Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Institutional Fund

Active International Allocation Portfolio

ACTIVE INTERNATIONAL ALLOCATION TEAM | COMMENTARY | CLASS I SHARES | JUNE 30, 2021

Portfolio Commentary

In the quarter period ending June 30, 2021, the Portfolio's I shares returned 6.89% (net of fees)[1], while the benchmark returned 5.48%.

Most global equity markets posted positive performance in the second quarter. MSCI index regional returns were: U.S. +9%, Europe +8%, emerging markets +5%, Pacific ex Japan +1% and Japan flat. Second quarter MSCI All Country World ex U.S. Index sector returns were: health care +10%, energy and consumer staples +8%, technology +7%, materials +7%, consumer discretionary and industrials +5%, financials + 4%, real estate 3%, communication services +2% and utilities flat. Local currency returns versus the U.S. dollar were: Swiss franc +2%, euro +1%, and British pound and Japanese yen flat.

For the second quarter, the portfolio outpaced the benchmark, 6.89% versus 5.48% (Class I shares net of fees). Positioning in media & entertainment and materials (gold and copper mining stocks), overweight to and positioning in staples, and the underweight to and positioning in Japan were significant contributors to performance. The allocation to the U.S. and positioning in technology, particularly semiconductors, health care and discretionary detracted. On a year-to-date basis, the portfolio has had a strong absolute return of 7.62% but was behind the benchmark return of 9.16% (Class I shares net of fees).

During the quarter, we reduced our exposure to the technology (mostly semiconductors), industrials, communications and discretionary sectors, while we added to materials, health care, staples and energy. The trims were driven by stocks reaching or exceeding our estimates of fair value, and/or where we judged that expectations had gotten ahead of what we believed was likely to be achieved by the companies during a less robust phase of economic recovery. The new ideas added to the portfolio consisted of commodity companies where our research showed a favorable supply outlook, health care companies where the valuation today does not give credit for potential research and development and pipeline surprises, and consumer companies exposed to a recovering consumer in emerging markets.

Strategy and Outlook

We continue to overweight euro Europe with a focus on the core markets of Germany, the Netherlands and France. We have a slight overweight to Spain and zero allocation to Italy. In Asia, the portfolio remains overweight to Singapore as a proxy for Southeast Asia growth, holds below benchmark exposure in Japan (9.2% versus 14.3%), with zero allocations to Australia, Hong Kong and New Zealand. The portfolio is neutrally positioned in emerging markets, primarily with a focus on exposure to technology, commodities and the consumer, through e-commerce and premiumization of goods as incomes grow and demand moves to higher value products. Overall, our investment outlook continues to expect a patchy global recovery with continuing tug-of-war between structural deflationary forces and cyclical shortages/inflationary impulses.

In Europe, the European Central Bank (ECB) announced a revision to its inflation policy that will accept consumer price index (CPI) inflation above 2% on systemic basis. This is a significant shift for a central bank known for its hawkishness on inflation. The bank signaled that policy will likely be highly accommodative for some time. While this revised policy is more in line with other major central banks, we see the most significant implication for the euro. Investors have seen the ECB as taking more of a "hard currency" stance, and on the fiscal side the region had, up until the pandemic, limits on fiscal deficits. The result of the revised monetary policy may be a weaker euro, which is positive for a region so dependent on exports. For equities, earnings revisions, on both absolute and relative measures, are strengthening and stronger earnings should allow equities to re-rate. Vaccine

[1] Source: Morgan Stanley Investment Management. Data as of June 30, 2021.

distribution has positively surprised in its pace and economies are normalizing, which should further broaden the recovery from the strong manufacturing growth we have witnessed for the past year.

In Japan, the song remains basically the same. There are incremental positive policy initiatives such as raising the minimum wage by 3%, back to the 2016-2019 levels seen under Abenomics, which boosted wage growth, as well as a focus on digitalization, which is likely to improve productivity and reduce corruption. There has also been improvement on the corporate governance front with a couple of high-profile events that demonstrate that the authorities are beginning to recognize the importance of transparency and shareholders rights. However, these are small steps and we do not believe they are enough to move the needle to catalyze value recognition for the overall market. In Japan, the portfolio is overweight consumer-related and technology companies that we believe offer compelling value and a solid business story.

In the U.S., the Federal Reserve (Fed) was forced to acknowledge the robust economic growth and sharp increase in both consumer and producer prices to assure markets that it was aware of these dynamics even if it does not plan to act for some time to tighten policy. To refresh, Treasury 10-year yields had backed all the way up to 1.74% in late March, and following the Fed's hawkish turn in mid-June, the yield moved down to 1.29%.[2] We think this move makes sense. The post-COVID-19 recovery has been marked by incredible easing from both monetary and fiscal policies, and a turn toward becoming less accommodative at a time when the world is still significantly impacted by the ongoing pandemic should impact the growth and inflation outlook. Therefore, the markets are simply acknowledging that the environment remains very policy driven, and that it may not be yet time to withdraw accommodation.

While the recovery has thus far seen supply constraints and logistics chain problems causing prices to jump, we think that there are reasons for these pressures to ease. This is because, as it currently looks, some fiscal stimulus and government support is due to roll off in September and October, and this is likely to stem consumer demand. This, coupled with the increasing pace of vaccinations globally, is likely to result in many bottlenecks sorting themselves out. In fact, we are already starting to see such developments in areas such as lumber, where extreme shortages have given way to supply resumptions, leading prices to come down substantially from a few months back. In addition to this, we also see distinct distortions in the recent CPI prints. In short, this means that we expect that the sharp rise seen in CPI over the last several months to subside.

Having said that, our internal research and analysis point to a strong probability that once the pandemic is clearly in the rear-view mirror, prices of select commodities could be higher than pre-pandemic as a result of significant changes to the supply outlook of certain industries and labor markets. As we have communicated in previous letters, we think it makes sense to think long term and focus our investments on those industries that we believe can continue to have a tight supply/demand balance for several years, not months. To that end, we continue to see the potential for supply tightness and favorable pricing for copper, platinum, gold and several other smaller commodities that have seen underinvestment in the last decade.

The portfolio is fully invested, and we continue to hold our barbell positioning between sustainable growers and compelling value opportunities. Global economic growth is quite remarkable coming off the pandemic lows, earnings are increasing and equities are attractive for a world practically awash in cash. However, there are several significant anomalies (record levels of debt, deglobalization and sizeable supply chain challenges, among others) that bear careful watching. Also, while vaccines are being distributed more broadly and governments are able roll back restrictions, the pandemic is far from over; only about 10% of the world is vaccinated and the delta variant is contributing to further spread for second, third and fourth waves. We are also mindful of the possibility of a policy mistake as governments, through monetary and fiscal measures, are inordinately involved in the global economy and markets. This could take the form of a policy tightening that causes dislocations or conversely providing too much stimulus that overheats labor markets or consumer and producer prices. This is not our base case, but, given the unusual nature of this situation, we are alert to the possibilities. As a result, we anticipate periods of volatility as growth is uneven across regions and economies and policies continue to evolve.

We expect that we may increase the defensiveness of the portfolio as earnings and growth near peaks, and we will keep you apprised of our thoughts and portfolio strategy.

FUND FACTS

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

[2] Source: Bloomberg L.P. Data as of June 2021.

Performance (%)

As of date June 30, 2021 (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	-1.30	6.89	7.62	46.66	15.30	13.71	6.82	6.68
MSCI All Country World ex USA Index	-0.65	5.48	9.16	35.72	9.38	11.08	5.45	6.21
Blended Index	-0.65	5.48	9.16	35.72	9.38	11.10	6.29	6.04
MSCI EAFE Index	-1.13	5.17	8.83	32.35	8.27	10.28	5.89	5.90

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 1.02% 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.

Please keep in mind that high double-digit returns are highly unusual and cannot be sustained. Investors should also be aware that these returns were primarily achieved during favorable market conditions.

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 values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this portfolio 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 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.

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 objective, risks, charges and expenses of the fund carefully before investing. The prospectus contains this and other information about the fund. To obtain a prospectus, download one at morganstanley.com/im or call 1-800-548-7786. Please read the prospectus carefully before investing.

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

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