Morgan Stanley

INVESTMENT MANAGEMENT

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Morgan Stanley Investment Funds

Emerging Markets Equity 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 I shares returned -1.94% (net of fees)[1], while the benchmark returned -2.66%.

Our underweight allocation to China was the largest contributor to performance during the month as the country underperformed relative to the broader index. Our stock selection and overweight allocation to Peru also contributed strongly to returns during the month. Our overweight allocations to Indonesia and Mexico were also important contributors to returns. In aggregate, our country allocations contributed positively, while stock selection slightly detracted—and primarily in a few countries. In Korea, for example, our stock selection was our largest detractor from returns in the portfolio. Our holding of Erste bank in off-index country Austria was also a top detractor.

On a sector basis, our stock selection and overweight allocation to financials was the largest contributor to returns. Also contributing strongly during the month was our stock selection in consumer discretionary, our overweight to consumer staples and our stock selection in materials. Our stock selection and underweight allocation to technology was also positive for the month. Detracting from returns were our stock selection in health care, as well as our stock selection and underweight allocations in communication services and industrials.

Market Review

The MSCI Emerging Markets (EM) Index returned -2.66% during the month, outperforming the MSCI World Index, which returned -7.60%. Mexico (+3.29%) led the index during the month followed by Malaysia (+1.62%), the Philippines (+1.51%), Peru (+1.48%) and Indonesia (+0.85%). Pakistan (-11.72%) fell the most during the month, followed by China (-6.05%), Greece (-5.33%), Turkey (-5.16%) and Colombia (-3.72%).

Portfolio Activity

We added to our position in Russian information technology (IT) company Yandex. Yandex has a strong franchise and an expanding position in high utility internet-based applications/businesses in Russia. It has been retaking share in its core search business while continuing to grow its non-search user base (via online and mobile services including maps, navigator, Zen, images and classifieds) and also has been scaling its taxi business. Based on our company research, we believe the company can sustain its current growth rate mainly via its search and portal business as it expands its potential ad inventory while the overall ad market grows and continues its conversion to digital. We also think its taxi business can meet management's guidance of profitability in the fourth quarter 2018, given its high growth rate, strong user experience and consolidated market structure post the Uber merger. We funded this by selling our position in Russian oil company Lukoil. Lukoil has outperformed in 2018 as its improved governance has been fully recognized by the market. In our view the stock has re-rated, and we see less visible earnings growth drivers from here.

We initiated a position in pharmaceutical company Richter Gedeon of Hungary. We like Richter as we think, based on our company research, its earnings and free cash flow growth can accelerate over the next two years, while the stock has been relatively ignored given its size, complexity and recent history (safety concerns about its drug Esmya). We think the principal driver of the earnings growth acceleration likely will be royalties from cariprazine, which are continuing to grow and could disproportionately contribute to the bottom line.

We reduced our position in pharmaceutical company Sino Biopharmaceutical of China, taking from recent gains to reduce our overweight position versus the index.

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

This document constitutes a commentary and does not constitute investment advice nor a recommendation to invest. The value of investments may rise as well as fall. Independent advice should be sought before any decision to invest.

Strategy and Outlook

Before its downturn during the fourth quarter of 2018, technology had dominated returns in emerging markets for nearly three years, showing high correlation with its U.S. counterparts. As a sector, tech had contributed around 40% of EM returns over the prior three years—a share matched only by energy in 2007. Tech-heavy China had accounted for nearly half of all returns during this same three-year period. The infatuation with big tech stocks had driven the relative performance of small- and medium-cap stocks (on an equal-weighted index) to nearly two standard deviations below its historical trend in the emerging markets. This is highly unusual.

Our argument for some time has been that when market imbalances grow this extreme, they don't persist. Now that we have begun to see major falls in tech and the tech-heavy MSCI China Index, the question is how the rebalancing is likely to play out. After the busts of tech and telecom in 2000 and energy in 2008, the beaten-down sectors recovered, small and medium caps came back to life and forgotten countries were rediscovered.

Any bubble will generate in its wake a series of anti-bubbles: a string of countries, companies and markets that are ignored not because they are inherently weak but because they fall outside the current focus of market hype. All the attention lavished on the United States and tech has generated numerous anti-bubbles, depressing the stock markets in solid emerging economies from Indonesia to Poland and the stock prices of companies in many industries outside tech.

One simple indicator of anti-bubbles: when any one company has grown to dwarf the entire market in large countries or regions, the hype is distorting the flow of investment dollars. At its height in October, Apple was worth more than $1 trillion—more than entire regions like Southeast Asia and Eastern Europe; equal to the market value of Indonesia, Malaysia and the Philippines combined; and almost triple Poland, the Czech Republic and Hungary combined.

Even the daily trading volume of a tech name like Apple has been six times more than the total trading volume in the three largest markets of Southeast Asia. But since tech began to crack, there have been signs that investors are rediscovering forgotten countries. The markets of the Philippines and Indonesia have risen in dollar terms since October even as the U.S. market is down 10% from its peak since then.

Investors are also rediscovering overlooked markets in Eastern Europe and Latin America. Those markets had been battered in part by the strong U.S. dollar, which always sucks money out of EM. Since the early 1980s, the dollar has rarely traded more than 15% above or below its long-term range, and it is now at the high end of that range. Dollar bear markets have tended to last around seven years. Our view is that the dollar's rise in 2018 was a temporary rally within the downtrend that began in 2016 and could prove long-lasting.

Some of the hardest hit EM currencies have stabilized, and there is no reason to expect the broad collapse to resume. As a group, emerging markets—even excluding China—are in current account surplus. This contrasts with the aggregate current account deficit in 2013 when the "taper tantrum" rattled countries with large deficits, such as Brazil and India. Both those countries and others have seen their deficits narrow since then.

Concerns about emerging market debt are really reflecting worries about China's debt. While the rest of EM has seen its non-financial debt climb by 20 percentage points as a share of gross domestic product (GDP) since the global financial crisis of 2008, China's debt has grown by more than 100 percentage points.

Total global debt today is 320% of global GDP, up from 200% in 2000. The big borrowers include the U.S. government, U.S. firms and corporations in China. These debt clouds put an invisible ceiling on how high and fast central banks can normalize interest rates. The markets had expected the Federal Reserve to follow through on plans to raise rates in 2019, but as it became clear that any further hikes would slow an already weakening global economy and trigger turmoil in the markets, those expectations have receded of late.

In our portfolio, we remain overweight those countries where economic growth is high or accelerating. We remain invested in good quality, growth-oriented companies capable of sustaining or expanding their earnings—and benefiting from healthy domestic demand, resistant to declines in global trade and resilient in the face of higher interest rates.

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

FUND FACTS

Launch date	Base currency	Index
01 July 1993	U.S. dollars	MSCI Emerging Markets Net 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 Emerging Markets Equity Fund - I Shares	-17.05	35.20	5.83	-10.66	-4.30
MSCI Emerging Markets Net Index	-14.58	37.28	11.19	-14.92	-2.19

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.
- 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 31 December 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 **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.

The **MSCI China Index** captures large and mid-cap representation across China A-shares, B-shares, H-shares, Red-chips and P-chips. It reflects the Mainland China and Hong Kong opportunity set from an international investor's perspective.

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