Morgan Stanley

INVESTMENT MANAGEMENT

1H 2020

Engage

GLOBAL FRANCHISE/BRANDS | GLOBAL QUALITY | GLOBAL SUSTAIN | INTERNATIONAL EQUITY | **ESG REPORT**

Engagement is our Edge

- In the first half of 2020 we engaged with company management on a range of themes, including decarbonisation, diversity, the impact of COVID-19 on employees and suppliers, executive pay and the circular economy, amongst others.
- In the 2020 UN PRI Assessment MSIM received a straight A score card, including A+ for Strategy & Governance. In Listed Equity, MSIM scored A+ for Incorporation and for Active Ownership, the latter for a second year running, reflecting the firm's commitment to stewardship. MSIM is in the top scoring brackets (A and A+) for both investment managers globally and those based in North America across all of our PRI disclosure modules.

A+

Inside this Issue:

Signatory of:

PRI Principles for Responsible Investment

ESG IS INTEGRATED INTO ALL OUR TEAM'S STRATEGIES

- Our investment process focuses on the sustainability and direction of future returns on operating capital because we believe that companies with sustained high long-term returns should outperform.
- Material ESG risks and opportunities are more important than ever to companies' future returns. ESG is an integral part of our assessment of long-term sustainability of returns.
- We have engaged directly with companies on issues of sustainability and governance for over 20 years, rather than outsourcing the process.

OUR ENGAGEMENT RECORD FOR 1H 2020[1,2]

155
MANAGEMENT ENGAGEMENTS ON ESG ISSUES

946
RESOLUTIONS VOTED ON ACROSS ALL OF OUR STRATEGIES

104
THE NUMBER OF TIMES THAT WE VOTED AGAINST MANAGEMENT, INCLUDING 37 TIMES ON EXECUTIVE COMPENSATION[3]

74
THE NUMBER OF TIMES WE DISAGREED WITH ISS PROPOSALS

[1] The International Equity Team defines an engagement as an interaction with senior management or non-executive board members.
[2] Data shown is for the 6 month period to 30 June 2020.
[3] Any remuneration-related proposals.

ENGAGEMENT IS A MARATHON, NOT A SPRINT

All engagements are carried out by our portfolio managers and our Head of ESG Research. We don't outsource engagement – we do it ourselves. We believe that direct and focused engagement helps us to build a more comprehensive picture of a company's ESG profile. It also allows us to identify those behind the curve by comparing companies' actions with those of their competitors.

By conducting our own analysis both before and after we engage, we are better able to assess the robustness of companies' ESG and sustainability processes. In addition, it helps us to determine if the company is making progress.

Dialogue with companies on issues can take years and require multiple engagements. As long-term shareholders, we believe that engagement is a marathon and not a sprint. Accordingly, our engagement policy is aligned to our long-term investment approach.

Positive steps, but still a way to go

(Global Franchise, Global Quality, Global Sustain)

We engaged with one of our **software holdings** on data security, diversity and executive pay.

Externally recognised for its data security programme

The discussion with the chief security officer focused on the company's data security management practices, essential given it handles large amounts of client information. Cyber threats are ever evolving, and the speed of detection, response and remediation of attacks is what differentiates robust data security programmes. In this context, we believe the company has sufficient processes in place to minimise cyber risks, including regular updates to senior management and running cyber-attack simulations. It has also received several industry awards in recognition of the maturity of its security programme, and receives external verification of security practices. The company's data privacy policies have been assessed and accredited by the EU as part of the GDPR regulation.

Diversity and inclusion tools and software to encourage best practice

On the subject of diversity and inclusion, we were encouraged to learn that the company has started to use some practical tools to enhance diversity and equality in its hiring process. For example, it does not require candidates to disclose past pay information that can lead to the transfer of past pay gaps and it requires recruiters to present diverse slates of candidates. Some of the company's new HR software products also help clients to reduce unconscious bias in hiring, for example by hiding name, geography or school characteristics to focus purely on the candidate's skills and fit for the role.

While the company reports on ethnic and gender diversity within the company, they do not report on pay gaps today. We encouraged them to start disclosing this information.

More to do on executive pay

On **executive pay,** we expressed our concern about the long-term incentive plan being linked 100% to net income, which we don't believe is the best metric – we prefer return on capital based metrics and/or relevant organic metrics, and encouraged the company to consider improving their scheme.

TAKEAWAYS

While the company has a strong framework for the key material ESG risk of data security and has made meaningful strides in fostering diversity, we encouraged it to improve its pay plan and enhance its pay gap reporting.

An eye on supply (chains)

(International Equity)

We engaged with one of our **consumer holdings**, a diversified company with a large presence in fashion retail, to assess how the company was treating its employees and suppliers in the face of the global pandemic. In addition, we discussed social risks in the garment manufacturing supply chain, and the environmental footprint of apparel manufacture. These are high profile issues that we believe companies in the sector should prioritise.

Commitment to employees and suppliers during the pandemic

The company, unlike many of its peers, made no redundancies at its apparel stores during the crisis. It has committed to paying its garment suppliers for a large part of orders they had to cancel due to store closures, with priority given to factory workers' wages. Its supplier audit team will be monitoring that these payments go directly to workers wherever possible. All managers took a pay cut this year.

Mitigating supply chain risks

Monitoring suppliers' labour practices is an important area of focus for apparel brands given the risks inherent in the complex supply chain. The company has a large team that conducts extensive audits of garment factories, the majority of which are unannounced, improving their effectiveness. It is trialling a new smartphone technology to receive feedback on factory conditions directly from workers, as well as RFID (radio frequency identification) tags on garments to prevent illegal subcontracting to unaudited factories, which has been an issue in the industry. We believe the company takes supply chain risks seriously, which is also evidenced by external assessments – for example, its apparel business has received a better than average ranking from Know The Chain, an NGO focusing on labour issues.

Sustainable farming and decarbonisation measures
The high environmental impact of apparel manufacturing (in terms of greenhouse gas emissions, water and pesticide use in cotton growing) has received increased attention recently. We were encouraged by the fact the company has created its own sustainable cotton programme, where cotton supplies are fully segregated and traceable, which is not the case with the largest alternative sustainable cotton standard. Through educating farmers on more sustainable farming methods, this initiative has helped reduce fertiliser and water use while improving yields and farmer incomes. The company aims to train 160,000 farmers by 2022 and source at least 50% of their cotton needs through this programme by next year.

The company's apparel retail operations also have a lower carbon footprint than the industry average as it ships full containers, use more rail freight instead of trucks, and do not use air freight unlike some of their competitors. The company is also very positive on the potential for recycled polyester and is planning to significantly increase its use, as supply has expanded and the price premium to virgin polyester has come down.

We encouraged the company to improve its disclosure of its Scope 3 emissions, which currently do not capture many parts of its supply chain.

TAKEAWAYS
The company has sensible measures in place to tackle the material ESG risks for the industry, including supply chain management and sustainable sourcing. We will continue monitoring its progress on this.

You can only manage what you can measure

(Global Franchise, Global Quality, Global Sustain, International Equity)

In our latest engagement with a large **software holding** we discussed its contribution to decarbonising the economy, as well as employee diversity, engagement and welfare.

Helping clients to reduce their environmental impact
The company has seen a significant increase in interest from its clients in its suite of sustainability tools in the last 12-18 months, due to stakeholder and government demands. These software tools help reduce carbon footprint and other environmental impacts, such as water use or food waste, by optimising supply chain processes. This may become a significant differentiator for the company over time, given its software is used by most companies and covers many industries' entire supply chains, giving it an edge over smaller competitors.

The company shared plans to enhance its offering, for example, by automating carbon data flows between companies and their suppliers. This would help track and manage a product's complete environmental impact throughout its lifecycle. The company recently collaborated with others on a study which concluded that through such digitisation of businesses, the IT industry as a whole can potentially help abate 7.6 gigatons of greenhouse gas emissions (around 14% of global total) in carbon-heavy industries (e.g. utilities, transport and agriculture).[4]

Industry-leading employee engagement and welfare practices
On employee engagement and welfare, we believe the company tracks it in a more frequent and granular fashion than most companies. During our meeting it shared an example of how this recently helped them identify and address employee concerns and prevent potential acquisition integration issues. It has also quantified the positive impact of improving inclusion and engagement on underlying business performance, e.g. operating profit.

During the course of our engagement, we noted that it does not report gender pay gap data. We encouraged them to do so, highlighting potential reputational issues if they do not.

TAKEAWAYS
We believe the company is ahead of others in their sustainability and diversity efforts, and could further enhance their approach through reporting.

Here's to change

(Global Franchise/Brands, Global Quality, International Equity)

We arranged a follow-up meeting with one of our **beverage holdings** to discuss their measures to encourage responsible drinking. This also provided the opportunity to discuss a broader range of topics including decarbonisation, the circular economy, sustainable agriculture and diversity.

Encouraging more disclosure on responsible drinking efforts
We view the subject of responsible drinking as a potential risk for the industry's returns on capital, should more restrictive regulation be introduced by governments. The company has sponsored many campaigns to encourage responsible drinking, however in our view it doesn't report on its efforts or positive impact in a clear, aggregated fashion. We encouraged it to provide more disclosure on this, which would help stakeholders to understand the efforts it is making and help the company to mitigate this social risk.

Strong progress and new targets for carbon emissions
On decarbonisation, having achieved a 34% reduction in Scope 1 and 2 carbon emissions per unit of production in the last decade, the company recently announced new targets, in line with the SBT (science-based targets) approach. The company now aims for a further 30% reduction in absolute Scope 1 and 2 emissions (its own emissions), as well as a 50% Scope 3

(supply chain emissions) carbon intensity reduction by 2030. In terms of own emissions, the company plans to convert its plants from natural gas to renewable electricity, among other measures, and has disclosed the amount of investment earmarked for this. The Scope 3 target is closely linked to the company's circular packaging and sustainable agriculture initiatives.

Firm steps towards a circular economy
On circular packaging, glass bottles are the largest source of upstream emissions for the company. It is increasing the amount of recycled glass it uses to 50% by 2030, compared with 35% today, which should lower the carbon footprint of its products. It is also working with its glass suppliers to electrify and decarbonise glass production over time. In addition, it is trialling returnable bottle schemes in both Asia and Europe.

Innovation in sustainable agriculture
Sustainable agriculture is an important emerging topic for consumer staples companies. Such companies sit at the top of the agricultural supply chain and can potentially influence and improve agricultural practices, provided they have the right tools and focus on this. While this company sources most of its agricultural inputs externally, it does own some land that provides for a small percentage of its needs. The company has been using it as a testing ground for new regenerative farming methods. For example, it has managed to reduce the usage of agrochemicals (herbicides, insecticides and fungicides) by nearly 50% since 2013. All of its owned vineyards now use drip irrigation, reducing water intensity. The company plans to further share these models with its suppliers and is in the process of mapping 100% of its *terroirs* to assess the impact of existing methods on the environment. It has also committed to have 100% of the key raw materials it sources certified to selected sustainability standards by 2030.

Greater diversity than five years ago
On diversity, several positive changes are underway. The headquarters employs 33 nationalities among a staff of 300 and meetings are now conducted in English, versus French five years ago. Four women now sit on the Board versus one five years ago. In 2020, the company recruited its first American (a woman) to head the U.S. spirits business (the company's largest market).

TAKEAWAYS
We believe the company has strong sustainability governance in place and is taking concrete actions on key ESG topics including diversity. We will continue monitoring their progress on this.

Monitoring corporate behaviour in response to COVID-19

The global pandemic descended upon the world with little notice and long-term ramifications that continue to play out. From an ESG perspective, COVID-19 exposed both saints and sinners across the corporate world, particularly in terms of management treatment of employees. We don't believe that the crisis has given corporates a reprieve from taking ESG matters seriously. On the contrary: over the medium and long term, we believe that ESG factors have become more, rather than less, important. Companies face increasing pressure to progress faster – primarily from governments, but also from their investors, consumers, employees and other stakeholders.

We have been tracking our companies' responses to the pandemic, both in terms of their workforce actions as well as contributions to fighting the virus, and have engaged where we had concerns.

The crisis has acted as a reminder that leading software and health care companies provide indispensable, critical tools and products that help businesses and broader society to stay resilient.

For example, a software company we own has been supporting the UK's National Health Service in its efforts to analyse the epidemic, as well as supplying free remote learning software to schools.

In health care, companies we own have been working with governments to extend the access to diagnostics and are developing rapid tests and potential treatments for the virus.

Meanwhile, leading consumer brands companies have recognised the need to shift from marketing to consumers to mattering to people – having real purpose. The pandemic has highlighted the value of essential hygiene products and protective equipment, but companies which also lead on matters such as payment flexibility and environmentally-friendly packaging should benefit in the long run.

Finally, COVID-19 has governance implications as well. This crisis is a real test of companies' risk management and capital allocation strategies. Companies with prudent balance sheet management and long-term focused executive pay plans should be better positioned to withstand the challenges ahead.

[4] Source: http://smarter2030.gesi.org/#

Pay X-Ray

The International Equity Team has always engaged with companies on their pay plans – we believe management remuneration is key to good governance.

Individual portfolio managers are responsible for analysing and voting on 'say-on-pay' resolutions. We believe that the in-depth company and industry knowledge that informs our decisions gives us an information advantage.

The Pay X-Ray is our proprietary scoring tool, used to better compare company pay plans, facilitate team discussions and inform our voting approach. A streamlined scoring system, it enables us to flag good and bad practices and rank our holdings' remuneration plans. Each element of the plan receives a positive or negative score, rolled up into an overall company score.

DISPLAY 1

Proxy voting overview *(6 months to 30 June 2020)*

Number of meetings voted	82
Total proposals voted	1,252
Votes against management	6%

Source: ISS Proxy Exchange; MSIM

Our team voted on 57 say-on-pay management proposals during the six months to 30 June 2020:

- 32% of the votes were cast against the proposal

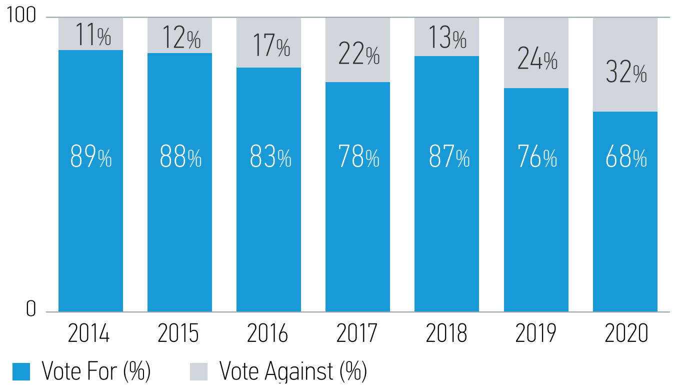
Reasons the team voted against say-on-pay proposals included: excessive levels of pay, insufficient weight of performance-based remuneration, subjective or undisclosed targets for management, or performance incentives that are, in our view, not aligned with shareholders.

The following chart illustrates the percentage of votes for and against management-sponsored say-on-pay proposals the team voted on during the period from 2014 – 1H 2020.

DISPLAY 2

Votes on management say-on-pay proposals voted 2014 – 1H 2020

Votes on management say-on-pay proposals



Source: ISS Proxy Exchange; MSIM

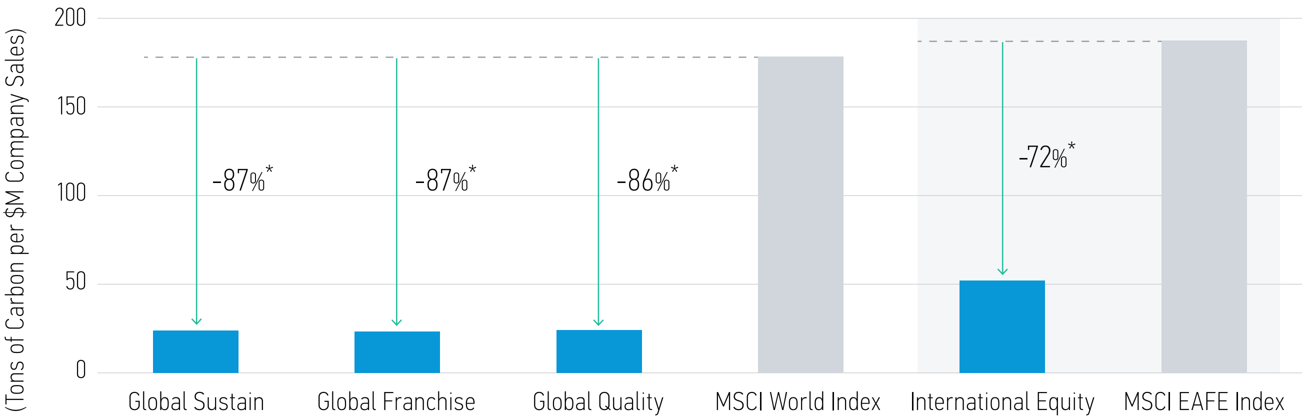
Proxy voting policy

MSIM votes proxies in a prudent and diligent manner and in the best interest of our clients, including beneficiaries of, and participants in a client's benefit plan(s) for which the subadvisor manages assets, consistent with the objective of maximising long-term investment returns. MSIM has retained research providers to analyse proxy issues and to make vote recommendations on those issues. While we are aware of the recommendations of one or more research providers, we are in no way obligated to follow such recommendations. The investment teams vote all proxies based on MSIM's proxy voting policies in the best interests of each client.

DISPLAY 3

Carbon light portfolios

Our global portfolios typically have less than a fifth of the average carbon intensity of the benchmark.



*Percentage shown is lower than the benchmark.

Source: MSCI ESG Research; Morgan Stanley Investment Management. Data as at 30 June 2020. MSCI ESG Research defines a portfolio's carbon footprint as the carbon emissions (Scope 1 and 2) of a portfolio per $1 million invested or per $1million of portfolio companies' sales. They sum up all emissions in a portfolio based on the investor's ownership share, using reported or estimated emissions data.

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. 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 strategy. Please be aware that this strategy 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. Investments in **foreign markets** entail special risks such as currency, political, economic, and market risks. 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. The risks of investing in **emerging market countries** are greater than risks associated with investments in foreign developed markets. **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.

Any questions or comments? Please contact:

VLADIMIR DEMINE
Head of ESG Research, International Equity Team
Vladimir.Demine@morganstanley.com

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