Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

In Search of Resilience

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We are in unprecedented times. Governments have deliberately, and very understandably, tipped economies into severe recession, or as the Australian Prime Minister put it 'economic hibernation', with the mix of social distancing and lock-downs. The impact on gross domestic product (GDP) is tough to quantify but it will be extremely large, even by the standards of the Global Financial Crisis (GFC).

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There has been talk of double-digit falls in GDP in the second quarter and record rises in unemployment. Fortunately, many governments have already announced extremely large measures, both in terms of protecting corporates and also in getting cash into the hands of individuals who need it. The U.K. government will pay 80% of the wages of those who are unable to work, and the U.S. has passed a $2 trillion package. Unfortunately, while individual European countries are taking action, notably Germany, a vigorous response from the European Union is taking longer to emerge.

Responses from governments and Central Banks do seem to have calmed the financial panic and should help avert a financial crisis. Markets have responded favourably since their low on March 23rd. However, even with the most extreme government action, corporate earnings are going to be severely hit this year, and a great deal of debt is going to be piled on, by individuals, corporates and governments. This debt is going to have to be paid back, forgiven or inflated away—none of these options are likely be particularly favourable for the equity market. Focusing in on corporates, many already had high

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leverage at the onset of this crisis, having gorged on a decade of cheap money. They could well be facing a double whammy on their net debt/EBITDA ratios, as the numerator rises and the denominator falls. Even with the best efforts of governments, there is going to be plenty of financial distress.

The pain for the market may not be over

While the MSCI World Index's 35% correction from its peak on February 19th to the trough on March 23rd was very jarring, looking at the first quarter as a whole, the market is 'only' down 21%. If we assume that the market's 2021 earnings end up the same as those in 2019, i.e. two years of growth are lost forever, that would easily explain a circa 20% fall since the start of the year, even without worrying about the long-running impacts of the disruption and the debt hangover. We are not top-down strategists, but 2021 earnings at the 2019 level does not seem a particularly conservative outcome. The market seems to have moved from its view of a quick V-shaped downturn to something more prolonged, but it is not clear that it has priced in all the potential damage from the crisis. It is also worth bearing in mind that the market was expensive at the start of the year, with the MSCI World Index on 17x what was then the next twelve months earnings forecast. We were dubious at the start of the year that those earnings would actually be delivered—now it is very clear that they will not be.

> "The market's view has moved from a quick V-shaped downturn to something more prolonged, but has it priced in all the potential damage?"

The crisis may be another spur for ESG

It is true there have been some comments that ESG is a bull-market fad, a 'nice-to-have' that will disappear as investors try to put out fires elsewhere. We do not believe this is the case. There is preliminary evidence that ESG funds have continued to see inflows even as people have been pulling money out of equities in general. And ESG funds have by and large outperformed recently. We believe ESG is here to stay, because we believe it matters. In fact we believe it is more likely that the current crisis elevates social factors (e.g. how companies treat employees, health and safety, pay and job security) in the pecking order, and begins to define a blueprint for more sustainable business and society. After all, governments are writing very large cheques to keep businesses afloat... and they are likely to require some payback in the years to come, not least given their newly acquired taste for intervention.

The benefits of quality

Fortunately, we believe our global portfolios are far higher quality than the market, as has been shown by the measure of reduced downside participation they have demonstrated once again this quarter, as they did in 2008, 2011, 2015 and 2018. For the first quarter, the portfolios were down between 12.9% - 14.1% in USD, versus 21% for the MSCI World Index. This outperformance comes on the back of decent outperformance over the last few years. Even after this quarter's fall, our flagship global strategy has compounded at around 8% per year in USD over the last three years and 9% over the last five years to 31 March 2020. In contrast, the index has only managed around 2-3% for both periods. Given the strength of the dollar, absolute returns have been stronger in other currencies.

Analysing the impacts on the portfolio

Our relentless focus on companies with powerful intangible assets, notably brands and networks, means they have pricing power, and, when combined with recurring revenues, this drives resilient earnings in tough times. However, sadly this does not mean that the companies in our portfolios are immune from what is going on. As a result, we are analysing the impact of the crisis on sectors and individual companies in three buckets.

- First, there is the direct effect of COVID-19 and the efforts to control its spread, for instance the collapse in travel, eating and drinking out, or the deferral of non-urgent operations in hospitals, alongside increased demand in areas such as food retail, sanitising products and software. There are also the effects of the more complete shut-downs, or hibernations, in some localities.
- The second is the indirect impact of the extremely sharp economic downturns that are resulting across the world.
- The third, and arguably a lower priority in the immediate term, is how the world is going to be changed after the crisis is finally past, and how this will affect both sectors and individual companies. While it is far too early to have any firm views on this, we have to feel comfortable that any new names we consider are not going to be compromised in the new era.

Historically, we have concentrated on the second bucket, making sure our holdings have relatively greater resilience in tough times. Therefore, much of the team's new work has been concentrated on the specific direct effects of COVID-19, the first bucket, assuming around three months of lockdowns and a longer period of social distancing, and then combining those impacts with those of a sharp economic downturn into 2021. We would argue this is a pretty conservative scenario. Importantly, we have also been testing the resilience of our

names against much tougher stress scenarios, if lockdowns last longer. Crucially, our companies' balance sheets look resilient even in the toughest scenarios, not something we believe will be the case in the wider market.

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One other point worth making is that the U.S. dollar has strengthened against all other currencies, particularly emerging markets ones. This will clearly be a significant dollar headwind for companies with revenue exposure to the depreciating areas, but it could also be an opportunity for companies whose share prices are denominated in weakening currencies.

Combining both COVID-19 and recession impacts in our conservative scenario, and marking currencies to market, the fair values for most of our holdings fall by 0-15% in USD terms. This is less than their share price falls, meaning there is slightly more upside in the global portfolios than at the start of the year, even in the event of a severe global recession.

Key Sector Review

80-85% of our global portfolios are in consumer staples, information technology or health care. We discuss the three sectors in more detail below.

CONSUMER STAPLES

Consumer staples have once again proved their mettle in a downturn. There are no real questions about the defensive nature of the sector, so the pattern of performance within staples has been driven by the particular circumstances and direct effects of COVID-19, the first bucket mentioned above. Food retail, an area we avoid given the low margins and lack of returns on operating capital, has benefited from the frenzied panic shopping. This benefit has also fed into food manufacturers, which we don't hold, along with hygiene-exposed household and personal care companies, which we do.

At the other end of the staples spectrum, the beverages sector is naturally under pressure given the closure of bars and restaurants in many countries. On-premises business represents 40% of sales for the alcohol and soft drinks companies that we own. Elsewhere, the beauty area is relatively discretionary, and at the luxury end partly driven by travel, and has suffered, but a strong e-commerce platform, such as that a French personal care company that we own has in place provides a useful offset. What does seem odd is that the market has to date treated tobacco similarly to beverages, while we see it as far less exposed to social distancing measures given consumption patterns.

INFORMATION TECHNOLOGY

Within information technology, the portfolio's holdings are dominated by software and IT services. Our thesis here has been that the economics of software in particular should be relatively defensive in a downturn. In the Global Financial Crisis (GFC) its earnings held up as well as consumer staples and health care.

> "We believe the economics of software should be relatively defensive in a downturn"

There is reason to believe that software should be even more robust now, given the rise in recurring revenue thanks to cloud-based 'Software as a Service' (SaaS) subscriptions, which are much stickier than software license sales. As an example, the European multinational software corporation we own entered the GFC with only 50% of its gross profits coming from recurring business, with most of the rest in software licenses, which fell by a quarter. This figure is now up to 80%. Software has indeed delivered in the first quarter, down only 5%, helped by a strong start to the year before the crisis hit. The American multinational technology company we own is actually flat year-to-date, helped by the extra demand for its cloud offerings.

The IT services bucket (down 17% in Q1) is a bit more cyclical than software, if arguably less so than the rest of information technology. To state the obvious, the consulting projects of the Irish-domiciled multinational professional services company we own are more discretionary and shorter duration than the aforementioned American tech company's software revenues. That said, there was a comforting update from the professional services company, which expects revenues to be roughly flat year-on-year over the next two quarters, and margins to be unaffected by the crisis. It remains to be seen whether this outlook will turn out to be too optimistic, given the recent shut down of India where a third of the staff are located, but the company will at least gain from companies efforts to digitise and build telecommuting and collaboration tools for employees as well as customers.

Elsewhere in IT services, the core businesses of the two financial services companies we own look perfectly robust, but both companies face COVID-19-specific issues. The collapse in international travel is hitting the payments company's lucrative cross-border business, which is around 30% of revenues, though the shift to on-line transactions may help, while the merchant acquirer business of the financial services company we own risks being disrupted in the short-run by the difficulties in non-food

retail. An American payroll provider we own is more exposed to Bucket 2 cyclical risk, as it has been hit by concerns that U.S. employment will fall sharply, given that its revenues are driven by the numbers working in small to medium sized businesses, and so the nature and extent of the U.S. economic rescue package will make a difference.

HEALTH CARE

The global portfolios are concentrated in the health care equipment and life sciences elements of the sector, which face fewer political risks and fewer patent expiries. As in the case with consumer staples, it is pretty uncontroversial that the sector is defensive, and it has shown this during this crisis, down only 11% versus 21% for the MSCI World Index.

The complicating factor is the direct impact of COVID-19 on the hospital sector. Non-urgent operations are being cancelled in many countries as they gear up for the pressure from infected patients. This is not helpful for medical device players, as far fewer knees and other body parts are replaced. Fortunately, our holdings are skewed towards consumables, for instance needles or sterile bags. An American medical devices and health care company we own looks slightly more vulnerable, with 40% of revenues coming from capital equipment or other deferrable areas, but at least it has 20% of revenue from diagnostics, which may be boosted, and should get plenty of sales from its 5 minute COVID-19 test.

"Our global portfolios are about resilience"

In conclusion

Our global portfolios are about resilience. We have a resilient team, working very effectively from home, a resilient investment process, checking that the companies in our portfolios will be able to continue to compound and avoid any permanent destruction of capital, and perhaps most importantly resilient portfolios, which have once again delivered reduced downside participation in tough times.

Risk Considerations

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