Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Funds (UK)

Global Sustain Fund

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | MONTHLY COMMENTARY | 30 SEPTEMBER 2020

Performance Review

In the one month period ending 30 September 2020, the Fund's I ACC shares returned 0.17% (net of fees)[1], while the benchmark returned 0.00%.

For the third quarter (Q3), the portfolio returned 3.63% (net of fees) versus 3.15% for the MSCI World Index. Year-to-date (YTD), the portfolio is still comfortably ahead of the MSCI World Index, returning 11.75% (net of fees) versus 4.22% for the benchmark.

The portfolio slightly outperformed the index in September, mainly due to sector allocation. The overweight in consumer staples and health care, along with the lack of energy stocks, were the main positives for sector allocation. Stock selection was a touch positive, thanks to the outperformance in consumer staples and consumer discretionary.

For Q3 as a whole, the portfolio was slightly ahead of the index. Sector allocation was marginally positive. The overweight in information technology, the lack of energy stocks and the underweight in financials all helped, while the underweights in consumer discretionary and industrials hindered, as did the overweight in health care. In terms of stock selection, the outperformance in health care and consumer staples was outweighed by the underperformance in information technology and industrials.

The largest contributors to absolute performance in the quarter were TSMC (+55 basis points [bps]), Danaher (+49 bps) and Procter & Gamble (+48 bps). The major detractors in the same period were Baxter (-46 bps), Automatic Data Processing (-28 bps) and Becton Dickinson (-27 bps).

Market Review

The MSCI World Index ended September down 3.4% in U.S. dollars (USD), and down a very similar 2.9% in local currencies. Energy was the clear laggard, off 14% in the month and 46% YTD. The other sectors were more tightly bunched, with the defensive consumer staples, health care and utilities all down only 1%, along with materials and industrials. Financials were down 6%, while all the other sectors were within 2% of the overall index. Japan was the only major geography that was up in September (+1% in USD, +0% in yen), while Switzerland (-1% USD, +0% local), Sweden (-1%, +3%) and the Netherlands (-1%, +1%) were also ahead of the index. At the other end of the spectrum were Norway (-8%, -1%), affected by oil, and Australia (-7%, -4%), Italy and Spain (both -6%, -4%). The U.S. (-4%) was a touch behind the MSCI World Index.

For Q3 as a whole, the MSCI World Index was up 7.9% in USD and 6.7% in local currencies, making a 27% rise over the last six months since the end of March. Unsurprisingly, in a strong quarter, the cyclical sectors tended to do best, with consumer discretionary up 16% (including automobiles, +28%), while materials, industrials and information technology were all up 12%. Within information technology, hardware was up 19%, while software & IT services were only up 8%. The cyclical exceptions were energy, down 16%, and financials, only up 2%. On the defensive side, consumer staples (+8%) was in line with the market, while health care and utilities (both +5%) were moderately behind. In terms of geography, Sweden (up 15% in USD, 10% in local currency) was the strongest market, perhaps rewarded for its avoidance of a lockdown, while the U.S. (+10%) was also ahead of the index. The main laggards came from the periphery of Europe, namely Spain (-4% in USD, -8% local), the U.K. (-0%, -5%) and Italy (+1%, -3%), or from Asia, in the case of Singapore (-1%, -3%) and Hong Kong (+2%, +2%).

Portfolio Activity

Overall, it was a fairly quiet quarter for portfolio activity.

We initiated a position in Intercontinental Exchange (ICE). As a leading exchange group, it has strong barriers to entry in its diverse collection of businesses. It benefits from network effects in its trading and clearing venues, particularly in derivatives, brands (notably the New York Stock Exchange) and valuable data sets in fixed income. As a result, ICE has a 100% return on

[1] Source: Morgan Stanley Investment Management Limited. Data as of 30 September 2020.

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operating capital employed, with half of its revenue recurring and the other half spread across a wide range of products and asset classes. It is acquisitive, most recently buying Ellie Mae in the mortgage industry, but it has a proven record of making deals work. Despite the strong history of organic growth, it was trading at a 21x 2021 price-earnings ratio and a near 5% free cash flow yield at the time of purchase.

The source of funds for buying ICE was reducing some of the more expensive names, such as Microsoft, Accenture and Zoetis. This fits with the pattern over the last three years of managing valuation risk in the portfolio. In addition, we reduced Alphabet due to our concerns about the potential regulatory anti-trust and privacy pressures.

Strategy and Outlook

Why Isn't the Market Paying for Compounders' Resilience?

Compounders do compound better

The key to compounders is that they grow, or "compound", earnings better than "average" companies across cycles, largely because their earnings hold up better in tough times … such as 2020. The portfolio's forward earnings are flat YTD, versus a 15% fall for the MSCI World Index as a whole.[2]

Mystery is the lack of a larger premium

Merely growing earnings faster at high returns is not enough to outperform; it also depends on the starting valuation – after all, growth stocks are well known for trading at a premium in anticipation of the faster progress in earnings. The sustained outperformance of compounders over decades implies that the market does not give them enough of a premium to make up for the stronger cross-cycle earnings growth, an anomaly that we would argue continues up to the present day.

It should not be a mystery that sustaining high returns on capital should drive superior earnings growth over time, as the combination of pricing power and recurring revenues at low capital intensity is a naturally attractive one. Compounders are also generally pretty well-known and well-researched companies, in contrast to mysterious small caps, for example. In our view, the success of the sub-asset class of compounders is best explained as a failure, or rather failures, of the market as a whole. We believe these failures are driven by measuring the wrong things, namely short-term relative performance and forward price-earnings multiples.

The industry structure pushes focus on to relative performance

The first measuring failure is driven by the industry structure. There are generally multiple parties in the investment value chain, which, for instance, can go from the board of a corporate with a pension scheme, to the professional pension fund staff at the corporate, to the consultant to the pension scheme and the portfolio managers. In addition, the skill of participants in the chain is very difficult to measure, even if all such participants remained in place unchanged over the measurement period, as style and idiosyncratic factors can be significant contributors to performance in the short and medium term.

As a result, the industry ends up with a focus on relative performance, and fairly short-term performance at that, as participants all along the chain try to justify the value they are bringing and ultimately seek to avoid being fired. This leads to "relative" risk-averse behaviour, with participants having limited risk budgets built around tracking error, rather than focusing on the absolute risk – the risk of losing money. Given these incentives, strategies that have high relative risk, or tracking error, but low absolute risk may be neglected, particularly, as in the case of compounders, where the outperformance can be episodic and concentrated on periods of market turbulence, with more ordinary performance, at least in relative terms, during the periods between the crises.

Price-earnings ratios can be deceptive

The second measuring error is focusing on forward price-earnings measures. These are flawed for a host of reasons. We like to refer to the earnings part as "guesses about lies". Guesses because the forward estimates are systematically too optimistic. Actual earnings disappoint by an average of 8% one year forward and 15% two years forward.[2] The lies come from the fact that these are adjusted earnings, or as we prefer to call them, earnings "before the bad stuff", be it write-offs or paying staff with shares. Over the last five years (2015-19), 15% of MSCI World adjusted profits – the measure used for consensus and often for paying management – have disappeared before reaching the ultimate profit number at the bottom of the profit and loss (P&L) statement.[2] That is $1.7 trillion vanishing over the five-year period.[2]

Combine the guess and lie elements, and forward earnings estimates two years out are likely to be 30% too high on average, and thus the notional multiples 40% too low.[2] High quality companies are less likely to disappoint on both grounds, having more predictable earnings, as shown this year, and less of a tendency to be hit by below-the-line write-offs; not least because their intangible assets are not as likely to be on the balance sheet as the tangible assets owned by other companies, be they factories or oil reserves, because the intangible assets are built through the P&L rather than capital expenditure.

The preceding points suggest that the wrong earnings number is being used, but that is not the only issue. Using the multiple of earnings is problematic, even if the right earnings number is used. The two concerns are leverage and cash conversion. We prefer to look at the multiple on an unlevered basis as well, comparing the enterprise value (EV), which is the market value of the equity plus the value of the debt, with the net operating profit after tax (NOPAT), which is the earnings of the company if it

[2] Source: FactSet, September 2020.

had no debt, i.e. adding the interest cost back. Looking at EV/NOPAT removes the benefit of juicing of earnings through leverage, and as a result, leveraged companies, quite rightly, will look more expensive.

We also like to focus on the free cash flow, with free cash flow yield and discounted cash flow mutually cross-checked. Our focus on cash is a natural one, as earnings (an accounting measure) do not actually deliver anything. Cash is required to invest in the future, pay dividends, execute buy-backs or acquire other companies. Having a higher return on operating capital also means that more of the earnings actually turn into cash, as capital expenditure and working capital requirements do not soak it up. High operating returns also mean that there is less need for leverage to get to a respectable return on equity; this is in contrast with utilities, which have an average 8% return on operating capital, or banks, where it is often below 1% for unlevered returns.[2]

On an adjusted basis, the portfolio's premium to the market is very low

Adjusting for leverage and cash conversion is useful when comparing valuations of potential investments for the portfolio, but it also suggests that compounders are cheaper than the simple price-earnings data suggests. The portfolio currently trades on a 20% premium to MSCI World on the next 12 months forward earnings.[2] Shifting to EV/NOPAT takes 5% off this premium, and the move to cash 5%, meaning that only half, or 10%, of the 20% premium is left, even if you accept the "guesses about lies" produced by the analyst community as discussed earlier.[2] This does not seem like a high enough premium at any time, given the far higher quality and track record of compounding earnings. It seems even less sufficient at present given the myriad economic and geopolitical uncertainties. In a very fragile world, anti-fragile companies such as the compounders we own definitely have their attractions.

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

FUND FACTS

Launch date	Base currency	Index
23 September 2019	Sterling	MSCI World Net Index

12 Month Performance Periods to Latest Month End (%)

	SEPTEMBER '19 - SEPTEMBER '20	SEPTEMBER '18 - SEPTEMBER '19	SEPTEMBER '17 - SEPTEMBER '18	SEPTEMBER '16 - SEPTEMBER '17	SEPTEMBER '15 - SEPTEMBER '16
OEIC Global Sustain Fund - I ACC Shares	12.49	--	--	--	--
MSCI World Net Index	5.24	--	--	--	--

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.**

[2] Source: FactSet, September 2020.

Share Class I ACC Risk and Reward Profile

Lower Risk **Higher Risk**

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 30 September 2020 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 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.

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Applications for shares in Morgan Stanley Funds (UK) 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 are available free of charge from the Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA.

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