A Sub-Fund of Morgan Stanley Funds (UK)

American Resilience Equity Fund

INTERNATIONAL EQUITY TEAM

Performance Review

In the one month period ending 31 December 2024, the Fund's I ACC shares returned -2.46% (net of fees)[1], while the benchmark returned -0.93%.

Following a strong third quarter, which saw the portfolio display its defensive characteristics, the portfolio delivered +4.59% in the fourth quarter. The S&P 500 Index returned +9.68% in the quarter. For the full year 2024, the portfolio provided a respectable absolute return of +12.21%, in keeping with the investment team's long-term compounding expectation of circa 9%-10% per annum (in U.S. dollars); however, it was unable to match another impressive year from the S&P 500, which returned +27.26%. Given the portfolio is designed for long-term capital appreciation through steady and predictable compounding, lagging the index in years of such extraordinary returns is not unusual, as witnessed in 2023.

For the quarter, the largest contributors to absolute performance were: **Visa** (+125 basis points [bps]), as the company surpassed third quarter earnings expectations; **Alphabet** (+95 bps), which rallied on news of a quantum computing breakthrough; and **Booking Holdings** (+74 bps), which has continued to see momentum following robust third quarter earnings with growth in core revenue streams.

The largest absolute detractors during the quarter were **CDW** (-32 bps), which has suffered amid a cyclical slowdown in hardware spending; **Thermo Fisher** (-32 bps), which we added to after the company reported unremarkable third quarter results, given the industry's post-pandemic challenges are now beginning to show signs of easing; and **IQVIA** (-27 bps), as the company revised its 2024 guidance downward due to uncharacteristic trial delays.

In terms of fourth quarter relative performance, the portfolio benefited from the financials overweight and from not owning the lower quality, capital-intensive sectors, notably materials, which somewhat mitigated the hit from the overweight to health care and the underweight to consumer discretionary. Stock selection was hurt by relatively weaker returns in information technology (IT), financials, consumer staples and health care.

For 2024 overall, the largest absolute contributors were **Alphabet** (+148 bps), which despite investor concerns surrounding the tech industry's significant artificial intelligence (AI) capital expenditure spend saw AI optimism and strong operational performance boost the share price; **Visa** (+131 bps), which benefited from robust consumer spending and a rise in cross-border transaction volumes; and **Microsoft** (+109 bps), which had modest double-digit performance combined with its large position size.

The largest absolute detractor during the year was **Constellation Brands** (-44 bps), which suffered due to Mexican tariff fears, although the operating performance remains solid with its U.S. beer brands continuing to grow share, underpinning mid-single-digit sales and high-single-digit profit growth in 2024. **CDW** (-40 bps) was also weak, as the company has been affected by the continued weakness in hardware demand in the post-COVID era. While some of this is cyclical, we remain vigilant to any structural issues which may hamper future compounding potential. The other key detractors were all health care names. **IQVIA** (-35 bps) fell -15% due to what appears to be an industry-level slowdown in clinical research.

For 2024, the relative underperformance was primarily due to stock selection, largely on account of weakness in IT, financials and health care. Within IT, the portfolio's sector return lagged the S&P 500's extraordinary IT sector return, given the portfolio's tilt toward software and IT services, which make up over 70% of the portfolio's IT exposure; in 2024, this significantly lagged semiconductors and hardware. Another way of looking at allocation is considering the impact of the "Magnificent Seven":[2] the portfolio owned Microsoft and Alphabet; however, the investment team's high quality bar and strict valuation discipline precluded it from owning the other five. This cost the portfolio over 650 bps of relative performance, with over half of this attributable to Nvidia alone. Within financials, stock selection lagged due to the strength of the index returns as banks were up 38%, despite CME and Intercontinental Exchange delivering strong absolute performance. Within consumer staples, relative weakness was primarily down to Constellation Brands for the reasons noted above. Meanwhile for sector allocation, the portfolio benefited from the financials overweight, consumer discretionary underweight, and not owning the low quality, cyclical sectors, specifically materials, energy and real estate. However, the drag from the underweight to communication services and IT and overweight to health care was larger. The portfolio's residual cash position was also unhelpful in a sharply rising market.

Market Review

The final quarter of the year saw the S&P 500 Index return a modest +2.3% in U.S. dollars (USD). Notwithstanding the mild fourth quarter returns, the index had another remarkable year, delivering +25%; a cumulative two-year gain of nearly +60%. U.S. election sentiment drove performance in the fourth quarter, with the highly cyclical, growth-tilted sectors leading. Consumer discretionary

[1] Source: Morgan Stanley Investment Management Limited. Data as of 31 December 2024.
[2] Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, Tesla.

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was the quarter's top performer (+14%) largely thanks to Tesla, which rallied +54% in the fourth quarter due to investor optimism surrounding the potential benefit from President-elect Trump's economic and industrial policies; meanwhile, the health care (-10%) and materials (-13%) sectors saw double-digit losses in the fourth quarter. Communication services (+9%) and information technology (+5%) also reported good quarterly gains on hopes of deregulation and corporate tax cuts. AI euphoria has seen these sectors continue their strong performance from 2023, returning +40% and +36% respectively, with the "Magnificent Seven" stocks driving both the sectors' and overall market's returns for the second year in a row. Financials, which returned +7% in the fourth quarter and a highly impressive +30% in the year, was the only other sector to outperform the S&P 500 Index. Low quality cyclicals on the other hand were out of favour. Energy (-3% in the fourth quarter) and real estate (-8% in the fourth quarter) finished the year with modest returns of less than 5%, while materials was the only sector to finish 2024 in the red (-1%). Somewhat unsurprisingly, the typically defensive sectors also struggled to deliver good relative returns in a strong up market: health care returned just +2% for the year, while consumer staples was slightly stronger (-3% fourth quarter, +14% 2024).

Portfolio Activity

There were no new purchases or final sales in the fourth quarter. During the quarter, we added to our positions in Procter & Gamble, Jack Henry, Thermo Fisher, AutoZone and Roper Technologies. We reduced our positions in Constellation Software, Booking Holdings, ADP, AJ Gallagher and InterContinental Exchange.

Strategy and Outlook

Navigating certain markets in an uncertain world

2024 was a very strong year for markets overall, with the S&P 500 Index up 25% in USD, making it five out of the last six years with returns above 16%.[3] However, this success was far from equally shared, with the "Magnificent Seven" delivering over half of the index's returns, and the "Magnificent One", Nvidia, generating over 20% of them all on its own. It is also worth noting that the S&P 500's returns were over 20 percentage points ahead of the rest of the world, with the MSCI EAFE Index up just 4% in USD.

Earnings explain much of this hierarchy in 2024 returns. The S&P 500's forward earnings rose 12% in the year, but this was made up of the "Magnificent One's" 38% earnings' surge alongside a mere 6% for the "S&P 493". However, even this long tail of the U.S. market was well ahead of EAFE's 2% earnings fall. The strength of the dollar helped the U.S., as did the country's stronger economic growth. U.S. gross domestic product (GDP) growth reached a very healthy 2.7% in 2024, in contrast with the shrinking German and Japanese economies.[4] There was also a significant multiple gap. The U.S. market rerated by 10% to almost 22x forward earnings, and 19x even without the "Magnificent Seven", while EAFE's multiple edged up by just 3% to 13.8x, a record 36% discount to the U.S.

Looking forward, the U.S. economy continues to look healthier than other developed markets. Its 2%+ expected GDP growth for 2025 is twice that of EAFE, despite the continued softness in some areas such as low mortgage issuance and weak manufacturing PMIs (purchasing managers' index). However, positive surprises for the U.S. economy may be tougher to find than in the last two years, given the higher starting base for economic growth. Optimists point to the potential for further corporate tax cuts, deregulation, and merger and acquisition liberalisation to boost corporate profitability under the incoming Trump presidency. The flip side is fears that his policies may aggravate already sticky inflation, be they tariffs increasing consumer prices or deportations raising labour costs. The U.S. policy environment is unusually fluid at present, with a lack of clarity about the incoming administration's plans, never mind their ability to actually implement them.

The economic factor not receiving as much attention as it should is the U.S. budget deficit, which is running at an unprecedented 6%-7% of GDP at a time when the economy is at close to full employment. The macro purists cite the Kalecki-Levy equation, pointing out how U.S. fiscal profligacy boosts corporate profitability. To put it less abstractly, either the U.S. budget deficit will be cut significantly by the DOGE's (Department of Government Efficiency) efforts outpacing tax cuts, which could suck demand out of the economy, acting as a major dampener on economic growth and thus corporate profits, or the deficit will remain very high, growing debt further from the current $36 trillion, which could put pressure on long-term Treasury yields and even the mighty dollar. The 10-year Treasury rate rising 100 basis points as the U.S. Federal Reserve has cut policy interest rates by 100 basis points is perhaps an ominous sign.

Our real concern is how the expected 2025 earnings growth of 15% for the U.S. gets delivered. The expectation is not that we are dependent on the "Magnificent Seven" to deliver this but that the earnings growth will be broad-based, with the "493", excluding the "Magnificent Seven", growing earnings at 13%. Given revenues are only expected to grow 5%, in line with nominal GDP growth expectations, this double-digit EPS growth implies a sharp further improvement in margins from what are already at near-record levels, even excluding the "Magnificent Seven".

It has not been the easiest time to invest in steady, high quality compounders in relative terms, due to the twin issues of GenAI excitement and the elevated level of profitability in lower quality companies. In 2024, the challenge was around multiples. The portfolio grew its forward EPS by 17%, ahead of the 12% delivered by the wider index despite the headwind from the strengthening dollar to those companies making significant sums of revenue outside the U.S. However, performance lagged the S&P 500 as the portfolio derated by -6%, versus the rerating of 10% for the index. Looking forward, this leaves the portfolio relatively well placed on valuation, as the price-to-earnings (PE) premium has fallen to just 6%, a historical low for the portfolio, while the free cash flow

[3] Source for markets and stock performance, multiples, earnings and revenue data cited in this commentary: FactSet, as of 31 December 2024.
[4] Source for GDP and Treasury rates data cited in this commentary: Bloomberg L.P., as of 31 December 2024.

premium has disappeared, with the portfolio now at a 7% discount to the index, despite the far higher quality and better top-line growth prospects.

Credible earnings growth given healthy top line

The portfolio also looks well placed in terms of earnings. They are very likely to be far more resilient than those of the index in any economic downturn, given the holdings' strong pricing power and recurring revenues. Arguably more importantly, the portfolio looks well placed in both absolute and relative terms even in the absence of a downturn. Consensus puts the portfolio's EPS growth at 11% per year over the next two years. We believe this looks achievable, based on the estimated 7% annual revenue growth, with some modest help from operational leverage, acquisitions and buybacks making up the other 4% of EPS growth. This seems much more credible than the margin-driven 14% annual EPS growth expected for the index, which is supposed to come off revenue growth of only 6%, an 8% delta when margins are already close to peaks.

The claim that "prediction is very difficult, particularly about the future" is attributed to both the Nobel Prize winning physicist Niels Bohr and the baseball Hall of Fame member Yogi Berra. Despite their differing backgrounds, they would probably both agree that prediction is particularly difficult in 2025 given the heightened geopolitical and U.S. policy uncertainty combined with wildly varying prognostications for GenAI. However, the markets do not seem to be afflicted by any such doubt, given the elevated equity multiples, modest VIX and, most starkly, BBB-rated bond spreads at their lowest this century. Given this market obliviousness to the world's volatility, we believe a strategy that seeks to deliver steady compounding through decent top-line growth and resilient earnings, which is trading at an attractive multiple, offers an important role to play in clients' portfolios.

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

Fund Facts

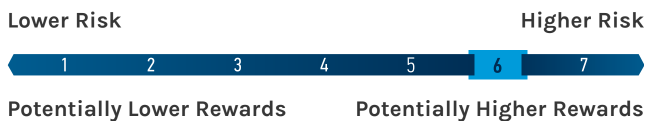
Launch date	31 October 2023
Base currency	Sterling
Benchmark	S&P 500 Index

12 Month Performance Periods to Latest Month End (%)

	DECEMBER '23 - DECEMBER '24	DECEMBER '22 - DECEMBER '23	DECEMBER '21 - DECEMBER '22	DECEMBER '20 - DECEMBER '21	DECEMBER '19 - DECEMBER '20
OEIC American Resilience Equity Fund - I ACC Shares	12.21	--	--	--	--
S&P 500 Index	27.26	--	--	--	--

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 shares. The sources for all performance and index data is Morgan Stanley Investment Management ('MSIM Ltd'). **Please visit our website www.morganstanley.com/im to see the latest performance returns for the fund's other share classes.**

Share Class I ACC Risk and Reward Profile



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.

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- 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 Fund's 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 31.12.2024 and subject to change daily.

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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

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