Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Investment Funds

US Property Fund

MARKETING COMMUNICATION | GLOBAL LISTED REAL ASSETS TEAM | MONTHLY COMMENTARY | 30 JUNE 2022

Important information

- The Fund invests primarily in equity securities of companies in the US real estate industry.
- Investment involves risks. Key risks for this fund include Risk of Investment in the Real Estate Industry and REITs, Risk of Investment in Equity and Risk of Exposure to the Euro and Eurozone.
- There is a risk that you may potentially lose your entire investment in this Fund.
- The investment decision is yours but you should not invest unless the intermediary who sells it to you has advised you that it is suitable for you and has explained why, including how buying it would be consistent with your investment objectives. You should not make any investment decision solely based on this document. Please read the relevant offering document carefully for further fund details including risk factors.

Performance and Market Review

In the three month period ending 30 June 2022, the Fund's A shares returned -20.61% (net of fees)[1], while the benchmark returned -17.22%.

U.S. real estate securities (FTSE Nareit Equity REITs Net Index, -17.2%, the "Index") underperformed the broader equity market (S&P 500 Index, -16.1%) for the quarter, as the impact of high inflation, rapidly rising interest rates and weaker sentiment moderated growth, increasing the odds for a recession in 2023. Ongoing global supply chain disruptions from the war in Ukraine and COVID-related lockdowns in China also weighed on the market. COVID-19 cases continued to rise due to omicron variants, although economies work to resume business as usual, and China's "zero-COVID" policy slowly began to loosen at the end of the quarter starting with the quarantine policy for incoming travelers. The Fund underperformed the Index, returning -20.5% (Class I shares net of fees).

The Federal Reserve (Fed) approved an interest rate hike of 75 basis points[2] in June. Fed Chair Powell's testimony to Congress implied the Fed would raise rates to whatever level necessary to bring inflation down. Increased COVID-19 cases due to omicron subvariants continue to remain mild overall and businesses continued to operate normally. Within the Index, less economically sensitive sectors with more defensive cash flow growth profiles and strong balance sheets outperformed. Specifically, student housing outperformed on the heels of a take-private transaction by Blackstone[3] and the net lease sector outperformed given the relative stability of its cash flows. The more economically sensitive sectors of office (West Coast and NYC), regional malls, industrial and hotels underperformed.

The Fund's security selection in the apartment and retail net lease sectors, the underweight to regional malls, and the overweight to and security selection within seniors housing health care were relative contributors for the quarter. This was more than offset by the underweight to gaming net lease, security selection in industrial and shopping centers, and security selection within and the overweight to economically sensitive billboard companies.

Strategy and Outlook

The team uses internal proprietary research to invest in public real estate companies that we believe offer the best value relative to their underlying assets and growth prospects. The team combines a bottom-up approach, assessing the intrinsic value, equity multiples and growth prospects of each security, with a top-down view that incorporates fundamental inflection points, macroeconomic considerations and geopolitical risk. By incorporating both an equity market valuation and a more traditional real estate valuation with a top-down overlay, we believe the Fund will be better prepared to identify securities with the best expected total returns.

Forecasted returns for the asset class have deteriorated in the intermediate term given the more challenging macro backdrop. However, we believe relative strength in cash flows can be expected given the unique nature of listed real estate. Specifically, the contracted rental streams with inflation-linked escalations and the necessity-based nature of real estate, coupled with limited new

1 Source: Morgan Stanley Investment Management Limited. Data as of 30 June 2022.
2 One basis point = 0.01%
3 As of June 30, 2022, not held in the portfolio.

real estate supply additions, may portend limited downside in cash flows, despite near-term macro uncertainty. Additionally, we believe the relative valuation of real estate securities is attractive, specifically when compared to direct property investment, and could lead to continued merger and acquisition activity and privatizations, thereby crystalizing value and potentially outsized returns for investors.

Secular trends that have been unfolding over the past several years and that were accelerated in the face of COVID-19 will result in winners and losers for real estate.

- In retail, secular headwinds remain given the continued growth in e-commerce and focus on omnichannel distribution, and COVID-19 has highlighted the importance of physical stores due to benefits from increased brand recognition and superior insulation from supply chain issues, among others. Discretionary spending and consumer confidence are declining amid record high inflation and growing tenant bankruptcy watch lists. Enclosed malls remain more challenged than open-air shopping.
- In office, work-from-home (WFH) policies will likely be an overhang on office demand, and related uncertainty regarding future office absorption is expected to remain an open question. However, increased focus on health, wellness and safety could offset some of the demand impairment as densification trends not only stop, but reverse. Layoff announcements and jobless claims are increasing with new job listings declining, and this bears watching.
- In lodging, pent-up demand for leisure travel is strong and exceeding forecasts, although it is anticipated to fall given the stretched consumer. Essential business travel and group/conference demand will return, but likely at below pre-pandemic levels. Regional gaming and casinos, where demand is more reliant on consumer/leisure activities, is stable. Increasing recession odds are a negative for corporate capex and lodging demand.
- In residential, affordability concerns regarding homeownership given increasing mortgage rates and home price appreciation will likely lead to increasing renter demand. Supply growth, regulation, weaker jobs and wage growth remain key risks for rental residential markets.
- In industrial, e-commerce drivers continue to fuel robust demand, resulting in strong fundamentals as evidenced by record low vacancies and double-digit rent growth. A pullback in Amazon[3] leasing announced in the second quarter is not likely to have a material impact on net absorption. Investor interest and capital flow into the sector remains robust given fundamental strength.
- In health care, the necessity-based nature of seniors housing demand is anticipated to insulate fundamentals from macro headwinds. Labor shortages and expense pressures are expected to dissipate. Supply remains well below the prior seven-year average, and demographics are forecasted to be a strong source of incremental demand over the next several years.
- In data centers/towers, data growth observed over the past decade is expected to continue and fuel the need for additional capacity with the 5G rollout providing incremental demand drivers for towers. New supply within the tower space will remain muted. However, data center supply will likely continue to be robust and serve as a governor to growth.
- In self-storage, demand is anticipated to remain strong across major markets, with fundamentals less reliant on macroeconomic indicators and the potential to be "recession-resistant." Forecasted new supply remains rational and below historical averages.

For further information, please contact your Morgan Stanley Investment Management representative.

FUND FACTS

Launch date	Base currency	Index
09 January 1996	U.S. dollars	FTSE Nareit Equity REITs (Net) Index

Calendar Year Returns (%)

Past performance is not a reliable indicator of future results.

	YTD	2021	2020	2019	2018	2017	2016	2015	2014	2013	2012
Class A Shares	-21.83	40.04	-19.10	15.79	-10.82	2.30	3.09	-1.17	29.71	2.26	11.94
FTSE Nareit Equity REITs (Net) Index	-20.59	41.66	-9.07	24.50	-6.17	3.95	7.34	2.02	28.65	1.31	16.78

Investment involves risks. All performance data is calculated NAV to NAV, net of fees, and assume the reinvestment of all dividends and income. The sources for all performance and Index data is Morgan Stanley Investment Management. Please refer to the relevant offering documents for fund details, including risk factors.

3 As of June 30, 2022, not held in the portfolio.

INDEX INFORMATION

The **FTSE Nareit (National Association of Real Estate Investment Trusts) Equity REITs Index:** is a free float-adjusted market-capitalization-weighted index of tax qualified REITs listed on the New York Stock Exchange, NYSE Amex and the NASDAQ National Market Systems.

The **Standard & Poor's 500® Index (S&P 500®)** measures the performance of the large cap segment of the U.S. equities market, covering approximately 80% of the U.S. equities market. The Index includes 500 leading companies in leading industries of the U.S. economy.

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