Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

The ESG Advantage

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Approaching a new decade, our world faces a proliferation of challenges, from the impact of climate change and the growth of plastic waste, to ever more scarce safe drinking water and worsening malnutrition in many developing countries. With what appears to be an increase in damaging climate events, the global zeitgeist has shifted, raising sustainability as the new imperative for good business and corporate stewardship.

Corporations are also responding. Earlier this year, the influential U.S.-focused Business Roundtable, a consortium of CEOs from major companies, including Morgan Stanley, issued a new mission statement that redefines the purpose of the American corporation. It transcends a singular focus on shareholder value and broadens the commitment to environmental and social objectives.

As many companies seek to embody environmental, social and governance (ESG) principles, investors are no longer assuming that ESG integrated investing sacrifices performance or that it's a niche strategy. Some long-term investors, like us, realise that analysing companies through an ESG lens can be, in and of itself, a differentiated driver of returns. Governance has always been crucial, but in addition, political, regulatory and technological changes have made environmental and social concerns more important than ever before. For instance, the rise of social media makes brands more vulnerable to any scandals, while governments, be they from the left or the right, no longer see helping big business as a priority. It therefore

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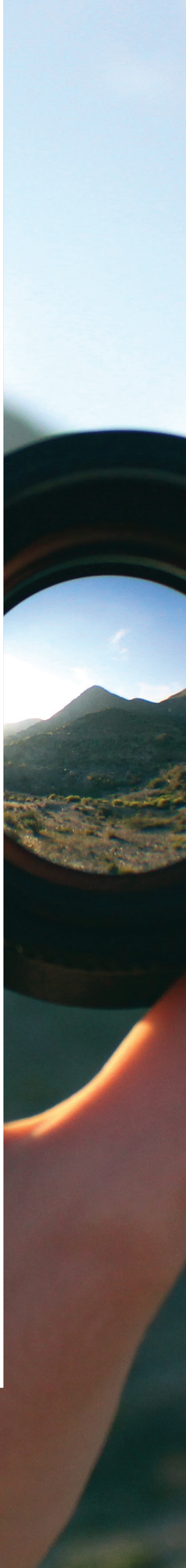

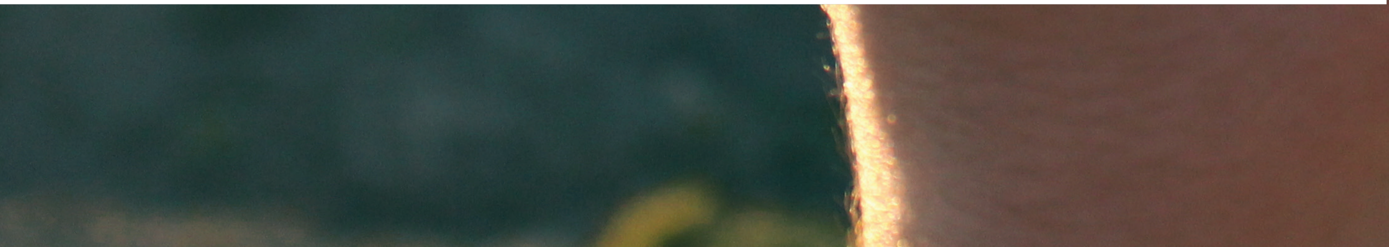

follows that allocating capital to high-quality companies that remain relevant with customers, improve employee engagement and stay on the right side of governments and regulators can provide solid financial performance and lower risk. Simply put, investing in companies with sound ESG practices means investing in better companies.

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Our focus on companies with high returns on capital, pricing power and recurring revenue excludes some of the more problematic and high-carbon sectors which may end up with trapped assets, be they developed oil fields, traditional auto factories or cement plants. In addition, even within the more favourable sectors which we do own, we believe analysing companies' ESG practices adds value in the determination of the viability of long-term returns on operating capital. Aside from our focus on governance, which applies across all sectors, we have spent considerable time identifying sector-specific material risks and opportunities in the key sectors for the portfolio:

1. **CONSUMER STAPLES:** Some companies are more attuned to the issues that are relevant to consumers, and their management teams embrace the increasing challenges of our complex world in efforts to protect and build brand equity. These companies are likely to outgrow their peers and thus offer robust long-term financial performance. Part of this comes from significant innovations that mean that the products better meet consumer needs. The well-run companies are more likely to make the investments required to achieve these innovations. Meeting needs is now a broader requirement, as it includes considering the negative externalities that come with the products, for instance with packaging, or generating positive externalities, through purpose-led brands. These purpose-led brands can drive social media engagement which helps sales. As an example, some businesses tackling the challenges of recycling are developing environmentally responsible packaging, like removable label adhesives to improve bottle usability in recycling, while others are investing heavily in infrastructure to help increase the rate of recycling, or producing paper-padded vs. plastic bubble wrapping mailers. Some are also leading social responsibility efforts, like reformatting their beverage recipes to respond to regulation or target health conscious consumers, or committing to sustainable sourcing of ingredients for commodity supply chains. Ultimately, success requires mattering to people rather than just marketing to consumers.

2. **HEALTH CARE:** The primary risk for corporates is around product safety, even more important today as the financial consequences for failures have risen sharply given escalating settlements. In addition, today's society demands that companies demonstrate that they use science ethically, responsibly and with social benefits rather than costs. Pharmaceutical companies' ability to maintain drug prices in the current political environment remains in question. This is one of the factors behind our preference for medical technology companies within the sector, where innovation is driving higher returns and consumables, such as needles and syringes and diagnostics. These companies enjoy strong barriers to entry in the form of regulation and relationships built on quality of product and distribution. In the global portfolios where we do own pharmaceutical companies, they are either diversified into other areas such as vaccines and consumer health, or focus on animals, limiting the exposure to the U.S. drug issue.

3. **SOFTWARE & IT SERVICES:** Data privacy and security are crucial issues. Aside from the need to avoid data breaches, companies that don't primarily rely on monetizing sensitive consumer data are of greater long-term interest—even more so if they seek to balance their own interests with the impact that their big data analytics have on society. Our portfolio is skewed towards companies that help corporates with their technology requirements, making them less vulnerable to the potential 'techlash'. In addition, corporations that promote responsible values with initiatives that make a real difference can benefit from having an engaged workforce, which is extremely valuable, given the fierce war for talent. Examples of these efforts include commitments to a diverse workplace and supply chain; inclusion initiatives, like the integration of people with autism into the workforce; the use of technology for environmental purposes, such as protecting endangered species or community education efforts that teach skills, such as coding or financial literacy to teachers and young people.

Active Company Engagement

Direct engagement with companies is paramount when understanding risk and sourcing opportunities—and not all portfolio managers do it. Some outsource the work to others who may be far removed from making decisions that shape portfolios, while others rely on third-party ESG scoring data, which can raise reliability questions in assessing the likelihood of environmental or social risks.

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A direct approach by the portfolio managers themselves can offer a significant competitive advantage. While engaging with companies, investors can position their dialogue to focus in on the material and relevant ESG factors that could affect the durability of returns. This can include asking about environmental issues, like carbon emissions, raw-material sourcing and packaging, or social concerns, such as supply-chain labour standards or product quality. Within governance, topics like capital allocation and incentives are always relevant, which has driven the development of our proprietary 'Pay X-Ray'. This active communication with management allows us to supplement our bottom-up fundamental analysis by identifying companies that lead or lag in ESG issues and, subsequently, positioning the portfolio for strong long-term performance in these difficult and unpredictable times.

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-capitalisation 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. Option writing strategy. Writing call options involves the risk that the Portfolio may be required to sell the underlying security or instrument (or settle in cash an amount of equal value) at a disadvantageous price or below the market price of such underlying security or instrument, at the time the option is exercised. As the writer of a call option, the Portfolio forgoes, during the option's life, the opportunity to profit from increases in the market value of the underlying security or instrument covering the option above the sum of the premium and the exercise price, but retains the risk of loss should the price of the underlying security or instrument decline. Additionally, the Portfolio's call option writing strategy may not fully protect it against declines in the value of the market. There are special risks associated with uncovered option writing which expose the Portfolio to potentially significant loss.

DEFINITIONS

Earnings before interest and taxes (EBIT) is a measure of a firm's profit that includes all incomes and expenses (operating and non-operating) except interest expenses and income tax expenses. **Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA)** is essentially net income with interest, taxes, depreciation, and amortization added back to it, and can be used to analyze and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions.

INDEX INFORMATION

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