Morgan Stanley

INVESTMENT MANAGEMENT

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Morgan Stanley Investment Funds

Global Quality Fund

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | MONTHLY COMMENTARY | 31 DECEMBER 2018

Performance Review

In the one month period ending 31 December 2018, the Fund's Z shares returned -6.44% (net of fees)[1], while the benchmark returned -7.60%.

At the end of December, the portfolio outperformed for the one-month, three-month and year-to-date periods. For the quarter the portfolio delivered -9.94%, outperforming the benchmark, which delivered -13.42%. The portfolio outperformed by 654 basis points (bps) for the full year 2018, returning -2.17% versus the benchmark's -8.71%.

The fourth quarter outperformance was driven by both sector allocation and stock selection. The large overweight in consumer staples was the main cause of the favourable selector allocation, while outperformance in information technology, communication services, industrials and health care comfortably outweighed the effect of underperformance in consumer staples to deliver strong stock selection. The largest contributors for the quarter were Twenty-First Century Fox (+22 bps), Coca-Cola (+7 bps) and Church & Dwight (+6 bps). The largest detractors were Reckitt Benckiser (-108 bps), SAP (-78 bps) and British American Tobacco (-74 bps).

For the year, sector allocation and stock selection were both distinctly positive. Sector allocation mainly benefitted from the underweight in financials and the overweight positions in information technology and health care. Stock selection was helped by outperformance across all the portfolio's main sectors except consumer staples, most notably communication services, information technology, consumer discretionary and health care. Over the year the largest absolute contributors were Twenty First Century Fox (+174 bps), Microsoft (+100 bps) and Nike (+66 bps). The largest detractors were British American Tobacco (-228 bps), Philip Morris International (-114 bps) and Reckitt Benckiser (-87 bps).

Market Review

The markets had been reasonably constructive for the first three quarters of the year, with the MSCI World Index returning around 5% up to the end of September. The final quarter saw a sharp fall, with the MSCI World Index down 13.3% in U.S. dollar (USD) terms, and a very similar 13.0% in local currency. Unsurprisingly, it was the more defensive sectors that outperformed in the fourth quarter, with utilities actually up 1%, consumer staples down 'only' 7% and health care dropping 9%. By contrast, the more cyclical energy fell 21% and industrials dropped 16%. Information technology's bull run came to a juddering halt, as it gave up 18% in the quarter. There was less of a contrast between geographies. The USA (-14%) was marginally behind the overall index, while Hong Kong (-4%) and Singapore (-7%) held up best.

The fall in the fourth quarter left the MSCI World Index down 8.2% for the year in USD (-6.9% in local currency). Defensives were the relative winners for 2018 as a whole, with health care and utilities actually up 3%, though consumer staples (-9%) lagged the market a touch, not helped by tobacco (-35%). Information technology was down only 2% for the year, despite its torrid fourth quarter, while the cyclical materials, financials, energy and industrials all struggled, falling 14% to 17%. The USA was the clear geographic outperformer, down 4%, while much of Europe lagged, most notably Germany (-22% in USD, -18% in euros).

Portfolio Activity

The fourth quarter was a relatively quiet quarter for the portfolio, with no final exits and only one new buy – IPG Photonics. IPG is the leading fibre laser source manufacturer, with a 70% market share. Lasers are likely to continue to gain share within the machine tool market and fibre should win within laser versus other technologies. IPG is supported by its vertical integration, overall low cost production and leadership in the growing ultra-high power market. While there is a cyclical slow-down in the company's end markets, reflected in the sell-off in the stock, our thesis is that IPG Photonics will see continued and significant structural growth from the adoption of its fibre lasers over the medium term.

1 Source: Morgan Stanley Investment Management Limited. Data as of 31 December 2018.

For the year as a whole, the bulk of the activity was valuation driven, with profits being taken in consumer discretionary (2018 net sales circa 450 bps, notably reductions in Nike and Booking.com), information technology (c.300 bps – reducing Accenture and Microsoft while selling Intuit) and communication services (c.300 bps, mainly selling Disney). The recipients of the funds were consumer staples (net adds c.700 bps, particularly adding to Reckitt Benckiser, along with buying Heineken and Henkel) and health care (net adds c.450 bps). Within health care, the focus was on medtech names, buying Baxter International, Abbott Laboratories and Becton Dickinson, at the expense of pharmaceuticals (selling Novartis and Roche), given their exposure to potential fading returns as drugs come off patent.

Strategy and Outlook

Multiples are down, risks are not

The good news about equities is that there are only two ways to lose money – falling earnings or falling multiples. A year ago, it was the multiples that worried us most. After the markets' bull run in 2017, the MSCI World Index passed 17x the next 12 months (NTM) earnings,[2] implying that markets were pricing in the improbable upside scenario of synchronized growth everywhere… and threatening considerable downside if things did not go quite according to plan. By contrast, 2019 starts with the MSCI World Index on 13.4x forward consensus estimates, 14% lower than the 20-year average price-earnings (P/E) ratio of 15.5x, and 20% below a year ago.[2] As a result our primary fears have moved from multiples to earnings.

Our generic fear about forward earnings estimates remain – the fact that they are guesses about lies. The guesses are because the sell-side is persistently over-optimistic, by an average of 8% one-year forward, slightly higher than the 7% earnings growth expected for the MSCI World Index in 2019.[3] The lies are down to the gaping gap between the 'adjusted' earnings used to power consensus numbers (and management pay) and the actual IFRS/GAAP[4] number at the bottom of the profit & loss statement. Over the last three years $600 billion has disappeared between the adjusted and actual earnings totals in the U.S. alone, overstating earnings there by an average of 21%.[3] Our more specific anxiety is fed by the fact that it is only on the leveraged earnings metric that markets look cheap. Looking at forward enterprise value (EV)/EBITDA[5] rather than P/E, the discount to the historic average disappears, and the market is on a slightly higher multiple (9.2x versus 9.0x) than it was in 2003, when the P/E ratio was at a lofty 17.6x.[2] Lower corporate taxes have helped, but so has the sharp increase in leverage, of which we discuss further later in the piece. Looking at EV/sales, the MSCI World Index is 1.8x, still 16% above its 20-year average.[2] The combination of an expensive market on sales with a 'cheap' market on earnings reflects the really high profitability at present, particularly in the U.S., where all the drivers look fairly maxed out in favour of profits at present, be it fat margins, low tax rates, high leverage or low interest rates.

We have no greater insight than anyone else on whether the expected earnings growth for 2019 will be delivered, or even exceeded, but we do have opinions (as usual) on the key variables to watch. The current China slow-down is an earnings risk, particularly for cyclical companies, and the extent (and success) of the gathering reflation is crucial. Even if the reflation does happen, and is successful, earnings could be soft in the first part of the year until it takes effect. As mentioned above, U.S. margins are very high, and while elements of this look structural, given the emergence of lucrative platform businesses and the way the country's political system has systematically advantaged capital against labour and consumers over the last four decades, tight labour markets and tariff impacts may cause margin issues for those without pricing power.

Leaving aside the tail-risks, such as a full trade war, utter paralysis of the U.S. government, Mid-East conflict or a collapse of the euro, one thing that would definitely cause a margin squeeze would be a significant slow-down in the U.S., or a further slow-down in Europe. The U.S. recovery is now very long in the tooth, and while recoveries do not just die of old age, the change at the U.S. Federal Reserve (the Fed) may be an extra cause for concern. It is still early days, but Jay Powell seems more interested in the state of the real economy than the exact level of the equity markets or the fate of anyone outside the U.S. who chooses to hitch their currencies to the U.S. dollar – i.e. emerging markets. He may therefore continue to tighten via a combination of interest rates and unwinding quantitative easing until he sees weakness in the U.S. economy. He will back off at that point, but this may be too late for markets.

2018 has ended with the combined balance sheets of the four major central banks – the Fed, the People's Bank of China, the European Central Bank and the Bank of Japan – finally shrinking after the massive build post the Global Financial Crisis (GFC). This means that the world is now in a liquidity squeeze, combining (depending on the geographic bloc) shrinking central bank balance sheets and tightening interest rates. It is precisely the opposite combination which drove up asset prices (and consequent levering up) since the nadir of 2009.

Our concern is that the combination of potentially falling earnings and a liquidity squeeze could be a truly toxic one for asset prices. We mentioned that we were unclear whether earnings estimates would be met this year, but we are clear that the world is an asymmetric place, with earnings downsides in bad times far higher than the upsides in good times. This is often forgotten, as is the fact that the asymmetry is magnified by leverage – and there is more leverage than ever, particularly in the U.S. corporate debt market. Corporate America as a whole is not inexpert at levering itself up at the wrong time, most

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2 Source: FactSet. Data as of 31 December 2018.
3 Source: FactSet, Morgan Stanley Investment Management. Data as of 31 December 2018.
4 IFRS = International Financial Reporting Standards; GAAP = Generally Accepted Accounting Principles
5 EBITDA = Earnings before interest, taxes, depreciation and amortization

spectacularly, just before the GFC last time round. Given the scale of corporate leverage now and – more particularly –the component of high yield or near-high yield (or as we prefer to call it, given that the interest rates are not that high, junk or near-junk), Corporate America has to be right that earnings will hold up.

We worry in particular about the outlook for near-junk, i.e. BBB. This has been at the epicentre of the build-up of corporate debt, ballooning from $0.7 trillion in October 2008 to the current c. $3 trillion.[2] Moreover, the component of near junk (BBB) and actual junk (BB, B and CCC and below) has increased from 46% of the U.S. corporate bond market in October 2008 to 58% currently,[2] so the quality of the overall corporate bond market has clearly deteriorated. If U.S. earnings do fall significantly, then there could be significant downgrades from BBB to junk. We do not think the currently quiescent so-called high yield market is pricing in such an outcome. In that event, the equity market is sure to hear about it – big problems in the credit market invariably mean big problems in the equity market, especially as they would have a common cause: falling earnings and too much debt.

In this uncertain and acutely asymmetric world, we would continue to advocate owning compounders. The combination of recurring revenue and pricing power should protect revenues and margins, respectively, in a down-turn, preserving earnings. They are also likely to be insulated from any financial distress if the corporate bond markets have a seizure, given the lower operational and financial leverage. The soft markets of the fourth quarter have deflated the portfolio's multiples a little, with the estimated 2019 free cash flow yield now over 5%, reducing the absolute downside risk.[1]

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

FUND FACTS

Launch date	Base currency	Index
01 August 2013	U.S. dollars	MSCI World Net Index

12 Month Performance Periods to Latest Month End (%)

	DECEMBER '17 - DECEMBER '18	DECEMBER '16 - DECEMBER '17	DECEMBER '15 - DECEMBER '16	DECEMBER '14 - DECEMBER '15	DECEMBER '13 - DECEMBER '14
MS INVF Global Quality Fund - Z Shares	-2.17	23.00	3.64	5.39	3.56
MSCI World Net Index	-8.71	22.40	7.51	-0.87	4.94

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.**

1 Source: Morgan Stanley Investment Management Limited. Data as of 31 December 2018.
2 Source: FactSet. Data as of 31 December 2018.

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 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.
- 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 December 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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