Morgan Stanley Investment Funds

International Resilience Fund

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.

INTERNATIONAL EQUITY TEAM

Performance Review

In the one month period ending 31 October 2024, the Fund's Z shares returned -7.01% (net of fees)[1], while the benchmark returned -4.91%.

The portfolio has underperformed for the year-to-date, returning +5.20% versus +8.61% for the index.

October's underperformance was due to negative stock selection, largely driven by weakness in information technology and consumer staples. Meanwhile, sector allocation was slightly positive as the benefit from the overweight to information technology more than offset the drag from the overweight to consumer staples.

The top contributors to absolute performance during the month were **TSMC** (+22 bps), as artificial intelligence (AI) demand boomed and other markets started to improve; **Visa** (+16 bps), on the back of better-than-expected fourth quarter results; and **Aon** (+15 bps), as organic revenue growth bounced back after a weaker period earlier in the year.

The largest absolute detractors were **L'Oréal** (-64 bps), as third quarter results were weaker than anticipated, held back by low consumer demand in China and a poor summer impacting sun care; **Davide Campari** (-56 bps), where supply issues, poor weather and destocking all contributed to weak third quarter results; and **Capgemini** (-53 bps), as stronger-than-anticipated headwinds in the manufacturing segment hit third quarter results.

Market Review

After a strong third quarter, equity markets retreated in October, with the MSCI All Country World (ACWI) ex-U.S. Index returning -4.9% in U.S. dollars (USD), but a milder fall of 1.8% in local currency as the USD strengthened. October's pullback means the index is now up +9% in USD and +12% in local currency year-to-date. All sectors were in the red in the month. Information technology (-2%) and financials (-3%) were relatively unscathed, while materials (-8%) and consumer staples (-8%) were the laggards. All the other sectors were within 250 bps of the overall index. Looking at geographies, the U.S. (-1%) significantly outperformed the MSCI ACWI ex-U.S. in the month. In euroland, Italy (-2% USD, +1% local) held up well despite soft third quarter economic data, while France (-6%, -4%) was weak due to announced austerity measures to balance its budget, including corporate tax rises. In Asia, China (-6% USD and local) and Hong Kong (-6% USD and local) were also in negative territory following uncertainty over China's stimulus plans. Strong semiconductor performance helped boost Taiwan (+4% USD, +5% local), while Japan (-4%, +2%) saw local currency gains on the back of a further falling yen. All other major markets were within 250 bps of MSCI ACWI ex-U.S.

Portfolio Activity

Portfolio activity is reported at quarter-end.

Strategy and Outlook

The Long-Term Case for Health Care

The health care sector has underperformed the broader MSCI ACWI ex-U.S. Index over the past two years, returning a cumulative 28% compared to 40% for the index.[2] Excluding the sector's "glamour" stock – Novo Nordisk – the two-year return drops to 18%, trailing the index by 22%.[2] With this lagging performance in mind, we believe it is a good time to reiterate what attracts us to the sector as a long-term investment.

Reflections on the sector

Firstly, it's important to reiterate the idiosyncratic demand, supply and funding environment that health care stocks have had to grapple with over the past five years. The onset of COVID-19 was certainly a driving force, particularly for the pharmaceutical companies making the vaccines, the life sciences companies providing testing kits, and the health care equipment companies manufacturing and supplying personal protective equipment (PPE) and other life-sustaining products such as ventilators. The unwinding of this cyclical distortion, however, has been significantly less wonderful for companies' revenues, particularly in bioprocessing where acute overstocking of raw materials and vaccines occurred amid uncertainty over the pandemic's duration. Across the sector more broadly, companies have since faced rapidly rising costs, increasingly fragmented supply chains, a tighter funding environment, and weakness in China[3] due to a lack of government and private funding.

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1 Source: Morgan Stanley Investment Management Limited. Data as of 31 October 2024.
2 Source: FactSet. Data as of 31 October 2024. Cumulative returns.
3 We are beginning to see signs of stabilisation and we believe the industry is positioned for future growth, given the continuing shift to more complicated drugs and gene therapies.

Despite these recent challenges, in our view, several factors drive a strong long-term outlook for health care:

- **Rapidly ageing global population.** The World Health Organisation projects that by 2050 the number of people over 60 will double to more than 2 billion, while those over 80 will triple to 436 million.[4] Wisdom isn't the only thing that comes with age; health spending typically increases.
- **Untapped market opportunities.** By 2050, two thirds of the world's elderly will reside in low-middle income countries, a dramatic shift from current trends in wealthier nations like Japan, where 30% of the population is already over 60.[4] This offers promising opportunities for those companies able to effectively pivot to where the growth is.
- **Non-discretionary nature of health care demand**. The products and services the sector offers are essential, regardless of economic conditions, making it more resilient to downturns than most sectors.
- **Innovation and digital transformation offer strong potential.** Advances in telemedicine, drug discovery, personalised medicine and genomics unlock new opportunities, while technologies like AI, electronic health records and remote monitoring are improving efficiency and patient outcomes.

Quality characteristics

On our two favoured quality metrics, ROOCE (return on operating capital employed) and gross margin, health care ranks among the top sectors. Additionally, it has delivered the second highest earnings per share growth of any sector in the index over the past 20 years.[5] Importantly, due to the sector's resilience, this growth has been remarkably steady, with consistent relative earnings outperformance in negative years for the index.[5] The market has recently seemed to place very little value on predictability given the recent benign economic backdrop and the outperformance of cyclical stocks. In our view this is misguided, as predictability often demonstrates its worth just when investors least expect they need it.

Seeking companies with earnings visibility

Within health care, revenue streams and returns may be safeguarded through product patents or by barriers to entry created by entrenched positions within value chains, such as high value, low-cost suppliers to drug developers and health care providers. Further, by virtue of selling single-use, repeat purchase consumables, many health care suppliers benefit from recurring revenue streams and "razor-razor blade"[6] business models. Certain pharmaceutical companies can also offer medium-term visibility, as generic competition for a patented drug can be anticipated years before market entry, providing a clear line of sight. Earnings visibility should underpin resilient earnings at high returns for our health care holdings – if we look in the right places.

Avoiding single product dependency

We believe that compounding wealth over time requires a sharp focus on downside risks, which is doubly important when a company is singularly reliant on one product. GLP-1 producers are a prime example, with over 70% of leader Novo Nordisk's sales from GLP-1 medications.[7] While these drugs have enormous potential, our concern is that they too face patent expiry and in time likely extremely aggressive competition – if consensus numbers are anywhere near right about the size of the market. There's also the risk that governments and insurance companies may refuse to pay for patients to receive these drugs, limiting the potential opportunity size. With a price-to-earnings ratio (P/E) approaching 30 times the next 12 months projected earnings, Novo Nordisk is significantly pricier than the 15x of a typical non-GLP-1 pharma company.[8] This elevated valuation renders the company vulnerable to these potential risks, currently making it an unappealing prospect for our quality portfolios.

Managing pipeline risk

For the select pharmaceutical names we do hold in the International Resilience portfolio, we need evidence of strong research and development (R&D) outcomes and healthy pipelines, including promising drugs potentially large enough to offset patent cliffs. For example, with AstraZeneca, much of the pipeline is in drugs that have already been approved in certain areas of oncology, but are in trial phases for different treatment areas. Over recent years we have observed that these pipeline assets carry less risk because the "mechanism of action"[9] has already been proven to work in other areas of the body.

Finding high ROOCE and growth outside of pharmaceuticals

Our investment process seeks to identity high quality, well diversified, non-cyclical business which are able to compound at high returns on operating capital employed. One such company is Qiagen, a Dutch-listed diversified life sciences and diagnostics company. Among other products, Qiagen supplies gold standard chemicals for preparing DNA and RNA samples for R&D activity, a field in which it commands a dominant market position. This is a relatively low-cost product, and one where customers place importance on reducing the number of variables in their processes. Therefore, revenues are sticky, with 85% recurring, and incentive to switch suppliers is incredibly low.[10]

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4 Source: World Health Organization (WHO) 1 October 2024. Available at www.who.int/news-room/fact-sheets/detail/ageing-and-health
5 Source: FactSet.
6 A company using a "razor-razor blade" business model sells a core product (e.g. razors) at a low margin while also selling a related consumable product (e.g. razor blades) at a high margin to drive recurring revenue.
7 Source: Novo Nordisk company reports.
8 Source: FactSet, as of 30 September 2024.
9 A term used to describe how a drug or other substance produces an effect in the body.
10 Source: Qiagen company reports, International Equity Team research.

Another example is Merck, a diversified German-listed health care company. Sixty percent of profits come from a steadily compounding and high returning life sciences business supplying equipment and consumables for drug manufacturing.[11] This business benefits from the structural growth of health care and drug expenditure, without the R&D and pipeline risk attributed to pharmaceutical companies. Enhancing the barriers to entry, many of the company's tools are written into the regulatory filings for the end drug, and so there is little incentive to change supplier.

Quality and resilience at a reasonable price

In a concentrated broader market with what we view as generally high valuations on lofty earnings expectations, we feel the risks to the market are appreciably higher than many anticipate. Our health care holdings are anchored by a focus on steady compounding, reasonable valuations and high returns on operating capital, which we believe should be resilient in tough economic times.

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

Fund Facts

Launch date	18 November 2014
Base currency	U.S. dollars
Benchmark	Blended- Blended 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	5.20	17.27	-13.52	4.11	11.54	20.31	-14.24	25.03	-2.51	0.41	--
Blended Index	8.61	17.65	-14.45	11.26	7.82	22.01	-13.79	25.03	1.00	-0.81	--
MSCI AC World ex-US Net Index	8.61	15.62	-16.00	7.82	10.65	21.51	-14.20	27.19	4.50	-5.66	--
MSCI EAFE Index	6.85	18.24	-14.45	11.26	7.82	22.01	-13.79	25.03	1.00	-0.81	--

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.**

Share Class Z Risk and Reward Profile

- 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 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.
- Investment in China A-Shares via Shanghai-Hong Kong and Shenzhen-Hong Kong Stock Connect programs may also entail additional risks, such as risks linked to the ownership of shares.
- There are increased risks of investing in emerging markets as political, legal and operational systems may be less developed than in developed markets.
- 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 October 2024 and subject to change daily.

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 official language of your local jurisdiction at morganstanleyinvestmentfunds.com or free of charge from the Registered Office of Morgan Stanley Investment Funds, European Bank and Business Centre, 6B route de Trèves, L-2633 Senningerberg, R.C.S. Luxemburg B 29 192.

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INDEX INFORMATION

The **Blended Index** performance shown is calculated using the MSCI EAFE Index from inception through 29 September 2023 and then the MSCI All Country World Ex-U.S. Index thereafter.

The **MSCI All Country World Ex-U.S. Index** is a free float-adjusted market capitalization weighted index designed to measure the equity market performance of developed and

[11] Source: Merck company reports, International Equity Team research.

emerging markets, excluding the U.S. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

The **MSCI EAFE Index (Europe, Australia, Far East)** is a free float-adjusted market capitalization index that is designed to measure the international equity market performance of developed markets, excluding the US & Canada. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The MSCI EAFE Index currently consists of 21 developed market country indices. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

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