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Engagement is our edge

Our investment process focuses on the sustainability and direction of future returns on operating capital because we believe that companies with sustained high long-term returns should outperform. Assessment of material ESG risks and opportunities constitutes an integral part of our analysis of long-term sustainability of returns, with active engagement playing a fundamental role in our investment process.

We have engaged directly with companies on issues of sustainability and governance for over 20 years. We believe that engagement is a marathon—not a sprint. We recognise that dialogue with companies can take years and multiple engagements. Accordingly, our engagement policy is aligned to our long term investment approach.

In the second half of 2020 we engaged with company management on a range of themes, including decarbonisation, biodiversity, workforce well-being, executive pay and the circular economy, amongst others. We paid particular attention to companies’ decarbonisation strategies, including direct carbon emission reduction and renewable energy use targets. Throughout 2020, we held 370 meetings with company management, of which 206 included discussions on ESG-related topics.

Our holistic approach to engagement means we typically engage with companies on more than one topic in any given meeting. Social topics featured in 116 (56%) of our ESG engagements, while environmental and governance topics presented in 96 (47%) and 84 (41%) of ESG engagements respectively.

We prefer to conduct 1:1 meetings with senior management since this is where we feel we can most effectively drive change. Ongoing social distance requirements brought about by COVID-19 meant these engagements took place remotely.

DISPLAY 2
Topics addressed during our engagements, full year 2020

The following diagrams show a breakdown of our E, S, and G engagements by topic.

<table>
<thead>
<tr>
<th>Topic</th>
<th>Count</th>
</tr>
</thead>
<tbody>
<tr>
<td>Decarbonization</td>
<td>64</td>
</tr>
<tr>
<td>Circular Economy</td>
<td>20</td>
</tr>
<tr>
<td>Biodiversity/ Ecological Impacts</td>
<td>19</td>
</tr>
<tr>
<td>Physical Impacts of Climate Change</td>
<td>5</td>
</tr>
<tr>
<td>Diverse &amp; Inclusive Business</td>
<td>17</td>
</tr>
<tr>
<td>Data Security</td>
<td>15</td>
</tr>
<tr>
<td>Product Quality &amp; Safety</td>
<td>15</td>
</tr>
<tr>
<td>Workforce Well-Being</td>
<td>12</td>
</tr>
<tr>
<td>Supply Chain Management</td>
<td>7</td>
</tr>
<tr>
<td>Pay Equity</td>
<td>2</td>
</tr>
<tr>
<td>Executive Compensation</td>
<td>27</td>
</tr>
<tr>
<td>Board Structure &amp; Composition</td>
<td>14</td>
</tr>
<tr>
<td>Sustainability</td>
<td>5</td>
</tr>
<tr>
<td>Governance &amp; Oversight</td>
<td></td>
</tr>
</tbody>
</table>

 DISPLAY 1
Number of engagements where we discussed ESG-related topics

<table>
<thead>
<tr>
<th>Topic</th>
<th>Count</th>
</tr>
</thead>
<tbody>
<tr>
<td>Social</td>
<td>116</td>
</tr>
<tr>
<td>Environmental</td>
<td>96</td>
</tr>
<tr>
<td>Governance</td>
<td>84</td>
</tr>
</tbody>
</table>

1 The International Equity Team defines an engagement as an interaction with senior management or non-executive board members.

2 Data shown is for the 12-month period to 31 December 2020.

3 Total count of ESG topics is higher than total number of ESG engagements as more than one topic may be discussed in a meeting.
The Race (or Marathon) to Net Zero

(Global Quality, Global Sustain, International Equity)

Ambitious targets for decarbonisation abound, with many companies embracing aspirations to reach 100% renewable energy use, net zero carbon emissions, or even be climate positive (removing more greenhouse gases than you emit). While laudable, the real test will of course be achieving these targets. Through engagement, we look to understand if our holdings have a realistic pathway to reach them.

One of our European companies, active in both consumer and industrial sectors, has a science-based target to reduce Scope 1 and Scope 2 emissions by 75% by 2030, including 100% electricity from renewable sources, and to be climate positive by 2040. They have already achieved their previous target, set from 2010 to 2020, to reduce Scope 1 and Scope 2 emissions by 30% per ton of product.

The company follows a combination of on-site green energy production, direct purchases of renewables for their facilities and novel virtual power purchase agreements (PPAs). These PPAs allow the company to effectively offset the emissions of their locations where not enough renewable capacity is available, by procuring renewables from energy plants located elsewhere. This way, they effectively contribute to creating new renewable electricity generation capacity.

From a governance perspective, the carbon planning strategy and decision-making process is steered by the company’s Sustainability Council who report into the Management Board. Planning is on a country by country basis, given every location has a different starting point and opportunity set.

Managing their production-led emissions (Scope 1) and the energy they purchase (Scope 2) is in their control, driven by their planning and efforts. To reduce Scope 3 emissions (those in the supply/value chain), it is also important the company innovates, creating products that contribute to sustainability for their customers. The target is to increase Scope 3 savings already made of 43.5 million metric tonnes of CO₂ to 100 million tonnes by 2025. Examples of how they are doing this include, in their Industrial division, energy-saving building facades to help reduce heat loss, special “cool roof” coatings able to reflect 87% more sunlight than conventional coatings, reducing the amount of energy required for air conditioning, and numerous solutions that contribute to weight reduction for car manufacturers. In construction, their adhesive solutions have made it possible to use Cross Laminated Timber (CLT) to replace concrete, reducing both energy use and CO₂ emissions.

We are encouraged by the company’s success in achieving their previous decade’s carbon reduction goal. Following our engagement to understand the pathway to their new 2030 goal, which now introduces both 100% renewable electricity and Scope 3 emission reductions, we believe they have a credible plan. We will continue to engage to follow progress.
In another environmental engagement with a British health, hygiene and nutrition company, we explored how green chemistry, also known as sustainable chemistry, helps develop products with lower environmental footprints.

As both packaging and chemicals used in products trend away from hydrocarbons, driven by the demand for natural bio-based ingredients, safer products and more environmentally friendly packaging, green chemistry offers real potential. New formulations and designs can lower energy consumption, help reduce natural resource impact and waste, and enable more recycling.

Linked to this, the company’s Ingredient Steering Committee has established a cross-functional task force to screen for innovative and safe ingredients and set up collaborative programmes with industry groups and suppliers. Further, their Global Safety Assurance Team conducts safety assessments of all ingredients and products throughout the product lifecycle.

The company sees that consumer preference for natural bio-based ingredients varies between products. Where efficacy is driving demand, natural ingredients are less of a priority, for example in anti-bacterial and cleaning products. Here the focus remains on ingredient and labelling transparency. However, the direction of travel is a move to more natural products with improved efficacy, a balance which is the focus of their innovation.

This engagement highlighted the compelling opportunities the company has, through green chemistry, to develop products relevant to consumer tastes and trends, as well as improve their environmental credentials. Further, we welcome the enhanced governance measures around ingredient procurement and product safety.
Trees for Tissues?

(Global Franchise/Brands, Global Quality, Global Sustain)

One of our holdings is among the largest manufacturers of consumer tissues and paper towels in North America. In a detailed conversation, we probed them on the feasibility of replacing virgin fibre with recycled material (which many manufacturers use). We also discussed their approach to sustainable forestry.

Despite the lower environmental impact of recycled fibre in packaging, in the company’s view, recycled fibre isn’t appropriate for quality absorbent tissue owing to the degradation of fibre quality. This results in low consumer acceptance and is the reason, they say, that virgin fibre is used by all premium tissue brands in North America.

Longer term, given tissue from recycled fibre has potential and also precedent—it’s penetration in Europe is higher—we would like to see company initiatives to explore North American consumer acceptance of tissue made from this resource.

While the company does not own or manage forests, through procurement practices they have a responsibility to ensure the sustainability of these resources. Their approach includes vetting the sources of virgin fibre, being transparent in sourcing and ensuring suitable forest management. Independent third-party verification systems are used, and the company partners with stakeholder organisations to help protect forest biodiversity.

We asked whether any suppliers had not met the standards expected. There had been one incident. The response was to cut 50% of this supplier’s volume immediately and then engage with relevant parties to remedy the problem.

In Canada—the company’s main source of virgin fibre—trees live for roughly 125 years. Harvested trees are aged over 90 years, meaning only old trees are used, but this still means a valuable source of carbon capture is removed. The company ensures that no pulp is derived from high-conservation-value (HCV) forests and aims for 75% of material to come from sources certified by FSC, the strictest sustainable forestry standard. We will continue to monitor their progress on increasing the FSC mix, and potential initiatives to move away from virgin fibre.

While we are encouraged by the incremental improvements the company has committed to, following our engagement, we voted in favour of the shareholder resolution that challenged the company to improve their disclosure around deforestation and their actions to combat it.
Lesson Learnt

(Global Franchise/Brands, Global Quality, Global Sustain, International Equity)

Our team has always paid close attention to executive compensation and engaged with companies to encourage improvements in remuneration practices. We believe that having the right metrics and structure in place is crucial for compounding as it helps avoid short-termism and incentivises disciplined investment by the C-suite.

We have been engaging with one of our UK-based consumer staples holdings on the subject of incentives for a long time. Last year we became concerned by the company’s proposal to remove return on invested capital (ROIC), one of our favoured metrics, from the list of management KPIs and replace it with total shareholder return (TSR).

In our recent engagement with the head of the remuneration committee we highlighted our strong opposition to this change. We argued that having a ROIC performance target is key to capital discipline and should focus the management on investing shareholders’ capital at high rates of return.

On the other hand, we believe TSR is a weak metric — simply because management cannot directly influence it. Instead, management should be incentivised on sensible operating metrics they can control, which in turn should help share price performance in the long run.

Focused and constructive engagement can have an impact, we believe. Early this year we were pleased to learn the company had decided to keep ROIC as one of the plan metrics, citing shareholder opposition.
A Follow-Up Appointment

(Global Franchise/Brands, Global Quality, Global Sustain)

We continued our engagement with one of our US health care holdings on product safety, diversity and inclusion and governance.

After the company experienced a higher than usual number of product recalls several years ago, we have been monitoring and engaging on their efforts to improve product safety. Following a re-organisation of the safety function, the company has continued to increase spending and headcount, as well as improving automated and visual product inspections. This has resulted in an 82% decline in the number of product alert reports submitted to the US Food and Drug Administration (FDA) compared to 2015. Despite the progress, the company admits it is not yet an industry leader and aims to be in the top quartile of peers on safety.

We also scrutinised their commitment to diversity and inclusion (D&I). The company informed us that their D&I goals for the next five years were to be published in their upcoming corporate social responsibility report. In this engagement, we were focused on identifying tangible practices that would support D&I goals. For example, to help improve workforce diversity and increase representation of women and minorities, the company requires a diverse candidate pool during the hiring process. However, they do not publish gender pay gap data for their global workforce—we encouraged them to do so.

Earlier last year we voted against the chair of the audit committee following an accounting restatement which heightened our concern that the board did not have sufficient financial controls in place. In this engagement we went through the steps the company has taken to improve oversight, such as regular in-depth reviews of finance and treasury functions to improve and automate controls and information flows to the board.

“...”

Our follow-up engagement on product safety demonstrated to us that the company has made progress, with a tangible improvement. Despite this, it is encouraging that the company isn’t resting on its laurels and sees more can be done to become recognised as an industry leader in this area. Progress on diversity and inclusion goals is welcome, and so too are the steps the company has taken to address weak financial controls. We will continue to press on these areas.
Let’s Be Open About It

(Global Franchise/Brands, Global Quality, International Equity)

We have been in dialogue with one of our multinational consumer staples holdings on the issue of child labour in their agricultural supply chain for over a year — and are encouraged by the company’s recent progress.

Child labour in supply chains is a complex issue, given the manufacturers of consumer products very often do not have visibility into or direct control of farm-level practices several layers down the value chain. It is further exacerbated by the lack of appropriate social infrastructure in lower-income emerging markets that produce many of the crops going into everyday products sold by multinationals.

We believe the company’s primary focus should be on enhanced monitoring and independent, publicly disclosed assessments of labour conditions in their supply chains. This should in turn enable corrective action and better inform stakeholders.

When we first engaged with the company on the topic, we compared the company’s reporting on and strategy to eliminate child labour to those of their closest peer. We found a lower level of disclosure and limited direct collaboration with independent third parties (such as supply chain auditors and human rights NGOs) by the company we hold. We gave constructive feedback to help them improve their practices.

The company was receptive to our feedback. Soon after our most recent engagement, the company published their first ever human rights report. Among other topics the report included improved disclosure on incidences of child labour on supplier farms, as well as a summary of results from the first set of country-level human rights impact assessments conducted by independent experts. The company also outlined some of their corrective actions in response to issues uncovered by these assessments.

This by no means solves the problem entirely. Our ongoing engagement regarding child labour, and our highlighting of better practice in the peer group has, we believe, contributed to the company’s improved transparency and stakeholder engagement initiatives. This is an important step for the company to meet its target of eliminating child labour in its supply chain.
Voting Overview

Voting at shareholder meetings is a vital part of how we communicate with investee companies. As such, we do not outsource proxy voting. Our investment team votes proxies in a prudent and diligent manner and in the best interest of our clients, consistent with the objective of maximising long-term investment returns.

Our proxy voting is predominantly related to governance issues such as management incentives and director appointments. We also consider how to vote on proposals related to social and environmental issues on a case-by-case basis by determining the relevance of the issues identified in the proposal and their likely impact. We generally support proposals that, if implemented, would enhance useful disclosure or improve management practices.

During 2020, we voted at 89 meetings and on more than 1200 proposals. Overall, we voted against management in 9% of cases.

Display 3
Proxy voting overview (12 months to 31 December 2020)

- Number of meetings voted: 89
- Total proposals voted: 1246
- % votes against management: 9%
- % meetings with at least one vote against management: 64%

Source: ISS Proxy Exchange; MSIM

The most common reasons for voting against management were related to remuneration, board structure and capitalisation.

Display 4
% Votes against management by topic*

- Non-Salary Compensation: 36%
- Directors Related: 15%
- Shareholder Proposal - ESG: 15%
- Capitalisation: 13%
- Anti-Takeover Related: 11%
- Routine/Business: 5%
- Other Shareholder Proposal: 4%
- Other: 3%

*Expressed as a percentage of total votes against management

Pay X-Ray

The Pay X-Ray is our proprietary scoring tool, used to better compare company pay plans, facilitate team discussions and inform our voting approach. This streamlined scoring system enables us to flag what we consider to be “good” and “bad” practices and rank our holdings’ remuneration plans accordingly. Each element of the plan receives a positive or negative score, rolled up into an overall company score.

The following chart illustrates the percentage of votes for and against management-sponsored say-on-pay proposals the team voted on during the period 2014 – 2020.

Display 5
Votes on management say-on-pay proposals voted 2014 – 2020

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Votes For (%)</td>
<td>11%</td>
<td>12%</td>
<td>17%</td>
<td>22%</td>
<td>13%</td>
<td>24%</td>
<td>26%</td>
</tr>
<tr>
<td>Votes Against (%)</td>
<td>89%</td>
<td>89%</td>
<td>83%</td>
<td>78%</td>
<td>77%</td>
<td>74%</td>
<td>72%</td>
</tr>
</tbody>
</table>

Source: ISS Proxy Exchange; MSIM

Our team voted on 154 say-on-pay proposals during the twelve months to 31 December 2020. 28% of votes were cast against management. Reasons the team voted against say-on-pay proposals included: excessive levels of pay, insufficient weight of performance-based remuneration, subjective or undisclosed targets for management, or performance incentives that are, in our view, not aligned with shareholders.

Proxy voting policy

MSIM votes proxies in a prudent and diligent manner and in the best interest of our clients, including beneficiaries of, and participants in a client’s benefit plan(s) for which the subadviser manages assets, consistent with the objective of maximising long-term investment returns. MSIM has retained research providers to analyse proxy issues and to make vote recommendations on those issues. While we are aware of the recommendations of one or more research providers, we are in no way obligated to follow such recommendations. The investment teams vote all proxies based on MSIM’s proxy voting policies in the best interests of each client.
In the 2020 UN PRI Assessment, MSIM received a straight A score card, including A+ for Strategy & Governance. In Listed Equity, MSIM scored A+ for Incorporation and for Active Ownership, the latter for a second year running, reflecting the firm’s commitment to stewardship. MSIM is in the top scoring brackets (A and A+) for both investment managers globally and those based in North America across all of our PRI disclosure modules.

Risk Considerations
There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market value of securities owned by the portfolio will decline. 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 strategy. Please be aware that this strategy may be subject to certain additional risks. Changes in the worldwide economy, consumer spending, competition, demographics and consumer preferences, government regulation and economic conditions may adversely affect global franchise companies and may negatively impact the strategy to a greater extent than if the strategy’s assets were invested in a wider variety of companies. In general, equity securities’ values also fluctuate in response to activities specific to a company. Investments in foreign markets entail special risks such as currency, political, economic, and market risks. Stocks of small-capitalization companies carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in emerging market countries are greater than risks associated with investments in foreign developed markets. Non-diversified portfolios often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. 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.

Any questions or comments?
Please contact:

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International Equity Team
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