Morgan Stanley
INVESTMENT MANAGEMENT

**COMMENTARY**
September 30, 2024

**Morgan Stanley Institutional Fund**

# Long Duration Government Opportunities Fund

**MORTGAGE & SECURITIZED TEAM**

## Performance Review

In the quarter period ending September 30, 2024, the Portfolio's I shares returned 11.21% (net of fees)[1], while the benchmark returned 7.82%.

## Market Review

Global financial markets posted strong gains in the third quarter. Volatility spiked in early August due to a weak U.S. jobs report and an interest rate hike from the Bank of Japan that led investors to reconsider the popular yen carry trade. However, markets quickly regained their footing in response to more favorable U.S. economic data, including a drop in initial jobless claims and the strongest growth in retail sales in over a year.

During the quarter, the words and actions of the U.S. Federal Reserve (Fed) were a key driver of the broad rally in markets. At its July meeting, the Fed held interest rates steady but signaled a September cut, and at the August Jackson Hole Economic Symposium, Chair Powell said "the time has come" to start reducing rates. The Fed followed through on this dovish rhetoric, lowering rates 0.50% at its September meeting amid rising confidence that inflation was moving sustainably toward its 2% target. In addition, Fed officials projected another 0.50% of rate cuts by year-end.

Outside the U.S., moderating inflation allowed many developed and emerging markets central banks to either start or continue their easing cycles, including the Bank of England, European Central Bank and Bank of Mexico. Chinese monetary authorities also loosened policy, ramping up their efforts to boost China's ailing economy with new stimulus measures, such as cutting one-year lending rates by the most on record. The Bank of Japan remained an outlier among its peers, raising rates for the second time this year as weakness in the yen added to upside inflation risks.

Against this backdrop, the U.S. dollar weakened and government bond yields fell globally. Credit spreads widened during the brief bout of August volatility but finished the quarter largely unchanged. While gains were widespread across asset classes, emerging markets local currency debt performed especially well, benefiting from U.S. dollar weakness, declining interest rates and attractive carry. Conversely, oil was a notable laggard, falling sharply on expectations of slowing global demand.

## Portfolio Activity

The portfolio (I shares net of fees) outperformed its benchmark, the Bloomberg U.S. Long Treasury Index (the Index), during the period. Yields fell across the U.S. Treasury curve in the third quarter, and the yield curve experienced a pronounced steepening as markets began to price in a more accommodative Fed. The 2-year Treasury yield fell by 105 basis points (bps) during the quarter, while the 10-year and 30-year Treasury yields were down 55 bps and 37 bps, respectively.[2] As was widely telegraphed leading up to its September meeting, the Federal Open Market Committee reduced its target rate by 50 bps to a range of 4.75%-5.00%. After rising in each of the first two quarters of 2024, mortgage rates sank by nearly 100 bps in the third quarter, and the 30-year fixed-rate mortgage average closed the quarter at 6.08% — a level not seen since mid-2022.[2] The overall story in the U.S. housing market remains similar to recent quarters, as still-high mortgage rates and home prices have led to significantly lower agency mortgage-backed securities (MBS) supply than in prior years. On the demand side of the equation, while the Fed has been gradually reducing its agency MBS exposure, strong demand from money managers and an uptick in purchases by banks have partially offset that impact.

The Fund's yield curve positioning, which included greater exposure to the 7- to 10-year part of the curve and an underweight to securities with durations of 20 years and longer, contributed positively to returns relative to the Index. However, relative to the benchmark, the Fund maintained a slightly shorter duration, which served as a modest detractor as interest rates fell across the curve during the quarter.

In addition, security selection and sector allocation each benefited relative returns during the quarter. The Fund benefited from its focus on the agency MBS sector, as spreads tightened during the quarter amid expectations for easing monetary policy and reduced

**1** Source: Morgan Stanley Investment Management. Data as of September 30, 2024. Performance for other share classes will vary.
**2** Source: Bloomberg L.P. Data as of September 30, 2024. One basis point = 0.01%

interest rate volatility. Further, the Fund's off-benchmark allocation to fixed-rate collateralized mortgage obligations (CMOs) produced positive total returns via a combination of price appreciation and coupon income.

The portfolio is currently structured to have an underweight in Treasurys and a yield advantage relative to the Index. The Fund's largest allocations are in agency MBS, which is a sector that has been under significant pressure in recent years. Despite tightening during the third quarter, spreads are still trading more than 20 bps wider than long-term averages,[2] which has resulted in agency MBS offering a meaningful yield pickup relative to Treasurys and other high quality alternatives.

## Strategy and Outlook

On the surface, the current state of the U.S. economy appears relatively healthy; by historical standards, real gross domestic product remains strong, earnings have been solid and the unemployment rate is quite low. However, the direction of the data, particularly on the employment side of things, is what's raising red flags for us. Since hitting its lows in 2023, the unemployment rate has risen by nearly a full percentage point,[2] and the recent acceleration we've seen has historically foreshadowed even higher unemployment ahead. The U.S. consumer has also been resilient, but signs of weakness are beginning to emerge, such as the rise in credit card and auto loan delinquencies. Overall, our expectations for continued moderation in employment and inflation data have gradually come to fruition, and the Fed has finally begun to take the necessary action as it seeks to avoid a hard landing recession. While today's fixed income investment landscape appears compelling given still-high starting yields and the prospects for easier monetary policy, we believe a discerning approach focused on uncovering attractive relative value opportunities can generate alpha in this environment.

We continue to view agency MBS as one of the more attractive sectors in global fixed income markets at the moment, as they offer an attractive combination of quality, yield and liquidity. Agency MBS spreads experienced strong returns in the third quarter, tightening by nearly 20 bps as expectations for Fed easing and lower interest rate volatility served as tailwinds.[2] That being said, the sector is still trading more than 20 bps wider than its long-term average, and despite being an AAA-rated asset class, agency MBS spreads are wider than even BBB-rated corporate bonds.[2]

We expect the coming quarters to bring softer economic data and cooler inflation, which may drive Treasury yields lower. Inflation figures have been bumpy, but the trend lower remains in place, and the Fed's desire to successfully deliver a soft landing may keep it biased toward cutting rates to a greater extent than is currently priced in. As we expect the front end of the yield curve to experience a more pronounced decline than the back end, our portfolio has maintained a steepening bias, with greater exposure to the 7- to 10-year part of the curve relative to our benchmark. From a security selection standpoint, we continue to avoid low-coupon, fixed-rate agency MBS pools, which make up the bulk of the Bloomberg U.S. Mortgage Backed Securities Index, because they trade nearly 75 bps tighter than higher-coupon agency MBS.[2] While we believe mortgage rates will likely decline over the coming year, we think the borrowers in low-coupon mortgages would need rates to fall several percentage points from their current levels before seeing a substantial prepayment pickup in these deep-discount bonds. On the other hand, we think agency MBS investors can generate more alpha over the coming year via the CMO bond market, which offers investors an opportunity to pick up longer-duration structures comparable to low coupons, at substantially wider spreads. Lastly, we believe investors in specified pools of high-coupon MBS can benefit by targeting stories which are less likely to refinance, despite declining mortgage rates.

## Fund Facts

| | |
|---|---|
| Inception Date | July 28, 1997 |
| Minimum Initial Investment ($)* | A Shares - 1,000 |
| | I Shares - 1,000,000 |
| Benchmark | Primary- Bloomberg US Long Treasury Index |
| | Custom- BBG US Government/Mortgage / BBG US Long Treasury Blended Index |
| | Former- Bloomberg U.S. Government/Mortgage Index |
| Class I expense ratio | **Gross 0.91 %** |
| | **Net 0.49 %** |
| Class A expense ratio | **Gross 1.17 %** |
| | **Net 0.85 %** |

**Where the net expense ratio is lower than the gross expense ratio, certain fees have been waived and/or expenses reimbursed. These waivers and/or reimbursements will continue for at least one year from the date of the applicable fund's current prospectus (unless otherwise noted in the applicable prospectus) or until such time as the fund's Board of Directors acts to discontinue all or a portion of such waivers and/or reimbursements. Absent such waivers and/or reimbursements, returns would**

2 Source: Bloomberg L.P. Data as of September 30, 2024. One basis point = 0.01%

* Share class availability may vary by platform. For more information, please visit the specified fund page on the website.

**have been lower. Expenses are based on the fund's current prospectus, in effect as of the date of this commentary. For information on the applicable fund's current fees and expenses, please see the fund's current prospectus.**

## Performance (%)

| *As of September 30, 2024* | MTD | QTD | YTD | 1 YR | 3 YR | 5 YR | 10 YR |
|---|---|---|---|---|---|---|---|
| Class I Shares at NAV | 1.34 | 11.21 | 5.69 | 23.72 | -0.92 | 0.31 | 1.65 |
| Class A Shares at NAV | 1.18 | 10.98 | 5.43 | 23.14 | -1.29 | -0.03 | 1.31 |
| Class A Shares (With Max 3.25% Sales Charge) | -2.12 | 7.35 | 1.95 | 19.20 | -2.37 | -0.68 | 0.97 |
| Bloomberg US Long Treasury Index | 2.02 | 7.82 | 2.42 | 15.43 | -8.36 | -4.28 | 1.09 |

**Performance data quoted represents past performance, which is no guarantee of future results, and current performance may be lower or higher than the figures shown. For the most recent month end performance figures, please visit morganstanley.com/im. Investment returns and principal value will fluctuate and fund shares, when redeemed, may be worth more or less than their original cost.**

Returns are net of fees and assume the reinvestment of all dividends and income. They are compared to an unmanaged market index. Returns for less than one year are cumulative (not annualized). Performance for one year or more is based on average annual total returns. The returns are reported for Class I and A shares. Performance for other share classes will vary.

Please keep in mind that high double-digit returns are highly unusual and cannot be sustained. Investors should also be aware that these returns were primarily achieved during favorable market conditions.

Effective May 31, 2023, the Fund changed its name from Morgan Stanley U.S. Government Securities Trust to Morgan Stanley Long Duration Government Opportunities Fund, changed its benchmark, amended its principal investment strategy to target an average portfolio duration of at least ten years under normal circumstances, and changed the portfolio managers for the Fund. See prospectus supplement for details.

### INDEX INFORMATION

**Bloomberg U.S. Long Treasury Index** measures the performance of US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury with a maturity greater than 10 years.

Blended Index performance shown is calculated using the **Bloomberg U.S. Government/Mortgage Index** from inception through 05/31/2023 and the **Bloomberg US Long Treasury Index** thereafter.

The **Bloomberg U.S. Government/Mortgage Index** includes Treasuries, government-related issues, and agency mortgage-backed pass-through securities issued by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

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The index is unmanaged and does not include any expenses, fees or sales charges. It is not possible to invest directly in an index. Any index referred to herein is the intellectual property (including registered trademarks) of the applicable licensor.

The **Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index:** tracks agency mortgage backed pass-through securities (both fixed-rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The index is constructed by grouping individual TBA-deliverable MBS pools into aggregates or generics based on program, coupon and vintage. The index is unmanaged and does not include any expenses, fees or sales charges. It is not possible to invest directly in an index.

### RISK CONSIDERATIONS

There is no assurance that a mutual fund will achieve its investment objective. Funds are subject to market risk, which is the possibility that the market values of securities owned by the fund will decline and that the value of fund shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this fund. Please be aware that this fund may be subject to certain additional risks. **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 a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. **Longer-term securities** may be more sensitive to interest rate changes. 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. **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. **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. 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 strategy could sustain a loss. **Inverse floaters** are sensitive to early prepayment risk and interest rate changes and are more volatile than most other fixed-income securities. **Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). **Zero coupon securities** are more sensitive to interest rate changes than comparable interest-paying securities. By investing in **municipal obligations**, the Fund may be susceptible to political, economic, regulatory or other factors affecting their issuers. **Portfolio Turnover.** Consistent with its investment policies, the Fund will purchase and sell securities without regard to the effect on portfolio turnover. Higher portfolio turnover will cause the Fund to incur additional transaction costs.

## IMPORTANT INFORMATION



Morgan Stanley Investment Management is the asset management division of Morgan Stanley.