

Morgan Stanley Investment Funds

Japanese Small Cap Equity Fund

JAPANESE EQUITY TEAM

Performance Review

In the one month period ending 31 March 2024, the Fund's Z shares returned 1.08% (net of fees)¹, while the benchmark returned 4.79%.

Although the Bank of Japan (BOJ) decided to change its monetary policy in March, it indicated that the monetary environment would continue to be accommodative, which reduced concern about it tightening monetary policy. As a result, both the broader Japanese stock market and the Japanese small-cap market rose.

Early in the month, the Japanese stock market was supported mainly by bank stocks, due to expectations for capital efficiency to be improved through the sale of cross-shareholdings, while there was also growing concern about the BOJ's decision to change its monetary easing policy ahead of its meeting. As a result, the market fluctuated in a see-saw pattern. Later in the month, the BOJ decided to end its negative interest rate policy but indicated that the monetary environment would continue to be accommodative, while the U.S. Federal Open Market Committee projected modest interest rate cuts in 2024, which boosted U.S. stocks and improved investor sentiment. In response, the Japanese stock market moved upward. The market ended the month above the previous month-end level.

By sector, the portfolio was positively contributed to our underweight position in consumer staples, while negatively affected by our overweight position in information technology. At a stock level, the portfolio was positively contributed to Dexerials, which manufactures and sells bonding materials and optics materials, and SBI Sumishin Net Bank, a specialized internet bank. On the other hand, it was negatively affected by Osaka Soda, a manufacturer and seller of basic chemicals and functional chemicals, and Anycolor, which is engaged in managing virtual YouTuber businesses.

Market Review

Real gross domestic product (GDP) for the October-December 2023 period was +0.4% on an annualized quarter-on-quarter basis according to the government's secondary preliminary report, turning positive from -0.4% (annualized, quarter-on-quarter) in the first preliminary report. Within demand factors, personal consumption was revised downward and became negative for the third consecutive quarter, while capital investment was revised upward in response to the results of the Financial Statements Statistics of Corporations by Industry. Although Japan avoided a technical recession, the results did not yet give the country a sense of strength.

The BOJ decided to lift its large-scale monetary easing measures at the monetary policy meeting held in March. The yield curve control policy, which is used to control short- and long-term interest rates, was abolished, and new purchases of exchange-traded funds (ETFs) and Japanese real estate investment trusts (J-REITs) also ended. The unprecedented eight-year negative interest rate policy came to an end, marking a major historical turning point towards the normalization of monetary policy. On 22 March, Rengo, the Japanese Trade Union Confederation, announced the results of the 2024 shunto (spring wage negotiations), and the wage increase rate was at a high level of +5.25%. Given this result, we expect an upward trend in real wages.

Portfolio Activity

During the month, we newly purchased shares in Rakuten Bank, a major online bank, and increased our position in Itoki, one of the leading office furniture companies. On the other hand, we completely sold our shares in Shinko Electric Industries, which provides substrates for semiconductor packages, and Fullcast Holdings, a leading provider of temporary staffing and office work outsourcing services.

Among individual names, our top holdings include Dexerials, which manufactures and sells bonding materials and optics materials; Maruwa, a company that develops and produces ceramic products; and Sansan, a sales-focused DX (digital transformation) service provider for the corporate sector.

Strategy and Outlook

While the strength of the U.S. economy has been maintained, we are keeping an eye on its future inflation risk, the effect of the aggressive interest rate hikes implemented so far, and how the U.S. Federal Reserve will respond to them. On the other hand, from a domestic perspective, the BOJ decided to abandon its negative interest rate policy as it viewed the cycle of wages and prices as becoming more solid, anticipating that targets for stable prices would likely be achieved sustainably and stably. We continue to pay attention to private consumption and wages, as well as currency movements. In addition, we are seeing companies make gradual progress with regard to the Tokyo Stock Exchange's actions to encourage listed companies to implement reforms that are conscious of cost of capital and capital profitability, and we expect further positive changes to continue.

¹ Source: Morgan Stanley Investment Management Limited. Data as of 31 March 2024.

Under this market environment, we will continue implementing a bottom-up approach, focusing on evaluating individual companies' medium- to long-term growth potential.

We see there are still many growth companies that are not well recognized by investors in the inefficient Japanese small-cap equity market. We strive to identify attractive investment opportunities by doing thorough research to improve investment performance.

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

Fund Facts

Launch date	07 April 2022
Base currency	Japanese yen
Benchmark	MSCI Japan Small Cap Net Return Index (JPY)

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	6.95	11.04	--	--	--	--	--	--	--	--	--
MSCI Japan Small Cap Net Return Index (JPY)	12.75	21.09	--	--	--	--	--	--	--	--	--

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 fund's ability to buy or sell securities.
- 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 March 2024 and subject to change daily.

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INDEX INFORMATION

The **MSCI Japan Small Cap Index (JPY)** is a free-floated adjusted

market capitalization weighted index that is designed to track the equity market performance of the small cap segment of the Japanese market. The MSCI Japan Small Cap Index (JPY) is constructed based on the MSCI Global Investable Market Indices Methodology, targeting a free-float market capitalization coverage of approximately 14%.

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