

# Restriction Screening and ESG Policy

FIXED INCOME TEAM | NOVEMBER 2022

## Overview

The Restriction Screening and ESG Policy (“the Policy”) described below refers specifically to the sustainable range of fixed income Morgan Stanley Investment Funds (MS INVF) listed in footnote 1 (“the Fixed Income Sustainable Funds”).<sup>1</sup>

The MSIM Fixed Income Sustainable Investing team in collaboration with the Credit Analysts and Portfolio Managers (“the Investment Team”), are responsible for establishing the screening and Environmental, Social, and Governance (ESG) criteria of this Policy, 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 goals of the Funds.

## Restriction Screening 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:

- **Reducing exposure to risks related to 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.*
- **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.*
- **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.*
- **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.*
- **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 which may be detrimental to that profile.*

Our restriction screening process 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

<sup>1</sup> This Policy applies to the following funds:

- MS INVF Sustainable Euro Corporate Bond Fund
- MS INVF Sustainable Euro Strategic Bond Fund

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 list of restrictions applicable to the Fixed Income Sustainable Funds is presented below.

## I. Controversial Weapons

MSIM Fixed Income views controversial 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 shall not knowingly invest in securities of issuers that generate **any 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 including 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 shall not knowingly invest in securities of issuers that generate **any revenue** from the manufacturing or production of 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. 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 shall not knowingly 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

We take the view that 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 shall not knowingly invest in securities of issuers that derive **10 percent or more of their revenue** from gambling activities.

## V. Adult Entertainment

We take the view that adult entertainment is associated with social risks in the form of the degradation of human rights and dignity, and potentially promotes negative behaviour involving physical and/or emotional duress and even violence, especially against women.

We shall not knowingly invest in securities of issuers that derive **10 percent or more of their revenue** from adult entertainment activities.

## VI. Fossil Fuels

We recognise that climate change poses significant risks to the global economy and therefore look to exclude issuers with high exposure to carbon-intensive activities, as listed below, to mitigate our climate related financial risks.

## Thermal Coal

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

We shall not knowingly 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 shall not knowingly invest in securities of issuers that generate **5 percent or more of their revenue** from the extraction or production of oil sands.

## Arctic Oil & Gas

We believe the continuous decline of Arctic sea ice represents a serious threat to ecosystems and wildlife, as well as to local communities and indigenous people living in the region. We also take the view that 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 shall not knowingly 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).

The exception to the above fossil fuel exclusions is that the Funds may invest in labelled Green and Sustainability Bonds, as referred to further below in this Policy, which are issued to raise capital specifically for climate-related or environmental projects, 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 MSIM Credit Analysts.

We may also engage issuers' management more broadly around the topics of decarbonisation and climate risk (as well as corporate governance practices and what it deems to be materially important other environmental and/or social issues facing an issuer) including those issuers involved in fossil fuel-related activities. As part of such engagements, we will endeavor to encourage issuers to develop decarbonisation strategies, and specify science-based targets to transition their business models to more sustainable ones.

## VII. ESG Controversies and International 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 United Nations Global Compact, the Organisation for Economic Co-operation and Development's (OECD) Guidelines for Multinational Enterprises and the International Labour Organization's (ILO) fundamental principles.

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

A "Very Severe" controversy case is defined as an instance or ongoing situation in which company operations and/or products allegedly have an environmental, social, and/or governance impact that is serious or very serious in its nature, and extensive or extremely widespread in its scale.

We shall not knowingly invest in securities of issuers with controversy cases that we view as being "**Very Severe**", including those related to the OECD Guidelines for Multinational Enterprises, based on ratings by relevant ESG data providers, and where we believe appropriate remedial action has not been taken. We shall also not knowingly invest in securities of issuers that **fail to comply** with the UN Global Compact or the ILO fundamental principles.

## ESG Methodology

### Sustainability Objective

The sustainability objective of the Fixed Income Sustainable Funds is to maintain a lower carbon footprint than the relevant carbon footprint reference benchmark, taking into account the long-term global warming objectives of the Paris Agreement.

### Environmental & Social Characteristics

The Investment Team integrates the consideration of sustainability issues in its investment decision-making based on bespoke methodologies developed by MSIM Fixed Income to evaluate the ESG characteristics of issuers and transactions across sub-asset classes including corporates, sovereigns, securitised and sustainable bonds (as defined below). Details of the methodologies are available on the web links below:

- **ESG Credit model**
- **ESG Sovereign model**
- **ESG Securitised model**
- **Sustainable Bond evaluation**

The Fixed Income Sustainable Funds will only invest in the **top 80% of ESG-scoring corporates** in each sub-sector of their respective reference benchmarks, and, where applicable, in the **top 80% of ESG-scoring sovereigns** that we have evaluated.

We may include the evaluation of positive and negative alignment with the UN Sustainable Development Goals (“UN SDGs”) and may **engage company management** around corporate governance practices as well as what we deem to be materially important environmental and/or social issues facing a company, in particular in relation to MSIM’s priority sustainability themes of Decarbonisation & Climate Risk, Circular Economy & Waste Reduction, Diverse & Inclusive Business, and Decent Work & Resilient Jobs. Details on our engagement approach and thematic priorities are outlined in our **MSIM Fixed Income Engagement Strategy**

The Fixed Income Sustainable Funds may also invest in Sustainable Bonds, defined as labelled bonds where the issuer has committed to financing or attaining specific environmental and/or social objectives, including but not limited to the below based on the main labels of bonds issued to date, including those recognised by the International Capital Market Association (ICMA):

- Green Bonds
- Social Bonds
- Sustainability Bonds

## Sustainability Indicators

We have selected a set of indicators to assess, measure and monitor the sustainable objective as well as additional environmental and social characteristics of the Fixed Income Sustainable Funds. The table below specifies the sustainability indicators, the details of the metric, permitted threshold and data sources. We may change data sources for the reference indicators presented below in the future.

Sustainability indicator	Metric	Methodology	Data sources
Carbon footprint for scope 1 and 2 emissions	Weighted Average Carbon Intensity (WACI), defined as tons of CO2 equivalent per \$1 million revenue. Note: Scope 1 carbon emissions: direct emissions generated from sources that are controlled by the company that issues the underlying assets; Scope 2 carbon emissions: indirect emissions from the consumption of purchased electricity, steam, or other sources of energy generated upstream from the company that issues the underlying assets.	The portfolio WACI is compared against the reference benchmark and consideration is given to a corporate issuer's alignment to the objectives of the Paris Agreement.  Sustainable Bonds with climate-related objectives may be determined to have different carbon footprints than the issuers of the bonds. In such cases, MSIM Fixed Income shall disclose its methodology for determining the relevant carbon footprint of such instruments.	MSCI
Issuer's ESG score	ESG scores at issuer-level developed by MSIM, with data inputs from third-party providers.	Tilt towards the top 80% ESG rated issuers within each sub-sector for corporates and within each high-/medium-/low-income group for sovereigns, according to a proprietary scoring methodology	MSIM proprietary ESG corporate scores, based on MSCI data inputs;  MSIM proprietary ESG sovereign scores, based on data from: World Bank, United Nations, Emission Database for Global Atmospheric Research (EDGAR), University of Notre Dame
Issuers' product/service and business practices alignment with the UN SDGs	UN SDGs product/service alignment scores, and UN SDGs business practices alignment scores	Assessment of a corporate issuer's alignment with the UN SDGs based on revenue derived from its products/services, as well as on its business practices and operations, using third-party data; subsequent mapping of UN SDG alignment to MSIM's priority sustainability themes of Decarbonisation & Climate Risk, Circular Economy & Waste Reduction, Diverse & Inclusive Business and Decent Work & Resilient Jobs.	MSCI

## ESG Data

In undertaking the ESG assessment and restriction screening process described above, the Investment Team supplements its own analysis with data from third parties such as MSCI, Sustainalytics, S&P Trucost, ISS ESG and others. The Investment Team will bear the costs in relation to the use of third-party data. Third-party data 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.

## Policy Compliance

This Policy applies to the physical investments held directly in the Fixed Income Sustainable Funds, as listed in Footnote 1. 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 Team, taking into account the best interests of the Investors in the Funds.

Representatives from several areas of MSIM are responsible for monitoring the portfolio for compliance as outlined below:

*Portfolio Managers and the Fixed Income Sustainable Investing team* are primarily responsible for ensuring compliance with the Policy.

The *Information Technology team* is responsible for applying the screening rules outlined in this Policy to the respective reference benchmarks to determine the Fixed Income Sustainable Funds' investable universe.

*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 ESG-related rules 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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This document supplements the information provided in the Prospectus. Investors should read the Key Investor Information Document and Prospectus before investing.

There is no assurance that a Fund will achieve its investment objective. Funds are subject to market risk, which is the possibility that the market values of securities owned by the Fund will decline. Accordingly, you can lose money investing in this Fund.

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