COMMENTARY
September 30, 2023

Morgan Stanley Institutional Fund

American Resilience Portfolio

INTERNATIONAL EQUITY TEAM

Performance Review

In the quarter period ending September 30, 2023, the Portfolio's I shares returned -2.76% (net of fees)[1], while the benchmark returned -3.27%.

For the third quarter overall, the portfolio's outperformance was due to stock selection, thanks to strength in information technology, industrials and communication services, which more than offset financials and health care weakness. Sector allocation was negative, due to the drag from the lack of energy holdings and underweight to communication services.

Market Review

After a euphoric first half of the year, the S&P 500 Index was distinctly weaker in the third quarter, returning -3.3% for the quarter – although the index still remains up +13% for the year-to-date. The notable outperformer was energy, which finished up an impressive +12% amid rising oil prices, although the sector still lags the index for the year-to-date (+5%). Communication services (+3%) was the only other sector to finish the quarter in positive territory, adding to its mammoth year-to-date gains (+40%). The interest rate sensitive utilities (-10%) and real estate (-9%) sectors were the worst performers in the quarter. In a reversal from the second quarter, the growth-tilted information technology (-6%) and consumer discretionary (-5%) sectors lagged slightly, although they remain substantially ahead of the S&P 500 year-to-date (+34% and +26%, respectively). On the defensive side, health care (-3%) was in line with the index in the third quarter, while consumer staples (-6%) lagged, but both are well behind the index year-to-date (-4% and -5%, respectively).

Outlook

Walled Gardens: The Slow Burn AI Winners

2023 has been an artificial intelligence (AI)-driven market, with the "Magnificent Seven" (Meta, Apple, Nvidia, Amazon, Microsoft, Alphabet and Tesla)[2] dominating in the U.S., delivering over 85% of the S&P 500 Index's returns this year. The "Seven" combined returned 43% in the first nine months of the year, as against 3% for the other 493.[3] Their success is arguably not surprising. As we set out in our June 2023 Global Equity Observer "Compounding Through the Hype," the early winners of the AI "gold rush" have been the pick and shovel sellers; the semiconductor providers and the cloud "hyperscalers" who are responsible for the infrastructure necessary for generative AI deployment, specifically vast amounts of storage capacity and processing power. It is these companies that are already seeing the benefits of the new wave. The most extreme case is Nvidia, whose forward earnings estimates have tripled this year, while on a less spectacular level Microsoft has already claimed a 2% growth boost for Azure in the latest quarter. This early-stage revenue increase gives a line of sight to the likely significant increases in demand for the hyperscalers' cloud services, though the revenue boost will be accompanied by significant increases in capex as they build the required capacity.

Alongside these clear beneficiaries today, we believe there are others — the "slow burners" — for whom the benefits of generative AI (GenAI), and AI in general, will take longer to emerge, but could still be significant over time. These are more likely to be users of the models rather than the thought leaders, though they will of course be involved in creating use cases. These slow burners will need to be able to generate value for customers and/or reduce costs for themselves through GenAI — and most importantly have the pricing power to hang on to a decent chunk of the resulting benefits for their shareholders. It is leveraging the companies' existing competitive advantages that brings the opportunities, using GenAI to add further value to their already excellent business models. By contrast, were GenAI to increase customer value or reduce producer cost in a commoditised industry it would be the customers that gained rather than the shareholders. Competitive pressures would force the companies to pass the fruits of the technology to customers, whether in unrewarded higher quality or lower prices.

1 Source: Morgan Stanley Investment Management. Data as of September 30, 2023. Performance for other share classes will vary.
2 Meta, Apple, Nvidia, Amazon and Tesla are not owned in the portfolio as of September 30, 2023.
3 Source: FactSet. Data as of September 30, 2023.

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.

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Models and Walled Gardens

In May of this year, an anonymously leaked memo, allegedly from a Google researcher, made the claim that internally developed AI models have "no moat" when it comes to GenAI.[4] This is because new open-source models, which are based on readily available application programming interfaces (APIs), are quicker, more adaptable, more private and, not to mention, free. Why would consumers pay for a restricted model when unrestricted alternatives compete on quality and price? The major player Meta has now made the code for its conversational AI freely available on the internet after it was leaked. The fact that the non-open source players — OpenAI and Anthropic (and by implication their respective investors Microsoft and Amazon) — are now arguing for government licensing of cutting-edge models suggests that they are feeling the competitive heat, in contrast to the U.S. tech sector's usual antipathy to any form of government intervention.

Even if GenAI models do become relatively commoditised, the challenge in deploying them at a massive scale is far from trivial. Efficiency is key given the significant compute and memory costs in large language models, aside from the challenges around hallucinations, where the models simply make stuff up! Incorporating GenAI in search is about far more than the model. The challenge is far easier in relatively closed systems, or "Walled Gardens," which is where most of the companies we are discussing come in. There are significant opportunities where companies have proprietary data within their garden, either pure or blended with more public data. Many have been using traditional or predictive AI on their data for years to generate insights or automation, and are now adding in the GenAI element.

GenAI and the Portfolio

One relatively early mover is an American credit rating agency we hold. Its analytics business has long used predictive AI, for instance within its KYC (know your customer) business to screen for red flags, to look for potential fraud. Having partnered with Microsoft, it is bringing a ChatGPT-powered "research assistant" into the business to help customers navigate the system. The expectation is that this will bring significant efficiency gains for clients, as they can do their analyses far faster, with large elements of their investment reviews being written after a few prompts. It only uses the data within its own databases, and all statements will have sources attached which should limit the threat from hallucinations (and provide an extra revenue opportunity where clients don't have entitlements to those sources). The charging model is still under review, but the company will look to "price behind value," something it is pretty good at, as it already gets an extra 7% per year of revenue on average from existing clients on the back of cross-sells, upgrades and pricing. The company has also given its 14,000 staff the CoPilot app in a bid to generate ideas to improve the business. The current priority is the revenue opportunities, but there are significant expense gains to be reaped later.

There is a similar story for a U.S. financial data and software company in the portfolio. It too has introduced a GenAI interface to help customers interrogate its system or initiate tasks, and even help with Python programming, opening up its datasets to greater usage, and creating customer value, helping retention and pricing. In the medium term, there are also likely to be significant efficiencies from both client service — as GenAI helps handle client queries and content collection, the area where around 50% of its employees work — and as GenAI accelerates the acquisition and cleaning of the crucial data.

In both of these cases, the GenAI opportunity is evolutionary not revolutionary, offering an extra boost to the companies' top-line growth and margin improvements on what are already successful, profitable, growing businesses. There are many other examples of companies in the portfolio with AI-friendly franchises built around valuable data, for instance credit bureaus, professional publishers, insurance brokers or a health care data and clinical services provider. On top of this there are players in sectors such as consumer staples that have a significant edge on competitors as they have been investing significantly in their data, enabling an analytic edge. Accenture claims that only 10% of its clients are "data-mature" and able to fully exploit AI opportunities, meaning that those who have made the journey have a significant advantage.

Uncertain Times

The market has gone into reverse, dropping almost 6% over the last two months after the powerful recovery since September 2022.[3] As on the way up, the decline has been driven by multiple rather than earnings, which have remained roughly flat. The fall has come despite improving macro forecasts in the U.S., if not in Europe and China, though bears point to early warning signs, such as U.S. trucking employment and pending house sales. The catalyst for the market's fall seems to have been the relentless rise in yields, with the U.S. 10-year approaching 4.6% at the end of September, up 73 basis points (bps)[5] in the quarter and 46 bps in a month, even as the U.S. Federal Reserve (Fed) raising cycle comes to an end. There is plenty of speculation about the reason for this sharp rise in yields, be it higher rates for longer or better growth prospects, but it seems probable that it is simply about supply and demand. There is no shortage of supply of Treasuries, with the U.S. running a deficit of near 8% of gross domestic product despite sub-4% unemployment and $7.6 trillion of the existing stock due to mature in the next year,[6] while there are real question marks about the demand appetite of two of the main historical buyers, China and the Fed.

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3 Source: FactSet. Data as of September 30, 2023.
4 Source: semianalysis.com, "Google 'We have no moat, and neither does OpenAI': Leaked internal document claims open source AI will outcompete Google and OpenAI", May 4, 2023.
5 One basis point = 0.01%
6 Source: Apollo Asset Management

These higher yields put two question marks over the equity market. The first is whether the massively indebted system can deal with far more expensive credit without something breaking, as was the case with U.K. liability-driven investment (LDI) strategies a year ago and Silicon Valley Bank in the spring. The second is the impact that the yields have on the relative valuation and attractiveness of the equity market versus bonds, as the gap between the market's earnings yield and the "risk-free" rate has fallen to the lowest level in 20 years, a gap even lower than it was two months ago despite the fall in the equity market. Even ignoring the fixed income alternative, S&P 500's current 17.8x forward multiple does not look cheap, particularly as it is based on an arguably optimistic 12% earnings growth assumption for 2024,[3] in what is likely to be a slowing economy, even if the authorities do manage to pull off a soft landing. It is difficult to argue that the market is embedding any significant chance of a downturn in either its multiples or earnings. Our thesis, as ever, is that pricing power and recurring revenue, two of the key criteria for inclusion in our portfolios, will once again show their worth if there is indeed a downturn, and the market would once again come to favour companies which have resilient earnings in a tough economy, making quality a relatively safe haven in these uncertain times.

Fund Facts

Inception Date	July 29, 2022
Minimum Initial Investment ($)*	A Shares - 1,000
	I Shares - 1,000,000
Benchmark	S&P 500 Index
Class I expense ratio	**Gross 36.85 %**
	Net 0.70 %
Class A expense ratio	**Gross 41.47 %**
	Net 1.05 %

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.

Performance (%)

As of September 30, 2023	MTD	QTD	YTD	1 YR	3 YR	5 YR	10 YR	SINCE INCEPTION
Class I Shares at NAV	-5.11	-2.76	9.43	19.56	--	--	--	1.79
Class A Shares at NAV	-5.04	-2.87	9.24	19.23	--	--	--	1.45
Class A Shares (With Max 5.25% Sales Charge)	-10.00	-7.96	3.46	13.00	--	--	--	-3.08
S&P 500 Index	-4.77	-3.27	13.07	21.62	--	--	--	5.02

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.

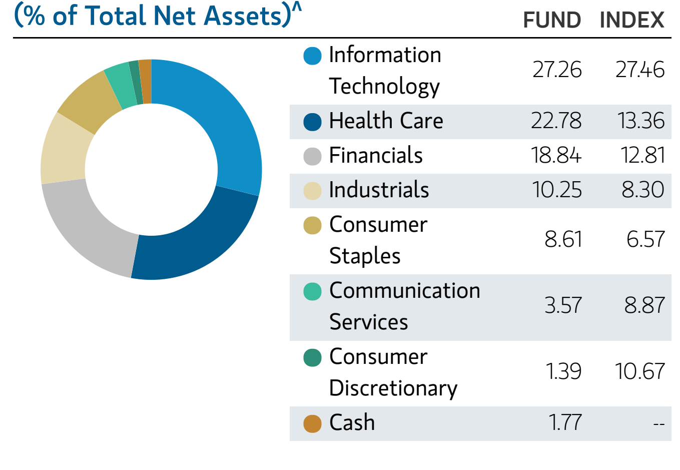
Returns are net of fees and assume the reinvestment of all dividends and income. They are compared to an unmanaged market index. Returns for less than one year are cumulative (not annualized). Performance for one year or more is based on average annual total returns. The returns are reported for Class I and A shares. Performance for other share classes will vary.

[3] Source: FactSet. Data as of September 30, 2023.
* Share class availability may vary by platform. For more information, please visit the specified fund page on the website.

Top Holdings (% of Total Net Assets)

	FUND	INDEX
Microsoft Corp	6.49	6.53
Accenture Plc	5.95	0.54
Visa Inc	5.20	1.03
Thermo Fisher Scientific Inc	4.80	0.54
Danaher Corp	4.30	0.45
Philip Morris International Inc	4.02	0.40
Intercontinental Exchange Inc	3.93	0.18
Alphabet Inc	3.57	4.01
Texas Instruments Inc	3.41	0.40
Becton, Dickinson & Co.	3.29	0.21
Total	**44.96**	--

Sector Allocation (% of Total Net Assets)^



	FUND	INDEX
Information Technology	27.26	27.46
Health Care	22.78	13.36
Financials	18.84	12.81
Industrials	10.25	8.30
Consumer Staples	8.61	6.57
Communication Services	3.57	8.87
Consumer Discretionary	1.39	10.67
Cash	1.77	--

^ May not sum to 100% due to rounding.

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. Changes in the worldwide economy, consumer spending, competition, demographics and consumer preferences, government regulation and economic conditions may adversely affect **global franchise companies** and may negatively impact the strategy to a greater extent than if the strategy's assets were invested in a wider variety of companies. **ESG strategies** that incorporate impact investing and/or Environmental, Social and Governance (ESG) factors could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. As a result, there is no assurance ESG strategies could result in more favorable investment performance. In general, **equities securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, market and liquidity risks. The risks of investing in **emerging market countries** are greater than risks associated with investments in foreign developed countries. 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. **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. **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. **Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk).

INDEX INFORMATION

The **S&P 500® Index** measures the performance of the large cap segment of the U.S. equities market, covering approximately 75% 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. Any index referred to herein is the intellectual property (including registered trademarks) of the applicable licensor.

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