Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Institutional Fund

Global Sustain Portfolio

INTERNATIONAL EQUITY TEAM | COMMENTARY | MARCH 31, 2023

Performance Review

In the quarter period ending March 31, 2023, the Portfolio's I shares returned 7.43% (net of fees)[1], while the benchmark returned 7.73%.

For the first quarter overall, underperformance was due to stock selection. While financials and consumer staples were positive contributors, weakness in information technology and health care left stock selection negative for the quarter. Sector allocation was mildly positive, helped by the overweight to information technology and the avoidance of energy stocks. This offset the drag from the overweight to health care and underweights to consumer discretionary and communication services.

As of March 31, 2023, the portfolio's carbon footprint is 86% lower than the MSCI All Country World Index.[2]

Market Review

Despite a volatile start to the year, the MSCI World Index managed to return +7.7% in U.S. dollars (USD) during the first quarter, and a similar +7.4% in local currency. The growth-tilted laggards of 2022 were the clear quarter winners: Information technology (+21%), communication services (+18%) and consumer discretionary (+16%) were ahead of the index by more than 800 basis points (bps).[3] The portfolio's defensive sectors lagged, with consumer staples up only 3% and health care down 2%. Financials (-2%) and energy (-3%) were also weak. Turning to geographies, the U.S. (+8%) was in line with the index in the quarter. Euroland was particularly strong, with Spain (+16% USD, +14% local), Germany, Italy and France (all +15%, +13%) notably ahead of the index. In Asia, Singapore (+7% USD, +6% local) and Japan (+6%, +7%) were a touch behind, while Hong Kong was towards the bottom of the pack (-2% in both USD and local).

Outlook

Reckoning Deferred

It was a strong quarter for markets, with the MSCI World Index in positive territory all quarter and finishing up 8%, on top of the 10% rise in the fourth quarter of 2022. The market was led by the growthier sectors that suffered last year: information technology, consumer discretionary and communication services. Even banks held up reasonably well despite the assorted failures, off only 4% in the quarter. The performance in the quarter was driven by a rerating, as the forward earnings multiple rose by over one point while forward earnings were flat.[4]

So where does that leave us? The market now looks far from cheap, with the forward multiple of 16.2x at a level 14% above the 2003-19 average, though perceptions may be skewed by the bubbly near 20x multiples of 2020-21. In addition, the earnings that lie behind that multiple, and especially the margins, still look high. The sell-side expects modest earnings growth of 2% in 2023 before a return to 10% growth in 2024, and the expected forward margins of 16.1% are still within 50 bps of the all-time highs and 80 bps above the pre-COVID peak. Bearing this in mind, it is very difficult to argue that the market is pricing in any significant economic slowdown, given a healthy multiple on these elevated earnings. This is worrying if you believe that the current economic robustness could be only temporary, and that the economic reckoning may well have merely been deferred rather than avoided.

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1 Source: Morgan Stanley Investment Management. Data as of March 31, 2023. Performance for other share classes will vary.
2 Source: Trucost based on the Scope 1 and 2 carbon emissions per $1 million of portfolio companies' sales. The portfolio-level statistics show the weighted average carbon intensity.
3 One basis point = 0.01%
4 Source for all earnings and valuations data used in this report: FactSet as of March 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.

It is true that there was good economic news in the first quarter, outside the banking sector at least. China bounced back after the fourth quarter COVID-19 spike, while the warm winter eased natural gas prices in Europe and helped U.S. economic activity. The 2023 gross domestic product (GDP) growth forecasts rose, from 0.3% to 1% in the U.S. and from -0.6% to 0% in Germany.[5] Even in the banking sector, it looks like March's banking scare has been contained, though with costs for the AT1 (Additional Tier 1 bonds) market and U.S. regional bank lending. And 2023 is not 2008: Banks are better capitalised, more liquid and, with the possible exception of those below the $250 billion asset threshold in the U.S., better regulated.

The flip side of the good news on today's economic activity is that the inflation threat remains. Wages are still rising, in nominal terms at least, and companies are still pushing up prices, protecting their margins. Goods pricing pressures are easing, with 0% goods inflation in the U.S. in February, as the physical economy is recovering from the COVID-related supply chain disruptions, but the more wage-linked services sector saw prices up 7%.[5]

Despite this continuing inflationary pressure, the market's expectations for U.S. interest rates have dropped dramatically, with the U.S. December 2023 rates forecast falling 150 bps in a few days[5] with the demise of Silicon Valley Bank. While volatile, bond prices currently suggest U.S. rates will begin falling later this year. It is possible that this comes about through an "immaculate disinflation" as inflation falls back without economic damage. But it is more probable that the bond market is forecasting a sharp economic slowdown, which then requires an easing by the Federal Reserve (Fed). Despite this, the equity market reacted very positively to the falling rates expectations.

There are indeed reasons for pessimism about the U.S. economy later in the year. Leading indicators, such as lending standards that were tightening even before the regional banking issues, low small business confidence and falling consumer confidence expectations, suggest caution. There has been a near 500 basis point rise in rates,[5] and some of the impacts come with lags. For instance, mortgage issuance has declined very sharply, but housing starts and construction employment have yet to suffer. In the Bloomberg survey, 65% of economists are now predicting a U.S. recession, though generally not a severe one, and 2024 GDP growth forecasts are falling as 2023 numbers rise. In terms of corporate earnings, this looks like a reckoning deferred, but a reckoning nonetheless.

We do not claim to have particular insight on what is going to happen in this unpredictable year, as leading economists squabble about whether the Fed has done too much or not enough. But we can say with some confidence that the equity market looks complacent, pricing a scenario at the happier end of the potential range of outcomes. After all, the market is trading on high multiples on close to peak margins in the face of a very possible, or even probable, U.S. recession. Equities are also showing normal levels of volatility, in contrast to the very elevated volatility in the bond market.

Given the vulnerability of the currently high earnings to an economic slowdown, we would argue that quality is a relative safe haven. We maintain our view that companies with proven long-term track records of pricing power and recurring revenues are likely to show more resilient earnings than the general market, if and when the downturn comes, and history suggests that resilience will likely be rewarded by outperformance. So far, the market's 2022 decline and 2023 recovery have all been about derating and then a partial rerating, with earnings roughly flat, meaning that quality companies have not been able to differentiate themselves. The real test will come when the market's earnings fall, perhaps later this year, which should allow quality companies to shine.

FUND FACTS

Inception Date	**Minimum Initial Investment ($)***	**Index**
August 30, 2013	A Shares - 1,000 I Shares - 1,000,000	MSCI World Net Index

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

Performance (%)

As of March 31, 2023

	MTD	QTD	YTD	1 YR	3 YR	5 YR	10 YR	SINCE INCEPTION
Class I Shares at NAV	5.63	7.43	7.43	-6.40	10.81	8.91	--	9.53
Class A Shares at NAV	5.59	7.33	7.33	-6.71	10.45	8.53	--	9.16
Class A Shares (With Max 5.25% Sales Charge)	0.06	1.69	1.69	-11.62	8.47	7.36	--	8.55
MSCI World Net Index	3.09	7.73	7.73	-7.02	16.40	8.01	--	8.84

Class A shares have a maximum front-end sales charge of 5.25%. 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.

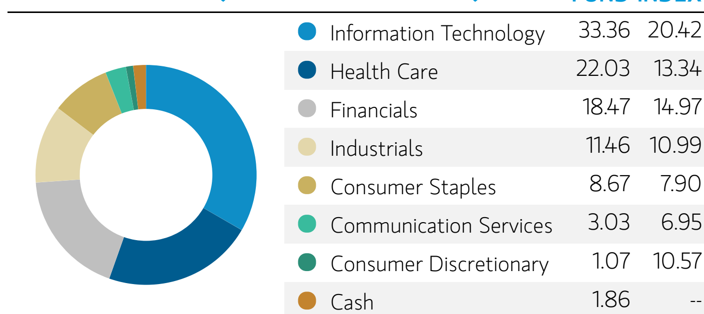
The gross expense ratio is 1.17% for Class I shares and the net expense ratio is 0.90%. The gross expense ratio is 1.46% for Class A shares and net expense ratio is 1.25%. Where the net expense ratio is lower than the gross expense ratio, certain fees have been waived and/or expenses reimbursed. These 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.

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.

Top Holdings (% of Total Net Assets)

	FUND	INDEX
Microsoft Corp	7.60	3.82
SAP SE	5.79	0.25
Visa Inc	5.72	0.69
Accenture Plc	5.24	0.34
Thermo Fisher Scientific Inc	4.30	0.42
Danaher Corp	4.26	0.33
Reckitt Benckiser Plc	3.95	0.10
Constellation Software Inc	3.49	0.07
Intercontinental Exchange Inc	3.36	0.11
Becton, Dickinson & Co.	3.28	0.13
Total	**46.99**	--

Sector Allocation (% of Total Net Assets)^



	FUND	INDEX
Information Technology	33.36	20.42
Health Care	22.03	13.34
Financials	18.47	14.97
Industrials	11.46	10.99
Consumer Staples	8.67	7.90
Communication Services	3.03	6.95
Consumer Discretionary	1.07	10.57
Cash	1.86	--

^ May not sum to 100% due to the exclusion of other assets and liabilities.

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. **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 public traded securities (liquidity risk).

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 **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 Indexes are 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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