Morgan Stanley
INVESTMENT MANAGEMENT

MONTHLY COMMENTARY
31 August 2023

Morgan Stanley Funds (UK)

Global Sustain Fund

INTERNATIONAL EQUITY TEAM

Performance Review

In the one month period ending 31 August 2023, the Fund's I ACC shares returned 0.68% (net of fees)[1], while the benchmark returned -0.89%.

The portfolio is slightly behind the index for the year-to-date, returning +9.49% versus +10.23% for the index.

The August outperformance was due to stock selection, owing to strength in information technology, financials and industrials. Meanwhile, sector allocation was roughly neutral.

The largest contributors to absolute performance during the month were Visa (+28 basis points [bps]), Accenture (+24 bps) and CDW (+23 bps). The largest absolute detractors were PayPal (-33 bps), Abbott Laboratories (-19 bps) and Prudential (-14 bps).

Market Review

Global equity markets were weaker in August, with the MSCI World Index returning -2.4% in U.S. dollars (USD) and -1.8% in local currency — the index's largest monthly percentage drop since February. Energy (+2%) was the month's top performing sector but still remains 12 percentage points behind the wider index year-to-date. All the other sectors were within 300 bps of the MSCI World. As has been the case for the year so far, the expensive and highly growth-tilted sectors — communication services, information technology (both -2%) and consumer discretionary (-3%) — performed better than the market's cheaper areas, notably financials (-4%) and materials (-5%). Meanwhile, the portfolio's key defensive sectors straddled the index: health care (-1%) was slightly ahead and consumer staples (-3%) was a touch behind.

Turning to geographies, the U.S. (-2%) finished ahead of the index in the month, meaning other major markets tended to lag. In Europe, France, Italy (both -4% in USD, -2% in local currency), the U.K. (-4%, -3%) and Germany (-5%, -3%) were slightly behind the MSCI World, while Spain (-3%, -1%) and Switzerland (-4%, -2%) performed better. In Asia, Singapore (-8% USD, -7% local) and Hong Kong (-9%, -8%) were notably weak, while Japan (-2%, -0%) was stronger in yen terms.

Portfolio Activity

Portfolio activity is reported at quarter-end.

Strategy and Outlook

Finding Diamonds in the Rough? Searching for Quality in Financials

For many in the market, being a quality investor within financials might seem like a contradiction in terms; financials is a value sector, they may argue — typically cheap and quite frequently not so cheerful. While that is certainly true of some parts of the sector, we believe that select high quality companies within financials do exist and that we can identify them for the benefit of our clients. However, this relies on a rigorous process to separate the wheat from the chaff.

A good place to start is to ask why, in general, financials may be considered low quality. A key aspect is their dependence on macroeconomic factors such as interest rates and the outlook for equity and credit markets, which means that their operational fate is often not in their own hands — a bank is a prime example. Just look at the recent earnings upgrades in the banking sector: For many bank stocks, this was driven by higher interest rates, the direction of which is both difficult to forecast ***and*** impossible for management to influence. In addition, many financials companies are highly cyclical, often driven by macro factors, be it the state of the overall economy or the health of asset markets, driving assets under management. We do not need to revisit the Global Financial Crisis to find examples of this; in early 2023, the collapse of a few small to medium-sized U.S. regional banks in the face of surging interest rates triggered the largest banking failure since 2008-09. All this adds up to relatively opaque business models with numerous share price drivers — macroeconomic and fundamental combined.

The presence of sustainably high returns on operating capital is one of the hallmarks of our team's definition of quality. Within financials broadly, however, the balance sheet heavy nature of many business models tends to weigh on returns, leaving them struggling to make our quality grade. Quality companies, as we have been defining them for more than 20 years, have (among other things) sustainably high returns on unlevered operating capital, robust balance sheets and the ability to fund their growth mostly out of the existing cash flow — things that banks, for instance, generally do not have or are unable to do. A typical bank could have an unleveraged return on assets of less than 1%, and this before leverage of typically more than 10x. Balance sheet requirements are of course determined by regulators and changes can be difficult to anticipate, with regulatory intervention — and its impact on balance sheets and earnings — often coming out of left field. As a result, we can never own banks in our pure quality portfolios.

While banks do not meet our high quality criteria, we believe that select high quality companies can be found elsewhere within the financials sector and make excellent candidates for our portfolios. Well-managed companies with strong intangible assets in balance

[1] Source: Morgan Stanley Investment Management Limited. Data as of 31 August 2023.

sheet light subsectors such as exchanges, niches in the insurance industry and payment companies can achieve the combination of high returns, moderate cyclicality and recurring revenues that we favour in quality companies.

The relative scarcity of suitable portfolio candidates within financials is less of an impediment for a well-resourced team managing high conviction portfolios where index weights do not determine investment decisions. In addition, disconnects regularly develop between share prices and the value of the underlying franchises, which can offer good opportunities for stock pickers with a bottom-up approach. Admittedly, they require effort and expertise to unearth; a discounted valuation can signal either opportunity or balance sheet distress. With the strength of our team working on financials — which includes Anton Kryachok and Isabelle Mast alongside Bruno Paulson, Alex Gabriele and Richard Perrott in coverage of the sector — we have been able to identify promising investments on behalf of our clients.

Examples of some relatively new additions to our portfolios may highlight our stock picking process within this space better than a theoretical description.

A U.S.-based insurance broker

Within financials, the insurance broking industry is a fertile hunting ground for us; this is a capital-light industry which is highly concentrated at the large company end and provides good opportunities to roll up smaller brokers in the SME (small and medium-sized enterprises) segment. The brokers help their clients buy insurance at a good price and also structure it for them, as well as giving advice in areas such as risk management, regulatory requirements and capital management. We consider insurance brokers to be diversified professional service providers with a good revenue growth outlook, supported by structural drivers of higher insurance premiums, such as climate change, cybersecurity risks and rising court judgements. We selected this particular company, rather than its peers, for two reasons. First of all, it has implemented a unified operating platform that has helped both to drive a significant expansion of its EBITDA[2] margin (from below 20% in 2013 to almost 32% in 2022)[3] and break down barriers between siloed subdivisions to improve the client offering. Secondly, in our assessment, it has a strong management team with a history of shrewd capital allocation for the benefit of shareholders. In essence, it is a capital-light company with structurally high — and improving — returns, negligible macro gearing and a shareholder-friendly management team, which fits the bill for our quality portfolios perfectly. Just as importantly, at the time of purchase the company was trading materially below its intrinsic value.

Two leading exchanges

Another good example is illustrated by two exchanges, one based in the U.S. and the other in Europe, where high returns on the modest amount of capital employed, recurring revenues and modest cyclicality coupled with an attractive valuation have allowed us to build positions in select global portfolios. Diversified revenue streams and high barriers to entry by virtue of a combination of network effects, brands and sticky software, combined with strong management, have helped these two names stand out from their peers.

A U.S.-based payment company

High barriers to entry and strong intangibles help to protect the exchanges' profitability and growth outlook, which is also part of what attracted us to a U.S.-based payment company held in select global portfolios. This leading e-wallet solution provider boasts a constantly growing user base and broadening merchant acceptance, which create a positive flywheel effect where its larger network and additional functionality make it more valuable to consumers and merchants alike. Payments are not a new area for us: we have owned a leading global provider since 2010, and it holds a top 10 position in our global portfolios.

While we typically find the greatest proportion of high quality compounders in the consumer staples, information technology and health care sectors, our bottom-up investment approach enables us to identify those niches of quality that exist within other sectors. Financials is a good example of this, and our exposure to investments in financials as a percentage of the overall portfolio has increased over time. The recent MSCI Global Industry Classification Standard update, which shifted a couple of payments stocks from the information technology sector to financials in early 2023, has certainly contributed to this. But perhaps more significantly, the breadth of investment expertise on our portfolio management team has allowed us to, in the words of Peter Lynch, turn over more stones and find the odd diamond in the rough to add to our portfolios.

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

Fund Facts

Launch date	23 September 2019
Base currency	Sterling
Benchmark	MSCI World Net Index

2 Earnings before interest, taxes, depreciation and amortization.
3 Source: MSIM Research, Company reports.

12 Month Performance Periods to Latest Month End (%)

	AUGUST '22 - AUGUST '23	AUGUST '21 - AUGUST '22	AUGUST '20 - AUGUST '21	AUGUST '19 - AUGUST '20	AUGUST '18 - AUGUST '19
OEIC Global Sustain Fund - I ACC Shares	4.67	-1.06	14.01	--	--
MSCI World Net Index	6.16	0.45	26.25	--	--

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.**

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.
- Investment in China A-Shares via Shanghai-Hong Kong Stock Connect program 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 August 2023 and subject to change daily.

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.

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