When creating ESG solutions for our liquidity clients, there is no one-size-fits-all approach. ESG goals vary by end investor and how they want to align their liquidity investments with broader corporate goals. But the one question we get asked more and more frequently is: “Can I integrate ESG into my liquidity portfolio?” We believe the answer is a definite "yes."

Recent global events have highlighted the significant impact social issues can have on economies, their deep interconnectedness with climate change considerations, and the importance for countries and businesses of having resilient structures in place to respond to short-term shocks and longer-term sustainability-related challenges.

As awareness of and urgency to act on these issues grow worldwide, investors are increasingly looking for investments that integrate Environmental, Social and Governance (ESG) criteria as a core component of the portfolio construction process.

At Morgan Stanley Investment Management (MSIM), we believe it is critical to address all three dimensions of the ESG equation holistically and in a way that appropriately reflects materiality, to properly assess the fundamental credit risk of a business and, in turn, determine the potential attractiveness of its liquidity instruments. By adopting a comprehensive approach to ESG analysis, our aim is to support issuers that are good corporate citizens and positively contribute to advancing relevant sustainability agendas, while complying with regulatory minimal credit risk thresholds.
However, third-party ESG research is not typically designed for the needs of liquidity investors. Therefore MSIM has created a proprietary ESG scoring methodology that explicitly considers the risks that material factors across the Environmental, Social and Governance dimensions, such as those outlined in Display 1, pose to money market issuers.

**MSIM ESG Scoring Model**

MSIM’s proprietary ESG assessment methodology combines third-party data with our in-house analysts’ views on the issuer and its sector. Our approach reflects a focus on materiality when it comes to ESG issues, taking into consideration the timeframe in which those issues are expected to manifest themselves, and tailored to respond to our specific requirements as liquidity investors.

Our analytical process (Display 2) consists of two main steps, as described in more detail below:

1. The definition of specific risk weights for E, S and G factors at the sector level, based on our credit analysts’ specialist expertise, and

2. Issuer-specific analysis, based on third-party data but applying forward-looking adjustments.

### 1. Combining Proprietary Sector Risk Analysis…

Built on their deep knowledge as sector specialists, our credit analysts complement their investment experience with ESG-focused research from leading third-party sources to derive sector risk weightings of high, medium or low. As shown in Display 3, these risk weightings reflect our view of how likely the ESG factor is to have a negative effect on the price of the issuer’s securities.

We use this sector risk analysis to assign weights to third-party ESG scores. Risk weightings will vary from low to high for environmental and social factors, but will always be high for governance. Governance is the strongest ESG driver of portfolio risk and return in money markets, given the short duration of the paper we invest in. As liquidity investors, we rely heavily on management teams’ controls to avoid involvement in fraud or corruption, and to execute on their commitments. This is especially relevant for the financial sector, to which money market funds are heavily exposed. We also view good governance as the foundation stone of strong sustainability fundamentals, reflected in robust policies and business practices on environmental and social issues.

For example, when looking at banks, our analysts assign the greatest weight to corporate governance factors, looking at multiple issues ranging from board diversity to the integration of sustainability metrics in management...
DISPLAY 2
MSIM ESG Scoring Analysis

For illustrative purposes only. This represents how the portfolio management team generally implements its investment process under normal market conditions.

DISPLAY 3
Sector Risk Factor Weightings

For illustrative purposes only. This represents how the portfolio management team generally implements its investment process under normal market conditions.
performance evaluations. However, social factors also bear significant weight, particularly in relation to a bank’s ability to attract, retain and develop its pool of skills over time, and to be active players in promoting inclusive lending practices. Finally, on the environmental side, climate-friendly business activities and policies are reviewed and scored.

2. …With Forward-looking Adjustments
We have found that many third-party ESG scores are largely based on past performance and controversies that might date several years back. To help correct for this, our analysts apply two adjustments that are intended to introduce a forward-looking element in our scores, which we believe enables us as liquidity investors to better predict the short-term sustainability trajectory of an issuer.

ADJUSTMENT #1: MOMENTUM
Our view is that companies should be rewarded for demonstrating a willingness to change and adopt ESG-friendly principles. To account for momentum in our scoring methodology, we make numerical adjustments using third-party data in favour of companies that demonstrate positive ESG momentum and against companies that demonstrate negative momentum.

ADJUSTMENT #2: CONTROVERSY
Negative ESG-related headlines can impact our ability to transact in an issuer’s securities. Not only can a controversy change the issuer’s fundamentals, it also tends to increase public scrutiny of its ESG performance. Portfolio managers may avoid the most obviously controversial names.

To account for controversy, we make a numerical adjustment against issuers that have been featured in the headlines for material negative ESG issues. Our adjustment for controversy has less impact than our adjustment for momentum on our final score—we prefer to skew our score towards the future rather than the past.

MSIM ESG Score
The final output is a numerical score that is comparable across sectors and used as one of multiple inputs into the final investment decision on a security-by-security basis. We use this score to better understand the ESG quality of our portfolios, as well as to apply any ESG tilts to select best-in-class strategies.

As an example, when assessing a US leasing company with an average third-party ESG score, we identified that, despite good traction on environmental initiatives, the company still lacked clear health and safety policies and procedures, and provided very little information on its health and safety track record, which could potentially lead to litigation and fines. It also continued to perform below peers on corporate governance, due to poor practices around disclosure and transparency. This resulted in a much poorer MSIM ESG score (3 points lower on a scale of 10) than the external third-party score.

On the other hand, when assessing a financial institution with a laggard third-party ESG score, our understanding of the company’s strong management, in terms of board composition, accounting and financial reporting, and the recognition of its positive momentum related to enhanced disclosure and incorporation of sustainability into its own products and services, resulted in a higher MSIM ESG score (2.5 points higher on a scale of 10).

A Dynamic Approach in an Evolving Space
The MSIM Fixed Income & Liquidity Sustainable Investing team continually re-evaluates our equations and data inputs based on the latest research and studies available. We acknowledge some of the difficulties, for example uneven data availability in some cases, when it comes to money markets. However, our objective is to approach ESG in a thoughtful and practical way rather than as a box-ticking exercise, leveraging our in-house specialist expertise to obtain an ESG metric that is robust and meaningful.

We aim to turn ESG considerations into insights that can mitigate risk and contribute to higher potential returns.
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 and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio.

Fixed-income securities are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. Longer-term securities may be more sensitive to interest rate changes.

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.

ESG ratings are not intended as a recommendation and are subject to change. Ratings are relative and subjective and are not absolute standards of quality. Ratings apply only to portfolio holdings and do not remove the risk of loss.
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