Morgan Stanley Investment Funds

International Resilience Fund

INTERNATIONAL EQUITY TEAM

Performance Review

In the one month period ending 31 January 2024, the Fund's Z shares returned 1.28% (net of fees)[1], while the benchmark returned -0.99%.

January's outperformance was due to stock selection and sector allocation. Stock selection benefited from strength in information technology, consumer staples and consumer discretionary, while sector allocation was helped by the zero weight in materials and the overweights in information technology and health care.

The largest contributors to absolute performance during the month were SAP (+74 basis points [bps]), Constellation Software (+49 bps) and TSMC (+33 bps). The largest absolute detractors were Hexagon (-29 bps), Infineon Technologies (-24 bps) and AIA (-21 bps).

Market Review

After a boisterous end to 2023, the MSCI All Country World (ACWI) ex-U.S. Index was muted in January, returning -1.0% in U.S. dollars (USD) and +0.7% in local currency. Health care (+1%) and information technology (+1%) were the only sectors to finish positively in the month, while materials (-6%) and real estate (-5%) were notable laggards. All other sectors finished within 200 bps of the index. Looking at geographies, major emerging markets were weak in the month, with China (-10% USD, -10% local currency) and Korea (-10%, -7%) significantly behind the index. Taiwan (-1% USD, +1% local) managed to finish in line. In Asia's developed markets, Japan (+5% USD, +8% local) was strong and well ahead of Hong Kong (-10%, -10%) and Singapore (-4%, -3%). European markets saw less variation, as Italy, France and Switzerland all finished flat in USD and +2% in local, while Germany (-1% USD, +1% local), Spain (-1%, +0%) and the U.K. (-1%, -1%) were all slightly negative in USD. The U.S. (+2%) outperformed the MSCI ACWI ex-U.S. in the month.

Portfolio Activity

Portfolio activity is reported at quarter-end.

Strategy and Outlook

Driving Quality

As a team, we've spent the last quarter of a century seeking out what we consider to be the world's best compounders. These are companies that we believe can continue to steadily — and organically — grow their earnings and free cash flows at an attractive rate over the long term.

Compounding is a powerful force. Grow $1,000 at 10% over seven years and you will have doubled your money. Continue for another 10 years and you'll have $6,000.

We have two principal tasks: one is finding the compounders, and the second is striving not to overpay. If a company is too expensive, then it is too expensive — and you run the risk of the price receding to a fair and sensible level. The recently departed Charlie Munger famously said, "A great business at a fair price is superior to a fair business at a great price." We agree. In his inimitable style, Munger also said, "If you buy something because it is undervalued, then you have to think about selling it when it approaches your calculation of intrinsic value. That's hard. But, if you can buy a few great companies, then you can sit on your *** …. That's a good thing." Here, we are less inclined to agree. The truth is, you can't just sit and watch — it is essential to check and check again that the compounding potential is intact and not under threat, that there's no risk of fade of returns, and that the valuation remains reasonable. That's a challenge we meet with rigorous fundamental analysis and company engagement.

What tells us a company might be a high quality compounder? There are two measures that are part of our quantitative screen: the first is return on operating capital employed (ROOCE), and the second gross margin. ROOCE isn't a measure readily found in FactSet or Bloomberg screening tools; even if you Google it, the search will likely default to ROIC (return on invested capital). Yet ROOCE isn't an invention of ours. It is a subset of ROIC, which is also an important measure; it includes goodwill and accounts for past capital allocation decisions. Essentially, what ROOCE tells us is how much incremental capital is required to grow a business. Using a car analogy, if we think of ROIC as the quality of the car engine plus the driver's historical capability, ROOCE is the quality of the car engine alone.

Historically, our analysis shows that high-ROOCE companies have had a better annualised long-term return than low-ROOCE companies. Using 20 years of data from the MSCI World Index and dividing the constituents into five buckets, split highest to lowest by ROOCE, the highest ROOCE bucket returns 10.5% on an annualised basis, followed by returns of 10.2%, 9.5%, 8.5% and finally

[1] Source: Morgan Stanley Investment Management Limited. Data as of 31 January 2024.

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7.5% for the lowest bucket.[2] At first glance, the spread might not seem that wide. But if we think of it in terms of compounding, $1,000 for 10 years at 10.5% rather than 7.5% results in $2,456 instead of $1,917 — nearly 30% more. Compounding matters.

ROOCE explained

ROOCE is made up of two distinct parts. The return component of ROOCE, the "RO", is from a company's profit and loss account — specifically the EBIT (earnings before interest and taxes). Meanwhile, the operating capital employed piece, the "OCE", comes from the balance sheet and is the sum of the net value of the company's property, plant and equipment, plus its inventory, along with the trade working capital (the net of debtors and creditors). The best way to achieve a high ROOCE is to have a high level of profitability for the "RO" and a limited need for operating capital, the "OCE". Companies that exhibit these characteristics are therefore typically high-margin, asset-light operations.

Why high and stable gross margins matter

When we look for high margins, we're after high gross margins. Companies with a relatively limited cost of goods tend to have high gross margins and therefore high gross profits. Performing the same exercise for gross margin as we did for ROOCE, we split the MSCI World Index constituents into buckets from highest to lowest gross margin. The results are remarkably similar, with the highest gross margin bucket producing the highest annualised 20-year return (+11.5%), and the lowest gross margin bucket producing the lowest return (+8.5%).[2]

Essential in the context of high gross margins is pricing power, regardless of whether a company is facing an inflationary, disinflationary or deflationary environment. Pricing power means a company is able to pass on input cost inflation to customers. Should input costs then recede, pricing power enables these companies to hold on to the higher pricing. This is reflected in the long-term stability of high gross margins. In other words, a company can't sustain a high gross margin if it doesn't have pricing power.

Returning to our car analogy, high gross profits might be thought of as the fuel needed to run the engine — the force behind the organic growth. The greater a company's gross profit, the more it can spend on operating costs to organically drive revenues. These operating costs are typically talent (the workforce), research and development (R&D) and marketing. They help power the sustainability of long-term ROOCE, keeping the company and its brands, networks, products and services relevant to its customers, be they consumers or businesses. High gross margins also mean that a company is less vulnerable to any rise in cost of goods, which lower the percentage of revenues.

The average company in the MSCI World Index, represented by the index itself, has a 30% gross margin and a 20% EBITDA margin (earnings before interest, taxes, depreciation and amortization).[2] In between these two lie the operating costs. To put some numbers on this, if the average company had, for example, $20 billion of sales, using the average gross margin and EBITDA margin referenced above, $20 billion x 30% = $6 billion of gross profit, and $20 billion x 20% = $4 billion of EBITDA. With a difference of $2 billion between the two, that means 10% of these sales are operating costs. One of our high quality compounders — L'Oréal, the world's leading cosmetics brand — has a 73% gross margin and a 23% EBITDA margin.[3] So that enables L'Oréal nearly two-and-a-half times the average company's spend and investment on hiring talent, along with innovating, marketing and advertising at much greater intensity — overall, it's a substantial advantage.

We focus on ensuring that company management is efficiently driving operating costs and on understanding how they might allocate cash flows and possibly use the balance sheet (cash and debt) for acquisitions. As we discussed in our May 2023 commentary, we are not averse to acquisitions; but if they come at the cost of reducing ROOCE, we believe it may signal that company management has misallocated capital and has potentially — and possibly permanently — diluted the quality of the whole company by buying a lower quality business. This is aside from the issue of overpaying, which is also discussed in our May 2023 commentary.

Perversely, an improving ROOCE could also be a red flag to watch for, just as much as a decline. In the short term, higher ROOCE can easily be achieved simply by cutting operating costs, such as reducing R&D or marketing expenses. Profits rise, but in the long term the sustainability of organic growth at the revenue line will be challenged due to the underinvestment. The business will likely slow, and its intrinsic value might decline.

The investment road is very long. We don't need an on-trend, flashy sports car to whizz from A to B, or to go too fast and then run out of fuel. And we're not taking our chances on a cheap and cheerful runabout either. We're looking for reliable, sensible cars with decent performance that won't let us down, that don't cost a fortune to run and aren't complicated to drive; in short, cars we're happy to ride in for a very long time — on the right road, in all weathers. Existing high ROOCE and gross margins indicate which companies to look at closely. However, most of our research effort is spent understanding whether these measures will both remain high given all the challenges firms face — whether due to competitors, disruptors, regulators, fashions or economic cycles — when continuing to grow at high profitability. After all (and with apologies to Thomas Jefferson), "the price of compounding is eternal vigilance."

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

[2] Source: FactSet. Data as of 31 December 2023.
[3] Source: Company reports, International Equity Team analysis.

Fund Facts

Launch date	18 November 2014
Base currency	U.S. dollars
Benchmark	Blended- Blended 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	1.28	17.27	-13.52	4.11	11.54	20.31	-14.24	25.03	-2.51	0.41	--
Blended Index	-0.99	17.65	-14.45	11.26	7.82	22.01	-13.79	25.03	1.00	-0.81	--
MSCI AC World ex-US Net Index	-0.99	15.62	-16.00	7.82	10.65	21.51	-14.20	27.19	4.50	-5.66	--
MSCI EAFE Index	0.58	18.24	-14.45	11.26	7.82	22.01	-13.79	25.03	1.00	-0.81	--

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 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.
- There are increased risks of investing in emerging markets as political, legal and operational systems may be less developed than in developed markets.
- 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 January 2024 and subject to change daily.

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INDEX INFORMATION

The **Blended Index** performance shown is calculated using the MSCI EAFE Index from inception through 29 September 2023 and then the MSCI All Country World Ex-U.S. Index thereafter.

The **MSCI All Country World Ex-U.S. Index** is a free float-adjusted market capitalization weighted index designed to measure the equity market performance of developed and emerging markets, excluding the U.S. 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 **MSCI EAFE Index (Europe, Australia, Far East)** is a free float-adjusted market capitalization index that is designed to measure the international equity market performance of developed markets, excluding the US & Canada. 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 EAFE Index currently consists of 21 developed market country indices. 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. Any index referred to herein is the intellectual property (including registered trademarks) of the applicable licensor.

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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