Morgan Stanley
INVESTMENT MANAGEMENT

Global Equity Observer

Quality is worth the wait

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Milestones and anniversaries offer the chance for reflection. My deeply held belief, shaped by some of the world's great investors, is that managing active equities with a focus on high quality remains critical to compounding capital over the long term for clients.

AUTHOR

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Managing Director

10 lessons learned from 30 years of investing

1. PICK GREAT BUSINESSES AND GET OUT OF THE WAY OF THE LONG-TERM COMPOUNDING

I believe our understanding of what constitutes a high quality company and our determination to maintain a high quality bar for our portfolios is what sets us apart, combined with our long-term perspective. We seek well-managed companies which can grow at long-term sustainably high returns on operating capital with low volatility of operating profits, pricing power and limited leverage. Identifying companies with these characteristics is very important, but just as important is giving these natural long-term compounders time to compound. We don't rent businesses, we own them for the long term.

2. YOU WIN TWICE WITH HIGH QUALITY EQUITIES

Avoiding the permanent destruction of capital is arguably just as important for investors as the chance to make money. I like to say you win twice by investing in our high quality equity approach: you win by sticking with winning businesses that compound in a superior way over the long term and you win again by losing less in sustained market downturns. Winning twice drives good long-term absolute returns.

3. THINK ABSOLUTE, NOT RELATIVE

A focus on risk is important, but I would argue that the industry is too focused on relative risk. We focus on absolute risk—the chance of losing money on an investment—not risks relative to a benchmark. We concentrate on seeking to understand any financially material franchise, regulatory, management, ESG (environmental, social and governance), and valuation risks associated with

> "I believe the secret to longevity in this business is to remain curious, to keep learning and to continue to ask the right questions."

our businesses. We believe that thinking in absolute terms means we are more likely to pick long-term winners and, just as importantly, avoid the losers.

4. WHAT YOU DON'T OWN IS JUST AS IMPORTANT AS WHAT YOU DO OWN

Certain sectors or industries don't make the grade for our high quality portfolios, for example, banks, utilities, real estate and energy. For nearly three decades, our skew to higher quality stocks in higher quality industries has provided clients with attractive long-term returns and resilience through the cycle.

5. VALUATION MATTERS

We're not just fussy on quality, we're also fussy on price—call this being double fussy—which has driven our long-term returns and the shape of those returns. As the late Charlie Munger pointed out, there is no great company that cannot become a lousy investment if you pay too much for it. We seek to buy and own companies at or below a conservative estimate of their long-term intrinsic value. Valuation discipline matters, and we focus on free cash flows rather than earnings, because cash is real. Even if something is too expensive now, experience has taught me that most things you want to own come your way eventually. Be patient.

6. ENGAGE AND TRUST YOUR INSTINCTS WITH MANAGEMENT

We engage with management to understand if they share our same long-term perspective in how they run the company, and if they allocate cash accordingly. We want to know if they grow or milk long-term intangibles such as research and development and branding/digital marketing. Are they able to innovate and grow sustainably? How well do they allocate capital? Many pay plans incentivise short-term outcomes which get management paid but could have damaging outcomes for long-term compounding. We aim to be aware of what behaviour is incentivised and whether management will act on these incentives, and we try to encourage change in pay plans we don't like.

7. HIGH QUALITY ASYMMETRIC PORTFOLIOS SERVE INVESTORS WELL AS A CORE ALLOCATION

Investment strategies which can compound over time with a high quality asymmetric profile can reap stronger and steadier rewards over time; for example, it is better to capture 80% of the upside and only lose 50% on the way down than to achieve 100% on the way up and lose everything (and possibly more!) on the way down. Whilst steady compounding may be less exciting than the latest trend, I believe this steadiness through thick and thin makes for an attractive core allocation for investors' portfolios. You also get to sleep better compared to some of the wilder alternative rides in the market.

8. REMAIN CURIOUS

Markets have provided an ever more interesting environment in which to seek to compound our clients' capital. I believe the secret to longevity in this business is to remain curious, to keep learning and to continue to ask the right questions. I've learned to encourage my team to question everything and everyone, including me(!), and foster a culture that rewards curiosity. We are lucky enough to work in one of the most interesting industries out there. If markets bore you, then it's probably your problem rather than that of the market! Seek always to kindle this curiosity by surrounding yourself with clever, interesting people who also love what they do.

9. STAY RELEVANT

It was Gertrude Stein who said, "Money is always there but the pockets change; it is not in the same pockets after a change." What we look for has never changed over 30 years—we buy businesses which can grow at sustainably high long-term returns on unlevered operating capital and at low volatility of unlevered operating profit. However, just as the world constantly changes, so where we find such businesses has changed over the years. Sometimes rivers cease to flow under historic toll bridges, instead diverting to other bridges. Be aware of this and recognise the need to stay relevant without giving up your basic principles and discipline.

10. QUALITY IS WORTH THE WAIT

I agree with Charlie Munger that "the big money is not in the buying or the selling, but in the waiting." Our investment approach focuses on identifying high quality companies that can compound. The art, as we have learned, is being patient enough to allow them the time to do so. Be the tenacious tortoise in a drove of hype-driven hares.[1]

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[1] Aesop's Fable: a race between a tortoise and a hare. The hare is so confident of winning it stops during the race and falls asleep. The tortoise continues to move slowly and ends up winning the race.

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 value of securities owned by the portfolio will decline. 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 strategy. Please be aware that this strategy may be subject to certain additional risks. Changes in the worldwide economy, consumer spending, competition, demographics and consumer preferences, government regulation and economic conditions may adversely affect global franchise companies and may negatively impact the strategy to a greater extent than if the strategy's assets were invested in a wider variety of companies. In general, **equity securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, and market risks. **Stocks of small- and mid-capitalisation companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities 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** 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 publicly traded securities (liquidity risk). Non-diversified 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. **ESG strategies** that incorporate impact investing and/or Environmental, Social and Governance (ESG) factors could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. As a result, there is no assurance ESG strategies could result in more favorable investment performance.

DEFINITIONS

Free cash flow (FCF) is a measure of financial performance calculated as operating cash flow minus capital expenditures. FCF represents the cash that a company is able generate after laying out the money required to maintain or expand its asset base.

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