Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Funds (UK)

Global Brands Fund

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | MONTHLY COMMENTARY | 31 AUGUST 2019

Performance Review

In the one month period ending 31 August 2019, the Fund's I ACC shares returned -0.09% (net of fees)[1], while the benchmark returned -1.51%.

Both sector allocation and stock selection were positive. Our overweight in consumer staples, underweight in financials and zero weight in energy easily outweighed the slight drag caused by zero weights in real estate and utilities. Meanwhile, strong stock selection in information technology and health care made up for underperformance in consumer staples.

Top absolute contributors to performance for the month were Zoetis (+35 basis points [bps]), Unilever (+28 bps) and Pernod Ricard (+27 bps). In the same period, the greatest absolute detractors were Philip Morris International (-98 bps), SAP (-19 bps) and Fox Corporation (-18 bps).

Market Review

August saw the MSCI World Index drop -2.05% in U.S. dollars (USD) and -1.95% in local currency. The sectors that struggled most were energy (-7.4% in USD), financials (-5.2%) and materials (-4.0%). Utilities (+3.2%), real estate (+2.6%) and consumer staples (+1.8%) showed material outperformance in the month.

Regionally, Asia struggled most with Hong Kong (-8.3% in USD/-8.2% local), Singapore (-6.0%/-4.7%) and Australia all down (-4.3%/-2.1%). The U.K. experienced a similar drop (-4.7%/-4.2%). The eurozone delivered -2.5% in USD and -1.4% in local currency. The U.S. (-1.8%) held up comparatively well. Japan outperformed in USD terms (-1.0%) with yen strength flattering local performance of -3.2%.

Portfolio Activity

Portfolio activity is reported at the quarter end.

Strategy and Outlook

Compounding in Health Care

Given our increased weighting in health care, we thought we would share how we think about the sector. In health care companies, as in other sectors, we are ideally looking for high sustainable returns on operating capital and predictable long-term growth.

There is no shortage of health care companies generating high returns on capital. Given the generally non-discretionary nature of the products, on top of structural growth drivers such as ageing populations and improving access to health care in emerging markets, there should also be plenty of companies able to grow in a predictable manner. Health care currently has the second highest return on operating capital employed (ROOCE); it has also grown the fastest and with the lowest drawdown in earnings per share (EPS) over the last 20 years.[2]

While this is an auspicious starting point, inevitably there are some complications, as we discuss in greater detail below.

Patents and generics:

Over half of the MSCI World Health Care Index consists of either pharmaceutical (pharma) or biotech companies where high returns are usually a result of patent protection. A company can generate significant profits on a patented drug for around 10 years, but once this patent expires, sales and profits are generally decimated by generic competition. Without a pipeline of products to replace these lost sales, a company will struggle to grow and its returns will fade. Pharma companies may spend a good proportion of their sales revenues ensuring a productive pipeline, but drug development is a lengthy process and

[1] Source: Morgan Stanley Investment Management Limited. Data as of 31 August 2019.
[2] Source: FactSet, as of 31 August 2019.

inherently unpredictable. While some companies have more productive research and development (R&D) engines than others, it is very hard to assess whether a company that has been productive over the previous 10 years will be productive over the next 10 years.

Single product companies:

The above issue is exaggerated when a company is reliant on a small number of drugs, a problem affecting a large number of pharma companies, particularly high growth biotechs. Unexpected competition or safety issues can have a devastating impact on individual drugs. Without suitable diversification the impact can be disastrous.

Government intervention:

Drug prices are a hugely controversial topic, most notably in the U.S. For years politicians have tried to find a way to bring prices down to levels seen elsewhere in the world, with very limited success. We are of the view that without moving to a prohibitively expensive single-payer system it is difficult to achieve anything dramatic. Nonetheless, selling drugs in the U.S. is not getting any easier. We anticipate that a combination of government and private market initiatives will ensure that this continues.

Pricing pressure:

Outside pharma, the patent/pipeline risk is significantly diminished, but other issues exist. Single product companies can still be at risk. Most notably, pricing pressure is often rife. The trouble with pricing pressure is you have to run to stand still. Small changes in price or volume can quickly reduce an acceptable level of organic growth to stall speed, impairing the potential for compounding. We seek companies reasonably immune from pricing pressure or at the very least where the volume/price dynamics are such that we are highly confident in the long-term organic growth outlook.

Cyclicality:

Given the likelihood of predictable recurring revenue streams, we have a strong preference for companies selling consumables rather than potentially cyclical capital equipment, and we keep a close eye on the specific type of consumable that they sell. Some hospital procedures are far more elective than others, and as a result the volume of consumables might be more prone to cyclicality. For example one might expect cosmetic surgery volumes to be more impacted by a recession than those for heart surgery.

Our strategy:

We look to avoid, as much as possible, the pitfalls outlined above while benefitting from the previously mentioned prevalence of high and sustainable ROOCE and predictable growth. As is often the case, we spend most of our time assessing what can threaten the sustainability of returns and the predictability of the growth. As always, we insist on good management and a reasonable valuation.

As one might expect, the pool of companies that meet our strict investment criteria is limited, but it has fortunately expanded over the last few years. Four of our health care holdings in Global Brands have been transformed over recent years by spin-offs. In one case the spin-off was the desirable asset, in the three other cases weaker businesses were spun-off, leaving behind three potentially wonderful companies. Even after this, in one case we patiently waited for a reasonable valuation, another required a change in management to transform the returns, and another one finally became investable after an acquisition improved the level of diversification within one of its businesses.

To avoid being too abstract, below are some examples of industries where we have found great businesses:

Animal health – selling medicines for animals has all of the virtues of selling conventional pharmaceuticals, such as high returns and predictable growth. Furthermore, the companies can be very well diversified. R&D output is actually much more predictable than in conventional pharma, but the biggest advantage is that there is very limited exposure to patent expiries and generics – crucially this seems likely to remain the case.

Diagnostics – these businesses sell large bits of equipment to perform diagnostic tests of various kinds. The equipment costs relatively little for customers, meaning there is limited scope to compete on price. The profitability comes from the consumables required for each test, which are generally supplied on long-term contracts, and as a result is highly predictable. Given the importance of the installed base of equipment, market shares also tend to be very stable.

Hospital supplies – selling syringes and intravenous fluids may not sound like great business, but the barriers to entry are very high. The quality of the product and the reliability of supply is absolutely essential to hospitals, and obtaining a reputation for this is very hard to achieve. Without a strong reputation, persuading a hospital to take your product is extremely challenging. In turn, this makes it nearly impossible to achieve the scale required to compete on price.

Governance around product quality and business practice is critical to this industry. Issues such as device safety, drug pricing or the pollution of water systems with antibiotics or other environmental hazards can quickly become reputational, operational and regulatory challenges for health care companies. Our ESG (environmental, social, governance) integrated approach seeks to identify the key risks and opportunities that health care management should be focused on addressing. Increasingly society demands that such organizations operate with a sense of social responsibility and use their R&D, science and technology to address the world's health and hunger needs.

A broad observation is that there is a higher concentration of high quality health care businesses in the U.S. than elsewhere in the world and that they are far more reasonably priced. While we have found great businesses outside the U.S., they are fewer in number and we generally struggle to find valuations that offer an appropriate margin of safety.

Our increased weight in health care reflects that some companies have reached our demanding standards for inclusion. That is, they have the essential characteristics required to generate the high and sustainable returns on operating capital we look for, and in so doing qualify as high quality compounders.

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

FUND FACTS

Launch date	Base currency	Index
03 February 2003	Sterling	MSCI World Net Index

12 Month Performance Periods to Latest Month End (%)

	AUGUST '18 - AUGUST '19	AUGUST '17 - AUGUST '18	AUGUST '16 - AUGUST '17	AUGUST '15 - AUGUST '16	AUGUST '14 - AUGUST '15
OEIC Global Brands Fund - I ACC Shares	20.93	13.98	16.40	32.56	7.30
MSCI World Net Index	7.00	12.13	18.09	25.28	3.52

Past performance is not a reliable indicator of future results. Returns may increase or decrease as a result of currency fluctuations. All performance data is calculated NAV to NAV, net of fees, and does not take account of commissions and costs incurred on the issue and redemption of units. The sources for all performance and Index data is Morgan Stanley Investment Management. **Please visit our website www.morganstanley.com/im to see the latest performance returns for the fund's other share classes.**

Share Class I ACC Risk and Reward Profile

Lower Risk **Higher Risk**

1 2 3 4 **5** 6 7

Potentially Lower Rewards **Potentially Higher Rewards**

The risk and reward category shown is based on historic data.

- Historic figures are only a guide and may not be a reliable indicator of what may happen in the future.
- As such this category may change in the future.
- The higher the category, the greater the potential reward, but also the greater the risk of losing the investment. Category 1 does not indicate a risk free investment.
- The fund is in this category because it invests in company shares and the fund's simulated and/or realised return has experienced high rises and falls historically.
- The fund may be impacted by movements in the exchange rates between the fund's currency and the currencies of the fund's investments.

This rating does not take into account other risk factors which should be considered before investing, these include:

- The fund relies on other parties to fulfill certain services, investments or transactions. If these parties become insolvent, it may expose the fund to financial loss.
- There may be an insufficient number of buyers or sellers which may affect the funds ability to buy or sell securities.
- Investment in China A-Shares via Shanghai-Hong Kong Stock Connect program may also entail additional risks, such as risks linked to the ownership of shares.
- Past performance is not a reliable indicator of future results. Returns may increase or decrease as a result of currency fluctuations. The value of investments and the income from them can go down as well as up and investors may lose all or a substantial portion of his or her investment.
- The value of the investments and the income from them will vary and there can be no assurance that the Fund will achieve its investment objectives.
- Investments may be in a variety of currencies and therefore changes in rates of exchange between currencies may cause the value of investments to decrease or increase. Furthermore, the value of investments may be adversely affected by fluctuations in exchange rates between the investor's reference currency and the base currency of the investments.

Please refer to the Prospectus for full risk disclosures. All data as of 31 August 2019 and subject to change daily.

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 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.

The **MSCI World Health Care Index** is a capitalization weighted index that monitors the performance of health care stocks from developed market countries in North America, Europe and the Asia/Pacific Region. The index includes reinvestment of dividends, net of foreign withholding taxes.

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. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA.

This document contains information relating to the sub-funds ('Funds') of Morgan Stanley Liquidity Funds, a Luxembourg domiciled Société d'Investissement à Capital Variable. Morgan Stanley Investment Funds (the "Company") is registered in the Grand Duchy of Luxembourg as an undertaking for collective investment pursuant to Part 1 of the Law of 17th December 2010, as amended. The Company is an Undertaking for Collective Investment in Transferable Securities ("UCITS").

Applications for shares in the Fund should not be made without first consulting the current Prospectus, Key Investor Information Document ("KIID"), Annual Report and Semi-Annual Report ("Offering Documents"), or other documents available in your local jurisdiction which is available free of charge from the Registered Office: European Bank and Business Centre, 6B route de Trèves, L-2633 Senningerberg, R.C.S. Luxemburg B 29 192.

Any index referred to herein is the intellectual property (including registered trademarks) of the applicable licensor. Any product based on an index is in no way sponsored, endorsed, sold or promoted by the applicable licensor and it shall not have any liability with respect thereto.

The views and opinions expressed are those of the portfolio management team at the time of writing/of this presentation and are subject to change at any time due to market, economic, or other conditions, and may not necessarily come to pass. These comments are not representative of the opinions and views of the firm as a whole. Holdings, countries and sectors/ region weightings are subject to change daily. All information provided is for informational purposes only and should not be deemed as a recommendation to buy or sell securities in the sectors and regions referenced. Information regarding expected market returns and market outlook is based on the research, analysis, and opinions of the team. These conclusions are speculative in nature, may not come to pass, and are not intended to predict the future of any specific Morgan Stanley Investment Management investment. Past performance is no guarantee of future results.

All investments involve risks, including the possible loss of principal. The material contained herein has not been based on a consideration of any individual client 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.

The information contained in this communication is not a research recommendation or 'investment research' and is classified as a 'Marketing Communication' in accordance with the applicable European or Swiss regulation. This means that this marketing communication (a) has not been prepared in accordance with legal requirements designed to promote the independence of investment research (b) is not subject to any prohibition on dealing ahead of the dissemination of investment research.

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. MSIM shall not be liable for, and accepts no liability for, the use or misuse of this document by any such financial intermediary. If you are a distributor of the Morgan Stanley Investment Funds, some or all of the funds or shares in individual funds may be available for distribution. Please refer to your sub-distribution agreement for these details before forwarding fund information to your clients.

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.

This document may be translated into other languages. Where such a translation is made this English version remains definitive. If there are any discrepancies between the English version and any version of this document in another language, the English version shall prevail.