



## The Benedict-McLoughlin Report 2018 Investment Outlook

By Christopher Benedict, CFA

- Volatility has returned to global financial markets and I expect that it will be with us for the foreseeable future as interest rates continue to normalize.
- Despite the expected continued volatility, economic and earnings growth should drive equity valuations higher over the next year or two.
- Caution is still warranted for traditional fixed income investors as interest rates appear to be in an uptrend.

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Global equities started 2018 the same way they left 2017...in a tight, upward trend, rising over 5% just in the month of January. Investors continued to take their cue from the three pillars of; solid global economic growth, pro-growth policies in the U.S., and relatively low interest rates. Things changed a little in February... global equities as measured by the MSCI All Country World Index sold off just over 10% from their recent peak, signaling the first real correction in more than a year. While I believe the first two pillars of solid growth and a pro-growth environment should be with us for a couple of more years, the third pillar likely will not. Importantly, this does not signal the end of the bull market...it just means that we will likely see more of a “two-way trade” (i.e., more volatility) in a world of both rising earnings *and* rising rates.

Earnings growth has been steady, if not spectacular, since the Great Recession as global economic growth has been somewhat muted when compared to past economic recoveries. The massive monetary policy stimulus by the global central banks provided a huge backstop and likely helped us avoid an economic depression. Only last year did we really see a slight uptick in economic growth as the economy appeared to transition from

“healing” to a more normal state. In the U.S., the economy also benefitted from the actual introduction as well as the promise of expansionary fiscal policies such as de-regulation, tax cuts and infrastructure spending. Additionally, significant technological innovation in recent years has benefitted the global economy from both an employment boost in the technology sector as well as an overall productivity boost as companies implement innovative products. In fact, McKinsey & Co. believes productivity could expand at a 2% pace over the next ten years due to technological advances<sup>1</sup>.

The wild card going forward will be the continued “normalization” of monetary policy. While the big central bank unwind really began in December 2015 when the Fed raised the fed funds rate for the first time since 2006, it began to pick up steam in 2017 with three fed funds increases and the start of the Fed’s bond selling program to reverse quantitative easing (i.e., quantitative tightening). These increases in the fed funds rate are expected to continue in 2018 at roughly the same pace while the bond selling program is actually scheduled to accelerate its pace as we move through 2018.<sup>2</sup> Combine this with

the additional increased supply of bonds from the U.S. Treasury to fund the continued budget deficits and the backdrop remains conducive for interest rates to keep climbing for the foreseeable future, in my opinion.

## Investing 2.5 – Updating to Investing 2.0

As my regular readers know, I hypothesized in December 2016 that the Republican sweep of the elections would “push out” the next recession by a couple of years and effectively give risk assets a runway for about two to three more years (or two and half years, i.e., Investing “2.5”). Fast forward a bit more than a year and, with the appropriate flexibility inherent in these types of predictions, I think we are now in an Investing “2.0” world. In other words, risk assets like global equities should continue to perform well through the end of 2019 as the outlook for economic growth and earnings looks fairly good.

Overall earnings were already doing pretty well when they got a boost with the reduction of the corporate tax rate to 21% under the recent U.S. tax overhaul. One of the key questions is; what will corporations do with the resulting increased cash flow? Will they buy back more stock, increase their dividends, pay employees more, or invest in their business? The first two uses effectively boost stocks in a direct manner while the latter two uses could boost stocks in a less direct manner by potentially improving overall economic activity. The announcements from companies so far indicate that we will basically see “all of the above”.

Investing 2.0 also has important implications for fixed income investing, namely, interest rates should continue their upward trend for the foreseeable future. The fundamentals warrant it and the Fed appears determined to do its part...and we all know what happens to bond prices as rates increase (see graph on p. 7). During “normal” times, the 10-year U.S. Treasury note typically yields around the inflation rate + 2%. With inflation currently at 1.8% as measured by the core CPI index, this implies a “fair value” yield of 3.80% for the 10-year vs. the current 2.84%.<sup>3</sup> So, still a lot of room for interest rates to rise and, if we do get an up-tick in inflation due to tighter employment/wage inflation (likely, in my opinion...see graph on p. 7), then we could see a “4 handle” on the 10-year rate. Importantly, this inflation rate + 2% is

generally considered a neutral rate, so, while an increase towards the 3.80% rate should not put us into recession, it will likely have an effect on global financial markets with an increase in volatility the most likely result.

This battle of rising earnings and rising rates will likely be raging for the next couple of years. Of course, the value of an asset, such as a stock, depends on cash flow, the growth of that cash flow and the discount rate used to calculate the present value of those future cash flows. Since the Great Recession, investors have enjoyed a positive environment of growing earnings/cash flows while interest rates stayed at historically low levels...which enabled valuation metrics to expand. If rates do rise, multiple expansion becomes less likely and stock market returns would need to be driven by actual earnings growth. The good news for bulls is that analysts expect earnings to grow by 17% in 2018 and another 10% in 2019, so, even with a little multiple contraction, stock returns could still be pretty good.<sup>4</sup>

## Asset Allocation<sup>5</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 decisions 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 (See graph on p. 8). 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 on p. 4). 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 take many years to make up. Similarly, investors that move to 100% cash may run the risk of getting back in the stock market too late 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. 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. It will be important for investors to continue to monitor their portfolios as relative performance of certain sub-asset classes (i.e., US equities relative to international equities, for example) may have stretched relative valuations too far and will eventually succumb to the "reversion to the mean" phenomenon that tends to repeat itself in financial markets.

## Hypothetical Allocation Ranges with a Balanced Allocation \*

Asset Class	Minimum (%)	Target (%)	Maximum (%)
Domestic Large Cap Equities	10%	20%	40%
Global Small/Mid Cap Equities	0%	5%	15%
International/EM Equities	5%	<u>15%</u>	30%
<b>Total Equities</b>	<b>25%</b>	<b>40%</b>	<b>55%</b>
Asset Class	Minimum (%)	Target (%)	Maximum (%)
Tax-Exempt Fixed Income	5%	20%	35%
Global Taxable Fixed Income	0%	10%	25%
High Yield/Floating Rate Fixed Income	0%	<u>10%</u>	20%
<b>Total Fixed Income</b>	<b>25%</b>	<b>40%</b>	<b>55%</b>
Specialty/Alternative/Opportunistic**	5%	20%	35%
<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

Given my view that economic growth looks promising at least for the next couple of years, combined with my view that interest rates are still too low, I continue to overweight equities and underweight fixed income in my model portfolios. Generally speaking and using the S&P 500 as an example, if investors assign an 18 multiple on 2019 consensus earnings estimates, the target for the

index would be 3114 in early 2019.<sup>6</sup> This would be an approximate 16% total return including dividends over the next twelve months. If investors only applied a 16 multiple to these same earnings, then the total return would be about 4%. Importantly, if my interest rate forecast is correct, even the 4% would handily beat the Barclays Aggregate Bond index, which would provide a negative return if yields go up the almost 100 basis points that I think they will.

Within equities, my model portfolios are overweight later-cycle and economically sensitive areas like energy, materials and consumer discretionary. I also expect to build up our weighting in financial services over the next few months. We remain underweight consumer staples and utilities. Globally, I have become a bit more agnostic between the U.S. and international as international markets outperformed in 2017 with the help of a weaker US dollar. The U.S. earnings outlook is actually stronger now and I would expect the dollar to hold its own and maybe strengthen a bit as interest rates rise.

Within income investing, my model portfolios continue to be underweight U.S. Treasury securities and investment grade bonds in general. Despite a pretty decent increase in rates over the past six months, the yields in this area are

still too low, in my opinion. Investors that would like to achieve a return in the fixed income portion of their portfolios should consider overweighting high yield corporate and emerging market bonds. Given the higher spreads (i.e., higher yields), I continue to believe it is more beneficial to take appropriate credit risk as opposed to interest rate risk at this point. Our model portfolios are also utilizing Master Limited Partnerships, Yield Co.'s and dividend paying equities to generate income.

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 below and on p. 9 for a summary of my overweights and underweights.

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## Tactical Allocation Recommendations

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

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

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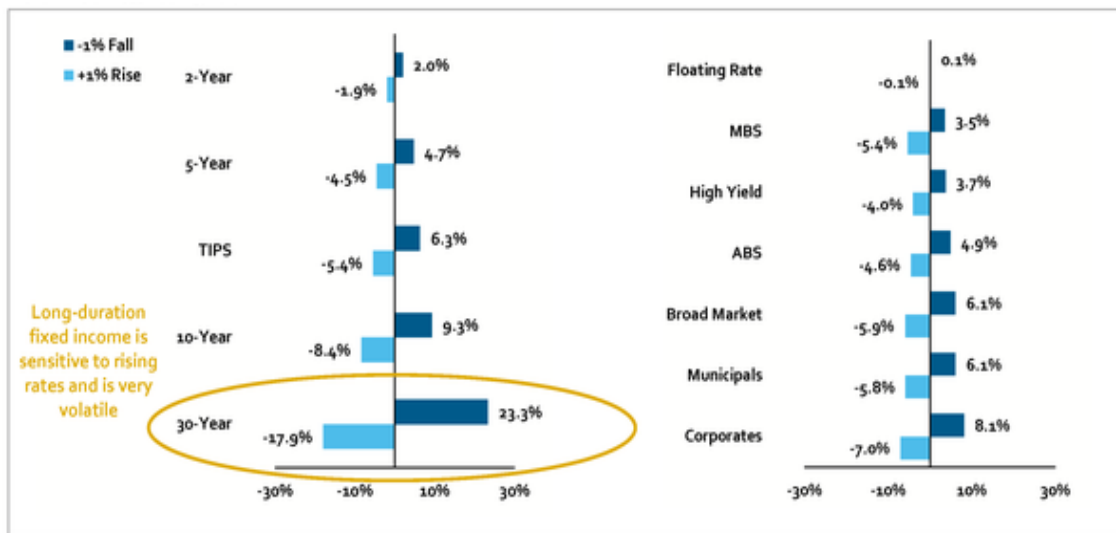
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## (Other) Things to Watch

- **U.S. Deficit/U.S. Dollar:** Although in better shape than during the Great Recession, we continue to run large deficits and it appears that this will improve only modestly over the next year or two, assuming we do see some growth upside. I do see the dollar stabilizing and potentially increasing as interest rates likely rise in the U.S. at a quicker pace than in Europe and Japan. Any weakness in the Yen and the Euro can cause regional trade issues and not everybody's currency can weaken at the same time. That said, the clearest case for renewed dollar strength remains vs. the Yen, in my opinion.
- **Protectionism:** The severe global recession and its aftermath has factions in many countries continuing to push for policies that would "protect" their respective economies...and now it appears that the U.S. Administration has joined this party. 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? Hopefully, our bark is louder than our bite on the protectionist front.
- **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. The new Administration appears to want to bring the U.S. back towards that optimal point.
- **Terrorism:** Sporadic terrorist strikes in Western nations remind us that the threat is still there. While these attacks in the West are serious, they pale in comparison to what has been happening in the Middle East, particularly in Syria. Besides the obvious and tragic human toll, it is a combination of the waste of resources used to combat terrorism (military, police, etc.) as well as a reduction in overall freedom that acts as a detriment to economic activity.  
  
Overall, terrorism adds to global uncertainty and this increases the risk premium for investors (i.e., lower asset valuations, all else equal). And, unfortunately, terrorism will continue to be a perennial risk and terrorists will continue to be active globally. Of course, a 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.
- **Europe:** Despite the exit of the U.K. from the E.U., Europe has the potential to become a positive catalyst that could help move the global economy to the next stage of recovery. While the membership of the European Union may, in fact, be different three 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 fairly healthy and normal housing market. Prices have been rising in the past couple of years and housing starts have improved from unsustainably low levels. Overall, I expect the measured recovery for housing to continue for a few more years. The path of interest rates is a wild card, though. If rates rise too fast, it could counteract improving fundamentals overall.

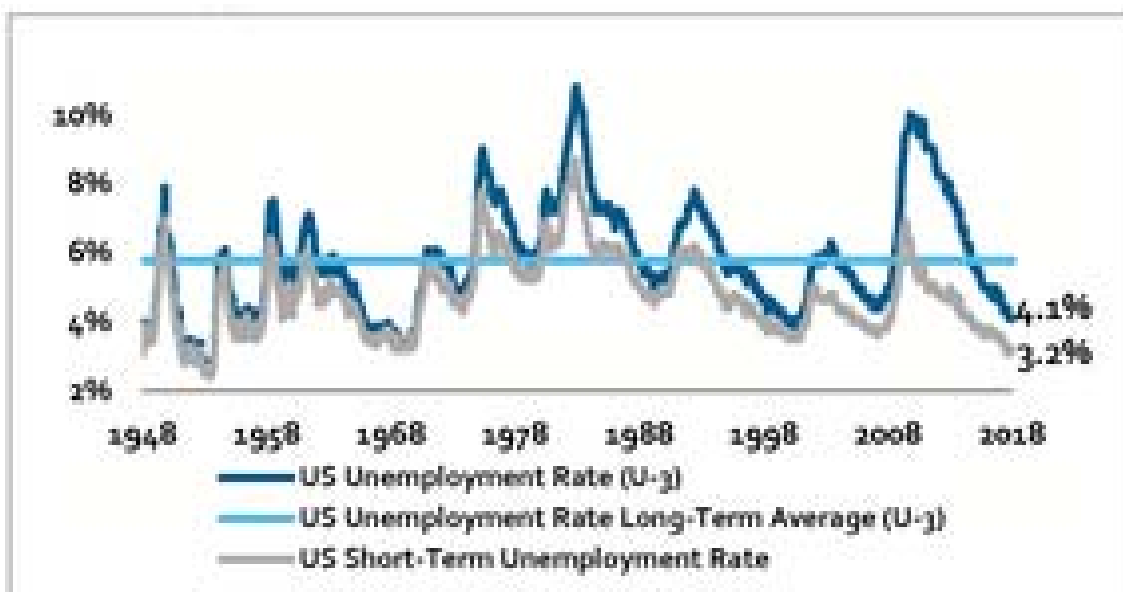
## GRAPHS OF INTEREST

Total Return Impact of a 1% Rise/Fall in Interest Rates



Source: Morgan Stanley Wealth Management GIC

U.S Unemployment Rate (1/31/18)



Source: Morgan Stanley Wealth Management GIC

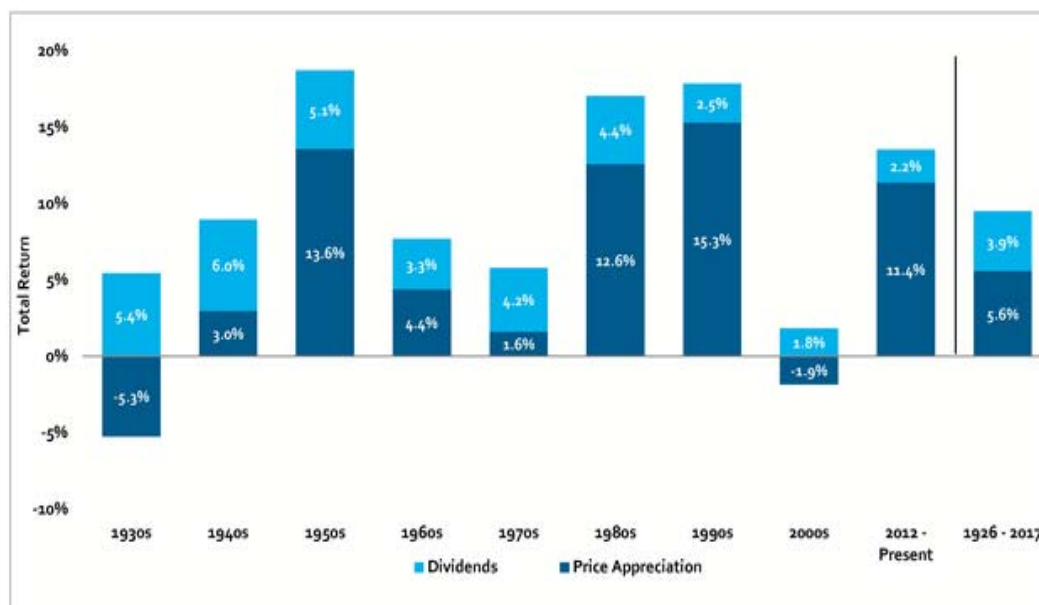
## Asset Class Correlations (12/31/17)

	Cash	US Investment Grade Bonds	High Yield Bonds (USD)	Int'l Investment Grade Bonds (Hedged to USD)	Large Cap Stocks	Developed Non-US Stocks	Emerging Market Stocks	Managed Futures	Hedged Strategies	Commodities
Cash	1.00									
US Investment Grade Bonds	0.16	1.00								
High Yield Bonds (USD)	-0.04	0.25	1.00							
Int'l Investment Grade Bonds (Hedged to USD)	0.18	0.72	0.16	1.00						
Large Cap Stocks	0.01	0.10	0.65	0.08	1.00					
Developed Non-US Stocks	-0.05	0.09	0.60	0.08	0.75	1.00				
Emerging Market Stocks	-0.04	0.03	0.71	0.02	0.68	0.73	1.00			
Managed Futures	0.10	0.26	-0.11	0.25	-0.11	-0.05	-0.07	1.00		
Hedged Strategies	0.15	0.07	0.57	0.05	0.54	0.55	0.66	0.17	1.00	
Commodities	0.04	0.04	0.35	-0.08	0.29	0.38	0.42	0.09	0.39	1.00

Investing in uncorrelated asset classes is key to risk and return management

Source: Morgan Stanley Wealth Management GIC

## Composition of S&P 500 Total Returns (12/31/17)



Source: Morgan Stanley Wealth Management GIC

## Summary of Overweights and Underweights

Asset Class/ Industry/Sector	Reason
<b>Overweights</b>	
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 stabilizing U.S. dollar over time.
Consumer Discretionary	Consumers have been helped by low interest rates for years and have increasingly been helped by the improving labor market. The drop in oil prices is further help. This combination should help the housing, retail and consumer technology sectors, among others. Any wage improvement would be a boost.
High Dividend Yield Equities	Over the long run, dividends have accounted for a significant portion of the total return in equities (see graph on p. 8). I believe this will be the case over the short and intermediate term as well.
China/Emerging Markets (Consumer Focused)	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.
Energy	After a significant bear market in 2015/2016, the price of oil has recovered fairly nicely. However, the stocks of energy companies remain largely depressed. OPEC should continue to support the market and the energy sector typically does better in the late cycle and when inflation is rising.
Corporate/High Yield Fixed Income	In the context of an overall underweight in fixed income, I am overweighting this sub-asset class. An expansionary economic backdrop should help keep yield spreads relatively tight.
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 around 2 percentage points above LIBOR. <sup>7</sup> Many of the existing securities outstanding are trading below par so there is the added potential of capital appreciation as credit markets normalize.
Absolute/Total Return Strategies	In what I believe will be a relatively modest return environment over the next 10 years, strategies that are designed to achieve 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 overall portfolio risk.
<b>Underweights</b>	
Long-term Fixed Income	Rates remain historically low. Real rate of return below historical average. The Fed is normalizing monetary policy. 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.
Highly Valued Tech	Many of the mega cap technology companies have done spectacularly well and their valuations assume many more years of spectacular growth, which may be tough if we see increased regulation.
Developed Market Consumer Staples Stocks	Seen as a “safe haven” in the early years of the recovery, they are now expensively valued as a result. Further, other sectors have become more “palatable” as the global economy stabilizes.
Real Estate Investments Trusts (REITs)	The U.S. commercial real estate has stabilized after the meltdown of 2008/2009. However, the recovery continues to be slow and dividend yields are still unattractive, particularly as overall interest rates rise.

*For illustrative purposes only and should not be construed as a specific recommendation. A review of each investors financial situation and risk tolerances must be performed to determine suitability of any investments. \* indicates new recommended overweight or underweight*

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1. Bloomberg News, 2/20/18
2. Bloomberg Markets, 3/8/18.
3. Bloomberg Markets, 3/16/18.
4. Barron's, 2/12/18.
5. Much of this section is from my 2004 Investment Outlook, Oppenheimer & Co. Inc., 2/16/04.
6. Barron's, 2/12/18.
7. LSTA, [www.lsta.org](http://www.lsta.org), 3/19/18

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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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.

Master Limited Partnerships (MLPs) are (rolled-up) limited partnerships or limited liability companies that are taxed as partnerships and whose interests (limited partnership units or limited liability company units) are traded on securities exchanges like shares of common stock. Currently, most MLPs operate in the energy, natural resources or real estate sectors. Investments in MLP interests are subject to the risks generally applicable to companies in the energy and natural resources sectors, including commodity pricing risk, supply and demand risk, depletion risk and exploration risk. Because of their narrow focus, MLPs maintain exposure to price volatility of commodities and/or underlying assets and tend to be more volatile than investments that diversify across many sectors and companies. MLPs are also subject to additional risks including: investors having limited control and rights to vote on matters affecting the MLP, limited access to capital, cash flow risk, lack of liquidity, dilution risk, conflict of interests, and limited call rights related to acquisitions.

REITs are subject to special risk considerations similar to those associated with the direct ownership of real estate. Real estate valuations may be subject to factors such as changing general and local economic, financial, competitive, and environmental conditions. REITs may not be suitable for every investor.

Dividend income from REITs will generally not be treated as qualified dividend income and therefore will not be eligible for reduced rates of taxation.

***S&P 500 Index is an unmanaged, market value-weighted index of 500 stocks generally representative of the broad stock market. An investment cannot be made directly in a market index.***

The **MSCI World Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. As of May 30 2011, the **MSCI World Index** consists of the following 24 developed market country indices: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States. An investment cannot be made directly in a market index.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

Bonds rated below investment grade may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk and price volatility in the secondary market. Investors should be careful to consider these risks alongside their individual circumstances, objectives and risk tolerance before investing in high-yield bonds. High yield bonds should comprise only a limited portion of a balanced portfolio.

Sample Holdings consist of the top issues in each sector within the model portfolio as of 3/31/17. These sample holdings are for informational purposes only and should not be deemed to be a recommendation to purchase or sell the securities mentioned. There are no guarantees that any securities mentioned will be held in a client's account. It should not be assumed that the securities transactions or holdings discussed were or will be profitable. Data are indicative only as of the given date. Holdings will fluctuate, and no assurance can be given that an actual portfolio will be able to obtain the same attributes.

Please see additional important information at the end of this report

The individuals mentioned as the Portfolio Management Team are Financial Advisors with Morgan Stanley participating in the Morgan Stanley Portfolio Management program. The Portfolio Management program is an investment advisory program in which the client's Financial Advisor invests the client's assets on a discretionary basis in a range of securities. The Portfolio Management program is described in the applicable Morgan Stanley ADV Part 2, available at [www.morganstanley.com/ADV](http://www.morganstanley.com/ADV) or from your Financial Advisor.

Past performance of any security is not a guarantee of future performance. There is no guarantee that this investment strategy will work under all market conditions.

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