

# Morgan Stanley Investment Funds

## Diversified Alpha Plus Fund

### Commentary<sup>1</sup>

- Global bonds and stocks sold off in the first half of October, with the JPM Global Government Bond Index down -2.8% in USD, and MSCI ACWI down -1.7% USD. As negative correlation between stocks and bonds has persisted over the past two cycles, the current reversal is potentially significant. Our analysis shows that such a reversal happens when the inflation outlook changes, and it is likely that signs of acceleration in U.S. inflation, having become apparent earlier this year, are finally being noticed. Fed Chair Yellen's October 14<sup>th</sup> speech, in which she all but advocated optimal control (i.e., letting the economy overheat to stimulate the supply-side) contributed to the higher inflation outlook. U.S. 10-year inflation breakevens widened +6 bps to 1.68%, and are now 30 bps wider than the post-Brexit trough.
- Brent oil rose +5.9%, reflecting optimism about a production cut by OPEC. Growth data was marginally better than expected, continuing to support the mild "reflation" environment we believe we are in now. Energy was the top performing sector, followed by financials, which was helped by higher rates and better growth. Defensive sectors broadly underperformed.
- It is unclear whether this break in stock/bond correlation will be durable, as it would be difficult for any major economy to overheat in the absence of a major credit cycle or fiscal stimulus. The former remains unlikely, given the high debt levels in most major economies, and optimism about the latter seems premature. Still, higher inflation remains a goal for policy makers.
- The sterling fell -6.0% vs. the U.S. dollar, with the sell-off triggered by UK Prime Minister May's populist speech in Birmingham, which advocated a hard Brexit. In our view, it is unclear if May's speech indicates a genuine change of course, rather than a typical politician's overpromising to gain voters from other parties. We note that "remain" and "leave" forces continue to be finely balanced, both within the Parliament and among the populations of the four nations in the UK, arguing for a soft approach. We had tactically closed our position in the sterling early in the month, limiting losses. We believe value in the GBP remains compelling, and we expect it to be revealed by the UK's current account narrowing in the coming months.
- In the first half of October, the Fund rose +0.5%. The top contributors were our "long value / short expensive safety" plays (short global government bonds, long banks). Longs in U.S. airlines and the MXN, and shorts in U.S. apartment REITs and the RMB also contributed. These gains were partially offset by losses from a short in luxury and a long in European airlines.
- In the first two weeks of October, we initiated a short position in equities, as we believe equities will remain threatened by higher rates. We added to long positions in U.S. and Eurozone banks, which we expect to benefit from cyclical improvement and higher rates. We booked profits on our short position in the Turkish lira, and we closed our short in luxury goods and our longs in European airlines and SEK vs. EUR, having hit our stops.

### Asset Allocation (%) as of 15 October 2016

	Net Exposure <sup>4</sup>	Gross Exposure <sup>5</sup>
<b>GLOBAL EQUITY<sup>6</sup></b>	<b>-11.5</b>	<b>102.0</b>
Developed Markets	-12.5	100.9
U.S. & Canada	-19.7	68.2
Europe	5.6	31.1
Japan	1.6	1.6
Asia ex-Japan	0.0	0.0
Emerging Markets	1.1	1.1
<b>GLOBAL FIXED INCOME<sup>7</sup></b>	<b>-24.1</b>	<b>85.8</b>
Developed Markets	-28.1	81.8
U.S. & Canada	-13.8	46.7
Europe	-21.9	22.6
Japan	-2.5	2.5
Asia ex-Japan	10.1	10.1
Emerging Markets	4.1	4.1
<b>COMMODITIES</b>	<b>0.9</b>	<b>0.9</b>
Brent Oil	0.9	0.9
<b>TOTAL EXPOSURE (Net of Cash)</b>	<b>-34.7</b>	<b>188.7</b>

<sup>1</sup>SITC (Since Investment Team Change) = annualized performance since change of investment team and policy as of 15 August 2011.

<sup>2</sup>Inception = annualized performance since 3 June 2008, the launch date of the MS INV Diversified Alpha Plus VaR 400 (Euro) Fund, managed by a different team with a different investment policy.

### Net Performance (%) as of 15 October 2016<sup>2</sup>

Class I Shares	MTD	QTD	YTD	SITC*	Since Inception**
Diversified Alpha Plus Fund	0.5	0.5	-6.9	2.5	1.9

### Contribution to Absolute Return (%) as of 15 October 2016<sup>3</sup>

	MTD	QTD	YTD	SITC*
Equity	0.0	0.0	-3.7	-0.1
Fixed Income	0.6	0.6	-1.4	1.0
Commodities	0.0	0.0	0.7	0.5
Cash/Currency	0.0	0.0	-1.7	2.1

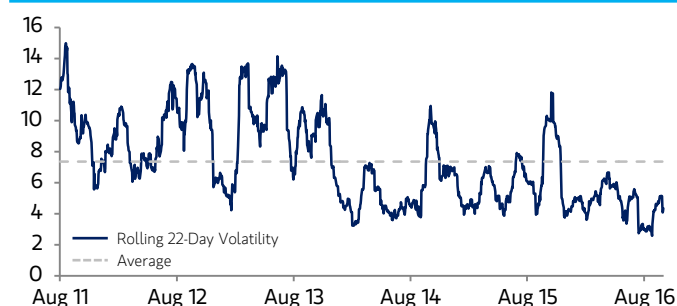
### Net Performance as of 15 October 2016 (€)<sup>2</sup>

Class I shares, performance of €100 invested since change of investment team, 31 August 2011



For net performance since inception, please see graph on page 2.

### Rolling 22-Day Volatility (%) as of 15 October 2016



Past performance is no guarantee of future results.

### Top Thematic Equity Pairs (%) as of 15 October 2016

	Gross Long <sup>5</sup>	Gross Short <sup>5</sup>	Net <sup>4</sup>
Long Eurozone Domestic Equities / Short U.S. Equities	12.9	-12.9	0.0
Short Global Aerospace / Long Global Equities	11.8	-11.8	0.0
Short U.S. Staples / Long U.S. Equities	8.9	-10.5	-1.6
Short U.S. Media / Long U.S. Equities	7.5	-7.5	0.0
Short U.S. Apartment REITs / Long U.S. REITs	7.2	-7.2	0.0
Long U.S. Banks / Short U.S. Equities	7.0	-7.0	0.0
Long U.S. Pharmaceuticals / Short U.S. Equities	4.2	-4.2	0.0
Long Eurozone Banks / Short Eurozone Equities	3.9	-3.9	0.0
Short European Staples / Long Eurozone Equities	3.4	-3.4	0.0
Long U.S. Housing / Short U.S. Equities	3.1	-3.1	0.0
<b>TOTAL EXPOSURE</b>	<b>69.9</b>	<b>-71.5</b>	<b>-1.6</b>

<sup>4</sup>SITC (Since Investment Team Change) = annualized performance since change of investment team and policy as of 15 August 2011.

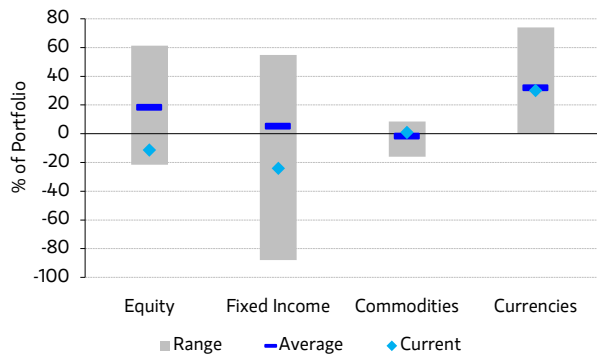
<sup>5</sup>Inception = annualized performance since 3 June 2008, the launch date of the MS INV Diversified Alpha Plus VaR 400 (Euro) Fund, managed by a different team with a different investment policy.

## Net Performance as of 15 October 2016 (€)<sup>2</sup>

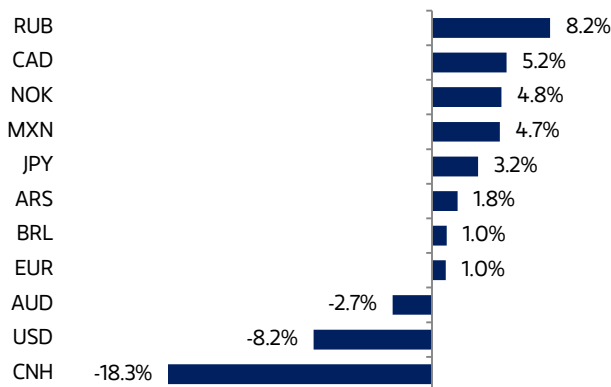
Class I shares, performance of €100 invested since inception, 3 June 2008



## Historical Net Exposures as of 15 October 2016<sup>6,7</sup>



## Currency Breakdown as of 15 October 2016<sup>9</sup>



## Top Fixed Income Positions as of 15 October 2016<sup>7</sup>

	Rating <sup>8</sup>	Gross Long <sup>4</sup>	Gross Short <sup>4</sup>	Net <sup>3</sup>
Long U.S. 10-Year TIPS / Short U.S. 10-Year Treasuries	A-1+ / NR	14.3	-12.4	1.8
Short Global 10-Year Gov't Bonds <sup>7</sup>	NR	0.0	-10.9	-10.9
Long Australian 10-Year Bonds / Short German 10-Year Bunds	A / NR	10.1	-10.1	0.0
Short U.S. 10-Year Treasuries	A	0.0	-8.5	-8.5
Short German 10-Year Bunds	NR	0.0	-8.4	-8.4
Long U.S. High Yield Bonds / Short U.S. 10-Year Treasuries	B+ / NR	2.5	-3.4	-0.9
Long Greek Bonds (Full Strip)	B-	1.7	0.0	1.7
Long Argentine 10-Year Bonds / Short U.S. 10-Year Treasuries	B- / NR	1.3	-1.3	0.0
Long Brazilian 5-Year Bonds	BB	1.0	0.0	1.0
<b>TOTAL EXPOSURE</b>		<b>30.9</b>	<b>-55.0</b>	<b>-24.1</b>

Source: Morgan Stanley Investment Management; Bloomberg (unless otherwise stated).

**Past performance is not indicative of future results.**

- Views expressed herein are the opinions of the Global Multi-Asset team and are subject to change based on market and economic conditions. These views are not necessarily representative of Morgan Stanley Investment Management (MSIM) or the firm as a whole. All performance figures are for the two week period ending 15 October 2016.
- Performance is quoted net of investment management fees and with income reinvested. For cash management purposes the Fund may invest shares in Morgan Stanley liquidity funds.
- Contribution to returns by asset class are meant to be representative of performance and may not sum to actual.
- Net exposure % calculated as [(MV of long cash security and derivative positions)-(absolute value of MV in short derivative positions)]/(portfolio MV)
- Gross exposure % calculated as [(MV of long cash security and derivative positions)+(absolute value of MV in short derivative positions)]/(portfolio MV)
- When applicable, equity exposures are delta-adjusted to account for options trades.
- Fixed income exposures are duration-adjusted (10-Year U.S. Treasury equivalents). Global 10-year government bond basket weights: 42% U.S., 28% Germany, 23% Japan, 7% UK.
- Ratings include derivatives. Futures are not rated (NR). For high yield cash bond basket, median rating has been provided; the basket's ratings range from BBB- to CCC-.
- Currency exposure is relative to the Fund's base currency (EUR). RUB exposure includes delta-adjusted notional exposure of RUB options positions (totaling +2.8%).

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The sources for all performance are Morningstar and Morgan Stanley Investment Management Limited. Calculations are NAV to NAV.

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