Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

The Risk of Losing Money

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

Most ultimate end customers of the asset management industry would agree with a fairly simple definition of 'risk.' Be they savers, those drawing down savings in retirement, or in the case of defined benefit schemes, the shareholders or tax payers backing the sponsor, they would generally say that the fundamental risk is the risk of losing money and, in particular, losing significant amounts of money.

Within the industry, life is rather more complex and has evolved to be out of line with the fairly simple proposition above. The understandable desire to measure investment performance, and mitigate career risk, means that the primary risk metric is often a relative one: 'tracking error.' Risk ends up defined as deviation from a benchmark, regardless of the absolute risk in the benchmark itself. Indeed, for those who concentrate on higher-quality stocks, it may well be the case that the higher the relative risk, or deviation from the benchmark, the lower the absolute risk of losing money.

In fairness to the industry, the limits of the relative metrics are well known. We would argue that the main absolute measurement of risk, volatility, is actually even more problematic at the moment, as it may well be providing false comfort. Volatility is the measure of the dispersion of returns for a given security, portfolio or market index over a given period of time. The issue today is that the generally used 'given

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period of time,' be it three or five years, is now unrepresentative and dangerous. We are over nine years into an economic recovery, and associated bull market, and for the last few years have been in an absurdly low period of volatility, with the VIX Index lurking around 10 or even below. February seemed to be a wake-up call, but the index is now down at 12 again.

After multiple years without a major drawdown, strategies can end up concentrating on minimising small losses of capital rather than being prepared for a major hit. One absurd example is from the U.S. variable annuity industry, where several providers have been offering products that protect investors from any capital losses up to 10%, but not the losses above 10%. We would argue that this is the exact opposite of what a sensible product would look like, as typical variable annuity investors really need the protection against the large losses.

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Our approach to risk is more aligned with that of our end customers. We focus on the risk of losing money. As we have explained before, the good news is that there are only two ways of losing money in equities – either the earnings go away or the multiple goes away. Our philosophy is designed to minimise both by owning companies where the earnings are unlikely to disappear and where the multiples are reasonable.

Effectively, our portfolios are made up of companies where the fundamentals have low volatility, when it is really needed. It is unfortunate that the portfolios fail to meet some industry participants' definition of 'low volatility' today, after years of market calm, but it is arguably more likely to do so after the next crisis.

In terms of the earnings, concentrating on companies with the combination of recurring revenues and pricing power means that both the revenues and margins should be robust even in very tough times, supporting earnings. Indeed, in the financial crisis our flagship global equity strategy saw a rise in earnings between 2007 and 2009. Multiples did contract for a while but revived. The portfolio was back to its late-2007 peak by 2010, compared to the market where there were six lost years, even with dividends reinvested, before the MSCI World Index regained its 2007 level in late-2013. While markets do go up and down, in particular we want to avoid a permanent destruction of capital. Drawdowns are not ideal, especially if they cause investors to flee near the bottom, but it is the permanent destruction of capital that does the most damage, as earnings or multiples disappear forever, or share counts rise due to distress. Our strategy fell to a 10 times multiple of forward earnings in 2009, which was very unlikely to be a permanent level given the quality of the companies.

"While markets do go up and down, in particular we want to avoid a permanent destruction of capital."

We would suggest that there is plenty to worry about today, and that the real world is far more volatile than the docile VIX or overall valuations would suggest. The economic cycle is old, there has been a massive buildup of debt from the already excessive levels of a decade ago, and the political environment for corporates is ever more toxic, as shown most recently by Italy and the trade skirmishes.

Our view is that our portfolios are well placed for any major dislocations. Our confidence is boosted by looking at our holdings in the two leading sectors that make up a large percentage of our portfolios, consumer staples and information technology (IT). The derating of consumer staples over the last 18 months has been a headwind for historic performance but gives us more comfort going forward, particularly given the concentration on the higher-quality sub-sectors. The sector now trades on virtually the same forward free cash flow yield as the market despite the far higher quality. Our IT holdings are software and IT services rather than hardware, and are showing ever increasing levels of recurring revenues with the move to the cloud and reasonable valuations given the strong structural growth prospects.

Overall, our portfolios' focus remains on companies that can compound even in tough times thanks to their recurring revenues and pricing power. Naturally, we cannot rule out a drawdown in the event of a global recession, but if the underlying companies compound as well as they did in the global financial crisis, the portfolios are positioned to offer the medium- to long-term capital preservation characteristics demonstrated in the past. We are rather less confident about the market as a whole.

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 value of securities owned by the portfolio will decline. Accordingly, you can lose money investing in this strategy. Please be aware that this strategy may be subject to certain additional risks. Changes in the worldwide economy, consumer spending, competition, demographics and consumer preferences, government regulation and economic conditions may adversely affect **global franchise companies** and may negatively impact the strategy to a greater extent than if the strategy's assets were invested in a wider variety of companies. In general, **equity securities**' values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, and market risks. Stocks of **small-capitalization companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in **emerging market** countries are greater than risks associated with investments in foreign developed markets. **Non-diversified portfolios** often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. **Option writing strategy.** Writing call options involves the risk that the Portfolio may be required to sell the underlying security or instrument (or settle in cash an amount of equal value) at a disadvantageous price or below the market price of such underlying security or instrument, at the time the option is exercised. As the writer of a call option, the Portfolio forgoes, during the option's life, the opportunity to profit from increases in the market value of the underlying security or instrument covering the option above the sum of the premium and the exercise price, but retains the risk of loss should the price of the underlying security or instrument decline. Additionally, the Portfolio's call option writing strategy may not fully protect it against declines in the value of the market. There are special risks associated with uncovered option writing which expose the Portfolio to potentially significant loss.

INDEX INFORMATION

The **MSCI World Index** is a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets. 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 **VIX Index** measures the stock market's expectation of volatility implied by S&P 500 index options, calculated and published by the Chicago Board Options Exchange. The performance of the indexes is listed in U.S. dollars and assumes reinvestment of net dividends. The index is unmanaged and does not include any expenses, fees or sales charges. It is not possible to invest directly in an index.

DEFINITIONS

Free cash flow is cash flows (net income plus amortization and depreciation) minus capital expenditures and dividends. **Free cash flow yield** is a financial ratio that measures a company's operating free cash flow minus its capital expenditures per share and dividing by its price per share. **Tracking error** is the amount by which the performance of the portfolio differs from that of the benchmark.

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