Morgan Stanley Institutional Fund

# Mortgage Securities Trust

**MORTGAGE & SECURITIZED TEAM**

## Performance Review

In the quarter period ending September 30, 2024, the Portfolio's I shares returned 5.20% (net of fees)[1], while the benchmark returned 5.53%.

The Fund had no negative sector returns on an absolute basis for the quarter. The portfolio's underperformance relative to the Bloomberg U.S. Mortgage-Backed Securities (MBS) Index (the Index) was primarily due to its underweight to both duration and to agency MBS—particularly to lower coupon, fixed-rate pass-throughs as these structures have the longest duration—as agency spreads tightened 20 basis points and interest rates rallied during the third quarter.[2] However, despite having a shorter or floating-rate duration profile, global non-agency residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) performed well due to spread tightening and their strong cash flow carry.

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

## Market Review

U.S. interest rates fell materially, and the Treasury yield curve steepened during the third quarter as weaker than anticipated economic data and dovish comments from the Federal Reserve (Fed) signaled it would likely cut interest rates sooner; this was followed by a 50 basis point rate cut in September. Market expectations for rate cuts rose from 50 basis points for 2024 at the beginning of the quarter to now pricing in 125 basis points of cuts (another 75 basis points of cuts for the remainder of the year). The Fed cut its policy rate 50 basis points to 4.75% during the third quarter and indicated there will be more rate cuts to come in the fourth quarter. The 2-year U.S. Treasury rate fell 111 basis points to 3.64% during the third quarter, and the 10-year U.S. Treasury rate fell 62 basis points to 3.78% during the quarter.[3] The Fed also continued letting its MBS holdings run off during the quarter, which declined $53 billion to $2.274 trillion.[4] U.S. commercial banks' agency MBS holdings increased during the third quarter by approximately $65 billion to $2.637 trillion, but bank holdings are still down $356 billion since early 2022.[3] We expect the Fed's MBS holdings to decline through the remainder of 2024. The 30-year mortgage rate fell 65 basis points during the quarter from 6.86% to 6.21%.[3] MBS current coupon nominal spreads tightened 20 basis points during the quarter to 129 basis points above interpolated U.S. Treasurys. The Index returned 5.53% during the quarter, outperforming U.S. Treasurys by 75 basis points on a duration-adjusted basis.[3] Agency MBS underperformed Treasurys by 76 basis points for all of 2023 on a duration-adjusted basis.[3] The duration of the Index shortened 0.4 years to 5.3 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]

## Portfolio Activity

Our agency MBS pass-through exposure rose 1% to 31% during the quarter as we slightly increased our holdings when spreads were wide at the beginning of the period. Our agency collateralized mortgage obligation (CMO) positioning fell by 1% to 7% during the quarter, yet we continue to favor agency CMOs versus agency pass-through MBS as they offer higher yields.

Over the period, our U.S. RMBS holdings rose 1% to 40% as this continues to be our favorite sector and we continue to seek to add exposure and replace runoff. Our non-U.S. RMBS holdings held at 5% as we continue to favor U.S. securitized credit opportunities in over their European counterparts. Our U.S. CMBS holdings fell 1% to 5% as we remain cautious of CMBS overall and took advantage of tighter spreads to decrease some of our retail CMBS exposure. Our U.S. asset-backed securities (ABS) exposures fell 2% to 8%, and our non-U.S. ABS holdings held at 1%.

[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%
[3] Source: Bloomberg L.P. Data as of September 30, 2024.
[4] Source: Federal Reserve. Data as of September 30, 2024.

This document constitutes a commentary and does not constitute investment advice nor a recommendation to invest. The value of investments may rise as well as fall. Independent advice should be sought before any decision to invest.

**NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A DEPOSIT**

## Strategy and Outlook

After a slight widening in the second quarter, spreads largely tightened for both agency and non-agency assets in the third quarter of 2024. We expect spreads to stabilize at current levels in the final quarter of the year as securitized credit spreads are approaching agency MBS spread levels given the differentiated performance over the past several months. Overall demand levels remain strong, but we believe it will be challenging to push spreads much tighter than current levels. Securitized credit sectors have been among the best performing sectors in 2024, but performance should continue to normalize in the coming months. We also believe that after the backup in interest rates in early October, rates will likely remain rangebound for the remainder of 2024, and returns will result primarily from cash flow carry in the coming months.

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. However, given that a lower rate environment is approaching, the outlook for CMBS looks more positive than it did earlier this year. Residential mortgage credit opportunities remain our favorite sector 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 have moved from a neutral to a positive view on agency MBS valuations, which is one of the very few sectors whose spreads are flat to slightly tighter year-to-date, while nearly all other sectors' spreads have tightened materially. Agency MBS continue to remain attractive versus investment grade corporate bond spreads and versus historical agency MBS spreads, but we believe that agency MBS spreads have stabilized.

We remain most constructive on RMBS 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 – which is at the highest level in more than 40 years.[3] Lastly, residential mortgage lending standards have remained very conservative in the post-financial crisis era, and mortgage credit performance continues to be relatively pristine with very minimal delinquencies and defaults.

We remain much more cautious on commercial real estate exposure, especially to the office sector. Higher financing costs have stressed all commercial real estate sectors, but sectors such as hotels, multifamily 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. However, as mentioned earlier, the pressure of these higher financing costs should ease in the coming months as interest rates come down.

We also remain cautious on consumer ABS, as inflation, higher interest rates and declining government stimulus are showing strain on 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. We are more constructive on business-related ABS, such as aircraft leases, mortgage-servicing rights and small business loans.

We believe that the Fed will likely cut interest rates twice more in 2024 to 4.25%, after a 50 basis point cut in September. Much of the projected rate decline has now been priced into the market, but we still expect the forward path for rates will 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 for a mild recession, which we do not believe would have a material impact on our securities' performance, but 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 performance potential for the remainder of 2024.

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 (42%) given our concerns of deteriorating economic conditions and attractive relative value.

---

[3] Source: Bloomberg L.P. Data as of September 30, 2024.

## Fund Facts

| | |
|---|---|
| Inception Date | July 28, 1997 |
| Minimum Initial Investment ($)* | A Shares - 1,000 |
| | I Shares - 1,000,000 |
| Benchmark | Bloomberg U.S. Mortgage Backed Securities (MBS) Index |
| Class I expense ratio | **Gross 0.91 %** |
| | **Net 0.70 %** |
| Class A expense ratio | **Gross 1.20 %** |
| | **Net 1.00 %** |

**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 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 | 1.37 | 5.20 | 7.26 | 13.92 | 2.08 | 2.35 | 3.60 |
| Class A Shares at NAV | 1.32 | 5.05 | 6.91 | 13.51 | 1.70 | 1.95 | 3.21 |
| Class A Shares (With Max 3.25% Sales Charge) | -1.91 | 1.60 | 3.43 | 9.79 | 0.58 | 1.27 | 2.87 |
| Bloomberg U.S. Mortgage Backed Securities (MBS) Index | 1.19 | 5.53 | 4.50 | 12.32 | -1.20 | 0.04 | 1.41 |

**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.

The fund has received proceeds related to certain non-recurring litigation settlements. If these monies were not received, any period returns which include these settlement monies would have been lower. These were one-time settlements, and as a result, the impact on the net asset value and consequently the performance will not likely be repeated in the future. Please visit www.morganstanley.com/im for additional details.

### INDEX INFORMATION

The **Bloomberg 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.

"Bloomberg®" and the Bloomberg Index/Indices used are service marks of Bloomberg Finance L.P. and its affiliates, and have been licensed for use for certain purposes by Morgan Stanley Investment Management (MSIM). Bloomberg is not affiliated with MSIM, does not approve, endorse, review, or recommend any product, and. does not guarantee the timeliness, accurateness, or completeness of any data or information relating to any product.

The Indexes are unmanaged and do 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.

### 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)

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

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. **High yield securities ("junk bonds")** are lower rated securities that may have a higher degree of credit and liquidity risk. **Foreign securities** are subject to currency, political, economic and market risks. **Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). **Inverse floaters** are sensitive to early prepayment risk and interest rate changes and are more volatile than most other fixed-income securities. **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. **LIBOR Discontinuance or Unavailability Risk.** The regulatory authority that oversees financial services firms and financial markets in the U.K. has announced that, after the end of 2021, it would no longer persuade or compel contributing banks to make rate submissions for purposes of determining the LIBOR rate. As a result, it is possible that commencing in 2022 , LIBOR may no longer be available or no longer deemed an appropriate reference rate upon which to determine the interest rate on or impacting certain derivatives and other instruments or investments comprising some of the Fund's portfolio.

## IMPORTANT INFORMATION

The views and opinions and/or analysis expressed are those of the investment team as of the date of preparation of this material and are subject to change at any time without notice due to market or economic conditions and may not necessarily come to pass. Furthermore, the views will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date of publication. The views expressed do not reflect the opinions of all investment personnel at Morgan Stanley Investment Management (MSIM) and its subsidiaries and affiliates (collectively "the Firm"), and may not be reflected in all the strategies and products that the Firm offers.

This material is a general communication, which is not impartial and all information provided has been prepared solely for informational and educational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The information herein has not been based on a consideration of any individual investor circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.

Certain information herein has been prepared on the basis of publicly available information, internally developed data and other third-party sources believed to be reliable. However, no assurances are provided regarding the reliability of such information and the Firm has not sought to independently verify information taken from public and third-party sources.

**Please consider the investment objective, risks, charges and expenses of the fund carefully before investing. The prospectus contains this and other information about the fund. To obtain a prospectus (which includes the applicable fund's current fees and expenses, if different from those in effect as of the date of this commentary), download one at morganstanley.com/im or call 1-800-548-7786. Please read the prospectus carefully before investing.**

The whole or any part of this material may not be directly or indirectly reproduced, copied, modified, used to create a derivative work, performed, displayed, published, posted, licensed, framed, distributed or transmitted or any of its contents disclosed to third parties without MSIM's express written consent. This material may not be linked to unless such hyperlink is for personal and non-commercial use. All information contained herein is proprietary and is protected under copyright and other applicable law.

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

© 2024 Morgan Stanley. All rights reserved. Morgan Stanley Distribution, Inc.