Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Institutional Fund

Short Duration Income Portfolio

GLOBAL FIXED INCOME | GLOBAL FIXED INCOME TEAM | COMMENTARY | AUGUST 31, 2019

Performance Review

In the one month period ending August 31, 2019, the Fund's I shares returned 0.70% (net of fees)[1], while the benchmark returned 0.81%.

Spread positioning was the main contributor to returns over the month, in both investment grade corporates and securitized credit. However, duration positioning detracted from performance.

Market Review

U.S. growth is likely to continue to be lower for the remainder of 2019, although stabilized via easier monetary policy. Central banks have become more accommodative, particularly in the U.S. and eurozone, and we expect that to continue as uncertainty in the geopolitical and economic landscape remains prevalent. We currently see three major risks to the outlook, which are Brexit, U.S.-China trade disputes and the U.S. presidential election. Right now, we do not foresee an amicable end to the U.S.-China trade war.

Recent speeches from the Federal Reserve (Fed) policymakers give us further confidence that the Fed is committed to being flexible regarding future interest rate policy. With that being said, at this point we believe additional "insurance" rate cuts may be warranted over the next 12 months to help lengthen the economic cycle and avoid a recession, with at least one cut expected in the fourth quarter of this year, and will likely occur at the September meeting.

Sovereign bond yields across developed markets rallied sharply in August, with the yield on the 30-year U.S. Treasury dropping below 2% for the first time ever. The spread between the 10-year and 2-year Treasury note inverted further, reigniting recession fears amongst investors. During the month, yields on 2-, 5-, 10- and 30-year Treasuries fell by 37, 44, 52 and 56 basis points (bps), respectively.[2]

August saw corporate spreads wider overall, reversing most of the tightening seen in July, as concerns over the global economic growth slowdown offset global accommodative monetary policies stances. The Bloomberg Barclays U.S. Corporate Index spread widened 12 bps in August to end the month at 120 bps over government bonds.[3] Financials outperformed non-financials during the month.

While valuations have tightened in the strong performance in 2019 to date, we see a number of signals that macro risk is rising. This includes increased risk of a hard Brexit, continued trade negotiations between the U.S. and China with no resolution, and weak global manufacturing data (PMIs). Uncertainty makes the short-term outlook for corporate earnings less clear. Our base case does not call for a recession; rather we expect continued low global growth and low inflation, supported by low real rates and easy financial conditions. We are carefully monitoring the incoming economic data (with heightened focus on employment trends) as well as comments from central banks to see if the central bank economic put will be rekindled, which would quickly turn market confidence.

Agency mortgage-backed securities (MBS) materially underperformed in August as MBS spreads widened 15 bps to 79 bps above similar duration U.S. Treasuries.[2] Lower rate levels are causing prepayment expectations to increase substantially, putting

[1] Source: Morgan Stanley Investment Management. Data as of August 31, 2019.
[2] Source: Bloomberg L.P. Data as of July 31, 2019.
[3] Source: Bloomberg Barclays. Data as of July 31, 2019.

pressure on agency MBS. Mortgage prepayments have already begun to accelerate and are expected to increase from current levels as rates have continued to decline, with mortgage rates hitting the lowest levels since 2016 in August. Pay-ups for specified pools continue to grow as investors look for pools with lower prepayment risks.

We remain slightly negative on agency MBS, but less so than in the recent past. Although agency MBS are under pressure from both increased prepayment risks from lower mortgage rates, and also due to the continued supply-demand dynamics from the Fed continuing to reduce its MBS holdings, agency MBS spreads have widened materially over the past few months reflecting these risks, and now offer better relative value. Much of the negative conditions for agency MBS seem to be priced in at this stage.

Non-agency residential mortgage-backed securities (RMBS) spreads were largely unchanged in August. Fundamental credit conditions in the U.S. housing market remain positive. The pace of home price appreciation has slowed over the past couple years but remains positive and more in line with income growth. Home affordability has improved in recent months as home prices have tracked with wage growth and mortgage rates have declined. Commercial mortgage-backed securities (CMBS) spreads were also largely unchanged in August on very light flows. Overall, commercial real estate market credit conditions remain positive. Asset-backed securities (ABS) spreads continue to grind tighter and consumer credit conditions remain healthy. We still have a positive fundamental credit outlook for residential and consumer credit conditions, but we have begun reducing some of our securitized credit exposure as concerns over a potential economic downturn become more pronounced.

Portfolio Activity

Given the recent benchmark change from a 1-year to 1-3 year duration, we are looking to extend corporate holdings to take advantage of steeper credit curves. We also added to the short duration securitized credit position via new issues. We are targeting to be +0.10 year long U.S. duration as to bring the portfolio's empirical duration closer to flat.

Strategy and Outlook

Looking ahead, we expect corporates to generate attractive excess returns, primarily through carry as opposed to capital gains. We do not expect spreads to retest cycle lows given the age of the cycle, the lower quality and longer duration makeup of the market, and questionable technicals. Sector and issuer selection will remain key decisions in 2019 as technology and behavioral change are both fast moving and disruptive for many traditional industry business models. These concerns, coupled with absolute valuations, will likely keep us cautious and tactical with our additions and subtractions of risk in the near future.

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 August 31, 2019 (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	0.70	0.79	3.29	4.15	3.80	3.04	2.67	3.12
Bloomberg Barclays 1-3 Year U.S. Government/Credit Index	0.81	0.70	3.18	4.41	1.62	1.35	1.24	3.73
ICE BofAML 1-Year U.S. Treasury Note Index	0.38	0.44	2.21	3.07	1.58	1.10	0.78	--

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 Short Duration Income Portfolio - I Shares	0.46	1.23	2.48	3.84	3.64	2.90	2.73	3.11
Bloomberg Barclays 1-3 Year U.S. Government/Credit Index	0.52	1.46	2.47	4.02	1.31	1.23	1.23	3.73
ICE BofAML 1-Year U.S. Treasury Note Index	0.40	0.94	1.76	2.98	1.43	1.02	0.76	--

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 0.50% for Class I shares and the net expense ratio is 0.28%. 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 or call 1-800-548-7786.

Effective August 1, 2019, the Fund's primary benchmark index has changed to the Bloomberg Barclays 1-3 Year U.S. Government/Credit Index. In addition, the Fund's average duration target has changed from 1 year or less to 3 years or less. See prospectus for 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 the current rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. **Longer-term securities**may be more sensitive to interest rate changes. In a declining interest-rate environment, the portfolio may generate less income. 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 **ICE BofAML 1-Year U.S. Treasury Note Index** is an unmanaged index tracking U.S. government securities with a maturity of at least one year and less than three years.

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

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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