Morgan Stanley Investment Funds

US Dollar Short Duration High Yield Bond Fund

HIGH YIELD TEAM

Performance Review

In the one month period ending 31 January 2024, the Fund's Z shares returned 0.66% (net of fees)[1], while the benchmark returned 0.03%.

An underweight position and favorable credit selection in the cable & satellite sector was the primary positive contributor to relative performance during the month. The primary individual contributor in the sector from a holdings perspective was a lack of exposure to a satellite TV provider that is transferring assets between corporate entities and considering a series of distressed exchanges. Sound credit selection in the restaurant and midstream sectors also contributed positively to relative returns during the period. However, this was partially offset by challenging credit selection in the food & beverage sector. Relative underperformance in the sector was driven by an overweight position in a distressed U.S.-based food manufacturer. The issuer's bonds sold off with the rest of the lower quality segments of the market. Adverse credit selection in the chemicals and industrial other sectors also hurt relative performance during the month.

From a credit quality perspective, sound credit selection in B-rated bonds as well as bonds rated CCC or below contributed favorably to relative returns during the month. A modest allocation to cash also helped relative returns in a flat month for the U.S. high yield market. Conversely, an overweight in B-rated bonds and an underweight in BB-rated bonds detracted from relative performance as the lower quality segment of the market generally outperformed in January.

Market Review

The U.S. and global high yield markets recorded a sluggish return in January as performance sputtered. Following a December-end rally that was fueled by paltry issuance, heavy retail inflows and light trading volume, January was characterized by a surge in primary issuance, continued retail flows, and several high-profile liability management exercises. Earnings, fundamentals and structure came back into focus in January as managers appeared to generally cast a more discerning eye on risk and relative value, after beginning the year with an average spread that ranked in the widest decile relative to the preceding 10-year period. The month ended on a bit of a sour note for risk markets as Federal Reserve (Fed) Chairman Powell pushed back against consensus expectations for a March interest rate cut.

The Bloomberg U.S. High Yield Index returned 0.00% in January. The yield-to-worst finished the month 21 basis points (bps) higher at 7.80%. The spread-to-worst closed the period 19 bps higher at 365 bps.[2]

The top-performing sectors for the month were banking, industrial other, and energy, with respective returns of 0.92%, 0.86%, and 0.73%. The communications, electric utility, and natural gas utility sectors were the worst-performing sectors in January, with respective returns of -1.81%, -0.51%, and -0.20%.[2]

The lower quality segments of the market generally underperformed for the one-month period. CCC-rated bonds were the worst-performing segment, with a one-month return of -0.66%. BB-rated and B-rated bonds posted respective one-month returns of 0.06% and 0.07%.[2]

The technical conditions in high yield softened in January amid continued inflows into the asset class coupled with heavy issuance volume, mainly focused on refinancings. Monthly issuance surged to $31.6 billion in January, marking the highest monthly total since November 2021. By use of proceeds, refinancing accounted for 81% of January issuance and acquisition financing accounted for 12%. According to preliminary Lipper estimates, U.S. high yield retail funds experienced a net inflow of $2.8 billion in January, after experiencing a revised inflow of $3.5 billion in December. Of note, the high yield exchange-traded funds (ETFs) took in $1.7 billion in January, while active high yield managers experienced inflows of $1.1 billion.[3]

Default activity among high yield bond and loan issuers decreased again in January. According to J.P. Morgan, the high yield trailing 12-month par-weighted default rate ended the month slightly lower at 2.04%. Including distressed exchanges, the default rate decreased from 2.85% to 2.77% in January.[3]

[1] Source: Morgan Stanley Investment Management Limited. Data as of 31 January 2024.
[2] Source: Bloomberg L.P. Data as of 31 January 2024.
[3] Source: J.P. Morgan. Data as of 31 January 2024.

Strategy and Outlook

The high yield market ended January with the still unique combination of a historically attractive yield and an average spread that ranked near cycle lows, despite being modestly wider month-over-month. Our outlook remains relatively cautious given the high yield valuations that, on average, nearly fully reflect a perfectly soft economic landing. From our perspective, caution is warranted due to: the disparity between the stated Fed policy and consensus market expectations; expectations for a slowing U.S. economy and struggling low-end consumer; softening corporate fundamentals; and an average spread that leaves little room for error. The silver lining is the historically high all-in yield that supports a positive return for high yield investors in 2024, even in our bear case scenario analysis.

We are progressing through the first quarter with a healthy range of valuations across rating segments, sectors and individual issuers in high yield. This range still implies opportunity, but also caution, after a period of tremendous compression in the final quarter of 2023 that appears from our perspective to have gone too far and periodic spread widening in January that appears to reflect this. The average yield in our market ended January still ranked in the top quartile relative to the preceding 10-year period, and modestly wider than where it began the month.[2] We expect the yield will prove sufficient to drive competitive relative returns in 2024, shielding investors from wider peak credit spreads in the coming quarters.

Our strategy is slightly more conservatively positioned than it was just a few months ago. Despite some of the aforementioned headwinds, we are not becoming significantly more defensive because we are also cognizant of the many supportive attributes of our market, such as record-high exposure to secured issuance, a historically high share of BBs, and technical conditions that we expect will remain supportive due in part to historically attractive absolute yields. Sector biases include overweight positions in defensive sectors trading with what we assess to be attractive long-term value, and underweight positions in cyclical sectors with asymmetric risk/return characteristics. We expect to continue to find many attractive idiosyncratic opportunities amid elevated dispersion that will benefit from healthy cash generation in non-cyclical and counter-cyclical sectors.

We continue to focus on the “tail” and potential downside scenarios. Furthermore, our scenario analysis supports the conclusion that — whether investors fall into the camp of soft, hard, no landing or a derivation thereof — January-end valuations on a spread basis indicate there is little room for additional spread tightening in the event of a Goldilocks outcome, and the probability-weighted analysis points to wider peak spreads and additional volatility in the coming quarters. Given starting yields, investors have the ability to generate attractive absolute returns in high yield in 2024, but the ramifications for reaching for spread and chasing momentum will likely define the difference between success and failure in the coming year. We saw a glimpse of this in January as the CCC segment lagged. Finally, we find ourselves in a U.S. presidential election year where both houses of Congress are up for grabs, and war rages on in Europe and the Middle East. We will spend our time concentrating on what we do best — focusing on bottom-up fundamental credit analysis with a discerning eye on relative value, as we seek to generate positive risk-adjusted alpha for our clients.

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

Fund Facts

Launch date	04 December 2014
Base currency	U.S. dollars
Benchmark	Bloomberg US High Yield 1-5 Year Cash Pay 2% Issuer Capped 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	0.66	11.04	-8.96	6.10	4.35	10.65	1.06	7.24	13.27	-0.68	--
Bloomberg US High Yield 1-5 Year Cash Pay 2% Issuer Capped Index	0.03	12.20	-5.90	6.07	4.49	9.88	0.12	6.38	16.19	-5.08	--

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.**

[2] Source: Bloomberg L.P. Data as of 31 January 2024.

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 fixed income securities and the fund's simulated and/or realised return has experienced medium 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 value of bonds are likely to decrease if interest rates rise and vice versa.
- The value of financial derivative instruments are highly sensitive and may result in losses in excess of the amount invested by the Sub-Fund.
- Issuers may not be able to repay their debts, if this happens the value of your investment will decrease. This risk is higher where the fund invests in a bond with a lower credit rating.
- 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.
- 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

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The **Bloomberg U.S. Corporate High Yield Index** measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The Index excludes emerging market debt.

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