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Overview

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Investment Research

Excerpt from 11/11/03 U. S. Investment Perspectives

US Strategy

November 11, 2003

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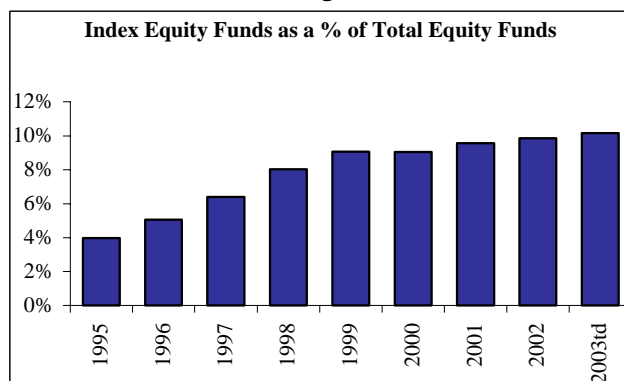
Having spent the bubble years in value Hades, we never enjoyed the \$5,000 bottle of wine dinners that are now part of industry lore. Our year-end holiday party was at *Bowlmor* lanes, not *Cipriani*. Last Monday night was going to change all this. Following guest lectures to my class at Columbia, I was to dine with the founder of the country's second-largest mutual fund, one of the most successful quantitative hedge fund operators, and the founding principal of a terrific value management firm. Anticipating extravagant appetites, I called Discover to ensure there were enough zeros on my credit limit. But what I heard at dinner instead was the comment, "I can't eat a whole steak, does someone want to split one?" After-dinner drinks brought calls not for bottles of Cristal but for a glass of Cabernet or Port, "*whichever is cheaper.*" So what's our point? Well, despite widely disparate methods for achieving investment success, there was a common theme to the speakers' message that night. Cost matters. Whether the fee an investor pays a manager or the price when buying a stock, costs drive returns more than most investors appreciate. In a low-return world, investors

can do worse than choose the cheapest port in the storm.

For those of us involved in the securities and asset management industries, it is hard to imagine a more depressing backdrop than that of the past few years. Last Monday brought the latest straw on a teetering capital markets camel as Congress held hearings on the mutual fund industry. Given the environment, we can think of easier things to do than assemble a group of investment professionals to describe, publicly, their approaches to a class of MBAs. For investment managers, the witness protection program probably looks more appealing than venturing out in public today. There's also the gnawing concern that today's revered stock jockey would be tomorrow's headline. Nonetheless, we have always made a point of bringing practitioners to our securities analysis class to talk about their craft, and this year would be no different. In addition to the portfolio manager foxes, we invited the most prominent investment hedgehog, Jack Bogle. Some of what he had to say (indexing wins) will shock no one, but everything he said was worth hearing.

Mr. Bogle goes to Washington and Velcro flies. If victory does indeed have 1,000 fathers, it seems as if the entire US

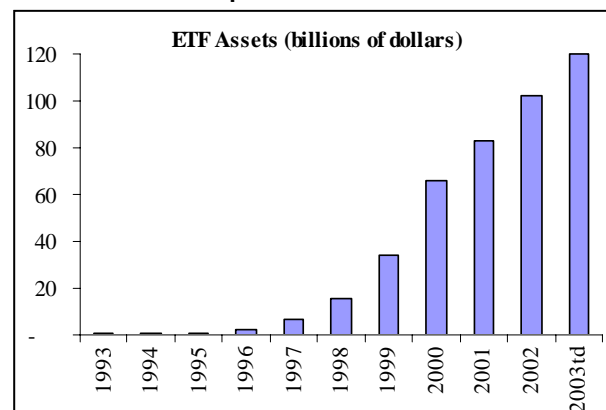
Exhibit 1

Index Funds Have Gained Significant Share ...

Source: Strategic Insight, Morgan Stanley Research. 2003 data as of Sept. 30

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Exhibit 2

...And ETFs Have Exploded

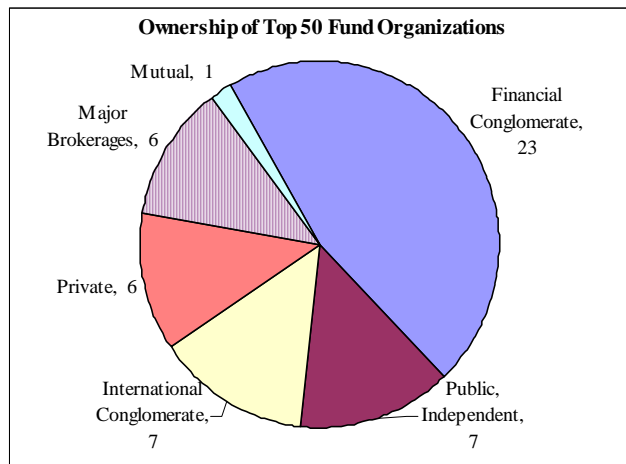
Source: ICI, Morgan Stanley Research. 2003 data as of Sept. 30

Please see analyst certification and other important disclosures starting on page 4.

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Exhibit 3

The March of the Entrepreneur



Source: Bogle Financial Center

Congress was hoping to adopt Jack Bogle last week. Clearly, when every third sentence of testimony started “according to Jack Bogle...,” he had made some converts. The man had become human Velcro, with everyone hoping to attach himself to the Vanguard founder. Our response (which unfortunately we have said after similar inquiries into margin debt, research practices, corporate governance issues, etc.) to the Velcro phenomenon is, where were these folks five years ago? If anything, the active/passive investment debate will only heat up given that fund malfeasance seems centered squarely in the active arena. But while some folks testifying in Washington seem to have had an epiphany on the benefits of indexing, consumers have understood its merits for some time. Pretty much since Vanguard’s founding, index funds have gained market share (Exhibit 1), while growth in ETFs has been nothing short of explosive (Exhibit 2), in part, admittedly, in response to the rent-a-stock trading culture.

A profession becomes a business. The profession of money management has evolved into a business — big business. This is precisely one of Bogle’s chief criticisms. Forty years ago the industry was comprised of professionals who, like lawyers, doctors, and heck, even accountants, were fiduciaries in the truest sense of the word. Today, as key industry players continue to be swallowed up by large financial services supermarkets and the like (Exhibit 3), the shareholders’ interests (of the fund complex) sometimes seem to take precedence over the fund investors’ interests. The market-timing incidents are the latest examples of some of the inherent conflicts imbedded in the industry that can lead to a potentially bad outcome for fund investors. Now life is full of conflicts, and having them need not ensure a bad result. As Phil Purcell noted in a speech to the SIA last week,

“acknowledging [conflicts], disclosing them and forthrightly addressing them” can help. While both private and public companies have been involved in the recent fund shenanigans, it strikes us that a private partnership (or mutual) structure is preferable for the investment management *profession*. Whether private partnerships will be the preferred structure of the investment management *business*, given its extraordinary profitability, remains debatable.

Cost matters — now, more than ever. While we are hardly doing justice to the substance, much less the nuance, of the class presentations, each speaker focused on the importance of price. Mr. Quant spoke in terms of owning statistically cheap stocks with improving fundamentals (momentum), while shorting expensive stocks with deteriorating ones. Mr. Value spoke of finding good businesses at attractive prices versus normalized earnings power. Mr. Bogle? Well, no surprises here. High costs are the ultimate drain on aggregate investor wealth. Although Wall Street may be the only part of the capitalist system where consumers seem to feel better paying higher prices than low ones, the stakes today are likely far higher today than 20 years ago. Why? Fees have actually risen in a period where yields and expected returns have diminished considerably. In an economic sense, “real” fees have skyrocketed and now eat up a whopping percentage of reasonable expected returns (Exhibit 4).

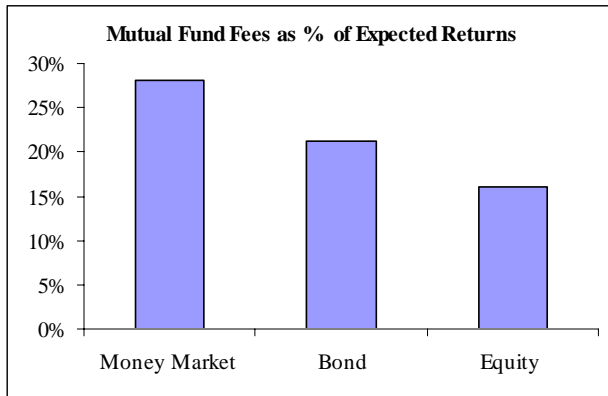
Fixing is more rewarding than breaking. So are we simply masochists? Not only did we bring in the father of indexing to tell a securities analysis class about the futility of what they learned during the semester, we did so on a day he waxed eloquent in Washington about the fund industry’s failings. Was our goal to eliminate a herd of MBAs from the analytical job market? Hardly. Intellectual honesty never goes out of style. Better to prepare tomorrow’s masters of the universe today with the odds they may face in running money successfully. Heck, Mr. Bogle’s own son is defying his father’s seemingly airtight logic by pursuing active investment management. More importantly, as perhaps only a man on his second heart could do, despite the grim news surrounding the industry he has devoted his life to, Jack Bogle left the audience with a sober, yet hopeful message. Fixing things can be more rewarding than breaking them.

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Exhibit 4

Fees Are Absorbing a Large Share of Expected Returns

the Lehman Aggregate for bond funds (4.3%), and the high end of our 6- 8% estimated expected return for equities.



Source: ICI, Bloomberg, Morgan Stanley Research. Expected returns are average current yields on money market funds (1.3%), current yield to worst for

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	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight	572	31%	237	38%	41%
Equal-weight	862	47%	282	46%	33%
Underweight	406	22%	99	16%	24%
Total	1,840		618		

Data include common stock and ADRs currently assigned ratings. For disclosure purposes (in accordance with NASD and NYSE requirements), we note that Overweight, our most positive stock rating, most closely corresponds to a buy recommendation; Equal-weight and Underweight most closely correspond to neutral and sell recommendations, respectively. However, Overweight, Equal-weight, and Underweight are not the equivalent of buy, neutral, and sell but represent recommended relative weightings (see definitions below). An investor's decision to buy or sell a stock should depend on individual circumstances (such as the investor's existing holdings) and other considerations. Investment Banking Clients are companies from whom Morgan Stanley or an affiliate received investment banking compensation in the last 12 months.

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