ENVIRONMENTAL, SOCIAL & GOVERNANCE INVESTING, EUROPE 2019

Moving from a marginal approach to a mainstream strategy

MAY 2019

Morgan Stanley

INVESTMENT MANAGEMENT

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If ESG is now mainstream, what is the role of equity in this new environment?

**Interviewer**

Pádraig Floyd, Consultant Publisher, Clear Path Analysis

**Interviewee**

Vladimir Demine, Head of ESG Research International Equity Team, Morgan Stanley Investment Management

**SUMMARY**

- Client interest and regulation is driving an increased interest in sustainable investing.
- Different managers have differing abilities to integrate ESG in their processes and fragmentation of the market place has resulted in increased sophistication.
- Managers are expected to integrate ESG into their investment processes and long term strategies and are under greater focus than before.
- There will be winners and losers and the winners will be those companies with better governance and defensible business models.

**Pádraig Floyd:** How far do you consider ESG investing having evolved in the last couple of years?

**Vladimir Demine:** We have seen strong growth driven by client interest and to some extent regulation. Our team has been receiving an increasing number of environmental, social and governance (ESG) related requests and we believe this trend is here to stay. ESG investing has evolved from a niche to being increasingly embraced by traditional fund managers, which we believe is exactly in line with the wider society objective of reorienting finance flows towards sustainable development.

ESG is no longer only the remit of some relatively small impact or activist funds. There has been a proliferation of approaches, as different types of managers have different levels of ability to integrate ESG in their processes, with differing levels of focus on it. This fragmentation of the market place has, in turn, led to an increasing level of sophistication, both in how clients assess the ESG capabilities of their managers and in how managers integrate ESG. Clients increasingly want to see detailed reports on impact and engagement as they try to cut through the greenwash.

Meanwhile fund managers face demands for robust internal processes that can be demonstrated both in the embedding of ESG into their investment process, and also in how they report these ESG processes and outcomes to their clients.

**Pádraig:** What is it about ESG investing that you believe institutional investors still haven’t yet understood?

**Vladimir:** There’s still this perception that ESG is about sacrificing investment returns in order to achieve a moral objective – or a regulatory objective. We disagree - we believe ESG integration enhances your investment process. It improves your understanding of the risks and opportunities that exist in an investment, while at the same time trying to improve the environmental and social profile of your portfolio.

The broad picture is that – especially in Europe – regulators believe consideration of ESG factors should be part of a manager’s fiduciary duty. Look at the recent UK regulation requiring pension fund trustees to specifically outline how they consider such factors. It’s about better management of long-term risks rather than moral objectives or the mission alignment.

It is not about sacrificing returns in order to achieve some moral objective; it’s about actually making your portfolio more robust.
Pádraig: How would you define your own approach to ESG investing?

Vladimir: First off – we are not an impact fund and we do not take a moral approach to investing. We are bottom-up stock pickers with a focus on high quality companies. We believe that well run companies with good governance – and very importantly, high and sustainable returns on capital – should be more robust in the long run than the index. That has been our philosophy for decades.

We are concentrated and hold companies for a long time, much longer than the average participant in the market. Because of that, we have always focused on any long-term risks or opportunities that may impact returns on capital. In the last few years we’ve formalised our ESG approach, and dedicated additional resources – for example, my role in the team. We believe ESG is crucial for high quality companies’ ability to sustain high return on capital in the long term. We think at some point, ESG may impact all companies’ levels of returns on capital and business models.

ESG analysis is carried out by the portfolio management team itself and not outsourced to another team or siloed in any way. We focus on material ESG risks as well as opportunities on a stock by stock basis. This is done in tandem with traditional investment analysis, and is embedded in our overall investment thesis on a company. We also directly engage with companies on material ESG issues.

My role as a dedicated head of ESG research involves coordination of our team’s ESG efforts and working together with individual portfolio managers who are responsible for the bottom-up stock analysis of a particular sector. I analyse broader ESG issues by theme and by sector and these insights are then incorporated into company-specific assessments of ESG risks and opportunities.

We directly engage with companies on material ESG issues. Our engagements with companies have always been focused on long-term issues, management behavior and management incentives – what are the managers actually being incentivised to do? Are they focused on short-term earnings or the long-term strength of the business, including environmental and social aspects?

We have been focused on governance for over twenty years, but it is arguably even more important now. Company boards must deal with completely new long-term environmental and social risks, such as data privacy and security. How management and the board respond to these risks in terms of how they adjust the company’s strategy, or how they define the strategy, is crucial. We want to see management that is aware of the ESG risks that exist and doing enough to address these risks in the long term. We believe good governance is key. Without good governance, everything else fails.

Our robust approach to ESG integration is in place across all of our team’s funds, but with our Global Sustain strategy, we give clients the option of investing in a fund that is tobacco, alcohol, fossil fuel, gambling, and weapons free for those who prefer to avoid exposure to these sectors altogether.

Pádraig: Is it that you do it yourselves makes it better integrated within your business? How it can actually truly be integrated into funds.
**Vladimir:** Some people think that if they change the language in a prospectus and do nothing else, then that is enough. Everybody is seeing an increased level of scrutiny and sophistication from clients and consultants in terms of actually being able to demonstrate your work on ESG. We believe that having the ESG research done by the fund managers themselves is really important as they are attuned to the material issues and opportunities in the companies they assess. You may have a very talented team that sits on a different floor and is dedicated to ESG research, but how do these insights translate to the actual investment decisions, and portfolio construction? I have been a buy side analyst for 17-plus years. I'm sitting in the team, I know the team very well, they know me, and more importantly I understand the investment process.

We also have great access to companies, and often well established relationships with them given the size of our team’s AUM (c. $48 billion as of 31 March 2019), the highly concentrated nature of our portfolios and our long holding periods. Companies understand that we are sizeable shareholders and that we are here to stay. This level of access and our long-term approach give us an edge in engaging with them on ESG issues, which are often long-term in nature.

Our focus on companies’ long-term strategy and management behaviour, on how they manage long-term risks to the business franchise, of any kind, make a natural fit with ESG analysis. On top of that, our focus on high quality, especially in our global strategies, makes us selective and narrows our potential investment universe. This naturally helps avoid heavy CO₂ polluters and badly run companies. Our global funds are naturally low-carbon – we are 90% better than the index on CO₂ emissions.

**Pádraig:** Are ESG scores beneficial to help clients understand what their managers are doing in terms of managing their portfolio?

**Vladimir:** Third-party scores can be a useful starting point in ESG research, but they have their limitations. As they currently stand, scores are backward-looking, based on companies’ historical public disclosure on policies, and their sector-relative approach can mean the best ranked oil company ends up with a better environmental score than an average software company, despite the oil company’s carbon emissions being far greater.

An ESG score provider trying to monitor entire indices can end up with tens of thousands of companies to cover, and so can’t engage with them in the same way a manager of a concentrated portfolio can. A good example of this is one of our health care holdings. The company received a bad product safety score from one of the ESG score providers, which didn’t tally with the research we had been conducting. Through further investigation and direct engagement with the company in question we discovered a flawed methodology was used for the original ranking, and learned that the actions that the company had taken to improve product safety over the last few years had not been taken into account when the ESG score provider was assigning them a rating.

While they can be a useful resource, for example providing a useful summary of any controversies the company may have been involved in, we don’t rely on ESG scores or score providers to form a final view on the ESG performance of a company.

**Pádraig:** Looking forward, in 2019 and beyond, what do you believe are some of the big ESG themes we’ll see?

**Vladimir:** Our global strategy has a significant overweight tilt towards consumer staples, health care, and software and services. Each sector has its own set of material ESG factors to consider. For consumer staples, an important ESG factor is brand relevance. Can a brand remain relevant to a modern consumer that increasingly demands sustainable consumption? One of our consumer staples holdings estimates that their brands with improved sustainability credentials are growing 50% faster than the rest of their business. In health care, product safety is incredibly important, and in software and services data security and privacy are key.

If I had to pick one theme it would be data security and privacy. There is a lot of uncertainty around this because it has been a largely unregulated area. Society is trying to figure out how to deal with this hugely powerful new commodity. Massive businesses have been created that are based on monetizing data, with little oversight by the regulators. This is changing. We’ve seen various headlines about politicians trying to reign in companies in this space, because of the impact data has on politics and society.

We believe there will be winners and losers, and the winners will be those companies with better governance and defensible business models and this is how we try to pick stocks in the sector. I believe it will be a bigger topic in the coming years.

**Pádraig:** Thank you for sharing your thoughts on this topic.

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Sustainable Investing

We view our approach to ESG as a journey guided by the needs of our clients, four decades of investing expertise and a set of shared principles:

• Putting Clients First
• Identifying Relevant Issues
• Being Good Stewards of Capital
• Seeking Good Governance

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Putting Clients First  |  Work with colleagues to deliver the best of the Firm to every client.
7.1 INTERVIEW

Fixed income and ESG – how do investors ensure they are on top of monitoring and reporting requirements?

Interviewer

Pádraig Floyd, Consultant Publisher, Clear Path Analysis

Interviewees

Joseph Mehlman, Head of U.S. Credit, Morgan Stanley Investment Management

Sarah Harrison, European High Yield Portfolio Manager, Morgan Stanley Investment Management

SUMMARY

- ESG can be viewed as another risk measure as it is not uncommon for companies with poor ESG policies to experience greater drawdowns.
- We believe strong governance is a critically important factor and a key driver of credit returns over time.
- Data coverage is one of the greatest challenges in certain areas, such as high yield. Proprietary scoring models for credit, sovereigns and securitised provide a standardised method to evaluate and measure ESG risks and exposures across a portfolio.
- ESG is no longer optional in Europe and is fast gaining traction in the US. Investors are becoming more sophisticated and asset managers must have their own way of analysing data to make it applicable to their products.

Pádraig Floyd: Do investors need to sacrifice returns/yield in order to follow an ESG integrated investment approach?

Sarah Harrison: We believe the answer to this question is no. This is because there are studies that have shown there has been a degree of correlation between performance and the incorporation of environmental, social and governance (ESG) factors.¹ There have been a number of individual security examples where companies have restructured or gone bankrupt as a result of having poor ESG policies. So, not only do you not need to sacrifice returns, but incorporating and integrating ESG can actually have a positive impact on performance.

Joseph Mehlman: I would echo Sarah. In many respects the explicit consideration of ESG can be viewed as another risk measure. It is not uncommon for companies with poor ESG policies to experience greater drawdowns. When you view it through that lens, incorporating ESG can help mitigate downside risks, help in wealth preservation and even assist in wealth creation.

Pádraig: What is the difference between ESG screens and ESG integration?

Joseph: This has been a key evolution in the ESG arena over the past few years. Many of our clients have moved away from simple negative screens towards a more integrated ESG approach. We consider restrictive screens to be a passive and often very one-dimensional way of implementing ESG. Negative screens certainly have their place, and we implement some in our funds, but the downside to negative screens is that they can be backward-looking. They do not take into account any steps that a company may be taking to improve its position from an ESG perspective. As investors, we know that change on the margin can be an important driver of returns, so simply relying on negative screens can miss these opportunities.

The shift toward ESG integration moves beyond the passive negative screens, and it allows investors to consider ESG criteria alongside traditional measures of financial, business and management analysis. In the end, investors may avoid some of the same companies that a negative screen would exclude, but an ESG integrated approach

¹ Barlows. Sustainable Investing and Bond Returns. 2016.
Section 7 - Interview

makes that an active decision. Importantly, it allows managers like us to identify companies where ESG might be changing but not yet fully priced in by the market. This is a key reason why we work hard to capture momentum factors in our ESG analysis.

Sarah: Momentum is one of the more important factors in our proprietary framework. We want to give companies credit for improving, for pivoting, for understanding that the world is changing and being willing and able to implement change for the better.

Pádraig Floyd: What are the main factors you look at when assessing a corporate from an ESG perspective?

Sarah: We have our own proprietary framework, where we score all of the companies in our universe. One input is a sector risk analysis performed by our credit analysts who rank the environmental, social and government factors of particular sectors, from low to high risk, to understand how each of these individual factors could have an impact on companies in that sector. For example, in the gaming space, environmental factors would be ranked as low and social factors would be ranked as high, for obvious reasons. Governance is ranked as high across all sectors, because as bond investors, we must put a lot of faith into a management team that they will do what they say they are going to do. We then use those sector risk weightings to reweight third-party company ESG data. We also consider momentum, as we emphasised before, and controversy, and incorporate these two factors into our final score.

Joseph: To build on Sarah’s points, as we have gained experience working with third-party ESG data, we have recognised that their research is a valuable tool but is not necessarily created for or geared to credit investors. For example, as credit investors, we believe that strong governance is a critically important factor and a key driver of credit returns over time. Sometimes when you look at underlying ESG data from certain third-party providers, the emphasis isn’t necessarily on the factors that we as credit investors find to be most important. For instance, governance might only contribute 15-20% of a company’s overall ESG score. So, as Sarah said, we build on the good work the third-party providers do to come up with underlying E, S and G scores, and then apply a weighting scheme we believe is more relevant for credit investors.

Pádraig: How does MSIM FI integrate ESG into the sovereign rate market?

Joseph: If you spoke with our colleagues focused on developed or emerging market rates, they would tell you that ESG factors have long been part of their sovereign analysis. At a minimum, the consideration of social and political factors is paramount when analysing sovereign risks, so these factors have been explicitly part of our models for some time now. More recently, we have taken steps to incorporate more environmental factors into our models as well.

This year, our team has developed a proprietary sovereign ESG scoring model that can be applied to both developed and emerging market countries. Similar to our approach for credit, it begins with third-party data at the environmental, social and governance levels, and then our sovereign team reweights those factors in a way that better aligns with their views of the asset class. As with our approach to credit, we ensure governance factors are weighted most heavily. Our sovereign team has built in a momentum component into their model as well. As we mentioned earlier, we want to reward positive changes on the margin while also having a way to capture those entities that might be on a negative trajectory. Momentum components are especially important in the sovereign space since many of the key inputs to ESG scores come from international organisations and are published

“IN MANY RESPECTS THE EXPLICIT CONSIDERATION OF ESG CAN BE VIEWED AS ANOTHER RISK MEASURE. IT IS NOT UNCOMMON FOR COMPANIES WITH POOR ESG POLICIES TO EXPERIENCE GREATER DRAWDOWNS. WHEN YOU VIEW IT THROUGH THAT LENS, INCORPORATING ESG CAN HELP MITIGATE DOWNSIDE RISKS, HELP IN WEALTH PRESERVATION AND EVEN ASSIST IN WEALTH CREATION”
with a significant lag. If you run a purely quantitative approach to sovereign ESG scoring, you might be pulling in metrics that are quite stale. To avoid this pitfall, we have reflected a momentum factor in the sovereign model in two ways. First, we look at the trajectory of third-party ESG ratings. We make adjustments if a country has seen an improvement or deterioration in its ESG ratings. We also pull in a subjective assessment from our sovereign analysts to help us capture those important changes at the margin in a more contemporaneous way. Lastly, our scoring model incorporates these ESG factors on an income adjusted basis, which allows for fairer comparisons across the developed and emerging market landscapes.

market approach, so obtaining data coverage in order to calculate our scores can be a challenge. This means our qualitative analysis, which is done by the credit analysts, needs to be really top-notch. Understanding the individual ESG issues that can affect a company and understanding what impact that might have on revenues and whether that particular issue can materially change the credit profile of a company.

Joseph: I would echo Sarah: Data is the challenge right now. As she noted, coverage of private or smaller public companies can be lacking in the credit space. Securitised credit broadly lacks good security-

Pádraig: How do you think about ESG integration in the securitised space?

Joseph: Within fixed income, the securitised space might be the hardest to implement an ESG integration approach. First, some of the topics and themes that we discussed earlier in the credit or sovereign space are not necessarily as relevant to securitised analysis. Second, the securitised asset class generally lacks good third-party ESG data at the security level. That being said, we understand that ESG risks within the asset class must be understood, captured and reported on. We have taken steps to ensure that ESG risks are ingrained in our proprietary analysis of individual securities and structures. To give you an example, our team will consider if the underlying loans or assets within a securitised structure have a positive or negative impact on the environment. When analysing a commercial mortgage-backed security (CMBS) structure we will look to see if the deal is collateralised by Leadership in Energy and Environmental Design (LEED) buildings, which have lower energy costs than non-LEED buildings. On the consumer finance side, we will consider if the lender adheres to fair lending practices, evaluates programs that provide capital to disadvantaged borrowers, and confirms lenders are compliant with current regulatory requirements. Just like our credit and sovereign investors, our securitised team has also created a proprietary ESG scoring methodology that takes the analysis I have described and assigns quantitative scores reflecting the ESG risks of their securities.

Pádraig: What are the largest challenges with integrating ESG into a portfolio?

Sarah: One challenge we have—particularly in high yield—is data coverage. The third-party data providers we work with are very focused on public companies. Our high yield business follows a mid-

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If you think about the evolution of ESG, it started with negative screening, then it moved to ESG integration, and now there is a lot of focus on engagement and impact measurement. For many years, this was really the domain of equity investors, but over the last few years, the idea of bondholders engaging management teams has become more widely accepted. Within the Global Fixed Income team at Morgan Stanley Investment Management (MSIM), we have implemented a formal approach to company engagements that will supplement our more frequent and informal communications with companies. Our engagement strategy comprises three pillars. First, by opening a dialogue with companies, we will seek detailed and updated corporate information and use these conversations to relay our ESG expectations. We can also collaborate with MSIM’s Global Stewardship Team and leverage our firm’s proxy voting platform to enhance our knowledge and effectiveness. Secondly, we document our engagements to help identify industry best practices, assess issuer liability and define issuers’ roles in effecting positive change. Finally, we can utilise these engagements to help us anticipate the direction of credit risks, mitigate exposures to certain industry risks, and encourage actions that protect the long term value of our holdings.

Impact—how are you planning to deal with that certain flavour of the month? People are looking to incorporate it. What’s your take on it?

Joseph: If you think about the evolution of ESG, it started with negative screening, then it moved to ESG integration, and now there is a lot of focus on engagement and impact measurement. For many years, this was really the domain of equity investors, but over the last few years, the idea of bondholders engaging management teams has become more widely accepted. Within the Global Fixed Income team at Morgan Stanley Investment Management (MSIM), we have implemented a formal approach to company engagements that will supplement our more frequent and informal communications with companies. Our engagement strategy comprises three pillars. First, by opening a dialogue with companies, we will seek detailed and updated corporate information and use these conversations to relay our ESG expectations. We can also collaborate with MSIM’s Global Stewardship Team and leverage our firm’s proxy voting platform to enhance our knowledge and effectiveness. Secondly, we document our engagements to help identify industry best practices, assess issuer liability and define issuers’ roles in effecting positive change. Finally, we can utilise these engagements to help us anticipate the direction of credit risks, mitigate exposures to certain industry risks, and encourage actions that protect the long term value of our holdings.
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Sarah: In high yield, because many of the companies we look at are private and tend to have a smaller amount of debt outstanding compared to a publicly listed company, what we have been trying to do is use the weight of the size of our business, as we are an important lender to many of these companies, to engage.

We start to engage simply by asking questions. We continue to ask these questions as we meet with these management teams to be able to track their responses. So an example would be if you are looking at a plastic bottling company, understanding what their thoughts are on the shift away from plastic, how they are planning to mitigate that, and whether they plan on changing strategy. We are in the process of narrowing down a short list of companies where we believe we can potentially make an impact in the long term, and tracking our progress of asking questions, understanding how their responses have evolved and changed.

Pádraig: Where is ESG heading next?

Joseph: In the U.S., ESG is still gaining in acceptance and popularity. Just a few years ago, ESG was not a focus for most U.S. investors. This is changing. The adoption rate has been going up pretty quickly—first among institutional investors and more recently among retail investors. As more investors come to understand that ESG integration does not sacrifice yield potential and can even help improve risk-adjusted returns, I expect interest only to grow.

Sarah: In Europe, ESG is no longer a "nice to have"; it is now mandatory. Furthermore, investors are becoming more sophisticated in what they are looking for, with regard to the way an asset manager approaches ESG. It is no longer sufficient just to take ratings reports and third-party data, you need to have your own twist. You need to have your own way of analysing the data and making it applicable to your product.

Pádraig: Thank you all for sharing your thoughts on this topic.

**Risk Considerations**

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.

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 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.

**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 the current rising interest rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. **Longer-term securities** may be more sensitive to interest rate changes. In a declining interest rate environment, the Portfolio may generate less income. Mortgage- and asset-backed securities are sensitive to early prepayment risk and a higher risk of default, and may be hard to value and difficult to sell (liquidity risk). They are also subject to credit, market and interest rate risks. Certain **U.S. government securities** purchased by the Strategy, such as those issued by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of the U.S. It is possible that these issuers will not have the funds to meet their payment obligations in the future. **High-yield securities** ("junk bonds") are lower-rated securities that may have a higher degree of credit and liquidity risk. **Public bank loans** are subject to liquidity risk and the credit risks of lower-rated securities. Foreign securities are subject to currency, political, economic and market risks. The risks of investing in emerging market countries are greater than risks associated with investments in foreign developed countries. **Sovereign debt securities** are subject to default 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. **Restricted and illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk).