Morgan Stanley Inst Discovery I MPEGX

Its risks are on display.

Morningstar's Take MPEGX

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	-24.31	-11.06
2021	-11.92	-24.98
2020	142.56	103.30
2019	39.80	7.28
2018	12.14	18.80

Data through 2-28-22

3-17-22 | by Katie Rushkewicz Reichart

Morgan Stanley Institutional Discovery is showing its downside. 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 are rated 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 Mid Cap Growth Index’s fell off its recent Nov. 16, 2021 peak to a March 8, 2022 trough, the U.S. vehicle's I shares crashed 51%, double the benchmark’s decline. Apple’s privacy guidelines change also weighed on several advertising-dependent holdings, including Pinterest and Twitter.

Other issues underscored a lack of traditional risk management. The team builds a compact portfolio that leans heavily on its highest-conviction ideas and will hold large stakes in successful picks without taking gains along the way. That approach works well on the way up and has fueled strong long-term results, but can inflict short-term pain. For instance, gaming company Roblox, nearly 6% of assets, lost 64% of its value for the year to date through mid March.

The strategy has been through such periods before and gone on to thrive. Huge gains in 2009 and 2017 followed weak showings in prior stretches. 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-peson 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. 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.

The team's research process distinguishes itself in a few other ways. For example, four analysts on the team conduct deep-dive research to 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 Mid Cap Growth Index's sector weightings. They're also willing to make concentrated bets on their best ideas, though successful picks can grow into big positions that court significant stock-specific risk. Meanwhile, it has invested in the Grayscale Bitcoin Trust as well as occasional private companies, increasing the likelihood of volatility.

Impressive performance led to $2 billion in inflows in 2020, and the team announced the fund would close to new investors as of April 5, 2021. It was also closed at points in the past, indicating the team’s attention to keeping assets manageable enough to stay nimble. Yet following outflows in 2021, it reopened to new investors in March 2022.

Most portfolio holdings fall in the growth bucket, with research heavily focused on companies causing disruptive change in their respective industries, especially those in the technology, communications, and healthcare sectors. Top holdings at year-end 2021 included a handful with no Morningstar Economic Moat, including top holding MongoDB at 7% of assets and Twitter at nearly 4%.

The team is willing to own unprofitable names if it sees a path forward, but that can come at the expense of the portfolio's aggregate quality metrics. Indeed, its returns on invested capital, assets and equity are below the benchmark's, 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's clearly a risky fund.

Performance Pillar | Katie Rushkewicz Reichart 03/17/2022
The fund's concentrated, high-growth style lends itself to boom-and-bust returns over short time periods, though long-term investors have come out ahead. Since Dennis Lynch took over in early 2002 through February 2022, the fund gained 11.8% annualized, ahead of the Russell Mid Cap Growth Index's 10.2% and the mid-growth Morningstar Category's 8.6%.

The edge was narrower in risk-adjusted terms, reflecting outsize returns in up and down markets. Strong showings landed it near the category's top in 2009, 2010, 2017, 2018, 2019, and 2020, while it fell toward the bottom in 2011, 2012, 2014, 2015, 2016, and 2021.

Recent performance exemplifies this strategy's extremes. It had a banner year in 2020, with the I shares gaining 142%, nearly four times the benchmark's return. The portfolio's technology holdings both buffered it in early 2020's pandemic-induced market selloff and supported its subsequent ascent, as it held stakes in COVID beneficiaries, such as Zoom Video Communications, Peloton, 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 40.1% loss for the trailing year through February 2022, a period where the benchmark lost one tenth as much, 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 here. 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, this hiring helps prepare for long-term succession.

The team runs a variety of strategies spanning the market-cap spectrum. While it 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 an additional resource.

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, Discovery 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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