Morgan Stanley

INSTITUTE FOR SUSTAINABLE INVESTING

An Emerging Trend for Investors to Consider Sustainable Improvers

Driving Financial Performance Alongside Long-Term Environmental or Social Change

SEPTEMBER 2024

1 Some Recent Fund Launches Consider Sustainable Improvers

Some recent sustainable fund launches are beginning to consider a sustainable improvers approach to portfolio construction, seeking out assets that are not considered sustainable today but show clear potential for change. As positive real-world changes play out, strengthening financials and/or valuation could also drive a conventional investment opportunity. An improvers thesis could apply to a range of different sectors, and include topics such as supply chain issues, manufacturing processes, governance structures or moving away from unsustainable products such as fossil fuels.

2 Attitudes to Traditional Energy Companies May Be Evolving

Energy sector holdings in sustainable funds have fallen over the past five years, driven by demand for low-carbon portfolios. But a January 2024 Sustainable Signals global survey of individual investors from the Institute for Sustainable Investing suggests that investor attitudes could change if strong transition plans are developed. Furthermore, analysis of a small, but growing, number of dedicated improver funds shows most have one traditional energy company in their top ten holdings.

3 Building Refurbishments Can Offer Both Financial and Sustainability Benefits

Operating buildings accounts for more than a quarter of primary energy demand, making Real Estate an important sector for decarbonization. Building renovations can reduce environmental impact while also driving lower running costs and higher asset values, meaning that tenants, owners and lenders can see both sustainability and financial benefits. Sustainable property funds treat refurbishments alongside assets with strong current green credentials, although dedicated improver funds seems less engaged with real estate improvements than specialist property funds.

4 Establishing Credibility is Key to Growing Both Supply and Demand

Corporate disclosures on sustainability topics have already increased significantly, building a more detailed picture of a company’s current sustainability performance. Sustainable investors have a growing number of tools at their disposal when assessing future potential, such as considering sustainability-related CapEx and R&D. Establishing forward-looking frameworks for sustainability topics to support investor confidence in future sustainability trajectories is key to further adoption of an improvers approach.

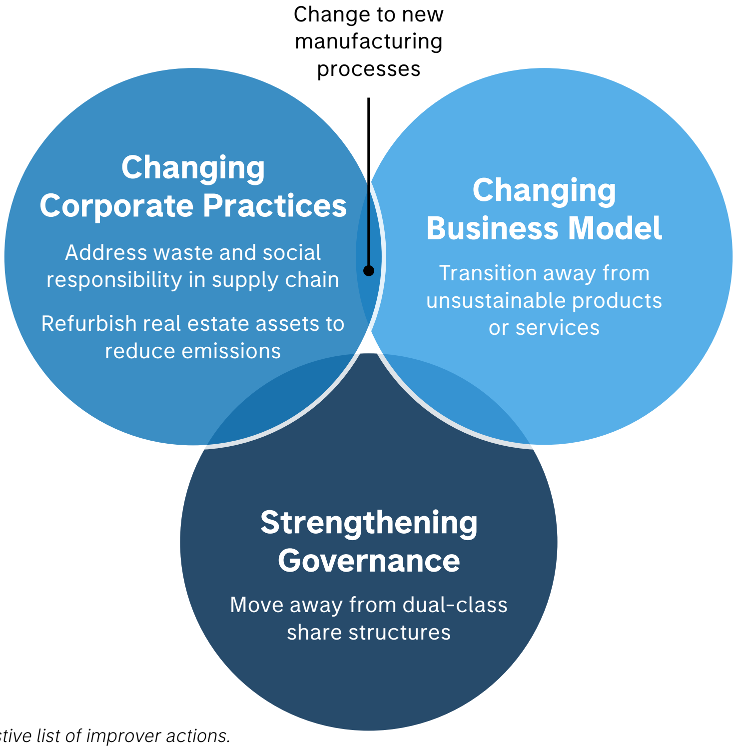
Some Recent Fund Launches Consider Sustainable Improvers

Sustainable improvers[1] are companies or assets that may not be considered sustainable today but have the potential to drive long-term environmental and/or social change. Strengthening financial performance or valuation could also drive a traditional investment opportunity alongside sustainability benefits. While many investors may still prefer to own companies with strong existing sustainability performance, new fund launches combine the two and others focus specifically on sustainable improvers.

Sustainable improvers could include a clothing company reducing waste and improving social responsibility in its supply chain, a company resolving common governance concerns such as dual-class share structures or an energy company reducing its fossil fuel exposure. Morgan Stanley Research calls these companies in transition "Sparks"[2] within listed equities, but the concept can apply across public and private market instruments.

FIGURE 1

Sustainable improvers may be changing corporate practices, transitioning their business model or strengthening governance



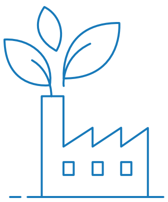
Illustrative examples; not exhaustive list of improver actions.

Source: Morgan Stanley Institute for Sustainable Investing

[1] Sustainable improvers may include, but are not limited to, the U.K.'s Sustainability Improvers label. See page 7 for more detail on this label.

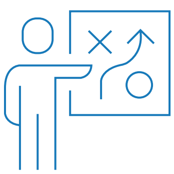
[2] Sustainability: Sustainable Stock Ideas in the Americas: 2Q24 Edition (May 9, 2024); For a copy, please reach out to your Morgan Stanley representative.

Why Might Investors Consider Sustainable Improvers?



1 Incentivize companies to make long-term investments in green innovation

Making sustainability improvements can be very capital intensive. In our May 2024 "Sustainable Signals" survey of 303 large companies, the high level of investments required was the top barrier to companies delivering on their sustainability strategies. Considering forward-looking metrics such as capital expenditures (CapEx) and research and development (R&D) as part of a sustainable improvers investment strategy could encourage companies to make the investments needed. Morgan Stanley Research uses a threshold of >20% of current-year CapEx exposed to sustainability themes as one of its metrics for defining companies as improvers, or what they consider "Sparks."



2 Investor engagement can shape strategy

The U.K. Financial Conduct Authority (FCA)'s recently published requirements for the "Improver" label note that, "Stewardship plays an important role in this category. Firms' investor stewardship category should support delivery of the objective and therefore help to accelerate improvements in environmental and/or social sustainability."[3] Investor engagement could help to drive change, for example with global clothing companies, of which two thirds do not have a program to reuse or recycle unsold goods in order to avoid destroying them.[4]

3 Improving sustainability characteristics can be an attractive investment opportunity

Companies or assets considered sustainable improvers could be a source of investment outperformance as the market recognizes their strengthened environmental, social and governance (ESG) characteristics. Some companies and industries are beginning to reflect business model changes in forecasted financials, even if reported financials still reflect the status quo. If credibility is established over time, some improver trajectories may result in strengthened financial metrics such as growth or profitability, while others could drive higher valuation or crystallize uncertainty that may have been depressing asset prices.

[3] FCA November 2023 PS23/16: Sustainability Disclosure Requirements (SDR) and investment labels (fca.org.uk)

[4] Fast on fashion, slow on sustainability: Clothing companies and the circular economy | S&P Global (spglobal.com), Mar. 16, 2023

Institutional Investors Say They Are Interested in Sustainable Improvers

In our 2024 “Sustainable Signals” survey of 901 global asset managers and asset owners, 79% of asset owners and 77% of asset managers said they were interested in pursuing a sustainable improvers strategy. This is a relatively new development, with 79% and 78% respectively describing their improvers approach as being at an early stage.

For those interested in sustainable improvers, their motivation includes the potential for financial outperformance (87% strongly/somewhat agree) as well as progress on ESG themes (81% strongly/somewhat agree).

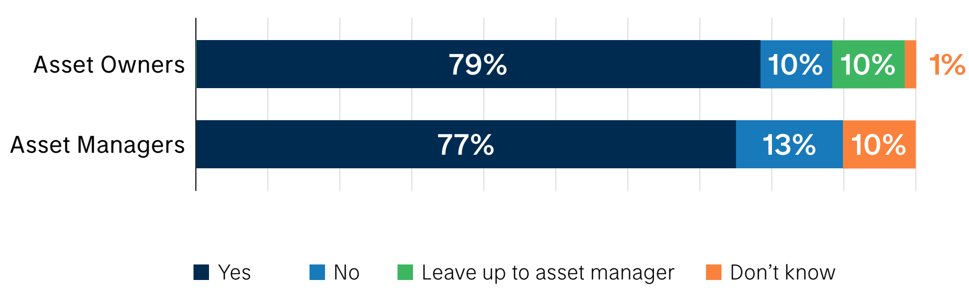
For those not interested in sustainable improvers, accounting for 10% of asset owners and 13% of asset managers, the main reason cited was that they prefer to own assets with strong current sustainability performance (54% strongly/somewhat agree), ahead of concerns around financial outperformance, progress on sustainability objectives, a lack of investments and a lack of trust in corporate disclosures.

> “Morgan Stanley Research highlights the valuation benefits that can come from reducing carbon intensity, particularly for high-emitting companies.[5] Across the firm, we increasingly hear from asset managers and asset owners that they see alpha in the transition from brown to green activities as well as the opportunity to drive positive change.”
>
> **Matthew Slovik**
> Head of Global Sustainable Finance
> Morgan Stanley

FIGURE 2

Almost 80% of institutional investors are interested in pursuing a sustainable improver strategy

Are you interested in pursuing a “sustainable improver” investment strategy?



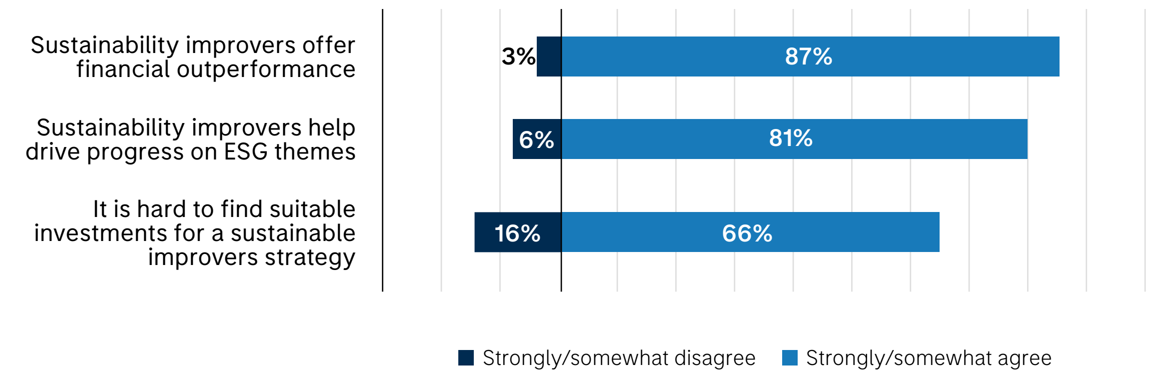
Source: Morgan Stanley Institute for Sustainable Investing Sustainable Signals survey, 2024

[5] Morgan Stanley Research, Impact of Carbon Emissions on Company Valuations (Oct. 26, 2023); For a copy, please reach out to your Morgan Stanley representative; “Alpha” is the excess return of an investment relative to the return of a benchmark.

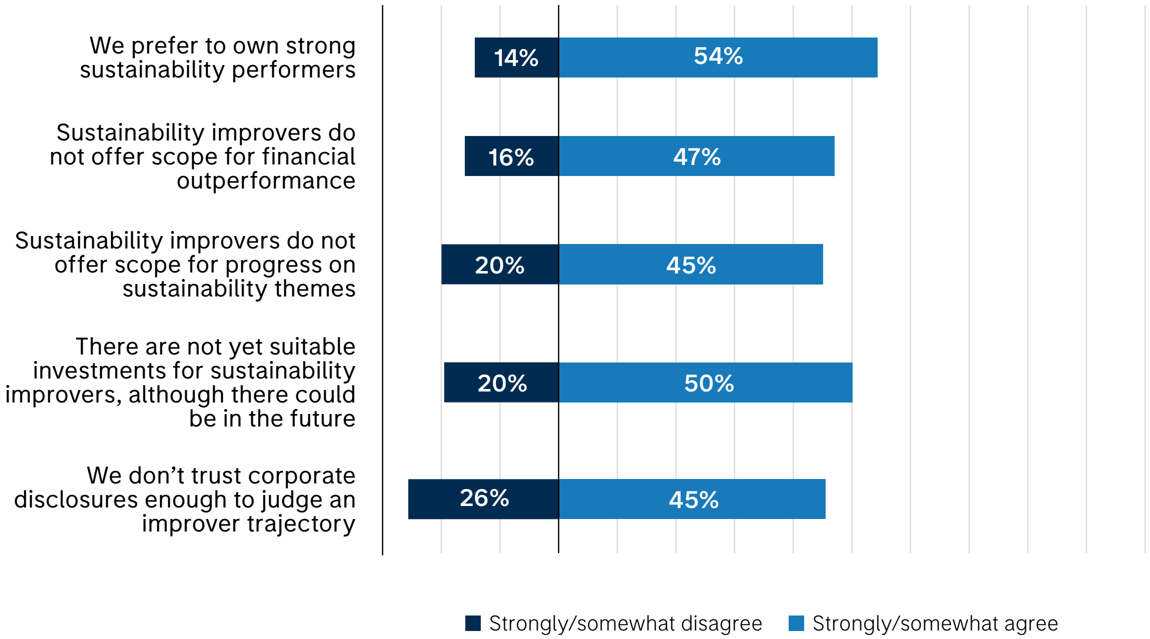
FIGURE 3

Financial outperformance is the top reason to explore sustainable improvers, while those not interested say they mostly prefer to own current strong performers

You answered that you ***are*** interested in pursuing a sustainability improver strategy. Please indicate your view on the following statements



You answered that you ***are not*** interested in pursuing a sustainability improver strategy. Please indicate your view on the following statements



Source: Morgan Stanley Institute for Sustainable Investing Sustainable Signals survey, 2024

Integrating Sustainable Improvers into Investment Objectives

Approaches to sustainable improvers are still relatively new to the sustainable fund universe. Since the start of 2023, some new fund launches have started to integrate improvers strategies into their investment objectives in three ways:

1 Dedicated Sustainable Improvers Funds

The current small number of dedicated improvers funds typically focus on the alpha generation opportunity in overlooked or underappreciated ESG improver stories.

2 Energy/Climate Transition Funds

Transition funds are more established, often focusing on clean energy investments that could already be considered sustainable, but some new fund launches explicitly include carbon-intensive sectors in their potential investment universe.

3 Broader Sustainability Funds

Some new funds are launching with mandates that include the ability to consider a company's future sustainability credentials as well as its current ones.

Regulators are beginning to give some guidance to investors about how sustainable improvers fit in to sustainable fund classifications.

- In November 2023, **the U.K's FCA developed an improvers fund label**, which states that such products have a "sustainability objective consistent with an aim to invest at least 70% in assets that have the potential to improve environmental and/or social sustainability over time."[6]
- In May 2024, the **European Securities and Markets Authority (ESMA) issued guidance on fund naming,** which includes transition-related terms. In a departure from prior commentary, ESMA now states that funds under its jurisdiction using transition-related terms such as "improving" do not have to exclude fossil-fuel related activities as long as fund managers demonstrate that the investments are on a "clear and measurable path to social or environmental transition."[7]
- In June 2024, alongside an ongoing review of the European Sustainable Finance Disclosure Regulation (SFDR) by the European Commission, the **three European Supervisory Authorities (ESA), including ESMA, published a joint opinion** on the SFDR framework. One of the ESA's recommendations is the use of a "Transition" category.

[6] FCA November 2023 PS23/16: Sustainability Disclosure Requirements (SDR) and investment labels (fca.org.uk)

[7] ESMA Guidelines establish harmonised criteria for use of ESG and sustainability terms in fund names (europa.eu). ESMA does not have jurisdiction over the SFDR Article 8 and Article 9 definitions, which do not currently give explicit guidance on transition or improver strategies.

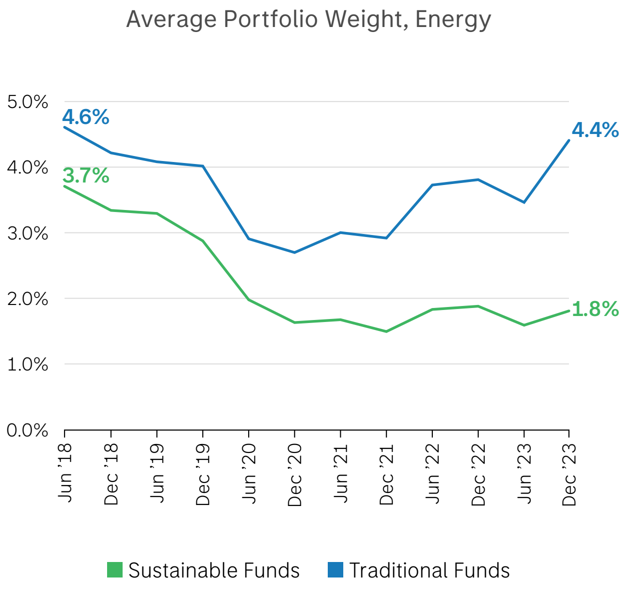
Investor Attitudes Toward Traditional Energy Companies May Be Evolving

Sustainable funds cut their exposure to traditional energy companies by more than half between 2018 and 2023. This was driven by demand for low-carbon portfolios. However, both individual and institutional investors appear open to investments in traditional energy companies if there is a robust climate transition plan in place. Some dedicated improver funds already offer exposure.

Since 2018, sustainable funds' exposure to the energy sector has dropped from 3.7% to 1.8%, less than half that of traditional funds (Figure 4). This decrease was driven by demand for low-carbon portfolios. Over $7 trillion, or 13% of global AUM, is now in funds that apply a pre-defined revenue threshold to screen out exposure to thermal coal, with more than $5 trillion (10% of global AUM) in funds that use the same approach to screen out other fossil fuels such as oil and gas (Figure 5). Nearly all of this is in Europe-domiciled funds, where funds excluding thermal coal account for 43% of Europe AUM and those excluding other fossil fuels account for 27% of Europe AUM.

FIGURE 4

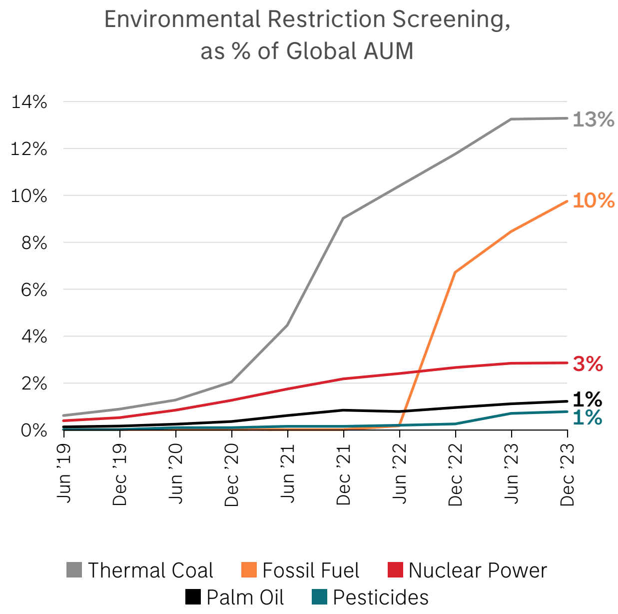
Sustainable funds' relative exposure to Energy is now less than half that of traditional funds[8]



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar, 2024

FIGURE 5

Thermal coal is the most widely used environmental restriction screen, followed by fossil fuels



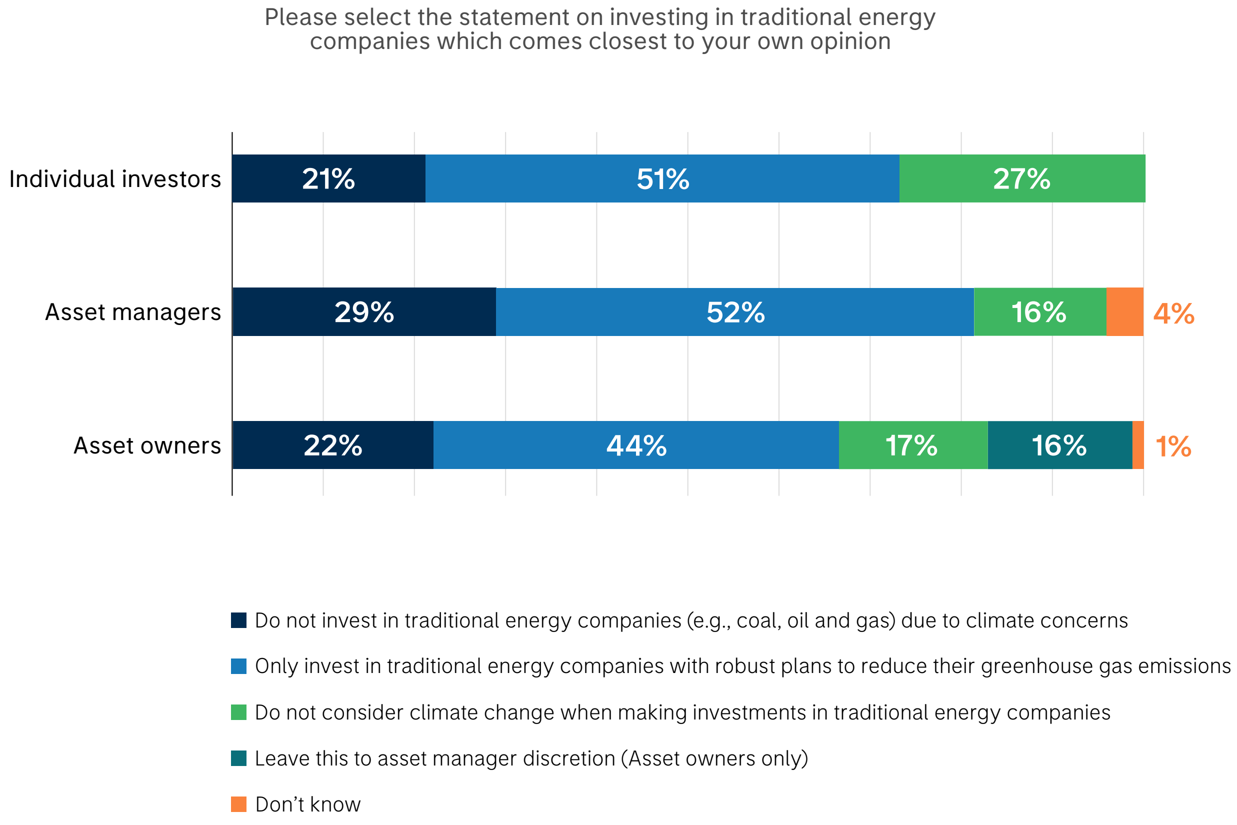
Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar, 2024

[8] Sustainable and traditional funds reflect Morningstar's "Sustainable" fund classification, as used in the Institute for Sustainable Investing's Sustainable Reality series. For more detail, see Sustainable Funds Outperform: Year-End 2023 | Morgan Stanley, Feb. 29, 2024.

Yet findings from two 2024 “Sustainable Signals” surveys conducted by the Institute for Sustainable Investing suggest that investor preferences and views could be evolving. More than half of individual investors and asset managers would consider traditional energy companies for their portfolio if the company had “robust” plans to reduce emissions and address climate change (Figure 6).

FIGURE 6

The majority of investors would consider traditional energy companies with “robust” transition plans for their portfolios



Source: Morgan Stanley Institute for Sustainable Investing Sustainable Signals surveys, 2024[9]

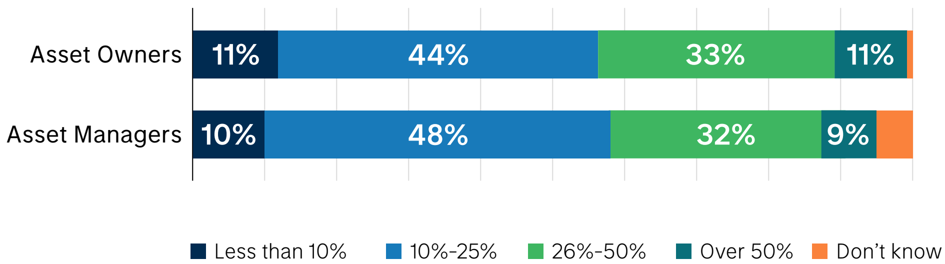
[9] The individual investor survey asked 2,820 individual investors in the U.S., Europe and Japan a variety of questions about attitudes toward sustainable investing. The survey was conducted in October 2023. The institutional investor survey asked 901 asset owners and asset managers in North America, Europe and APAC a variety of questions about attitudes and practices toward sustainable investing. The survey was conducted in July and August 2024.

Many individual investors' interest in traditional energy companies is contingent on those companies having a robust climate transition plan in place. However, the definition of a "robust" transition plan is far from clear and is likely to vary with institutional investors' broader investment philosophies as well as each firm's—or even each fund manager's—detailed views on the usefulness and credibility of technologies like carbon capture, utilization and storage (CCUS), the need for energy companies to diversify their business models or phase-outs of high-emitting assets.

FIGURE 7

Investor views vary widely on what proportion of traditional energy companies have robust transition plans

What proportion of traditional energy companies do you see as having robust plans to reduce their greenhouse gas emissions?



Source: Morgan Stanley Institute for Sustainable Investing Sustainable Signals survey, 2024

How Sustainable Funds are Approaching Improvers in the Energy Sector

Dedicated sustainable improvers funds:

As of September 2024, there is a small group of dedicated funds holding one traditional energy company within their top ten holdings with broad overall sector exposure.

Broader sustainable funds:

Some consider a company's environmental metrics such as greenhouse gas emissions against its industry peers (i.e., benchmarking performance within the relevant sector), and/or focus on fund-level emissions reduction over time. Both are a departure from the more mainstream approach where company metrics are compared across all sectors. Others articulate specific carve-outs from exclusionary policies, such as allowing investments in companies with explicit phase-out plans for activities that would otherwise put the company out of scope.

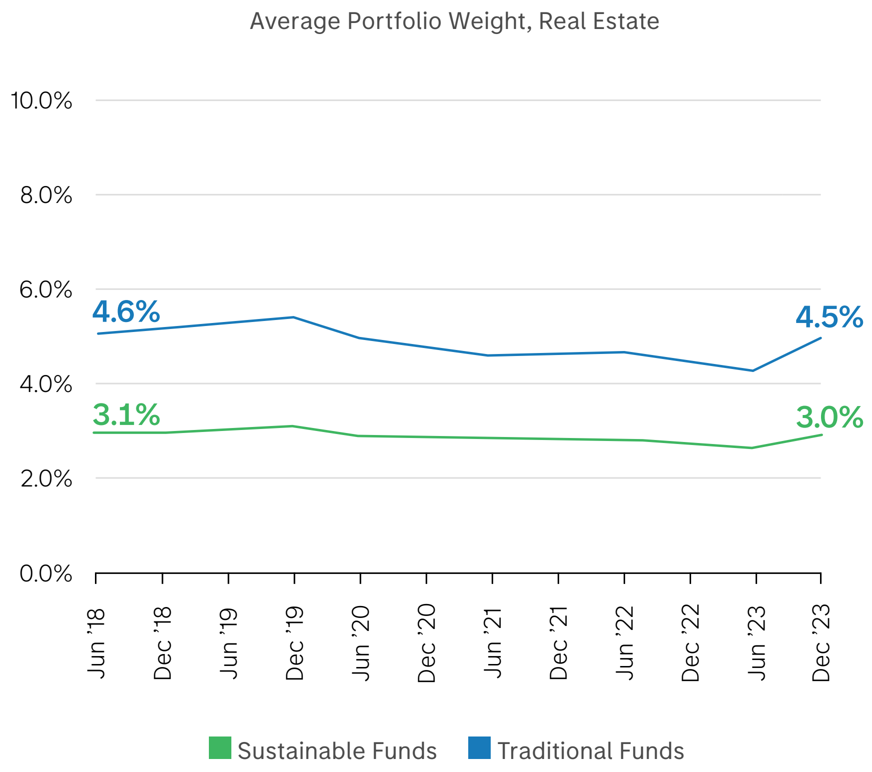
Building Renovations Can Offer Both Financial and Sustainability Benefits

Real Estate has been a relative underweight in sustainable equity funds for some time. However, building renovations can reduce environmental impact, driving lower running costs and higher asset values that bring both sustainability and financial benefits for tenants, owners and lenders. Sustainable property funds seek out refurbishments alongside current strong sustainability performers, although dedicated improvers funds seem less engaged with the theme today.

Real Estate has not historically been a major focus for sustainability funds. While it has not been covered by new exclusionary policies in the way that Energy has, the average portfolio weight of Real Estate within equity funds for the past five years has been around 3.0% compared to around 4.5% for traditional funds.

FIGURE 8

Historically, Real Estate exposure in sustainable equity funds has been lower than in traditional funds[10]



Source: Institute for Sustainable Investing analysis of Morningstar data

[10] Sustainable and traditional funds reflect Morningstar's sustainable fund classification, as used in the Institute for Sustainable Investing's Sustainable Reality series. For more detail, see Sustainable Funds Outperform: Year-End 2023 | Morgan Stanley, Feb. 29, 2024.

Buildings operations account for 30% of global final energy consumption, and many countries are increasing energy performance requirements for both new and existing buildings in order to reduce these emissions over time.[11] Morgan Stanley Research sees potential for a $2.8 trillion investment in renovation by 2030, and details how renovation can provide a broad range of both financial and sustainability benefits (see Figure 9).[12]

FIGURE 9

Building refurbishments can have both financial and sustainability benefits for tenants, owners and lenders

	Building and Construction Companies	Building Tenant / Operator	Building Owner	Lender / Finance Provider
Financial benefit	Increased demand for insulation and other supplies	Reduced operating costs	Increased / protected asset value; improved access to capital; rental premium	Stronger collateral; attractive yield
Sustainability benefit	Growth in green area of business	Lower scope 2 emissions	Lower scope 3 emissions	Lower financed emissions

Source: Institute for Sustainable Investing

"Building operations and construction account for around 40% of global energy related CO_2 emissions and 75% of the EU building stock is energy inefficient, so retrofitting buildings is a major environmental necessity. This endeavor requires significant involvement of private capital beyond traditional bank financing that is capacity constrained. We see this creating an attractive yield opportunity for targeted private credit contractually tied to sustainability performance improvements."

Claus Vinge Skrumsager
Head of North Haven Secured Private Credit
Morgan Stanley Investment Management

[11] Buildings - Energy System - IEA

[12] Morgan Stanley Research, Building & Construction: Energy renovation: A long-term theme, just getting started (Mar. 11, 2024); For a copy, please reach out to your Morgan Stanley representative.

How Sustainable Funds are Approaching Improvers in Real Estate

Real Estate securities aren't featured highly among the top holdings of dedicated "sustainable improver" funds. However, looking at both direct and indirect property funds classified as "Sustainable" by Morningstar, the investment potential of retrofitting buildings is well represented in some funds' investment approaches. This is alongside owning those companies already scoring highly on green metrics. It is also reflected in some of the indices that funds use as benchmarks, such as explicitly including renovation in "green building" definitions or by targeting emissions reductions over time (rather than seeking out existing low-emitting assets).

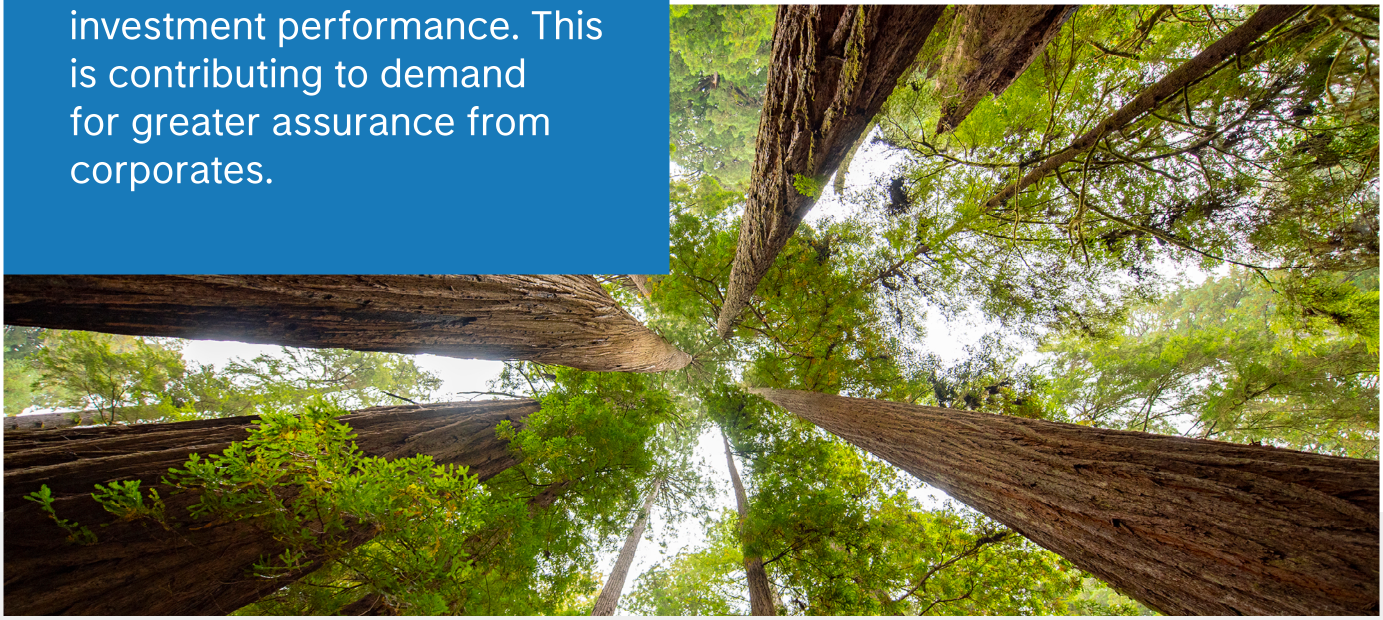
Establishing Credibility is Key to Growing Both Supply and Demand

Corporate sustainability disclosures have increased significantly, providing a clearer picture of current sustainability performance. Now, increasing investor confidence in companies' future sustainability trajectories is key to further adoption of an investing in improvers approach. In addition to the well-established tools that traditional investors use to evaluate companies' prospects, sustainable investors have a growing number of factors to consider. These include the allocation of sustainability-related CapEx and R&D, third-party ratings and target validation and how future regulatory developments could drive further progress.

Traditional investors have well-established frameworks to help them evaluate companies' future prospects. Established financial statements provide a strong basis for understanding a company's current financial performance, while detailed company earnings forecasts, valuation metrics, industry analysis and macroeconomic expectations all feed in to investors' evaluation of company targets and projections. Circumstances can always change, but there are clear structures in place to support investment decisions.

Over **60%** of individual investors name greenwashing as a key concern, ahead of investment performance. This is contributing to demand for greater assurance from corporates.

In sustainable investing, investors need access to both traditional and sustainability-focused information to help them assess a company's future prospects. These frameworks are still being established, but corporate disclosures have come a long way in helping investors better understand current sustainability performance. More forward-looking metrics are increasingly available as well, including disclosure on sustainability-related CapEx & R&D, third party target verification and disclosures associated with ESG-labeled bonds. Establishing credibility may be particularly important to sustainable investors due to concerns around greenwashing and the trust and authenticity of reported data. These concerns ranked just ahead of investment performance as a barrier to sustainable investing in the Morgan Stanley Institute for Sustainable Investing's 2024 "Sustainable Signals" survey of individual investors.[13]



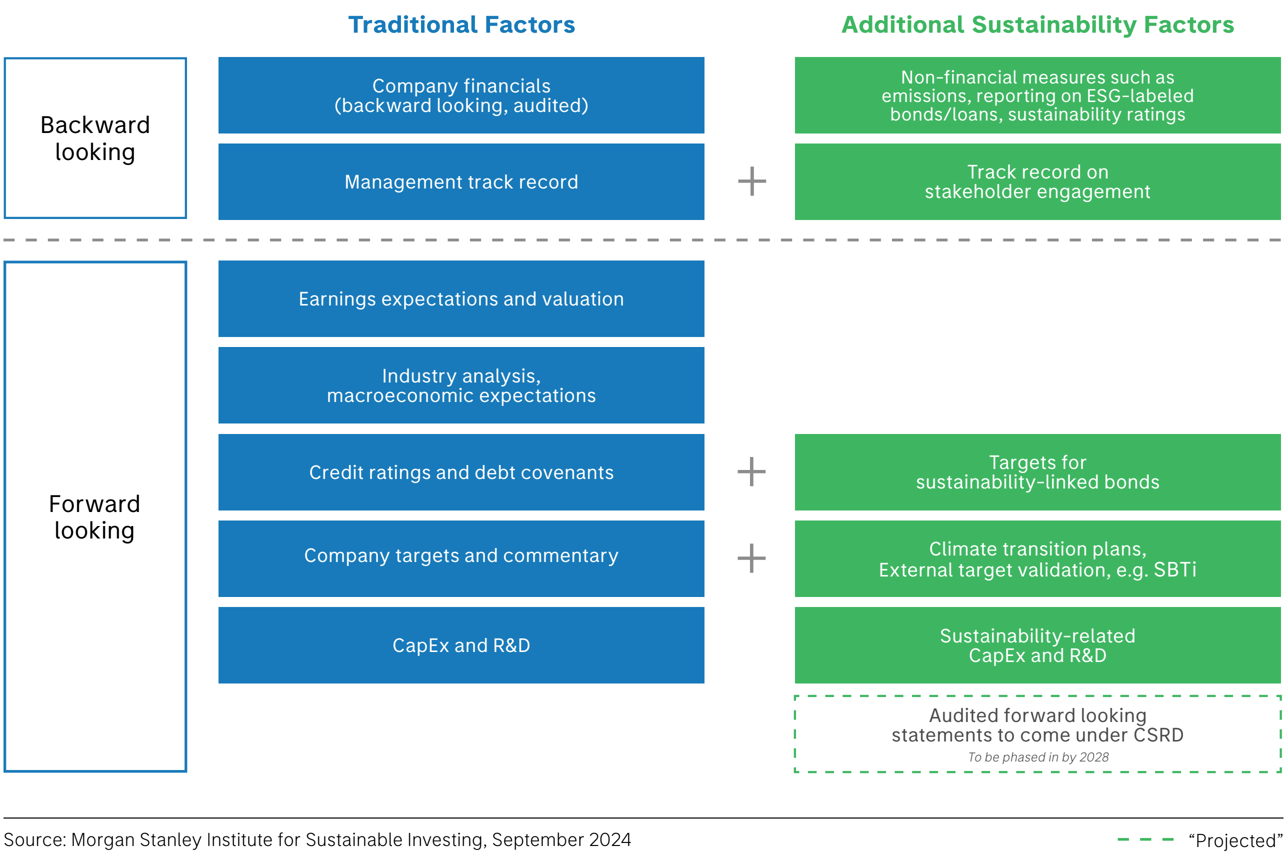
[13] Sustainable Investment Interest on the Rise in 2024 | Morgan Stanley, Jan. 26, 2024

Figure 10 shows some of the factors that sustainable investors now have available to evaluate companies. Some expand on existing traditional factors, such as providing data on environmental and social metrics, notably on the proportion of CapEx and R&D that relate to green investments (now required in the EU).[14] These metrics can be particularly helpful in building credibility in the time lag between companies announcing targets and achieving them, discussed in more detail on page 17. Transition plans may provide specific detail around how a company plans to achieve its climate targets, and external validation of those targets, such as by the Science Based Targets initiative (SBTi), supports investors with specialist scientific knowledge.

Future regulatory developments could drive further progress. Between 2024 and 2028, the EU's Corporate Sustainability Reporting Directive (CSRD) will require an increasing number of companies to report in line with EU sustainability reporting requirements. Phased in over time, key provisions include mandatory assurance of sustainability disclosures, the introduction of a new suite of European Sustainability Reporting Standards covering a broad range of ESG topics and a double materiality assessment to consider a company's impacts on people and the environment as well as the impact of ESG matters on the company. Disclosure is required against topics assessed as material and includes requirements to provide commentary on "current and anticipated financial effects" of sustainability topics. Depending on the company's business model, this may mean statements on how ESG matters like climate, pollution, water, biodiversity and circular economy are impacting the company's financials now as well as how these matters could affect the company's financials in the future.[15]

FIGURE 10

Frameworks for sustainable investors to evaluate companies' future prospects are becoming increasingly well established



Source: Morgan Stanley Institute for Sustainable Investing, September 2024

[14] Application of the EU Taxonomy for Companies (eu-taxonomy.info)

[15] European Sustainability Reporting Standards 2, General Disclosures

"A clear consideration around evaluating ESG performance is credibility, whether on targets for sustainability-linked bonds (SLBs) or the use of green bond structures from high-emitting companies. Ultimately, a company's ability to demonstrate a clear commitment to improved performance offered by an SLB can be very valuable as institutional investors work through how to balance the desire for an improvers approach with allaying greenwashing concerns."

Melissa James
Vice Chairman of Global Capital Markets, Head of the ESG Center of Excellence
Morgan Stanley

"There will always be an element of uncertainty about a company's future strategy—even the most robust plans may need to be adapted if external circumstances change. But regulation does not just mean a longer list of backward-looking metrics—greater visibility on future sustainability-related CapEx and R&D is creating a step change in the confidence that investors can have in a company's sustainability performance and future direction."

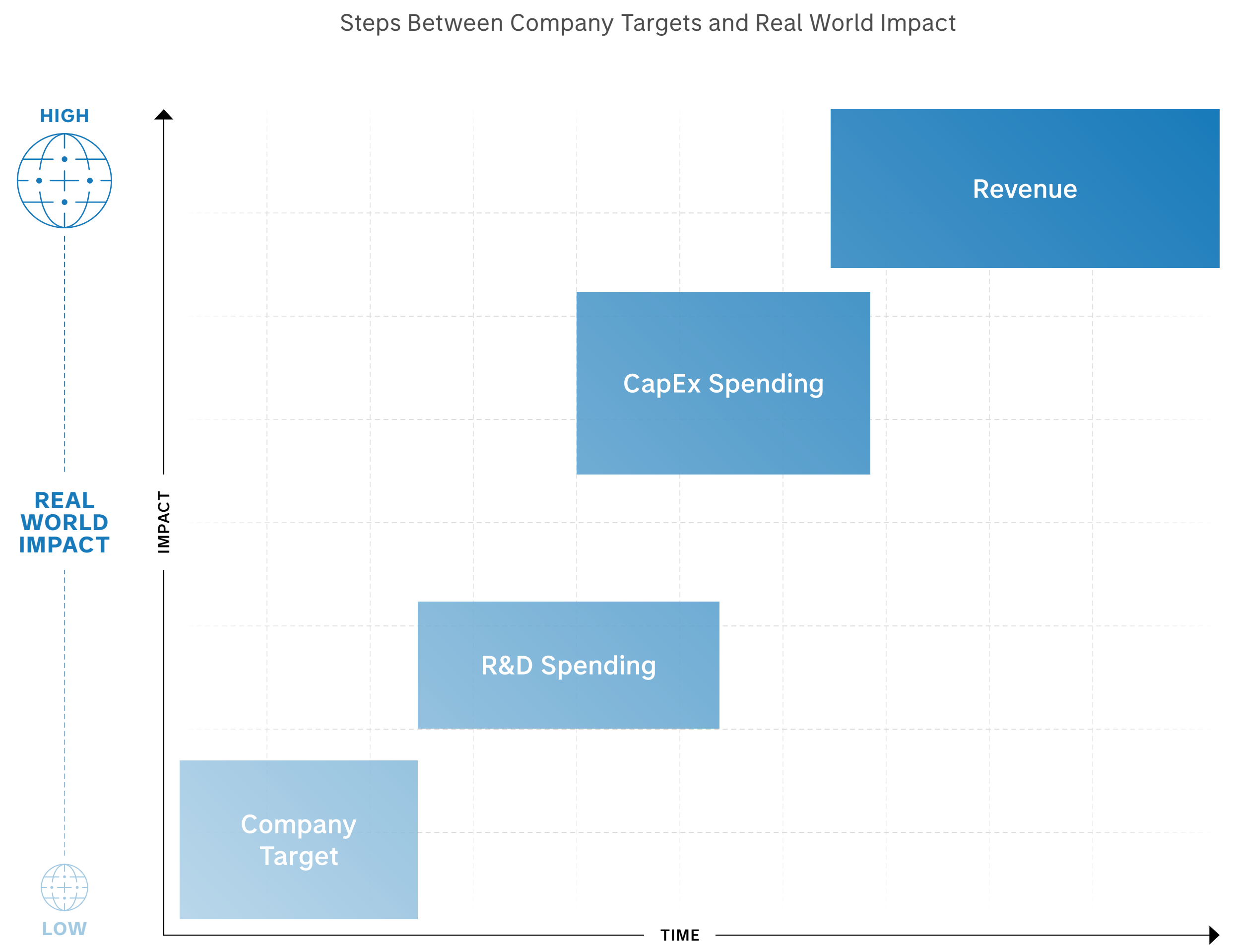
Jamie Martin
Head of the EMEA Sustainability Office
Morgan Stanley

Measures Like CapEx or R&D Can Signal Change to Come

Revenues and current emissions are good markers of a company's real-world impact today, but rates of CapEx[16] and R&D[17] investment may be better leading indicators of changes to come. Both CapEx and R&D are fully audited and clearly defined accounting measures that reflect a company's current spending on developing or manufacturing new products or services to be sold in future years. While a company's initial announcement of a new target or strategy may have limited real-world impact, changes in R&D and CapEx (particularly if the company discloses additional details) can be important intermediate steps for investors to track in the years before the company's new direction is evident in its revenues.

FIGURE 11

Intermediate steps between company targets and full execution



Source: Morgan Stanley Institute for Sustainable Investing, September 2024

[16] Capital expenditure is money a company invests in physical assets such as factories or equipment, either to maintain existing facilities or build new ones. Depending on the industry, a company's CapEx may be spent several years before the asset is operational.

[17] Research and development expenditure is money a company invests in developing new products and services to be sold in future years. Research spending is for early-stage exploratory work while development spending relates directly to future products or services.

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Certain portfolios may include investment holdings deemed Environmental, Social and Governance ("ESG") investments. For reference, environmental ("E") factors can include, but are not limited to, climate change, pollution, waste, and how an issuer protects and/or conserves natural resources. Social ("S") factors can include, but not are not limited to, how an issuer manages its relationships with individuals, such as its employees, shareholders, and customers as well as its community. Governance ("G") factors can include, but are not limited to, how an issuer operates, such as its leadership composition, pay and incentive structures, internal controls, and the rights of equity and debt holders. You should carefully review an investment product's prospectus or other offering documents, disclosures and/or marketing material to learn more about how it incorporates ESG factors into its investment strategy.

ESG investments may also be referred to as sustainable investments, impact aware investments, socially responsible investments or diversity, equity, and inclusion ("DEI") investments. It is important to understand there are inconsistent ESG definitions and criteria within the industry, as well as multiple ESG ratings providers that provide ESG ratings of the same subject companies and/or securities that vary among the providers. This is due to a current lack of consistent global reporting and auditing standards as well as differences in definitions, methodologies, processes, data sources and subjectivity among ESG rating providers when determining a rating. Certain issuers of investments including, but not limited to, separately managed accounts (SMAs), mutual funds and exchange traded-funds (ETFs) may have differing and inconsistent views concerning ESG criteria where the ESG claims made in offering documents or other literature may overstate ESG impact. Further, socially responsible norms vary by region, and an issuer's ESG practices or Morgan Stanley's assessment of an issuer's ESG practices can change over time.

Portfolios that include investment holdings deemed ESG investments or that employ ESG screening criteria as part of an overall strategy may experience performance that is lower or higher than a portfolio not employing such practices. Portfolios with ESG restrictions and strategies as well as ESG investments may not be able to take advantage of the same opportunities or market trends as portfolios where ESG criteria is not applied. There is no assurance that an ESG investing strategy or techniques employed will be successful. Past performance is not a guarantee or a dependable measure of future results. For risks related to a specific fund, please refer to the fund's prospectus or summary prospectus.

Investment managers can have different approaches to ESG and can offer strategies that differ from the strategies offered by other investment managers with respect to the same theme or topic. Additionally, when evaluating investments, an investment manager is dependent upon information and data that may be incomplete, inaccurate or unavailable, which could cause the manager to incorrectly assess an investment's ESG characteristics or performance. Such data or information may be obtained through voluntary or third-party reporting. Morgan Stanley does not verify that such information and data is accurate and makes no representation or warranty as to its accuracy, timeliness, or completeness when evaluating an issuer. This can cause Morgan Stanley to incorrectly assess an issuer's business practices with respect to its ESG practices. As a result, it is difficult to compare ESG investment products.

The appropriateness of a particular ESG investment or strategy will depend on an investor's individual circumstances and objectives. Principal value and return of an investment will fluctuate with changes in market conditions.

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