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INVESTMENT MANAGEMENT

Sustainable Investing – The Long View

MORGAN STANLEY INVESTMENT MANAGEMENT SUSTAINABILITY TEAM | January 2026

At Morgan Stanley Investment Management (MSIM), our investment activity spans public and private markets, developed and emerging markets, and a spectrum of asset classes. MSIM's Sustainability team partners closely to support the sustainable investing work of MSIM's dedicated investment professionals. From our team's perspective, the landscape for sustainable investing has become fragmented and complex. Filtering the noise, we share our view of five key themes that we believe will influence the long-term direction of sustainable investing.

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1 Transition requires investment, not divestment

There is a growing realisation among asset owners and asset managers that excluding certain sectors or companies from portfolios is unlikely to facilitate the move to a more sustainable global economy. Exclusions may sometimes be used in portfolios to manage exposure and downside risk. However, companies need capital to transition business models, which requires investors. Divesting from high-intensity sectors may lead to an immediate drop in a portfolio's emissions, but it does not translate directly to real world emissions reductions. In addition, providing capital allows investors to have a voice in the future direction of a company. By investing in challenging companies and sectors and helping them transition, investors have the potential to participate in the upside and help generate alpha for their clients.

As an example, investors who approach climate-focused investing with screening criteria may exclude utilities, as the vast majority of utilities companies in the S&P 500 have some tie to fossil fuels.[1] However, the decarbonisation rate of the sector is also one of the fastest, both in absolute terms and on an intensity basis for Scope 1 and Scope 2 emissions. Utilities companies with decarbonisation targets are transitioning at an even faster rate: the 24% year-over-year average intensity reduction is faster than any other sector, and approximately 13% of revenues come from low-carbon products and solutions.[2] The potential downside of an exclusion or divestment approach is that it makes little difference to companies' cost of capital.[3] In searching for alternative sources of capital, companies may turn to managers that are more focused on short-term returns rather than creating long-term value, likely perpetuating problems rather than resolving them.

In short, we believe the transition to a more sustainable economy requires investment across all sectors – regardless of emissions levels – and to back companies transforming their business models with credible targets, capital expenditure and research and development in support of a clean energy future.

2 Diversity & inclusion is not tokenism, it is financially relevant

Diversity and inclusion ("D&I") initiatives have attracted some criticism at times, often based on the claim that they do not impact commercial outcomes. Much of this critique narrowly focuses on the hiring of diverse candidates, but this lens overlooks the broader scope of what D&I entails. To find long-term value, investors should look beyond demographic statistics alone to identify the companies that are building inclusive cultures that encourage diverse perspectives.

Inclusive cultures, as defined by Edmans et al., are those where "people of all backgrounds are respected and made to feel welcome, and that employees are encouraged to speak up [and] express their views". They find that while policies like parental leave or flexible working are part of the solution, they typically achieve maximum impact when employees are encouraged to

[1] 97% of utilities companies by count in the S&P 500 have some tie to fossil fuels. Source: MSCI Data as of November 28, 2025.

[2] Source: MSCI Data as of November 28, 2025. The decarbonization rate is determined by calculating the compound annual change between 2020 and 2023 using MSCI emissions data.

[3] A Stanford University and University of Pennsylvania study demonstrated that to effect more than 1% change in the cost of capital of a company, investors would need to make up more than 80% of all its investable wealth. Source: Jonathan Berk & Jules H. van Binsbergen, "The Impact of Impact Investing," Law & Economics Center at George Mason University Scalia Law School Research Paper Series No. 22-008 (2021).

participate. Their research emphasizes the importance of management playing an active role in building a culture to ensure employees feel valued, encouraged to innovate, and confident their contributions will be heard.[4]

Studies show that companies that actively foster inclusive cultures by including employees from diverse backgrounds in decision-making and provide them with the 'psychological safety' to share these perspectives tend to avoid group think and consider a broader range of possibilities before selecting a course of action.[5] Additionally, research suggests these companies are associated with higher future earnings surprises and higher valuation ratios.[6]

Investors who want to unlock this value should identify companies focused on inclusive corporate cultures, as these firms position themselves for stronger problem-solving and more resilient financial returns.

3 Sustainable supply must be accompanied by reduced demand

The focus on climate mitigation and global CO_2 emissions has led to significant efforts on the supply side of the equation, with the aim to catalyse a systemic shift

in energy supply to low-carbon sources. Surprisingly little focus has been given to the demand side of the equation. Research suggests that today's business practices will contribute to a global gap between the supply and demand of natural resources that translates to as much as $25 trillion of lost economic growth by 2050.[7]

Illustrating the downside of focusing on supply alone, the Morgan Stanley Institute for Sustainable Investing notes that decarbonisation efforts could cause the demand for critical minerals to rise sixfold by 2040.[8] As an example, in the transition to a low-carbon economy, copper will be vital for clean energy technologies and demand is set to increase by over 50%.

This demand means we need to mine more copper in the next 20 years than we have in the last 5,000 years, a challenge given decreasing rates of mine discovery and growing political backlash against the negative biodiversity effects of key South American producers.[9] Copper recycling is an efficient solution – it can save up to 85% of the energy needed for mining and extraction and is 13 times more cost efficient than mining new supply.[10] The financial benefits of circular strategies can lower input costs and should directly impact bottom lines, in addition to helping conserve finite global resources.

Looking at the fashion industry as another example, Gen Z and millennial consumers have been shown to seek cost-effective

[4] Alex Edmans, Caroline Flammer & Simon Glossner, "(Diversity) Equity and Inclusion," Finance, Economics & Banking Research Paper No. 07 (2024).

[5] Stephanie Duchek, Sebastian Raetze & Ianina Scheuch, "The role of diversity in organizational resilience: a theoretical framework," Business Research 13 (2020): p. 387-423; Erik Larson, "New Research: Diversity + Inclusion = Better Decision Making At Work," Forbes, September 21, 2017.; Georgi Karadzhov, Andreas Vlachos & Tom Stafford, "The effect of diversity on group decision-making," arXiv (2024); Henrik Bresman & Amy Edmonson, "Research: To Excel, Diverse Teams Need Psychological Safety," Harvard Business Review, March 17, 2022.

[6] Alex Edmans, Caroline Flammer & Simon Glossner, "(Diversity) Equity and Inclusion," Finance, Economics & Banking Research Paper No. 07 (2024).

[7] Accenture, "The Circular Economy Could Unlock $4.5 trillion of Economic Growth, Finds New Book by Accenture," Accenture, September 2015.

[8] "Navigating the Next Decade: 10 Demand Signals for the Next 10 Years of Sustainable Finance", Morgan Stanley, October 2023.

[9] Ed Conway, "Material World: The Six Raw Materials That Shape Modern Civilisation" (New York: Knopf Publishing Group, 2023).

[10] Xix Chen & Ke Wang, "More than Ore: The pivotal role recycled copper can play in the energy transition," World Resources Institute, January 7, 2025. "How copper recycling benefits the environment," Copper Sustainability Partnership, March 25, 2024.

and sustainable fashion alternatives.[11] As younger generations gain spending power, we can expect companies that deliver on these dimensions to continue to thrive.

Investors looking to capitalise on the opportunities presented by the circular economy should seek out companies pivoting their business models to ones that use less, use longer, and allow for regeneration to do it all again.

4 Investors are already exposed to nature, but it needs to be valued properly

According to the Intergovernmental Platform on Biodiversity and Ecosystem Services, over 50% of global GDP depends on natural resources, equivalent to $58 trillion.[12] Investors are therefore already exposed, and would benefit from understanding the impacts, dependencies, risks and opportunities posed by a company dependent on nature to generate profits. Ten major global equity indices have an average of 10% of their market value-based index weight flagged for biodiversity dependences or impacts, and around 20% flagged by revenue screens for biodiversity risk.[13] Landmark political agreements such as the COP26 deforestation pledge and the 30x30 target agreed at Biodiversity COP 15 ("a Paris Agreement for Nature") codify that the protection of land and marine resources must be prioritised alongside economic growth. The consequence of these developments is that when thinking about the sourcing of natural resources, investors need to question whether they are priced appropriately. Many companies already look at stress testing for carbon prices, but it is far less common to do so for timber, commodities, minerals and water. Sourcing them cheaply through unsustainable means may no longer be viable. This is already being reflected in policy, with the EU Deforestation Regulation (EUDR) introducing stricter requirements around traceability and sustainable sourcing, significantly increasing compliance requirements for companies sourcing key commodities like timber, soy, and palm oil.

Investors who want to properly factor in transition risks related to resource pricing need to understand which biodiversity dependencies they are exposed to. Engaging with investee companies to determine whether they have identified such dependencies, which, if any, they are pricing in, and any steps they may be taking to mitigate them, may help them build more profitable and durable businesses in the long term.

5 Climate resilience is an economic imperative

The Paris Agreement adopted in 2015 at the UN Climate Change COP 21 set long-term goals for countries to reduce global greenhouse gas emissions over time. However, in the years following this, the voice of developing countries in particular became amplified, highlighting the necessity for climate adaptation to tackle the challenges that they face today, irrespective of the global warming trajectory in the future.

The consequences of acute weather events such as heat waves, drought, flooding, hurricanes, and wildfires, as well as longer- term weather patterns, are likely to impact various asset classes. For equity investors, physical climate risks are already embedded in portfolios:

[11] Hyunsoo Rim, "Fashion Rental Market Makes A Comeback – As Gen Z And Millennials Revive Brands Like Nuuly, Rent The Runway", Forbes, May 28, 2024.
[12] "IPBES Transformative Change Assessment," IPBES, December 18, 2024.
[13] "Analyzing Portfolio Dependencies and Impacts on Nature with Morgan Stanley's Biodiversity IQ Tool", Morgan Stanley, February 2025.

S&P found that nearly 60% of S&P 500 companies hold assets with high physical risk exposure.[14] Insured losses related to natural disasters totalled $140 billion in 2024 alone[15] and insurance premiums are also rising given the increased risk. This surge in premiums is not without consequence: a one standard deviation increase in insurance premiums leads to a 16% rise in mortgage delinquency, putting residential mortgage-backed security portfolios at greater risk.[16] These direct financial impacts are becoming increasingly material, calling for urgent adaptation and resilience strategies. A 2024 study from the U.S. Chamber of Commerce found that a $10.8 billion investment in resilience ahead of a Category 4 hurricane hitting Miami could save 184,000 jobs, $26 billion in GDP, and $17 billion in earned income – underscoring that the cost of inaction far outweighs the price of preparedness.[17]

Equally, as environments potentially become uninhabitable, climate displacement should not be overlooked for its indirect contribution to the development of geopolitical and security crises, what the U.S. Department of Defense calls a "threat multiplier."[18] In 2022, 32 million displacements were caused by weather-related hazards representing a 41% increase compared to 2008.[19] An example of this action is the Sahel region in Africa, which has been experiencing an accelerated temperature rise compared to the global average leading to longer dry seasons. Land and water disputes are leading to civil unrest giving opportunities for extremists to escalate conflict. The United Nations notes that as of 2020, parts of the region were experiencing one of the world's fastest displacement crises with over 640,000 people impacted in 2020 alone.[20] If temperatures rise and forced migration accelerates globally as currently projected,[21] investors who want to appropriately manage related risks need to understand the exposures of companies and portfolios.

Look further and see deeper

The five sustainability themes we have identified are potentially of systemic significance, however, the way in which they will manifest for specific companies, countries or investment portfolios will be idiosyncratic, as will the timing and degree to which they may be financially material. To address this, the MSIM Sustainability team has designed a range of analytical tools – recognised by Risk.net's Risk Technology Awards for Best In-House Climate Risk Initiative[22] – that allow MSIM investment teams to interrogate the data on these five themes and evaluate how these could impact their investment theses. Through continuing to strategically assess potential sustainability headwinds and tailwinds, and by innovating and iterating our approaches to ESG data and analytics, we aim to empower our investment teams to critically evaluate the long view when it comes to sustainable investing, as appropriate, to ultimately look further and see deeper to generate value for our clients.

[14] Rick Lord, Steven Bullock, Murray Birt, "Understanding Climate Risk at the Asset Level: The Interplay of Transition and Physical Risks," S&P Global (2019).

[15] "Climate change is showing its claws: The world is getting hotter, resulting in severe hurricanes, thunderstorms and floods," Munich Re, January 9, 2025.

[16] Shan Ge, Stephanie Johnson & Nitzan Tzur-Ilan, "Climate Risk, Insurance Premiums, and the Effects on Mortgage and Credit Outcomes," Federal Reserve Bank of Dallas Working Paper 2505 (2025).

[17] "The Preparedness Payoff: The Economic Benefits of Investing in Climate Resilience", U.S. Chamber of Commerce, Allstate, and U.S. Chamber of Commerce Foundation, June 25, 2024.

[18] "Why climate change is a 'threat multiplier'," Yale Climate Connections, June 20, 2019.

[19] Siegfried, Kristy, "Climate change and displacement: the myths and the facts", UNHCR, November 13, 2023.

[20] "How climate change is multiplying risks for displacement", UNHCR, December 2, 2020.

[21] Robert Muggah & Katie Hill, "African cities will double in population by 2050. Here are 4 ways to make sure they thrive," World Economic Forum, June 27, 2018.

[22] As of June 2025. The award was open to banks, insurers, asset managers and other market participants that have built proprietary risk technology for internal purposes and/or client use with substantial development within the past year.

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