Morgan Stanley Investment Funds

Global Quality Fund

INTERNATIONAL EQUITY TEAM

Performance Review

In the one month period ending 31 March 2024, the Fund's Z shares returned 0.12% (net of fees)[1], while the benchmark returned 3.21%.

The portfolio underperformed for the first quarter (Q1), returning +5.15% versus +8.88% for the index.

The March underperformance was primarily due to stock selection, given weakness in financials and, to a lesser extent, health care, industrials and consumer staples. For sector allocation, the benefit from the underweight in consumer discretionary was outweighed by the drag from the zero weight in energy.

For Q1 overall, underperformance was due to stock selection, due to weakness in financials and consumer staples, health care and, to a lesser extent, industrials. Sector allocation, meanwhile, was positive as the benefit from the portfolio's lack of exposure to materials, real estate and utilities outweighed the drag from the overweight in consumer staples.

The largest contributors to absolute performance during Q1 were SAP (+123 basis points [bps]), as the cloud transition started to pay off; TSMC (+73 bps), which forecast a return to strong growth in 2024; and Microsoft (+68 bps), which was helped by excitement about potential GenAI revenues. The largest absolute detractors were AIA (-52 bps), held back by general China concerns and its financial results aside from the strong new business profits; Reckitt Benckiser (-44 bps), hit by disappointing fourth quarter numbers and then an adverse court judgement for its infant nutrition business; and Pernod Ricard (-15 bps), on sales struggles in both the U.S. and China.

Market Review

The MSCI World Index returned +3.2% in U.S. dollars (USD) in March and a similar +3.4% in local currency. Alongside energy (+9%), the month's top performer, it was the typically cheaper, more cyclical sectors that outperformed the MSCI World Index, notably materials (+6%), financials (+5%) and industrials (+4%). In terms of the higher-multiple sectors, communication services (+4%) was closer to the overall index, whilst information technology (+2%) and consumer discretionary (+1%) lagged. The defensive consumer staples and health care sectors also trailed the MSCI World Index in the month, both returning +2%. There was little variation by geography as Italy (+7% USD and local) and Hong Kong (-6% USD and local) were the only major markets to deviate by more than 200 bps from the index.

The MSCI World Index had a strong start to 2024, returning +8.9% in USD during Q1 and a slightly greater +10.1% in local currency. As in 2023, it was the growth-tilted communication services (+13%) and information technology (+12%) sectors that led the pack for the quarter, the latter bolstered by Nvidia's impressive +82% year-to-date return, driving the strong performance of its semiconductors subsector (+36%), though Tesla's travails meant that consumer discretionary (+6%) did not keep up with its 2023 pace. Financials, energy and industrials (all +10%) were also ahead of the index, while the defensive sectors, health care (+7%) and consumer staples (+3%), lagged. Turning to geographies, the U.S. (+10%) was a touch ahead of the index in the quarter. Italy (+14% USD, +16% local) was particularly strong and substantially ahead of its European counterparts: Spain (+8%, +11%), Germany (+7%, +10%) and France (+6%, +8%), as well as the U.K. (+3%, +4%) and Switzerland (-1%, +6%). Meanwhile in Asia, Japan (+11% USD, +19% local) boasted particularly strong performance in local currency, while Singapore (0%, +2%) was flat and Hong Kong struggled (-12%, -11%), finishing the quarter as the weakest major market.

Portfolio Activity

We initiated four new positions in the quarter: two in health care, UnitedHealth and Hologic, and two in consumer staples, Constellation Brands and Haleon; while exiting two, Amphenol and Nike.[2]

UnitedHealth is the largest health insurer in the U.S. with 55 million members, giving it a 15% market share. The company benefits from classic network effects. The 55 million members are very attractive to hospitals, which allows UnitedHealth to generate significant volume-based discounts that would be impossible for new entrants. These discounts allow the company to price insurance particularly competitively, which is not possible for normal insurers. A fantastic compounding track record (17% forward earnings over the last 10 years)[3] has been driven by market share gains as well as increased health care costs associated with ageing populations. The U.S. government is increasingly outsourcing to UnitedHealth given the company is able to reduce costs, making it part of the solution rather than part of the problem. The position was established at a sub-market multiple.

Hologic is focused on women's health. It has two key businesses, which between them make up 70% of sales: molecular diagnostics and breast health. Molecular diagnostics is a razor-razorblade business model based in sexually transmitted disease testing. Leasing

1 Source: Morgan Stanley Investment Management Limited. Data as of 31 March 2024.
2 Source for company financial data (unless otherwise noted): Latest company reports and International Equity Team analysis. Q1 2024.
3 Source: FactSet as of 31 March 2024.

the equipment on three- to five-year contracts means the business is highly recurring. The breast health business has a 90% share in mammography machines (known as gantries) in the U.S. Delivering the best product with a great service network makes life difficult for competition. Overall, 18% of sales come from equipment, with the rest coming from servicing and consumables. Management looks to deliver 5%-7% organic growth, which should not be too cyclical. The position was built at a sub-market multiple.

Constellation Brands has the dominant position in the fastest-growing segment of the U.S. beer market, namely premium international brands (i.e., Modelo, Corona), which is driving high single-digit sales and profit growth in its U.S. beer business. This growth is no longer significantly diluted by the wine operation, which is now only 12% of profits, and the capital allocation risks have dropped away as the Sands brothers relinquished their voting shares and left the executive board in 2023. The stock trades at a discount to its historic price-to-earnings (P/E) ratio.

Haleon is a consumer health care company effectively spun out of GSK and Pfizer. It is the leading player in therapeutic oral care (Sensodyne) and over the counter drugs (Advil, Otrivin), focusing on products that solve real consumer needs from sensitive teeth to back pain. Brand loyalty is high, translating into high returns, margins and cash conversion rates. Growth is mid-single digit, underpinned by dentists and pharmacists who play a crucial role in recruitment and retention of consumers and more people taking action to make themselves better. The stock trades at a discount to the consumer staples sector.

The sale of Amphenol was purely valuation driven. Strong stock performance meant the stock rerated and is now trading at a record earnings multiple, both absolutely and relative to the market, implying significant downside to our fair value. Amphenol remains a superbly run company in the attractive connectors sub-industry of tech hardware.

We also completed our exit from Nike in Q1. We have become increasingly concerned about the economics of its direct-to-consumer business (DTC), and especially the online channel. Despite management assurances, Nike's decade-long journey to shift away from wholesale towards DTC has not yielded the expected improvement in unit economics. More recently, Nike has lost the leadership position in the U.S. running market, a concerning sign for a company that has built its success around runners. The competitive pressure from challenger brands such as On, Hoka or Brooks, combined with weak consumer sentiment, clouds the outlook further.

Elsewhere, we reduced PMI as we have concerns about both the traditional combustible and next-generation IQOS businesses. The company failed to grow its dollar gross profits from the combustible business in 2023 and profits are likely to be only flat in 2024 given regulations on pricing in the U.S., tough European competition and emerging markets currency headwinds. On the next-generation side, regulators in several markets are being less supportive than management had hoped, for instance around tax treatment, which brings risks to the IQOS sales targets.

The other reductions were more valuation driven, trimming TSMC and SAP after strong performance and Danaher and Thermo Fisher in favour of cheaper health care plays. We added to Coca-Cola given its strong operational performance, Aon on weakness post the announcement of the NFP acquisition and Revvity given its attractive valuation due to the life science weakness.

Strategy and Outlook

Compound Interest

The market had a very strong first quarter (Q1), with the MSCI World Index up 9%, on the back of the 11% rise in the previous quarter.[4] The market rise has been about multiples rather than earnings, with the MSCI World Index at 18.6x the next 12 months earnings, versus the 13.7x trough in September 2022. This is close to the peaks reached during the COVID earnings slump and 10% above the highest multiple of 17x reached between 2003 and 2019. The forward earnings number has been edging upward, gaining 2% year-to-date and 8% in the last year. However, this is not due to an improving outlook, given that forecasts for 2024 and 2025 are flatlining, but instead due to the passage of time moving higher estimates to later years.

These "higher later" earnings also make us nervous, as they are dependent on margins rising from already high levels, given 10% per year earnings growth on sales that are expected to be up less than 5% per year. The MSCI World's EBIT (earnings before interest and taxes) margin is expected to go from an already peaky 15.7% in 2023 to 17.2% by 2025. As ever, there are only two ways of losing money in equities, either the earnings going away or the multiples going away — and right now we are worried about both.

2023 was the story of the "Magnificent Seven". The Seven have diverged in 2024, with talk of the "Fabulous Four", but it is really the "Omnivorous One", Nvidia, up another 89% in Q1 to a $2.3 trillion market capitalisation on the back of 2023's 239% return. For anyone benchmarked against the MSCI World, not owning Nvidia cost 151 basis points (bps) of relative performance in Q1 2024, on top of 155 bps in 2023, a relative hit of over 300 bps in 15 months. The largest five stocks now make up 17% of the MSCI World and tend to be both fairly volatile and correlated.

This combination of ebullient and concentrated markets makes for a challenging investment environment, particularly in relative terms. Our response is to continue to think in absolute terms and look to compound over the long run. Our flagship global strategy has been going since 1996, including more detailed data going back to 2000. Over the 23 years since then, the strategy has delivered annualised returns of 11.7%. Rising multiples contributed 1.7%, meaning that 10% of annualised performance has come from the actual compounding of portfolio companies. Breaking this down further, this 10% compounding is down to the strategy's earnings per share (EPS) rising 7%+ per year and dividends providing the rest of the 10%. This level out-compounds the MSCI World Index, whose earnings keep up in the good times but struggle in tough times, such as the Global Financial Crisis, when earnings fell 43% from their June 2008 peak to March 2009, and did not get back to the peak until August 2017 — nearly a lost decade. By

[4] Source for all data used in "Compound Interest" (unless otherwise noted): Morgan Stanley Investment Management, FactSet, International Equity Team.

contrast, thanks to pricing power and recurring revenue, our flagship strategy's earnings only fell 15% peak to trough, and were back at peak within two years, by mid-2010.

Looking forward, we aim for the companies in our global portfolios to continue to compound at around 10%. The ambition is that the portfolio companies' revenues should grow reliably at 5%-6% across the cycle, incremental improvement in margins should add another 1%, while the 4% free cash flow yield, helped by the near 100% free cash flow conversion, completes the picture. Assuming half of the free cash flow is paid out as dividends and the rest boosts EPS either through buybacks or acquisitions, this implies around 8% EPS growth for the portfolio, with a 2% dividend yield taking the overall compounding to 10%. We are not convinced that the market will match this compounding ability. It can keep up in the good times but is likely to suffer more heavily in the bad times. The worry is that after 15 years without a recession, barring the brief interregnum of COVID, the bad times may be on the way, though signs of an imminent U.S. recession are fading.

Future portfolio returns are not just from compounding, as multiples are also a factor and are more likely to be a headwind than a tailwind given high current valuations. Multiple moves dominate in the short run, as seen on the way down in 2022 and on the way back up since then. Both our flagship strategy and the index are at high multiples versus history, though the combination of superior cash conversion and our focus on both valuation and quality means that the strategy is only at a circa 10% premium versus the index on a free cash flow basis, which seems too little, given the large quality differential.

The good news is that where a portfolio compounds, it is the compounding that dominates over the longer term. For example, in the event of a 20% derating, for a portfolio compounding at 10%, the portfolio's multiple would fall to around 20x forward earnings and a 5% free cash flow yield, reducing the 5-year return to 6% per year while the 10-year return would still be a very respectable 8% per year. By contrast, the index faces a double threat; it's at least as vulnerable on multiples and more vulnerable on earnings. Being "double fussy", on both quality and valuation, seems to us to be the best approach to dealing with the double threat. After all, after the MSCI World has returned 25% in five months and 50% in the last year and a half, keeping the lights on should be more of a priority than shooting them out.

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

Fund Facts

Launch date	01 August 2013
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	5.15	19.45	-19.11	18.97	14.31	29.24	-2.17	23.00	3.64	5.39	3.56
MSCI World Net Index	8.88	23.79	-18.14	21.82	15.90	27.67	-8.71	22.40	7.51	-0.87	4.94

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.

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INDEX INFORMATION

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