Morgan Stanley

INVESTMENT MANAGEMENT

Upcoming Changes to the MS INVF Absolute Return Fixed Income Fund

FIXED INCOME | GLOBAL FIXED INCOME TEAM | INVESTMENT INSIGHT | 2019

On August 30, 2019, the Morgan Stanley Investment Funds (MS INVF) Absolute Return Fixed Income Fund changed its name and investment philosophy to become the MS INVF European Fixed Income Opportunities Fund (the "Fund"), which will follow a similar approach to our MS INVF Global Fixed Income Opportunities Fund (GFIO), but with a greater focus on euro-denominated assets and a higher exposure to European-related investment themes.

What are the key changes to the strategy?

A FOCUS ON EURO FIXED INCOME ASSETS

The Fund will focus primarily on euro denominated fixed income assets. This change in currency orientation partially reflects the high cost of hedging non-euro assets (and particularly U.S. dollar assets) to euros due to the elevated funding rate differentials. We believe this will allow us to offer a fund similar in many ways to the successful GFIO Fund, but with the EUR-denominated assets potentially enhancing returns for EUR-based investors. Note the base currency of the Fund will remain in euros.

HIGHER DURATION RANGE

The Fund will move from the current target duration range of -4 to +4 years, to a new range of 0 to 6 years. This range will mirror that of the GFIO Fund. The higher duration range better reflects our investment philosophy which seeks to maximise returns whilst minimising volatility through efficient portfolio construction.

Duration typically acts as a hedge to risk premia within the Fund, whilst at the same time augmenting the yield and expected return of the fund through carry (the additional contribution to yield) and roll (due to the normally upward-sloping yield curve). We believe that the new range for duration will have the potential to both increase returns and lower the expected volatility of portfolio performance.

Will the limit of non-investment grade securities that can be held in the Fund change?
The Fund will continue to invest no more than 30% of its net asset value (NAV) in securities rated below investment grade (versus an internal limit of 50% for the GFIO Fund).[1]

Will there be other changes to the way that you manage the Fund?

We plan to take a more active and flexible approach, as would be expected from an opportunistic fund. We will be taking similar risk positions to those in the GFIO Fund, although there will be a bias towards European-related risks. The investment process will be almost identical to the GFIO process, with key themes established by our Macro team. Security selection will be provided by our large team of researchers across the macro, credit, securitised and emerging market debt markets. The portfolio management team will take top-down investment themes, establish appropriate risk targets for the different opportunity sets and populate these with the best bottom-up investment ideas from our research teams to create a well-balanced, efficient portfolio.

Will the portfolio managers be changing?
With a shift to more of a focus on euro denominated assets, the portfolio managers of the Fund will be changing. The portfolio managers of the Fund will be: Leon Grenyer, Richard Ford, Michael B. Kushma and Richard Class. Leon Grenyer and Richard Class, who jointly head European Multi-Sector investing for the Global Fixed Income Team, will be added as portfolio managers. Leon will become the Fund's lead portfolio manager.

Christian G. Roth and Jim Caron will be removed as portfolio managers from the Fund. These changes are again to increase the European expertise and to align with the euro currency focus of the Fund.

Why are we making the changes?
Following the changes, the Fund will better fit with our investment philosophy and style of active, flexible investment across the global fixed income markets. We believe that the Fund will be better positioned to seek higher returns with lower volatility for the following reasons:

- The opportunistic approach should enhance investment returns given the potential greater flexibility and more active management.
- The euro denomination should enhance hedged returns.
- The new duration range should reduce the volatility of returns and minimise the risk of drawdowns, as well as reducing the drag on performance arising from the costs of hedging duration.

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[1] The Fund will not invest in any securities that are rated below B- (or below BBB- in the case of Asset Backed Securities, including Mortgage Backed Securities) by Standard & Poor's Corporation (S&P) or an equivalent rating from another rating agency or an equivalent internal rating from the Investment Adviser as at the date of investment. In the event that any securities held by the Fund are subsequently downgraded to a rating below B- (or below BBB- in the case of Asset Backed Securities, including Mortgage Backed Securities), the Investment Adviser may maintain a maximum total exposure of 3% of the Fund's Net Asset Value to such downgraded securities but will divest any such security that has not been upgraded to a rating of at least B- (or BBB- in the case of Asset Backed Securities including Mortgage Backed Securities) within six months of its downgrade.

Risk Considerations

Fixed income securities are subject to the ability of an issuer to make timely principal and interest payments (**credit risk**), changes in interest rates (**interest rate risk**), the creditworthiness of the issuer and general market liquidity (**market risk**). In the current rising interest rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. **Longer-term securities** may be more sensitive to interest rate changes. In a declining interest rate environment, the portfolio may generate less income. Certain U.S. government securities purchased by the strategy, such as those issued by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of the U.S. It is possible that these issuers will not have the funds to meet their payment obligations in the future. **Public bank loans** are subject to liquidity risk and the credit risks of lower-rated securities. **High-yield securities (junk bonds)** are lower-rated securities that may have a higher degree of credit and liquidity risk. **Sovereign debt securities** are subject to default risk. **Mortgage- and asset-backed securities** are sensitive to early prepayment risk and a higher risk of default, and may be hard to value and difficult to sell (**liquidity risk**). They are also subject to credit, market and interest rate risks. The **currency market** is highly volatile. Prices in these markets are influenced by, among other things, changing supply and demand for a particular currency; trade; fiscal, money and domestic or foreign exchange control programs and policies; and changes in domestic and foreign interest rates. Investments in **foreign markets** entail special risks such as currency, political, economic and market risks. The risks of investing in **emerging market** countries are greater than the risks generally associated with foreign investments. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. **Restricted and illiquid securities** may be more difficult to sell and value than publicly traded securities (**liquidity risk**). Due to the possibility that prepayments will alter the cash flows on **collateralized mortgage obligations (CMOs)**, it is not possible to determine in advance their final maturity date or average life. In addition, if the collateral securing the CMOs or any third-party guarantees are insufficient to make payments, the portfolio could sustain a loss.

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