The Morgan Stanley Emerging Markets External Debt Strategy is a value-oriented fixed income strategy that seeks high total return from income and price appreciation by investing in a range of sovereign, quasi-sovereign and corporate debt securities in emerging markets. Investments are mostly denominated in U.S. currency, and, to a lesser extent, in non-U.S. and/or local currencies. To help achieve its objective, the strategy combines top-down country allocation with bottom-up security selection.

Investment Philosophy

The investment team believes that sovereign, quasi-sovereign and corporate debt securities of emerging markets experiencing positive fundamental change may present attractive investment opportunities. Further, historical data shows that the performance correlation of emerging market debt (EMD) with other asset classes can be low, thus providing potential diversification benefits.\(^1\)

The team aims to capture the upside potential of emerging market debt securities through:

- **Country and security analysis**: As emerging markets vary significantly in their development, the team evaluates countries’ relative economic, political and social fundamentals in addition to bottom-up security selection.

- **Value orientation**: The team seeks to identify countries exhibiting fundamental improvements that have not yet been reflected in the prices of their debt securities. By following a country’s incremental rate of change in various areas over time—rather than simply analyzing a static snapshot of parameters—the team believes it can discern improvements at their early stages and monetize them through timely investments.

Investment Process

The team follows a disciplined investment process that combines top-down macro assessment with bottom-up security evaluation to construct portfolios. All investment recommendations undergo peer review, and final decisions with respect to portfolio construction and market-risk exposure are made on a team basis based on the following analysis:

- **Macro analysis**: The team begins with a top-down macro analysis of the global environment focusing on global growth—and its impact on global trade volume and commodity prices, and on global real interest rates and risk appetite—and its impact on capital flows. The output of the analysis is an overall risk target for all of our portfolios relative to their respective benchmarks.

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\(^1\) Diversification does not protect you against a loss in a particular market; however it allows you to spread that risk across various asset classes.

\(^2\) The strategy invests in the market capitalization of the JPMorgan Emerging Markets Bond Index Global, which is a market capitalization-weighted index that tracks total returns for U.S. dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities, including Brady bonds, loans and Eurobonds and local market instruments for over 60 emerging market countries. It is not possible to invest directly in an index.

\(^3\) Weights represent typical ranges, which a portfolio may exceed from time to time due to market conditions and outstanding trades.

**Strategy at a Glance**

<table>
<thead>
<tr>
<th>Inception</th>
<th>July 1993</th>
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<tbody>
<tr>
<td>Benchmark</td>
<td>JPMorgan Emerging Markets Bond Index Global (“EMBI Global”)</td>
</tr>
<tr>
<td>Country weight(^2)</td>
<td>Typically within ±10 percentage points of the benchmark. For non-index countries: Less than 5% of the portfolio at cost per country</td>
</tr>
<tr>
<td>Sector weight(^3)</td>
<td>Typically, investments in Domestic Debt or Corporate Debt are limited to 25% of the portfolio each.</td>
</tr>
<tr>
<td>Currency</td>
<td>U.S. dollar (typically 75-100%), and to a lesser extent, non-U.S., or EM local currencies</td>
</tr>
<tr>
<td>Credit ratings</td>
<td>There are no credit ratings restrictions. We believe that opportunities reside across the entire credit spectrum and do not set any minimum rating requirement for the portfolio. In addition, we do not believe that credit ratings are the best gauge of sovereign risk, as they tend to be lagging indicators. Credit rating, while considered, is not a primary factor in the decision to take a position.</td>
</tr>
</tbody>
</table>

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• **Sovereign analysis:** The team’s objective is to estimate “fair sovereign risk premiums” based not only on economic fundamentals but also on structural and sociopolitical factors. Their sovereign risk model consists of several building blocks, including:

  – **Capacity-to-pay/liquidity factors:** Variables reflecting capacity-to-pay (debt/GDP, for example) and liquidity (such as international reserves) considerations explain a large portion of variation in sovereign spreads.

  – **Sociopolitical indicators:** Factors such as political stability, rule of law, socioeconomic conditions, among others, also have a meaningful impact on sovereign spreads.

  – **Global conditions:** The model includes several variables that proxy for global liquidity conditions and investors’ risk attitudes as academic literature shows that these factors play a key role in explaining variation in sovereign spreads.

  – **Forward-looking indicators:** The fair-value model considers 1-year-ahead consensus estimates for domestic macro variables, as the use of historical data renders econometric estimation vulnerable to issues of reverse causality and serial correlation.

  – **Scenarios:** The team is able to quantify likely alternative scenarios in terms of the additional risk premium investors should demand from a country with larger vulnerabilities.

The different sources of sovereign risk premium are combined into a country’s estimate of “fair value sovereign spreads” and compared with the market’s implicit assessment of sovereign risk embedded in bond prices.

• **Security selection:** The team’s proprietary database is complemented by other, more specific and structural, data coming from third party sources and provides perspective on market valuations in different time periods, enabling them to identify potential mispricing and alpha opportunities. Each potential security is analyzed through a variety of valuation metrics. The valuation tools they use most frequently in EMD include historical spread relationship, regression models, and implied probability of default.

• **Portfolio construction:** The team uses a Positioning & Sizing framework that takes into consideration the total return potential of investment alternatives, the volatility of returns and correlation of such potential positions to assess risk, and a conviction factor about the return/risk trade-off based on a comprehensive review of event risk (including near-term political factors) and the market technicals such as planned issuance, investors’ positioning and outlook for asset class flows.

• **Risk management:** Risk management is integrated throughout the team’s investment process. An independent team also monitors portfolio adherence to guidelines, overall risk levels and composition.

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**Display 1: Country and security analysis helps identify investment opportunities in emerging market debt**

This diagram represents how the portfolio management team generally implements its investment process under normal market conditions.

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**Competitive Advantages**

• **Global presence:** The team is supported by Morgan Stanley’s presence in nearly every major financial market and region, drawing on the scale and scope of the firm’s global franchise to help manage risks and identify opportunities throughout market cycles.

• **Experience and complementary skill set:** The team has been through a variety of volatile markets and is comprised of investment professionals with complementary skill sets, which facilitate informed, well-researched investment decisions. Morgan Stanley Investment Management has managed dedicated EMD assets since 1993, with the head of the EMD effort being involved since 1997.

• **Morgan Stanley Investment Management’s structure:** The firm’s structure allows for entrepreneurial flexibility, equipping the investment team with the liberty to respond quickly to market developments and swiftly implement investment ideas.

**Investment Team**

The Emerging Markets External Debt Strategy is managed by Eric Baumreister, Jens Nystedt, Warren Mar and Sahil Tandon. In addition to the macroeconomic and sovereign analysts dedicated to the Emerging Markets universe, the team also draws on the wider expertise of the Global Fixed Income team.

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4 Subject to certain restrictions.

5 Team members may change without notice from time to time.
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