

Morgan Stanley Institutional Fund

Global Franchise Portfolio

INTERNATIONAL EQUITY TEAM

Performance Review

In the quarter period ending September 30, 2025, the Portfolio's I shares returned -3.14% (net of fees)¹, while the benchmark returned 7.27%.

For the quarter, among the largest contributors to absolute performance were the cloud hyperscalers, **Alphabet** and **Microsoft**, which have benefited from accelerating enterprise demand for artificial intelligence (AI) infrastructure and significant increases in cloud-related revenue, solid earnings from their cash-generative dominant platforms, and in the case of Alphabet, improving advertising trends supporting strong revenue growth in its Search and YouTube segments plus the favourable resolution of a key anti-monopoly regulatory case in the U.S. Elsewhere, **Thermo Fisher** rallied double digits after a challenged first half, as investor sentiment refocused on encouraging indications for its pipeline following management's adjustment to near-term organic growth targets. **AutoZone** also rerated following strong fourth quarter results which saw resilient top-line growth and an expanding domestic and international footprint, while **LVMH** contributed positively ahead of its sale from the portfolio in July.

The third quarter was strong for the index overall; however, the market's nervousness about generative AI disruption in the latter half applied a broad-brush concern to a wide range of data-rich businesses, without regard to important distinctions in industries and their underlying companies. This was demonstrated in software where there are concerns that generative AI tools, notably cheap coding and agents, could weaken companies' moats, as well as data-rich pockets of financials (e.g., exchanges and data providers) and industrials (e.g., professional services) due to fears that generative AI may be able to replicate companies' proprietary data. These concerns impacted the share price of a range of differentiated models with multi-layered defences against disruption, specifically **SAP**, **FactSet**, **Roper Technologies** and **RELX**, which were among the largest absolute detractors. Our view is that the portfolio's software companies, such as SAP and Roper, are so much more than *just* coding. Both are deeply entrenched in customer workflows, are backed by the technical complexity of their multi-year buildout and stand to gain from generative AI through enhancing their existing services: SAP through embedding generative AI in its core cloud and enterprise products, with generative AI helping accelerate the lucrative transition to the cloud, and Roper by adding generative AI into its vertical software platforms. Similarly, we think generative AI should benefit RELX, which is already monetising AI within its legal business. As such, we remain confident in these companies' compounding ability. The other notable detractor in the third quarter was **Accenture**. The shares have been challenged this year due to cyclical headwinds and generative AI uncertainty. Fourth quarter results announced late in September were decent, with better-than-expected organic growth and a meaningful uptick in AI bookings; however, 2026 guidance remained below historical norms. Encouragingly, management offered some reassurance on the pricing impact of generative AI, which they expect to be "expansionary" rather than "deflationary," although this is something we continue to monitor. Given the uncertainty, we have reduced the Accenture position.

In terms of **relative performance**, the impact of generative AI disruption fears is apparent when looking at stock selection and subsector performance. In information technology, our preferred software and services subsector was up just +2% in U.S. dollars (USD) in the third quarter while semiconductors delivered a massive +17% and hardware an even higher +22%. In financials, the payments industry fell 5% and the exchanges and data providers dropped 7%, while banks (not held in the portfolio) returned double digits. In industrials, we are skewed to professional services (-7%), which significantly lagged capital goods (+7%). Sector allocation was also negative, primarily due to the overweight to consumer staples as the sector lagged the index amid the market's strong rally.

The impact of the portfolio's subsector exposure is also evident in the year-to-date performance. Since the mid-April lows, the market has been led by cyclical industries within sectors which the portfolio has either minimal or no exposure to, such as semiconductors, banks and capital goods, while those areas we do favour, described above, have significantly lagged the market. Although we would expect to trail the index to some extent in a strong up market given our defensive return profile, the portfolio's sector mix, coupled with some stock-specific mistakes most notably within health care, have impacted the degree of the relative underperformance. We have been decisive about taking action where our investment thesis has been challenged and we have high conviction in the ability of

¹ Source: Morgan Stanley Investment Management. Data as of September 30, 2025. Performance for other share classes will vary.

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the current portfolio to potentially compound at double digits over time through the combination of high-single-digit earnings per share growth and dividends, backed by strong top-line growth.

Market Review

Global equity markets posted another quarter of solid gains in the third quarter, with investor confidence helped by more-resilient-than-expected U.S. economic data and ongoing optimism around AI. The MSCI World Net Index returned +7.3% in the third quarter, with similar local currency returns (+7.5% in the quarter). Looking at the performance pattern by sector: information technology was the clear leader in the quarter (+12%), although the mix of strong demand for AI infrastructure and the generative AI fears described above meant gains were skewed to the growthy semiconductors (+17%) and hardware (+22%) subsectors rather than software and services (+2%). Communication services also outpaced the market in the quarter (+11%), largely thanks to Alphabet, which returned nearly 40% as the company avoided a forced break-up ruling in U.S. federal court. For the third quarter overall, there were pockets of strength outside the AI-skewed leaders: consumer discretionary had a better quarter (+8%), propped up by strong demand for autos (+28%), while industrials saw gains of +5%, helped by the capital goods area (+7%), despite professional services (-7%) being distinctly weak. Similarly, within financials (+5% overall), banks (+11%) were far stronger than payments (-5%) and the exchanges and data providers (-7%), again due to generative AI fears. More generally, investor preference for growthier segments over companies with modest and predictable cash flows hurt consumer staples (-2%) in particular, while health care (+3%) was slightly stronger, if still lagging the MSCI World.

Looking at geographies, the U.S. outperformed the MSCI World Index in the quarter (+8%), though it still lags year-to-date. Asia was strong overall in the third quarter, with Hong Kong and Singapore both up around 10%. Japan was also ahead in USD for the third quarter, its dollar returns propped up by yen weakness and corporate reform momentum. Meanwhile, with the exception of Italy (+8% USD and local), European markets – France, Germany, the U.K. and Switzerland – lagged the index during the quarter.

Outlook

The Tug of War

We spoke last quarter about the sharp reversal in market direction and leadership following the market trough post the “Liberation Day” tariff announcements in early-April. The third quarter saw a continuation of that upward trajectory, with global equity markets returning +7%, taking year-to-date MSCI World Index performance to an impressive +17%, despite numerous remaining uncertainties in terms of policy and geopolitics. The MSCI World Index is now on over 20x forward earnings, with the S&P 500 Index at 23x.² These extended multiples are on forward earnings that are meant to grow by double-digits for the next two years on the back of margins improving even further from record highs. Indeed, when we consider what is priced into today’s historically high market valuations, the market is betting on a continuation of the vigorous AI boom and a macro backdrop strong enough to deliver the double-digit earnings growth, with confidence that easing policy and AI-linked productivity will keep margins elevated. In short, expectations are high. Yet, the record gold price reminds us that uncertainties linger.

This six-month growth-tilted cyclical rally leaves us with unprecedented underperformance of quality against the broader index, as demonstrated by the performance of the S&P 500 Quality Index vs. S&P 500 Index. We have only ever seen quality underperform to this degree in the run up to the tech-media-telecom bubble burst. In the past, periods in which quality has significantly underperformed have frequently been followed by a prolonged period of meaningful outperformance of quality vs. the broader market.

We see a tug of war within markets, between the bull argument that AI will be visibly transformational to corporate profitability in the near term and/or the U.S. economy sharply accelerates, and the bear argument where these high expectations are not met. The bear scenario may come from the scaled enterprise adoption of generative AI taking longer than expected, raising anxieties about the return on the hyperscalers’ massive investments or the macro environment not being strong enough to justify the double-digit earnings growth expectations. Our long-tenured team is also acutely aware of how painful it can be when elevated expectations reset downwards.

Taking data from the last 150 years, the market appears to be in its fourth “New Tech” era, with the associated extreme valuation, and the S&P 500 CAPE³ over two standard deviations above trend. Comparisons to the three previous episodes of extreme valuation, in the 1900s, the 1920s and most recently the dot-com bubble, highlight the risk of significant overall market drawdowns when market sentiment shifts (anything from a 15% to 50% drawdown). The most exposed areas suffer more heavily on the way down, while underappreciated segments get their turn in the sun; consumer staples in the dot-com crash, and potentially the supposed “AI victims” this time, be they in software or in data-rich financials and industrials.

While there are similarities to the over-exuberance seen during the internet “New Tech” era, we do see notable differences today: the companies at the centre of the boom are earning real money, and their earnings momentum remains strong, while their current

² Source for data cited in the Outlook commentary, unless otherwise stated: MSIM, FactSet, as of September 30, 2025.

³ CAPE: cyclically adjusted price-to-earnings ratio, a stock valuation measure usually applied to the S&P 500 Index.

price-to-earnings ratios, though high, are not remotely extreme compared with 1999. Another critical difference is that today's massive hyperscaler capital expenditure is largely being self-funded from operational cash flow, allowing for continued and even expanded investment with limited dependence on external funding.

However, uncertainty remains. There is a paradox currently at the core of the generative AI boom. It has garnered an unprecedented mindshare among C-suites for a new technology and the potential is clear to anyone who has used it, but the scale adoption and value realisation among corporates has been very limited. This could drive a classic Gartner Hype Cycle, with a shift from the period of "Inflated Expectations" to the "Trough of Disillusionment" as implementation proves hard and drawn out, even if it is eventually successful and transformative. In addition, the macroeconomic position is unclear given the high levels of policy uncertainty, not least around the eventual effect of tariffs, and worldwide geopolitical risks. It is worth remembering that while growth is positive, the macroeconomic outlook remains modest, with U.S. growth expected around 1.5%-2% for both 2025 and 2026 and EAFE markets closer to 1%.

During the quarter, markets became increasingly preoccupied with the question of whether AI will disrupt, in particular, data-centred businesses. The initial reaction has been quite broad-based, with investors indiscriminately punishing nearly all companies perceived to have exposure to data regardless of differences in business models, competitive positioning or adaptability. We believe this blanket approach by the market is wrong as it ignores important differences between the industries and companies involved. We carefully examine both the potential vulnerability to AI disruption and the revenue and cost opportunities on a case-by-case basis.

There are some general principles behind our company-specific analysis. In our view, those data-rich businesses that avoid disruption are likely to control proprietary datasets that cannot be imitated by generative AI bots scraping the internet, or are likely to be deeply embedded into clients' workflows or even core to whole ecosystems. On the positive side, they should have the financial and technical capacity to integrate AI into their offerings in a way that enhances client value and also utilise the technology to remove significant costs, be it in client relations or coding. In the case of RELX, held in our portfolios, we are already seeing generative AI technology combined with its proprietary data sets accelerating revenue growth in its legal division. SAP, another holding, is buffered from disruption by being deeply embedded into mission-critical operations, and by its well-established domain and industry expertise. Its Joule copilots and agents are potential sources of extra revenue, while generative AI innovation could speed clients' lucrative transition to S/4 Hana, its next-generation enterprise resource planning system. It is precisely these sort of high quality, data-rich businesses we seek to own in our portfolio.

As the debate matures and the market develops a clearer view of which companies are truly vulnerable to disruption and which can harness AI as a competitive advantage, we expect to see much greater dispersion in returns across the sector. In the meantime, we see the broad-brush approach applied by the market as an opportunity to selectively upgrade some of our holdings in which some uncertainty exists on the impact of AI – where compounding babies have been chucked out with the disrupted bathwater.

In a market where investor "certainty" meets a very uncertain reality and valuations are stretched, we remain focused on companies we believe offer credible earnings per share growth, driven by strong revenue growth, which we consider a more reliable source of long-term compounding than supposed margin improvement. Our portfolio is set to deliver resilient top-line growth close to twice that of the index and is available at a free cash flow discount to the market not seen over the last decade, a very attractive proposition, particularly in relative terms.

Fund Facts

Inception Date	November 28, 2001
Minimum Initial Investment (\$)*	A Shares - 1,000
	I Shares - 1,000,000
Benchmark	MSCI World Net Index
Class I expense ratio	Gross 0.93 %
	Net 0.93 %
Class A expense ratio	Gross 1.16 %
	Net 1.16 %

* Share class availability may vary by platform. For more information, please visit the specified fund page on the website.

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, in effect as of the date of this commentary. For information on the applicable fund's current fees and expenses, please see the fund's current prospectus.

Performance (%)

As of September 30, 2025	MTD	QTD	YTD	1 YR	3 YR	5 YR	10 YR
Class I Shares at NAV	-1.91	-3.14	3.81	0.38	13.46	7.00	10.41
Class A Shares at NAV	-1.95	-3.21	3.59	0.13	13.18	6.74	10.13
Class A Shares (With Max 5.25% Sales Charge)	-7.10	-8.29	-1.86	-5.14	11.16	5.60	9.54
MSCI World Net Index	3.21	7.27	17.43	17.25	23.72	14.41	12.43

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.

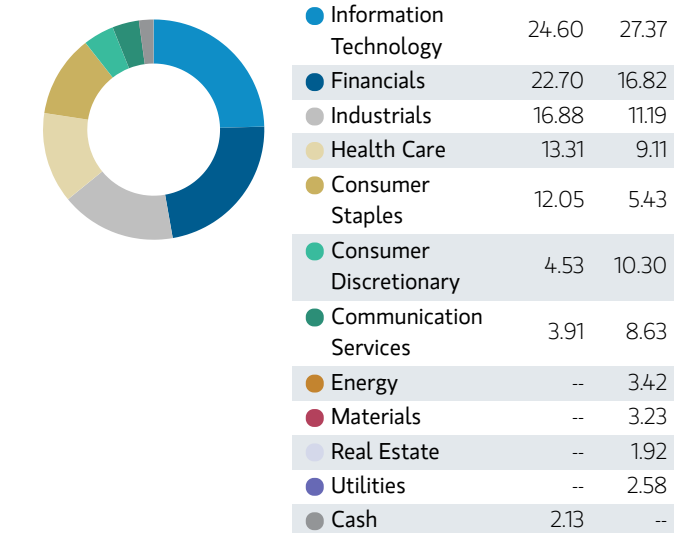
Returns are net of fees and assume the reinvestment of all dividends and income. They are compared to an unmanaged market index. Returns for less than one year are cumulative (not annualized). Performance for one year or more is based on average annual total returns. The returns are reported for Class I and A 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.

Top Holdings (% of Total Net Assets)

	FUND	INDEX
Microsoft Corp	9.10	4.54
SAP SE	7.95	0.35
Visa Inc	4.93	0.73
RELX Plc	4.88	0.11
Arthur J Gallagher & Co.	4.10	0.10
Alphabet Inc	3.91	3.24
Automatic Data Processing Inc	3.77	0.15
Coca-Cola Co.	3.73	0.34
Procter & Gamble	3.49	0.45
L'Oréal S.A.	3.49	0.13
Total	49.35	--

Sector Allocation (% of Total Net Assets)^



^ May not sum to 100% due to rounding.

INDEX INFORMATION

The **MSCI World Net Index** is a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed 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 performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

The **Standard & Poor's 500® Index (S&P 500®)** measures the performance of the large cap segment of the U.S. equities market, covering approximately 80% of the U.S. equities market. The Index includes 500 leading companies in leading industries of the U.S. economy.

The **S&P 500 Quality Index** measures the performance of high quality stocks in the S&P 500, based on a quality score calculated from return on equity, accruals ratio and financial leverage ratio.

The Index is unmanaged and does not include any expenses, fees or sales charges. It is not possible to invest directly in an Index. Any index referred to herein is the intellectual property (including registered trademarks) of the applicable licensor.

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