



Morgan Stanley

INVESTMENT MANAGEMENT

Engage

ESG REPORT | GLOBAL FRANCHISE/BRANDS | GLOBAL QUALITY | GLOBAL SUSTAIN | INTERNATIONAL EQUITY | 2H 2019

Engagement Is Our Edge

- We believe active managers running concentrated portfolios are well positioned to explore potentially material ESG risks as well as opportunities and to engage directly with companies as they arise.
- In the second half of 2019 we engaged on plastic waste, energy transition and executive remuneration. We also engaged on social issues, such as child labour in consumer companies' agricultural supply chains.
- All engagements are carried out by our portfolio managers and our Head of ESG Research – we do not outsource engagement.
- We don't rely on third-party scores. Direct and focused engagement helps our team 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. Overleaf is a summary of some of our notable engagements and our suggestions to companies where we spotted areas of relative weakness.

Inside this Issue:

Wash, Rinse, Refill

- How Japanese consumer companies deal with plastic waste

Looking Under the Hood

- Executive remuneration in the complex insurance industry

Winds of Change

- Oil, renewables and decarbonisation

Compare and Contrast

- How consumer staples companies address child labour in their supply chains

Signatory of:



ESG IS FULLY 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^{1,2}

1,252

RESOLUTIONS VOTED ON ACROSS ALL OF OUR STRATEGIES

283

MANAGEMENT ENGAGEMENTS ON ESG ISSUES

79

THE NUMBER OF TIMES THAT WE VOTED AGAINST MANAGEMENT, INCLUDING 25 TIMES ON EXECUTIVE COMPENSATION³

60

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 12 month period to 31 December 2019.

³ Any remuneration-related proposals.

Wash, Rinse, Refill
(International Equity)

On a recent trip to Japan we engaged with our **Japanese consumer holdings**. The main topic of engagement was plastic waste, as we sought to compare their strategies with those of their European and North American peers, who have recently stepped up their efforts in making their packaging more sustainable (see previous issue of Engage).

Japan is unique in how it manages its waste. Household packaging, including plastic, is carefully collected and segregated by consumers and municipalities with very little landfilled or leaked into the waterways. However, around 80% of the plastic is then incinerated, mainly in waste-to-energy power plants. While this is better, in relative terms, than landfilling or marine leakage, as it replaces the fossil fuels that would have been burnt instead, it still produces significant CO₂ emissions and is not sustainable in the long term. The true recycling rate is low, similar to other markets.

Disclosures and tracking are important

As far as Japanese consumer companies are concerned, our conclusion was that while they are increasingly cognisant of the plastics issue, and some progress has been made, they are still early on in their journey and lag their European counterparts. The level of disclosure and targets on reducing plastic waste is generally lower, although some companies have been working on addressing this or have promised greater action in the near future. We encouraged our holdings to disclose more data on their plastic use and collaborate with recognised global sustainability alliances such as the Ellen MacArthur Foundation.

Country peer comparison

One area where Japanese companies lead the world is the use of refillable packaging in household and personal care products. In some categories, for example liquid laundry detergents, refillables already account for 80% of the market.

Lower packaging costs are passed on to the consumer, making them cheaper than non-refillable options, which has buoyed user take-up. This increases our confidence that similar early pilots by Western companies that we have been tracking have a reasonable chance of success.

Direct engagement with our Japanese holdings on broader environmental and social topics was also useful as it highlighted that some of the early initiatives these companies are pursuing are in line with that of their global peers. These include for example, piloting bio-degradable plastics, or using the latest innovative third-party supply chain tracking tools to monitor potential social risks.



Looking Under the Hood

(Global Quality, Global Sustain, International Equity)

We recently discussed proposed management incentive plan changes with one of our **insurance holdings**. Accounting practices in the insurance industry are notoriously complex, therefore extra diligence is required when discussing remuneration metrics in order to understand their impact on the management's behaviour. Our Pay X-Ray – a proprietary streamlined scoring system that enables us to flag good and bad practices and rank our holdings' remuneration plans – is a useful assessment tool. We believe that using our in-depth industry knowledge in such situations increases the efficacy of our engagements and helps inform our voting positions.

In this particular instance, the company tabled a new pay plan while going through International Financial Reporting Standards (IFRS) accounting rule changes. The proposed changes could potentially affect the timing of when profits on long-dated insurance products are recognised.

The company proposed to use this metric as the main remuneration target. What concerned us was the fact (missed by other shareholders, as the company told us subsequently) that the management would in effect have discretion to retroactively adjust past profits, as well as influence how future profits are reported, depending on which accounting approach they choose. This would have rendered the target meaningless, as it would not have been linked to the underlying performance of the business. As a result, we made clear to management that, in this form, we would oppose the pay plan.

Winds of Change

(International Equity)

We continued to engage with one of our **energy holdings** on the subject of decarbonisation. We examined the company's strategy in growing its renewable energy business, as well as potential decarbonisation-related risks in the oil and gas business.

We were encouraged that the company has become more focused on investing in renewable (wind and solar) electricity projects. Although its renewable business is currently small in the context of the group, it now targets an eight-fold increase in installed generation capacity by 2025, a significant improvement from last year's target. If this target is met, it would make this business comparable in size to leading renewables operators today.

Need to maximise the renewables opportunity

The company expects to generate a higher return on equity on these projects than before, now estimated to be comparable to its oil and gas project returns. This represents a change in attitude from our previous discussions, when the company quoted the lower return potential of renewables as a hurdle to investing in them.

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However, the company still uses the same cost of capital for all projects. We highlighted to them that wind and solar projects tend to be less risky than complex oil exploration projects and should be valued using a lower cost of capital, leading to higher valuations. Renewable projects often benefit from higher cash flow visibility thanks to long-term offtake contracts, government policy support and lower operational risks. As we pointed out to the company, this is reflected in high valuation multiples for leading pure-play renewables companies, but is not yet reflected in the valuation of those oil companies that are investing in renewables. They do not disclose enough information (and until recently downplayed the actual amount of capital going into their renewables projects) for the market to properly reward their efforts. In our view, this suggests the oil industry's mind-set must continue to evolve in order to maximise the opportunity represented by the growth in renewables.

Addressing the stranded assets issue

We think the company is cognisant of stranded asset risks in its fossil fuel business. It adds an internal carbon price to oil and gas project costs when evaluating their viability. It has been shifting its portfolio away from oil to gas, which has much lower carbon intensity and therefore faces lower long-term risks. On its estimates, 90% of the company's value is in projects with less than ten years of expected life. This reduces the risk of these assets becoming stranded in the long run, as the company has the option of letting these projects run off, at the same time reducing expenditure on new reserves if oil demand starts to plateau or decline in the future. Such a shift would free up capital to be either returned to shareholders or to increase investments in low-carbon projects.



Compare and Contrast

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

We engaged with two of our **consumer staples holdings** on the topic of child labour in their agricultural supply chains. We examined how the two companies track and address instances of child labour at independent farms that supply their raw materials.

Child labour in agriculture is a complex issue given the final users of agricultural inputs, the fast-moving consumer goods (FMCG) manufacturers, very often do not have visibility into or direct control of farm-level practices, several layers down the value chain. This is exacerbated by the lack of appropriate social infrastructure (e.g. accessible schooling in rural areas) in many lower-income emerging markets that produce a significant part of the crops going into everyday products sold by multinationals.

Both companies have long-term remediation programmes to reduce and eliminate child labour. However, our analysis and engagement have shown some important differences. One of the companies we spoke to has been tracking and disclosing information on child labour and its actions to address the root causes of the problem for some time now. It has also been working with a supply chain non-government organisation as well as with an independent supply chain auditor since 2011 to supplement its own farm audits in certain countries and provide regular external assessment of their work.

According to the company, instances of child labour have gone down over time, and 98% of their audited farms did not employ child labour.

The other company, while acknowledging the issue, has a lower level of disclosure and does not yet collaborate with independent third parties directly. While we do not see this as a material financial risk for either company at this stage, it may have potential reputational and litigation consequences over time.

These engagements demonstrated that companies that focus on this issue should be able to better mitigate their reputational risk, and that there are leaders and laggards in terms of how companies manage social risks in their supply chain.

After comparing the progress of each company on this important topic, we gave constructive feedback to the company we felt was further behind to help improve its practices. We continue to monitor this, and will follow up on this topic in our upcoming interactions with them.



Proxy Voting Overview (12 months to 31 December 2019)

Number of Meetings Voted	82
Total Proposals Voted	1,252
Votes Against Management	6%

Source: ISS Proxy Exchange; MSIM

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 analyzing and voting on ‘say-on-pay’ resolutions. We never outsource this and 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 mechanism, 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 (such as performance metrics, types of award delivery instruments, length of the performance measurement period etc) receives a positive or negative score, rolled up into an overall company score.

Our team voted on 104 say-on-pay management proposals during the 12 months to 31 December 2019:

- 76% of the votes were cast in favour of the proposal
- 24% of the votes were cast against the proposal (the highest percentage over the last 6 years)

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, performance incentives that are, in our view, not aligned with shareholders.

Notable votes against management in 2019

U.S. multinational software company

We supported a shareholder proposal requesting the company publish a report on gender pay gap

U.S. electrical component manufacturer

We supported a shareholder proposal requesting the company publish a report on the human rights risks in their operations and supply chain, against management opposition.

U.S. multinational technology company

We voted in favour of a shareholder proposal that all stock should have one vote per share, against management recommendations.

We voted against management, backing a shareholder proposal requiring the company in question to adopt a policy prohibiting unequal employment practices.

We supported a shareholder proposal requesting the company publish a report on sexual harassment policies, against management opposition.

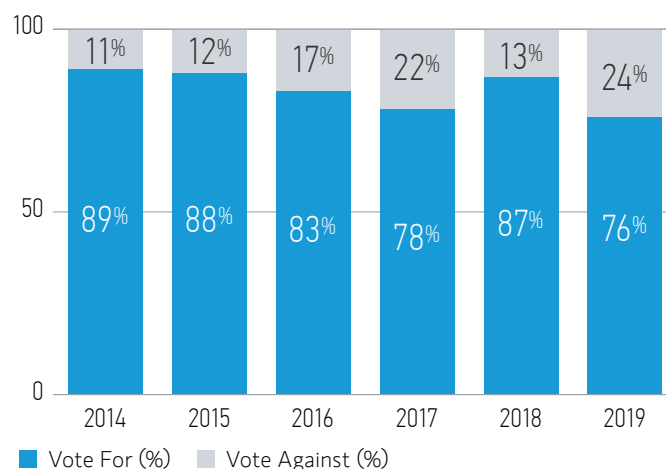
We voted in favour of a shareholder proposal requesting the company publish a report on policies and risks related to content governance, despite management opposition.

European bank

We voted in favour of a shareholder proposal that the board should consider exercising clawback of management bonuses in light of poor performance

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 – 2019.

Votes on Management Say-on-Pay Proposals 2014–2019



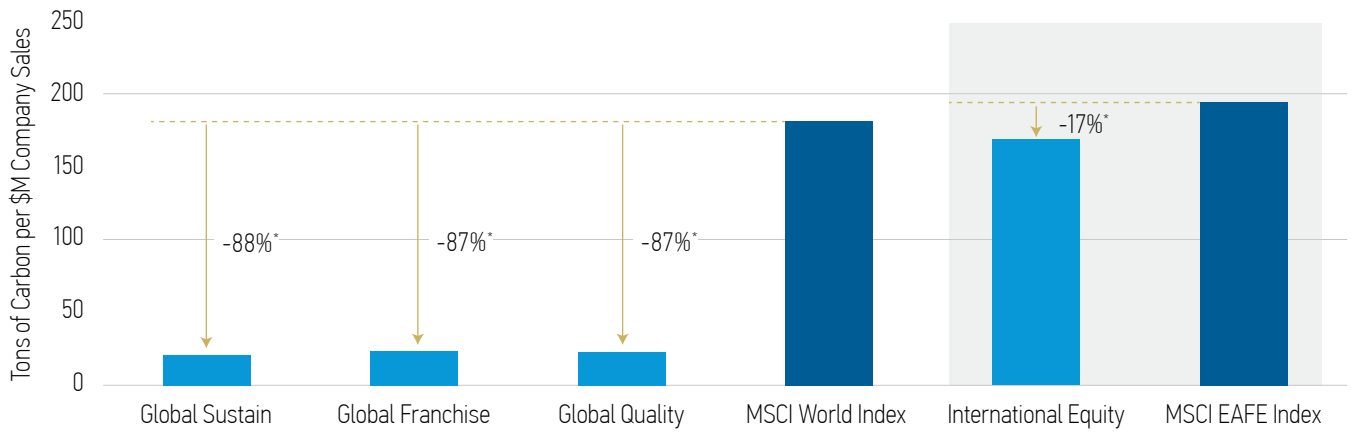
Source: ISS Proxy Exchange; MSIM

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 maximizing long-term investment returns. MSIM has retained research providers to analyze 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.

Carbon light portfolios

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



*Percentage shown is lower than the benchmark.

Source: MSCI ESG Research; Morgan Stanley Investment Management. Data as at 31 December 2019. 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 \$1 million 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:



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