Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Institutional Fund

Dynamic Value Portfolio

GLOBAL MULTI-ASSET TEAM | COMMENTARY | JUNE 30, 2021

Performance Review

In the quarter period ending June 30, 2021, the Portfolio's I shares returned 3.79% (net of fees)[1], while the benchmark returned 5.21%.

During the quarter, the portfolio was on average 30% overweight a portfolio of Value stocks and -30% underweight a portfolio of Anti-Value stocks. Growth (which shares characteristics with our Anti-Value portfolio of stocks) outperformed Value during the quarter, with the Russell 1000 Growth Index returning +11.9%.

Market Review

U.S. equities rose +8.6% (S&P 500 Index) in the second quarter of 2021 as the global economic reopening continued amid record fiscal and monetary stimulus and gradually improving vaccine availability, with the recovery in activity broadening out to services and to non-U.S. developed markets. During the quarter, the proliferation of the COVID-19 virus in emerging markets, which had access to fewer and often less effective vaccines, led to the mutation of the virus into more contagious new variants, and as a result to the reimposition of lockdowns in some regions. Supply chain disruptions and labor shortages caused prices to rise globally, calling into question the Federal Reserve's (Fed) commitment to their uber-dovish FAIT (flexible average inflation targeting) policy. The yield curve flattened, with U.S. 2-year Treasury yields rising by +9 basis points (bps) to 0.25%, and U.S. 10-year Treasury yields falling by -27 bps, to below 1.5%.[2] Commodity prices were up overall (S&P GSCI Index +15.7%), with gains across the board led by oil (Brent +20%) as global demand improved amid still-constrained supply.

Concerns over peaking growth and declining stimulus as well as the flatter U.S. yield curve helped defensive and Growth stocks catch up somewhat to Value and cyclicals during the quarter, with the Russell 1000 Growth Index up +11.9% versus its Value counterpart, which rose by +5.2%.

Portfolio Activity

We made no changes to the portfolio during the second quarter. Throughout the quarter, the portfolio maintained a 30% overweight position in a portfolio of Value stocks and a -30% underweight in a portfolio of Anti-Value stocks. As a reminder, the portfolio does not take active sector/industry positions versus the benchmark.

Strategy and Outlook

After underperforming by a cumulative 60% for 14 years, the Russell 1000 Value Index has outperformed the Russell 1000 Growth Index by 15% from summer 2020 to May 31, 2021.[3] Value gave back some of this outperformance in June 2021, as a resurgence in COVID-19 cases has paused the reopening process in many countries. Will Value reassert itself?

We believe it will. Value has historically outperformed by 3.5% annually over the long term for the past 100 years, with periodic downcycles.[4] The underperformance of the last 14 years can be explained by high starting valuations for Value stocks following

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[1] Source: Morgan Stanley Investment Management Limited. Data as of June 30, 2021.
[2] Source: Bloomberg L.P. Data as of June 30, 2021.
[3] Source: Bloomberg L.P. Data as of May 2021.
[4] Source: MSIM Global Multi-Asset (GMA) Team Analysis and Estimates, Bloomberg L.P., Fama-French. Fama-French from 1926 to 1978, Russell 1000 Value Index and Russell 1000 Growth Index from 1978 to present. Data as of March 31, 2021.

the burst of the 1990s tech bubble, low "nominals" (low growth, interest rates, and inflation) which favor long-duration growth stocks, and technological disruption—most of which have either reversed or are in the process of reversing. Value stocks now trade at a steep discount to Anti-Value, "nominals" are rising, and the pace of technological disruption is likely no longer accelerating. We see the recent modest outperformance of Value as the beginning of a structural bull market for Value after a record structural bear market. Historically, a structural bull market for Value has delivered +100% outperformance over multiple years.[5]

Valuation: Value stocks are -36% cheap to their long-term median relative valuation to Anti-Value, and have only been cheaper 5% of the time in 55 years.[6]

Fundamentals: As far as near-term catalysts go, we expect "nominals" (growth, rates, inflation) to continue to rise.

- Growth: As the race between increased vaccinations and the fast-spreading COVID-19 delta variant continues, with the vaccine having some chance of outpacing the virus in major developed markets, we expect that continued economic reopening and record stimulus will keep global growth above-trend, though there is evidence that growth could peak in the third quarter. The recovery is being powered by enormous policy support. The U.S. has enacted $2.8 trillion of stimulus, with another $1.5 trillion likely coming, the Eurozone Recovery Fund disbursement is beginning in the second half of the year, and global monetary policy is at record easy levels, with substantial excess savings adding another tailwind to growth.
- Rates: The U.S. 10-year Treasury yield has declined significantly over the past few months, led by a decline in U.S. TIPS (Treasury inflation-protected securities) yields. This has been at odds with the rebound in global growth, and we expect the U.S. 10-year Treasury yield to rise to 1.84% by the end of 2021.
- Inflation: We expect U.S. inflation pressures to continue, with increased likelihood of a sustained overshoot of expectations. Temporary factors such as supply bottlenecks and labor supply shortages are causing a near-term spike in inflation, but more lasting price increases may be possible, given increasing fiscal and monetary policy extremism and the fact that we have not experienced deleveraging in the COVID-19 crisis. We expect the U.S. output gap to reach 2-3% by end-2021 and 3-5% by end-2022. We forecast core inflation to be 2.7% by year-end 2021, moderating closer to, or just below, target by the end of 2022. We note that there is potential upside risk to this forecast. Labor market tightness may persist to the extent that the COVID-19 delta variant causes normalcy to be delayed, and the longer these "temporary" inflationary forces persist, the more likely it is that expectations for higher inflation become embedded.

In summary, we remain overweight Value vs. Anti-Value within U.S. equities, as we expect continued improvement in economic activity and underperformance of rates to benefit Value stocks relative to Anti-Value stocks. In addition, as the macro regime shifts from the expansion to the overheating phase (and by 2022 will likely reach stagflation), we expect to see mini-bubbles bursting in overvalued areas of the market such as Anti-Value.

FUND FACTS

Launch date	Base currency	Index
March 19, 2021	U.S. dollars	Russell 1000 Value Index

[5] Source: MSIM GMA Team Analysis; Bloomberg L.P., FactSet. The team identifies Value as the cheapest 20% and Anti-Value as the most expensive 20% of stocks for each industry group within the Russell 1000 Index universe based on six valuation metrics, including forward P/E and free cash flow yield. Since 1990, periods of Value outperformance have been 1990 to 1998 (+75%), 2000 to 2007 (+316%), and 2009 to 2017 (+80%). Periods of Value underperformance have been 1998 to 2000 (-39%), 2007 to 2009 (-30%) and 2017 to 2020 (-43%).
[6] Source: FactSet and Bloomberg L.P. Data as of June 30, 2021.

Performance (%)

As of June 30, 2021 (Class I Share at NAV)

	MTD	QTD	YTD	1 YR	3 YR	5 YR	10 YR	SINCE INCEPTION
MSIF Dynamic Value Portfolio - I Shares	-3.61	3.79	4.00	--	--	--	--	4.00
Russell 1000 Value Index	-1.15	5.21	5.93	--	--	--	--	5.93

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 0.91% for Class I shares and the net expense ratio is 0.55%. 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.

Short-term returns may not be indicative of the fund's long-term performance potential. A fund's performance, especially for very short time periods, should not be the sole factor in making your investment decision.

INDEX INFORMATION

The **Russell 1000® Growth Index** measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000® Index companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000® Index is an index of approximately 1,000 of the largest U.S. companies based on a combination of market capitalization and current index membership.

The **Russell 1000® Value Index** is an index that measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

The **Standard & Poor's 500® Index (S&P 500®)** measures the performance of the large cap segment of the U.S. equities market, covering approximately 80% of the U.S. equities market. The Index includes 500 leading companies in leading industries of the U.S. economy.

The **S&P GSCI Commodity Index** is a composite index of commodity sector returns, representing an unleveraged, longonly investment in commodity futures that is broadly diversified across the spectrum of commodities.

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.

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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.

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