Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Institutional Fund

Global Real Estate Portfolio

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

Performance

In the one month period ending August 31, 2019, the Fund's I shares returned -0.59% (net of fees)[1], while the benchmark returned 1.92%.

The Fund underperformed the benchmark, the FTSE EPRA Nareit Developed Real Estate Index – Net Total Return to U.S. Investors, for the month.

Analysis

Recently, the real estate securities market has been dominated by thematic investing 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. The key theme in August was to favor stocks viewed as being more defensive. 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 further widening of the 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 portfolio trades at a discount of approximately 12% 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 5% premium as of the end of August.

The global developed real estate securities market posted local currency gains in August. There was a very wide disparity of returns as, generally, sectors that are viewed as defensive outperformed and those viewed as being more subject to risks of a weaker economy underperformed the index. In addition, Hong Kong stocks posted significant declines on negative sentiment related to trade war concerns and protests.

The Fund underperformed the benchmark for the month. Performance within the regional portfolios detracted from relative performance and top-down regional allocation was relatively neutral. In the Asian region, the Fund benefited from the underweight to Australia; this was more than offset by the overweight to Hong Kong and China, and the underweight to and stock selection within Japan. In the European region, the Fund benefited from stock selection in Continental retail and the underweight to Germany; this was more than offset by the overweight to Continental retail and underweight to Switzerland and Sweden. In the North American region, the key detractors were the overweight to and stock selection within the U.S. mall, primary central business district (CBD) office and hotel sectors, underweight to the health care and net lease sectors, and stock selection in the diversified sector.

Strategy

Regional bets are currently relatively muted due to a lack of large valuation disparities among the regions and due to macro uncertainties which may impact regional share prices far more than underlying fundamentals and valuations, and we have instead

[1] Source: Morgan Stanley Investment Management. Data as of August 31, 2019.

focused more on the significant disparity in valuations within each of the regions. While the overall global real estate securities market ended the month trading at a 5% premium to NAVs, we see enormous disparities in valuations among market segments within each of the major regions, with the most attractive expected return prospects from companies concentrated in U.S. CBD office (especially NYC office), the Hong Kong commercial property companies, U.S. and Continental high-quality retail, the U.K. Majors and London office specialists, U.S. hotels, and select opportunities to invest in other core assets at attractive discounted valuations in a number of other global markets.

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. Following significant declines in August on the back of negative sentiment related to trade war concerns and protests, the stocks ended the month trading at an average 51% discount to NAVs and continue to trade at the widest discounts on a global basis despite solid recurring cash flow growth and continued strength in asset values in the private markets. The discounted valuations are further accentuated as the Hong Kong REOCs maintain very modest leverage levels. Select companies have tried to narrow these NAV discounts by recycling assets on their balance sheets to realize their latent gains and by engaging in corporate restructuring to improve transparency and capital management. The Japan REOCs ended the month trading at an average 21% discount to NAVs. The outlook for cash flow growth and further cap rate compression remains modest; however, the J-REOCs continue to offer attractive value relative to the Japan real estate investment trusts (J-REITs), which ended the month trading at a 22% 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. The Fund is underweight Japan overall, driven primarily by the large underweight to the J-REITs. In Australia, the key office markets in Sydney and Melbourne experienced continued improvements in occupancy and rents. In the retail sector, operating fundamentals remain weighed down and landlords will have to spend capex to ensure their malls/shopping centers remain competitive; moreover, there is a large supply of assets for sale, which may not bode well for retail asset valuations. The Australian REIT sector ended the month trading at an average 10% premium to NAVs, and there was a wide disparity in valuations, with office, industrial and residential stocks trading at premiums to NAV and retail stocks trading at modest discounts. The Fund is underweight Australia overall given far less attractive valuations relative to the Hong Kong REOCs within Asia.

In Europe, property stocks in the U.K. ended the month trading at an average 8% discount to NAVs, with the large-cap U.K. Majors trading at an average 22% discount and the London office specialists trading at an average 19% 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. Property stocks on the Continent ended the month trading at an average 5% discount 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 (-41%), and stocks trading above NAV in the Nordics (+12%), Switzerland (+16%) and Belgium (+60%). 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. Within Europe, we are overweight the U.K. Majors and London office specialists and Continental retail, and remained underweight German residential and other segments in the U.K.

Within the U.S., the overall REIT market ended the month at a 14% premium to NAVs, but there is an enormous disparity in relative valuations, with some property sectors at premiums and various other sectors at significant discounts to NAVs. We think that the most attractive value can be found in the companies that own NYC office assets as the stocks ended the month trading at a 35% discount. This is despite significant transactional evidence for NYC office assets that continues to demonstrate strength in asset values. We also see attractive value in high-quality retail, CBD office and hotel stocks. The exceptionally discounted valuations in certain market segments provide prospects for value-add/opportunistic returns excluding the level of risk that traditionally goes with those investments, given predominant exposure to high-quality, fully leased asset portfolios backed by strong balance sheets with modest leverage. Given significant funds that need to be invested in real estate, we expect to see further corporate and take-private activity if the significant disparities between public and private market valuations continue to persist. The Fund remained underweight U.S. net lease, U.S. health care and Canada due to relative valuations.

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.

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. We must admit that this current prolonged period in which underlying private market valuation is not a relevant determinant of share prices has been shocking. 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. We are in active discussions with companies trading at discounted valuations on various options to narrow their valuations gap. We believe we could be rewarded as these stocks provide positive risk-adjusted returns based on our analysis.

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

- Underlying private market valuation has become a less relevant metric for generalist investors and passive funds, who have become the marginal buyer of REITs;
- Generalist investors appear less comfortable using private real estate value as a key metric and turn to more traditional stock market metrics such as earnings multiples, dividend yields and earnings growth rates. Generalist investors have favored REIT stocks with perceived defensive characteristics (net lease and health care) or that benefit from a secular investment theme, such as e-commerce penetration (industrial), growth in data analytics and cloud computing (data centers) or "platform investing" (net lease), and shunned those perceived as being more vulnerable to weaker economic growth;
- Growth of passive investing within REITs has contributed to a prolonged challenging environment for value-oriented investors due to a lack of focus on differentiating among stocks based on fundamentals, and instead adding to stocks that trade at premiums to NAV that have grown in market capitalization and reducing exposure to stocks that trade at discounts to NAV that have decreased in size; and
- 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 multiples than NYC office REITs.

We believe the following may be the catalysts for the valuation gap to narrow, which could help overall performance:

- ***Take-private activity to focus investors on NAV as a meaningful metric.*** Given the enormous disparities between public and private market valuations that exist within certain market segments and record levels of dry powder to invest, there may be increased take-private activity as 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 may 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 may cause a reversal in the lower-for-longer investment theme.
- ***Resurgence of value-based investment***. The current market environment characterized by momentum and thematic investing with less emphasis on valuation has caused enormous valuation disparities amongst sectors in the real estate securities market. Mean reversion may provide significant upside potential for undervalued stocks to narrow the large price per NAV (P/NAV) discounts, and also may 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 multiples.

FUND FACTS

Launch date	Base currency	Index
August 30, 2006	U.S. dollars	FTSE EPRA Nareit Developed Real Estate Index - Net Total Return to US Investors

Performance (%)

As of date August 31, 2019 (Class I Share at NAV)

	MTD	QTD	YTD	1 YR	3 YR	5 YR	10 YR	SINCE INCEPTION
MSIF Global Real Estate Portfolio - I Shares	-0.59	-1.55	10.77	-0.24	1.89	2.91	7.67	3.70
FTSE EPRA Nareit Developed Real Estate Index - Net Total Return to US Investors	1.92	2.30	17.52	8.77	5.11	5.61	9.55	4.44

Performance (%)

As of date June 30, 2019 (Class I Share at NAV)

	MTD	QTD	YTD	1 YR	3 YR	5 YR	10 YR	SINCE INCEPTION
MSIF Global Real Estate Portfolio - I Shares	0.88	-1.90	12.51	3.23	3.24	3.62	9.46	3.88
FTSE EPRA Nareit Developed Real Estate Index - Net Total Return to US Investors	1.66	0.09	14.88	8.33	5.12	5.51	11.16	4.31

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 1.07% for Class I shares and the net expense ratio is 1.00%. 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.

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. **Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). 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. 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.

INDEX INFORMATION

The **FTSE EPRA Nareit Developed Real Estate Index** - Net Total Return to U.S. Investors 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 performance of the Index is listed in U.S. dollars and assumes reinvestment of dividends. "Net Total Return to U.S. Investors" reflects a reduction in total returns after taking into account the withholding tax on dividends by certain foreign countries represented in the Index.

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.

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 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.

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