A Sub-Fund of Morgan Stanley Investment Funds

# US 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 28 February 2025, the Fund's Z shares returned 0.63% (net of fees)[1], while the benchmark returned 0.65%.

Retail and diversified financial services were the Fund's top-performing sectors relative to the benchmark in February, due to favorable credit selection in both sectors. In retail, the primary individual driver of outperformance was a lack of exposure to an online automobile retailer. The company's bonds softened modestly in February, following a significant rebound in 2024. The primary individual contributor in the diversified financial services sector was an off-benchmark position in a Canadian wealth management firm. The longer duration characteristics of this BBB-rated position benefited performance as interest rates fell.

Health care and automotive & auto parts were the Fund's worst-performing sectors relative to the benchmark during the month, due to challenging credit selection in both sectors. The primary detriment from a holdings perspective in the health care sector was a lack of exposure to a specialty pharmaceuticals company that is drawing closer to a sweeping liability management exercise to refinance its capital structure. The slight relative underperformance in automotive & auto parts was led by a modest position in an auto parts provider. The company's fourth quarter margins beat expectations and the private equity sponsor recently put in new equity.

In terms of performance by rating segments, the Fund's credit selection in BB-rated bonds helped relative performance. Conversely, challenging credit selection in bonds rated CCC or below hurt relative returns.

The Fund's overall duration positioning had no impact on performance in February. Sound credit selection in securities with durations between three and five years as well as between five and seven years contributed positively to relative performance. Adverse credit selection in securities with durations between one and three years detracted from relative performance.

## Market Review

Performance in the U.S. and global high yield markets remained positive in February amid a meaningful spread widening that was more than offset by a sharp drop in U.S. Treasury yields, with the yield on the 5-year Treasury decreasing almost 50 basis points (bps) from its mid-month peak to end the month just above 4%.[2] U.S. macroeconomic data was generally weaker as pending tariffs impacted growth expectations, consumer confidence and spending, and labor market data was broadly softer. The Manufacturing ISM Report on Business showed contraction in new orders, employment and order backlog in February, coupled with increasing prices.[3] The weakening in risk sentiment generally resulted in spread decompression across the high yield market. For the first time in months, the CCC segment underperformed as relative valuations in lower-rated credit widened and dispersion across the high yield market increased.[2]

The ICE BofA U.S. High Yield Index returned 0.65% in February. The yield-to-worst finished the month 1 basis point lower at 7.16%. The spread-to-worst closed the period 27 bps higher at 311 bps.[2]

The top-performing sectors for the month were paper, health care, and food, beverage & tobacco, with respective returns of 1.57%, 1.25%, and 1.25%. The railroad, publishing & printing, and consumer products sectors were the worst-performing sectors in February, with respective returns of -1.73%, -0.31%, and -0.12%.[2]

The higher quality segments of the high yield market generally outperformed in February, driven by the sharp drop in Treasury yields. The BB-rated segment returned 0.72% for the month. Meanwhile, the single-B and CCC segments posted respective one-month returns of 0.61% and 0.46%.[2]

The technical conditions in high yield remained strong in February. Gross issuance decreased month-over-month from $23.0 billion in January to only $18.7 billion in February amid a drop in non-refinancing related activity. By use of proceeds, refinancing accounted for approximately 82.4% of monthly issuance and acquisition financing accounted for only 6.1%. Over 61% of February issuance was rated BB. U.S. high yield retail funds recorded a net inflow of approximately $2.9 billion in February, following an inflow of approximately $2.1 billion in January.[4]

Default and distressed exchange activity in leveraged credit marked a new two-year low in February. According to J.P. Morgan, the high yield trailing 12-month par-weighted default rate including distressed exchanges decreased by 28 bps, ending the month at

1 Source: Morgan Stanley Investment Management Limited. Data as of 28 February 2025.
2 Source: ICE Data Indices, Morgan Stanley Investment Management. Data as of 3 March 2025.
3 Source: Institute for Supply Management. Data as of 3 March 2025.
4 Source: J.P. Morgan. Data as of 3 March 2025.

1.25%. Excluding distressed exchanges, the rate ended February 3 bps lower at 0.27%. For loans, the trailing 12-month par-weighted default rate including distressed exchanges decreased 60 bps to close the month at 3.90%. Excluding distressed exchanges, the rate dropped to 1.26%.[4]

## Strategy and Outlook

We are progressing through the first quarter of 2025 with a relatively balanced view for the high yield market. This outlook includes the expectation for episodic volatility, and the sober realization that, while yields remain historically attractive, on a spread basis the high yield market appears to be priced nearly to perfection, even in light of recent widening. We come to this conclusion after a thorough analysis of factors including the evolving monetary policy of global central banks, trade policy, U.S. and global economic growth, consumer health, the fundamentals of high yield issuers, technical conditions, and valuations. Ultimately, we believe that, on average, the yield provides attractive compensation for the underlying credit risk, but reaching for risk in lower-rated credits will likely be punitive.

We begin March with an average spread approximately 30 bps above post-Global Financial Crisis lows, reached in January, and an average yield that remains well above the 10-year average.[2] The incremental spread relationship between the CCC and single-B segments, which decreased from 639 bps in the first week of August to 409 bps by January-end, widened by nearly 46 basis points in February.[2] Sectors that have benefited most from the six-month rally in distressed credit bear the most scrutiny. These include cable and telecommunications, which remain plagued by secular headwinds and ongoing exposure to liability management exercises (LMEs). Several structures in these sectors have successfully completed recent LMEs but remain at risk of re-defaulting in coming years. While valuations across much of the non-distressed segment of our market are tight, 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.

Our strategy has taken advantage of opportunities in several defensive areas that are either experiencing above-trend secular growth or that we feel are positioned to benefit from deregulation and increased strategic consolidation. We expect growth in power demand will likely be above trend and geographically concentrated, spurring aggressive non-linear growth in power demand in select regions where power generation is provided by a limited number of independent power producers (IPPs). As a result, we increased our overweight to the utility sector. We do not view media, telecommunications and cable & satellite TV as areas with attractive long-term growth prospects; however, we are taking advantage of select idiosyncratic opportunities that are either likely to benefit from a change in Federal Communications Commission (FCC) ownership rules, in the case of select companies in media, or from strategic consolidation in the case of telecommunications and cable. In energy, we have a generally conservative outlook. Broadly, the fundamentals in energy are strong, but risk premium is historically tight and has grown less compelling amid the possibility of increased supply, waning geopolitical risk and ultimately lower oil and gas prices. In health care, we are balancing idiosyncratic opportunity and historically attractive valuations against the challenges of Medicaid profitability and higher payouts from managed care providers. Ultimately, we continue to find attractive opportunity within the sector.

In conclusion, we expect 2025 to be a competitive year for high yield, with global institutional investors likely to benefit from harvesting historically attractive yield in exchange for taking below-average credit risk. It will certainly not be a year without volatility, and we anticipate blind buyers of yield will likely be penalized. Geopolitical tensions and regional conflicts present the potential for expansion or ultimate resolution. Trade policy, U.S. and European fiscal affairs and advancing populism manifest additional risk and opportunity. Amid a shifting 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 | 29 August 2002 |
| Base currency | U.S. dollars |
| Benchmark | ICE BofA U.S. High Yield Index |

[2] Source: ICE Data Indices, Morgan Stanley Investment Management. Data as of 3 March 2025.
[4] Source: J.P. Morgan. Data as of 3 March 2025.

## 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 | 1.97 | 7.31 | 11.85 | -10.81 | 5.70 | 4.76 | 13.94 | -2.43 | 6.06 | 13.32 | -1.88 |
| ICE BofA U.S. High Yield Index | 2.04 | 8.20 | 13.46 | -11.22 | 5.36 | 6.17 | 14.41 | -2.26 | 7.48 | 17.49 | -4.64 |

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.**

## Share Class Z Risk and Reward Profile

- The value of bonds is 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 28.02.2025 and subject to change daily.

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Applications for shares in the Fund should not be made without first consulting the current Prospectus and the Key Information Document ("KID") or Key Investor Information Document ("KIID"), which are available in English and in the language of countries authorized for fund distribution and is available online at Morgan Stanley Investment Funds Webpages or free of charge from the Registered Office at European Bank and Business Centre, 6B route de Trèves, L-2633 Senningerberg, R.C.S. Luxemburg B 29 192.

The summary of investor rights is available in the aforementioned languages and website location under the General Literature section.

Information in relation to sustainability aspects of the Fund is available in English online at: Sustainable Finance Disclosure Regulation.

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