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Sustainable Investing: GIMA's Due Diligence Perspective

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Executive Summary

Given the increasing and varied investment choices that focus on generating positive environmental and social impact, the importance of investment manager selection is greater than ever. Global Investment Manager Analysis (GIMA) considers environmental, social and governance factors during the due diligence process for all investments on the Approved List or Focus List.* However, those investments that meet a higher bar for a documented, defensible and repeatable approach to sustainability may be selected for Morgan Stanley Wealth Management's Investing with Impact Platform (IIP). These investment options undergo the same rigorous fundamental due diligence that the GIMA team performs on all investments, and are compared to traditional benchmarks and peers. This paper provides an overview of the sustainable investing market, a discussion of the IIP and an outline of GIMA's due diligence approach and best practices for managers assessing environmental and social factors.

*Approved List managers meet an acceptable due diligence standard based upon GIMA's evaluation and are approved for use in advisory programs. Focus List represents our highest conviction ideas across asset classes and have the highest confidence to outperform relevant benchmarks over a full market cycle.

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Growth of Sustainable Investing

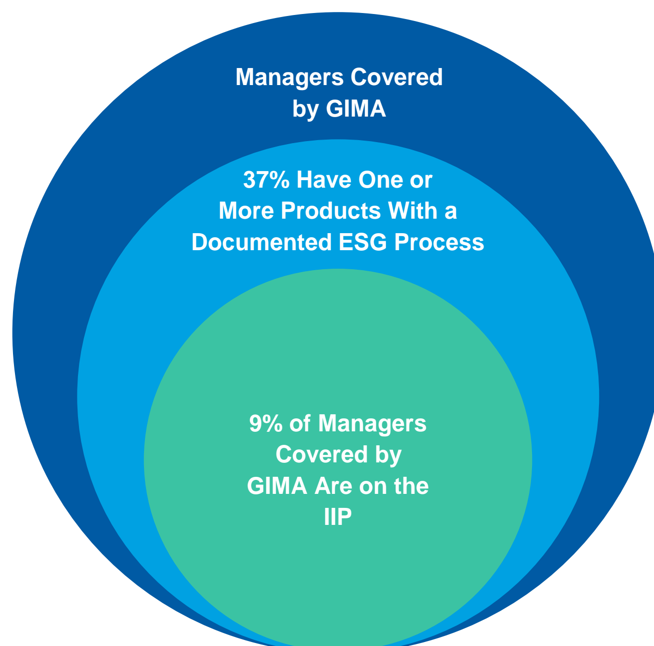
Investing to generate positive environmental and social impact has grown significantly since its inception—more than a century ago. In 1898, the Quakers Friends Fiduciary Corporation was founded and adopted a no weapons, alcohol or tobacco investment policy. Now, according to Morgan Stanley Institute for Sustainable Investing, the percent of institutions pursuing or actively considering incorporating environmental, social and governance (ESG) practices into their investment process has increased to nearly 85%. Most are relatively new to ESG: 60% began this process in the past four years and 37% within the past two.[1] Focusing on individual investors, a 2017 survey revealed more than 75% of investors indicated that they are interested in sustainable investing and 71% believe companies with leading sustainability practices may be better long-term investments. Although millennials showed the greatest interest in sustainable investing, the institute has seen interest grow among investors across demographics since its first survey in 2015 when 71% of investors expressed interest in sustainable investing.[2] Alongside this growth in demand, we are also seeing a proliferation of investment strategies in the market.

As of 2018, 1,588 asset managers worldwide with a collective $62.6 trillion in assets under management have signed the United Nations' Principles for Responsible Investing, which are aimed at providing a global standard for responsible investing.[3] Importantly, becoming a signatory does not require investment firms to take one standard approach. In fact, today there is greater variation in investment team experience, investment philosophy, investment process and performance as it relates to sustainable and impact investing than when Morgan Stanley Wealth Management launched the Investing with Impact Platform (IIP) in 2012. Today, 37% of the nearly 300 asset managers covered by GIMA analysts self-report that they have a documented investing with impact approach for one or more offerings (see Exhibit 1).

GIMA's Best Practices for Assessing Environmental and Social factors

Due to the variation in investment managers and strategies, expertise and experience in manager selection is crucial in determining which investments are driving lasting positive impact and which offerings are simply "greenwashing," or portraying themselves as ESG-conscious without any real benefits. GIMA applies a consistent and rigorous due diligence process, which includes a comprehensive quantitative and qualitative analysis as well as a business and operational review. This process applies to all GIMA-covered Approved List and Focus List products, including those on the IIP. Importantly, GIMA's 60 analysts incorporate questions regarding sustainable investing as part of the due diligence process for all managers, including questions in the initial request for information (RFI). For strategies considered for

Exhibit 1: GIMA Covered Managers With A Documented ESG Process



Source: Global Investment Manager Analysis

inclusion on the IIP, GIMA has dedicated resources to analyze each manager's approach to sustainable investing. GIMA's approach includes the evaluation of many factors including an assessment of the product against our proprietary IIP framework.

The initial assessment considers the manager's responses to a comprehensive list of questions on GIMA's RFI. Other stipulations include:

- Legal documentation with specific sustainability language
- Experience of the investment team
- Clear and intentional process for incorporating ESG factors
- Well-defined and repeatable method for evaluating data and materiality
- Shareholder engagement
- Strong performance relative to both sustainable and traditional peers and benchmarks
- Outcomes measurement and impact reporting

Products deemed to have the most comprehensive and robust overall sustainable investing platform are included on the IIP. Due diligence also includes ongoing monitoring of covered managers for an improving or evolving approach to investing with impact, and a review of the sustainability policies in place across all investments.

Exhibit 2: Morgan Stanley Wealth Management's Investing With Impact Framework

Minimize Objectionable Impact → Create Targeted Impact

	Restriction Screening	Environmental, Social & Governance (ESG) Integration	Thematic Exposure	Impact Investing
Definition	Intentionally avoid certain companies, industries or countries due to values or risk-based criteria	Proactively consider ESG criteria alongside financial analysis to identify opportunities and risks during investment process	Themes solving sustainability-related domestic and challenges across sectors, populations or geographies	Investment funds delivering specific positive social and/or environmental impacts through their business model, products and services
Investment Characteristics	• Often not proactively seeking positive environmental and social impact • Differentiated by screening criteria including issue area and revenue threshold used	• Differentiated by ESG data integration process –ESG momentum, ESG as a screen, ESG as a tool to engage with companies owned and/or ESG as part of the valuation model	• Differentiated by macro-analysis, sustainability research and sector focus	• Differentiated by impact approach, regional focus, liquidity and more • May have investor qualification restrictions
	Shareholder or company engagement and impact reporting play a critical role in differentiating managers across approaches			
Investment Examples	• Strategy (mutual fund, exchange-traded fund, separately managed account or private fund) that does not own certain companies, industries or countries due to values misalignment or risk	• Strategy (mutual fund, exchange-traded fund, separately managed account or private fund) incorporating analysis of ESG performance into equity and fixed income valuation process or using ESG data as a factor to filter investable universe	• Strategy (mutual fund, exchange traded fund, separately managed account or private fund) investing in companies with significant exposure to sustainability themes such as renewable energy, affordable housing, faith-based values etc. across equity and fixed income	• A private market strategy (e.g. venture capital, private equity, multiasset fund, hedge fund etc.) focused on affordable housing in low-income communities, emerging consumers, workforce training, etc.
	Public and Private Markets			**Private Markets**

Source: Morgan Stanley Wealth Management

GIMA's Assessment Using the Investing With Impact Framework

Morgan Stanley's Investing with Impact team has defined a range of approaches to generating positive environmental and social impact (see Exhibit 2). This proprietary framework delineates four approaches to potentially generating market-rate returns alongside positive environmental and social impact: restriction screening; ESG integration; thematic exposure; and impact investing. Investments considered for the IIP are assessed by GIMA using this framework. That is, asset managers must employ one or more approaches as part of their investment process. Furthermore, across the framework, shareholder engagement is considered part of an even more robust assessment of impact. This framework should be viewed as a spectrum, moving from left to right, the positive measurable impact of each approach becomes increasingly specific, overt and explicitly integrated into investment offerings. Today around two-thirds of the investments on the IIP are classified under the second approach, ESG integration.

Request for Information Questionnaire

GIMA requires completion of a standard RFI document. Standard RFIs now include 25 questions regarding investing with impact such as:

- What investing with impact approaches are employed by the manager?
- What restriction screens does the firm use and how are the restrictions defined?
- How diverse is the manager's staff and leadership?
- Which of the UN Sustainable Development Goals (SDGs), if any, is an intentional focus area?
- If using shareholder engagement, what methods are employed?
- Is a regular impact report (at least once per year) published for the selected investment strategy?

Legal Documentation with Specific Sustainability Language

Every strategy on the IIP should include specific language in either a prospectus or similar offering document describing the manner in which investing with impact criteria is incorporated into the strategy's investment process. The best prospectus language details specifically the ESG factors emphasized. For example, specific data items, such as carbon intensity or workplace equality, should be delineated. The documents should outline the benefits of integrating ESG factors, such as risk mitigation, while describing the impact of this approach on portfolio construction, such as a higher-quality bias. Documentation is also important for restriction screens.

 Please refer to important information, disclosures and qualifications at the end of this material.

Experienced Sustainable Investment Team

There are numerous ways for managers to launch investing with impact strategies. While some of the methods include acquiring established teams, others seek internal talent interested in sustainability to build teams. Still others hire industry leaders to build out a sustainable investing methodology and teach investment professionals about the benefits of and best practices in sustainability. GIMA has found the most successful managers hire external leaders in sustainability, whether an individual or team, to help develop a sustainable investing framework and gain acceptance from investment professionals firmwide.

Once a team is established, some managers have dedicated ESG analysts while other firms hire analysts to conduct both ESG and fundamental financial research. While GIMA has seen success with both methods, it is important for investment professionals to be fully versed and understand the sustainability aspect of the investment process. The strongest managers demonstrate a thorough understanding of ESG factors throughout all levels of the team, including the portfolio manager. During meetings with managers, GIMA seeks to understand how the portfolio manager thinks about ESG and how the investment team leverages the firm's resources.

Clear and Intentional Process

GIMA seeks a repeatable and defensible process for creating positive environmental or social impact. In other words, GIMA must be able to understand where the manager draws the line, or when they will not invest due to ESG reasons. Investment criteria may simply include restriction screening, but the strongest managers focus on an in-depth analysis of underlying risks. For example, a manufacturing company might look attractive due to low costs and high margins. However, if the firm had cut costs by not paying fair wages, it may have headline and perhaps regulatory risk resulting in forced wage increases. Ultimately, this could lead to pressure on margins and result in headwinds to stock prices.

Gaining a thorough understanding of when a manager will not invest in a company due to ESG risks is one of the most important pillars of GIMA's due diligence analysis. GIMA seeks to identify strategies with a genuine approach to incorporating environmental, social and governance factors into the investment process. Through specific examples and guidelines provided by the manager, GIMA can gain a deeper understanding of the portfolio construction process. A clearly defined process is important to ensure the manager's approach is intentional and that the outcome is not only the result of an unintended byproduct of an investment process which could change over time. For example, funds may have earned high sustainability scores from Morningstar based solely on the composition of the portfolio at one point in time, not because of a documented and deliberate investment process.

Process for Evaluating ESG Data and Materiality

ESG data can vary greatly by sector, region and data provider. Much of the data from ESG data providers is based on publicly disclosed information. This tends to favor large-cap companies, which have more resources to create sustainability reports and ensure data is publically available. It may also favor companies in regions where disclosure is mandatory or more ingrained in the culture, such as in Europe, while companies operating in the emerging markets may be less likely to report. Finally, the data tends to be backward-looking. To counterbalance this, IIP managers typically review data from multiple sources including ESG data providers, nonprofits, nongovernmental organizations and the companies themselves. In addition, these managers usually have an established system for dealing with gaps in the data and the breadth of available data.

Examining how a company allocates its revenue can be a more forward way to think about impact, helping to overcome the backward-looking nature of data from providers. For example, a company that builds wind turbines or creates technology to democratize access to high-quality education would score well based on use of proceeds, while a tobacco company would score lower. Successful business strategies for each of these companies would have different impacts on society and the environment, and can be an important consideration for some managers. Fixed income or private investments can go a step further to allocate investment proceeds to specific projects. When evaluating these investments, a best practice is to employ both ESG and revenue analysis.

With the increasing quantity of ESG data available, it may be difficult to draw conclusions. Sophisticated managers should be able to differentiate what is material for a company or important to the business line. Investors may be more familiar with this idea in regard to financial data; however, it is also important when evaluating ESG factors. For example, if a financial company occupies a LEED (Leadership in Energy and Environmental Design) platinum building, which is good for the environment, it may not make a significant impact on the profit margin. However, if an oil company considers environmental factors, it may have a positive economic impact on the company's shareholders by mitigating risk, which ultimately adds value. Managers included in the IIP should have a framework for assessing materiality that references outside sources such as the Sustainability Accounting Standards Board (SASB) as well as their own research and understanding of the unique ESG issues across industries and regions in which they invest.

Shareholder Engagement

Shareholder engagement plays a critical role in the investment process for the majority of IIP managers. There are three main ways in which managers who own the equity of public or private companies may engage to improve their environmental, social and governance behavior. These include filing shareholder resolutions, voting proxies and speaking with company management. Some managers invest in companies that have room to improve on certain aspects of their operational or governance practices such as establishing targets and policies to reduce carbon footprint or increase diversity of its workforce. The objective of this shareholder engagement is to put pressure on companies to improve their ESG operations in the pursuit of delivering value, from both a financial and sustainability perspective. Engagements—especially dialogue and resolutions—can sometimes take years to deliver results.

Managers with robust ESG platforms typically employ a combination of engagement tactics. For example, an IIP manager has engaged with a social media company to encourage the creation of a risk oversight board committee. The purpose of this committee would be to help foresee and mitigate risk, particularly in the face of public scrutiny the company has undergone. This manager has affected positive change through conversations with the company, introducing a resolution for a shareholder vote and publishing a letter to shareholders to encourage others to vote for the proposal. Some IIP managers seek leverage with companies by joining forces with other managers who are pursuing the same changes. Often demand from investors can be the impetus for change at a company and force a company's management to recognize issues and work to fix the underlying concern.

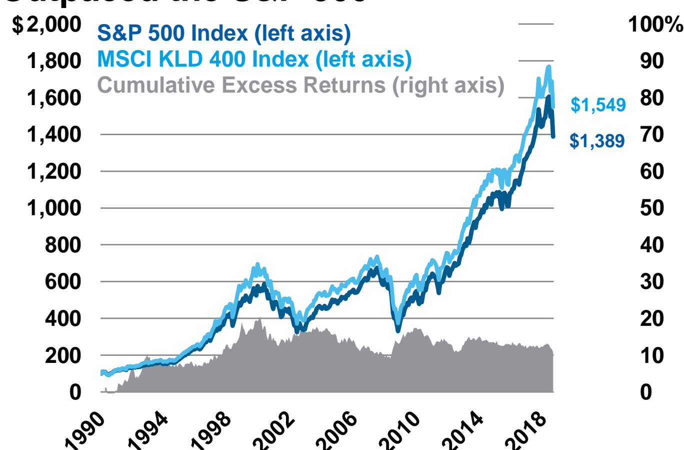
Investing with Impact Performance

Managers on the IIP meet the same rigorous analysis applied to traditional investments covered by GIMA. Performance is compared to a peer group of traditional managers as well as traditional benchmarks. Today, approximately 18% of IIP offerings have been selected for the GIMA Focus List, a status indicating our high conviction in the overall quality of the investment strategy and its potential to outperform applicable benchmarks over a full market cycle. This approach spans across our investing with impact pillars.

Restriction Screening

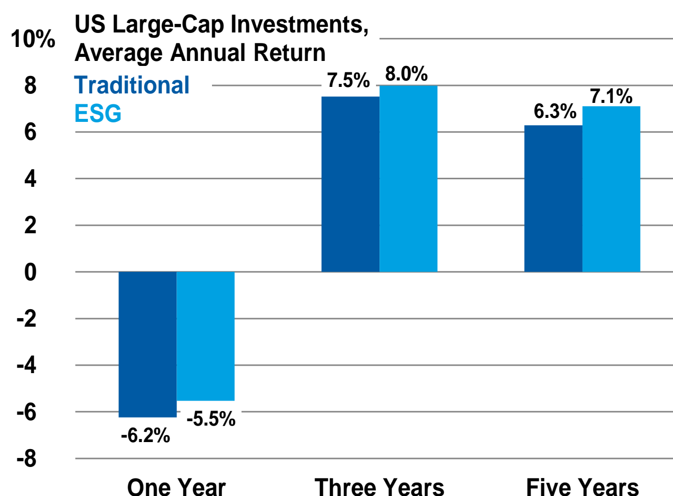
Restriction screens tend to underweight certain sectors or industries such as tobacco, gaming or coal mining, which creates some tracking error. For example, a carbon-free portfolio would likely have lower exposure to the energy sector. However, historically this has not had a negative impact on returns over a full market cycle.[4] Several of the screening options on the IIP allow clients to customize portfolios including a review of the historical tracking error prior to implementation.

Exhibit 3: ESG Index Performance Has Outpaced the S&P 500



Past performance is no guarantee of future results. The index returns are illustrative and shown for comparative purposes only. They do not represent the performance of any specific investments. An investor cannot invest directly in an index.
Source: Bloomberg, MSCI, Morgan Stanley Wealth Management as of Dec. 31, 2018

Exhibit 4: ESG ETFs and Mutual Funds Perform In Line with Traditional Peers



Source: Morningstar as of Dec. 31, 2018
Note: Traditional performance is based on the US Large Blend Morningstar group. ESG performance is based on the portion of those ETFs and Funds that have a documented ESG investment process.

ESG Integration

The most significant body of research on investment performance centers on the ESG integration approach. Studies have shown that integrating ESG factors do not negatively affect returns. A study conducted in 2015 found that products integrating ESG factors supported returns and provided better relative

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performance during the 2007 financial crisis.[5] Other studies have gone even further, demonstrating that ESG factors can allow managers to uncover material issues that might not be factored into a stock's price. According to a study conducted by Calvert Investment Management and George Serafeim, a professor at Harvard Business School, focusing on material ESG issues can be leading indicators of future financial performance and can improve risk adjusted returns.[6]

Performance has supported this research. The MSCI KLD 400 Index, an index of companies that meet best-in-class ESG criteria, was launched May 1, 1990. As of Sept. 30, 2018, it outperformed the S&P 500 index by 50 basis points on an annualized basis (see Exhibit 3). Looking broadly at mutual funds and ETFs that document ESG integration, performance has slightly outperformed non-ESG peers, according to Morningstar (see Exhibit 4).

Thematic Approach

Thematic investments tend to target themes or sectors to address sustainability challenges. Given this approach, managers may leverage data such as a company's revenue sources to determine investment opportunities that align with a desired theme such as water infrastructure or community investing. This analysis may provide helpful insight in assessing a product's impact. Performance for these products will vary depending on the sector and theme, but given these investments can be more concentrated, performance may be more volatile.

Impact Investing

Impact investing options are most prevalent in the private market. These investments tend to be more "pure play" by nature with fewer revenue sources, and can be a way for investors to make targeted positive measurable impact with the goal of scaling over time. By contrast, publicly traded companies tend to be diverse, with a broad range of products or services and an operational footprint that may be across the globe. In 2015, Cambridge Associates and the Global Impact Investing Network created a benchmark for private market impact investments. This benchmark and subsequent research has shown that risk-adjusted market rates of return are achievable in impact investing.[7] According to the report, small funds and those focused on emerging markets outperformed comparable peers. However, manager selection and due diligence are critical components of performance and risk management.

Outcomes Measurement and Impact Reporting

Managers' impact reporting capabilities have evolved with the industry more broadly, but are still in the early stages of development and are generally limited. Impact reporting provides a way for our clients to assess, alongside their financial returns, the alignment of their overall investments with their defined impact objectives and measure the positive impact that their investment is generating. Data that IIP managers assess vary but cover a wide variety of topics such as shareholder engagement; ESG metrics such as carbon emissions or diversity in management relative to the benchmark; and solutions-oriented metrics such as the revenue generated from providing access to financial services for underbanked populations. When GIMA is vetting managers, it seeks best practices in impact reporting including a regularly published, client-friendly report. Reports may range from a snapshot highlighting key metrics to a more comprehensive report discussing engagement efforts.

There are also global standards or frameworks that managers may utilize as part of their investment selection. For instance, the UN SDG agenda set in 2015, consisting of 17 goals to end poverty by 2030, has been increasingly incorporated into managers' ESG integration processes. Since the establishment of these goals, several public equity and fixed income managers have begun to refocus their measurement of positive impact to reflect alignment with the SDGs—including companies that generate revenue in support of these goals. IIP managers may align to the SDGs through engagement, investment selection or impact reporting. During the due diligence review, managers are asked to discuss which SDGs are intentional areas of focus for the investment process. Based on 2018 data from Investing with Impact managers, over half of the investments on the IIP are aligned to one or more SDGs.

In addition to manager-level reporting, Morgan Stanley's Investing with Impact team has been a leader in establishing portfolio-level methodology that aggregates data across underlying securities to ultimately reflect the total portfolio alignment with various impact objectives. Both approaches to measuring impact—at the strategy level and at the portfolio level—are critical to the advancement of the industry.

Ongoing Monitoring

GIMA analysts conduct continuing due diligence for all Approved List and Focus List investments, which includes annual reviews, regular meetings with managers, phone calls, performance analysis and questionnaires. For IIP managers, this review also includes a periodic review of the portfolio holdings to ensure they match the manager's defined impact objectives, and engaging with managers when there seems to be misalignment. For example, a manager that says it focuses on gender diversity, but owns no companies that are leaders in corporate diversity would need to explain this discrepancy. If there continues to be misalignment between stated impact goals and outcomes, the manager might be removed from the IIP. As the industry evolves, GIMA expects managers to stay up to date on new data, resources, and frameworks. Products that no longer represent best in class approaches to investing with impact will be removed from the IIP.

Please refer to important information, disclosures and qualifications at the end of this material.

Conclusion

Given client demand for ESG investments, the number of offerings will most likely continue to grow. As a result, the choices will also challenge investors to differentiate among various impact approaches that aim to deliver strong performance and generate positive environmental and social impact. GIMA has established a set of best practices and evaluation techniques for assessing investments that are aligned with an approach to investing with impact. GIMA encourages managers to fully document their approach to investing with impact, engage with companies in which they invest on important issues and report on their positive impact. Furthermore, as new investment choices and market innovations become available, GIMA will continue to search for the best-in-class options for clients interested in generating both positive environmental and social impact as well as financial returns. ■

Endnotes

[1]"Sustainable Signals: Asset Owners Embrace Sustainability" Morgan Stanley Institute for Sustainable Investing, June 2018

[2] "Sustainable Signals: New Data from the Individual Investor," Morgan Stanley Institute for Sustainable Investing, August 2017

[3]UNPRI Global Growth 2006-2018, www.unpri.org

[4]Geddes, Patrick, et al. "Building a Carbon-Free Equity Portfolio," Aperio Group, 2016

[5]Becchetti, Leonardo and Ciciretti, Rocco and Giovannelli, Alessandro, Corporate Social Responsibility and Earnings Forecasting Unbiasedness (April 21, 2012). CEIS Working Paper No. 233. Available at SSRN: https://ssrn.com/abstract=2050870 or http://dx.doi.org/10.2139/ssrn.2050870

[6]Serafeim, George, et al. "The Financial and Societal Benefits of ESG Integration: Focus on Materiality," The Calvert-Serafeim Series, 2017

[7]Matthews, Jessica, et al. "Introducing the Impact Investing Benchmark," Cambridge Associates and the GIIN, 2015, www.cambridgeassociates.com/research/introducing-the-impact-investing-benchmark/

Please refer to important information, disclosures and qualifications at the end of this material.

Index Definitions

For indexes referenced in this report please visit the following: http://www.morganstanleyfa.com/public/projectfiles/id.pdf

Risk Considerations

Investing in the markets entails the risk of market volatility. The value of all types of investments, including stocks, mutual funds, exchange-traded funds (“ETFs”), closed-end funds, and unit investment trusts, may increase or decrease over varying time periods.

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

The value of **fixed income securities** will fluctuate and, upon a sale, may be worth more or less than their original cost or maturity value. Bonds are subject to interest rate risk, call risk, reinvestment risk, liquidity risk, and credit risk of the issuer.

International investing entails greater risk, as well as greater potential rewards compared to U.S. investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging and frontier markets, since these countries may have relatively unstable governments and less established markets and economies.

Alternative investments often are speculative and include a high degree of risk. Investors could lose all or a substantial amount of their investment. Alternative investments are suitable only for eligible, long-term investors who are willing to forgo liquidity and put capital at risk for an indefinite period of time. They may be highly illiquid and can engage in leverage and other speculative practices that may increase the volatility and risk of loss. Alternative Investments typically have higher fees than traditional investments. Investors should carefully review and consider potential risks before investing.

Private Equity strategies (which include hedge funds are private equity funds) often engage in speculative investment techniques and are only suitable for long-term, qualified investors. Investors could lose all or a substantial amount of their investment. They are generally illiquid, not tax efficient, and have higher fees than many traditional investments.

The returns on a portfolio consisting primarily of **environmental, social, and governance-aware investments (ESG)** may be lower or higher than a portfolio that is more diversified or where decisions are based solely on investment considerations. Because ESG criteria exclude some investments, investors may not be able to take advantage of the same opportunities or market trends as investors that do not use such criteria.

Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

The **indices** are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment.

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The Global Investment Manager Analysis team uses a disciplined process to evaluate investment managers and products for Morgan Stanley’s investment advisory programs. This dedicated team of more than 40 investment analysts regularly reviews more than 1,300 investment products across a broad spectrum of asset classes and investment styles in an effort to ensure that they continue to meet our rigorous standards.

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