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 | OCTOBER 31, 2017

FOR PROFESSIONAL CLIENTS ONLY.

PERFORMANCE REVIEW

In the one month period ending 31 October 2017, the fund's I shares returned 2.26% (net of fees) while the benchmark returned 2.49%.

The biggest contributor to performance in October was our stock selection in Russia. Our overweight allocation to Poland also contributed for the month. Our positions in Russian mining company Norilsk Nickel and Polish financial mBank were the top stock contributors.

The biggest detractor from performance during October was stock selection in Turkey. Stock selection in South Africa also detracted for the month. Our underweight position in South African internet company Naspers and our position in South African quick service restaurant company Famous Brands were the largest detractors from a stock perspective.

MARKET REVIEW

The MSCI EMEA Index was up +2.49% in Euro terms in October, underperforming both the MSCI Emerging Markets (+5.04%) and the MSCI World (+3.40%) Indices.

Hungary (+6.55%) and Poland (+4.81%) were the best performing markets for the month, continuing their strong performance year to date. Greece (-0.69%), Qatar (-0.55%), and Russia (-0.50%) were the worst performing markets with slightly negative returns for the month.

PORTFOLIO ACTIVITY

During the month we established a new position in South African health care and insurance provider Discovery. Discovery has a leading position in the private health care administration market in South Africa, a maturing business in life insurance, and growing businesses in investments, auto insurance, and credit cards/banking. Discovery also has an innovative wellness and engagement program they are taking overseas in a series of partnerships with leading insurance companies in Asia, Europe and the U.S.

We think Discovery should be able to grow earnings in the mid-teens driven by continuing growth in its core South African health and life business, plus the transitioning of several newer businesses (auto, banking, partnerships) from losses to profitability over the next 12-24 months. We like that it has an internally driven growth dynamic, but would also benefit from any sustained recovery in the South African economy and, in particular, its private job market. We also continued to increase our exposure to domestically oriented South African companies by adding to our position in Standard Bank during the month.

We added to our existing position in Polish insurance company PZU during the month. PZU appears to be in a sweet spot as the company is both growing and benefitting from a low combined ratio. They are gaining market share in the sector while still lowering

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

costs, and sector consolidation will further improve pricing trends.

We funded these changes by exiting South African 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 portfolio, the cycle is entering its later innings and therefore we are using it to fund the more compelling opportunities that are domestically-focused. We also trimmed our positions in IT service company EPAM Systems, Polish supermarket company Jeronimo Martins, and Polish footwear company CCC.

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 normalisation 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 ad 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 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. We are concerned about the country's large current account deficit, which will become a source of greater stress on economic growth and the country's external debt burden as global interest rates rise. 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.

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