Active ownership: investing for the long term in volatile markets

Managing Director and Portfolio manager, William Lock, Head of Morgan Stanley Investment Management's International Equity Team, seeks out the world's safest and most sustainable compounders.

William Lock, Managing Director, Portfolio Manager and Head of the London-based International Equity Team.

It has become fashionable to access global equity markets broadly, passively, synthetically, particularly while markets have continued their upward trajectory. Late cycle investors considering a potentially bumpier ride for markets ahead, and a more complicated corporate and geopolitical landscape, may wish to revisit the attractions of truly active investing. Benchmarks, in our view, are inherently risky; simply seeking to match index performance creates a false complacency. Active investing, particularly in the hands of disciplined and experienced managers, offers the potential for meaningful long-term outperformance.

Global franchise: the essence of active investing

"Red October" saw the MSCI World Index experience its first correction of over 10% since early 2016. The correction is attributed to a range of factors including rising interest rates, political upheavals in Europe and the escalation of trade tensions between the US and China.

We cannot influence or even predict the macroeconomic or political environment, but we can aim to ensure that the stocks we hold are the most robust we can find. Our investment team is focused on selecting high quality stocks that will grow capital over the long term and seek to minimise the chance of any permanent loss of capital. We call such well-managed high and sustainable return on operating capital companies with growth potential and resilient earnings, "compounders".

These companies are fairly rare so, when we buy them, our conviction is reflected in meaningful position sizes, up to 10% of the portfolio, and an active share for the portfolio of greater than 90%. The advantage of a portfolio of such stable compounders is evidenced by the Global Franchise strategy's 22 year track record of long-term capital appreciation at lower long-term volatility than that of broad benchmarks.

Engaging with sustainable compounders in a more complex world

The Global Franchise strategy has always centred on capital light companies with strong intangible assets, such as brands or networks, which enable pricing power and steadily growing revenues, robust profits, strong free cash flows, and a steady dividend.

As active investors, we are ever vigilant to the changing consumer and competitor landscape and mindful of potential risks to the sustainability of long-term returns on capital. This includes material ESG risks as well as material opportunities ESG can present to the companies we own. Our portfolio managers analyse material ESG factors themselves as part of their bottom-up fundamental research. We believe that incorporating ESG is essential to long-term compounding, helpful in identifying sustainable compounders and picking the winners from the losers.

How do some of the world's most famous branded companies continue to dominate mind share and market share in an ever more disruptive world of e-commerce and social media? It is a question on which we are increasingly focused. The answer for consumer goods companies lies in staying relevant to the consumer's changing preferences and values, for example the use of natural or organic ingredients or more environmentally friendly packaging. Consumer goods companies that stay relevant can gain market share and maintain pricing power over competitors who do not. This often results in rising long-term returns as a consequence. Further, governance structure really matters – we typically prefer agile and decentralised management teams that can react to local market conditions, choose to invest in their franchises and do not squander free cash flow on low return acquisitions.

Not all strong franchise companies are consumer brands. Recurring revenues from networks can also mean compelling stability of earnings, even more so with the shift to the cloud. For the software and IT services companies in which we choose to invest, staying relevant means supporting other businesses in their changing digital needs and being cautious with the use of data.

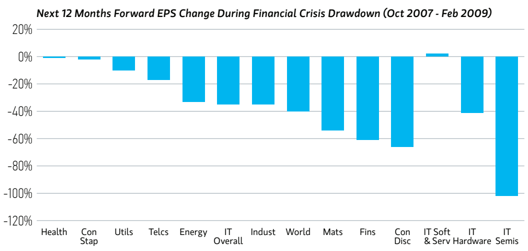
We do not analyse companies from a distance. We handle proxy voting directly, meeting regularly with the senior management, board members and remuneration committees of companies we own, and engage where we must. Often that means focusing on incentive structures, which in our view can be critical to the decisions of management.

An active portfolio to protect against today's uncertain markets

In our view, a few conditions that shaped the investment environment from the last financial crisis to 2016 have changed in the last two years: earnings, not multiples, will be the dominant driver of performance and holding cash has become a more viable option with US 12-month Treasuries around 2.6%, and one year inflation expectations around 2%. Additionally, a more volatile political climate suggests companies will need to manage for greater protectionism and shifting tide of opinion on data protection and antitrust.

High quality is by its nature less exposed to potential adverse events, as demonstrated by the Global Franchise strategy's history of relative outperformance in down markets. Even more interesting perhaps is a closer look at the sustainability of earnings across different sectors during the last financial crisis. Earnings of software and services companies were up 2% over 18 months, against a 40% fall for the MSCI World Index, while health care and consumer staples were only down marginally. With our portfolio's primary skew to these high quality defensive sectors, it gives us some comfort going forward that the portfolio earnings are likely to hold up better than the market as a whole.

Figure 1: History suggests that the software and services subsector is relatively defensive



Source: FactSet.

Political uncertainty, increasing regulatory scrutiny, climate change and rapid advances in technology – the conditions for companies' continued success are ever more complex. In this changing world, global equity investors should be looking for companies that are robust and for portfolio managers that own stocks for the long term rather than just rent them.

	Oct 2017-Oct 2018	Oct 2016-Oct 2017	Oct 2015-Oct 2016	Oct 2014-Oct 2015	Oct 2013-Oct 2014
Global Franchise Composite	**8.17**	**21.75**	**2.14**	**12.52**	**7.38**
MSCI World	**1.16**	**22.77**	**1.18**	**1.77**	**8.67**

Performance shown gross of fees and in USD. Past performance is not a reliable indicator of future results. Individual client portfolios may differ from the Composite performance shown.

Morgan Stanley

INVESTMENT MANAGEMENT