Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Investment Funds

Sustainable Emerging Markets Equity Fund

MARKETING COMMUNICATION | EMERGING MARKETS EQUITY TEAM | QUARTERLY COMMENTARY | 30 JUNE 2022

Important information

- The Fund invests primarily in emerging country equity securities.
- Investment involves risks. Key risks for this fund include Risk of Investment in Equity, Emerging Market Risk, ESG Investing Risk, Exchange Rate Risk and Risk of Exposure to the Euro and Eurozone.
- There is a risk that you may potentially lose your entire investment in this Fund.
- The investment decision is yours but you should not invest unless the intermediary who sells it to you has advised you that it is suitable for you and has explained why, including how buying it would be consistent with your investment objectives. You should not make any investment decision solely based on this document. Please read the relevant offering document carefully for further fund details including risk factors.

Performance Review

In the three month period ending 30 June 2022, the Fund's A shares returned -19.24% (net of fees)[1], while the benchmark returned -11.45%.

Growing investor concerns about lower global growth and downward revisions to some projected earnings contributed to the sell-off in emerging markets (EM) in June, leading to its worst monthly return this year. Most central banks have been raising interest rates to combat inflation and keep up with the U.S. Federal Reserve (Fed). China stands out in contrast as the People's Bank of China has continued to cut rates, which along with some recent other stimulus measures and some COVID-19 openings, contributed to the market's recent positive performance. Historically, rising rates in EM, along with high commodities prices and economic recovery, have supported EM currencies and markets, but the multiple global problems have sparked investor worries about potential recessions in select EM countries.

The Fund's underweight to China had served the portfolio well over most of the past 18 months, but in the last two months, China's market has been boosted by government announcements of some economic stimulus and the reopening of major cities such as Shanghai following severe COVID-19 lockdowns.

With China outperforming during the quarter (+3.4%),[2] information technology (IT) and consumer names rebounded as lockdowns in China eased in selective cities and consumption showed signs of recovering. Our allocations to select Chinese consumer names BYD Co., Proya Cosmetics and China Tourism Group Duty Free contributed positively to performance. LONGi Green Energy also contributed to returns. With regard to BYD Co., we remain positive on the renewable and electric vehicle (EV) thematic in China and have added to select quality growth EV and battery storage/inverters companies. While allocations to these select names contributed, our aggregate underweight allocation to and, to a lesser degree, stock selection in China detracted, largely driven by our zero allocations to Alibaba (+18.2% in the second quarter of 2022)[3] and Meituan.

After contributing strongly to performance for the past 18 months or so, our overweight to and stock selection in South Africa detracted, with the market facing pressure in June as the rand weakened against the dollar amid continued Fed rate hikes. Our allocation to Anglo American and Anglo American Platinum detracted as the commodity market pulled back on recession concerns during the month. We remain positive on select commodities — particularly those required for the green transition to greater decarbonization — as there is still a lack of significant supply response in commodities on the horizon; we believe a recovery in demand can help prices recover. Elsewhere in the portfolio, our allocations to NVIDIA and Hindalco also detracted.

While our zero allocation to index heavyweight Vale contributed to returns, it did not offset our overall adverse stock selection in Brazil as MercadoLibre (MELI) declined more than 46% during the second quarter, largely as part of the broader sell-off across the technology sector.[3] Brazilian equities faced pressure in June from indications of policy changes that may follow the October elections, in addition to the impact of the central bank's aggressive inflation battle and the correction of commodity prices.

[1] Source: Morgan Stanley Investment Management Limited. Data as of 30 June 2022.
[2] Regional and country returns are represented by their respective MSCI regional/country indexes, which are broad measures of the region/country's stock market performance. Data as of 30 June 2022.
[3] Source: Bloomberg L.P. Data as of 30 June 2022.

This document constitutes a commentary and does not constitute investment advice nor a recommendation to invest. The value of investments may rise as well as fall. Independent advice should be sought before any decision to invest.

Our allocation to Globant also hampered returns as the stock continued to underperform as it has year-to-date. While we expect the company to continue delivering high growth with solid financial results supported by the secular digital transformation trend, the stock continued to suffer in conjunction with this year's tech/IT services sell-off, which has particularly hit high valuation names.

Our overweight allocation to Poland detracted, largely driven by the underperformance of apparel retailer LPP and Bank Pekao. LPP had underperformed particularly in the first quarter of 2022 as markets sold off stocks with exposure to Russia, Belarus and/or Ukraine (18% of LPP's revenues were from Russia and Belarus, with an additional 6% from Ukraine).[4] We maintained our position and continue to believe our investment thesis for the company remains intact absent the Russia operations. The company has resized its growth strategy for this year and shifted resources into the balance of its geographic footprint.

Our stock selection in India contributed to returns, though gains were partially offset by the overweight allocation as the market sold off on a combination of high crude prices, inflation and monetary policy tightening. Our allocations to automobile and motorcycle manufacturers Mahindra & Mahindra, Bajaj Auto and Eicher Motors contributed positively. Bajaj Auto is a main player in the two-wheeler industry, which has seen significant pent-up demand as this is the third year in a row that the industry has been hit. With India's transition to EVs threatening new competition, valuations have stayed low, but we believe that the market is still a good couple of years away from consolidating. Incumbents, such as Bajaj Auto, with distribution and efficient sourcing strategies could benefit as cost effectiveness is going to be critical in India.

Our allocations to Mahindra & Mahindra Financial and Reliance Industries also contributed. With regard to Mahindra & Mahindra Financial, we believe domestic banks are likely to see improving credit growth in the coming quarters. The pick-up in real estate, commodity, chemical and textile prices/margins has helped address a large portion of the stressed assets of Indian banks. We remain positive on energy, and Reliance Industries is making a shift to focus on new/renewable energy, which we believe can be beneficial as the world transitions to net zero.

The United Arab Emirates and Saudi Arabia, which had been among the best performing EMs year-to-date, pulled back -19.4% and -12.5%, respectively,[2] during the quarter and our zero allocations to these countries contributed to returns. While we remain constructive that oil prices will likely remain in the high end of their range, we do not think they can go much higher; we maintain our zero allocation to the Gulf Cooperation Council region as we have not found companies that meet our quality growth criteria at reasonable valuations.

Within Taiwan, our allocation to Airtac contributed positively to returns while Taiwan Semiconductor (TSMC) detracted. Airtac is the second largest component supplier for pneumatic equipment. We remain positive on the secular trend in industry automation demand, and we believe Airtac can continue to gain market share. TSMC remains the key enabler of the multi-year digitalization trend and has continued to demonstrate solid technology leadership and solid execution.

Overall, we remain focused on managing an active portfolio of quality growth stocks that are informed by our thematic research and assessment of macro drivers and risks. Some of the key drivers that had been supporting our performance have included identifying and allocating for: economic recovery and/or improving policy reform prospects in South Africa, Central Europe and Mexico; rising demand for the select materials needed in the green technology critical to carbon reduction; recovery in demand for transportation and select consumer staples and services as societies continue to adjust to the COVID-19 pandemic; and greater demand for credit, particularly in countries that have avoided or cleaned up past debt problems, as in India and Indonesia. The sell-off this quarter has enabled us to add to our high conviction views in some cases and find new opportunities at compelling valuations.

Market Review

The MSCI Emerging Markets Index returned -11.45% during the quarter, outperforming the MSCI World Index, which returned -16.19%. Latin American equities underperformed, with Peru (-30.23%) and Colombia (-28.01%) being the worst performing EMs during the quarter.[2] Brazil (-24.40%), Chile (-15.90%) and Mexico (-15.17%) also underperformed.[2] During the first quarter of 2022, the commodities-related stocks and currencies in Latin America had benefited from the sharp rise in oil and material prices globally stemming from the Russian invasion of Ukraine and rapid escalation of sanctions against Russia. However, during the second quarter, given a broad inflation acceleration, rising interest rates and fears of recession, the majority of gains from the strong first quarter performance reversed itself. The Brazilian real and Chilean peso were among the worst performing EM currencies, depreciating approximately 10% and 14%, respectively.[3]

Within the Europe, Middle East and Africa (EMEA) region, Poland (-27.12%), Hungary (-26.26%) and South Africa (-23.00%) also underperformed.[2] Elsewhere, Korea (-20.90%), Egypt (-20.37%), Taiwan (-19.81%), the Philippines (-19.49%) and the United Arab Emirates (-19.39%) lagged the index.[2] China (+3.41%) was the only EM equity market to post a positive return in the June.[2] China equities had a roller-coaster ride in the second quarter, slumping in the first half of the quarter as cities locked down and the economy sputtered amid COVID-19 spikes, then rebounding in the latter half as the country had select openings in some large cities, then gradually reopened, and the government initiated additional economic stimulus while the People's Bank of China (PBOC) continued its accommodative monetary policy—in direct contrast to the Fed's tightening to combat inflation.

[2] Regional and country returns are represented by their respective MSCI regional/country indexes, which are broad measures of the region/country's stock market performance. Data as of 30 June 2022.
[3] Source: Bloomberg L.P. Data as of 30 June 2022.
[4] Source: Bloomberg L.P. and FactSet

Portfolio Activity

During the quarter we increased our overall allocation to the metals and mining industry and our responsible energy theme by initiating a position in hydro-based aluminum producer, Companhia Brasileira de Alumino (CBA) and adding to our existing positions in Norsk Hydro, Antofagasta and Anglo American Platinum. With regard to CBA, the company provides exposure to the cost and carbon position of the hydro-based producers, which may further benefit from high energy prices following the Russian invasion of Ukraine.

We increased our overweight allocation to India by adding to existing positions Bajaj Auto, Max Healthcare and Reliance Industries. We have been overweight India given our structurally positive view on the macro environment, particularly with a new capex cycle emerging and positive fundamentals.

Max Healthcare is part of our access, affordability and inclusion theme. The medical tourism opportunity is growing in India, and there has been a solid track record of judicious capital allocation to private sector hospitals. Additionally, government-led price intervention, for devices such as stents, are largely in place, and we believe brownfield expansion opportunities will likely continue to drive sector growth for the next three to five years.

To fund the above trades, we exited our positions in Novatek Microelectronics and MediaTek and reduced our position in Samsung Electronics. 5G smartphone growth, particularly in China, could be peaking while there is an increasingly tougher competitive landscape. While MediaTek still offers good dividend and tailwinds from 4G demand, we believe growth has peaked.

We held a dedicated ESG (environmental, social, governance) engagement call with Chinese apparel retailer Li Ning to address some of our concerns on labor practices and human rights issues, and while the company denied any ties to forced labor, they were unwilling to provide much transparency. Given our focus on quality and Li Ning's lack of effort or initiatives in place to minimize supply chain risk, we exited the name.

We also sold Bank Pekao in Poland due to increased prospects of government intervention in the sector to counteract the impact of higher rates on consumers, particularly mortgage holders. Though the regulatory hit to earnings might be manageable, even the prospect (given recent history) of more government intervention will likely increase the equity risk premium for the sector and prevent any "rerating" in line with an increase in profitability/return on equity. We trimmed our positions in ASE Technology and Housing Development Finance Corp (HDFC). In early April it was announced that HDFC and HDFC Bank would begin the merger process. We think the companies could face a long merger timeline and increased regulatory uncertainty, and therefore we reduced our allocation to HDFC.

Strategy and Outlook

Multiple factors contributed to a difficult quarter for equities globally, including the Federal Reserve's continued tightening cycle, which has particularly dampened the performance of high growth and indebted companies; Russia's war in Ukraine and its contribution to already high energy and food prices; China's mixed policy signals and broader economic slowdown; and ongoing supply disruptions as more countries seek to increase the domestic production of critical technologies.

Our underweight to China had served the portfolio well over the past 18 months with the exception of the latter half of the second quarter, with the market benefiting from signs of policy easing, fewer regulations and an improving COVID-19 situation, all leading to improving market sentiment.

While these government measures and additional reopening announcements may improve growth slightly in the second half of the year, we continue to have concerns about larger economic constraints the country faces from still high debt, an aging population and damp demand for exports related to onshoring trends and economic slowdowns among key trading partners. Some policy uncertainty has subsided of late as the authorities move closer to wrapping up the regulatory overhaul. However, corporate fundamentals remain weak as the earnings downcycle has yet to bottom. Key things we will monitor for any changes in our allocation are China's credit growth trajectory and COVID-19 situation. Even with these challenges, we believe high quality companies with secular growth potential will enjoy a valuation premium and outperform the market in the longer run. We own and will continue to look for companies with structural growth, competitive advantages, strong corporate governance and financial strength. We believe any improvement in China's COVID-19 policies will likely eventually support consumption, infrastructure and production.

We remain constructive and overweight South Africa as President Ramaphosa appears to remain committed to reform and the economy is supported by tailwinds from demand for metals, such as platinum, that are linked to electric vehicles and other green-friendly production. We believe strongly that paper and packaging, as provided by a company like Mondi, are part of the gradual but increasing move away from plastics and that there will likely be long-term earnings benefits from this trend.

Eastern Europe—and Poland in particular—remains an engine room of innovation and entrepreneurship in regard to tech companies providing solutions for cybersecurity and other IT services, as well as growing global demand for gaming. In software and IT services, e-commerce platforms, and payments, some of the most innovative growth companies are located in markets like Brazil, and we remain positive on earnings growth in this area.

Select financials are beginning to benefit from the rise in interest rates in certain countries; banks with effective fintech strategies will likely be the beneficiaries of rising demand for credit at greater profitability. We remain positive not only on such names as

Capitec in South Africa and HDFC in India, but we also own select quality names in China such as China Merchant Bank and China Construction Bank. Financials remain our second largest overweight (after IT) on a sector basis. While individual names detracted from performance during the quarter, the overweight was essentially flat.

Overarching our high conviction in these individual names driven by these themes are broader macro factors that we believe may help shift investor demand in favor of EM as an asset class, despite the issues that have arisen in recent months. Key among the catalysts to trigger improved returns for EM equities are an eventual weakening of the U.S. dollar on the back of historic fiscal deficits and debt buildup, the sustainability of earnings for select commodities linked to carbon emissions reduction goals, emerging reforms in countries such as Indonesia and India that are attracting investor attention and continuing digital innovations emanating from many EM countries. We also note that EM valuations overall are at compelling lows relative to the U.S. equity market, which may also help catalyze asset allocation shifts.

Detailed outlooks for some of the top overweight and underweight country positions in the portfolio follow.

Overweight strategy:

We are overweight **India,** and while our country allocation detracted slightly during the quarter, it was more than offset by our strong stock selection in the country. India made it past the peak of the omicron wave and is beginning to benefit from the reopening of the economy. India did not have the fiscal resources of other major EM countries during the worst stages of the COVID-19 pandemic, which imposed spending discipline and limited excess loan growth. This was underscored in the fiscal budget announced during the quarter, which was broadly constructive and did not include any major complications or roadblocks for the private sector, which historically had hampered growth. While the broad market may appear expensive, we are confident that select forward earnings justify current multiples in the quality growth companies we own. No matter the future path of the virus, we think policy makers will seek to keep the economy open and vibrant. Our exposure in India includes well-managed financials, industrials and consumer names linked to recovery, select IT names and the aluminum producer Hindalco, which we continue to believe will play a critical role in global green technology need for decarbonization. We are also adding to our health care exposure as private sector hospitals in India enjoy structural tailwinds, including growing medical tourism.

We have been gradually increasing our position in **Mexico** since last year. We believe Mexico will emerge from the pandemic potentially in a better macroeconomic position than it entered, with strong growth in both real and nominal terms. The country's economy should benefit for the next couple of years from even closer trade links with the United States as onshoring and "friend"-shoring of manufacturing increases. In the long run, Mexico should benefit from the reformulated United States-Mexico-Canada Agreement, particularly given the relatively weak currency, the reconfiguration of supply chains and its proven monetary policy framework. The AMLO administration has shown fiscal rectitude, even if the state has increased its role in the oil and electricity sectors. Uncertainties and risks that will mark the second half of his term are potential further reversals of past reforms in the energy and electricity sectors, a new central bank governor that would have to lead the central bank through a critical stage, weak investment prospects and lower financial buffers. We believe the stocks we own are likely to continue to deliver on earnings as they emerge from the crisis to deliver above-average growth.

We continue to overweight the **Central and Eastern European** (CEE) region through our exposure to stocks in Poland and the Czech Republic and maintained our positions in these economies even with the contagion brought about by Russia's invasion of Ukraine. We expect growth to remain healthy and interest rates to normalize after the sharp declines in 2020. We expect Poland's economy to continue expanding at a rapid pace in the coming years, benefiting from its integration with the European Union and a stable set of economic policies. The companies we own have little to no leverage and have proved flexible and resilient under past periods of stress. Financial sectors in the region remain sound and with little to no exposure to Russia. After years of depressed earnings, we expect banks to generate attractive growth and return on equity as regulatory pressures abate and interest rates increase in several markets in the region.

Underweight strategy:

We remain underweight **China**. The Chinese economy decelerated notably in the second quarter as COVID-19 outbreaks hit major cities across the country, leading to widespread lockdowns and production disruptions. As the government has ratcheted up economic stimulus and cities reopened, we expect a gradual growth recovery in the rest of the year. Meanwhile, policy uncertainty has subsided of late as the authorities move closer to wrapping up the regulatory overhaul. Corporate fundamentals, however, remain weak as the earnings downcycle has yet to bottom. Key things to watch for near-term macro direction include China's credit growth trajectory and the COVID-19 situation.

Our medium-term view of the market hinges on whether China can take the external pressure to implement long-term structural reforms and achieve economic transformation featuring more sustainable growth that is driven by technological innovation and productivity gains. Improved quality and sustainability of the economy could help boost China's corporate return on equity and valuation multiple. We also identify attractive investment themes in China that offer structural growth potential, including consumption upgrade, high-end manufacturing and renewable energy development. Against the macro backdrop of slower growth and lower interest rates in China, we believe high quality companies with secular growth potential will likely continue to enjoy a valuation premium and outperform the market in the longer run. As such, we believe bottom-up stock selection is important to generate alpha. Our portfolio has always been focused on long-term fundamentals and we continue to position for structural growth opportunities in China. We look for companies with structural growth, competitive advantages, strong corporate governance and financial strength.

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

FUND FACTS

Launch date	Base currency	Index
01 July 1993	U.S. dollars	MSCI Emerging Markets Net Index

Calendar Year Returns (%)

Past performance is not a reliable indicator of future results.

	YTD	2021	2020	2019	2018	2017	2016	2015	2014	2013	2012
Class A Shares	-28.73	2.83	13.61	18.08	-17.52	34.45	5.23	-11.17	-4.83	-0.23	18.28
MSCI Emerging Markets Net Index	-17.63	-2.54	18.31	18.42	-14.57	37.28	11.19	-14.92	-2.19	-2.60	18.22

Investment involves risks. All performance data is calculated NAV to NAV, net of fees, and assume the reinvestment of all dividends and income. The sources for all performance and Index data is Morgan Stanley Investment Management. Please refer to the relevant offering documents for fund details, including risk factors.

Effective 1st November 2021 the Morgan Stanley Investment Funds Emerging Markets Equity Fund was renamed to Sustainable Emerging Markets Equity Fund.

INDEX INFORMATION

The **MSCI Emerging Markets Net Index** is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of emerging 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 MSCI Emerging Markets Index currently consists of 24 emerging-market country indices. The performance of the index is listed in U.S. dollars and assumes reinvestment of net dividends.

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 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.

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