Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

It's All About The Earnings – The Long-Term Earnings

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | INVESTMENT INSIGHT | JULY 2018

The market is obsessed with earnings, but unfortunately the wrong kind of earnings: the short-term kind. This piece is in no way an attempt to defend the bizarre quarterly ritual where even large and stable companies' share prices oscillate wildly based on the last 90 days' trading and managements' often inaccurate views on the prospects for the next 90 days. It is more an attempt to concentrate on the longer-term earnings paths and the importance of holding up in tough times for long-term compounding. Given that the economic expansion and the associated bull-market are now both fairly long in the tooth, it is arguably particularly important to think about the implications of any potential slowdown.

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The good news is that MSCI World Index earnings[1] have doubled since the trough in early 2009. The bad news is that they are still only up 20% on the pre-financial crisis peak of 2007, as they fell 40% in the 18-month slump. This implies that global earnings have compounded at less than 2% per year over the last 11 years. Add in dividends, and the market's overall compounding has been a pretty miserable 4-5% per year over the last decade or so.

"…concentrate on the longer-term earnings…and the importance of holding up in tough times for long-term compounding."

Four of the 10 GIC sectors have significantly outperformed the market since 2007: information technology, health care, consumer discretionary and consumer staples.[2] They are also

[1] Throughout this piece we use Next Twelve Months Forward Earnings. Source: FactSet, 31 July 2018.

[2] Real estate is excluded from the analysis due to a lack of track record, having only recently become a sub-sector. Industrials were also marginally ahead of market performance.

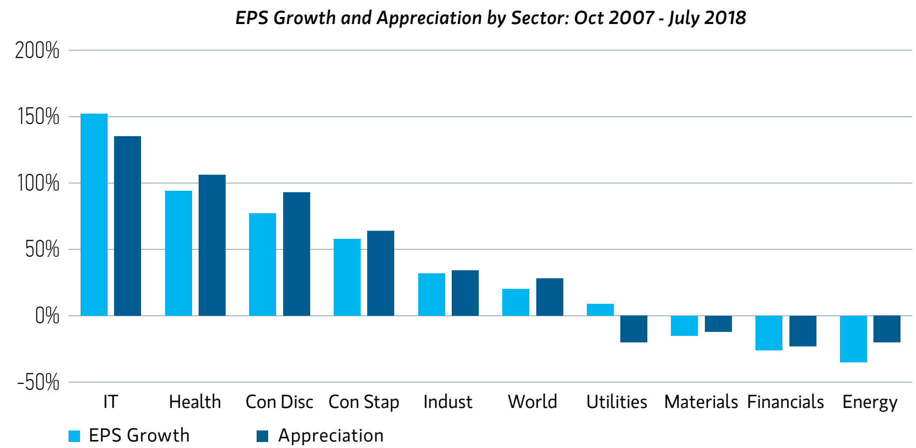
the sectors where earnings growth has been well ahead of the market over the 11 years *(Display 1)*. Health care (earnings per share [EPS] +94% since 2007) and consumer staples (EPS +61%) have done it 'the compounding way' – the earnings growth has been a bit behind that of the market on the way up, but earnings were virtually flat (down 1% and 2%, respectively) during the downturn, compared to the market's 40% fall, leaving them well ahead over the cycle. Consumer discretionary (EPS +77%) has beaten the market in a different way. It was the worst performing sector during the downturn (EPS -66%), followed by a massive cyclical rise (EPS +414% since 2009). Approaching a decade into the recovery, there is a case that it is time to worry about the potential impact of the next downturn on the sector's earnings.

Information technology (+152% EPS since 2007) has led the way on earnings. The sector's outperformance has been built on its earnings growth rather than the valuation bubble, which drove it in the late 1990s. The key from here is the sustainability of this earnings performance. Overall, the sector's earnings fell 35% in the crisis, roughly in line with the market. However the picture is very different across the three sub-sectors within information technology *(Display 2)*. The hardware and equipment sub-sector was down a market-like 41%, while the semiconductor sub-sector saw earnings vanish (down 102% into negative territory). By contrast, software and services' earnings were actually UP 2% over the 18 months. Clearly, experience is likely to vary by company, but history suggests that the software and services sub-sector is relatively defensive, even without considering the extra defensiveness that may be offered by the recent rise in recurring revenue from the growth of the cloud.

The one sure fact about the next downturn is that it will be different from the last one. Our portfolios invest in companies not sectors. Nevertheless, the fact that over 75%[3] of our global portfolios are invested in both of the two most defensive sectors (consumer staples and health care) or the defensive sub-sector within information technology (software and services), does give comfort that portfolio earnings are likely to hold up better than those of the market as a whole. Reflecting on the Global Financial Crisis, portfolio earnings for our flagship global strategy actually rose between 2007 and 2009. So rather than attempt to shoot the lights out from here, we would argue that it is time to focus on simply keeping them on, and on, and on. In our view, owning high-quality, well-managed companies with high and sustainable returns on their operating capital is the best route to achieving this.

DISPLAY 1

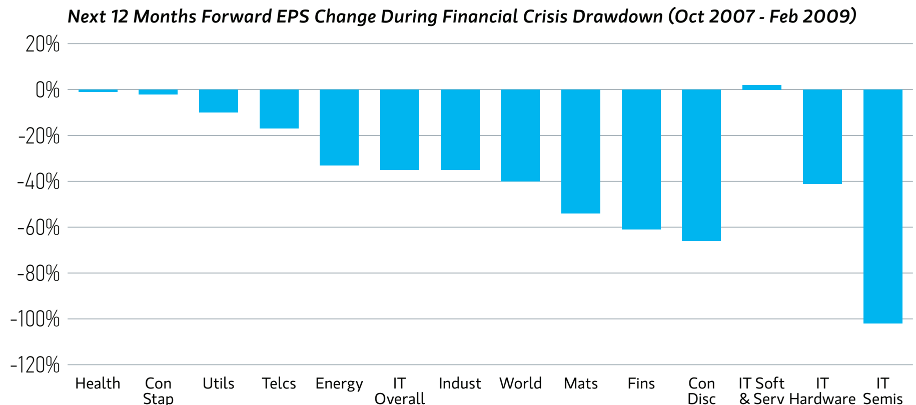
Information technology, health care, consumer discretionary and consumer staples have significantly outperformed the market since 2007



Source: FactSet, as at 31 July 2018.

DISPLAY 2

History suggests that the software and services subsector is relatively defensive



Source: FactSet, as at 31 July 2018.

[3] As at 31 July 2018.

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DEFINITIONS

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