Morgan Stanley
INVESTMENT MANAGEMENT

Global Equity Observer

The importance of discipline in the long game

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Managing a public equity portfolio for clients is an exercise in extreme transparency. Investors are able to scrutinise returns on a daily basis and benchmark them against a closely followed index. While we believe our long-term absolute investment performance will be dictated by how well a few dozen businesses we own perform, our relative performance is dictated by what nearly 1,500 other stocks in the market do.

That in turn depends on the actions of millions of market participants. A small subset of them might approach public equity investing in a similar fashion to us, but most others will not.

In fact, the equity market has many different players with often very different objectives, mandates and time horizons. A university endowment with a multi-decade time horizon, a day trader buying a zero-day call option on the S&P 500 Index at the opening, a market-neutral equity long-short hedge fund and a pension trustee deciding how to best meet her long-term liabilities all might look for "performance," but clearly rely on very different strategies to achieve it.

As Morgan Housel in the opening chapter of "The Psychology of Money" has put it, "No one's crazy." Perfectly reasonable actions of one actor can appear to be irrational to another. Chasing up a meme stock on an impossible-to-explain valuation as it squeezes higher after a hashtag storm on social media might look like an act of clinical insanity to a fundamental equity investor but could actually be a very profitable trading strategy for a momentum trader who is there to rent a stock for a few days or maybe even hours.

Some investment themes might drive the market for months, quarters or even years, prompting us to explain on our quarterly calls why we are not (sufficiently) exposed to the ripping end of the market. Unprofitable tech was the belle of the ball during the "free money" era of COVID-lockdowns and Gen-AI (generative artificial intelligence) is the dominant thematic now. Conversely, some pockets of the market might become completely out of fashion and thus deemed un-investable by those seeking short-term returns.

> "Even if one is lucky with an entry multiple, true compounding of value is only possible when the underlying profits of the business show strong growth."

For those chasing "thematic" investments, the valuation multiples they are prepared to pay are often an afterthought. Instead, the focus is for how long the theme remains relevant and the mood music positive to attract more buyers into the space. In other words, for those actors the key is not to get the intrinsic long-term value of future cash flows right, but to guess what other people will pay for a particular stock.

> "Our main focus is on owning and checking, and checking again, and then again, that we have a portfolio of those rare companies with the ability to compound at a high and sustainable return on their operating capital, trading at what look like reasonable valuations for the long term."

These investor sentiment mood swings are best captured by rerating and derating of near-term valuation multiples—something we spend very little time trying to predict. Instead, our main focus is on owning and checking, and checking again, and then again, that we have a portfolio of those rare companies with the ability to compound at a high and sustainable return on their operating capital, trading at what look like reasonable valuations for the long term.

It is interesting to break down the drivers of market returns according to time frame. In any single year, multiples can often be *the* driving force behind what equity performance is realised. However, when approached from the lens of a long-term investor, the significance of multiples in driving returns becomes increasingly less relevant the longer the investment horizon. When you split the annualised returns of MSCI World between earnings growth, multiple changes and dividends, over one year to 31 December 2023[1] the multiple accounts for 68% of the total return, over five years 43%, 10 years 20%, and over 20 years only 4%. Year-to-date to 31 March 2024, it's as high as 85%! Meanwhile, earnings growth only accounts for 24% over one year but as much as 71% over 20 years. In other words, earnings compounding (peppered with some capital return) is the engine that drives long-term wealth creation in the equity markets.

Let me illustrate this point with our investment in a European luxury goods company. We bought the stock in select Global portfolios just as the market troughed in March 2020 on peak Covid uncertainty. At a multiple of just ~20x 12-month forward earnings,[2] our timing was auspicious, purchasing the stock close to the bottom of its valuation trading corridor. A good fortune we don't expect to replicate too often! A subsequent re-rating towards a more normalised multiple of around ~24x was helpful for our returns, but its ~110% rise in 12-month forward earnings estimates has been the true driver of its excellent returns.[3] In other words, even if one is lucky with an entry multiple, true compounding of value is only possible when the underlying profits of the business show strong growth.

That is not to say that we don't care about multiples. Our investment approach is heavily focused on making sure that valuation, using cash-based earnings over a long time, looks reasonable and justified by the fundamentals. We are "double fussy" on both the ability of our holdings to compound earnings and the multiple we are paying for it. However, we don't spend our time trying to predict where multiples are going to swing in the near term based on positioning, market sentiment or exposure to a particular theme.

In a market obsessed with catching the next big thing or trying to chase a MOMO (momentum trading) train, where relative performance is often dictated by large swings in multiples of an extremely small number of stocks with gargantuan market capitalisation, our approach remains unchanged. Namely, finding companies at a reasonable valuation that can reliably compound earnings at a high return on capital through good and, importantly, tough times, run by good managers with a solid capital allocation framework.

As was highlighted by the head of our team, William Lock, in our February 2024 Global Equity Observer, *"Quality is worth the wait"*: "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."

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[1] Source: FactSet, annualised returns to 31 December 2023 and YTD to 31 March 2024.

[2] Source: FactSet, May 2024.

[3] Ibid.

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

Market Capitalisation is the total dollar market value of all of a company's outstanding shares.

Return On Capital (ROC) is a measure of a company's efficiency at allocating the capital under its control to profitable investments, calculated by dividing operating income by total capital.

The **MSCI World Index** is a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets. 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 **S&P 500® Index** measures the performance of the large cap segment of the U.S. equities market, covering approximately 75% of the U.S. equities market. The Index includes 500 leading companies in leading industries of the U.S. economy.

IMPORTANT INFORMATION

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market.

A separately managed account may not be appropriate for all investors. Separate accounts managed according to the particular Strategy may include securities that may not necessarily track the performance of a particular index. A minimum asset level is required.

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