Performance Review

In the one month period ending 31 October 2020, the Fund’s I ACC shares returned -5.19% (net of fees)\(^1\), while the benchmark returned -3.08%.

Year-to-date, the portfolio is slightly ahead of the MSCI World Index, returning 3.83% versus 1.00% for the benchmark.

The portfolio underperformed the index in October due to both sector allocation and stock selection. The underweight in communication services and overweight in consumer staples caused a drag on performance, not helped by the underweight in financials and overweight in health care and information technology. Strong stock selection in health care wasn’t enough to counterbalance underperformance from stock selection in information technology, consumer staples, industrials and financials.

The greatest contributors to absolute performance for the month were ADP (+46 basis points [bps]), Danaher (+27 bps) and Thermo Fisher (+24 bps). In the same period, the greatest absolute detractors were SAP (-140 bps), Reckitt Benckiser (-89 bps) and Visa (-48 bps).

The largest detractor from performance during the month was SAP, whose third quarter results postponed its 2023 targets to 2025, with flat earnings forecast due to delayed revenue recognition. The reset is a strategic decision to switch clients to a cloud subscription model as clients accelerate their move to hyperscale hosting services. After meeting management, we are comfortable that SAP’s strategy to invest in its organic business and not pursue further acquisitions is the right one, and the share price is relatively attractively valued against a backdrop of management still needing to execute on their strategy.

Market Review

The MSCI World Index declined by 3% in both U.S. dollars (USD) and in local currencies during the month of October, as coronavirus concerns resurfaced and new lockdown measures were announced across Europe. The shape of the share price decline differed considerably from that of March’s market slump. Apart from energy, which fell again in October (-5.3%), it was the traditionally more robust information technology (-5.1%), health care (-4.9%) and consumer staples (-3.9%) sectors that suffered most, while utilities (+1.8%), communication services (+1.1%) and financials (-1.2%) performed better. October’s moves, however, only marginally shifted the relative sector performance year-to-date, with information technology (+20.8%) still well ahead, and energy (-48.8%) and financials (-22.6%) still lagging significantly.

In terms of geography, Australia (0.0% in USD, +2.1% in local currency), Hong Kong (-1.2%, -1.1%) and Japan (-1.6%, -2.5%) did somewhat better than the MSCI World Index, while Germany (-10.3%, -9.7%), Italy (-6.9%, -6.3%) and the U.K. (-5.0%, -5.1%) lagged. The U.S. slightly outperformed the overall market (-2.6%).

Portfolio Activity

Portfolio activity is reported at quarter end.

Strategy and Outlook

A Value Rally Ahead? Looking in the Rear-View Mirror

After the extraordinary rally in growth stocks over the summer, the question we frequently hear from investors is whether the market will enter a value rally – perhaps not right now, but over the near to medium term.

We do not have strong views about the potential external triggers of such a value rally, be it government intervention, central bank policy, inflation or political change. However, we believe that earnings – or more precisely, cash flows – are ultimately the drivers of a value rally, in particular the predictability of earnings growth. The more predictable the earnings growth for the market as a whole, the more likely we experience a value rally. As historical data shows, the value rallies of 2003-07, 2009-10,\(^1\)


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2012-13 and 2016 occurred when consensus earnings per share growth expectations for the MSCI World Index were closely aligned with actual earnings per share growth.

This should not be much of a surprise. A value stock is one that is cheap relative to its near-term intrinsic value. The intrinsic value of a company is a function of its future free cash flows, of which earnings are an important component and hence its ability to pay dividends or reinvest in the business. During periods of predictable earnings, value stocks can be attractive as they often trade at a discount to intrinsic value due to uncertainty caused by cyclical, management or perceived structural issues, for example. In such instances, the gap between price and intrinsic value can be determined fairly easily. When earnings keep disappointing, determining the intrinsic value can become difficult for investors, and the discount for uncertainty deepens.

If we look at the value rally from 2003 to July 2007, the stable "Goldilocks" environment made earnings growth predictable and value stocks outperformed. Similarly, during the 2009-10 recovery period, earnings forecasts for cyclical value stocks were reliable and so investors bought into them.

Since 2010, we have gone through nearly 10 years of near-consistent earnings disappointments, driven not only by negative rates, but also technological disruption and political upheaval – first in the eurozone and then in the U.S.-China relationship. Apart from the very brief periods of 2012-13 and 2016, when temporary relief measures created earnings growth that matched up to forecasts, earnings have disappointed and value stocks underperformed.

What matters very little is the relative valuation of value stocks versus growth stocks. The premium in price-to-earnings terms between growth stocks and value stocks was fairly stable before and during the four main value rallies of the last 20 years. In other words, a value rally is first and foremost an earnings phenomenon, not a valuation phenomenon.

The Picture Emerging in 2020

During the current COVID-19 crisis, we have seen by far the largest underperformance of value versus growth of the last 20 years, even though near-term earnings disappointment is no worse than in 2018, for example. This has left us with the biggest relative valuation gap between value and growth since 2000.

The gap suggests that the market believes that there is more earnings disappointment ahead, i.e. the consensus 35% earnings improvement for the next 12 months will simply not materialise. We do not know whether the market is right, but we are fairly confident that without earnings growth becoming more predictable, there will not be a value rally. And as we have seen in the last 10 years, predictability of earnings is not just a function of economic growth, but also a question of how well companies handle disruption, embrace new technology and – increasingly – how well they deliver on environmental, social and corporate governance matters. In other words, quite a lot of things need to go right for a value rally to happen.

Quality in a Value Rally

This brings us to the next question: how does a quality portfolio behave in a value rally? A quality stock as we define it has first and foremost predictable earnings growth at sustainably high returns. In a period when very few companies have predictable earnings, quality stocks tend to outperform. This is mostly on the back of stronger earnings, but also due to a higher scarcity premium. In a value rally, this scarcity premium goes down. However, the predictable earnings growth should not be affected. Therefore, the absolute risk to a quality portfolio lies in valuation, not in earnings. If we look at historical trends and the relative performance of the Fund, we see that in periods of value rallies (2003-07, 2009-10, 2012-13 and 2016), generally performance lagged in relative terms but was strong in absolute terms.

More recently, we have again seen the portfolio’s earnings profile showing predictability and resilience, even in this unprecedented environment.

Our main concern now is valuation. In the pandemic, companies with predictable earnings profiles have become even scarcer and their valuation premium has gone up. That is particularly true for high growth technology companies and the so-called “COVID winners”.

We believe that there are two ways to lose money: either the earnings go away or the multiple goes away. This makes us wary of high growth/high valuation companies. As a result, the portfolio changes we have undertaken in the last few years have mostly been driven by concerns about valuation rather than earnings growth. We have steadily shifted out of stocks with excessively high valuation into stocks with more realistic valuations. As a consequence of both stronger earnings and our approach to valuation, our portfolio has actually de-rated versus the market. In contrast, most growth portfolios have rerated during the pandemic.

Going forward, we have no visibility on valuations, neither absolute nor relative. Whether the portfolio outperforms in the near and medium term will partly depend on whether or not the market shifts into a world of higher overall earnings predictability. But relative performance is not our objective. We aim to buy stocks with earnings that compound predictably and sustainably...
high returns on operating capital, at acceptable prices. Our goal is to generate absolute rather than relative returns over the long term.

For further information, please contact your Morgan Stanley Investment Management representative.

### FUND FACTS

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<tr>
<th>Launch date</th>
<th>Base currency</th>
<th>Index</th>
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<tbody>
<tr>
<td>03 February 2003</td>
<td>Sterling</td>
<td>MSCI World Net Index</td>
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### INDEX INFORMATION

The **MSCI World Net Index** is a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends. The Index is unmanaged and does not include any expenses, fees or sales charges. It is not possible to invest directly in an index.

The index has been chosen for performance comparison purposes because it is a broad global equity index that represents large and medium sized company performance across developed countries.

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