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Q&A

4 Growth Stocks That Will Own the Future

The Morgan Stanley Institutional Fund Growth Portfolio has trounced its peers over both the short and long term.

By NICHOLAS JASINSKI

For a fund manager whose top holdings are Facebook, Amazon.com, and Alphabet, Dennis Lynch prefers an old-school investing style.

Money management is his family business. Lynch worked summers at Lynch & Mayer, his father's asset-management firm in New York. After college and a three-year stint on the sell-side at JPMorgan, he got his M.B.A. at Columbia Business School to follow his father into active management. Now 46, Lynch went to work at Morgan Stanley Investment Management in 1998, where he has led the Morgan Stanley Institutional Fund Growth Portfolio (ticker: MSEGX) since 2004.

The industry has changed dramatically since he got his start in the early '90s. Before computers and the internet became so widespread, Lynch says, investors often wouldn't know their results until the end of the month or quarter. While that technical limitation no longer applies today, Lynch tries to apply that perspective to his investment decisions.

"It allows you to think a little more clearly about the future, as opposed to getting very caught up in those minute-to-minute fluctuations that can be very significant in the stock market," Lynch said in a recent interview with Barrons.com.

It means that Lynch and his team don't feel pressured to react to each piece of news and trade every day, but instead aggregate their research and analysis into tactical decisions they apply every few months or quarter. Rather than being concerned with short-term fluctuations, Lynch aims for strong results over a three-to-five-year basis by taking a bottom-up view and "collecting unique companies that we can own for many years that have very strong, very competent managers."

The approach has paid off, with Lynch's fund holding a five-star rating from Morningstar and outperforming his benchmark, the Russell 1000 Growth Index, over the past one, three, five, and 10 years and ranking in at least the top 3% of large-cap growth funds in each of those periods.

Here are some highlights from our interview.

***Barrons.com:* We're currently enjoying one of the longest periods of stock market growth in decades. Your fund holds or has held companies responsible for a significant share of those gains– Tesla (TSLA), Alphabet (GOOGL), Amazon.com (AMZN), and Facebook (FB)–so it's fair to say you've had a front-row seat. Do you see a correction on the horizon, or does the bull still have room to run?**

Dennis Lynch: Well, first off, you never know when there is going to be a correction, and you have to be careful about believing in being able to time what the market or the economy is going to do. So the first answer is, I have no idea if we're due for a correction.

I think that there is no question that given the recent price history of some of the companies in our portfolio that the prospective returns are just not as good as they were at the beginning of the year. I do think, though, that our portfolio generally–including those names–is still a better portfolio than most of the alternatives that we look at in the rest of the market.

Manager's Bio

Name: Dennis Lynch
Age: 46
Title: Head of growth investing at Morgan Stanley Investment Management
Education: B.A. in political science, Hamilton College; M.B.A. in finance with honors, Columbia Business School
Hobbies: Tennis, watching movies and TV

(over please)

Fund Facts
(as of July 25, 2017)

Morgan Stanley Institutional Fund Growth Portfolio (MSEGX)

Assets:	**$3.977 billion**
Front Load:	**5.25%**
Expense Ratio:	**0.92%**
Annual Portfolio Turnover:	**39%**
Yield:	**None**

Source: Morgan Stanley

Top 10 Holdings
(as of June 30, 2017)

Facebook	**(FB)**
Amazon.com	**(AMZN)**
Alphabet	**(GOOGL)**
Priceline Group	**(PCLN)**
Starbucks	**(SBUX)**
ServiceNow	**(NOW)**
Illumina	**(ILMN)**
Salesforce.com	**(CRM)**
Intuitive Surgical	**(ISRG)**
Workday	**(WDAY)**

Source: Morgan Stanley

I think that the quality of their businesses and the quality of their competitive edge means that even at today's prices, they still represent attractive investments. They are not as attractive as they were even at the beginning of the year, but that's simply because the prices have gone up a lot.

Technology is the best-performing sector this year, which has inevitably led to comparisons with the dot-com bubble. Given that your portfolio is overweight on tech, do you think that comparison is fair?

I think it's not even close. The internet bubble had a lot of companies that were really more concepts than businesses in positions where they had to burn a lot of cash to survive. The moment funding disappeared, we saw a dramatic bursting of the bubble. The tech companies we hold are not only primarily cash-flow positive and have high cash-flow-growth potential, but also have very large, entrenched businesses that don't require external financing. So I really don't think that's a great comparison.

Amazon, over 8% of your portfolio, has been in the news quite a bit lately. What do you see as the company's big opportunities going forward?

They still have a large penetration opportunity across all their businesses. As a percent of global consumer spending, Amazon is still quite low. I think that Amazon is the best-run company in terms of how they think. They think long term and make investments without regard for how it will affect their short-term earnings. People criticize them for it, but I think it has shown to be the right mindset. Their goal appears to be the biggest end-game possible. They really act like a private company in the sense that they are trying to maximize how big they can be when they grow up. Of all the companies we own, if I had to buy one it would be Amazon, because of the combination of the person in charge, their capital allocation, and their online and offline competitive advantages.

Illumina (ILMN) and Intuitive Surgical (ISRG) are two of your holdings that both sit at the intersection of tech and health care. What do you see there?

Illumina is a next-generation genome-sequencing company with absolutely dominant market share. They've gotten to the point where their end users can sequence a genome for $1,000, and they're going to push that down to $100 sometime in the future. As that occurs, it opens up the usage of their technology to very different and much bigger end markets. Today what drives most of the company's sales is spending on research and drug development by universities or pharmaceutical companies. But as their technology becomes cheaper it is far more likely to be used in a diagnostic setting and at the doctor level to treat patients using information about their genome. Additionally, their business model is like the razor-handle/blade model: They sell a machine and then sell consumables so there is a high amount of recurring revenue.

Intuitive Surgical's technology is equally dominant. They offer a system for robotic surgery that has become such a standard that if you go to medical school now, you will learn on their platform. There are ecosystem benefits that are starting to occur, so even if someone else comes along with a similarly effective product, the switching costs for a hospital are very high. They still have tremendous global market penetration potential in terms of surgeries overall, and have shown their ability to do that through product innovation and going beyond their historical market for procedures like hysterectomies to more broad, general surgeries. If you look at it that way then they are still probably only in the mid-single-digit percentage penetration of their overall opportunity.

Your top holding is Facebook, which you've held since before its 2012 initial public offering. It's recently been trading at all-time highs. What would make you sell?

Given the quality of Facebook's business and the strength of its competitive advantage, we still think it is a valued-added position even at today's price. They are very dominant, and the network effect of having two billion users is just extraordinary. They're a large public utility, in a way.

One thing we keep our eye on is whether a new platform comes along that makes people rethink how they build their social network. Everyone uses cellphones right now, but what if there is another technology that changes the way people tap into the internet and their social network? It could be augmented reality glasses or voice control. We want to understand how Facebook would evolve through that transition. Inherently, Facebook's business model is based on people spending all of their time on their platforms, and then they monetize that through advertising. Anything else that might capture people's time and imagination would be a risk to Facebook.

Has the rise of index funds had any impact on your ability to find outperforming stocks?

The way people are investing has been altered a lot over the past five or 10 years simply by the fact that passive has become a much bigger part of the equation. Most managers haven't added value over time, and if you are somebody who wants to just get a market return, it might be a really good option for you. Now, how does that change the market environment? Does it lead to anomalies or more alpha potential or not?

I think that ultimately this trend will lead to more anomalies. Because what passive investing does essentially is allocate money to the market based on the market prices today, and that process could lead to some really undervalued or interesting names. But the flip side is: When are you going to realize the benefit of that insight or that anomaly? If the passive trend continues, the challenge is that it could be quite some time, because passive allocation might continue to perpetuate current trends.

Thank you.

Important Disclosures:

The opinions are those of *Barron's* and Dennis Lynch as of the date presented and are subject to change at any time due to changes in market or economic conditions. The comments should not be construed as a recommendation of individual holdings or market sectors, but as an illustration of broader themes. The material does not purport to address the financial objectives, situation or specific needs of any individual reader. The use of this article is not a solicitation, or an offer to buy or sell any security or investment product. Moreover, the opinions expressed in this article are not necessarily those of Morgan Stanley or its employees.

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Morgan Stanley Institutional Fund (MSIF) Growth Portfolio Top Ten Holdings

Security Name	% of Portfolio
Facebook Inc	8.40
Amazon.com Inc	8.34
Alphabet Inc	6.24
Priceline Group Inc/The	4.90
Starbucks Corp	4.89
Servicenow Inc	4.88
Illumina Inc	4.87
Salesforce.com Inc	4.84
Intuitive Surgical Inc	4.82
Workday Inc	4.61

As of June 30, 2017. Subject to change daily and are provided for informational purposes only and should not be deemed as a recommendation to buy or sell the securities shown above.

MSIF Growth Portfolio Class A – Average Annual Total Returns as of June 30, 2017

	1 Year	3 Years	5 Years	10 Years	Since Inception
MSEGX (%)	23.27	10.88	16.58	9.78	9.39
Russell 1000 Growth Index (%)	20.42	11.11	15.30	8.91	8.04

Class A shares include maximum front-end sales charge of 5.25%. Performance data quoted represents past performance, which is no guarantee of future results, and current performance may be lower or higher than the figures shown. For the most recent month-end performance figures, please visit morganstanley.com/im or call 1-800- 548-7786. Investment returns and principal value will fluctuate and fund shares, when redeemed, may be worth more or less than their original cost.

The inception date of the MSIF Growth Portfolio is April 2, 1991. Performance and fund information is as of June 30, 2017, unless otherwise noted. Returns are net of fees and assume the reinvestment of all dividends and income. Returns for less than one year are cumulative (not annualized). Performance of other share classes will vary. Please keep in mind that double-digit returns are highly unusual and cannot be sustained. Investors should also be aware that these returns were primarily achieved during favorable market conditions.

Expense Ratio	Symbol	CUSIP	Gross (%)	Net (%)	Minimum Initial Investment ($)
Class A	MSEGX	61744J564	0.92	0.92	1,000
Class C	MSGUX	61760X414	1.70	1.70	1,000
Class I	MSEQX	61744J861	0.63	0.63	5,000,000
Class IS	MGRPX	61760X711	0.54	0.54	10,000,000

Where the net expense ratio is lower than the gross expense ratio, certain fees have been waived and/ or expenses reimbursed. These waivers and/or reimbursements will continue for at least one year from the date of the applicable fund's current prospectus (unless otherwise noted in the applicable prospectus) or until such time as the fund's Board of Directors acts to discontinue all or a portion of such waivers and/or reimbursements. Absent such waivers and/or reimbursements, returns would have been lower. Expenses are based on the fund's current prospectus.

Class IS shares, are being offered only to eligible investors who must meet a minimum initial investment of $10,000,000 or be a defined contribution, defined benefit or other employer sponsored employee benefit plan, whether or not qualified under the Internal Revenue Code of 1986, as amended (the "Code"), in each case subject to the discretion of the Portfolio's investment advisor.

MORNINGSTAR RATING & RANKINGS AS OF JULY 31, 2017

MSIF Growth Portfolio Ratings: Class A Shares Fund ratings out of 5 Stars: 3 Years, 5 Stars; 5 Years, 5 Stars; 10 Years, 4 Stars.

Rankings	Percentile	Rank/Total in Category
1 Year	4	47/1,398
3 Years	4	40/1,260
5 Years	1	10/1,132
10 Years	2	16/796

Rankings are based on total returns, are historical and do not guarantee future results. Ratings are based on Risk Adjusted Return. For additional Morningstar information, refer to the disclosures below**.**

Please visit www.morganstanley.com/im for more information including the complete performance history of the Portfolio.

RISK CONSIDERATIONS

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Accordingly, you can lose money investing. Please be aware that this portfolio may be subject to certain additional risks.

In general, **equities securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, market and liquidity risks. The risks of investing in **emerging market countries** are greater than risks associated with investments in foreign developed countries. **Privately placed and restricted securities** may be subject to resale restrictions as well as a lack of publicly available information, which will increase their illiquidity and could adversely affect the ability to value and sell them (liquidity risk).

MORNINGSTAR

Rankings: The percentile rankings are based on the average annual total returns for the periods stated and do not include any sales charges, but do include reinvestment of dividends and capital gains and Rule 12b-1 fees. The highest (or most favorable) percentile rank is 1 and the lowest (or least favorable) percentile rank is 100. The top-performing fund in a category will always receive a rank of 1.

Ratings: The Morningstar Rating™ for funds, or "star rating", is calculated for managed products (including mutual funds, variable annuity and variable life subaccounts, exchange-traded funds, closed-end funds, and separate accounts) with at least a three-year history. Exchange-traded funds and open-ended mutual funds are considered a single population for comparative purposes. It is calculated based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a managed product's monthly excess performance, placing more emphasis on downward variations and rewarding consistent performance. The top 10% of products in each product category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars, and the bottom 10% receive 1 star. The Overall Morningstar Rating for a managed product is derived from a weighted average of the performance figures associated with its three-, five-, and 10-year (if applicable) Morningstar Rating metrics. The weights are: 100% three-year rating for 36-59 months of total returns, 60% five-year rating/40% three-year rating for 60-119 months of total returns, and 50% 10-year rating/30% five-year rating/20% three-year rating for 120 or more months of total returns. While the 10-year overall star rating formula seems to give the most weight to the 10-year period, the most recent three-year period actually has the greatest impact because it is included in all three rating periods. Ratings do not take into account sales loads.

OTHER CONSIDERATIONS

The **Russell 1000 Growth Index** measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000 Index is an index of approximately 1,000 of the largest U.S. companies based on a combination of market capitalization and current index membership. The index is unmanaged and does not include any expenses, fees or sales charges. It is not possible to invest directly in an index.

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