Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Institutional Fund

International Real Estate Portfolio

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

Performance

In the one month period ending May 31, 2019, the Fund's I shares returned -1.42% (net of fees)[1], while the benchmark returned -0.50%.

The Fund underperformed the benchmark, the FTSE EPRA Nareit Developed ex-North America Real Estate Index – Net Total Return, for the month.

Analysis

The global developed real estate securities market was relatively flat in local currency terms in May. However, listed real estate stocks that are viewed as defensive dramatically outperformed in the month. As a reminder, many of these stocks trade at large premiums to their underlying property values so we do not view them as defensive. However, in recent periods, generalist investors have been attracted by the perceived stability of their cash flow and/or dividend yield and are not detracted by the premium share price valuations. As a result, the Fund underperformed the benchmark for the month.

Performance within the European region detracted from relative performance, while the Asian region was relatively neutral. Top-down regional allocation was relatively neutral. In the Asian region, the Fund benefited from stock selection in Hong Kong and Japan, and the underweight to Singapore; this was offset by the overweights to Hong Kong and the China real estate operating companies (REOCs) and underweight to Japan. In the European region, the Fund benefited from stock selection in U.K. Other and Continental retail; this was more than offset by the overweight to and stock selection within the U.K. Majors, the overweight to Continental retail, and underweights to German residential and Sweden.

Strategy

The Fund is comprised of two regional portfolios with a global allocation which weights the European and Asian regions relative to the index based on our view of the relative attractiveness of each region in terms of underlying real estate fundamentals and public market valuations. Moreover, each of the regional portfolios reflects our core investment philosophy as a real estate value investor, which results in the ownership of stocks that provide the best valuation relative to their underlying real estate values, while maintaining portfolio diversification. Our company-specific research leads us to specific preferences for sub-segments within each of the property sectors and countries. 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 focused more on the significant disparity in valuations within each of the regions. While the overall global real estate securities market ended the period trading at around par to net asset values (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 the Hong Kong commercial property companies, Continental high-quality retail, the U.K. Majors and London office specialists, and select opportunities to invest in other core assets at attractive discounted valuations in a number of other global markets.

In Hong Kong, there is continued strength in valuations for commercial assets as evidenced by elevated transaction volumes. The Hong Kong office market features low vacancy levels and continued rental growth, while there has recently been a slowdown in the strong growth of retail sales. The Hong Kong REOCs continue to represent a significant overweight in the global portfolio,

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

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. The stocks ended the period trading at an average 44% discount to NAVs and continue to trade at the widest discounts on a global basis despite healthy operating fundamentals, solid recurring cash flow growth and continued strength in asset values in the private markets, as well as improving corporate governance and capital management. The discounted valuations are further accentuated as the Hong Kong REOCs maintain very modest leverage levels. These NAV discounts could eventually narrow for companies that are willing to recycle assets on their balance sheets to realize their latent gains and engage in corporate restructuring to improve transparency and capital management, and potentially eliminate any holding company discounts, as well as any improvement in negative sentiment. In Japan, the outlook for cash flow growth and further cap rate compression remains modest. There is a significant disparity in valuations with the J-REOCs trading at a 21% discount to NAVs and continuing to offer attractive value relative to the Japanese real estate investment trusts (J-REITs), which ended the period trading at a 14% 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 portfolio 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 period trading at a 13% 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 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 period trading at an 11% discount to NAVs, with the large-cap U.K. Majors trading at a 28% discount and the London office specialists trading at a 16% 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 in certain market segments. Property stocks on the Continent ended the period trading at a 7% discount to NAVs, although there is meaningful disparity in valuations within the Continent, with the Continental retail stocks trading at deeply discounted valuations (-34%). 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.

Outlook

Investment values for prime real estate assets have generally remained stable due to very strong capital flows to the sector as investors have embraced real estate within their multi-asset portfolios. There continues to be concern among some market participants that values may have peaked or are even poised to decline after significant appreciation, but declining bond yields year-to-date coupled with continued robust credit availability have reduced those concerns. Generally, current cap rates have been supported by historically wide cap rate spreads versus financing costs and continued strong demand for real estate. Moreover, real estate asset values and transaction volumes remain well supported by the record amount of investor allocation to the real estate sector, with record target allocations and rising levels of dry powder.

While there are pockets of the global listed property market trading at premium valuations relative to peers due to being perceived as defensive or benefiting from a secular investment theme, there is significant negative investor sentiment towards key market segments resulting in very wide discounts to NAVs despite transactional evidence continuing to demonstrate strength in asset values. Certain market segments, including Hong Kong commercial property companies, Continental high-quality retail, and the U.K. Majors and London office specialists, trade at attractive valuations and can offer the best expected return prospects. As a result, we believe there is a compelling case for active management to take advantage of wider than typical valuation disparities on a global basis.

FUND FACTS

Launch date	Base currency	Index
October 01, 1997	U.S. dollars	FTSE EPRA Nareit Developed ex-North America Real Estate - Net Total Return Index

Performance (%)

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

	MTD	QTD	YTD	1 YR	3 YR	5 YR	10 YR	SINCE INCEPTION
MSIF International Real Estate Portfolio - I Shares	-1.42	-3.15	10.48	0.04	5.11	2.21	7.44	7.29
FTSE EPRA Nareit Developed ex-North America Real Estate - Net Total Return Index	-0.50	-2.85	10.06	1.97	5.87	3.40	8.10	5.96

Performance (%)

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

	MTD	QTD	YTD	1 YR	3 YR	5 YR	10 YR	SINCE INCEPTION
MSIF International Real Estate Portfolio - I Shares	4.08	14.07	14.07	4.73	6.36	4.31	11.31	7.51
FTSE EPRA Nareit Developed ex-North America Real Estate - Net Total Return Index	4.10	13.29	13.29	6.59	7.01	5.42	11.83	6.15

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 1.90% 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 portfolio. 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 the risks generally associated with investments in foreign developed countries. **Real estate investments, including real estate investment trusts (REITs),** 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. **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.

Illiquid securities may be more difficult to sell and value than public traded securities. 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 ex-North America Real Estate–Net Total Return Index** is a free-float adjusted market capitalization weighted index designed to represent general trends in eligible real estate equities worldwide excluding North America. The performance of the Index is listed in U.S. dollars and assumes reinvestment of dividends. "Net Total Return" reflects a reduction in total returns after taking into account the withholding tax on dividends by certain foreign countries represented in the Index for periods after 2/18/05 (gross returns used prior to 2/18/05).

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.

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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.

Morgan Stanley Investment Management is the asset management division of Morgan Stanley.

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