Morgan Stanley

INVESTMENT MANAGEMENT

Engagement & Stewardship: MSIM Cross-Asset Class Perspectives

MORGAN STANLEY'S SUSTAINABLE FINANCE SUMMIT | KEY TAKEAWAYS | August 2023

Morgan Stanley has a comprehensive list of investment strategies for clients to choose from, each of which approaches ESG integration in a different way. At Morgan Stanley's inaugural Sustainable Finance Summit in New York, Navindu Katugampola moderated a discussion with Barbara Calvi, Thomas Kamei, Mona Benisi and Marte Borhaug, during which panelists discussed how they incorporated ESG and sustainability into their work, and what collaboration meant to them. Among the key takeaways:

FIXED INCOME

Using Our Seat to Engage on Sustainability

Fixed Income is a good platform for engagement dialogue: we have a well-deserved seat at the table in determining where capital is used, given the diversity of debt issuers and the frequency of primary issuance. The active market for labelled Green and Sustainable bonds, in particular, represents a great opportunity to engage with an issuer early in the process, when they are thinking about multiple tools to execute their sustainable financing frameworks and can be nudged to enhance their process and disclosure. Investors can start discussions with an issuer on the specific concerns associated with the structure of the bond, but then zoom out on their broader sustainability strategy since we tend to engage during a window of time, ahead of new transactions, when issuers are particularly attentive to investor needs.

Engaging With Sovereign Bond Issuers

Engaging with sovereigns can be a hurdle given the smaller individual investor stakes and the potential political sensitivities. Nevertheless, it is important to engage because governments have an inherent mandate to promote economic and social development within their countries, and sustainability factors can be material to their credit profile and bond pricing, especially for longer-term financing. Some ways to engage with large players include keeping them accountable on existing commitments and frameworks, notably climate-related pledges like the Paris Agreement, and push them to be a little more ambitious especially when they fall short of NetZero goals. From a broader perspective, we engage them on the UN Sustainable Development Goals, and on the data

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and disclosure side we look at how countries can provide more impact-focused data.

INTERNATIONAL EQUITY

A Long-Term Investor-Led Approach to Engagement

Engagement with companies is a key part of understanding the long-term viability of their returns on operating capital. Meeting with some of the world's leading companies contributes towards our assessment of whether they can maintain their returns while growing their businesses over the long-term. Our AUM and the long-term nature of our investments grants us access to senior management. Our engagement activities are conducted by the investment team directly, as we believe effective engagement is best carried out by the same people who conduct the bottom-up fundamental research and allocate capital. In our opinion active managers running concentrated portfolios are well positioned to develop long-term relationships with companies – helpful given dialogue can be prolonged and require multiple engagements.

The Investment Value of Diversity in Clinical Trials

There is a lot of focus on diversity in the workplace, but an overlooked area is how companies' products and services meet the diverse needs of their customers – and the risks of failing to do so. A good example is the health care sector. New drugs are approved following clinical trials, but research has found trials are often not representative of the patients who end up using the medicine, with racial and ethnic minority groups acutely underrepresented. This is a risk for drug safety and effectiveness, as drugs may elicit different responses due to a patient's race, ethnicity, and gender. It also carries potential financial risks. In 2022, we met with our health care companies to understand how they assess, manage and mitigate this risk. The meetings helped build our comfort in the companies' ability to manage the risk, as well as identify leading practices and show how better clinical trial diversity may even be a financial opportunity.

COUNTERPOINT GLOBAL

Sustainability as a Business Value Driver

At Counterpoint Global we look for positive sustainability optionality, where environmental and social initiatives extend a company's moat, spur growth, drive profitability and provide optionality. We find that often because this optionality is hard to measure, it can provide a unique perspective on an investment opportunity.

Company Culture a New Research Frontier

We're looking to innovate on how to evaluate companies' human capital. We've conducted a study in collaboration with experts from Harvard Business School using a dataset of 300 million employees and are able to rank companies on how well they retain talent. Our findings were novel, yet intuitive: companies with strong retention tend to outperform those with cultures where people leave more often.

REAL ASSETS

Local Approach Is Key

As a real estate manager, the type of "engagement" we do is somewhat different compared to the public markets' approaches. We make investments in real estate across select asset classes and regions. As part of our efforts, we engage with various stakeholders. Community engagement is relevant since we are, by definition, part of the community. This requires local expertise, strategies and case-by-case consideration of where our investments are being made. For example, an industrial warehouse in a less densely populated area may require one type of stakeholder and community engagement, such as introducing a skilled labor program, whereas a retail shopping mall may address other topics, such as youth education by working with education NGOs (non-governmental organizations) to "bring classrooms to the mall." In summary, as part of real estate engagement, we create asset- and regional-specific action plans and work with stakeholders to achieve results.

Real Estate Plays a Key Role

Between 30-40% of global energy-related greenhouse gas emissions can be attributed to building operations and construction. Real estate plays a key role in decarbonizing the economy. In addition to general sustainability disclosure requirements, a big driver has been building-level regulations. Tenant demand for green and healthy building certifications, especially for certain asset classes such as office, has increased over the last few years. Having tenants on board is critical, since in most asset classes, a large portion of the building's square footage is typically tenant-controlled spaces. As an example, it can be challenging to obtain green building certifications or pursue other sustainability-related initiatives without tenants' collaboration. "Green leases", or sustainability clauses that help facilitate tenant and landlord collaboration, can get things started, but to really make significant progress we need to go beyond that.

RISK CONSIDERATIONS

The value of investments may increase or decrease in response to economic, and financial events (whether real, expected or perceived) in the U.S. and global markets. 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. 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. 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. Real estate investments, including real estate investment trusts, are subject to risks similar to those associated with the direct ownership of real estate.

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