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INVESTMENT MANAGEMENT

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Morgan Stanley Investment Funds

Sustainable Asian Equity Fund

EMERGING MARKETS TEAM | MONTHLY COMMENTARY | 28 FEBRUARY 2021

Performance Review

In the one month period ending 28 February 2021, the Fund's I shares returned 0.81% (net of fees)[1], while the benchmark returned 1.25%.

The Asian markets delivered positive returns, even though China underperformed, as India, Hong Kong and Singapore ended the month on a strong note. Stock selection in Singapore contributed but was offset by stock selections in Hong Kong and Korea, which detracted. At the sector level, the underweight allocations to the consumer discretionary and health care sectors and stock selection in information technology (IT) contributed, while the stock selection in and underweight allocation to materials detracted.

At the stock level, our underweight selection to NIO along with the overweight selections to ASE Technology and Reliance Industries contributed. We had been underweight NIO on concerns about valuation and investors' euphoria in the electric vehicle space. ASE Technology performed strongly on the back of a continued strong semiconductor cycle while Reliance Industries recorded strong performance on higher oil prices and the announced divestment of its oil-to-chemical operation. Expectations are also rising on investments into clean energy. Hong Kong Exchanges and Clearing's share price fell sharply at month-end on the proposal to increase the stamp duty, which could impact turnover in the market. Our underweight selection in Baidu detracted as the company recorded a more than 20% return during the month on strong quarterly results and high investor expectations on autonomous driving, given the government's buildout plan.

Market Review

China equities had a roller-coaster ride in February, extending gains early in the month on strong sentiment, upbeat corporate earnings results and improved liquidity conditions, but correcting sharply towards month-end on a jump in U.S. bond yields and concerns over earlier-than-expected stimulus exit. The MSCI China Index finished the month returning -1.04%, snapping a four-month winning streak and trailing the MSCI All Country Asia ex-Japan Index, which returned +1.25% in February. Reflation trades gained momentum amid a commodity price rally and higher interest rates. Cyclical and value stocks in the materials, energy and real estate sectors surged, while secular growth sectors including consumer, information technology and health care plunged on rich valuations.

Recent economic data came in mixed, suggesting slower growth momentum. Both manufacturing and service purchasing managers' indexes eased for the third straight month through February, likely due to earlier social distancing amid COVID-19 resurgence and holiday disruptions. While economic growth is expected to recover going into March as factory production resumes, external demand is key to watch as global economies gradually reopen. Economic activities showed significant divergence across sectors during the Chinese New Year Golden Week holiday, as the government instructed people to avoid traveling. Movie box office sales and express deliveries reached record highs, while tourism and rural consumption remained lackluster. As most migrant workers spent the Spring Festival in cities, China could see faster manufacturing resumption after the holiday. Meanwhile, consumer price index inflation moderated to -0.3% year-on-year in January, primarily driven by lower non-food inflation. Producer price index inflation turned positive in January in year-on-year terms, the first time since February 2020, at +0.3%. Inflation is expected to rise in the coming months on higher commodity prices and service sector recovery.

Policy outlook continued to be the major market focus, as investors looked for signals on a potential shift in policy stance and liquidity condition. In its fourth quarter monetary policy report, the People's Bank of China's (PBoC) language around its overall monetary policy stance is broadly consistent with December's Central Economic Work Conference, although the tone is a touch more hawkish. While the authorities repeated that there would be no U-turn in policy stance, a recent liquidity withdrawal by the PBoC still left investors wary of potential policy tightening amid an improving economic and inflation outlook.

1 Source: Morgan Stanley Investment Management Limited. Data as of 28 February 2021.

In Hong Kong, the equity market advanced amid sector and style rotation. The MSCI Hong Kong Index returned +4.70% in February, outperforming regional peers. Cyclical and value stocks rallied on vaccine and reopening optimism, while growth stocks pulled back on valuation and liquidity concerns. On a sector basis, Macau gaming, real estate and utilities outperformed, while information technology and financials lagged. The latest budget proposal remained expansionary, but more cautious in the face of large deficits. However, the government's decision to hike the stock transaction stamp duty from 0.1% to 0.13% spooked investors and weighed on the equity market. Meanwhile, the seasonally adjusted unemployment rate jumped to a 16-year high of 7.0% for the three months ending January. The government lifted social-distancing rules from February 18 as the prolonged fourth wave of the COVID-19 resurgence finally came under control.

The MSCI Taiwan Index gained +4.60%, with non-tech sectors such as resources, financials, industrials and discretionary recording strong results, while the tech sector performed in line with the index. Within tech, foundry supply tightness remained a dominant theme. Moreover, display names were one of the best performers, and DRAM names also remained strong due to a faster-than-expected price rebound. Export order growth accelerated in January, soaring 49.3% year-over-year from 38.3% in December.

India was the best performing country during the month as investors welcomed the growth-focused budget that was announced with supply-side reforms and increased capital expenditures. Mid- and small-cap companies significantly outperformed large caps with strong returns from the utilities, energy and industrial sectors. Foreign institutional investors added to India for the fifth consecutive month. Industrial production in December rose 1.0% year-over-year versus the -2.1% drop in November.

In Southeast Asia, Indonesia recorded a -2.1% decline in the economy after stronger-than-expected fourth quarter gross domestic product growth from less strict lockdowns compared to rest of the Southeast Asian economies. The Indonesian central bank continued to ease, cutting the policy rate by 25 basis points, while the Bank of Thailand maintained its rate at 0.50% even as it warned that the growth rate will likely disappoint its estimate of 3.2% for 2021. Thailand approved an additional $1.2 billion stimulus.

Korea was essentially unchanged, returning 0.21% during the month as tech companies generally performed well. Hynix benefited from the rising DRAM price and Naver saw increased interest with the upcoming listing of Coupang, while Kia Motors fell on news that the tie-up with Apple may not be happening. (These stocks were not held in the Fund.) The Korean government approved the AstraZeneca vaccine for people 65 and older. The consumer price index rose at a slightly faster than expected 0.6% in January from 0.5% in December.

Portfolio Activity

During the month, we initiated a position in China's leading manufacturer of solar wafers, LONGi Green Energy Technology. With China's pledge to be net-zero by 2060 and the target of raising non-fossil fuel's share in the electricity mix to 50% by 2030, we see strong tailwinds for China's renewables sector. The environment is especially favorable for solar, where the levelized cost of electricity (LCOE) has been getting close to coal-fired power plants and is more competitive than wind energy. While LONGi started out as a semiconductor materials and equipment company, it entered into the solar photovoltaics industry in 2012 and has expanded from simply wafers to the solar cell and module business. China is currently the largest consumer and supplier of solar energy, and we expect solar capacity in China to increase at an attractive growth rate in the next few years. Among all the players in solar wafer production, LONGi leads the pack with the highest global market share of 40%. We see LONGi as likely the biggest beneficiary of the secular tailwind and expect the company to continue to maintain its dominance in the market.

Strategy and Outlook

Our Engagement Philosophy and 2021 Outlook

Outlook

China is likely to continue to lead the world in economic recovery given its successful containment of COVID-19 infections. We also expect the policy measures by the global central banks of maintaining relative stable liquidity even while there has been increased focus on the recent rise in the U.S. Treasury rate from low levels in the third quarter of 2020. We continue to believe the companies that have weathered the challenges in 2020 will likely emerge stronger, gaining market share. The pandemic already seems to have changed consumer behavior and corporates are also adapting to the changes in their operating environment.

While the vaccine rollouts in certain Asian countries have been slower than expected, we expect the program to provide some level of security and likely increased economic activities. As seen by the recent announcements by the Biden administration, we expect the current trend of deglobalization will likely remain for some time, leading towards more inwards-focused growth. This trend toward localization—companies looking to produce more locally, and consumers looking to buy from local brands—was already getting underway and is likely to pick up speed.

The last redoubt of globalization is the virtual economy, which was booming before the pandemic and has accelerated under the lockdowns, as people retreat home to work, play, shop and study. New habits are forming, which is going to help virtual enterprises to continue growing rapidly—from a much higher base—even after the pandemic. Using these trends as a lens, we have made sure that the portfolio is well positioned for what we are calling the "After Corona" world. We continue to be overweight secular growth winners.

At the end of the quarter, we have overweight allocations to Taiwan, India and Singapore and underweight allocations to China and Malaysia. At the sector level, we have overweight exposures to the information technology, communication services and financials sectors. We have underweight exposures to the consumer discretionary, industrials, health care, utilities, real estate and materials sectors.

Engagement

From early on in the pandemic our sense was that COVID-19 was less likely to "change everything" than to bring more of the same. Indeed it has, deepening trends that were already underway, most notably ESG (environmental, social and governance) investing. The pandemic has redirected investor attention to how companies incorporate and manage risks, including carbon emissions reduction, human capital, governance and transparency. High-quality companies that have sustainable business models, strong balance sheets and forward-looking management teams with a proven track record of addressing ESG risks tend to be more resilient in the face of a crisis than their peers. In 2021 and beyond, we expect this interest in ESG will continue to gather momentum at a rapid pace, and we believe that active investors will play a critical role in driving outcomes and improving performance on important issues that drive company results.

While the worldwide lockdown halted travel and on-the-ground meetings with management, we remain diligent in engaging with portfolio companies and addressing what we identified to be key material ESG risks. By understanding that each company faces their own challenges and opportunities, we are able to fine-tune our engagements so that they are efficient and thoughtful. Through these direct engagements, we are also able to build trust and long-term relationships with these management teams and encourage companies to adopt better corporate practices.

The investment team is committed to aligning the portfolio to find mispriced opportunities where sustainability considerations, notably climate change, are under-analyzed. We invest in high-quality companies that exhibit strong management of ESG factors relative to peers, and that offer scalable and profitable solutions to address pressing sustainability issues in emerging markets. We believe that companies with forward-looking management teams that have proactive strategies on sustainability issues will be better positioned from a business perspective over the long term than companies that do not consider them at all. We have found that oftentimes data from emerging market companies lack transparency. Company engagements are critical to our process as it furthers our understanding of how management teams are incorporating sustainability considerations into their strategies and also provides us an opportunity to track a company's progress.

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

FUND FACTS

Launch date	Base currency	Index
01 October 1991	U.S. dollars	Blended Benchmark

12 Month Performance Periods to Latest Month End (%)

	FEBRUARY '20 - FEBRUARY '21	FEBRUARY '19 - FEBRUARY '20	FEBRUARY '18 - FEBRUARY '19	FEBRUARY '17 - FEBRUARY '18	FEBRUARY '16 - FEBRUARY '17
MS INVF Sustainable Asian Equity Fund - I Shares	46.79	2.98	-14.55	27.74	21.10
Blended Benchmark	41.95	0.11	-8.22	31.93	26.52

Past performance is not a reliable indicator of future results. Returns may increase or decrease as a result of currency fluctuations. 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.**

Effective 31st December 2020 the Morgan Stanley Investment Funds Asian Equity Fund was renamed to Morgan Stanley Investment Funds Sustainable Asian Equity Fund.

Share Class I Risk and Reward Profile

Lower Risk						Higher Risk
1	2	3	4	5	**6**	7
Potentially Lower Rewards						Potentially Higher Rewards

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.
- 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 28 February 2021 and subject to change daily.

INDEX INFORMATION

The Blended Index performance shown is calculated using the **MSCI AC Far East Free Ex-Japan Index** (Gross Returns) from inception through 31 December 2000, the **MSCI AC Far East Free Ex-Japan Index** (Net Returns) from 1 January 2001 through 29 February 2016 and the **MSCI AC Asia ex Japan Index** (Net Returns) thereafter.

The **MSCI AC Far East ex Japan Index:** captures large and mid cap representation across 2 Developed Markets countries (excluding Japan) and 7 Emerging Markets countries in the Far East*. With 553 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The **MSCI AC Asia ex Japan Index:** captures large and mid cap representation across 2 of 3 Developed Markets (DM) countries* (excludingJapan) and 9 Emerging Markets (EM) countries* in Asia. With 637 constituents, the index covers approximately 85% of the free float adjusted market capitalization in each country.

The **MSCI China Index** captures large and mid-cap representation across China A-shares, B-shares, H-shares, Red-chips and P-chips. It reflects the Mainland China and Hong Kong opportunity set from an international investor's perspective.

The **MSCI Hong Kong Index** measures the performance of the large- and mid-cap segments of the Hong Kong market.

The **MSCI Taiwan Index** measures the performance of the large- and mid-cap segments of the Taiwan stock market.

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