Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Institutional Fund

Global Franchise Portfolio

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | COMMENTARY | MARCH 31, 2019

Performance Review

In the quarter period ending March 31, 2019, the Portfolio's I shares returned 15.15% (net of fees)[1], while the benchmark returned 12.48%.

For the first quarter (Q1), the portfolio outperformed despite the strong markets. Stock selection was very strong for the quarter, as sector-beating performance in health care, consumer staples and financials had far more impact than the underperformance in communication services, industrials and information technology. Sector allocation was positive, with the benefits of the overweight in information technology and the underweight in financials stronger than the costs of the consumer staples' slight lag to the market and the drag from the small cash holding.

Market Review

During the quarter, the MSCI World Index was up a striking 12.5% in U.S. dollars (USD), and a very similar 12.6% in local currencies. Unsurprisingly, it was some of the more cyclical sectors that led the way in such a strong quarter. Information technology (+20%) took up the mantel of market leadership again after a wobbly fourth quarter, while real estate (+16%), energy (+14%) and industrials (+14%) also beat the overall index. The defensive health care (+8%) and utilities (+10%) did not match the index, along with the more cyclical financials (+8%), which suffered from falling interest rate expectations. Consumer staples (+12%) were roughly in line with the index for the quarter as a whole after their strong March.

The quarter was rather muddled by geography. Hong Kong (+16% USD and local currency) massively outperformed Singapore (+6% USD and local), and amongst the resource-rich countries, Canada (+15% USD, +13% local) was far stronger than Norway (+7% USD, +6% local). There was a similar lack of pattern in Europe, with Italy doing well (+15% USD, +17% local), while Germany and Spain (both +7% USD, +9% local) struggled in relative terms. The U.S. (+14%) was slightly ahead of the index, while the U.K. (+12% USD, +9% local) was roughly in line despite the troubled political situation. Japan (+7% USD, +8% local) was amongst the laggards.

Outlook

In search of a late-cycle buffer

2019 has some worrying echoes of 1999. Markets are up strongly despite soggy earnings, initial public offering frenzy is back on CNBC as Lyft[2] starts the wave of unicorns heading to market before the music stops, and perhaps most alarmingly, Goldman Sachs[2] has abolished business dress. Oh, and the Backstreet Boys are back. This may be more anecdotal than scientific, but it is all starting to feel rather late cycle, and therefore arguably a good time to deploy a late-cycle buffer, if one is not in place already.

Applying a bit more rigor, at the start of 2018 we were worried about the elevated level of market multiples. By the end of 2018, which saw a combination of a sharp de-rating and strong earnings rises, our primary worry had shifted over to earnings. After Q1 2019, which saw double-digit returns despite a global economic slow-down, we are now anxious about both multiples and earnings. We like to say that the good news is that there are only two ways to lose money in equities… if the earnings go away or if the multiple goes away. The bad news right now is that both are under threat.

1 Source: Morgan Stanley Investment Management. Data as of March 31, 2019.
2 Not held in the portfolio as of March 31, 2019.

The multiples are a concern as they have bounced back to September levels, with the MSCI World Index back above 15x the next twelve months' earnings[3] as Q1 has reversed the fourth quarter (Q4) de-rating. It is true that some of the fears that stalked Q4 have faded, thanks to the seeming U-turn from the U.S. Federal Reserve and the more positive mood-music from the U.S.-China trade talks, but the experience of last year's two market swoons suggests that there is significant downside multiple risk, even without any cyclical earnings shock.

As for earnings, our underlying anxiety is that they may be unsustainably high, particularly in the U.S. Margins are near peak levels, as are profits' share of gross domestic product and the level of earnings-per-share-boosting leverage. Earnings are also drifting down while the market surges up. The 2019 MSCI World Index earnings estimates are off 6.5% since the start of Q4 2018 and 4.0% down year-to-date.[3] In the U.S., where quarterly data is available, earnings are actually expected to be down around 3% year-on-year in Q1.[3] The interesting point is the source of the U.S. earnings drop. Revenues are still healthy, up around 5% on the year,[4] but the margins are falling. Costs are rising in the U.S., notably for labour, and many companies are having trouble passing them on. The National Association of Business Economics reported that 58% of respondents were facing higher labour costs, but that only 19% had been able to increase prices, presumably the 19% with the strongest pricing power. The market, as per usual, assumes that things will improve. By Q4 2019, consensus has U.S. earnings up nearly 10% year-on-year, as against the Q1 2019 fall.[3] Our fear is that this may be over-optimistic, either due to the late-cycle margin pressure, or the even-later-cycle economic downturn.

If we are indeed late cycle, and therefore vulnerable to late-cycle margin pressure followed by an economic downturn, then a portfolio of compounders seems a reasonable place to hide. Compounders have sustainable high returns supported by powerful intangible assets. Importantly, we also require strong pricing power, recurring revenues and limited operational and financial leverage. The pricing power, generally fed by powerful brands and networks, allows companies to protect their margins when costs rise, while the recurring revenues, from repeat purchases or long-term contracts, support the level of sales. The combination of robust sales and robust margins should help drive robust profits, particularly if there is limited operational or financial leverage.

While of course past performance doesn't guarantee future outcomes, we believe the impact of the 2008-09 Global Financial Crisis supports our thesis that compounders can be a late-cycle buffer. The portfolio actually saw its earnings rise over the course of the crisis, while the market saw a 40% fall. In addition, the earnings for the core sectors for Global Franchise today, consumer staples, software & IT services within information technology, and health care, which combined are close to 85% of the portfolio, held up far better than their more cyclical peers.

On forward price-to-free cash flow, our favoured valuation metric, the portfolio trades on only a 22% premium to the far lower-quality MSCI World Index, despite the far higher return on capital, gross margins and margin stability.[3] We would argue that this 22% is actually an overstatement of any real premium, given the market's chronic failure to deliver the expected forward cash flows and earnings and the habit of tucking any unpleasant news 'below the line'.

The Fund looks to compound wealth over the long term, by owning high-quality companies that compound their earnings steadily at reasonable valuations. It looks to keep the lights on, rather than shooting them out, and has been described as a get rich slowly scheme. We would assert that compounders should be owned across the cycle… but in particular if the cycle may be coming to an end.

FUND FACTS

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

3 Source: FactSet. Data as of March 31, 2019.
4 Source: Refinitiv. Data as of March 31, 2019.

Performance (%)

As of March 31, 2019 (Class I Share at NAV)

	MTD	QTD	YTD	1 YR	3 YR	5 YR	10 YR	SINCE INCEPTION
MSIF Global Franchise Portfolio - I Shares	4.95	15.15	15.15	14.44	13.28	10.81	15.53	11.48
MSCI World Net Index	1.31	12.48	12.48	4.01	10.68	6.78	12.38	6.53

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 0.98% for Class I shares and the net expense ratio is 0.98%. 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. 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, 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 objectives, risks, charges and expenses of the fund carefully before investing. The prospectus contains this and other information about the fund. To obtain a prospectus, contact your financial advisor or download one at morganstanley.com/im. Please read the prospectus carefully before investing.

Morgan Stanley Investment Management is the asset management division of Morgan Stanley.

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