Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Investment Funds

Emerging Europe, Middle East and Africa Equity Fund

ACTIVE FUNDAMENTAL EQUITY | GLOBAL EMERGING MARKETS EQUITY TEAM | MONTHLY COMMENTARY | SEPTEMBER 30, 2017

FOR PROFESSIONAL CLIENTS ONLY.

PERFORMANCE REVIEW

In the one month period ending 30 September 2017, the fund's I shares returned -1.30% (net of fees) while the benchmark returned -3.35%.

The biggest contributor to performance in September was our stock selection in South Africa. Our stock selection in Russia and underweight allocation to South Africa also contributed for the month. Our positions in Russian internet company Yandex and Polish supermarket company Dino Polska were the top stock contributors.

The biggest detractor from performance during September was stock selection in Hungary. Our underweight allocation to the United Arab Emirates (UAE) and overweight to Romania also detracted. Our holdings in Polish debt collector Kruk and South African software services company EOH were the biggest detractors from a stock perspective.

MARKET REVIEW

The MSCI EMEA Index was down -3.35% in euro terms in September, underperforming both MSCI Emerging Markets (+0.17%) and MSCI World (+2.82%) Indices.

Russia (+5.06%) was the top performing market helped by stronger oil prices during September. Czech Republic (+2.30%) and the UAE (-1.67%) also outperformed the index. Greece (-13.52%) was the worst performing market with the potential for an IMF lead asset quality review of the banks weighing on sentiment. Turkey (-9.04%) fell for the first month in 2017 and South Africa (-5.95%) also lagged as the rand declined.

PORTFOLIO ACTIVITY

We established new positions in South African companies Standard Bank and Imperial Holdings during the month. We are increasing our exposure to domestically oriented South African stocks given depressed sentiment, growth on the cusp of recovery, and the potential for a confidence boost post the ANC conference in December.

Standard Bank has broad corporate and retail franchises in South Africa and will likely benefit from any pickup in the economy. It also has the most comprehensive Sub-Saharan Africa franchise amongst the major South African banks and should now benefit from any sustained upturn in the region. Management has done a good job in recent years on focusing the business, restoring liquidity, improving cost controls, and maintaining asset quality through the downturn. Imperial Holdings is a mini-conglomerate focused on two core businesses, auto sales and logistics. It is highly sensitive to South African domestic economic activity, and auto sales are showing signs of a replacement-cycle recovery helped by falling interest rates.

We funded these trades by exiting paper and packaging company Mondi. We continue to like the management team and growth strategy of the company but are mindful that it remains in a cyclical industry. While the stock has been a strong performer in the

FUND FACTS

Fund launch
October 2000

Investment team
Gaite Ali, Eric Carlson, Paul Psaila

Location
New York

Base currency
Euro

Benchmark
MSCI Emerging Europe, Middle East and Africa Index

portfolio, the cycle is entering its later innings and therefore we are using it to fund the more compelling opportunities in domestic South Africa. We also exited our position in Romanian financial BRD.

In Russia, we trimmed our position in gas company Gazprom and continued adding to Sberbank. In addition to benefiting from the cyclical recovery and recovery in lending, Sberbank is facilitating a dramatic shift in Russia as the country moves toward becoming a cashless society. It commands 90% market share in the growing peer-to-peer transactions market and over 60% share in the business to consumer market.

STRATEGY AND OUTLOOK

We continue to overweight the Central and Eastern European region. We think that growth in Central and Eastern Europe should remain healthy, driven by strong consumption which has been supported by increases in both employment and real wages. We also now expect fixed investment growth to accelerate, which will bolster overall growth and improve its quality. Finally, there are now consistent signs that inflation is returning to the region, which should eventually lead to a normalization of interest rates which remain negative in real terms throughout the region. In sum, we see the region as offering attractive investment opportunities through a combination of this solid economic growth, emerging reflationary trends, attractive currencies, and overlooked equity markets. We continue to like stocks that are exposed to secular growth opportunities in consumer markets in the region. And we have built a substantial position in financials in the region, which we believe will particularly benefit from the emerging reflationary trend after having suffered from tighter regulation and low rates.

We maintain an underweight position in Russia, where the economy continues its cyclical recovery under tight monetary and fiscal conditions. Within the market, we continue to like select names for their secular growth opportunities which should garner additional support from any cyclical recovery. In particular, we see a recovery in overall advertising spending adding to the existing secular trend of online advertisement growth, which –in turn- should help the internet stocks. We also see opportunities for market share gains in sectors that have struggled during the past recession, such as X5 which is continuing to benefit from ongoing consolidation in the food retail industry. And we have added a position in Sberbank as we see it benefitting from the budding recovery, especially given its dominant retail franchise and the opportunity it has in payments.

We recently visited South Africa, where politics remain the topic of the day and sentiment toward growth and politics is depressed. We expect a limited cyclical recovery in the economy after a flattish 2016. Still, the economy remains stuck in a low growth equilibrium, with limited prospects for the structural reforms to necessary to lift growth given the current politics in South Africa. Specifically, President Jacob Zuma remains embattled and the ANC increasingly split heading into its critical elective conference in December of this year. The party will elect a new president at this conference, who will replace Mr Zuma as head of the ANC and effectively lead the country thereafter. And, while fresh ANC leadership could be a positive catalyst for the market, there is much uncertainty around who will succeed Mr Zuma and, as a result, how policy could change going forward In this environment, we maintain an underweight to the market as a whole but continue to invest where we find compelling opportunities from a bottom-up stock perspective.

The political and economic outlook remains negative in Turkey in our view. Although political uncertainty is now reduced, we believe the continuing erosion of check and balances by President Erdogan ultimately hurts the investment and innovation climate in Turkey and thus the structural outlook for the economy. Economic growth has surprised positively this year though we believe for unsustainable reasons. As such, we continue to underweight the market and positioned in stocks exposed to either the export market or to longer term secular growth stories within Turkey.

For further information, please contact your Morgan Stanley representative.

IMPORTANT INFORMATION

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