

Morgan Stanley Institutional Fund

Global Franchise Portfolio

INTERNATIONAL EQUITY TEAM

Performance Review

In the quarter period ending June 30, 2023, the Portfolio's I shares returned 5.16% (net of fees)¹, while the benchmark returned 6.83%.

For the second quarter overall, the portfolio's underperformance was down to both stock selection and sector allocation. Negative stock selection was driven particularly by information technology, where the portfolio is less exposed to the growthier, artificial intelligence (AI)-perceived winners, as well as by weakness in the health care and consumer discretionary sectors. Whilst financials was a positive contributor, it was insufficient to compensate. The negative sector allocation was driven by the overweight in consumer staples, the underweight in consumer discretionary and the zero weight in communication services, overshadowing the gains from the overweight in information technology and the zero weights in energy, materials and utilities.

Market Review

In the second quarter, the MSCI World Index returned +6.8% in U.S. dollar (USD) and +7.2% in local currency. There was a great deal of variance between sectors; similar to the first quarter, the growth-tilted sectors, information technology (+15%) and communication services (+10%) outperformed, thanks to strength in the AI-led stocks. Consumer discretionary (+11%) also outperformed. As in June, the portfolio's key defensive sectors, health care (+2%) and consumer staples (+0%), underperformed in the quarter, while energy (-1%) actually fell. Turning to geographies, a weak yen saw Japan (+6% USD, +16% local) perform very strongly in yen terms, though it was slightly behind the U.S. (+9%) in dollar terms. Elsewhere in Asia, Hong Kong (-5% USD, -5% local) and Singapore (-6%, -4%) were in the red. In euroland, Italy (+8% USD, +8% local) was the only outperformer, as Spain (+6%, +5%), France (+3%, +3%) and Germany (+3%, +2%) all underperformed, along with the neighbouring U.K. (+2%, -1%) and Switzerland (+4%, +2%).

Outlook

Compounding Through the Hype

Global equity markets flourished in the first half of 2023, with the MSCI World Index returning +15% in U.S. dollars (USD), and now up over a quarter from the third quarter 2022 trough. In a mirror image of the derating in 2022, the rise has been down to a rerating on fairly flat earnings, with the MSCI World's forward multiple expanding from 13.7x to 17.0x.² The sector picture has also been a reversal of 2022, as the market has been led by the growthier sectors that suffered last year: consumer discretionary, communication services and, in particular, information technology, with the outpouring of euphoria around the promise of generative artificial intelligence (AI) offering a new lease on life for tech mega-caps after a tough 2022. June saw a more general cyclical recovery, but up until the end of May, the "magnificent seven" or "MANAMAT",³ around a quarter of the S&P 500 Index by weight, had effectively delivered all the U.S. index returns, with the other 493 constituents being slightly down overall.²

The ChatGPT phenomenon

It is true that AI has entered its next chapter, with algorithmic and processing power advancements, in addition to the explosion of data in recent years, ushering in a new era of generative AI. These clever large language models (LLMs), powered by advanced machine learning (ML) algorithms and trained on an enormous number of parameters, analyse and learn from the vast amounts of data they are fed to generate original, human-like content at warp speed. Since the debut of chatbot ChatGPT by OpenAI late last year, the market has been preoccupied with how to understand, implement and price the accessibility advancements offered by generative AI.

What is unusual about the AI frenzy is that this isn't a eureka moment. While the use of generative AI has surged since ChatGPT's launch, narrower AI technologies like ML and natural language processing (NLP) have already been in use for a number of years. Face recognition, for example, uses ML algorithms to unlock your smartphone, and digital voice assistants such as Siri and Alexa use AI, NLP and ML to understand commands and carry out a range of tasks. AI algorithms are used in e-commerce to make personalised

¹ Source: Morgan Stanley Investment Management. Data as of June 30, 2023. Performance for other share classes will vary.

² Source: FactSet

³ Meta, Apple, Nvidia, Amazon, Microsoft, Alphabet, Tesla. As of June 30, 2023, the Fund does not hold all of the MANAMAT stocks.

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shopping recommendations, in clinical trials to improve drug discovery and efficiency, and elsewhere across an array of industries to automate a host of back-office tasks. The incremental improvement of models from learned behaviour, along with the arrival of big data and computer processing power advancements, have all played their part in the release of generative AI.

Nonetheless, there have been two major surprises this year. The first is the speed of consumer adoption. In 2006, it took Twitter⁴ nearly two years to reach one million users; in 2010, it took Instagram two and a half months; for ChatGPT, it took just five days, with the service reaching 100 million users in a then groundbreaking two months – at the time, the fastest adoption of any technology in history.⁵ The second, and arguably more significant, surprise is the lack of barriers to entry to run AI code. The general assumption up until now, which we shared, was that large incumbents developing AI models would dominate given their economic moats: cloud expertise, computing power and massive stores of proprietary data – not to mention they have invested enormous amounts of capital to refine their AI capabilities. However, this doesn't appear to be the case. New large-scale, open-source models based on readily available application programming interfaces (APIs) are public; anyone with a good level of coding knowledge can adapt and redistribute the data architecture to satisfy their own specifications without requiring the large computational power and storage space normally necessary to run these. While this has advantages from a consumer perspective (including access to customisable AI models at far lower cost), for corporates, the barrier to entry for trialling code has reduced to one person with a laptop. The moat seems not to be the AI technology itself, but rather other elements of the business model – for instance, access to proprietary data, customer base or the ability to provide services at scale.

The shovelers

As in previous tech cycles, the early winners of the “AI gold rush” have been the pick and shovel sellers, notably the semiconductor providers. A California-based chip designer, a leader in the graphic processing units (GPUs) that power AI applications, gained nearly \$200 billion of market capitalisation in one day on powerful forward guidance. The other obvious shovels are the “hyperscalers” – cloud computing service providers – who are responsible for the infrastructure necessary for generative AI deployment, notably vast amounts of storage capacity and processing power. The global technology and software company we own commented that it is expecting AI-related products to boost its cloud computing platform growth by one percentage point from next quarter, with a current revenue run-rate of circa \$600 million. A further category of shovels is those offering AI services to customers; for instance the global technology and software company we hold offering its AI tool within its software product family, creating a first draft for users to edit within its word processing software or enabling faster clearance of emails within its email software.

Identifying the opportunities...

While the full impact of AI remains ambiguous, here are our early thoughts through the lens of our high quality investment approach and the stocks we own. Away from the technology-based shovelers, many of our companies already have a healthy degree of AI exposure, with further opportunities particularly in terms of cost reduction and value creation.

- **Process improvement/cost reduction:** AI presents clear opportunities for cost reduction as existing processes get automated, particularly rules-based functions. Much of this is not new. A professional services company we own talks of its outsourcing business having already gone from 90% labour and 10% automation to 60:40, with plenty of progress still to be made. In payments, the financial services company we hold has launched a high performance AI platform to help make payments more predictable, transparent and faster. Broadly, the generative AI revolution should help content creation in customer operations, sales and marketing, and software development by sharply reducing the quantity of human inputs. This is not to say these functions will necessarily become obsolete: the nuance and depth that comes with human input will likely still be needed in some capacity. In its current form, generative AI may be great at finding and summarising information embedded in websites – but should probably not yet be trusted with any complex legal agreements.
- **Value creation:** As well as reducing costs, AI enables companies to improve the quality of their services and product offering. Companies with large proprietary datasets across an array of industries may be able to use AI to run more effective and efficient data analysis to deepen their moats. In the health care industry, AI presents the possibility of improved capabilities in patient diagnostics and the optimisation/automation of a number of parameters in the drug discovery process. As an example, we hold a supplier of scientific instrumentation, consumables and software services that has used AI to develop an electron microscope, helping researchers analyse the structures of molecules, proteins and cells and expediting the process by automating vital steps. Meanwhile, for consumer brands, AI can enhance the customer experience through virtual offerings and personalised advertising. We own the world leader in beauty, which has developed a system that analyses popular trends online to tailor its products in line with emerging trends and preferences. Overall, it is early days for the technology, so the most exciting developments may well turn out to be ones beyond our current imagination.

⁴ Not held in the portfolio as of June 30, 2023.

⁵ As of June 30, 2023. Data cited in <https://ai.plainenglish.io/chat-gpt-achieving-100-million-users-in-just-2-month-a-deep-analysis-a453e6f85acf>

With an eye on the threats

In addition to where the opportunities lie, we are also focused on how change might adversely affect the companies we own. As ever, we worry about potential downsides more than we get excited by potential upsides.

- **Customer automation risk:** As mentioned above, AI should be able to help corporates cut costs by automating a range of rules-based and back-office tasks. This is a potential downside if a company's model depends on supplying services that get automated, for instance operating call centres, or on supporting personnel that may be automation targets, such as offering a data product to junior lawyers. IT services companies such as a professional services company we hold will need to generate enough high-value expertise-based work to compensate for any losses for automation.
- **Disruption risk:** AI will likely disrupt existing business models. AI's ability to accelerate the writing of code may provide extra competition for software providers, for instance. This threat requires constant vigilance as the technology evolves, and we are closely watching our holdings' proprietary data sources in case AI generates viable alternatives.
- **Legal and regulatory risks:** It is still early days for generative AI adoption, and as such regulatory and legal frameworks are very underdeveloped. The issue of patent and copyright is a central one, as models are being trained on intellectual property without any compensation to the owners. The creative computer software company we hold is hoping that its library of copyrights will be an advantage amid this uncertainty. In addition, there remains the risk of hallucinations, whereby input data is reconfigured or learned in such a way that is factually inaccurate. More significantly, there is the worry about AI embedding discriminatory "black-box" algorithms into processes. Credit scorers are already using AI code to make business and operational improvements, although those we own will not be using it to apply credit scores due to bias risks. In general, regulation may choke off innovation and the ability to create value, particularly if global companies are only able to progress at the speed of regulation in the slowest geography.
- **Disappointment risk:** Aside from AI hurting companies' future earnings, there is potential risk to valuations if the current excitement dissipates. Gartner's hype cycle has five phases when it comes to emerging technologies: the upward curve of the Technology Trigger and the Peak of (Inflated) Expectations, followed by the slump into the Trough of Disillusionment before the gradual recovery into the Slope of Enlightenment and the Plateau of Productivity.⁶ The risk is that as we approach the peak of expectations, a trough may not be far behind...

Compounding through the hype

At the end of 2021, we were worried about both multiples and earnings. Following the derating in 2022, our multiple anxieties faded, just leaving us worried about earnings. The last three quarters have put both concerns back on the table, with the MSCI World Index's forward earnings multiple back up to 17.0x, a level never reached between 2003 and 2019, while the multiple of the information technology sector at 27.4x is now worryingly close to its COVID-era highs.²

This elevated multiple is not on depressed earnings, with expected margins still close to all-time peaks, and consensus earnings expected to be flat this year before rising 10% in 2024,² despite all the worries about a potential recession. It is true that the U.S. economy has proved more robust than expected, but the downside of that is that labour markets remain very tight, meaning that a continued monetary squeeze is required to get inflation down. Our view is that any resultant downturn is not in today's earnings expectations... nor in the current multiple. We maintain that the world is an asymmetric place, with earnings downsides in bad times far higher than the upsides in good times. Our bet, 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 in any downturn, and the market will once again come to favour companies which have resilient earnings in tough times.

Ultimately, it's still early days for generative AI, and its full impact remains unclear. Which industries and companies will thrive and whose business models will be made redundant? What does employment, education, health care, finance, consumption and politics look like in an AI world? What does copyright mean in a machine-generated world? Will regulation be fast and sensible enough to put guardrails in place without hindering progress? Whose advice can we trust? Whose image is real? Does the world get smaller, faster and even more personalised? Does it become more unequal? And what becomes of the artisanal craft of the bottom-up fundamental portfolio manager?

Our team has been exploring new datasets and developing automation tools for some time, keeping an eye out for any valuable signals from sentiment or NLP analysis of earnings calls. We remain front-footed about innovation and yet steeped in a tradition of research excellence and management evaluation. We have yet to abandon deep research on the sustainability of returns on operating capital, team-based debate, absolute risk management or human judgement. We trust in our team's experience and have no intention of replacing human expertise with bots when constructing portfolios or servicing clients any time soon – the outcomes and our clients are too important for that.

² Source: FactSet

⁶ <https://www.gartner.co.uk/en/methodologies/gartner-hype-cycle>

Glossary

- **ChatGPT:** AI chatbot, Chat Generative Pre-Trained Transformer, using natural language processing, a neural network machine learning model and transformer to pull from significant data to predict a text response.
- **Narrow/Weak AI:** AI we typically experience in our day-to-day lives performing a single task or a set of closely related tasks, e.g., weather apps, digital assistants.⁷
- **General/Strong AI:** where sentient machines emulate human intelligence, thinking strategically, abstractly and creatively, with the ability to handle complex tasks.⁷
- **Generative AI:** describes algorithms (such as ChatGPT) that can be used to create new content, i.e., code, images, etc.⁸
- **Large Language Models (LLMs):** a deep learning model trained on a vast volume of datasets that understands and performs tasks in a human-like fashion.⁹
- **Machine Learning (ML):** a way of developing AI through models that can “learn” from data patterns without human direction i.e., Large Language Models (LLMs).⁸
- **Natural Language Processing (NLP):** a branch of AI within computer science that focuses on helping computers to understand the way that humans write and speak.¹⁰

Fund Facts

Inception Date	November 28, 2001
Minimum Initial Investment (\$)*	A Shares - 1,000
	I Shares - 1,000,000
Benchmark	MSCI World Net Index
Class I expense ratio	Gross 0.92 %
	Net 0.92 %
Class A expense ratio	Gross 1.16 %
	Net 1.16 %

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 June 30, 2023	MTD	QTD	YTD	1 YR	3 YR	5 YR	10 YR
Class I Shares at NAV	5.49	5.16	11.79	13.36	8.27	9.53	10.33
Class A Shares at NAV	5.48	5.07	11.66	13.07	8.02	9.26	10.04
Class A Shares (With Max 5.25% Sales Charge)	-0.06	-0.46	5.82	7.13	6.09	8.09	9.45
MSCI World Net Index	6.05	6.83	15.09	18.51	12.18	9.07	9.50

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.

⁷ <https://www.accenture.com/gb-en/insights/artificial-intelligence-summary-index>

⁸ <https://www.mckinsey.com/featured-insights/mckinsey-explainers/what-is-generative-ai>

⁹ <https://machinelearningmastery.com/what-are-large-language-models/>

¹⁰ <https://www.ibm.com/topics/natural-language-processing>

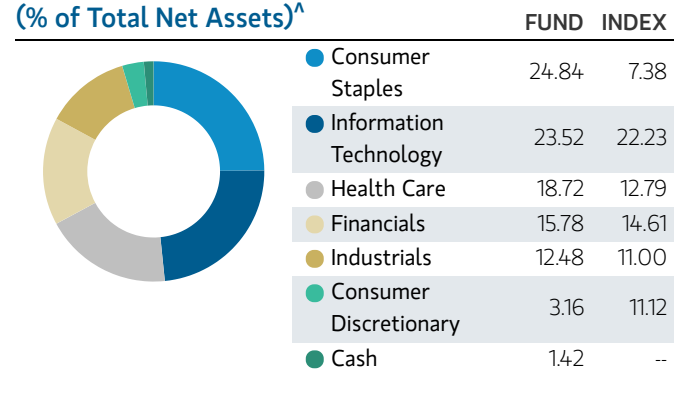
* Share class availability may vary by platform. For more information, please visit the specified fund page on the website.

Top Holdings (% of Total Net Assets)

	FUND	INDEX
Microsoft Corp	7.62	4.24
Philip Morris International Inc	6.59	0.27
SAP SE	6.04	0.25
Accenture Plc	5.65	0.34
Reckitt Benckiser Plc	5.65	0.09
Visa Inc	5.40	0.68
Danaher Corp	4.74	0.29
Thermo Fisher Scientific Inc	4.44	0.35
Intercontinental Exchange Inc	3.93	0.11
Becton, Dickinson & Co.	3.59	0.13
Total	53.65	--

Effective June 30, 2023, the investment team updated the investment criteria to allow for greater flexibility regarding the need for companies in the Portfolio to pay a dividend. While a steady dividend can help underpin shareholder returns, in some cases, using capital for acquisitions and/or steady share buybacks may offer a reasonable alternative to returning capital to shareholders.

Sector Allocation (% of Total Net Assets)^



^ 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 value of securities owned by the portfolio will decline. Portfolios are subject to market risk, which is the possibility that the market value 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 strategy may be subject to certain additional risks. **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. 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. In general, **equity securities'** values also fluctuate in response to activities specific to a company. Stocks of **small-capitalization companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. Investments in **foreign markets** entail special risks such as currency, political, economic, and market risks. The risks of investing in **emerging market** countries are greater than the risks generally associated with investments in foreign developed countries. **Non-diversified 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. **Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). **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.

INDEX INFORMATION

The **MSCI World Index** is a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets. 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 performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

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 do 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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