SGH SG HISCOCK & COMPANY

Morgan Stanley

Morgan Stanley Global Sustain Fund

31 January 2024

Performance[1] (Unhedged)	Total Net Return[2]	MSCI World (Net) Index [3]
1 month (%)	5.33	4.46
3 months (%)	11.31	11.22
6 months (%)	8.08	7.35
1 year (%)	23.90	24.71
3 years (% p.a.)	10.51	13.56
Inception (% p.a.) [2]	12.12	12.09

Performance[1] (Hedged in AUD)	Total Net Return	MSCI World (Net) Index - Hedged[4]
1 month (%)	2.39	1.76
3 months (%)	14.78	14.24
6 months (%)	5.39	5.02
1 year (%)	14.63	16.38
3 years (% p.a.)	4.67	8.28
Inception (% p.a.) 5	6.37	11.79

Past performance is not a reliable indicator of future performance.

[1] Distribution Return is the return due to distributions paid by the Fund; Growth Return is the return due to changes in initial capital value of the Fund, Total Net Return is the Fund return after the deduction of ongoing fees and expenses and assumes the reinvestment of all distributions.

[2] Performance prior to 30 June 2020 is for the Global Sustain Composite was created on April 30, 2018 and its inception date is April 30, 2018. This Composite comprises all separately managed accounts managed on a fully discretionary basis according to the Global Sustain strategy. This has been adjusted to reflect the fee of 1.18% p.a. for Morgan Stanley Global Sustain Fund.

[3] Net of Withholding Tax, AUD

[4] MSCI World (Net) Index – hedged to AUD

[5] The inception date for the Morgan Stanley Global Sustain Fund (Hedged) (ETL5365AU) is 1 July 2020, with a start unit NAV price of $1.0133. While the Morgan Stanley Global Sustain Fund was seeded on 29 June 2020, the Hedged class was not invested until 1 July 2020.

[6] Includes estimated GST payable, after taking into account Reduced Input Tax Credits ("RITC").

Key Facts

Investment manager	SG Hiscock & Company Ltd
Fund manager	Morgan Stanley Investment Management (Australia) Pty Limited (MSIM)
Inception date	29 June 2020
Management fee[6]	1.18%
Performance fee	n/a
Fund size	67.5M
Number of stocks	35-50 stocks
Dividends payable	Annually
Buy/sell spread	+0.20/ -0.20%
Minimum initial investment	$20,000
Base currency	AUD
APIR	ETL9199AU
APIR (hedged)	ETL5365AU
mFund (unhedged)	SHF09
Domicile	Australia
	Unit price (unhedged)
Application	$1.3656
Net Asset Value	$1.3629
Withdrawal	$1.3602
	Unit price (hedged)
Application	$1.2357
Net Asset Value	$1.2332
Withdrawal	$1.2307

Fund strategy

The Morgan Stanley Global Sustain Fund offers a high-quality approach to ESG investing with a clearly defined process. The Strategy invests in high-quality companies at reasonable valuations that can sustain their high returns on operating capital over the long term. The portfolio has a low carbon impact and scores well on environmental, social and governance (ESG) factors as measured by third parties, such as MSCI ESG, relative to broad equity indices such as the MSCI World Index. The Strategy seeks to provide attractive long-term returns with less long-term volatility than the broader market.

Portfolio positioning

10 Largest Holdings

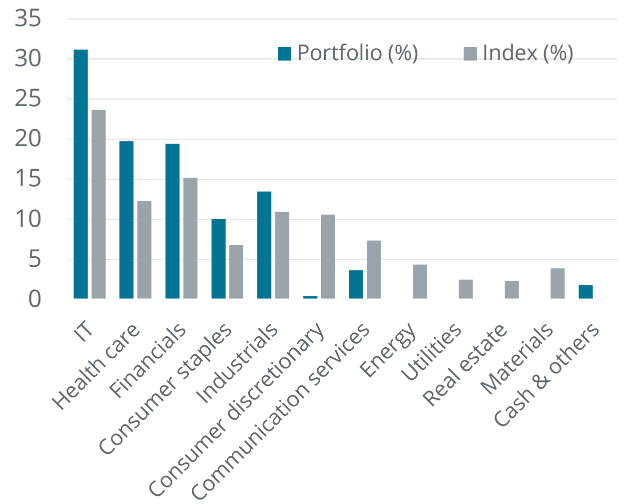
Name	Country	Sector	% Portfolio
Microsoft Corporation	United States	Software	6.50
SAP SE	Germany	Software	5.87
VISA Inc	United States	Financials	5.28
Accenture Plc	United States	IT Services	5.08
Intercontinental Exchange Inc	United States	IT Services	3.56
Constellation Software INC/CANADA	Canada	Software	3.40
Thermo Fisher Scientific Inc	United States	Life Sciences Tools & Services	3.34
Relx Plc	United Kingdom	IT Services	3.23
Beckton Dickinson & Co	United States	Medical Technologies	3.14
Reckitt Benckiser Group Plc	United Kingdom	Consumer Goods	3.12
TOTAL			**42.52**

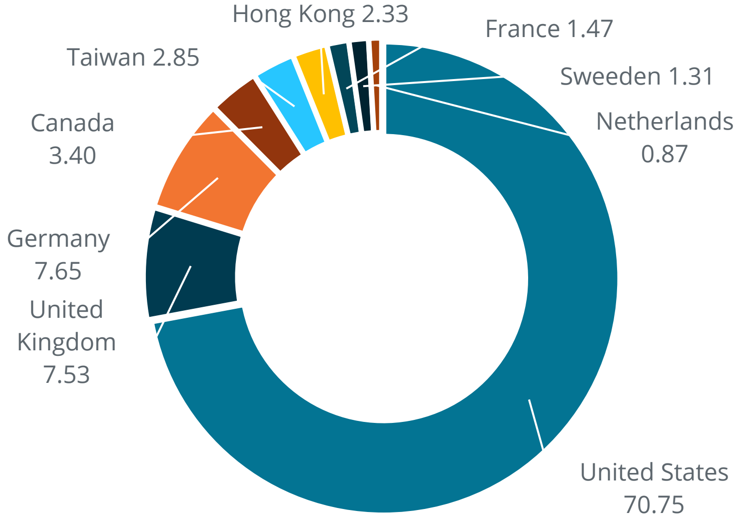
Stock Attribution

Top 5 Absolute Contributors	Performance Return %	Contribution %
SAP	17.02	0.88
Microsoft	9.14	0.58
Constellation Software	15.13	0.49
VISA	8.34	0.43
Accenture	7.43	0.37
Top 5 Absolute Detractors	**Performance Return %**	**Contribution %**
IQVIA	-7.09	-0.23
AIA	-7.75	-0.19
Texas Instruments	-2.37	-0.06
Atlas Copco	-3.15	-0.05
Nike	-3.46	-0.02

Source: Morgan Stanley Investment Management. Data as of 31 January 2024.

Sector & Country Allocation (% of Total Net Assets)





Source: Morgan Stanley Investment Management. Data as of 31 January 2024.

Portfolio Review

In January, the Portfolio returned +5.33%, ahead of the MSCI World Net Index which returned +4.46%.

The January outperformance was due to sector allocation as the underweight in Consumer discretionary, the zero weight in Materials and the overweight in Information Technology helped performance. Stock selection was negative as weakness in Health Care and Financials more than offset strength in Information Technology and Consumer Staples.

As of January 30, 2024, the Portfolio's carbon footprint was 84% lower than the MSCI AC World Index.*

**Source: Trucost based on the Scope 1 & 2 carbon emissions per $1million of portfolio companies' sales. The portfolio-level statistics show the weighted average carbon intensity (WACI).*

Market review

After a boisterous end to 2023, the MSCI World Index was significantly more muted in January, returning +1.2% in U.S. dollars (USD) and +1.8% in local currency (+4.5% in AUD).

Exposure to continued AI optimism saw Communication Services and Information Technology (both +4%) finish as the month's top performers, helped by Netflix (+15%) and Meta (+10%) and Nvidia (+24%) and ASML (+15%) respectively.

Health Care (+3%) also outperformed the MSCI World Index, while Financials and Consumer Staples (both +1%) were in line. All other sectors finished in the red with the lower quality, more cyclical sectors – notably Real Estate (-4%) and Materials (-5%) – finishing at the bottom.

Turning to geographies, the U.S. (+2%) was only a touch ahead of the index in the month. Japan (+5% USD, +8% local currency) was the only other major market to outperform in USD and local currency, well ahead of its Asian peers Singapore (-4%, -3%) and Hong Kong (-10%, -10%).

Looking at the major European markets as a whole: Italy, France and Switzerland (each 0%, +2%) marginally outperformed in local currency but lagged in USD, while Germany (-1%, +1%), Spain (-1%, +0%) and the UK (-1%, -1%) were all slightly behind the index.

Outlook

Driving Quality

As a team, we've spent the last quarter of a century seeking out what we consider to be the world's best compounders. These are companies we believe can continue to steadily – and organically – grow their earnings and free cash flows at an attractive rate for the long term.

Compounding is a powerful force. Grow $1,000 at 10% over seven years and you will have doubled your money. Continue for another 10 years and you'll have $6,000.

We have two principal tasks. One is finding the compounders. The second is striving not to overpay. If a company is too expensive then it is too expensive – and you run the risk of the price receding to a fair and sensible level.

The recently departed Charlie Munger famously said,

> *"A great business at a fair price is superior to a fair business at a great price."*

We agree. In his inimitable style, Munger also said,

> *"If you buy something because it is undervalued, then you have to think about selling it when it approaches your calculation of intrinsic value. That's hard. But, if you can buy a few great companies, then you can sit on your ****.... That's a good thing."*

Here, we are less inclined to agree. The truth is, you can't just sit and watch – it is essential to check and check again the compounding potential is intact and not under threat, that there's no risk of fade of returns, and that the valuation remains reasonable. That's a challenge we meet with rigorous fundamental analysis and company engagement.

What tells us a company might be a high quality compounder? We have two measures that are part of our quantitative screen, the principle one being **Return on Operating Capital Employed**, or **ROOCE**, and the other being gross margin. ROOCE isn't a measure readily found in FactSet or Bloomberg screening tools; even if you Google it, the search will likely default to ROIC (Return on Invested Capital). ROOCE isn't an invention of ours, however. It is a subset of ROIC (also an important measure; it includes goodwill and accounts for past capital allocation decisions). Essentially, what ROOCE tells us is how much incremental capital is required to grow a business. Using a car analogy, if we think of ROIC as the quality of the car engine and the driver's historical capability, ROOCE is only the quality of the car engine.

Historically, our analysis shows that high ROOCE companies have had a better annualised long-term return than low ROOCE companies. Using 20 years of data for the MSCI World Index and dividing the constituents into five buckets, split highest to lowest by ROOCE, the highest ROOCE bucket returns 10.5% annualised, the next returns 10.2%, then 9.5%, then 8.5% and finally 7.5% for the lowest bucket.1 At first glance the spread might not seem that wide. But if we think of it in terms of compounding, $1,000 for 10 years at 10.5% rather than 7.5% results in $2,456 instead of $1,917 – nearly 30% more. Compounding matters.

ROOCE explained

ROOCE can be thought of in two distinct parts. The return component of ROOCE, the "RO", is from a company's Profit and Loss account – specifically the EBIT, or Earnings Before Interest and Tax. The operating capital employed piece, the "OCE", comes from the balance sheet and is a combination of the net value of the Property, Plant and Equipment the company has, plus its inventory, along with the trade working capital (the net of debtors and creditors). The best way to achieve a high ROOCE is to have a high level of profitability for the "RO", and a limited need for operating capital, the "OCE". Companies that exhibit these characteristics are therefore typically high margin, asset light operations.

Why high and stable gross margins matter When we look for high margins, we're after high gross margins. Companies with a relatively limited cost of goods tend to have high gross margins and therefore high gross profits. Performing the same exercise for gross margin as we did for ROOCE, we split the MSCI World Index constituents into buckets from highest to lowest for gross margin. The results are remarkably similar, with the highest gross margin bucket producing the highest annualised 20-year return (+11.5%) and the lowest gross margin bucket producing the lowest return (+8.5%).

Essential in the context of high gross margins is pricing power, whether a company is facing an inflationary, disinflationary or deflationary environment. Pricing power means a company is able to pass on input cost inflation to customers. Should input costs then recede, pricing power enables these companies to hold on to the higher pricing. This is reflected in the long-term stability of high gross margins. Effectively, you can't sustain your high gross margin if you don't have pricing power.

Returning to our car analogy, high gross profits might be thought of as the fuel needed to run the engine – the force behind the organic growth. Greater gross profit for a company means it can spend more on operating costs to organically drive revenues.

These operating costs are typically talent (the workforce), research and development (R&D) and marketing. They help power the sustainability of long term ROOCE, keeping the company and its brands, its networks, products and services relevant to its customers, be they consumers or businesses. High gross margins also mean that a company is less vulnerable to any rise in cost of goods (COGs), as COGs lower the percentage of revenues.

The average company in the MSCI World Index, represented by the index itself, has a 30% gross margin and a 20% EBITDA margin (earnings before interest, tax, depreciation and amortization).2 In between these two lie the operating costs.

To put some numbers on this, if the average company had, say, $20bn of sales, using the average gross margin and EBITDA margin referenced above, $20bn x 30% = $6bn of gross profit, $20bn x 20% = $4bn of EBITDA. Thus, the difference between the two is $6bn – $4bn = $2bn – so 10%, or $2 bn of these sales are operating costs. One of our high quality companies, Procter & Gamble, a U.S. based household and personal care company with global operations and a host of world leading brands, has a 50% gross margin and a 26% EBITDA margin. So that's more than twice the spend and investment of the average company on hiring the best, along with innovating, marketing and advertising at much greater intensity – it's a substantial advantage.

It is our focus to ensure company management is efficiently driving the operating costs and get a strong handle on how they might allocate cash flows and possibly use the balance sheet (cash and debt) for acquisitions. As we discussed in a previous commentary (To Buy or Not to Buy, May 2023), we are not averse to acquisitions, but if they come at the cost of reducing ROOCE, then we believe it may signal that company management has misallocated capital and has potentially (and possibly permanently) diluted the quality of the whole company by buying a lower quality business. This is aside from the issue of overpaying (also discussed in our May 2023 piece).

Perversely, an improving ROOCE could also be a red flag to watch for, just as much as a decline. In the short term, higher ROOCEs can easily be achieved simply by cutting operating costs, such as reducing R&D or marketing costs. Profits rise, but long term the sustainability of organic growth at the revenue line will be challenged due to the underinvestment. The business will likely slow, and its intrinsic value might decline.

The investment road is long, very long. We don't need an on-trend, flashy sports car to whizz from only A to B, or to go too fast and then run out of fuel. And we're not taking our chances on a cheap and cheerful runabout either. We're looking for reliable, sensible cars with decent performance that won't let us down, or cost a fortune to run, aren't complicated to drive and ones we're happy to ride in for a very long time – on the right road, in all weathers.

Existing high ROOCE and gross margins suggest companies to look at closely. However, most of our research effort is spent understanding whether they will both remain high given all the challenges firms face when continuing to grow at high profitability, be it competitors, disruptors, regulators, fashions or economic cycles.

After all (and with apologies to Thomas Jefferson), "the price of compounding is eternal vigilance."

Commentary Disclosures

[1] Source: FactSet; International Equity Team analysis
[2] Source: FactSet, December 31, 2023

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