Performance

In the one month period ending January 31, 2020, the Fund’s I shares returned -4.01% (net of fees), while the benchmark returned 0.84%.

The Fund underperformed the benchmark, the FTSE EPRA Nareit Developed Real Estate Index – Net Total Return, for the quarter.

Analysis

In recent years the global real estate securities market has generally been dominated by thematic investing and an emphasis on macro factors with little to no regard to underlying property values as a key metric. We suspect that underlying private market property valuation has become a less relevant metric as generalist investors and passive funds have become the marginal buyer of real estate securities. Generalist investors appear to place a greater focus on secular themes and are untethered to private market valuations. Given this combination of thematic investing and all-time low bond yields, we have witnessed a continued willingness to pay premium valuations for segments of the market that are viewed as having greater predictability in cash flows. In addition, concerns with regard to economic growth have generally placed downward pressure on segments viewed as more vulnerable – office, retail and hotels. Many of these stocks are trading at large discounts to net asset values (NAVs), despite significant transactional evidence in the private markets in the office and hotel sectors. This has resulted in a wide disparity in share price valuations among market segments. The Fund continues to be underweight segments that have benefited from defensive and secular investment themes due to premium share price valuations, and overweight market segments which trade at very attractive discounted valuations. As a result, the Global Concentrated Real Estate Strategy trades at a discount of approximately 25% versus private market valuations which we believe provides a very attractive entry point in select market segments; this compares to the global index which trades at an overall 8% premium as of the end of January.

The key contributors for the month were the Fund’s exposure to London office specialists and U.S. shopping centers. This was more than offset by the Fund’s overweight exposure to U.S. Class A malls, the Hong Kong real estate operating companies (REOCs), U.K. Majors, Continental European retail and U.S. hotels. The lack of exposure in U.S. net lease also detracted.

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.

Within the U.S., the overall real estate investment trust (REIT) market ended the month at an overall 14% premium to NAVs, although there is a significantly wider than typical disparity in relative valuations, with some property sectors at significant premiums and various other sectors at significant discounts to NAVs. Generally, we see share prices untethered to private real estate values. We think the most attractive value can be found in companies that own NYC office assets as the stocks ended the month trading at a 26% discount. This is despite significant transactional evidence for NYC office assets that continue to demonstrate strength in asset values. Manhattan office transactions totaled $18.9 billion in full-year 2018 and $14.6 billion in full-year 2019. We also see attractive value in select owners of high quality retail, CBD office and hotel stocks. These companies provide exposure to high quality core assets at significant discounted valuations.


This document constitutes a commentary and does not constitute investment advice nor a recommendation to invest. The value of investments may rise as well as fall. Independent advice should be sought before any decision to invest.
In Asia, the Fund continues to be overweight the Hong Kong REOCs. Following declines in the month on coronavirus concerns, the stocks ended the month trading at an average 52% discount to NAVs and continue to trade at the widest discounts on a global basis. The discounted valuations are further accentuated as the Hong Kong REOCs maintain very modest leverage levels. Select companies have tried to narrow these discounts by recycling assets on their balance sheet to realize their latent gains and by engaging in corporate restructuring to improve transparency and capital management. Notably, our valuations for the Hong Kong REOCs do not reflect the low cap rates evidenced in the private investment market prior to the protests, thus providing a substantial buffer to potential downside risk in asset values. The Japan REOCs ended the month trading at a 14% discount to NAVs and continued to offer attractive value relative to the Japan real estate investment trusts (J-REITs), which traded at a 27% premium. The J-REITs generally own lower quality assets as compared to the J-REOCs, but J-REIT share prices have been bolstered by investors’ search for yield and the Bank of Japan’s commitment to monetary easing and the asset purchase program.

In Europe, property stocks in the U.K. ended the month trading at an average 9% premium to NAVs, with the large-cap U.K. Majors trading at an average 9% discount. Property stocks on the Continent ended the month trading at an average 5% premium to NAVs, although there is meaningful disparity in valuations within the Continent, with the French and Dutch companies focused on pan-European shopping centers trading at deeply discounted valuations (-34%) and stocks trading above NAV in the Nordics (+22%), Switzerland (+28%) and Belgium (+70%). 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

We maintain a strong adherence to our value-oriented, bottom-up driven investment process, which focuses on investing in equity securities of publicly listed real estate companies we believe offer the best value relative to underlying real estate value and NAV growth prospects, irrespective of short-term market trends.

We believe listed real estate security returns should mirror private real estate performance. This strategy may result in periods of underperformance, particularly when the market is driven more by thematic/momentum investing and macro factors, as opposed to fundamentals and intrinsic value. The current prolonged period, in which underlying private market valuation is not a relevant determinant of share prices, has been surprising. The private market is more than six times larger than the public markets and has, up until this period, always served as a key determinant of share prices and our key metric. It is logical to us that persistent discounts cannot exist when there is so much money on the sidelines needing to invest and we believe we will be rewarded as these stocks provide favorable risk-adjusted return opportunities based on our analysis.

We would note the lack of focus on valuations/fundamentals has been prolonged due to the following factors:

- Institutional investors have demonstrated a significant preference for private real estate (as opposed to public real estate); as a result, generalist and passive investors have become the marginal buyers.
- Generalist investors tend to focus less on valuations and more on traditional stock market metrics (such as earnings growth and dividend yields) and secular themes (lower-for-longer, e-commerce, tech).
- Growth of passive investing in the REIT space has contributed to exacerbating the dislocation due to a lack of focus on differentiating among stocks based on fundamentals, and instead adding to overvalued stocks that have grown in market capitalization and reducing exposure to undervalued stocks that have decreased in size.
Untethered to private real estate valuations, earnings multiples have expanded to record levels in sectors viewed as more defensive or benefiting from favorable secular themes. This has resulted in a willingness to ignore the distinction in multiples used to value assets in the private real estate sector and therefore indifference about the quality of the real estate cash flow when buying stocks based on fund from operations (FFO) multiples, as shown by net lease and health care REITs trading at higher or comparable multiples to NYC office REITs (in the private market, net lease and health care properties trade at high-6% cap rates, based on asset mix of public REIT portfolios versus high-4% cap rates for NYC office).

We believe the following may be the catalysts for the valuation gap to narrow:

- **Take-private activity to focus investors on NAV as meaningful metric:** Given the enormous disparities between public and private market valuations that exist within certain market sectors and record levels of dry powder to invest, there may be increased take-private activity as the private funds put capital to work and can access real estate at more attractive valuations through the public companies than through acquisitions in the private market.
- **Well-known activist/event driven investors enter:** The appearance of well-known investors taking long positions in discounted companies that have underperformed and are viewed as short candidates can quickly reverse sentiment on the stocks.
- **Reversal in current theme:** As we have witnessed in past periods, an improved outlook for the economy and higher interest rates would cause a reversal in the lower-for-longer investment theme. Indeed this is precisely what occurred starting in early September and continued through year-end 2019, which resulted in relative outperformance for our strategies over the last four months of 2019.
- **Resurgence of value-based investment style:** The current market environment characterized by momentum and thematic investing with less emphasis on valuation has caused enormous valuation disparities amongst sectors. Mean reversion may provide significant upside potential for undervalued stocks to narrow the large price per NAV (P/NAV) discounts, and may also provide significant downside potential for those stocks that are expensive on a P/NAV basis and also trade at very large premiums to their long-term average earnings multiple.

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<thead>
<tr>
<th>FUND FACTS</th>
<th>Launch date</th>
<th>Base currency</th>
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<tbody>
<tr>
<td></td>
<td>June 18, 2018</td>
<td>U.S. dollars</td>
<td>FTSE EPRA Nareit Developed Real Estate Net Total Return Index</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 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...
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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.

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