Morgan Stanley

INVESTMENT MANAGEMENT

A Yield Focused ESG Approach

FIXED INCOME | GLOBAL FIXED INCOME TEAM | INVESTMENT INSIGHT | 2019

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When creating solutions for our fixed income clients that integrate environmental, social and governance (ESG) factors, there is no one-size-fits-all approach. ESG goals vary by end investor.

However, there is one question we are asked regularly: "Can I incorporate ESG into my portfolio without giving up yield?" We believe the answer is a resounding yes.

ESG considerations have always been implicit in our credit investment analysis. Given the asymmetric nature of price moves in fixed income,[1] minimising defaults is crucial—and we find that more responsible companies tend to have fewer defaults. We believe that ESG factors have the ability to impact the fundamental credit risk of a company and, in turn, a company's bond price.

[1] When a bond issuer experiences negative events (i.e.: a payment default, credit rating downgrade, negative headlines, etc.) bonds issued by this issuer are likely to experience a greater change in price (price decrease) than if there had been a positive event (price increase) for the issuer. This makes the price movements of bonds asymmetric.

Controversies and negative ESG-related headlines can hinder investors' ability to transact in a bond over the short term.

However, ESG research is not typically designed for fixed income investors. As a result, the MSIM Fixed Income team has created a proprietary ESG-scoring methodology that explicitly considers the risks and opportunities ESG factors pose to corporate bonds.

Although fixed income investors are slightly behind equity investors in recognizing how ESG factors can provide unique insights into long-term risks and opportunities, as we see in *Display 1*, there is no shortage of examples where a sector-related ESG factor has led to sharp downward bond price movements, restructuring or default:

- **ENVIRONMENTAL:** Litigation and fines resulting from environmental disasters in the energy space
- **SOCIAL:** Business model disruptions as a result of additional regulation to better protect the vulnerable in consumer finance
- **GOVERNANCE:** Excessive financial engineering, partially as a result of poor governance, in the construction sector

We aim to capture the potential for these risks in our proprietary sector risk analysis (MSIM ESG Credit Scoring Analysis, *Display 2*).

DISPLAY 1

Examples of Company ESG Incidents

	BOND PRICE HIGH BEFORE THE INCIDENT	BOND PRICE LOW FOLLOWING THE INCIDENT	% CHANGE
Environmental Disaster	107.54	97.33	-9.5%
Social Responsibility	96.15	57.30	-40.4%
Governance Misstep	104.14	2.28	-97.8%

Source: Bloomberg. Each row of data represents one company, as an example, that experienced the ESG incident described. The bond price before and following the incident represents one individual bond that was issued by the respective company taken at the peak bond price right before the incident was made public and at the trough bond price following the incident.

For illustrative purposes only and should not be construed as how each security have moved, or will move, before and after an incident.

Proprietary Sector Risk Analysis…

Built on their deep knowledge as sector specialists, our credit analysts complement their investment experience with ESG-focused research from a wide array of leading third-party sources to derive sector risk weightings of *high*, *medium* or *low* across 47 sub-sectors. As seen in *Display 3*, these risk weightings reflect our view of how likely the ESG factor is to have a negative effect on a bond's price movement.

…Combined With Third-Party Company ESG Data

We use this sector risk analysis to assign weights to raw ESG data provided by leading third-party experts. Risk weightings will vary from *low* to *high* for environmental and social factors, but will always be *high* for governance. We find that governance is the strongest ESG driver of portfolio risk and return, and as fixed income investors, we rely heavily on management teams' controls to avoid involvement in fraud or corruption, and to execute on commitments to repay debt.

Adjustment #1: Momentum

While we offer our clients the option of using negative screening and sector exclusion lists for segregated mandates, our view is that companies should be rewarded for demonstrating a willingness to change and adopt stronger ESG principles. Sustainability experts have recently raised questions about the effectiveness of negative screens, preferring instead a more holistic view of a company's approach.

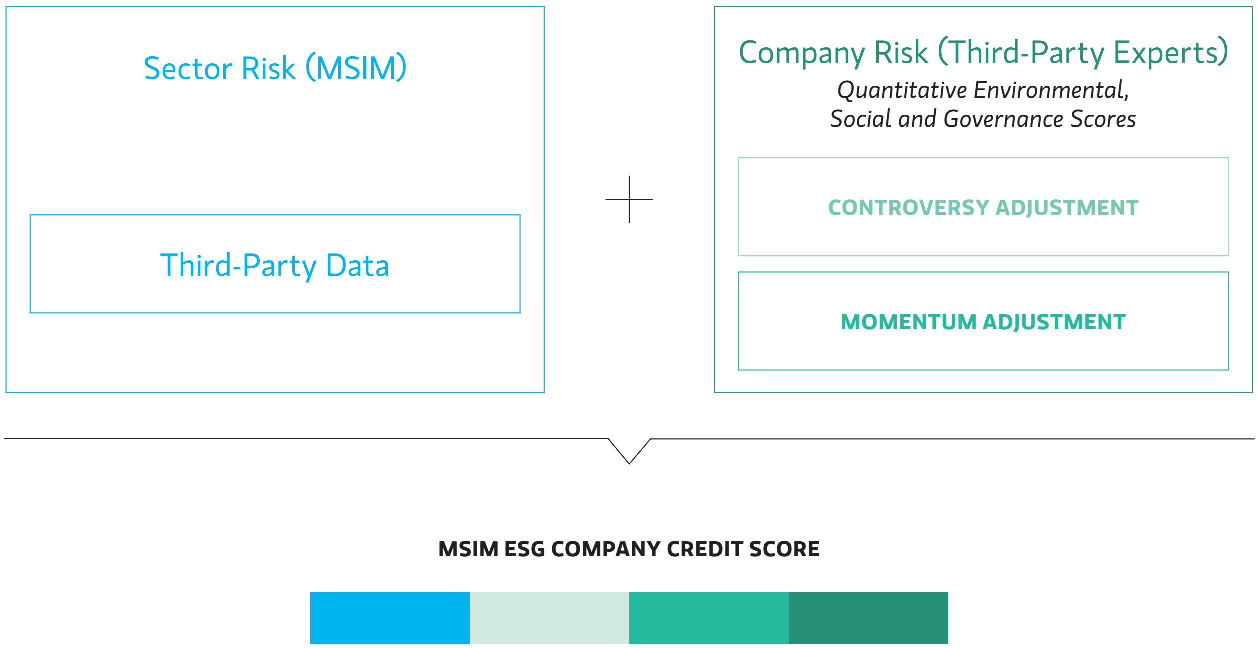
To account for momentum in our scoring methodology, we make numerical adjustments to third-party data in favour of companies that demonstrate positive ESG momentum and against companies that demonstrate negative momentum.

Adjustment #2: Controversy

Negative ESG-related headlines can impact our ability to transact in a company's bonds. Not only can a company's controversy change its credit fundamentals, but it tends to increase public focus on ESG topics. Portfolio managers may move to avoid the most obviously controversial names.

To account for controversy, we make a numerical adjustment against companies that have been featured in the headlines for negative reasons. Our adjustment for controversy has less impact than our adjustment for momentum in our final score—we prefer to bias our score towards the future rather than the past.

DISPLAY 2
MSIM's ESG Credit Scoring Analysis



DISPLAY 3
Sector Risk Factor Weightings

For illustrative purposes only. This represents how the portfolio management team generally implements its investment process under normal market conditions.

MSIM ESG Credit Scoring Analysis

The final output is a numerical score that is comparable across sectors and used as one of many inputs into the final investment decision on a security-by-security basis. We also use these scores to calculate the weighted-average MSIM ESG Credit Scoring Analysis of a portfolio and its corresponding benchmark. We use this score to better understand the ESG quality of our portfolios.

In *Display 4* we demonstrate how our ESG Credit Score can differ from third-party ratings. In this example we compare two U.S. retail companies, which for simplicity we will refer to as Retailer A and Retailer B. As you can see, using MSCI data the companies appear to have similar ESG risk profiles. However, when we look a bit deeper we notice several factors that we believe differentiate the credits, impacting their ESG risks and possibly their bond prices in the future.

First, we have already discussed the importance of explicitly considering momentum and controversy factors. In this example, Retailer A and Retailer B couldn't be more different. Retailer A has been involved in some significant controversies and has had downward ESG ratings momentum. Retailer B has been involved in fewer material controversies and more importantly has demonstrated positive ESG momentum.

When we look at the two companies' quantitative E, S and G scores we see that the environmental and social scores of these companies are similar but the governance ratings are quite far apart. As we see governance being the ESG risk that most drives credit performance, it becomes imperative in our model to differentiate between Retailer A and Retailer B.

Taken in aggregate, our MSIM ESG Credit Score model incorporates the divergent momentum, controversy and governance scores to come up with a proprietary ESG Credit Score that is not only more applicable to fixed income investors, but we believe also properly differentiates these two credits**.**

DISPLAY 4

Case Study: Retailer A vs. Retailer B

	RETAILER A	RETAILER B
	MSCI ESG Scores	
MSCI Score	3.8	3.7
MSCI Rating	BB	BB
	Momentum and Controversy Adjustments	
ESG Momentum	↓	↑
MSCI Controversy Flag	Red	Yellow
	MSCI Environmental, Social and Governance Scores	
Environmental	7.7	7.9
Social	2.5	2.3
Governance	3.3	7.0
	MSIM Sector Risk Weighting	
Environmental: Medium	Social: Medium	Governance: High
MSIM ESG Credit Score	**4.1**	**7.1**
MSCI ESG Scores	3.8	3.7

Source: Morgan Stanley Investment Management, MSCI. June 2018. Information is subject to change and provided for illustrative purposes only. Scale: 1–10, 0 worse, 10 best

This represents how the portfolio management team generally implements its investment process under normal market conditions.

Our Continued Focus on ESG

The Fixed Income ESG Strategy team continually re-evaluates our methodology and data inputs based on the latest research and studies available. We plan to continue empirical work to refine our ESG weights and scoring methodology over time.

Our objective is to approach ESG in a thoughtful and practical way rather than as a box-ticking exercise.

By embedding ESG within the core investment team and process, we aim to optimise a portfolio's ESG profile in a way that not only minimises any yield discount, but turns ESG considerations into insights that can help mitigate risk and contribute to higher potential returns.

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 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.

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