Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Institutional Fund

Global Franchise Portfolio

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

Performance Review

In the quarter period ending September 30, 2020, the Portfolio's I shares returned 6.58% (net of fees)[1], while the benchmark returned 7.93%.

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

Market Review

For the third quarter as a whole, the MSCI World Index was up 7.9% in U.S. dollars (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%).

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 year-to-date, versus a 15% fall for MSCI World as a whole, contributing to the 6% compound earnings growth over the near 15 years since the end of 2005, versus 2% for the MSCI World Index, along with the dividend income.[2] This equates to the earnings having risen 134% over the period, against a mere 36% for the index – such is the power of compounding.[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.

1 Source: Morgan Stanley Investment Management. Data as of September 30, 2020.
2 Source: FactSet, September 2020.

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 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

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2 Source: FactSet, September 2020.

15% premium to the MSCI World Index on the next 12 months forward earnings. Shifting to EV/NOPAT takes 3% off this premium, and the move to cash 6%, meaning that only 6% of the 15% 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 of the portfolio 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.

FUND FACTS

Launch date	Base currency	Index
November 28, 2001	U.S. dollars	MSCI World Net Index

Performance (%)

As of September 30, 2020 (Class I Share at NAV)

	MTD	QTD	YTD	1 YR	3 YR	5 YR	10 YR	SINCE INCEPTION
MSIF Global Franchise Portfolio - I Shares	-2.42	6.58	7.26	14.74	13.89	13.92	12.41	11.63
MSCI World Net Index	-3.45	7.93	1.70	10.41	7.74	10.48	9.37	6.80

Performance data quoted represents past performance, which is no guarantee of future results, and current performance may be lower or higher than the figures shown. For the most recent month end performance figures, please visit morganstanley.com/im. Investment returns and principal value will fluctuate and fund shares, when redeemed, may be worth more or less than their original cost.

The gross expense ratio is 0.93% for Class I shares and the net expense ratio is 0.93%. Where the net expense ratio is lower than the gross expense ratio, certain fees have been waived and/or expenses reimbursed. These waivers and/or reimbursements will continue for at least one year from the date of the applicable fund's current prospectus (unless otherwise noted in the applicable prospectus) or until such time as the fund's Board of Directors acts to discontinue all or a portion of such waivers and/or reimbursements. Absent such waivers and/or reimbursements, returns would have been lower. Expenses are based on the fund's current prospectus. The minimum initial investment is $5,000,000.

Returns are net of fees and assume the reinvestment of all dividends and income. They are compared to an unmanaged market index. Returns for less than one year are cumulative (not annualized). Performance for one year or more is based on average annual total returns. The returns are reported for Class I shares. Performance for other share classes will vary.

RISK CONSIDERATIONS

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market value of securities owned by the portfolio will decline.Portfolios are subject to market risk, which is the possibility that the market value of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events.Accordingly, you can lose money investing in this portfolio. Accordingly, you can lose money investing in this strategy. Please be aware that this strategy may be subject to certain additional risks. Changes in the worldwide economy, consumer spending, competition, demographics and consumer preferences, government regulation and economic conditions may adversely affect **global franchise companies** and may negatively impact the strategy to a greater extent than if the strategy's assets were invested in a wider variety of companies. In general, **equity securities'** values also fluctuate in response to activities specific to a company. Stocks of **small-capitalization companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. Investments in **foreign markets** entail special risks such as currency, political,

[2] Source: FactSet, September 2020.

economic, and market risks. The risks of investing in **emerging market** countries are greater than the risks generally associated with investments in foreign developed countries. **Non-diversified portfolios** often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. **Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk).

INDEX INFORMATION

The **MSCI World 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 indexes are unmanaged and do not include any expenses, fees or sales charges. It is not possible to invest directly in an index.

IMPORTANT INFORMATION

The views and opinions expressed are those of the investment team at the time of writing 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 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.

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Certain information herein is based on data obtained from third party sources believed to be reliable. However, we have not verified this information, and we make no representations whatsoever as to its accuracy or completeness.

Please consider the investment objective, risks, charges and expenses of the fund carefully before investing. The prospectus contains this and other information about the fund. To obtain a prospectus, download one at morganstanley.com/im or call 1-800-548-7786. Please read the prospectus carefully before investing.

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