Long-Term Conviction in a Short-Term World

By extending an academic study to global equities, we show that high active share portfolios have outperformed. We discuss the importance of maintaining a long-term ownership mindset to focus on high-conviction, bottom-up ideas for client portfolios.

How Do You Measure Conviction?

A manager’s conviction in the thesis underlying each portfolio company is key to long-term outperformance because conviction enables concentrating capital in big ideas. Additionally, conviction reduces the possibility of being shaken out of undervalued ideas based on short-term noise. A helpful tool to measure conviction is active share, which was developed in academia to quantify differentiation from the benchmark through stock selection.

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Key Highlights

Active share

Stock selection versus factor timing

The short-term focus of markets

The benefits of taking a long-term view
What Is Active Share?
Active share was developed in 2006 by professors Martijn Cremers and Antti Petajisto as a simplistic measure of stock selection, calculated as the size of positions that differ from the benchmark as a percentage of the total portfolio. The authors introduced active share to complement tracking error, a measure of systematic risk that measures the volatility of a portfolio not explained by movements in its benchmark.

Their analysis of portfolio data from 1980 to 2003 (later extended to 2009) found that managers have become less active over time. Average active share declined and the proportion of portfolios with high active share above 80% halved since 1980, in part due to the rise of passive index investing.

In contrast, the authors found that the active share of individual portfolios was persistent over time. Moreover, portfolios with the highest active share outperformed their benchmarks annually by an average of 1.13% net of fees. Their analysis concludes, “Funds with the highest active share outperform their benchmarks, while funds with the lowest active share underperform.”

High Active Share Global Equity Portfolios Have Outperformed
Since Cremers and Petajisto focused on U.S. equity portfolios, we recreated the academic study for global equity portfolios to see if the relationship between high active share and outperformance holds true for managers accessing a broader universe.

Consistent with the academic study, we found that global equity portfolios with high active share have outperformed. As of September 30, 2016, global equity portfolios with high active share (over 90%) delivered annualized outperformance of 1.16%, 1.18% and 1.25% net of fees over the three years, five years and since inception. Global equity portfolios with low active share (below 75%) had mixed results over the same respective time periods (Display 1).

![Display 1: Annualized Relative Performance Net of Fees](chart)

Intuitively, the results of our analysis make sense: active managers must invest differently from the benchmark to outperform. The challenge lies in separating the sources of outperformance.

**Stock Selection Can Help Drive Outperformance**

The foundation of modern performance attribution was established by Eugene Fama who in 1972 articulated the conceptual difference between the two ways an investment manager may outperform a benchmark: selectivity and factor timing. Selectivity “measures how well the chosen portfolio did relative to a naively selected portfolio at the same level of risk.” Factor timing, on the other hand, refers to time-varying allocations to systematic risk factors such as size, sector or geography. In simple terms, an equity manager can add value through factor allocation or stock selection (Display 2). Active share seeks to capture the latter.

Market rotations based on factors such as size, sector, geography and value metrics have been shown in several studies to explain short-term performance, typically over time periods under 12 months. Based on our experience, over periods of three years or more, we believe that stock selection drives performance.

**Market Participants Are Increasingly Short-Term**

We believe that the short-termism of market participants creates opportunities for long-term investors willing to extend their time horizon out three to five years. Economies and markets have benefited immeasurably from advancements in technology over the past half century that have boosted productivity and enabled communications that instantly bridge the world. But these benefits have not come without unintended consequences, particularly when we examine the shrinking attention span and time horizon of our financial markets. Consider the following three long-term market trends:

1. THE MACHINES ARE WINNING. The rise of passive investing, algorithmic and high-frequency trading means that the majority of trading volume on the world’s largest stock exchanges is now by machines rather than humans. Programmed trading by definition shorts the time horizon of the market by focusing less on underlying company fundamentals and more on short-term price movements and correlations between securities.

2. BUY-SIDE TENDS TO HOLD STOCKS FOR JUST ONE YEAR. Over time, the composition of equity market participants has shifted to shorter-term investors, such as hedge funds and programmed trading. As a result, the implied average holding period of mutual funds has fallen to less than one year from seven years in 1960. In parallel, the implied average holding period on the NYSE dropped from eight years to one year in 2010 (Display 3).

3. SELL-SIDE ESTIMATES TEND TO FOCUS ON NEXT 2-3 YEARS. Wall Street analysts typically focus on the next quarterly earnings event rather than long-term intrinsic value. The average large-cap company has over 20 published earnings estimates over the next two years, but only three brave souls, on average, publish estimates five years out. The result is greater informational asymmetry for investors able to extend their time horizon and focus on long-term value.

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9 Morningstar.

Concentration in Highest-Conviction Ideas Can Lead to High Active Share

As illustrated in Display 5, one of the primary drivers of high active share is the concentration of global equity fund portfolios in their top 10 holdings. The top right quadrant contains a small minority of funds in which the top 10 holdings account for over 40% of the portfolio. Conversely, funds with less than 20% of the portfolio in the top 10 holdings are associated with lower active share. One potential explanation is the size of the low active share funds. “Closet Indexers,” as labeled by Cremers and Petajisto, refer to large portfolios that invest similarly to their benchmark (Display 6).

Global Opportunity

The MSIF Global Opportunity Portfolio fund has a 95.5 active share - rounding up to 96 different to the benchmark MSCI All Country World Index as of September 30, 2016.

To outperform across equity market cycles, we believe investors must possess long-term conviction despite the short-term myopic focus of participants in the equity markets. Such conviction can only be built upon a foundation of core values.

- **INTELLECTUAL CURIOSITY AND FLEXIBILITY** enable a worldview capable of pursuing a diversity of new ideas.
- **PERSPECTIVE** frees investors from overspecialization and tunnel vision to make objective investment decisions.
- **SELF-AWARENESS** and introspection are crucial tools for learning from mistakes and evolving over time.
- **PARTNERSHIP** builds trust, accountability and a strong sense of ownership.

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**Source:**


These intangibles, while difficult to quantify, establish the culture of an investment team—something far more difficult to replicate than performance outcomes. We invest significant time and resources in our investment team to build a partnership culture and align incentives with client interests by linking pay with three-year performance.

In stark contrast, the investment management industry has embraced statistical concepts developed in academia that seek to measure the skill of investment managers by using quantitative measures of risk. Tracking error, attribution analysis and other measures in common use add to the mosaic of information available to asset allocators attempting to differentiate between investment managers in competition for scarce assets. However, each of these measures is based on historical performance and therefore can only provide limited insight into manager skill, selectivity or future outcomes. Rather than rely on the industry axiom past performance is no guarantee of future results, we prefer the words of ice hockey legend Wayne Gretzky: “I skate to where the puck is going to be, not where it has been.”

**Long-Term Ownership Mindset**

Investing as long-term owners allows us to concentrate capital in our highest-conviction ideas for typical holding periods of three to five years. As of September 30, 2016, the top 10 holdings of MSIF Global Opportunity Portfolio represented over half of the portfolio with an average holding period of over five years (Display 7).

We believe that by applying a price discipline to investments in high-quality companies—strictly defined as those with sustainable competitive advantages and long-term growth that creates value—we can best capture opportunities and manage risk for clients. We view our conviction-based concentration as a source of long-term outperformance.

Our stock selection focuses on finding high-quality companies, developing insights around competitive advantage and uniqueness that can make them successful over time, and having the perspective to...
hold them through short-term disruptions, as long as those disruptions do not affect
the thesis. We typically expect that 75% or more of the value added, over time, will
come from stock selection.

We continue to explore new ideas to further develop our portfolios in line with
our strict criteria for quality and long-term value creation.

### DISPLAY 7

**Long-Term Ownership Mindset – Top Ten holdings average over five years**

<table>
<thead>
<tr>
<th>COMPANY</th>
<th>DESCRIPTION</th>
<th>KEY COMPETITIVE STRATEGY</th>
<th>% OF PORTFOLIO</th>
<th>INITIAL PURCHASE</th>
<th>MONTHS HELD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Facebook</td>
<td>Social Network</td>
<td>Network Platform</td>
<td>8.9</td>
<td>03/08/12</td>
<td>54</td>
</tr>
<tr>
<td>Amazon.com</td>
<td>E-commerce</td>
<td>Cost Leadership</td>
<td>6.5</td>
<td>05/30/08</td>
<td>105</td>
</tr>
<tr>
<td>TAL Education</td>
<td>Education Services</td>
<td>Brand Name Focus</td>
<td>6.3</td>
<td>10/23/12</td>
<td>47</td>
</tr>
<tr>
<td>EPAM Systems</td>
<td>Business Services</td>
<td>Cost Focus</td>
<td>5.7</td>
<td>10/14/14</td>
<td>23</td>
</tr>
<tr>
<td>DSV A/S</td>
<td>Freight Forwarding</td>
<td>Cost Focus</td>
<td>5.2</td>
<td>05/30/08</td>
<td>105</td>
</tr>
<tr>
<td>Priceline</td>
<td>Online Travel Agent</td>
<td>Differentiation</td>
<td>5.0</td>
<td>12/23/11</td>
<td>57</td>
</tr>
<tr>
<td>MasterCard</td>
<td>Payment Network</td>
<td>Network Effect</td>
<td>4.1</td>
<td>10/10/08</td>
<td>95</td>
</tr>
<tr>
<td>Visa</td>
<td>Payment Network</td>
<td>Network Effect</td>
<td>4.1</td>
<td>06/16/11</td>
<td>63</td>
</tr>
<tr>
<td>Luxoft</td>
<td>Business Services</td>
<td>Cost Focus</td>
<td>4.0</td>
<td>09/05/13</td>
<td>36</td>
</tr>
<tr>
<td>Cognizant</td>
<td>Business Services</td>
<td>Cost Leadership</td>
<td>3.9</td>
<td>09/17/13</td>
<td>36</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td><strong>53.2</strong></td>
<td></td>
<td><strong>62</strong></td>
</tr>
</tbody>
</table>


### Annualized Performance as of September 30, 2016

<table>
<thead>
<tr>
<th>PRODUCT</th>
<th>INCEPTION DATE</th>
<th>1 YEAR (%)</th>
<th>3 YEAR (%)</th>
<th>5 YEAR (%)</th>
<th>SINCE INCEPTION ANNUALIZED (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>MSIF Global Opportunity Portfolio - Class I (% net of fees)</td>
<td>5/30/08</td>
<td>17.68</td>
<td>16.50</td>
<td>17.57</td>
<td>10.76</td>
</tr>
<tr>
<td>MSCI All Country World Index (%)</td>
<td>–</td>
<td>11.96</td>
<td>5.17</td>
<td>10.63</td>
<td>2.64</td>
</tr>
</tbody>
</table>

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Performance and fund information is as of September 30, 2016, unless otherwise noted. Returns are net of fees and assume the reinvestment of all dividends and income. Returns for less than one year are cumulative (not annualized). Performance of other share classes will vary.

Please keep in mind that double-digit returns are highly unusual and cannot be sustained. Investors should also be aware that these returns were primarily achieved during favorable market conditions.

The gross expense ratio is 1.20% for Class I shares and the net expense ratio is 0.81%. Where the net expense ratio is lower than the gross expense ratio, certain fees have been waived and/or expenses reimbursed. These waivers and/or reimbursements will continue for at least one year from the date of the applicable fund’s current prospectus (unless otherwise noted in the applicable prospectus) or until such time as the fund’s Board of Directors acts to discontinue all or a portion of such waivers and/or reimbursements. Absent such waivers and/or reimbursements, returns would have been lower. Expenses are based on the fund’s current prospectus. The minimum initial investment is $5,000,000 for Class I shares.

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15 The information provided is that of the MSIF Global Opportunity Portfolio. The typical active share, number of holdings and other information provided represent typical ranges and are not a maximum number. The portfolio may exceed these from time to time due to market conditions and outstanding trades.
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