Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Institutional Fund

Active International Allocation Portfolio

ACTIVE FUNDAMENTAL EQUITY | ACTIVE INTERNATIONAL ALLOCATION TEAM | COMMENTARY | MARCH 31, 2019

Portfolio Commentary

In the quarter period ending March 31, 2019, the Portfolio's I shares returned 10.02% (net of fees)[1], while the benchmark returned 10.31%.

During the quarter, equity markets responded very positively to a pause in rate hikes by the Federal Reserve, multiple stimulus announcements by the Chinese government and increasing optimism that a resolution would soon be found to U.S.-China tariff tensions. This was enough for what we may call a "relief rally;" technology, real estate, energy and industrials led the markets higher and once again the U.S. was a strong performer. The S&P 500 Index is now nearly back to all-time high levels.

For the first quarter, the Fund gained +10.02%, slightly behind the benchmark return of +10.31%. From a country perspective, trimming our allocation to Japan and our positioning in the market were positive, as were our zero allocation to Korea, underweight to South Africa and the allocation to the U.S. (average weight was 7.5%). Sector-wise, overweights to health care and gold stocks and the underweight to real estate detracted from returns. Overweights to technology and communication services stocks in Japan and an underweight to utilities contributed to portfolio performance.

Strategy and Outlook

Global economic data has been on the softer side in recent months, but the world economy continues to grow. Across most markets there are a number of factors moving in the same direction: inflation is low, bond yields have fallen, labor markets are solid and economic indicators for services are rising while those for manufacturing are slowing their pace of decline. Our base case is that given accommodative policy nearly everywhere around the world and also that we are experiencing slowing-but-steady economic growth, global equities can move higher in line with earnings. Additionally, last year's rocky stock markets have resulted in valuations that are more reasonable, especially outside of the U.S. Given that incremental equity market flows have been going into U.S. stock markets, the tide may turn as the relative valuation case for international equities improves. To get more granular, the MSCI USA Index forward price-to-earnings ratio (P/E) is currently at 17.2x consensus earnings estimates, while the MSCI Europe Index is at a forward P/E of 13.3x, MSCI Japan Index at 12.6x and MSCI Emerging Markets Index at 12.1x.[2] In addition to more favorable valuations, our work shows that non-U.S. regions also have the potential for higher earnings growth, another important factor which gives them room to appreciate. Therefore, our view is that at the margin, fundamentals favor many non-U.S. markets. A final point on asset allocation relates to our view on the U.S. dollar. While currencies can be at expensive levels and trend for a long time, our work shows much more value outside of the U.S. dollar, especially within select emerging markets (EM) that have been under pressure over the last 18 months due to a tightening global liquidity environment. We see an improving liquidity environment this year and therefore think that last year's headwinds have the potential to turn into tailwinds for the EM currency complex. Due to this, we have been adding to our EM holdings over the last quarter, as well as to some more cyclical sectors that have historically outperformed in line with EM.

While liquidity is better and some economic stimulus is coming from China and parts of Europe, we still don't see global growth inflecting sharply upwards from the pace we are recording today. Therefore, we continue to focus on countries, sectors, industries and stocks that we expect could be resilient in a more muted growth environment. Much of the recent market rally was the result of a re-rating of stocks due to hurried responses of global policymakers as they surveyed the significant fourth

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1 Source: Morgan Stanley Investment Management. Data as of March 31, 2019.
2 Source: MSIM, Bloomberg L.P., FactSet, Haver Analytics

quarter decline in asset prices and valuations. The easier policy stance from global monetary authorities is no doubt a positive, but we have to be cognizant that they have just moved slightly towards being less restrictive and any uptick in inflationary pressures could tilt them towards being more hawkish again. This could then present a similar challenge to global liquidity and growth momentum that we saw in 2018.

Adding it all up, while global stocks are cheaper than last year, we expect that earnings growth is required to nudge stocks noticeably higher. Portfolio positions are therefore focused on areas that we expect may be best able to weather the sideways pattern of economic growth by having structural tailwinds at their back, favorable/improving industry dynamics, or defensible and steady business models that we believe should result in consistent earnings in any environment.

FUND FACTS

Launch date	Base currency	Index
January 17, 1992	U.S. dollars	MSCI All Country World ex USA Index

Performance (%)

As of date March 31, 2019 (Class I Share at NAV)

	MTD	QTD	YTD	1 YR	3 YR	5 YR	10 YR	SINCE INCEPTION
MSIF Active International Allocation Portfolio - I Shares	1.68	10.02	10.02	-6.31	6.21	1.25	7.78	5.51
MSCI All Country World ex USA Index	0.60	10.31	10.31	-4.22	8.09	2.57	8.85	5.63
Blended Index	0.60	10.31	10.31	-4.22	7.83	2.64	9.12	5.44
MSCI EAFE Index	0.63	9.98	9.98	-3.71	7.27	2.33	8.96	5.38

Performance data quoted represents past performance, which is no guarantee of future results, and current performance may be lower or higher than the figures shown. For the most recent month end performance figures, please visit morganstanley.com/im. Investment returns and principal value will fluctuate and fund shares, when redeemed, may be worth more or less than their original cost.

The gross expense ratio is 1.14% for Class I shares and the net expense ratio is 0.90%. Where the net expense ratio is lower than the gross expense ratio, certain fees have been waived and/or expenses reimbursed. These waivers and/or reimbursements will continue for at least one year from the date of the applicable fund's current prospectus (unless otherwise noted in the applicable prospectus) or until such time as the fund's Board of Directors acts to discontinue all or a portion of such waivers and/or reimbursements. Absent such waivers and/or reimbursements, returns would have been lower. Expenses are based on the fund's current prospectus. The minimum initial investment is $5,000,000.

Returns are net of fees and assume the reinvestment of all dividends and income. They are compared to an unmanaged market index. Returns for less than one year are cumulative (not annualized). Performance for one year or more is based on average annual total returns. The returns are reported for Class I shares. Performance for other share classes will vary.

Effective December 30, 2016, the benchmark index for the MSIF Active International Allocation Portfolio changed from Morgan Stanley Capital International (MSCI) EAFE (Europe, Australasia, and Far East) Index to the MSCI All Country World ex USA Index. Blended Index performance shown is calculated using the MSCI EAFE Index from inception through 12/30/2016 and the MSCI All Country World ex USA Index thereafter.

RISK CONSIDERATIONS

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market value of securities owned by the portfolio will decline. Accordingly, you can lose money investing in this strategy. Please be aware that this strategy may be subject to certain additional risks. In general, **equities securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, market and liquidity risks. The risks of investing in **emerging market** countries are greater than risks associated with investments in foreign developed markets. **Derivative instruments** can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the portfolio's performance. **Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk).

INDEX INFORMATION

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

The **S&P 500® Index** measures the performance of the large cap segment of the U.S. equities market, covering approximately 75% of the U.S. equities market. The Index includes 500 leading companies in leading industries of the U.S. economy.

The **MSCI U.S. Index** is designed to measure the performance of the large and mid cap segments of the U.S. market.

The **MSCI Europe Index** is a free float-adjusted market capitalization index that is designed to measure developed market equity performance in Europe. 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 Japan Index** is a free-floated adjusted market capitalization weighted index that is designed to track the equity market performance of Japanese securities listed on the Tokyo Stock Exchange, Osaka Stock Exchange, JASDAQ and Nagoya Stock Exchange. The MSCI Japan Index is constructed based on the MSCI Global Investable Market Indices Methodology, targeting a free-float market capitalization coverage of 85%.

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 Indexes are unmanaged and do not include any expenses, fees or sales charges. It is not possible to invest directly in an Index.

IMPORTANT INFORMATION

The views and opinions expressed are those of the investment team at the time of writing and are subject to change at any time due to market, economic, or other conditions, and may not necessarily come to pass. These comments are not representative of the opinions and views of the firm as a whole. Holdings and sectors/region weightings are subject to change daily. All information provided is for informational purposes only and should not be deemed as a recommendation to buy or sell securities in the sectors and regions referenced.

This material is a general communication, which is not impartial and all information provided has been prepared solely for informational and educational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The information herein has not been based on a consideration of any individual investor circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.

Certain information herein is based on data obtained from third party sources believed to be reliable. However, we have not verified this information, and we make no representations whatsoever as to its accuracy or completeness.

Please consider the investment objectives, risks, charges and expenses of the fund carefully before investing. The prospectus contains this and other information about the fund. To obtain a prospectus, contact your financial advisor or download one at morganstanley.com/im. Please read the prospectus carefully before investing.

Morgan Stanley Investment Management is the asset management division of Morgan Stanley.

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