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INVESTMENT MANAGEMENT

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Morgan Stanley Investment Funds

Emerging Markets Small Cap Equity Fund

ACTIVE FUNDAMENTAL EQUITY | EMERGING MARKETS TEAM | MONTHLY COMMENTARY | 31 DECEMBER 2018

Performance Review

In the one month period up until 31 December 2018, the Fund's Z shares returned -3.27% (net of fees)[1], while the benchmark returned -2.93%.

Our allocations to Saudi Arabia and Egypt were top contributors to performance. Our stock selection in Vietnam and underweight allocations to Romania and Kenya also contributed. Our allocation to the United Arab Emirates and underweight allocations to Morocco and Kuwait detracted from returns. From a sector perspective, our stock selection in financials and consumer discretionary added to returns, while our stock selection in health care and communication services hampered returns.

Market Review

The MSCI Frontier Markets Index (-2.93%) slightly underperformed the MSCI Emerging Markets Index (-2.66%) during the month. Jordan (+4.54%), Serbia (+4.40%), Slovenia (+3.86%) and Saudi Arabia (+2.08%) led market returns. Romania (-16.52%) was the worst performing market in the region as Romanian stocks plunged on the back of a government announcement in mid-December including major tax reforms and a revision of the pension system. Pakistan (-11.72%), Estonia (-7.03%) and Kenya (-6.87%) underperformed the region.

Portfolio Activity

During the month we closed our underweight allocation to Argentina. We believe dynamics between the currency depreciation and its effect on the trade balance, inflation and growth will be relatively limited on the downside from here. We increased our weights to financials Grupo Financiero Galicia and Banco Macro and added Grupo Supervielle. With falling inflation, policy rates may fall sooner than expected and lower inflation may also lead to an easing of restrictive reserve requirements. Most banks have solid provision coverage and remain well-capitalized. We also added consumer plays Arcos Dorados and Despegar as we become more positive on the recovery of the Argentine consumer. Real wages may turn positive in the first quarter of 2019, which will stimulate consumer demand, and both companies have material exposure to the Brazilian consumer where we also expect to see a rebound.

We sold Emaar Properties in the United Arab Emirates (U.A.E.) as the oversupply in residential, hospitality and retail is a significant headwind to its core businesses. Although policymakers are passing legislation to make it easier for property buyers to have a residency permit for the U.A.E., we do not think this will be enough to generate significant demand. The company's core businesses will continue to face difficulties this year.

Strategy and Outlook

We remain positive on the opportunity in frontier markets (FM) as the global growth reset should see higher upside in frontier. Frontier gross domestic product (GDP) growth should start to accelerate in 2019, picking up from 2.9% in 2018 to 3.2% in 2019 and 3.6% in 2020. During this time, emerging markets (EM) ex-China economies are expected to see growth stable at 3.3%. The last time we saw a narrowing then widening of the GDP growth differential between FM and EM economies was in 2013-2015 when FM equities outperformed EM equities materially.

Frontier markets debt levels in aggregate are much lower than EM, allowing policymakers to use credit creation to support economic expansion. Frontier countries are also less exposed to a trade war, given their low percentage of total exports to China. Excluding oil, total frontier exports to China are only 8% versus 15% for emerging markets countries. Given this, if there is a trade war and China growth slows, FM countries should be more insulated, and some economies such as Vietnam could be net beneficiaries of manufacturing moving out of China over the medium term.

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

Frontier currencies are now in aggregate undervalued and back to the valuation levels of 2013, as virtually all FM currencies have had material adjustments with only two currencies left overvalued, the Bangladeshi taka and the Kenyan schilling. From a bottom-up perspective, frontier corporates are growing top-line faster with better returns than those in emerging markets. Frontier corporates are seeing higher sales growth and return on equity and corporate debt-to-EBITDA (earnings before interest, taxes, depreciation and amortization) are at lower levels than emerging markets and developed markets.

The correlation of frontier equities to other equity asset classes has fallen materially since peaking at 0.75-0.80 in 2013 and is now a very low 0.55-0.65 to MSCI EM Index, MSCI All Country World Index and MSCI EAFE Index equities. In addition, the volatility of frontier equities remains significantly lower than EM equities at 12% versus 15% in EM (as measured by standard deviation). Frontier markets have historically been a good way to diversify and reduce risk in a global equity allocation, and we believe this benefit is now even stronger.

We continuously assess the growth levers providing tailwinds to frontier economies such as strong demographics with labor force growth sufficient for high GDP growth, an underpenetrated credit cycle, a relatively low level of private debt-to-GDP and healthy domestic demand. Many of the frontier markets are recovering off a low in GDP growth and experienced significant resets in the economy, including markets like Nigeria and select markets across the Middle East.

From a thematic perspective, we continue to own and seek companies benefiting from healthy domestic demand, particularly in regards to health care, and select consumer discretionary and staples. We also see demand for financial services in countries with low credit penetration. We are seeking to minimize our exposure to countries highly dependent on trade as protectionism is increasingly part of the platform on new populist leaders.

We are turning positive on **Argentina**. The new monetary policy regime and higher interest rates are having the desired effect on inflation, which peaked in September at 6% month-over-month and has steadily declined to around 3%. The central bank placed very high cash reserve requirements on the banking system, and the trade balance is back in surplus with the fiscal deficit steadily reducing. With Argentina's external liabilities reduced, assets should be relatively more insulated from a risk-off external event. Growth is likely to bottom in the first or second quarter of this year as better wheat and soy harvests and wage increases should help to offset the impact of high interest rates. Politics remain front and center ahead of the 2019 elections and the potential of Cristina Fernandez de Kirchner running against Macri, which are contributing to headline risk.

We have become a bit more cautious on the **Middle East** in the near term. In the **U.A.E.**, we worry about an overhang in the property markets of both Dubai and Abu Dhabi, driven by excessive supply and what we see as fairly weak demand for property. In **Saudi Arabia** the outlook has been clouded slightly due to the unfortunate events in Istanbul and the geopolitical implications, including the risk of sanctions. Nonetheless, we believe the events will lead to more centralized decision-making in the country, as well as a potential de-escalation of the war in Yemen and the more normalized relations with Qatar, which we view as positives. Additionally, authorities in Saudi are more likely to increase government spending domestically in the near-term in order to stimulate the economy.

Pakistan continues to suffer from twin deficits, with the current account deficit reaching its highest level since the Global Financial Crisis. Though the currency has devalued, it falls in the higher range compared to other frontier markets. The currency may have another round of devaluation before a possible International Monetary Fund (IMF) program, which is now being questioned given Prime Minister Imran Khan's more populist agenda since taking office in August. The latest finance bill does not place appropriate austerity measures at a high priority, which could place the IMF package at risk and lengthen the economic reform required in the country.

We remain underweight **Kenya** as the macro outlook continues to weaken. Kenya suffers from twin deficits and its growth is fiscal-led, which we do not believe can be funded further. The Kenyan macro situation, from a consumer, private sector and banking perspective, remains under pressure. The current account deficit remains large and sticky, and the currency appears to be overvalued. Industry loan growth is likely to remain subdued as banks lack the capacity and model to grow lending with the rate cap in place.

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

FUND FACTS

Launch date	Base currency	Index*
28 March 2013	U.S. dollars	MSCI Emerging Markets Small Cap 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 Small Cap Equity Fund - Z Shares	-22.60	19.92	5.25	-10.17	3.56
MSCI Emerging Markets Small Cap Index	-16.41	31.86	2.66	-14.46	6.84

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.**

***Effective 12th September 2017, the Morgan Stanley Investment Funds Frontier Emerging Markets Equity Fund was renamed to Morgan Stanley Investment Funds Frontier Markets Equity Fund. Subsequently, effective 2nd January 2019, the Morgan Stanley Investment Funds Frontier Markets Equity Fund was renamed to the Morgan Stanley Investment Funds Emerging Markets Small Cap Equity Fund, and the fund's benchmark changed from the MSCI Frontier Index to the MSCI Emerging Markets Small Cap Index, and the fund's investment objective changed. Please refer to the fund's prospectus for further information on these changes.**

The Blended Index performance shown is calculated using the MSCI Frontier Index from inception through 2 January 2019 and the MSCI Emerging Markets Small Cap Index thereafter.

Share Class Z 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 and frontier 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 and frontier 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 Small Cap Index** includes small cap representation across 23 Emerging Markets countries. With 1,864 constituents, the index covers approximately 14% of the free float-adjusted market capitalization in each country. The small cap segment tends to capture more local economic and sector characteristics relative to larger Emerging Markets capitalization segments.

The **MSCI Frontier Markets Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance of frontier markets. The MSCI Frontier Markets Index currently consists of 24 frontier market country indices. The performance of the Index is calculated in U.S. dollars and assumes reinvestment of net dividends. "Net dividends" reflects a reduction in dividends after taking into account withholding of taxes by certain foreign countries represented in the Index.

The **MSCI All Country World Index (ACWI)** is a free float-adjusted market capitalization weighted index designed to measure the equity market performance of developed and 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 performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

The **MSCI Emerging Markets Index (MSCI EM)** is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of emerging markets.

The **MSCI EAFE Index (Europe, Australasia, Far East)** is a free float-adjusted market capitalization index that is designed to measure the international equity market performance of developed markets, excluding the US & Canada. 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 EAFE Index currently consists of 21 developed market country indices. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

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