Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

Avoiding losing money in equities

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | INVESTMENT INSIGHT | JANUARY 2021

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One of the benefits of compounders is that they are robust in tough times. Their recurring revenues help preserve their sales, while their pricing power protects margins. 2020 was certainly tough times, with world gross domestic product estimated to be down 4.4%, and advanced economies faring even worse, down 5.8%.[1]

The idiosyncratic nature of the crisis did affect some of the companies we typically prefer, with beverage companies hit by the closure of bars and restaurants; payments companies' lucrative cross-border businesses severely affected by the collapse in travel; and some health care players affected by the cancellation of routine operations and the logistical challenges of the pandemic. Despite pockets of local difficulty, the earnings of high quality global stocks generally held up well.

This is in stark contrast to the MSCI World Index as a whole. Its forward earnings fell 7%, despite all the government support for corporates. This meant that more than 100% of the overall index return of 16% was accounted for by the major 23% rerating. This repeated the pattern of 2019, when the index returned 27%, despite a 1% fall in forward earnings, with rerating driving the performance. Across the two years of 2019 and 2020, the index has rerated by 55% from 13.4x to 20.7x NTM earnings. It is also at an elevated 17.9x on a 24-month forward basis. Our high quality global stocks have also rerated but at least half the returns have come from the compounding earnings, up 18%, and dividends.

[1] Source: International Monetary Fund.

Apart from the cyclical/value rally of Q4, the key issue to note in 2020 was the dominance of technology in the market's returns. The information technology sector alone delivered 60% of the MSCI World Index's 16% 2020 return, and adding in certain household names in e-commerce, streaming, electric vehicles, and social media—regarded by most people, if not MSCI, as technology companies—takes the share to 89%, meaning that the rest of the market only delivered 11% of the index performance. Another way of looking at it is that over half the total MSCI World Index performance was delivered by only five companies, and 78% by the top 25, of which only one is listed outside the U.S.

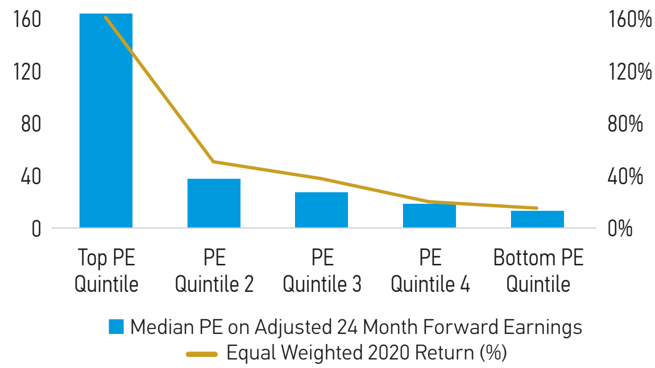
> "The Information Technology sector alone delivered 60% of the MSCI World Index's 2020 return"

While our global portfolio managers favour a strong weighting in information technology particularly software in addition to staples and healthcare, the IT sector's hot pace bears noting. The team's valuation discipline meant that our global quality portfolios did not get the benefit of the year's massive growth boom.

2020 saw a spectacular 480 initial public offerings, amongst which there were 248 SPACs (special purpose acquisition companies), also known as "shell" or "blank cheque" companies. The euphoria in the growthier end of the market can be seen in the information technology returns. Splitting the sector into five quintiles by adjusted 24-month forward earnings shows, as in the chart below, the seeming exuberance. The top quintile has a median price-to-earnings ratio (P/E) of 166 times adjusted earnings. This (P/E) is arguably being generous, as using pure GAAP/IFRS numbers, i.e., deducting share-based compensation, takes the majority of this quintile into loss, even two years ahead. This elevated valuation was helped by the group's average 2020 return of 163%. Even the relatively sober second quintile, with adjusted P/Es from 33 to 56 times, saw a return of over 50%. Our valuation discipline has limited us to the third quintile and below (quality concerns kept us out of the bottom quintile), meaning that we missed out on much of the excitement.

DISPLAY 1

2020 Return by Information Technology Valuation Quintiles



Source: FactSet and Morgan Stanley Investment Management.

There are only two ways of losing money in equities: either the earnings go away or the valuation goes away. Our quality-obsessed investment philosophy looks to minimise the former, and we have also looked to reduce the risk of the latter, in the face of the market's 20x forward multiple. Not only have we continued to avoid the more boisterous quintiles of the information technology sector, but we have shown discipline within our global portfolios' existing holdings shifting from companies with top-line growth of 6% or above to those with sub-6% growth. This shift to cheaper stocks has been to the detriment of performance, given the continued progress for growthier names, but should support the portfolios' resilience in the future.

We don't suggest that high quality global equity is cheap in absolute terms but relative earnings multiples look far more defensible. Now more than ever, it is time to focus on keeping the lights on, rather than attempting to shoot them out, and reasonably priced compounders seem a reasonable way of avoiding a plunge into darkness.

Source for all earnings and valuations within the document: FactSet and Morgan Stanley Investment Management.

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