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MFS®

Manifesto

MFS Meridian® Funds –

Prudent Capital Fund

Barnaby Wiener*
Portfolio Manager
24 years at MFS
28 years in the industry

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29 years in the industry

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Portfolio Manager
11 years at MFS
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Risks of the fund

The fund may not achieve its objective and/or you could lose money on your investment in the fund. **Stock:** Stock markets and investments in individual stocks are volatile and can decline significantly in response to or investor perception of, issuer, market, economic, industry, political, regulatory, geopolitical, and other conditions. **Bond:** Investments in debt instruments may decline in value as the result of, or perception of, declines in the credit quality of the issuer, borrower, counterparty, or other entity responsible for payment, underlying collateral, or changes in economic, political, issuer-specific, or other conditions. Certain types of debt instruments can be more sensitive to these factors and therefore more volatile. In addition, debt instruments entail interest rate risk (as interest rates rise, prices usually fall). Therefore, the portfolio's value may decline during rising rates. Portfolios that consist of debt instruments with longer durations are generally more sensitive to a rise in interest rates than those with shorter durations. At times, and particularly during periods of market turmoil, all or a large portion of segments of the market may not have an active trading market. As a result, it may be difficult to value these investments and it may not be possible to sell a particular investment or type of investment at any particular time or at an acceptable price. The price of an instrument trading at a negative interest rate responds to interest rate changes like other debt instruments; however, an instrument purchased at a negative interest rate is expected to produce a negative return if held to maturity. **Derivatives:** Investments in derivatives can be used to take both long and short positions, be highly volatile, involve leverage (which can magnify losses), and involve risks in addition to the risks of the underlying indicator(s) on which the derivative is based, such as counterparty and liquidity risk. **Value:** The portfolio's investments can continue to be undervalued for long periods of time, not realize their expected value, and be more volatile than the stock market in general. **High Yield:** Investments in below investment grade quality debt instruments can be more volatile and have greater risk of default, or already be in default, than higher-quality debt instruments. **Strategy:** There is no assurance that the portfolio will achieve a positive rate of return or have lower volatility than the global equity markets, as represented by the MSCI World Index, over the long term or for any year or period of years. In addition, the strategies MFS may implement to limit the portfolio's exposure to certain extreme market events may not work as intended, and the costs associated with such strategies will reduce the portfolio's returns. It's expected that the portfolio will generally underperform the equity markets during periods of strong, rising equity markets. Please see the prospectus for further information on these and other risk considerations.

Philosophy

The investment world is riddled with principal–agent conflicts. Principals want to protect their capital. Agents want to protect their jobs. This leads to a misalignment of interests. We try to avoid this trap by investing our clients' money as we invest our own.

The world is multicoloured, but people keep trying to make it black and white. The investment community is as guilty as any of falling into this trap. It wants to put everyone, and everything, in a box.

We're wary of benchmarks. Benchmarks serve the practitioner (agent) but not the end client (principal). They encourage you to measure performance over very short time periods, and they

* Effective April 30, 2024, Barnaby Wiener will retire from MFS and his responsibilities as a Portfolio Manager on the MFS Prudent Capital / Prudent Investor, Prudent Wealth and Managed Wealth strategies.

allow you to claim success if you're down 'only' 40% when your benchmark is down 50%. In practice, benchmarks also lead to herding. Studies have shown that most portfolios look similar to their benchmark (and deliver modestly worse returns on average).

The risk we worry most about is the risk of permanent capital loss.

We don't like style categories. Again, they serve the agent, not the principal. They allow you to put a manager in a box, but at the expense of investment returns. The art of investing involves considering the problem from every angle. We're not solely value nor solely growth; we're both. We're not just top-down nor just bottom-up; we're both.

Financial markets wax and wane, albeit less predictably than the lunar cycle. Identifying where we are in the cycle is a challenge, but not one we shirk. Our duty is to strike the right balance between wealth preservation and wealth creation.

We believe the biggest arbitrage opportunity is time. Investment horizons should be measured in years if not decades, but in practice they're measured in months if not weeks. Being wrong about the journey is uncomfortable, but ultimately what matters is being right about the destination.

We believe the key to making money is not losing it. We respect the mathematical law of compounding. Grow 7% a year for 10 years and you double your money. Lose 50% and you need to double your money just to break even.

When appropriate, we're happy to hold cash and short-term government securities. We recognise that the return profile of 'cash' might be modest, but it's the only thing that never goes down in value. As such it acts as a buffer in the portfolio, limiting your losses and enabling you to exploit bargains when they arise.

To the question 'Why would we pay you to hold cash and cash-like instruments?' we would answer 'Why would you pay us to be fully invested when the market halves?' Our entire industry is incentivised to invest its clients' money at all costs — another example of the principal–agent conflict in action.

Strategy

The fund's objective is capital appreciation, measured in US dollars. Our aim is to provide a return at least in line with global equities but with materially lower volatility over a full investment cycle. These are long-term objectives, closer to ten years than to one.

We recognise that this goal may appear somewhat vague, but we believe it's more honest than offering an explicit target. The danger with overly precise objectives is that they imply the future is more knowable than it is, and setting such objectives can incentivise the wrong sort of behaviour (as managers adapt their approach to meet their target). We believe the process should drive the outcome, not the other way around.

We act as principal rather than agent. We put capital at risk when we believe the potential return warrants it. We think about risk only from the perspective of the end client. We don't think about relative risk, *i.e.* the risk of looking stupid compared to our peers should we underperform a benchmark in any given year. This frees us to do things differently, namely

- reduce market exposure when opportunities aren't attractive
- build an investment portfolio that bears no resemblance to the index

Equities will generally account for at least 50% and up to 90% of the assets. Our equity exposure will fluctuate based on our assessment of market risk and return. Our portfolio will be concentrated in a

select group of names (generally, the portfolio has held between 20 and 50 stocks) which meet our rigorous investment criteria. We seek to invest in high-quality, durable franchises with staying power that trade at valuations which leave some margin of safety.

Fixed income securities will typically account for the balance of the assets and therefore constitute between 10% and 50% of assets in practice. We will be opportunistic in managing overall exposure to credit and interest rate risk while seeking to exploit mispricing at the issuer level and to provide liquidity to the market when well compensated. Within fixed income, the credit allocation has generally been concentrated, but issuer count can move higher or lower in line with overall exposure. If we don't feel we're being adequately compensated for taking credit or duration risk, we simply avoid such risks. Additionally, within the 10% to 50% of the portfolio allocated to fixed income securities we have the flexibility to hold other debt instruments, such as short-term treasuries, mortgage-backed securities and money market instruments.

We may also use derivatives to help mitigate downside risk in the portfolio. We work closely with our quantitative research team, discussing ideas and sourcing the positions that we're looking to purchase. Generally, these have been index put options and futures, but we're not limited to these. If we come across individual stock ideas with the potential for asymmetric payoffs, we may consider exploiting such opportunities. Generally speaking, derivatives are used to manage exposure risks and the focus is on downside risk mitigation in the portfolio.

We (the portfolio managers) are responsible for every decision we make. A fantastic team of analysts supports us: over 100 people, covering equity and fixed income across every sector and region. We work closely with them on every name we investigate. The breadth and depth of their coverage is impressive, but what is truly unique is the extent of our collaboration. No silos here!

Equity selection process

We stick to good companies and try to buy them when they are attractively priced. What makes a good company in our view?

To some extent, we can define corporate quality in purely financial terms. The value of an equity, like any other investment, is driven by its future cash flows. The more cash a company generates the better. And cash flow is ultimately an output from a number of variables: revenue growth, profit margins, capital intensity, etc. We can analyse each in detail, but with one caveat: We can analyse only the history. What matters is the future, and there we can only speculate. Let's look at each of these variables:

- **Revenue growth:** All else being equal, the faster a company grows the better. But all things are not equal. The evidence suggests that it is very difficult for companies to sustain high growth for any meaningful time period. High growth may be the consequence of unsustainable demand (*e.g.* a fad). High growth may lead to changes on the supply side that erode future profitability (*e.g.* new competition emerges). And high growth may also lead to excessive pressure on the business (in the real world, consistently growing at 20% a year will put a considerable strain on the operations and culture of most businesses). Generally, we are cautious of companies with rapid revenue growth (and that's before we take valuation into account).
- **Profit margins:** We like companies with high profit margins. They indicate a degree of pricing power, and they provide a buffer to protect the business from minor fluctuations in either costs or revenue. But again, there are caveats. High margins can be a cyclical phenomenon, or they can be a symptom of overpricing or underinvestment, both of which undermine a company's competitive edge.

- **Capital intensity:** Companies with low working capital and low capex convert more of their profit into cash. That's great, so long as it's durable. If it's because the company is underinvesting or squeezing its suppliers too hard, that's a concern. And beware of a company with negative working capital that then sees its revenue decline. Ouch!
- **Balance sheet:** By and large, we love a strong balance sheet: plenty of liquidity, assets that don't depreciate (and might even appreciate), not too much debt and not too much in the way of other liabilities (either on or off balance sheet). A strong balance sheet provides a cushion in a crisis. More important, it says a lot about how management run the company. Actions speak louder than words. Once a company starts using leverage to drive the bottom line, you know the game is up. It means they've run out of ideas, and their time frame is now measured in quarters not years.

However, while a strong balance sheet is almost always a good thing (until the day you wake up to discover the company has used it to make a vast, over-priced and incomprehensible acquisition), it will only protect investors so long as the cash flow keeps coming. To evaluate the future cash flows of the business, we need to understand the company's economic 'moat' — the structural attributes which enable it to generate cash well into the future — and that requires us to analyse the business, not just the numbers. This is a complex, multi-faceted process that can't be described in an elegant schematic on a PowerPoint slide.

We're looking for companies with the following attributes:

- Sustainable demand: a product or service not at the mercy of fashion or substitution risk
- Limited competition: a unique franchise, not just one of many
- High barriers to entry: tough to imagine a new competitor arriving on the scene
- High switching costs: difficult for customers to swap suppliers
- High customer loyalty: customers that could switch but won't
- Low customer concentration: not overly dependent on a small number of customers
- Pricing power: the ability to set prices rather than have them set for you
- Control over costs: not at the mercy of volatile input costs
- Latency: hidden potential not yet reflected in current returns

Other attributes:

- Management is focused on developing and strengthening the value proposition rather than maximising short-term profitability.
- Management speak and write about their business in plain English, and they don't try to hide the warts.
- The company has values. It stands for something beyond just making a profit.
- Employees like working there.
- Suppliers feel cultivated, not exploited.
- The impact of the business on society and the environment is at worst neutral.
- Management deploys capital wisely.

This list of attributes above, while long, is far from exhaustive. Some of these attributes are tangible and to an extent measurable. Others are inherently subjective but no less important. There is no company on Earth that meets all these criteria. Our job is to figure out how to weigh them.
We eschew the scorecard approach: it suggests there is an easy, fool-proof weighing mechanism, and really, it's just an intellectual cop-out. Instead, we rely on that most old-fashioned of algorithms: judgment.

Equity valuation

'Cheap' means that the stock is trading at a discount to the company's intrinsic value. However, again, the devil is in the details. With bonds, you can calculate intrinsic value with a degree of exactitude. With equities, there are too many variables to do so. It's always a guess.

Discounted cash flows models are in our view a waste of time. They're highly sensitive to relatively minor changes in the model. Garbage in, garbage out.

Multiples of current profitability are a good place to start, especially when comparing similar companies. But they come with caveats:

- Beware using earnings-based multiples for companies whose earnings are cyclical, unpredictable or bear no resemblance to cash flow.
- Beware using cash flow based multiples for companies who might be under-investing in the business.
- Beware using equity-based multiples for companies with high levels of debt and other financial liabilities.

Again, there's no simple answer. It's a bit like viewing a house. You have to look at it from many different angles, inside and out. You have to weigh the pros and cons and then make a decision. Often it's easier to reverse the process. In other words, rather than trying to figure out what the company is worth, ask instead what the current value implies for future profitability. We don't need a precise valuation; we just need to be confident that the company will end up more valuable than its current market cap.

Fixed Income selection process

Fixed income investing and equity investing share many similarities; however, they are fundamentally different beasts. Unlike shareholders, the true owners of the business, creditors have only a contractual relationship with a company. As long as the issuer abides by the contract terms, lenders have no say over how it is managed. Moreover, the cash flows and expected returns of a debt security can be calculated with far fewer assumptions. Ultimately, what matters is the ability and willingness of debt issuers to honour their obligations. Generally, most debtors make good on their bonds and investors earn what they are promised. But more than a few do not. As a result, the investment return profile in credit is typically less volatile than in equities but with more of a negative skew due to defaults.

How do we avoid investing in deteriorating credits? Our deep and experienced analyst team fully vets all potential investments. In general, we favour issuers with the following:

- Solid competitive positions in relatively stable sectors
- Stable free cash flow generation or cyclical issuers on a positive cash flow trajectory
- Financial prudence; specifically, modest financial leverage and manageable debt maturity schedules

- Sensible capital allocation track record; shareholder returns based on sustainable earnings, not through financial engineering
- Perceived stress, but have the means to continue to meet their debt obligations, including the possible sale of non-core assets or the use of equity to bridge financing needs

Our evaluation of management is a crucial element of the process. Understanding management's goals and incentive structures and evaluating their ability to navigate economic and credit cycles is paramount. We have lived through many credit cycles, and these experiences guide our determination of capital structure viability.

Fixed income valuation

This is where investment processes for equities and credit really diverge. Valuing equities is inherently difficult. Earnings and cash flows are impossible to predict, and even if you could do it with perfect foresight, determining how much investors should pay today for that future value is fraught with uncertainty.

Fixed income means exactly that: A bond's cash flows are certain in amount and timing. The two primary risks associated with bonds are the time value of money (the discount rate associated with the cash flows) and credit risk (the probability of an issuer fulfilling its obligations to bondholders). These two risks cut across all the flavours of fixed income and are therefore non-diversifiable. The portfolio management team must manage them.

We formulate macro views with input across MFS. Important considerations include the following:

- Economic growth and inflation environments
- Fiscal and monetary policies
- Foreign exchange rates and terms of trade
- Imbalances in financial flows, especially in credit markets
- Long-term fundamental drivers: demographics, technological advances, political shifts, etc.
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Once our outlook is determined, we narrow the universe of credit ideas to those in alignment with the broader views. In an environment of depressed interest rates, relatively flat yield curves and low credit spreads around the developed world, duration and credit risk seem unattractively priced. Bonds with fairly low interest rate sensitivity and relatively low credit risk would be favoured in this type of market.

However, in the wake of the financial crisis and all the subsequent increase in bank regulations, fixed income markets are less liquid than in prior history. Valuations can and will (in our view) change quickly. This portfolio is meant to capitalise on these periods of market volatility. In a period of spread widening, we will do that by increasing our appetite for credit risk. At times, the total return profile of lower-quality credit markets can match that of equities.

Market exposure

Market exposure is ultimately driven by the availability of investible opportunities. If we find lots of compelling investment opportunities, we're likely to be fully invested. If we don't, we aren't.

We consider macro as well as micro factors, recognising that the macro is an amalgamation of many micros.

Our focus is on long-term, structural factors. We don't pay much attention to short-term data points. Our view is that most people struggle to distinguish between causality and coincidence and hence attach too much weight to so-called indicators.

"Doing nothing is very hard to do. You never know when you're finished." ~ Leslie Nielsen

Our primary tool for determining market exposure is valuation. Valuation has very little bearing on short-term market performance, but it's the main driver of longer-term returns. The debate about whether it matters is really a debate about investment time frame. Hopefully, it's clear where we are on that spectrum.

Contrary to popular opinion, interest rates aren't the sole determinant of equity valuations. In the long run, they are closely linked to nominal GDP growth and the two variables often cancel each other out.

Through the cycle, equity multiples fluctuate wildly, but in the long term they revert to the mean. That's been true historically, and we expect it to continue.

Alongside valuation, we consider the broader outlook for corporate profits.

We worry about debt. High levels of debt in an economy are a drag on growth and a source of added instability. Not a great combination. The current global debt accumulation has no historical precedent (outside of war), and this bothers us.

Demographic trends are also a key driver of economic growth, and they don't look favourable either.

Profit margins, like valuations, fluctuate over time but tend to mean revert. Safe to say that from today's level there is more downside than upside.

We ponder many other big issues, ones pertaining to the economy, politics and society at large, without necessarily reaching firm conclusions.

We don't forecast. We try to identify risks.

Of course, there are always risks, some identifiable, some not. What matters is whether such risks are already reflected in the market value of the securities we are buying. That is why valuation is the ultimate arbiter of our market exposure.

Summary

If our investment approach sounds a bit vague and subjective, that is because it is. We wish there were a simple formula for investing, but we don't think there is one, and we're certainly not going to create one just to hoodwink clients into thinking we're smarter than we are.

However, there are a few rules we try to adhere to:

Guiding principles

- Try to avoid large losses.
- Keep it simple.
- Question everything and everyone.
- Know your own weaknesses.
- Dare to be different (and look stupid).
- Be patient.
- When in doubt, don't invest; missing out is annoying, but owning a damp squib is worse.
- Avoid excessive turnover.

Please note that this is an actively managed product.

See the fund's offering documents for more details, including information on fund risks and expenses. For additional information, call **Latin America:** 416.506.8418 in Toronto or 352.46.40.10.600 in Luxembourg. **European Union**: MFS International (U.K.) Ltd., One Carter Lane, London, EC4V 5ER UK. Tel: 44 (0)20 7429 7200.

MFS Meridian® Funds is an investment company with a variable capital established under Luxembourg law. MFS Investment Management Company (Lux) S.à.r.l is the management company of the Funds, having its registered office at 4, Rue Albert Borschette, L-1246, Luxembourg, Grand Duchy of Luxembourg (Company No. B.76.467). The Management Company and the Funds have been duly authorized by the CSSF (Commission de Surveillance du Secteur Financier) in Luxembourg.

The offering documents (sales prospectus and Key Information Documents (KIDs) or in the U.K. Key Investor Information Documents (KIIDs)), articles of incorporation and financial reports are available to investors at no cost in paper form or electronically at meridian.mfs.com, at the offices of the paying agent or representative in each jurisdiction or from your financial intermediary. KIDs are available in the following languages; Danish, Dutch, English, French, German, Italian, Norwegian, Portuguese, Spanish, and Swedish. KIIDs and the sales prospectus and other documents are available in English.

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