not have been significantly impaired.

Compare that to a market timer who may have thought the market bottomed and moved 100% into equities in 2001/early 2002 or in 2008 (pre-Lehman Brothers bankruptcy), only to suffer through significant declines which may take many years to make up. Similarly, investors that moved to 100% cash may run the risk of getting back in the stock market too late over the next months or years in order to achieve their long-term return objectives.

Finally, careful monitoring and rebalancing are considered essential components of a disciplined approach. A major benefit of rebalancing, of course, is the potential reduction of overall portfolio volatility. For example, if stocks outperform bonds for a period of time, eventually an investor's allocation to stocks will likely grow to a percentage above the high end of the strategic range. In this case, rebalancing would require trimming stocks and adding to fixed income. Recent examples of this would have been during the stock market run-up in the late 1990s and 2006 - 2007 where trimming stocks and adding to fixed income served investors well while the opposite move in late 2002/early 2003 and late 2008/early 2009 was the appropriate adjustment. After the recent run-up, I believe investors should consider taking advantage of the current time period to do the same thing. By incorporating rebalancing in an asset allocation strategy, an investor is essentially "forced" to sell relatively dear assets while buying relatively cheap assets. Buying low and selling high has never served an investor wrong. The last dozen years has proven to be a good time period to follow the re-balance discipline as markets have generally traded in a fairly wide trading range. It will be important for investors to continue to monitor their portfolios as I expect markets to remain in this trading range for the foreseeable future.

### Hypothetical Allocation Ranges with a Balanced Allocation\*

Asset Class	Minimum (%)	Target (%)	Maximum (%)
Domestic Large Cap Equities	10%	25%	40%
Domestic Small/Mid Cap Equities	0%	5%	15%
International/Global Equities	5%	<u>15%</u>	30%
<b>Total Equities</b>	30%	<b>45%</b>	60%
Tax-Exempt Fixed Income	10%	25%	40%
Taxable Investment Grade Fixed Income	0%	5%	20%
High Yield (or) Floating Rate Fixed Income	0%	<u>10%</u>	20%
<b>Total Fixed Income</b>	25%	<b>40%</b>	55%
Specialty/Alternative/Opportunistic**	5%	15%	30%
<b>Total</b>		<b>100%</b>	

\* For illustrative purposes only and should not be construed as a specific recommendation.

\*\* Specialty/Alternative/Opportunistic may include hedge funds, private equity, real estate as well as tactical investments that are shorter term in nature.

*Please note that alternative investments, such as hedge funds and funds of hedge funds are made available only to qualified investors and involve varying degrees of risk.*

Importantly, many new investment vehicles are making this process easier for the knowledgeable investor. Not only should investors broaden their horizons geographically speaking, I believe they also need to broaden their horizons in terms of investment vehicles as well. Gone are the days where an investor just had to consider stocks, bonds and mutual funds. Today, we have Separately Managed Accounts (SMAs), Exchange Traded Funds (ETFs), closed-end funds, asset-linked Certificates of Deposit and, of course, an increasing number of alternative strategies (for qualified investors). Furthermore, over 2000 international companies are tradable in the U.S. via American Depositary Receipts (ADRs). These choices, while potentially daunting, enable private investors as well as smaller institutions to invest on the same playing field as the largest and most sophisticated institutional investors. From my perspective, these choices enable tremendous flexibility to match specific client objectives with the appropriate investment allocation, the appropriate investment vehicle, and the ability to manage the entire process in the most effective manner.



## Current Strategy

Overall, I believe investors should expect below average returns across all asset classes on an annualized basis over the next few years. When the 10-Year US Treasury Note yields approximately 2% and the valuation of basically every other asset class on the planet is essentially derived from this, it pretty much sums up the landscape. Even if we assume risk premiums in some asset classes are elevated, “normalization” of these risk premiums would likely also mean that the 10-Year yield increases as well, negating any potential relative upside. When considering the U.S. equity market, I believe investors should heed the structural backdrop discussed earlier which, I fear, makes it very likely that the U.S. and, indeed, global economic growth will be below average over the next several years. Given that the U.S. equity market is trading near its historical price-to-earnings (P/E) average and the fact that corporate profit margins are at all-time highs (and are cyclical), U.S. equities will have to rely on real economic growth to achieve any significant gains from current levels, in my opinion. Furthermore, there also lies the question of what U.S. policy makers do when we inevitably enter our next recession. The playbook of the last several decades has been to lower interest rates and provide fiscal stimulus, rinse and repeat. I would argue that we’re just about out of bullets on both fronts. We just might have arrived to where we need to let the baby cry itself to sleep.

For growth, I continue to overweight emerging market equities relative to the U.S. The expected economic growth is expected to be higher in emerging economies, their debt-to-GDP levels are lower and their valuations are below historical averages while the U.S. market is trading near its long-term average P/E level. Emerging market equities actually trade relatively cheaper than their developed market counterparts on some metrics, such as versus net assets, where emerging markets trade at a 12%

discount to developed market equities.<sup>12</sup> Additionally, whereas the U.S. and other developed economies have spent the greater part of the last few decades boosting their growth by deficit spending, most emerging economies have the same opportunity in front of them.

In the fixed income arena, I believe traditional bond investing has never been trickier. U.S. Treasury securities and many other “high quality” fixed income instruments provide paltry yields and, in many cases, offer a negative real return. And of the two major risks that face fixed income investors, interest rate and credit, I am taking on some of the latter while attempting to avoid the former. If interest rates on the highest quality bonds begin to rise back to more normalized levels, investors face the prospect of capital losses on their bonds and the longer the maturity of the bond, all else equal, the larger potential price risk. In my opinion, investors should focus on “spread” product with an average maturity in the 3 – 7 year range where a decent yield can be achieved and the interest rate risk is fairly low. Additionally, I also include some non-dollar fixed income investments, where appropriate. Finally, I am also utilizing non-fixed income securities to achieve some yield such as select high-dividend yielding equities.

Where appropriate, non-traditional investments such as total and absolute return strategies are also an important part of a well balance portfolio, in my opinion. These strategies attempt to achieve a decent return regardless of how equity markets are performing and may help to reduce overall portfolio risk due to their low correlation to traditional equities and fixed income. Please see the tables on p. 7 as well as on p. 12 for a summary of my overweights and underweights.

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## Tactical Allocation Recommendations

Equities	Equal	Fixed Income	-1	Alternative Investments	+1
U.S.	-2	Treasuries	-2		
Int'l/Em. Mkts	+2	Inv. Grade Corp./ Muni's	+1		
Growth	Equal	High Yield	+1		
Value	Equal	REITS	-2		
Large Cap	+2	Floating Rates	+2		
Small/Mid Cap	-2				

Legend	
+2	20% Overweight
+1	10% Overweight
Equal	Equal Weight
-1	10% Underweight
-2	20% Underweight

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## Things to Watch

- **U.S. Deficit/U.S. Dollar:** We are running record deficits and it appears that this will improve only modestly over the next year or two. After strengthening considerably during the heart of the financial crisis in 2008 – 2009 and again in 2010 and 2011 during acute episodes of the Euro crisis, I expect the U.S. dollar to weaken again over the next several years as we attempt to reduce our significant debt level. Higher growth in Asia may also help the dollar depreciate versus most currencies in this region. I believe China will also continue to allow its currency to appreciate against the U.S. dollar as that country is facing an inflation threat
- **The “Welfare State”:** Social safety nets play an important role in a modern economy; however, they can also dis-incentivize people from becoming productive members of society. There is an optimal point and any country/economy that goes beyond this point risks developing a culture where risk-taking is less prevalent, which could reduce economic dynamism at the margin
- **Stimulus—Monetary and Fiscal:** In my opinion, the only question is when, not if, does both monetary and fiscal policy become less accommodative. The Federal Reserve is just about out of bullets and I believe inflationary pressures will re-emerge over the next few years. The budget problem at all levels of government in the U.S. really limits any new fiscal stimulus, in my opinion
- **Unemployment:** The unemployment rate in the U.S. peaked at 10.1% in 2009 but, still remains at 7.9% (as of 2/1/13) almost four years into a recovery.<sup>13</sup> Economists expect unemployment to remain relatively high throughout the recovery. A continued slowdown in hiring (and outright layoffs) by governments due to budget constraints certainly does not help the outlook
- **Europe:** While we have been able to avoid a “Lehman Moment” over the last couple of years, it is too early to signal the “all clear” sign for Europe. While the membership of the European Union may, in fact, be different two years from now, the original reasons for the European Union (efficiency, increased global competitiveness, etc.) are as relevant as ever, in my opinion. Investors should hope for a relatively orderly evolution
- **U.S. Housing Market:** The statistics appear to be consistent with a bottoming process. Pricing has leveled off and housing starts have begun to improve from unsustainably low levels (see graph on p. 10). However, I believe housing starts will remain at below average levels and this should help clear the existing inventory of unsold homes. Overall, I expect a slow recovery for housing over the next several years. After ten years of artificial forces effectively distorting housing both to the upside and downside, I expect a return to a “normal” market to be a stabilizing force for the economy
- **Protectionism:** The severe global recession and its aftermath has factions in many countries pushing for policies that would “protect” their respective economies. Of course, we have learned that protectionist policies during the Great Depression exacerbated that economic downturn and we have proven the economic benefits of free trade in both theory and practice. I mean, come on, is this not why we educate ourselves?
- **Terrorism:** Clearly, a perennial risk these days and terrorists continue to be active globally. Worst case would result from a terrorist strike using Weapons of Mass Destruction (WMD), either nuclear or biological. A large enough event has the potential to negatively affect globalization and even population growth



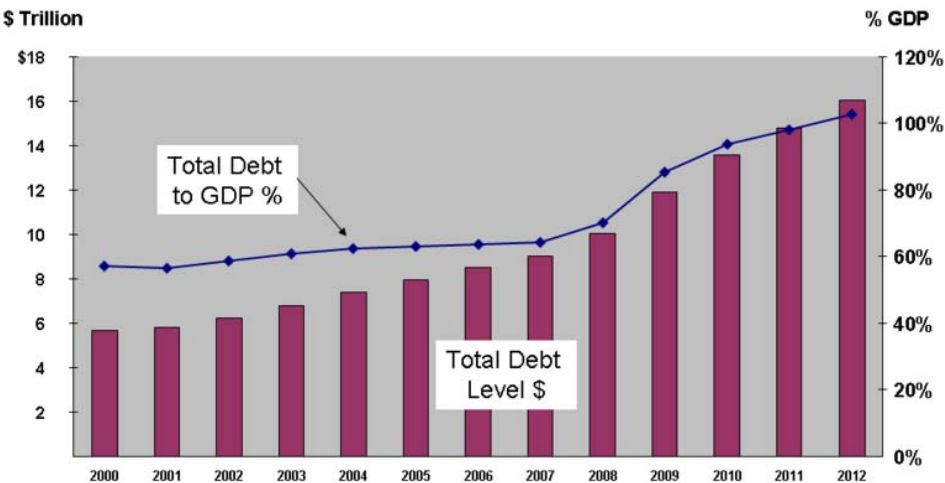
GRAPHS OF INTEREST

S&P 500 (1997–2013)



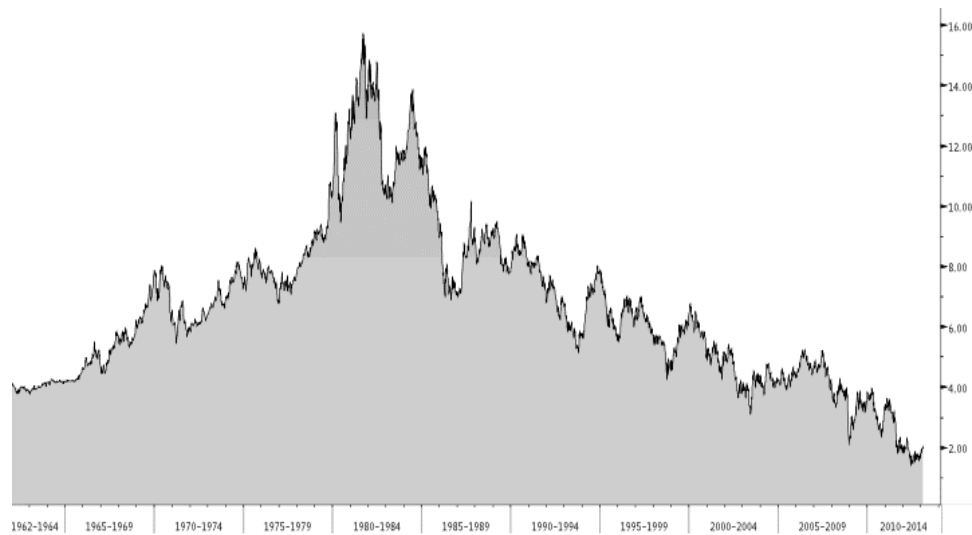
Source: : Data Provided by Bloomberg

Gross U.S. Government Debt (\$ and % of GDP) — 2000 – 2012



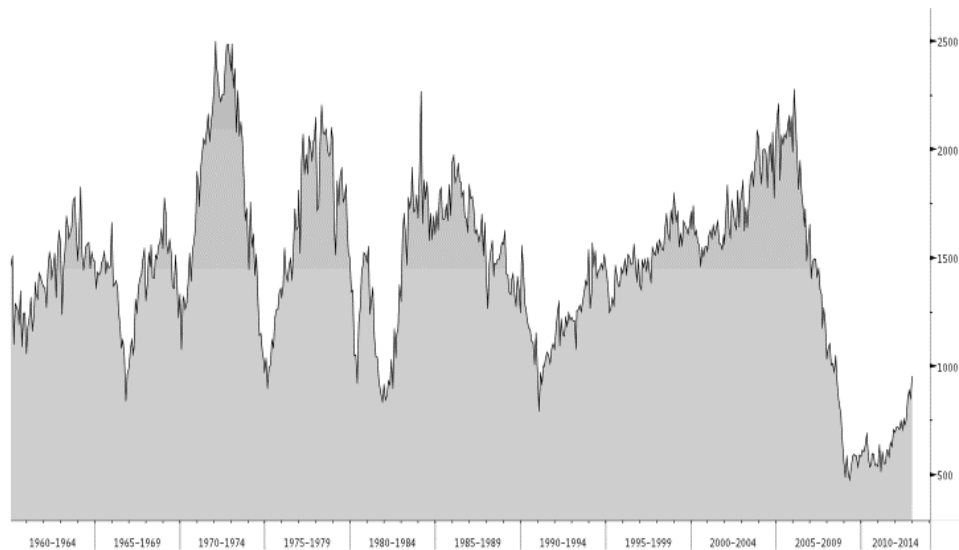
Source: Farcaster, BEA, U.S. Treasury Direct

**Yield on the 10-Year U.S. Treasury Note (1962 – 2013)**



*Source: Data Provided by Bloomberg*

**U.S. Housing Starts in 000's (1960 – 2013)**



*Source: Data Provided by Bloomberg*

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1. Bloomberg Analytics
  2. Fed Maintains \$85 billion Pace of Purchases as Growth Pauses, Bloomberg News, 1/30/13
  3. The Setting Sun – Japan’s Forgotten Debt Problem, EconoMonitor, 1/15/13
  4. The Wall Street Journal, 6/11/12
  5. Investment Outlook, Bill Gross, PIMCO, February 2013
  6. Growth in a Time of Debt, Reinhart and Rogoff, January 2010
  7. Economic Data Bulletin, Morgan Stanley, 2/28/13
  8. [www.PeakProsperity.com](http://www.PeakProsperity.com), 12/26/12
  9. Barron’s, 2/18/13
  10. U.S. News, 11/19/12
  11. Much of this section is from my 2004 Investment Outlook, Oppenheimer & Co. Inc., 2/16/04
  12. Emerging Stocks Cheapen as Profits Disappoint, Bloomberg News, 2/24/13
  13. Bloomberg Analytics
  14. S&P Capital IQ, [www.lsta.org](http://www.lsta.org), 2/3/12

## Summary of Overweights and Underweights

Asset Class/ Industry/Sector	Reason
<b>OVERWEIGHTS</b>	
Absolute/Total Return Strategies*	In what I believe will be a relatively low return environment across asset classes, strategies that are designed to achieve mid-to-high single digit returns may be additive to overall portfolio returns. These strategies typically have a low correlation to traditional assets, which may help reduce portfolio risk.
Large Cap Multi-Nationals	Still cheaper than small caps on many metrics. Large cap multi-nationals are generally in stronger financial shape and are more exposed to global growth, particularly from emerging markets. U.S. based multinationals would get added benefit from a weakening U.S. dollar over time.
High Dividend Yield Equities	Over the long run, dividends have accounted for a significant portion of the total return in equities. I believe this will be the case over the short and intermediate term as well.
Emerging Markets	I believe we are in a significant shift of economic “power” from a U.S./Europe driven economic model to one where emerging market consumers decide that they would like a similar lifestyle which they increasingly see Westerners enjoy on the TV/Internet. There is still a very wide per-capita income gap between the emerging and developing markets that I expect will continue to narrow over time. Importantly, this dynamic should create a positive feedback loop for the global economy.
China	China’s economic expansion continues and they likely have experienced a modest step function to the upside relative to the West during the 2008/2009 crisis as they are in drastically better fiscal shape. New leadership and a new focus on developing a consumer-driven economy provide a number of interesting investment opportunities that may benefit investors over the short and long-term.
Brazil	A resource rich country with a growing middle class that has been leading a fast growing South American continent. Brazil will host the 2014 World Cup and the 2016 Olympics which symbolizes how much progress this country has made in recent years. Capital investment should get a boost as well as the country prepares for these prestigious events and generally upgrades their sub-par infrastructure.
Gold Stocks	Trading call on trend of central banks diversifying their reserves out of U.S. dollar. Rising demand from India/China helps. However, gold market effectively has an “out of the money” covered call option in the sense that all gold that has been mined is essentially still around and would be “melted” at right price.
Corporate/High Yield Fixed Income	In the context of an overall underweight in fixed income, I am overweighting this sub-asset class. Yield spreads have narrowed dramatically since the crisis but still offer some value in the short and intermediate maturities. The senior bonds of certain banks look interesting as the increase of regulatory capital standards puts an extra capital cushion in the lower part of the capital structure.
Floating Rate Loans/Bonds	In the context of an overall underweight in fixed income, I am overweighting this sub-asset class. The floating rate nature of these securities essentially eliminates any duration risk while still yielding approximately 4 percentage points above LIBOR. <sup>14</sup> Many of the existing securities outstanding are trading below par so there is the added potential of capital appreciation as credit markets normalize.
<b>UNDERWEIGHTS</b>	
Long-term Fixed Income	Rates remain low. Real rate of return below historical average. Aggressive rate cuts by the Federal Reserve may stoke higher future inflation. Higher quality bonds relatively expensive versus equities.
U.S. Treasury Securities	Low yields, potential future inflation and increasing supply to fund record deficits pretty much sums it up.
Small Cap Equities	The global nature of large caps (i.e., larger companies derive a greater percentage of their revenues from faster growing emerging markets) and relative valuation continues to favor large caps.
Developed Market Consumer Stocks	Continued soft employment market and consumer de-leveraging will crimp consumer spending at the margin. Consumer staples stocks can be a safe haven but they are expensively valued.
Real Estate Investments Trusts (REITs)	The U.S. commercial real estate has stabilized after the meltdown of 2008/2009. However, the recovery is expected to be slow and dividend yields still remain depressed.
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Investments in high-yield or distressed securities involves a substantial risk of default and/or loss of principal and may be more difficult to sell prior to maturity than investment grade securities. Accordingly, they are not suitable for all investors and careful consideration should be given to individual objectives before engaging in such transactions.

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.

Small cap stocks carry greater risk than investments in larger, more established companies.

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There is no guarantee that the investments mentioned will be in each client's portfolio.

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Asset Allocation, Diversification and Rebalancing do not guarantee a profit or protect against a loss.

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Equity securities may fluctuate in response to news on companies, industries, market conditions and the general economic environment. Companies cannot assure or guarantee a certain rate of return or dividend yield; they can increase, decrease or totally eliminate their dividends without notice.

The initial interest rate on an inflation-linked security may be lower than that of a fixed-rate security of the same maturity because investors expect to receive additional income due to future increases in CPI. However, there can be no assurance that these increases in CPI will occur. Some inflation-linked securities may be subject to call risk.

International investing may not be suitable for every investor and is subject to additional risks, including currency fluctuations, political factors, withholding, lack of liquidity, the absence of adequate financial information, and exchange control restrictions impacting foreign issuers. These risks may be magnified in emerging markets.

The value of fixed income securities will fluctuate and, upon a sale, may be worth more or less than their original cost or maturity value. High yield bonds are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues.

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Investments in high-yield or distressed securities involves a substantial risk of default and/or loss of principal and may be more difficult to sell prior to maturity than investment grade securities. Accordingly, they are not suitable for all investors and careful consideration should be given to individual objectives before engaging in such transactions.

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.

Small cap stocks carry greater risk than investments in larger, more established companies.

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Date of first use: 3/7/13