



Morgan Stanley

INVESTMENT MANAGEMENT

Diving Below the Surface: ESG Integration in Emerging Markets

ACTIVE FUNDAMENTAL EQUITY | GLOBAL EMERGING MARKETS TEAM | 2020

The dawn of the new decade is a bellwether moment for investing based on environmental, social and governance (ESG) issues. Billions of dollars flowed into ESG funds in the 2010s and the flow is likely to accelerate in the 2020s. From politicians, consumers, CEOs, retail and institutional investors—the range of support for sustainable investing principles seems to grow broader and more vocal every year. The big recent shift: investors have tired of asset managers who merely talk a good line on sustainability. They demand to see a system in place for pressuring companies to make genuine progress on ESG goals—without sacrificing superior returns.

We have been working for years to fully incorporate ESG analysis into our investment process, and made significant strides in 2019. We created a new post, Head of Environmental, Social and Governance Research, and transitioned an experienced investment analyst into the job. We ramped up training for portfolio managers and analysts—all of whom have now completed at least level one of the UN Principles for Responsible Investing (PRI) training. We continued building our library of ESG research, and created an in-house website that will serve as a guide to all our portfolio managers and analysts on how to engage companies on ESG issues, industry by industry.

In the first of what will become a series of deep dives into ESG issues by sector, we spent part of July examining the performance of financial companies in Latin America, EMEA, small cap and frontier. In our daily meetings with corporations, we focused on deepening the substance of our engagement with management—longer meetings, with more dedicated solely to ESG, including more than 90 discussions focused on carbon footprint and other issues related to climate change.

AUTHORS

GLOBAL EMERGING MARKETS TEAM

“Monitoring progress on ESG issues helps us to build a more complete picture of the growth opportunities and risks in our portfolio.”

We have been investing in emerging markets for 25 years, and experience tells us that the most capable corporate managers invest with an eye to the long term, including the massive risks and opportunities presented by issues such as climate change. They position themselves for regulatory risks like carbon taxes, and physical risks like supply disruptions from storms. They anticipate opportunities to cut costs, develop new products, and improve their brand image. As active managers, we believe the link between solid ESG performance and financial outperformance is likely to grow stronger over the course of the 2020s. We will continue refining our process to spot those winners, and seek to deliver the real results our clients and the world now demand.



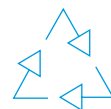
Team Structure and Training

In 2019, we created a new role, Head of Environmental, Social and Governance Research for our team. Jessica Whitt, an analyst focused on Latin America since 2015, took over in that post effective January 1. Jessica is a 15-year industry professional and brings a level of investing knowhow that is often absent from executives in ESG leadership roles. She has a strong background in financial and company analysis, a deep personal interest in sustainability and extensive experience covering companies with an ESG overlay. She is a natural fit to integrate ESG into our investment process, which identifies market opportunities both top down (by country) and bottom up (by company). Jessica now coordinates these integration efforts across our regions.

We also extended UN PRI training for all portfolio managers and analysts who engage with corporate leaders in the field. Each of our investment analysts have finished level one training from UN PRI, on the foundations of

responsible investing. A few have started level two, which goes more in-depth on integrating ESG data into financial modeling.

We also set up a detailed internal research library and dashboard, which allows our investment team to follow a variety of ESG topics, from specific issues such as climate change to the evolution of ESG regulations and best practices for implementing ESG in an investment portfolio.



Formalizing Our Process

Early in the year, our team began working to develop an internal website with systematic guidelines on how our portfolio managers and analysts should engage with corporate management. It identifies ESG best practices and a specific list of questions to ask and topics to cover by industry, and in some cases by company. We also brought in industry specialists to conduct in-depth teach-ins on ESG issues impacting the financials and consumers sector, with a focus on the unique considerations for emerging markets.

In July, we spent several days conducting our first in-depth ESG engagements focused on one sector. We started with finance, focusing on companies in Latin America, EMEA, small cap and frontier. Examining a broad range of companies in one sector helped us to clarify financial industry trends, best practices, and areas for improvement. It was also eye opening for analysts who don't normally focus on the financials sector. Many of the banks we spoke to identified their biggest ESG Risks as cyber security and above all climate change, given the large agricultural component of GDP in emerging markets. We plan to continue these thematic engagements, focusing next on consumer staples.

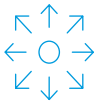


ESG DRIVING MACRO INSIGHTS

Our top down investment approach follows our ten rules of the road, which identify factors from politics to inequality that have the biggest impact on which countries will outperform, or underperform, over the next three to five years. Many of the rules have a direct impact on ESG issues. Early last year, for example, we exited Chile in part because it was scoring very poorly on a rule that uses a close reading of Forbes billionaire lists to identify countries where rising wealth inequality threatens to provoke social unrest. Later in the year, a hike in bus fares triggered violent protests and labor

strikes in Chile, offering dramatic proof of how ESG can matter for the economy and markets.

Increasingly, our research is filtering countries and industries directly for ESG risks and opportunities. In November, our team completed and presented a research project on how climate change will impact emerging and frontier markets, including the general threat posed by rising temperatures and seas, and the specific threats to countries and companies in our portfolio. We also studied the opportunities that are likely to emerge during a period of decarbonization and transition to renewable energy sources, including wind and solar, battery storage and electrification.



Focus on Engagement

We engage companies on ESG issues mainly in one on one meetings with management, where we discuss material environmental and social issues and review corporate governance. In cases where management teams are falling short, and we can send a message through our shareholder vote, we don't hesitate to do so. Recently, we have voted against proposals that raised clear governance issues, including one that would have tied executive compensation to share price at a payments company that has been doing share buybacks, and another that in our view would have given the board of a Russian internet company too much authority to issue new shares, and too much discretion on how to structure new share offerings.

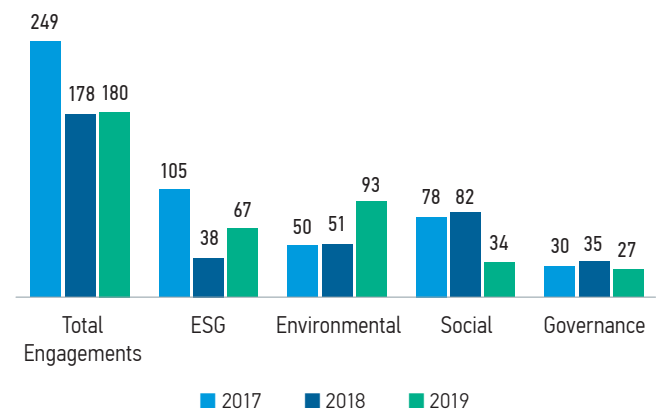
In 2019 we held 180 engagements, or meetings that included a significant ESG discussion, which was about the same number as 2018 but down from 2017. This is by design. As continued research and training refines our engagement process, our emphasis is increasingly on quality and impact over quantity: engagements that have a potentially tangible influence on corporate behavior, and yield clear insights into how ESG issues will impact the bottom line.

In 2019 we sharpened the focus of our engagements, including 93 discussions devoted to the environment and its direct impact to the company's long term profitability

and returns. We expanded the range of issues they cover, adding biodiversity and land use, responsible lending and raw material sourcing.

We also held 14 hour-long calls with companies we own, dedicated to ESG questions. These discussions with senior management, investor relations and sustainability officers have yielded valuable insights on management thinking and quality, and how ESG considerations can be a positive (or negative) driver of overall returns.

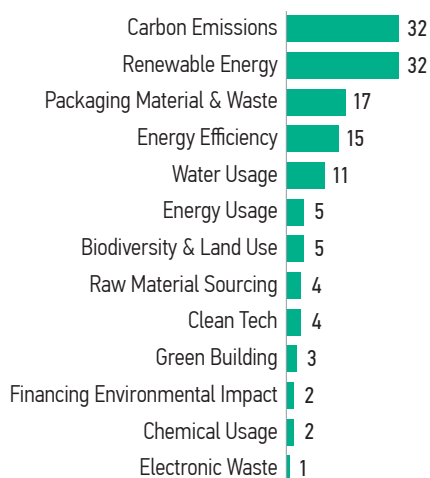
2019 ESG Engagement Meetings



ESG category includes when we discussed an Environmental, Social and Governance issue in the same meeting.

2019 ESG Engagement Meetings, Issue Breakdown

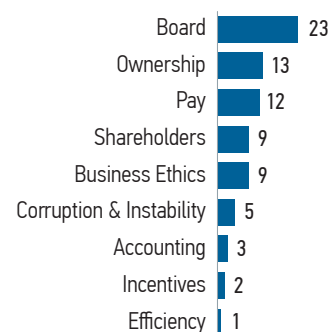
Environmental



Social



Governance



Engagement Examples

COMPANY	ISSUE WE ENGAGED ON	ENGAGEMENT DETAILS
ENVIRONMENT		
Supermarket operator in Poland	Carbon Emissions	We engaged with this supermarket operator on carbon emissions and energy efficiency as the company has been experiencing margin pressure, with room to cut energy costs and reduce their carbon footprint. Management discussed their efforts towards reducing energy costs and carbon emissions per square foot, which they have already reduced by 17% in the last five years. Management also discussed their targets for 2020. We will follow up with them on their benchmarks in our next engagement.
Large developer of multi-purpose complexes in Thailand	Energy Efficiency	We engaged with this Thai developer on their energy usage as it is one of the largest cost items in their operations. We asked about whether they had a plan to reduce usage, save on costs or become more efficient. The company has several plans to become more efficient including automating control systems and installing solar panels as well as making further technology investments to reduce energy usage. As they have engaged a consultant to help them in these efforts, this will be a follow up item for us at the next engagement to discuss progress and metrics.
SOCIAL		
Industrial company in South Africa	Labor Management	This South African industrial company has a very large workforce. The company faces a potential major challenge in the future as its workforce continues to grow, through more outsourcing from public companies to private ones, especially this company. We engaged with this company on their efforts towards absorbing more employees, training, and reducing turnover. While we believe private sector employment for South Africa will be increasing overall, this company's need to improve labor efficiency is an important aspect to their business model.
One of the largest private banks in Brazil	Labor Management	We engaged with this large Brazilian bank on labor management, especially as the company could improve employee turnover. We asked the company about their continued efforts towards hiring from within and reducing temporary employees. Over the last few years, the company has progressed on this metric as total employee turnover has declined from 15% to 8%, which is now lower with Latin American banks' peers. We also discussed the company's targets for improving benefits for all employees and will follow up on these metrics in future engagements.
GOVERNANCE		
Leading bank in Hungary	Board	We have voiced concerns on the level of independence on the Board of Directors due to the inclusion of former executives and employees and the long tenure of some directors. Management claims given the volatility of the business it benefits from an experienced board who has seen the bank through multiple cycles. We will continue to engage management on this subject to make sure board independence is not at risk.
Large retailer in Mexico	Anti-corruption, Ethics	We engaged with the company on violations by the parent company in the US over federal allegations of overseas corruption, namely violations of the Foreign Corrupt Practices Act. Management discussed the enhancements to policies, procedures and investments they have made into ethics and compliance to strengthen their global anti-corruption compliance program. We reviewed the metrics and feel comfortable with management's strategy but will continue to follow up as needed.



ESG IS KEY TO OUR RESEARCH: A CASE STUDY

We first invested in a Brazilian apparel retailer in 2016. Since then we have had three in depth engagements on ESG, focusing on issues most relevant to the fast fashion industry, including supply chain management, emissions, and material usage. Over the course of these discussions, we came to see how the company was incorporating ESG into a management style already known for long-term, strategic planning.

As Brazil went into recession in 2014, international and domestic retailers began shutting stores and retreating, but not this company. It continued to expand, investing in an advanced logistics system that allowed it to reduce both inventory and stockouts. It tightened its safety standards, and deployed a team of auditors to enforce these standards

at major suppliers. During this period, the company outpaced its competitors.

By last year, the company's valuation had risen, so we re-evaluated our position and conducted another in-depth ESG engagement with management. But the company remains years ahead of the local competition in confronting the next big long term challenges, including a more open Brazilian retail market, and climate change. It has adopted ambitious targets for the use of recycled and environmentally friendly materials, positioning the company well from a cost and brand standpoint as Brazilian consumers and regulators begin to focus more on climate. Paying the company the ultimate compliment, local rivals have begun copying its strategy, managing with an eye to both the bottom line and ESG.

Summary

As fundamental investors, we have always sought out well-run companies that are well positioned to capitalize on growth opportunities in sustainable ways. Adding sustainable environmental, social and governance principles to our process is thus a smooth fit. Monitoring progress on ESG issues helps us to build a more complete picture of the growth opportunities and risks facing companies and countries in our portfolio.

ESG factors matter for company results, and rather than rely on external data providers, we are institutionalizing our in-house process for engaging with companies, understanding how their ESG risks and opportunities are evolving, and how they may impact long-term financial performance. Our clients now expect real engagement on ESG issues, and our team is delivering, because we can see it works.

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. Accordingly, you can lose money investing. 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. 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

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"ESG" investment: Environmental Social and Governance based investment is an investment approach which takes explicit account of the environmental, social and corporate governance aspects of all proposed investments..

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