Morgan Stanley Institutional Fund
Emerging Markets Portfolio

Performance Review
In the quarter period ending September 30, 2019, the Portfolio’s I shares returned -2.14% (net of fees)\(^1\), while the benchmark returned -4.25%.

Our stock selection in China continued to be the largest contributor to returns for both the quarter and year-to-date periods. Also contributing strongly to returns during the quarter was our stock selection in and overweight allocation to Turkey, stock selection in Taiwan and Korea, and our zero allocation to Saudi Arabia. Stock selection in South Africa and Brazil were also strong contributors to returns. Stock selection in and our overweight allocation to Mexico also contributed. Detracting from returns was our stock selection in India, stock selection in and overweight allocation to Argentina, and our overweight allocation to Peru.

Market Review
The MSCI Emerging Markets (EM) Index returned -4.25% during the quarter, underperforming the MSCI World Index, which returned +0.53%. Turkey (+11.65%) gained the most during the quarter, followed by Egypt (+7.44%), Taiwan (+5.19%) and Pakistan (+1.09%). Argentina fell -46.83% during the quarter, primarily in response to the first round of elections in August, in which the populist ticket of Alberto Fernandez/Cristina Fernandez de Kirchner surprised with a 16 percentage point victory. The size of their win makes it highly difficult for current President Mauricio Macri to win the October 27 presidential election. The Argentine peso and stock market sold off sharply following the results. The wide margin of victory by Fernandez and Kirchner signaled to the market that a potential return to populist, unorthodox, non-International Monetary Fund (IMF) supported economic policies could be on the horizon. Also leading negative returns during the quarter were South Africa (-12.60%), Poland (-12.12%), Czech Republic (-10.12%) and Saudi Arabia (-9.50%).

Portfolio Activity
We initiated a position in Telef Brasil (VIVO, 0.8% of the portfolio), which is the leading integrated telecom service operator in Brazil. We think the stock could have improving revenue and cash flow growth going forward, supported by an improving industry structure, management putting through pricing in mobile, fiber-to-the-home penetration supporting growth in fixed-line broadband, digitalization driving cost efficiencies and potentially a more favorable regulatory environment.

Also in Brazil, we initiated a position in health care company Hapvida (0.8% of the portfolio). The company has solid organic growth driven by mid- to high-single digit organic member growth and what we believe to be sustainable margin trends over the long term. Bolt-on acquisitions have provided an additional boost to growth. The company is raising additional primary capital to fund its merger and acquisition strategy. From a top-down perspective, Hapvida is a late-cycle company exposed to corporate hiring trends in Brazil. We funded this by eliminating our position in bank Bradesco in Brazil.

In India, we added IT services company Infosys (1.0% of the portfolio). With domestic growth struggling and the expected economic recovery unlikely to be V-shaped, we are adding to IT as domestic growth opportunities wane. We expect this stock and sector to benefit from a weak currency.

Also in India, we eliminated our position in industrial company Ashok Leyland (AL). AL is a play on the manufacturing and infrastructure side of the economy that had benefited previously from almost five years of industry upscale. While the second

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\(^1\) Source: Morgan Stanley Investment Management. Data as of September 30, 2019.

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half of 2020 could see some pre-buying ahead of the transition to the Bharat Stage VI emission-norm change, the overall weaker macro environment could overshadow this pre-buy.

**Outlook**

The recovery from the global financial crisis of 2008 is nearly 10 years old, making it the longest—but also the weakest—expansion on record. The long duration of this recovery is likely the outcome of endless stimulus. Central banks have been steadily lowering interest rates since the early 1980s and inflation expectations have stayed low, allowing central banks to provide instant stimulus at the first sign of a downturn.

We attribute the weakness of the recovery to four global trends that have crystallized since the crisis of 2008 and which we call the four “Ds”: depopulation (a steep drop in working age population growth, which is depleting national labor forces), declining productivity, debt growth (chiefly in the developed countries but within EM, confined primarily to China and Turkey while most EM countries have very low levels of debt), and deglobalization (a broad slowdown in cross border flows of goods, money and people).

To invest in a world economy slowed by these factors, we think investors need to adjust downward their expectations of what is considered “fast” growth and focus on the most resilient and promising economies. For countries with average incomes under $5,000, 5% is the new 7%; for those with income up to $15,000, 3% to 4% should be considered successful growth. With expectations recalibrated, we are focusing our portfolio on economies largely insulated against the four “Ds.” This includes countries that still have growing populations (such as India, the Philippines and Mexico) or strong domestic markets relatively immune to trade wars (Brazil, India, Indonesia and Egypt) or low debt burdens and solid banks (Mexico, Hungary, India, Indonesia and Egypt).

Within these broad themes, there will be pockets of opportunities even in countries hit hard by the four “Ds.” China is a frontline state in the trade wars with a shrinking labor force and rising debts. Yet the worst of these effects are hitting old state-run industries. China’s new private industries, led by technology but including education and health care, still have relatively few debt issues and many companies with bright prospects.

In our portfolio, we remain invested in good quality, growth-oriented companies capable of sustaining or expanding their earnings as a result of healthy or improving domestic demand and resistant to declines in global trade. Our aggregate sector overweight allocations are in the financials and consumer staples sectors—which we believe should benefit from the economic recovery and expansion phase that most EM countries only began to enter in the past couple years.

**Overweight strategy:**

We continue to overweight the Central and Eastern European region primarily through our exposure to stocks in Poland and Hungary. We think that growth in Central and Eastern Europe should remain healthy, supported by strong consumption and investment. We see the region as offering attractive investment opportunities through a combination of this solid economic growth and overlooked equity markets. Poland and Hungary both feature consumer growth accelerating at a faster pace than overall growth as households and businesses tap credit markets from a low base. We continue to like stocks that are exposed to secular growth opportunities in banks, staples, health care and industrial sectors in the region. We have focused the portfolio on stocks with earnings driven by volume growth and operating leverage independent of policy rates.

We remain overweight Indonesia as the country continues to make reform progress, delivers high and accelerating growth relative to northern Asian markets vulnerable to trade disruptions, and is benefiting from some improvements in foreign direct investment. The country should continue to post GDP growth around 5%. Indonesia has room to be accommodative on monetary policy, as long as inflation remains benign and overall stability is maintained, which appears likely. Overall policy direction is focused on supply-side reform and policymakers are aware that they need to focus on this in order to generate much needed foreign direct investment to fund their current account deficit. Other reforms which should be supportive of growth include enhancements to education/vocational training and review of the 2003 labor law, which would ideally make it easier for employers to right-size their formal workforce and invest in better training. Additionally, the administration of President Joko Widodo has put forth plans to roll back some of the 2019 subsidies (subject to budget approval) and is studying a new tax law, which includes potentially reducing corporate tax and introducing a digital tax amongst others.

We remain overweight Mexico. While there have been mixed signals on policy from the Lopez Obrador administration this year, the country is still poised to benefit from a combination of its cheap currency, especially considering its exports of

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manufactured goods, low debt levels and rising access to credit as a result of labor reform changes in the previous administration. Our exposure to consumer recovery names has benefited the portfolio.

We increased our overweight to Brazil during the quarter. Critical progress on pension reform has continued as a cross section of politicians provide support. Additional constructive reform includes likely approval of central bank independence, a sanitation bill, telecom reform, potential Transfer of Rights Bill and continued privatizations, which have come to $20 billion year-to-date. Tax reform, however, is not expected until 2021 or beyond. Investors are also taking cues from growth. What should help increase consumption is the release of Fundo de Garantia do Tempo e Serviço (FGTS) funds, which began in September. Lower interest rates and higher mortgage issuance is an additional potential positive as consumers gradually recover from the deep recession following the collapse in commodity prices. Business investment continues to take its cue from progress on the overall reform agenda.

Underweight strategy:

We remain underweight China on our concerns of slowing growth. However, we have been adding to our high conviction growth names among companies, which are generally geared toward rising demand in select areas. China continues to slow as a result of its credit expansion over the past 10 years, weakening trade and demographic overhang with an actual labor force shortage. What we are encouraged by in China is that state-owned enterprises (SOEs) have been steadily a less important segment of urban employment and among privately managed companies, corporate debt is much lower than among SOEs.

We think the wage growth of highly skilled, well-educated Chinese workers will continue to gradually improve, considering their large differential with developed country peers. The consumption power within this segment will continue to expand, providing ample room for companies to conceive of new products and services to satisfy the demand of this expanding middle class. In our portfolio positions in China, we are actively focused on good quality structural growth stories involving upgrades to consumption and greater demand for services broadly, particularly in the education, health care, and consumer discretionary segments.

We remain underweight Taiwan as we view it as a mature economy lacking the dynamic growth characteristics of other EM countries and it remains vulnerable to further disruptions in global trade.

Korea, our largest underweight, faced even greater challenges during the quarter. The economy continues to be impacted by the global slowdown, the cyclical decline in DRAM memory storage, and the fall in Chinese auto demand. In addition, trade tensions with Japan arose in the quarter as Japan removed Korea from the so-called “white list” of countries—requiring Korea to apply for permits for each import of strategic goods. This will likely lead to even more complicated trade relations between these two major economies. On domestic policy, there were negative consequences from the Moon administration’s increase in the minimum wage—chiefly higher unemployment as the traditional mom and pop stores struggled to keep up with rising costs. The Supreme Court-ordered retrial of Samsung billionaire J.Y. Lee—who had been indicted for bribery charges—is a reflection of the anti-business sentiment of the government. On the back of poor market performance, securities—particularly in the DRAM segment—saw earnings downgrades across the board. Given all these negative pressures, our stock selection in Korea remains focused on identifying growth opportunities within the specific themes of biotechnology, gaming, select global cyclicals (as they relate to the International Maritime Organization 2020 regulation) and China plays linked to improving relations between the two nations (largely in the consumer discretionary segment).

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<tr>
<th>FUND FACTS</th>
<th>Base currency</th>
<th>Index</th>
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<tr>
<td>Launch date</td>
<td>September 25, 1992</td>
<td>U.S. dollars</td>
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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 values 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 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).

INDEX INFORMATION

The MSCI Emerging Markets Net Index is a free float-adjusted market capitalization weighted index that is designed to measure the global 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.

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