Morgan Stanley
INVESTMENT MANAGEMENT

**COMMENTARY**
September 30, 2023

Morgan Stanley Institutional Fund

# Global Strategist Portfolio

**GLOBAL MULTI-ASSET TEAM**

## Performance Review

In the quarter period ending September 30, 2023, the Portfolio's I shares returned -3.28% (net of fees)[1], while the benchmark returned -3.40%.

The Fund outperformed the MSIM Global Allocation Index, its custom index, which returned -3.46%, and the MSCI All Country World Equity Index (ACWI), its primary benchmark, which returned -3.40% in USD[2] During the quarter, the J.P. Morgan Global Government Bond Index (GBI) returned -4.27% in USD.

The Fund's asset allocation mix of an average overweight to fixed income and underweight to global equities had a negative impact on performance. Top-down thematic contributors during the quarter included overweights in Japan and Korea Value stocks vs. Anti-Value stocks, in European Union (EMU) banks vs. EMU equities, in U.S. exploration and production (E&P) equities vs. U.S. equities, and a directional overweight in oil futures. An underweight in luxury stocks vs. global equities also contributed. Detractors from performance included overweights in U.S. defense stocks vs. U.S. equities, in U.S. industrials vs. U.S. tech stocks, and in Mexican bonds vs. U.S. 5-year Treasuries. An overweight in U.S. 10-year TIPS (Treasury inflation-protected securities) also detracted.

## Market Review

The 2023 market rally reversed course in the third quarter as rising bond yields caused both stocks and bonds to sell off (MSCI ACWI -3.4%, JPM GBI -4.3% in USD). Investors worried that central banks might be forced to keep policy rates higher for longer in response to a stronger-than-expected economy, ultimately driving the economy into a more severe recession in order to achieve their inflation targets. Another cause for investor concern was a $20 per barrel rise in oil prices that sent Brent crude to $95.31 per barrel by the end of the period, adding fears that economic activity might be impacted by higher input costs. The surge in oil prices also added upward pressure to headline inflation in the U.S. where the year-over-year consumer price index (CPI) reaccelerated to +3.7%. Renewed fears surrounding the U.S. budget deficit also added to the rise in bond yields and depressed investor sentiment further as Fitch Ratings downgraded the U.S. credit rating from AAA to AA+. Meanwhile, House Speaker McCarthy passed a last-minute bill to extend government funding through mid-November in order to avoid an imminent government shutdown. However, McCarthy's bipartisan deal with House Democrats came at a steep cost, as he was ultimately ousted by a small minority of Republicans and with the full backing of Democratic House members.

***U.S. equities*** fell during the period (S&P 500 Index -3.3%) as rising rates weighed on valuations and diminished the odds of achieving a soft landing. The rate-sensitive NASDAQ Composite fell -3.9%, led by declines in mega-cap tech stocks such as Apple (-11.6%) and Microsoft (-7.1%). The energy sector (S&P 500 Energy Index +12.2%) was the main exception to the broad equity sell-off as energy stocks were propelled higher by a +27% rise in oil prices (Brent spot). ***Eurozone equities*** fell -7.7% (Euro Stoxx 50 Index in USD) due to tightening monetary policy and weak growth data. Composite purchasing manager's index (PMI) measures in the eurozone remained in contractionary territory throughout the quarter while core inflation made little progress toward the European Central Bank's (ECB) 2% target. As a result, the ECB hiked its policy rate to 4.00%, its highest level on record. ***Emerging markets (EM)*** fell -2.9% (MSCI EM Index in USD) on the back of a +3.2% increase in the U.S. dollar and weakness in Brazil and Mexico equities (MSCI Mexico Index -6.6%, MSCI Brazil Index -3.6%). Chinese equities outperformed the EM benchmark during the quarter (MSCI China Index -1.9% in USD) as slight improvements in economic data caused a bounce from oversold levels at the start of the quarter. ***Japan*** equities outperformed developed market peers, falling only -1.6% (MSCI Japan Index in USD) as Japanese inflation continued to progress toward the Bank of Japan's inflation target, supporting the narrative that Japan is likely exiting its era of deflation.

Global government bonds were at the center of this quarter's price action as yields reached multi-year highs around the world. The 10-year yields for the U.S., Germany, and Japan increased 73, 45, and 36 basis points (bps)[3] respectively, to levels not seen in over a decade. As a result, global government bonds sold off -4.3% (JPM GBI in USD). Central banks played a pivotal role in this decline by maintaining their hawkish policy stance and increasing their long-end rate expectations. The Federal Open Market Committee (FOMC)

1 Source: Morgan Stanley Investment Management. Data as of September 30, 2023. Performance for other share classes will vary.
2 Currency (FX) abbreviations used in this report are: EUR = euro, USD = U.S. dollar.
3 One basis point = 0.01%.

raised its median rate forecast for year-end 2024 and 2025 by 50 bps each, driving the narrative of higher rates for longer. Market expectations for rate cuts in 2024 were subsequently pushed out from the second quarter of 2024 to the third quarter of 2024. Meanwhile, the ECB completed its 10th straight rate hike but signaled that it would likely keep rates on hold going forward, acknowledging the recent weakness in the eurozone economy. In contrast to the U.S., investors brought forward their expectations for rate cuts in 2024, doubting the ECB's resolve to keep rates elevated in the face of a potential economic downturn.

Within currencies, the U.S. dollar gained +3.2% supported by a rise in real yields while the euro and the yen fell -3.1% and -3.4%, respectively. The British pound also lost -4.0% versus the dollar. EM currencies fell -3.9% (JPM EMCI), led by the Argentine peso, which dropped -25.6% due to an agreement with the International Monetary Fund to depreciate the official exchange rate by nearly 18% and peg the currency to the U.S. dollar at 350 pesos per dollar.

## Portfolio Activity

- We initiated an underweight in U.S. cyclical equities vs. U.S. defensive equities. After significant outperformance by cyclicals year-to-date, we now see meaningful downside to the basket in both the short and medium term. Both U.S. and global PMIs declined for several months and are now below 50 (pointing to a contraction in growth), but cyclicals continued to outperform defensive equities. This has created a short-term gap between performance and macro fundamentals, increasing the likelihood of cyclical equities underperforming in the near term all else equal. We have also initiated an underweight position in U.S. equities relative to an overweight in the U.S. 30-year Treasury bond. Historically, stocks underperform bonds as the GDP growth rate falls below potential, causing the output gap to widen. This underperformance accelerates as the economy enters a recession, causing equity earnings to decline and the Fed to cut interest rates. While we don't believe we're in a recession yet, we believe the risk of a recession is increasing and could begin within the next three to six months. Lastly, we initiated an underweight position in Macau gaming stocks relative to global equities on the view the recovery in gross gaming revenues will be incomplete, due to the weakness in China's post-reopening economy, consumer deleveraging, and weakened wealth effects from a deteriorating property market. We estimate that for these stocks to achieve the consensus expectations for 95% of 2019 EBITDA (earnings before interest, taxes, depreciation and amortization) levels by 2024, gross gaming revenue must rise to at least 118% of 2019 levels.
- We increased our overweight in U.S. Value stocks relative to Anti-Value stocks on technical indicators. Recently, positive trends have been re-established, and we are maintaining trading discipline in a theme we believe has very attractive return potential. From a valuation perspective, Value continues to look attractive relative to Anti Value globally, with U.S. Value extremely cheap on a relative basis.
- We reduced our overweight position in Mexican bonds vs. U.S. 5-year Treasuries, booking profits. As disinflationary trends continue to emerge, expectations for lower future policy rates from Mexico's central bank have pushed government bond yields lower. Real yield differentials relative to the U.S. have compressed from 6.00% to 3.00% in Mexico (in line with the historical average).
- In line with our stop-loss policy, we have closed our overweights in EMU and Japanese equities vs. U.S. equities, U.S. defense stocks vs. U.S. equities, and in U.S. 10-year TIPS.

## Outlook

The recent sell-off of the long end of the bond market caught many investors by surprise. The nearly 100 bps increase of the U.S. 10-year yield from its July lows rivals the taper tantrum of 2013 and is larger than most other large sell-offs in recent history. Cumulatively the bond bear market that started in August 2020 has by now resulted in a 25% decline in U.S. 10-year bonds (Bloomberg U.S. Treasury Bellwethers 10-Year Index), the largest bond bear market in over 100 years. Below we consider the numerous potential influences that may have caused this recent move and debate whether duration has become attractive at this point. Our sense is that real yields offer an attractive risk-reward at present.

The recent surge in yields got going in earnest on the day of the FOMC meeting (July 26), and the market's changing perception of the outlook for Fed policy appears to have been a key driver. In addition to hiking rates 25 bps once more in July, the Fed's "higher for longer" message was communicated through a number of speeches as well as upward revisions for growth in its economic outlook. ***"We are prepared to raise rates further if appropriate, and intend to hold policy at a restrictive level until we are confident that inflation is moving sustainably down toward our objective,"*** Chair Powell remarked at Jackson Hole. Cleveland Fed President Mester said, ***"The question is, how long do we need to keep monetary policy restrictive in order to be confident inflation is going to come down to 2%? … we're going to have to keep policy restrictive for some time."*** As a result, 50 bps of rate cuts (or about half of the 10-year yield increase) has been priced out: at the end of September the fed funds rate for December 2024 was expected to be at 4.6%, 50 bps higher than it was expected to be at the end of June.

The bond market has been lagging the Fed, judging its hawkishness to be excessive and temporary and thus expecting a rapid reversion to lower rates. Over the past 12 months, the fed funds rate was priced to fall by 136 bps on average over the following 18 months, and by the peak in May 2023 the expected cuts exceeded 240 bps. This left the long end of the bond market 66 bps below the fed funds rate, in contrast to the 12 hiking cycles since 1960 during which, on average, bonds yields ended up peaking 15 bps above the fed funds rate. The two instances (in 1969 and 1974) were exceptions where bond yields were below the fed funds rate at the end of the hiking cycle likely due to surging inflation, which continued to accelerate and ultimately caused bond yields to sell off and move closer to policy rates and inflation. These exceptions don't seem relevant today as inflation has been decelerating quickly. What else might explain the bond market's change of heart about the longer-term rate outlook?

Resilient economic growth, which has given rise to the perception of "low rate sensitivity" of the economy appears to be the more likely explanation for the unusual recent bear steepening. Investors gave up on the widespread expectation of a recession that they have had for much of the past 12 months and have come to believe in a more benign "soft landing" scenario, as growth data releases over the past several months suggested that the U.S. economy continued to grow at an above-trend pace while inflation declined continuously. The view that the dominant share of the impact of rate hikes has already been felt appears to have been gaining wider acceptance in recent months. This thinking may have at least partially affected policymakers too, as several have commented that at least the short-run real neutral rate may have increased[4]. Even as inflation has been coming down, with the core personal consumption expenditures (PCE) deflator moderating from 5.1% to 2.2% over the past 6 months (3-month annualized rate) and near-term inflation forecasts also coming down, the effective increase in the real fed funds rate that this entails has not dented the positive growth outlook.

Is the current perception of real neutral rates (and real bond yields) sustainable? In the short term, the answer hinges on the longevity of above-trend economic growth, which is essential for the "rate insensitivity" argument to endure. Numerous forces are lining up to lead to a growth slowdown in the short term, perhaps as soon as the fourth quarter of this year (waning fiscal boost, depletion of excess savings, possible government shutdown and resumption of student loan interest payments). Short-term ebb and flow aside, it is likely that monetary policy is excessively tight and real bond yields are prohibitively high, and their negative impact on growth will ultimately become clear.

At the current level of rates, if the stock of fixed debt were instantly repriced, economic growth and fiscal outlook would be severely challenged. Housing affordability for buyers is at its worst level since 1985 as mortgage payments represent 28.5% of household income. Obviously only a small portion of the population is exposed to this, but as existing housing stock ownership turns over and existing mortgages reprice over time, this would raise the overall debt servicing ratio from 9.8% today to 12.4%, the highest level since 2009. Similarly, while corporate fixed-rate debt maturities are spread over the next few years, once all are refinanced at current rates (and average spread), the average debt cost will likely increase by around 250 bps. The economy-wide ratio of interest expense to non-financial firm profits would increase to its highest level since 2010 and would lead to a pick-up in defaults. Already, corporate credit growth has slowed to a crawl (with loan growth running at near zero) due to high rates. The private sector headwinds would weigh on consumption, investment, and labor income growth.

Further, the public sector's finances would be challenged with real yields above 2%. As the government stock of debt gradually reprices to this level, the real interest costs would exceed GDP growth. The debt-to-GDP ratio trajectory is much worse if rates exceed growth because unlike the past decade it would not offset ongoing primary budget deficits in the years ahead. At 2% real yield, the interest cost on government debt would represent over 4% of GDP and around 25% of tax revenue and would exceed prominent items such as defense spending. Our forecast for the average primary balance over the next 10 years is 5% (versus 2.9% from the Congressional Budget Office) as expiring tax cuts are likely extended, and we add an extra 10%-15% due to a likely recession during that period. Our assumptions suggest the U.S. debt-to-GDP ratio will stand at around 150% of GDP in 10 years. This debt trajectory would likely raise doubts about debt sustainability and some combination of spending cuts and interest cost reduction, as in prior debt deleveraging cycles in the U.S. and other major economies, would become necessary. In other words, all major sectors of the economy, households, business, and government will struggle if real rates remain at current levels for a prolonged period of time.

From a longer-term empirical point of view, the conclusion seems similar: real rates appear too high. Looking at interest rates relative to trend GDP growth, real 10-year yield is overshooting its historical average by about 140 bps. On average, 10-year real bond yields have undershot real GDP growth by 70 bps since the 1960s while today, at 2.4%, the 10-year real yield is overshooting trend GDP growth by 70 bps. As we discussed in previous notes on this issue,[5] although growth is the more important determinant of interest rates, there have been several distinct "regimes" during which real rates substantially undershot GDP growth (e.g. by 300 bps during the higher-inflation 1945-1980 period) or overshot it by 90 bps (during the inflation-fighting 1980s through 2010s). We believe the following items will be critical for assessing what "rates versus GDP growth" regime we might we be in today.

[4] "It's possible given the dynamics of the reopening of the economy, that the neutral rate may have moved up." Minneapolis Fed President Neel Kashkari comments made to CNBC, Sep. 27, 2023.
[5] GMA Viewpoint: Secular Outlook for Bond Yields Structurally Higher, January 2019.

**Inflation.** In the short term, the Fed's commitment to its "keeping at it" inflation-fighting mode suggests that interest rates should substantially overshoot GDP. During 1980s-2010s, real 10-year rates were 125 bps higher than GDP and, everything else being equal, one might conclude that the current overshoot is insufficient and real rates need to go higher still. Empirically, we have found that inflation has tended to react to the bond yield-to-GDP gap with a substantial delay, usually of around 5-10 years. This empirical analysis is heavily influenced by the high inflation period of the 1970s during which real rates ended up lower than real GDP (250 bps below) but were followed, with a delay, by real yields being 260 higher than GDP during the 1980s. Higher real rates right now are a response to the depressed real rates of 2020-21, replaying the 1970s-1980s sequence on a compressed timescale. But, if high real rates prove too damaging to economic growth and fiscal sustainability, they will likely bring inflation down quickly, at least on a cyclical basis, and thus will enable rate cuts. On the other hand, if growth remains weak with inflation entrenched due to ongoing supply-side pressures, it seems unlikely that commitment to tight monetary policy will survive the inevitable public pressure.

**Investment Upcycle**. The prospect of higher investment growth and the need to finance it is often cited as a reason for the end of secular stagnation, which was characterized by anemic investment and excess saving. On the investment and financing side of this argument, structural change remains a forecast as investment as a share of GDP remains at the 2014-2017 level of 13.6%. Likewise, private sector debt remains at 120% of GDP today, the same level as it was for several years before 2020, suggesting no change relative to the preceding decade. In our prior research we have found a positive correlation between the pace of debt growth relative to GDP and the real rates gap to GDP growth. When debt growth was high, rates were relatively elevated. From this point of view, the lack of investment upcycles so far, constrained by the high starting point of debt-to-GDP, suggests real rates should remain relatively low.

**Government Debt and Deficits**. While private sector borrowing and investing remains relatively stable, government debt and deficits exploded during the pandemic and deficits appear to be persisting. As mentioned above, we expect government debt-to-GDP to keep rising over the coming decade as structural primary deficits persist. Some academic literature finds a positive correlation between budget deficits and real rates in the U.S. and a number of other countries. According to these studies,[6] real rates increase by 20-30 bps for each structural widening of budget deficit. If the primary budget deficit during the 2020s is 5% as we expect, it will be 1.6 percentage points higher than during the 2010s (average of 3.4%), suggesting 30-50 bps higher interest rates, everything else being equal. However, most of these recent studies focus on the past 50 years of history during which government and aggregate debt levels were substantially lower than they are today. Therefore, we believe there is a high probability that large fiscal deficits in the context of high debt burdens will be managed via a range of regulatory and policy measures, akin to the post-World War II period. [7]

**Demand Shortfall**. Just as the need to finance nearly $1.6 trillion of fiscal year 2024 annual budget deficit ($0.9 trillion primary) is setting in, some of the sources of demand may no longer be there. In August, we saw a notable bond market reaction during the quarterly refunding as supply became a more salient issue. First, many of the foreign reserve managers have been reducing their holdings of Treasuries, most notably China, whose holdings fell from $1.1 trillion to $0.8 trillion over the past three years. However, our analysis indicates that on aggregate foreign investors have been net buyers of government bonds this year (Treasuries and agency securities). It is likely that the absence of a foreign buyer strike is the reason that the U.S. dollar has remained strong. Second, quantitative tightening in principle should lift rates. For each $100 billion of balance sheet reduction, interest rates should rise anywhere from 3 to 5 bps. [8] In principle, therefore, if the Fed were to reduce its nearly $8 trillion balance sheet by $2 trillion[9] the term premium should increase by 60 to 100 bps. However, continued quantitative tightening, just like rate hikes, is cyclical in nature and is likely to be paused and reversed as cyclical disinflation progresses and economic growth slows under the weight of higher rates.

In summary, the outlook for real rates appears finely balanced. In the short term, resilient growth and the inflation-fighting Fed are keeping real rates high. At some point, perhaps in the near future, faced with continued fiscal deterioration, bond vigilantes may push real yields higher still. However, the economy's potential inability to sustainably tolerate elevated real rates in the context of unprecedented debt levels and the difficulty of reining in government deficit spending will likely pull real rates lower. So, what is the new regime for real rates likely to look like? As discussed above, real 10-year rates at 2.4% are already about 140 bps higher than where they should be if they were to return to the historical 70 bps discount to trend GDP growth. We don't expect a full return to "secular stagnation" of 2009-2019 when rates undershot GDP growth by 110 bps, or to the 2020-21 gap of negative 380 bps. But a 1% real 10-year rate seems reasonable. It would be higher than during "sec stag" and, consistent with history, would undershoot trend GDP growth by 70 bps.

**6** Thomas Laubach "New Evidence on the Interest Rate Effects of Budget Deficits and Debt" 2009. CBO, "The Effect of Government Debt on Interest Rates" 2019. "Recent and Prospective Trends in Real Long-Term Interest Rates" OECD, 2003.
**7** Carmen M. Reinhart and M. Belen Sbrancia "The Liquidation of Government Debt" 2011.
**8** NY Fed "Large-Scale Asset Purchases by the Federal Reserve: Did They Work?" 2010. Federal Reserve Board "The Effect of the Federal Reserve's Securities Holdings on Longer-term Interest Rates" 2017.9 The recent NY Fed Primary Dealer Survey suggests a $2 trillion drop is around a 20% probability.
**9** The Bloomberg 10-year U.S. Treasury Bellwethers Index tracks the total return on U.S. 10-year Treasury bonds.

How might a road to lower yields unfold? A recession in 2024, which we expect, will likely undermine the "rate insensitivity" of the economy and perception of a higher neutral real rate. Even if the near-term headwinds (such as weak housing, fading fiscal stimulus, exhaustion of accumulated savings, and the lapsing of various COVID-era forbearance measures) prove insufficient to cause a recession in the short term, gradual debt repricing will eat into consumer disposable incomes and will weaken corporate balance sheets. A growth slowdown that should naturally follow would likely lead to rate cuts and the attendant reconsideration of the "higher for longer" narrative. Somewhere along the way a bond buyers' strike in the face of looming budget deficits and further step-up of debt-to-GDP will become increasingly likely. Ultimately, spiking yields during a recession will be dealt with very quickly through restarting quantitative easing and a large number of regulatory tools to cap yields. The path towards substantially lower neutral real rates is highly likely and equally unlikely to be linear.

## Fund Facts

| | |
|---|---|
| Inception Date | December 31, 1992 |
| Minimum Initial Investment ($)* | A Shares - 1,000 |
| | I Shares - 1,000,000 |
| Benchmark | Primary- MSCI All Country World Index |
| | Custom- Blended Index |
| Class I expense ratio | **Gross 0.84 %** |
| | **Net 0.75 %** |
| Class A expense ratio | **Gross 1.06 %** |
| | **Net 1.06 %** |

**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 |
|---|---|---|---|---|---|---|---|
| Class I Shares at NAV | -3.64 | -3.28 | 3.93 | 13.72 | 1.68 | 2.93 | 3.81 |
| Class A Shares at NAV | -3.69 | -3.39 | 3.70 | 13.35 | 1.35 | 2.60 | 3.48 |
| Class A Shares (With Max 5.25% Sales Charge) | -8.75 | -8.47 | -1.75 | 7.43 | -0.46 | 1.50 | 2.92 |
| MSCI All Country World Index | -4.14 | -3.40 | 10.06 | 20.80 | 6.89 | 6.46 | 7.56 |
| Blended Index | -3.65 | -3.46 | 5.05 | 13.18 | 1.33 | 3.44 | 4.21 |

**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.

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

## Asset Allocation(%)

| | PORTFOLIO | ACTIVE WT |
|---|---|---|
| Global Equities | 59.48 | -0.52 |
| Global Fixed Income | 43.83 | 3.83 |
| Commodities | 1.16 | 1.16 |
| Cash | -4.47 | -4.47 |

## Currency Exposure(%)

| | FUND |
|---|---|
| **Developed Markets** | **88.81** |
| North America | 58.72 |
| Europe | 19.78 |
| Asia ex-Japan | 1.52 |
| Japan | 8.79 |
| **Emerging Markets** | **11.20** |

## Regional Allocation (% Net of Cash)

| | EQUITIES | FIXED INCOME |
|---|---|---|
| North America | 40.04 | 21.54 |
| Europe | 7.66 | 10.71 |
| Asia ex-Japan | 1.14 | 3.63 |
| Japan | 3.92 | -7.02 |
| Emerging Markets | 6.72 | 14.97 |

### 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, **equity securities'** values also fluctuate in response to activities specific to a company. 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 risks associated with investments in foreign developed countries. **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 a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. **Longer-term securities** may be more sensitive to interest rate changes. **High yield securities ("junk bonds")** are lower rated securities that may have a higher degree of credit and liquidity risk. **Mortgage- and asset-backed securities (MBS and ABS)**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. Certain **U.S. government securities**purchased by the Portfolio, such as those issued by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of the United States. It is possible that these issuers will not have the funds to meet their payment obligations in the future. **Real estate investment** trusts 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. **Derivative instruments** can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the Portfolio's performance. **Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). By investing in **investment company securities**, the portfolio is subject to the underlying risks of that investment company's portfolio securities. In addition to the Portfolio's fees and expenses, the Portfolio generally would bear its share of the investment company's fees and expenses. **Subsidiary and tax risk** the Portfolio may seek to gain exposure to the commodity markets through investments in the Subsidiary or commodity index-linked structured notes. The Subsidiary is not registered under the 1940 Act and is not subject to all the investor protections of the 1940 Act. Historically, the Internal Revenue Service ("IRS") has issued private letter rulings in which the IRS specifically concluded that income and gains from investments in commodity index-linked structured notes or a wholly-owned foreign subsidiary that invests in commodity-linked instruments are "qualifying income" for purposes of compliance with Subchapter M of the Internal Revenue Code of 1986, as amended (the "Code"). The Portfolio has not received such a private letter ruling, and is not able to rely on private letter rulings issued to other taxpayers. If the Portfolio failed to qualify as a regulated investment company, it would be subject to federal and state income tax on all of its taxable income at regular corporate tax rates with no deduction for any distributions paid to shareholders, which would significantly adversely affect the returns to, and could cause substantial losses for, Portfolio shareholders. **Cryptocurrency (notably, Bitcoin)** operates as a decentralized, peer-to-peer financial exchange and value storage that is used like money. It is not backed by any government. Federal, state or foreign governments may restrict the use and exchange of cryptocurrency. Cryptocurrency may experience very high volatility.

### INDEX INFORMATION

The **Customized MSIM Global Allocation Index** is comprised of

60% MSCI All-Country World Index (benchmark that measures the equity market performance of developed and emerging markets), 30% Bloomberg Global Aggregate Bond Index (benchmark that provides a broad based measure of the global investment grade fixed-rate debt markets), 5% S&P GSCI Light Energy Index (benchmark for investment performance in the energy commodity market), and 5% ICE BofAML US Dollar 1-Month LIBID Average Index (benchmark that tracks the performance of a basket of synthetic assets paying LIBID to a stated maturity).

The **MSCI All Country World Index (ACWI)** is a free float-adjusted market capitalization weighted index designed to measure the equity market performance of developed and emerging 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 index is unmanaged and does not include any expenses, fees or sales charges. It is not possible to invest directly in an index.

The **MSCI Emerging Markets Net Index** is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of emerging 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 MSCI Emerging Markets Index currently consists of 24 emerging-market country indices. The performance of the index is listed in U.S. dollars and assumes reinvestment of net dividends. The index does not include any expenses, fees or sales charges, which would lower performance. The index is unmanaged and should not be considered an investment. It is not possible to invest directly in an index.

The **JP Morgan Global Government Bond Index** is a market value weighted fixed income index comprised of government bonds in developed countries.

The **Nasdaq Composite Index** is a stock market index of the common stocks and similar securities listed on the NASDAQ stock market. It is used as an indicator of the performance of stocks of technology companies and growth companies. Since both U.S. and non-U.S. companies are listed on the NASDAQ stock market, the index is not exclusively a U.S. index.

The **MSCI ACWI Energy Index** includes large and mid cap securities across 23 developed markets and 25 emerging markets countries. All securities in the index are classified in the energy sector as per the Global Industry Classification Standard (GICS®).

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 **Euro Stoxx 50 Index** is a market capitalization-weighted stock index of 50 large, blue-chip European companies operating within Eurozone nations. The universe for selection is found within the 18 Dow Jones EURO STOXX Supersector indexes, from which members are ranked by size and placed on a selection list.

The **MSCI Brazil Index** is designed to measure the performance of the large and mid cap segments of the Brazilian market. With 68 constituents, the index covers about 85% of the Brazilian equity universe.

The **MSCI China Index** captures large and mid-cap representation across China A-shares, B-shares, H-shares, Red-chips and P-chips. It reflects the Mainland China and Hong Kong opportunity set from an international investor's perspective.

The **MSCI Japan Index** is a free-floated adjusted market capitalization weighted index that is designed to track the equity market performance of Japanese securities listed on the Tokyo Stock Exchange, Osaka Stock Exchange, JASDAQ and Nagoya Stock Exchange. The MSCI Japan Index is constructed based on the MSCI Global Investable Market Indices Methodology, targeting a free-float market capitalization coverage of 85%.

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