Performance Review

In the quarter period ending December 31, 2019, the Portfolio’s I shares returned 0.51% (net of fees)\(^1\), while the benchmark returned 0.71%.

The Fund performed well during the fourth quarter of 2019 on an absolute basis, with the I shares up 0.51% despite an increase in rates; however, the Fund underperformed the Index by 20 basis points, which returned 0.71% during the quarter. The Fund’s sector allocations to U.S. non-agency residential mortgage-backed securities (RMBS), non-U.S. RMBS, U.S. agency collateralized mortgage obligations (CMOs) and U.S. asset-backed securities (ABS) all outperformed the Index during the quarter, while the Fund’s U.S. commercial mortgage-backed securities (CMBS) and U.S. agency fixed-rate passthrough positions slightly underperformed.

The Fund’s allocation to U.S. agency fixed-rate passthroughs underperformed primarily due to the Fund’s higher coupon positioning relative to the Index during the quarter as rates increased and the curve steepened, and volatility subsided, relaxing prepayment concerns for the more prepay-sensitive MBS (30-year 3.0%, 30-year 3.5% and 30-year 4.0%); as a result, the lower coupon MBS outperformed the broader MBS market. The Fund was underweight these more-volatile coupon MBS, which contributed to the underperformance for the quarter. The outperformance of non-U.S. RMBS, U.S. non-agency RMBS and U.S. ABS was primarily due to the large concentration of floating rate bonds in these sectors, which were less negatively impacted by the sell-off in rates during the quarter. The Fund’s duration averaged 2.9 years during the quarter and ranged from 0.4 years to 0.7 years shorter than the Index, and this shorter duration positioning had a 2 basis point positive attribution relative to the Index as interest rates rose during the quarter.

Market Review

Interest rates rose and the U.S. Treasury curve steepened sharply in the fourth quarter, as the Federal Reserve (Fed) pivoted from an easing bias to more of a neutral positioning. The Fed cut its benchmark interest rate 25 basis points at its October meeting but indicated that it was likely finished cutting rates for the foreseeable future, moving to more of a neutral, data-dependent position. The market had been anticipating 50 basis points of Fed rate cuts during the fourth quarter and further rate cuts in 2020, but improving economic data helped shift the Fed’s policy stance. The 10-year U.S. Treasury rate increased 25 basis points to 1.92%, while the 2-year U.S. Treasury rate decreased 5 basis points to 1.57%.\(^2\) Agency MBS spreads tightened as

---


\(^2\) Source: Bloomberg L.P. Data as of December 31, 2019.

This document constitutes a commentary and does not constitute investment advice nor a recommendation to invest. The value of investments may rise as well as fall. Independent advice should be sought before any decision to invest.
Prepayment fears eased. The Bloomberg Barclays U.S. MBS Index returned 0.71% during the fourth quarter, substantially outperforming the Bloomberg Barclays U.S. Treasury Index, which returned -0.79%. Current coupon agency MBS nominal spreads tightened 10 basis points during the quarter to 91 basis points above interpolated U.S. Treasuries. The duration of the U.S. MBS Index lengthened from 2.73 years to 3.21 years during the quarter.

The Fed’s MBS portfolio shrank by $58 billion during the quarter to $1409 trillion. Mortgage mutual funds saw $3.9 billion of net inflows during the fourth quarter of 2019, increasing the total 2019 net inflows to $16.6 billion. Mortgage mutual fund inflows in 2019 have partially offset the decline in Fed MBS holdings, but overall, the Fed’s balance sheet MBS reductions significantly outweigh incremental fund inflows, and this headwind is expected to continue in 2020.

Non-agency RMBS spreads were 5 to 10 basis points wider in the quarter but finished 2019 roughly 15 to 20 basis points tighter for the year. Fundamental credit conditions in the U.S. housing market remain positive. National home prices increased 0.1% in October and were up 3.3% over the trailing 12 months. November existing home sales decreased 1.7% from October but are still up 2.7% from November 2018. Housing inventory fell further in November to 1.64 million existing homes for sale, or a 3.7 month supply based on current sales volumes, which is down from a 1.74 million homes for sale (4.0 month supply) a year ago, and remains very low by historical standards. Lower mortgage rates continue to improve home affordability, which is very reasonable from a historical perspective with the median monthly mortgage payment accounting for 15.3% of the U.S. median household income in October 2019, up slightly from 15.2% a month earlier, but down meaningfully from 17.0% in October 2018. Mortgage credit performance continues to be strong, and new delinquencies remain very low, at 0.8%. Overall, we believe the U.S. housing market remains on solid ground, supported by low unemployment, rising wages and lower mortgage rates.

CMBS spreads were slightly tighter during the fourth quarter and year-to-date. CMBS new issuance continued to be heavy during the fourth quarter, but the market easily absorbed the supply. Commercial real estate market credit conditions remain positive, and commercial real estate prices rose 0.4% in November and are up 2.5% over the past year. Fundamental conditions remain favorable in most commercial real estate markets, with high occupancy rates and improving rental rates. CMBS delinquency rates fell 0.1% in November to 2.3% and are 1.0% lower over the past year. Overall, we remain positive on residential-related commercial real estate and remain cautious on retail shopping centers.

ABS spreads were also tighter during the fourth quarter and consumer credit conditions remain healthy. In 2019, AAA-rated ABS were generally 5 to 10 basis points tighter, while BBB-rated ABS were 15 to 25 basis points tighter. U.S. unemployment levels fell to 50-year lows of 3.5% in November. Personal income increased 0.5% in November, and personal spending rose 0.4% during the month. Personal savings rates increased slightly to 7.9% in November and remain high from a historical perspective. Overall consumer debt levels remain below historical levels on an inflation-adjusted basis. The Fund’s U.S. ABS holdings increased by 0.5% to 14.5% during the fourth quarter.

In Europe, interest rates climbed significantly in the fourth quarter as geopolitical and economic conditions improved. European securitized spreads tightened both in the U.K. and eurozone in the quarter and finished 2019 meaningfully tighter. Although the timing of any Brexit resolution has now been extended into 2020, the recent landslide election for the Conservatives should strengthen the U.K.’s negotiation positions and reduce the potential of a “No-Deal Brexit.” Europe could also benefit from an easing of the U.S.-China trade tariff war, which has hampered global growth expectations over the past year. With potentially positive geopolitical developments and broad global central bank stimulus, we expect economic conditions to improve in Europe. Additionally, we expect the latest round of European Central Bank (ECB) asset purchases, which were announced in September and began in November, to provide further support for euro RMBS and ABS. The ECB asset holdings increased by €32 billion to €2.579 trillion in December, and the ECB’s ABS holdings increased by €200 million to €284 billion. Despite the recent rise in rates, mortgage rates throughout the eurozone and U.K. remain historically low, which is a positive dynamic for European real estate and consumer credit. Consumer credit conditions remain healthy, employment continues to improve in

---

2 Source: Bloomberg L.P. Data as of December 31, 2019.
9 Source: S&P Experian First Mortgage Default Index. Data as of December 31, 2019.
11 Source: Green Street Advisors. Data as of December 31, 2019.
Europe, incomes are rising across the majority of the region and consumer balance sheets are improving, helped by low rates and rising wages.

**Portfolio Activity**

During the fourth quarter, the Fund reduced its U.S. agency MBS positioning by 2% and increased the Fund’s U.S. non-agency RMBS positioning by 2%. The Fund also decreased its non-U.S. RMBS exposure by 1% and increased U.S. ABS holdings by 0.5%.

Within agency MBS, we increased our to-be-announced (TBA) holding from 3% to 5% and decreased our specified pool exposure by 4%.

**Strategy and Outlook**

We enter 2020 with a positive outlook for securitized market opportunities. Agency MBS has cheapened meaningfully over the past two years and looks attractive on a risk-adjusted relative value basis for the first time in many years. Securitized credit opportunities also look attractive as fundamental credit conditions remain very positive for residential and consumer lending markets in both the U.S. and Europe. Securitized markets performed well in 2019, but still underperformed corporate credit markets due to less benefit from the rally in interest rates and less spread tightening relative to corporate credit markets in 2019. In 2020, we project rates to remain relatively range-bound or potentially drifting slightly higher, as global central banks remain accommodative and global recessionary fears wane. We believe returns in 2020 will likely not be the product of lower rates and tighter spreads as was the case in 2019, but more a function of cash flow carry and fundamental performance. With this backdrop, we expect securitized markets to outperform in 2020, given the wider risk-adjusted spreads and lower duration-risk profile.

We moved from underweight to neutral on agency MBS in 2019 as spreads widened due to increased prepayment concerns from lower mortgage rates and from supply pressures as the Fed continued to reduce its agency MBS holdings. Prepayment risk should subside in 2020, now that rates have backed off their lows from August and now that a greater portion of the mortgage market has already refinanced into lower coupon mortgages. The supply pressure from the Fed’s balance sheet reduction will continue in 2020, as we anticipate the Fed to reduce its MBS holdings by another $200 billion in 2020, but we also expect increased demand for agency MBS in 2020 from money managers, U.S. banks and foreign central banks now that agency MBS look attractive from a relative value perspective versus corporate credit and U.S. Treasuries. Overall, we believe the supply pressure could continue to push spreads modestly wider in 2020, but improving demand should minimize the impact. Within agency MBS, we favor higher yielding, more prepayment sensitive pools. The dominant agency MBS trade in 2019 was paying up for specified pools with significantly better prepayment risk profiles, and these specified pool pay-ups spiked higher as a result. As rates ease off the lows and likely remain more range-bound in 2020, we expect demand for these better prepayment story pools to weaken, and we believe the recently shunned, more prepayment sensitive pools should outperform in 2020. TBA rolls will likely remain weak, but low pay-up pools or specified pools that trade with price concessions to TBA should outperform.

Our U.S. non-agency RMBS outlook remains relatively steady. We are positive on the U.S. housing market and U.S. household economic conditions (employment, savings rates, etc.), but relative value remains more challenging in the non-agency market versus previous years. Legacy pre-crisis non-agency MBS looks relatively expensive as we enter 2020, but more recent securitizations of newly originated loans and non-performing/re-performing loans look more compelling. Overall, we continue to find attractive risk-adjusted relative value opportunities in the U.S. non-agency RMBS market, and we are maintaining our overweight to this sector.

We continue to have a mixed view of CMBS: overall the sector seems marginally expensive on a risk-adjusted basis, but there are still a number of idiosyncratic opportunities that look compelling. We have reduced our overall CMBS exposure over the past
year as spreads have tightened, and as we continue to selectively sell securities with potential credit concerns. The spread compensation for taking risk has been reduced such that some opportunities no longer make sense from a risk-adjusted return perspective.

In U.S. ABS, we continue to have a positive outlook on consumer credit sectors. Consumer balance sheets are in good shape from a historical perspective due to low unemployment, increasing wages, higher savings rates and consumer confidence levels that remain high by historical comparison. Total consumer debt remains at a reasonable level, interest rates remain historically low and credit card utilization rates are near lowest levels in 20 years. Additionally, ABS securitizations in the post-financial crisis era are being structured with robust levels of credit protection, designed to withstand much higher levels of defaults. ABS credit spreads have tightened over the past year, and as a result we believe that current consumer ABS opportunities offer less compelling relative value as we enter 2020.

We remain positive on European RMBS opportunities given the positive credit picture, attractive spreads in select markets and the benefits of hedging euro- and sterling-denominated assets back into U.S. dollars. Historically low mortgage rates are making European home prices more affordable, and we expect rates to remain exceptionally low across Europe for the foreseeable future. The employment picture also continues to improve in Europe, further supporting home prices. Lastly, the ECB seems committed to both its renewed asset purchase program and to accommodative interest rate policies for 2020.

From a duration perspective, we continue to run our portfolio slightly short, both from an absolute perspective and relative to our benchmark. However, we slightly decreased this underweight as the curve steepened and the yield compensation for taking on added duration exposure became more attractive.

<table>
<thead>
<tr>
<th>FUND FACTS</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Launch date</td>
<td></td>
<td></td>
</tr>
<tr>
<td>July 28, 1997</td>
<td>U.S. dollars</td>
<td>Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index</td>
</tr>
</tbody>
</table>
Performance (%)  
As of December 31, 2019 (Class I Share at NAV)  

<table>
<thead>
<tr>
<th>Fund/Metric</th>
<th>MTD</th>
<th>QTD</th>
<th>YTD</th>
<th>1 YR</th>
<th>3 YR</th>
<th>5 YR</th>
<th>10 YR</th>
<th>SINCE INCEPTION</th>
</tr>
</thead>
<tbody>
<tr>
<td>MS Mortgage Securities Trust - I Shares</td>
<td>0.08</td>
<td>0.51</td>
<td>6.70</td>
<td>6.70</td>
<td>5.17</td>
<td>4.66</td>
<td>5.44</td>
<td>4.81</td>
</tr>
<tr>
<td>Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index</td>
<td>0.28</td>
<td>0.71</td>
<td>6.35</td>
<td>6.35</td>
<td>3.25</td>
<td>2.58</td>
<td>3.15</td>
<td>4.83</td>
</tr>
</tbody>
</table>

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 1.05% for Class I shares and the net expense ratio is 0.70%. 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.

The fund has received proceeds related to certain non-recurring litigation settlements. If these monies were not received, any period returns which include these settlement monies would have been lower. These were one-time settlements, and as a result, the impact on the net asset value and consequently the performance will not likely be repeated in the future. Please visit www.morganstanley.com/im for additional details.

RISK CONSIDERATIONS

There is no assurance that a mutual fund will achieve its investment objective. Funds are subject to market risk, which is the possibility that the market values of securities owned by the fund will decline and that the value of fund shares may therefore be less than what you paid for them. Accordingly, you can lose money investing in this fund. Please be aware that this fund may be subject to certain additional risks. Fixed-income securities are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. Longer-term securities may be more sensitive to interest rate changes. Certain U.S. government securities purchased by the Strategy, such as those issued by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of the U.S. It is possible that these issuers will not have the funds to meet their payment obligations in the future. Mortgage and asset-backed securities are sensitive to early prepayment risk and a higher risk of default and may be hard to value and difficult to sell (liquidity risk). They are also subject to credit, market and interest rate risks. 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. Due to the possibility that prepayments will alter the cash flows on Collateralized mortgage obligations (CMOs), it is not possible to determine in advance their final maturity date or average life. In addition, if the collateral securing the CMOs or any third party guarantees are insufficient to make payments, the strategy could sustain a loss. High yield securities ("junk bonds") are lower rated securities that may have a higher degree of credit and liquidity risk. Foreign securities are subject to currency, political, economic and market risks. Illiquid securities may be more difficult to sell and value than publicly traded securities (liquidity risk). Inverse floaters are sensitive to early prepayment risk and interest rate changes and are more volatile than most other fixed-income securities.

INDEX INFORMATION

The Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index tracks agency mortgage backed pass-through securities (both fixed-rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The index is constructed by grouping individual TBA-deliverable MBS pools into aggregates or generics based on program, coupon and vintage. The index is unmanaged and does not include any expenses, fees or sales charges. It is not possible to invest directly in an index.

The Bloomberg Barclay's U.S. Treasury Index includes public obligations of the U.S. Treasury.

S&P CoreLogic Case-Shiller U.S. National Home Price NSA Index measures U.S. residential real estate prices, tracking changes in the value of residential real estate nationally.

S&P/Experian First Mortgage Default Index measures the default rates across first mortgages.

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