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Mutual Funds

Talking With Kristian Heugh

Manager, Morgan Stanley International Opportunity Portfolio Fund

Taking Buffett Overseas

By Lewis Braham

Photograph by Morgan Stanley

The following has been excerpted

The first thing Kristian Heugh does when newcomers join his investment team is ask them to read a book of Warren Buffett's essays. "The book covers 50 years of Berkshire Hathaway's annual reports and focuses on those key kernels of wisdom that Buffett has graciously provided," says the manager of the **Morgan Stanley International Opportunity Portfolio**. "One of the great concepts he focuses on is that of time—not timing the market, but time in the market."

Like Buffett, Heugh believes in concentrated long-term investing, and that is what has given him his edge. His \$1.1 billion fund (ticker: MIOPX) has delivered a 9.3% five-year annualized return, besting 98% of its peers in Morningstar's Foreign Large Growth category, which have returned only 2.1% on average. To keep his focus long term, Heugh aligns his own financial future with fund shareholders: "80% of my financial assets are in the funds we manage," Heugh says.

Heugh, who grew up in Atlanta, New York, and London, spent his summers learn-

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ing “patience fishing” in Norway with his grandfather. Based in Hong Kong, Heugh also runs three other Morningstar-rated five-star funds—the more conservative **Morgan Stanley International Advantage Portfolio** (MFAPX), **Morgan Stanley Global Opportunity** (MGGPX), and **Morgan Stanley Asia Opportunity Portfolio** (MSAUX).

Heugh’s entire investment team is heavily invested in the funds. “Think like an owner,” he says. “That’s one of our mantras.” The team searches for companies with executives who have heavy insider ownership, as well, so the fund can invest long-term alongside them. What’s more, Heugh doesn’t call any of the 15-member investment team analysts or managers, but fellow investors. “We don’t like to use the terms ‘portfolio manager’ and ‘analyst’ because everyone is contributing,” he says.

Heugh favors high-quality companies with strong brands and low debt that consistently generate enough cash flow so they don’t need to borrow during economic downturns. He says this is what Buffett’s strategy evolved into over time, pointing out that when Buffett began investing in the 1950s, he was a traditional value investor, as there were a lot of cheap stocks, but less so as markets have become more efficient. The rampant inflation of the 1970s also taught Buffett that “companies with pricing power are critical because they can continue to grow and pass on the price increases of their inputs into the final price for their customers,” Heugh says. “They actually may be the beneficiaries of inflation.”

That’s why Heugh likes companies such as luxury-goods maker Hermès International (RMS.France), which has such a strong brand it has been in business since 1837. “Hermès is family controlled, and the family thinks long term,” Heugh

says. “They’re very careful about how they expand the business. They don’t discount their prices but instead very slowly raise them on an almost yearly basis. They really want to maintain that brand image of craftsmanship.”

While Heugh has a 26% weighting in consumer-staples companies such as Reckitt Benckiser Group (RB.UK), which makes popular health and cleaning products like Clearasil, Woolite, and Lysol, his largest sector exposure at 28% is in consumer-discretionary companies like Hermès. His No. 1 holding at 6.7% of his 36-stock portfolio is Moncler (MONC.Italy), an Italian apparel maker that specializes in coats and outerwear. While fashion retail can be fickle, such isn’t always the case in luxury brands. He notes that Moncler isn’t expanding too quickly like mainstream retailers, having about 200 stores and planning to increase them at a rate of 10 to 15 stores per year. “When you compare Moncler’s business to its peers in the luxury industry, its profit margins are at the very high end, around 30%, which is comparable to Hermès,” he says. The reason for that, Heugh says, is the company’s focus on quality in its specific niche: “The company’s not trying to be everything for everyone but to do what it does better than anybody else in the world.”

Given the resilient nature of the businesses he invests in, Heugh isn’t too worried about macroeconomic and individual country risk. Despite the U.S. trade war, Chinese stocks such as math-and-science tutoring company Tal Education Group (TAL) and soy-sauce maker Foshan Haitian Flavouring & Food (603288.China) account for 24% of his portfolio, versus just 8% for the fund’s benchmark, the MSCI All Country World Ex-U.S. Index.

One risk that Heugh faces is the po-

tential to overpay for these brand-name companies. According to Morningstar, his fund’s valuation metrics are all higher than those of its fund category peers. But Heugh would argue that current valuations don’t capture the long-term growth potential of great businesses, and the stock market seems to agree with him. In the past five years, this fund has produced 112% of its Morningstar benchmark’s upside when the market rose, with only 64% of its downside when it fell. Clearly, despite any valuation concerns, Heugh has been successful at playing defense. ■

Morgan Stanley International Opportunity

	Total Return		
	1-YR	3-YR	5-YR
MIOPX	-12.5%	13.6%	9.3%
Foreign Large Growth Fund Category	-14.5	6.3	2.0
Top 10 Holdings		% of Net Assets	
Company / Ticker			
Moncler / MONC.Italy	6.7		
Tal Education Group / TAL	6.2		
HDFC Bank / HDFCB.India	5.6		
DSV / DSV.Denmark	5.2		
Booking Holdings / BKNG	4.7		
Reckitt Benckiser Group / RB.UK	4.4		
EPAM Systems / EPAM	4.2		
Hermès International / RMS.France	4.1		
Fevertree Drinks / FEVR.UK	4.0		
Chocoladefabriken Lindt & Spruengli / LISN.Switzerland	3.6		
Total:			48.7

Note: Holdings as of 11/30; all returns as of 01/08; three- and five-year returns are annualized. U.S. holdings do most of their business overseas.

Sources: Morningstar; Morgan Stanley

Morgan Stanley

INVESTMENT MANAGEMENT

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Please note the reprint was altered from its original form.

Morgan Stanley Institutional Fund International Opportunity Portfolio – Class A Shares

Top Ten Holdings (% of Total Net Assets)	Fund	Index
Moncler SPA	6.92	0.04
Tal Education Group	6.61	0.06
EPAM Systems Inc	5.25	--
HDFC Bank Ltd	5.17	--
DSV	4.68	0.08
Fevertree Drinks Plc	4.51	--
Hermès International S.A.	4.10	0.10
Foshan Haitian Flavouring	3.92	--
Booking Holdings Inc	3.21	--
Rightmove Plc	3.18	

Sector Allocation (% of Total Net Assets)	Fund	Index
Consumer Discretionary	37.29	11.13
Consumer Staples	21.11	9.92
Information Technology	11.93	8.39
Communication Services	8.00	7.05
Industrials	7.37	11.68
Financials	7.13	21.60
Health Care	3.10	8.38
Cash	4.12	--

As of March 31, 2019. 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 or securities within sectors shown below.

Average Annual Total Returns as of March 31, 2019 – Class A Shares	1 Year	3 Years	5 Years	Since Inception (3/31/2010)
MIOPX with max sales charge (%)	-2.86	16.83	11.62	11.27
MIOPX without max sales charge (%)	2.53	18.95	12.82	11.94
MSCI All Country World Ex-U.S. Index (%)	-4.22	8.09	2.57	4.22
Morningstar Category Average (%)	-3.20	8.05	3.86	--

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 gross expense ratio for the International Opportunity Portfolio (Class A shares) is 1.36% and the net expense ratio is 1.29%. 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.

Morningstar: Rankings and ratings as of 3/31/19. **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.

International Opportunity: Class A Shares Foreign Large Growth Category 3 years 5 Stars out of 373 funds, 5 years 5 Stars out of 314 funds. Percentile Rank/Absolute Rank/Total in Category 1 Yr 11/45/442, 3 Yr 1/3/373, 5 Yr 1/4/314. **International Advantage:** Class A Shares Foreign Large Growth Category 3 years 5 Stars out of 373 funds, 5 years 5 Stars out of 314 funds. **Asia Opportunity:** Class A Shares Pacific/Asia ex-Japan Stock Category 3 years 5 Stars out of 77 funds. **Global Opportunity:** Class A Shares World Large Stock Category 3 years 5 Stars out of 732 funds, 5 years 5 Stars out of 617 funds.

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Assets under management for MSIF International Opportunity Portfolio are \$1.34 billion as of March 31, 2019.

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