MORGAN STANLEY INVESTMENT MANAGEMENT

INVESTMENT CLARITY IN A CLAMOROUS WORLD

In a rapidly evolving global market, well-established procedures and the determination to follow it through are the beacons that guide investment decisions. So we learned from Kristian Heugh, Head of Global Opportunity Team, and manager of a highly concentrated portfolio. Having won two coveted titles – House Award and Manager of the Year – in this year's Global Equity category, the asset manager evidenced the ability to see clarity, through stringent processes, in a noisy investment world.

BENCHMARK (BM): Congratulations on sweeping this year's Global Equity category, Kristian! We are deeply impressed with your concentrated investment approach. Can you tell us how high-conviction ideas are derived?

Kristian Heugh (KH): With pleasure. We adopt a multi-pronged approach to generate new ideas worthy of further due diligence. That includes applying screens, networking, mining for patterns, and identifying disruptive changes. We then comprehensively assess the quality of our best new ideas to thoroughly understand the companies' business models, investment theses, and anti-theses. We value each company using a customized, discounted cash-flow model and seek to pay a price much lower than the intrinsic value of the company.

GRAND AWARD

Outstanding Values Alignment Award

MANAGER AWARD

Global Equity — Kristian Heugh, Manager of Year

HOUSE AWARD

Global Equity — Best-in-Class

Morgan Stanley Investment Management

Kristian Heugh
Head of the Global Opportunity Team
Morgan Stanley Investment Management

We care much more about avoiding a permanent loss of capital than minimizing volatility. Our risk management ensures that our exposure is deliberate, diversified, and scaled appropriately. To do this, we scale our ideas according to their risks to reward characteristics; and impose limits based on position size, geography, and industry, while implementing our strict selling discipline. We make sure that selling actions are executed immediately when a thesis is no longer valid, or when the valuation is no longer attractive.

BM: Your investment horizon on a single security typically spans three to five years. How do you gauge if an investment idea has run its course? Your core positions are concentrated in a few stocks. Do you allow room for tactical allocations?

KH: As long-term investors, we are able to concentrate capital in our highest conviction ideas for a typical holding period of three to five years. We believe that by applying price disciplines to high-quality companies – strictly defined as those with sustainable competitive advantages, long-term growth, and the potential for value creation – we can best capture opportunities and manage risk for our clients. We view our conviction-based concentrated portfolio as a source of long-term outperformance.

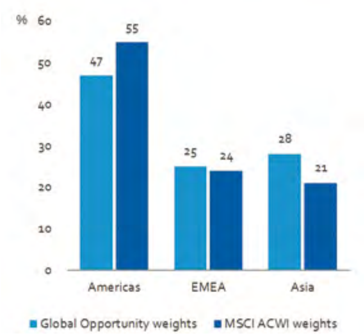
We generally sell positions for two reasons – deterioration in quality or unattractive ratio of price-to-value. First, the quality of a business may experience a decline in sustainability with respect to disruptive change, financial strength, and ESG, or fundamentals, as competitive advantage deteriorates or high-return growth prospects diminish. Second, we sell when the price-to-value ratio approaches or exceeds 1.00, or when we have identified more attractive alternatives to allocate capital.

BM: Geography-wise, you have been overweighting Asia against the benchmark index. Is this a top-down decision, or a by-product of your bottom-up stock selection?

KH: I'd say the latter. We have been overweight Asia relative to the benchmark since the inception of the portfolio. While country allocations are the residuals of our bottom-up stock selection, we do believe that Asia has more high-quality companies than the US and Europe do, as shown by our screening work. That said, though, we also consider diversification at the company level and strive to have a portfolio that is diversified by the uniqueness of the underlying business drivers and customer segments.

Data as of 31 December 2017

Holdings by Domicile Region[1]



1. Source: Factset, Morgan Stanley Investment Management

Again, we believe that owning high-quality companies with sustainable competitive advantages, and purchased at a deep discount to intrinsic value, will deliver outperformance over a three- to five-year investment horizon.

BM: And finally, how do you define risk? And how does your team mitigate risk?

KH: We define risk as "losing money". We believe that risk is not driven by fluctuations in tracking error or the performance of a portfolio but stems from profit and loss over a period of time. To mitigate risk, we strive to reduce the probability of having a permanent loss of capital on each investment by buying companies at a discount to their intrinsic value. That, to us, is the best risk-control fundamental investors can employ in client portfolios. BM

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The article was originally published in the *Benchmark Guide to Asset Management – special issue 2018* in March 2018.
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