A Sub-Fund of Morgan Stanley Investment Funds

US Dollar Short Duration High Yield Bond Fund

HIGH YIELD TEAM

Investors should note that, relative to the expectations of the Autorité des Marchés Financiers, this UCITS presents disproportionate communication on the consideration of extra-financial criteria in its management.

Performance Review

In the one month period ending 31 March 2025, the Fund's Z shares returned -1.24% (net of fees)[1], while the benchmark returned -1.06%.

Transportation services and midstream were the Fund's top-performing sectors relative to the benchmark in March, both due to favorable credit selection. In transportation services, a lack of exposure to a car rental business that defaulted in 2020 was the top individual contributor. The company's bonds were down nearly 18% in March amid a decline in earnings, challenged fundamentals and a growing concern the company may be heading toward another restructuring. The top individual contributor in the midstream sector was a lack of exposure to a struggling integrated gas-to-power energy infrastructure company whose bonds were downgraded by Moody's during the month.

Building materials and consumer cyclical services were the Fund's worst-performing sectors relative to the benchmark during the period. Relative underperformance in building materials was driven by challenging credit selection and an overweight position in this underperforming sector. The primary individual detriment was an overweight position in a manufacturer of bathware products. The company's bonds sold off early in the month along with other building materials providers as news about potential tariffs negatively impacted the sector. However, the company reported quarterly earnings later in the month that were better than feared, which helped the bonds partially recover their losses from earlier in the month. Adverse credit selection drove relative underperformance in the consumer cyclical services sector and was led by an overweight position in an interior design company, which was also negatively impacted by news surrounding potential tariffs.

In terms of performance by ratings segments, an underweight position in BB-rated bonds and overweight positions in bonds rated CCC or below as well as B-rated bonds hurt relative returns, as the higher quality segments of the market generally outperformed during the month. Adverse credit selection in BB-rated bonds also hurt relative returns. Conversely, sound credit selection in B-rated bonds and an allocation to not-rated securities, which encompasses the Fund's exposure to select convertible bonds, contributed positively to relative performance.

Market Review

Performance in the U.S. and global high yield markets turned negative in March amid high volatility, wider spreads and a further decline in U.S. Treasury yields. The Federal Reserve's (Fed) March decision to hold its key policy rate steady was virtually a non-event, and its projection of two interest rate cuts later this year was quickly overshadowed by the market's growing expectations for a greater number of cuts, driven by mounting concerns over an expanded scope of tariffs and the potentially dire near-term economic consequences. Amid the volatility, the high yield market remained orderly and relatively well bid, with healthy March issuance volume that was generally well received by a receptive investor base. The lower-rated segment of the high yield market broadly underperformed on an absolute and relative basis, with the average spread differential between the single-B and CCC segments ending the quarter at nearly 550 basis points (bps), relative to a January-end level of just over 400 bps.[2]

The Bloomberg U.S. Corporate High Yield Index returned -1.02% in March. The yield-to-worst finished the month 58 bps higher at 7.73%. The spread-to-worst closed the period 64 bps higher at 374 bps.[2]

The top-performing sectors for the month were insurance, banking, and finance companies, with respective returns of -0.32%, -0.33%, and -0.57%. The transportation, technology, and basic industry sectors were the worst-performing sectors in March, with respective returns of -2.82%, -1.42%, and -1.18%.[2]

The higher quality segments of the high yield market generally outperformed in March, driven by an up-in-quality trade. The BB-rated segment returned -0.51% for the month. Meanwhile, the single-B and CCC segments posted respective one-month returns of -1.26% and -2.24%.[2]

The technical conditions in high yield remained healthy in March. Gross issuance increased month-over-month from $18.7 billion in February to a five-month high of $26.6 billion in March. By use of proceeds, refinancing accounted for approximately 77% of monthly issuance and acquisition financing accounted for only 11%. Over 56% of March issuance was rated BB. U.S. high yield retail funds recorded a net inflow of approximately $2.1 billion in March, following an inflow of approximately $2.9 billion in February.[3]

Default and distressed exchange activity in leveraged credit rose modestly off the two-year low set in February. According to J.P. Morgan, the high yield trailing 12-month par-weighted default rate including distressed exchanges decreased by 5 bps, ending March

1 Source: Morgan Stanley Investment Management Limited. Data as of 31 March 2025.
2 Source: ICE Data Indices, Bloomberg L.P., Morgan Stanley Investment Management. Data as of 1 April 2025.
3 Source: J.P. Morgan. Data as of 1 April 2025.

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at 1.20%. Excluding distressed exchanges, the rate ended March unchanged at 0.27%. For loans, the trailing 12-month par-weighted default rate including distressed exchanges decreased 4 bps to close the month at 3.86%. Excluding distressed exchanges, the rate dropped to 1.24%.[3]

Strategy and Outlook

We continue to be cautious on the high yield market as we begin the second quarter. The basis for this outlook includes the dynamic and uncertain evolution of trade, immigration and tax policy, as well as the expectation for stickier inflation, slowing economic growth with an increased probability of recession, and elevated volatility. Yields remain historically attractive and the average spread in the high yield market, while approximately 98 bps above post-Global Financial Crisis (GFC) lows, reached in January, remains susceptible to further widening.[4] We come to this conclusion after a thorough analysis of factors including the evolving monetary policy of global central banks, U.S. and global economic growth, consumer health, the fundamentals of high yield issuers, technical conditions, and valuations. Ultimately, we believe that caution is warranted and expect more comprehensive price realization, particularly in the lower-rated and more challenged segments of leveraged credit.

Global central banks are navigating a precarious period where sticky inflation, uncertain trade and economic growth backdrops and shifting fiscal priorities are complicating the projected and perhaps intended path of key policy rates. In March, the European Central bank reduced its key policy rate by 25 bps, supported by a recent February reading on eurozone inflation of 2.3%.[2] This decision was complicated by the pro-growth and potentially inflationary stated German intent to materially increase defense spending. The Bank of England held its key policy rate at 4.5%, a decision supported by annualized wage growth that is holding at nine-month highs at 5.9% (ex-bonus).[5] Meanwhile, the Federal Reserve maintained its key policy rate at its March meeting and reduced quantitative tightening from $25 billion per month to $5 billion, while continuing the pace of mortgage-backed securities (MBS) runoff. The U.S. headline and core personal consumption expenditures (PCE) price indexes were under 3% in February, but core PCE increased 0.4% month-over-month.[2] Furthermore, Fed Chair Powell struck a patient and perhaps cautious tone in addressing future impacts from evolving trade policy and tariffs. The likely pro-inflationary effects of tariffs are complicated by a labor market that has recently showed additional signs of softening. Average hours worked, temporary labor, and weekly earnings have drifted lower, while the number of employed holding multiple jobs has increased and the U-6 underemployment rate registered 7.8% in February, at cycle highs.[6] The Fed's dot plot indicates two reductions in its key policy rate through year-end, with the skew in favor of fewer cuts. Our base case expectation is for one to two rate cuts, with a skew in favor of more cuts, and given the quarter-end yield on the 5-year Treasury, we anticipate potential cuts through the balance of the year to likely be broadly offset by widening in credit spreads.

The U.S. economy entered 2025 on a positive and perhaps hopeful footing, while the backdrop in Europe appeared less favorable. U.S. gross domestic product (GDP) in the fourth quarter of 2024 was 2.4%, capping a strong print of 2.8% for the full year.[7] Three months into 2025, a lot has changed. Animal spirits and corporate optimism surrounding deregulation and tax relief have been supplanted by uncertainty and anxiety around immigration, trade and fiscal priorities. A March release of the CEO Confidence Index showed that, of 220 CEOs surveyed, 36% believe business conditions will worsen this year, up from 20% at the start of the year, and CEOs' overall assessment of business conditions fell 30% over the same period.[8] Uncertainty regarding the breadth and magnitude of tariffs and the impact on economic growth has both depressed corporate investment and caused irregular activity as certain companies rush to prepare for the fallout. The February ISM Report On Business released in March showed slowing business activity/production and a sharp, sequential slowdown in manufacturing new orders, which fell from 55.1% in January to 48.6% in February, marking an abrupt transition from healthy expansion to contraction.[9] In January, the U.S. goods and services trade deficit was reportedly $131.4 billion, up 34% month-over-month and 96.5% year-over-year.[10] A key driver of the increase in this surging deficit was certainly an effort to get ahead of potential tariffs. While the U.S. administration believes tariffs will correct trade imbalances, raise revenue and support policy goals such as combatting illegal immigration and the cross-border flow of illicit narcotics, we expect them to restrict economic growth and stimulate near-term inflation. Additionally, it is not realistic from our perspective that burgeoning deficit spending and plans for tax reductions can be effectively offset by government efficiency efforts and tariff revenue, especially if corporate earnings contract. Ultimately, we believe the path of least resistance is slow growth and a modest though increasing chance of recession, coupled with stubborn, above-target inflation.

U.S. consumer health remains generally supportive as we transition into April; however, economic uncertainty is impacting consumer behavior across economic strata, and the existing strain on lower-end consumers, which appeared to plateau in late 2024, now appears to be worsening. The Conference Board's most recent Consumer Confidence Survey at the end of March showed consumer confidence at a four-year low, with forward-looking expectations having recently fallen to a 12-year low.[11] The Expectations Index reading registered 65.2, falling below the reading of 80 that is often regarded as a potential recessionary signal. This data is consistent with the trend we are seeing in reduced personal consumption, particularly personal goods. March guidance from the airline industry also indicated growing consumer caution. Meanwhile, 90-day delinquencies on personal loans, auto loans and credit

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2 Source: ICE Data Indices, Bloomberg L.P., Morgan Stanley Investment Management. Data as of 1 April 2025.
3 Source: J.P. Morgan. Data as of 1 April 2025.
4 Source: ICE BofA U.S. High Yield Index, Morgan Stanley Investment Management. Data as of 31 March 2025.
5 Source: Office for National Statistics, United Kingdom. Data as of 20 March 2025.
6 Source: U.S. Bureau of Labor Statistics. Data as of 7 March 2025.
7 Source: U.S. Bureau of Economic Analysis. Data as of 27-28 March 2025.
8 Source: Chief Executive Research. Data as of 3 March 2025.
9 Source: Institute for Supply Management. Data as of 5 March 2025.
10 Source: U.S. Bureau of Economic Analysis: U.S. International Trade in Goods & Services. Data as of 6 March 2025.
11 Source: The Conference Board: Consumer Confidence Survey. Data as of 25 March 2025.

cards are generally increasing and are at or near post-GFC peaks, confirming growing strain on lower-end consumers.[12] While the balance of these data points is somewhat concerning, we still derive a level of confidence from metrics including strong growth in disposable personal income and record-high U.S. household net worth. Over the near term we are not concerned by the low probability of a sharp decline in consumer health; we are more focused on the potentially rapid impact that volatility and uncertainty can have on consumer discretionary spending and the follow-on impact on issuer fundamentals.

The fundamentals of high yield issuers remain healthy in a historical context, and fourth quarter earnings released in the first quarter depict modest improvement. Top- and bottom-line growth remained underwhelming and margins continued to weaken, but leverage and interest coverage improved. According to J.P. Morgan, fourth quarter earnings released in the first quarter of 2025 show revenue growth of 2.8% and EBITDA[13] growth of 6.2% — marking the best quarter for top- and bottom-line growth in nearly two years. At the same time, profit margins deteriorated for the third consecutive quarter, falling to 14.9% in the fourth quarter, nearly a four-year low.[14] Earnings across sectors were generally stronger, with some notable laggards. Year-over-year EBITDA growth in the transportation, technology, and media sectors was reportedly 53.7%, 34.7%, and 31.9% in the fourth quarter, while EBITDA growth declined -12.3% in metals & mining, -6.7% in energy, and -4.7% in retail.[14] The average leverage (debt-to-EBITDA ratio) of high yield issuers remained healthy and decreased from 4.05x to 3.98x in the fourth quarter, well below the long-term average.[14] Cable, telecommunications and transportation remained the most aggressively levered sectors in high yield. Meanwhile, after eight consecutive quarterly increases, interest expense decreased 0.1% for the trailing 12-month period ending December 31, and coverage (EBITDA-to-interest expense) increased from 4.66x to 4.74x, after two years of decline.[14] Though well below post-pandemic peaks, interest coverage of high yield issuers remains historically healthy relative to a long-term average of 4.5x, and is once again moving in the right direction.[14]

The pace of primary issuance in the high yield market was somewhat erratic in the first quarter, in response to a constantly evolving macroeconomic backdrop fraught with uncertainty. Ultimately, it was a healthy quarter of issuance that ended with a surge of deals in the final full week of March, contributing to a total gross issuance volume of $68.3 billion.[3] Despite elevated volatility, issuers generally found a receptive investor base, and the quarter concluded with a sweeping liability management exercise (LME) that included a $4.4 billion bond that was multiple times oversubscribed. It entered the ICE BofA U.S. High Yield Index at the end of the quarter as the third largest bond in the index. We did see a notable increase in the average credit quality of issuance and the share of primary activity used for refinancing, which appears logical given the sell-off in lower-rated credit amid the elevated volatility in the second half of the quarter. Lower-rated issuers largely sat on the sidelines. While this period of limited issuance from lower-rated issuers is not yet long enough to be statistically significant, it bears watching given the greater portion of CCC-rated bonds that mature in the next two to three years relative to the single-B or BB-rated segments. Gross issuance volume and use of proceeds for the balance of 2025 are becoming more difficult to estimate. The results of the election in November bolstered a conviction that we would see an increase in strategic, sponsor-to-sponsor and take-private transactions in 2025, and that elevated animal spirits would also usher in an increase in dividend financing. Moving into the second quarter, we still anticipate healthy issuance volume, but we believe elevated uncertainty and apprehension among C-suite leadership and investors alike should result in lower issuance this year, relative to initial full-year expectations. This will likely, in part, be driven by lower acquisition activity and related financings, and fewer leveraged buyouts (LBOs) and dividend financings, and we expect issuers with time on their side to be patient and opportunistic with regard to refinancing. Less than $100 billion in high yield bonds are set to mature prior to 2027.[4] Ultimately, we think a shift toward deregulation under the Trump administration and a lower regulatory hurdle for strategic consolidation should spur additional issuance across sectors including oil and gas, cable, media, and telecommunications. Finally, institutional demand from global yield-based investors in the first quarter was remarkably firm, in aggregate. We expect demand from this cohort to remain supportive given historically attractive yields that we do not expect to contract materially over the balance of the year. We anticipate, however, that investors will likely be more discerning and less receptive to aggressive and lower-rated opportunities over the near-to-intermediate term.

The pace of LMEs among high yield bond and leveraged loan issuers remains elevated; however, the aggregate volume of distressed exchanges and traditional defaults in high yield bonds remains manageable and well below long-term averages. The trailing 12-month par-weighted default rate for high yield issuers, inclusive of distressed exchanges, decreased from 1.47% at the end of the 2024 to 1.20% by quarter-end. The same metric for loan issuers decreased to 3.86%.[3] Over the next several quarters, our base case is that default and LME activity in leveraged credit will likely remain elevated, but more concentrated in loan-only issuers. We expect the default rate for high yield bonds inclusive of distressed exchanges to remain well below the long-term average and likely finish 2025 in the context of 2%. Our confidence in these projections, however, is undermined by our assessment of the potential impacts from tariffs. In the event slowing growth ultimately transitions to economic contraction, we expect that default volume would increase beyond long-term averages. Approximately half of all LMEs re-default in the subsequent three years, and the elevated volume of LMEs over the last couple of years provides upside risk to default rates in the event of a contraction in economic growth. This, coupled with broad weakness in credit agreements that results in poor creditor protections, adds to our general aversion to the distressed pockets of the high yield market. Quarter-end ICE BofA U.S. High Yield Index levels provide a glimpse into anticipated distress and expected credit losses: Anticipated credit losses increased in the first quarter, with 5.91% of the face value of the index trading with a spread wide of 1,000 bps at quarter-end, up from 4.04% at the end of 2024.[4] The average price of this cohort is approximately $71.69, relative to a trailing 12-month recovery rate in high yield of approximately 35%.[15]

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3 Source: J.P. Morgan. Data as of 1 April 2025.
4 Source: ICE BofA U.S. High Yield Index, Morgan Stanley Investment Management. Data as of 31 March 2025.
12 Source: Board of Governors of the Federal Reserve System. Data as of 18 February 2025.
13 Source: Earnings before interest, taxes, depreciation and amortization.
14 Source: J.P. Morgan. Data as of 20 March 2025.
15 Source: J.P. Morgan. Data as of 10 March 2025.

We begin the second quarter with an average spread that is approximately 98 bps above post-GFC lows, reached in January, and an average yield that remains well above the 10-year average, but only 26 bps above where it began the year given the decline in the 5-year Treasury yield.[4] The notable compression in the incremental spread relationship between the CCC and single-B segments continued in January, reaching a low of 409 bps relative to a peak of 639 bps in August 2024. As lower-rated risk broadly sold off in February and March, this relationship widened to a peak of 543 bps at quarter-end.[4] Remarkably, two of the sectors that benefited most from the rally in distressed credit, and which we argued bore the most scrutiny coming into the year — cable & satellite and telecommunications — were relatively resilient during recent weakness. We do not believe their recent relative performance represents a changing dynamic, but rather speaks to the incomplete nature of recent price realization. We expect that as the ultimate landscape of trade policy and tariffs matures, sectors directly impacted by new trade policy, as well as higher risk credits most negatively exposed to an up-in-quality trade, have room to materially widen. While we believe valuations across several segments of the high yield market will likely reach wider peak spreads in coming months, we believe there remains opportunity. We continue to identify idiosyncratic situations to capture spread compression in segments experiencing secular growth, where issuers are able to decrease leverage through a combination of earnings growth and prudent capital allocation. Additionally, we have recently found select opportunities in challenged segments where neatly structured covenants, adequate loan-to-value ratios, and appropriate risk compensation form to represent compelling investment opportunities.

In conclusion, we are in a less certain world relative to just three months ago. Fundamentals and technical conditions remain supportive and, generally, valuations have grown marginally more compelling. The elephant in the room, at present, is trade policy, and the tremendous follow-on effects. We expect the balance of 2025 will likely be a competitive period for high yield, but certainly not a period without volatility. Geopolitical tensions and regional conflicts continue to present the potential for expansion or ultimate resolution. Amid a volatile and uncertain backdrop, we will continue to 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	2024	2023	2022	2021	2020	2019	2018	2017	2016	2015
Class Z Shares	0.43	9.49	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	0.86	8.64	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 shares. The sources for all performance and index data is Morgan Stanley Investment Management ('MSIM Ltd'). **Please visit our website www.morganstanley.com/im to see the latest performance returns for the fund's other share classes.**

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- 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 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, available at www.morganstanleyinvestmentfunds.com. All data as of 31.03.2025 and subject to change daily.

[4] Source: ICE BofA U.S. High Yield Index, Morgan Stanley Investment Management. Data as of 31 March 2025.

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