Morgan Stanley

INVESTMENT MANAGEMENT

Engage

GLOBAL FRANCHISE/BRANDS | GLOBAL QUALITY | GLOBAL SUSTAIN | INTERNATIONAL EQUITY | **ESG REPORT** | 2019

Engagement Is Our Edge

- We believe active managers running concentrated portfolios are best positioned to identify potentially material ESG risks as well as opportunities. Investor-led engagement helps our team build a more comprehensive picture of a company's ESG profile.
- We are pleased to announce that MSIM was ranked A[1] for the Listed Equity modules in its UN PRI Annual Assessment, and A+ on the Engagement sub-score as of September 2019. For 2019, all MSIM UN PRI Annual Assessment scores meet or exceed the peer median.
- In the first half of 2019 a lot of our engagement was focused on the issue of plastic waste. Overleaf is a summary of our engagements and our conclusions on the impact on consumer staples companies of the transition to a circular plastic economy.

Signatory of:

PRI | Principles for Responsible Investment

ESG IS FULLY INTEGRATED INTO ALL OUR TEAM'S STRATEGIES

- 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.
- Material ESG risks and opportunities are more important than ever to companies' future returns. ESG is an integral part of our assessment of long-term sustainability of returns.
- We have engaged directly with companies on issues of sustainability and governance for over 20 years, rather than outsourcing the process.

OUR ENGAGEMENT RECORD[2,3]

1,239

RESOLUTIONS VOTED ON ACROSS ALL OF OUR STRATEGIES

295

MANAGEMENT ENGAGEMENTS ON ESG ISSUES

83

THE NUMBER OF TIMES THAT WE VOTED AGAINST MANAGEMENT, INCLUDING 17 TIMES ON EXECUTIVE COMPENSATION[4]

60

THE NUMBER OF TIMES WE DISAGREED WITH ISS PROPOSALS

[1] To be ranked A, a company must receive a combined score between 75-95/100 in the core and additional assessed indicators. To be ranked A+ a company must score >95/100.

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

[3] Data shown is for the 12 month period to 30 June 2019.

[4] Any remuneration-related proposals.

Solving the plastic waste problem

We have engaged with *eight* of our **fast moving consumer goods** (FMCG) holdings, including those in beverages and household and personal care, on plastic waste. As well as an important environmental issue (due to plastic's impact on marine and land ecosystems and its potential impact on human health), plastic waste may impact the reputation and cost base of those who fail to adapt to the future reality of the new circular economy.

We conclude that although the single-use plastic problem is very complex and will not be solved overnight, most of our holdings, which are among the largest consumer staples companies, are likely to lead the rest of the FMCG industry in terms of focus, allocated resources and public commitments to reduce plastic waste. Although meeting these commitments may result in somewhat higher costs in the near term, they are manageable and should protect the companies from potentially elevated risks including increased regulation, such as taxes on virgin plastic, higher waste management costs or plastic bans.

There is no single solution to the single-use plastics problem given the sheer scale of virgin plastic production and society's dependence on it. Every possible avenue of improvement should be pursued. We believe solutions should involve governments and consumers as well as companies. During our engagements we discussed company-specific strategies and targets as well as the hurdles to achieving them.

In the case of FMCG companies, the most practical near-term solution is increasing the percentage of recycled content in their packaging. This should increase demand for recycled plastic and encourage badly needed investments in the collection and recycling infrastructure. As part of the Ellen MacArthur Foundation's Global Commitment, most of our consumer holdings exposed to plastic packaging have now publicly committed to significantly increase recycled content, from less than 10% in most cases to 20-50% by 2025-30.

Although this will definitely not solve the problem by itself (the largest FMCG user of plastic accounts for only about 2% of global plastic packaging volumes), it should protect these companies from future regulatory risks, such as potential taxes on virgin plastic (the UK was the first country to announce one), or reputational damage if consumers eventually start penalising brands they view as not addressing the problem. These incremental commitments should provide a material demand boost for the currently small recycled plastic market.

Other initiatives undertaken by our holdings include partnerships with, and investments into, innovative start-ups that explore breakthrough technologies in chemical recycling, work on circular/refillable packaging, or try to find new ways to improve plastic waste capture in emerging markets. They also continue to work on simplifying and reducing the weight of their packaging and increasing its recyclability (which already ranges between 70-100% in most cases).

We encouraged the management of one of the **beverage companies** we hold to allocate a greater proportion of their sizeable annual charity donations towards projects related to tackling plastic waste in emerging markets. The company shared with us that it was already in their plans - we will monitor future developments.

As part of our engagement and research we tried to assess the cost impact of this move to a more sustainable, circular plastic supply chain. Despite the potential temporary increase in prices of recycled plastic due to higher demand, we believe that the cumulative impact is likely to be limited to low single-digit percentage of sales.

Another finding was that more companies are starting to use circular plastic as a marketing tool by converting certain brands' packaging to 100% recycled plastic, and advertising this on the pack and in the media.

We believe this is important for the long-term health of their brands as more consumers, particularly younger ones, make brand choices based on sustainability credentials.

In April 2019, Morgan Stanley launched its Plastic Waste Resolution, committing to facilitate the prevention, reduction and removal of 50 million metric tonnes of plastic waste from entering rivers, oceans, landscapes and landfills by 2030.
https://www.morganstanley.com/Themes/plastic-pollution-resolution

Future proof

We engaged with one of our **personal care holdings** to discuss its sustainability strategy. The company launched its comprehensive sustainability plan in 2013. Importantly, it linked the CEO's pay to achieving certain sustainability key performance indicators, and later expanded this to other senior managers. This has resulted in significant progress over the last five years, not only in terms of achieving quantitative targets, e.g., on sustainably sourced raw materials, but also by setting up internal systems and processes to improve environmental and social performance and prepare for more stringent demands from stakeholders.

For example, it took the company several years to develop a tool to measure the environmental footprint of all individual products. This, in turn, has enabled a continuous product footprint reduction programme through re-engineering of formulas and packaging. The company has now shared its methodology with the rest of the industry.

Another recent initiative enabled by this measurement tool is a unique pilot project trialling environmental product labels. The relative environmental profile of the product is shown on the pack, similar to traditional nutritional labels on food products.

The consumer can see a standardised table comparing the company's product to the average for the category on key environmental indicators, such as carbon, water and plastic footprint. We believe this may become an effective way of linking sustainability to brand marketing, staying relevant to environmentally conscious consumers.

There are further examples of how the company is trying to future-proof itself. It has already secured the necessary volumes of recycled plastic to fulfil its ambitious target of increasing recycled content in its packaging. Having done a lot of work on minimising the impact of its packaging, it already has the lightest shampoo bottles on the market.

On the social side, it is one of very few companies independently verified as having closed the gender pay gap over the last several years, an action led by the CEO.

These examples highlight the importance of having the right culture and management incentives in place to focus on the long-term strength of the business. We believe the company is one of the industry leaders in sustainability, embedding it in its culture and investing in environmental and social initiatives ahead of many other players, at a time when the benefits of doing so were not as obvious. Our in-depth engagement with the company has reassured us that the company is positioned well for future challenges. We believe its actions around ESG have potentially added to its competitive advantages versus peers.

Investigating value chains

In the context of sustainability and nutrition, we met with a **leading UK supermarket chain** to discuss consumer trends, regulatory challenges and the performance of branded companies in food and beverage categories. Although this company is not held in our portfolios, the meeting provided additional insights from a major retailer, rather than a brand owner's, perspective.

We discussed the UK's recently introduced tax on sugared soft drinks. Encouragingly, the overall impact on sales has been minimal. In order to reduce the amount of tax and therefore limit price increases to the consumer many producers have successfully reformulated their products to reduce sugar content. The UK also has a well-developed diet carbonated soft drinks segment, and while the full-sugar varieties of the largest carbonated brands have not been reformulated, some of the demand has switched to their diet versions, which are not taxed. This shows that sugar taxes can be effective in reducing sugar intake, without necessarily being a material negative for manufacturers, provided they invest sufficiently in growing their low- and no-sugar offerings ahead of time.

However, the company believes more tax-based regulation is likely in the future, for example, expanding the sugar tax from beverages to more categories such as confectionery, or introducing a 'junk-food' tax, as governments try to cope with the costs of the obesity epidemic. Again, this is likely to impact those food and beverage companies that have not invested enough in product development.

Branded food and beverage companies have also been challenged by the rise of organic, natural and 'free-from' segments that in some cases have taken market share from mainstream brands. Another finding from the meeting was this retailer's view that it is better positioned to take advantage of this trend via its private label range than branded manufacturers. It believes that its outsourced manufacturing, in which small third-party suppliers compete for private label contracts, allows for greater flexibility. As it does not own production assets, this retailer can introduce these 'on-trend' products more quickly by outsourcing manufacturing, without having to invest in new equipment itself. This need for investment has, in their view, been an impediment for many branded manufacturers that have been slow in expanding in these new segments.

They also highlighted the challenge of extending mainstream brands into healthier product segments as the customer base for these products is very different, and therefore brand owners may have to create new brands, as opposed to relying on established brands' equity. This has confirmed our view that many developed world branded food manufacturers that have not managed to adapt to changing consumer preferences may face structural brand fade, which is why we are underweight this sector in our strategies.

Reducing carbon risk

In the first half we reviewed two **cement companies** held in our International Equity strategy. As cement is one of the most carbon-intensive industries, we assessed the potential impact of carbon pricing on these players' profitability, having engaged with one of the companies in 2018 to discuss the impact of EU carbon policies on the industry. Partly to reflect potential long-term carbon risk, we raised the WACC (weighted average cost of capital) in our valuation models. Further, one of these companies is short EU emissions trading scheme credits, which may hurt its profits disproportionately relative to the rest of the industry.

We decided to sell this holding given its disadvantaged position and the fact our new modelling assumptions resulted in no valuation upside. The other company is long carbon credits, which should protect them for the next several years, and remains attractively valued. In the long-run, higher carbon costs may spur consolidation in the industry, as smaller companies with more carbon-intensive plants decide to exit in the face of tightening emissions caps.

Proxy Voting Overview *(12 months to 30 June 2019)*

Number of Meetings Voted	86
Total Proposals Voted	1,293
Votes Against Management	7%

Source: ISS Proxy Exchange; MSIM

Pay X-Ray

The International Equity Team reviews all remuneration proposals and votes on a case-by-case basis. Our team voted on 60 say-on-pay management proposals during the 12 months to 30 June 2019:

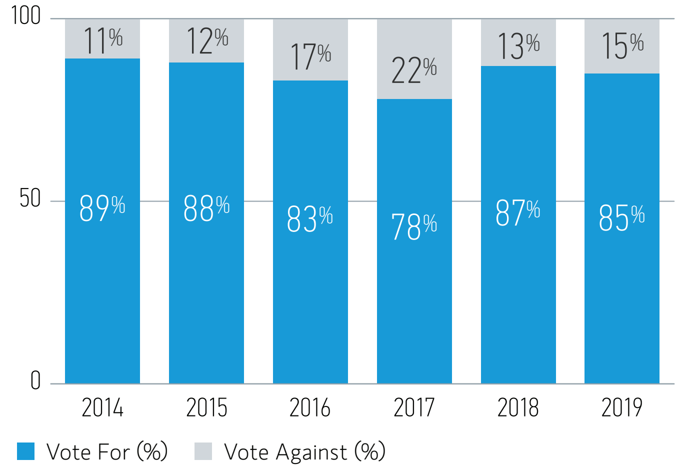
- 85% of the votes were cast in favour of the proposal
- 15% of the votes were cast against the proposal

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, performance incentives that are, in our view, not aligned with shareholders.

The following chart illustrates the percentage of votes for and against management-sponsored say-on-pay proposals the team voted on during the period from 2014 – 2018.

Votes on Management Say-on-Pay Proposals

Voted 2014 – YTD 2019 (12 months to 30 June 2019)



Source: ISS Proxy Exchange; MSIM

Proxy Voting Policy

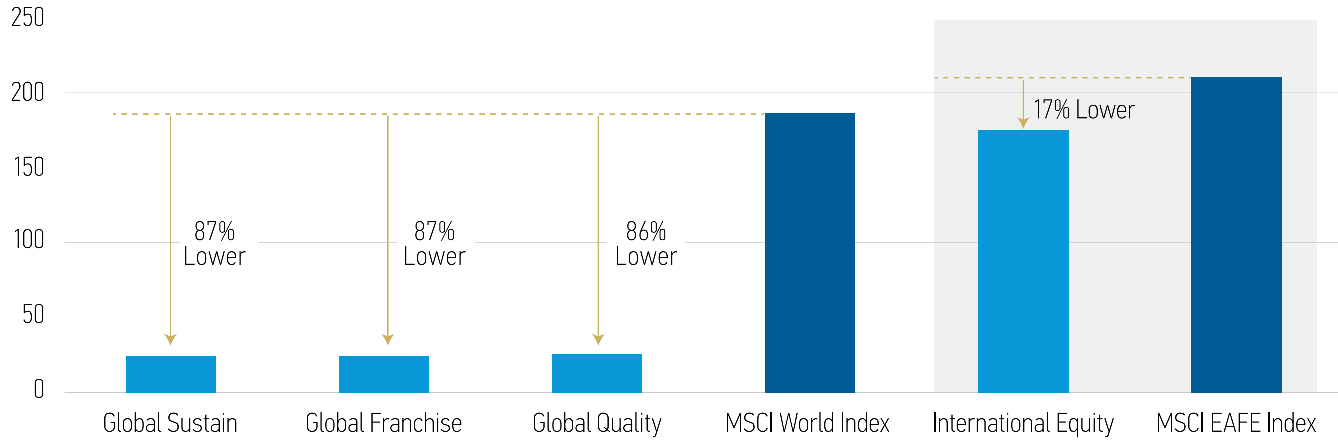
MSIM votes proxies in a prudent and diligent manner and in the best interest of our clients, including beneficiaries of, and participants in a client's benefit plan(s) for which the subadvisor manages assets, consistent with the objective of maximizing long-term investment returns. MSIM has retained research providers to analyze 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.

Notable votes against management *(12 months to 30 June 2019)*

Large U.S. media company	We voted in favour of a shareholder proposal that all stock should have one vote per share, against management recommendations.
	We voted against the appointment of seven directors.
U.S. electrical component manufacturer	We supported a shareholder proposal requesting the company publish a report on the human rights risks in their operations and supply chain, against management opposition.
U.S. multinational technology company	We voted in favour of a shareholder proposal that all stock should have one vote per share, against management recommendations.
	We voted against management, backing a shareholder proposal requiring the company in question to adopt a policy prohibiting unequal employment practices.
	We supported a shareholder proposal requesting the company publish a report on sexual harassment policies, against management opposition.
	We voted in favour of a shareholder proposal requesting the company publish a report on policies and risks related to content governance, despite management opposition.

Carbon light portfolios

Our global portfolios typically have less than a fifth of average carbon intensity of the benchmark. (Tons of Carbon per $M Company Sales)



Source: MSCI ESG Research; Morgan Stanley Investment Management. Figures are based on the representative account for each strategy. Data as at 30 June 2019. MSCI ESG Research defines a portfolio's carbon footprint as the carbon emissions (Scope 1 and 2) of a portfolio per $1 million invested or per $1million 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.

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. **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.

Any questions or comments? Please contact:

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