Morgan Stanley

INVESTMENT MANAGEMENT

History Lessons

ACTIVE FUNDAMENTAL EQUITY | INVESTMENT INSIGHT | 2016

"What we learn from history is we don't learn from history".

Archbishop Emeritus Desmond Tutu

Watch someone blow up a balloon and soon they'll begin to tightly close their eyes, risking explosion in pursuit of full size. Whilst the current market hasn't quite reached that point yet, it is inflating and valuations are elevated. History teaches us that periods of elevated valuations are not sustainable if these valuations fail to be underpinned by progressive earnings or fundamentals. The Dutch Tulip mania in the 17th century, the South Sea bubble 40 years later, the Wall Street Crash of the last century or even more fresh in our minds, the two crises we've had in the last 15 years—the dot-com boom and the debt fuelled binge of the noughties—all tell us that in hindsight paying significant prices that struggle for justification typically ends in tears.

Display 1 shows the P/E (Price to Earnings), the price you have to pay expressed as the multiple for the earnings in the MSCI World Index. It peaked at 15.5x estimated earnings prior to the 2008 credit crisis, and has since risen even further.

Considering a much longer historical period, and using the Schiller P/E instead, which measures the price you have to pay for 10 year average earnings for the S&P, we're also near the summit, a full standard deviation from the mean since 1955.

Either the estimation of earnings is too low, and earnings will need to grow to justify their P/Es, or the P/E is too rich and will need to fall to better accommodate the outlook for earnings.

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Alistair is a portfolio specialist for the Global Quality strategy and a member of the International Equity team. He joined Morgan Stanley in 1997 and was an investor on the International Small Cap strategy for 12 years. Alistair also formed part of a large cap global research team contributing at a sector level up until 2005. Prior to joining the firm, Alistair worked in the luxury goods industry for five years. He received a B.Sc. in geography from Kingston University, an M.B.A. from the Graduate School of business, University of Cape Town and an M.Sc. in computer science from Kent University.

The permanent destruction of capital occurs when both the earnings and the multiple you pay for the earnings falls away. Truly long term investors seek to avoid this combination, instead choosing companies whose economics and resilience compound their way through occasional market-reversing multiple pressure. Warren Buffet and Charlie Munger are classic examples of such patient investing. Buying quality companies at reasonable prices that consistently invest in their business over many years, driving growth to generate profits which can be reinvested to drive further growth, far outweighs the short-term benefits of buying a stock and then flipping it for a quick profit after a brief rise. Nothing beats compound interest. Albert Einstein is said to have called it the "eighth wonder of the world".

This philosophy of patient investing in quality, dependable companies, by definition, prevents the investor being swept up by the madness of crowds driven by the prospect of short-term gains, the pursuit of themes, or the anxiety of being left behind. It is a wonder that, given such a simple investment philosophy works, it isn't something that attracts the crowd in droves.

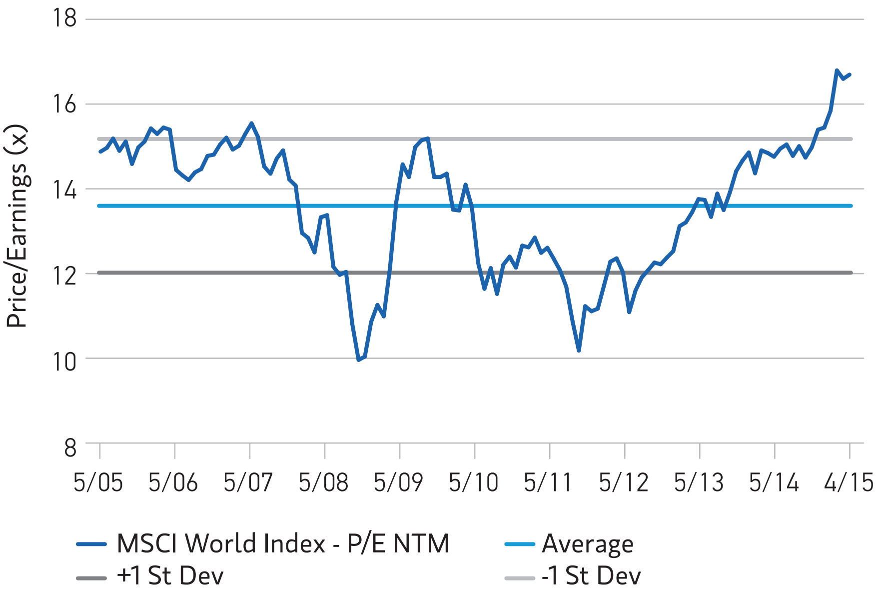
Not only do we seem unwilling to learn from mistakes—bubbles—we also seem unwilling to learn from success. It would, however, be flippant to suggest that a long-term, high quality investment strategy for equities is simple. "Long-term" isn't just about time, it's about commitment. Additionally, quality needs definition and boundaries.

Our client tenure is a source of pride within the International Equity team. We are fortunate our clients extend to us the freedom to invest for the long term in order to allow compounding the time to bear fruit, focusing on a journey, not a point in time.

We look for a similar focus in the management teams that run the companies we invest in. After all, they should be managing the company for the owners—the shareholders—so their interests and those of our clients should be aligned. Executive incentive and remuneration programmes can be instructive. For example, consider incentives based on earnings per share growth. This is something that can be manipulated for short-term gain. In this era of low interest rates and typically strong balance sheets, M&A activity can buy extra earnings with little regard to price and potentially at lower returns. The company management benefits whilst long-term shareholders

DISPLAY 1

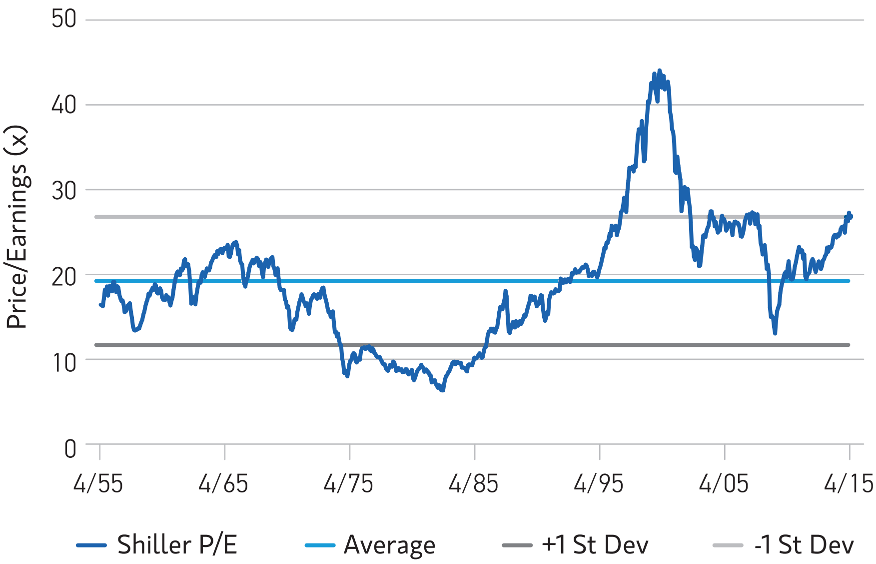
P/E MSCI World Index



Source: FactSet, data as at 30 April 2015.

DISPLAY 2

Schiller P/E



Source: FactSet, data as at 30 April 2015.
Note: Schiller P/E includes S&P 500, Composite Index, Price Earnings, P/E, Ratio - United States.

risk suffering a lower quality business with an impaired compounding profile. Buybacks can achieve the same short term reward. Earnings can rise, but the company might not actually grow. This is pure financial engineering. Another "technique", more typical for consumer businesses, can be cutting advertising and promotion. Again, earnings rise, but long-term the brands that drove the earnings become weaker, resulting in the compounding engine beginning to stall.

We prefer to see management teams focus on return on operating capital employed (ROOCE). We believe this imparts discipline and fosters long-term decision making. ROOCE measures the ratio of operating income (before interest and tax) to the operating capital employed (essentially the property, plant and equipment together with net working capital). This directs management's focus to maintaining and improving the profitability in the P&L, whilst at the same time ensuring that inventory, receivables and payables are managed as efficiently as possible. It also encourages an efficient manufacturing infrastructure, owing to the required focus on property, plant and equipment. Do all of this well and the result is maximising the free cash flow capacity of the business, free cash flow which can be re-invested or returned to shareholders. Indeed, capital allocation is another reason why ROOCE is such a powerful tool when combined with measuring return on investment (ROI). Together these ratios help concentrate management's mind on how best to allocate capital. To maintain or improve returns, they must invest at an equal or higher rate of return than the current business, otherwise the quality of the business is impaired and the use of cash sub-optimal. If they do buy a lower return asset, management must, over time, prove that this acquisition can become as good as, or better than the existing business.

High and sustainable ROOCE is a cornerstone of our definition of quality, together with robust balance sheets and limited capital intensity. Capital intensive, low return businesses struggle to both invest in their growth and throw off surplus cash at the same time. Typically their growth requires balance sheet funding or significantly increased capital expenditure, for example, a utility needing a new power plant, a telecoms company purchasing new spectrum or a gas company laying an extensive distribution network. In the process, they are less able to generate surplus free-cash flow to return to shareholders or to re-invest.

Low return companies generally have lower margins with higher depreciation charges because of their capital intensity, so investing in organic growth through the P&L is that much harder. Their ability to organically compound is relatively lower and their vulnerability in drawdowns is greater owing to lower margins and higher operating leverage.

Companies with sustainably high returns, however, are able to grow and generate surplus free cash flow, rather than grow at the expense of it. Their growth is organic, a product of their relatively significant investments in advertising and promotion as well as through research and development supported by their high margins.

So in this challenging world of rising valuations across all asset classes and sectors, where the risk of draw-downs grows as multiples increase, we believe that acknowledging a little bit of history is a worthwhile lesson. Look for high quality, high return companies that have the potential, owing to their resilient economics and ability to compound, to ride out potential market storms. Seek out companies that are well managed with a focus on maintaining and improving sustainably high returns. Avoid those that, through their inferior economics, their short term focus, or their poor allocation of capital, could present both multiple and earnings risk.

Looking back through time, it's easy to scoff at bubble behaviour, to lament at people paying crazy prices for tulip bulbs or internet ideas, for negative or low real yielding bonds. Humans always want things that seem hard to get, especially if everyone else seems to want them too. It's only afterwards that we stand back, shake our heads and wonder what on earth we were thinking—especially when we didn't even need hindsight to know that a proven alternative exists.

About Morgan Stanley Investment Management

Morgan Stanley Investment Management (MSIM), together with its investment advisory affiliates, has 586 investment professionals around the world and approximately $406 billion in assets under management or supervision as at March 31, 2015. MSIM strives to provide outstanding long-term investment performance, service and a comprehensive suite of investment management solutions to a diverse client base, which includes institutions, governments, corporations and individuals worldwide.

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