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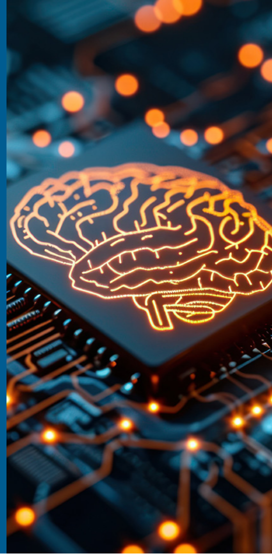

Global Equity Observer

Nvidious position

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Global equity markets are back to high multiples on high earnings, with the MSCI World Index at 18.5x forward earnings, and those earnings meant to rise 12% in 2025 despite already record margins.[1] The market seems to be dominated by the twin beliefs in the invulnerability of the U.S. economy and the massive impact of generative artificial intelligence (GenAI).

AUTHORS

BRUNO PAULSON
Managing Director

LAURA BOTTEGA
Managing Director

The confidence in the U.S. economy is understandable given that there has been no economic recession for 15 years, barring the special case of COVID in 2020, and the GenAI excitement fits with the history of potentially transformative technologies, from railways to the internet. This is not the easiest environment for an investment philosophy that looks to back proven and established winners, with earnings that are resilient in tough economic times. When risk is "on" and the market is fixated on exponential growth curves, rating stocks on their "AI-ness", a portfolio of businesses designed for long-term compounding at reasonable valuations is not in fashion. But what if the prevailing orthodoxy is wrong or starts to unravel?

While the companies we own generally continue to compound and include good potential second-wave beneficiaries of AI, where they control proprietary data and strong market positions, they are not experiencing the rocketing valuations seen by those first-wave AI "winners". This narrative is not a surprise to those who invested through the internet bubble of the late 1990s. In recent years quality has become more conflated with growth, and many quality managers are unabashed in claiming current market winners as quality trophies. The disconnect persists long enough to test the steeliest resolve, to force conversations about whether semiconductors still display cyclical characteristics, and for the conversation to turn to one $3 trillion-plus topic: Nvidia's position.

"We remain steadfast in following our quality process and our focus on valuation and fundamentals."

[1] Source: FactSet, as at 30 June 2024.

Even with its recent pullback, Forbes' "hottest stock of the decade" (June 2024)—valued at more than 20x sales and above 40x price-to-earnings (P/E)[2]—has growth rates more akin to a startup, with earnings expectations having increased a staggering five times versus where they were just two years ago. Nvidia holds a 90%-95% market share in data centre graphics processing units (GPUs), has EBIT (earnings before interest and taxes) margins of 60%+ and has single-handedly produced the equivalent of 80% of the market capitalisation rise of the dot-com bubble.[3] The current valuation assumes two things: that there will be massive commercial applications of GenAI and that Nvidia's dominance will continue.

GenAI does indeed have enormous potential in multiple areas, from coding to customer relations to image generation and beyond, and we do expect some data-rich constituents of our portfolios to benefit. However, so far at least, most businesses, which are the potential end users, have more been experimenting with GenAI rather than betting heavily as they are often struggling to find clear-cut use cases. There is a stark contrast between the forecasts of close to a trillion dollars of annual GenAI capital expenditures in a few years, and the mere $500 million of GenAI-related revenue that the world's leading IT services company that we hold has reported over the past year.

The other threat will come if any of Nvidia's four largest customers (Microsoft, Amazon, Alphabet and Meta, which currently comprise around 40% of its revenues) succeed in their efforts to design a better priced alternative to the H100 or its next generation follow-up chips Blackwell (2025) and Rubin (2026). Economics undergraduate principles spring to mind: abnormal profits first attract abnormal speculation and then abnormal competition. Moreover, there's an inherent cyclicality of demand for capital expenditure beneficiaries—whatever today's trend might be—as shown by the history of massive 50%-90% drawdowns in Nvidia's otherwise very successful history, in 2002, 2008, 2018 and 2022.[4]

For the avoidance of doubt, we are not making a bear case for Nvidia here; there is plenty of potential upside. It is just that there is plenty of potential downside as well, and the market seems more focused on the former at present. It is this very wide range of outcomes that excludes us from owning Nvidia. Our strategies do embrace change and evolve significantly over time—our flagship global strategy's consumer staples weight has gone from over 60% to under 20% over the past decade, and information technology is now over a quarter of the portfolio, even excluding the stocks that the Global Industry Classification Standard, known as GICS, moved into other sectors last year. However, we continue to look for the same characteristics since our strategy launched: strong intangible assets delivering high returns and pricing power, recurring revenues, and decent, resilient growth, all at a reasonable valuation. We have also reflected on some important lessons, most notably in consumer staples and health care. We shall aim to be less patient where larger holdings underdeliver on earnings while overdelivering on negative surprises, even if their valuations appear to be supportive. Also, we recognize we need to be more wary of transformational acquisitions, especially if they may be covering up existing problems in the core business.

While recent relative performance may have tested your trust, our experienced team sees good prospects for our portfolio holdings. Our portfolio composition has continued to evolve, from companies with powerful strongholds in dental care and painkillers to medtech for burgeoning women's health services, innovative life sciences that support medical discovery, digital music, leading data companies set to benefit from AI and the enterprise staples of our era—cloud-based software as a service, data, payments and insurance broking. We believe these should deliver a portfolio offering resilient revenue growth and faster earnings growth at a reasonable valuation, with a free cash flow yield close to that of the market, with a history of double-digit compounding achieved over the last quarter of a century.

The current index composition and economic sailing conditions have made it challenging to deliver strong relative performance. We remain steadfast in following our quality process and our focus on valuation and fundamentals. We believe our focus on absolute compounding has worked in the past and will continue to work in the future. The backdrop of high expectations generally in the market and high expectations specifically for direct GenAI plays (and increasingly one exceptional company) make us nervous about the prospects for the market. There are only two ways of losing money in equities: the earnings go away or the multiple goes away. Our "double fussy" philosophy—owning resilient earnings at reasonable valuations—should help mitigate both risks, while providing decent compounding.

[2] Source: FactSet, as at 30 June 2024.

[3] Source: Forbes, 13 June 2024, "The World's Largest Semiconductor Companies 2024"

[4] Source: FactSet, as at 30 June 2024

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

Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) is essentially net income with interest, taxes, depreciation, and amortization added back to it, and can be used to analyze and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions.

Free cash flow yield is a financial ratio that measures a company's operating free cash flow minus its capital expenditures per share and dividing by its price per share. Free cash flow yield ratio is calculated by using the underlying securities of the fund.

Price-Earnings (P/E) is the price of a stock divided by its earnings per share for the past 12 months. Sometimes called the multiple, P/E gives investors an idea of how much they are paying for a company's earning power. The higher the P/E, the more investors are paying, and therefore the more earnings growth they are expecting.

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.

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