Morgan Stanley

INVESTMENT MANAGEMENT

Engage

GLOBAL FRANCHISE/BRANDS | GLOBAL QUALITY | GLOBAL SUSTAIN | INTERNATIONAL EQUITY | 2019

Engagement Is Our Edge

- We believe active managers running concentrated portfolios are best positioned to identify potentially material environmental, social and governance (ESG) risks as well as opportunities and to engage directly with companies as they arise.
- Direct and focused engagement helps our team build a more comprehensive picture of a company's ESG profile than solely relying on third-party scores.
- Included in the report are some real-life examples of our ESG engagement and ESG-influenced portfolio activity from the second half of 2018. We also show how they are linked to the UN Sustainable Development Goals (SDGs) below. Although we do not base our investment decisions on SDGs, they are a useful tool for helping investors track corporate sustainability progress.[1]

Signatory of:

PRI Principles for Responsible Investment

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[2,3]

1,384
RESOLUTIONS VOTED ON ACROSS ALL OF OUR STRATEGIES

229
MANAGEMENT ENGAGEMENTS ON ESG ISSUES

88
THE NUMBER OF TIMES THAT WE VOTED AGAINST MANAGEMENT, INCLUDING 15 TIMES ON EXECUTIVE COMPENSATION[4]

71
THE NUMBER OF TIMES WE DISAGREED WITH ISS PROPOSALS

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[1] The content of this publication has not been approved by the United Nations and does not reflect the views of the United Nations or its officials or Member States. For additional information, please see the United Nations Sustainable Development Goals web site at https://www.un.org/sustainabledevelopment/sustainable-development-goals.

[2] The International Equity Team defines an engagement as an interaction with senior management or nonexecutive board members.

[3] Data shown is for the 12-month period ending 31 December 2018.

[4] Any remuneration-related proposals.

Better safe than sorry

In the second half of 2018, we continued our engagement with one of our key holdings, a **large consumer staples company.** In our previous interactions, we addressed the question of product safety with management following a recent incident. This time, our aim was to gather evidence that the improved safety controls recently introduced were in fact working. The company gave specific examples of how potential product-quality incidents had been escalated immediately to senior management since the new procedures were implemented. In one incident, management made the decision to take a loss on a batch of baby food products before it left the factory, and, in another, to promptly withdraw a personal care product from the market. This increases our confidence that senior management will be more aware of potential quality problems and that the company will take proper action. In the past, such decisions were typically left to local management. *Evidence of improving focus on product safety contributed to our decision to increase position in the name earlier in the year.*

We also discussed responsible marketing, expressing our concern about recent NGO allegations of over-promotion of infant nutrition products by the company and its peers. The company is in the process of rolling out improvements to their marketing practices and we will continue to engage and monitor progress in this area.

We believe product safety and responsible marketing are key social factors for consumer companies whose brands' reputation in the eyes of consumers and regulators is fundamental to the sustainability of their returns on capital.

Lastly, we believe the company has a long-term opportunity to strengthen their brands by embedding sustainability in their products and messaging, which in our view will increasingly drive consumer brand choices. The company shared with us examples of recent sustainability-led innovation and marketing campaigns for some of their key brands, confirming their increased focus on this strategic opportunity.

Thanks for calling back

Following one of our first-half 2018 engagements, we received a call from the management of one of our holdings, a **large consumer staples conglomerate.** In earlier meetings, we expressed our strong opposition to their proposal to move headquarters to a country that we believe has a lower level of shareholder rights protection than their current domicile. One of our concerns was that the proposed regulatory regime could potentially shield companies from hostile takeovers, reducing the pressure on management to perform well. We believe our stance as a large shareholder contributed to their recent decision to abandon this move. We are encouraged that the company was willing to engage with us after the event and solicit our feedback. We will continue to engage with them.

On a more positive note, we are pleased by the company's improving disclosure of their sustainability efforts, recently quantifying their positive impact on top-line growth. Brands with improved sustainability credentials are growing 1.5 times faster than the rest of their business and delivered 70% of the company's total growth in 2017. This confirms our view that *sustainability can be a material incremental opportunity for well-run companies.*

Apples to oranges

One of our **health care equipment** holdings has been given a low product safety and quality score by an ESG data provider. Regulatory compliance is extremely important for this industry as a failure to invest sufficiently in product safety can result in significant penalties and loss of customer trust – the key ESG topic of our most recent engagement with the company. We believe the revenue-based 'product recall intensity of sales' methodology used by the data provider unfairly penalises the company compared to its peers. The company sells a vast quantity of low-priced products compared to peers who may sell smaller numbers of more highly priced products. We believe this revenue-based metric can be misleading and makes an accurate 'apples-to-apples' comparison of incidence of recalls difficult; instead, one should look at the percentage of physical units recalled.

However, the company did have period of higher-than-usual product recalls several years ago, and as a result we have been focused on management's initiatives to improve product safety. The CFO outlined the actions the new management team has taken over the last few years, including increased spending on the product-safety function and additional headcount. It is also ring-fenced from the cost-cutting programme implemented in the rest of the business, minimising the risk of future underspending in this crucial area.

We believe these measures are working–the number of recalls, regulatory warnings and complaints has significantly fallen in the last four years. However, this is not reflected in the major ESG data providers' assessments of the company, which we believe can be imperfect and backward-looking. Engagement helps us build a more comprehensive picture of a company's exposure to material ESG risks and opportunities. *This example highlights the importance of direct engagement with companies and not solely relying on third-party scores.*

On the opportunity side, the company is likely to benefit as a key contender in the generic injectable drugs market. Generics reduce healthcare costs for society and improve access to medicine. This is an area of major focus for the company, and management have laid out a sensible strategy and specific milestones to achieve outsized growth. As a leading player in injectable medicines overall, with key scale and manufacturing expertise, we believe the company is well-positioned to grow market share in injectable generics, which should contribute materially to their overall growth.

Defending the fortress

We met with one of our large holdings, **a leading payments network,** to discuss data security and financial inclusion. The key question we ask all companies potentially impacted by data security concerns is how information security is governed. In this particular case, the chief risk officer reports to the board on data security on a weekly basis. They also receive regular third-party assessments of all aspects of their data security management by a leading independent consultancy. The company is rolling out new technologies, such as one-time digital 'tokens' and enhanced transaction fraud tests, that should help reduce the risk of data breaches in their payments eco-system. This detailed engagement has increased our confidence that the company is well-positioned to mitigate data security risks, which is a growing area of concern for society.

Regarding financial inclusion, this company has an *SDG-aligned target* of providing 500 million lower-income people in emerging markets with access to electronic payments. It has invested significantly in this initiative, reaching 240 million people by the end of 2017. This not only improves financial inclusion across the globe but should also strengthen the company's franchise in the long run, giving them an opportunity to expand their customer base in these high-growth markets and protect themselves from potential competition from alternative payment providers.

Laser focus on the environment

We recently initiated a position in **a leading manufacturer of industrial lasers.** It is a high-quality cyclical, in our view, as it benefits from structurally high growth and generates high returns on operating capital. Lasers are a fast-growing category as they are increasingly replacing traditional machinery in industrial processing.

Importantly, fiber lasers - where the company has a 70% global market share - reduce energy consumption by 70-90% compared to traditional manufacturing methods. The company estimates the cumulative environmental savings from operating their lasers has amounted to 15,000 gigawatt hours of electricity, or over 8mn tons of CO_2e, since 2011. Lasers also significantly bring down raw material waste, water usage and pollution from chemicals used for metal processing, as well as enable 'light-weighting' of products such as car components.

This is an example of a high-quality company that also has a *positive environmental impact* through emissions avoidance and reduction in waste and pollution for its customers and society as a whole.

Proxy Voting Overview *(12 months to December 2018)*

Number of Meetings Voted	90
Total Proposals Voted	1,384
Votes Against Management	6.4%

Source: ISS Proxy Exchange; MSIM

Remuneration

MSIM reviews all remuneration proposals and votes on a case-by-case basis. Our team voted on 60 say-on-pay management proposals during the 12 months leading up to 31 December 2018[4]:

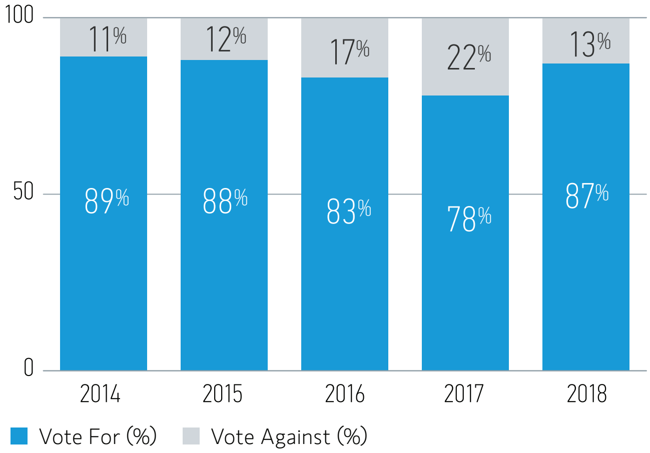
- 87% of the votes were cast in favour of the proposal
- 13% of the votes were cast against the proposal
- Reasons the team voted against say-on-pay proposals included: excessive levels of pay, insufficient weight of performance-based remuneration, subjective or undisclosed targets for management, performance 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 to 2018.

[4] Includes only advisory votes to ratify/approve executive officers' compensation and remuneration reports.

Votes on Management Say-on-Pay Proposals

Voted 2014 – 2018



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.

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