2017 Investment Outlook

January 2017

Executive Summary 2016 was better than expected, and 2017 is poised to be another moderate year in our view. The surprising results of the US election last year were enough for us to quickly adjust portfolios and change our tone for 2017 and 2018. Although we lack any meaningful details, the broad suggestions of the incoming Trump administration point to supply-side stimulus for the US economy that will likely have a net positive effect. Execution is key at this point, but we must remember that Trumpian stimulus will be dropped into an already tired US economic expansion with a central bank that is currently tightening policy (raising interest rates). The global economy (ex-US) has improved somewhat recently and we expect momentum into the new year; although, we admittedly have longer term concerns about zero interest rates and a considerable global debt accumulation.

Investment Strategy In 2017 we are roughly balanced with respect to risk, but very selective about where we take that risk. Equities have room to move higher, in our view, first in Japan, then in the US and Europe. Credit looks expensive and very late cycle and we are actively stepping away. Interest rates are likely to move higher at the short end (driven by Fed rate increases), but we are currently unsure about mid and long-term rates. The direction of rates depends on the growth and inflationary effects of Trumpian stimulus, for which we lack any concrete details. We are modestly underweight duration across our portfolios.

Investment Returns Not much has changed since last year and we continue to expect returns that are below average (vs history). We expect modest single digit returns from US stocks. Japan is more interesting and we see the potential for double digit returns in 2017. Bonds are likely to offer low single digits returns but could show losses if rates rise meaningfully (for investment grade) or if defaults begin to rise (for junk bonds). We have yet to escape the effects of a zero interest rate world and project muted returns well into the future.
Looking Back

A quick glance back at 2016...

Better than expected  Overall, 2016 was better than we expected, but the path, beginning to end, was a bit bumpy (recall the severe market plunge in January/February, the sharp rally in March and the short lived Brexit volatility in June). Ultimately, our forecasts for asset classes and portfolio blends proved a bit too cautious for the full year, but much of the out-performance occurred following the surprising result of the US presidential election. We readily admit that at this time last year we weren’t expecting a Trump victory or building into our forecasts any of the positive economic developments that might accompany such an outcome. One can easily gather, from reading our Q3 Commentary (published in October – copy available here), that we positioned portfolios defensively in the fall of 2016, anticipating a Clinton victory and the possibility of a recession arriving in the US in coming quarters.

US Stocks  US stocks performed considerably well in 2016, returning +12.0% versus our original forecast of +6.2%. Interestingly, US stocks closed on November 8th (the night of the election) up +6.65% for the year. The extra +5.35% of out performance occurred following the Trump victory. Fortunately, we tactically upgraded and increased our exposure to US stocks on the morning of November 9th following the election results.

European and Japanese Stocks  Perhaps our biggest miss of the year was our projected return for European stocks (which lost -0.3% versus our forecast of a +6.6% gain). We reasoned in January 2016 that European valuations, economic data, and earnings growth were promising and chose to overweight the asset class in our portfolios. Fortunately, we realized our mistake early in the year as growth proved elusive, and downgraded European stocks to underweight in May just a few weeks before the Brexit vote. Japanese stocks performed more in line with our expectations, rising +2.8% versus our forecast for +4.6%.

Emerging Market Stocks  Emerging market stocks returned a strong +10.9% in 2016 versus our forecast of +4.3%. While these returns are obviously attractive, we remained underweight this asset class for the entire year. We had, and continue to have, concerns about the efficacy of global emerging markets in the current environment.

US High Yield Bonds  Our big win for 2016 was undoubtedly our call to aggressively overweight US high yield bonds. The asset class suffered losses in 2015 and early 2016 on energy sector and deflation fears, but we argued that this selloff was overdone. We further suggested that it was preferable (on a risk-adjusted basis) to own high yield bonds in 2016 over US stocks, and despite the stronger than expected rally in US stocks, our call proved accurate. US high yield bonds returned +14.4% in 2016 versus our forecast of +4.9% and US stock performance of +12.0%.

US Bonds  US bond investors had a wild ride in 2016. The year began with falling global interest rates and strong returns, but this trend reversed course sharply after the US presidential election, and bonds gave up much of their year-to-date gains. The post-election prospect of stronger economic growth and higher inflation drove US interest rates upward and bond prices lower in the last 8 weeks of the year. Despite this back and forth, US investment grade bonds managed to return +2.4% in 2016, above our forecasted return of -0.6%. It appears that our call was a bit too early, and that bond losses were to arrive later in the year than we expected.

Moving Forward  While it is very important to look back and assess the accuracy of our predictions, it is more important to look forward and ask, “What’s next?” We focus the rest of our report on answering this question...
Our World View

A new hope for the US?

Changing our tone (again?) Our last report, published in October of 2016, struck a notably cautious tone as we predicted the arrival of a modest recession in the US over the next year or two. Our base case, at the time, was a White House victory for the Dems and status quo in Washington (four more years of political gridlock). The economy, already very long into the current cycle, would not receive any meaningful help from a divided Washington at a time when the Fed was removing monetary accommodation. At the same time, global economic data was drifting lower and our firm’s economic cycle indicator registered its first "downturn" reading in nearly 8 years. The outcome of our analysis, then, was to begin moving portfolios in a more defensive direction.

Didn’t see that coming The Republican victory on November 8th that delivered the White House and Congress into single party hands is admittedly a sea change for our economic outlook. We must adjust our forecasts to meet the new reality. The policy path in Washington is now considerably more broad and current proposals surrounding tax cuts, deregulation, trade adjustments, fiscal spending, etc… have the potential to extend the current expansion further into the future. The proof, as you might expect, will be in the pudding. While markets are understandably optimistic about the prospects of lower taxes, better terms of trade, fiscal spending, and deregulation, the success of such measures will depend entirely on the execution of the incoming Trump administration. We certainly don’t want to throw cold water on the situation, but we do want to soberly evaluate the possibilities (good and bad), and properly model outcomes and impact.

A shot in the arm We are committed supply-siders and, as such, we view lower taxes, deregulation, and better terms of trade as obvious positives for the US economy, but the real question, in our view, deals with the effectiveness of these adjustments at this stage in the cycle. The economic expansion that began in 2009 is 8+ years old, despite historic expansions (since 1900) lasting an average of only 4 years (or 5 years, post-WWII). Today, corporate leverage (borrowing) has reached all-time highs, M&A activity has recently peaked, the economy is arguably at full employment, wages are beginning to rise pressuring corporate margins, and stocks are at all-time highs. At the same time, the Fed is raising interest rates and removing monetary accommodation from the system which will likely have a flattening effect on US yield curves. These are textbook pre-recession indicators. Typically, fiscal stimulus (tax cuts or federal deficit spending) occur early in an economic expansion as the government seeks to jump-start the private sector. We have few historical instances of economic stimulus arriving this late into an economic cycle. As a result, we expect the positive effects of Trumpian stimulus to be absorbed somewhat by an already late-cycle economy and concurrent Fed policy tightening. We will likely get less bang for the buck, but this stimulus could serve to extend the current expansion even further than originally projected, acting as a "shot in the arm" for a patient who is already in decline.

Upgrading our forecasts Lacking a well-defined policy agenda (as of the time of writing) we take onboard certain baseline assumptions about possible Trumpian economic stimulus. We assume tax cuts of $190 billion and $240 billion per year for corporate and individual tax payers, respectively. We further assume a fiscal spending package of $500 billion spread over 5 years beginning in 2018. Netting these estimates against our late cycle expectations leads us to increase our 2017 US economic growth forecast to +1.9%, up from +1.4% originally. We expect similar economic growth in 2018.

Paying closing attention We have heard many promises on the campaign trail and now we need to see action. While Washington may be more united today under a Republican controlled White House and Congress, there continues to be considerable disagreement even within the same parties (i.e., deficit-hawk Republicans). How the incoming administration prioritizes its agenda will affect the outcome for the US economy. We will be paying close attention over the next 180 days.

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Our World View

The rest of the world?

Growth inflecting higher  After a tumultuous two years of volatility in global stock, bond, and foreign exchange markets, it appears that global assets are finding some stability on a foundation of more stabilized economies. As the dust settles from the US dollar’s dizzying 40%+ rally, internal and external economic adjustments appear to be nearing completion, giving way to a more stable operating environment.

We currently expect global growth to accelerate from +3.0% in 2016 to +3.4% and +3.6% in 2017 and 2018, respectively. Recent data have shown that global growth and global trade are increasing and demonstrating renewed momentum. At the same time, we continue to view various economies of the world as being out of sync with one another. Many are early cycle (Russia, Brazil, and Mexico), others are mid-cycle (peripheral Europe and India), and the balance are late cycle (US, core Europe, UK, and China). This asynchronous global expansion tends to mute aggregate growth in both directions (up and down) and gives good reason for a tactical investment strategy.3

In 2016 we rated the global economy as a 5.5 on a scale of 1 (horrible) to 10 (great). In 2017, we upgrade our subjective assessment to a 6.0. As you might gather we are not claiming any great amount of conviction but we readily admit that the global economy is trending in the right direction.

Longer term headwinds  Despite recent adjustments and the positive nature of certain mini-cycles occurring within local economies, we observe several headwinds to long-term global economic growth:

The first is the accumulation of global debt over the last few decades. Global national, corporate, and consumer debt in 2016 sum to an incredible $199 trillion, or 238% of global GDP. This figure is up from $87 trillion (194% of global GDP) at the turn of the millennium. In other words, our debt is growing faster than the global economy. This will either weigh heavily on future growth, or become a much bigger issue down the road if left unchecked.2

The second headwind facing the global economy, today and over the next few decades, is demographics. Developed economies (accounting for 35% of the global population and 76% of global economic output) have both slowing birth rates and rising dependency ratios, weighing on growth and potential output.3

Third, and perhaps more specifically, is China. We don't mind expressing our opinion now that if a global crisis (non-terrorist related) occurs during the next decade, China will be at the epicenter. Decades of debt-fueled growth paired with a closed capital account have led to incredible excess capacity and over leverage in China. China's debt binge has also created artificial demand for natural resources and raw materials from other countries, who have developed entire industries to meet the demand. China, in our view, cannot continue to fund their expansion with debt while simultaneously liberalizing their economy. If they are forced to slow the pace of expansion it could be destabilizing internally and painful externally for China’s global supply chain.

Cautiously optimistic  Short term, we expect the global economy to pick up steam and do relatively well. With that said, we clearly have concerns about the future and we are watching these areas closely for signs of stress.
The Fidelis Group at Morgan Stanley

Performance

Cautiously optimistic...

Returns to remain modest  In 2017, similar to 2016, we are targeting below-average returns (versus long-term historical averages). Our projections are sober and honest, but we admit they are not very exciting. We are, as we have explained, upgrading our views on the US and global economy in 2017, but we are not expecting this modest acceleration in economic growth to translate into a marked increase in investment returns.

Stocks  In 2017 we expect improved growth corporate earnings for US stocks (+7.5%), European stocks (+12.0%) and Japanese stocks (+28.0%). At the same time, we recognize the late cycle nature of the current environment and the downward pressure rising interest rates could have on stock multiples. Keeping all of this in mind, we expect 5 – 6% growth from US and European equities and a stronger +12% return from Japanese stocks. Japan, an obvious outlier, will, in our view, benefit from a well-controlled yield curve and a significantly weaker yen that stands to increase export competitiveness. The US will likely benefit from pro-growth policies offered by the incoming Trump administration, and Europe stands to benefit from a modestly weaker Euro and improving internal economic stability. Emerging markets may surprise us again, but we are keeping our estimates low based on our concerns that EM could suffer if the dollar meaningfully appreciates against local currencies (putting strain on external borrowing capabilities).


Credit (junk bonds) also face re-pricing risks, in our view. In 2016, high yield bonds were our asset class of choice. We argued that markets had overpriced energy and deflation-related risks, and these below-investment grade bonds were a bargain. Today we believe just the opposite. Junk issues, in particular high yield bonds, are very expensive (versus history) while underlying fundamentals are deteriorating quickly. As a result, we are modestly underweight credit at the beginning of 2017 and we anticipate reducing our exposure further later into the year. We note that Trumpian economic growth might be a reason to hang on to junk bonds (and their higher cash flows) for a little while longer, but we worry about being late to sell these issues. Credit markets are forward looking and we expect bond values to begin falling long before defaults appear (around the time of the next recession).

What should investors do?  We, of all people, understand the frustration of low returns associated with late cycle markets. We also understand the nagging temptation to “reach” for better returns by increasing exposure to stocks and junk bonds (thus increasing risk). Fortunately, this isn’t our first rodeo. Our assessment of the current environment suggests that we be cautiously optimistic and roughly balanced with respect to risk. We want to capture what little growth is left in the remaining years of this expansion, but we want to keep watch for an almost certain recession on the horizon. If we are patient and can endure a few years of modest growth without giving in to the temptation to “reach” for better returns, we believe we will be rewarded when asset prices correct. Today is not an opportunity, in our view, to increase portfolio risk.

The importance of honesty  We are honest about modest returns because we want our clients to be well prepared for the future. Promising 8% because “that’s what we have seen historically” is uninformed, disingenuous, careless or perhaps all three combined. The long-term success of our clients’ financial plans depend on sound assumptions. While we aren’t forecasting great returns, we are being brutally honest for the sake of our clients’ long-term success.

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2016 Investment Strategy

Balanced...

PORTFOLIO WEIGHTING | ASSET CLASS

GOVERNMENT AND CORPORATE BONDS 
Government and corporate bonds have almost always represented the core of a conservative portfolio or served to mitigate risk in more aggressive allocations. Today this asset class is admittedly hard to own, but an arguably necessary component of a diversified portfolio. Collectively, the annual yield on this asset class (Barclays US Aggregate Index) is 2.33%. With a duration of 5.33 years, a quick 1% rise in interest rates could wipe out more than 2 years worth of income. With the Fed looking to increase rates 3 times in 2017 and twice in 2018, this asset class should be owned carefully and selectively. Today we prefer to keep our exposure to these bonds equal to our long-term targets, but we are selectively shifting our exposure towards shorter-term bonds that will yield less today but lose less if rates increase. As we approach the next recession, these bonds will become a critical source of risk mitigation and serve as dry powder to purchase falling assets.

HIGH YIELD BONDS AND BANK LOANS 
In 2016 high yield bonds were our highest conviction trade idea, but after a 14%+ rally we no longer consider them attractive. In fact, we are bearish on high yield bonds and can model paths for the asset class that produce negative returns in 2017. In short, junk bonds bear credit risk, or the risk that the issuer cannot repay the loan. Since early 2016 these issuers have experienced considerable deterioration in financial health and yields are now much lower. Said differently, you are paid a lot less today (5.76% vs 8.9% last year) to lend money to a company that is now in more debt and less able to pay their bills in the future. Thanks, but no thanks. This cycle is fairly common historically. High yield issuers become overleveraged late in an economic cycle after years of borrowing at lower rates. As rates rise and the economy slows, these issuers begin to default. Our analysis suggests that we step away from junk issuers and wait for a better opportunity (and yield) to own them again.

GLOBAL STOCKS 
The surprise results of the US election and recently improving economic data warrant slightly more optimism in our view. In concert with our upgrades for US and global economic growth, we have also returned to equal weight positioning in global stocks. At the beginning of 2017, we are aggressively overweight Japanese equities (yen hedged) on currency driven tailwinds. We are roughly equal weight US large cap stocks, but modestly overweight middle and small cap companies in the US. Trumpian policy, as outlined thus far, is likely to disproportionately favor small and mid-sized companies in the US versus their larger peers. Our concerns of a stronger dollar also suggest that we favor small and mid-cap companies who are less exposed to export competitiveness. We remain slightly underweight European stocks, but expect modestly positive performance. We remain underweight emerging market stocks, citing acute currency and capital flow related risks.

ALTERNATIVE INVESTMENTS 
In an environment with limited upside (i.e., late cycle for stocks and already low yields for bonds), and with the possibility of considerable downside stemming from monetary policy mistakes, geopolitical crisis, terrorism, etc., diversification into alternative investments can be a good source of uncorrelated growth. Historically, alternative investments, when responsibly included in a diversified portfolio, have helped to mitigate risk and offer returns that are not correlated to stocks and bonds. For clients with aggressive investment portfolios, a shift from stocks into an equity long/short fund can potentially reduce risk and ease volatility. For clients with more conservative portfolios, a shift into equity-hedged strategies can provide market-linked upside with some downside protection. For retired clients who need annual income, private real estate and private credit strategies offer opportunities for yield from non-public assets.

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Enhancing Our Framework

Adding goals-based strategy to our risk-adjusted portfolios

**Adding depth**  For the first time in nearly five years we are making adjustments to our team’s investment framework to enhance our ability to meet specific clients’ needs and improve outcomes for clients in different stages of life.

Over the years our clients have become accustomed to seeing and utilizing our five risk-adjusted portfolios ranging from conservative (Model 1) to aggressive (Model 5). This framework has been quite useful, allowing our clients the flexibility to quickly increase or decrease risk in their portfolios based on changing circumstances or life events. Similarly, this framework offered clients a glide path for retirement planning, allowing them to step down risk as they approach and transition into retirement. Most importantly, perhaps, this framework offers simplicity and avoids the complexity and headache clients often face when evaluating lists of potential investment options and vehicles.

**Income vs growth**  The application of our five risk-adjusted portfolios over time has followed a predictable pattern. Our younger clients, with many years until retirement, tend to utilize our more aggressive portfolios (Models 4 & 5). Conversely, our clients who are nearing retirement or who are already retired tend to utilize our more-balanced and conservative portfolios (Models 1, 2, and 3). In addition to identifying our clients’ risk tolerance (1 – 5), we can also identify their life stage and a corresponding primary goal: long-term growth or current income.

To better address our clients’ respective life stages while continuing to control risk, we will now utilize six portfolios. Three of our portfolios will focus on income-oriented investments that generate current cash flow to fund retirement spending, and the other three will focus on growth-oriented investments that generate less current cash flow and reinvest proceeds towards future growth. To achieve this we have redesigned our asset class architecture within our portfolios (see pages 8 and 9). With this seemingly subtle adjustment we expect that we will be able to provide clients with portfolios that are better tailored to their current life stage, ultimately leading to better long-term outcomes.

Enhanced Framework: Portfolio Summary

Risk / Volatility (Increasing from left to right)

- **Income-oriented Portfolios**
  - 1i
  - 2i
  - 3i

- **Growth-oriented Portfolios**
  - 3g
  - 4g
  - 5g

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Income Portfolio Allocations
As of January 1, 2017

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Current Bias (Weight)</th>
<th>Conservative Income</th>
<th>Moderate Income</th>
<th>Balanced Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Government Bonds</td>
<td>UNDER</td>
<td>29.45%</td>
<td>23.25%</td>
<td>12.95%</td>
</tr>
<tr>
<td>Corporate Bonds</td>
<td>OVER</td>
<td>25.30%</td>
<td>18.40%</td>
<td>11.50%</td>
</tr>
<tr>
<td>Preferred Stocks</td>
<td>OVER</td>
<td>12.00%</td>
<td>9.60%</td>
<td>4.80%</td>
</tr>
<tr>
<td>High Yield Bonds</td>
<td>UNDER</td>
<td>7.15%</td>
<td>5.85%</td>
<td>3.25%</td>
</tr>
<tr>
<td>Bank Loans</td>
<td>OVER</td>
<td>12.10%</td>
<td>9.90%</td>
<td>5.50%</td>
</tr>
<tr>
<td>Emerging Market Bonds</td>
<td>NEUTRAL</td>
<td>4.00%</td>
<td>3.00%</td>
<td>2.00%</td>
</tr>
<tr>
<td>US Stocks</td>
<td>NEUTRAL</td>
<td>5.00%</td>
<td>15.00%</td>
<td>30.00%</td>
</tr>
<tr>
<td>International Stocks</td>
<td>NEUTRAL</td>
<td>3.00%</td>
<td>9.00%</td>
<td>18.00%</td>
</tr>
<tr>
<td>Master Ltd. Partnerships</td>
<td>NEUTRAL</td>
<td>2.00%</td>
<td>6.00%</td>
<td>12.00%</td>
</tr>
</tbody>
</table>

| Total Strategic/Hedges     | 100.00%               | 100.00%             | 100.00%        |

Quality yield is hard to find  In a world of interest rates at or near zero, assets that offer investors current cash flow are in very high demand. Demographic trends (aging/retiring populations in wealthy countries) and excess liquidity created by central banks only make matters worse. This increase in demand for yield-generating assets drives prices (and risk) higher while pushing yields even lower.

Balancing Risk  The current environment requires careful risk management. Many “safe”, yielding assets have never been more expensive and rising interest rates pose a serious threat to their valuations. Meanwhile, higher yielding, but lower-quality, assets are subject to risks inherent in late-cycle economies (i.e., defaults and higher costs of borrowing). In 2017, we are reducing credit risk in our income portfolios by 10% (versus our long-term target) and reducing duration risk by roughly 20%.

Overweight Corporate IG  We see better value today in the investment grade corporate bond market in both the belly of the curve (3-7 year bonds) and at the long end (20+ years). While we would normally seek to avoid longer date bonds in a rising interest rate environment, we find such bonds relatively attractive and less exposed to future rate increases than their sovereign peers.

Underweight High Yield  For reasons we have detailed, we believe that high yield bonds are significantly overpriced today, offering unattractive yields and deteriorating underlying fundamentals. We are heavily underweight the asset class at 35% below target. We admit we may be early to “get out” of these bonds, but we would rather be early than late at current yield levels.

Equal Weight Stocks  Our upgraded view of US and global economic trends warrants an allocation to stocks that match our long-term targets. We are, at this point, neither bullish nor bearish but, instead, remaining neutral.
Growth Portfolio Allocations
As of January 1, 2017

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Current Bias</th>
<th>Balanced Growth</th>
<th>Moderate Growth</th>
<th>Aggressive Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td></td>
<td>9.00%</td>
<td>4.50%</td>
<td></td>
</tr>
<tr>
<td>Government Bonds</td>
<td>UNDER</td>
<td>9.00%</td>
<td>4.50%</td>
<td></td>
</tr>
<tr>
<td>Corporate Bonds</td>
<td>OVER</td>
<td>5.50%</td>
<td>3.30%</td>
<td></td>
</tr>
<tr>
<td>Preferred Stocks</td>
<td>OVER</td>
<td>6.00%</td>
<td>2.40%</td>
<td></td>
</tr>
<tr>
<td>High Yield Bonds</td>
<td>UNDER</td>
<td>5.20%</td>
<td>2.60%</td>
<td></td>
</tr>
<tr>
<td>Bank Loans</td>
<td>OVER</td>
<td>8.80%</td>
<td>4.40%</td>
<td></td>
</tr>
<tr>
<td>Emerging Market Bonds</td>
<td>NEUTRAL</td>
<td>4.00%</td>
<td>2.00%</td>
<td></td>
</tr>
<tr>
<td>US Large Cap Stocks</td>
<td>UNDER</td>
<td>24.75%</td>
<td>31.70%</td>
<td>39.50%</td>
</tr>
<tr>
<td>US Mid Cap Stocks</td>
<td>OVER</td>
<td>7.70%</td>
<td>9.90%</td>
<td>13.20%</td>
</tr>
<tr>
<td>US Small Cap Stocks</td>
<td>OVER</td>
<td>5.00%</td>
<td>6.25%</td>
<td>7.50%</td>
</tr>
<tr>
<td>European Stocks</td>
<td>UNDER</td>
<td>11.70%</td>
<td>15.30%</td>
<td>19.80%</td>
</tr>
<tr>
<td>Japanese Stocks</td>
<td>OVER</td>
<td>8.75%</td>
<td>12.25%</td>
<td>14.00%</td>
</tr>
<tr>
<td>Emerging Market Stocks</td>
<td>UNDER</td>
<td>3.60%</td>
<td>5.40%</td>
<td>6.00%</td>
</tr>
<tr>
<td>Total Strategic/Hedges</td>
<td>100.00%</td>
<td>100.00%</td>
<td>100.00%</td>
<td></td>
</tr>
</tbody>
</table>

Trading Trump Although not well defined today, the general outline of Trump’s economic policies suggest increasing exposure to mid and small cap US companies. Corporate tax cuts will be a tailwind for this group, and proposed boarder adjustments and a potentially strong US dollar should not be as a much of a headwind.

Reducing credit risk Yields on junk bonds are no longer attractive in our view. We have decreased our exposure to the asset class by 35% compared to our long-term target. We see better value in higher quality corporate bonds and preferred stocks.

Double upgrade for Japan For the last few years Japan has struggled to achieve consistent results from Prime Minister Abe’s “Three Arrows” agenda. In 2016 the Japanese central bank attempted negative interest rates, but failed to realize how this might hurt Japanese bank balance sheets. More recently, the central bank has implemented yield curve control (instead of purely lower rates) and the solution is working quite well. We expect the Japanese yen to fall by 15%+ in 2017. A weaker currency will increase export competitiveness which should drive corporate earnings higher. We are currently 75% overweight Japanese equities (currency hedged) on our expectation of strong performance in 2017.

Underweight Emerging Markets Despite stronger performance in 2016, we continue to see major headwinds for EM economies and markets moving forward. The risks are too high, in our view, to warrant a full allocation to this asset class. We will continue to be heavily underweight emerging market stocks.

MLPs After two years of volatility and valuation adjustment, MLPs have found relative stability along with the price of crude oil. Moving forward, we view the asset class favorably and look to have exposure, even in our growth-oriented portfolios. MLPs have the ability to generate 8%+ total return over the next ten years, a rate notably above our forecast for stocks in general.

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Discretionarily Managed Portfolio Targets

As of January 1, 2017
Conservative Income Portfolio (Portfolio 1) is our most conservative portfolio, designed for investors who seek to maximize current income while significantly restraining portfolio volatility typically associated with equity markets. This portfolio regularly allocates 64% of capital to investment-grade bonds, 26% to below-investment-grade bonds, and 10% to global equities. Risk stemming from credit and equity exposure are offset by a considerably larger allocation to investment grade bonds. Our income-oriented portfolios will usually prefer investment grade bonds to non-investment grade bonds, US dividend paying equities to non-US dividend paying equities, and duration risk roughly equal to its index. The portfolio regularly employs active managers who seek to outperform their respective benchmarks through careful and tactical security selection. Adjustments to the broader asset allocation are made as warranted by changing market conditions to either avoid risk or pursue opportunities primarily in credit and rates markets. This portfolio is most appropriate for investors who need maximum current income and value risk aversion over future growth and inflation risk.

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Moderate Income Portfolio (Portfolio 2) is our 2nd most conservative portfolio, designed for investors who seek to generate current income with the potential for moderate future growth while restraining portfolio volatility typically associated with equity markets. This portfolio regularly allocates 49% of capital to investment grade bonds, 21% to below investment grade bonds, and 30% to global equities. Risk stemming from credit and equity exposure are offset by a roughly equal allocation to investment grade bonds. Our income-oriented portfolios will usually prefer investment-grade bonds to non-investment-grade bonds, US dividend paying equities to non-US dividend paying equities, and duration risk roughly equal to its index. The portfolio regularly employs active managers who seek to outperform their respective benchmarks through careful and tactical security selection. Adjustments to the broader asset allocation are made as warranted by changing market conditions to either avoid risk or pursue opportunities in credit, rates, and global equity markets. This portfolio is most appropriate for investors who need current income and are willing to assume a modest amount of asset volatility to seek longer term growth and stem future inflation risk.
Balanced Income Portfolio (Portfolio 3i) is a balanced income portfolio, designed for investors who seek an equitable combination of current income and future growth. This portfolio regularly allocates 28% of capital to investment grade bonds, 12% to below investment grade bonds, and 60% to global equities. Risks stemming from credit and equity exposure are tempered by a smaller allocation to investment grade bonds. Our income-oriented portfolios will usually prefer investment grade bonds to non-investment-grade bonds, US dividend paying equities to non-US dividend paying equities, and duration risk roughly equal to its index. The portfolio regularly employs active managers who seek to outperform their respective benchmarks through careful and tactical security selection. Adjustments to the broader asset allocation are made as warranted by changing market conditions to either avoid risk or pursue opportunities in credit, rates, and global equity markets. This portfolio is most appropriate for investors who are comfortable with moderate portfolio volatility and who desire a combination of current income and future growth.

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Balanced Growth Portfolio (Portfolio 3g) is a balanced growth portfolio, designed for investors who seek long-term growth while lessening portfolio volatility typically associated with equity markets. This portfolio regularly allocates 20% of capital to investment grade bonds, 20% to below investment grade bonds, and 60% to global equities. Risks stemming from credit and equity exposure are tempered by a notably smaller allocation to investment grade bonds. Our growth-oriented portfolios will usually seek an equal allocation to investment grade vs non-investment grade bonds and will prefer US to non-US stocks. With a primary focus on long term growth, this portfolio will also prefer growth stocks to value stocks and will invest in smaller capitalization companies with little or no dividend yield. The portfolio regularly employs active managers who seek to outperform their respective benchmarks through careful and tactical security selection. Adjustments to the broader asset allocation are made as warranted by changing market conditions to either avoid risk or pursue opportunities in credit, rates, and global equity markets. This portfolio is most appropriate for investors who ultimately seek long term growth but have a roughly equal preference for risk mitigation over a moderately long time horizon.

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## Moderately Growth Portfolio

### Q1 2017 Primary Allocation Adjustment

<table>
<thead>
<tr>
<th>Current Allocation</th>
<th>Current Bias</th>
<th>Long-term Allocation</th>
<th>Jan 2017 Allocation</th>
<th>Variance to LT Target (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
</tr>
<tr>
<td>Government Bonds</td>
<td>UNDER 5.00%</td>
<td>4.50%</td>
<td>-0.50%</td>
<td></td>
</tr>
<tr>
<td>Corporate Bonds</td>
<td>OVER 3.00%</td>
<td>3.30%</td>
<td>+0.30%</td>
<td></td>
</tr>
<tr>
<td>Preferred Stocks</td>
<td>OVER 2.00%</td>
<td>2.40%</td>
<td>+0.40%</td>
<td></td>
</tr>
<tr>
<td>High Yield Bonds</td>
<td>UNDER 4.00%</td>
<td>2.60%</td>
<td>-1.40%</td>
<td></td>
</tr>
<tr>
<td>Bank Loans</td>
<td>OVER 4.00%</td>
<td>4.40%</td>
<td>+0.40%</td>
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</tr>
<tr>
<td>Emerging Market Bonds</td>
<td>NEUTRAL 2.00%</td>
<td>2.00%</td>
<td>0.00%</td>
<td></td>
</tr>
<tr>
<td>US Large Cap Stocks</td>
<td>UNDER 33.00%</td>
<td>31.70%</td>
<td>-2.30%</td>
<td></td>
</tr>
<tr>
<td>US Mid Cap Stocks</td>
<td>OVER 9.00%</td>
<td>9.90%</td>
<td>+0.90%</td>
<td></td>
</tr>
<tr>
<td>US Small Cap Stocks</td>
<td>OVER 5.00%</td>
<td>6.25%</td>
<td>+1.25%</td>
<td></td>
</tr>
<tr>
<td>European Stocks</td>
<td>UNDER 17.00%</td>
<td>15.30%</td>
<td>-1.70%</td>
<td></td>
</tr>
<tr>
<td>Japanese Stocks</td>
<td>OVER 7.00%</td>
<td>12.25%</td>
<td>+5.25%</td>
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</tr>
<tr>
<td>Emerging Market Stocks</td>
<td>UNDER 9.00%</td>
<td>5.40%</td>
<td>-3.60%</td>
<td></td>
</tr>
<tr>
<td>Commodities</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
<td></td>
</tr>
<tr>
<td>Real Estate</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
<td></td>
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<tr>
<td>Strategic/Hedges</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
<td></td>
</tr>
</tbody>
</table>

100.00% 100.00%

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**Moderate Growth Portfolio (Portfolio 4g)** is our 2nd most aggressive portfolio, designed for investors who seek moderately aggressive, long-term growth while slightly reducing risk associated with equity markets. This portfolio regularly allocates 10% of capital to investment grade bonds, 10% to below investment grade bonds, and 80% to global equities. Risks stemming from credit and equity exposure are tempered by a small allocation to investment grade bonds. Our growth-oriented portfolios will usually seek an equal allocation to investment grade vs non-investment grade bonds and will prefer US to non-US stocks. With a primary focus on long-term growth, this portfolio will also prefer growth stocks to value stocks and will invest in smaller capitalization companies with little or no dividend yield. The portfolio regularly employs active managers who seek to outperform their respective benchmarks through careful and tactical security selection. Adjustments to the broader asset allocation are made as warranted by changing market conditions to either avoid risk or pursue opportunities in credit, rates, and global equity markets. This portfolio is most appropriate for investors who are seeking to aggressively grow capital while modestly tempering volatility over a long time horizon.

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Aggressive Growth Portfolio
Q1 2017 Primary Allocation Adjustment

Aggressive Growth Portfolio (Portfolio 5g) is our most aggressive portfolio, designed for investors who seek aggressive, long-term growth without concern for volatility typically associated with equity markets. This portfolio regularly allocates 100% of capital to global equities. Our growth-oriented portfolios will usually prefer US to non-US stocks, growth stocks to value stocks, and will invest in smaller capitalization companies with little or no dividend yield. The portfolio regularly employs active managers who seek to outperform their respective benchmarks through careful and tactical security selection. Adjustments to the broader asset allocation are made as warranted by changing market conditions to either avoid risk or pursue opportunities in global equity markets. This portfolio is most appropriate for investors who are seeking to aggressively grow capital over a long time horizon.

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Disclosures

Works Cited


Disclosures

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Index Definitions

Barclays 1-3 Year Credit Index – The Barclays U.S. 1-3 Year Credit Bond Index measures the performance of investment grade corporate debt and sovereign, supranational, local authority, and non-U.S. agency bonds that are U.S. dollar denominated. The Index includes investment grade U.S. credit securities that have a remaining maturity of greater than or equal to 1 year and less than 3 years and have more than $250 million or more of outstanding face value.

Barclays US Treasury Bond Index – The Barclays U.S. Treasury Bond Index measures the performance of the public obligations of the U.S. Treasury with a remaining maturity of one year or more.


iBoxx High Yield Bond Index – The Index is a rules-based index consisting of liquid U.S. dollar-denominated, high yield corporate bonds for sale in the United States, as determined by the Index Provider. The Index is designed to provide a broad representation of the U.S. dollar-denominated high yield corporate bond market. There is no limit to the number of issues in the Index.

Barclays US Floating Rate Note <5 Yr Index – The Index measures the performance of U.S. dollar-denominated, investment grade floating rate notes. Securities in the Index have a remaining maturity of greater than or equal to one month and less than five years.

JP Morgan EMBISM Global Core Index – The Index is a broad, diverse U.S. dollar denominated emerging markets debt benchmark which tracks the total return of actively traded external debt instruments in emerging market countries.

S&P 500 Cap Weighted Index – The Index measures the performance of the large capitalization sector of the US equity market. The Index serves as the underlying index for the S&P500 Growth and Value Index series. It is a capitalization-weighted index from a broad range of industries chosen for market size, liquidity, and industry group representation.

Alerian MLP Index - The Alerian MLP Index is a composite of the 50 most prominent energy Master Limited Partnerships ("MLPs") that provides investors with an unbiased, comprehensive benchmark for this emerging asset class. The index, which is calculated using a float-adjusted, capitalization-weighted methodology, is disseminated real-time on a price-return basis (NYSE: AMZ) and on a total-return basis (NYSE: AMZX).

MSCI EAFA Index – The Index was developed by MSCI Inc. as an equity benchmark for international stock performance. It is a capitalization-weighted index that aims to capture 85% of the (publically available) total market capitalization.

Japan TOPIX Index – The Index consists of 225 leading stocks traded on the Tokyo Stock Exchange

MSCI Emerging Markets Index – The Index was developed by MSCI Inc. as an equity benchmark for emerging market stock performance. It is a capitalization-weighted index that aims to capture 85% of the (publically available) total market capitalization.

Cohen and Steers US REIT Index – The Index consists of selected Real Estate Investment Trusts. The objective of the index is to represent relatively large and liquid REITs that may benefit from future consolidation and securitization of the U.S. real estate industry.

Summer Haven Dynamic Commodity Index - SDCI tracks the performance of a fully collateralized portfolio of 14 commodity futures, selected each month from a universe of 27 eligible commodities based on observable price signals, subject to a diversification requirement across major commodity sectors. The commodity sectors for the SDCI include Precious Metals, Industrial Metals, Energy and agricultural products such as Livestock, Softs, and Grains.

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# Index Blends

<table>
<thead>
<tr>
<th>Index</th>
<th>100% Bonds</th>
<th>70% Bonds</th>
<th>40% Bonds</th>
<th>20% Bonds</th>
<th>100% Stocks</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500 Cap Weighted Index</td>
<td>0%</td>
<td>16%</td>
<td>31%</td>
<td>41%</td>
<td>54%</td>
</tr>
<tr>
<td>MSCI EAFA</td>
<td>0%</td>
<td>7%</td>
<td>15%</td>
<td>21%</td>
<td>24%</td>
</tr>
<tr>
<td>Japan Topic Index</td>
<td>0%</td>
<td>4%</td>
<td>8%</td>
<td>11%</td>
<td>14%</td>
</tr>
<tr>
<td>MSCI Emerging Markets</td>
<td>0%</td>
<td>2%</td>
<td>3%</td>
<td>5%</td>
<td>8%</td>
</tr>
<tr>
<td>Barclays US Corporate AAA-A Index</td>
<td>74%</td>
<td>45%</td>
<td>21%</td>
<td>10%</td>
<td></td>
</tr>
<tr>
<td>iBoxx High Yield Bonds Index</td>
<td>22%</td>
<td>23%</td>
<td>20%</td>
<td>10%</td>
<td></td>
</tr>
<tr>
<td>JP Morgan EMBISM Global Core Index</td>
<td>4%</td>
<td>3%</td>
<td>2%</td>
<td>2%</td>
<td></td>
</tr>
</tbody>
</table>

Source: Morgan Stanley Global Investment Committee

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