

Global Equity Observer

The Second Mountain

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | INVESTMENT INSIGHT | JANUARY 2020

In his recent book, David Brooks argues that as we mature, we need to move beyond 'the first mountain', the one we think we're meant to climb, beyond self-gratification and individual goals, to climb the second mountain, where we find fulfilment in helping others or addressing a common good. It's not difficult to extrapolate this argument beyond the individual to corporations (and even fund managers), where today's environmental and social challenges offer businesses ample opportunity to focus on purpose as well as profit.

It is now 50 years, half a century, since the economist Milton Friedman argued that the sole purpose of business was to generate profits for shareholders. He did have a greater good in mind—that successful companies would pay taxes which would benefit society—but this second notion didn't gain as much currency as the first, particularly among the business community. This thinking has appeared a somewhat immutable truth over the past five decades. However, last year's announcement by the U.S. Business Roundtable, made up of some of the world's leading companies, including many world class multinationals we own in our portfolios, provided a watershed moment that it was perhaps time to reframe Friedman's argument. Might sustainability or durability—for these companies and the world—in fact depend on a more holistic perspective? In particular the signatories made commitments to

AUTHORS



BRUNO PAULSON
Managing Director



LAURA BOTTEGA
Managing Director

"Today's environmental and social challenges offer businesses ample opportunity to focus on purpose as well as profit"



their customers, employees, suppliers and communities, alongside the promise of generating long-term value for their shareholders.

As long-term investors in high quality companies, this just strikes us as good business practice and even common sense. Dealing briefly with the four stakeholders the Business Roundtable mentioned, there are obvious examples of why each of these matter:

- **CONSUMERS:** It is becoming increasingly clear in the world of consumer staples that to be successful companies have to deliver ‘performance’ products, which actually deliver benefits, not least because social media helps consumers become far savvier.
- **EMPLOYEES:** In many sectors dependent on highly skilled workers, most obviously software & IT services, the ability to recruit, motivate and retain staff is a crucial source of competitive advantage.
- **SUPPLIERS:** Companies are increasingly being held responsible for their whole supply chain, be it around worker safety or environmental impacts.
- **COMMUNITIES:** Aside from the obvious point that communities are generally consumers, companies now have to deal with a tougher political and regulatory environment, for instance around trade, tax, anti-trust, data privacy and the environment.

“Our portfolios are designed for performance not impact, but it is increasingly true that impact will affect performance over time.”

To us there is no trade-off between ‘doing the right thing’ and long-term success. Long-term success requires that companies ‘do the right thing’. We have been clear from the start that our portfolios are designed for performance not impact, but it is increasingly true that impact will affect performance over time, as companies are becoming increasingly responsible for the externalities they create, be they carbon, plastic waste or the loss of privacy.

Being more positive, the new *Zeitgeist* presents opportunities as well as risks, as purpose-led brands or those that stay on

the right side of employees and regulators, can drive financial opportunity. This may be in the form of market share gains, pricing or an engaged workforce respectful of the regulatory environment. As Unilever’s CEO Alan Jope argues it is “not about purpose instead of profit but rather profit through purpose”—in other words, customers are more likely to purchase brands that clearly signal values with which they are aligned.

“Environmental and social factors have become ever more important to the companies we invest in given the climate crisis, social media, and less predictable political environments”

As investors in compounders, we have always been focussed on the long term. The companies we own tend to be less cyclical than the index, and have strong strategic positions. As such, it has always been implicit that ESG-type factors were towards the top of the list of threats to sustaining high returns, hence our historic focus on governance. Over the last few years, the environmental and social factors have become ever more important to our companies, given the climate crisis, prevalence of social media and the less predictable political environments. Our response has been to become more systematic around ESG considerations. As a result, as an investment team we are climbing what at times feels like our own second mountain, grappling with what are often difficult to quantify ESG risks and opportunities.

In some cases, it is relatively easy to get to the familiar comfort of numbers, for instance in accounting for the likely incremental costs of around 30 bps per year to consumer staples companies paying the 40% premium for fully recycled plastic (or cutting the growth rates for those who fail to adapt). Equally, the risk from higher corporate taxes can be measured by comparing the company’s current tax rate with the revenue weighted average of tax rates where the company operates. It is even possible to model the impact of a \$100/tonne tax on CO₂ emissions; fortunately this is manageable for the companies in our global portfolios, as the carbon intensity is 87-89% lower than that of the index, based on tonnes of CO₂ per \$million sales.¹

¹ Source: MSCI, Morgan Stanley Investment Management, as at 31 December 2019.

Other issues are not so easily reduced to numbers, and these have given rise to fascinating conversations within the team. For instance:

- How to think about tail-risks—low probability events with major potential costs, such as a data breach?
- Which risks are sufficiently material for us to change a company's cost of capital or terminal growth rate in our model?
- What value do we put on diversity, and what cost on its absence? More broadly, culture is crucial, but is it measurable?

It is within this context that we have been working on developing a proprietary ESG scorecard for our companies which will focus not only on material stock specific issues and controversies, but also on attaching metrics to pressing “universal” issues such as environment threatening carbon emissions, safety, data, regulation and diversity, whether risks or opportunities. Where these are significant enough, there will be an explicit adjustment to either our modelled numbers, our valuation methodology or to the position sizes in our portfolios.

“We don't have all the answers yet, but what we offer is a commitment to confront these issues within the team rather than outsourcing, and a history of thorough engagement with the companies we own”

As ever, we remain pragmatists, artists as well as scientists, recognizing that issues are seldom clear-cut. As bottom-up fundamental investors, we seek greater understanding of our investments in an ever more complex world. We are striving to arrive at a reasonably objective assessment of the net effect of our companies' positive and negative activities on their return potential. We openly admit we do not have all the answers yet, and almost certainly never will! What we can offer is a genuinely long-term perspective, a commitment to confront these issues within the team rather than outsourcing them elsewhere, a history of thorough engagement with the companies we own, and the deep sector and company expertise to isolate and analyse the key issues. We look forward to climbing the second mountain together with you.

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.

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 | OFFER 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 2.20% 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 Limited ("MSIM"). Authorised and regulated by the Financial Conduct Authority. Registered in England No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA.

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.

This material is a general communication, which is not impartial and has been prepared solely for informational and educational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The information herein has not been based on a consideration of any individual investor circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.

Except as otherwise indicated herein, the views and opinions expressed herein are those of the portfolio management team, are based on matters as they exist as of the date of preparation and not as of any future date, and will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date hereof.

Forecasts and/or estimates provided herein are subject to change and may not actually come to pass. Information regarding expected market returns and market outlooks is based on the research, analysis and opinions of the authors. These conclusions are speculative in nature, may not come to pass and are not intended to predict the future performance of any specific Morgan Stanley Investment Management product.

MSIM has not authorised financial intermediaries to use and to distribute this document, unless such use and distribution is made in accordance with applicable law and regulation.

Additionally, financial intermediaries are required to satisfy themselves that the information in this document is suitable for any person to whom they provide this document in view of that person's circumstances and purpose. MSIM shall not be liable for, and accepts no liability for, the use or misuse of this document by any such financial intermediary.

The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without MSIM's express written consent.

All information contained herein is proprietary and is protected under copyright law.

Explore our site at www.morganstanley.com/im