Performance Review

In the quarter period ending December 31, 2019, the Portfolio’s I shares returned 7.40% (net of fees), while the benchmark returned 8.17%.

The portfolio underperformed slightly for both the fourth quarter (Q4) and the year. The fourth quarter underperformance was driven by sector allocation, which was negative mainly due to the underperformance of the consumer staples sector, the portfolio’s largest overweight. Stock selection was positive, as outperformance in consumer staples and financials had more of an impact than underperformance in industrials.

The largest absolute contributors for the quarter were Fresenius, Prudential plc and SAP (3.3%, 2.6% and 3.4% of the portfolio, respectively). The top absolute detractors were Thales, Shiseido and Unilever (1.5%, 1.1% and 1.5% of the portfolio, respectively).

Market Review

The MSCI EAFE Index was up 8.2% in U.S. dollars (USD) in the fourth quarter (Q4) and a rather lower 5.2% in local currency terms as the dollar weakened. The quarter started with a sharp value rally, as fears about the macro environment and trade wars faded, and the defensive and rate-sensitive names wound up as the laggards, namely consumer staples (+2%), real estate (+4%), utilities and communication services (both +5%), while energy (+4%) was also weak. The two strongest sectors were information technology (+13%), particularly hardware and semiconductors, and health care (+12%), which was helped as political fears in the U.S. eased. In terms of geography, the resource-intensive markets of Australia (+4% in USD, +0% in local currency), Norway (+4%, +1%) and Canada (+5%, +3%) struggled. Spain (+6%, +3%) was also behind the index given the political uncertainty, but all other major markets were within 2% of the MSCI EAFE Index. The U.S. (+9%) was a touch ahead of EAFE.

Portfolio Activity

Q4 was a relatively quiet quarter for the portfolio, with the largest move a significant reduction in Unilever at the start of the quarter, given concerns about its ability to grow and the valuation.

Outlook

As simple souls we attempt to disaggregate investing into earnings and multiples. Concerned as we are with the preservation of capital, we maintain that there are only two ways to lose money in equities; if the earnings go away, or the multiple goes away. While our daily business is at the stock level, we also attempt to apply this logic to markets as a whole. At the end of 2017, our concern was multiples, with the MSCI World Index on 17.0x forward consensus estimates. This fear proved well founded, as 2018 was a down year despite double-digit earnings growth as the market de-rated to 13.4x. Given this de-rating, our concern for 2019 switched to earnings... and we were a quarter right! We say a quarter, as we were half right on earnings, which mildly disappointed being down a fraction for the year rather than the expected 7% rise, but did not foresee that the multiple would bounce back to 17.0x. If we disaggregate the 2019 return of 28% for the MSCI World Index, a massive 26% came from the re-rating, -1% from earnings, with the remainder from dividends. This is an extreme example of the pattern since 2012, where more of the market return has come from multiple expansion than earnings growth, with only 2017 offering a strong return year driven by earnings.


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This significant re-rating implies a large increase in optimism during 2019. This was clearly not driven by the actual earnings, which disappointed in 2019 and have yet to revive, but rather by hopes for the future. Monetary policy was one clear shift. The U.S. Federal Reserve’s (the Fed) raising cycle, which saw four rises in 2018 amidst talk of “normalisation,” ended in December of that year, and 2019 saw three cuts, along with more dovish noises, and a return to a growing balance sheet as it battled the crisis in the repo market. The European Central Bank (ECB) and the People’s Bank of China have followed suit in easing monetary conditions in an attempt to boost growth. Markets were also helped by a reduction in fears about a trade war between the U.S. and China, with talk of an imminent “Phase 1” deal, which would at least imply a truce.

So where does this revival of market morale leave us for 2020? Frankly, we are now nervous about both multiples and earnings. The fears about multiples is natural enough, with the MSCI World Index back up to 17.0x, and this time without the benefit of the imminent earnings boost from the Trump tax cuts that it had in early 2018. Even putting the risk of multiple compression to one side, it is tough to see how there can be much mileage for the markets from expanding multiples – a 10% boost would require the MSCI World Index to be on close to 19x!

This leaves earnings as the main potential driver of any significant upside for markets, and here we are sceptical for the broad market in the medium term. It may well be that an industrial recovery can drive progress in 2020, but our structural concerns remain. Our anxiety is based on the fact that most of the levers for earnings growth have been pulled hard already, particularly in the U.S., leaving limited opportunity for them to help further, and skewing the risk to the downside. Margins are high, as corporates have been advantaged relative to labour, given globalisation and the political move to the right over the last few decades, and also relative to consumers, given the falling role of anti-trust. Profits have also been boosted by low interest rates and increased leverage, decreasing interest payments and allowing earnings per share-boosting buybacks. On top of all this, the gap between the “adjusted” numbers, used for consensus and paying management, and the actual profit at the bottom of the income statement has ballooned, reaching $600 billion over the last three years in the U.S. alone. These are all tailwinds for earnings over the last few years that are unlikely to be repeated, and may turn into headwinds if they go into reverse.

This may not matter in 2020. It is quite possible that the U.S. can continue to steer between the Scylla of recession and the Charybdis of inflation, delivering economic and earnings growth without the Fed having to tighten and end the party. With the MSCI U.S.A. Index earnings multiple now at 18.7x, and double-digit earnings growth forecast for 2020 after the slight fall in 2019, success seems to be what the market is expecting.

Arguably EAFE looks better placed than the U.S., not least due to valuation, given its record 20% discount. Europe looks more reasonably priced, at a “mere” 14.6x, as there is far less optimism about growth. Part of this is down to the relative shortage of fast growing technology companies, but it is also down to the continent as a whole being mired in very slow growth. Here, there could be a positive story if there is a move towards fiscal reflation in 2020. The block, as ever, is Germany, given its balanced budget requirement, but if this is eased, perhaps using the need for infrastructure to deal with the climate emergency as an excuse to issue green bonds, then this could drive faster growth, or at the very least the hope of faster growth, which may be all that is needed to drive a rally. The ECB under Christine Lagarde is likely to remain helpful. By contrast, it is probably fruitless to expect structural change in Japan, which at 14.3x is marginally cheaper than Europe. However, having suffered a double-digit earnings fall in 2019, as industrial production struggled, it may well be a beneficiary of any industrial bounce-back.

Alongside the U.S. premium to the rest of the developed world, growth is thriving relative to value, trading at a relative multiple not seen since the tech-media-telecom (TMT) bubble at the start of the millennium. We are relatively agnostic on the growth vs value debate, since we are less than fully convinced by either of them! Over the last couple of years we have reduced some of the faster growing stocks in the portfolio, for instance L’Oréal, Shiseido and Pernod Ricard (1.0%, 1.1% and 2.8% of the portfolio, respectively) in consumer staples and Tencent, Keyence and Fanuc in the tech space (2.1%, 1.3% and 1.2% of the portfolio, respectively). As for value, it is the companies’ prospects that often look relatively dim, with several of the struggling sectors facing genuine threats, be it trapped assets for energy or the rise of electric vehicles for autos. One “value” area where we have added is in European banks, where we have reduced the underweight versus the index. Their net interest margins are indeed threatened by the chronic low interest rates, but valuations seem to assume a permanent Japanification of the system. Our view is that this is unduly pessimistic, as Europe is seeing both loan growth and much more appetite to protect lending margins.

The real skew in the portfolio is towards quality rather than either growth or value. We like companies with the intangible assets to give them the combination of recurring revenue and pricing power, along with the ability to sustain high returns on capital. One of the pluses they offer is resilience in tough times: the recurring revenue protects sales and the pricing power protects margins. In a time of heightened multiples and high uncertainty (uncertainty that is arguably not properly reflected in the
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. Accordingly, you can lose money investing in this strategy. Please be aware that this strategy 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. Investments in small-and medium-capitalization companies tend to be more volatile and less liquid than those of larger, more established, companies. The risks of investing in emerging market countries are greater than risks associated with investments in foreign developed markets. Derivative instruments can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the portfolio’s performance. Illiquid securities may be more difficult to sell and value than publicly traded securities (liquidity risk).

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 performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

The MSCI World Index is a free float adjusted market capitalization weighted index that is designed to measure the
The MSCI USA Index is designed to measure the performance of the large and mid cap segments of the US market. With 631 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in the US.

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

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