Morgan Stanley

INVESTMENT MANAGEMENT

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Morgan Stanley Investment Funds

Global Brands Equity Income Fund

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | MONTHLY COMMENTARY | 30 NOVEMBER 2018

Performance Review

In the one month period ending 30 November 2018, the Fund's Z shares returned 2.64% (net of fees)[1], while the benchmark returned 1.14%.

For the year-to-date, the portfolio is well ahead of the MSCI World Index, returning 3.07% versus -1.20% for the benchmark.

As of 30 September 2018, the Fund had produced a distributed yield of 4.19% over the previous four quarters.

The portfolio outperformed in November due to stock selection, as the sector allocation was roughly neutral, with the benefit of the zero weight in energy balanced by the drag from the information technology overweight. Stock selection was positive, with outperformance in the information technology, communication services and health care sectors comfortably outweighing the underperformance in consumer staples. The overwrite (sale of index call options) contributed to performance for the month (+2 basis points [bps]).

The largest contributors to absolute performance in the month were Twenty-First Century Fox (+56 bps), Baxter International (+31 bps) and Danaher (+31 bps). The major detractors were British American Tobacco (-73 bps), Altria (-34 bps) and SAP (-17 bps).

Market Review

The MSCI World Index rose 1.1% (+1.2% in local currencies) in November during what was a volatile month. From its peak on 8 November to its trough on 20 November, the index fell 5% before staging a recovery as the month ended. Defensive and interest rate sensitive sectors performed well, as the U.S. 10-year Treasury yield fell back to 3%, with health care and real estate both up 5%, and utilities up 3%. Consumer staples (+1%) was also a fraction ahead of the index, despite the fall in tobacco (-11%). The resource sectors lagged, with energy down 4% and materials falling 1%. Information technology (IT) was down 2%, mainly due to the travails of Apple rather than any weakness in the software & IT services sub-sector, the sub-sector we focus on, which was actually up 1%.

The geographic variation was less clear cut, other than the strong performance in Asia, with Hong Kong (+7%) and Singapore (+3%) leading the way. The USA (+2%) was a little ahead of the MSCI World Index for the month. The Netherlands gained 3%, Spain increased 2% and Italy was up 1%, but the other European markets were generally down, with Germany, France and the U.K. all off 2%. Japan, Australia and Canada were all roughly flat.

Portfolio Activity

Portfolio activity is reported at quarter end.

Strategy and Outlook

In Praise of Tortoises…and Compounders

In Aesop's original fable, the Tortoise took on the Hare. The Hare's raw pace took it into a substantial lead, but a complacent nap meant that the Tortoise plodded past to victory. The investment variant of the fable is somewhat different. Once again, the Hare races off into an early lead and is presumably awarded an eye-wateringly steep multiple by the market. Sadly, the flying four-legged fur-ball is likely to come to an unfortunate end, picked off by a farmer or some other predator, frozen to death in a cold recession or just running around in frenzied circles. Meanwhile, the Tortoise just trundles along steadily, perhaps pulling its head in when times get tough.

The tortoise is not a perfect analogy for a compounder, as we like to think of the companies we own as somewhat more dynamic than the sluggish shell-bearing reptile. Nevertheless, the secret of compounding lies in steady modest growth, at

1 Source: Morgan Stanley Investment Management Limited. Data as of 30 November 2018.

sustained high returns. A company growing at, say, 4% a year, adding another 1% to earnings growth from incrementally improving margins, combined with a free cash flow yield of around 5% should compound at close to 10% over time. This would not only provide an excellent absolute return, doubling one's capital every seven years, but it is unlikely to be matched by lower quality companies, as bad things happen to bad companies at bad times… as many hares discover sooner or later. Slow and steady wins the long-term race in the markets as well. The problem is that these compounders are very rare beasts, and rather tougher to pick out than tortoises, so here's a spotters guide.

What is the essence of a compounder?

At the core of the compounder are powerful and hard to replicate intangible assets, notably brands or networks. These help deliver pricing power. Compounders have decent growth prospects together with predictable sales, often driven by recurring revenues. Crucially, management must be shareholder friendly. Being careful stewards of capital and investing sufficiently in innovation and advertising to help perpetuate the franchises are essential management hallmarks.

Where is the compounder found?

It is easier to describe where the compounder will not be found; banks, utilities, telecoms (even if rebranded as communication services), miners and energy companies are all low-return, cyclical price-takers and thus unable to compound. The two richest hunting grounds for compounders are consumer staples and the software & IT services sub-sector of information technology, effectively 'the brands consumers choose, the software and services businesses need and the networks people trust'. Our commentaries from May and June 2017, 'Information Technology – Winners and Losers' and 'Amazonians at the Gate', discuss what the team looks for in these two sectors.

What do the compounder's financials look like?

They possess powerful intangible assets to drive high returns on operating capital, plus demonstrate robust, steadily growing earnings, even in tough times, as pricing power and recurring revenues protect the fat gross margins and stable sales, respectively. The high returns on operating capital help drive strong free cash flow generation, as earnings actually turn into cash. Finally, we prefer to see cash flowing back to shareholders, rather than wasted on poor acquisitions, and a balance sheet that is robust for the long-run, rather than 'efficient' for the short-run.

What is the main challenge in deciding whether a company is a compounder?

It is easy to tell whether a company is profitable today and whether it has compounded in the past. The challenge is to work out whether this will continue or whether the high returns and growth will fade. The first step is to work out why the company has high returns, i.e., what the key intangible assets are. Having done that, the crucial analysis is around the myriad threats to those assets, be they fashion, technology, environmental or social issues. Even if the conclusion is that the returns are likely to stay high or even improve and the growth should be steady, the governance side needs checking, as management can easily foil compounding, either by underinvestment in search of short-term profits or by poor allocation of capital. Meeting management and understanding their incentives can help mitigate the risks of poor management, but as in all human endeavours, it is far from fool-proof.

Can tobacco companies still compound?

The key asset of the tobacco industry has been pricing power. An addictive product, a concentrated industry and steadily rising taxes that make up most of the purchase price have all combined to drive circa 5% per year pricing. As such, the price rises have more than made up for the impact of the tightening regulatory environment over the last 50 years. Our view, for now at least, is that the recent regulatory noises in the U.S. around reducing nicotine in combustible cigarettes and banning menthol are not a break with this long-term pattern, as any implementation is likely to take a long while, if it occurs at all.

What has changed is the introduction of new technology, the 'next generation products', be they vaping or 'heat not burn'. While this change may embolden regulators to take firmer action against traditional combustible cigarettes, given the availability of alternative nicotine delivery systems, the main impact is on competitive dynamics. The new products can upset the historically stable market shares, be it Philip Morris International taking 16% of the Japanese market with IQOS or JUUL's vaping product threatening the U.S. incumbents. Our belief is that those with good next generation products should gain share and therefore can compound, but that other players cannot. As a result, the investible universe within tobacco has shrunk, meaning for us that it has fallen to below 10% of the portfolio from its peak of around 25%.

Is this a good time to invest in compounders?

Our view is that compounders are a chronically undervalued asset class thanks to the market's short-term and relative focus. If one is taking a medium- or long-term view, we would argue that it is always a good time to invest in compounders. That said, there is a case that the current late-cycle environment may be particularly favourable, since a compounder's ability to preserve earnings in a downturn may become especially valuable.

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

FUND FACTS

Launch date	Base currency	Index
29 April 2016	U.S. dollars	MSCI World Net Index

12 Month Performance Periods to Latest Month End (%)

	NOVEMBER '17 - NOVEMBER '18	NOVEMBER '16 - NOVEMBER '17	NOVEMBER '15 - NOVEMBER '16	NOVEMBER '14 - NOVEMBER '15	NOVEMBER '13 - NOVEMBER '14
MS INVF Global Brands Equity Income Fund - Z Shares	5.42	22.00	--	--	--
MSCI World Net Index	0.14	23.66	--	--	--

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 Z 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 value of financial derivative instruments are highly sensitive and may result in losses in excess of the amount invested by the Sub-Fund.
- 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 and Shenzhen-Hong Kong Stock Connect programs may also entail additional risks, such as risks linked to the ownership of shares.
- The derivative strategy aims to increase the income paid to investors, but there is potential for the fund to suffer losses.
- 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 November 2018 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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