Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Institutional Fund

Short Duration Income Portfolio

GLOBAL FIXED INCOME TEAM | COMMENTARY | CLASS I SHARES | JULY 31, 2021

Performance Review

In the one month period ending July 31, 2021, the Fund's I shares returned 0.22% (net of fees)[1], while the benchmark returned 0.17%.

In July, the portfolio's allocation to non-agency residential mortgage-backed securities (RMBS) contributed positively, followed by commercial mortgage-backed securities (CMBS) and asset-backed securities (ABS). The portfolio's short U.S. duration positioning detracted from relative performance as Treasury yields fell on the front end of the curve.

Market Review

Looking at the performance of U.S. Treasuries (and other developed government bond markets) in both nominal and real terms, one could be forgiven if one believed the economy was sinking, the Federal Reserve (Fed) was easing, and/or inflation was falling. Nothing could be further from the truth! Other financial asset prices are sending a different message. Indeed, the U.S. and global economies are doing just fine, even if growth is not turning out to be quite as strong as expected a few months ago. But, even most of that can be explained by supply-side/production problems. Aggregate demand remains robust, economic reopening is improving, and employment growth is robust (especially given the recent July report released August 6). Other asset prices are sending the signal that all is well on the economic front as equities continue to rally and credit spreads remain relatively firm. What gives?

In fact, this phenomenon began earlier in the second quarter; it's just that July's rally has taken yields much lower than almost anyone had expected (circa 1.2% on the U.S. Treasury 10-year note).[2] To put things in perspective, real yields made new LOWS in July, meaning they are now lower than they were at the peak of the pandemic or at the low in nominal yields in September of last year. During this period, inflation continued to surprise to the upside, on all measures, even taking into account supply disruptions and COVID-induced anomalies. Not surprisingly, this has elicited worrisome comments from several Fed officials and market participants.

Market analysts have put forward a whole host of reasons for the surprisingly strong performance of government bonds. Technicals, not fundamentals, are what we hear most. This explanation encompasses a whole host of explanatory factors including: expectation adjustments, market positioning, delta variant fears, relatively high U.S. yields compared to other countries, excess reserves in the banking sector, Treasury funding and its balances at the Fed, and hawkishness of some Fed officials. The answer is probably all of the above, but, most importantly, the largest contributor is excess liquidity/savings in the world. In a world awash with cash and cash yields zero almost everywhere, money has to go somewhere.

Where does that leave us? Government bond yields everywhere are unlikely to go lower even with the delta variant complicating return to work and reduced social distancing. Central banks want easy policy, but nowhere have they said they want easier policy! With real yields plummeting in the U.S. and elsewhere, this constitutes material easing of financial conditions. With economies growing strongly, inflation rising, and, more importantly, inflation expectations no longer low or falling, central banks should not want to increase accommodation further. Indeed, Canada, New Zealand, Australia and Norway have already taken measures to reduce accommodation (not embark on tightening, mind you, just reducing accommodation no longer needed). However, to send bond yields back up, markets need a catalyst and that catalyst is likely to be time. Time for labor markets to

[1] Source: Morgan Stanley Investment Management. Data as of July 31, 2021.
[2] Source: Bloomberg L.P. Data as of July 31, 2021. One basis point = 0.01%

continue to heal; time for central banks to be confident economies will not falter; time for higher inflation expectations to stabilize. This could easily begin soon.

In July, 2-, 5-, 10- and 30-year Treasury yields fell by 6, 20, 25 and 19 basis points (bps), respectively.[2] As 10-year breakeven inflation rates rose by 5 bps, the 10-year real (TIPS) yield declined by 30 bps.[2]

Investment grade corporate spreads widened in July, helped by slightly higher equities and lower volatility. The Bloomberg Barclays U.S. Corporate Index closed 6 bps wider to end the month at 86 bps over government bonds.[3] News on increased cases of the delta variant were a key driver of sentiment, although vaccinations continued to roll out and economies reopened. In addition, volatility was seen in Chinese credits, which led to negative ripple effects, following concerns that government intervention was increasing in housing, health and education. Sector/corporate news in the month was focused on second quarter reporting, where the majority of companies beat expectations, and on merger and acquisition (M&A) activity, where numerous deals were announced, consistent with the theme of looking to take advantage of the economic rebound and low debt costs. Another notable factor in the month was the continued increase in commodity prices, which is consistent with the economic rebound. This has led to higher input costs for corporates with both consumer product and beverage companies citing margin pressures.

We remain fundamentally constructive on credit, although valuations look fully priced. We expect financial conditions to remain easy, which will likely support the continuation of the rebound in economic activity, and low corporate default rates. We expect corporates to maintain conservative strategies as overall macro uncertainty remains high. Finally, there is likely continued demand for credit in general, as risk-free assets offer negative real and nominal yields.

Agency mortgage-backed securities (MBS) spreads widened in July as volatility increased, bank buying of agency MBS slowed, and talks of potential Fed tapering continued to weigh on the market. Current coupon agency MBS spreads widened 7 bps during the month to 72 bps above comparable duration interpolated Treasuries.[2] We remain cautious on the agency MBS sector, as we think that spreads still do not fully reflect the risk of demand from the primary recent buyers continuing to decline.

Securitized credit spreads were again stable in July. The fundamental U.S. housing market outlook appears solid as home prices are up 17% over the past year, driven by affordability from historically low mortgage rates, low housing supply, and increasing demand from both the millennial generation (the largest U.S. demographic cohort in history) and evolving work-from-home dynamics.[4] Additionally, loan underwriting standards remain conservative, given memories of the Global Financial Crisis, so delinquency and default levels continue to be low, and securitization structures continue to provide very robust levels of structural credit protection.

For CMBS, valuations remain very idiosyncratic, with some attractive value opportunities and some potential credit problems as well. Commercial real estate continues to be the securitized sector most severely impacted by the pandemic. Shopping centers and business-oriented hotels remain under stress as business volumes are still substantially lower and these sectors appear less likely to fully recover, even in a post-pandemic world. Multi-family apartment buildings and office buildings have performed better and have lower risks of near-term defaults; however, these sectors have some uncertainties in the post-pandemic world, given the new work-from-home dynamic and suburban flight, but the impact on these sectors appears to be less severe. Logistics centers and warehouse spaces are the one bright spot in CMBS, benefiting from the sharp rise in e-commerce.

Portfolio Activity

In July, we selectively added to high quality corporates in the new issue and secondary markets. We added to ABS within securitized credit.

Strategy and Outlook

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The Short Duration portfolio continues to have a duration close to its benchmark, while maintaining its overweight to investment grade corporates and securitized credit.

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[2] Source: Bloomberg L.P. Data as of July 31, 2021. One basis point = 0.01%
[3] Source: Bloomberg Barclays. Data as of July 31, 2021.
[4] Source: S&P CoreLogic Case-Shiller U.S. National Home Price NSA Index. Data as of July 31, 2021.

FUND FACTS

Launch date	Base currency	Index
March 31, 1992	U.S. dollars	Bloomberg Barclays 1-3 Year U.S. Government/Credit Index

Performance (%)

As of July 31, 2021 (Class I Share at NAV)

	MTD	QTD	YTD	1 YR	3 YR	5 YR	10 YR	SINCE INCEPTION
MSIF Short Duration Income Portfolio - I Shares	0.22	0.22	0.63	1.77	3.08	3.24	2.58	3.08
Bloomberg Barclays 1-3 Year U.S. Government/Credit Index	0.17	0.17	0.17	0.43	2.99	1.91	1.48	3.82

Performance (%)

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

	MTD	QTD	YTD	1 YR	3 YR	5 YR	10 YR	SINCE INCEPTION
MSIF Short Duration Income Portfolio - I Shares	-0.13	0.44	0.41	2.20	3.07	3.26	2.61	3.08
Bloomberg Barclays 1-3 Year U.S. Government/Credit Index	-0.15	0.04	0.00	0.44	2.96	1.88	1.49	3.82

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 0.53% for Class I shares and the net expense ratio is 0.30%. 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 Portfolio received monies related to certain nonrecurring litigation settlements. If these monies were not received, any period returns which include these settlement monies would have been lower. The returns on the other Share Classes would also have been similarly impacted. 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. Rankings for the fund were more favorable due to these settlements and ratings may also have been positively impacted. For additional information please visit morganstanley.com/im.

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. 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 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 **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. **Foreign securities** are subject to currency, political, economic and market risks. The risks of investing in **emerging market** countries are greater than risks associated with investments in foreign developed countries. **Restricted and illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk).

INDEX INFORMATION

The **Bloomberg Barclays 1-3 Year U.S Government/Credit Index** tracks the securities in the 1-3 year maturity range of the Barclays U.S. Government/Credit Index which tracks investment-grade (BBB-/Baa3) or higher publicly traded fixed rate U.S. government, U.S. agency, and corporate issues.

The **Bloomberg Barclays U.S. Corporate Index** is a broad-based benchmark that measures the investment grade, fixed-rate, taxable, corporate bond market.

The **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.

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 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.

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