Performance Review

In the quarter period ending March 31, 2019, the Portfolio’s I shares returned 11.19% (net of fees), while the benchmark returned 9.98%.

The portfolio outperformed in the first quarter, despite the very strong markets. Sector allocation was positive, as the benefits from the overweight in consumer staples and information technology, along with the underweight in consumer discretionary and financials, more than offset the drag from the small cash holding. Stock selection was also positive overall, as the impact of the sector-beating performance in financials, information technology and energy was larger than the effect of the underperformance in health care and materials.

The largest contributors to absolute performance during the quarter were Constellation Software (2.55% of the portfolio), British American Tobacco (2.76% of the portfolio) and Novartis (3.52% of the portfolio). The largest detractors were Henkel (2.85% of the portfolio), Bayer (2.01% of the portfolio) and BT Group (1.03% of the portfolio).

Market Review

During the quarter, the MSCI EAFE Index was up a striking 10.0% in U.S. dollars (USD), and a similar 10.6% in local currencies. Falling interest rate expectations helped real estate (+14%), but were relatively unhelpful to financials (+7%). Despite the strong quarter there was no clear cyclical/defensive split. The outperformers included the cyclical materials (+13%), industrials (+11%) and information technology (+15%) sectors, but also consumer staples (+12%) and health care (+11%). On the other side, consumer discretionary (+8%) underperformed along with financials, but so did the more defensive communication services (+4%) and utilities (+9%).

The quarter was also rather muddled by geography. Hong Kong (+16% USD and local) massively outperformed Singapore (+6% USD and local), and amongst the resource-rich countries, Canada (+15% USD, +13% local) was far stronger than Norway (+7% USD, +6% local). There was a similar lack of pattern in Europe, with Italy doing well (+15% USD, +17% local), while Germany and Spain (both +7% USD, +9% local) struggled in relative terms. The U.K. (+12% USD, +9% local) actually outperformed EAFE, despite the troubled political situation, while Japan (+7% USD, +8% local) was amongst the laggards. The U.S. (+14%) finished the quarter ahead of the EAFE index.

Portfolio Activity

It was a relatively quiet quarter for portfolio activity, with turnover only 3.5%. We initiated a position in Ashtead (0.61% of the portfolio), the U.K.-listed industrial equipment rental business. It is an industry leader, operates in a market that is growing (as rental penetration deepens), and has an opportunity to significantly increase its market share over the next decade. Eighty-five percent of sales and 90% of profits are from its fast growing U.S. Sunbelt business. Over the last decade, Sunbelt has doubled its market share in the U.S. to 8%, mostly from organic expansion, quadrupling Ashtead’s capital base at a circa 20% return on capital. We believe the opportunity for Sunbelt remains large given the very fragmented industry, with 70% of the market held by firms with no more than 0.2% market share.

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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.
The Ashtead position was funded by exiting Aggreko. While Aggreko’s developed market rental solutions business has improved, the emerging market utility business has continued to deteriorate, meaning that it is unclear how group returns can improve from current levels. We also sold the position in CRH during the quarter. Cement has relatively low returns across the cycle, as it is plentiful and easy to extract, and we are wary of the optimistic consensus outlooks that have driven the recent re-rating.

Outlook

2019 has some worrying echoes of 1999. Markets are up strongly despite soggy earnings, initial public offering frenzy is back on CNBC as Lyft starts the wave of unicorns heading to market before the music stops, and perhaps most alarmingly, Goldman Sachs has abolished business dress. (Lyft and Goldman Sachs are not held in the portfolio.) Even the Backstreet Boys are back! This may be more anecdotal than scientific, but it is all starting to feel rather late cycle and, therefore, arguably a good time to deploy a late-cycle buffer, if one is not in place already.

Applying a bit more rigor, at the start of 2018 we were worried about the elevated level of market multiples. By the end of 2018, which saw a sharp derating, our primary worry had shifted over to earnings. After Q1, which saw double-digit returns despite a global economic slow-down, we are now anxious about both multiples and earnings. We like to say the good news is that there are only two ways to lose money in equities... if the earnings go away or if the multiple goes away. The bad news right now is that both are under threat.

The multiples are a concern as they have bounced back to the September levels, with MSCI EAFE Index back above 13x the next twelve months’ earnings as Q1 reversed the Q4 derating. It is true that some of the fears that stalked Q4 have faded, thanks to the seeming U-turn from the U.S. Federal Reserve and the more positive mood-music from the U.S.-China trade talks, but the experience of last year’s two market swoons suggests that there is significant downside multiple risk, even without any cyclical earnings shock.

As for earnings, our underlying anxiety is that they may be unsustainably high, particularly in the U.S. Margins are near peak levels, as are profits’ share of gross domestic product and the level of earnings-per-share-boosting leverage. Earnings are also drifting down while the market surges up. The 2019 MSCI EAFE earnings estimates are off 7.0% since the start of Q4 2018 and 4.7% year-to-date. In the U.S., where quarterly data is available, earnings are actually expected to be down around 3% year-on-year in Q1 2019. The interesting point is the source of the U.S. earnings drop. Revenues are still healthy, up around 5% on the year, but the margins are falling. Costs are rising in the U.S., notably for labor, and many companies are having trouble passing them on. The National Association of Business Economics reported that 58% of respondents were facing higher labor costs, but that only 19% had been able to increase prices, presumably the 19% with the strongest pricing power. The market, as per usual, assumes that things will improve. By Q4 2019, consensus has U.S. earnings up nearly 10% year-on-year, as against the Q1 2019 fall. Our fear is that this may be over-optimistic, either due to the late-cycle margin pressure, or the even-later-cycle economic downturn.

If we are indeed late cycle, and therefore vulnerable to late-cycle margin pressure followed by an economic downturn, then a compounding-rich portfolio seems a reasonable place to hide. Compounds have sustainable high returns supported by powerful intangible assets. Importantly, we also require strong pricing power, recurring revenues and limited operational and financial leverage. The pricing power, generally fed by powerful brands and networks, allows companies to protect their margins when costs rise, while the recurring revenues, from repeat purchases or long-term contracts, support the level of sales. The combination of robust sales and robust margins should help drive robust profits, particularly if there is limited operational or financial leverage.

The portfolio offers a mix of compounders and value opportunities, which varies over time on a bottom-up analysis of the risk and return available stock-by-stock. At present, the portfolio is heavily biased towards compounders versus history. We estimate, on an admittedly subjective basis, that 57% of the portfolio is invested in compounders. This leads to a portfolio that is far higher-quality than the index, given a far higher return on operating capital employed (23% vs. 16%) and gross margin (35% vs. 25%). Another measure is the elevated weightings in the two highest quality and most defensive sectors, consumer staples and health care, which between them are 48% of the portfolio, over twice their 23% weight in the index. While of course past performance doesn’t guarantee future outcomes, these were the two sectors whose earnings held up best during the 2008-09 Global Financial Crisis.

On forward price-to-free cash flow, our favored valuation metric, the portfolio trades on only a 12% premium to the far lower-quality MSCI EAFE Index, despite the far higher return on capital, gross margins and margin stability. We would argue that this 12% is actually an overstatement of any real premium, given the market’s chronic failure to deliver the expected forward earnings and the habit of tucking any unpleasant news ‘below the line’.

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2 Source: FactSet. Data as of 31 March 2019.
3 Source: Refinitiv. Data as of 31 March 2019.
The market had two ‘mini-strokes’ last year, both of which were followed by fairly speedy full recoveries. Importantly, both were temporary de-rating incidents, rather than any serious earnings shocks. The real test of defensiveness will come when the economic cycle finally comes to an end, revealing companies’ earnings power in tough times. Our hope is that the heavy weight in compounds will then come into its own.

FUND FACTS
Launch date
August 04, 1989
Base currency
U.S. dollars
Index
MSCI EAFE Index

Performance (%)  
As of March 31, 2019 (Class I Share at NAV)

<table>
<thead>
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<th></th>
<th>MTD</th>
<th>QTD</th>
<th>YTD</th>
<th>1 YR</th>
<th>3 YR</th>
<th>5 YR</th>
<th>10 YR</th>
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<td>MSIF International Equity Portfolio - I Shares</td>
<td>2.18</td>
<td>11.19</td>
<td>11.19</td>
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<td>-3.71</td>
<td>7.27</td>
<td>2.33</td>
<td>8.96</td>
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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 0.99% 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. Performance 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.

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).

INDEX INFORMATION
The MSCI EAFE Index (Europe, Australasia, Far East) 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 performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

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

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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. 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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