Morgan Stanley Funds (UK)

American Resilience Equity Fund

INTERNATIONAL EQUITY TEAM

Performance Review

In the one month period ending 31 October 2024, the Fund's I ACC shares returned 2.13% (net of fees)[1], while the benchmark returned 3.39%.

For the year-to-date, the portfolio has returned +9.58% versus S&P 500 Index's +19.95%. Our focus is on absolute compounding over the long term.

The October underperformance was due to stock selection as outperformance in consumer discretionary was overshadowed by weakness in information technology and health care and to a lesser extent in consumer staples and financials. Sector allocation was roughly neutral as the drag from the health care overweight was balanced by the financials overweight.

The largest contributors to absolute performance were **Visa** (+54 basis points [bps]), on the back of better-than-expected fourth quarter results; **Booking Holdings** (+46 bps), having reported strong third quarter results exceeding earnings and revenue estimates, boosted by an increase in travel bookings; and **Aon** (+39 bps), as organic revenue growth bounced back after a weaker period earlier in the year.

The largest absolute detractors were **Thermo Fisher** (-24 bps), reporting mixed third quarter results, with earnings surpassing expectations, while revenues fell slightly short; **CDW** (-24 bps), which reported mixed third quarter results as it anticipates continuing weak demand in the U.S. for the remainder of 2024; and **IQVIA** (-23 bps), after the company lowered full-year guidance to reflect trial delays due to short-term logistical challenges.

Market Review

The S&P 500 Net Index returned -0.9% in U.S. dollars (USD) in October, breaking a five-month streak of increases. The three sectors in positive territory in the month were financials (+3%), communication services (+2%) and energy (+1%). Information technology (-1%) was in line with the index in the month, whereas it is well ahead year-to-date. All other sectors finished in the red, with health care (-5%) at the bottom of the pile. Consumer staples (-3%) and consumer discretionary (-2%) were also slightly behind the index.

Portfolio Activity

Portfolio activity is reported at quarter-end.

Strategy and Outlook

The Long-Term Case for Health Care

The health care sector has significantly underperformed the broader market over the past two years, delivering a 14% sector return compared to 52% for the S&P 500 Index.[2] Excluding the sector's "glamour" stock – Eli Lily – the sector's two-year return drops to just 5%, trailing the index by a significant 47%.[2] With this lagging performance in mind, we believe it is a good time to reiterate what attracts us to the sector as a long-term investment.

Reflections on the sector

Firstly, it's important to reiterate the idiosyncratic demand, supply and funding environment that health care stocks have had to grapple with over the past five years. The onset of COVID-19 was certainly a driving force, particularly for the pharmaceutical companies making the vaccines, the life sciences companies providing testing kits, and the health care equipment companies manufacturing and supplying personal protective equipment (PPE) and other life-sustaining products such as ventilators. The unwinding of this cyclical distortion, however, has been significantly less wonderful for companies' revenues, particularly in bioprocessing where acute overstocking of raw materials and vaccines occurred amid uncertainty over the pandemic's duration. Across the sector more broadly, companies have since faced rapidly rising costs, increasingly fragmented supply chains, a tighter funding environment, and weakness in China[3] due to a lack of government and private funding. Investors' recent preference for mega-cap growth stocks, coupled with political pressures from the U.S. presidential election, have also been further headwinds.

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1 Source: Morgan Stanley Investment Management Limited. Data as of 31 October 2024.
2 Source: FactSet. Data as of 31 October 2024. Cumulative returns.
3 We are beginning to see signs of stabilisation and we believe the industry is positioned for future growth, given the continuing shift to more complicated drugs and gene therapies.

Despite these recent challenges, in our view, several factors drive a strong long-term outlook for health care:

- **Rapidly ageing global population.** The World Health Organisation projects that by 2050 the number of people over 60 will double to more than 2 billion, while those over 80 will triple to 436 million.[4] Wisdom isn't the only thing that comes with age; health spending typically increases.
- **Untapped market opportunities.** By 2050, two thirds of the world's elderly will reside in low- to middle-income countries, a dramatic shift from current trends in wealthier nations like Japan, where 30% of the population is already over 60.[4] This offers promising opportunities for those companies able to effectively pivot to where the growth is.
- **Non-discretionary nature of health care demand**. The products and services the sector offers are essential, regardless of economic conditions, making it more resilient to downturns than most sectors.
- **Innovation and digital transformation offer strong potential.** Advances in telemedicine, drug discovery, personalised medicine and genomics unlock new opportunities, while technologies like artificial intelligence (AI), electronic health records and remote monitoring are improving efficiency and patient outcomes.

Quality characteristics

On our two favoured quality metrics, ROOCE (return on operating capital employed) and gross margin, health care ranks among the top sectors. Additionally, it has delivered the second highest earnings per share growth of any sector in the index over the past 20 years.[5] Importantly, due to the sector's resilience, this growth has been remarkably steady, with consistent relative earnings outperformance in negative years for the index.[5] The market has recently seemed to place very little value on predictability given the recent benign economic backdrop and the outperformance of cyclical stocks. In our view this is misguided, as predictability often demonstrates its worth just when investors least expect they need it.

Avoiding patent certainty…

As is the case with other sectors, we tend to find high quality compounders in certain sub-sectors and industries. While the health care sector's general lack of cyclicality lends itself to predictability in the short to medium term, we find it challenging to maintain confidence in all sub-sectors over the long term. A sizeable proportion of the health care sector is pharmaceutical and biotech companies, where high returns are primarily a result of patent protection – it is the patents that are the main intangible assets. However, these intangible assets fade away, as when a drug goes off-patent it is exposed to generic competition, which often results in a dramatic decline in sales – often up to 80%[6] – as generic versions undercut the originator on price. A new patented drug is needed to make up for the shortfall in revenues, but this requires a long research and development (R&D) process, which may or may not be profitable and is certainly not predictable. As such, pharmaceutical companies tend to not meet the high quality bar we maintain for the portfolio.

…and single product dependency

A key tenet of our investment philosophy is that compounding wealth over time requires a sharp focus on downside risks, which is doubly important when a company has a large dependence on one product. GLP-1 producers are a prime example, with roughly 50% of Eli Lilly's sales from GLP-1 medications.[7] While these drugs have enormous potential, our concern is that they too face patent expiry and in time likely extremely aggressive competition – if consensus numbers are anywhere near right about the size of the market. There's also the risk that governments and insurance companies may refuse to pay for patients to receive these drugs, limiting the potential opportunity size. With a price-to-earnings ratio (P/E) approaching 40x the next 12 months projected earnings, Eli Lilly is significantly pricier than the 15x of a typical non-GLP-1 pharma company.[8] This elevated valuation renders the company even more vulnerable to these potential risks, currently making it an unappealing prospect for the portfolio.

Finding high ROOCE and growth without patent or concentration risk

We look for recurring revenues through consumables or services, where the incentive to change supplier is very low. Examples include "razor-razor blade"[9] business models found in providers of diagnostic tests, or in high quality mission-critical products and services that, for reasons of safety, regulatory compliance or scientific integrity, require a strong competing reason to switch suppliers.

As an example, we hold Steris, a leading global provider of infection prevention products and services. Steris sells sterilisers and the associated consumables and services required to sterilise surgical instruments. For obvious reasons this is not something that you risk getting wrong to save a few cents, particularly given these products represent a low proportion of its customers' costs. As a result, customers tend to stick with this demonstrated high quality supplier. The company also provides outsourced sterilisation services for medical device producers. Again, a low cost but vitally important activity for its customers that notably is written into regulatory filings, meaning an expensive and time-consuming process to change supplier and an expensive and time-consuming process for those considering entering the market.

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4 Source: World Health Organization (WHO) 1 October 2024. Available at www.who.int/news-room/fact-sheets/detail/ageing-and-health
5 Source: FactSet.
6 Source: "Effect of Patent Expiry on the Performance of Innovator Multinational Pharmaceutical Companies in a Low Middle Income Country", Farrukh Khalil, Joseph Odhiambo Onyango, Frontiers in Medical Technology 2022 April 4. Available at https://pmc.ncbi.nlm.nih.gov/articles/PMC9014174/
7 Source: Visible Alpha.
8 Source: FactSet, as of 30 September 2024.
9 A company using a "razor-razor blade" business model sells a core product (e.g. razors) at a low margin while also selling a related consumable product (e.g. razorblades) at a high margin to drive recurring revenue.

Charlie and Luna[10]

We believe global animal health is an attractive non-cyclical market largely without the patent and concentration risks we see in pharmaceuticals and biotech. Pets (like Charlie and Luna) need care, and owners do indeed care about their pets: a good recipe for resilience and growth. The industry was valued at US$304 billion in 2023 and is expected to grow at a compound annual growth rate of 6.8% to 2032.[11] We hold Zoetis, the world's leading, diversified, animal health company that develops, manufactures and commercialises vaccines, medicines and diagnostics for both pets and livestock. Its direct salesforce is a key barrier to entry, since most competitors are too small to justify having one. Generic drug penetration is very low, payment is out of pocket and customers are extremely fragmented with little incentive to change brands or use generics, particularly as prescriptions are issued by vets.[12] It is a very high quality company, with a return on operating capital more than twice that of the average company in the index at 53%, with pricing that has increased 2%-3% per annum, and supported by positive volume growth.[12] The earnings are resilient, having risen every year over the last decade, as against the MSCI World Index, which has seen two earnings falls in the last 10 years.[5] We consider this an unusual company in the health care sector, with the characteristics we look for to help support steady long-term compounding.

Diversified with a difference: scale and network effects

Our largest health care holding is UnitedHealth, the biggest U.S. health insurer with 55 million members and a 15% market share.[12] Well diversified, the company also owns a health care services business that includes general practitioner (GP) clinics, data services and a pharmacy benefit manager. Acting as an intermediary in the health system, the company operates between the buyers (employers, government) and the providers (hospitals, clinics, drug manufacturers). Leveraging its considerable membership scale, it achieves discounts from providers, creating a two-sided network with high barriers to entry. Further, the ability to vertically integrate into primary care GPs helps align financial incentives with doctors and generates efficiencies by paying based on quality of outcomes rather than volume of procedures. We believe this is a high quality, non-cyclical business which can compound attractively due to its membership scale and two-sided network effect.

Quality and resilience at a reasonable price

In a concentrated broader market with what we view as generally high valuations on lofty earnings expectations, we feel the risks to the market are appreciably higher than many anticipate. Our health care holdings are anchored by a focus on steady compounding, reasonable valuations and high returns on operating capital. In our longer-running Global portfolios, the high quality attributes we prioritise in our health care holdings have historically contributed to consistent performance in difficult economic times; we believe they are well positioned to continue to do so.

For further information, please contact your Morgan Stanley Investment Management representative.

Fund Facts

Launch date	31 October 2023
Base currency	Sterling
Benchmark	S&P 500 Index

12 Month Performance Periods to Latest Month End (%)

	OCTOBER '23 - OCTOBER '24	OCTOBER '22 - OCTOBER '23	OCTOBER '21 - OCTOBER '22	OCTOBER '20 - OCTOBER '21	OCTOBER '19 - OCTOBER '20
OEIC American Resilience Equity Fund - I ACC Shares	19.03	--	--	--	--
S&P 500 Index	30.27	--	--	--	--

Past performance is not a reliable indicator of future results. Returns may increase or decrease as a result of currency fluctuations. All performance data is calculated NAV to NAV, net of fees, and does not take account of commissions and costs incurred on the issue and redemption of units. The sources for all performance and Index data is Morgan Stanley Investment Management. **Please visit our website www.morganstanley.com/im to see the latest performance returns for the fund's other share classes.**

5 Source: FactSet.
10 The most popular dog and cat names in the U.S. Source: "The Most Popular Pet Names of 2023 in Each U.S. State" Chris Corlew, Mental Floss, 16 October 2024. Available at https://www.mentalfloss.com/posts/most-popular-pet-names-each-state#:~:text=Instead%20of%20Fido%2C%20the%20top,top%20five%20spots%20for%20boys
11 Source: Global Market Insights, June 2024.
12 Source: International Equity Team research.

Share Class I ACC Risk and Reward Profile

Lower Risk						Higher Risk
1	2	3	4	5	6	7
Potentially Lower Rewards						Potentially Higher Rewards

The risk and reward category shown is based on historic data.

- Historic figures are only a guide and may not be a reliable indicator of what may happen in the future.
- As such this category may change in the future.
- The higher the category, the greater the potential reward, but also the greater the risk of losing the investment. Category 1 does not indicate a risk free investment.
- The fund is in this category because it invests in company shares and the fund's simulated and/or realised return has experienced high rises and falls historically.
- The fund may be impacted by movements in the exchange rates between the fund's currency and the currencies of the fund's investments.

This rating does not take into account other risk factors which should be considered before investing, these include:

- The fund relies on other parties to fulfill certain services, investments or transactions. If these parties become insolvent, it may expose the fund to financial loss.
- Sustainability factors can pose risks to investments, for example: impact asset values and increased operational costs.
- There may be an insufficient number of buyers or sellers which may affect the funds ability to buy or sell securities.
- Where information is sourced from ESG third party providers, there may be limitations in the accuracy, completeness and availability of this information. How ESG factors are considered may vary between different investments.
- Past performance is not a reliable indicator of future results. Returns may increase or decrease as a result of currency fluctuations. The value of investments and the income from them can go down as well as up and investors may lose all or a substantial portion of his or her investment.
- The value of the investments and the income from them will vary and there can be no assurance that the Fund will achieve its investment objectives.
- Investments may be in a variety of currencies and therefore changes in rates of exchange between currencies may cause the value of investments to decrease or increase. Furthermore, the value of investments may be adversely affected by fluctuations in exchange rates between the investor's reference currency and the base currency of the investments.

Please refer to the Prospectus for full risk disclosures. All data as of 31 October 2024 and subject to change daily.

INDEX INFORMATION

The **Standard & Poor's 500® Index (S&P 500®)** measures the performance of the large cap segment of the U.S. equities market, covering approximately 80% of the U.S. equities market. The Index includes 500 leading companies in leading industries of the U.S. economy. The index is unmanaged and does not include any expenses, fees or sales charges. It is not possible to invest directly in an index.

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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