Sustainability has become an increasingly prominent consideration for investors, as they assess whether their portfolios are aligned to a more sustainable future, and how they can support positive outcomes through their capital without compromising their alpha targets or sector diversification. In order to help our clients achieve these goals, Morgan Stanley Investment Management (MSIM) introduces our MS INVF Sustainable Euro Corporate and Strategic Funds—comprehensive sustainable investing offerings which combine the best of our bottom-up analytical approach as an active Fund Manager, with a top-down sustainability lens.

Overview

Investors are paying greater attention to the implications of global sustainability challenges, both in terms of the risks they may pose to their investments and in terms of how they can invest their capital to achieve positive environmental or social outcomes. The challenge, however, is how to implement a holistic sustainable investing strategy without compromising traditional financial objectives. Some sustainable funds do not go far enough, only focussing on reducing sustainability risks rather than driving positive outcomes. Other funds go too far in their specialisation, resulting in concentrated portfolios with impaired diversification.

The MS INVF Sustainable Euro Corporate Bond Fund and MS INVF Sustainable Euro Strategic Bond Fund (“the Funds”) seek to address these issues, bringing together a top-down set of specific sustainability goals and criteria with the best of our bottom-up analytical capabilities. In doing so, we seek to provide our clients with a comprehensive sustainable investing solution without compromising alpha targets or portfolio sector diversification.

Strategies At-a-Glance

<table>
<thead>
<tr>
<th>SUSTAINABLE EURO CORPORATE BOND FUND</th>
<th>SUSTAINABLE EURO STRATEGIC BOND FUND</th>
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<tbody>
<tr>
<td><strong>Benchmark</strong></td>
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<tr>
<td>Bloomberg Barclays Euro Aggregate Corporate</td>
<td>Bloomberg Barclays Euro Aggregate</td>
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<tr>
<td><strong>Investment Universe</strong></td>
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</tr>
<tr>
<td>Euro-denominated fixed income securities issued by corporations that fulfil MSIM’s ‘Fixed Income Securities’ ESG criteria.</td>
<td>Euro-denominated fixed income securities issued by corporations, governments or government guaranteed issuers that fulfil MSIM’s ‘Fixed Income Securities’ ESG criteria.</td>
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<tr>
<td><strong>Duration</strong></td>
<td><strong>Duration</strong></td>
</tr>
<tr>
<td>+1/-1 year vs. benchmark</td>
<td>+3/-3 years vs. benchmark</td>
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<tr>
<td><strong>Currency</strong></td>
<td><strong>Currency</strong></td>
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<tr>
<td>• Base currency of the fund is Euro</td>
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<tr>
<td>• Can buy bonds in non-Euro currencies</td>
<td>• Can buy bonds in non-Euro currencies</td>
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<tr>
<td>• Requirement to hedge currency risk</td>
<td>• No requirement to hedge currency risk</td>
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Top-Down Sustainability Approach

The Funds employ a dynamic approach to define an eligible universe that has superior sustainability characteristics on a sector-by-sector basis, and select securities from that universe with a focus on positive sustainability contributions.

The aims of the top-down process are to:

• Reduce exposure to material ESG risk and negative sustainability impacts, through restriction screening;

• Tilt the portfolios in favour of strong sustainability performers;

• Monitor and support positive sustainability outcomes to key themes; and

• Contribute to clear beneficial impacts by investing in issuers or instruments that explicitly aim to achieve environmental or social objectives.

Our approach follows three steps:

STEP 1: SCREEN OUT CONTROVERSIAL SECTORS AND ISSUERS

STEP 2: DEFINE AN ELIGIBLE UNIVERSE OF BEST-IN-CLASS SUSTAINABILITY PERFORMERS

STEP 3: PURSUE PORTFOLIO SUSTAINABILITY OBJECTIVES
STEP 1: Screen out controversial sectors and issuers

We believe that exposure to certain sectors or names represents material reputational, regulatory or financial risk on the basis of ESG factors or economic trends. As active investors, our preferred ESG risk mitigation strategy is through direct engagement with issuers to encourage their transition towards more sustainable business models or business practices. However, for several industries or in some specific cases, engagement has limited potential to resolve our concerns.

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

Our current Restriction Screening Policy specifies exclusions across controversial weapons, civilian firearms, tobacco, gambling and some fossil fuels, with thresholds in some cases defined by the percentage of the company’s revenue that is derived from the activity.

With respect to ESG controversies, and adherence to international ESG norms, the Funds will not invest in securities of issuers with very severe controversies where we believe appropriate remedial action has not been taken. The Funds will also not invest in securities of issuers that fail to comply with the United Nations Global Compact (UNGC), the International Labour Organisation’s (ILO) fundamental principles, or the Organisation for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises.

A detailed description of our process and rationale in defining these exclusions, and how they are integrated in our systems, can be found in our separate Restriction Screening Policy, which is subject to review and update on at least an annual basis to ensure we continue to apply what we believe are best practices.

STEP 2: Define an eligible universe of top sustainability performers

We apply MSIM’s proprietary ESG scoring to select the top 80% of issuers in each subsector for corporates (e.g., banking, basic industry, utilities). This allows the Funds to have exposure across the full range of sectors in the index, without automatically creating concentration in any one sector. It also allows the Funds to tilt to the stronger sustainability issuers, while still remaining diversified.

For sovereign issuers, we will apply MSIM’s proprietary ESG sovereign model to select issuers who are in the top 80% according to our evaluation of their sustainability performance. However, we recognise that sovereign ESG data can have a significant lag due to collection and reporting frameworks. Consequently, if our analysis and research indicates that a Sovereign has positive sustainability momentum, which may not yet be reflected in the reported data, we will consider investing in issuers in the bottom 20%. We may also consider labelled Sustainable Bonds (see definition below) from sovereigns in the bottom quintile, as we have direct visibility on projects and their sustainability impacts, which enables us to support driving meaningful change in these countries.

In the supranational and agency space, we view these issuers as primarily purpose-driven organisations, and seek out those issuers with strong sustainable development agendas that are contributing to positive impacts on society.

The eligible investable universe, as defined by Step 1 and Step 2, is monitored by our Portfolio Surveillance team and updated on a monthly basis. Any holdings that have become ineligible are sold by as soon as is feasible, with the best interests of the investors in the Funds in mind.
STEP 3: Pursue Portfolio Sustainability Objectives

Within the eligible investable universe, the team constructs and maintains the portfolio according to the following sustainability objectives:

- **Decarbonisation**: Maintaining a lower carbon intensity than the Index, with a target of net zero emissions by 2050 in line with the Paris Agreement;
- **Making a positive contribution to the UN Sustainable Development Goals (“SDGs”);**
- **A minimum of 10%* allocation to positive impact instruments in the form of Sustainable Bonds.**

* Thresholds should be intended to be on a best-effort basis; the actual proportion of sustainable bonds in the portfolio might vary depending on the risk/return considerations.

Portfolio Construction

*Sustainable Euro Corporate Bond & Sustainable Euro Strategic Bond Funds*

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

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1. Note: The portfolio might include minor allocations to additional asset classes including ABS, MBS, or HY. These will be disclosed as part of the regular reporting.
2. Note: In line with MSIM Fixed Income’s Restriction Screening Policy.
3. Note: Exceptions can be applied to investments in green/sustainability/sustainability-linked or transition bonds that are issued to raise capital specifically for climate related or environmental objectives.
4. Note: Include Green, Social, Sustainability, Transition, and Sustainability-linked bonds.
5. Note: Threshold should be intended to be on a best-effort basis; the actual proportion of sustainable bonds in the portfolio might vary depending on the risk/return considerations.
Delivering the Best of our Proprietary Bottom-Up ESG Analysis & Processes

Our Top-Down processes are supported by the full range of the Global Fixed Income team’s bottom-up analysis and processes from our Sustainable Investing Toolkit:

1. ESG INTEGRATION & PROPRIETARY SCORING METHODOLOGIES

The team applies a proprietary ESG assessment methodology, incorporating third-party data as well as our own analysis, to evaluate corporates and sovereigns. Our approach reflects a focus on materiality when it comes to ESG issues, and it is tailored to reflect our specific requirements as Fixed Income investors.

**Corporates**

We rely on quantitative ESG data from third-party providers as an input. Our credit analysts complement their sector-specialist expertise with ESG-focused research from a wide variety of sources to derive sector risk weightings that are applied to the E, S, and G factors. Additionally, we apply adjustments to reflect:

- **CONTROVERSIES**: Given the material impact an ESG controversy can have on credit spreads, our analysts apply their own views in assessing a company’s risks of being implicated in this type of event, based on news screening and incident monitoring.

- **MOMENTUM**: We want to reward companies that are making progress to improve their ESG scores and achieving a positive sustainability trend.

Our output is an issuer-specific MSIM ESG credit score, comparable across sectors, which we interpret as a long-term measure of risk and commitment to sustainable business practices. The score forms the basis of our top 80% selection criterion, described above. Our model is flexible and consistently reviewed to maintain relevance, with inputs from the Sustainable Investing team to reflect developments in ESG integration best practices.

**Sovereigns**

The team has a dynamic, evolving proprietary model of country sustainability, which combines three elements:

- Integrating and weighting of E, S, and G factors based on third-party data;
- The incorporation of analyst input to reflect ESG momentum; and
- The measurement of sovereign sustainability performance relative to GDP, to so that the ESG assessment reflects the stage of development of each country.

The final result is an MSIM proprietary score reflecting the country’s ESG performance versus its GDP per capita-predicted score.

2. SUSTAINABLE BOND EVALUATION

As part of our pursuit of a positive impact, we commit to investing at least 10% of each of the Funds in sustainable bonds: labelled debt instruments in which the issuer has committed to financing specific environmental and/or social objectives (see table below).

<table>
<thead>
<tr>
<th>SUSTAINABLE BOND CATEGORY*</th>
<th>OBJECTIVE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Green Bonds</td>
<td>Environmental goals</td>
</tr>
<tr>
<td>Social Bonds</td>
<td>Social goals and/or target populations</td>
</tr>
<tr>
<td>Sustainability Bonds (including SDG Bonds, Blue Bonds)</td>
<td>Environmental and social goals</td>
</tr>
<tr>
<td>Transition Bonds</td>
<td>Transition to low-carbon business models</td>
</tr>
<tr>
<td>Sustainability-linked Bonds (or SDG-linked Bonds)</td>
<td>Based on Key Performance Indicators (KPIs)</td>
</tr>
</tbody>
</table>

*Note: Categorisation based on the main labels of bonds issued to date, including those recognised by the International Capital Market Association (ICMA).
To ensure transparency, MSIM FI’s Sustainable Investing team has developed a proprietary Sustainable Bond Evaluation Model to evaluate sustainable bonds in a systematic and objective way, which can be applied in a consistent and comparable fashion across the full spectrum of issuers, themes and asset classes. This quantitative and qualitative analysis results in a MSIM Sustainable Bond Score, which evaluates four key pillars:

1. The issuer’s ESG profile and fit of the bond within its sustainability strategy;
2. Structure of the bond, characteristics of the projects or goals and alignment with market frameworks.
4. Quality of reporting.

This model allows us to determine which sustainable bonds are market-leading and impactful versus those which lag best practice, and informs the decision whether to own a bond based on sustainability characteristics, in addition to risk/return considerations.

3. A THREE-PRONGED COLLABORATIVE APPROACH TO ESG ENGAGEMENT

As active investors with a focus on long-term value creation, we view ESG engagement as an indispensable and powerful tool to implement our sustainable investing strategy. Engagement allows us to build a constructive dialogue with issuers and support them in pursuing positive sustainability outcomes and in enhancing ESG disclosure. Engagement also helps us understand ESG risks better, aiding in the price discovery of the proper cost of capital. Our goal is to contribute, over time, to raising the bar of issuers’ sustainability profiles. At the **issuer level**, we deploy a three-pronged approach to engagement.

1. **THEMATIC:** Engagement priorities are based on ESG issues and risks at a sectoral level, and we have defined a clear set of sustainability themes that are priority for MSIM Fixed Income, specifically:
   - Decarbonisation and Climate Risk
   - Circular Economy and Waste Reduction
   - Inclusive and Diverse Business
   - Decent Work and Resilient Jobs

2. **TARGETED:** The selection of issuers to engage is based on the materiality of the ESG flags or opportunities based on our MSIM ESG score, additional analytics, and insights from our research analysts and Sustainable Investing team. We focus on ESG laggards to encourage improvements on the themes above, as well as on other ESG issues, but also on select ESG leaders to support best practices and innovative sustainable solutions.

3. **INTEGRATED:** ESG topics are included in our regular interactions with company management, led by our research analysts, which are tracked and followed-up. In addition, dedicated ESG engagement sessions benefit from the additional expertise of our Sustainable Investing team, and from the cross-asset insights of the Global Stewardship team, which operates across the whole of MSIM and with whom we collaborate.

To complement our issuer-level engagement, which is focused on companies’ ESG policies and practices, we also conduct engagement at the **product level**, leveraging our MSIM Sustainable Bond Evaluation Model and the Sustainable Investing team’s expertise to engage proactively on the quality of new sustainable bond issuances in the market, as well as at the **market level**, maintaining a constructive dialogue with external stakeholders and industry associations to share and promote best practices for sustainable investing.
Investment Team

The funds are managed by senior members of the Global Fixed Income team, complemented by Navindu Katugampola, the Head of Sustainable Investing for Global Fixed Income and Liquidity.

PORTFOLIO MANAGERS

- RICHARD FORD
  Global Head of Credit
- LEON GRENYER
  Portfolio Manager
- RICHARD CLASS
  Portfolio Manager (Strategic Strategy)
- DIPEN PATEL
  Portfolio Manager (Corporate Strategy)

SUSTAINABLE INVESTING

- NAVINDU KATUGAMPOLA
  Head of Sustainable Investing Team
- BARBARA CALVI
  Sustainable Investing

Putting it all into Practice: Managing the Funds with a Focus on Sustainability Outcomes

Ongoing management of the Funds will bring together the expertise of MSIM Portfolio Managers, the specialist knowledge of our Research Analysts, and the scrutiny of the Sustainable Investing team, ensuring the investment process embeds the most up-to-date sustainability insights that can contribute to both financial and ESG performance.

Through its augmented approach that combines MSIM’s established bottom-up ESG integration models with specific top-down criteria, the Funds offer the advantage of achieving positive impact and outcomes across a range of sustainability themes and sectors, as opposed to focussing on a narrow and static pool of issuers. This represents an attractive investment opportunity for a wide range of clients, who are looking to implement a comprehensive, active sustainable investing strategy that effectively minimises ESG-related risk, while also seeking out ESG alpha, to drive both positive financial returns and sustainability results. Crucially, our holistic approach means that investors can capitalise on this opportunity without sacrificing the benefits of portfolio sector diversification and compromising their alpha targets.
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