Morgan Stanley

TO OUR SHAREHOLDERS:

Never before in its history has Wall Street experienced the unprecedented events that occurred in 2008. With the fall of Bear Stearns and Lehman Brothers, two storied franchises, the turmoil that followed shook global markets, fundamentally reshaped the competitive landscape and led to unheard of government intervention in the financial sector. As a consequence, it was a year of extraordinary challenges and necessary adjustments for Morgan Stanley. But throughout this period, one overriding goal remained constant: protecting our shareholders and our employees. Due in large part to our outstanding teamwork and intense focus, Morgan Stanley continues to be an industry leader positioned to deliver value of the highest caliber—value that our shareholders, clients and employees have come to expect.

Clearly, these tumultuous markets and the global economic downturn present serious challenges for every firm in our industry. At Morgan Stanley, however, we believe they offer unique opportunities, and our Firm stands poised to seize them.

We realized one such tremendous opportunity when we announced the joint venture this past January combining our Global Wealth Management business with Citigroup's Smith Barney unit, under Morgan Stanley's operational control, thus advancing our long-term corporate strategy. The combined entity—to be called Morgan Stanley Smith Barney—will be the clear leader in wealth management with more than 20,000 high-quality financial advisors and $1.4 trillion in client assets.

Early and Aggressive Action to Adapt Our Business to the New Environment

While no firm anticipated the full dimension of the financial crisis that arrived in 2008, Morgan Stanley began moving aggressively in 2007 to adapt our business to the new environment—reducing leverage, trimming our balance sheet, raising private capital and cutting costs.

We brought down leverage significantly—from 32.6 times at the end of 2007 to 11.4 times at the end of 2008. We took down our balance sheet from about $1 trillion in 2007 to approximately $650 billion in 2008, reducing our exposure to legacy assets. This proved critical in navigating the most challenging market shocks of last September and October. Today, we are maintaining prudent levels of leverage—carefully targeting our capital to those businesses that offer the most attractive risk-adjusted returns.

In October 2008, we entered into a global strategic alliance with Mitsubishi UFJ Financial Group, Inc. (MUFG)—the second largest commercial bank in the world—as part of its $9 billion investment in Morgan Stanley. This further bolstered the Firm's strong capital and liquidity positions and enhanced our ability to identify and act upon new opportunities around the world. As a result of MUFG's investment, our Tier-1 capital ratio was approximately 15%[1]—one of the highest in the industry—even before the U.S. Department of the Treasury added $10 billion in our Firm last fall.

As we moved to diversify our funding sources, we received approval from the Federal Reserve for our new financial holding company status. This new status will allow us to continue building our bank deposit base that had approximately $43 billion by year end. Our goal moving forward is to continue diversifying both our revenue and our funding mix to create an even more stable foundation for our businesses.

Delivered Profitability in 2008 Despite Unprecedented Market Turmoil

These measures, together with the determination and focus of Morgan Stanley's people, enabled the Firm to deliver profitability in 2008—with net revenues of $24.7 billion, net income of $1.7 billion and three straight quarters of profitability in the first nine months of the year. We achieved record full-year results in commodities, foreign exchange, and equity sales and trading, including equity derivatives, as well as strong performance in Global Wealth Management. Although disruptions in the market clearly impacted our performance, we ended the year with a strong balance sheet, an industry-leading Tier-1 capital ratio and, most important, a clear vision for repositioning the Firm for continued growth in the future.

Building on Industry-Leading Client Franchises in Institutional Securities—Morgan Stanley continues to have an unmatched client franchise in our capital markets and advisory businesses. Indeed, despite the challenging environment, these institutional businesses still generated pre-tax income of $2.9 billion on net revenues of $16.6 billion in 2008.

The reputation of our Institutional Securities business is perhaps best exemplified by the fact that the U.S. government turned to Morgan Stanley to advise it on both the Fannie Mae and Freddie Mac situations as well as on the restructuring of AIG. We also advised on some of the year's most prominent

[1] Prior to becoming a financial holding company, Morgan Stanley was subject to group-wide supervision and examination by the Securities and Exchange Commission (SEC). Morgan Stanley calculated its minimum capital requirements in accordance with Basel II as interpreted by the SEC.

private transactions, including the largest airline merger, the largest media transaction, the largest transaction in South America and several of the largest rights issues by financial institutions on both sides of the Atlantic.

Moving forward, under the leadership of Co-President Walid Chammah, we are targeting capital toward those businesses in which we have leading positions and the best opportunities for risk-adjusted returns, including *Flow Trading, Equity Derivatives, Foreign Exchange, Interest Rates* and *Commodities.* At the same time, we are exiting or reducing some higher risk and balance sheet intensive businesses, such as *Proprietary Trading, Principal Investments* and *Residential Mortgage Origination.*

Continuing to Strengthen and Grow Our Wealth Management Franchise—Our Global Wealth Management business has continued to build on the turnaround launched by Co-President James Gorman nearly three years ago. The strong full-year results of this franchise included pre-tax income of $1.2 billion and a return on average common equity of 48%. We had net new assets of $35 billion during 2008, and total client assets under management at year end were approximately $546 billion.

As Morgan Stanley moves forward in 2009, we are building on that strong position through our joint venture with Smith Barney. This new combined entity will provide valuable benefits for our financial advisors and our clients, as well as Morgan Stanley's Institutional Securities business, which will gain an enhanced distribution capacity from the significantly increased scale of the new company. We are moving quickly to take advantage of this promising new opportunity and will be intensely focused on integration and execution in the months ahead.

Restructuring Asset Management for Profitability—Although losses in principal investments and lower assets under management drove a pre-tax loss of $1.8 billion in Asset Management, we made substantial progress in building up critical areas of this franchise. This included growing our alternatives group, seeding new products and expanding our infrastructure business. As an example, we closed Morgan Stanley Infrastructure Partners with $4.0 billion of equity commitments, exceeding the Firm's initial target of $2.5 billion.

Asset Management remains a critical component of our strategy, and improving the results in MSIM will continue to be a high priority for our management team. It is a high ROE business that takes advantage of the Firm's distribution power and provides a channel to monetize our intellectual capital. We are confident we will achieve competitive advantage and profitability in this business as markets improve.

Markets Remain Challenging, but Our Strategic Priorities Are Clear

There is no doubt that the markets will be challenging in 2009, but we are continuing to adapt our business accordingly. We are shifting people and capital to the most promising opportunities. We are rigorously reducing costs by $2 billion from last year's level. We are reducing legacy exposures further, as conditions allow. And we are changing the way we pay our people—including being the first major U.S. bank to institute a "clawback" provision for deferred year-end compensation.

At the same time, we are moving quickly to gain market share. We are pursuing a seamless integration of our Global Wealth Management franchise into the new Morgan Stanley Smith Barney joint venture. We are building out our new Retail Banking Group under the leadership of two industry veterans who joined the Firm last fall. In addition, we are working with our new strategic partner, MUFG, to realize the full potential of this strategic alliance.

The financial markets right now are as challenged as I have ever seen them in my 40-year career on Wall Street. As I've traveled the globe visiting our people and clients in recent months, it has become increasingly clear that despite the market turmoil, there still are attractive opportunities for the Firm to take advantage of. We will continue to remain nimble and to move quickly to seize them. We also will stay close to our clients to help them navigate these challenging markets. Above all, we will stay intensely focused on delivering long-term value to you, our shareholders, by capitalizing on the full potential of the Morgan Stanley franchise.

Sincerely,

John J. Mack
Chairman and Chief Executive Officer

March 16, 2009