Morgan Stanley

INVESTMENT MANAGEMENT

Compounding With a Conscience

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | INVESTMENT INSIGHT | 2019

Strong on Engagement, Low on Carbon, Built on Quality

The trend toward sustainable investing has exploded over the last decade, with an estimated $23 trillion in assets under management globally.[1] With our focus on high quality companies with earnings resilience, sustainability is key. In our view, understanding and integrating environmental, social and governance (ESG) factors is essential for successful compounding.

We believe material social and environmental risks are more important than ever given political and technological changes. Naturally, any material ESG risk to the sustainability of a company's returns may pose a risk to the prospects for long-term sustainable compounding. However, many investors miss that companies with good governance and the ability to lead the way on social and environmental issues can also be a positive force for corporate success, driving consumer loyalty, and improving employee retention and stakeholder engagement. We believe that clients are increasingly looking for ESG funds to meet their investment requirements without any compromise to returns. Global Sustain is Morgan Stanley Investment Management's solution for this—aiming to deliver compounding with a conscience.

The strategy builds on the International Equity Team's existing foundation of high-quality investing. It combines our historical focus on good governance, our successful and regular engagement with company managements, full integration of ESG into the investment process, and the exclusion of certain industries that conflict with social or environmental considerations.

[1] Morningstar, January 2018: Sustainable Funds U.S. Landscape Report.

AUTHOR

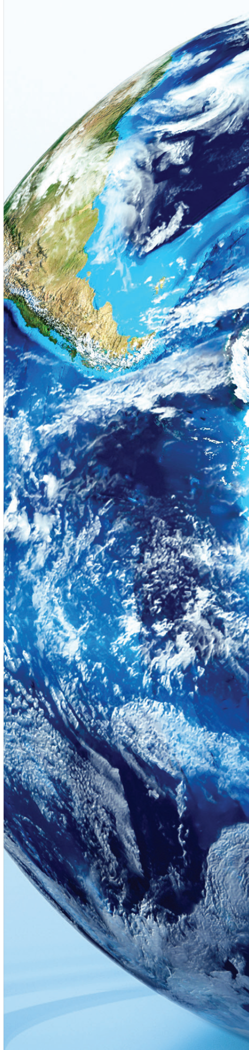
WILLIAM LOCK
Managing Director
Head of International Equity Team

BRUNO PAULSON
Managing Director

VLADIMIR DEMINE
Executive Director
Head of ESG Research

"In our view, understanding ESG factors is essential for successful compounding."

William Lock



Global Sustain includes 25-50 of the world's highest quality compounders at reasonable valuations. It is naturally carbon light, given the avoidance of low-return polluting sectors, such as bulk commodities, energy, and gas and electric utilities. It has exposure to corporations leading the way in consumer and staff engagement through a focus on material social and environmental issues. It benefits from superior allocation of capital driven by good management and the right attitude to governance. Furthermore, the strategy excludes controversial industries, including tobacco, alcohol, weapons, gambling, adult entertainment and fossil fuels.

Built on Quality

High-quality companies are those able to grow steadily over the long term at sustainably high returns on operating capital.

Global Sustain has nearly three times the return on operating capital than that of the MSCI World Index, combined with more stable operating margins—the recipe for sustainable compounding and, therefore, long-term capital appreciation *(Display 1)*.

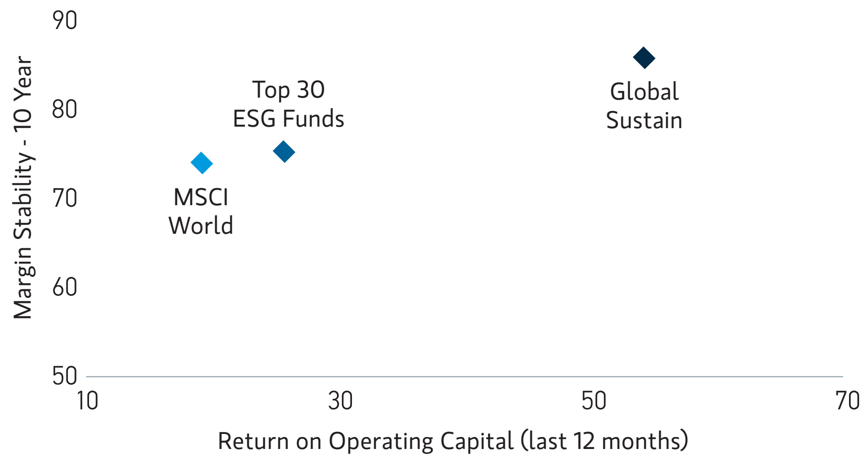
The success of high-quality companies is built on strong, sustainable and difficult to replicate intangible assets, for instance, brands, networks or licences, which bring pricing power *(Display 2)*. When combined with recurring revenues that hold up in tough times, the pricing power helps drive robust profits. These companies generally have low capital intensity and, therefore, generate high returns on operating capital, leading to strong, sustainable free cash flow generation.

Strong management is vital to sustain the virtuous circle of compounding and avoid fading returns. There needs to be sufficient investment in innovation, and carefully thought-out advertising and promotion, to preserve and enhance the quality of the franchises and remain relevant. The effective allocation of capital is crucial, since poor acquisitions at low returns can impair compounding.

"The success of high-quality companies is built on strong, sustainable...intangible assets."

DISPLAY 1

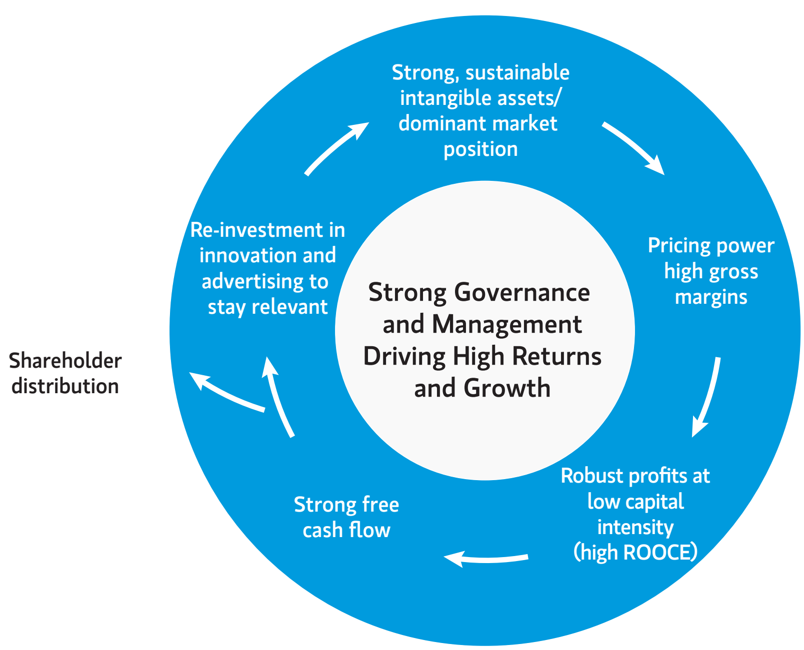
The Foundation of Compounding Is High and Sustainable Returns



Source: FactSet. Data as of December 31, 2018. Top 30 ESG Funds are the largest global equity investment funds from FactSet and Morningstar databases with ESG, Environmental or Ethical focus, as defined by Morningstar, or where ESG factors are stated as an investment consideration. ROOCE (Return on Operating Capital Employed) = EBITA (Earnings Before Interest, Taxes and Amortization) / PPE (Property, Plant, Equipment) + Trade working capital (excludes goodwill). Ex-Financials. Five-year averages to latest reported period as of December 31, 2018. EBIT margin stability is 1-(std deviation)/(mean), 10-year averages to latest reported period as of December 31, 2018.

DISPLAY 2

How Sustainable Quality Works



Light on Carbon

Global Sustain is a naturally low-carbon portfolio. Based on Scope 1 (internally generated) and Scope 2 emissions (those embedded in purchased power), the portfolio has a carbon intensity 94% lower than the MSCI World per $1MM invested *(Display 3)*, and is also 88% lower than the MSCI World per $1MM of company sales.[2] In other words, when Global Sustain companies grow sales by $1MM, compared to an average company in the index, the incremental CO_2 footprint is much lighter; in this case, the equivalent of saving 64 acres of forest.[3]

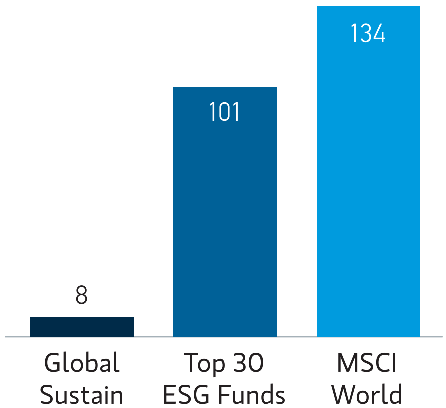
We explicitly exclude capital intensive, low-return businesses or businesses we believe will fade, and only invest in businesses we believe will have high, sustainable long-term future returns. Our underlying focus on high-return companies with pricing power and limited cyclicality means that the typically carbon-intensive sectors, such as energy and materials, would comfortably fail to meet our requirements were they not explicitly excluded. Utilities, some of which are also carbon intensive but often more defensive, are regulated and generate low returns on capital and thus don't make the grade.

While the portfolio is naturally carbon-light, what is key for us is considering environmental issues that have the potential to be material, be they the energy sources for data centers, the sustainability of the supply chain, or packaging for FMCG (fast moving consumer goods) companies.

DISPLAY 3

MSCI Carbon Intensity

Carbon emissions per $1MM invested



GLOBAL SUSTAIN AND THE MSCI CARBON INTENSITY RATIO

Global Sustain is a low-carbon portfolio, with less than 10% of the broader MSCI World Index carbon intensity.

MSCI ESG Research defines a portfolio's carbon footprint as the carbon emissions of a portfolio per million dollars invested. They sum up all the emissions in a portfolio based on the investor's ownership share, using reported or estimated emissions data.

Source: MSCI ESG Research, Morningstar, FactSet; Morgan Stanley Investment Management. Data as of December 31, 2018. Top 30 ESG Funds are the largest global equity investment funds from FactSet and Morningstar databases with ESG, Environmental or Ethical focus, as defined by Morningstar, or where ESG factors are stated as an investment consideration.

Leading the Way

Focusing on the material risks that social and environmental issues can bring is crucial to successful investing in compounders, as it reduces the left-tail risk of very poor outcomes. However, there is also the potential for such issues to be a positive force. Companies that get this right can help differentiate themselves from competitors who do not, both with consumers and staff.

THE DATA OPPORTUNITY

A good example of this is data. The ability to use the data that is collected on all of us on a daily basis is increasing exponentially. Some of the biggest names in technology are highly dependent on monetizing such data. At the same time, companies that fail to protect the integrity of the data they have collected are punished by loss of customers and plummeting share prices. Governments and regulators are catching up. The EU's recent General Data Protection Regulation (GDPR) has greatly increased potential fines, with the most serious violations being fined up to 4% annual global turnover. The U.S. Congress' recent examination of two large social media companies saw significant drops in their share prices.

When investing in software and services, our preference is for companies which have limited platform risk, don't primarily rely on monetizing sensitive consumer data, and seek to balance their own interests with the wider contribution their big data analytics make to society. We favor those companies that can use big data to create new business and help society and the environment. That may be an electronic health record company that uses big data algorithms to provide better treatments and lower health care costs for society, or a software and services company whose cloud service provides considerable energy savings and data security advantages to its clients over self-hosted solutions.

[2] Data as of December 31, 2018, for the Global Sustain representative account. MSCI ESG Research defines a portfolio's carbon footprint as the carbon emissions (Scope 1 and 2) of a portfolio per $1 million of portfolio companies' sales. They sum up all emissions in a portfolio based on the investor's ownership share, using reported or estimated emissions data.

[3] Based on MSIM calculations. Sources: Canadian Council of Forest Ministers www.sfmcanada.org.

CONSUMER RELEVANCE

Companies choosing to stay relevant to the consumer can open up new markets, support premium pricing and gain market share. Companies that innovate in response to new revenue opportunities—be they environmental or social, or demanded by a developing demographic—can improve or maintain strong returns. Environmentally friendly products and waste reduction strategies can strengthen brands as well as financials *(Display 4)*.

ATTRACTING AND RETAINING TALENT

Having an engaged workforce is also extremely valuable. Creating a sense of purpose around the role of the company, above mere profitability, can foster a culture of innovation and development, help with engagement, improve recruitment and retention, and even enhance productivity.

Strong on Engagement

Over time, many companies may experience environmental and social issues. The key is how material they are and how management plans to deal with them. We look for sensible solutions and where relevant, monitor progress on issues over time. There is little chance of doing this successfully without having active engagement with companies as the basic foundation *(Display 5)*. As bottom-up stock pickers and active owners with meaningful ownership in the companies we hold, we have believed in the importance of active ownership for many years, engaging directly with companies on a number of different material issues, assisted where appropriate by MSIM's Global Stewardship Team.

Our mantra is simple: good governance is the cornerstone of sustainable returns—without it, all else fails. There are three main sources of damage that we identify as stemming from poor governance:

DISPLAY 4
Sustainable Compounders

	SOFTWARE & IT SERVICES	HEALTH CARE	CONSUMER STAPLES
Opportunities	Business models robust in the new cloud environment Companies investing in innovative technologies to help corporates' digitization Inclusive cultures that maximize human capital and employee engagement	Predictable medtech with aftermarket consumables Exposure to over-the-counter, vaccines, animal health, emerging markets where brand is important Aging demographics	Fully invested, particularly in digital In touch with consumer trends, e.g., organics/naturals Emerging market consumer exposure
Avoid	Hardware	Excessive exposure to patent expiry, single-product risk, pricing risk	Food retail and increasingly, food manufacturing

DISPLAY 5

406

Meetings with management in 2018

229

ESG engagements in 2018

Source: International Equity Team, Morgan Stanley Investment Management, as of December 31, 2018, for the period covering the preceding 12 months.

1. Short-term thinking

Management teams may prioritize short-term measures over longer-term success, manifesting as an excessive fixation on quarterly results, top-line growth or this year's earnings per share. This can destroy longer-term compounding, particularly if poorly structured incentive schemes encourage management to make cuts to investment in order to meet short-term targets.

2. Poor allocation of capital

Investing capital at low returns, either through paying too much for acquisitions or expanding into lower-return businesses, can undermine the overall quality of the business and impair the ability to compound over time.

3. Risk taking

The third challenge is that poor governance may lead to excessive risk-taking, not least around environmental and social issues.

DISPLAY 6

Companies are increasingly publicly supporting the UN SDGs

	RECKITT BENCKISER[2]	MICROSOFT[2]	VISA[1]	SAP[3]	ACCENTURE[2]	UNILEVER[3]
1 No Poverty	✓		✓	✓		✓
2 Zero Hunger	✓✓			✓		✓
3 Good Health and Well-Being	✓✓	✓		✓		✓
4 Quality Education	✓	✓		✓	✓	✓
5 Gender Equality	✓✓	✓	✓	✓	✓	✓
6 Clean Water and Sanitation	✓✓			✓		✓
7 Affordable and Clean Energy	✓			✓		✓
8 Decent Work and Economic Growth	✓	✓	✓✓	✓	✓	✓
9 Industry, Innovation and Infrastructure		✓		✓		
10 Reduced Inequalities				✓	✓	✓
11 Sustainable Cities and Communities	✓	✓		✓		
12 Responsible Consumption and Production	✓			✓		✓
13 Climate Action	✓	✓	✓	✓	✓	✓
14 Life Below Water	✓			✓		✓
15 Life on Land	✓			✓		✓
16 Peace, Justice and Strong Institutions		✓		✓	✓	✓
17 Partnerships for Goals	✓		✓	✓	✓	✓

The content of this publication has not been approved by the United Nations and does not reflect the views of the United Nations or its officials or Member States. For additional information, please see the United Nations Sustainable Development Goals web site at https://www.un.org/sustainabledevelopment/sustainable-development-goals. Source: Morgan Stanley Investment Management. [1] Source: Company Annual Report 2016. [2] Source: Company Annual Report 2017. [3] Source: Company Annual Report 2018. Provided for informational purposes only, and should not be deemed as a recommendation to purchase or sell the securities mentioned. Two check marks refer to those with the biggest impact.

Companies shown are taken from the Top 10 holdings in the Global Sustain Representative Account as of December 31, 2018.

Staying relevant and running the business for the long term can give huge advantages over companies managed for the short term. Increasingly, we see companies reporting their contribution toward the meeting of the U.N. Sustainable Development Goals (SDGs) *(Display 6)*—while not universally representative of management's focus on sustainability, we do see this as evidence of management's increasing engagement with a wider set of stakeholders. Those that lose touch with their stakeholders will not be sustainable long term, and their long-term returns will be impacted.

It may seem counterintuitive, but our view is that governance is even more important in the high-quality companies we focus on. This is partly because management has more degrees of freedom. Earnings are often relatively easy to massage for high-quality companies. For instance, consumer staples companies generally have large advertising and promotion budgets, as high as 15% of sales or more. These budgets can be trimmed in tricky years to inflate short-term profits at the cost of the health of a company's long-term franchise. The threat around capital allocation is also elevated since high-return companies tend to generate large quantities of free cash flow, with all the temptations for misallocation that involves.

Quite simply, high-quality companies have even more to lose from excessive risk-taking because of the greater value of any franchises that can be damaged.

With over 20 years of managing clients' money, Morgan Stanley's International Equity Team is known for its focus on compounding. The team uses a consistent and successful investment philosophy, investing in the world's highest quality companies—those with sustainably high returns on operating capital. ESG is integrated across all of the team's strategies. We believe incorporating ESG is essential for long-term compounding.

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. 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. **Nondiversified 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. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. **Illiquid securities** may be more difficult to sell and value than public traded securities (liquidity risk).

INDEX INFORMATION

The **MSCI World Net Index** is a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. *The performance of the index is listed in U.S. dollars and assumes reinvestment of net dividends. The index is unmanaged and does not include any expenses, fees or sales charges. It is not possible to invest directly in an index.*

DEFINITIONS

Earnings per share is the portion of a company's profit allocated to each outstanding share of common stock. Earnings per share serves as an indicator of a company's profitability. **Free cash flow** is cash flows (net income plus amortization and depreciation) minus capital expenditures and dividends. **Free cash flow yield** is a financial ratio that measures a company's operating free cash flow minus its capital expenditures per share and dividing by its price per share.

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: Morgan Stanley Investment Management (Ireland) Limited. Registered Office: The Observatory, 7-11 Sir John Rogerson's, Quay, Dublin 2, Ireland. Registered in Ireland under company number 616662. 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:** Morgan Stanley Investment Management Limited Niederlassung Deutschland Junghofstrasse 13-15 60311 Frankfurt Deutschland (Gattung: Zweigniederlassung (FDI) gem. § 53b KWG). **Italy:** Morgan Stanley Investment Management Limited, Milan Branch (Sede Secondaria di Milano) is a branch of Morgan Stanley Investment Management Limited, a company registered in the UK, authorised and regulated by the Financial Conduct Authority (FCA), and whose registered office is at 25 Cabot Square, Canary Wharf, London, E14 4QA. Morgan Stanley Investment Management 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 08829360968. **The Netherlands:** Morgan Stanley Investment Management, Rembrandt Tower, 11th Floor Amstelplein 1 1096HA, Netherlands. Telephone: 31 2-0462-1300. Morgan Stanley Investment Management is a branch office of Morgan Stanley Investment Management Limited. Morgan Stanley Investment Management Limited is authorised and regulated by the Financial Conduct Authority in the United Kingdom. **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 suitable 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 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 | NO BANK GUARANTEE | MAY LOSE VALUE |NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A 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 document 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 material 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 2.16% 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 Morgan Stanley Investment Management (Ireland) Limited ("MSIM Ireland"). Registered Office: The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, Ireland. Registered in Ireland under company number 616662. Regulated by the Central Bank of Ireland.

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.

A separately managed account may not be suitable 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.

Explore our site at **www.morganstanley.com/im**

CRC 2240937 Exp. 4/30/2020 Lit-Link: INVINSIGHTCOMPOUND 9292168_KC_0718
US