Morgan Stanley Institutional Fund
U.S. Real Estate Portfolio

Performance

In the one month period ending January 31, 2020, the Fund’s I shares returned -1.26% (net of fees), while the benchmark returned 1.21%.

In January, the real estate investment trust (REIT) sector gained 1.2%, as measured by the benchmark index. Markets turned decidedly risk-averse in January due to the U.S.-Iran conflict and the outbreak of the coronavirus. This caused the yield on the 10-year Treasury bond to fall 39 basis points (bps) in the month and equity market sentiment to return to the lower-for-longer investment theme. REIT share prices followed their typical pattern (similar to August 2019 when the yield on the 10-year Treasury bond fell by 50 bps) with sectors viewed as defensive posting gains and those viewed as being tied to economic growth declining. Among the three primary sectors, the apartment sector outperformed and the office and retail sectors underperformed the index. The apartment sector outperformed in a month where most of the companies provided 2020 same-store net operating income guidance that was modestly below what they had achieved in 2019, but still in the 2-4% range. The office sector underperformed as the primary central business district (CBD) REITs underperformed and secondary CBD/suburban REITs performed in line with the index. The retail sector underperformed with investors turning decidedly cautious as both the mall and shopping center sectors were weak, falling 10.9% and 5.3%, respectively. The health care sector outperformed in the month as it continued to be a key beneficiary of the risk-off trade. Among the smaller sectors, the industrial, storage and net lease sectors outperformed, the data center sector performed in line with and the hotel sector underperformed the index. Indeed, the hotel sector was the weakest performer, with a decline of 10.7%, reflecting investor concerns with regard to weaker global economic growth and a decline in travel due to the coronavirus.

Attribution

The Fund significantly underperformed the index in the month. Unfortunately, relative performance for the Fund was similar to August 2019, another period when the market turned decidedly “risk-off.” We have noted that the REIT market has recently been dominated by thematic investing with little to no regard to underlying property values as a key metric. We suspect that underlying private market property valuation has become a less relevant metric as generalist investors have become the marginal buyer of REIT stocks. These investors appear to place a greater focus on secular themes and are untethered to private market valuations. The key theme in January (as it was in August 2019) was to favor stocks that are viewed as being more defensive. Given this combination of thematic investing and low bond yields, we have witnessed a continued willingness to pay premium valuations for segments of the REIT market that are viewed as having greater predictability in cash flows. For example, the U.S. net lease and health care sectors ended January trading at 54% and 43% premiums to net asset values (NAVs) (and all-time high earnings multiples), respectively. In addition, the concerns with regard to economic growth have generally placed downward pressure on segments that are viewed as more vulnerable – office, retail and hotels. Many of these stocks are trading at large discounts to NAVs, despite significant transactional evidence in the private markets in the office and hotel sectors. This has resulted in a further widening of the disparity in share price valuations among market segments. The Fund continues to be underweight to segments that have benefited from defensive and secular investment themes due to premium share price valuations, and overweight to market segments which trade at very attractive discounted valuations.

The key detriment in the Fund was a result of the top-down sector allocation. The most significant detractors were the overweight to the mall and hotel sectors and underweight to the net lease sector. Other top-down detractors were the...
underweight to the health care and industrial sectors. The Fund benefited from the underweight to the shopping center sector. The Fund had a modest benefit from stock selection in the primary CBD office and health care care sectors, though this was largely offset by stock selection in the mall sector.

**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 and hotel assets and an underweighting to companies concentrated in the ownership of health care, data center and net lease assets.

**Outlook**

Our outlook for the REIT market is based on two key factors: private market pricing for underlying real estate assets and public market pricing for the securities. Private market asset values for high quality assets have generally been flattish since 2016 and appear well supported by a record level of capital committed to invest in real estate. The overall REIT market ended the month trading at an approximate 14% premium to NAVs, although there is an enormous disparity in relative valuations among the REIT sectors, with various segments trading at meaningful discounts. Generally, we see share prices untethered to private real estate values. We see the most attractive value in the owners of NYC office assets. The stocks ended the month trading at a 26% discount. This is despite significant transactional evidence for NYC office assets that continue to demonstrate strength in asset values. Manhattan office transactions totaled $18.9 billion in full-year 2018 and $14.6 billion in full-year 2019. We also see attractive value in select owners of high quality retail, CBD office and hotel assets. These companies provide exposure to high quality core assets at significant discounted valuations.

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<thead>
<tr>
<th>FUND FACTS</th>
<th>Launch date</th>
<th>Base currency</th>
<th>Index</th>
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<tr>
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<td>U.S. dollars</td>
<td>FTSE Nareit Equity REITs Index</td>
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**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. 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 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 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**

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