Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Institutional Fund

Emerging Markets Small Cap 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 11.81% (net of fees)[1], while the benchmark returned 11.25%.

Our stock selection in China contributed the most to returns, led by our allocation to Chinese fintech platform 360 DigiTech (3.2% of the portfolio).[2] Our stock selection and overweight allocation to Brazil also contributed to performance, driven by our overweight allocation to waste management company Ambipar (2.8% of the portfolio), which outperformed the market during the quarter.[2]

Our overweight allocations to off-benchmark names, including Grid Dynamics and Vasta Platform, detracted the most from performance during the quarter, as the stocks underperformed the market due to disappointing first quarter results (1.6% and 0.9% of the portfolio).[2] Grid Dynamics reported a total loss of $2.1 million in its first quarter.[3] Vasta Platform saw more than a 28% drop in revenue year-over-year after the end of the first quarter due to a reduction in operating income from the impacts of COVID-19.[3] Our overweight allocation to Network International (1.8% of the portfolio) also detracted as the company suffered from a sharp decline in payment volumes in its home country as COVID-19 impacted the heavily tourism-based economy of the U.A.E.[2]

Our stock selection in Korea and Thailand also detracted from returns during the quarter. We continue to invest in structural stories with sustainable growth that benefit from domestic, consumer-oriented themes in emerging markets.

From a sector perspective, our stock selection in information technology added the most to returns, followed by our stock selection in consumer discretionary and consumer staples. Our stock selection in financials and our underweight allocation to industrials and materials detracted from performance.

Market Review

MSCI Emerging Markets (EM) Small Cap Index equities returned +11.25% during the quarter, outperforming the MSCI EM Index, which returned +5.05%. Small caps in Brazil (+27.86%), Poland (+23.25%), Saudi Arabia (+18.67%), Taiwan (+14.41%) and Korea (+14.24%) outperformed, while small caps in Peru (-13.79%), Turkey (-10.69%), Chile (-10.66%), Malaysia (-7.27%) and Colombia (-6.54%) underperformed the index.

Portfolio Activity

During the quarter, we exited some of our lower conviction names in Asia, including China Education Group, A-Living Smart City, Jinke Smart Services, Douzone Bizon and Subros, and we reallocated the funds to stocks where we have higher conviction. We initiated a position in engineering IT services company Grid Dynamics (1.6% of the portfolio).[2] We believe the business has similar characteristics as digital outsourcing peers, such as EPAM and Globant (neither stock is held in the portfolio).[2] We expect Grid Dynamics to potentially grow earnings in excess of frontier and emerging markets primarily due to continued demand for digital transformation services and revenue growth from an existing client base due to increased pricing. Grid has developed a very successful outsourcing model in accessing talent pools in Eastern Europe and has historically exhibited higher revenues

[1] Source: Morgan Stanley Investment Management Limited. Data as of June 30, 2021.
[2] Holdings as of June 30, 2021
[3] Source: FactSet

versus its peers, which we believe illustrates the company's ability to offer high value-added digital expertise. The company has also seen improved margins post-COVID-19.

In Russia, we initiated a position in Ozon (2.5% of the portfolio), a leading e-commerce platform in Russia. Given the lack of legacy retail infrastructure in Russia, especially outside of Moscow and a handful of major cities, we believe e-commerce could grow significantly, which could translate into a multiyear period of rapid growth and several business opportunities for Ozon. Ozon manages one of the largest logistics infrastructures in the country, which could translate to quick revenue growth and profitability. We expect Ozon to outperform broader EM if its revenues grow faster and its returns on investment capital turn positive.

In Poland, we initiated a position in Grupa Kety (2.8% of the portfolio).[2] Kety is a producer of flexible packaging solutions, extruded products and aluminum systems. As economies recover from the pandemic, we expect demand for aluminum products to remain robust. Given their sustainability profile, aluminum products could continue to gain share in the construction and automotive industries. The industry remains fragmented in Europe. However, Kety is agile and has a strong balance sheet that will likely allow the company to capitalize on favorable industry demand trends and exceed market expectations. We expect Kety can outperform in the next 12 to 18 months, if the company can maintain its currently strong returns and if it sees more growth from strong demand for aluminum products. We funded this trade by exiting our position in educational technology company Arco Platform and our position in Indian low-cost airline SpiceJet.

Strategy and 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 (GDP) 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.[4] During this time, the number of people who own a smartphone globally has risen from 150 million to more than 4.5 billion.[5] 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 (OECD), 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 the greater potential to find innovative ways to meet everyday needs through digital technology.

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2 Holdings as of June 30, 2021

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

5 Source: Ben Evans, Haver Analytics, United Nations Population Database

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 than10,000 tech firms have been launched in EM, nearly half outside China, and many have grown beyond the risky start-up phase.[6] 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.

FUND FACTS

Launch date	Base currency	Index
December 15, 2015	U.S. dollars	MSCI Emerging Markets Small Cap Net Index

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 Emerging Markets Small Cap Portfolio - I Shares	4.47	11.81	16.85	41.68	7.62	8.09	--	8.52
MSCI Emerging Markets Small Cap Net Index	2.34	11.25	19.78	63.75	12.31	11.86	--	11.81

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 1.96% for Class I shares and the net expense ratio is 1.30%. 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

[6] Source: Boston Consulting Group, MSIM

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, **equity securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, and market 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-capitalization companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. **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 Small Cap Net Index** includes small cap representation across 23 Emerging Markets countries. With 1,864 constituents, the index covers approximately 14% of the free float-adjusted market capitalization in each country. The small cap segment tends to capture more local economic and sector characteristics relative to larger Emerging Markets capitalization segments.

The **MSCI Emerging Markets Index (MSCI EM)** is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of emerging markets.

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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