Morgan Stanley Inst Growth I MSEQX

Its ugly side is on full display.

Morningstar's Take MSEQX

Morningstar Rating	★★★★
Morningstar Analyst Rating	Gold

Morningstar Pillars	
Process	Above Average
Performance	—
People	High
Parent	Average
Price	—

Role In Portfolio
Supporting Player

Fund Performance

Year	Total Return (%)	+/- Category
YTD	-22.94	-9.94
2021	0.43	-20.02
2020	115.57	79.71
2019	23.16	-8.74
2018	7.66	9.75

Data through 2-28-22

3-17-22 | by Katie Rushkewicz Reichart

Morgan Stanley Institutional Growth's ups and downs are on full display. Its People, Process, and Parent pillars remain the same, but shifts in the composition of its category peer group boost its cheapest share classes' Morningstar Analyst Ratings to Gold. The more-expensive shares range from Bronze to Silver.

Wide performance swings are inevitable at this growth-fueled strategy. It has taken a sharp turn since posting triple-digit gains in 2020. As the Russell 1000 Growth Index fell from its Dec. 27, 2021 peak to its recent March 8, 2022, trough, the U.S. vehicle's I shares dropped nearly 40%, more than double the benchmark's decline. Big picture headwinds hurt, including concerns that rising interest rates would clobber the growth stocks this portfolio prefers. Apple's privacy guidelines change also weighed on several advertising-dependent holdings, including Pinterest, Snap, and Twitter.

Other issues underscored a lack of traditional risk management. The team builds a compact portfolio leaning heavily on its highest-conviction ideas and will hold large stakes in successful picks without taking gains as they rise. That works well on the way up and has fueled strong long-term results, but can inflict short-term pain. For instance, Snowflake, a 2020 IPO, grew into a 7% position by December 2021, but plunged after muting its growth forecast in early 2022, which hurt this strategy's year-to-date results.

The strategy has been through such periods before and gone on to thrive. It posted huge gains in 2009 and 2017 after weak prior years. Yet fund flows show investors often lack patience; they poured into the strategy in 2020 during its steep ascent, leading the team to close it to new investors, only to rush for the exits when trouble brewed in 2021. The fund reopened in March 2022.

The team, led by Dennis Lynch, oversaw $79 billion across a mix of strategies, as of December 2021, more than ever. It has added researchers, including in key areas like healthcare, disruptive change, and blockchain, though most are recent hires; nearly half of the 25-person team joined in the past two years.

Even so, this strategy remains appealing for risk-tolerant investors.

Process Pillar Above Average | Katie Rushkewicz Reichart 03/17/2022
The effective implementation of a long-term, high-conviction approach earns an Above Average Process rating.

Dennis Lynch and team look for companies with defensible business models that dominate their markets or benefit from a strong network effect. However, the portfolio also owns less-established industry disrupters, using a variety of valuation methods to assess new business models that may appear expensive on traditional metrics and looking out five years, resulting in modest turnover. The managers' patient mindset shows in their decision to typically limit major trades to every four to six weeks so they're not overly focused on the market's short-term movements.

Four analysts on the team solely conduct deep-dive research that can help the team's stock-pickers spot innovative companies that can disrupt established industries, and two others focus on big-picture research. Lynch and team are willing to go wherever their research takes them, so they pay little attention to the Russell 1000 Growth's sector weightings. They're also willing to take concentrated positions in their best ideas to get ahead, though successful picks can grow into big positions that result in significant stock-specific risk. Holdings in the team's small- and mid-cap strategies can appear here, and the portfolio has recently tilted further down the market cap spectrum than the benchmark.

Most portfolio holdings fall in the growth bucket and tend to be companies disrupting their industries, the most promising of which the team will stick with through adversity. Cloud provider Snowflake, a 2020 IPO, grew to a 7% position by December 2021 but hurt as it plunged in early 2022 after muting its growth outlook. Shopify, also nearly 7% of assets and a winning longer term pick, lost half its value in 2022's first two months.

Technology, communications, and healthcare stocks are prominent, but the fund doesn't mimic the Russell 1000 Growth Index. It shunned top constituents Apple, Microsoft, Alphabet, or Amazon.com as of December 2021, opting for smaller stocks where the team sees more robust growth. The fund's active share (or how much it differs from its benchmark) was recently in the 90s--near the large-growth category's top.

While the portfolio's less-established names may have longer growth runways, several of them don't make money yet. The fund's return on invested capital and return on equity are below the Russell 1000 Growth's, though its debt/capital is also lower, so its average holding isn't very levered. There was more evidence of volatility and momentum than quality in the portfolio as of December 2021, according to Morningstar's Risk Model. It also owns the Grayscale Bitcoin Trust and a handful of private companies, which courts volatility.

Performance Pillar | Katie Rushkewicz Reichart 03/17/2022
Shareholders who have owned this fund since the start of manager Dennis Lynch's tenure have been rewarded, but they've endured some tough stretches. Since Lynch took over in mid-2004 through February 2022, the I shares gained 13.7% annualized, well ahead of the Russell 1000 Growth Index's 11.9% and the large-growth Morningstar Category's 9.8%.

The edge was narrower in risk-adjusted terms, reflecting big swings in up and down markets. Indeed, the fund gained 113% as much as the benchmark in rising markets and captured 112% of its losses in drawdowns. Strong showings landed it near the category's top in 2013, 2015, 2017, 2018, and 2020, while it fell toward the bottom in 2014, 2016, 2019, and 2021.

Recent performance exemplifies this strategy's extremes. It had a banner year in 2020, with the I shares gaining 115%, about 3 times the benchmark's return. The portfolio's technology holdings both buffered it in early 2020's pandemic-induced market sell-off and supported its subsequent ascent, as it held stakes in COVID beneficiaries, such as Zoom Video Communications, Moderna, and Shopify. Its fortunes have since reversed, with many of its technology-related holdings tanking on concerns about rising interest rates, the impact of Apple's privacy changes, and stock-specific bumps. Its 27.7% loss for the trailing year through February 2022, a period in which the benchmark gained 12.6%, highlights its potential for huge losses. Its relatively concentrated and sector-agnostic portfolio means investors should have a stomach for volatility and maintain a long-term mindset.

People Pillar ● High | Katie Rushkewicz Reichart 03/17/2022
Dennis Lynch fosters a unique and long-term investment culture that embraces curiosity, flexibility, and self-awareness. He anchors a stable, experienced team and has had success developing and retaining team members, earning the strategy a High People rating.

Lynch took over in mid-2004, and was the 2013 Morningstar Domestic-Stock Fund Manager of the Year. He works with 24 team members, seven of whom have double-digit tenures. The team hasn't seen any departures since 2011 and has added to its ranks as interesting people have surfaced to broaden its range of perspectives. As assets have grown, the team has expanded: 12 have joined in the past two years. Industry veteran Michael Mauboussin and Dan Callahan joined in January 2020 to focus on "consilience" research, or looking across disciplines to come up with new ideas and sharpen analysis. Lynch has also deepened the analyst bench in key sectors, including healthcare and technology, and added a director of research to help oversee the growing team. While no immediate departures are anticipated, the hiring helps prepare for long-term succession.

The team runs a variety of strategies spanning the market-cap spectrum. While the team follows a bottom-up approach, it includes four analysts focusing on big-picture disruptive change research. Lynch protege Kristian Heugh runs a Hong Kong-based team that's also helps.

Parent Pillar ● Average | Gabriel Denis 12/16/2021
Morgan Stanley Investment Management, which acquired Eaton Vance in March 2021, has pockets of strength within its motley and expansive lineup. Yet, ongoing uncertainty as the merger shakes out underpins its Average Parent rating.

Both MSIM and Eaton Vance had mixed success as asset managers prior to their 2021 unification. MSIM's greatest strength is the handful of strong teams in its equity lineup, including Dennis Lynch's Counterpoint Global team, but its fixed-income franchise had less success, and the workload of some of its key equity contributors has expanded quite rapidly in recent years. Eaton Vance, for its part, found success among parts of its fixed-income lineup and with some of its affiliates, but its eponymous equity unit struggled with outflows and personnel instability.

While there is potential for these once disparate teams to prosper under MSIM's combined leadership, there are several areas of uncertainty as the firm grows together. The firm made the decision to keep fund closures and mergers to a minimum, leading to a situation where it now offers distinct strategies with overlapping mandates. Turnover has reared its head here, and several longtime team leads retired or departed the firm over 2021. As Morgan Stanley CEO James Gorman continues his quest for expansion, MSIM faces operational challenges in stewarding its growing empire.

Price Pillar | Katie Rushkewicz Reichart 03/17/2022
It's critical to evaluate expenses, as they come directly out of returns. The share class on this report levies a fee that ranks in its Morningstar category's cheapest quintile. Based on our assessment of the fund's People, Process and Parent pillars in the context of these fees, we think this share class will be able to deliver positive alpha relative to the category benchmark index, explaining its Morningstar Analyst Rating of Gold.

IMPORTANT INFORMATION

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To view the most recent standardized performance, holdings, and important fund disclosures please click on the following link, Growth Portfolio.

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Morningstar Analysts have rated the fund a Gold medal (effective 03/17/22).

Morningstar Analyst Rating™("Rating"): The Rating is a subjective evaluation, is not a credit or risk rating, and a high rating is not a guarantee for relatively strong performance. The Morningstar's Manager Research group ("MRG") evaluates funds based on five key pillars (process, performance, people, parent, and price) to determine how they believe funds are likely to perform relative to a benchmark over the long term on a risk adjusted basis. They consider quantitative and qualitative factors. The weighting analysis for actively managed strategies are: people and process 45% each; parent 10%; performance has no explicit weight (it is incorporated into people and process); price (share-class level where applicable) is subtracted from an expected gross alpha estimate derived from the analysis of other pillars. The impact of the weighted pillar scores for people, process and parent on the final Rating is further modified by a measure of the dispersion of historical alphas among relevant peers.

Rating scale: Gold, Silver, Bronze, Neutral, and Negative. For active funds, Gold, Silver, or Bronze reflects the MRG's level of expectation that the fund will be able to deliver positive alpha net of fees relative to the standard benchmark index assigned to the Morningstar category. Ratings reflect the MRG's overall assessment, are overseen by an Analyst Rating Committee, and are continuously monitored and reevaluated at least every 14 months.

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