A Sub-Fund of Morgan Stanley Investment Funds

US High Yield Middle Market Bond Fund

HIGH YIELD TEAM

Performance Review

In the one month period ending 31 January 2025, the Fund's Z shares returned 1.21% (net of fees)[1], while the benchmark returned 1.37%.

Media & entertainment and airlines were the top-performing sectors in the Fund relative to the benchmark, due to positive credit selection in both sectors. Outperformance in the media & entertainment sector was led by an off-benchmark position in an audio streaming and media service provider that posted its first full year of profit in 2024. In airlines, the primary individual driver of outperformance was an overweight position and selection within the capital structure of a private aviation company that continues to exhibit strong customer growth and high retention. At the end of January, it was rumored the company was in the later stages of a convertible preferred equity raise.

Transportation services and health care were the worst-performing sectors in the Fund relative to the benchmark in January, due to challenging credit selection in both sectors. Within transportation services, the primary individual impediment was an overweight position in a U.S. provider of full-service logistics solutions. The position was down less than 2% on technical weakness, likely as a result of tariff-related sentiment. Relative underperformance in health care was led by an overweight position in a leading operator of surgical facilities and related services. Toward the end of the month, a private equity firm made a takeover bid for the company. This firm would not trigger a change-of-control and therefore the bonds would remain outstanding in the event the acquisition is completed. The position finished the month down less than 2%.

In terms of performance by rating segments, the Fund's credit selection in the BB, single-B and CCC segments weighed on relative returns. An underweight in the BB segment and an overweight in the single-B segment were modestly accretive to performance.

Market Review

Performance in the U.S. and global high yield markets was strong in January amid generally strong demand, a primary market calendar that was slow to gain momentum, and a modest retreat in 5-year U.S. Treasury and German bund yields in the second half of the month. With a dearth of issuance and ample demand over the first three weeks of the year, lower quality beta led performance. The dynamic shifted later in the month as a surge in acquisition-related financings reignited the primary market, and valuations in lower-rated structures within the cable & satellite TV sector came under modest pressure. The Federal Reserve's decision in January to maintain its key policy rate and the European Central Bank's decision to reduce its key policy rate by a quarter-point were well telegraphed but elicited little reaction. The month ended with the market squarely focused on the potential for impending trade tariffs.

The Bloomberg U.S. Corporate High Yield Index returned 1.37% in January. The yield-to-worst finished the month 29 basis points (bps) lower at 7.20%. The spread-to-worst closed the period 26 bps lower at 288 bps.[2]

The top-performing sectors for the month were real estate investment trusts (REITs), communications, and energy, with respective returns of 2.50%, 1.76%, and 1.66%. The electric utility, natural gas utility, and consumer non-cyclical sectors were the worst-performing sectors in January, with respective returns of 0.40%, 0.77%, and 0.97%.[2]

The lowest quality segments generally outperformed for the one-month period, despite a period of relative underperformance to finish the month. The CCC-rated segment returned 1.54% for the month. Meanwhile, the single-B and BB segments posted respective one-month returns of -1.41% and 1.28%.[2]

The technical conditions in high yield improved in January. Gross issuance increased month-over-month from $11.5 billion in December to $23.0 billion in January, on the back of a strong week of issuance to close the month. By use of proceeds, refinancing accounted for approximately 67% of monthly issuance and acquisition financing accounted for approximately 28%. U.S. high yield retail funds recorded a net inflow of approximately $1.5 billion in January, following an outflow of approximately $3.8 billion in December.[3]

January was the lightest month for default and distressed exchange activity in leveraged credit in more than two years. According to J.P. Morgan, the high yield trailing 12-month par-weighted default rate including distressed exchanges decreased by 4 bps, ending the month at 1.43%. Excluding distressed exchanges, the rate ended January 5 bps lower at 0.30%. For loans, the trailing 12-month par-weighted default rate including distressed exchanges decreased 7 bps to close the month at 4.42%. The gap in these respective metrics between the high yield and loan markets is at the highest level since 2000.[3]

1 Source: Morgan Stanley Investment Management Limited. Data as of 31 January 2025.
2 Source: Bloomberg L.P., ICE Data Indices, Morgan Stanley Investment Management. Data as of 3 February 2025.
3 Source: J.P. Morgan. Data as of 3 February 2025.

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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. We come to this conclusion after a thorough analysis of factors including the evolving monetary policy of global central banks, 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 February with an average spread hovering near post-Global Financial Crisis lows, reached in January, and an average yield that remains well above the 10-year average, despite contracting modestly in January. The notable spread compression experienced since early August was largely the result of a compression in CCC valuations that we assess to be overdone, leaving the prospect of investing in the lower-rated segments of our market less compelling on a go-forward basis. The incremental spread relationship between the CCC and single-B segments decreased from 639 bps in the first week of August 2024 to 409 bps by January-end, marking a low since the spring of 2022.[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	02 December 2014
Base currency	U.S. dollars
Benchmark	Bloomberg US Corporate High Yield Index

[2] Source: Bloomberg L.P., ICE Data Indices, Morgan Stanley Investment Management. Data as of 3 February 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	1.21	8.83	13.34	-11.97	5.30	5.24	15.60	-2.53	8.15	16.30	-0.52
Bloomberg US Corporate High Yield Index	1.37	8.19	13.44	-11.19	5.28	7.11	14.32	-2.08	7.50	17.13	-4.47

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.
- 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 31.01.2025 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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INDEX INFORMATION

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