

# ESG Investing: Living in a Material World

SOLUTIONS & MULTI-ASSET | APPLIED EQUITY ADVISORS TEAM | SUSTAINABILITY INSIGHT | 2021

Investing sustainably has rapidly gained mindshare with investors, particularly over the past several years. Yet it seems the deeper the dive into what investing sustainably means, the more questions arise. For example, when choosing stocks as part of a portfolio, how does a manager choose one company over another when ESG data sources may not paint a complete picture? Or, if striving for good returns relative to a broad benchmark, how does a manager evaluate and become comfortable owning companies that in a different context might not be considered ESG friendly, companies such as a bank or a utility company? Or, is it necessary to sacrifice performance in favor of sustainable and ethical behavior of companies?

In our mind, the key to answering these key questions is materiality.

### ESG: Why materiality matters

ESG investing is specifically focused on evaluating the investment viability of companies through an ESG lens:

- Is a company focused on ways to minimally impact the environment as they make decisions?
- Does it treat its employees and suppliers fairly?
- Does it have the appropriate governance structure in place to deliver results in an ethically sustainable way while managing risk?
- How is a company progressing in its quest to improve its ESG behavior?

But for ESG investing to improve financial results, companies have to focus on the specific ESG issues that can have a

### AUTHOR



**LESLIE DELANY**  
Executive Director  
Applied Equity Advisors

**“For ESG integration to improve financial results, companies have to focus on the specific ESG issues that will have a material impact on their business.”**



**material** impact on their business. For example, a financial services company renovating a corporate headquarters to be LEED-certified is great for the environment, but that in itself will likely not materially help its bottom line. However, a food distributor reworking supply chain logistics to minimize truck routes will improve the carbon footprint of the planet **and** reduce fuel costs, a material outcome.

Similarly, asset managers must pay attention to material ESG factors when evaluating companies to build a portfolio. Applied Equity Advisors understands that materiality matters, and with increasing evidence that ESG influences performance results, our investment process for all of our actively managed equity products systematically integrates ESG analysis into our stock selection process. Additionally, we have a strategy that launched in 2018, Global Concentrated ESG Equity, which leverages our integrated and systematic ESG analysis and additionally screens out companies in certain industries.

### Why ESG integration matters: Research results

While there is plenty of research that indicates that companies focusing on ESG factors do better financially,<sup>1</sup> one study in particular<sup>2</sup> provided evidence that focusing on material ESG factors can lead to superior investment results.

#### “CORPORATE SUSTAINABILITY: FIRST EVIDENCE ON MATERIALITY”

Aaron Yoon (Kellogg Business School), Mozaffar Khan (University of Minnesota) and George Serafeim (Harvard Business School), the authors of “Corporate Sustainability: First Evidence on Materiality 2015,” set out to quantify a correlation between a company’s ESG initiatives and financial results in the form of their stock price returns. They felt that providing evidence of positive results when investing in companies with strong ESG performance would allow

### DISPLAY 1 Extracting Excess Returns

STYLE POSITIONING	STOCK SELECTION
Valuation Growth Quality	Correlation to factors Fundamental Analysis ESG Materiality

investors to make better decisions about the value of firms’ ESG programs.

The research concluded that not all ESG investments are created equal when it comes to generating returns. The best approach was to buy stock in companies that prioritize ESG issues that are **material** to core business practices for a company’s particular sector.

The researchers ranked companies based on a materiality score. They created a portfolio of firms that scored highly on material sustainability issues and compared its stock returns to those of a portfolio of firms that scored poorly on those issues. The difference in stock returns was clear over a 22-year horizon (1992-2013). **On an annualized basis, the portfolio of firms that scored high on materiality delivered returns that were higher than those of the other portfolio.**

“Our paper shows that investing in ESG was not value-disrupting,” Yoon says, “as long as the ESG investments the companies make improve materiality.”

#### The Applied Equity Advisors investment process: Emphasizing the material

Many asset managers claim to have addressed ESG issues in their investment process. But what does this really mean? Some might merely exclude “sin” stocks. Others might rely on unadjusted third-party ESG rankings. Others still might talk with company management.

The Applied Equity Advisors team uses elements of screening, company engagement **and** third-party data, but it does so holistically. Our key differentiator is that we systematically integrate ESG analysis into our investment process by thoroughly evaluating those ESG issues that are **material** to the companies under our investment microscope. Being a core equity manager, that link was essential. Our primary mandate is to deliver performance relative to our benchmark, regardless of the market style (valuation, growth, quality) that is in favor. Integrating ESG analysis into our stock selection means utilizing a framework that can be applied to any type of stock, not simply those that are considered “green.”

The Applied Equity Advisors investment process is built on the basis of two engines (*Display 1*). The first engine is the team’s proprietary Style Positioning Engine, designed to determine positioning with regard to broad market factors, such as growth, valuation or quality.

Our second engine is our Stock Selection Engine. In selecting stocks, Applied Equity Advisors seeks to first choose those companies that can achieve the desired factor positioning from a style and regional perspective prior to conducting its in-depth stock analysis.

<sup>1</sup> Axioma, 2018. Boston Consulting Group, 2018. **Past performance is no guarantee of future results.** This is shown for illustrative purposes only and is not and is not meant to depict the performance of a specific investment. The results shown do not take into account any expenses.

<sup>2</sup> “Corporate Sustainability: First Evidence on Materiality 2015.” **Past performance is no guarantee of future results.** This is shown for illustrative purposes only and is not and is not meant to depict the performance of a specific investment. The results shown do not take into account any expenses.

**DISPLAY 2****Sampling of Material ESG Issues from SASB Materiality Map®**

Material Issues Guiding Applied Equity Advisors Stock Selection

SECTOR	CONSUMER GOODS	FINANCIALS	HEALTH CARE	FOOD & BEVERAGE	TECHNOLOGY & COMMUNICATIONS
INDUSTRY	Apparel, Accessories & Footwear	Commercial Banks	Managed Care	Processed Foods	Semiconductors
MATERIAL ISSUES	Product Quality & Safety Supply Chain Management Materials Sourcing & Efficiency	Data Security Access & Affordability Product Design & Lifecycle Management Business Ethics Systemic Risk Management	Data Security Access & Affordability Product Quality & Safety Customer Welfare Physical Impacts of Climate Change	Energy Management Water & Wastewater Management Product Quality & Safety Customer Welfare Selling Practices & Product Labeling Product Design & Lifecycle Management Supply Chain Management Materials Sourcing & Efficiency	GHG Emissions Energy Management Water & Wastewater Management Waste & Hazardous Materials Management Employee Health & Safety Employee Engagement, Diversity & Inclusion Product Design & Lifecycle Management Materials Sourcing & Efficiency Competitive Behavior

© 2021 The SASB Foundation. All Rights Reserved.

The ESG analysis integrated in the Stock Selection Engine starts with a sustainability screen across five dimensions categorized by the Sustainability Accounting Standards Board (SASB):

- 1. ENVIRONMENT**
- 2. SOCIAL CAPITAL**
- 3. HUMAN CAPITAL**
- 4. BUSINESS MODEL & INNOVATION**
- 5. LEADERSHIP & GOVERNANCE**

It is important note that we objectively choose not to rely solely upon third-party ESG rankings, as we find that ESG data is imperfect, might have a lag, and represents only a single point

of view. More importantly, we find that third-party rankings do not always focus enough on ESG factors that are material to a business, and thus do not tell the complete story.

To help determine the ESG issues most relevant for a given company, our internal analysts license the intellectual property behind the SASB Materiality Map<sup>®</sup><sup>3</sup>, a critical resource that pinpoints

sustainability issues that have been identified as likely to affect the financial condition or operating performance of companies within an industry.

SASB identifies 26 sustainability-related business issues, known as general issue categories that apply across multiple industries, and Disclosure Topics and associated Accounting Metrics that vary across 11 sectors and 77 industries

**“The guidance and information provided by the SASB Materiality Map® allows the Applied Equity Advisors team to be efficient with its resources and spend time on what matters, or is truly material to the desired outcome.”**

<sup>3</sup> © 2021. Reprinted with permission from The SASB Foundation. All rights reserved.

(Display 2). For example our analysts will understand from the map that Data Security is a material ESG issue in the Commercial Banking and Managed Care industries and less so or not at all likely to be material in Apparel, Accessories & Footwear, Processed Foods and Semiconductors. From our analysis, if we understand that a company in the Commercial Banking industry is investing heavily in Data Security, we view this as long-term positive for the firm, as opposed to a drain on investment capital.

The SASB Materiality Map® allows for further understanding the specific metrics that illustrate performance on a disclosure topic for a particular industry. In addition, our team is able to use the SASB Materiality Map® as an ongoing

discussion framework for corporate engagement, in an effort to understand if a company is moving in a positive direction in terms of its sustainability and ESG investment.

The guidance and information provided by the SASB Materiality Map® allows the Applied Equity Advisors team to be efficient with its resources and spend time on what matters, or is truly material to the desired outcome. Given the evidence provided, we expect integrating ESG into our investment process to be additive to portfolio results.

### ESG integration in the material world

Compelling research shows that a focus on ESG factors has the potential

to improve investment results. The Applied Equity Advisors team integrates sustainability analysis into its stock selection by focusing on those ESG factors that are material to the companies that we are evaluating.

In all, we believe our integrated ESG approach will continue to drive good corporate citizenship, while helping investors thrive in the material world of ESG investing.

**This represents how the portfolio management team generally implements its investment process under normal market conditions. Past performance is no guarantee of future results.**

## 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 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. Please be aware that this portfolio may be subject to certain additional risks. In general, **equities securities'** values also fluctuate in response to activities specific to a company. Stocks of **small-and medium-capitalization companies** entail special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. Investments in **foreign markets** entail special risks such as currency, political, economic, market and liquidity risks. **Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). **Non-diversified portfolios** often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. **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

## DISCLOSURES

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

Forecasts and/or estimates provided herein are subject to change and may not actually come to pass. Information regarding expected market returns and market outlooks is based on the research, analysis and opinions of the authors or the investment team. These conclusions are speculative in nature, may not come to pass and are not intended to predict the future performance of any specific Morgan Stanley Investment Management product.

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

This material is a general communication, which is not impartial and all information provided has been prepared solely for informational and educational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The information herein has not been based on a consideration of any individual investor circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.

### Past performance is no guarantee of future results.

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

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market. Prior to investing, investors should carefully review the strategy's / product's relevant offering document. There are important differences in how the strategy is carried out in each of the investment vehicles.

## DISTRIBUTION

**This communication is only intended for and will only be distributed to persons resident in jurisdictions where such distribution or availability would not be contrary to local laws or regulations.**

**Ireland:** MSIM Fund Management (Ireland) Limited. Registered Office: The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, D02 VC42, Ireland. Registered in Ireland as a private company limited by shares under company number 616661. MSIM Fund Management (Ireland) Limited is regulated by the Central Bank of Ireland. **United Kingdom:** Morgan Stanley Investment Management Limited is authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA. **Dubai:** Morgan Stanley Investment Management Limited (Representative Office, Unit Precinct 3-7th Floor-Unit 701 and 702, Level 7, Gate Precinct Building 3, Dubai International Financial Centre, Dubai, 506501, United Arab Emirates. Telephone: +97 (0)14 709 7158). **Germany:** MSIM Fund Management (Ireland) Limited Niederlassung Deutschland, Grosse Gallusstrasse 18, 60312 Frankfurt am Main, Germany (Gattung: Zweigniederlassung (FDI) gem. § 53b KWG). **Italy:** MSIM Fund Management (Ireland) Limited, Milan Branch (Sede Secondaria di Milano) is a branch of MSIM Fund Management (Ireland) Limited, a company registered in Ireland, regulated by the Central Bank of Ireland and whose registered office is at The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, D02 VC42, Ireland. MSIM Fund Management (Ireland) Limited Milan Branch (Sede Secondaria di Milano) with seat in Palazzo Serbelloni Corso Venezia, 16 20121 Milano, Italy, is registered in Italy with company number and VAT number 11488280964. **The Netherlands:** MSIM Fund Management (Ireland) Limited, Rembrandt Tower, 11th Floor Amstelplein 1 1096HA, Netherlands. Telephone: 31 2-0462-1300. Morgan Stanley Investment

Management is a branch office of MSIM Fund Management (Ireland) Limited. MSIM Fund Management (Ireland) Limited is regulated by the Central Bank of Ireland. France: MSIM Fund Management (Ireland) Limited, Paris Branch is a branch of MSIM Fund Management (Ireland) Limited, a company registered in Ireland, regulated by the Central Bank of Ireland and whose registered office is at The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, D02 VC42, Ireland. MSIM Fund Management (Ireland) Limited Paris Branch with seat at 61 rue de Monceau 75008 Paris, France, is registered in France with company number 890 071863 RCS. **Spain:** MSIM Fund Management (Ireland) Limited, Sucursal en España is a branch of MSIM Fund Management (Ireland) Limited, a company registered in Ireland, regulated by the Central Bank of Ireland and whose registered office is at The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, D02 VC42, Ireland. MSIM Fund Management (Ireland) Limited, Sucursal en España with seat in Calle Serrano 55, 28006, Madrid, Spain, is registered in Spain with tax identification number W0058820B. **Switzerland:** Morgan Stanley & Co. International plc, London, Zurich Branch Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered with the Register of Commerce Zurich CHE-115.415.770. Registered Office: Beethovenstrasse 33, 8002 Zurich, Switzerland, Telephone +41 (0) 44 588 1000. Facsimile Fax: +41(0)44 588 1074.

## U.S.

A separately managed account may not be appropriate for all investors. Separate accounts managed according to the strategy include a number of securities and will not necessarily track the performance of any index. Please consider the investment objectives, risks and fees of the strategy carefully before investing. A minimum asset level is required. For important information about the investment manager, please refer to Form ADV Part 2.

**Please consider the investment objectives, risks, charges and expenses of the funds carefully before investing. The prospectuses contain this and other information about the funds. To obtain a prospectus please download one at [morganstanley.com/im](http://morganstanley.com/im) or call 1-800-548-7786. Please read the prospectus carefully before investing.**

Morgan Stanley Distribution, Inc. serves as the distributor for Morgan Stanley Funds.

**NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A BANK DEPOSIT**

**Hong Kong:** This document has been issued by Morgan Stanley Asia Limited for use in Hong Kong and shall only be made available to "professional investors" as defined under the Securities and Futures Ordinance of Hong Kong (Cap 571). The contents of this document have not been reviewed nor approved by any regulatory authority including the Securities and Futures Commission in Hong Kong. Accordingly, save where an exemption is available under the relevant law, this document shall not be issued, circulated, distributed, directed at, or made available to, the public in Hong Kong. **Singapore:** This publication should not be considered to be the subject of an invitation for subscription or purchase, whether directly or indirectly, to the public or any member of the public in Singapore other than (i) to an institutional investor under section 304 of the Securities and Futures Act, Chapter 289 of Singapore ("SFA"); (ii) to a "relevant person" (which includes an accredited investor) pursuant to section 305 of the SFA, and such distribution is in accordance with the conditions specified in section 305 of the SFA; or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. This publication has not been reviewed by the Monetary Authority of Singapore. **Australia:** This publication is disseminated in Australia by Morgan Stanley Investment Management (Australia) Pty Limited ACN: 122040037, AFSL No. 314182, which accept responsibility for its contents. This publication, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act.

**Japan:** For professional investors, this document is circulated or distributed for informational purposes only. For those who are not professional investors, this document is provided in relation to Morgan Stanley Investment Management (Japan) Co., Ltd. ("MSIMJ")'s business with respect to discretionary investment management agreements ("IMA") and investment advisory agreements ("IAA"). This is not for the purpose of a recommendation or solicitation of transactions or offers any particular financial instruments. Under an IMA, with respect to management of assets of a client, the client prescribes basic management policies in advance and commissions MSIMJ to make all investment decisions based on an analysis of the value, etc. of the securities, and MSIMJ accepts such commission. The client shall delegate to MSIMJ the authorities necessary for making

investment. MSIMJ exercises the delegated authorities based on investment decisions of MSIMJ, and the client shall not make individual instructions. All investment profits and losses belong to the clients; principal is not guaranteed. Please consider the investment objectives and nature of risks before investing. As an investment advisory fee for an IAA or an IMA, the amount of assets subject to the contract multiplied by a certain rate (the upper limit is 2.20% per annum (including tax)) shall be incurred in proportion to the contract period. For some strategies, a contingency fee may be incurred in addition to the fee mentioned above. Indirect charges also may be incurred, such as brokerage commissions for incorporated securities. Since these charges and expenses are different depending on a contract and other factors, MSIMJ cannot present the rates, upper limits, etc. in advance. All clients should read the Documents Provided Prior to the Conclusion of a Contract carefully before executing an agreement. This document is disseminated in Japan by MSIMJ, Registered No. 410 (Director of Kanto Local Finance Bureau (Financial Instruments Firms)), Membership: the Japan Securities Dealers Association, The Investment Trusts Association, Japan, the Japan Investment Advisers Association and the Type II Financial Instruments Firms Association.

#### **IMPORTANT INFORMATION**

**EMEA: This marketing communication has been issued by MSIM Fund Management (Ireland) Limited. MSIM Fund Management (Ireland) Limited is regulated by the Central Bank of Ireland. MSIM Fund Management (Ireland) Limited is incorporated in Ireland as a private company limited by shares with company registration number 616661 and has its registered address at The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, D02 VC42, Ireland.**

Any index referred to herein is the intellectual property (including registered trademarks) of the applicable licensor. Any product based

on an index is in no way sponsored, endorsed, sold or promoted by the applicable licensor and it shall not have any liability with respect thereto. Charts and graphs provided herein are for illustrative purposes only.

The information contained in this communication is not a research recommendation or 'investment research' and is classified as a 'Marketing Communication' in accordance with the applicable European or Swiss regulation. This means that this marketing communication (a) has not been prepared in accordance with legal requirements designed to promote the independence of investment research (b) is not subject to any prohibition on dealing ahead of the dissemination of investment research.

MSIM has not authorised financial intermediaries to use and to distribute this document, unless such use and distribution is made in accordance with applicable law and regulation. Additionally, financial intermediaries are required to satisfy themselves that the information in this document is appropriate for any person to whom they provide this document in view of that person's circumstances and purpose. MSIM shall not be liable for, and accepts no liability for, the use or misuse of this document by any such financial intermediary.

The whole or any part of this work may not be directly or indirectly reproduced, copied, modified, used to create a derivative work, performed, displayed, published, posted, licensed, framed, distributed or transmitted or any of its contents disclosed to third parties without MSIM's express written consent. This work may not be linked to unless such hyperlink is for personal and non-commercial use. All information contained herein is proprietary and is protected under copyright and other applicable law.

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

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