Morgan Stanley Investment Funds

Global Brands Equity Income Fund

INTERNATIONAL EQUITY TEAM

Performance Review

In the one month period ending 31 October 2023, the Fund's Z shares returned -2.39% (net of fees)[1], while the benchmark returned -2.90%.

The portfolio is behind the index for the year-to-date, having returned +4.16% versus +7.88% for the index.

As of 30 September 2023, the Fund had produced a distributed yield of 4.41% over the previous four quarters.

The October outperformance was largely driven by stock selection, owing to strength in information technology and financials, which more than outweighed weakness in health care. Sector allocation was also positive, helped by the overweight in consumer staples.

The largest contributors to absolute performance during the month were Microsoft (+51 basis points [bps]), SAP (+16 bps) and Pernod Ricard (+13 bps). The largest absolute detractors were Danaher (-60 bps), Thermo Fisher (-55 bps) and Reckitt Benckiser (-32 bps).

The overwrite (sales of index calls) contributed +22 bps to performance for the month.

Market Review

Global equity market weakness continued in October, with the MSCI World Index returning -2.9% in U.S. dollars (USD) and a similar -2.6% in local currency in the month. The index is still up +7.9% for the year-to-date in USD and +9.1% in local currency. There was not much variation by sector; other than utilities (+1%), all sectors were negative and within two percentage points of the MSCI World Index. The growth-tilted information technology (-1%) and communication services (-2%) sectors were marginally ahead of the index in the month, as they have been for much of this year, while the typically cheaper, more cyclical materials (-3%), financials and industrials (both -4%) sectors were a touch behind. In terms of the portfolio's key defensive sectors, consumer staples (-2%) held up slightly better than the overall index, while health care (-4%) struggled, partly due to weakness in its life sciences subsector, which was off -14%. The geographical performance pattern was similarly condensed: all major markets were negative and within 250 bps of the MSCI World Index, with Italy (-1% USD and local), Hong Kong (-2% USD and local) and the U.S. (-2%) the only major markets to finish ahead of the index in the month.

Portfolio Activity

Portfolio activity is reported at quarter-end.

Strategy and Outlook

***Executive pay:** "**Show me the incentive and I will show you the outcome**"*

Modern capitalism suffers from the "principal-agent problem", given the differing interests of the owners of assets versus the corporate executives who manage them. The executive pay industry, with its complex packages of bonuses and performance shares, has evolved to try to align the interests of the two parties. The pay industry has certainly succeeded in increasing the rewards for CEOs, who the Economic Policy Institute claims are now paid 344 times as much as a typical worker, in contrast to 1965 when they only earned 21 times as much.[2] We would argue that there is still progress to be made in making sure that this extra executive compensation is matched by improved alignment.

As long-term investors, we want the companies our clients own to have pay plans in place that encourage longer-term thinking over short-term opportunism. After all, we support Charlie Munger's claim that incentives drive outcomes. Our fear is that the wrong incentives, for instance excessive focus on earnings per share (EPS), can encourage management to take decisions that boost profits in the short run at the expense of their companies' ability to compound over the long run. This may be a consumer company cutting advertising, or a firm making large acquisitions that, while "accretive", i.e., boosting short-term EPS, deploy a large amount of capital at low returns. By contrast, when compensation is managed effectively, it aligns key decision-makers' behaviours with the company's objectives, encouraging better performance and long-term returns to shareholders.

As a result, we take the process very seriously, using our proprietary Pay X-Ray scoring framework to evaluate pay schemes, engaging with boards to improve them and voting against them where we are unhappy with the structures. Our attempts to effect change on pay schemes for the benefit of shareholders is helped by our well-resourced team and concentrated long-term holdings in the companies we cover. This allows us to invest the effort and time required to improve pay schemes, and to get the access to boards to make our case. We have recorded successes, often after years of discussions, proving that perseverance can pay off. After

[1] Source: Morgan Stanley Investment Management Limited. Data as of 31 October 2023
[2] Source: Economic Policy Institute report on CEO pay in 2022. Published 21 September 2023.

all, we have been talking to companies about how they incentivise their executives for over 20 years, long before the concept of environmental, social and governance (ESG) investing came to the fore.

Asking the key questions

While there is no magic formula that can be uniformly applied to companies across all sectors and industries, we have established some principles based on our extensive experience of investment team-led engagement with companies about pay. We favour incentive schemes that align goals with shareholder interests, and which are structured on sensible and disciplined performance-based targets that cannot be easily manipulated in the short term. Looking beyond the technical details of each proxy, the fundamental questions investors should ask are:

- What kind of behaviour does the scheme incentivise: short term or long term?
- Are the incentives balanced, and do they make sense given the nature of the business – e.g., is a mature business incentivised to grow at the expense of returns? Is a growth business incentivised to underinvest, thereby missing growth opportunities?
- How could executive pay be gamed to the benefit of management? Can a seemingly good metric have negative side effects (e.g., can a cash flow key performance indicator disincentivise necessary capital expenditure)?
- Can we monitor management's actual behaviour to identify if the scheme is not working or is being abused?

Assessing pay with the Pay X-Ray

We created the Pay X-Ray some years ago as a framework for a comprehensive and rigorous analysis of company schemes. We do use proxy vote data providers as resources for our efforts, but are in no way bound by their recommendations, given our in-depth knowledge of the companies and their management. The Pay X-Ray splits the detailed scoring of the company schemes into the four buckets shown below.

1. Performance metrics: ***What is management paid on?***

There are several measures we like, such as organic growth, margin and free cash flows. The ideal balance between them will depend on the strategic position of the company, for instance as it trades off growth and margin improvement. For consumer companies, we like any profit or margin metrics to be before advertising and promotion costs to remove the incentive to cut advertising to meet short-term profit targets. Generally, we are particularly keen to see return on capital included in the metrics, as it forces management to value capital and penalises low-return acquisitions.

We are less enthusiastic about total shareholder return as a measure, especially when using a broad index as a comparator, as much is driven by sector rather than company performance. We are not fans of EPS, as that can be boosted by "accretive" acquisitions, even if they are at low returns on capital, or by levering up the company.

2. Delivery mechanisms: ***How is management paid?***

Here we prefer the company to issue shares rather than options, as the asymmetry of options can favour excessive risk-taking, particularly once they are "out of the money". We also want those rewards to be performance shares, which require management to hit targets to get rewarded, rather than simple restricted shares — or "pay for stay" — where management merely has to avoid being fired to benefit.

3. Vesting period: ***When is management paid?***

This is a case of "the longer the better", in our view, as it encourages management to strive for the long-term success of the company rather than simply hitting short-term targets. Even a scheme with good pay metrics can be rendered useless by an insufficiently long vesting period. We also like issuance of the shares to be delayed until after the end of the performance period. This is most notable in the case of departing executives, as we have been burnt by management plumping up the business for the point of their exit, with the bill later due for their successors.

4. Shenanigans: ***What tricks are management up to?***

Along with the core metrics above, we worry about what we term "shenanigans" — the games management can play to get paid out. These include changing targets ex-post where there are "adverse circumstances" (you won't be surprised to hear that we do not find many cases where targets are toughened when the environment helps a company), targets that are too easy or where the numbers are not disclosed, ex gratia payments to management on top of the stated schemes, and massive payments for failure when management is dismissed.

Investment team-led engagement and voting are crucial tools

We look for companies to achieve a positive Pay X-Ray score, but also for signs of improvement. The results feed into our engagements with the companies. As much as 25% of our company engagements year-to-date (as of 30 September 2023) have included conversations on executive pay. As mentioned, we are privileged to gain access to management given our significant assets under management within concentrated portfolios: In our global portfolios, we hold at least 0.5% of the companies' free floats in 70%-85% of the holdings in our strategies.

In addition to talking to companies about pay, we vote on it. In the first half of 2023 we voted on 244 compensation-related proposals for 78 of the companies held across strategies we manage. We voted ***against*** 51 of these, or 21% of the time. Furthermore, 47% of the time we voted against management on at least one compensation-related proposal (37 companies).

The most common and often high-profile votes involve approving the compensation of a company's executive officers. These can be on an individual basis or for the whole executive team, depending on the company's jurisdiction. With occasionally eyebrow-raising sums involved, in our view the quantum of pay needs to be assessed both absolutely and relative to stated targets. There were 79 such proposals at companies held across our strategies in the first half of 2023, and we voted ***against*** 35 of these (44% of the time).

We don't restrict our voting to pay plans. If, having previously voted against a compensation proposal, we wish to underline our point, further escalation may include voting against the election of committee members. During the first six months of 2023, we voted against the election of the chair of the compensation committee at three different companies due to ongoing concerns with their pay plans. For one of these companies, our escalation went a step further: We also voted against the election of two directors who were members of the company's compensation committee.

Pay is a key instrument in incentivising management to operate in the long-term interests of a company and its shareholders, given the principal-agent problem. It is therefore critical for boards and management teams to get it right, and for active long-term investors to hold company boards accountable for their actions through a programme of monitoring, engagement and voting. This is why we take our fiduciary responsibilities in this area so seriously.

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

Fund Facts

Launch date	29 April 2016
Base currency	U.S. dollars
Benchmark	MSCI World Net Index

Calendar Year Returns (%)

Past performance is not a reliable indicator of future results.

	YTD	2022	2021	2020	2019	2018	2017	2016	2015	2014	2013
Class Z Shares	4.16	-16.18	19.64	11.99	25.55	-3.07	22.60	--	--	--	--
MSCI World Net Index	7.88	-18.14	21.82	15.90	27.67	-8.71	22.40	--	--	--	--

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 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 value of financial derivative instruments are highly sensitive and may result in losses in excess of the amount invested by the Sub-Fund.
- 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.
- The derivative strategy aims to increase the income paid to investors, but there is potential for the fund to suffer losses.
- 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.

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INDEX INFORMATION

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