Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Institutional Fund

Emerging Markets Portfolio

EMERGING MARKETS TEAM | COMMENTARY | CLASS I SHARES | JUNE 30, 2021

Performance Review

In the quarter period ending June 30, 2021, the Portfolio's I shares returned 6.62% (net of fees)[1], while the benchmark returned 5.05%.

Our aggregate country allocation and aggregate stock selection both contributed to excess returns. Country allocation has been a strong contributor to excess returns over the year-to-date and last 12 months as dispersion continues to increase, with formerly ignored markets in 2020 (particularly in the Latin America and EMEA regions) benefiting from signs of economic recovery.

Stock selection in and overweight allocations to Russia and Poland contributed strongly, led by allocations to digital bank Tinkoff and apparel retailer LPP, respectively (2.2% and 1.4% of the portfolio).[2] We believe LPP can emerge from the pandemic in a stronger position given its brands, geographic footprint, focus on affordability and financial strength. We believe the company has several years of attractive growth ahead as LPP expands its affordable brand Sinsay and gains share in Russia and other Eastern European countries. Our allocation to Allegro (0.7% of the portfolio) in Poland also contributed, as first quarter results showed that revenue momentum remains strong even as economies reopen, as the company continues to increase its moat versus competitors.[2] Elsewhere in Russia, our allocations to low-cost natural gas company Novatek and internet company Yandex also added to returns (1.5% and 1.5% of the portfolio, respectively).[2]

Our overweight allocation to Brazil and zero allocations to Thailand, Chile and Malaysia also contributed to returns. From a sector perspective, our stock selection within communication services and IT and in select financials contributed to performance. Allocations to semiconductor equipment company ASML, IT services company EPAM and online platform company Sea Limited were top contributors (2.1%, 1.3% and 1.7% of the portfolio, respectively).[2] EPAM could benefit from the combination of strong demand for IT services as companies continue investing in digital transformation, access to best-in-class talent pools, and an increasing offer of higher value-added services.

Our underweight allocation to China contributed to returns during the quarter, though our stock selection detracted as New Oriental Education and TAL Education underperformed (0.6% and 0.3% of the portfolio).[2] Chinese education companies were impacted by the news of a potential increase in regulations. The details released by the Beijing Education Commission focused on the role of in-school education and improving quality, along with reducing the burden of homework and after-school tutoring on students. While the industry may continue to face such headwinds in the near term, we believe the industry will likely benefit from longer-term growth considering the relatively lower penetration of after-school tutoring in China compared to markets like Japan and Korea. In China, zero allocations to Nio, Li Ning and BYD Company detracted as these stocks rallied during the quarter.

Stock selection in materials and industrials also detracted, led by allocations to Anglo American Platinum (0.9% of the portfolio) and Copa Holdings (1.1% of the portfolio) and our zero allocation to Vale.[2] The stock price of Vale has rallied this year on the back of the increase in iron ore prices, however, we maintain our conviction in avoiding Vale on environmental, social and governance grounds.

1 Source: Morgan Stanley Investment Management. Data as of June 30, 2021.
2 Holdings as of June 30, 2021

Market Review

The MSCI Emerging Markets Index returned +5.05% during the quarter, underperforming the MSCI World Index, which returned +7.74%. Brazil was the top performer in emerging markets (EM), returning +22.91%. Poland (+18.67%), Hungary (+14.81%), Czech Republic (+14.56%) and Russia (+14.03%) also outperformed. Chile (-14.19%), Egypt (-9.23%), Peru (-8.78%) and Pakistan (-6.65%) lagged the EM index.

Portfolio Activity

During the quarter, we initiated a position in Mexican airport operator Grupo Aeroportuario del Sureste (0.2% of the portfolio), which could benefit strongly from ongoing vaccine rollouts and the recovery of travel and tourism.[2] We added to Globant and MercadoLibre, funding it by trimming our position in PagSeguro (1.3%, 1.5% and 0.6% of the portfolio, respectively).[2] While we maintain our conviction that PagSeguro remains an attractive investment opportunity in the digital payments and fintech industries in Brazil, we believe Globant and MercadoLibre have larger addressable markets and better geographic diversification.

We trimmed our position in Taiwan Semiconductor Manufacturing Company (TSMC) and added to high conviction names in the semiconductor industry such as AirTac, Delta Electronics, Applied Materials and Lam Research (8.9%, 0.6%, 1.9%, 0.9% and 0.8% of the portfolio, respectively).[2] While we remain positive on TSMC in the foundry space, we continue to add to semiconductor capital equipment (semicap) names such as Applied Materials and Lam, as this segment may benefit from structural capacity expansion and rising complexity in chip manufacturing. Delta Electronics could see growth from the opportunity in electric vehicles and the general trend for more efficient power management in areas such as 5G and data centers. AirTac could gain market share as it launches products in new segments amid the secular trend in industry automation demand.

In China, we exited our positions in CICC and China Resources Land. China Resources Land is facing headwinds from continued pressure on margins and tightening housing policies. We also sold generics company Joincare Pharmaceutical, which lacks a strong in-house research and development capacity. We have focused our holdings in the Chinese health care industry on niche players such as WuXi Biologics (0.7% of the portfolio), a leading pure-play biologics contract research organization with an advanced technology platform for biologics drug development.[2]

Outlook

We are very constructive on the broad outlook for emerging markets as an asset class over the next five-plus years, after the U.S. dominance of market returns in the past decade. Key among the catalysts to drive robust returns for EM equities are an eventual weakening of the U.S. dollar, the continued recovery of commodities prices, and the emerging reforms and digital innovations emanating from many EM countries. EM valuations overall are compelling relative to the U.S. equity market, which is likely to support asset allocation shifts. We believe we are at an important inflection point, as drivers of economic growth and equity market returns converge to help power the asset class after nearly a decade of underperforming the U.S.

Many critical global commodity prices are in the midst of a cyclical rebound after commodity producers spent the last decade cutting excess supply. The U.S. dollar is near historical extremes, and a weaker dollar is usually supportive of higher commodity prices, which are often denominated in dollars. A rise in commodity prices has typically correlated with stronger EM gross domestic product growth. Diversified exporters like Brazil could gain from a broad increase in commodity prices. As net-zero regulations increase globally, countries involved in green electrification (i.e., producers of nickel, aluminum and copper), like Chile and Peru, may benefit. The move to a hydrogen economy will likely also help boost exporters of platinum, led by South Africa and Russia.

From early on in the pandemic, our sense was that COVID-19 was less likely to “change everything” than to bring more of the same. Indeed it has, deepening trends that were already underway, most notably the expansion of the role of government in the economy and the adoption of digital technology.

Under pressure from weak growth and rising debts, several large emerging markets such as India and Indonesia were making tough reforms even before the pandemic hit, and are still pushing ahead now. With their backs up against the wall from the pandemic, these EM countries are being forced to reform, solidify national finances, streamline government and be open to global market forces in ways that could help sustain faster growth for many years.

Perhaps most importantly, the pandemic has proven the importance of the digital revolution. Over the last decade, the number of internet users doubled in G20 countries, with the biggest gains coming from 10 large emerging markets, including Russia, Brazil and India.[3] During this time, the number of people who own a smartphone globally has risen from 150 million to more than

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2 Holdings as of June 30, 2021

3 Source: ITU World Telecommunications Database/ICT Indicators Database, Organisation for Economic Co-Operation and Development (OECD)

4.5 billion.[4] Digital technology, including smartphones, is becoming increasingly affordable and within reach for EM customers, and the quality of connections is also improving rapidly. According to the Organisation for Economic Co-operation and Development, of the 10 countries where internet bandwidth is growing fastest, eight are in the emerging world. Aiding this technological revolution is the large population of millennials in many emerging countries and the lack of legacy brick-and-mortar infrastructure in these markets. With younger generations—who have been raised on the internet—making up a growing part of the population in emerging markets, and limited or no access to reliable infrastructure for industries like banking, retail and health care, there lies greater potential to find innovative ways to meet everyday needs through digital technology.

Digital technology has the capacity to transform for the better any large domestic economy, including the many that have been forgotten by global investors, such as Indonesia, the Philippines and Vietnam. New companies are arising to cater to the growing technological wave spreading across the emerging world: since 2014, more than 10,000 tech firms have been launched in EM, nearly half outside China, and many have grown beyond the risky startup phase.[5] Even outside the well-known internet boom in China, these companies are targeting a virtually endless list of unsatisfied needs and underserved populations. Some have already become national or regional market leaders. EM adopters and adapters are quickly becoming the new innovators in areas such as e-commerce, fintech and ride sharing. With a smartphone now in most adults' pockets, and rising demand from tech-savvy youth, the technology revolution is unfolding fastest in emerging markets, and is likely just in its early days, with its impact likely to grow in the coming decades.

Our portfolio remains focused on the themes, stocks and countries that we believe can thrive, even if growth levels are much lower than they were in the first decade of the 2000s, when EM boomed as an asset class. We continue to be overweight secular growth winners in themes such as technology, media and consumer staples and have incrementally added cyclical recovery plays, including select materials and energy companies that meet our high quality criteria with sustainable earnings.

Overweight strategy:

We continue to overweight the **Central and Eastern European** (CEE) region through our exposure to stocks mostly in Poland. CEE countries entered the pandemic with little or no economic imbalances and have ample room both on the monetary and fiscal sides to counter the economic impact of COVID-19, making it possible for these economies to recover faster than other developing countries. We continue to invest in secular growth stories and strong franchises in CEE.

We remain overweight **Russia**. We continue to have confidence in the country's orthodox macro policy framework, which has materially reduced its economy's vulnerability to external shocks. While we do not foresee rapid economic growth in the country, a sizable economy of around $1.5 trillion in value, the abundant low-cost natural resources, lack of legacy infrastructure, strong human capital and declining foreign competition create very attractive investment opportunities, some of which still trade at very attractive valuations. We remain invested in companies in financial services, e-commerce, energy and materials.

Brazil has been hit hard by the coronavirus pandemic, but we have remained overweight, owing to the prospects for an eventual improvement in the macro environment and our high conviction in the quality of the companies we own. We have already seen signs of macro recovery in the past couple of months, and think the outlook can improve over the course of this year as vaccinations ramp up aggressively, the domestic economy reopens and the currency, which is undervalued, is bolstered by the global commodity recovery and interest rate normalization by the Central Bank of Brazil. As vaccinations continue to roll out, we think the Bolsonaro administration has a good chance of returning to its reform path. Structurally, we are encouraged by Brazil's large domestic economy, which offers significant growth opportunities given fragmented and/or inefficient industry structures, the limited presence of global players and relatively nascent digital adoption. We believe the stocks we own in the country can execute against these opportunities and have high quality management teams and sustainable competitive advantages, and that they will likely benefit from ongoing market share gains (often enabled by superior digital value propositions) and/or a broader economic recovery and subsequent market share growth.

Underweight strategy:

We remain underweight **China**, mostly owing to our limited exposure to state-owned "old" China industries. Beyond the pandemic, we believe surviving companies with strong balance sheets and cash flow could become market share consolidators afterward and thus likely long-term winners. In addition, the pandemic is likely to foster digital trends on both the consumer and enterprise sides, favoring companies that embrace and enable the digital transformation. Although we are underweight e-commerce/internet/gaming companies in China relative to the index, we maintain positions in incumbent leaders such as Tencent (6.7% of the portfolio) and continue to look for winners in this space in other parts of EM, such as Korea and Southeast Asia.[2] In China, we continue to focus on long-term fundamentals and identifying structural growth opportunities.

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[2] Holdings as of June 30, 2021
[4] Source: Ben Evans, Haver Analytics, United Nations Population Database
[5] Source: Boston Consulting Group, MSIM

Our medium-term view on the market hinges on whether the Chinese government can take the external pressure to further launch and implement long-term reform measures. While the economic growth rate may continue to slow over time, reforms could help enhance the quality and sustainability of the economy, which in turn could help boost China's corporate return on equity and valuation multiple. There are also structural themes that will likely play out, including the ongoing industry consolidation and consumption upgrade. We expect "new economy" companies to deliver superior growth and attract market interest. Against the macro backdrop of slower growth and lower global interest rates, we believe high quality stocks with secular growth trends will likely continue to enjoy a valuation premium and outperform the market in the longer run. As such, we continue to focus our bottom-up stock selection on companies with structural growth, competitive advantages, strong governance and financial strength.

We are underweight **Korea** given its high absolute levels of debt and status as a quasi-developed market. Our stock selection in Korea remains focused on identifying growth opportunities within the specific themes of technology, electric vehicles, media and gaming, most of which are driven by global demand.

FUND FACTS

Launch date	Base currency	Index
September 25, 1992	U.S. dollars	MSCI Emerging Markets Net Index

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 Emerging Markets Portfolio - I Shares	1.17	6.62	9.16	42.45	10.81	10.80	4.11	7.97
MSCI Emerging Markets Net Index	0.17	5.05	7.45	40.90	11.27	13.03	4.28	7.94

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 1.10% for Class I shares and the net expense ratio is 1.05%. 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.

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. 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 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 the risks generally associated with investments in foreign developed countries. **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). **China Risk.** Investments in securities of Chinese issuers, including A-shares, involve risks associated with investments in foreign markets as well as special considerations not typically associated with investments in the U.S. securities markets. Investments in China involve risk of a total loss due to government action or inaction. Additionally, the Chinese economy is export-driven and highly reliant on trade. Adverse changes to the economic conditions of its primary trading partners, such as the United States, Japan and South Korea, would adversely impact the Chinese economy and the Fund's investments. Moreover, a slowdown in other significant economies of the world, such as the United States, the European Union and certain Asian countries, may adversely affect economic growth in China. An economic downturn in China would adversely impact the Portfolio's investments. **Risks of Investing through Stock Connect.** Any investments in A-shares listed and traded through Stock Connect, or on such other stock exchanges in China which participate in Stock Connect is subject to a number of restrictions that may affect the Portfolio's investments and returns. Moreover, Stock Connect A shares generally may not be sold, purchased or otherwise transferred other than through Stock Connect in accordance with applicable rules. The Stock Connect program may be subject to further interpretation and guidance. There can be no assurance as to the program's continued existence or whether future developments regarding the program may restrict or adversely affect the Portfolio's investments or returns.

INDEX INFORMATION

The **MSCI Emerging Markets Net Index** is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of emerging markets. 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 Emerging Markets Index currently consists of 24 emerging-market country indices. The performance of the index is listed in U.S. dollars and assumes reinvestment of net dividends.

The **MSCI World Index** is a free float-adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets. 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 World Index currently consists of 23 developed market country indexes. 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.

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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.

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

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