Performance Review

In the quarter period ending December 31, 2019, the Portfolio’s I shares returned 10.27% (net of fees), while the benchmark returned 11.84%.

The quarter was a tale of two very distinct halves. The first part, till November, saw the Fund outperforming the benchmark due to individual stocks reporting strong quarterly results or triggers for share price appreciation materializing – exactly in sync with our portfolio picks and philosophy.

The second part, in December, however, saw the Fund lose its performance edge over the benchmark, with the market’s relentless rally in cyclicals and higher beta stocks. Again, the Fund’s performance was exactly along the expected lines, with our portfolio picks being completely thematic, idiosyncratic, very high quality (versus beta) and secular (versus cyclical) growth in nature.

Market Review

The MSCI Emerging Markets (EM) Index returned 11.84% during the quarter, led by Pakistan (+26.54%), Hungary (+22.18%), Taiwan (+17.94%) and Russia (+16.75%); EM Leaders Fund currently has exposure only to Taiwan at the moment. Chile (-8.83%), the United Arab Emirates (-1.51%) and Thailand (-0.85%) were the worst performing countries.

Information technology (+18.92%), real estate (+17.63%), consumer discretionary (+16.74%), health care (+14.68%) and materials (+12.33%) were the top performing sectors. Consumers staples (+2.55%), utilities (+4.26%) and industrials (+7.79%) were the laggard sectors.

The top contributor to performance during the quarter was our position in Meituan (3.8% of the portfolio), the leading Chinese online-to-offline (O2O) company. We had initiated the position in Meituan in the second quarter of 2019. The company delivered incrementally strong earnings in the third quarter of 2019, following up on its performance in the second quarter when it became profitable for the first time, with the food delivery business becoming profitable. We firmly believe that Meituan has a high probability of emerging as the third largest internet ecosystem in China after Alibaba (8.9% of the portfolio) and Tencent (7.0% of the portfolio). The food delivery business has massive operating leverage driven both by take rate and cost efficiencies. The potential opportunity in advertising can be a positive surprise as the platform scales up, and we are seeing emerging evidence of this.

Our position in Alibaba also contributed significantly to our performance during the quarter, on the back of very strong quarterly performance and easing tensions around trade war. Note that we had added to our holding in the stock during the previous quarter, taking advantage of the broad macro volatility given our confidence on its earnings growth trajectory. We continue to believe that Alibaba is well positioned on a significant runway of multi-year growth ahead, with a significant upside to its take rates as it monetizes its massive ecosystem, leading to further upside to its return on equity.

Silergy (2.0% of the portfolio), the power management analog integrated circuit (PMIC) maker, contributed near the top rung for the second successive quarter. Silergy benefited from further demand recovery in the consumer and industrial segments during

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the quarter following a slowdown during the second half of 2018 and early 2019. It has also been successfully ramping up its new third generation product. Silergy has just 1% market share in the global PMIC market and is the biggest beneficiary of China’s focus on increasing its reliance on localized semiconductor supply. We believe Silergy has substantial un-monetized intellectual property in automotive, 5G communication and smart meter technology that could drive revenue and profit growth over the next three to five years. We expect Silergy’s long runway of growth to be driven by increasing market share and the potential to be a domestic China champion in the PMIC segment. The company has nearly 20% return on equity, a net cash balance sheet, and stable operating margins based on our estimates, which we believe could increase as it monetizes its intellectual property.

The biggest detractor from performance was our position in Apollo Hospitals (7.4% of the portfolio). While the name continues to deliver in line with our expectations and management guidance, and the management is progressing well on its stated commitment to reduce stock pledges, we believe there has been some profit taking in the name post a strong stock performance in the second and third quarters of 2019. We believe that the first half of 2020 should see the company deliver on major milestones, with the investment phase ending, an improving earnings trajectory as new hospitals ramp up operating leverage kicks in, and value unlocks as the pharmacy business divests.

Budweiser Brewing Company (3.6% of the portfolio) detracted from our performance. We established a position when the stock was first listed during the third quarter of 2019. The company announced its inaugural quarterly results in the fourth quarter, and since then the name has seen some correction. We remain positive on the theme of premiumization in beer consumption in China, as a long-term structural trend wherein profitability/economics may be significantly superior compared with mass-market beer, and with Budweiser, as the majority leader in the industry, being the biggest beneficiary of it.

Our position in Kotak Mahindra (4.8% of the portfolio) detracted during the quarter as the stock consolidated after strong share price performance through the first nine months of the year. This remains a premium bank with one of the strongest asset quality control and run by one of the best bankers in India, in our opinion. Apart from strong retail and corporate franchises, it also has exposures to investment banking, life and non-life insurance, wealth management and personal finance.

### Portfolio Activity

During the quarter, we initiated a new position in Bajaj Finance (3.0% of the portfolio) and continued to add to it during the quarter. We have looked at the company several times during the past, but gave it a pass on valuations – even as the stock has moved from strength to strength, given a stellar track record of execution. We believe that Bajaj Finance’s business model is one of the strongest in the non-banking financial companies (NBFC) space (in India, or globally), and the business is run by an extremely agile management, sits at the forefront of technological evolution/innovation, has a well-diversified asset and liability franchise, and has a strong track record of steady asset quality.

We initiated a new position in PagSeguro Digital (16% of the portfolio), a disruptor in the payments/fintech and digital banking spaces within Brazil. PagSeguro has been an aggressive market share gainer since inception, taking share from incumbents, with a specific focus on individual entrepreneurs/micro merchants and incremental focus on small and medium-size enterprises (SMEs). Coupling with this is PagBank, its digital banking solution, which is disrupting the banking space in Brazil with an increasingly all-encompassing solution focused on cross-selling multiple services (debit cards, prepaid cards, transfers, working capital loans, credit cards, investments, QR code payments and payrolls). There is a clear intent and execution to transition the combined offering of the platform into a superapp/ecosystem structure as additional services are added to its mobile app (Uber, Spotify, Google Play credits).

We established a new position in China’s largest online and second-largest offline after-school tutoring (AST) company, TAL Education (16% of the portfolio). While it has the strongest market positioning, for perspective given extremely high fragmented nature of the industry, TAL’s current market share is only ~1-2%. The K-12 AST market is estimated at ~1 trillion renminbi in 2019 and is in a secular growth phase thanks to increasing urbanization, parents’ education level and aspirations for their children (often only one child), extremely competitive/tough talent selection system for higher education that determines job opportunities, and rapid technology development/adoptions (especially in the younger population). We believe this should continue to support robust growth in the next 5-10 years, and likely lead to a strong compound annual growth rate (CAGR) over that time. Meanwhile, market consolidation is accelerating because of higher regulatory requirements and the leading players’ more aggressive penetration into lower tier cities. We believe TAL is likely to be a major beneficiary of this through its expanding

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2 Source: Company management estimates
3 Source: Morgan Stanley Investment Management
4 Uber, Spotify and Google parent company Alphabet are not held in the portfolio.
5 Source: China Ministry of Education
offline presence (Xueersi Peiyou). The company has been selling tailored supporting content online (Peiyou Online) to these offline class curriculums, which have existing captive students, and this is adding high quality margins (albeit small) to the offline business. Moreover, TAL is leading the charge in developing a highly scalable, low asset-intensity, online business stream called Xueersi, and this has been seeing rapid adoption especially in Tier 3 cities.

We further added to our positions in Nike and Li Ning (3.6% and 0.9% of the portfolio, respectively), as we further strengthen our exposure to the athleisure thematic. Another key reason behind increasing our size in these names is the strong growth these names are witnessing in China. This wave of growth is amplifying in China due to country-specific factors such as: a) growth in sub-categories like running; b) supportive government policies (National Fitness Plan 2016-20, Healthy China Outline 2030); c) surge in demand stimulated by a government push ahead of international sporting events (Tokyo Olympics 2020, Beijing Winter Olympics 2022); and d) a population culturally passionate about sports, now witnessing a premiumization in spending on athleisure. The revenue growth opportunity is a function both of size and penetration, with China’s population four times that of the U.S. and with an annual sportswear spend per capita of ~$29 compared to ~$358 in the U.S. and, closer to home, ~$110 in Japan.6

We also completely exited Credicorp, a name which has been a strong compounder for us in the past. However, the dysfunctional political relationship between President Vizcarra and Congress has created growth uncertainty in Peru. Moreover, the recent civilian turmoil is further exacerbating the worsening macro backdrop in Peru. We believe that this uncertainty will not be resolved soon and will slow the credit and earnings growth for Credicorp.

During the quarter, we trimmed our weights in Crompton Greaves Consumer, Silergy and Voltronic (1.0%, 2.0% and 2.9% of the portfolio, respectively) as we right-sized our position sizes following strong performance.

**Outlook**

We remain steadfast believers in our investment philosophy that repeatedly investing into high quality thematic growth leads to structural, scalable and predictable returns over the long term. Over time, we have repeatedly seen a few common hallmarks of such investments, key among those being strong track records of execution/delivery, high returns on invested capital and strong managements. That said, the nature of successful businesses has evolved significantly in this millennium so far. For one, we have come to conclude that the world we live in today is significantly different from what it was when this millennium began, and hence today’s investments need to reflect this change. For another, we have realized that while growth in pockets linked to the broader economic backdrop still exists, given the unpredictable macro, geopolitical and social outlooks globally, the predictability of such growth is increasingly in question. In this regard, it is of utmost importance to look at disruptive business models, which are increasingly taking share away from existing ‘lazy’ profit/revenue pools, largely leading to a collapse of sector-level growth (and inflation) or creating new sectors altogether. Identifying and investing in such businesses that also exhibit our cornerstone philosophy is hence a logical step for us. To clarify, such growth is not exuberant by any stretch of imagination, but merely an economic efficiency-led disruption of existing profit/revenue pools, and wherever it syncs with our core philosophy, we intend to own it.

With this in view, this quarter we examine a key thematic which is becoming increasingly relevant for us: Ecosystems. We think of (commercial) ecosystems as platforms possessing a network of users interacting with each other or with the service(s) offered by the platform, either online or through a combination of online-offline. Generally speaking, a typical ecosystem will have at its core a use case that induces enough affinity for its users to keep returning and engage upon the network/platform. By nature, a single use case ecosystem typically will have linear economics, unless the service offering is causing disruption to an existing sector(s), causing a shift in an existing profit/revenue pool. That said, given our core philosophy that requires a track record of profitability, most likely the first (or first few) use case(s) will have matured to an extent, and will largely exhibit linear economics. However, with a large enough sticky user base, it becomes possible to create additional use cases, either as adjacencies to the existing service or otherwise, that leverage the same user base. This in turn creates a non-linear economic returns, with significant operating leverage, simply because the costs of user acquisition and network creation are largely fixed/one-time in nature, while the additional revenues lead to profitability, translating directly from the gross profit level to the net profit level. Mobile data and smartphone proliferation helps further strengthen these ecosystems.

While identifying an investible ecosystem, we tend to look for four qualities: 1. Size of the existing user base, and its ultimate potential size (i.e. Scale and Scalability of the existing network), 2. User stickiness to the platform (i.e. Predictability of
incremental engagement, which can translate into monetizable revenues), 3. Additional new use cases, and possible use cases being targeted (i.e. Scalability potential for monetizable profitable growth, and whether high quality profitable returns could be made), and 4. Management capability and intent (i.e. Track record of successful execution while implementing the first or first few use cases, a must-have for us to build a thesis). To us, the first three factors are essential ingredients for an investible ecosystem. For instance, user stickiness may be high for an existing user base, and certain other use cases may be targeted, but if enough scale or potential scale isn’t available (due to demographics, or population density, etc.), profitable growth will be extremely challenging even with new use cases. The fourth one to us, however, is paramount for us to invest. Mere statement of management intent or having made some efforts in adding commercial use cases doesn’t cut it. Given our core investment philosophy, unless we see enough evidence of successful execution and visible profitability, we are likely to only monitor ongoing progress. We are steadfast believers in commercial success that can be repeated/replicated predictably, which is the only way to ensure that downside of our investments remains protected.

Two key geographies where we think ecosystems are creating a significant impact, and are proliferating profitably, are China and Brazil (or in one specific case, Latin America). That said, we do see some emerging candidates (though not investible at the moment) in both India and Indonesia, and given the scale of the demographics, a few of these might become a part of our investment consideration set in future. Currently exemplifying our ecosystem thematic are Alibaba, Tencent and Meituan Dianping (Meituan) in China, and MercadoLibre (3.9% of the portfolio), Stone Co (3.1% of the portfolio) and PagSeguro in Brazil/Latin America. In terms of evolution, we believe that Alibaba and Tencent are near the top of the spectrum, and appear to us as the global leaders that are shaping the template of the ecosystem business model. Meituan and MercadoLibre are fast evolving, already proven ecosystems. They are currently in the process of scaling multiple use cases and have proven track records of their capability to create profitability in at least one use case. Stone Co and PagSeguro are fast scaling, profitable fintech disruptors that are currently reshaping their respective offerings into ecosystems. We think that these two names are comparatively the least evolved ecosystems at the moment, but nonetheless they are fantastic long-term investments, given the merit of their fintech achievements, execution capabilities and strategy ahead.

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RISK CONSIDERATIONS

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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 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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