

# An Emerging Markets Approach to ESG: Our Progress

ACTIVE FUNDAMENTAL EQUITY | GLOBAL EMERGING MARKETS TEAM | 2019

Our Portfolio Managers believe ESG factors matter for company results and will exclude a company based on our assessment of material ESG risks and how the company is handling them. Our ESG process is truly integrated—and the final decision makers, the portfolio managers, lead the engagements.

We provide a high level of transparency into our ESG process with detailed tracking of our engagements. We believe integrating information about ESG issues into our investment process makes us better investors and is consistent with our approach as long term, growth managers in the emerging markets.



## ESG Integration into Our Investment Process

As fundamental investors we seek out areas of growth and opportunity which we believe will last for the next 3 to 5 years and sustainable, well-run businesses which can capitalize on these trends. Our research process considers environmental, social and governance issues that confront policymakers and company management, because they matter for sustainable growth. Information we gather about the environmental, social and governance issues faced by both country policymakers and company management teams helps us build a more complete picture of these investment opportunities and the potential risks involved. ESG is integrated throughout our investment process at both the company engagement level as well as in our top-down country analysis.

Our investment process integrates ESG analysis in a simple and repeatable way: identifying and assessing material issues and engaging company management on these issues.

## AUTHORS

GLOBAL EMERGING MARKETS TEAM

“ESG is integrated in our investment process in a simple and repeatable way.”

## Our Active Ownership Approach

Identify and Assess Material ESG Issues

Engage Company on Key ESG Issues

Actively Vote Proxies

- **MITIGATE RISKS, RECOGNIZE OPPORTUNITIES**
- **IDENTIFY QUALITY COMPANIES**
- **ENGAGE MANAGEMENT FOR BETTER CORPORATE BEHAVIOR**

**IDENTIFY AND ASSESS MATERIAL ESG ISSUES:** We identify the issues that are most material to the health of the business we are analyzing. We look by industry at the issues most directly linked to key business drivers for each company—for example resource efficiency in heavy industries, working conditions in labor intensive sectors, and talent attraction and retention in intellectual property based industries.

We have access to several different ESG resources, which help our understanding of the key ESG issues, including the Morgan Stanley Institute for Sustainable Investing, MSCI ESG ratings and research and sell-side ESG research, and the company's own disclosure on corporate social responsibility. While we draw on these external resources, rather than simply relying on a third-party rating, we focus on understanding the issues raised by these providers

and conducting our own analysis on these issues and the companies' accompanying strategy. We ultimately form our own independent judgment based on our analysis and engagement with management.

**ENGAGE WITH COMPANIES:** Our portfolio managers travel widely meeting with company management as part of our due diligence process. During these meetings we engage management with questions on the most pressing ESG issues facing their business. These conversations often give us information we need to focus on and dig deeper in later meetings. Over time, we have found increasing management interest in ESG issues, especially when ESG can be tied directly to the company's financial outlook. We also support good corporate governance through proxy voting and will vote against board recommendations we do not perceive to be in the best interests of shareholders.

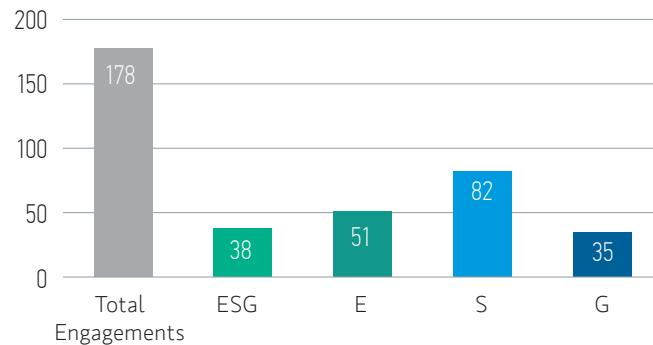
**TOP-DOWN COUNTRY ANALYSIS:** ESG factors are deeply embedded in Our Rules of the Road framework for identifying economies with a promising growth trajectory. The rules assist in measuring balance across the cycles—from politics to credit, investment and market sentiment—that shape economic growth. ESG factors can and do play an important role in tipping these balances.

As long-term investors, we firmly believe that a strong system for monitoring ESG in emerging markets helps us stay alert to the risks and opportunities of our company holdings for the long haul.

In an effort to increase transparency on our ESG integration progress, below are the engagement statistics for our team over the past year.

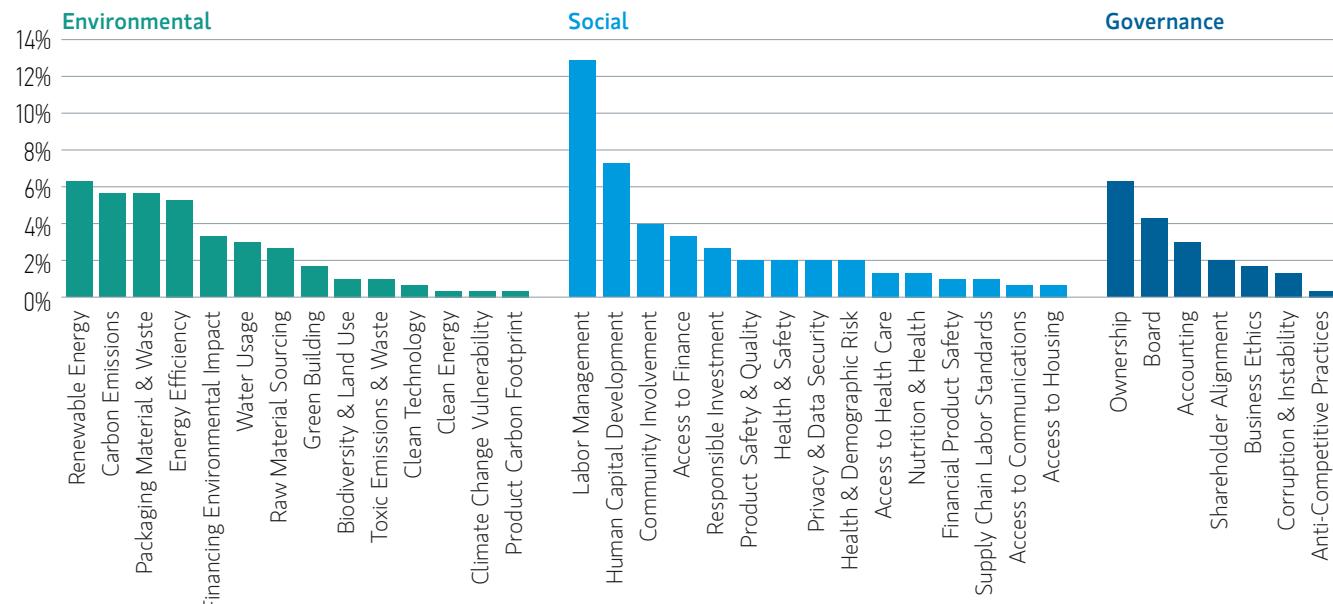
### Engagements Statistics and Breakdown (January 1, 2018 – December 31, 2018)

Of the total 424 documented meetings during this time period, the Emerging Markets Equity team engaged with companies on ESG issues in 178 meetings. This represents 42% of the total.



There were a total of 178 engagements. The above includes overlap if one or more topics were discussed in the same company engagement. Documented meetings are defined as meetings in which the portfolio manager or analyst wrote a note.

### Engagements by Key Issue\*



\*Engagements by key issue are represented as a percentage of total engagements and may include two or more topics discussed in one meeting.

## Engagement Examples

Below are examples of our engagements with management on E, S and G issues. In each case, we have asked about the key issue we feel most affects the company and taken note of their responses. Our ESG analysis helps us mainly to understand company risks and business model sustainability. It can also help us understand the opportunities for companies in terms of branding, product segmentation and customer perception.

COMPANY	ISSUE	ENGAGEMENT DETAILS
<b>ENVIRONMENT</b>		
<b>Largest brewer in Latin America</b> <i>August 2018</i>	Packaging Material & Waste	We discussed recycling of bottles with the company, asking if could lead to potential cost savings and opportunities. Management stated one of their main initiatives is to improve its returnable glass bottle penetration. Currently roughly 50% of its global volumes are in returnable glass bottles, and it believes it can increase this number specifically in Brazil. Management believes this not only has obvious environmental benefits, but is very positive for the business.
<b>MULTI-FORMAT RETAILER IN MEXICO WITH PRESENCE ACROSS CENTRAL AMERICA</b> <i>August 2018</i>		
<b>Multi-format retailer in Mexico with presence across Central America</b> <i>August 2018</i>	Carbon Emissions, Renewable Energy	A key issue for this retailer is carbon emissions, which we engaged the company on. We discussed the company's goals of reducing greenhouse gases by 18% by 2025. They are a leader in renewable energy; currently 91% of their units in Mexico are supplied with renewable energy. There were recent electricity tariff increases in Mexico, but since the company has already been moving toward renewables, the company now has a competitive advantage on costs. This is an example where good ESG management can actually lead to opportunity. We will continue to engage with them on their progress toward greenhouse gas reduction in future meetings.
<b>SOCIAL</b>		
<b>Integrated state-owned Brazilian oil company</b> <i>May 2018</i>	Health & Safety	A main concern remains safety. We continue to engage with them on their safety record each time we meet with management. Safety continues to be a top priority and the company has reached its target of 1 accident per 1 million work hours, two years ahead of target. We also engaged on corporate governance and renewable energy.
<b>Leading bank in Hungary with presence across Eastern Europe</b> <i>September 2018</i>	Privacy and Data Security	We asked management about privacy and data security as there was a recent cybersecurity breach that hit the bottom line. The bank has spent significant capex to ensure data security, recently employing a third party to provide secure digital payments and risk management solutions. Management is trying to deliver increased openness while ensuring the highest levels of privacy and data protection for their clients.
<b>Non-Banking Financial Company in India with exposure to infrastructure, housing and rural</b> <i>June 2018</i>	Labor Management, Financing Environmental Impact	Attrition is critical to a company highly dependent on the work force. We engaged with management on the company's labor practices including company culture and morale, leadership programs, talent pipelines and board diversity and composition, salary and incentive structures. We also asked about whether they are looking for impact financing projects. The bank is funding two big projects on water management and rain water harvesting, and are focusing on providing long-term innovative solutions benefitting the water-deprived communities in rural India.
<b>GOVERNANCE</b>		
<b>Chilean bank</b> <i>September 2018</i>	Corruption and Instability	Cybersecurity, fraud and money laundering is addressed at the board level. The bank has a dedicated unit within their commercial areas to monitor cybersecurity and fraud, and these are overseen by the risk and auditing units. The bank's money laundering controls have received recognition from U.S. authorities.
<b>Philippines bank</b> <i>January 2018</i>	Corruption and Instability	A main issue for banks is corruption and instability. In order to help alleviate this, management rotates relationship managers across customer accounts to prevent fraud. They are also implementing tighter controls and have hired a third party to conduct a full review of operational risk framework and processes. They have a strong whistleblower policy that requires the CEO to receive reports.
<b>Convenience store operator in Thailand</b> <i>September 2018</i>	Accounting	The company has set up a corporate governance committee headed by an independent director. Management has shown that despite concerns on their high debt levels, they consistently pay down debt and have lowered their net debt/equity ratio.



## Proxy Voting

During the time period January 1, 2018 – December 31, 2018 we voted against management on 271 agenda items, representing 11% of the total 2448 agenda items, in our Global Emerging Markets Equity portfolio.

## Proxy Voting Examples

1. **COMMERCIAL BANK IN INDONESIA:** Voted against approving remuneration and tenure of directors and commissioners because disclosure was limited and, in our view, needs to improve.
2. **LARGEST BANK IN HUNGARY:** Voted against authorizing a share repurchase program because the repurchase limit of 25% of the company's share capital is excessive. We prefer a dividend issuance instead of a share buyback.
3. **PROPERTY DEVELOPER IN THE PHILIPPINES:** Voted against director nominees that served on multiple boards and were considered over-boarded.
4. **PRIVATE BANK IN MALAYSIA:** Voted against the approval of director remuneration as the average director fee in 2017 was already a 27% increase from the previous year. The proposed director fees were considered significantly higher than those of its peers.
5. **DAIRY MANUFACTURER IN CHINA:** Voted against the issuance of equity or equity-linked securities without preemptive rights because the issue price discount was not disclosed.
6. **FOOD RETAILER IN RUSSIA:** Voted against the approval of remuneration for the supervisory board because based on 2017 practices and amount granted, the proposed non-executive remuneration appears excessive in relation to both Dutch and Russian market practices.
7. **LEADING PHARMACEUTICAL COMPANY IN CHINA:** Voted against the approval of issuance of equity or equity-linked securities without preemptive rights because of excessive issuance and the failure to disclose the price discount. Voted against grant of options under their share option scheme because it included a 9% dilution and a provision that provides for accelerated vesting if the company changes control.
8. **INTEGRATED OIL AND GAS COMPANY IN CHINA:** Voted against a provision of guarantee and relevant authorizations because the company would be taking in a disproportionate amount of risk relative to its ownership stake without compelling justification.
9. **TRAVEL LUGGAGE COMPANY:** Voted against the approval of restricted share units pursuant to the share award scheme as we believe stock options are a better way to reward management. The administrators of the scheme have to be different from the directors or the terms of the scheme should be approved by shareholders and tied to targets on revenue, ROI, profit and cash flow productivity.
10. **SOUTH AFRICAN HOLDING COMPANY:** Voted against director nominees considered over-boarded and against re-electing audit committee members who attended less than 75% of meetings held by the board and committees in the fiscal year.

## Exhibit

Examples of key issues we consider and questions we ask when engaging with companies

INDUSTRY	KEY ISSUES	KEY QUESTIONS
<b>Retail, Textiles &amp; Luxury Goods</b>	Labor Management Supply Chain Standards	What employee management programs are in place to incentivize loyalty and to encourage professional development?
<b>Banks &amp; Insurance</b>	Access to Finance Privacy & Data Security Responsible Lending	What are your efforts toward expanding financial inclusion measures in the markets you operate? What steps are taken to improve access to finance? What are practices in place to mitigate risks related to data privacy and security? What is your greatest exposure to regulatory risk? What are the controls and practices to prevent ethical breaches? Do you lend to carbon intensive industries? How do you price risk in loans that have high environmental, social or governance risk?
<b>Oil &amp; Gas</b>	Toxic Emissions & Waste Employee Safety	How do you ensure your chemical usage is keeping in compliance with changes in regulatory and reformulation costs? How does the company aim to reduce the environmental footprint (emissions) of its products? How do you manage labor relations and what are your practices to engage with labor including employee health and safety? What safety goals have been put in place? How does the board value employee safety? Do they receive regular updates and reports on safety targets? What steps are taken to protect existing biodiversity of the land/environment that the company's operations take place on?
<b>Internet, Mobile &amp; Social Media</b>	Privacy & Data Security	Are employees trained on cybersecurity and how to handle privacy and data issues? How well is the company prepared to handle a breach of customer data? What data protections and oversight practices are in place at your subsidiaries and third-party service providers? What is the company's strategy to avoid anticompetitive behavior?

## 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. Accordingly, you can lose money investing. ESG Strategies that incorporate impact investing and/or Environmental, Social and Governance (ESG) factors could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. As a result, there is no assurance ESG strategies could result in more favorable investment performance. Please be aware that this portfolio may be subject to certain additional risks. In general, **equities securities'** values also fluctuate in response to activities specific to a company. Investments in

**foreign markets** entail special risks such as currency, political, economic, market and liquidity risks. The risks of investing in **emerging market countries** are greater than the risks generally associated with investments in foreign developed countries. **Stocks of small- and medium-capitalization companies** entail special risks, such as limited product lines, markets, and financial resources, and greater market volatility than securities of larger, more-established companies. **Derivative instruments** can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the Portfolio's performance. **Illiquid securities** may be more difficult to sell and value than public traded securities (liquidity risk). **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.

## DEFINITIONS

**"ESG" investment:** Environmental Social and Governance based investment is an investment approach which takes explicit account of the environmental, social and corporate governance aspects of all proposed investments. The **MSCI Emerging Markets Index (MSCI EM)** is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of emerging markets.

## IMPORTANT DISCLOSURES

The views and opinions are those of the author as of the date of publication and are subject to change at any time due to market or economic conditions and may not necessarily come to pass. Furthermore, the views will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date of publication. The views expressed do not reflect the opinions of all portfolio managers at Morgan Stanley Investment Management (MSIM) or the views of the firm as a whole, and may not be reflected in all the strategies and products that the Firm offers.

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 MSIM product.

Certain information herein is based on data obtained from third party sources believed to be reliable. However, we have not verified this information, and we make no representations whatsoever as to its accuracy or completeness.

The information herein is a general communications which is not impartial and has been prepared solely for information 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 material contained herein has not been based on a consideration of any individual client 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.

This communication is not a product of Morgan Stanley's Research Department and should not be regarded as a research recommendation. The information contained herein has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.

## 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.**

**Ireland:** Morgan Stanley Investment Management (Ireland) Limited. Registered Office: The Observatory, 7-11 Sir John Rogerson's, Quay, Dublin 2, Ireland. Registered in Ireland under company number 616662. Regulated by the Central Bank of Ireland. **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, authorised and regulated by the Financial Conduct Authority. **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 11096HA, 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](http://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 BANK 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. This material has not been reviewed by the Monetary Authority of Singapore. **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 Japan Securities Dealers Association, The Investment Trusts Association, Japan, the Japan Investment Advisers Association and the Type II Financial Instruments Firms Association.

#### **IMPORTANT INFORMATION**

**EMEA:** This marketing communication has been issued by Morgan Stanley Investment Management (Ireland) Limited. Registered Office: The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, Ireland. Registered in Ireland under company number 616662. Authorised and regulated by Central Bank of Ireland. ("MSIM Ireland").

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.

Charts and graphs provided herein are for illustrative purposes only. Past performance is no guarantee of future results.

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.

This document may be translated into other languages. Where such a translation is made this English version remains definitive. If there are any discrepancies between the English version and any version of this document in another language, the English version shall prevail.

The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without MSIM's express written consent. All information contained herein is proprietary and is protected under copyright law.

Morgan Stanley Investment Management is the asset management division of Morgan Stanley.

Explore our site at [www.morganstanley.com/im](http://www.morganstanley.com/im)