Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Institutional Fund

Global Concentrated Real Estate Portfolio

REAL ASSETS | GLOBAL LISTED REAL ASSETS TEAM | COMMENTARY | MAY 31, 2019

Performance

As the Fund is less than a year old we are constrained from commenting on its performance.

Strategy

We see the most attractive expected return prospects from companies concentrated in U.S. central business district (CBD) office (especially NYC office), Hong Kong commercial properties, U.S. and Continental Europe high-quality retail, and the U.K. Majors and London office specialists.

In the U.S., the listed property market ended the period trading at an approximate 9% premium to net asset values (NAVs), although there is a significantly wider than typical disparity in relative valuations among the sectors, with various segments trading at meaningful discounts. We see the most attractive value in the owners of NYC office assets trading at the most significant discounts to net asset values (NAVs) and to select stocks in other core asset classes including high-quality retail, CBD office, hotel and residential also trading at attractive valuations, and an underweighting to companies concentrated in the ownership of net lease and health care assets.

In Hong Kong, the Hong Kong real estate operating companies (REOCs) continue to represent a significant overweight in the global portfolio, as we believe the stocks offer highly attractive value given the wide discrepancy between public and private valuations, and relative to other public listed property markets. The stocks ended the period trading at an average 44% discount to NAVs and continue to trade at the widest discounts on a global basis despite healthy operating fundamentals, solid recurring cash flow growth and continued strength in asset values in the private markets, as well as improving corporate governance and capital management. The discounted valuations are further accentuated as the Hong Kong REOCs maintain very modest leverage levels. These NAV discounts could eventually narrow for companies that are willing to recycle assets on their balance sheets to realize their latent gains and engage in corporate restructuring to improve transparency and capital management, and potentially eliminate any holding company discounts, as well as any improvement in negative sentiment.

In Europe, property stocks in the U.K. ended the period trading at an average 11% discount to NAVs with the large-cap U.K. Majors trading at a 28% discount and the London office specialists trading at a 16% discount. In the U.K., there is downside risk to cash flows and asset values due to continued uncertainty over Brexit, but these risks appear to be more than priced into the discounted share prices in certain market segments. Property stocks on the Continent ended the period trading at a 7% discount to NAVs, although there is meaningful disparity in valuations within the Continent, with the Continental retail stocks trading at deeply discounted valuations (-34%). The Continental retail companies continue to deliver solid operating results, and we expect them to continue to report positive like-for-like rental growth over the coming years, especially those companies focused on centers in prime locations with quality catchments and high footfall.

Our research process is driven by our bottom-up analysis of each public real estate company. We maintain a strong conviction that a disciplined, bottom-up investment methodology will result in the highest returns and outperformance over the long term. As such, the stock selection process for the Fund is based on our bottom-up analysis of real estate companies. Pursuant to determining which real estate securities, in our view, offer the best value (versus peers and direct real estate valuations) based on our NAV models and other real estate valuation metrics (implied price per square foot, implied capitalization rate, etc.), we apply our analysis to select those securities that we believe offer the highest total expected returns on a risk-adjusted basis.

This rigorous portfolio construction process is strictly implemented so that we include only our highest conviction ideas in the portfolio. Diversification is also a significant consideration in constructing and managing the Fund.

Outlook

Investment values for prime real estate assets have generally remained stable due to very strong capital flows to the sector as investors have embraced real estate within their multi-asset portfolios. There continues to be concern among some market participants that values may have peaked or are even poised to decline after significant appreciation, but declining bond yields year-to-date coupled with continued robust credit availability have reduced those concerns. Generally, current cap rates have been supported by historically wide cap rate spreads versus financing costs and continued strong demand for real estate. Moreover, real estate asset values and transaction volumes remain well supported by the record amount of investor allocation to the real estate sector, with record target allocations and rising levels of dry powder.

While there are pockets of the global listed property market trading at premium valuations relative to peers due to being perceived as defensive or benefiting from a secular investment theme, there is significant negative investor sentiment towards key market segments resulting in very wide discounts to NAVs despite transactional evidence continuing to demonstrate strength in asset values. Certain market segments, including NYC office, Hong Kong commercial property companies, U.S. and Continental high-quality retail, the U.K. Majors and London office specialists and U.S. CBD office, hotels and residential, trade at attractive valuations and can offer the best expected return prospects. As a result, we believe there is a compelling case for active management to take advantage of wider than typical valuation disparities on a global basis, particularly within the U.S.

FUND FACTS

Launch date	Base currency	Index
June 18, 2018	U.S. dollars	FTSE EPRA Nareit Developed Real Estate Net Total Return Index

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. 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, and market risks. The risks of investing in **emerging market** countries are greater than the risks generally associated with foreign investments. **Real estate investments, including real estate investment trusts,**are subject to risks similar to those associated with the direct ownership of real estate and they are sensitive to such factors as management skills and changes in tax laws. **Non-diversified 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. When investing in **value securities** (those believed to be undervalued in comparison to their peers), the market may not have the same value assessment as the manager, and, therefore, the performance of the securities may decline. 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.

INDEX INFORMATION

The **FTSE EPRA Nareit Developed Real Estate Index** is a free float-adjusted market capitalization weighted index designed to reflect the stock performance of companies engaged in specific aspects of the major real estate markets/regions of the developed world.

The Index is 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 objectives, risks, charges and expenses of the fund carefully before investing. The prospectus contains this and other information about the fund. To obtain a prospectus, contact your financial advisor or download one at morganstanley.com/im. Please read the prospectus carefully before investing.

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

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