Morgan Stanley Investment Funds

Global Sustain Fund

INTERNATIONAL EQUITY TEAM

Performance Review

In the one month period ending 31 May 2024, the Fund's Z shares returned 1.41% (net of fees)[1], while the benchmark returned 4.47%.

For the year-to-date, the portfolio has returned 3.44% versus 9.52% for the index. Our focus is on absolute compounding over the long term.

Sector allocation was mildly positive in May as the benefit from the underweight in consumer discretionary and zero weight in energy counteracted the drag from the overweight in health care. In terms of stock selection, the main issue was weak performance in information technology as the software industry (up only 3%, and down if excluding Microsoft) and IT services (down 6%), which make up over 75% of the portfolio within information technology (IT), were over 10 percentage points behind hardware (up 13%) and semiconductors (up 16%), which were boosted by Apple and Nvidia, respectively. Health care, consumer staples and financials detracted to a lesser extent, while industrials was stronger.

The largest contributors to absolute performance during the month came from IT. Texas Instruments (+28 basis points [bps]) and TSMC (+21 bps) participated in the strong semiconductor stock performance, while Microsoft (+40 bps) defied the relative weakness of software stocks. IT also provided two of the largest absolute detractors. Accenture (-24 bps) continued to derate alongside the IT services subsector due to the continued soft demand for discretionary projects and fears about the lack of significant GenAI (generative artificial intelligence) revenues, while CDW (-13 bps) also derated as it was hit by the 3% downgrade to 2024 earnings. Forward earnings per share (EPS) is actually marginally higher than it was at the start of 2024 for the two companies. IQVIA (-17 bps) detracted due to an unhelpful headwind to the otherwise healthy order book from a last-minute trial cancellation.

Market Review

Global equity markets regained strength in May, with the MSCI World Index returning a healthy +4.47% in U.S. dollars (USD) and +4.07% in local currency. Information technology (+9%) and communication services (+6%) were both strong, continuing their impressive year-to-date performance, with both now up 35% so far this year. As mentioned earlier, semiconductors – boosted by NVIDIA, up a mighty +27% in the month – and hardware were far stronger than software and services within IT. Utilities (+8%) also outperformed in the month. At the other end of the spectrum were energy and consumer discretionary (both +0%), which finished as this month's laggards. All other sectors were within 200 bps of the index.

Turning to geography, the performance pattern was mixed. Switzerland (+8% USD, +6% local currency) and Spain (+6%, +4%) outperformed the index, whilst Italy (+5%, +3%), Germany (+4%, +3%) and the U.K. (+4%, +2%), although broadly in line in USD, were a touch behind in local currency. France (+3% USD, +1% local) was weaker on both accounts. In Asia, Hong Kong (+3% USD, +3% local) and Japan (+1%, +1%) were in the red, while Singapore (+4%, +3%) held up slightly better. The U.S. roughly finished in line with the index (+5%) in the month.

Portfolio Activity

Portfolio activity is reported at quarter-end.

Strategy and Outlook

Independent Thinking

The timing of investing in an index is important. Markets are back to high expectations, with high multiples and double-digit earnings growth forecasts for MSCI World for the next two years, on top of peak margins. This brings risk for passive investors, in our view. Three consensus trades dominate today's markets: being invested in the American economy, owning obvious artificial intelligence plays and positioning for a soft or no landing in the U.S. If anything other than this consensus view prevails, index investors may find themselves in relative difficulty.

For many investors, opting to invest in an index has been an easy decision these last years. An era of historically low interest rates and loose monetary policy meant that as the U.S. 10-year Treasury yield declined from 4% in 2010 to just 0.5% in 2020, the S&P 500 Index's price-to-earnings (PE) forward multiple rose from 14x to 18x.[2] Since 2022's market sell-off, the S&P 500 PE has continued its upward climb and is back at 21x – almost 40% above its 2022 low.[2] As a rising tide has helped lift all boats, index investing has reaped substantial rewards; S&P Global's SPIVA research shows that in the U.S., over one, three-, five-, 10- and 15-year

[1] Source: Morgan Stanley Investment Management Limited. Data as of 31 May 2024.
[2] Source: FactSet. Data as of 31 March 2024.

periods, passive investing has beaten most large-cap actively managed funds.[3] For the average investor, the transparency and liquidity offered by index investing, as well as its lower cost, have also added to the appeal.

While active versus passive is a well-worn debate, it needn't be an either/or decision. In fact, we would argue that there's a strong case for both index investing and active management to co-exist in portfolios. How they are balanced can be determined by an investor's investment objective, preferred time horizon, and appetite for risk – whether the definition is tracking error or losing money.

The active/passive conundrum

The decision to opt for passive investing is still an active decision. According to the Index Industry Association, there are over 3 million stock indices in the world – over 50 times more indices than stocks![4] Choosing to track an index, or combination of indices, still requires an investor to make an active decision.

Then there's risk. By owning ***more*** stocks via an index fund, an investor may hope to benefit from the positive effects of diversification. But is owning everything regardless of quality or valuation really the best way for investors to diversify a portfolio? Equally, with the focus of so many managers and investors on relative risk, the market has provided a comfortable place to take shelter. But is weighting an investment based on size sensible, given that most widely recognised and invested indices are typically market-cap weighted? An investor may hope for the wisdom of the crowd but instead get a crowded trade. In bull markets, market-cap weighted indices in particular can become increasingly biased and lopsided as valuations for those stocks perceived as "winners" are stretched beyond fundamental rationality, and the weights of the "winners" mechanically increase in the passive indices. Recent research from Morgan Stanley observed that S&P 500 concentration is at an historical extreme, increasing its vulnerability to a steep correction as the cycle or "theme du jour" turns.[5]

This risk is further compounded by the connected aspects of the largest stocks that dominate several equity indices. In the S&P 500, the recent fortunes of some of the largest market constituents have been driven by euphoric earnings expectations around the promise of generative artificial intelligence. Of course, an investor may attempt to diversify some of this thematic risk by tracking a global index, but with the U.S. weighting in global indices at an all-time high,[6] they may not achieve the diversification expected. Attempting to work around this by using an equal-weighted alternative may come at the expense of missing the opportunity that recent distortions have presented.

The benefit of being selective

While passive funds provide broad-based exposure and nimble, cheap access to tactical themes, there is still an opportunity to be selective – particularly given indices' biases. When stock prices become disconnected from fundamentals, skilled stock pickers can take advantage — that is, of course, provided they have the luxury of a longer time horizon if a lopsided multiples-powered bull run still has momentum.

As with passive options, investors face a plethora of choice when it comes to picking an active equity manager, not least because the tracking error constraints some active managers have in place can reduce the active/passive "balance" an investor may be seeking to achieve. We believe that our team's concentrated, benchmark-agnostic strategies offer a useful counterbalance to index investing. Why?

- We seek to own what we believe to be the highest quality companies in the word. Our focus is on high quality companies at reasonable prices, those that have the ability, in our view, to sustain their already high returns on operating capital, compound their earnings and cash flows steadily over time, and exhibit resilience in tough times.
- Selecting a long-term, high conviction, high active share portfolio offers a commitment device to remain invested and resist behavioural biases to buy high and sell low. We seek to act as owners for the long term, not tactical renters for the short term.
- We pay attention to the fundamentals of what we own more than the current price or performance of what we don't. Our focus is, and always has been, on the absolute: absolute price, absolute performance and absolute quality.
- Our focus on company fundamentals has seen us take advantage of the market's recent bias towards the more "tech-y" stocks. The lagging of defensive sectors, notably consumer staples and health care, and the accompanying dispersion in valuations provided us with an attractive entry point for three buys in our global portfolios in the first quarter: two in health care and one in consumer staples.
- Investors who seek minimal tracking error participate fully in the market's ups, but just as crucially, fully in the market's downs. Investing in an active portfolio of high quality companies whose earnings can compound steadily over time offers reduced risk of permanent loss of capital.
- Managing concentrated portfolios with a long investment horizon enables us to represent our clients effectively as shareholders, seeking to engage with companies on financially material matters ranging from capital allocation to compensation and incentives, strategy, risk and opportunity, and to check that the company's ability to compound remains intact.

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3 Source: S&P Global SPIVA Scorecard results. Data as of 31 December 2023. Available at https://www.spglobal.com/spdji/en/research-insights/spiva/
4 Source: Index Industry Association 14 November 2018, and FactSet and MSIM analysis 27 March 2024.
5 Source: Morgan Stanley Wealth Management, Global Investment Committee, 19 January 2024, "Consequences of Concentration".
6 Source: FactSet. Peak U.S. weighting of MSCI World Index 29 March 2024 at 70.9%, trough 31 March 2008 at 46.7%. 20-year average 57%.

Independent thinking

In 2016, an article in The New Yorker expressed a concern that with the rise of passive investing, investment decisions could be "increasingly on autopilot", as money pours into the largest companies irrespective of traditional investment considerations such as price, volatility or fundamental conviction.[7] In an environment where the biggest companies make up a larger share of the index, we believe a bottom-up, high quality strategy focusing on steady, resilient compounding can serve as a useful complement – particularly should the market take a knock – and offers investors a way to differentiate from the crowd. As Benjamin Graham commented, "There are two requirements for success in Wall Street. One, you have to think correctly; and secondly, you have to think independently."

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

Fund Facts

Launch date	29 June 2018
Base currency	U.S. dollars
Benchmark	MSCI World Net Index

Calendar Year Returns (%)

Past performance is not a reliable indicator of future results.

	YTD	2023	2022	2021	2020	2019	2018	2017	2016	2015	2014
Class Z Shares	3.44	21.90	-21.02	19.32	15.79	29.73	--	--	--	--	--
MSCI World Net Index	9.52	23.79	-18.14	21.82	15.90	27.67	--	--	--	--	--

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.**

Share Class Z Risk and Reward Profile

- The fund may be impacted by movements in the exchange rates between the fund's currency and the currencies of the fund's investments.
- 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, increased operational costs.
- There may be an insufficient number of buyers or sellers which may affect the funds ability to buy or sell securities.
- Investment in China A-Shares via Shanghai-Hong Kong and Shenzhen-Hong Kong Stock Connect programs may also entail additional risks, such as risks linked to the ownership of shares.
- 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 May 2024 and subject to change daily.

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INDEX INFORMATION

The **MSCI World Net 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. 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

[7] Source: The New Yorker, "Is passive investment actively hurting the economy?" James Ledbetter, 9 March 2016.

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.

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.

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