Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

Seeking Sustainability: Compounding and ESG

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | INVESTMENT INSIGHT | SEPTEMBER 2018

AUTHOR

WILLIAM LOCK
Head of International Equity Team

BRUNO PAULSON
Managing Director

DIRK HOFFMANN-BECKING
Executive Director

The International Equity Team spent 2017 ensuring that environmental, social and governance (ESG) analysis was fully integrated into the investment process across all its strategies. This did not require any radical changes given the team's philosophy of investing for the long term and always being mindful of risks to companies' returns, but it did involve formalising the process around ESG risks and opportunities and, in particular, environmental and social factors.

Governance has always been a focus of the team, as weak governance has always been a threat to compounding. Our global portfolios are focused on very high-quality companies that generate plenty of free cash flow and give management plenty of degrees of freedom. They are at risk if there is insufficient investment to maintain the franchises, effectively milking the businesses, or if the free cash flow is squandered on low-return acquisitions.

The importance of the environmental and social lenses is rising. The future of carbon in the world economy is unclear, leaving the risk of trapped assets, be they oil in the ground or combustion engine production lines in an auto factory. Given the shape of the portfolio, with minimal exposure to carbon, the larger threat is in the social area. This is not only the increasing volatility of politics – and the more robust regulation which accompanies it – but also the rise of social media, which means brands that have been built up over decades or centuries can be tarnished almost instantly. Given these threats, an ESG focus has become essential for long-term compounding.

"ESG [is] fully integrated into the investment process across all strategies"

Thinking robustly about ESG can therefore reduce risks, but it can also point to opportunities. This may be L'Oréal's focus on natural ingredients, giving it a competitive advantage with consumers, or the development of FlyKnit and FlyLeather by Nike, dramatically reducing waste and improving gross margins. Staying relevant to the consumer can bring market share gains. In addition, superior governance can drive gains, as in Accenture's enthusiastic adoption of the 'New,' helping companies with their digital transitions, which is now bearing fruit after several years of squeezing margin improvement. The partnership culture at Accenture meant that the company focused on the long-term opportunities rather than the short-term earnings.

"Our portfolios score well on independent ESG scores"

The team's ESG approach, like the rest of its investment process, is bottom-up and at the company level, focusing on material risks and opportunities that can affect the future returns of the companies in the portfolio. It includes access to the third-party ESG research and controversy reports from MSCI and Sustainalytics, which contribute to identifying and assessing the key ESG concerns that could undermine the long-term sustainability of a company's returns. This element is more useful than the actual ESG scores, which the team takes with a pinch of salt. That said, our portfolios score well relative to the benchmark on independent ESG scores. Equally, the engagement with corporates, including proxy voting, is undertaken by the team, with support from Morgan Stanley Investment Management's (MSIM) Global Stewardship Team.

The basis of the ESG analysis is to support returns, and thus compounding, rather than any moral stance. However, the team has recently launched the Global Sustain Strategy. This is based on the existing Global Quality Portfolio but offers a choice to investors by excluding several controversial sectors, notably tobacco, alcohol, weapons, gambling and fossil fuels.

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. 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. **Option writing strategy.** Writing call options involves the risk that the Portfolio may be required to sell the underlying security or instrument (or settle in cash an amount of equal value) at a disadvantageous price or below the market price of such underlying security or instrument, at the time the option is exercised. As the writer of a call option, the Portfolio forgoes, during the option's life, the opportunity to profit from increases in the market value of the underlying security or instrument covering the option above the sum of the premium and the exercise price, but retains the risk of loss should the price of the underlying security or instrument decline. Additionally, the Portfolio's call option writing strategy may not fully protect it against declines in the value of the market. There are special risks associated with uncovered option writing which expose the Portfolio to potentially significant loss.

DISTRIBUTION

This communication is only intended for and will only be distributed to persons resident in jurisdictions where such distribution or availability would not be contrary to local laws or regulations.

United Kingdom: Morgan Stanley Investment Management Limited is authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA. **Dubai:** Morgan Stanley Investment Management Limited (Representative Office, Unit Precinct 3-7th Floor-Unit 701 and 702, Level 7, Gate Precinct Building 3, Dubai International Financial Centre, Dubai, 506501, United Arab Emirates. Telephone: +97 (0)14 709 7158). **Germany:** Morgan Stanley Investment Management Limited Niederlassung Deutschland Junghofstrasse 13-15 60311 Frankfurt Deutschland (Gattung: Zweigniederlassung (FDI) gem. § 53b KWG). **Italy:** Morgan Stanley Investment Management Limited, Milan Branch (Sede Secondaria di Milano) is a branch of Morgan Stanley Investment Management Limited, a company registered in the UK, authorised and regulated by the Financial Conduct Authority (FCA), and whose registered office is at 25 Cabot Square, Canary Wharf, London, E14 4QA. Morgan Stanley Investment Management Limited Milan Branch (Sede Secondaria di Milano) with seat in Palazzo Serbelloni Corso Venezia, 16 20121 Milano, Italy, is registered in Italy with company number and VAT number 08829360968. **The Netherlands:** Morgan Stanley Investment Management, Rembrandt Tower, 11th Floor Amstelplein 1 1096HA, Netherlands. Telephone: 31 2-0462-1300. Morgan Stanley Investment Management is a branch office of Morgan Stanley Investment Management Limited. Morgan Stanley Investment Management Limited is authorised and regulated by the Financial Conduct Authority in the United Kingdom. **Switzerland:** Morgan Stanley & Co. International plc, London, Zurich Branch Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered with the Register of Commerce Zurich CHE-115.415.770. Registered Office: Beethovenstrasse 33, 8002 Zurich, Switzerland, Telephone +41 (0) 44 588 1000. Facsimile Fax: +41(0) 44 588 1074.

U.S.

A separately managed account may not be suitable for all investors. Separate accounts managed according to the Strategy include a number of securities and will not necessarily track the performance of any index. Please consider the investment objectives, risks and fees of the Strategy carefully before investing. A minimum asset level is required. For important information about the investment manager, please refer to Form ADV Part 2.

Please consider the investment objectives, risks, charges and expenses of the funds carefully before investing. The prospectuses contain this and other information about the funds. To obtain a prospectus please download one at morganstanley.com/im or call 1-800-548-7786. Please read the prospectus carefully before investing.

Morgan Stanley Distribution, Inc. serves as the distributor for Morgan Stanley funds.

NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A DEPOSIT

Hong Kong: This document has been issued by Morgan Stanley Asia Limited for use in Hong Kong and shall only be made available to "professional investors" as defined under the Securities and Futures Ordinance of Hong Kong (Cap 571). The contents of this document have not been reviewed nor approved by any regulatory authority including the Securities and Futures Commission in Hong Kong. Accordingly, save where an exemption is available under the relevant law, this document shall not be issued, circulated, distributed, directed at, or made available to, the public in Hong Kong. **Singapore:** This document should not be considered to be the subject of an invitation for subscription or purchase, whether directly or indirectly, to the public or any member of the public in Singapore other than (i) to an institutional investor under section 304 of the Securities and Futures Act, Chapter 289 of Singapore ("SFA"); (ii) to a "relevant person" (which includes an accredited investor) pursuant to section 305 of the SFA, and such distribution is in accordance with the conditions specified in section 305 of the SFA; or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. **Australia:** This publication is disseminated in Australia by Morgan Stanley Investment Management (Australia) Pty Limited ACN: 122040037, AFSL No. 314182, which accept responsibility for its contents. This publication, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act. **Japan:** For professional investors, this document is circulated or distributed for informational purposes only. For those who are not professional investors, this document is provided in relation to Morgan Stanley Investment Management (Japan) Co., Ltd. ("MSIMJ")'s business with respect to discretionary investment management agreements ("IMA") and investment advisory agreements ("IAA"). This is not for the purpose of a recommendation or solicitation of transactions or offers any particular financial instruments. Under an IMA, with respect to management of assets of a client, the client prescribes basic management policies in advance and commissions MSIMJ to make all investment decisions based on an analysis of the value, etc. of the securities, and MSIMJ accepts such commission. The client shall delegate to MSIMJ the authorities necessary for making investment. MSIMJ exercises the delegated authorities based on investment decisions of MSIMJ, and the client shall not make individual instructions. All investment profits and losses belong to the clients; principal is not guaranteed. Please consider the investment objectives and nature of risks before investing. As an investment advisory fee for an IAA or an IMA, the amount of assets subject to the contract multiplied by a certain rate (the upper limit is 2.16% per annum (including tax)) shall be incurred in proportion to the contract period. For some strategies, a contingency fee may be incurred in addition to the fee mentioned above. Indirect charges also may be incurred, such as brokerage commissions for incorporated securities. Since these charges and expenses are different depending on a contract and other factors, MSIMJ cannot present the rates, upper limits, etc. in advance. All clients should read the Documents Provided Prior to the Conclusion of a Contract carefully before executing an agreement. This document is disseminated in Japan by MSIMJ, Registered No. 410 (Director of Kanto Local Finance Bureau (Financial Instruments Firms)), Membership: The Investment Trusts Association, Japan, the Japan Investment Advisers Association and the Type II Financial Instruments Firms Association.

IMPORTANT INFORMATION

EMEA: This communication has been issued by Morgan Stanley Investment Management Limited ("MSIM"). Authorised and regulated by the Financial Conduct Authority. Registered in England No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA.

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market. Prior to investing, investors should carefully review the strategy's / product's relevant offering document. There are important differences in how the strategy is carried out in each of the investment vehicles.

A separately managed account may not be suitable for all investors. Separate accounts managed according to the Strategy include a number of securities and will not necessarily track the performance of any index. Please consider the investment objectives, risks and fees of the Strategy carefully before investing.

This material is a general communication, which is not impartial and has been prepared solely for informational and educational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The information herein has not been based on a consideration of any individual investor circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.

Except as otherwise indicated herein, the views and opinions expressed herein are those of the portfolio management team, are based on matters as they exist as of the date of preparation and not as of any future date, and will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date hereof.

Forecasts and/or estimates provided herein are subject to change and may not actually come to pass. Information regarding expected market returns and market outlooks is based on the research, analysis and opinions of the authors. These conclusions are speculative in nature, may not come to pass and are not intended to predict the future performance of any specific Morgan Stanley Investment Management product.

MSIM has not authorised financial intermediaries to use and to distribute this document, unless such use and distribution is made in accordance with applicable law and regulation. Additionally, financial intermediaries are required to satisfy themselves that the information in this document is suitable for any person to whom they provide this document in view of that person's circumstances and purpose. MSIM shall not be liable for, and accepts no liability for, the use or misuse of this document by any such financial intermediary.

Explore our site at **www.morganstanley.com/im**