Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Institutional Fund

U.S. Real Estate Portfolio

REAL ASSETS | GLOBAL LISTED REAL ASSETS TEAM | COMMENTARY | SEPTEMBER 30, 2020

Performance

In the quarter period ending September 30, 2020, the Portfolio's I shares returned -1.18% (net of fees)[1], while the benchmark returned 1.44%.

The real estate investment trust (REIT) sector continued to recover somewhat from the significant losses experienced in the first quarter, but only modestly, as the FTSE Nareit Equity REITs Index ("Index") returned +1.4% in the third quarter, after gaining +11.8% in the second quarter, but is still down 17.5% year-to-date. Volatility remained significant as the market continued to gyrate from macro investing trends including risk-off/risk-on and momentum/value. The property sector once again underperformed the broader equity markets. The S&P 500 Index rallied +8.9% in the third quarter, after gaining +20.5% in the second quarter and ended in positive territory year-to-date by the end of the third quarter. We attribute this relative weakness primarily to concerns over significant parts of the listed real estate universe of companies being leveraged owners of assets which are expected to face declines in value in this environment (i.e., retail, office, apartments), although there is a segment of the universe that is exposed to sectors that are viewed more favorably (industrial, data centers).

Generally, returns among the sectors in the third quarter were an extension of year-to-date trends as optimism for a return to normalcy was pushed back due to a revised outlook for a lengthening COVID-19 crisis. This resulted in a further widening of returns in which share prices of stocks in a number of sectors, especially retail and office companies, posted additional losses, but sectors viewed as being less impacted posted gains in the quarter.

In the office sector, there was a continuing narrative in the third quarter on the potential structural impact of the work-from-home theme. Office companies have had high rent collections and limited tenant bankruptcies, but investors have turned increasingly negative on the group. We remain more concerned with the impact of a weaker economy on tenant demand coupled with the increasing levels of sublease being put on the market but see some potential upside to demand from the reversal of the office densification trend.

Office companies have, on average, collected approximately 95% of billed rents, with credit issues mostly isolated to retail and co-working tenants. Current utilization of office space ranges from 5%-10% for major mass transit-serviced central business districts such as Manhattan, Boston and San Francisco to 30%-40% for suburban drive-to locations. A number of high-profile companies have indicated that they do not expect their employees back until mid-2021. In addition, the amount of space available for sublease has increased in a number of key markets including New York City (NYC) and San Francisco as companies re-evaluate growth plans and future space needs. The increasing availability of space is expected to put additional pressure on net effective rents that have already fallen by approximately 10% in both markets.

Retail assets faced challenges prior to the crisis, however, and the crisis has accelerated these challenges, resulting in retailer bankruptcies and greater scrutiny from surviving retailers as to the level of rents they are able to pay. Retail real estate remains particularly exposed under the scenario of a lengthening COVID-19 crisis as many elements will strain the balance sheets and potentially reach the point where the businesses cannot be restarted. Rents are ultimately driven by retailers' expectations of sales levels, which have become more uncertain during and post recovery. Retail assets have had the weakest rent collections.

The open-air shopping centers collected on average 73% of second quarter rents, which marked an improvement over the preliminary reports of 64% for April and 57% for May. Moreover, the shopping centers reported positive monthly trends with

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1 Source: Morgan Stanley Investment Management. Data as of September 30, 2020.

78% collected in July and 84% collected for August. The U.S. mall companies were less systematic with disclosing the status of rent collections but were below the shopping centers and also appeared to have a positive trend in collections. The malls reported second quarter collections plus deferrals at about 62%, but not all companies disclosed the actual cash collection rate, which is believed to have been less than 50%. Still, this marks an improvement over the early reports of mall rent collections in the 20%-30% range for April. July rents plus deferrals increased to about 65%.

With respect to actual bankruptcies, the 29 retail bankruptcies filed through mid-August of this year already exceed the total of 22 in 2019. Retail store closures due to bankruptcies so far this year total just shy of 6,000 and are on pace to set a record, as is the total store closings, which already eclipses the record 9,500 stores that closed in all of 2019. One of the most significant bankruptcies was the May filing of J.C. Penney,[2] which continues to garner close attention given not only the uncertainty of its size and viability when/if it emerges from bankruptcy, but also due to reports that Simon Property Group[3] has bid on the entity jointly with a distressed retailer fund managed by Brookfield Asset Management[2]. Notably, in the third quarter, according to the Census Bureau, total aggregate sales in the U.S. returned to pre-pandemic levels, with each of June through August's monthly sales exceeding the levels from the prior year's by 2.1%-2.6%. But the distribution of the sales and complexion of the channels shifted substantially as best exemplified by the 16%-20% declines in restaurants and apparel and the approximately 20% increase in e-commerce and 10% increase in groceries.

Transaction activity picked up in the third quarter after a cessation of activity in the second quarter. Activity has generally been concentrated in stabilized assets and sectors less impacted by the COVID-19 crisis. As we have noted, this crisis has significant dissimilarities to the Global Financial Crisis (GFC) of 2008-09 as the rapid and significant actions by global central bankers have assured that this is not a financial crisis. Investment grade borrowers can finance at cheaper levels in the U.S. at the end of third quarter than they could at year-end 2019. We have focused on the likely impact to cash flows relative to stabilized 2019 levels. The consensus estimate is that cap rates will likely be flat to down in most sectors, but clearly there will be varying assumptions as to the resultant impact on cash flows. There is a discussion as to sectors that may face structural changes as a result of the crisis, which may negatively impact valuations. The primary sectors that are included in this discussion are malls and office assets, where there is heightened uncertainty as to post-recovery demand levels and a wider range of potential outcomes.

Public market sentiment towards the office sector has remained negative as the uncertainty over future working arrangements persists, but transaction activity re-emerged in the office sector in the third quarter. There were 16 transactions of $100 million or greater that closed in the quarter with a cumulative value of approximately $3.8 billion. Subsequent to quarter-end, two additional transactions were announced that support minimal diminution to office values: Korean investor Hana's[2] purchase of Qualtrics Tower in Seattle for $668 million ($969/square foot) and German investor Allianz's[2] acquisition of a 45% interest in 221 Main Street in San Francisco for $180 million ($1,050/square foot).

There has been a lack of distressed asset sales, with a few limited examples in the hotel sector. It is noteworthy that, as in past crises, we believe the best manner to capture current market dislocation in select out-of-favor real estate sectors is through the public markets given significant liquidity in the public markets and a lack of distressed sales.

Since the crisis began, there have been select dividend reductions. Companies in the retail and hotel sectors face the greatest near-term stress and as a result of the crisis most of the companies in these sectors have elected to reduce or eliminate dividends. In the third quarter, a number of companies reinstated dividends. In the shopping center sector, only two companies have maintained their dividend, three cut by 33%-84% and eight initially suspended their dividends, with one of those eight reinstating their dividend in the third quarter at 64% below the pre-pandemic level. Each of the mall companies initially suspended their dividends prior to the first quarter earnings season except for Simon,[3] which announced in June that it would cut its quarterly dividend by 38%, and Macerich,[3] which cut by 33% but plans to pay its dividend in stock. There have been no subsequent follow-up comments from the mall companies on dividends. All U.S. hotel REITs have either eliminated their dividends or reduced them to a nominal level. The only office companies to either reduce or suspend their dividends took these actions for issues outside of the operating fundamentals of their core office portfolio. Vornado[3] reduced its dividend by 20% due to a drop in income from its NYC Street retail portfolio along with the closing of its Hotel Pennsylvania and Chicago Merchandise Mart assets. Empire State Realty Trust (ESRT)[2] and Mack-Cali Realty (CLI)[3] both suspended their dividends for the third and fourth quarters. ESRT's suspension was driven by the loss of income from the observation deck at the Empire State Building while CLI's was driven primarily by executing high cap rate suburban office sales and using the proceeds to pay back low interest rate debt.

Companies have had ready access to both equity and debt markets. There was an additional $20 billion of bond issuance in the third quarter, resulting in year-to-date 2020 issuance of $60 billion, which is ahead of the record-setting issuance pace from

2 Not held in the portfolio as of September 30, 2020.
3 As of September 30, 2020, Simon Property Group was 8.0%, Macerich 0.1%, Vornado 1.7%, Mack-Cali 1.0%, Aimco (Apartment Investment and Management Company) 0.4%, and SL Green 8.3% of the portfolio.

2019 when $70 billion was issued for the full year. Capital availability in the bond market has been broad based, including sectors severely impacted by the COVID-19 crisis (e.g. hotels). Investment grade companies across a variety of sectors have been able to borrow at attractive rates. Equity issuance has primarily been executed by companies trading at premiums to their net asset values (NAVs). The quarter featured $4.3 billion of equity issuance, representing $3.4 billion of follow-on equity offerings and $0.9 billion of initial public offerings (IPOs). Both IPOs were for companies in the net lease sector. Among the follow-on equity offerings, 50% were from specialty residential (manufactured homes and single-family rental) REITs and 30% were from a life science office REIT. There has been no dilutive equity issuance in the U.S. since the COVID-19 crisis began. Heavily impacted companies (e.g. hotel, retail, health care) have relied on the bond and bank markets for liquidity and have not been required to take actions to de-lever their balance sheets.

Corporate activity remained relatively subdued in the quarter. Apartment REIT Aimco[3] announced that it plans to split the company, creating a new company composed of stabilized assets (gross asset value (GAV) of $10.4 billion) and leaving behind a smaller company (GAV of $1.3 billion) that is composed of more complicated development and lease-up properties. Along with this announcement, it entered into a joint venture on a $2.4 billion portfolio of its stabilized California apartment assets at a low 4% cap rate. The company is attempting to close the significant gap between its share price and NAV by recognizing the highly attractive bid for stabilized apartment assets in the private market (as further evidenced by its successful joint venture announcement). The initial stock market reaction was favorable, but that dissipated, and at quarter-end an activist investor was pushing for a special meeting for shareholders to vote against the plan, as the investor favors a sale of the entire company in order to close the gap.

NYC office REIT SL Green[3] continues to sell assets and buy back stock. With the additional 6.2 million shares repurchased in 2020 through the end of the second quarter, it has now repurchased 30% of its float over the last three years. In addition to asset sales of $615 million thus far in 2020, it is pursuing a sale of 410 Tenth Avenue in Hudson Yards, a building it is redeveloping and leased to Amazon[2] as an anchor tenant for over $1 billion.

In the storage sector, small-cap debt/equity provider Jernigan Capital (JCAP)[2] agreed to be acquired at a +23.5% premium to last sale by NextPoint Advisors[2] in an all-cash take-private transaction valued at approximately $900 million total enterprise value including approximately $410 million equity market cap. JCAP's portfolio consists of equity and debt investments in development projects and recently constructed storage facilities.

The REIT sector ended the quarter trading at an approximate 3% premium to adjusted NAVs. In the second quarter, we revised our estimated company NAVs to reflect the limited activities as well as anecdotal evidence with regard to bid-ask spreads from the assets that had been offered for sale and comments from private equity funds with regard to the pricing levels that will be of interest to them to acquire assets. This resulted in average NAV declines of 9%. In the third quarter, we made modest revisions to these estimates of +1%. On average, since the crisis began, NAVs have been reduced by approximately 35% for malls, 25% for shopping centers, 15% for office assets (ex NYC), with declines of 25% for NYC office, and 5% for residential assets.

As in past crises, we believe the best manner to capture current market dislocation in select out-of-favor real estate sectors is through the public markets given significant liquidity in the public markets and a lack of distressed sales. Share price declines year-to-date have resulted in attractive valuations for stocks in various market segments, including NYC office, high quality retail, central business district (CBD) office, hotels and apartments, even after assuming significant NAV declines.

In the third quarter, the REIT market recovered 1.4% but is still down 17.5% year-to-date, as measured by the Index. Each of the major sectors – apartment, office and retail – underperformed the index. The apartment sector was dragged down by stocks with an urban concentration as investors remain fearful of a lack of recovery in this portion of the market. The office sector underperformed, as both the primary CBD and the secondary CBD/suburban REITs underperformed the Index. Investors remain cautious with regard to the impact of an economic slowdown on the sector and the working-from-home narrative put additional pressure on urban owners. Both the mall and shopping center sector stocks underperformed the Index in the quarter on continued fears of the impact of a continuation of the COVID-19 crisis. The health care sector outperformed in the quarter. Among the other sectors, the storage, industrial, data center and net lease sectors outperformed and the hotel sector underperformed the Index.

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3 As of September 30, 2020, Simon Property Group was 8.0%, Macerich 0.1%, Vornado 1.7%, Mack-Cali 1.0%, Aimco (Apartment Investment and Management Company) 0.4%, and SL Green 8.3% of the portfolio.

Attribution

The Fund underperformed the Index in the quarter due to sector allocation. The most significant detraction was a result of the overweight to the primary CBD office sector. The Fund experienced additional negative attribution from the overweights to the mall and apartment sectors and underweights to the data center, industrial and net lease sectors. The Fund benefited from stock selection in the health care, mall and net lease sectors. This was partially offset by stock selection in the diversified and data center sectors.

Strategy

We have maintained our core investment philosophy as a real estate value investor. This results in the ownership of stocks whose share prices provide real estate exposure at the best valuation relative to their underlying asset values. We continue to focus on relative implied valuations as a key metric. Our company-specific research leads us to an overweighting in the Fund to a group of companies that are focused in the ownership of NYC office assets as well as select owners of high quality retail, CBD office, hotel and apartment assets and an underweighting to companies concentrated in the ownership of data center, net lease and health care assets.

Outlook

The overall REIT market ended the quarter trading at an approximate 3% premium to adjusted NAVs. We see the public markets as the best means of accessing the distress in the real estate markets and find the most attractive value in the owners of NYC office assets. We also see attractive value in select owners of high quality retail, CBD office, hotel and apartment assets. These companies provide exposure to high quality core assets at significant discounted valuations.

Stocks in out-of-favor sectors, particularly office and retail, are trading at very significant discounts to our downward-revised NAVs. NYC office stocks are trading at a 49% discount to NAVs and retail stocks are trading at greater than 30% discounts to NAVs. We favor these stocks as we believe we have been conservative in our reassessment of NAVs and that as long as these downward-revised NAVs represent trough values, then we believe there is upside from these significant discounts shrinking as investor pessimism wanes. In addition, there is further upside potential if transactional evidence requires us to upwardly revise NAVs. We recognize that continued uncertainty with regard to the length of the COVID-19 crisis has been an impediment to improved sentiment.

FUND FACTS

Launch date	Base currency	Index
February 24, 1995	U.S. dollars	FTSE Nareit Equity REITs Index

Performance (%)

As of date September 30, 2020 (Class I Share at NAV)

	MTD	QTD	YTD	1 YR	3 YR	5 YR	10 YR	SINCE INCEPTION
MSIF U.S. Real Estate Portfolio - I Shares	-2.69	-1.18	-29.81	-28.62	-7.52	-2.16	4.32	9.42
FTSE Nareit Equity REITs Index	-3.26	1.44	-17.54	-18.16	0.20	3.95	7.90	9.54

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 1.02% for Class I shares and the net expense ratio is 0.90%. 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. 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 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. **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. 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 Nareit (National Association of Real Estate Investment Trusts) Equity REITs Index** is a free float-adjusted market-capitalization-weighted index of tax qualified REITs listed on the New York Stock Exchange, NYSE Amex and the NASDAQ National Market Systems. 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 **Standard & Poor's 500® Index (S&P 500®)** measures the performance of the large cap segment of the U.S. equities market, covering approximately 80% of the U.S. equities market. The Index includes 500 leading companies in leading industries of the U.S. economy.

The index is unmanaged and does 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.

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