Morgan Stanley

INVESTMENT MANAGEMENT

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Morgan Stanley Investment Funds

China A-shares Fund

ACTIVE FUNDAMENTAL EQUITY | EMERGING MARKETS TEAM | MONTHLY COMMENTARY | 31 DECEMBER 2018

Performance Review

In the one month period ending 31 December 2018, the Fund's Z shares returned -2.02% (net of fees)[1], while the benchmark returned -3.64%.

December marked another month of outperformance for the Fund on back of strong stock selection in the health care, industrials, financials, information technology and real estate sectors along with the underweight allocation to the financials sector. Stock selection in energy and an overweight allocation to health care along with an underweight allocation to utilities detracted. In 2018 overall, the Fund's Z shares (net of fees) outperformed the benchmark by 16.39% in a year of challenging performance.[1]

Market Review

Trade war has remained a large concern throughout the quarter. China's market rallied following the developments at the G20 meeting in the beginning of December. However, the surge did not last long as the market soon came off the rally given the uncertainty surrounding the U.S.-China trade negotiations. Chinese markets were even weaker in the following days amid concern over relations with the U.S. and the health of the domestic economy with Huawei Technologies CFO Meng Wanzhou being arrested in Canada for violating Iran sanctions.

Going towards the economic planning meeting, Chinese stocks jumped as the market bet it would signal further easing but went down again because of weak macro data. Beyond trade, the gap between the two countries on intellectual property protection, industrial policy and geopolitical basis remains significant, and is likely to remain a source of market risk over the next 12 months.

On the policy front, China is calling on local governments to complete debt disposals of zombie companies and those with excessive production capacity by 2020, and Chinese government agencies have started to screen and clean up regulations that include restrictions on foreign investments beyond the so-called negative list for foreign investments.

The annual Central Economic Work Conference (CEWC) was held on December 19-21, which laid out key tasks and economic policies in 2019. The conference emphasised that the economy is facing downward pressure amid a complicated external environment, driven by both cyclical and structural factors and near- and long-term issues. We expect policy support will further step up in 2019 in response to downward pressure on economic growth.

Two items that remain important are the inflation rate and interest rate hikes. China's consumer price index (CPI) rose 1.9% year-over-year in December 2018, slightly lower than 2.2% in November. The producer price index for December was +0.9% year-over-year, which dropped 1.8 percentage points from November's level. We think going forward, CPI may continue to gradually pick up, propelled by the price hikes in raw material costs.

Portfolio Activity

We added Huadong Medicine after a recent share price correction on market concerns over price pressure on its traditional Chinese medicine Bailing, which helps alleviate chronic kidney and lung diseases. We remain more positive on the development of the over-the-counter channel, which has been seeing strong growth. Its strength in the diabetes markets should provide long-term growth. While other pharma companies have come under pressure on group purchasing organization tendering, Huadong's drugs are not included in the tendering. In addition, the recent acquisition of Sinclair, a U.K.-based Botox and filler company, should provide growth over the longer term.

We reduced holdings in Daqin Railway given its outperformance year-to-date and have used this as funding source for other buys. As its rail capacity is near the maximum capacity, we believe there's little room for growth going forward. We've also

[1] Source: Morgan Stanley Investment Management Limited. Data as of 31 December 2018.

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taken some profit on China Fortune Land after its relative outperformance on news of increased financial support from the Ping-An Group and appointment of ex-CR Land managers into the company.

Strategy and Outlook

Overall, despite the potential macro risks, at the bottom-up level we believe a majority of the stocks in our portfolio have positive dynamics and good valuation support, and exhibit good risk-reward profiles. Our focus remains on stocks that have stable earnings growth, stable cash flow streams, healthy balance sheets and attractive valuations, given the aforementioned potential macro risks and the slowing economy.

Looking forward, we remain positive on the very long-term prospects for China, given the vast amount of productive assets that China has been building up and the know-how that the Chinese accumulated over the past few decades. As the economy adjusts itself, there will likely be write-offs in unproductive assets and it may take some time and effort to sort out the arrangements for various stakeholders and re-allocate the human resources to sectors that can maximize the productive power of the labor for future growth.

In terms of the portfolio positioning strategy, as the valuation dispersion of China A share stocks remain significantly large, with some stocks trading at unreasonably demanding valuations while others now offer strong value after the recent correction. With the economy still transitioning away from an investment- and export-driven one to a consumption-driven one, we believe our valuation-sensitive approach and emphasis on positioning in sectors and stocks that have superior dynamics should continue to deliver strong performance over the medium to long term.

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

FUND FACTS

Launch date	Base currency	Index
29 December 2017	U.S. dollars	MSCI China A Onshore Index

12 Month Performance Periods to Latest Month End (%)

	DECEMBER '17 - DECEMBER '18	DECEMBER '16 - DECEMBER '17	DECEMBER '15 - DECEMBER '16	DECEMBER '14 - DECEMBER '15	DECEMBER '13 - DECEMBER '14
MS INVF China A-shares Fund - Z Shares	-16.60	--	--	--	--
MSCI China A Onshore Index	-32.99	--	--	--	--

Past performance is not a reliable indicator of future results. Returns may increase or decrease as a result of currency fluctuations. All performance data is calculated NAV to NAV, net of fees, and does not take account of commissions and costs incurred on the issue and redemption of units. The sources for all performance and Index data is Morgan Stanley Investment Management. **Please visit our website www.morganstanley.com/im to see the latest performance returns for the fund's other share classes.**

Share Class Z Risk and Reward Profile

Lower Risk **Higher Risk**

1 2 3 4 5 **6** 7

Potentially Lower Rewards **Potentially Higher Rewards**

The risk and reward category shown is based on historic data.

- Historic figures are only a guide and may not be a reliable indicator of what may happen in the future.
- As such this category may change in the future.
- The higher the category, the greater the potential reward, but also the greater the risk of losing the investment. Category 1 does not indicate a risk free investment.
- The fund is in this category because it invests in company shares and the fund's simulated and/or realised return has experienced high rises and falls historically.
- The fund may be impacted by movements in the exchange rates between the fund's currency and the currencies of the fund's investments.

This rating does not take into account other risk factors which should be considered before investing, these include:

- The fund relies on other parties to fulfill certain services, investments or transactions. If these parties become insolvent, it may expose the fund to financial loss.
- There may be an insufficient number of buyers or sellers which may affect the funds ability to buy or sell securities.
- Investment in China A-Shares via the Shanghai-Hong Kong and Shenzhen-Hong Kong Stock Connect programs may also entail additional risks, such as risks linked to the ownership of shares.
- There are increased risks of investing in emerging markets as political, legal and operational systems may be less developed than in developed markets.
- Past performance is not a reliable indicator of future results. Returns may increase or decrease as a result of currency fluctuations. The value of investments and the income from them can go down as well as up and investors may lose all or a substantial portion of his or her investment.
- The value of the investments and the income from them will vary and there can be no assurance that the Fund will achieve its investment objectives.
- Investments may be in a variety of currencies and therefore changes in rates of exchange between currencies may cause the value of investments to decrease or increase. Furthermore, the value of investments may be adversely affected by fluctuations in exchange rates between the investor's reference currency and the base currency of the investments.

Please refer to the Prospectus for full risk disclosures. All data as of 31 December 2018 and subject to change daily.

INDEX INFORMATION

The **MSCI China A Onshore Index** is a free float-adjusted market capitalization index that captures large and mid-cap representation across China securities listed on the Shanghai and Shenzhen exchanges.

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