

Morgan Stanley Investment Funds

Emerging Leaders Equity Fund

ACTIVE FUNDAMENTAL EQUITY | EMERGING MARKETS TEAM | QUARTERLY COMMENTARY | 30 SEPTEMBER 2018

Performance Review

In the three month period ending 30 September 2018, the Fund's Z shares returned -4.39% (net of fees)¹, while the benchmark returned -1.09%.

The biggest contributor to performance for the quarter was our position in sportswear company Adidas, which reported strong earnings. KBank in Thailand and Indonesian minimart company Alfamart also contributed for the quarter.

The biggest detractors from performance during the quarter were our positions in Indian financials AU Small Finance Bank and L&T Finance. Our holdings in India suffered due to sell-off in the broader Indian markets in the month of September. L&T Finance and AU Small Finance Bank were also impacted due to negative sentiment around non-bank financial companies (NBFC) in India following a default at an infrastructure finance company. None of our positions in Indian financials are exposed to funding and non-performing loan issues, and we are confident that these businesses can emerge stronger over the next six to 12 months. Integrated circuit company Silergy also detracted due to concerns on demand slowdown in China and trade wars. While Silergy could experience a short-term slowdown in revenue growth, the company is a structural play on China's long-term goal of achieving self-sufficiency in semiconductors.

Market Review

The MSCI Emerging Markets (EM) Index returned -1.09% in the third quarter, underperforming the MSCI World Index, which returned +4.98%.

Energy (+14.30%), materials (+3.84%) and industrials (+2.91%) were the top-performing sectors, while consumer discretionary (-10.37%), health care (-7.15%) and real estate (-5.64%) lagged. From a country perspective, the top-performing markets were Thailand (+13.57%), Qatar (+12.83%) and Poland (+10.64%). Laggards were Turkey (-20.54%), Greece (-17.59%) and China (-7.51%).

Portfolio Activity

During the quarter we established a position in AU Small Finance Bank in India. AU Bank is an NBFC that started with a focus on vehicle financing and has successfully built a franchise in micro, small and medium enterprises financing. While other private sector banks have a focus on mass affluent and affluent customers and microfinance institutions cater to the lower end of pyramid, AU Bank is focused on the mass income customers. It has a strong track record of maintaining pristine asset quality and has shown discipline in fixing wrong lending decisions. We believe loan growth can accelerate and return on assets should improve as we have confidence in the execution capabilities of the organization.

During the quarter we also established a position in Brazilian financial Bradesco. The pessimism and concerns on October's elections were close to a peak during the quarter. Brazilian financials, in our view, are the best way to play the recovery in the market given their market share dominance and earnings visibility.

During the quarter we exited our position in Korean furniture company Hanssem. Our growth expectations for the company have deteriorated as property regulations have weighed on sentiment, and in our view, recent capital allocation decisions are a departure from its core business. In Mexico, we sold our position in financial Banorte as it hit our target price.

Strategy and Outlook

The return of volatility to emerging markets this year was always likely as markets worldwide had gone many months with barely any correction. The portfolio was outperforming through the end of August but underperformed for the quarter due to the sharp sell-off in India during September.

¹ Source: Morgan Stanley Investment Management Limited. Data as of 30 September 2018.

The month of September was marked by high market volatility in India, especially in financials. A local infrastructure finance company, IL&FS, defaulted and IL&FS paper owned by mutual funds had to be marked down, which sparked redemptions, forcing them to sell down other NBFC paper at large losses. This sparked off contagion in the NBFC space. While there is no solvency issue with a vast majority of NBFCs in the listed space, tight liquidity has weighed heavily on sentiment and led to a sell-off across the sector. We believe that a bottom is likely in place as far as contagion risk goes, and we remain convinced on the quality and the balance sheets of Indian financials we own in the portfolio. Our discussions with company management and research indicate that these businesses can continue to see accelerating earnings, and we remain confident in our exposure to credit and consumer themes in India.

In the midst of all the macro noise, we reiterate our single-minded focus on owning high-quality growth businesses exposed to secular growth themes. We continue to favor consumer plays benefiting from healthy domestic demand and see rising demand for health care, travel and leisure activities. We are constructive on EM financials benefiting from underpenetrated credit markets and favorable interest rate environments in individual countries. We own technology companies which are growing for structural reasons, while avoiding more cyclical tech plays, and we also have exposure to high-quality small- and mid-cap companies.

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

FUND FACTS

Launch date	Base currency	Index
17 August 2012	U.S. dollars	MSCI Emerging Markets (Net) Index

12 Month Performance Periods to Latest Month End (%)

	SEPTEMBER '17 - SEPTEMBER '18	SEPTEMBER '16 - SEPTEMBER '17	SEPTEMBER '15 - SEPTEMBER '16	SEPTEMBER '14 - SEPTEMBER '15	SEPTEMBER '13 - SEPTEMBER '14
MS INVF Emerging Leaders Equity Fund - Z Shares	(6.92)	9.60	15.97	(10.08)	0.65
MSCI Emerging Markets (Net) Index	(0.81)	22.46	16.78	(19.28)	4.30

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



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 fund's ability to buy or sell securities.

- Investment in China A-Shares via 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 30 September 2018 and subject to change daily.

INDEX INFORMATION

The **MSCI Emerging Markets Net Index** is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of emerging markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The MSCI Emerging Markets Index currently consists of 23 emerging-market country indices. The performance of the index is listed in U.S. dollars and assumes reinvestment of net dividends. The index does not include any expenses, fees or sales charges, which would lower performance. The index is unmanaged and should not be considered an investment. It is not possible to invest directly in an index.

The **MSCI World Index** is a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

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