Morgan Stanley

INVESTMENT MANAGEMENT

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Morgan Stanley Investment Funds

Sustainable Emerging Markets Equity Fund

MARKETING COMMUNICATION | EMERGING MARKETS EQUITY TEAM | QUARTERLY COMMENTARY | 31 MARCH 2022

Performance Review

In the three month period ending 31 March 2022, the Fund's I shares returned -11.64% (net of fees)[1], while the benchmark returned -6.97%.

Maintaining our longer-term perspective on the positive drivers we expect to support our holdings helped preserve capital in the month of March when the portfolio returned -1.15% (I shares net of fees) versus the index return of -2.26%. Over the one-year period, the portfolio is outperforming by +113 basis points (bps), returning -10.24% (I shares net of fees) versus the index return of -11.37%.

Despite another challenging quarter for emerging markets (EM) – with widely disparate returns from different countries – we maintained our focus on the quality growth companies benefiting from the tailwinds of either strong commodities prices, economic recovery, rising credit demand or the continued robust demand in the semiconductor and related industries. While markets endured volatility stemming from Russia's war in Ukraine, mixed policy signals from China and the detriments and benefits of higher oil prices and inflation, we kept our focus on the longer-term thematic trends that we believe will sustain the earnings of the companies in our portfolio. Some of the stocks that had suffered in February and early March from contagion or partial exposure to Russia and Ukraine—such as Polish retailer LPP and software services company EPAM with employees in the region—recovered over the course of March. Our stock selection within materials, energy and consumer staples all contributed positively in March.

In January and early February, in recognition of the rising geopolitical tensions between Ukraine and Russia, we began to de-risk the portfolio by reducing allocations to Russia. Following the full invasion launched by Russia on 24 February, we have since significantly reduced our allocation to a de minimis position. As mentioned in our previous commentary, we will not consider Russia part of the investable universe of the portfolio under the current government regime.

Our stock selection in and overweight to Poland hampered returns amid the massive sell-off in Russia and Poland (which shares a border with Ukraine) and in non-Russian names with some exposure to Russia (EPAM). LPP declined more than 35% during the quarter as markets severely punished companies with exposure to Russia, Belarus and Ukraine (18% of LPP's revenues were from Russia and Belarus, and an additional 6% from Ukraine).[2] Maintaining our overweight in LPP, however, contributed positively in March when the stock rose 33%.[3] EPAM detracted for the quarter as the stock faced volatility due to its exposure to Russia, Ukraine and Belarus. EPAM offers information technology (IT) services in the U.S., Europe and Asia, using more than 43,000 IT professionals, with most historically located in Eastern Europe.[4] The company continues to deliver and is a leader in the IT services industry, and we believe management will be able to successfully adjust their business rapidly and return to growth. EPAM will likely benefit from such positive tailwinds as increasing demand for IT services as more companies undergo the digital transformation, and it also has a strong balance sheet and experienced management team. The company has been expanding its IT talent pool in Latin America and India, as well as Romania, Bulgaria and Armenia, and is broadly seeking to connect EM IT engineering talent with developed market clients.

Our continued underweight to China contributed strongly in the quarter, but was slightly offset by our stock selection in the country as Shenzhou International underperformed.

March was marked by severe volatility in China's equity market stemming from a barrage of regulations hitting its tech industry, government curbs on borrowing in the property sector, surging corporate bond yields and allegations of human rights abuses in Xinjiang, in addition to the government's ambiguous stance on the war in Ukraine. Chinese markets were down 55% from a February 2021 peak (represented by the MSCI China Index). Adding to the volatility is the increasing lockdowns affecting Shenzhen and other regions as part of China's "zero-COVID" strategy to try to control the spread of the omicron variant. On 16 March, Vice Premier Liu He, President Xi's top economic adviser, made a surprise policy change announcement offering "concrete actions" to allay investor

[1] Source: Morgan Stanley Investment Management Limited. Data as of 31 March 2022.
[2] Source: Bloomberg L.P. and FactSet
[3] Source: Bloomberg L.P.
[4] Source: Company data

concerns. Following the announcement, the NASDAQ Golden Dragon China Index jumped 33% in one day, the largest ever.[3] Hong Kong's Hang Seng Index surged 9.1%, the most since 2008, while China's CSI Index climbed 4.3%.[3]

While we remain underweight China given slowing growth and other issues, we believe high quality stocks with secular growth trends will enjoy a valuation premium and outperform the market in the longer run. As such, we continue to focus our stock selection within China on companies with structural growth, competitive advantages, strong governance and financial strength.

Our overweight to South Africa contributed strongly to returns, led by our allocation to Anglo American Plc—the single largest security contributor for the quarter—with the stock returning +34%.[5] Anglo American Platinum also contributed. We continue to be positive on select commodities, in particular green commodities, on our conviction that demand will remain robust for select materials needed in the green technology critical to carbon reduction. Capitec Bank also contributed strongly. Aside from these top stock contributors in South Africa, other holdings led to an aggregate drag from stock selection in South Africa. Detracting was our overweight to paper and packaging company Mondi, which has operations in Russia, and zero allocations to FirstRand, Standard Bank and MTN.

Our stock selection in and overweight allocation to Mexico contributed to returns, led by allocations to Banorte and Walmex. We remain positive on the improving macro outlook in Mexico. Given the positive backdrop for earnings growth acceleration due to better economic growth prospects and higher interest rates, faster loan growth, normalization of provisions and efficiency improvement, Banorte is well positioned to translate this into strong earnings per share (EPS) growth with an attractive valuation. Walmex is the largest brick-and-mortar grocer in Mexico with a fast-growing e-commerce business poised to gain market share.

Within Brazil, our overweight allocations to Itau Unibanco and apparel retailer Lojas Renner contributed to returns but were more than offset by our zero allocation to Petrobras and Vale, which rallied as oil and iron ore prices reached historical highs. Both Petrobras and Vale are excluded for environmental, social and governance (ESG) issues. Our zero allocation to Saudi Arabia and the United Arab Emirates also detracted, as the two markets benefited from higher oil prices.

Overall, we remain focused on managing an active portfolio of quality growth stocks that are informed by our thematic research and assessment of macro drivers and risks. Some of the key drivers supporting our performance over the past 12 months have included identifying and allocating for: economic recovery and/or improving policy reform prospects in South Africa, Central Europe and Mexico; rising demand for the select materials needed in the green technology critical to carbon reduction; recovery in demand for transportation and select consumer staples and services as societies have adjusted to the COVID-19 pandemic; and greater demand for credit, particularly in countries that have avoided or cleaned up past debt problems, as in Poland, India and Indonesia.

Market Review

The MSCI Emerging Markets (EM) Index returned -6.97% during the quarter, underperforming the MSCI World Index, which returned -5.15%. Latin America led EM returns, with Brazil (+35.92%), Peru (+34.90%), Colombia (+33.80%) and Chile (+29.54%) the best performing EM equity markets year-to-date. EMEA markets—outside of Eastern Europe countries like Hungary (-19.38%) and Poland (-9.80%), which were affected by the contagion sell-off from the Russia-Ukraine situation—also posted strong returns for the quarter, with the United Arab Emirates (+21.19%), South Africa (+20.29%), Qatar (+19.50%) and Kuwait (+19.40%) also among the top performing markets in EM. Egypt (-23.42%) was the worst performing EM during the quarter, while North Asian markets including China (-14.19%), Korea (-9.57%) and Taiwan (-6.58%) also underperformed.

Portfolio Activity

During the quarter we increased our overall allocation to banks by initiating positions in CTBC and Itau Unibanco. In the near term, we are positive on financials given the positive leverage to potentially higher interest rates in select emerging markets.

CTBC is one of the highest quality banks in Taiwan. It has the highest overseas loan exposure among Taiwanese financial companies and high domestic market share in terms of credit card and small and medium-sized enterprise (SME) loans, which should help CTBC benefit from both Taiwan and Southeast Asia's reopening loan growth cycle. We believe that with the rising rate environment, gradual reopening of the economy and the company's intention to improve capital allocation, CTBC may continue to outperform its peers.

Itau is a leading universal Brazilian bank. We believe Itau can deliver a robust EPS growth rate over the next two years due to the expansion of its loan book (at a rate above inflation), driven by strong demand in retail despite a weak macro backdrop and an increase in net interest margins (NIMs) throughout the year given the accelerated hike in rates and credit spreads. The company is likely to see stable to higher operating expenditures given investments in technology and digitalization being offset by efficiency improvements, a flatter organizational structure and branch network rationalization. Moreover, we believe the stock is attractively priced considering the bank's return profile and management's track record to control asset quality under a challenging macroeconomic scenario.

In China, we initiated positions in BYD Co., Sungrow Power Supply and Hua Hong Semiconductor. With regards to BYD and Sungrow, we are positive on the renewable and electric vehicle (EV) theme in China and have added to these select quality growth EV and battery storage/inverters companies, which are beginning to trade at attractive valuations. We believe these companies should be well supported as the world transitions to net zero. We started building some position in the China semiconductor

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3 Source: Bloomberg L.P.

5 Source: Morgan Stanley Investment Management

market after its underperformance in 2021. We believe Hua Hong Semiconductor could see supporting demand from China domestic integrated circuit design companies to support its growth and mitigate part of the cyclical risk faced by other second tier foundries.

We initiated a position in leading Chilean global copper mining company, Antofagasta. The copper market has attractive supply-demand dynamics, and Antofagasta has solid fundamentals which should be driven by long-term trends such as electric vehicle adoption, renewable energy and green infrastructure. We also added to our existing position in aluminum producer, Hindalco, as aluminum remains the most attractive long-term story in the metals space.

In the semiconductor space, we continued adding to SK Hynix. SK Hynix is the second largest global memory chip maker in Korea. We are constructive on the memory sector and believe the fundamentals of the memory companies remain solid and the latest underperformance provides an opportunity.

Following the full invasion of Ukraine launched by Russia on 24 February, we significantly reduced our allocation to Russia by exiting Novatek and Tinkoff. As of 31 March 2022 the portfolio has a de minimis position Russia, through a small remaining position in GDR (global depositary receipt) shares of Fix Price.

We trimmed Tencent and sold our positions in SEA and Meituan, where near-term headwinds on regulatory concerns for internet companies may likely weigh on stock performance. We also exited South African retailer Mr. Price.

Strategy and Outlook

Emerging markets as an asset class continued to struggle year-to-date as they did for most of the second half of 2021, exacerbated by Russia's invasion of Ukraine and the mixed policy signals and economic slowdown in China, and the consequent volatility such events contributed to global markets.

Russian President Putin's decision to launch a full invasion of Ukraine, in a matter of days, took the Russian economy from a globally integrated economy of scale and potential into one that is isolated and on a trajectory toward pariah status. Russia was hit with unprecedented sanctions by the EU, U.K., U.S. and others, meant to be punitive in nature and only increasing in breadth and depth over the past few weeks. Russia announced its own counter sanctions and domestic policy responses on 28 February.

The initial sanctions enacted by the G7 and EU countries the week of 21 February were significant but manageable. The sanctions built up at the end of the month, however, are essentially unprecedented for an economy the size of Russia. Their main goal is to target the financial system punitively for Russia's attack on Ukraine—the ability of Russia to access the international capital markets, international payments systems (SWIFT), and even its long accumulated foreign reserves (Central Bank of Russia asset freeze). In the years since Russia's annexation of Crimea in 2014, Russia has been conducting prudent fiscal and monetary policy and seeking to insulate its economy from external vulnerabilities. In response to these latest sanctions, Russia itself has announced its own counter measures on 28 February, including freezing foreign stock holdings, hiking interest rates to 20%, banning citizens from moving capital abroad, and forcing the conversion of foreign exchange revenues from exports in rubles—in other words, Russia has imposed capital controls.

Elsewhere in the portfolio, we remain underweight China, which helped performance in 2021 and year-to-date as the market suffered significant volatility in March and continued to underperform broader EM. Market participants, particularly locals, have already efficiently discounted the prices and valuations of companies explicitly or perceived as being affected by the ruling Communist Party's goal of "Common Prosperity" and have driven up the valuations of companies considered somewhat on the side of the government's policy goals. Chinese authorities—as they have for decades—will continue to occasionally intervene in the functioning of certain companies when they are seen as disrupting the social order too dramatically. But with its goal of becoming the world's largest economy in its sights in future years, Chinese authorities are also mindful not to disrupt too dramatically the spirit of entrepreneurship and pride in having national champions.

We will be selective in potentially adding to Chinese positions or new names that meet our quality growth criteria with longer-term earnings capabilities still intact. For example, certain structural themes will likely endure, and some companies will benefit from industry consolidation and upgrades in consumption as income per capita increases. Consumers across the income spectrum still demand certain goods and services as their incomes allow, and we note some brands are increasingly benefiting from a growing sense of national pride as quality has improved.

We remain constructive and overweight South Africa as President Ramaphosa appears to be wisely allowing the justice system to run its course with former President Zuma and the economy is supported by tailwinds from demand for metals, such as platinum, that are linked to electric vehicles and other green-friendly production. We believe strongly that paper and packaging, as provided by a company like Mondi, are part of the gradual but increasing move away from plastics and that there will likely be long-term earning benefits from this trend.

Eastern Europe—and Poland in particular—remains an engine room of innovation and entrepreneurship in regard to tech companies providing solutions for cybersecurity and other IT services, as well as growing global demand for gaming. In software and IT services, e-commerce platforms, and payments, some of the most innovative growth companies are located in Brazil and Indonesia, and we remain positive on earnings growth in this area.

Select financials are beginning to benefit from the rise in interest rates in certain countries; banks with effective fintech strategies will likely be the beneficiaries of rising demand for credit at greater profitability. We remain positive not only on such names as Capitec in South Africa and HDFC in India, but we also own select quality names in China such as China Merchant Bank.

Overarching our high conviction in these individual names driven by these themes are broader macro factors that we believe can help shift investor demand in favor of EM as an asset class, despite the issues that have arisen in recent months. Key among the catalysts to trigger improved returns for EM equities are an eventual weakening of the U.S. dollar on the back of historic fiscal deficits and debt buildup, the sustainable earnings for select commodities linked to carbon emissions reduction goals; emerging reforms in countries such as Indonesia and India; and continuing digital innovations emanating from many EM countries. We believe EM valuations overall are at compelling valuations relative to the U.S. equity market, which is likely to be helpful in catalyzing asset allocation shifts. We believe we are at an important inflection point, as drivers of economic growth and equity market returns converge to help power the asset class after more than a decade of underperforming the U.S.

Detailed outlooks for some of the top overweight and underweight country positions in the portfolio follow.

Overweight strategy:

We are overweight **India,** which contributed positively to returns during the quarter along with our stock selection in the country. India made it past the peak of the omicron wave and is beginning to benefit from the reopening of the economy. India did not have the fiscal resources of other major EM countries during the worst stages of the COVID-19 pandemic, which imposed spending discipline and limited excess loan growth. This was underscored in the fiscal budget announced during the quarter, which was broadly constructive and did not include any major complications or roadblocks for the private sector, which historically had hampered growth. While the broad market may appear expensive, we are confident that select forward earnings justify current multiples in the quality growth companies we own. No matter the future path of the virus, we think policy makers will seek to keep the economy open and vibrant. Our exposure in India includes well-managed financials, industrials and consumer names linked to recovery, select IT names and the aluminum producer Hindalco, which we continue to believe will play a critical role in global green technology need for decarbonization. We are also adding to our health care exposure as private sector hospitals in India enjoy structural tailwinds, including growing medical tourism.

We have been gradually increasing our position in **Mexico** since last year. We believe Mexico will emerge from the pandemic potentially in a better macroeconomic position than it entered, with strong growth in both real and nominal terms. The country's economy should benefit from the massive fiscal stimulus and economic recovery taking place in major trading partner the United States. In the long run, Mexico should benefit from the reformulated United States-Mexico-Canada Agreement, particularly given the relatively weak currency, the reconfiguration of supply chains and its proven monetary policy framework. The Lopez Obrador (AMLO) administration has shown fiscal rectitude, even if the state has increased its role in the oil and electricity sectors. We believe the stocks we own are likely to continue to deliver on earnings as they emerge from the crisis to deliver above-average growth.

We continue to overweight the **Central and Eastern European** (CEE) region through our exposure to stocks in Poland and the Czech Republic and maintained our positions even in the contagion brought about by Russia's invasion of Ukraine. In these economies, we expect growth to remain healthy and interest rates to normalize after the sharp declines in 2020. We expect Poland's economy to continue expanding at a rapid pace in the coming years, benefiting from its integration with the European Union and a stable set of economic policies. The companies we own have little to no leverage and have proved flexible and resilient under past periods of stress. Financial sectors in the region remain sound and with little to no exposure to Russia. After years of depressed earnings, we expect banks to generate attractive growth and return on equity as regulatory pressures abate and interest rates increase in several markets in the region.

Underweight strategy:

We remain underweight **China**. Our identification of the looming, larger macro problems and the risk of government policy intervention has been well served in the portfolio since late 2020. Our steady reduction of our exposure to China last year coincided with our observation that a decline in projected earnings for some of the previously highest flying stocks preceded the massive regulatory intervention that occurred over the course of 2021. We increased our underweight last year to the largest we have ever been on China.

In our view, China's economic slowdown is here to stay. Real estate challenges will continue to persist. And while the People's Bank of China (PBOC) is cutting rates in response, we do not expect these moves to be accompanied by the additional hefty fiscal and other stimulus measures of the past, which tended to prompt enormous enthusiasm from international investors. Beijing has sent sufficient signals recently to stem the extreme downward market spiral of the past year, but investors need to be nimble and think hard about what will drive sustainable future returns. In our opinion, the well-known "New China" names that dominated the market in the last decade will continue to fade. Among the companies that excite us are the next generation, science-based industries. Innovation here will lead to world-class companies that will attract talent and generate well-paid jobs. In addition, we continue focusing on the consumer companies that are meeting the service needs of a population that is much richer on a per capita basis than it was even 10 years ago, owning industrials that are innovating with robotics or meeting de-carbonization goals, or are part of onshoring trends of critical industries. Even within China's challenging macro environment, these are the types of companies which we believe should deliver the growing earnings that meet our demanding quality growth criteria.

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

FUND FACTS

Launch date	Base currency	Index
01 July 1993	U.S. dollars	MSCI Emerging Markets Net Index

Calendar Year Returns (%)

Past performance is not a reliable indicator of future results.

	YTD	2021	2020	2019	2018	2017	2016	2015	2014	2013	2012
Class I Shares	-11.64	3.40	14.24	18.72	-17.05	35.20	5.83	-10.66	-4.30	0.36	19.02
MSCI Emerging Markets Net Index	-6.97	-2.54	18.31	18.42	-14.57	37.28	11.19	-14.92	-2.19	-2.60	18.22

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 1st November 2021 the Morgan Stanley Investment Funds Emerging Markets Equity Fund was renamed to Sustainable Emerging Markets 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 shares of companies from emerging markets 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.
- Investments in China involves a risk of a total loss due to factors such as government action or inaction, market volatility and reliance on primary trading partners.
- 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 March 2022 and subject to change daily.

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INDEX INFORMATION

The **MSCI Emerging Markets Net Index** is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of emerging 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 MSCI Emerging Markets Index currently consists of 23 emerging-market country indices. The performance of the index is listed in U.S. dollars and assumes reinvestment of net dividends.

The **MSCI World 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 **Hang Seng Index** is a free-float capitalization-weighted index of a selection of companies from the Stock Exchange of Hong Kong.

The **NASDAQ Golden Dragon China Index** is a modified market capitalization-weighted index comprised of companies whose common stock is publicly traded in the United States and the majority of whose business is conducted within the People's Republic of China.

The **CSI 300 Index** is a capitalization-weighted stock market index designed to replicate the performance of 300 stocks traded in the Shanghai and Shenzhen stock exchanges.

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.

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