Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Institutional Fund

Emerging Markets Leaders Portfolio

ACTIVE FUNDAMENTAL EQUITY | EMERGING MARKETS TEAM | COMMENTARY | SEPTEMBER 30, 2020

Performance Review

In the quarter period ending September 30, 2020, the Portfolio's I shares returned 20.93% (net of fees)[1], while the benchmark returned 9.56%.

During the quarter, stock selection in China, Brazil, Indonesia and India, along with the overweight position in India, contributed. Global stocks with emerging market exposure such as Nvidia (2.7% of the portfolio)[2] also contributed, while the overweight position in Brazil and Indonesia detracted. The performance during the quarter was dominated by the larger continental-sized markets that are the focus of the Emerging Markets Leaders Strategy: Greater China and India. At the sector level, the consumer discretionary and information technology sectors (the two largest overweight selections) were the best performers. At the stock level, stock selection in Apollo Hospitals (4.5% of the portfolio), Meituan Dianping (8.2% of the portfolio), SEA Ltd (5.6% of the portfolio), LiNing (3.8% of the portfolio) and Nvidia (2.7% of the portfolio) contributed, while Silergy (2.5% of the portfolio), Kotak Mahindra (3.1% of the portfolio) and AIA (0.1% of the portfolio) detracted during the quarter.[2]

Market Review

During the third quarter, emerging markets continued to build on the market recovery that began in the second quarter, and have now delivered their best six months of returns since 2009. While the COVID-19 pandemic continues to cause health and economic burdens to varying degrees in different EM countries, investors have been drawn to the overall EM compelling valuations and cheaper currencies brought about by the pandemic and the drawdown earlier in the year. Individual countries have had differing responses to the pandemic, of course. China, Taiwan and Korea, for example, have greater fiscal resources available to counter the pandemic's effects, along with having many of the mega-cap technology names investors have been drawn to for some time. They were among the strongest performing markets in the quarter.

China's weighting in the MSCI Emerging Markets Index continued to climb from 34.10% in December of 2019 to average 41.63% in the third quarter of 2020 (July marked the peak weight during the quarter, at 41.71%, while September ended with a 41.60% weight).[3] With the upcoming mega-cap initial public offerings and continued interest in this continental-sized market, we expect this weighting to continue to rise, also helped by market performance.

China continued its quarterly advance, up +12.50% after gaining +15.29% in the second quarter of 2020.[4] Taiwan continued its recent outperformance and rallied +16.54% in the third quarter after rising +21.39% in the second quarter. The technology hardware sector outperformed on the back of the U.S. crackdown on Chinese technology companies. Korea was the best performing market, ending the quarter on strong return of +3.08% in September, helped by the index heavyweight Samsung Electronics (not held in the portfolio),[2] which was up +9.81% during the month. After outperforming the MSCI Emerging Markets Index in the second quarter with a return of +19.55%, Korea's outperformance continued, returning +12.83% in the third quarter. India gained +14.95% for the third quarter after +20.58% return in the second quarter. While the infection rate in India remained a worry, the focus was on the possible recovery, which according to the Reserve Bank of India is expected to be gradual. The manufacturing PMI accelerated on back of new domestic orders. Inflation slowed slightly to 6.69% versus 6.93% in July. Both India and China agreed to ease tension along the border and to cease sending more military personnel there. Indonesia was

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1 Source: Morgan Stanley Investment Management. Data as of September 30, 2020.
2 Holdings data as of September 30, 2020.
3 Source: Morgan Stanley Investment Management and MSCI.
4 Country market performance represented by the MSCI country indexes.

impacted by the weakness in the rupiah. Rupiah was the weakest Asian currency during the quarter, depreciating 4% against the U.S. dollar, along with Thai baht, which depreciated 2.5%, while all other currencies strengthened. Indonesia recorded the worst return for the month of September, -12.98%, bringing the quarterly decline to -6.86%. The Indonesian finance minister lowered the gross domestic product (GDP) outlook from a range of -1.1% to +0.2% to a range of -1.7% to -0.6%. Brazil reported a worse-than-expected GDP decline of -9.7% quarter-over-quarter and -11.4% year-over-year. But Brazil looks to see some recovery as economic activity resumes and should see improvement for the rest of the year, as noted in the +5.5% rise in July retail sales compared to +0.5% in June and July's industrial production decline of -3% versus -9% in June. Brazil fell -3.32% for the quarter as the real continued to weaken and remained the weakest EM currency against the U.S. dollar for the year. EMEA lagged the broader EM index, with Turkey (-15.67%) as the worst performing market in the quarter. Hungary (-8.94%), Czech Republic (-6.18%) and Russia (-4.72%) also underperformed.

Portfolio Activity

Apollo Hospitals, which has been one of the core holdings in the health care sector, has now emerged not just as a hospital provider but also as a leader in tele-medicine with presence in 10 countries. We think the latest results reflect the headwinds it has faced during the COVID-19 lockdown and expect earnings momentum to improve going forward, as the pandemic had only delayed our main investment thesis with elective surgeries being postponed and utilization falling in second quarter.

Platform and delivery companies have continued to benefit from the rising adoption of e-commerce and changes to users' lifestyle and behavior. Meituan Dianping continued its recent strong performance as economic activity in China continued to recover and it continues its leadership as the lifestyle platform for most of consumers' day-to-day needs and wants. SEA Ltd looks to be cementing its dominance in e-commerce, and the gaming business continues to benefit from the rising popularity of FreeFire. Gaming has been one of the biggest beneficiaries of the lockdown and SEA's shopping platform Shopee has seen significant growth of gross merchandise value.

After two quarters of large outperformance, Silergy took a breather in the third quarter. The localization theme remains unchanged and the ongoing tension between the U.S. and China regarding not just trade but also technology seems to be worsening, with further moves by the Trump administration to add more Chinese companies to its watch list.

During the quarter, we increased our position in Ping An Healthcare and Technology (0.8% of the portfolio), a one-of-a-kind pioneer in the emerging health care technology space.[2] The company's business model centers around its novel artificial intelligence (AI) doctor app, Ping An Good Doctor (PAGD), which conducts general medical consultations. This application was initially conceived to address the absence of general medical practitioners in China, as only specialist doctors practice in China's predominantly social health care system. According to Ping An company management, general consultation demand is more than five times the existing bench capacity (of specialist doctors) in China, resulting in a significant systemic strain on the public hospital network. Consequently, an average outpatient visit requires roughly three hours despite the actual consultation time being 15 minutes at most. Moreover, this presents a massive systemic problem for the government, not to mention a projected expanding health care deficit (around 2.3 trillion renminbi in 2026, according to company estimates). To ease this strain, the company estimates that China needs to train approximately 300,000 new general doctors, but this requires decades of training. Another way is to train an AI; one that constantly learns from the highest-end medical minds and specialists over a period of time, combines this learning into a generalist offering, and with time diagnoses at an accuracy rate similar to the specialist doctor bench whose consultation/diagnosis data set trained the AI. This AI-based system is PAGD. Over its more than six years of existence, the AI has been learning from over 2,000 specialist doctors and an estimated 900 million consultations (i.e., the training data set for the AI). This has resulted in a more than 99% diagnosis accuracy by the AI, and has also resulted in similar customer satisfaction numbers, according to the company. With this AI doctor as its central pillar, the company is now uniquely poised to expand operations across China (and into other countries as well – Indonesia and Japan are two examples).

We at Emerging Market Leaders believe that the company today occupies a significantly differentiated moat compared with all other health-tech competitors in China. For starters, the time and size of the data set required to train an efficient AI for general medical consultation are very real barriers to entry. This is especially true considering the requirement of near-certain accuracy for diagnosis (we believe PAGD is almost there). In contrast, e-commerce or appointment-centric health tech models are relatively much easier to replicate, with scale of operations and network optimization being the barriers to entry. Moreover, for general medical consultation purposes, PAGD fulfills the role of providing a proper diagnosis remotely, saving precious time (travel and waiting) and money. This unique offering, therefore, has an innately strong pull for the Chinese population. More

[2] Holdings data as of September 30, 2020.

importantly, it can potentially ease the excessive strain on the public health care system, help optimize the medical consultations framework (specialists catering to specialist problems, and PAGD taking up the general consultations load), and help the government better plan and minimize health care budgetary support.

The company is focused on creating an ecosystem of offerings around its PAGD offering such as prescription drugs, wellness offerings and diagnostics tests, among several others. The support from the central government as well as provincial governments has been steadily increasing. In fact, Ping An Healthcare and Technology has already rolled out "online hospitals" in both collaborative (with local governments) and self-construction business models in several cities, and is in the process of aggressively rolling out these offerings in more cities. The Chinese government has already allowed online consultations to be treated in line with physical consultations for the purpose of reimbursements from patients' social insurance coverage. As adoption increases, and reimbursements from the government pick up, Ping An Healthcare and Technology is set to break even in the near term (according to the company's official guidance by 2021). With the significant array of offerings and associated services that it already has and that it can expand into directly or collaboratively within the health care pie, there is a strong adjacency-led operating leverage – typical to platforms/ecosystems – inset within the business model. Association with Ping An Group is beneficial both from a branding and an economics perspective, as the company acquires roughly half of its customers without any acquisition cost from Ping An references. Moreover, the cost of acquisition for the other half is steady at around 14 renminbi per customer,[5] further buttressing the business model's inset operating leverage.

At the last count, PAGD was handling around 300 million consultations annually, which is a small fraction of the approximately 8.5 billion total consultations being handled by the Chinese offline health care system annually.[5] Penetration into this consultation total addressable market (TAM) itself is a very significant opportunity, not to mention that the TAM itself is constrained by the existing medical capacity. With government support expanding and accuracy continuing to shine especially with a fast-expanding user base (approximately 346 million user base at the first half of 2020, growing more than 50% annually), we believe PAGD can reasonably reach approximately 1 billion consultations in the next three to five years.[6] Reimbursements (likely 15-20 renminbi per consultation) haven't really commenced yet, and monetization of the platform is being done very gradually by the company at the moment via a subscription model. As reimbursements pick up, PAGD believes it can reasonably achieve an estimated 10-15 billion renminbi in revenue[5] during this time frame, at reasonably high operating margins (base costs are largely fixed, being the cost of doctors and the tech team). Other adjacent revenue streams meanwhile can contribute another similar revenue profitably. Moreover, the growth should continue to remain structurally high over a longer-term period (three-plus years) – for starters, total medical health care expenditure in China itself is expected to grow around 9.4% over 2016-26 to 11.6 trillion renminbi,[7] of which the company's addressable portion will be a small fraction in any manner one looks at. As such, there is a reasonable possibility of Ping An Healthcare and Technology becoming a US$50 billion-plus market cap company in a three- to five-year period.[7] Looking further ahead, there is a demonstrated pathway to global expansion with an even better operating leverage if adoption is successful (AI training done on the original data set in China can simply be replicated across other countries with high accuracy). In all, we feel confident that this company is at the beginning of its multi-year structural growth runway and could emerge as likely leader of the health-tech sector.

Outlook

Through the current period of significant market moves both to the upside and the downside, we have remained unchanged in investment process and philosophy. The COVID-19 pandemic has brought forth some of the structural trends that we had originally expected to be adopted over three to five years to a much shorter time frame. We continue to reassess and analyze the impact to our invested companies. In some cases, we have resized some of the positions given the significant re-rating that we have seen in the last two quarters, and we have continued to find interesting investment opportunities during this period of crisis.

Our investing philosophy has remained unchanged, focused on bottom-up, structural thematic-driven and deeply rooted in the fundamentals of our businesses. The importance we attach to businesses with high inherent return ratios, strength of net cash/near net cash balance sheets and structural repeatability of cash flows remains unwavering. While we have taken the opportunity of the recent strength in share prices to right-size the positions, there has not been much change to the portfolio overall.

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5 Source: Company estimates.
6 Source: Morgan Stanley Investment Management.
7 Source: Frost & Sullivan and Company presentation.

FUND FACTS

Launch date	Base currency	Index
June 30, 2011	U.S. dollars	MSCI Emerging Markets Net Index

Performance (%)

As of September 30, 2020 (Class I Share at NAV)

	MTD	QTD	YTD	1 YR	3 YR	5 YR	10 YR	SINCE INCEPTION
MSIF Emerging Markets Leaders Portfolio - I Shares	-0.61	20.93	28.74	41.96	13.37	13.00	--	6.95
MSCI Emerging Markets Net Index	-1.60	9.56	-1.16	10.54	2.42	8.97	--	1.83

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 1.57% for Class I shares and the net expense ratio is 1.20%. 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.

Pursuant to an agreement and plan of reorganization, between the fund, on behalf of the Emerging Markets Leaders Portfolio (the "Portfolio"), and Morgan Stanley Emerging Markets Leaders Fund (Cayman) LP (the "Private Fund"), a private fund managed by Morgan Stanley Investment Management Inc., the Portfolio's adviser, on January 6, 2015, the Portfolio acquired substantially all of the assets and liabilities of the Private Fund in exchange for shares of the Portfolio (the "Reorganization"). The Private Fund commenced operations on June 30, 2011, and had an investment objective, policies , and strategies that were, in all material respects, the same as those of the Portfolio, and was managed in a manner that, in all material respects, complied with the investment guidelines and restrictions of the Portfolio. However, the Private Fund was not registered as an investment company under the Investment Company Act of 1940 (the "1940 Act"), and therefore was not subject to certain investment limitations, diversification requirements, liquidity requirements, and other restrictions imposed by the 1940 Act and the Internal Revenue Code of 1986, as amended, which, if applicable, may have adversely affected its performance . The Portfolio adopted the performance history of the Private Fund. As a result, the historical performance information shown reflects, for the periods prior to the Reorganization, the historical performance of the Private Fund. The performance of the Private Fund has been restated to reflect any applicable sales charge but is otherwise not adjusted to reflect differences in expenses between the Private Fund and each Class. If adjusted to reflect such difference in expenses, returns would be different.

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 and that the value of portfolio shares may therefore be less than what you paid for them. 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 portfolio. Please be aware that this portfolio 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. Stocks of **small- and medium-capitalization** companies entail special risks, such as limited product lines, markets, and financial resources, and greater market volatility than securities of larger, more-established companies. **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 public traded securities (liquidity risk). **Nondiversified portfolios** often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility.

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 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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