Morgan Stanley

INVESTMENT MANAGEMENT

How Flexible is Your Approach?

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There's an old golf joke:

A con artist and his 800-pound gorilla convince an unsuspecting golfer into $1,000 bet that he can't beat the gorilla in a round of golf. The confident golfer accepts the bet — and then stares in disbelief as the gorilla hits a 420 yard drive six inches from the pin on the first hole.

The con artist chuckles and says, "I told you, this gorilla can golf. Look, you seem like a nice guy. Give me $500 and I'll call the bet off." The relieved golfer accepts and agrees to finish the round for fun.

As they walk up the first fairway, the golfer asks, "By the way, how does the gorilla putt?"

The con artist responds, "Same as he drives. Straight as an arrow — and 400 yards!"

As every golfer knows, you can't hit every shot the same way. Woods are often used from the tee box, irons in the fairway, wedges from the sand, putters on the green. But what if your ball is sitting in the high rough three feet off the green? Some golfers will use a wedge, others a hooded seven iron and others still a putter depending on a number of variables: the height and thickness of the rough, the pitch and speed of the green and the weather, among others.

The point is that the best golfers have to be flexible and experienced enough to be able to hit any of these shots (and others) depending on any number of factors. We think the same holds true for portfolio managers and their approach to managing money.

A disciplined approach

Research shows that over the past 20 years, broad market factors have driven about 65% of a global equity manager's relative returns, with stock selection accounting for the remaining 35%.

Understanding that portfolio positioning has been responsible for the majority of returns, Applied Equity Advisors uses a flexible, yet disciplined, process powered by two engines. The first engine is the team's proprietary Factor Timing Engine, designed to determine positioning with regard to broad market factors, and the second being our Stock Selection Engine. In selecting stocks, Applied Equity Advisors seeks to choose those companies they wish to hold in the portfolio that can achieve the desired factor positioning from a style and regional perspective.

Applied Equity Advisors believes that the flexibility to intelligently position the portfolio, tilting toward or away from a certain style or region, depending on what the equity markets are favoring, is a critical differentiator in how we approach money management.

The importance of style flexibility

Imagine a second shot on a long par four, facing a headwind and water hazard directly in front of the green. Is it better to "go for it" and hit a five wood to the green or lay-up with five iron? The answer of course is "it depends", based on any number of factors, but great golfers are flexible and experienced enough to hit either effectively. Similarly, a good investment manager needs to be able to effectively "hit" on more than a single type of stock.

Managers who are blindly beholden to only growth or only value will ultimately suffer when their style is out of favor. If you look over the past twenty calendar years (1999-2018), growth stocks have outperformed value stocks in nine of those years, with an average outperformance of +11.26%. Similarly, value stocks have outperformed growth stocks in the other eleven, generating an average outperformance of +8.78% *(Display 2)*.

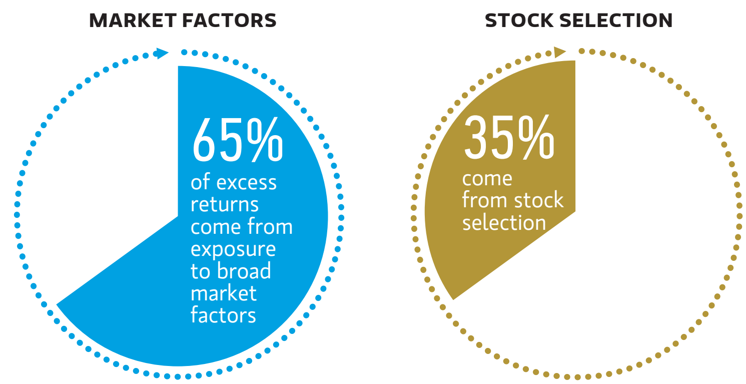
Clearly, being constrained by a robotic adherence to either growth or value stocks forces a manager to miss out on some significant return opportunities. Yet with a more flexible approach, the manager has the ability to adjust the portfolio to better capture the opportunity that the market is offering.

There is no substitute for experience

Every golfer knows that the more you play the "tough 12th hole" at the local course, the better you will shoot. While our investment process is based on the premise that having the flexibility to not be constrained by style can lead to improved performance, experience is a critical

DISPLAY 1

Two ways to extract excess return[1]



DISPLAY 2

Style flexibility matters[2]

	RUSSELL 1000 GROWTH	RUSSELL 1000 VALUE	GROWTH BEATS VALUE	VALUE BEATS GROWTH
1999	33.16	-1.49	34.65	
2000	-22.42	7.01		29.43
2001	-20.42	-5.59		14.83
2002	-27.88	-15.52		12.36
2003	29.75	30.03		0.28
2004	6.30	16.49		10.19
2005	5.26	7.05		1.79
2006	9.07	22.25		13.18
2007	11.81	-0.17	11.98	
2008	-38.44	-36.85		1.59

	RUSSELL 1000 GROWTH	RUSSELL 1000 VALUE	GROWTH BEATS VALUE	VALUE BEATS GROWTH
2009	37.21	19.69	17.52	
2010	16.71	15.51	1.20	
2011	2.64	0.39	2.25	
2012	15.26	17.51		2.25
2013	33.48	32.53	0.95	
2014	13.05	13.45		0.40
2015	5.67	-3.83	9.50	
2016	7.08	17.34		10.26
2017	30.21	13.66	16.55	
2018	-1.51	-8.27	6.76	

Average when growth outperforms value: +11.26%
Average when value outperforms growth: +8.78%

[1] Rolling 18-month R-squared for Global Equity Managers Time Series Regression. Information as of December 31, 2015. Returns are net-of-fees based on mutual fund NAVs. **Past performance is not indicative of future results.** For illustrative purposes only and not meant to depict the performance of a specific investment. Source: Morningstar, 2015

[2] The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See Disclosure section for index definitions.

factor needed to make the process work. Applied Equity Advisors' Factor Timing Engine is built to examine important market factors: Quality, Value, Growth, Momentum and Risk. But we believe it is the understanding of the nature of the signals, including the strength, valuation relative to past history and factor crowding that provides us the information necessary to make a decision, much like choosing which club and strategy to use on a particularly tricky hole. Similar to comparing a seasoned professional golfer to the weekend warrior, it is the combined decades of experience in interpreting these signals that sets our team and process apart from those with less experience.

The 19th Hole

In summary, great golfers and portfolio managers need both flexibility in their approach, and experience. Like our fictional gorilla, the best golfers must be able to hit long, straight drives off the tee. But they won't survive long on the tour if that's their only shot. They also need to be able to navigate doglegs with a combination of draws and fades, and be able to hit the ball lower when playing into the wind. They need a flexible approach, and only become better with practice and experience.

We believe the same is true of investment managers. We believe that the best managers are the ones who are experienced and flexible enough to "hit" alpha given any range of broad market factors, and as importantly, select stocks without being constrained by a style box. We believe the end result gives investors the potential to "break par."

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