Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Investment Funds

US Property Fund

REAL ASSETS | GLOBAL LISTED REAL ASSETS TEAM | MONTHLY COMMENTARY | SEPTEMBER 30, 2017

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PERFORMANCE REVIEW

In the one month period ending 30 September 2017, the fund's I shares returned 0.82% (net of fees) while the benchmark returned -0.20%.

In the third quarter of 2017, the fund's I shares returned -0.37% (net of fees) while the benchmark returned +0.64%.

The REIT sector advanced 0.6% in the third quarter, as measured by the FTSE NAREIT Equity REITs (Net) Index. The fund underperformed the index in the quarter due to unfavourable sector allocation. Notably, the fund's outperformance in September was almost sufficient to offset the relative weakness in July and August. From a top-down perspective, once again, the most significant detractor was the overweight to the Class A malls. Other detractors from performance resulted from the underweight to the data center, industrial and net lease sectors. The fund benefited from the underweight to the health care sector. From a bottom-up perspective, the fund benefited from stock selection in the primary Central Business District (CBD) office, apartment and hotel sectors. This was offset by stock selection in the secondary CBD/suburban office and retail sectors.

MARKET REVIEW

REITs advanced 0.6% in the third quarter, and have gained 2.7% year to date. Despite a modest quarterly return, there continued to be a significant disparity in returns among the sectors.

Property values for core assets have fully recovered and remain, on average, approximately 20% in excess of peak levels achieved in 2007. There have been concerns that values may have peaked, or were even poised to decline, after significant appreciation. However, values have generally remained stable at peak levels for the last twelve to eighteen months. According to data from Real Capital Analytics, year-to-date transaction volume through August 2017 totaled $279.0 billion, which was a 9% decline from the previous year. They noted that the year-to-date themes on transaction volume remain consistent: industrial transaction volume is up 19.5% year-on-year ($42 billion transaction volume) and the other major asset classes down 10-20% year-on-year. Within office, which is down 9% year-on-year ($80 billion transaction volume), CBD office is down 25% year-on-year ($31 billion transaction volume) and suburban office is up 6% year-on-year ($49 billion transaction volume) as they noted that "in a market where investors are hungry for fixed income alternatives, suburban office investment simply represents a better yield opportunity." It seems logical that sustained volume declines may eventually lead to broad-based declines in asset values, however, this has not yet occurred. Values for low quality regional malls with sales productivity of about $350 per square foot or lower have experienced significant declines, but ownership of these assets in the public markets is limited.

The REIT market features a wider than typical disparity in valuations, with a group of property sectors at premiums and significant discounts to NAVs, but the overall

FUND FACTS

Fund launch
January 1996

Investment team
Ted Bigman, Bill Grant

Location
New York

Base currency
U.S. dollars

Benchmark
FTSE NAREIT Equity REITs (Net) Index

sector ended the quarter at an approximate 2% premium to NAVs. The current valuation disparity may generally be described in three categories: Premiums, Near Par and at Significant Discounts to NAVs. Premiums are sectors with perceived defensive characteristics (health care, net lease) which have been the greatest beneficiaries of the lower-for-longer interest rate environment that has been pervasive in recent years and/or benefiting from secular demand growth of digital technology and e-commerce (data center, industrial); Near Par are sectors experiencing decelerating SS NOI growth due to conventional supply-demand factors as these sectors advance into the latter phase of the real estate cycle (apartment, storage, office ex-New York City, hotels); and Significant Discounts are sectors experiencing extreme negative investor sentiment due to concerns over prospects for cash flows and asset values (retail and New York City office). We think that the most attractive value can be found in the companies that own Class A malls and New York City office assets as they are trading at the most significant discounts to NAVs despite significant transactional evidence that New York City office assets continue to demonstrate strength in asset values and the continued resilience in cash flow growth for the Class A malls, despite the headwind of elevated store closures.

Many REITs, primarily in traditional sectors, have shifted away from the acquisition market and have turned their attention to development and redevelopment activity. This shift is driven by the superior returns from development, discounted shares prices and continued aggressive bidding by private buyers. Development and redevelopment activity is most pervasive in the apartment sector, but we are also witnessing increased activity from select REITs in most other sectors. In contrast, REITs in sectors trading at premium valuations continue to be active acquirers. Aside from asset sales, REITs continue to fund their external activity largely with the issuance of new debt and equity capital as REITs take advantage of continued easy access to attractive capital. Equity issuance was subdued in 3Q, totaling only $2.5 billion, following $9.1 billion in 2Q and $9.5 billion in 1Q, respectively. Unsecured corporate debt market issuance remained robust and continues to be at record setting annual pace. Issuance was $15 billion in 3Q, following $9 billion in 2Q, leading to $35 billion year-to-date. This is almost equal to FY16, which had been the most active year to date. Proceeds were used both to fund external growth and to refinance maturing debt to take advantage of low interest rates and to extend debt maturities.

In the third quarter, the REIT market gained 0.6% and has advanced 2.7% year-to-date. Each of the major sectors underperformed the index in the quarter. The apartment sector underperformed in the quarter but has still posted outperformance on a year-to-date basis as investors appear to be encouraged by their SS NOI growth guidance despite high levels of new supply in select markets.

Within the office sector, both the companies with exposure to primary CBD markets and those focused on the secondary CBD/suburban markets underperformed the index and this is a continuation of the year-to-date trend.

The retail sector underperformed in the quarter. The mall owners underperformed the index, and are the second weakest performer year-to-date. The shopping center owners outperformed in the quarter but are still the weakest performer year-to-date. The malls continue to be plagued by concerns with regard to department store closures and specialty retailer bankruptcies resulting in additional store closures. We acknowledge these issues as legitimate concerns in the retail sector; however, the stock market is not sufficiently recognizing that the public companies tend to be owners of high quality assets that have remained resilient even with the backdrop of continued retailer challenges. This has resulted in a significant valuation disparity between the public market valuations of these companies versus the private market valuation of the companies' assets.

The health care REITs were the weakest performer in the quarter, but have still outperformed year-to-date. Recent weakness appears to be related to investor concerns with regard to oversupply in the senior living sector and weakness in the skilled nursing facility tenants. Among the smaller sectors, the industrial and data center sectors once again posted the best returns in the quarter. They continue to benefit from investor focus on the secular demand growth of digital technology and e-commerce. The storage, net lease and hotel sectors outperformed in the quarter.

PORTFOLIO ACTIVITY

Our company-specific research leads us to an overweighting in the fund to a group of companies that are focused in the ownership of Class A malls, New York City office assets, and a number of out-of-favour companies and an underweighting to companies concentrated in the ownership of health care, data center and net lease assets.

STRATEGY AND OUTLOOK

Our outlook for the REIT market is based on two key factors: private market pricing for underlying real estate assets and public market pricing for the securities. The REIT sector gained 0.6% in the third quarter and has advanced 2.7% year-to-date. With asset values for high quality assets having fully recovered and now, on average, approximately 20% in excess of peak levels achieved in 2007, the overall REIT market ended the quarter trading at an approximate 2% premium to NAVs, although there is wider than typical disparity in relative valuations among the sectors. We see the most attractive value in the owners of Class A mall and New York City office assets. These companies provide exposure to high quality core assets at significantly discounted valuations.

For further information, please contact your Morgan Stanley representative.

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Copies of the Prospectus, Key Investor Information Document, the Articles of Incorporation and the annual and semi-annual reports, in German, and further information can be obtained free of charge from the representative in Switzerland. The representative in Switzerland is Carnegie Fund Services S.A., 11, rue du Général-Dufour, 1204 Geneva. The paying agent in Switzerland is Banque Cantonale de Genève, 17, quai de l'Ile, 1204 Geneva.

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