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THE CIPFA Pensions Network Annual Conference

Alternatives in a Low Growth Environment

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Morgan Stanley Alternative Investment Partners

Alternatives Allocations

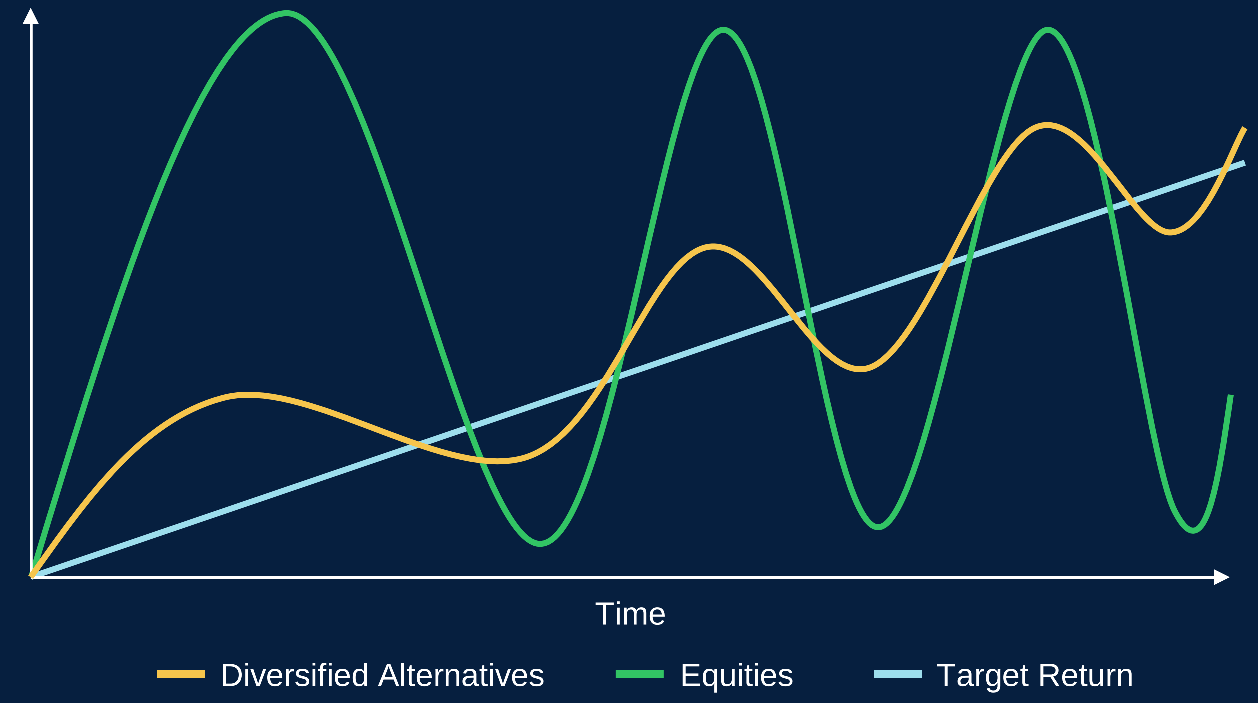
- How should my alternative portfolio behave?
- What does low growth mean for ones alternatives allocations?
  - Expected Returns
  - Alternative “risk mitigation”
  - Alternatives “premium”
- Which alternative strategies have historically done well in low growth environments?
- Which strategies have historically done well in the range of growth / inflation scenarios?
- Basic alternative beta strategies are problematic in low growth environments e.g. passive commodities
- Volatility and low growth environments
- ‘Point of entry’ and segmentation as key determinants of returns
- Implicit inflation hedging among institutional investors

How Should a Diversified Alternatives Program Behave?

Objectives

Cumulative Returns

Return: LIBOR +5%　　Equity Beta < 0.30　　Volatility < 10%



Target Characteristics:

Independent return sources >12

Diversification across economic environments

Diversification across time

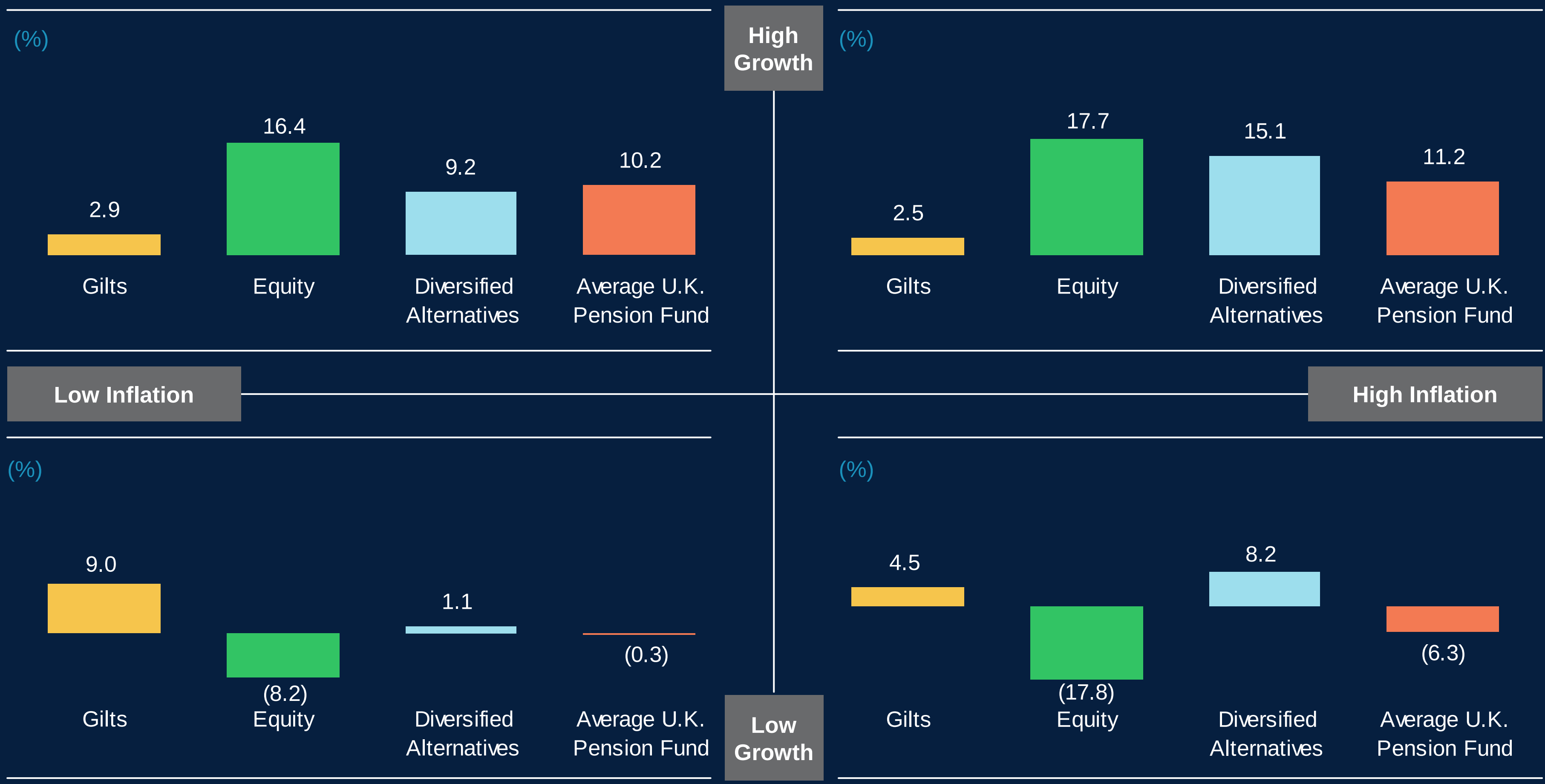
Tail risk elements incorporated into the strategy

Source:
Morgan Stanley AIP. For illustrative purposes only. Past performance is not indicative of future results. There can be no guarantee that any portfolio will achieve its objectives.

For illustrative purposes only. Does not reflect actual historical or projected returns.

Diversification in Different Economic Environments

January 2001 – March 2011



For illustrative purposes only. Past performance is not indicative of future results.

(1) Source: Morgan Stanley Investment Management – AIP PSG Health Check Analysis.

(2) Gilts performance is based on the BarCap Sterling Bond Gilts All Maturities Index. Equity performance is based on the FTSE All Share Index. Diversified Alternatives performance is based on the Morgan Stanley AIP Diversified Alternatives Fund, which has included between 7 – 15 alternative asset classes. For Diversified Alternatives we have modelled a passive implementation before February 2007, based on index returns and using the Morgan Stanley AIP Diversified Alternatives Fund asset allocation as at February 2007.

(3) Average U.K. Pension Fund performance is based on the asset allocation of a typical U.K. pension fund as outlined in the Mercer Asset Allocation Survey 2010 (with 41% Gilts, 50% Equity and 9% Alternatives).

(4) Major asset classes and the Average U.K. Pension Fund are assessed to show how they perform in different economic environments in terms of annualized return. Here we look at four distinct economic .environments – low growth / low inflation, low growth/high inflation, high growth / low inflation and high growth/high inflation – measured and categorised relative to their historic median.

Consider More Detail......

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(1) Source: Morgan Stanley Investment Management – AIP PSG Health Check Analysis.

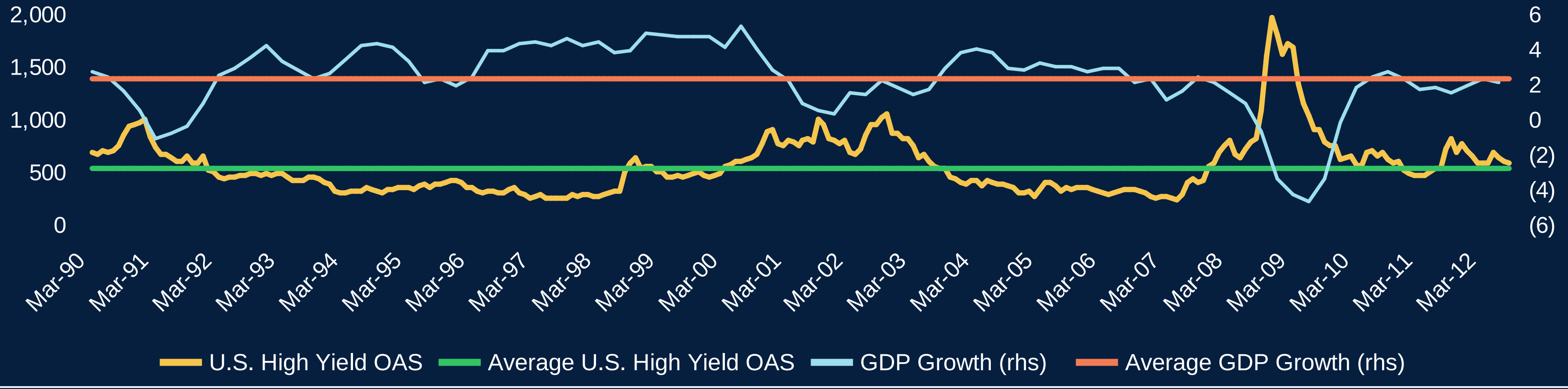
(2) Time periods reflect longest since inception data to June 2012. Indices and inception dates are: Moodys / REAL Commeiical Property Index (October 2001), GSCI Lite (February 1990), Barclays Global High Yield Unhedged USD (February 1990). Swiss Re CAT Bond USD (February 2002), HFRI Macro Total Return Index (February 1990), Barclays U.S. MBS Index (February 1990). VIX (February 1990), Macquarie Global Infrastructure Main Local Total Return (July 2000).

(3) Asset classes are assessed to show how they perform in different economic environments in terms of annualized return. Here we look at four distinct economic .environments – low growth/low inflation, low growth/high inflation, high growth / low inflation and high growth / high inflation – measured and categorised relative to their historic median.

Spread Sectors Can Benefit in Low Growth

- Spreads in credit sectors are often elevated during periods of low growth
- Attractive carry can buoy returns when growth assets flounder
- Care needs to be taken to avoid defaults. However, actual defaults are at historic lows (US)
- Opportunities in ‘expanded credit’ remain attractive but are getting closer to fair value

Option Adjusted Spreads (bps) vs. GDP Growth (%) [(1)]



Source:
BoA Merrill Lynch, Morgan Stanley AIP
Note: **Past performance is no guarantee of future results.**
(1) As at August 31, 2012. U.S. High Yield shows Bank of America Merrill Lynch U.S. High Yield Index. GDP Growth shows year over year GDP Growth. Averages are calculated over the period shown, from march 1990 to August 2012.

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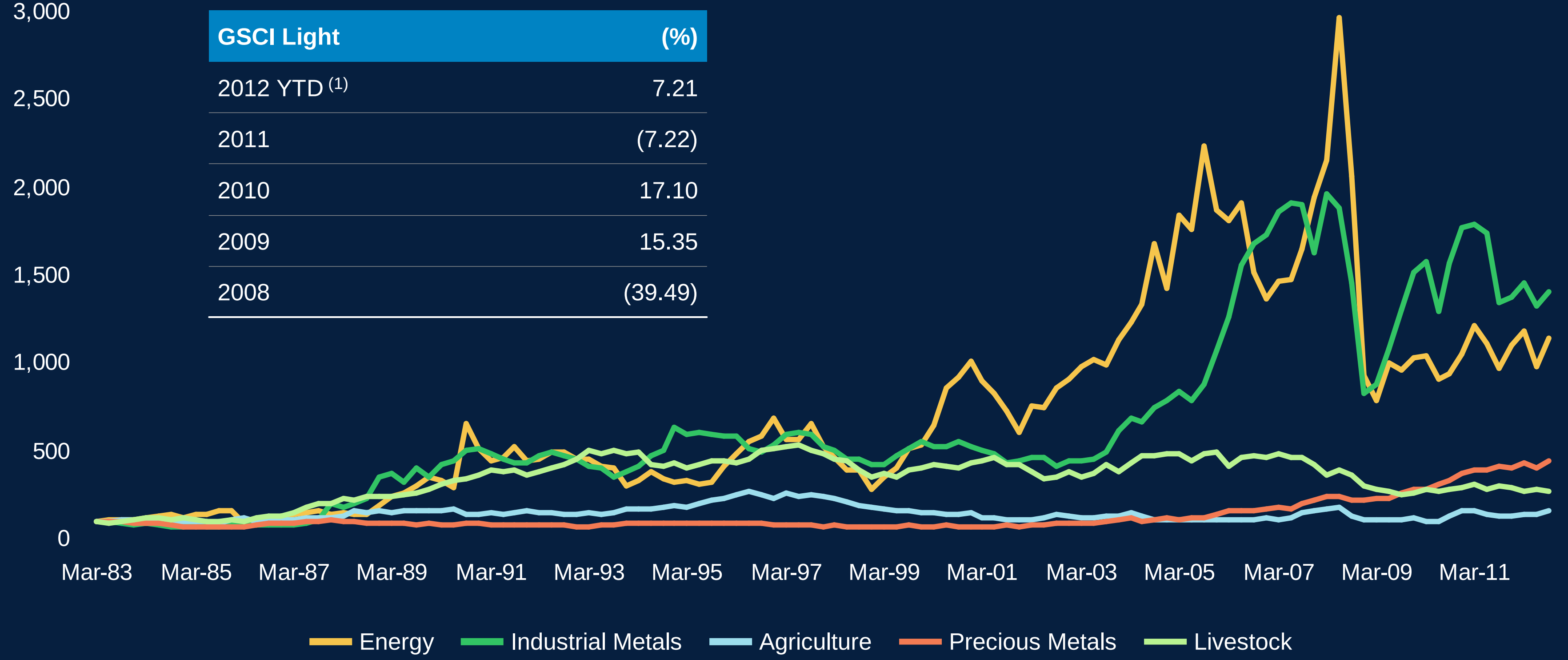
Commodity Market Dispersion

Dispersion Suggests Benefits of Active Management
Low Growth means Active Management component is more important

Performance of Primary Commodity Markets

GSCI Light	(%)
2012 YTD (1)	7.21
2011	(7.22)
2010	17.10
2009	15.35
2008	(39.49)



Source:
Bloomberg, Morgan Stanley AIP. The statements above reflect the views and opinions of Morgan Stanley AIP hereof and not as of any future date. Market developments may cause reassessment of these views at any time and consequently, these views may change at any time

(1) As at 31 August 2012.

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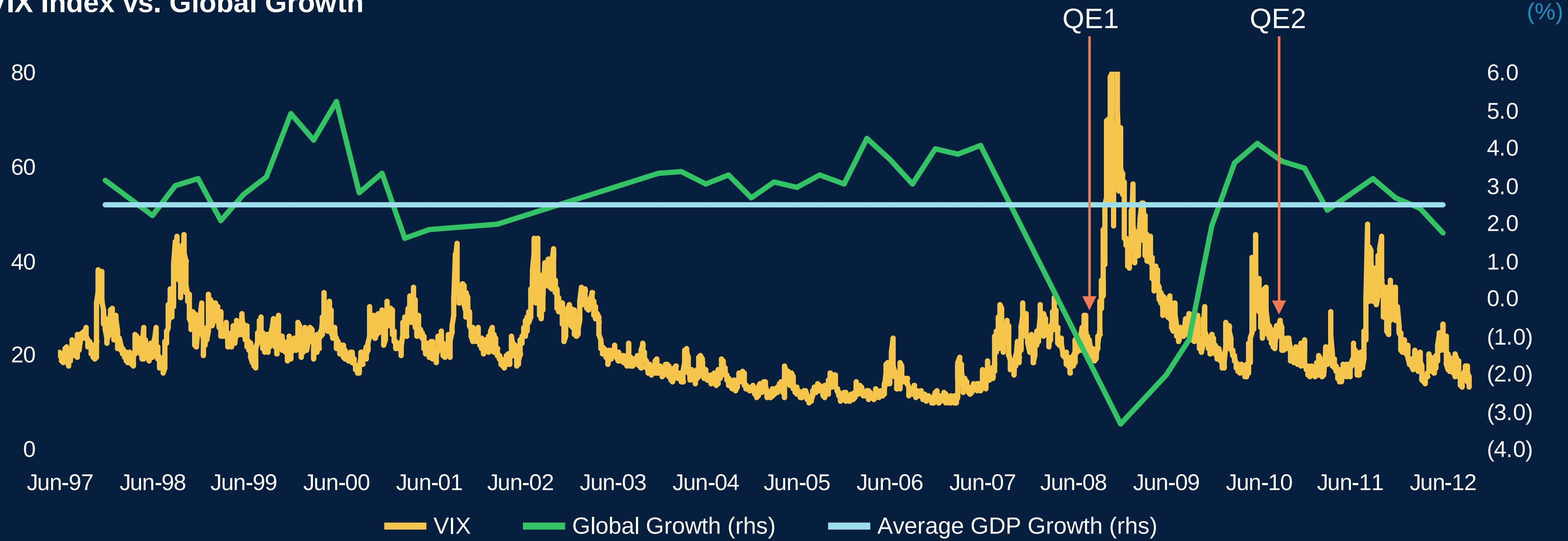
Global Growth vs. VIX

Volatility Tends to Spike in Low Growth Environments

- QE1: September 2008
- QE1: November 2010
- QE3: September 2012?

VIX Index vs. Global Growth



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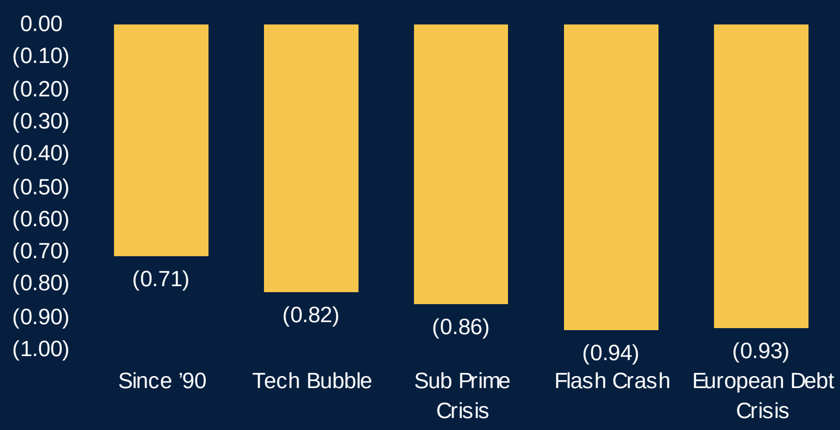
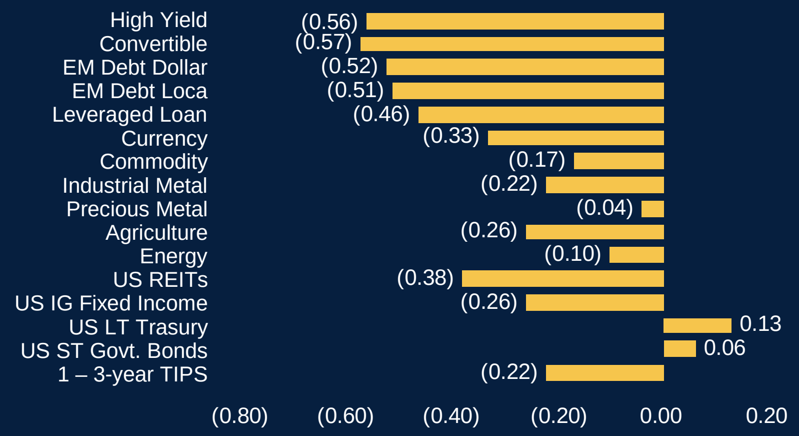
Volatility – Tail Risk Management

VIX Correlation to S&P 500



Correlation to Other Assets



Evaluation Component	Observation
Market Exposure	Historically negative correlation with risky assets
Return Distribution	Conversely on the downside: low drag on portfolio performance in normal market conditions
Diversification	Negative to most asset classes with the exception of government bonds
Impact on Portfolio	Positive impact on Sharpe Ratio
Ability to Generate Alpha	Importance of timing decision; minimal input of discretionary decision
Manager Uncertainty	Moderate uncertainty

Source:
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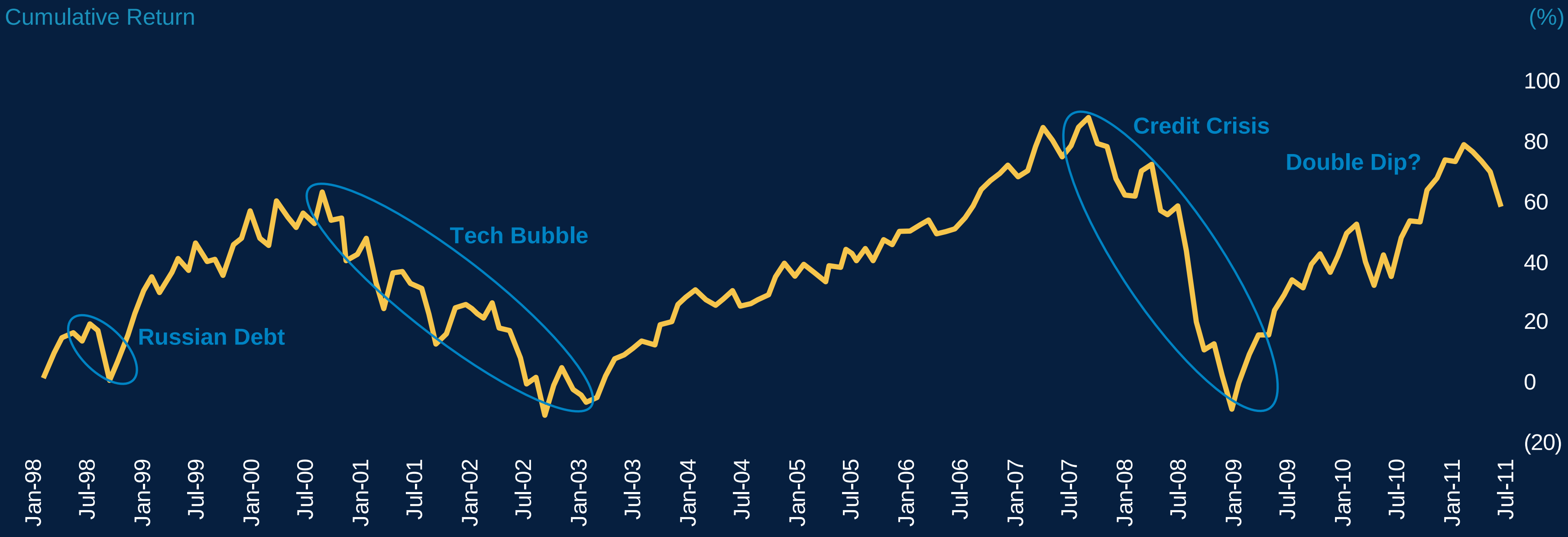
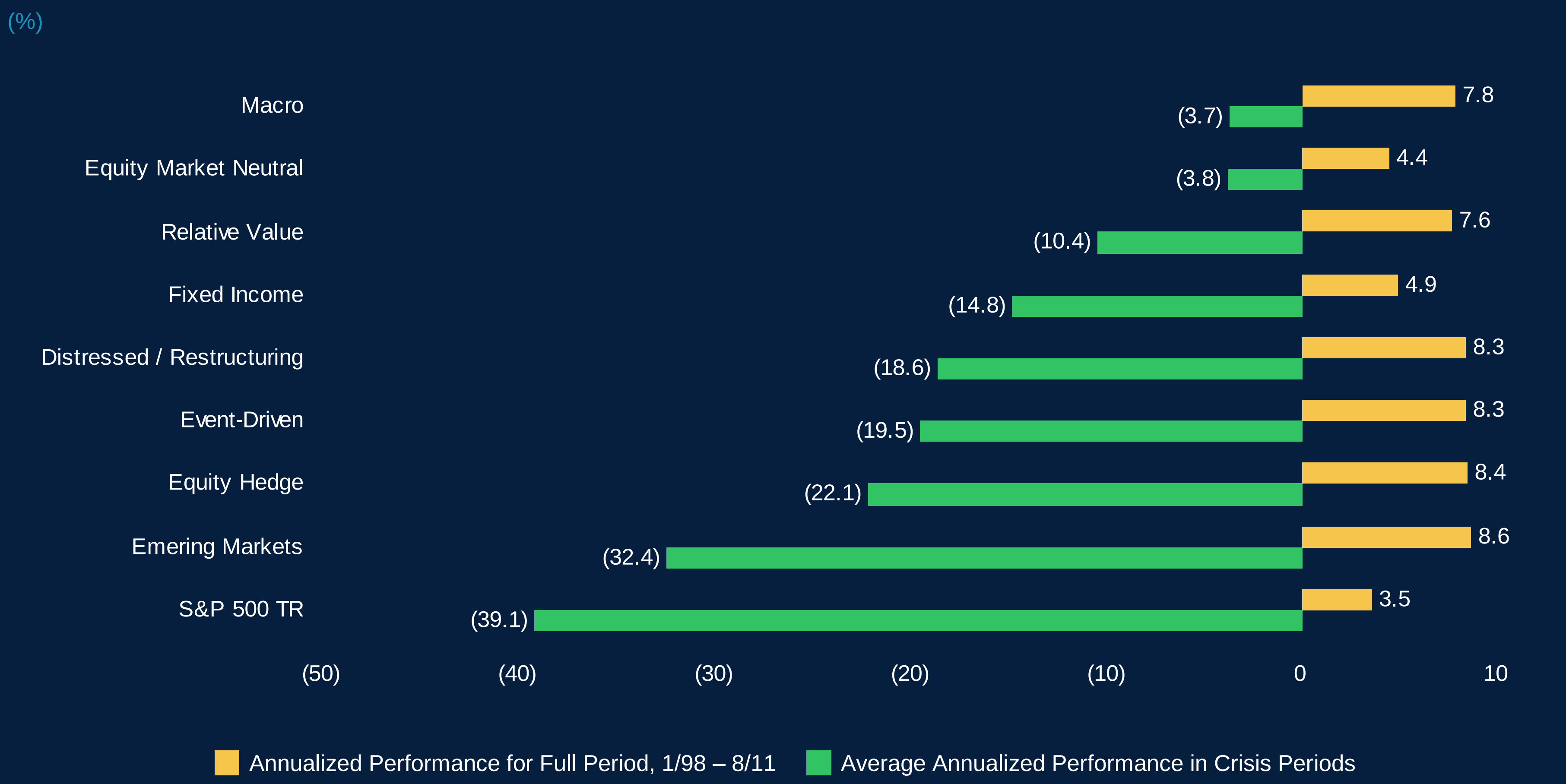
S&P 500 Crisis Periods Since 1998



Crisis Periods	Performance (%)
Russian Debt Crisis 07/98 – 8/98	(15.4)
Tech Bubble 9/00 – 9/02	(44.7)
Credit 11/07 – 2/09	(51.0)

Source:
Bloomberg
Data as of August 31, 2011

Risk / Reward of HFRI Hedge Fund Strategies, Since 1998



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Source:
Hedge Fund Strategy Index data from HFRI
Past performance is not indicative of future results.

Stock Market Dispersion

Current Environment Presents Intra-Market Opportunities

Performance of U.S., German and Spanish Equity Markets

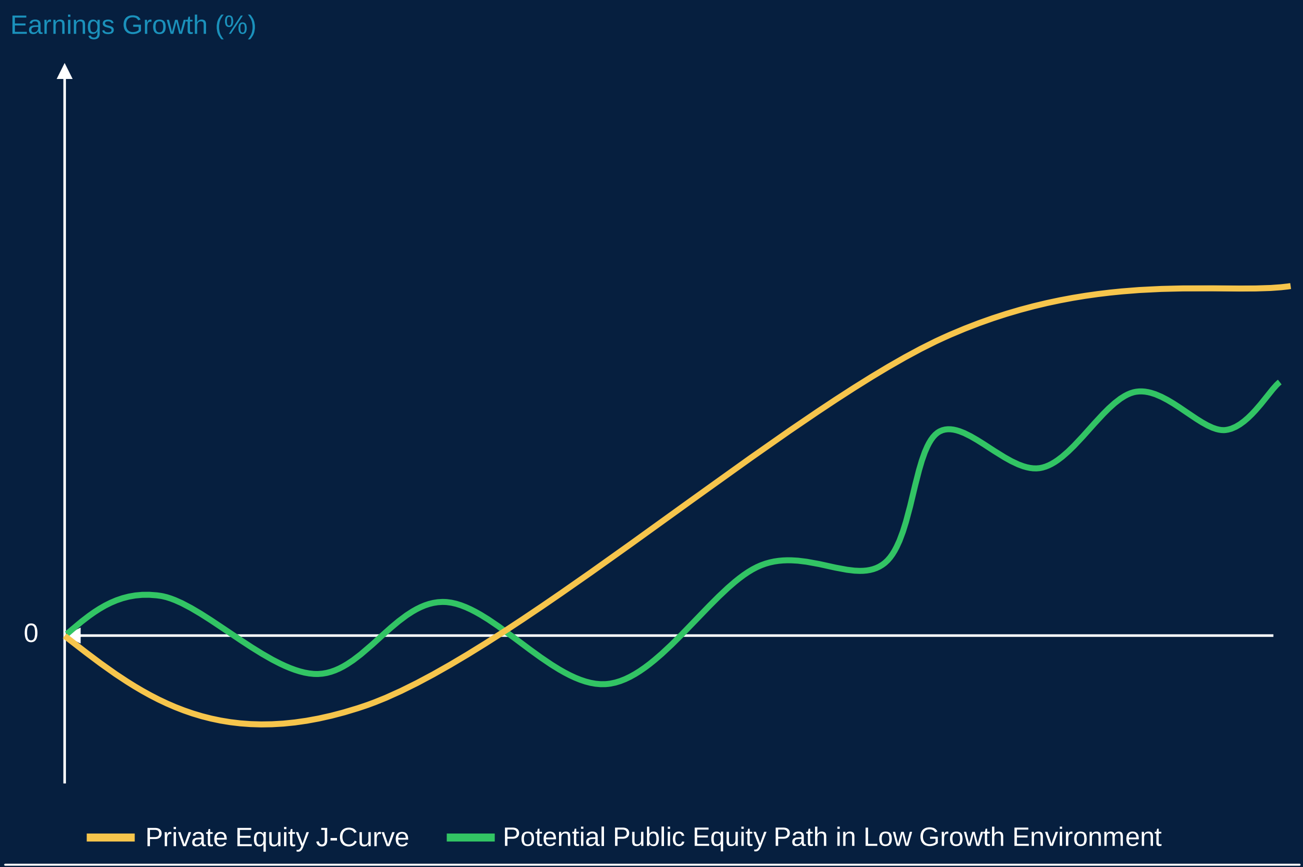
Performance of Financials vs. Broad Equity Market

Source:
Bloomberg, Morgan Stanley AIP. The statements above reflect the views and opinions of Morgan Stanley AIP hereof and not as of any future date. Market developments may cause reassessment of these views at any time and consequently, these views may change at any time.

Private Markets

Opportunity Cost of Private Markets Is Reduced When Growth Is Low

- **Lack of conviction in public equity can be a good entry point into private markets**
- **Seek out PE segments with lower correlation to overall public equity market. Avoid leverage plays**
- **Seek out segments where incumbents are in retreat (financials)**
- **Real asset strategies with yield component (inflation hedging)**



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Historic Private Equity Secondary Pricing

Purchasing Interests at a Discount Can be Beneficial

Average High Bid as a % of NAV

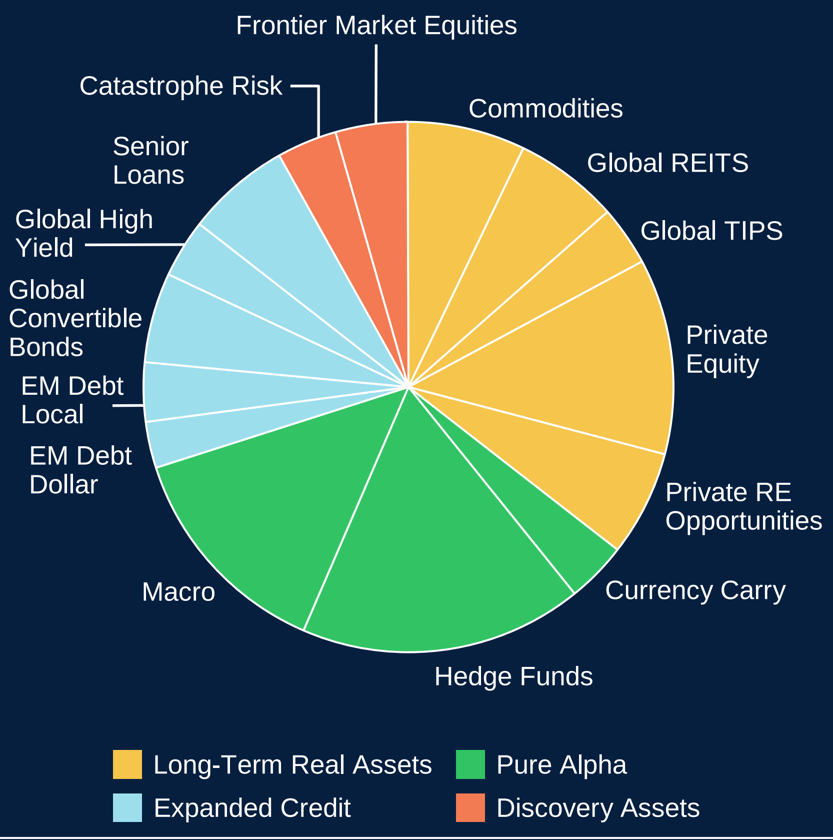
Source:
Cogent Partners

Inflation Thoughts

- While inflation has moderated of late, greater QE should lead to more inflation pressures
- Over the last five years Central Banks have placed little emphasis on inflation management. There is a credibility gap
- Long-term structural changes in key Emerging Markets are likely to be inflationary
- Negative Real Yields – little interest in outright inflation hedging
- Poor funding levels mean that increasingly Institutional Investors are looking at other ways to meet long-term inflation obligations

Return Seeking Alternatives Portfolio

Active Tilts in Alternatives Portfolio to Meet Specific Objectives



Managing Downside Risk

- ▼ Long-Term Risk Assets
- ▲ Volatility and Macro
- ▼ Broad Credit

Hedging Inflation Risk

- ▲ CPI Equity Stocks
- ▲ Long-Term Real Assets
- ▼ Hedge Funds
- ▲ Inflation Sensitive FI

Potential Benefits of Liquid Alternative Portfolios

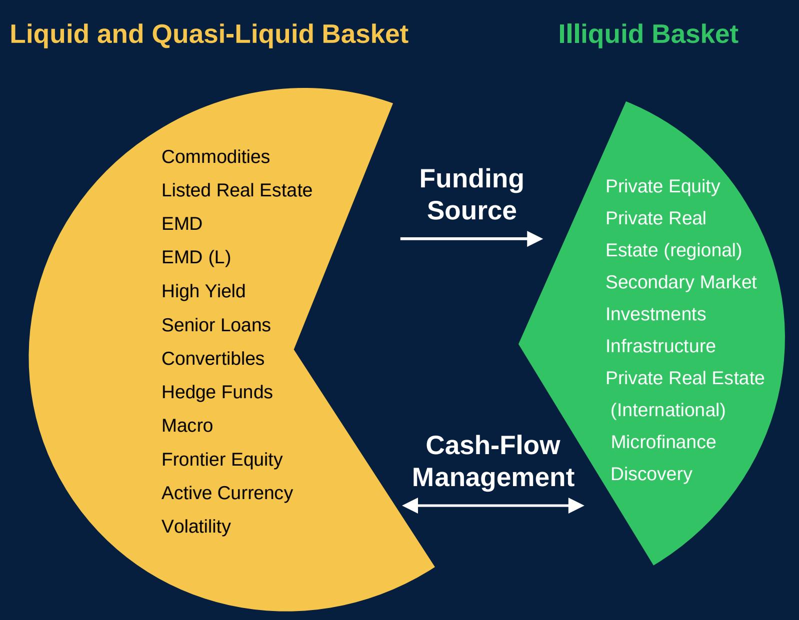
Potential Benefits Include

- Combination of four main alternative asset class categories – **diversification within the alternatives portfolio**
- Opportunistic – ability to **tactically adjust** portfolio according to market cycle can add value
- **Source of funding** for illiquids – reduce cash drag through careful cash-flow management
- **Expanded credit** assets can offset some costs of carry in other assets to maintain positive holding return overall

Program Manager Can Offer

- Integrated reporting package
- Detailed liquidity modeling of hedge fund and private equity holdings
- Target full investments, minimal cash drag
- Risk analytics incorporated into risk budgeting
- Single line-item performance for total portfolio

Liquid Alternative Portfolio Acts as Funding Source for Illiquid Assets



Program manager can internalize operational complexities and offer substantial potential benefits

Conclusions for Alternatives Allocations

- Low Growth environment
  - Expanded Fixed Income remains a good option but approaching fair value
  - Basic alternative beta strategies are problematic in low growth environments e.g. passive commodities
  - Volatility spikes are prevalent in low growth environments. Bias liquid portfolio to capital protection strategies
  - Macro continues to be popular. Greater intra market dispersion will also be supportive here
  - Consider the ‘opportunity cost’ of private markets . Point of entry and segmentation as key determinants of returns
  - Increased emphasis on ‘implicit’ inflation hedging among institutional investors to avoid high explicit cost