

This letter is dated March 2013

***You will come to a place where the streets are not marked.
Some windows are lighted. But mostly they're darked.
A place you could sprain both your elbow and chin!
Do you dare to stay out? Do you dare to go in?
How much can you lose? How much can you win?
- Dr. Seuss¹***

Oh, the Places You'll Go! is one of my favorite children's books. Written by Theodor Seuss Geisel (Dr. Seuss) at the age of 86, a year before he passed away, it describes life's path as a journey with good times and bad, filled with uncertainty and difficult decisions but a great trip all in all. *Oh, the Places You'll Go!* is different from the many children's stories of princes and princesses living happily ever after. While those stories are fun, they risk promoting unrealistic expectations. When my sons were growing up I read *Oh, the Places You'll Go!* to them so many times that the pages tattered, the spine broke and the cover fell off. My hope was that it would help them better deal with tough times when they came along—to recognize them as rough patches to work through rather than something daunting or permanent. I also hoped it would help them keep good times in perspective, to enjoy them with a sense of appreciation rather than entitlement. I should also admit that the rhymes made reading it fun, the drawings made it entertaining and the book was nice and short (attributes I think most parents can appreciate).

My career in the investment business started just before the 1987 crash and has included one of the best decades the stock market has ever seen (the 1990s) and one of the worst (the 2000s). My professional experience has helped me appreciate *Oh, the Places You'll Go!* as providing useful perspective for investors. The financial markets, like Dr. Seuss's description of life's journey, involve plenty in the way of ups and downs, uncertainties and difficult decisions. The book serves as a lighthearted and healthy reminder to be prepared for good times and bad.

In this letter I will touch on why I think it is important that investors strive to be realistic in their outlook on the financial markets as opposed to optimistic or pessimistic. While it is often simpler and more comfortable to see

situations in black or white, they are usually more accurately viewed in shades of gray. Much like Oh, the Places You'll Go! the path forward for investors is likely to include exciting times and scary times. It is my hope that recognizing this will help investors make more rational, balanced decisions and guard against being swayed too much by the emotions of the day.

From childhood, we are encouraged to be optimistic. There are many good reasons for this including a sunnier disposition and a greater sense of possibilities. In the investment world, however, excessive optimism can be dangerous. Optimists, confident that good times will roll on, tend to take on more risk as prices hit new highs. They are usually the most confident about the future after prices have moved up and forecasts predict more of the same. The optimist's greatest worry is not taking full advantage of opportunities that he believes are sure to pay off in the future. The optimist prefers to be fully invested, perhaps even borrowing additional money to leverage the surefire gains he sees ahead. The optimist tends to do quite well in good times and suffer large losses in bad times.

Pessimists, on the other hand, are focused squarely on the risks and problems they expect will trigger a major decline in the markets. The pessimist's biggest fear is losing some of what he already has. The pessimist is sure that hunkering down and waiting for prices to fall is the best strategy. Unfortunately for the pessimist the bottom is not clearly identified until long after it occurs and since the pessimist's basic mentality is rooted in the expectation that things will get worse he generally sits on the sidelines waiting for prices to decline further even when bargains are widely available. By remaining in a perpetual state of defense, the pessimist misses out on the many opportunities that present themselves along the way.

The realist is likely to agree with the optimist about the promise the future holds while also agreeing with the pessimist regarding problems that pose a threat. Skeptical of grand predictions, the realist sees both sides and thinks in terms of probabilities, cycles, and risk versus reward. The realist recognizes that most predictions are little more than extrapolations of the recent past, making them reasonably accurate when trends persist but dangerously wrong at critical turning points. He is likely to be a contrarian when the crowd embraces an extreme view.

The realist is price sensitive. He recognizes that while higher prices may make investors feel better and seem to confirm the optimist's view they actually can make purchases much more risky (recall the aftermath of exorbitant prices for technology stocks in 1999 and residential real estate in 2006). To the realist, the higher the price of a given asset the more there is to lose and the less there is to gain. Conversely, while falling prices generally make investors nervous and seem to confirm the pessimist's view, the realist sees the relationship between risk and reward improving as prices move lower. The realist understands the mathematics of a loss—that it takes a 100% increase to get back to breakeven after a 50% decline—and realizes that avoiding losses can be even more important than making gains.

In the current investment environment, I think the realist would agree with the optimist regarding opportunities but also with the pessimist regarding threats. I think he would agree that advances in technology are opening up new opportunities in sectors from healthcare to energy. I think he would also agree that demand in emerging economies is likely to grow longer term, creating significant opportunities for world class businesses, a great many of which are based in the U.S. He would likely also agree that today's stronger banking system and improving housing market are important positives for the U.S. economy.

The realist, of course, would not agree with the optimist on everything. I think the realist would be reluctant to accept higher stock prices as confirmation that unprecedented monetary stimulus has somehow solved the world's economic problems. He would likely be skeptical of the view that ongoing central bank bond purchases will continue to reward risk taking for the foreseeable future. The realist sees that higher asset prices reflect, at least in part, raised expectations and increased downside risk.

The realist is likely to agree with the pessimist's view that massive and growing debt among developed nations poses an increasing threat to the global financial system. The realist keeps in mind that market prices tend to climb slowly and fall quickly so he proceeds with caution, seeking to take advantage of opportunities when prices imply upside that makes the associated risk worth taking. The realist, in my view, understands that the low level of interest rates on bonds is not in itself sufficient reason to increase exposure to stocks.

*So be sure when you step.
Step with care and great tact
And remember that Life's
a Great Balancing Act.¹*

Our core growth model portfolio has a current allocation of approximately 60% equities consisting primarily of three sectors— staples, technology, and healthcare. The balance of approximately 40% is primarily allocated to high grade short-term fixed income and cash alternatives. We maintain this relatively high allocation to short term fixed income and cash not because of the return it provides—the yields are next to nothing— but rather because it allows us to keep options open in an investment environment that we view as increasingly risky. During the depths of the financial crisis our valuation work indicated that many stocks were priced below 60 cents on the dollar of intrinsic value. Today, however, our analysis suggests that prices are closer to 100 cents on the dollar. To be clear, we do not prefer nor expect to hold high levels of cash long term; not only are the expected returns subpar, but we are also wary of holding too much of an asset that can simply be “printed” by a central bank. We far prefer to invest in assets that generate significant cash flow and stand to benefit from limited supply and rising demand. Put simply, price is the issue, and at this point, with the S&P 500 having returned nearly 140% since the market bottomed in March of 2009 and many measures of investor optimism at their highest levels since 2007, we believe that caution is warranted.

Phil McCauley III
March 2013

¹ Dr. Seuss, *Oh, the Places You'll Go!* (New York, NY: Random House Children's Books, 1988)

² Thomson Reuters

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