Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Institutional Fund

Global Sustain Portfolio

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | COMMENTARY | JUNE 30, 2020

Performance Review

In the quarter period ending June 30, 2020, the Portfolio's I shares returned 17.74% (net of fees)[1], while the benchmark returned 19.36%.

Our underperformance in June was led by our overweight to health care and our underweight to consumer discretionary. In consumer staples, good stock selection was enough to offset the effects of the overweight and vice versa in information technology, where weaker stock selection was more than offset by the overweight to the sector.

Second quarter underperformance was led by the health care and consumer discretionary sectors driving the relative underperformance. The overweight to consumer staples was unsurprisingly a drag in this aggressive value rally, while information technology stock selection posed a significant headwind to relative performance despite a 24% return for the quarter.

Market Review

The MSCI World Index rose 2.7% in June, led by information technology (+7.3%), consumer discretionary (+4.7%) and materials (+3.9%). Health care (-1.3%), utilities (-1.3%) and energy (-1.0%) were quite soft as was consumer staples (+0.6%).

June ends a truly extraordinary quarter that yielded returns of 19.4% in the MSCI World Index, the kind of move last seen in 2009-2010. June did not differ much from the quarter overall in terms of sector breakdown, where the big drivers were information technology (+31%), consumer discretionary (+30%) and materials (+26%). At the other end were utilities (+6.2%), consumer staples (+8.7%) and real estate (+11.7%). Despite the sharp move, the index is still down 5.8% for the year, though some of the "COVID winners" like information technology (+13.9%), health care (+1.4%) and consumer discretionary (+1.4%) have now managed to turn positive for the year.

By geography, we saw Australia leading (+28.9% in U.S. dollars) this quarter, thanks to materials. Export-oriented Northern Europe, e.g. Germany (+26.5%), the Netherlands (+24.8%) and Sweden (+20.1%), also did very well. The U.S. was up 21.6% in the quarter, reflecting the strong performance of information technology and other COVID winners. At the same time, the U.K. (+7.8%), Hong Kong (+9.2%), Singapore (+9.5%) and Japan (+11.6%) were laggards, but still produced strong absolute performance in the quarter.

Portfolio Activity

During the quarter, most of our portfolio activity was driven by valuation. We shifted from names where valuations were looking extended into names that had experienced drawdowns which we found unjustified in light of their medium-term prospects.

Outlook

Paying up

The payments industry is gradually emerging as one of the most attractive parts of the financial technology (fintech) world. Prior to COVID-19, approximately 50% of transactions globally were done in cash.[2] COVID-19 has forced many in-person transactions online, where cash is not a practical way to pay. Furthermore, it is likely physical money is a vector for the transfer of the virus. Once consumers are habituated to using more convenient digital payments, the shift away from cash should remain structurally

1 Source: Morgan Stanley Investment Management. Data as of June 30, 2020.
2 Source: Capgemini World Payments Report 2019

higher in the post-COVID-19 world; digital payment volume growth is expected to be in excess of 12% per annum in the medium term, an attractive tailwind for the sector.[2]

The payments universe is complicated and there are a range of players with differing roles and value propositions. Broadly speaking there are three main categories: Card Issuers, Card Networks and Merchant Acquirers. Card Issuers are mostly banks and credit card companies who issue credit and debit cards to retail or wholesale customers. Card Networks provide the infrastructure and the rulebook for the exchange of authorisations and funds. Merchant Acquirers provide the connection between the shops or websites that accept the payment and the Card Networks.

For instance, if customers swipe their cards to pay for their fully loaded COVID-19 shopping trolleys at the local supermarket, the device sends a message to the Merchant Acquirer asking for authorisation of the payment. The Merchant Acquirer sends the message through the Card Network, which forwards it to the Card Issuer. If the Card Issuer confirms the card to be good for payment, the authorisation is conveyed back through the Card Network to the Merchant Acquirer and finally to the supermarket. Depending on the card used and geography, for every $100 shopping basket the consumer buys, the supermarket receives approximately $98.00 to $99.00 whilst the Merchant Acquirer gets a $0.10 to $0.20 fee, the Card Network collects a roughly $0.20 fee and the Card Issuer gets generally $0.60 to $1.30.[3] Optically it looks like Card Issuers are making the most money, but in reality they pass some of the fee back to consumers in the form of incentives like air miles, cash back or reduced foreign exchange fees.

Card Networks – the resilient part of the system

Traditionally the two pure card networks, Visa and MasterCard, have been the most attractive bottleneck in the ecosystem (Visa was 5.5% of the portfolio as of March 31, 2020).[4] They have a strong set of three overlapping moats – a network of consumers, a network of merchants and a network of financial institutions. These overlapping moats have proven very difficult to break. There are some vertically integrated operators, domestic card networks and new emerging electronic payment providers, but without the help of government regulation tilting the playing field, and extensive capital, it has proven very hard to compete; the majority of these alternatives lack the scale of investment, international reach or service quality to compete with Visa or MasterCard. That has allowed Visa and MasterCard to maintain stable and often dominant market shares in a growing market, with the persistent global move from cash to card.

Merchant Acquirers – making progress

Most merchant acquiring activity is still done by banks, particularly in Europe. Historically, it was a part of commercial banking services that banks provided to their clients. Over time, the inherent economies of scale in this business have resulted in the emergence of initially bank-owned utilities and now independent commercial operators that provide processing and merchant acquiring services. These companies pursue one of two strategies. Either they consolidate the existing merchant banking infrastructure under one roof and create synergies from streamlining systems and cost, or they operate one unified technology stack and acquire customers organically. Players like Adyen, Stripe and PayPal have pursued the second strategy and saw very strong growth at highly attractive economics, resulting in elevated valuations. At the same time, some of the consolidators that trade at more digestible multiples are making good progress based on sensible pricing of deals and improving integration skills.

Card Issuers – buried in the banks and credit companies

Most issuing activity sits within banks and credit card companies. They sometimes outsource the processing part to gain economies of scale but tend to hold on to the core issuing activity, which gives access to the interchange fee. Whilst card issuing produces very attractive returns, with some variance depending on how much they have to give away in direct or indirect incentives, these activities are rarely big enough to drive the economics of the organisations where they occur.

Data - the next frontier

The current investment case rests on the benefit of consolidating what is by nature a largely fixed cost business. Beyond this, the payments industry provides an unrivalled treasure trove of data on which to build value-added services.

For example, fast food restaurants are putting up kiosks in their restaurants where you can order food to pick up at the counter. Customers tend to order more or higher value items at the kiosk, maybe because they feel less under pressure from the people waiting in the queue behind them. A similar trend is happening with the use of apps. Creating a tool that helps fast food restaurants project the return on investment for the kiosk based on their existing customer base could be of material value.

---

2 Source: Capgemini World Payments Report 2019
3 Source: Adyen, Nexi, Visa and Morgan Stanley analysis
4 Except Visa and Alphabet, all companies discussed in this commentary were not held in the portfolio as of March 31, 2020.

Ultimate success in this industry will be determined by who will be able to generate the highest quality data. Some of the large banks who have both issuing and acquiring under one roof should, in theory, be best equipped. However, this requires integration across often separate divisions (retail and commercial banking) and a material upgrade and integration of existing systems. Historically, banks, in particular incumbent banks, have struggled with these kinds of challenges. Card Networks have by far the deepest set of data. However, their role at the centre of card payments is not just one of processing, but also to be the arbiter and rule maker between acquirers and issuers. It will be difficult to remain a referee whilst competing with the contestants on data.

Some of the Merchant Acquirers are positioning themselves in value-added services. Similar to the banks, the system architecture will be critical to success, favouring the single technology stack players. Recently established digital wallets like ApplePay and GooglePay are also in a strong position, assuming they can integrate the payments data with their other databases.

Implications

From an ESG (environmental, social, governance) perspective, the shift to digital payments away from cash may lead to the financial exclusion of people without access to the banking system, especially in emerging markets. Visa is acutely aware of this and has been helping unbanked individuals access electronic payments accounts, with the aim of meeting 500 million people by 2020. The shift to digital also raises payment security issues. Visa has been investing heavily in data security. It received the highest rating in the sector from Gartner Consulting during its 2019 Cybersecurity program review, and also prevented approximately $25 billion in fraud using artificial intelligence.[5]

As quality investors with a focus on reduced downside participation, we have always been drawn to the Card Networks given the robustness of their business model and scale economics. We have access to the data opportunity through a position in Alphabet (4.8% of the portfolio as of March 31, 2020).[4] Banks and pure credit card companies are out of bounds for our global portfolios due to low returns and high leverage. Merchant Acquiring is more interesting, although valuations are very elevated for players with single technology stacks.

FUND FACTS

Launch date	Base currency	Index
August 30, 2013	U.S. dollars	MSCI World Net Index

[4] Except Visa and Alphabet, all companies discussed in this commentary were not held in the portfolio as of March 31, 2020.
[5] Source: Visa press releases, June 17, 2019 and September 16, 2019.

Performance (%)

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

	MTD	QTD	YTD	1 YR	3 YR	5 YR	10 YR	SINCE INCEPTION
MSIF Global Sustain Portfolio - I Shares	2.34	17.74	1.43	10.28	12.19	11.74	--	11.24
MSCI World Net Index	2.65	19.36	-5.77	2.84	6.70	6.90	--	8.12

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 1.92% for Class I shares and the net expense ratio is 0.90%. 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.

MSIF Global Quality Portfolio is changing to MSIF Global Sustain Portfolio effective April 30, 2018.

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. 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 risks 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. **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. **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 public traded securities (liquidity risk).

INDEX INFORMATION

The **MSCI World 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 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.

This material is a general communication, which is not impartial and all information provided has been prepared solely for informational and educational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The information herein has not been based on a consideration of any individual investor circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.

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.

NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY LOSE VALUE NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A DEPOSIT