Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Institutional Fund

# Global Sustain Portfolio

**INTERNATIONAL EQUITY TEAM** | COMMENTARY | CLASS I SHARES | JUNE 30, 2021

## Performance Review

In the quarter period ending June 30, 2021, the Portfolio's I shares returned 6.19% (net of fees)[1], while the benchmark returned 7.74%.

For the second quarter (Q2) overall, the underperformance was due to stock selection. Sector allocation was positive, with the overweight in information technology and the lack of utilities holdings both helping, while the overweight in consumer staples was a drag. The negative stock selection came from underperformance in health care, consumer staples, information technology and financials, despite outperformance in the industrials and communication services sectors.

As of June 30, 2021, the portfolio's carbon footprint is 80% lower than the MSCI All Country World Index.[2]

## Market Review

Q2 overall was yet another strong quarter, the fifth in a row since the March 2020 trough, with the MSCI World Index gaining 7.7% in U.S. dollars (USD) (+7.6% in local currency), leaving it up 67% over the last five quarters. The U.S. market was up 9% and Canada gained 10% in USD (+8% local). With the exceptions of Switzerland (+12% USD, +10% local) and France (+9%, +8%), European markets lagged in the quarter, with Italy up 4% in USD (+3% local), Germany gaining 5% (+4%) and the U.K. achieving +6% (+6%). Asia was weaker still, with Japan and Singapore roughly flat, and Hong Kong only up 3% in USD (+2% local). The quarter's sector picture was similar to June's. Information technology led the way (+12%), ahead of real estate (+10%), while cyclicals tended to mildly underperform. Industrials were up 4%, materials +5% and financials gained +7%. Not all defensives benefited. Health care was up 9%, but consumer staples only returned 6%, while utilities (-1%) was the weakest sector.

## Outlook

***Quality in the Brave New World***

The last quarter century since the inception of our team's longest-standing global strategy has proved fertile ground for high quality compounders. Their combination of pricing power and recurring revenues has allowed them to comfortably out-earn the market as a whole, helped by the disasters that befell the technology, media and telecommunications (TMT) sector in the 2001-03 crash and the financials sector in the 2008-09 Global Financial Crisis. The other positive has been that, despite this superior record, they have generally only traded at a mild premium to the market, particularly when looking at free cash flow yields.

There is speculation that quality and compounders will struggle in the "Brave New World" of reflation and inflation. Our view is that the companies should continue to prosper, even if there is a shift to a more inflationary regime.

It is true that the last year has been less favourable for quality in relative terms. The first issue was that 2020 saw a growth boom, as investors got excited about a lot of the technological winners from the pandemic. Our view is that elements of this turned into a bubble, with some extreme valuations and speculative excesses around special purpose acquisition companies (SPACs). Our valuation discipline meant that we did not participate in this exuberance. On top of that, the fourth quarter of 2020 and first quarter of 2021 saw significant good news around the speed of vaccine development and rollout, which sharply

**1** Source: Morgan Stanley Investment Management. Data as of June 30, 2021.
**2** Source: Trucost based on the Scope 1 & 2 carbon emissions per $1 million of portfolio companies' sales at June 30, 2021. The portfolio-level statistics show the weighted average carbon intensity (WACI).

accelerated the likely path of recovery. As a result, the value sectors and cyclical recovery plays in sectors such as financials, materials and industrials naturally came into favour, as their earnings expectations improved sharply in the "reflation trade," comfortably outpacing the defensive sectors – notably consumer staples and health care – that make up much of the portfolio.

Last year's growth bubble has deflated somewhat in 2021, with information technology's most expensive quintile only returning 3% year-to-date, against an average of 12% for the other four quintiles.[3] The median valuation in the top quintile has dropped from around 130x 24-month forward earnings to a mere 110x or so.[3] (This is provided you are kind enough to exclude stock-based compensation from their costs – otherwise the median stock in the quintile is loss-making.) More recently, the discussion has shifted toward how much longer the cyclical, or reflation, trade may last.

It is unclear whether there are further positive growth surprises to come, how much upside still remains in cyclical earnings, and the extent to which any good news is already in stock prices, with materials up 82% and financials up 74% since March 2020, compared with only 32% for consumer staples and 42% for health care.[3] The experience of the second quarter of 2021, with the cyclical sectors generally lagging slightly behind the overall index, suggests that the momentum behind the value trade may be fading.

*Inflation watch*

The fear is that the current economic boom will drive inflation, and prices have indeed already risen sharply for many commodities and products. What is not yet clear is how much of this is transitory – the result of spikes in demand and supply still constrained by the pandemic – and how much may prove to be permanent. The consensus seems to be that much of the inflationary pressure will indeed fade away as demand normalises and supply recovers, meaning that governments will not have to slam on the brakes.

We would agree that some commodities, for instance iron ore, are above likely long-term prices (which incidentally means that their producers may be over-earning at present). The key inflation variable to watch is wage growth: in service-orientated economies, people costs are more important than the costs of "stuff," be it semiconductors or lumber. In the meantime, the market obsesses over tiny micro-signals about central bank intentions, reminiscent of the Cold War sport of Kremlinology, described by one eminent historian of the time as the attempt to work out who was winning the power struggles within the Politburo by the width of the black armbands worn at public state funerals in Red Square.

Looking through the timing and strength of the current economic recovery, there are longer-term concerns in the market about the fate of quality equities in a higher-inflation world, if that does indeed come to pass. While we do not have a strong view as to the likely path of inflation, given that there are decent arguments for both the transitory and the more permanent cases, we do believe that quality companies can still thrive in a more inflationary environment.

One key point to make is that inflation is fundamentally a nominal rather than a real phenomenon. It will accelerate headline revenue growth rates, but any benefits are illusionary, as they are cancelled out by the rise in the price level. That said, there are arguments that inflation can particularly help lower quality companies. "Money illusion" can fool people into crediting companies that are not growing in real terms with growth status – not something that happens in today's low-inflation world. In addition, inflation may help asset-heavy companies' accounting profits, as sales rise relative to the book value of their assets and the associated depreciation. The final argument in favour of lower quality stocks in an inflationary regime is that they are less vulnerable to an inflation-driven rise in discount rates as nominal rates rise, given their lower multiple and shorter duration compared with more expensive stocks. This makes sense mathematically … providing you ignore the fact that the long-run nominal growth rate is likely to rise in parallel with the inflation and discount rates, cancelling out any effect on the multiple.

*Compounders remain attractive*

Overall, our view is that these inflation gains for lower quality companies are not "real" or "economic" and are thus unlikely to have a long-lasting impact, with the exception of some financials, which may see net interest gains from higher interest rates. We would also argue that there are two significant relative pluses for higher quality companies in a higher inflation world:

**3** Source: FactSet. Data as of June 30, 2021.

- The first is that inflation will mean that companies have to deal with rising input costs. This is likely to put a premium on those companies who can pass those costs on to customers through their pricing power, one of the key characteristics that we look for in compounders.
- The other is that this regime will probably require more frequent government intervention to keep inflation under control, prompting shorter economic cycles. The last few decades have seen unprecedentedly long economic cycles as governments have not had to slow economies down to dampen price rises, and this would unlikely be sustained if inflation became an issue. In a world of frequent recessions, compounders' recurring revenues would be an even more valuable source of earnings stability.

Ultimately, the case for compounders remains largely unchanged in a more inflationary world. Companies that can grow their earnings steadily in real terms across cycles are likely to continue out-earning the market, just as they have done over the last few decades. Pricing power and recurring revenues are arguably even more important in a world of rising input costs and higher economic volatility. The other point we made at the start of this piece also stands. With the portfolio at only a 26% premium to MSCI World Index on forward earnings, and at roughly half that premium on free cash flow yields, the market is still failing to recognise the power of compounders.[3] In a world of expensive markets, with the MSCI World Index still at a 20x forward multiple for the first time since the TMT bubble at the start of the century - even after a 40% rise in earnings over the last year - compounders remain attractive.[3] After all, given that markets currently involve significant valuation risk, why take earnings risk as well?

We regularly report on our engagements with company management and proxy voting. For the latest update, please visit www.msim.com and download the International Equity Team's engagement newsletter, *Engage*. We also publish a quarterly Global Sustain environmental, social and corporate governance (ESG) factsheet with portfolio-level ESG data.

**FUND FACTS**

| Launch date | Base currency | Index |
|---|---|---|
| August 30, 2013 | U.S. dollars | MSCI World Net Index |

## Performance (%)

*As of date June 30, 2021 (Class I Share at NAV)*

| | MTD | QTD | YTD | 1 YR | 3 YR | 5 YR | 10 YR | SINCE INCEPTION |
|---|---|---|---|---|---|---|---|---|
| MSIF Global Sustain Portfolio - I Shares | 1.18 | 6.19 | 8.69 | 24.26 | 16.06 | 15.06 | -- | 12.82 |
| MSCI World Net Index | 1.49 | 7.74 | 13.05 | 39.04 | 14.99 | 14.83 | -- | 11.65 |

**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 1.45% for Class I shares and the net expense ratio is 0.90%. 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.

Please keep in mind that high double-digit returns are highly unusual and cannot be sustained. Investors should also be aware that these returns were primarily achieved during favorable market conditions.

[3] Source: FactSet. Data as of June 30, 2021.

## Top Holdings (% of Total Net Assets)

| | FUND | INDEX |
|---|---|---|
| Microsoft Corp | 7.78 | 3.35 |
| Reckitt Benckiser Plc | 5.54 | 0.11 |
| Visa Inc | 5.51 | 0.69 |
| SAP SE | 5.25 | 0.25 |
| Accenture Plc | 4.28 | 0.32 |
| Henkel AG & Co. KGaA | 4.26 | 0.05 |
| Baxter International Inc | 3.89 | 0.07 |
| Becton Dickinson and Co. | 3.88 | 0.12 |
| Abbott Laboratories | 3.73 | 0.35 |
| Danaher Corp | 3.73 | 0.30 |
| **Total** | **47.85** | -- |

### 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 values 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. Please be aware that this portfolio may be subject to certain additional risks. Please be aware that this Portfolio may be subject to certain additional risks. In general, **equities securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, market and liquidity risks. The risks of investing in **emerging market** countries are greater than risks associated with investments in foreign developed countries. Stocks of **small- and medium-capitalization companies** entail special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. **Nondiversified 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. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. **Illiquid securities** may be more difficult to sell and value than public 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 **CNBC SPAC 50 Index** tracks the performance of the 50 largest, U.S.-based pre-merger special purpose acquisition company (SPAC) deals by market capitalization.

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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