

INSTITUTIONAL LIQUIDITY FUNDS

Market Insights: June 2008

Macro-Level Perspective

Morgan Stanley Investment Management is dedicated to providing our shareholders and prospective investors with relevant information regarding the positioning of our money market funds. Given recent developments in the short-term credit markets, we believe the following points are relevant when assessing the current positioning of the Morgan Stanley Institutional Liquidity Funds.

- 1) The Funds do not have any exposure to structured investment vehicles (SIVs).
- 2) The Funds do not have any exposure to auction rate securities.
- 3) The Funds do not have any exposure to single-seller mortgage conduits or structured liquidity notes.
- 4) The Funds do not have any direct, unsecured exposure to any sub-prime asset classes.
- 5) The Funds continue to invest in traditional asset backed conduits where our credit and risk teams have confidence in the quality of the assets, the structure of the conduits, and the financial strength of the sponsoring institutions.
- 6) The Funds continue to purchase deposit liabilities and senior obligations of strong financial institutions and corporations.

Morgan Stanley Investment Management continues to monitor market developments closely and is committed to managing these funds with a focus on safety and liquidity. We welcome the opportunity to discuss our investment strategy in greater detail and highly value your business.

Taxable Market

Overview

June delivered mixed results in terms of economic data. The U.S. Leading Economic Index¹ was positive, marking this index's third consecutive month of positive or neutral results. Meanwhile, the ISM Manufacturing Index ended the month slightly above 50.0 for the first time since January, which is noteworthy as readings above 50.0 are indicative of economic expansion.

Overall, however, the economy remained weak. The Consumer Price Index (CPI) and Producer Price Index (PPI) numbers surprised to the upside and payrolls continued to decline, ending the sixth consecutive month in negative territory. The 5.5% spike in the unemployment rate was significantly higher than expected. At the same time, consumer confidence continued to fall, hitting the lowest level in more than 15 years.

In light of the ambiguity between indicators signaling economic stabilization and economic deterioration, the U.S. Federal Reserve (the Fed) remains somewhat limited in how it can respond. While the Fed is concerned about inflationary pressures, it must contend with economic deterioration and financial instability.

Following seven straight rate cuts, the Fed left rates unchanged at the June FOMC meeting. Looking to the upcoming August FOMC meeting, the market generally expects the Fed again to leave rates at current levels. However, the market anticipates additional tightening by the end of the year. 1-month LIBOR² was flat over June, while 3-month LIBOR³ finished higher.

Strategy

Prime and Money Market Portfolios

During the month, in the Money Market and Prime Portfolios, we continued to maintain a relatively high cash balance in overnight maturities. We maintained this short cash level in efforts to take advantage of quarter-end technical and balance sheet pressures at major broker-dealers. Accordingly, we sought to maintain a neutral duration stance rather than extending the Weighted Average Maturity (WAM). Purchases included 1- to 3- month asset-backed CP obligations and high-quality bank and finance paper in the 5- and 6- month range.

At month-end, the WAM was the Prime and Money Market Portfolios were 46 days and 51 days, respectively.

Government and Government Securities Portfolios

In light of our view that the Fed's next move will be to raise interest rates, in the Government Portfolio we slightly shortened the portfolio's WAM. We selectively purchased obligations in the 1- to 4- month maturity space. At month-end, the Portfolio's WAM was 40 days.

For the Government Securities Portfolio, we primarily focused on securities that matured within the 1-month range. We sought to take advantage of quarter-end funding pressures by selectively purchasing small amounts of relatively inexpensive 2- to 4- month fixed rate paper and floating rate notes resetting off a daily Index. At the same time, we purchased attractive Tennessee Valley Authority (TVA) paper. At month-end, the Portfolio's WAM was 25 days.

Treasury Portfolio

The U.S. Treasury continued to experience relatively high funding needs in response to the Government's rebate checks, which are part of the Congressional fiscal stimulus package. Among purchases were short-dated Treasury bills in the 1- to 4-week range, some attractively priced term repos and 6-month Treasury obligations. At month-end, the Treasury Portfolio's WAM was 6 days.

Outlook

We will continue to structure the Portfolios to reflect the tenuous situation in the credit market. We remain focused on maintaining adequate liquidity due to the periodically illiquid market of recent months. At the same time, we will also focus on positioning the Portfolios' duration to help ensure that our clients can potentially benefit when the market is properly rewarding longer dated assets.

- Jonas Kolk, Dale Albright

Tax-Exempt Market

Overview

Municipal bonds cheapened significantly compared to Treasuries throughout the month of June. Much of the softness and decline in liquidity in the municipal market has been directly tied to recent downgrades of bond insurers this month by Standard & Poor's and Moody's Investors Service, which has resulted in forced selling from institutions that require certain ratings on insured bonds. We expect to see the slow return to more normal market conditions continue in the second half, as issuers begin to re-enter the market to sell new-money deals they delayed in the first half of the year and buyers continue to adapt to a market with fewer insured deals and to global ratings scales that yield less differentiation in municipal bond ratings. The SIFMA Index⁴ of weekly variable rate securities dropped 7 basis points from 1.62% at the end of May to 1.55% at the end of June. The Bond Buyer One-Year Note Index⁵ dropped 10 basis points from 1.79% to 1.69%. The new issue calendar remained strong throughout June in conjunction with issuers' desire to restructure troubled auction rate and mono-line insurance backed debt.

Strategy

We continued to maintain our ongoing efforts to protect the safety and liquidity of the Portfolio's assets, taking additional steps to reduce or eliminate exposure to institutions under stress. Morgan Stanley Investment Management is dedicated to providing our shareholders and prospective investors with relevant information regarding the positioning of our money market funds.

Given recent developments in the short-term credit markets, we believe the following points are relevant when assessing the current positioning of the Morgan Stanley Institutional Liquidity Funds- Tax-Exempt Portfolio.

- 1) Over the past three quarters, we have identified and eliminated any securities enhanced by the troubled mono-line insurers that do not have the benefit of additional guarantees or protection, such as the presence of an irrevocable Letter of Credit.
- 2) The Funds do not have any exposure to auction rate securities.

Morgan Stanley Investment Management continues to monitor market developments closely and is committed to managing these funds with a focus on safety and liquidity.

Outlook

During this period of market upheaval, we continue to remain diligent for any new developments that may impact the Portfolio. We will also continue to closely monitor the implications of the slowing economy on municipal government balance sheets.

- Kathy Stromberg, Paul Daggy

- 1 The U.S. Leading Economic Index is an American economic index intended to estimate future economic activity.
- 2 1-Month LIBOR is the London Inter-Bank Offered Rate for a one month deposit in U.S. Dollars on the last business day of the previous month.
- 3 3-Month LIBOR is the London Inter-Bank Offered Rate for a three month deposit in U.S. Dollars on the last business day of the previous month.
- 4 The SIFMA Index is issued weekly and is compiled from the weekly interest rate resets of tax-exempt variable rate issues included in a database maintained by Municipal Market Data which meet specific criteria established from time to time by The Bond Market Association.[®]
- 5 The Bond Buyer One-Year Note Index is based on estimated yields for theoretical new one-year note issues from 10 state and local issuers: California, Colorado, Idaho, Los Angeles County, Michigan, New Jersey, New York City (RANs), Pennsylvania, Texas and Wisconsin. The index is an unweighted average of the average estimated bid-side yields for the 10 issues.

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Please consider the investment objectives, risks, charges and expenses of the fund carefully before investing. The prospectus contains this and other information about the fund and can be obtained by contacting your financial professional, or by downloading a copy at morganstanley.com. Please read the prospectus carefully before investing.

Risk Considerations

There is no assurance that a portfolio will achieve its investment objective. **An investment in a money market portfolio is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the portfolio seeks to preserve the value of an investment at \$1.00 per share, if it is unable to do so, it is possible to lose money by investing in the portfolio. Accordingly, you can lose money investing in any of these portfolio's. Please be aware that these portfolio's may be subject to certain additional risks, such as Fixed-income securities.** Subject to credit and interest-rate risk. Credit risk refers to the ability of an issuer to make timely payments of interest and principal. Interest rate risk refers to fluctuations in the value of a fixed-income security resulting from changes in the general level of interest rates. In a declining interest-rate environment, the portfolio may generate less income. In a rising interest-rate environment, bond prices fall.

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