Morgan Stanley

INVESTMENT MANAGEMENT

An Emerging Markets Approach to ESG

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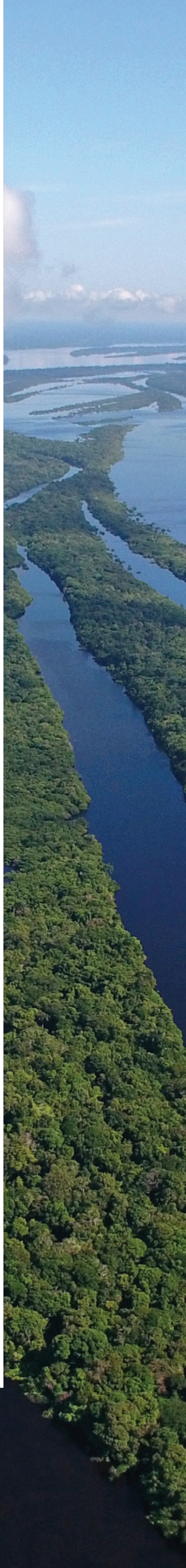


As long term investors in emerging markets, we look for companies and countries that can sustain balanced growth in this turbulent world—and we believe environmental, social, and governance (ESG) factors are integral to that search.

For us, ESG is more than a list of do-good boxes we need to check off, after the real work of finding good investments is done. Gathering information about environmental, social and governance issues can tell us a lot about which countries are likely to sustain solid growth, and which companies are well-managed and capable of expanding earnings for an extended period. In fact ESG considerations were integrated into our process for picking countries and companies years before ESG became a popular litmus test for choosing money managers.

Display 1 offers a sketch of some of the specific environmental, social or governance issues that come to play in our decisions on country allocation, and stock selection.

“Our research process continues to consider ESG issues that confront policy-makers and company management, because they matter for sustainable growth.”

DISPLAY 1

Our Approach to ESG Integration

	ENVIRONMENTAL	SOCIAL	GOVERNANCE
Country Allocation	• Commodities	• Demographics • Inequality • Investment and job growth • Credit cycle	• Politics and reform • Government involvement
	ESG ENGAGEMENT		
Stock Selection	• Emissions • Resource intensity • Energy efficiency • Environmental regulations • Environmental safety	• Labor force conditions • Human rights • Community impact • Supply chain management • Access to health care, communications and finance • Product safety	• Quality of management • Government and regulatory risk • Minority shareholder alignment • Business ethics • Ownership

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

Top-Down: ESG in Our Country Allocation Process

Our top-down, country allocation decisions have long been guided by ten factors we call our Rules of the Road, which are outlined in *Display 2*. We score each country on each of these rules, which have been carefully chosen and refined over years of research to provide real-time insight on which economies are most likely to accelerate, or slow down, in coming years. The reason for this focus is simple: we believe markets respond less to absolute growth than to shifts in growth, and differences between countries.

To oversimplify a bit, economies are often poised to decelerate when they are out of balance, and to accelerate when they are coming into balance. So the rules are all about measuring balance across the cycles—from politics to credit, investment and market sentiment—that shape economic growth. And ESG factors can and do play an important role in tipping these balances, for better or worse.

DISPLAY 2

Ten Rules for Spotting Change in the Post-Crisis World

People Matter:
Is the talent pool growing?

The Circle of Life:
Is the nation ready to back a reformer?

Good Billionaires, Bad Billionaires:
Is inequality threatening growth?

Perils of the State:
Is the government meddling more or less?

The Geographic Sweet Spot:
Is the nation making most of its location?

Factories First:
Is investment rising or falling as a share of the economy?

The Price of Onions:
Is inflation high or low?

Cheap is Good:
Does the country feel cheap or expensive?

The Kiss of Debt:
Is debt growing faster or slower than the economy?

The Hype Watch:
How is the country portrayed by global opinion makers?

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

GOVERNANCE RISKS

Consider governance factors. They are central to the way we monitor political developments, under our rule on the "Circle of Life," sketched in *Display 3*. The core of this rule is that economies are most likely to prosper when they are confronted by crisis, facing pressure to reform, and electing new governments with a mandate to reform. As the circle of political life turns, and regimes grow old, even reform minded governments often grow stale and complacent. They are increasingly likely to run out of reform ideas, bring cronies into government or install them in state companies—generating governance problems across the public and private sectors.

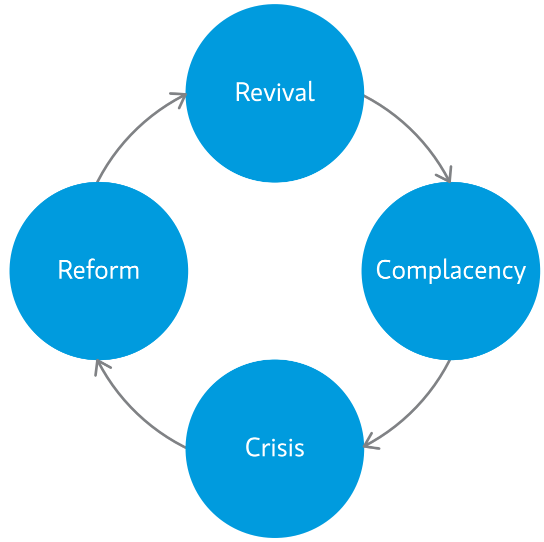
Governance questions are also central to our "Perils of the State" rule. It is built on the idea that while the ideal state is balanced—neither overly powerful nor too weak to provide basic public goods and services—the economy is generally best positioned to grow when the state is meddling less and less. And one basic reason is that state meddling breeds governance problems. The more directly the state is involved in owning companies, regulating the private sector, providing cheap food and energy, the more it fuels governance risks by widening opportunity for corrupt bureaucrats, dodgy middlemen, and unqualified company managers holding on to jobs by virtue of who they know in government.

Governance risks are also highlighted by our rule for monitoring financial system stability, which we call the Kiss of Debt. The basic framework is that while economies can't grow if credit is not expanding at a healthy pace, they are in big trouble when credit is growing significantly faster than GDP for a sustained period. During periods of excessive credit growth, easy lending terms feed a culture of manic exuberance, and every player in the credit game—from borrowers to lenders and often regulators as well—tends to make increasingly bad decisions. As unqualified borrowers and fly by night lenders join the game, the end result is a governance mess, revealed in gory detail only when the mania pops.

Once a debt bubble pops, however, the resulting clean-up can lead quickly to the reform and recapitalization of banks, the forced retirement of corrupt bankers and their regulatory allies, and a surprisingly fast system recovery. As a period of healthy credit growth gains momentum, it can reduce governance problems, encouraging sensible lending practices, practical innovations, and the introduction of important new lending tools. One blockbuster example: after the financial crises of the late 1990s, a healthy credit growth phase was accompanied by widespread bank reform, as well as the introduction of mortgage lending and credit cards in many emerging markets.

DISPLAY 3

Is the Nation Ready to Back a Reformer?



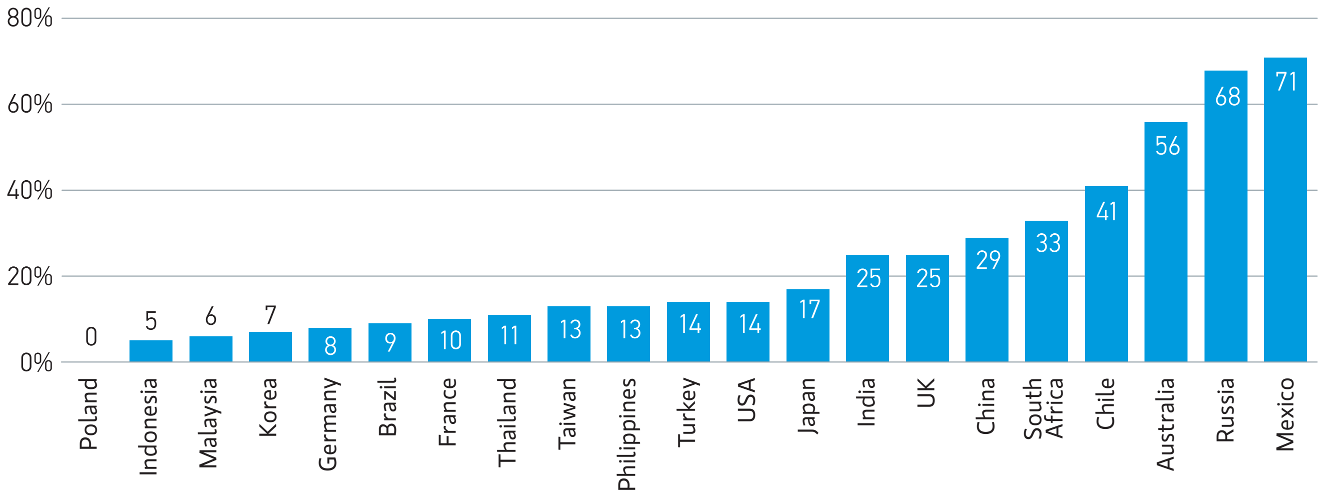
SOCIAL RISKS

Social factors like poverty, inequality, and labor force conditions also help shape many of our rules, starting with the one governing demographics, "People Matter". The basic idea is that economic growth is heavily shaped by population growth—the number of people entering the workforce. While governments have tried to boost population growth with "baby bonuses," it generally hasn't had much effect—and any economic impact must wait many years, until the babies grow up.

Governments can, however, quickly boost the workforce by bringing in underemployed adults, and lifting barriers to immigrants, retirees, and women. We have been struck for example, to find that the world's fastest gains in female labor force participation rates have been made in Latin countries, which have a particularly bad reputation for macho cultural biases.

DISPLAY 4

Good Billionaires, Bad Billionaires: Is Inequality Threatening Growth?
The key is the "bad billionaire" share of total billionaire wealth



Source: MSIM EM Research, Forbes as of June 2017

Fighting employment biases is not just politically or socially correct. At a time when nearly all the major economies face slowing growth in the working age population, the big winners will likely come from among those countries that do most to bring fresh talent into their workforce, and make sure companies are not biased against the elderly, foreigners and females in their hiring decisions. Understanding the demographic risks each country faces is an important part of our country allocation process.

Social and governance factors both inform the way we monitor inequality in our "Good Billionaires, Bad Billionaires" rule. The first step is to analyze changes in billionaire wealth as a share of GDP, because social resentment against wealth massing in the tycoon class has often provoked destabilizing political revolt. A government's response to social unrest is key, leaders must balance future economic growth with populist policies.

The most important step, however, is an analysis of how much wealth is concentrating in "bad billionaires," defined as those who are building fortunes in rent-seeking industries traditionally associated with corruption—like mining or real estate. Wealth rising in the hands of bad billionaires is not only more likely to trigger social unrest than wealth rising in the hands of good billionaires, in industries like tech. The rent-seeking industries are also more likely to be riddled with governance problems, from corruption and state influence to disregard for minority shareholders.

Social concerns about labor force conditions and inequality also animate our understanding of inflation, defined in "The Price of Onions" rule. Often, rising prices for staples like onions have fueled social unrest and political revolt, and we reward governments who understand this and work aggressively to contain consumer price inflation, and its market-destabilizing effects.

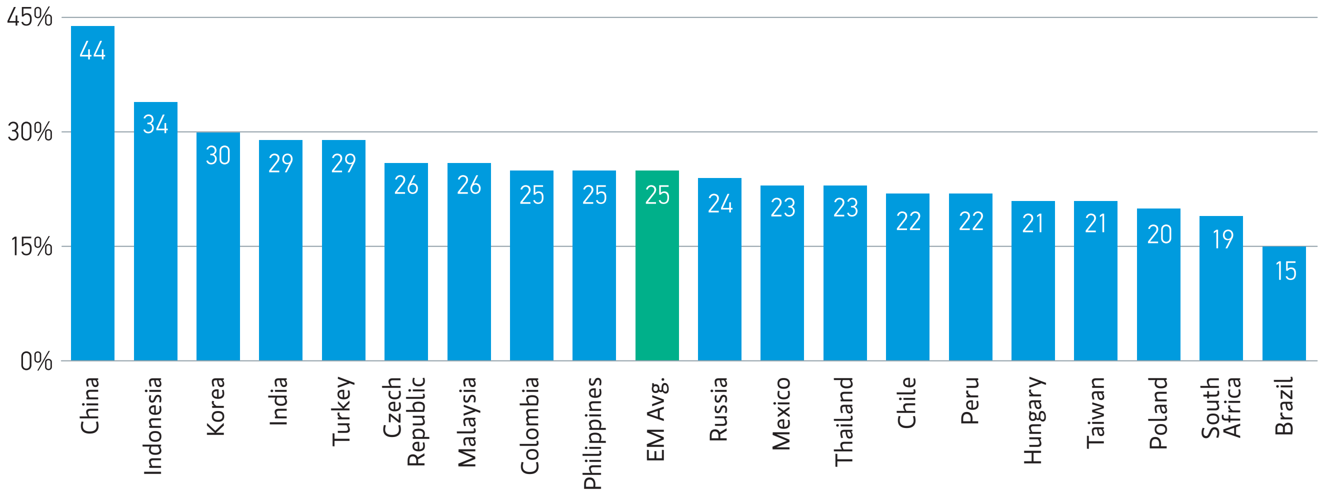
More radically, we think asset price inflation is as important as consumer price inflation, in good part for social reasons. If money is flowing heavily into asset markets it tends to drive up the value of stocks and bonds held mainly by the wealthy, at the expense of investment in the real economy where growth provides jobs for the middle class. This widening income and wealth gap is the story of many developed and emerging markets in recent years, and the resulting social tensions have fed the angry populism that threatens economic growth.

ENVIRONMENTAL RISKS

Environmental concerns are part of the backdrop to our investment rule, "Factories First". We look first at investment as a share of GDP as shown in *Display 5*, to see if a country is investing enough to grow in the future. More important, we look at where the money is going—to speculative ventures

DISPLAY 5

Investment to GDP %



Source: MSIM EM Research, Haver as of September 2017

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

in real estate, or productive investment in new factories, the roads and ports required to get manufactured goods to market, and the water mains, power plants and other infrastructure needed to make an industrializing country both productive and attractive. In the many countries where investment is weak, and misdirected, the environmental fallout is striking: it is a symptom of underinvestment in Brazil that the Sao Paolo sewers spit raw effluent onto the streets when it rains. This is one of the many environmental signs that also send a telling signal about economic prospects.

The emphasis on "Factories First" reflects the fact that investing in manufacturing is a proven path to steady growth and job creation in emerging markets. The rule thus gives higher scores to countries investing in factories, lower scores to those investing in commodity industries, because growth in commodity economies tends to swing erratically with prices for oil and other raw materials. Beyond the problem of erratic growth, commodity countries are also vulnerable to all kinds of ESG problems: the environmental fallout of strip mines, the social dysfunction of petro-dictatorships, the governance issues and corruption that bedevil rent-seeking, extractive industries.

Make no mistake, commodity economies can work as investment targets, but we keep a close eye on them, in part because they often start out with several ESG strikes against them. On the other hand, investment in commodities can be a positive for both growth and ESG when the money is effectively flowing into new technology—including green energy technology and the raw materials for electric cars and solar panels.

Bottom Up: ESG in our Stock Selection Process

From a bottom-up perspective, we invest in stocks that exhibit robust corporate governance, quality management with sustainable business models and the potential for solid growth in earnings. We take an integrated approach to ESG, focusing on engaging company management with each holding in our portfolio on key issues. We do not use negative screening or "blacklists". No stock is ruled out of our investment universe or portfolio due to poor ESG metrics. We engage on ESG as a way to raise management awareness and potentially to have a positive impact on how such factors shape a company's operations and competitiveness over our investment horizon of 12 to 18 months.

We engage management primarily in direct meetings, by asking about their governance practices and the environmental and social issues that are most pressing and material to their company or industry. We have identified the most material issues for emerging markets by sector and industry, as outlined in *Display 6*, and use this as a guide for these conversations. We also support good corporate governance through

DISPLAY 6

Our Definition of Key ESG Issues in Emerging Markets

CONSUMER DISCRETIONARY/STAPLES

Autos Product safety & quality, product carbon footprint

Beverages Product safety & quality, packaging material & waste

Food & Staples Retailing Product safety & quality, labor management

Food Products Product safety & quality

Media & Broadcasting Labor management, corruption & instability

Retail & Department Stores Labor management

INDUSTRIALS

Aerospace & Defense Corruption and instability

Airlines Carbon emissions, labor management

Construction & Engineering Health & safety

Industrial Machinery Health & safety

Transportation Infrastructure Health & safety

ENERGY, MATERIALS AND UTILITIES

Chemicals Toxic emissions & waste, chemical safety

Construction Materials Carbon emissions, health & safety

Electric Utilities Toxic emissions & waste, opportunities in renewable energy

Oil & Gas Toxic emissions & waste, health & safety

Metals & Mining Health and safety, toxic emissions & waste

Refiners Carbon emissions, toxic emissions & waste

IT/TELECOM SERVICES

Diversified/Wireless Telecoms Privacy & data security

Technology Hardware Electronic waste management, supply chain labor standards

Instruments & Components Chemical safety, opportunities in clean tech

Internet Software & Services Privacy & data security

Semiconductors Corporate governance, opportunities in clean tech

HEALTH CARE

Pharmaceuticals Product safety, quality & access

Providers & Services Product safety, quality & access

FINANCIALS/REAL ESTATE

Banks Privacy, data security & access to financial products

Insurance Access to financial products, human capital development

Real Estate Green buildings

Source: MSIM, MSCI

proxy voting. We will vote against board recommendations we do not perceive to be in the best interests of shareholders.

We don't engage companies on the entire list of issues, only those most relevant to their business or industry over our investment time horizon. The initial conversation often gives us information we need to focus and dig deeper in later meetings, and we find that talking about ESG can reveal a lot about the general quality and effectiveness of management.

These conversation do not focus only on negative impacts. There are examples of companies deriving long-term cost savings and growth opportunities from ESG initiatives. For example, investing in energy-saving technologies can position companies to cope with increasing energy prices. Environmental and social initiatives can also be positive for brand perception and market share across a variety of industries.

After we meet with management, we document our discussion, including specifics on the ESG portion of the discussion, both for tracking purposes and for follow up at the next meeting. Over time, we have found increasing management interest in ESG issues, especially when ESG can be tied directly to the company's financial outlook. *Display 7* shows the issues we raise most often, for each ESG category.

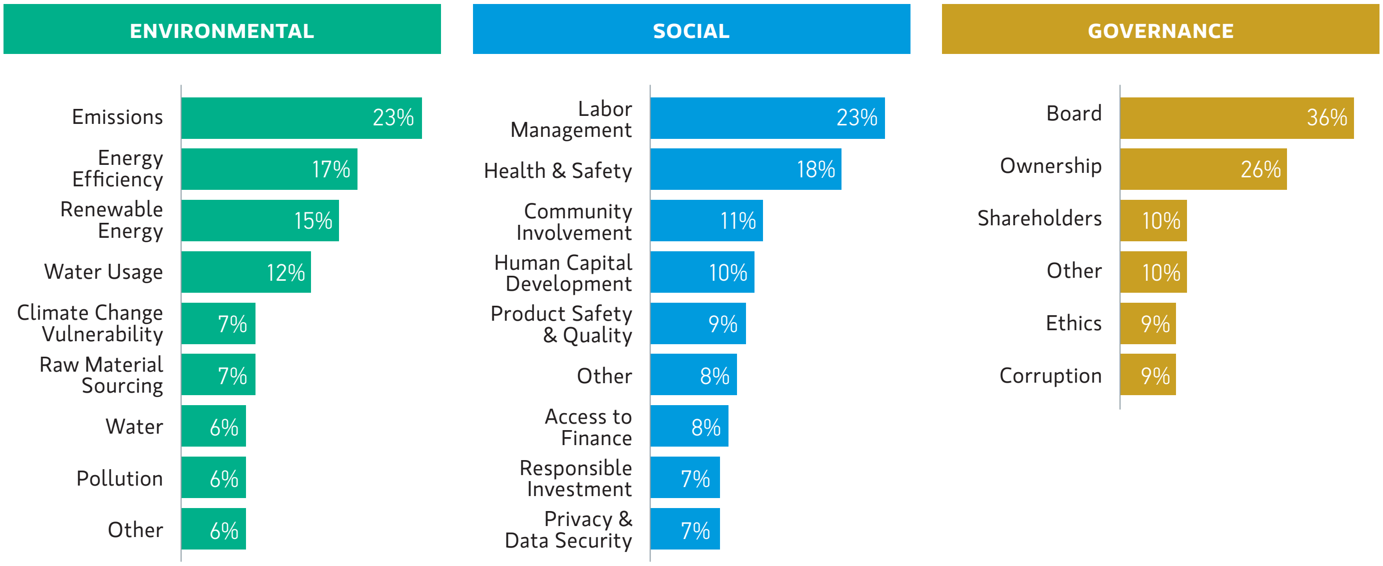
Our ESG analysis helps us mainly to understand company risks and business model sustainability. It can also help us understand the opportunities for companies in terms of branding, product segmentation and customer perception.

ENGAGING WITH COMPANIES ON GOVERNANCE FACTORS

Good corporate governance practices are paramount to driving sustainable growth and returns, and defending shareholder interests. It can be a challenge to protect minority shareholder rights in the many emerging markets that have high levels of government and majority shareholder ownership, so we tend not to own many companies in these markets.

DISPLAY 7

MSIM EME Team's Most Frequently Engaged on ESG Topics



Other categories include: Environmental: Green building, Recycling, Land Use; Social: Supply chain standards, Access to health care, Nutrition & health, Inequality ; Governance: Management, Accounting.

Source: MSIM, Factset's Research Management System, Using 1 year data ending 9/30/17

When analyzing corporate governance we look at several factors including past accounting and auditing track record, ownership structure, board make-up, compensation and accountability, capital management and succession planning. While companies in emerging markets have significantly improved disclosure and transparency in recent years, they can lag behind developed markets. We believe our regular and direct contact with company management in emerging markets gives us a leg up on competitors in addressing these issues, and is crucial to our investment case.

ENGAGING WITH COMPANIES ON SOCIAL ISSUES

We find many companies increasingly focused on social factors including overall product safety, employee safety, labor management, and cybersecurity.

We engage with companies on labor management including safety practices, employee retention, incentives and benefits, wages and other costs, sources, and shortages. Recently, for example, we asked an energy company in Brazil about safety initiatives including their plan to reduce their workplace injury rate. The company discussed safety as a key priority and described a new committee that monitors safety goals and metrics. Management committed to provide regular updates on the topic, and we will monitor progress closely.

We have engaged with banks on access to credit and cybersecurity, which is important to the investment outlook for a company. We find quality banks tend to be particularly aware of cybersecurity risks, many have committees dedicated to the issue, and they invest accordingly. Data security is also crucial to the IT companies we invest in, especially those with e-commerce platforms and strong social influence in the local community.

ENGAGING WITH COMPANIES ON ENVIRONMENTAL FACTORS

We believe the most material environmental issues in emerging markets include energy efficiency and renewables, resource intensity, regulations, emissions and waste.

We have found growing company interest in energy efficiency, especially if there are savings to be captured. For example, at companies with extensive networks of stores or branches, installing energy efficient LEDs or reducing consumption can lead to significant margin improvement.

To track resource intensity, we focus on usage and marginal costs of inputs as well as the supply and demand conditions that will affect pricing of resources. This is a particularly vital issue if raw materials are a company's main source of revenue, or the main input for their key products.

To monitor emissions, we typically ask companies to disclose data on how much pollution they emit and on their reduction targets. In a recent meeting with a nickel company, we found their emissions disclosure much improved and their commitment to efficiency improved. For companies like this, that are increasingly aware of ESG risks, we can pursue a more in-depth discussion of emissions strategy, touching on multiple facets such as fuel efficiency and consumption and resource dependency.

Developing Our ESG Resources

To strengthen our engagement effort, we have developed resources to help identify which ESG issues are most important for each company, and to better document our discussions. After our portfolio managers meet with a company, they write a note documenting the entire discussion, including an entry for ESG issues. When necessary, our investors also hold meetings or make calls focused on ESG, in order to engage more comprehensively on these issues. We log all of these interactions in our research management system in Factset.

We also utilize wider Morgan Stanley resources, in particular working alongside the Morgan Stanley Institute for Sustainable Investing, which helps us learn about industry best practices and continually improve our ESG engagement process.

We may reference ESG score reports, from third parties, to identify which of our portfolio holdings have the highest and lowest ratings and why. We may also discuss these reports with company management to better understand these concerns. In addition, we encourage company management teams to follow up with the reporting agencies and to publish their own sustainability reports, in order to improve the quality of information available to investors.

Conclusion

Our team has invested in Emerging Markets for nearly 30 years, seeking countries with high and/or accelerating growth where well-run companies can thrive for the long term. Our research process continues to consider environmental, social and governance issues that confront policy-makers and company management, because they matter for sustainable growth. Now that ESG is a factor for choosing money managers, we have devoted considerable time and resources into incorporating ESG more formally and openly into our investment process.

ESG risks are deeply embedded in Our Rules of the Road for identifying economies with a promising growth trajectory. They are also an increasingly important subject in our meetings with companies, and our assessment of the risks and opportunities these companies pose over the next 12 to 18 months. While we watch these warning signs in real time, we are long term investors, and we firmly believe that a strong system for monitoring ESG also helps keep us alert to the risks and opportunities of our company holdings for the long haul.

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 in this portfolio. 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 special risks such as currency, political, economic, and market risks. The risks of investing in emerging market countries are greater than the risks generally associated with investments in foreign developed countries. Stocks of **small- and medium-capitalization companies** entail special risks, such as limited product lines, markets, and financial resources, and greater market volatility than securities of larger, more-established companies. **Derivative instruments** can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the portfolio's performance. **Illiquid securities** may be more difficult to sell and value than public traded securities (liquidity risk). **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.

DEFINITIONS

"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. **MSCI ESG Rating/Score** is designed to identify ESG risks or opportunities that may not be captured through conventional analyses. **Gross Domestic Product (GDP)** is a monetary measure of the market value of all final goods and services produced in a period (quarterly or yearly) of time.

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