Portfolio Commentary

In the quarter period ending December 31, 2019, the Portfolio’s I shares returned 10.50% (net of fees)\(^1\), while the benchmark returned 8.92%.

For the fourth quarter, significant contributors to portfolio performance were the overweight to and positioning in technology, and positioning in energy and communication services. Significant detractors included the overweight to and positioning in consumer staples, positioning in health care and the underweight allocation to China.

Strategy and Outlook

The portfolio remained fully invested during the fourth quarter. We made some minor changes to positioning in the quarter by adding to energy services, semiconductors and gold stocks. We reduced the portfolio position in the U.S. and U.K.

This is a core portfolio and our regional/country allocation is geared towards stability and growth, as well as reform potential when we believe it will generate positive structural change. Currently, the portfolio is overweight Germany, the Netherlands and India, is underweight Japan, China and Canada, and has zero allocation to Australia and Italy. The portfolio has an allocation to the U.S. as a means to capture specific themes in technology and health care and for gold stocks. The portfolio has a slight underweight to emerging markets (EM), where we expect to add to positions over time as specific countries, sectors, industries and stocks could offer attractive growth and reasonable valuations.

We are focused on structural themes, namely technology (software, internet and the Internet of Things), health care (aging and innovation), and select staples/consumer stocks. We also have a number of value and cyclical investments such as oil services, European airlines and DRAM (dynamic random-access memory) manufacturers where consolidation and supply rationalization are leading to much better industry dynamics.

Our investment outlook continues to be cautiously optimistic for global equities. The headwinds markets faced earlier in 2019 – Federal Reserve (Fed) tightening, slowing economic growth, falling corporate earnings – have been addressed or are showing signs of bottoming. While this is not the most optimal environment for equities, it certainly is not the worst.

On a longer-term view for 2020 and beyond, we see the potential for non-U.S. markets, which are more attractively valued than the U.S., to re-rate if earnings growth exceeds current consensus forecasts. Importantly, we also think that there will be increased dispersion in country, sector, industry and stock performance, which should provide greater opportunity for active managers to add value. Our investment outlook is detailed below.

2019’s robust S&P 500 Index return has continued the multiyear trend of U.S. equities outperforming the Rest of the World (RoW), with minimal dispersion in sectors and historically low levels of volatility. With earnings declining by -2%, multiple expansion was responsible for more than 80% of the U.S. equity market’s gain seen in 2019.\(^2\) At this point, U.S. relative outperformance is more than two standard deviations above an established average trend line going back 100 years.\(^3\) This is an unprecedented development that looks to have run too far given very stretched relative valuations and weak earnings trends.

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\(^2\) Source: MSCI/IBES. Based on the MSCI United States Index return and decomposition.
\(^3\) Source: MSIM, Bloomberg L.P., FactSet, Haver Analytics.

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.
Fittingly, as investors have continued to favor U.S. stocks over all others, some have dubbed the strong run as "the FOMO market."

If fear of missing out has propelled the U.S. stock market over others, what can we expect from the early years of the 2020s and the decade to come? Over time, we expect a new market regime to raise the currently low levels of country, sector and industry dispersion, and to result in more normal volatility of returns. As this occurs, it should open the door to a comeback for non-U.S. relative performance and should also favor active over passive allocation strategies.

Here are some of our key expectations:

- **U.S. outperformance looks hard to sustain.** Many global investors have favored the U.S. economy and stock market because of the perception that the U.S. is mostly insulated from trade tensions, helping drive its outperformance in 2019. However, over the last year, U.S. earnings growth has decelerated from +26% to -2%;\(^2\) weighed down by the same trade and geopolitical uncertainty that has impacted foreign markets. U.S. earnings held up slightly better than non-U.S.; however, investors have paid for this by buying in at much higher valuations. Relative price-to-cash earnings (best back-tested indicator) is already at 97th percentile, meaning that U.S. stocks have only been more expensive relative to non-U.S. just 3% of the time since the data began.\(^4\) This is an extreme level, and today the implied relative returns for U.S. versus global equities are in the worst decile, consistent with negative-implied relative returns one, three and five years out.\(^4\) In sum, slightly better U.S. economic and earnings expectations look fully priced in versus the RoW, and overweighting U.S. equities may no longer be a good relative bet. With foreign markets currently much more attractively valued than their U.S. counterparts, and several signs that the growth outlook is improving, it wouldn’t take much improvement in fundamentals to drive strong relative outperformance.

- **The repo market fiasco of 2019 means that the liquidity environment will likely be more supportive towards non-U.S. assets.** Developments in 2019 showed that the Fed’s quantitative tightening (QT) policy destroyed too many excess reserves in a world where regulated financial institutions have rigorous capital standards. As this realization has dawned on policymakers, they have called off the first coordinated monetary tightening campaign since the global financial crisis, in the face of ever-present record-high debt levels and the downward pressure that this dynamic exerts on world economic growth. The Fed’s QT policy disproportionately impacted international financial markets, creating a scramble for liquidity and funding challenges, while at the same time promoting U.S. dollar strength. As global and U.S. economic growth undershot projections over the last 18 months, the Fed cut rates three times and was forced by repo market issues to once again actively expand its balance sheet. The exact duration and size of the Fed’s response is still debated, but it is clear that policymakers’ bias is towards maintaining ample liquidity. In turn, the Fed’s easy posture may not only improve global funding, it may also result in better growth dynamics outside the U.S., attracting more currency inflows towards the high yielding currencies (most of which are in EM). These dynamics illustrate that the strong headwinds facing non-U.S. growth are abating, and argue for rotation away from U.S. equities.

- **The strong U.S. dollar faces weakening fundamentals and rising political uncertainty that could take its toll.** Our proprietary foreign exchange (FX) framework, which considers many intrinsic variables to derive relative values for all currencies, shows that the U.S. dollar’s strong run since 2011 has made it very expensive relative to virtually all global currencies. On top of stretched valuation, a large and widening fiscal deficit as well as a more accommodative Fed all make the dollar more of a sell than a buy. Interestingly, over the past decade, more than $16 trillion of foreign capital have flowed into the United States,\(^5\) attracted by its relatively higher growth dynamics, yield advantages, a robust equity market and capital-friendly policies. While other currencies have been frequently undermined by negative political surprises, the U.S. dollar has been regarded as the bastion of stability in an uncertain world. However, in our view, the challenged fundamentals outlined above, in addition to deepening political division in Washington and the uncertainty stemming from the upcoming 2020 presidential and congressional elections, could dent the Teflon status of the U.S. dollar. Foreign investors who have sent all that capital into the U.S. have thus far been resilient in the face of mounting government dysfunction, extreme partisanship in Washington and stark polarization between the coasts and the middle of the country. As the 2020 electoral race gathers pace, foreign investors may struggle to handicap the election outcomes and the real-world impacts of the vastly different policy proposals being espoused by the two major parties. With one party clearly in favor of increasing taxes on the wealthy, implementing more redistributive policies and proposing intervention in several large sectors of the economy, and the incumbent administration looking to continue with assertive trade re-negotiation and efforts to make the U.S. dollar more competitive versus other currencies, we see the possibility of unusually large moves and higher volatility (in rates, in U.S. equities and, above all, in FX). All of this is important, because in recent years FX volatility has been very low, and complacency about the U.S. dollar has been high. In sum,

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\(^2\) Source: MSCI/IBES. Based on the MSCI United States Index return and decomposition.

\(^4\) Source: MSIM AIA Team analysis, historical return, MSCI, Bloomberg L.P., FactSet, Haver Analytics.

investors may increasingly question the premium valuation of the dollar, especially in the face of the fundamental challenges outlined above and a better non-U.S. growth and liquidity environment. Therefore, the strong U.S. dollar – a key pillar of support for U.S. asset outperformance since 2011 – could fade in the months to come.

- **EM offers better return prospects in 2020 and the decade to come.** EM’s painful decade of underperformance has produced relative valuations that are now at the most attractive levels in about 20 years. Outside of China, many EM currencies are now cheap, and many EM governments have been reducing external vulnerabilities, deleveraging, reforming and generally putting their economic house in order. In addition to attractive equity and FX valuations, the fundamental improvements seen over the last decade and the recent improvement in the global liquidity environment may all overpower the headwinds that have confronted the asset class since 2011. Over the next year, a trade truce may be good for the entirety of emerging markets, and may broadly result in better growth and earnings trends. Looking a bit further ahead, with China and the U.S. continuing to restructure their trade relationship, emerging economies will have to choose which wagon to hitch themselves to; producing a much clearer distinction between winners and losers, as well as contrarian opportunities. In sum, EM equities look poised to reverse their decade of underperformance, with a focused and highly active approach required to truly find those EM countries, sectors, industries and stocks that can sustain multi-year outperformance.

- **The FOMO market will likely fade and active management may come back in vogue.** The U.S. FOMO market characterized not only 2019, but much of the 2010s. When investors are all making the same bet and profiting in an unusually calm market, there are less reasons to pay an active manager. As U.S. equity markets rose while volatility and dispersion plumbed new record lows, cheap passive funds took off over the last decade, exacerbating a tough environment for active investors. However, we think the pendulum is now poised to swing back to active. As we have argued, further decoupling, stretched U.S. relative valuations and threats to the strong U.S. dollar are likely to result in greater dispersion in performance, and a rotation towards non-U.S. assets. There are also other factors that bear consideration. A decade of easy money has been good for financial assets, but has also encouraged some capital misallocation towards real estate and indebtedness, while fueling the resentment of those who do not own financial assets. Populist political movements promising to correct built-up imbalances are rising, alongside massive public protests, in virtually every developed democratic state. As a result of popular upheaval, record-high debt levels and stubbornly low economic growth, politicians of all stripes are pondering new tools such as modern monetary theory, along with heavier regulation and taxation of the very same companies that were the big winners of the last decade. All this is likely to increase dispersion and volatility of returns, and reward those who are able to take advantage of country selection as well as sector and industry distinctions to add value. In short, it should be an environment in which active managers set themselves apart from the benchmark-driven crowd.

Calling a shift in market regimes is always difficult, but there are signs that investors will be less likely to continue piling on the big trends of the 2010s, bringing the U.S. FOMO market to a close. Encouragingly, in recent months, non-U.S. markets have performed in line with the U.S. equity market, while the U.S. dollar has generally been weaker. While getting the timing right is hard, we believe our country allocation framework, coupled with our rigorous sector, industry and company selection process, is well suited to thrive in a regime that should reward a wider set of winners.

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<th><strong>FUND FACTS</strong></th>
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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 Indexes are unmanaged and do not include any expenses, fees or sales charges. It is not possible to invest directly in an Index.

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