Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Investment Funds

Emerging Europe, Middle East & Africa Equity Fund

ACTIVE FUNDAMENTAL EQUITY | EMERGING MARKETS TEAM | MONTHLY COMMENTARY | 30 JUNE 2018

Performance Review

In the one month period ending 30 June 2018, the Fund's I shares returned -6.02% (net of fees)[1], while the benchmark returned -2.34%.

The biggest contributor to performance in June was our stock selection in Russia. Our overweight to Egypt also contributed for the month. Russian internet company Yandex and Russian financial Sberbank were the top stock contributors.

The biggest detractor from returns was stock selection in Poland. Stock selection in South Africa was an additional detractor. Our underweight position in South African internet company Naspers and our position in Polish footwear company CCC were the biggest detractors from a stock perspective.

Market Review

MSCI EMEA Index equities returned -2.34% in euro terms in the month, underperforming the MSCI World Index (-0.07%) but outperforming the MSCI Emerging Markets (EM) Index (-4.18%).

Greece (+4.04%) was the best-performing market during the month. Egypt (+1.98%) and Russia (+0.34%) also outperformed. Turkey (-4.71%), South Africa (-4.35%) and Poland (-2.23%) were the laggards.

Portfolio Activity

During the month, we established a new position in Koc Holdings in Turkey. We reallocated capital from Russia, the outperformer in EMEA, to Turkey. Though Turkey has just started its process of macroeconomic adjustment, we think some of the stocks have already priced in a negative scenario, so we are reducing our underweight in the market. In particular, Koc was trading at 20% discount to net asset value (NAV) compared with an average of 6% in the last 10 years. Koc owns a diversified portfolio of companies across several sectors of the Turkish economy, from refining to consumer durables to car manufacturers to food. The company owns and manufactures products for well-known brands in Turkey and abroad, and it generates more than 30% of its revenues outside Turkey.

Hence, we think Koc could generate profit growth even if domestic conditions deteriorate. Finally, Koc companies are among the most conservative in terms of financial management in Turkey. The company offered a dividend yield of 4%. We funded the trade by trimming our position in Yandex given its outperformance. We still like the company due its dominant position in digital advertising and online taxi booking services in Russia, which should result in strong revenue growth in the coming two years and even faster earnings before interest, taxes, depreciation and amortization (EBITDA) expansion.

Elsewhere in Russia, we exited our position in Gazprom as our original thesis has not materialized. The improvement in operating earnings did materialize, driven primarily by rising gas prices and export volumes to Europe. However, corporate governance has only improved marginally and, in particular, the dividend has not moved any closer to the government-mandated 50% payout level. Hence, the valuation has not improved. The incremental cash flow being generated by the improved operating earnings is being allocated to higher capital expenditure to finance new projects, and hence, is not translating into a material free cash flow improvement.

[1] Source: Morgan Stanley Investment Management Limited. Data as of 30 June 2018.

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 could bolster overall growth and improve its quality. Inflation has remained surprisingly low despite continuing wage pressures and will likely pick up as the year progresses. In sum, we see the region as offering attractive investment opportunities through a combination of this solid economic growth, a potential pick-up in inflation and overlooked equity markets. We continue to like stocks that are exposed to secular growth opportunities in consumer markets in the region. We have built a substantial position in financials in the region, which we believe could particularly benefit from an increase in inflation expectations after having suffered from tighter regulation and low rates.

We believe that the economic recovery in Russia, which began last year, can continue in 2018, though we note that recently implemented sanctions could add downside risk to growth. We do not expect major reforms from the new government but continue to believe the monetary and fiscal policies of the Russian government have not only reduced inflation to post-Soviet lows, but also are reducing materially the sensitivity of the Russian economy to oil. We think this is particularly true given the weak ruble policy being followed by authorities. In terms of our portfolio, we are invested in companies that we believe should benefit from these macro policies, specifically commodity producers who could experience earnings upgrades as stronger commodity prices are no longer offset by a strong ruble. We also continue to like select domestic names for their secular growth opportunities, which we think should gain additional support from the emerging recovery. We are finding opportunities in ‘old Russia’ energy and mining stocks, which look likely to benefit from the new macroeconomic framework—a weaker ruble and lower rates—and attractive valuations/yields. The market sold off in April due to uncertainty over the most recent round of U.S. sanctions. This new set of sanctions casts a wider net on listed entities and individuals than the sanctions imposed under the Obama administration. However, we believe the risk to the publicly held companies in our portfolio was already discounted.

In South Africa, improved sentiment should lead to a growth pick-up in the medium term with continued low inflation, which may surprise on the downside. Despite winning the African National Congress party (ANC) election by a thin margin, Cyril Ramaphosa has surpassed expectations and moved quickly to consolidate power and send a message of fiscal responsibility and cooperation with the private sector. Following the national elections in 2019, Ramaphosa could embark on more structural reforms. If the policy momentum continues, an investment cycle may ensue as corporates have underinvested for many years, focusing instead on investing abroad. The key question remains whether Ramaphosa can implement the reforms needed to boost sustainable growth while appeasing the left wing of the ANC. While we are still underweight the market, we have a significant absolute weight in South Africa stocks and continue to see compelling opportunities from a bottom-up perspective. In particular, industrials and financials companies in South Africa that are levered to the domestic economy could see earnings upgrades and re-rating.

In Turkey, President Erdogan and the AK party won a convincing first round victory in the 24 June general election, cementing his already firm grip on power. Though the unsustainable monetary and fiscal policies which bolstered growth in 2017 have begun to change in response to market pressures, Erdogan’s victory and his initial policy moves suggest he will not proactively pursue a more orthodox policy framework to rebalance the economy. We believe the economy needs a substantial balance of payments adjustment after accumulating large external deficits over many years, and this will now likely be dictated by the market. Though the prospects for the economy do not look good, valuations have become more attractive on the currency and on stocks. For now, we continue to remain substantially underweight to the country and are 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 Investment Management representative.

FUND FACTS

Launch date	Base currency	Index
16 October 2000	Euro	MSCI Emerging Europe, Middle East and Africa Index

12 Month Performance Periods to Latest Month End (%)

	JUNE '17 - JUNE '18	JUNE '16 - JUNE '17	JUNE '15 - JUNE '16	JUNE '14 - JUNE '15	JUNE '13 - JUNE '14
MS INVF Emerging Europe, Middle East & Africa Equity Fund - I Shares	(3.87)	16.21	(7.01)	8.03	14.73
MSCI Emerging Europe, Middle East and Africa Index	3.17	9.96	(13.94)	5.49	6.70

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 I 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 shares of companies from emerging markets 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.
- There are increased risks of investing in emerging markets as political, legal and operational systems may be less developed than in developed markets. Due to the nature of the markets in which the fund invests, there might be circumstances where the safekeeping and custody arrangements of the fund are not as secure as those of more 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 30 June 2018 and subject to change daily.

INDEX INFORMATION

The **MSCI Emerging Markets EMEA Index** captures large and mid cap representation across 10 Emerging Markets (EM) countries in Europe, the Middle East and Africa (EMEA). With 163 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. EM EMEA countries include Czech Republic, Egypt, Greece, Hungary, Poland, Qatar, Russia, South Africa, Turkey and United Arab Emirates.

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