A Sub-Fund of Morgan Stanley Investment Funds

Global Asset Backed Securities Fund

MORTGAGE & SECURITIZED TEAM

Performance Review

In the three month period ending 31 December 2024, the Fund's Z shares returned -1.05% (net of fees)[1], while the benchmark returned -3.16%.

The Fund's only source of negative returns for the quarter was its allocation to agency mortgage-backed securities (MBS); however, even the Fund's agency MBS allocation outperformed the Index. The portfolio's outperformance was primarily due to its underweight to both duration and to agency MBS—particularly to lower coupon, fixed-rate passthroughs as these have the longest duration—as agency spreads widened 6 basis points and interest rates sold off during the fourth quarter.[2] Due to their shorter or floating-rate duration profile and high cash flow carry, global non-agency residential mortgage-backed securities (RMBS), commercial mortgage-backed securities (CMBS) and asset-backed securities (ABS) all performed well; performance was also supported by tightening securitized credit spreads during the quarter.

The Fund's relative duration positioning slightly added to relative performance as the Fund's duration remained shorter than that of the Index during the quarter.

There were no material detractors from relative performance in the quarter.

Market Review

The U.S. Treasury yield curve steepened and interest rates sold off materially in December after hawkish statements from Federal Reserve (Fed) Chair Powell and stubborn inflation data. Rate cut expectations have fallen materially over the past few months due to strong economic data and the U.S. election results; the market is now only pricing in two rate cuts for the entirety of 2025, with the first cut not until May. The Fed cut rates twice during the quarter by 25 basis points each to a range of 4.25% to 4.50% and indicated at the December meeting that in the post-election world there would likely be fewer rate cuts in 2025 than previously expected.

The Fed also continued letting its MBS holdings run off during the quarter, which declined $49 billion to $2.225 trillion.[3] The 2-year U.S. Treasury rate rose 60 basis points to 4.24% during the fourth quarter, and the 10-year U.S. Treasury rate rose 79 basis points to 4.57%.[3] U.S. commercial banks increased their agency MBS holdings during the quarter by approximately $6 billion to $2.643 trillion, but bank holdings are still down $329 billion since early 2022.[3] The 30-year mortgage rate rose 64 basis points during the quarter from 6.21% to 6.85%.[3] MBS current coupon nominal spreads widened 6 basis points during the quarter to 135 basis points above interpolated U.S Treasurys.[3] The Bloomberg U.S. MBS Index returned -3.16% during the quarter, underperforming U.S Treasurys by 12 basis points on a duration-adjusted basis.[3] Agency MBS underperformed Treasury by 76 basis points for all of 2024 on a duration-adjusted basis.[3] The duration of the Bloomberg U.S. MBS Index lengthened 0.3 years to 5.6 years, and the majority of the outstanding U.S. mortgage market remains "out-of-the-money" to refinance with new origination mortgage rates still at historically high levels.[3]

Current coupon agency MBS spreads tightened only slightly in 2024, while nearly all other sectors tightened materially, and therefore agency MBS look attractive, both from a historical perspective and relative to other asset classes. Agency MBS supply-demand dynamics appear to be relatively stable: the Fed continues to let its agency MBS holdings run off, but U.S. banks and foreign entities have increased their holdings recently. We expect demand for agency MBS to increase in the coming months and for spreads to tighten as we expect flows from cash and cash alternatives to move toward the attractive return profile of this sector. We also expect credit securitized spreads to tighten in sympathy with agency MBS spreads.

Portfolio Activity

Our agency MBS positions held at 41% during the fourth quarter as this sector still remains attractive from both a historical and relative value perspective.

Over the period, our U.S. RMBS holdings rose by 1% to 22% as this sector remains our favorite, and our non-U.S. RMBS holdings fell by 2% to 15% as some Greek, Spanish, U.K. and Irish RMBS deals paid off; we continue to seek opportunities to rotate out of European securities into comparable U.S. securities. Our U.S. CMBS holdings held at 5%, and our European CMBS holdings held at 4%. Our U.S. ABS exposures rose by 1% to 10% with the addition of some residential-related ABS, and our non-U.S. ABS holdings held at 3%.

1 Source: Morgan Stanley Investment Management Limited. Data as of 31 December 2024.
2 One basis point = 0.01%
3 Source: Bloomberg L.P. Data as of 31 December 2024.

Strategy and Outlook

We expect U.S. agency MBS spreads to tighten as we expect flows from cash and cash alternatives to move to the attractive return profile of this sector. We also expect credit securitized spreads to tighten in sympathy with agency MBS spreads. Securitized credit sectors were among the best performing sectors in 2024, and we expect this to continue into 2025. We believe that returns will result primarily from cash flow carry in the coming months as we enter the year with higher yields, but also get an added boost from tighter spreads due to increased demand. We still believe that current interest rate levels remain stressful for many borrowers and will continue to erode household balance sheets, causing stress for some consumer ABS, particularly involving lower income borrowers. Commercial real estate also remains challenged by current financing rates. Residential mortgage credit opportunities remain our favorite sector currently and is the one sector where we remain comfortable going down the credit spectrum, as we remain more cautious regarding lower-rated ABS and CMBS. We remain positive on agency MBS valuations as they continue to remain attractive relative to investment grade corporate spreads and to historical agency MBS spreads. Our sector-specific outlooks follow:

We have moved from a neutral to positive view on agency MBS valuations, which are one of the very few sectors that are flat to slightly tighter in 2024, while nearly all other sectors have tightened materially. Not only is there attractive carry but we also believe that there is potential for additional spread tightening as we anticipate demand to pick up in this sector.

We remain most constructive on residential mortgage-backed securities and residential-related investments. Most homeowners have locked in 30-year fixed-rate mortgages at substantially lower mortgage rates and have not faced payment shocks from higher rates. Additionally, the substantial home price appreciation over the past few years has meaningfully increased homeowner equity – homeowner equity is at the highest level in more than 40 years. Lastly, residential mortgage lending standards have remained very conservative in the post-financial crisis era, and mortgage credit performance continues to be pristine with very minimal delinquencies and defaults.

We are cautious yet opportunistic on commercial real estate, especially in our exposure to the office sector. Higher financing costs have stressed all commercial real estate sectors, but sectors such as hotels, multi-family housing and retail shopping centers have seen healthy revenue growth to help offset the higher financing costs. The office sector has felt the brunt of both declining revenue and higher financing costs. Leisure hotels are continuing to experience high post-pandemic demand with record occupancy and room rates, but this travel boom may have peaked, and performance numbers could begin to decline. Multi-family residential properties continue to perform well in terms of occupancy and rental rates, benefiting from the positive housing market supply-demand dynamics, but rental housing units are facing increasing cost pressures from rising mortgage rates and maintenance costs, and further rent increases could be difficult. Retail shopping centers continue to improve occupancy and rental rates in the post-pandemic era, but overall, the retail sector is still challenged by the longer-term threat of online shopping growth. Industrial, storage and logistics properties continue to perform well, with demand benefiting from the growth of e-commerce. Within CMBS, our focus has been primarily on multi-family housing, logistics, and high quality hotels, shopping centers and trophy office, and we have been generally moving up in credit quality within CMBS. However, as mentioned earlier, the pressure of these higher financing costs should ease in the coming months as rates come down and high quality office with strong tenants in booming metro areas have been performing well and we believe offer attractive relative value.

We also remain cautious on consumer ABS, as inflation, higher interest rates and declining government stimulus are straining consumer balance sheets, especially for lower-income borrowers. The savings surplus built up during the pandemic has now been depleted, and we expect more consumer stress for the remainder of 2024. Additionally, traditional ABS look expensive on a relative value basis. We are more constructive on business-related ABS, such as aircraft leases, mortgage-servicing rights, aircraft ABS and small business loans, as these offer significantly wider spreads and look attractive.

We believe that the Fed will likely cut interest rates twice in 2025 to 3.75%, with the first rate cut not occurring until May. Much of the projected rate decline has now been priced into the market, but we still expect the forward path for rates to likely be lower from current levels on the front end.

We continue to prefer U.S. securitized opportunities over U.K. and European securitized markets. U.S. spreads are currently wider than comparable credit-profile European/U.K. opportunities, yet we believe the U.S. credit landscape is more favorable. European inflation has been slower to recede, and economic growth looks to be weaker in Europe. Geopolitical risks also remain higher in Europe.

Our base forecast is no longer for a recession; however, even if a mild recession were to occur, we do not believe it would have a material impact on our securities' performance. We also believe our securities could handle a severe recession given that they were designed with the Global Financial Crisis as a stress test. We remain watchful of ongoing geopolitical risks as well as broader economic risks across the globe. Despite these risks, we remain excited about the Fund's return potential for 2025 as we enter the year with a high yield, good credit quality and added return potential from spread tightening.

Overall, we believe the securitized market offers a unique opportunity to achieve competitive returns with solid credit fundamentals. Although volatility has increased and credit conditions are weaker, we remain constructive on securitized credit conditions overall — specifically in the U.S. — with the U.S. economy remaining strong and housing and consumer credit conditions continuing to be relatively healthy. As a result of these views, we have a meaningful credit overweight in the Fund, but we have increased our U.S. agency MBS position to its highest level in several years given our concerns of deteriorating economic conditions and attractive relative value.

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

Fund Facts

Launch date	03 December 2012
Base currency	U.S. dollars
Benchmark	Bloomberg U.S. Mortgage Backed Securities (MBS) 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	5.40	5.40	8.18	-6.62	1.91	2.62	6.91	2.14	7.37	4.71	1.77
Bloomberg U.S. Mortgage Backed Securities (MBS) Index	1.20	1.20	5.05	-11.81	-1.04	3.87	6.35	0.99	2.47	1.67	1.51

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 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.
- 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, available at www.morganstanleyinvestmentfunds.com. All data as of 31.12.2024 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 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.

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