In December, the Portfolio returned -1.63%, outperforming the MSCI World Index, which returned -1.76%. For the fourth quarter, the Portfolio underperformed, returning 5.40%, compared to 5.50% for the index. This resulted in the Portfolio ending the year up, with a strong positive return of 6.50% compared with an index decline of 0.87%.

The fourth quarter of 2015 started with a strong rally in October after markets looked into the void in September, had a relatively uneventful November, and then fell again in December. After all was said and done, the MSCI World Index ended the year down 0.87% in USD terms (+2.1% in local terms) as a strong USD continued to affect local market returns and fears of a China slowdown added to volatility.

Notable developed market laggards in 2015 were the countries most exposed to the commodity complex: Canada (-24.2% in USD), Norway (-15.0%) and Australia (-10.0%). Some of the best performers were Denmark (+23.4%), Ireland (+16.5%) and Belgium (+12.1%). On the back of additional quantitative easing, Japan put in decent performance, up 9.6% for the year. However, the Eurozone (-2.8%) and the UK (-7.6%) underperformed. The US was modestly up over the full year (+0.7%). In terms of the developing markets, the MSCI Emerging Markets Net Index was down 14.92% for the year, with Greece (-61%) and Latin America (-31%) inflicting much of the damage. China ended the year down 7.8%, and Russia eased back into positive territory, up 4.2% (all in USD).

After a dismal third quarter, the MSCI World Index rebounded in the fourth quarter, up 5.50% in USD, led by technology (+8.9%), health care (+7.0%), industrials (+6.7%) and telecommunications (+6.3%). Consumer staples delivered 6.2%, closely followed by the consumer discretionary sector, which returned 5.3%. Materials (+4.3%) and financials (+4.2%) underperformed the broad market, while utilities were up just 1.3% and energy (-0.7%) was the major laggard.

For the year, five sectors were in positive territory and ahead of the index. Health care was the strongest performer, returning 6.6%, closely followed by consumer staples up 6.4%. Consumer discretionary and information technology returned a positive 5.5% and 4.8%, respectively. Telecommunications also finished up 2.4%. Energy was the key laggard, declining 22.8%, followed by materials (-15.3%) and utilities (-6.6%). Financials (-3.4%) and industrials (-2.1%) were also slightly behind the index.

The Portfolio’s marginal outperformance of the benchmark in December was primarily driven by its overweight in consumer staples. For the quarter, the Portfolio’s slight underperformance was mainly due to stock selection in consumer discretionary, health care and consumer staples, which offset the positive contributions from stock selection in information technology, zero weights in energy, utilities and materials, and the underweight in financials.

The Portfolio outperformed the benchmark significantly for the year thanks to both sector allocation and stock selection. Sector allocation was very strong as the major overweight in consumer staples and zero weights in energy, materials and utilities all helped, although the underweight in health care was a bit of a drag on relative performance. For stock selection, outperformance in information technology and consumer staples comfortably outweighed underperformance in consumer discretionary.

**Portfolio Activity**

During the year, we added to and reduced holdings across a broad range of companies as we managed positions for quality or valuation reasons. Sales in the fourth quarter
can be summarized as retreats from areas where we are worried about the business or the deteriorating environment for the business. We initiated two new positions in what we consider high quality companies at the upper end of reasonable valuations.

Outlook

This time last year we identified a litany of problems facing equity markets – ranging from high valuations and earnings risk, emerging markets malaise and a likely destructive underlying tide of disinflation or outright deflation, which showed few signs of abating. Suffice it to say that none of these has gone away. Rather, existing problems have intensified and new ones have emerged and there are few hiding places across increasingly correlated asset classes.

It strains our belief that for a fifth year running, hope springs eternal in the market for a return to the halcyon days of double-digit earnings growth. The 2016 earnings estimates for the MSCI World Index have been mugged to an extent by reality, and after falling 22% from consensus forecasts made at the start of 2014 (in USD terms), now show 8% growth, having been as high as 13% in March 2015. Nevertheless, the market’s natural optimism remains undaunted, with 12% growth penciled in by the sell side for 2017.

To us, this looks simply like the wallowing of the balloon in the clouds, especially given some of the intensifying macro issues. Growing earnings in USD terms, both in and outside the US, is likely to be just as difficult in 2016 as in 2015 – if not more so – and does not seem to be reflected in current valuations of 15.8x next 12 months’ earnings for the MSCI World Index. While below the peaks of last spring, this multiple is above that of a year ago and the outlook has deteriorated further, in our view.

To the extent that a rational bull case for equity markets can be articulated, it probably goes as follows: While the plunge in commodities costs is unfortunate for the few (oil and mining stocks and commodity-based emerging markets, etc.), the many benefit. Consumers gain in real terms from lower prices and spend the proceeds, in turn helping companies who also benefit from lower input costs. All this takes place in a still-low interest rate environment, so effectively, the Goldilocks scenario of not too hot, not too cold prevails, meaning, in practice, further rises in multiples on modest rates of earnings growth, given the lack of investment alternatives. However, this case overlooks two critical factors. Firstly, consumers in zero interest rate environments tend to become more risk averse as they can see they will make no income on their savings and so tend to be reluctant to spend. Secondly, most companies do not have pricing power and have to pass on lower input costs to consumers rather than bank them. To us, the bull scenario does not look likely.

Meanwhile problems are intensifying. Global deflationary forces are again on the rise following the collapse in commodity markets, and subsequent direct and indirect impacts on emerging markets are triggering credit concerns. Accordingly, credit markets are at the center of our concerns going into 2016, in particular high-yield corporate and emerging markets debt. Our other principle concern is politics. All the reams of commentary about “will she, won’t she” rather miss the point, in our view. Although Federal Reserve Chair Janet Yellen has now raised US interest rates by 0.25% to 0.5%, monetary conditions have been tightening dramatically across the board for US corporates for the last 12-18 months, with nominal yields on Moody’s long-term bond averages rising from 3.7% in January 2015 to 4.7% at December 31, 2015. For high-yield, the Bank of America Merrill Lynch US High Yield Master II Effective Yield Index increased from 5.2% in the summer of 2014 to 8.8% as of December 31, 2015. One-year inflation expectations dropped from 1.2% to 0.9%, so that real high yields increased from 4% to 7.8%. Ten-year inflation expectations fell from 2.2% to 1.5%, hence long-term real high-yields increased from 3.0% to 7.2%.

In our view, the credit markets – as usual ahead of the equity markets – are sniffing out the toxic combination of 1) pressure on top lines from a mixture of deflation and the turning of the industrial cycle, and 2) the fact that many companies have been gorging themselves on debt to pay for share buy-backs to get management paid. This means lower corporate cash flows on high levels of debt, which increases the risk of default, especially at the lower quality end of the debt spectrum. Just when debt investors appear to be waking from their slumber and are beginning to look for the exit door, they are finding the lack of liquidity due to the double whammy of far larger fixed income mutual funds and far lower inventory at banks, a direct consequence of the increased regulation on banks.

The risks are rising that corporate bond funds are facing a downward spiral – as investors such as Carl Icahn are predicting - with funds having to sell the good to fund redemptions on the unsellable bad, thus increasing pressure for further redemptions. The recent closures of several corporate bond funds – such as Third Avenue – are unlikely to be the last and the real risk is that a rout in the corporate bond market could spread into a wave of
risk aversion and or liquidity seeking (i.e. selling what one can) in the US equity market, which is not cheap. More prosaically, the increased costs of corporate borrowing will probably choke off the recent tsunami of buybacks and mergers and acquisitions, which has been the principal reason for such earnings growth as there has been in the US.

The rout in most commodities in 2015 is very deflationary and will further add to pressure on emerging markets. Few emerging markets look as if they have repaired their current account deficits to levels associated with recoveries in prior emerging market bottoms (1998, 2002-3 and 2008-9). Turkey, South Africa, Indonesia and Brazil are all of particular concern to us and may also face pressure on their capital accounts as yield-seeking hot money that flowed in due to quantitative easing during the good times flies the coop during the bad. We note that Brazil’s President Dilma Rousseff has managed to achieve an approval rating of 9%, below that of Brazil’s 10.5% inflation rate – a “real” negative approval rating of 1.5%. Few leaders have achieved this remarkable feat. Lack of liquidity may mean that investors find it even more difficult to get out of emerging market debt than corporate debt. Problems with emerging market debt would soon feed into emerging markets more generally, both equity markets and currencies. This in turn would almost certainly cause further dislocation in developed-market credit and equity markets and further increase deflationary pressures.

These credit worries are front of mind before factoring in any likely, in our view, dislocation in China, which has now shown its hand on its currency, the Renminbi, after the initial depreciation versus the dollar in August 2015. Now that China has gotten what it wanted the initial depreciation versus the dollar in August 2015. We continue to believe that political risk going into 2016 is under-appreciated by markets, especially in Europe. While 2016 is relatively free of elections – with the big ones to come in 2017 in Germany and France – the referendum on the UK staying in the European Community is likely this year. BREXIT, the term given to the UK leaving the European Union, could be very disruptive. In addition, the impacts of some 2015 elections are still to be absorbed, with Spain and Portugal struggling to form stable majority governments after the rise of insurgent parties. In addition, the whole EU project of ever closer union is under threat from the continuing tide of refugees. More broadly, the rise of populism remains a worry, be it from the potential success of fringe players, such as Donald Trump, or attacks on particular sectors, such as Hillary Clinton on pharmaceutical pricing. Markets are not good at discounting political risk, and the pre-2016 world where politicians bent over backwards to help corporations is now a distant memory.

In our view, risks appear skewed to the downside for 2016 and it is not clear to us what cavalry is supposed to ride to the rescue should some of the larger risks eventuate. None of the quantitative easing in Japan, the US or Europe seems to be creating the inflation or growth desired by policy makers. Rather, the US Fed appears to be losing faith in its own medicine. It is striking that the Fed increased interest rates by 0.25% at a time when its principal measure of inflation expectations – the 5-Year Forward Inflation Expectation Rate – was at 1.8% as of December 31, 2015, below the 2% floor at which the Fed has previously launched several rounds of quantitative easing and at a time when growth (at least from the manufacturing side) appears to be slowing not accelerating. Though from our view quantitative easing has not worked, that will probably not stop the Fed from launching another round of easing in 2016 if growth disappoints, even if the Fed’s own faith in monetary easing is apparently waning. Market reaction to any additional easing will be critical. The market may greet it with Pavlovian relief, but if the bubble of faith in the omniscience of central bankers bursts and the market too loses faith in quantitative easing, watch out for squalls.

This difficult macro outlook and the gathering deflationary clouds are hardly a propitious backdrop for us as bottom up stock pickers. They present an increasingly difficult outlook for the companies we invest in – or hope to invest in. We are, of course, used to uncertainty and this uncertainty is not in itself problematic, provided one is given a good margin of

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relative safety on valuation to hold an existing stock or invest in a new stock idea.

For the Portfolio’s existing holdings, we are not overly concerned about what we consider our highest quality stocks, such as the consumer staples or pharmaceuticals, where the investment proposition amounts to seeking to own wonderful companies at fair prices, albeit with some concerns such as emerging markets exposure/US drug pricing, etc.

As for new opportunities generally, the pickings are slim. We continue to concentrate on what we consider the higher quality stocks in the higher quality sectors, combining steady, if moderate, top-line growth through recurring revenues, sustainable high margins through pricing power, and the ability to generate cash from high returns on unleveraged capital. While not offering a perfect defense against any general market declines in the short term, we believe these companies should continue to compound their earnings steadily, while generating cash, which should mitigate the impact of any market correction in the medium term. For now, our approach continues to be not to blow the lights out, but just to keep the lights burning.

\[\text{\textsuperscript{1}}\text{All performance figures are MSCI country or regional returns in US dollars as of 12/31/15, unless otherwise noted. Past performance is not indicative of future results.}\]

\[\text{\textsuperscript{2}}\text{Source: MSCI, Bloomberg, FactSet}\]

\[\text{\textsuperscript{3}}\text{Source: Twitter December 14, 2015}\]
Performance (%) as of December 31, 2015 (Class I Share at NAV)

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<thead>
<tr>
<th></th>
<th>MTD</th>
<th>QTD</th>
<th>YTD</th>
<th>1 Year</th>
<th>3 Year</th>
<th>5 Year</th>
<th>10 year</th>
<th>Since Fund Inception 11/28/01</th>
</tr>
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<tbody>
<tr>
<td>MSIF Global Franchise Portfolio</td>
<td>-1.63</td>
<td>5.40</td>
<td>6.50</td>
<td>6.50</td>
<td>10.15</td>
<td>11.02</td>
<td>8.98</td>
<td>11.02</td>
</tr>
<tr>
<td>MSCI World Index</td>
<td>-1.76</td>
<td>5.50</td>
<td>-0.87</td>
<td>-0.87</td>
<td>9.63</td>
<td>7.59</td>
<td>4.98</td>
<td>5.81</td>
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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 total expense ratio is 0.97% for Class I shares. Expenses are based on the fund’s current prospectus. The minimum initial investment is $5,000,000.

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 (unannualized). Performance for one year or more is based on average annual total returns. The returns are reported for Class I shares. Performance for other share classes will vary.
The views and opinions expressed are those of the portfolio management team at the time of writing and are subject to change at any time due to market, economic, or other conditions, and may not necessarily come to pass. These comments are not representative of the opinions and views of the firm as a whole. Holdings and sectors/region weightings are subject to change daily. All information provided is for informational purposes only and should not be deemed as a recommendation to buy or sell securities in the sectors and regions referenced.

Financial Definitions: Operational Leverage is a measurement of the degree to which a firm or project incurs a combination of fixed and variable costs. Financial leverage is the degree to which a company uses fixed-income securities such as debt and preferred equity. A high degree of financial leverage means high interest payments, which negatively affect the company’s bottom-line earnings per share.

Risk Considerations: There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Accordingly, you can lose money investing in this portfolio. Please be aware that this portfolio may be subject to certain additional risks. 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.

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 MSCI World Index currently consists of 23 developed market country indexes. 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.

Please consider the investment objectives, risks, charges and expenses of the fund carefully before investing. The prospectus contains this and other information about the fund. To obtain a prospectus, contact your financial advisor or download one at morganstanley.com/im. Please read the prospectus carefully before investing.

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