Morgan Stanley

INVESTMENT MANAGEMENT

Investing Overseas with Morgan Stanley's International Equity Team

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | INVESTMENT INSIGHT | 2018

William Lock, who led Morgan Stanley's International Equity team through the 2008 financial crisis, has invested for over 25 years in overseas markets. His team's Morgan Stanley Institutional Funds (MSIF) International Equity Portfolio, nearing the end of its third decade, has delivered shareholder returns at an annualised rate of 8.6% since 1989—nearly twice the rate of the MSCI EAFE Index.[1]

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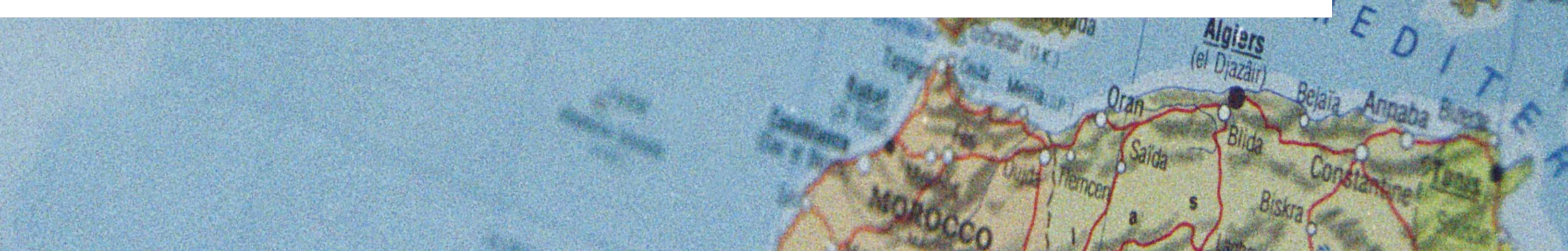
"Long term, it's all about the compounding", says Lock. "$100 invested at 8.6% annualized over 28 years will grow to just over $1,000, compared to the just over $380 the MSCI EAFE Index rate of 4.8% would have given you *(Display 1)*. The key is to avoid companies with fading returns and to determine the appropriate margin of safety on a company by company basis. The goal is to deliver attractive absolute portfolio returns in rising markets, a measure of downside protection in challenging markets, and a lower volatility of returns than the MSCI EAFE Index.

A focus on price and prospects

Lock continues, "We achieve this by bottom-up stock picking, investing in companies that can broadly be categorized as either Value Opportunities or High Quality Compounders. For Value Opportunity companies, we look for improving returns due to management actions and/or cyclical tailwinds, with a

"The key is to avoid fading returns"

[1] Source: Morgan Stanley Investment Management, MSCI. Data as of 31 December 2017.



sufficient discount to intrinsic value to compensate for risk. Companies in the High Quality Compounder category can generally sustain their high returns on operating capital by virtue of their powerful intangible assets and pricing power, are run by management teams dedicated to preserving these returns, and can be found at intrinsic value or better. There is no top-down allocation between the two types of companies—we are stock pickers and the proportion of companies in the two categories is determined by the individual price and prospects for each company we invest in, on a bottom-up basis. Our overall investment opportunity is having a longer time horizon than the market and where appropriate, a disagreement with the market on the shape of the cycle or the size of the restructuring opportunity.

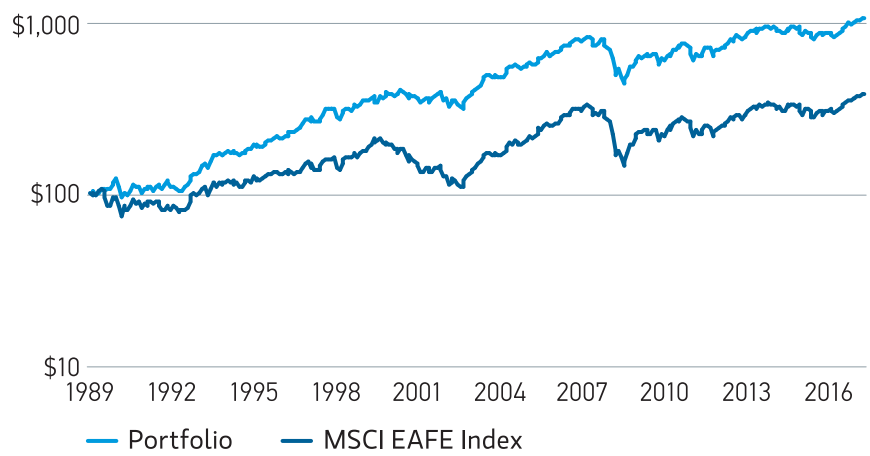
Asymmetry and relative downside protection

This value and quality combination underpins the portfolio's asymmetric performance profile—reasonable up-market participation and an ability to withstand shocks. "It's a bit like the opening line to Kipling's poem IF," says Lock. *"...if you can keep your head when all about you are losing theirs..."*. Markets have the habit of turning. We've seen eight negative market years since 1989. Over the life of our fund, we've provided a measure of relative downside protection, on average declining 7% compared to a 15% fall in the market. In rising markets, we've delivered an average annual increase of 16% compared to 17.5% for MSCI EAFE Index.[2] So it's this asymmetric return profile that has given us the superior compounding over time. *Display 2*, which shows the fund's three-year returns have exceeded the index in nearly all downturns, illustrates this asymmetry.

DISPLAY 1

Long-term Compounding since inception

MSIF International Equity Portfolio, I share class

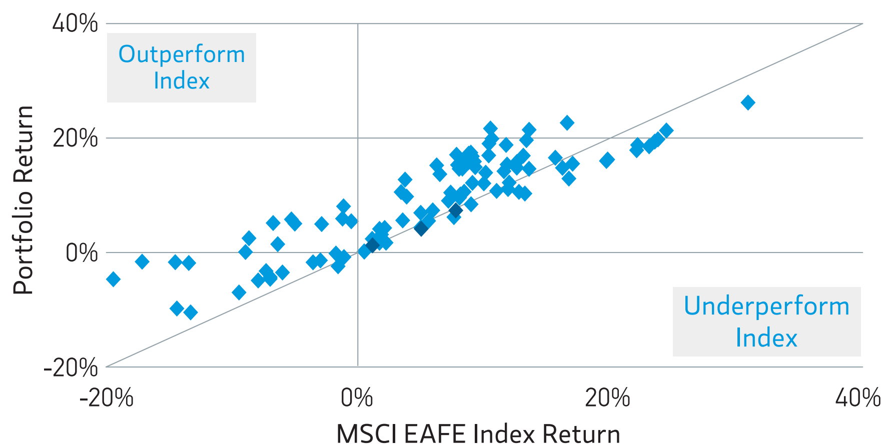


Source: Morgan Stanley Investment Management. Data since inception date of September 30, 1986 through December 31, 2017. **Past performance is no guarantee of future results. For each portfolio may differ due to specific investment restrictions and guidelines. Individual results will vary.** I share class of the MSIF International Equity Portfolio. Performance returns reflect the average annual rates of return. Performance returns are compared to those of an unmanaged index and are considered to be a relevant comparison to the portfolio. Comparisons of performance assume the reinvestment of all dividends and income. **Please see the fund's standardized performance on page 5.**

DISPLAY 2

Rolling 3 year annualised returns – quarterly data

The fund has demonstrated strength in down markets



Source: Morgan Stanley Investment Management. **Past performance is no guarantee of future results.** The returns represent the Morgan Stanley Institutional Fund International Equity Class I shares and are presented net of fees, and include the reinvestment of all dividends and income. Performance for other share classes will vary. It is not possible to invest directly in an index.

[2] Source: MSCI, FactSet. Data as of 31 December 2017.

"We're seeing plenty of investor interest right now in international ex-U.S. markets on the basis they are seen to be more at the mid-stage rather than late stage of a recovery, and in the case of Europe and Japan, probably in the sunset of their loose monetary policy era.

"As for valuations, given the EAFE market is now trading on a P/E ratio (price to the next twelve months earnings estimate) above its last cycle peak, achieved just prior to the global financial crisis, we don't generally see much striking value in the markets. Yes, international markets are cheaper relative to the U.S., but we're talking largely fully priced compared to more than fully priced, in our view.

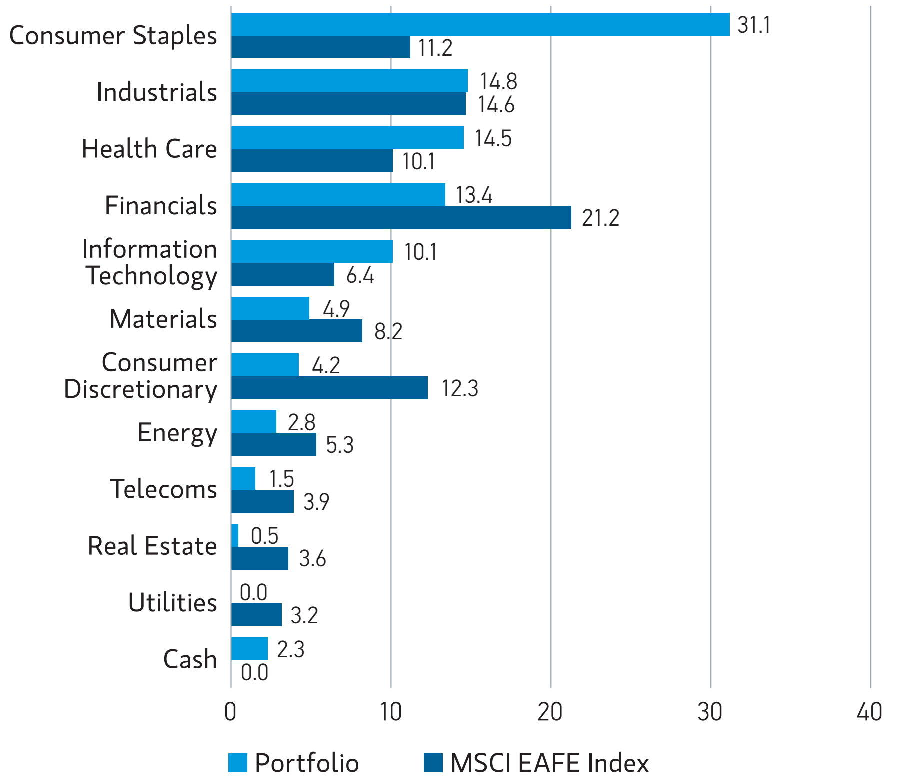
Skewed towards high quality compounders . . . for now

"So given where markets are, the balance between the portfolio's High Quality Compounders and Value Opportunities is skewed towards the Compounders. If we saw an attractive combination of price and prospects in Value Opportunities, the skew would naturally develop in the other direction through bottom-up stock picking. We have over-weights in consumer staples, health care and technology, and underweights in consumer discretionary, financials and materials *(Display 3)*. The portfolio's revenue exposure is very global, with 33% in emerging markets, 19% in Europe, 24% in the USA and 13% in Japan." *(Display 4)*

DISPLAY 3

Sector Weightings

MSIF International Equity Portfolio, I share class

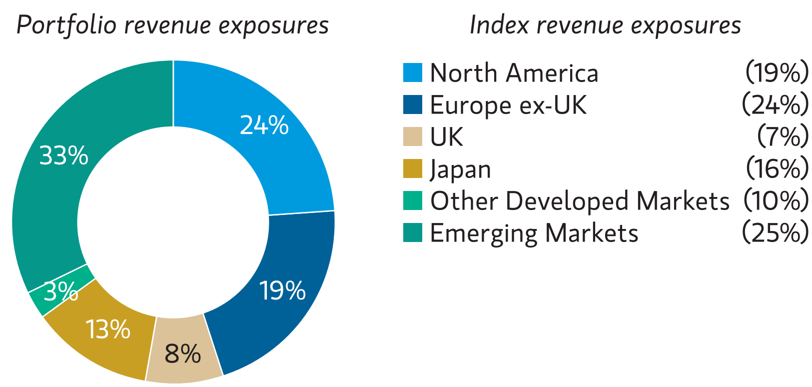


Source: Morgan Stanley Investment Management. Data as of December 31, 2017. Subject to change daily. Provided for informational purposes only and should not be deemed as a recommendation to buy or sell securities in the industries shown above.

DISPLAY 4

Revenue Exposure

MSIF International Equity Portfolio (I Shares) and MSCI EAFE Index



Source: MSCI, FactSet and Morgan Stanley Investment Management. Data as of December 31, 2017. Updated quarterly. This portfolio is actively managed therefore holdings may not be current. Provided for informational purposes only and should not be deemed as a recommendation to buy or sell the securities mentioned or securities in the countries or regions shown above. Holdings are weightings are subject to change. Each portfolio may differ due to specific investment restrictions and guidelines. Weighted Regional Exposure – percentage of Company Sales. Excludes cash and re balanced to 100%. Data shown is the MSCI EAFE Index.

"Unilever[3] *(Display 5)*, one of our top holdings, trades at near a ten-year relative low to the MSCI USA consumer staples sector on price to the next twelve months estimated earnings', says Nic Sochovsky, "despite the company out-earning US staples companies over the same period and having all the hallmarks of quality we look for. Unilever has demonstrated high and improving returns on operating capital over the last 10 years, rising from 58% to 66%. They have spent Euro 160bn over the last 20 years *alone* on marketing and incremental innovation to *reinforce* a very high mind-share moat, meaning their well invested brands typically occupy No 1 and No 2 category positions. The company has exceptional reach, being in 190 countries and 30 million outlets globally, and management effectively deploys a global/local model to empower local decision making. On top of this, they have a relentless focus on costs, with programs focusing on the supply chain to enhance the gross margin, zero-based budgeting for the operating costs, and Connected For Growth to focus on a leaner senior and mid-management layer.

DISPLAY 5

Top Ten Holdings

MSIF International Equity Portfolio

SECURITY	INDUSTRY	COUNTRY	(%)
British American Tobacco	Tobacco	United Kingdom	4.8
Unilever	Personal Products	Netherlands	4.3
Reckitt Benckiser	Household Products	United Kingdom	4.1
L'Oréal	Personal Products	France	3.9
Pernod Ricard	Beverages	France	3.8
GlaxoSmithKline	Pharmaceuticals	United Kingdom	3.7
RELX*	Commercial & Professional Services	United Kingdom, Netherlands	3.6
Shiseido	Personal Products	Japan	3.3
Novartis	Pharmaceuticals	Switzerland	3.3
Tencent	Internet Software & Services	China	3.0
Total			**37.9**

Source: Morgan Stanley Investment Management. Data as of December 31, 2017. Subject to change daily. Provided for informational purposes only and should not be deemed as a recommendation to buy or sell the securities mentioned or securities in the industries and countries shown above. *The position relating to RELX Group plc has been aggregated and is comprised of RELX PLC and RELX NV securities. This has been aggregated in accordance to the split of ownership. Should separate holdings be required, contact Morgan Stanley Investment Management.

"58% of their revenues come from Emerging Markets. We like stocks with exposure to the emerging market consumer, where organic growth rates have typically been 2-3 times those of the developed consumer. It's worth noting that whilst the MSCI USA Index only has 15% of its revenues exposed to emerging markets and the MSCI EAFE Index has 25%, our fund has 32%, with sales ranging from leisure to baby food, cosmetics, medicines, drinks, tobacco and protection insurance".[4]

"What really matters for Value Opportunity companies", says Portfolio Manager Bruno Paulson, "is being selective in what you own—looking for companies where returns are headed in the right direction. In Japan, we're seeing returns improving due to management actions in industries from beer to beauty. We have exposure to potential cyclical improvement in the starved mining equipment industry and also have positions in robotics and automation—a particular Japanese strength. Elsewhere, we're finding cheap compounders in European pharmaceuticals. In materials, we see opportunities in construction where earnings offer high operational leverage to any economic recovery. We're wary of industrial metals due to concerns over Chinese demand. In financials, we prefer insurers to banks since the margin of safety is better owing to relatively limited solvency, liquidity and regulatory risks. Few bank franchises can beat their cost of capital and the de-levering and forced alterations to their business models requires a heavy discount to account for the considerable risks.

Deflecting disruption

"We're seeing a host of disruptive forces globally, especially in the supply chain. Areas that we're steering clear of include food companies that are struggling with both price and competition from the trinity of discounters, e-commerce and innovative new entrants. In auto components the advent of electric cars, where the parts requirement will be much less, will hurt the traditional supply chain. Cars will always need tyres, but what about the future sales of transmission systems, spark plugs and valves for example? In energy, fossil fuel companies run the risk of

[3] Second largest stock holding for the MSIF International Equity Portfolio as of 31 December 2017.

[4] Source: MSCI, FactSet, Morgan Stanley Investment Management. Data as of 31 December 2017.

capital misallocation by investing in future reserves that could be supplanted by renewables, raising the risk of stranded assets.

"We think a lot about the positive and negative impacts of disruptive change in our portfolio and believe that the names we own are generally well positioned to adapt and grow in a period of unprecedented change."

"In our view", concludes Lock, "in a world of high expectations and high valuations, but with a lack of market consideration for any risk, bottom up stock selection and a focus on price and prospects—is the most effective approach to the risk and rewards the international equity market has to offer".

DISPLAY 6

Annualized performance

MSIF International Equity Portfolio, I share class as of December 31, 2017

	MTD	QTD	YTD	1 YEAR	3 YEAR	5 YEAR	10 YEAR	SINCE INCEPTION 8/4/89
MSIF International Equity Portfolio	0.97	3.79	25.17	25.17	7.17	6.84	2.86	8.60
MSCI EAFE Index	1.61	4.23	25.03	25.03	7.80	7.90	1.94	4.83

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.

The gross expense ratio is 0.98% for Class I shares and the net expense ratio is 0.95%. 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. The minimum initial investment is $5,000,000.

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 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 views and opinions expressed are those of the portfolio management team at the time of writing and are subject to change at any time due to market, economic, or other conditions, and may not necessarily come to pass. These comments are not representative of the opinions and views of the firm as a whole. Holdings and sectors/region weightings are subject to change daily. All information provided is for informational purposes only and should not be deemed as a recommendation to buy or sell securities in the sectors and regions referenced.

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.

RISK CONSIDERATIONS:

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline. Accordingly, you can lose money investing in this strategy. Please be aware that this strategy may be subject to certain additional risks. In general, **equities securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, market and liquidity risks. Investments in **small- and medium-capitalization** companies tend to be more volatile and less liquid than those of larger, more established, companies. The risks of investing in **emerging market** countries are greater than risks associated with investments in foreign developed markets. **Derivative instruments** can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the portfolio's performance. Illiquid securities may be more difficult to sell and value than publicly traded securities (liquidity risk).

The **MSCI EAFE Index** is a free float-adjusted market capitalization index that is designed to measure the international equity market performance of developed markets, excluding the US & Canada. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The MSCI EAFE Index currently consists of 21 developed market country indices. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

The **MSCI U.S. Index** is designed to measure the performance of the large and mid-cap segments of the U.S. market.

The indexes are unmanaged and do not include any expenses, fees or sales charges. It is not possible to invest directly in an index.

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. To obtain a prospectus, contact your financial advisor or download one at morganstanley.com/im. Please read the prospectus carefully before investing.

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