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).

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 to be particularly favourable for the equity market. Focusing in on corporates, many already had high

“Even with the most extreme government action, corporate earnings are going to be severely hit this year”
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 bullmarket 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.

“Historically we have concentrated on making sure our holdings have relatively greater resilience in tough times”

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
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.
DISTRIBUTION
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.


U.S.
A separately managed account may not be suitable for all investors. Separate accounts managed according to the Strategy include a number of securities and will not necessarily track the performance of any index. Please consider the investment objectives, risks and fees of the Strategy carefully before investing. A minimum asset level is required. For important information about the investment manager, please refer to Form ADV Part 2.

Please consider the investment objectives, risks, charges and expenses of the funds carefully before investing. The prospectuses contain this and other information about the funds. To obtain a prospectus please download one at morganstanley.com/im or call 1-800-548-7786. Please read the prospectus carefully before investing.

Morgan Stanley Distribution, Inc. serves as the distributor for Morgan Stanley funds.

NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY loose VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A DEPOSIT

Hong Kong: This document has been issued by Morgan Stanley Asia Limited for use in Hong Kong and shall only be made available to “professional investors” as defined under the Securities and Futures Ordinance of Hong Kong (Cap 571). The contents of this document have not been reviewed nor approved by any regulatory authority including the Securities and Futures Commission in Hong Kong. Accordingly, save where an exemption is available under the relevant law, this document shall not be issued, circulated, distributed, directed at, or made available to, the public in Hong Kong. Singapore: This document should not be considered to be the subject of an invitation for subscription or purchase, whether directly or indirectly, to the public or any member of the public in Singapore other than (i) to an institutional investor under section 304 of the Securities and Futures Act, Chapter 289 of Singapore (“SFA”); (ii) to a “relevant person” (which includes an accredited investor) pursuant to section 305 of the SFA, and such distribution is in accordance with the conditions specified in section 305 of the SFA; or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. This material has not been reviewed by the Monetary Authority of Singapore. Australia: This publication is disseminated in Australia by Morgan Stanley Investment Management (Australia) Pty Limited ACN: 122040037, AFSL No. 314182, which accept responsibility for its contents. This publication, and any access to it, is intended only for “wholesale clients” within the meaning of the Australian Corporations Act.

Japan: For professional investors, this document is circulated or distributed for informational purposes only. For those who are not professional investors, this document is provided in relation to Morgan Stanley Investment Management (Japan) Co., Ltd. (“MSIMJ)”s business with respect to discretionary investment management agreements (“IMA”) and investment advisory agreements (“IAA”). This is not for the purpose of a recommendation or solicitation of transactions or offers any particular financial instruments. Under an IMA, with respect to management of assets of a client, the client prescribes basic management policies in advance and commissions MSIMJ to make all investment decisions based on an analysis of the value, etc. of the securities, and MSIMJ accepts such commission. The client shall delegate to MSIMJ the authorities necessary for making investment. MSIMJ exercises the delegated authorities based on investment decisions of MSIMJ, and the client shall not make individual instructions. All investment profits and losses belong to the clients; principal is not guaranteed. Please consider the investment objectives and nature of risks before investing. As an investment advisory fee for each contract, the client incurs a contingency fee which is subject to the Contract multiplied by a certain rate (the upper limit is 2.20% per annum (including tax)) shall be incurred in proportion to the contract period. For some strategies, a contingency fee may be incurred in addition to the fee mentioned above. Indirect charges also may be incurred, such as brokerage commissions for incorporated securities. Since these charges and expenses are different depending on a contract and other factors, MSIMJ cannot present the rates, upper limits, etc. in advance. All clients should read the Documents Provided Prior to the Conclusion of a Contract carefully before executing an agreement. This document is disseminated in Japan by MSIMJ. Registered No. 410 (Director of Kanto Local Finance Bureau (Financial Instruments Firms)), Membership: the Japan Securities Dealers Association, The Investment Trusts Association, Japan, the Japan Investment Advisers Association and the Type II Financial Instruments Firms Association.

IMPORTANT INFORMATION
EMEA: 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. 198121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA.

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market. Prior to investing, investors should carefully review the strategy’s/product’s relevant offering document. There are important differences in how the strategy is carried out in each of the investment vehicles.

A separately managed account may not be suitable for all investors. Separate accounts managed according to the Strategy include a number of securities and will not necessarily track the performance of any index. Please consider the investment objectives, risks and fees of the Strategy carefully before investing.

This material is a general communication, which is not impartial and has been prepared solely for informational and educational 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 information herein has not been based on a consideration of any individual investor 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.

Except as otherwise indicated herein, the views and opinions expressed herein are those of the portfolio management team, are based on matters as they exist as of the date of preparation and not as of any future date, and will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date hereof.

ACTIVE FUNDAMENTAL EQUITY | MORGAN STANLEY INVESTMENT MANAGEMENT
Forecasts and/or estimates provided herein are subject to change and may not actually come to pass. Information regarding expected market returns and market outlooks is based on the research, analysis and opinions of the authors. These conclusions are speculative in nature, may not come to pass and are not intended to predict the future performance of any specific Morgan Stanley Investment Management product.

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.

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.