Morgan Stanley

INVESTMENT MANAGEMENT

ESG and Sustainable Investing Report

ACTIVE FUNDAMENTAL EQUITY | GLOBAL OPPORTUNITY TEAM | 2019

This annual report on environmental and social externalities and governance (also referred to as ESG) for the Global Opportunity team[1] discusses ESG integration within the investment process, company engagement, the carbon footprint of the portfolios and summarizes participation in collaborative initiatives and relevant MSIM policies.

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ESG and the Sustainability of Competitive Advantage

The Global Opportunity team's investment process integrates analysis of sustainability with respect to disruptive change, financial strength and environmental and social externalities and governance (also referred to as ESG). We view ESG as a component of quality and consider the valuation, sustainability and fundamental risks inherent in every portfolio position. As bottom-up investors, we do not apply top-down ESG positive/negative screens to a benchmark. Nor do we utilize ESG scorecards from third parties which rank companies versus industry peers. In other words, ESG in isolation is not a principal driver of our investment thesis; it is but one component of our quality assessment.

Our ESG analysis focuses on a company's ability to sustain competitive advantage over the long term. Areas assessed include environmental management to minimize externalities, reduce consumption of energy, water and other resources and mitigate costs thereby improving profitability; social factors such as consumer product safety, human capital management, supply chain management and regulatory impacts; and governance issues such as management incentives, capital allocation, independent boards and transparent accounting.

[1] The Global Opportunity team manages highly differentiated, concentrated portfolios that invest across geographies, sectors and market capitalizations. Our Opportunity Strategies — managed by Kristian Heugh, and available on a global, regional and customizable basis — seek long-term capital appreciation by investing in high quality companies that the investment team believes are undervalued at the time of purchase.

Within the emerging markets, where rule of law and corporate governance standards can be lower than developed markets, additional due diligence steps are necessary. Risks stemming from corruption, political instability, governance and accounting issues must be thoroughly investigated. For every emerging market company, we typically commission a full due diligence report, including a background check on company management, board directors and cross-holdings, court and tax filings, and local language press to assess governance risk.

Incorporating ESG-related potential risks and opportunities within an investment process is about ensuring long-term stewardship of capital. Over extended time horizons, we believe that ESG risks are more likely to materialize and externalities not borne by the company are more likely to be priced into the value of securities. Therefore, we continue to innovate and evolve our process and believe that integrating ESG within our investment analysis improves the risk and reward profile of client portfolios.

Engagement with portfolio companies

Our research has identified ESG risks that diminished the investment thesis of several companies and resulted in the sale of (or decision not to invest in) a company's securities. Our investors also engaged with several portfolio companies over the course of 2018.

We engaged a Chinese operator of hotel properties on how the company addresses potential environmental risks and secures key stakeholder relationships. The company provided information regarding the implementation of an online hotel energy management IT system which records daily energy consumption of all leased and owned hotel properties which is monitored by a dedicated team of specialists. This system monitors use of light-emitting diode lighting fixtures, energy efficient HVAC equipment such as split-type air conditioning for economy hotels and duct air-conditioning for midscale hotels as well as heat pump and solar photovoltaic equipment. As the company shifts to a higher proportion of franchised properties, the company conducts surveys which found that franchises are over 93% satisfied with the franchise agreement process, hotel opening process, product design and construction quality, demonstrating that the needs of this key stakeholder group are being addressed.

We engaged a Japanese mergers and acquisitions intermediary on how the company addresses its key stakeholder, company employees, through human capital management initiatives. The company detailed its new hire training, compensation policies and the establishment of a certification exam which has become the de facto standard M&A expert qualification system in the country and established a strong ecosystem for the business as qualified M&A experts have strong loyalty to the firm. The company also aims to minimize potential negative externalities from M&A by tracking economic losses avoided and employee inducement while supporting regional banks and accounting firms to prevent small- and medium-size enterprises from disappearing in the region.

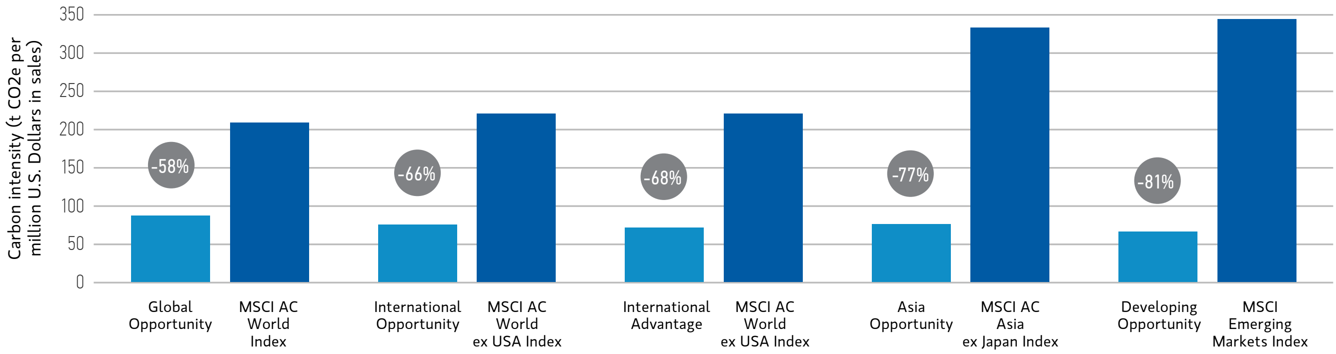
We identified single-use plastics waste as a potential risk to the brand of a global specialty coffee retailer as consumers become more eco-conscious. Our co-operative engagement with management enhanced our analysis. The company turned this risk into an opportunity with a big brand win channeling a consumer movement when it announced it will eliminate plastic straws globally by 2020 thereby eliminating more than one billion plastic straws per year.

We engaged the CFO of an education company on improving their environmental and social disclosures. We believe that the company creates positive social externalities through the advancement of primary and secondary education in China with minimal negative externalities. As the company's success relies upon the strength of its math and science curriculum, the company pays its teachers a rate much higher than industry average to ensure it attracts and retains talented teachers.

We chose not to invest in a consumer staples company involved in the manufacture of cigarettes and other tobacco products. Our evaluation determined that the company's competitive advantage is not sustainable as it externalized the healthcare costs of cancer treatment upon society and was therefore over-monetized while reliant on pricing growth due to declining unit volumes. We also declined to participate in the initial public offering of a tobacco product packaging company.

Carbon intensity

Our portfolios typically have less than half of the weighted average carbon intensity of benchmark indices. This is a result of our view that solar will likely disrupt value for fossil fuel companies as costs become more competitive based on our disruptive change research. The representative accounts for the Global Opportunity, Asia Opportunity, Developing Opportunity and International Opportunity strategies held no coal, oil or gas companies involved in the extraction of fossil fuel reserves and no holdings in the utilities sector. The International Advantage strategy held no coal, oil or gas companies involved in the extraction of fossil fuel reserves and had limited exposure to the utilities sector.



Source: Morgan Stanley Investment Management, Carbon Disclosure Project, MSCI ESG Research LLC.

MSIM Global Stewardship

MSIM's approach to ESG is led by a Sustainability Council, a team of cross-functional leaders, and supported by an Advisory Committee comprised of senior investors and other subject matter experts within MSIM who provide insights on incorporating ESG factors in the investment process. Both the Sustainability Council and the Advisory Council are supported by MSIM's Global Stewardship team. The Global Stewardship team is made up of dedicated ESG professionals who facilitate proxy voting and collaborate with investment teams on company engagements and ESG integration.

OUR ENGAGEMENT RECORD[2,3]

4,979	93%	7%
TOTAL PROPOSALS VOTED IN 2018	VOTES WITH MANAGEMENT	VOTES AGAINST MANAGEMENT

Proxy voting

MSIM views proxy voting as an integral part of the investment process and ownership oversight. All proxy voting decisions are made in-house based on collaboration between members of the investment team and the Global Stewardship team and in line with the principles addressed in our policy. Consequently, we do not automatically support management recommendations. The Global Stewardship team has an internal voting system that facilitates communication with the investment teams and that documents vote rationale. We combine the in-depth knowledge of the investment teams with the global governance expertise of the Global Stewardship team to make informed voting decisions, rather than relying on external advisory firms or making proxy voting a rote, box-ticking exercise. The Global Stewardship team oversees the proxy voting process to ensure a consistent set of policies and procedures are applied across our global portfolios.

[2] The Global Opportunity team defines an engagement as an interaction with senior management or non-executive board members.

[3] Source: ISS Proxy Exchange, Morgan Stanley Investment Management. Data shown is for the 12 month period to December 31, 2018 and represents all the strategies managed by the Global Opportunity team.

Controls are in place to help ensure that meetings are voted in a timely manner and are consistent with our policies across global portfolios. In most cases, we do not view attendance at portfolio company annual general meetings as productive and instead prefer to engage in one-to-one meetings or conference calls with our portfolio companies. The Global Stewardship team provides clients with proxy voting records relating to votes held and voted on their behalf.

Collaboration and reporting

MSIM is a signatory of the UN Principles for Responsible Investing ("UNPRI"), the UK Stewardship Code, and the Japan Stewardship Code. MSIM also participates in the Sustainability Accounting Standards Board (SASB) Investor Advisory Group and is an investor member of GRESB. In addition, Morgan Stanley is a member of the Global Impact Investing Network and the Ceres Investor Network.

We view our involvement in these initiatives as opportunities to stay abreast of industry developments and best practices, which help us to continually refine our ESG approach. They are also opportunities for us to share our ESG story with the broader ESG community.

Another way in which we share our ESG efforts is through our annual proxy voting and engagement report summarizing key ESG engagement topics and our proxy voting record on important ESG issues. Our individual investment teams also communicate their ESG efforts through thought leadership pieces that describe their strategy-level approach and views on key ESG issues and trends. MSIM encourages teams to tell their ESG story as relevant to their strategy, while recognizing that the field and practice is continually evolving.

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 that the value of portfolio shares may therefore be less than what you paid for them. 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. Investments in **foreign markets** entail special risks such as currency, political, economic, market and liquidity risks. The risks of investing in **emerging market countries** are greater than risks associated with investments in foreign developed countries. **Privately placed and restricted securities** may be subject to resale restrictions as well as a lack of publicly available information, which will increase their illiquidity and could adversely affect the ability to value and sell them (**liquidity risk**). **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. To the extent that the Strategy invests in a limited number of issuers (**focused investing**), the Strategy will be more susceptible to negative events affecting those issuers and a decline in the value of a particular instrument may cause the Strategy's overall value to decline to a greater degree than if the Strategy were invested more widely.

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