SGH SG HISCOCK & COMPANY

Morgan Stanley

Morgan Stanley Global Quality Fund

31 March 2024

Performance[1] (Unhedged)	Total Net Return[2]	MSCI Word (Net) Index[3]
1 month (%)	0.00	3.02
3 months (%)	9.84	13.88
6 months (%)	14.46	20.01
1 year (%)	18.39	28.44
3 years (% p.a.)	10.27	14.36
5 years (% p.a.)[2]	10.68	14.00
10 years (% p.a.)[2]	12.68	13.30
Inception (% p.a.) [2]	12.92	13.94

Past performance is not a reliable indicator of future performance.

Performance[1] (Hedged in AUD)	Total Net Return	MSCI Word (Net) Index – Hedged [4]
1 month (%)	0.19	3.34
3 months (%)	5.58	10.0
6 months (%)	14.20	20.14
1 year (%)	13.86	24.83
3 years (% p.a.)	4.42	8.66
Inception (% p.a.) [5]	7.56	13.58

[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 Morgan Stanley Global Quality Composite which was created on July 31, 2013 and its inception date is June 30, 2013. This Composite comprises all separately managed accounts managed on a fully discretionary basis according to the Global Quality strategy. The Performance has been adjusted to reflect the annual fee of 1.18% p.a. for Morgan Stanley Global Quality Fund.

[3] MSCI World (Net) Index (Net of Withholding Tax, AUD))

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

[5] The inception date for the Morgan Stanley Global Quality Fund (Hedged) (ETL5737AU) is 1 July 2020, with a start unit NAV price of $1.0107. While the Morgan Stanley Global Quality 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
Sub-manager	Morgan Stanley Investment Management (Australia) Pty Limited (MSIM)
Inception date	29 June 2020
Management fee[6]	1.18%
Performance fee	n/a
Dividends payable	Annually
Buy/sell spread	+0.20/ 0.20%
Minimum initial investment	$20,000
Base currency	AUD
APIR	ETL8936AU
APIR (hedged)	ETL5737AU
mFund (unhedged)	SHF08
Domicile	Australia
Unit price (unhedged)	
Application	$1.3425
Net Asset Value	$1.3398
Withdrawal	$1.3371
Unit price (hedged)	
Application	$1.2675
Net Asset Value	$1.2650
Withdrawal	$1.2625

Fund strategy

The Morgan Stanley Global Quality Strategy is a concentrated global equity strategy. The investment team believes that high quality companies can generate superior returns over the long term. Such companies are typically built on dominant market positions, underpinned by powerful, hard to replicate intangible assets that can generate resilient, high, unlevered returns on operating capital and strong free cash flows. Other characteristics are recurring revenue streams, organic growth, pricing power and typically low capital intensity.

Portfolio review

In March, the Portfolio was flat for the month after fees, behind the MSCI World Net Index which returned +3.02%. The Portfolio underperformed for the March quarter (Q1), returning +9.84% after fees versus +13.88% for the index.

The March underperformance was primarily due to stock selection, given weakness in Financials and, to a lesser extent, Health Care, Industrials and Consumer Staples. For sector allocation, the benefit from the underweight in Consumer Discretionary was outweighed by the drag from the zero weight in Energy.

For the March quarter overall, underperformance was due to stock selection, due to weakness in Financials and Consumer Staples, Health Care and, to a lesser extent, Industrials. Sector allocation meanwhile was positive as the benefit from the Portfolio's lack of exposure to Materials, Real Estate and Utilities outweighed the drag from the overweight in Consumer Staples.

At the strategy level*, among the largest contributors to absolute performance during Q1 were SAP, as the cloud transition started to pay off, TSMC, which forecast a return to strong 20%+ growth in 2024, Microsoft, which was helped by excitement about potential GenAI revenues, Aon, which recovered after the poor reaction to the NFP acquisition in December, and Visa, a large position up in line with the index. At the strategy level*, among the largest absolute detractors were AIA, held back by general China concerns and its financial results aside from the strong new business profits, Reckitt Benckiser, hit by disappointing Q4 numbers and then an adverse court judgement for its infant nutrition business, Pernod Ricard, on sales struggles in both the US and China, Heineken after facing multiple headwinds in 2023, and Zoetis, which was hit by an EU competition investigation.

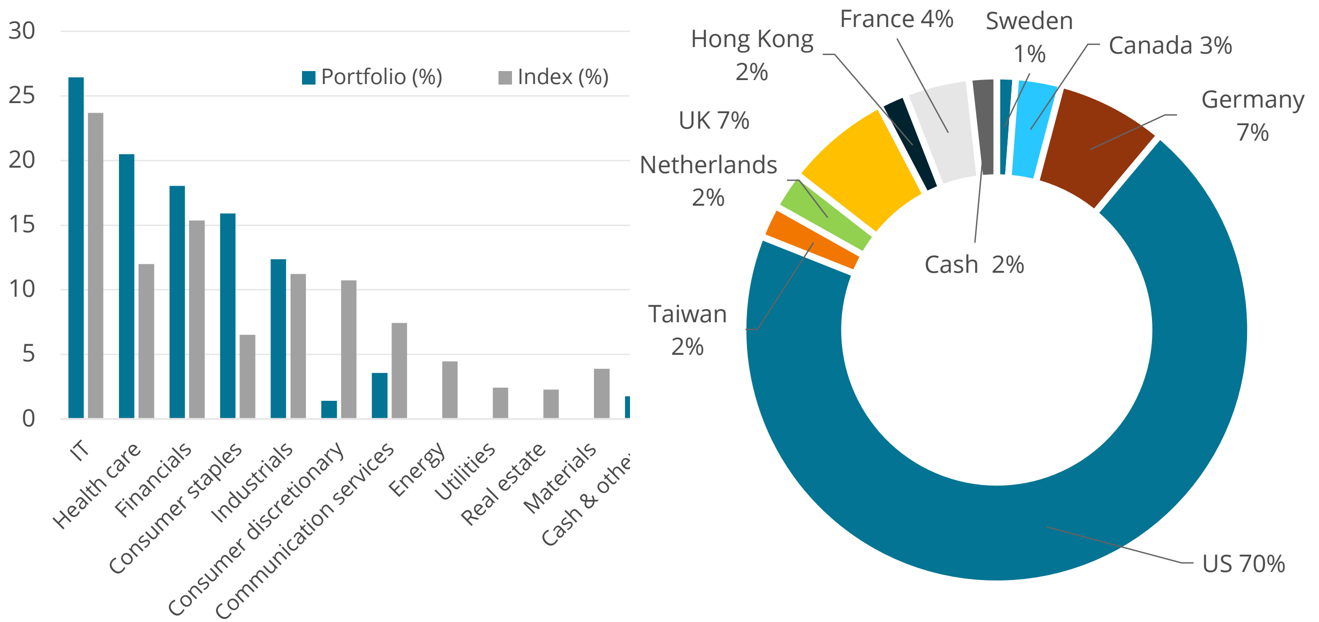
*based on the strategy's representative Account in USD.

Portfolio positioning

10 Largest Holdings

Name	Country	Sector	% Portfolio
Microsoft Corporation	United States	Software	5.86
SAP SE	Germany	Software	5.40
VISA Inc	United States	IT Services	4.72
Accenture Plc	United States	IT Services	4.22
Intercontinental Exchange Inc	United States	IT Services	3.36
Thermo Fisher Scientific Inc	United States	Life Sciences Tools & Services	3.17
IQVIA Holdings Inc	United States	Healthcare	3.08
Aon Plc	United States	Consulting	3.01
UnitedHealth Group Inc	United States	Health Services	2.98
Relx Plc	United Kingdom	IT Services	2.94
TOTAL			**38.73**

Sector & Country Allocation (% of Total Net Assets)



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

Market review

Stock Attribution

Top 5 Absolute Contributors	Performance Return %	Contribution %
Alphabet	8.79	0.23
SAP	3.98	0.21
Aon	5.40	0.16
Becton Dickinson	5.20	0.14
TSMC	5.91	0.13
Top 5 Absolute Detractors	**Performance Return %**	**Contribution %**
AIA	-17.51	-0.38
Accenture	-7.70	-0.35
Reckitt Benckiser	-9.95	-0.24
Abbott Labs	-4.37	-0.12
Zoetis	-14.85	-0.11

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

Market review

The MSCI World Index returned +3.2% in U.S. dollars (USD) in March and a similar +3.4% in local currency (+3.0% in AUD).

Alongside Energy (+9%), the month's top performer, it was the typically cheaper, more cyclical sectors that outperformed MSCI World, notably Materials (+6%), Financials (+5%) and Industrials (+4%). In terms of the higher-multiple sectors, Communication Services (+4%) was closer to the overall index, whilst Information Technology (+2%) and Consumer Discretionary (+1%) lagged.

The defensive Consumer Staples and Health Care sectors also trailed MSCI World in the month, both returning +2%. There was little variation by geography as Italy (+7% USD and local) and Hong Kong (-6% USD and local) were the only major markets to deviate by more than 200 bps from the index.

The MSCI World Index had a strong start to 2024, returning +8.9% in USD during Q1 and a slightly greater +10.1% in local currency (+13.9% in AUD).

As in 2023, it was the growth-tilted Communication Services (+13%) and Information Technology (+12%) sectors that led the pack for the quarter, the latter bolstered by Nvidia's impressive +82% year-to-date return, driving the strong performance of its Semis subsector (+36%), though Tesla's travails meant that Consumer Discretionary (+6%) did not keep up with its 2023 pace. Financials, Energy and Industrials (all +10%) were also ahead of the index, while the defensive sectors, Health Care (+7%) and Consumer Staples (+3%), lagged.

Turning to geographies, the U.S. (+10%) was a touch ahead of the index in the quarter. Italy (+14% USD, +16% local) was particularly strong and substantially ahead of its European counterparts: Spain (+8%, +11%), Germany (+7%, +10%) and France (+6%, +8%), as well as the UK (+3%, +4%) and Switzerland (-1%, +6%). Meanwhile in Asia, Japan (+11%, +19%) boasted particularly strong performance in local currency, while Singapore (0%, +2%) was flat and Hong Kong struggled (-12%, -11%), finishing the quarter as the weakest major market.

Outlook

Compound interest

The market had a very strong March quarter, with MSCI World up 9%, on the back of the 11% rise in the previous quarter.

The market rise has been about multiples rather than earnings, with the MSCI World Index at 18.6x the next 12 months earnings, versus the 13.7x trough in September 2022. This is close to the peaks reached during the COVID earnings slump and 10% above the highest multiple of 17x reached between 2003 and 2019.

The forward earnings number has been edging up, gaining 2% year-to-date and 8% in the last year. However, this is not due to an improving outlook, with forecasts for 2024 and 2025 flatlining, but the passage of time moving higher estimates to later years.

These 'higher later' earnings also make us nervous, as they are dependent on margins rising from already high levels, given 10% per year earnings growth on sales that are expected to be up less than 5% per year. MSCI World's EBIT margin is expected to go from an already peaky 15.7% in 2023 to 17.2% by 2025.

As ever, there are only two ways of losing money in equities, either the earnings going away or the multiples going away… and right now we are worried about both.

2023 was the story of the Magnificent Seven. The Seven have diverged in 2024, with talk of the Fabulous Four, but it is really the Omnivorous One, Nvidia, up another 89% in Q1 to a $2.3 trillion market capitalisation on the back of 2023's 239% return.

For anyone benchmarked against MSCI World, not owning Nvidia cost 151 basis points of relative performance in March quarter 2024, on top of 155bps in 2023, a relative hit of over 300 bps in 15 months. The largest five stocks now make up 17% of MSCI World and tend to be both fairly volatile and correlated.

This combination of ebullient and concentrated markets makes for a challenging investment environment, particularly in relative terms. Our response is to continue to think absolute… and look to compound over the long run.

Our Global Franchise strategy has been going since 1996, with reliable detailed data going back to 2000. Over the 23 years since then, the strategy has delivered annualized total returns of 11.7%. Rising multiples contributed 1.7%, meaning that 10% of annualized performance has come from the actual compounding of portfolio companies.

Breaking this down further, this 10% compounding is down to the strategy's EPS rising 7%+ per year, which includes reinvesting the proceeds of companies taken over, and dividends providing the rest of the 10%. This level outcompounds the MSCI World Index, whose earnings keep up in the good times but struggle in tough times, such as the Global Financial Crisis, when earnings fell 43% from their June 2008 peak to March 2009, and did not get back to the peak until August 2017, nearly a lost decade.

By contrast, thanks to pricing power and recurring revenue, the Global Franchise strategy's earnings only fell 15% peak to trough, and were back at peak within two years, by mid-2010.

Looking forward, we aim for the companies in our global portfolios to continue to compound at around 10%. The ambition is that the portfolio companies' revenues should grow reliably at 5-6% across the cycle, incremental improvement in margins should add another 1%, while the 4% free cash flow yield, helped by the near 100% free cash flow conversion, completes the picture.

Assuming half of the free cash flow is paid out as dividends and the rest boosts EPS either through buybacks or acquisitions, this implies around 8% EPS growth for the Portfolio, with a 2% dividend yield taking the overall compounding to 10%. We are not convinced that the market will match this compounding ability. It can keep up in the good times but is likely to suffer more heavily in the bad times. The worry is that after 15 years without a recession, barring the brief interregnum of COVID, the bad times may be on the way, though signs of an imminent US recession are fading.

Future portfolio total returns are not just from compounding, as multiples are also a factor, and more likely to be a headwind than a tailwind given high current valuations. Multiple moves dominate in the short run, as seen on the way down in 2022 and on the way back up since then.

Both the strategy and the index are at high multiples versus history, though the combination of superior cash conversion and our focus on valuation as well as quality means that the strategy is only at a c. 10% premium versus the index on a free cash flow basis, which seems too little, given the large quality differential.

The good news is that it is the compounding, where a portfolio compounds, that dominates over the longer term. In the event of a 20% de-rating, for a portfolio compounding at 10%, the portfolio's multiple would fall to around 20x forward earnings and a 5% free cash flow yield, reducing the 5-year return to 6% per year, while the 10-year return would still be a very respectable 8% per year.

By contrast, the index faces a double threat, being at least as vulnerable on multiples and more vulnerable on earnings. Being double fussy, on both quality and valuation, seems to us to be the best approach to dealing with the double threat. After all, after the MSCI World has returned 25% in five months and 50% in the last year and a half, keeping the lights on should be more of a priority than shooting them out.

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The Fund's Target Market Determination is available on the SGH website here. A Target Market Determination is a document which is required to be made available from 5 October 2021. It describes who this financial product is likely to be appropriate for (i.e. the target market), and any conditions around how the product can be distributed to investors. It also describes the events or circumstances where the Target Market Determination for this financial product may need to be reviewed.