Morgan Stanley

INVESTMENT MANAGEMENT

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Morgan Stanley Investment Funds

International Equity (ex US) 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 -5.37% (net of fees)[1], while the benchmark returned -4.85%.

The portfolio was broadly in line with the benchmark in the fourth quarter. Sector allocation was a positive, mainly due to the outperformance of consumer staples, the largest overweight in the portfolio. Stock selection was negative, as underperformance in consumer staples, financials and health care outweighed the benefit of outperformance in communication services and industrials.

The largest absolute contributors to performance during the quarter were Barrick Gold (+32 basis points [bps]), NCSoft (+7 bps) and BT Group (+5 bps). The largest absolute detractors were Fresenius (-107 bps), British American Tobacco (-104 bps) and Reckitt Benckiser (-78 bps).

The portfolio outperformed for the year, due primarily to sector allocation. The benefit from the overweight positions in consumer staples and health care, along with the underweights in consumer discretionary and financials, outweighed the headwind from not owning any utilities. Stock selection was roughly neutral overall as outperformance in industrials, information technology and energy roughly matched underperformance in health care, materials and financials.

The largest absolute contributors to performance for 2018 were Shiseido (+81 bps), Glaxo SmithKline (+46 bps) and L'Oréal (+30 bps). The largest absolute detractors were British American Tobacco (-222 bps), Bayer (-130 bps) and Fresenius (-124 bps).

Market Review

The EAFE markets held up reasonably well for the first nine months of 2018 with only marginally negative returns up to the end of September, but then cracked in the fourth quarter, finishing the quarter down 12.5% in U.S. dollar (USD) terms and a very similar 12.2% in local currency. Unsurprisingly, it was the defensive sectors that held up better, with utilities flat, consumer staples down 8%, and communication services and health care both 'only' falling 10%. It was the cyclical sectors that underperformed, most notably with energy and information technology both down 17%. There was less variation between geographies, with Hong Kong (-5%) and Singapore (-7%) faring best. Incidentally, the U.S. (-14%) performed marginally worse than EAFE in the fourth quarter.

The year-end slump left the MSCI EAFE Index down 13.8% for the year in USD (-11.0% in local currencies). As in the fourth quarter, the defensive sectors fell less, with utilities actually up 1% and health care down just 4%. Consumer staples (-11%) only outperformed slightly, not helped by the 40% fall in tobacco. The cyclical sectors suffered worst, most notably financials (-20%) and materials (-17%). In geographic terms, the worst performing major market was Germany (-22% in USD, -18% local), which managed to underperform Italy (-18%, -14%) and the U.K. (-14%, -9%) despite their political travails. Japan (-13%, -15%) was in line with the overall index, while the Asian constituents, Hong Kong (-8%, -8%) and Singapore (-9%, -8%) outperformed. The U.S. (-5%) was well ahead of EAFE for the year as a whole.

Portfolio Activity

The fourth quarter was not particularly active, with some trimming of strong performers and adding to selective names which had suffered in the market fall. The mild outperformance of the more defensive sectors in 2018 has not been nearly strong enough to persuade us to abandon the strong defensive tilt of the portfolio, particularly given the current level of uncertainty, with close to half the portfolio in consumer staples (31%) or health care (17%).

For the year as a whole, there was a bit of a rotation within consumer staples from some of the more expensive names (reducing L'Oréal, Shiseido and Pernod Ricard) into cheaper plays within the sector (initiating a position in Henkel and adding to

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

Kirin). On the cyclical side, there was a switch from some of the stretched industrials and information technology holdings (selling out of Komatsu and Hitachi, reducing Fanuc, Tencent and Keyence) into cheaper-looking banks (ING, BBVA and Danske). Despite the valuation gap, the move into financials has yet to pay off.

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 EAFE Index neared 15x 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 EAFE Index on 11.9x forward consensus estimates, 20% lower than the 20-year average price-earnings (P/E) ratio of 14.8x, and 21% below a year ago.[2] As a result, our primary fears have moved from multiples to earnings.

Our generic fear about forward earnings estimates remains – 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 6% earnings growth expected for the MSCI EAFE 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] numbers 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 than it was in 2003 (8.0x versus 7.7x), when the P/E ratio was at a lofty near 17x.[2] Lower corporate taxes have helped, but so has the sharp increase in leverage, which we discuss further later in the piece. Looking at EV/sales, the MSCI EAFE Index is at 1.3x, still 6% above its 20-year average.[2] The combination of a fairly 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, 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 that 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 greater than the upsides in good times. This is often forgotten, as is the fact that the asymmetry is magnified by leverage – and there is now 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 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 interest rates are not that high, junk or near-junk), Corporate America has to be right that earnings will hold up.

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2 Source: FactSet, as of 31 December 2018
3 Source: FactSet, Morgan Stanley Investment Management, 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

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 & 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 are continuing our bias to 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 their lower operational and financial leverage. The more cyclical sectors still do not offer a sufficient margin of safety given the uncertainty and potential pressure on earnings, although opportunities may come if the China slowdown does impact earnings in the first half of 2019. As such, we retain our strong overweight positions in the two most defensive sectors, consumer staples and health care, which between them make up 48% of the portfolio.

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

FUND FACTS

Launch date	Base currency	Index
18 November 2014	U.S. dollars	MSCI EAFE 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 International Equity (ex US) Fund - Z Shares	-14.24	25.03	-2.51	0.41	--
MSCI EAFE Index	-13.79	25.03	1.00	-0.81	--

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, 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.
- There are increased risks of investing in emerging markets as political, legal and operational systems may be less developed than in developed markets.
- 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 EAFE Index (Europe, Australasia, Far East)** is a free float-adjusted market capitalization index that is designed to measure the international equity market performance of developed markets, excluding the US & Canada. 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 MSCI EAFE Index currently consists of 21 developed market country indices. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

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