Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Institutional Fund

International Equity Portfolio

INTERNATIONAL EQUITY TEAM | COMMENTARY | CLASS I SHARES | JUNE 30, 2021

Performance Review

In the quarter period ending June 30, 2021, the Portfolio's I shares returned 6.50% (net of fees)[1], while the benchmark returned 5.17%.

Stock selection was behind the underperformance in June due to underperformance in consumer staples, health care and materials. Sector allocation was positive as the portfolio's three main overweight sectors - consumer staples, health care and information technology – all outperformed the index. These three sector overweights also drove positive sector allocation in the second quarter (Q2), while selection was also slightly positive over the period as the outperformance in consumer discretionary, industrials, health care and energy outweighed the impact of underperformance in consumer staples and financials.

The top positive contributors to absolute performance in the quarter were Deutsche Post (2.9% of the portfolio), SAP (3.3% of the portfolio), Fresenius (2.7% of the portfolio), Pernod Ricard (2.6% of the portfolio) and Moncler (2.4% of the portfolio).[2] The leading absolute detractors were Prudential (2.5% of the portfolio), ABF (1.8% of the portfolio), Henkel (3.4% of the portfolio), Lion (0.4% of the portfolio) and Tencent (2.4% of the portfolio).[2]

Market Review

Q2 was yet another strong quarter, the fifth in a row since the March 2020 trough, with the MSCI EAFE Index gaining 5.2% in U.S. dollars (USD) (+4.8% in local currency), leaving it up 53% over the last five quarters. Europe was mixed with Switzerland (+12% USD, +10% local) and France (+9%, +8%) strong, while the U.K. (+6%, +6%) was also ahead of the index, but Italy (+4%, +3%) and Germany (+5%, +4%) lagged. Asia was weaker still, with Japan and Singapore roughly flat, and Hong Kong only up 3% in USD (+2% local). The U.S. market was up 9%, well ahead of EAFE. The quarter's sector picture was supportive for the portfolio, with health care (+9%), consumer staples (+8%) and information technology (+8%) all outperforming, while cyclicals tended to mildly underperform, as energy and financials were only up 3% and industrials gained 4%. Utilities (-1%) and communication services (+0%) were the weakest sectors.

Portfolio Activity

We initiated four positions during Q2.

AstraZeneca (1.3% of the portfolio) has managed a successful turnaround after a period of severe revenue erosion due to patent expiries and pricing struggles.[2] Its current licenced assets could support decent growth from here even without the pipeline, while research and development (R&D) productivity has improved. The position was funded by cutting the position in GlaxoSmithKline (0.9% of the portfolio), where we worry about the company's ability to compensate for patent cliffs given the weak pipeline and poor R&D productivity record.[2]

DBS (0.6% of the portfolio) is arguably among the best banks in the EAFE universe, given its high return on tangible equity, strong funding, digital leadership and large, growing wealth management exposure.[2] This position was partly funded by reducing the stake in Sumitomo Mitsui Financial Group (1.1% of the portfolio), after its decent share price performance this year.[2]

---

1 Source: Morgan Stanley Investment Management. Data as of June 30, 2021.
2 Holdings as of June 30, 2021.

Qiagen (0.5% of the portfolio) is a high quality life science and diagnostics company, with 80% recurring revenues and high barriers to entry around its sample testing and diagnostics businesses.[3] We took the opportunity to establish a position, exploiting the uncertainty about the duration of COVID-related testing revenues.

Legrand (0.5% of the portfolio) provides low-voltage electrical products and generally has strong market positions in the segments where it operates in this fragmented market.[2] It has decent pricing power, as the products are selected by contractors and paid for by the end customer. Given that the products make up a tiny fraction of the overall project cost, availability, reliability and ease of installation are far more important than price.

There were no final exits other than from the minuscule holdings in Thungela, the thermal coal business spun out of Anglo American (0.9% of the portfolio) during the quarter, although we did reduce positions in metals and mining companies (Cameco, 0.5% of the portfolio, and BHP, 1.0% of the portfolio) and some industrials (Hexagon, 1.5% of the portfolio, and Deutsche Post, 2.9% of the portfolio) on valuation after very strong performance.[2]

Outlook

Quality in the Brave New World

The International Equity strategy is a blend of high quality compounders and value opportunities, generally skewed towards the compounders, which currently make up 54% of the portfolio. This bias towards quality has been helpful over the last few decades as compounders have done well. Their combination of pricing power and recurring revenue has allowed them to comfortably out-earn the market as a whole, as demonstrated by consumer staples and health care, two compounder-rich sectors that have roughly doubled their earnings per share since 2005, while the EAFE index as a whole has only grown earnings by 30%.[4] This large earnings gap is despite the strong cyclical rally over the last year. The other positive has been that, despite this superior record, they have generally only traded at a mild premium to the market, particularly when looking at free cash flow yields.

There is speculation that quality and compounders will struggle in the "Brave New World" of reflation and inflation. Our view is that the companies should continue to prosper, even if there is a shift to a more inflationary regime.

It is true that the last year has been less favourable for quality stocks in relative terms. The fourth quarter of 2020 and first quarter of 2021 saw significant good news around the speed of vaccine development and rollout, which sharply accelerated the likely path of recovery. As a result, the value sectors and cyclical recovery plays in sectors such as financials, materials and industrials naturally came into favour, as their earnings expectations improved sharply in the "reflation trade," comfortably outpacing the defensive sectors - notably consumer staples and health care - that make up over 40% of the portfolio. Fortunately, strong stock selection over the past 15 months has mitigated the performance drag from this cyclical rally from the March 2020 low.

More recently, the discussion has shifted toward how much longer the cyclical, or reflation, trade may last. It is unclear whether there are further positive growth surprises to come, how much upside there still remains in cyclical earnings, and the extent to which any good news is already in stock prices, with materials up 83% and consumer discretionary up 77% since March 2020, compared with only 30% for consumer staples and 29% for health care.[4] The experience of the last quarter, with the cyclical sectors generally lagging slightly behind the overall index, suggests that the momentum behind the value trade may be fading.

The fear is that the current economic boom will drive inflation, and prices have indeed already risen sharply for many commodities and products. What is not yet clear is how much of this is transitory – the result of spikes in demand and supply still constrained by the pandemic – and how much may prove to be more permanent. The consensus seems to be that much of the inflationary pressure will indeed fade away as demand normalises and supply recovers, meaning that governments will not have to slam on the brakes.

We would agree that some commodities, for instance iron ore, are above likely long-term prices (which incidentally means that their producers may be over-earning at present). However, the key inflation variable to watch is wage growth: in service-orientated economies, people costs are more important than the costs of "stuff," be it semiconductors or lumber. In the meantime, the market obsesses over tiny micro-signals about central bank intentions, reminiscent of the Cold War sport of Kremlinology, described by one eminent historian of the time as the attempt to work out who was winning the power struggles within the Politburo by the width of the black armbands worn at public state funerals in Red Square.

---

2 Holdings as of June 30, 2021.
3 Holdings as of June 30, 2021. Revenues data from FactSet and MSIM.
4 Source: FactSet. Data as of June 30, 2021.

Looking through the timing and strength of the current economic recovery, there are longer-term concerns in the market about the fate of quality equities in a higher-inflation world, if that does indeed come to pass. While we do not have a strong view as to the likely path of inflation, given that there are decent arguments for both the transitory and the more permanent cases, we do believe that quality companies can still thrive in a more inflationary environment.

One key point to make is that inflation is fundamentally a nominal rather than a real phenomenon. It will accelerate headline revenue growth rates, but any benefits are illusionary, as they are cancelled out by the rise in the price level. That said, there are arguments that inflation can particularly help lower quality companies. "Money illusion" can fool people into crediting companies that are not growing in real terms with growth status – not something that happens in today's low-inflation world. In addition, inflation may help asset-heavy companies' accounting profits, as sales rise relative to the book value of their assets and the associated depreciation. The final argument in favour of lower quality stocks in an inflationary regime is that they are less vulnerable to an inflation-driven rise in discount rates as nominal rates rise, given their lower multiple and shorter duration compared to more expensive stocks. This makes sense mathematically … providing you ignore the fact that the long-run nominal growth rate is likely to rise in parallel with the inflation and discount rates, cancelling out any effect on the multiple.

Overall, our view is that these inflation gains for lower quality companies are not "real" or "economic" and are thus unlikely to have a long-lasting impact, with the exception of some financials, which may see net interest gains from higher interest rates. We would also argue that there are two significant relative pluses for higher quality companies in a higher inflation world:

- The first is that inflation will mean that companies have to deal with rising input costs. This is likely to put a premium on those companies who can pass those costs on to customers through their pricing power, one of the key characteristics that we look for in compounders.
- The other is that this regime will probably require more frequent government intervention to keep inflation under control, producing shorter economic cycles. The last few decades have seen unprecedentedly long economic cycles as governments have not had to slow economies down to dampen price rises, and this would unlikely be sustained if inflation became an issue. In a world of frequent recessions, compounders' recurring revenues would be an even more valuable source of earnings stability.

Ultimately, the case for compounders remains largely unchanged in a more inflationary world. Companies that can grow their earnings steadily in real terms across cycles are likely to continue out-earning the market, just as they have done over the last few decades. Pricing power and recurring revenues are arguably even more important in a world of rising input costs and higher economic volatility. The other point we made at the start of this piece also stands. With the high quality compounder-rich International Equity Portfolio at only a 4% premium to the MSCI EAFE Index on forward earnings, despite a return on operating capital over twice that of the index, the market is still failing to recognise the power of compounders.[4] In a world of expensive markets, with the MSCI EAFE Index still at a 16-17x forward multiple for the first time since the TMT (technology, media and telecommunications) bubble at the start of the century - even after a 39% rise in earnings over the last year - a high quality portfolio remains attractive.[4] After all, given that markets currently involve significant valuation risk, why take earnings risk as well?

FUND FACTS

Launch date	Base currency	Index
August 04, 1989	U.S. dollars	MSCI EAFE Index

[4] Source: FactSet. Data as of June 30, 2021.

Performance (%)

As of June 30, 2021 (Class I Share at NAV)

	MTD	QTD	YTD	1 YR	3 YR	5 YR	10 YR	SINCE INCEPTION
MSIF International Equity Portfolio - I Shares	-1.92	6.50	7.16	26.80	8.01	9.18	6.03	8.35
MSCI EAFE Index	-1.13	5.17	8.83	32.35	8.27	10.28	5.89	4.98

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 1.00% for Class I shares and the net expense ratio is 0.95%. 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.

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.

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 strategy. Please be aware that this strategy may be subject to certain additional risks. **ESG strategies** that incorporate impact investing and/or Environmental, Social and Governance (ESG) factors could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. As a result, there is no assurance ESG strategies could result in more favorable investment performance. In general, 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. Investments in **small- and medium-capitalization** companies tend to be more volatile and less liquid than those of larger, more established, companies. The risks of investing in **emerging market** countries are greater than risks associated with investments in foreign developed markets. **Derivative instruments** can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the portfolio's performance. **Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk).

INDEX INFORMATION

The **MSCI EAFE Index** (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the international equity market performance of developed markets, excluding the US & Canada. 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 MSCI EAFE Index currently consists of 21 developed market country indices. 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

CRC 3651153 Exp: 6/30/2022