

MORGAN STANLEY FUNDS (UK)

Sustainable Fixed Income Opportunities Fund

Restriction Screening Policy

GLOBAL FIXED INCOME | GLOBAL FIXED INCOME TEAM | JANUARY 2021

Overview and Rationale

Restriction screening refers to intentionally avoiding investments in certain sectors or issuers. In designing the restriction screening policy as part of our investment strategies, we consider the following aspects:

- I. Reducing exposure to risks related to Environmental, Social and Governance (ESG) factors.** These risks may be reputational, regulatory or financial, stemming from the business activities or practices of the issuer. We aim to remove some of the most material of these risks through restriction screening at the sector level.
- II. Values alignment.** We may decide to exclude certain sectors from the portfolio based on our assessment that they have an overall negative impact on society or the environment which is not aligned to the objectives of the fund.
- III. Consideration as to whether there is an opportunity for engagement on ESG issues and whether an issuer may be able to transition its business activities or practices to a more sustainable model.** We therefore may apply thresholds or carve-outs as part of the sector-level exclusions with an aim to engage with certain issuers to help drive positive change and long-term value.
- IV. Adherence to core basic standards, minimum safeguards and ethical norms.** We expect issuers to adhere to minimum standards as defined by international ESG norms and we aim to not invest in issuers that violate, or are at high risk of violating, these international norms.
- V. Implications for portfolio construction.** We aim to consider whether restrictions may have an effect on the risk/return profile of the fund, or narrow the investable universe to an extent to which it may be detrimental.

The policy and process described below refers specifically to the MS Funds (UK) Sustainable Fixed Income Opportunities Fund.

Restriction Screening Policy & Process

Our Sustainable Investing team, in partnership with the Global Fixed Income Team MSIM Credit Analysts and Portfolio Managers, are responsible for establishing MSIM Fixed Income's Restriction Screening Policy ("Policy") for the MS Funds (UK) Sustainable Fixed Income Opportunities Fund, which will be reviewed and updated on at least an annual basis to ensure that it remains consistent with our view on best practice in the context of the sustainability objectives of the Funds.

Our Policy is designed to avoid investing in identified sectors and securities. The Policy uses information from third parties – complemented, where needed, by input from our Global Fixed Income Team MSIM Credit Analysts – and is subject to change, which can result in delays in reflecting such changes in the portfolios. Where this is the case, we will resolve such instances as soon as possible.

Our restriction screening approach for the MS Funds (UK) Sustainable Fixed Income Opportunities Fund combines *sector-level exclusions*, which are intended to avoid investment in sectors that are not aligned with our core investment principles or our sustainable investing philosophy, and norms-based exclusions, through which we screen out securities of issuers that are found to be in breach of minimum standards of responsible business practice based on international norms.

Our current Policy is presented below.

i. Controversial Weapons

MSIM Fixed Income views controversial weapons (anti-personnel landmines, cluster munitions, biological/chemical weapons and nuclear weapons) as indiscriminate and excessively injurious, often resulting in civilian casualties and causing a disproportionate level of pain and suffering. These weapons may also pose a long term risk to civilian population from unexploded ordnance which can detonate long after their initial use.

We will not invest in securities of issuers that generate revenue from the manufacturing or production of controversial weapons or intended use components, or are a majority owner of, or majority owned by controversial weapons companies. Controversial weapons are defined as anti-personnel landmines, cluster munitions, biological/chemical weapons and nuclear weapons.

Our approach to controversial weapons is consistent with the following treaties:

- The Ottawa Convention, 1999: banning the use, stockpiling, production and transfer of anti-personnel landmines.
- The Oslo Convention 2010: banning the use, stockpiling, production and transfer of cluster munitions.
- Weapons banned under the Biological Weapons Convention, 1975 and the Chemical Weapons Convention, 1997.

ii. Civilian Firearms

We take the view that although firearms can in some cases support rightful and peacekeeping activities, their use by civilians, particularly in the case of automatic and semi-automatic firearms, poses a threat to society as there is a high risk that they might end up being used illegally or indiscriminately against other people, causing mass wounding or death.

We will not invest in securities of issuers that generate revenue from the manufacturing or production of whole automatic or semi-automatic civilian firearm systems.

iii. Tobacco

We believe tobacco has significant negative social and economic impacts and is considered the single greatest preventable cause of death. 14 of the 17 Sustainable Development Goals will require major advances in tobacco control. We estimate that as a result tobacco companies are exposed to significant ongoing financial and reputational risk from increased regulation. Moreover, in our view, there is no reasonable level of tobacco consumption and we believe engagement with the tobacco industry will not lead to significant change.

We will not invest in securities of issuers that generate any revenue from the manufacturing or production of tobacco products, or in securities of issuers that generate 10 percent or more of their revenue from the distribution or retail of tobacco products or the supply of key products necessary for the production of tobacco products, such as filters.

iv. Gambling

Gambling activities embed a high risk of generating direct negative social impacts, in particular addiction and over-indebtedness, as well as indirect impacts especially for more vulnerable groups, including reduced familial stability and household income and increased propensity to crime.

We will not invest in securities of issuers that derive 10 percent or more of their revenue from gambling activities.

v. Fossil Fuels

We recognise that climate change poses significant risks to the global economy and therefore look to exclude the most exposed carbon-intensive sectors from our MS Funds (UK) Sustainable Fixed Income Opportunities Fund to mitigate our climate related financial risks and where we estimate that we are unable to drive positive impact through engagement towards the low carbon transition.

The exception to this is that the Fund may invest in labelled bonds such as green / sustainability / transition bonds, sustainability-linked bonds, or other debt securities that are issued to raise capital specifically for climate-related or environmental projects, which are issued by issuers that would otherwise be subject to the fossil fuel exclusions below, so long as we have determined that the objectives of such instruments are consistent with a reduction by the issuer in its carbon emissions. Investment in such instruments will be subject to diligence by the Sustainable Investing team, with the support of our Fixed Income MSIM Credit Analysts.

Coal

We estimate that coal is the most carbon-intensive fuel source compared to other fossil fuels and it is exposed to significant stranded asset risk from climate policy.

We will not invest in securities of issuers that generate any revenue from the mining and extraction of thermal coal, or in securities of issuers that generate 10 percent or more of their revenue from coal-fired power generation.

Oil Sands

We estimate that oil sands have the highest Green House Gas (GHG) potency (kg per GJ) compared to conventional fossil fuels and have significant negative environmental and social impacts related to their extraction/refining methods, which can in turn generate complex legal regulatory and social risks to shareholder value.

We will not invest in securities of issuers that generate 5 percent or more of their revenue from the extraction or production of oil sands. We will also engage with issuers that derive between 0 and 5 percent revenue from these activities to encourage their phase-out.

Arctic Oil & Gas

Since 2011 Arctic sea ice has been declining at a rate of 12.85 percent per decade, relative to the 1981 to 2010 average.¹ This represents a serious threat to ecosystems and wildlife, as well as to local communities and indigenous people living in the region. Arctic oil extraction and production not only capitalizes on the effects of global warming, but also contributes to worsening it through further emissions, and can lead to serious environmental damage in case of spills.

We will not invest in securities of issuers that generate 5 percent or more of their revenue from oil or gas extraction or production in the Arctic region, including in the Arctic National Wildlife Refuge (ANWR). We will also engage with issuers that derive between 0 and 5 percent revenue from these activities to encourage their phase-out.

vi. ESG Controversies and International ESG Norms

We expect the issuers we invest in to comply with minimum standards and safeguards around human rights, labour rights, environment, business ethics and corruption as defined by international norms such as the UN Global Compact, the OECD Guidelines for Multinational Enterprises and the International Labour Organization's (ILO) fundamental principles, and we aim to not invest in issuers that violate these international ESG norms.

We monitor business practices on an ongoing basis, through data on ESG controversies and standards screening that we source from third party providers.

A "Severe" ESG controversy is defined as an instance or ongoing situation in which company operations and/or products allegedly have a significant negative environmental, social, and/or governance impact.

¹ Source: NSIDC/NASA.

We will not invest in securities of issuers with controversy cases that we view as being “Very Severe” based on ratings by relevant ESG data providers, and where we believe appropriate remedial action has not been taken. We will also not invest in securities of issuers that fail to comply with the UN Global Compact or the ILO fundamental principles Restriction Screening Policy Compliances.

Restriction Screening Policy Compliances

This Policy applies to the physical investments held directly in the MS Funds (UK) Sustainable Fixed Income Opportunities Fund. Investments that are held by the funds but become restricted after they are acquired for the funds will be sold. Such sales will take place over a time period to be determined by the Investment Adviser, taking into account the best interests of the Investors in the funds.

Representatives from several areas of the Morgan Stanley Investment Management are responsible for monitoring the portfolio for compliance as outlined below:

Portfolio managers & the Sustainable Investing team are primarily responsible for ensuring compliance with the policy. Portfolio managers enter orders into the portfolio trading system to ensure compliance with the guidelines of the portfolio.

Traders are responsible for executing trades that are consistent with policy and subject to best execution. They also must enter trades into the portfolio trading system, which enables traders to monitor individual portfolios for guideline conformity.

The Portfolio Surveillance team is responsible for coding the policy into our trade compliance system which uses an automated process to monitor the policy and ensure adequate surveillance of the portfolio.

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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. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this Portfolio. Please be aware that this Portfolio may be subject to certain additional risks. **Fixed-income** securities are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. **Longer-term securities** may be more sensitive to interest rate changes. **Mortgage-and asset-backed securities** are sensitive to early prepayment risk and a higher risk of default and may be hard to value and difficult to sell (liquidity risk). They are also subject to credit, market and interest rate risks. **Municipal securities** are subject to early redemption risk and sensitive to tax, legislative and political changes. **High yield securities ("junk bonds")** are lower rated securities that may have a higher degree of credit and liquidity risk. **Public bank loans** are subject to liquidity risk and the credit risks of lower rated securities. **Foreign securities** are subject to currency, political, economic and market risks. The risks of investing in **emerging market countries** are greater than risks associated with investments in foreign developed countries. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. **Restricted and illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). 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.

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