

Investing Overseas with Morgan Stanley's International Equity Team

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | INVESTMENT INSIGHT | 2018

William Lock, who led Morgan Stanley's International Equity team through the 2008 financial crisis, has invested for over 25 years in overseas markets. His team's International Equity strategy, now into its fourth decade, has delivered shareholder returns at an annualised rate of 11.3% since 1986—nearly twice the rate of the MSCI EAFE Index.¹

"Long term, it's all about the compounding", says Lock. "\$100 invested at 11.3% since inception will grow to over \$2,800 compared to the \$660 the MSCI EAFE Index rate of 6.2% would have given you (*Display 1*). The key is to avoid companies with fading returns and to determine the appropriate margin of safety on a company by company basis. The goal is to deliver attractive absolute portfolio returns in rising markets, a measure of downside protection in challenging markets, and a lower volatility of returns than the MSCI EAFE Index.

A focus on price and prospects

Lock continues, "We achieve this by bottom-up stock picking, investing in companies that can broadly be categorized as either Value Opportunities or High Quality Compounds. For Value Opportunity companies, we look for improving returns due to management actions and/or cyclical tailwinds, with a sufficient discount to intrinsic value to compensate for risk. Companies in the High Quality Compounder category can generally sustain their high returns on operating capital by virtue of their powerful intangible assets and pricing power, are run by management teams dedicated to preserving these returns, and can be

AUTHORS



WILLIAM LOCK

Managing Director
Head of International
Equity Team



BRUNO PAULSON

Managing Director



NIC SOCHOVSKY

Executive Director

"The key is to
avoid fading
returns"

¹ Source: Morgan Stanley Investment Management, MSCI. Data as of 31 December 2017.

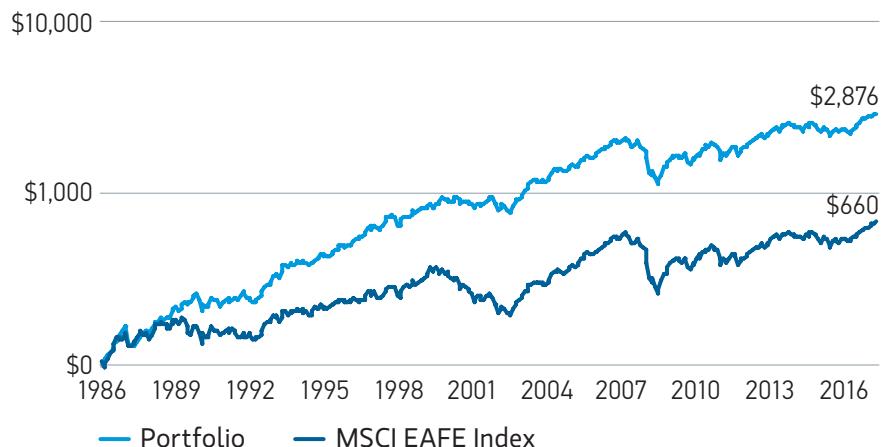
found at intrinsic value or better. There is no top-down allocation between the two types of companies—we are stock pickers and the proportion of companies in the two categories is determined by the individual price and prospects for each company we invest in, on a bottom-up basis. Our overall investment opportunity is having a longer time horizon than the market and where appropriate, a disagreement with the market on the shape of the cycle or the size of the restructuring opportunity.

Asymmetry and relative downside protection

This value and quality combination underpins the strategy's asymmetric performance profile - reasonable up-market participation and an ability to withstand shocks. "It's a bit like the opening line to Kipling's poem IF," says Lock. "...if you can keep your head when all about you are losing theirs...". Markets have the habit of turning. We've seen nine negative market years over the life of our strategy. In each of these, we've provided relative downside protection, on average declining 7% compared to a 15% fall in the market. In rising markets, we've delivered an average annual increase of 16% compared to 17.5% for MSCI EAFE Index.² So it's this asymmetric return profile that has given us the superior compounding over time. *Display 2*, which shows how the strategy's three-year returns have exceeded the index in nearly all downturns, illustrates this asymmetry.

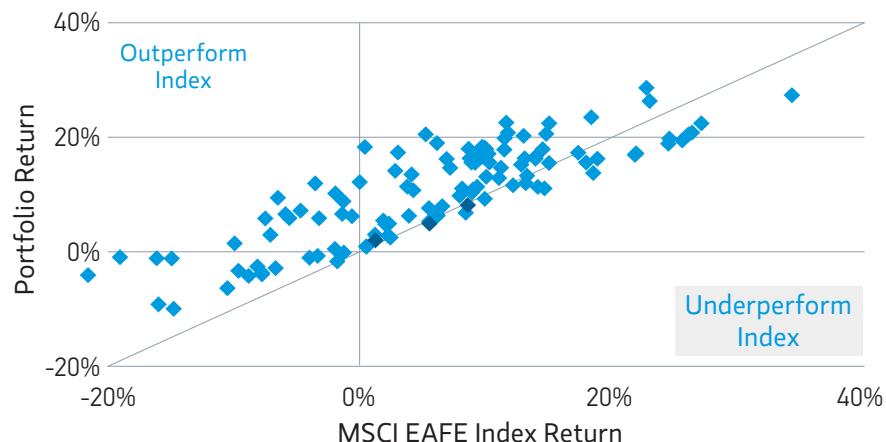
"It's this asymmetric return profile that has given us the superior compounding over time."

DISPLAY 1 Long-term Compounding



Source: Morgan Stanley Investment Management. Data since inception date of September 30, 1986 through December 31, 2017. **Past performance is no guarantee of future results.** The returns represent the Morgan Stanley International Equity Strategy Composite and are presented GROSS of custody as well as investment management fees. Had fees been included, returns would be lower and results may be less favorable. Returns are quoted in USD terms and include the reinvestment of all dividends and income. The inception date of the Morgan Stanley International Equity Strategy Composite is September 30, 1986.

DISPLAY 2 Rolling 3 year annualised returns – quarterly data



Source: Morgan Stanley Investment Management. Data since inception date of September 30, 1986 through December 31, 2017. **Past performance is no guarantee of future results.** The returns represent the Morgan Stanley International Equity Strategy Composite and are presented GROSS of custody as well as investment management fees. Had fees been included, returns would be lower and results may be less favorable. Returns are quoted in USD terms and include the reinvestment of all dividends and income. The inception date of the Morgan Stanley International Equity Strategy Composite is September 30, 1986.

² Source: MSCI, FactSet. Data as of 31 December 2017.

"We're seeing plenty of investor interest right now in international ex-U.S. markets on the basis they are seen to be more at the mid-stage rather than late stage of a recovery, and in the case of Europe and Japan, probably in the sunset of their loose monetary policy era.

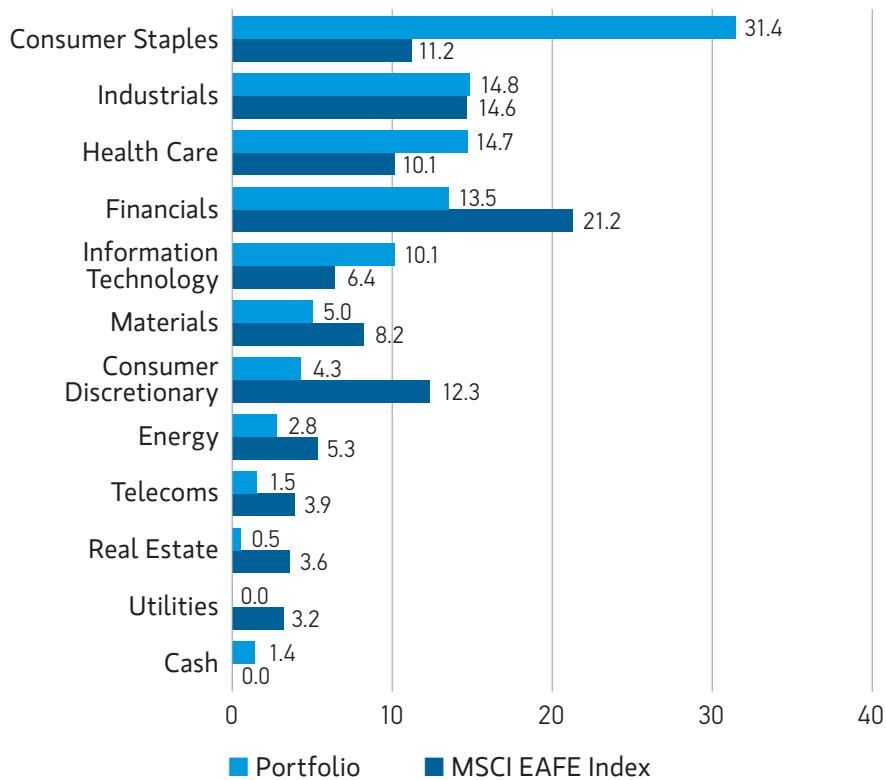
"As for valuations, given the EAFE market is now trading on a P/E ratio (price to the next twelve months earnings estimate) above its last cycle peak, achieved just prior to the Global Financial Crisis, we don't generally see much striking value in the markets. Yes, international markets are cheaper relative to the U.S., but we're talking largely fully priced compared to more than fully priced, in our view.

Skewed towards high quality compounders...for now

"So given where markets are, the balance between the portfolio's High Quality Compounders and Value Opportunities is skewed towards the Compounders. If we saw an attractive combination of price and prospects in Value Opportunities, the skew would naturally develop in the other direction through bottom-up stock picking. We have over-weights to consumer staples, health care and technology, and underweights in consumer discretionary, financials and materials (Display 3). The portfolio's revenue exposure is very global with 33% in emerging markets, 19% in Europe, 24% in the USA and 13% in Japan." (Display 4)

DISPLAY 3 Sector Weightings

MS INVF International Equity ex-U.S. Fund

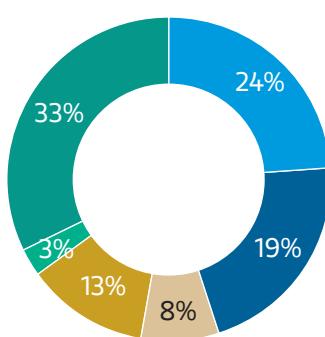


Source: Morgan Stanley Investment Management. Data as of December 31, 2017. Subject to change daily. Provided for informational purposes only and should not be deemed as a recommendation to buy or sell the securities mentioned or securities in the industries shown above.

DISPLAY 4 Revenue Exposure

International Equity Representative Account (Index weights)

Portfolio revenue exposures



Index revenue exposures

| | |
|-------------------------|-------|
| North America | (18%) |
| Europe ex-UK | (24%) |
| UK | (7%) |
| Japan | (16%) |
| Other Developed Markets | (10%) |
| Emerging Markets | (25%) |

Source: MSCI, FactSet and Morgan Stanley Investment Management. Data as of December 31, 2017. Updated quarterly. This portfolio is actively managed therefore holdings may not be current. Provided for informational purposes only and should not be deemed as a recommendation to buy or sell the securities mentioned or securities in the countries or regions shown above. Holdings are weightings are subject to change. Each portfolio may differ due to specific investment restrictions and guidelines. Weighted Regional Exposure - percentage of Company Sales. Excludes cash and re balanced to 100%. Data shown is the MSCI EAFE Index.

“Unilever³ (*Display 5*), one of our top holdings, trades at near a ten-year relative low to the MSCI USA consumer staples sector on price to the next twelve months estimated earnings’, says Nic Sochovsky, “despite the company out earning US staples companies over the same period and having all the hallmarks of quality we look for. Unilever has demonstrated high and improving returns on operating capital over the last 10 years, rising from 58% to 66%. They have spent euro 160bn over the last 20 years *alone* on marketing and incremental innovation to *reinforce* a very high mind-share moat, meaning their well invested brands typically occupy No 1 and No 2 category positions. The company has exceptional reach, being in 190 countries and 30 million outlets globally, and management effectively deploys a global/local model to empower local decision making. On top of this, they have a relentless focus on costs, with programs focusing on the supply chain to enhance the gross margin, zero-based budgeting for the operating costs, and Connected For Growth to focus on a leaner senior and mid-management layer.

“58% of their revenues come from Emerging Markets. We like stocks with exposure to the emerging market consumer, where organic growth rates have typically been 2-3 times those of the developed consumer. It’s worth noting that whilst the MSCI USA Index only has 15% of its revenues exposed to emerging markets and the MSCI EAFE Index has 25%, our fund has 32%, with sales ranging from leisure to baby food, cosmetics, medicines, drinks, tobacco and protection insurance”⁴

“What really matters for Value Opportunity companies”, says Portfolio Manager Bruno Paulson, “is being selective in what you own—looking for companies where returns are headed in the right direction. In Japan, we’re seeing returns improving due to management actions in industries from beer to beauty. We have exposure to potential cyclical improvement in the starved mining equipment industry and also have positions in robotics and automation—a particular Japanese strength. Elsewhere,

DISPLAY 5

Top Ten Holdings

MS INVF International Equity ex-U.S. Fund

| SECURITY | INDUSTRY | COUNTRY | (%) |
|---------------------------------|------------------------------------|-----------------------------|-------------|
| British American Tobacco | Tobacco | United Kingdom | 4.9 |
| Unilever | Personal Products | Netherlands | 4.4 |
| Reckitt Benckiser | Household Products | United Kingdom | 4.2 |
| L'Oréal | Personal Products | France | 4.0 |
| Pernod Ricard | Beverages | France | 3.8 |
| RELX* | Commercial & Professional Services | United Kingdom, Netherlands | 3.7 |
| GlaxoSmithKline | Pharmaceuticals | United Kingdom | 3.7 |
| Shiseido | Personal Products | Japan | 3.4 |
| Novartis | Pharmaceuticals | Switzerland | 3.4 |
| Tencent | Internet Software & Services | China | 3.0 |
| Total | | | 38.4 |

Source: Morgan Stanley Investment Management. Data as of December 31, 2017. Subject to change daily. Provided for informational purposes only and should not be deemed as a recommendation to buy or sell the securities mentioned or securities in the industries and countries shown above.

*The position relating to RELX Group plc has been aggregated and is comprised of RELX PLC and RELX NV securities. This has been aggregated in accordance to the split of ownership. Should separate holdings be required, contact Morgan Stanley Investment Management.

we’re finding cheap compounders in European pharmaceuticals. In materials, we see opportunities in construction where earnings offer high operational leverage to any economic recovery. We’re wary of industrial metals due to concerns over Chinese demand. In financials, we prefer insurers to banks since the margin of safety is better owing to relatively limited solvency, liquidity and regulatory risks. Few bank franchises can beat their cost of capital and the de-levering and forced alterations to their business models requires a heavy discount to account for the considerable risks.

Deflecting disruption

“We’re seeing a host of disruptive forces globally, especially in the supply chain. Areas that we’re steering clear of include food companies that are struggling with both price and competition from the trinity of discounters, e-commerce and innovative new entrants. In auto components the advent of electric cars,

where the parts requirement will be much less, will hurt the traditional supply chain. Cars will always need tyres, but what about the future sales of transmission systems, spark plugs and valves for example? In energy, fossil fuel companies run the risk of capital misallocation by investing in future reserves that could be supplanted by renewables, raising the risk of stranded assets.

“We think a lot about the positive and negative impacts of disruptive change in our portfolio and believe that the names we own are generally well positioned to adapt and grow in a period of unprecedented change.”

“In our view”, concludes Lock, “in a world of high expectations and high valuations, but with a lack of market consideration for any risk, bottom up stock selection and a focus on price and prospects, is the most effective approach to the risk and rewards the international equity market has to offer”.

³ Second largest stock holding for the MS INVF International Equity ex-U.S. Fund as of 31 December 2017.

⁴ Source: MSCI, FactSet, Morgan Stanley Investment Management. Data as of 31 December 2017.

DISPLAY 6**12 Month Performance Periods to Latest Month End (%)**

| | JANUARY '17 – JANUARY '18 | JANUARY '16 – JANUARY '17 | JANUARY '15 – JANUARY '16 | JANUARY '14 – JANUARY '15 | JANUARY '13 – JANUARY '14 |
|---|--------------------------------------|--------------------------------------|--------------------------------------|--------------------------------------|--------------------------------------|
| MS INVF International Equity ex-U.S. Fund – Z Shares | 26.49 | 6.04 | -7.34 | – | – |
| MSCI EAFE Index | 27.60 | 12.03 | -8.43 | – | – |

The inception date of the MS INVF International Equity ex-U.S. Fund was the 18 November 2014.

DEFINITIONS

Price-Earnings (P/E) is the price of a stock divided by its earnings per share for the past 12 months. Sometimes called the multiple, P/E gives investors an idea of how much they are paying for a company's earning power. The higher the P/E, the more investors are paying, and therefore the more earnings growth they are expecting.

INDEX INFORMATION

The **MSCI EAFE Index** is a free float-adjusted market capitalization index that is designed to measure the international equity market performance of developed markets, excluding the US & Canada. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The MSCI EAFE Index currently consists of 21 developed market country indices. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

The **MSCI U.S. Index** is designed to measure the performance of the large and mid-cap segments of the U.S. market.

Marketing Communication. For professional client use only. Not for use with the general public.

This communication is only intended for and will only be distributed to persons resident in jurisdictions where such distribution or availability would not be contrary to local laws or regulations.

IMPORTANT INFORMATION

This marketing communication has been issued by Morgan Stanley Investment Management Limited ("MSIM"). Authorised and regulated by the Financial Conduct Authority. Registered in England No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA

This document contains information relating to the sub-fund ("Fund") of Morgan Stanley Investment Funds, a Luxembourg domiciled Société d'Investissement à Capital Variable. Morgan Stanley Investment Funds (the "Company") is registered in the Grand Duchy of Luxembourg as an undertaking for collective investment pursuant to Part 1 of the Law of 17th December 2010, as amended. The Company is an Undertaking for Collective Investment in Transferable Securities ("UCITS").

Past performance is not a reliable indicator of future results. Returns may increase or decrease as a result of currency fluctuations. The value of the investments and the income from them can go down as well as up and an investor may not get back the amount invested.

Applications for shares in Morgan Stanley Investment Funds should not be made without first consulting the current Prospectus, Key Investor Information Document, Annual Report and Semi-Annual Report ('Offering Documents'), or other documents available in your local jurisdiction, which are available free of charge from the Registered Office European Bank and Business Centre, 6B route de Trèves, L-2633 Senningerberg, R.C.S. Luxembourg B 29 192. In addition, all Italian investors should refer to the 'Extended Application Form', and all Hong Kong investors should refer to the 'Additional Information for Hong Kong Investors' section, outlined within the Prospectus. Copies of the Prospectus, KIID, the Articles of Incorporation and the annual and semi-annual reports, in German, and further information can be obtained free of charge from the representative in Switzerland. The representative in Switzerland is Carnegie Fund Services S.A., 11, rue du Général-Dufour, 1204 Geneva. The paying agent in Switzerland is Banque Cantonale de Genève, 17, quai de l'Île, 1204 Geneva.

This communication has been prepared solely for informational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy.

The views expressed in this material are the views of the International Equity team through the 14th February 2018 and are subject to change based on market conditions. This document may contain certain statements that may be deemed forward-looking statements. Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those projected.

All information is provided for informational purposes only and should not be construed as a recommendation to purchase or sell the securities shown [or replicate the exposures/weightings shown].

Any index referred to herein is the intellectual property (including registered trademarks) of the applicable licensor. Any product based on an index is in no way sponsored, endorsed, sold or promoted by the applicable licensor and it shall not have any liability with respect thereto.

All investments involve risks, including the possible loss of principal. The material contained herein has not been based on a consideration of any individual client circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.

The information contained in this communication is not a research recommendation or 'investment research' and is classified as a 'Marketing Communication' in accordance with the applicable European or Swiss regulation. This means that this marketing communication (a) has not been prepared in accordance with legal requirements designed to promote the independence of investment research (b) is not subject to any prohibition on dealing ahead of the dissemination of investment research.

MSIM has not authorised financial intermediaries to use and to distribute this document, unless such use and distribution is made in accordance with applicable law and regulation. Additionally, financial intermediaries are required to satisfy themselves that the information in this document is suitable for any person to whom they provide this document in view of that person's circumstances and purpose. MSIM shall not be liable for, and accepts no liability for, the use or misuse of this document by any such financial intermediary. If such a person considers an investment in Shares of the Fund, she/he should always ensure that she/he has satisfied herself/himself that she/he has been properly advised by that financial intermediary about the suitability of an investment.

The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without MSIM's express written consent.

All information contained herein is proprietary and is protected under copyright law.

This document may be translated into other languages. Where such a translation is made this English version remains definitive. If there are any discrepancies between the English version and any version of this document in another language, the English version shall prevail.

© 2018 Morgan Stanley. All rights reserved.

Explore our site at www.morganstanley.com/im