Morgan Stanley

INVESTMENT MANAGEMENT

Engage

ENGAGEMENT REPORT | February 2024

INTERNATIONAL EQUITY TEAM

Contents

Scope of Report

This report covers the engagement activities of the International Equity Team, acting on behalf of its clients in the strategies set out below. The engagement case studies and/or proxy voting activities included in this document are examples of the type of engagements and proxy voting the team carries out with companies on matters it believes are financially material risks or opportunities.

This report relates to activities carried out in the period 1 January 2023 – 30 June 2023, unless otherwise stated. As at the date of publication, the International Equity Team manages the following strategies: Global Franchise, Global Franchise Equity Income, Global Franchise ex Tobacco, Global Quality, Global Quality ex Tobacco, Global Sustain, International Equity, International Equity Plus, American Resilience, International Resilience. These strategies are made available through different vehicles globally as well as segregated mandates. The activities in this document may not be applicable to all strategies or vehicles.

Sixty Second Snapshot

Testing the water

As a follow up to an engagement on water use with a brewery we hold, our Head of ESG took the opportunity to conduct a further fact-finding engagement, visiting the company's "best in class" brewery in the water-stressed region of North Mexico. Having identified water use as a financially material risk for the company, our engagement enabled us to gain on-the-ground insights into the measures used by the company and brewery to manage the risks associated with water scarcity.

Investing in people

Diversity, equity & inclusion (DEI) is both a financially material risk and opportunity for a European multinational software company we hold. We met with their Chief Diversity & Inclusion Officer to discuss how they are identifying internal candidates and supporting development to ensure female employees are in a better position to be promoted, enquire about data disclosure around DEI, and discuss the setting of effective targets around racial diversity. Overall, we believe that their new Chief Diversity & Inclusion Officer appears to be an effective and focused leader, driving the right DEI strategy and culture in the business.

Climate change – can insurers stand the heat?

Record temperatures and recent wildfires have brought further evidence that the climate is changing. With weather patterns more extreme, unpredictable and therefore costly, how will the insurance industry adapt? And what about re-insurers? While the protection gap may present a financially material opportunity for insurance companies, increasing insurance coverage increases the liabilities of those doing the insuring. The insurance companies control an essential aspect however – price, which we believe is one way they can manage this financial risk.

The devil is in the detail: carbon targets 101

A look at the key differences between carbon neutral and Net Zero, the basic building blocks involved in setting carbon reduction targets and why we believe targets approved by the Science Based Targets initiative (SBTi) are credible and consistent.

Executive pay: "Show me the incentive and I will show you the outcome"

As long-term investors, we want the companies we invest in to have pay plans in place that encourage longer-term thinking over short-term opportunism. We created the Pay X-Ray as a framework for a comprehensive and rigorous analysis of company pay schemes. In this piece we talk through what we do and don't like to see in executive pay plans, as well as giving case study examples of how we use proxy voting to emphasise our point.

Testing the Water

GLOBAL QUALITY

AUTHOR

MARTE BORHAUG
Head of ESG

E S G

BIODIVERSITY/
ECOLOGICAL IMPACTS

Fact-finding engagements = engagements where the primary purpose is to conduct further research into how a company is approaching a particular topic

As reported in "Understanding the Nature of the Issue" (Engage Summer 2023), we identified water use as a financially material risk for a brewing company we own, given water is both beer's primary ingredient and its largest waste by-product. Following our meeting with the company on the subject towards the end of 2022, our Head of ESG took the opportunity to conduct a further fact-finding engagement in June 2023, visiting one of the company's breweries in Northern Mexico, a water-stressed region.

Overview

Water use can pose a financially material risk to companies in a number of different ways. Water scarcity may, for example, lead to local authorities or communities limiting companies' access to water when local supplies become stressed, potentially disrupting companies' operations. At the same time, water pollution may result in increased litigation and reputational damage, while also destroying the valuable ecosystems that such companies are reliant upon for resources. For breweries, which are inherently water intensive and reliant on local water supplies for production, it is important that management have an effective strategy in place to manage water dependency and mitigate environmental impact.

In Northern Mexico water scarcity has become an increasing risk given more intense heat waves and reduced rainfall in recent years. Indeed, as a result of water scarcity, one of the company's competitors faced significant headwinds with setting up their new brewery in the region, impacting their share price, and ultimately were compelled to move their operations elsewhere.

Pre-engagement Preparation

The objective of our engagement was to gain on-the-ground insights into how the company and brewery are managing this financially material risk and their efforts to reduce, recycle, and replenish water. As we were aware from our research and previous engagements, the company already had several water-related projects in place and had declared environmental sustainability to be central to their most recent Northern Mexico-based brewery's design. However, we still felt better disclosure was needed given the financial materiality of this issue and wanted to reiterate

this to management on the ground. We were also interested to see if and how ideas and decisions taken at the European headquarters flowed through to breweries based on the other side of the world.

Prior to the visit, we prepared five key questions in order to frame our engagement.

What We Learned

1 What is local management's approach to managing financially material water-related risks?

The brewery's management explained that they have worked to avoid similar issues to those faced by their competitor by addressing water scarcity risks in three ways: adoption of circular approaches to improve efficiency; daily monitoring of wells (enabling a nimble response to shift brewing to a different brewery in advance of a problem); and building local relationships to ensure strong links to government, the water authority and local communities. These three points are explored in further detail below.

Our focus on the sustainability of companies' long-term returns means we pay attention not just to what the company is planning today, but the impact this will have on its business and top line growth over the next five, 10 and even 20 years. We asked local management whether they calculated potential returns on investment of future water-related projects and were told that future price and cost/benefit analysis is already included for every project. They acknowledge that inaction will lead to water price increases, so view investing in circularity as a means of protecting the brewery from future increases in water prices.

2 How is the brewery managing its water usage and efficiency?

Improved water to beer ratio

At present, the company's breweries use 3.3 litres of water on average for every litre of beer they produce globally, not including the water used in the growing of ingredients. The factory we visited however – considered best-in-class by the company – uses only two litres. This is possible as a result of efficiencies they have in place enabling them to use less water from wells, such as a fully circular water system, and they report no issues with leaking pipes. They are optimistic that this ratio could be reduced further over time.

We questioned whether the significant reduction they have made in the volume of water required to brew a litre of beer could be replicated throughout the company's breweries. Local management acknowledged that what is done at this brewery is not always possible elsewhere. Built in 2018, the brewery benefits from facilities being located in the same place, enabling efficiencies and greater control. However,

Calculating an internal water price is a way to work out the monetary value of water to a business. The internal price may factor in the environmental costs of extracting water in a local area or the benefits of improving water quality, water efficiency, or securing water supplies. This price is then used to inform investment decisions and protect against shocks caused by water shortages.

Source:
https://www.cdp.net/en/articles/water/internal-water-pricing-is-changing-how-companies-do-business

changes implemented here may be added to the company-wide best practice list and rolled out where feasible.

Water reclamation onsite

We had previously encouraged the company to disclose its water recycling rates and set a target for improvement globally. At present, the company does not disclose aggregate statistics publicly. Local management explained that there was a good reason for this: water recycling capabilities differ regionally, making it difficult to set a company-wide target. In previous engagements with the company, they shared that a number of their breweries had achieved 40% recycled water. The brewery we visited has its own water reclamation plant which treats and reuses wastewater – one of the company's six globally. This is strategically located near to the brewery, which reduces the risk of losing water through potentially compromised infrastructure. The brewery's water reclamation plant uses water filtration and reverse osmosis to recycle 60% of water, which can then be reused in the company's manufacturing processes to reduce reliance on freshwater, e.g., for general cleaning.

Supply chain management

Outside its own direct operations, the company has a training programme for its suppliers including farmers to try to reduce the water intensity for growing ingredients, notably barley. The company has mapped water risk at the crop supplier level and has focused its engagement efforts on the high-risk suppliers. This includes an explanation of the benefits of conservation agriculture and practical steps towards regenerative agriculture. While they acknowledge that the programme is still relatively new and results likely won't be visible until four or five years, we consider this a positive step towards managing water scarcity risks in the supply chain.

Internal pricing

We had previously encouraged the company to manage water efficiency by introducing an internal price on water. Local management explained that they account for the risk of price increases when budgeting for projects aimed to improve water efficiency. Given water risk differs across regions, they said a single internal price is impractical. Instead, they use a different price in different areas. We believe this is an effective risk management strategy.

3 How are they cleaning water that goes back into nature?

Water that does not go into the beer itself either evaporates during the brewing process, is recycled, or is disposed of by discharge into the environment. While beneficial, water recycling does have its limits. If water is recycled too much, it becomes too salty to be released into nature. Discharged water needs to be treated before it can be released back into nature in order to ensure water toxicity does not exceed designated levels. In terms of this particular brewery's wastewater quality, local management reported they are well within local regulatory standards, at less than half of the allowed concentration.

Across the company's global operations, the company is targeting treatment of 100% of wastewater across all breweries by the end of 2023. In the company's 2022 annual report, they reported that 179 of 186 sites have wastewater treatment, with 97% of wastewater volume treated before discharge (up from 95% in 2021).

4 What are they doing to replenish water taken from nature?

We asked local management about watershed management projects to return water taken from nature. They talked through their approach, from assessment of environmental and social vulnerabilities to partnering with NGOs, with external audits carried out when the project is complete. An example of the type of project that might be carried out was helping restore flows in the Colorado river delta.

More broadly, the company aims to fully balance water used in their products in 31 sites located in water-stressed areas by 2030. This means they aim to return to the local watershed every litre of water that goes into their product through both nature-based solutions (such as large-scale reforestation and rainwater harvesting) and improving infrastructure. By the end of 2022, they reported that 26 of these sites had started water balancing projects and 29% of them are fully water balanced.

The company uses the Volumetric Water Benefit Accounting standard launched by the World Resources Institute (WRI) to measure the outcomes and impacts of water balancing. When we discussed with local management the challenges of accounting for watershed replenishment, they remarked that while the WRI standard may not be perfect, it is a start – and a globally recognised approach.

5 How are they managing local community/government relations?

Local management acknowledged that community support is key to ongoing success. The Comisión Nacional del Agua is in charge of water management in Mexico, with water concessions dependent on the local area and local

support. The brewery we visited has been granted a 15-year concession, but in other areas breweries rely on "borrowing" concessions donated by other businesses that aren't using them. Local management are keen to maintain strong community relations. They visit local schools and provide education on the actions the company is taking. The brewery's Corporate Affairs team meets with NGOs and members of the local municipality and government, working to build strong relationships and have a voice within the community. They also meet regularly with other companies in the region to identify any common issues and share best practice. We were reassured by local management's recognition of the importance of strong community relations, especially in light of the issues their competitor faced.

In Conclusion

The current company CEO, previously CEO of the company's Mexican division, has been instrumental in encouraging a culture that tackles sustainability risks and strives for constant improvement. The company maintains an official list of best practices, available to all breweries. The Mexico-based breweries have implemented nearly 100% of the list.

Visiting the brewery enabled us to see exactly how measures to manage the risk of water scarcity were being implemented, including circular designed operations to reduce water use and increase water efficiency, as well as learning about daily monitoring and crisis management plans. Being on the ground gave us greater comfort that the company is taking action to manage the risks and that central commitments made at company headquarters are actually reaching their sites around the world.

Investing in People

GLOBAL QUALITY | GLOBAL SUSTAIN

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DIVERSE & INCLUSIVE BUSINESS

We met with the Chief Diversity & Inclusion Officer of a multinational software company we hold to discuss missed DEI targets and learn how they are progressing towards current targets. We consider DEI to be both a financially material risk and opportunity for the company, as we believe people and culture are key to performance for software businesses.

The Issue

How companies approach diversity, equity and inclusion (DEI) may present potentially financially material issues. Research suggests that companies in the top quartile for gender diversity on executive teams are 25% more likely to have above-average profitability than companies in the bottom quartile.[1] Further research has shown that gender diversity helps to promote innovation and strong governance; for example a study by Boston Consulting Group found that companies with leadership teams that have above-average diversity generate, through product innovation, revenues that are 19 percentage points superior to companies with less diverse leadership teams, and enjoy higher earnings, before taxes and interest (EBIT) margins.[2] Moreover, according to a study by MSCI, boards with higher levels of gender diversity tend to experience fewer instances of governance-related controversies, including bribery, corruption and fraud.[3]

In the case of a German multinational software company we hold, we consider DEI to be both a financially material risk and opportunity, as we believe people and culture are key to performance for software businesses. In our view, a strong approach to DEI should help the company attract and retain top talent and create an inclusive, high performing culture. This has long been understood by the company, which has worked to embed DEI within its business and workforce for the last two decades, for example through establishing gender equality policies, hiring programmes for people with autism, and formal DEI practices.

[1]McKinsey & Company. "Diversity Wins: How Inclusion Matters." May 2020.

[2]Rocío Lorenzo, Nicole Voigt, Miki Tsusaka, Matt Krentz, and Katie Abouzahr, "How Diverse Leadership Teams Boost Innovation", Boston Consulting Group, 2018.

[3]Linda-Eling, Lee Ric Marshall, Damion Rallis, Matt Moscardi. "Women on Boards: Global Trends in Gender Diversity on Corporate Boards," November 2015.

In general, we believe direct engagement is the best route to assess a company's approach to DEI, which includes understanding a company's strategy, policies and reporting. Meeting management affords us the opportunity to gauge integrity, ask the difficult questions, nudge for progress and, where we believe financially material, encourage improvement. As a follow up to a general ESG engagement meeting we held with the company in Q1 2023 where we encouraged the company to report on the financial benefits of its ESG strategy, we asked to meet with the company's Chief Diversity & Inclusion Officer in Q2. Given the company had narrowly missed its target to have 30% women in management positions by the end of 2022, we wanted to understand why, what action was being taken to meet the target, and what, if anything, has been learned. We also discussed their inaugural DEI report, probed further on how they are progressing against current targets, and sought to ascertain what their future targets might look like, given their existing targets are expiring.

What We Learned

The company's Chief Diversity & Inclusion Officer explained that they narrowly missed their women in management target in part due to the indirect effects of COVID-19. The shortfall was not due to attrition but rather in hiring: pandemic hiring curtailments meant they could not increase their staff numbers. Their goal, they explained, given the tenure of many of its employees, is to identify internal candidates and support development from within. We agree with this – helping employees acquire the skills necessary to "move up" not only encourages them to stay at the company, rather than taking their skill sets and knowledge to the open market, but it also avoids the company having to devote potentially significant resources to recruiting and training externally. The company has already been investing to expand its current "talent" pool, building internal development programmes to ensure female employees are in a better position to be promoted into management roles. They anticipate meeting their women in management target by end of 2023 as a result of these programmes, alongside encouraging employee participation.

We also enquired about the company's data disclosure journey. Since joining one and a half years ago, their Chief Diversity & Inclusion Officer has been working to develop quarterly disclosure reports on the diversity numbers within different business units. They explained that this exercise has yielded a new degree of transparency within the company, making available data that was previously unknown, and has encouraged senior leaders to think more thoughtfully about succession planning. When asked if such data is used to compare the company against competitors in terms of their diversity numbers, we were reassured that it was, and that not only are they seeking to be better than peers, but they "want to be at the top".

In addition, we asked about another ambitious target they have in place: to double the share of Black and African American employees in the workforce in the U.S., a goal they originally set in 2020. We clarified whether this included leadership teams – it doesn't – and enquired how they are progressing towards this. They admitted that, with hindsight, their goal was overly ambitious and too difficult to achieve in the time frame. Representation of Black and African American employees in the U.S. business today sits at 3.7%; they acknowledged that the first step is to increase self-identification/self-disclosure. Improving disclosure should also more accurately reflect current diversity levels, which will then allow the company to set effective targets.

Finally, as per our previous engagement, we asked whether they are able to show the return on investment from better DEI practices and more clearly communicate it in their reporting. They explained that they don't have the data – yet – but they acknowledged the importance of this for their clients and shareholders who are leaning on them for disclosure.

What Next?

Having met with management, we believe that the company is on track to meet their women in management target – albeit slightly late – and we will continue monitoring their progress. Generally, while we welcome the company's ambitions on diversity, we recognise leading practice as striving for gender parity, with racial and ethnic diversity reflective of local markets. In our view, setting realistic milestones and making these time bound – rather than striving for overly ambitious targets in the first instance – would also help to ensure that the company continues to make incremental and measurable progress.

Regarding the company's disclosure journey, in our view the delivery of their first annual DEI report is a step in the right direction, as this now gives a measure of the pace of progress to investors and other stakeholders. We continue to encourage the company to find clearer measures to communicate the financial benefit of DEI good practice to investors.

Overall, we believe that their new Chief Diversity & Inclusion Officer appears to be an effective and focused leader, driving the right DEI strategy and culture in the business. Following the meeting, we feel more confident in the company's ability to deliver on their strategy and related targets, and believe they are effectively managing DEI within their business/workforce.

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Climate Change – Can Insurers Stand the Heat?

Summer 2023 north of the equator brought further evidence that the climate is changing, with record temperatures and wildfires. Such events often leave insurers to pick up the bill which, of course, is their raison d'être – to provide cover against extreme events. That said, if climate change is accelerating and making weather patterns more extreme, unpredictable and therefore costly, how will the insurance industry adapt?

First a disclaimer: this article is not trying to disentangle the complexities of the science behind climate change or pin down the magnitude of future changes. Nor is our intention to examine the human cost associated with natural catastrophes, which is frequently severe and can be devastating. Our ESG integration approach focuses on assessing any financially material risks – or opportunities – to the sustainability of returns on operating capital for our holdings. In terms of insurance companies, our focus is therefore on the financially material impact that climate change poses to insurers, an important consideration given the increase in number of both weather-related events (frequency [*Figure 1*]) and their costs (severity [*Figure 2*]).

[5] Source: Howden

FIGURE 1

Increased frequency of weather events worldwide by decade – 1980 to 2019 (estimates provided by Swiss Re and the World Meteorological Organization)[5]

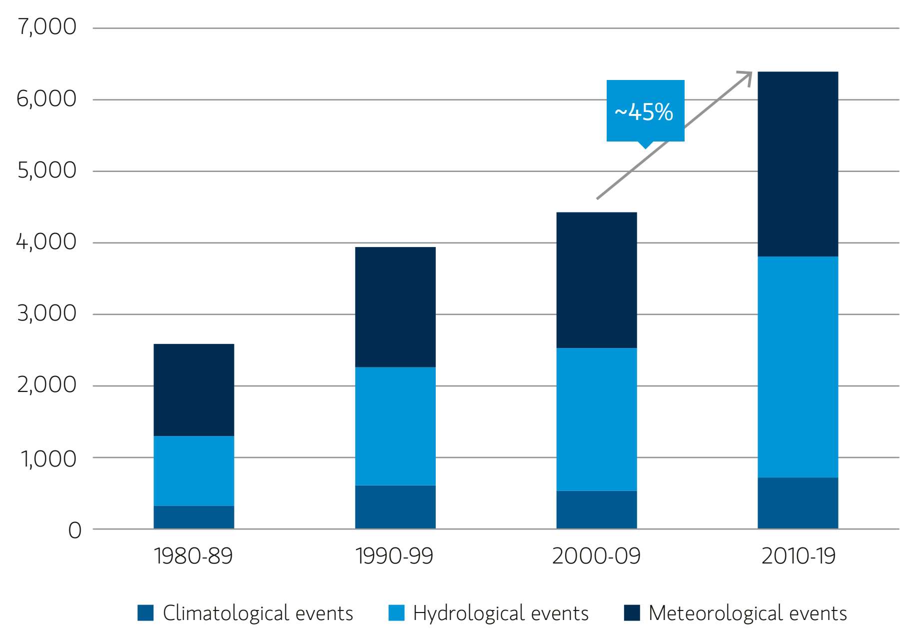


FIGURE 2

Economic losses worldwide for weather events – 1980 to 2019[6]

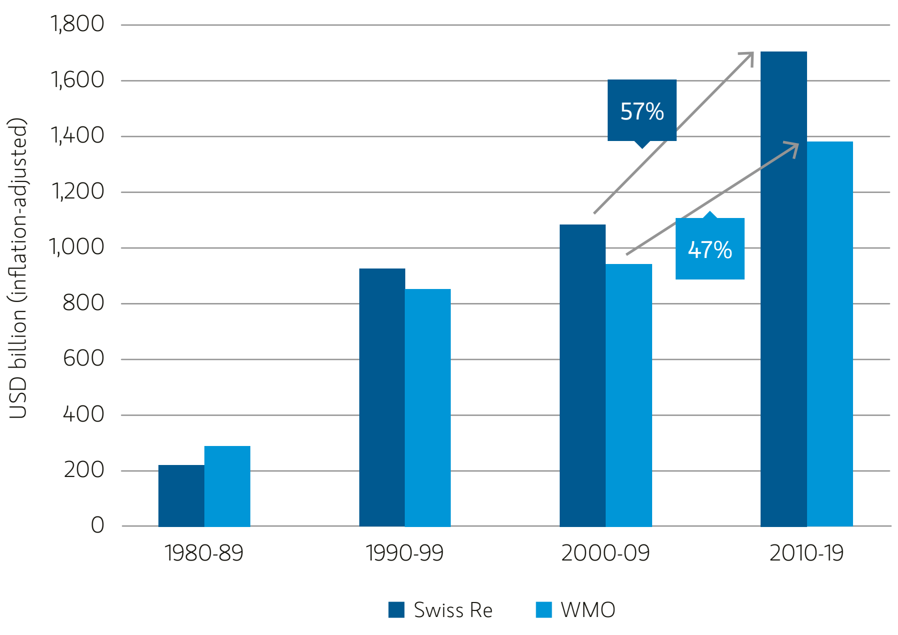
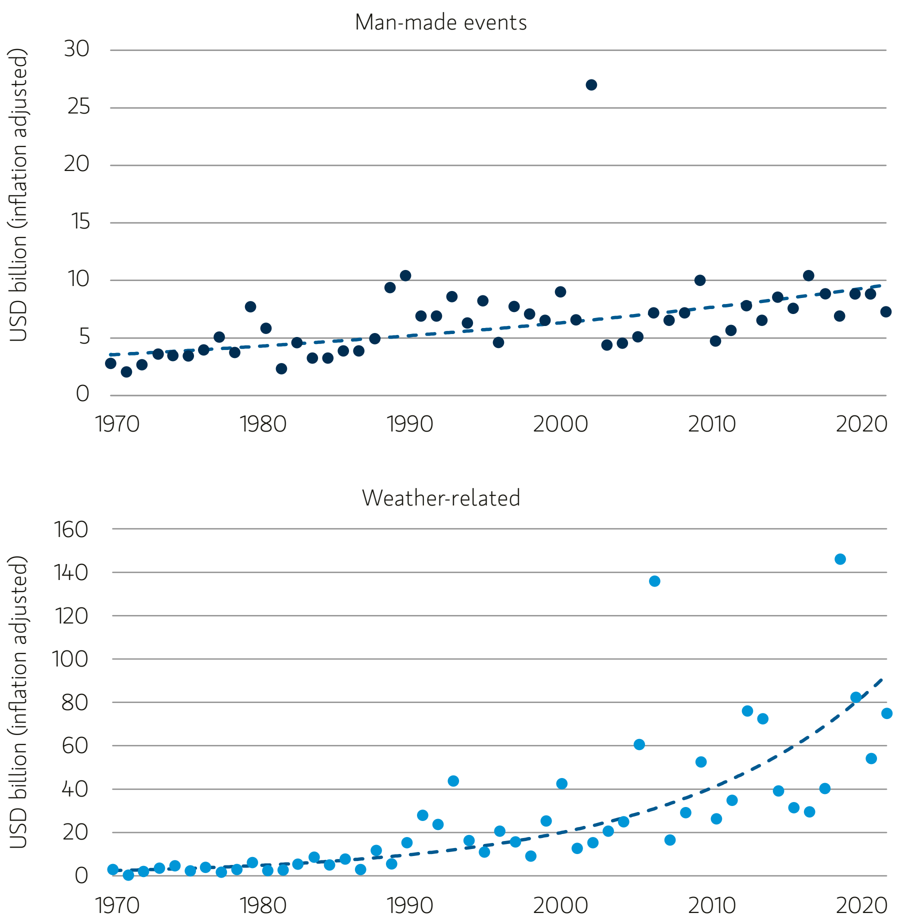


FIGURE 3

Distribution of insured losses for weather events vs. man-made events, 1970-2020

There has been a greater acceleration in insurance losses related to weather events than man-made events in recent years.



In order to better understand how more extreme and frequent weather events are affecting insurers, it is helpful to compare the distribution of insured losses stemming from weather-related events versus those from man-made events, for example factory fires. As demonstrated in *Figure 3*, since 1970 losses from man-made events have seen an increase roughly in line with inflation, whereas weather-related losses show a concerning acceleration, particularly over the last 15-20 years. Perhaps more concerningly, from 2017 onwards, average annual insured losses from natural catastrophes have been over $110 billion – more than double the average of $52 billion over the previous five-year period.[7] The expectation is that this trend will only accelerate, given the higher loss frequency and increased severity of natural catastrophes.

While a larger population and economic growth naturally increase weather-related insured losses, this is also true for insured losses from man-made events and so doesn't explain the stark difference in these trends. What does help to explain the difference are the effects of urbanisation and coastal migration, both of which impact the scale of insured losses resulting from weather events. In general, urban areas are more vulnerable to weather-related insured losses as they are disproportionately affected by phenomena such as heat waves (large towns are warmer than the surrounding countryside) and flooding (water cannot be absorbed due to hard impermeable surfaces, meaning

[6] Source: Howden

[7] https://www.swissre.com/institute/research/sigma-research/sigma-2023-01/5-charts-losses-natural-catastrophes.html

an increase in surface run-off). In addition, urban areas across the globe are often located in coastal regions, which are typically more vulnerable to losses. Taking the U.S. as an example, the significant increase in extreme weather-related insured losses is in part a result of people moving to storm-prone coastal areas such as Florida and the Gulf Coast. The Miami metro area's population is 10 times larger than it was in 1950. Greater population density in more vulnerable areas is likely to result in more insured losses.

Exacerbated insured losses from extreme weather events cannot be explained by urbanisation and coastal migration alone; according to the World Meteorological Organisation, the absolute number of these events has increased in frequency by a factor of five over the period from 1970 to 2019.

But what about those losses that aren't insured?

Closing the protection gap

The protection gap is the difference between the amount of insurance that is economically beneficial and the amount of insurance that is actually purchased. In other words, the protection gap describes uninsured losses. Despite natural catastrophes such as hurricanes, floods, wildfires and winter storms increasing in frequency and intensity over the last number of years, large numbers of people and businesses still don't have insurance coverage in place for such events. This means a potentially severe financial burden not just for individuals and businesses, but for governments too who may be forced to step in to bail out both businesses and citizens. Helping to close the protection gap by providing insurance not only offers greater protection to those that are vulnerable but also represents a financially material business opportunity for both insurance companies and insurance brokers.

Globally, it is estimated that there has been insurance cover in place for only about a third of weather-related losses – although this varies significantly by region, with the most vulnerable economies facing the largest protection gaps. For example, over the last 10 years, the U.S. suffered weather-related losses in the region of $1,034 billion, of which only $587 billion were insured – a protection gap of 43%. Meanwhile in Italy, which sits on the point where the African and European tectonic plates converge and thus has one of the most significant exposures to natural hazards in Europe, the respective figures of $37 billion and $5 billion point to a significantly higher protection gap of 87%. In emerging markets, the lack of insurance cover is even more pronounced: in China, for instance, which is vulnerable to all manner of extreme weather patterns including floods, typhoons, thunderstorms and earthquakes, the protection gap stands at 95% ($292 billion losses vs. $16 billion insured losses).[8]

Ultimately, a large protection gap may weaken the financial resilience of economies. Countries and states are beginning to seek cover for potential losses, offering additional opportunity for the insurance industry. For example, the World Bank provided Jamaica with financial protection worth up to $185 million against the hurricane season of 2023 and Jamaica became the first government in the Caribbean to independently sponsor a catastrophe bond. Meanwhile Morocco took out $250 million in insurance against earthquake damage, which is expected to pay out after the earthquake that struck in September 2023.

The world has become a riskier place for insurers

Assuming, with some degree of optimism, that insurers manage to meaningfully decrease the protection gap through offering insurance solutions, there are obvious benefits for

[8] Source: All figures from Swiss Re

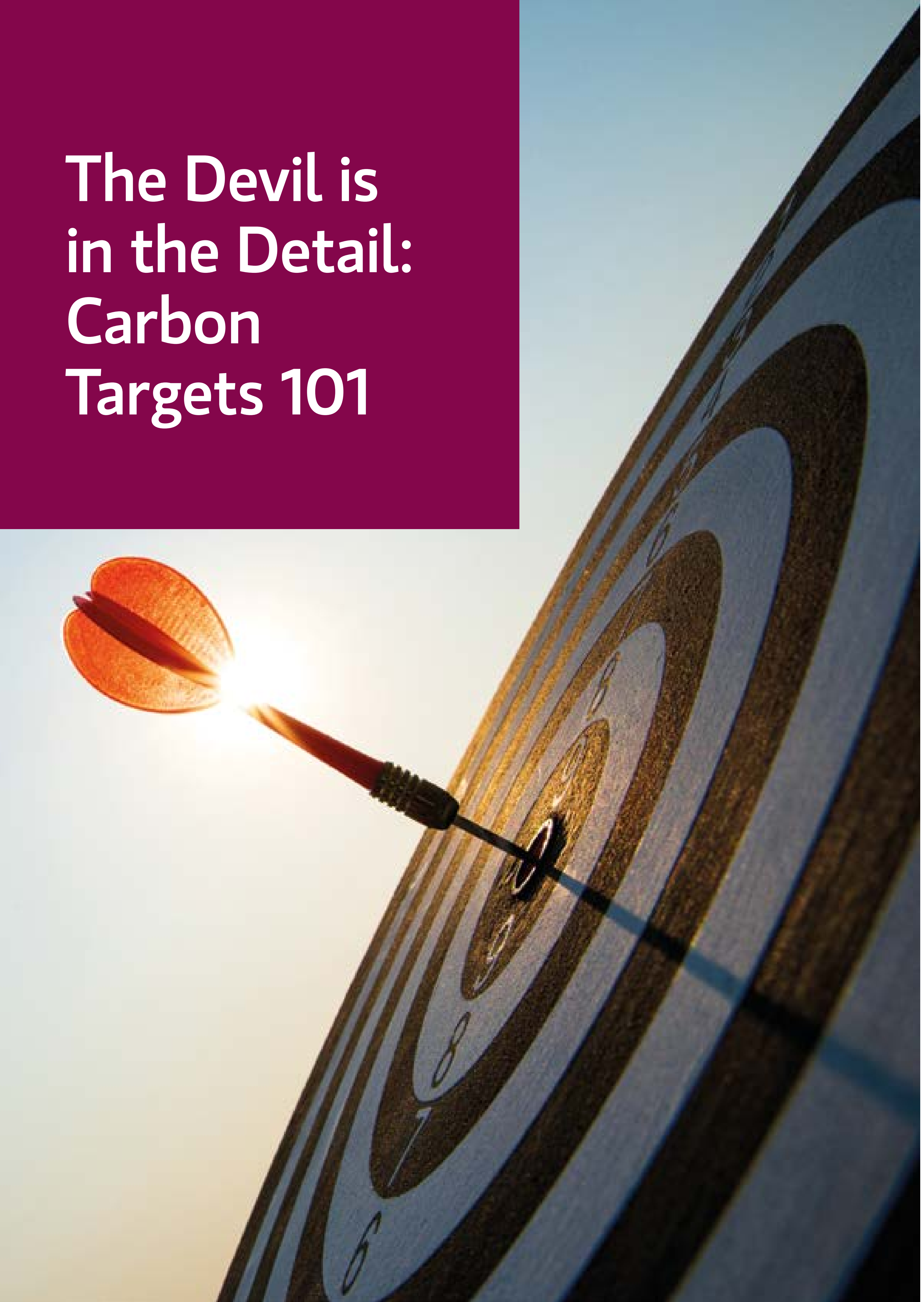
their clients, particularly for those living in areas vulnerable to natural disasters. Insurance can be a source of resilience and stability for economies. It can help businesses, communities, and people recover financially from what can be profound natural disasters. But there are two sides to every coin, and from an investment perspective it's hard to ignore the obvious: increasing insurance coverage increases the liabilities of those doing the insuring. The increase in both losses and frequency of such events is particularly of relevance to reinsurance companies, who provide cover to the insurers for large-scale natural catastrophes.

Is it possible for re-/insurers to succeed when faced with the joint trends of rising frequency and severity of losses? We believe it is, given one essential ingredient which these companies themselves control – price. Insurers are not hapless victims in the face of changing loss trends. They look to manage their risks: their 'natural catastrophe' cover reprices on an annual basis, which means that rather than having to predict their likely costs from weather-related disasters over the next 5, 10 or 20 years, re/-insurers must only price appropriately for the coming twelve months. A one-year pricing model enables them to raise prices in line with rising costs, and is one crucial way insurers can manage this financial risk. Over the last five years, pricing has firmed considerably for weather-related losses and now stands at its highest like-for-like level.[9] Getting it right means balancing price with risk: pricing too high might mean fewer customers take out insurance: pricing too low increases the financial risk of losses to insurers.

In the context of our portfolios
In our view, climate change and its associated impact is both a challenge and opportunity for the insurance industry. In our Global and American Resilience portfolios, we have bought two insurance brokers this year. We like them given they are balance sheet light, diversified professional service providers who are set to benefit from the current inflationary pricing trends as they often charge a percentage of the premiums, without having to bear the risks of increasing losses themselves. Following engagements in the latter half of 2023, we believe the insurance brokers we own are well positioned to benefit from increasing client interest in analysing and mitigating their physical climate risk, such as hurricanes and floods. The insurance brokers we hold were responsible for brokering the deals mentioned earlier on behalf of Jamaica and Morocco. However, we believe that even balance-sheet heavy insurance companies, a few of which we own in our more diversified Global portfolios as well as our International portfolios, can offer good investment opportunities – provided the exposure to natural catastrophe losses is tempered by effective re-/insurance pricing, a diversified income stream, and a solid balance sheet.

(Re)insurance?
Most readers will have personal experience with – and have paid for – insurance, whether in the form of motor, home, life or health insurance. But there is an entire insurance industry that many may be unaware of, which provides insurance cover to insurance companies – the reinsurance industry. While they may share tools and methodologies in common, they differ in one crucial aspect. Insurers deal with the law of large numbers and cover frequency – they will price a motor insurance policy on the number of claims they expect to see and the average costs. Meanwhile reinsurers, especially in the context of climate change and its associated 'natural catastrophe cover', mostly focus on severity – the very high losses associated with an event. To illustrate, if we were to use as an example a severe storm: insurers would cover the damage to homes associated with the storm, but they would themselves seek cover from a reinsurer for the severe and widespread damage resulting from a hurricane with landfall in a densely populated urban area. Reinsurance companies support insurance companies by absorbing some of their losses for a price.

[9] Source: https://www.guycarp.com/insights/2023/01/chart-guy-carpenter-global-property-catastrophe-rate-on-line-index-2000-2023.html



The Devil is in the Detail: Carbon Targets 101

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An increasing number of companies are setting carbon targets in an attempt to mitigate the potentially financially material risks they believe carbon emissions may pose to their business. However, the setting of such targets – and in particular the quality of the targets – may itself pose potentially financially material risks to companies. These risks include both direct commercial risks and broader reputational and litigation risks.

Direct commercial risks
Having robust, publicly available carbon targets can be commercially material, especially for companies in the middle of the value chain – i.e. companies supplying other companies (for example those we own in health care supplies or industrial sectors). What we have seen in many engagements is that the companies who are customers are starting to incorporate their suppliers' environmental performance into purchasing decisions, using presence or absence of carbon targets as a decision criterion e.g. if a supplier doesn't have a science-based target, we are not going to give business to them. In short, not having a robust carbon target may lead to a company losing business.

Similarly, with the potential for governments to increasingly incorporate environmental criteria into their purchasing decisions in order to meet their own Net Zero goals, carbon targets offer an easy data point with which to score suppliers and make decisions.

Reputational and litigation risks
Many companies have made public statements about their carbon reduction ambitions, but the actual targets being set vary in quality. At the same time, environmental claims are being closely examined by advertising regulators, consumer and financial watchdogs and governments. The risks of getting it wrong are potentially significant, with companies facing the risk of reputational damage if they are found to be misleading the public.

In this piece, we seek to demystify the targets companies might commonly set, looking at the the key difference between what it means to be carbon neutral or Net Zero, the basic elements of carbon reduction targets and the standards set by the Science Based Targets initiative (SBTi).

Carbon Neutral vs Net Zero Targets

Perhaps the best place to start is by looking at the key difference between two common types of targets set by companies which can easily be confused: carbon neutral and Net Zero. In a nutshell, companies with carbon neutral targets generally seek to compensate for their ongoing emissions using offsets. On the other hand, companies with Net Zero targets tend to be focused on reducing their emissions as much as possible, using carbon removals to offset any residual emissions.

The SBTi
seeks to define and promote best practice in emissions reductions and Net Zero targets in line with climate science. The initiative was launched in 2015 and is a partnership between CDP (formerly the Carbon Disclosure Project), the United Nations Global Compact, World Resources Institute (WRI) and the World Wide Fund for Nature (WWF).

IN MORE DETAIL

1 Carbon avoidance offsets

created by projects that switch current methods to less polluting alternatives, reducing the amount of carbon dioxide (CO_2) released into the atmosphere. For example, renewable energy projects emit significantly less CO_2 emissions compared with non-renewable energy sources (i.e. fossil fuels). The CO_2 emissions from the non-renewable source are compared with the emissions from the installation and production of renewable energy, and the difference between the two is considered avoided emissions. The avoided CO_2 emissions are converted into carbon credits, which can then be bought by other companies to offset their own emissions.

2 Carbon removal offsets

created by projects that remove carbon dioxide from the atmosphere and lock it away, preventing its re-release into the atmosphere. This can be achieved via nature-based solutions such as reforestation, soil carbon sequestration and wetland restoration, or technological alternatives such as Carbon Capture and Storage (CCS) and Direct Air Capture (DAC). Companies can offset their emissions by investing in these projects themselves or by buying carbon credits from removal projects managed by other companies.

Carbon neutral describes a state where the amount of carbon emissions released into the atmosphere by a company is *balanced out* by carbon offsets. It is worth noting that, while companies may look to reduce some of their own emissions as part of a carbon neutral target, typically the focus is on offsetting their emissions via carbon credits from carbon avoidance and/or removal projects – see *Diagram 1*. These projects tend to be outside their own value chain, meaning companies can claim to be carbon neutral without actually reducing their own emissions.

DIAGRAM 1

Carbon removal and avoidance offsets

Not all offsets are equal

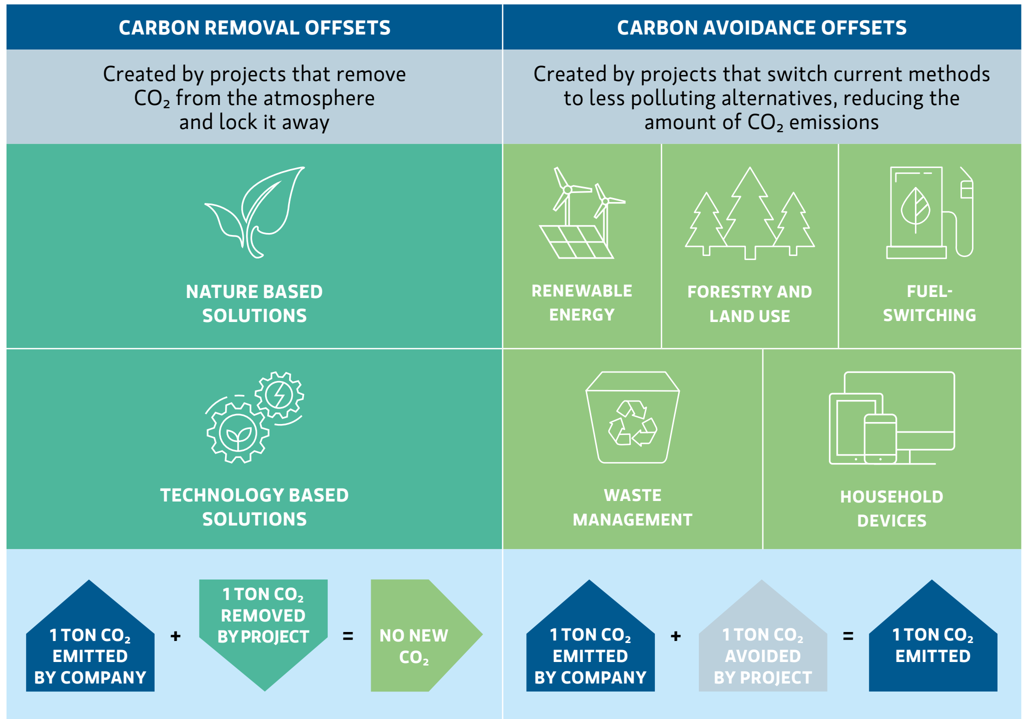


DIAGRAM 2

Technological and nature based solutions

TRADE OFF	TECHNOLOGY BASED	NATURE BASED
Cost	High	Low
Permanence of removal	High	Low
Time to remove CO_2	Short	Long
Input energy required	High	Low

Net Zero describes a state where the amount of greenhouse gas (GHG)[10] emissions released into the atmosphere by a company is reduced to as close to zero as possible, with any residual emissions offset by carbon removals. Therefore, unlike carbon neutral targets, companies with Net Zero targets should be primarily focused on reducing their value chain emissions emissions.

[10] GHG emissions, as defined by the GHG protocol include carbon dioxide (CO_2), methane (CH^4), nitrous oxide (N_2O), hydrofluorocarbons (HFCs), perfluorocarbons (PFCs) and sulphur hexafluoride (SF^6).

How does Net Zero fit with the Paris Agreement and 1.5°C?

A quick refresher on the Paris Agreement: adopted by 196 parties at the UN Climate Change Conference (COP 21) in 2015, the agreement states the parties' intention to hold "the increase in the global average temperature to well below 2°C above pre-industrial levels" and pursue efforts "to limit the temperature increase to 1.5°C above pre-industrial levels."[11]

In the years since the Paris Agreement was signed, climate science suggests that preventing global warming from exceeding 1.5°C above pre-industrial levels could limit the most dangerous and irreversible effects of climate change. Limiting warming to 1.5°C implies reaching Net Zero by 2050 and requires GHG emissions to peak before 2025 at the latest and decline by 43% by 2030.

Although Net Zero can technically be achieved in many ways and according to different time frames, each with different implications for the planet and global economy, it is most commonly referred to in the context of the overarching goal of the Paris Agreement, i.e. to limit global warming to 1.5°C above pre-industrial levels by 2050.

Net Zero almost certainly cannot be achieved without carbon removal as, realistically, many hard-to-abate industries will not be able to reach zero emissions. In fact, the Intergovernmental Panel on Climate Change (IPCC) acknowledged "the deployment of carbon dioxide removals to counterbalance hard-to-abate residual emissions is unavoidable if Net Zero emissions are to be achieved."[12] The issue today however is one of scale; carbon removals represent a fraction of global emissions and require a large scale increase to meet many of the 1.5°C pathways currently modelled by climate scientists.[13]

Basic elements of carbon reduction targets

For companies to achieve Net Zero emissions, they need to reduce their GHG emissions as much as possible, which is where carbon reduction targets come in.

Carbon reduction targets generally consist of a combination of the following elements:

1. SCOPE

Mention of Scopes 1, 2 and 3 are commonplace when discussing GHG emissions. When setting a reduction target, companies must choose which sources of their emissions (known as Scopes) are to be captured by their reduction target. There are three types:

- Scope 1 – direct emissions from owned or controlled sources.
- Scope 2 – indirect emissions from the generation of purchased energy.
- Scope 3 – all indirect emissions (excluding scope 2) that occur in the value chain of the reporting company, including both upstream and downstream emissions.

Carbon reduction targets typically concentrate on reducing emissions from company operations (Scope 1) and switching energy use to renewables (Scope 2). Whilst these scopes can be the lion's share of emissions for many capital-intensive industries, for asset light consumer facing industries, Scope 3 emissions can be the most significant, with the supply and value chain often representing well over 80% of the total carbon footprint. The most robust carbon targets include a company's most material sources of carbon emissions in the target, if not all carbon emissions.

[11] https://unfccc.int/process-and-meetings/the-paris-agreement
[12] https://www.ipcc.ch/report/ar6/wg3/resources/spm-headline-statements/
[13] State of Carbon Dioxide Removals, 2023

2. PERCENTAGE REDUCTION

Companies must choose the magnitude of the reduction they seek to achieve from their chosen Scopes.

3. ABSOLUTE OR INTENSITY

Companies can commit to reduce their absolute carbon emissions or their carbon intensity – the absolute amount of carbon they produce per unit of measurement (typically per million USD of sales). There are pros and cons for both: while the former is arguably preferable from an environmental perspective, it potentially penalises companies that are growing even if they are reducing their carbon intensity. Meanwhile, companies can look good on paper by reducing their carbon intensity but still have increasing absolute emissions.

4. BASE YEAR

Companies need to select a base year for their target which acts as a reference point to monitor their progress. We like to see companies with a robust starting point, in other words, a base year for which they have an accurate measurement of their emissions, at the very least for the Scopes they have chosen in their target.

5. TARGET YEAR

Companies need to select the year by which they intend to achieve their target.

Carbon reduction and Net Zero targets have risen up the corporate agenda

The number of companies setting carbon reduction targets has rapidly increased in recent years. For example, looking at the Forbes 2000 list, 417 of these companies had set Net Zero targets as of December 2020. This figure more than doubled to 929 companies by June 2023.

As carbon reduction and Net Zero targets have become more mainstream, the quality and comparability of targets is increasingly becoming an issue. How do investors and consumers know which companies have set credible, meaningful and achievable targets versus those that haven't?

Science Based Targets Initiative

This is where the SBTi comes in. We believe targets approved by the SBTi are credible and consistent with robust minimums standards.

The SBTi independently validate three types of science-based targets (SBTs)[14]:

1. NEAR-TERM SBTS

These are five to 10-year GHG reduction targets that put companies on a trajectory towards limiting warming to 1.5°C by 2050. The target year determines the level of emissions reduction that needs to be achieved in order to put companies on this pathway.

Near-term SBTs must cover at least 95% of company-wide Scope 1 and 2 emissions. Where Scope 3 emissions make up 40% or more of total emissions (Scope 1, 2, and 3 emissions), companies must set one or more emission reduction targets and/or supplier or customer engagement targets that collectively cover(s) at least two-thirds (67%) of total Scope 3 emissions.

2. LONG-TERM SBTS

These targets show companies how much they must reduce value chain emissions (i.e. Scope 1, 2 and 3) to align with reaching Net Zero at the global or sector level in eligible 1.5°C pathways. Companies can choose to achieve this level of value chain emissions reduction by 2050 or sooner.

Long-term SBTs must cover at least 95% of company-wide scope 1 and 2 emissions and at least 90% of Scope 3 emissions. Most companies' long-term SBTs require at least a 90% reduction in GHG emissions overall.

3. NET ZERO SBTS

A Net Zero science-based target is a long-term SBT where a) the company commits to reduce GHG emissions by 100% across all Scopes; or b) the company commits to reduce GHG emissions by at least 90% across all Scopes (in most cases) and neutralise any residual emissions through carbon removals.

In summary

With carbon targets, the devil is in the detail. It is important for investors to closely scrutinise companies' targets to understand what they have committed to, especially given the increasingly complex array of terminology and the range of different targets that companies are setting.

Where we consider carbon targets to be a financially material risk to the companies that we invest in, we look out for and engage with companies for them to use independently verified SBTs, such as those validated by the SBTi, which demonstrate credibility and alignment with robust standards.

[14] https://sciencebasedtargets.org/resources/files/Net-Zero-Standard.pdf

Show me the incentive and I will show you the outcome

AUTHOR

BRUNO PAULSON
Managing Director

Modern capitalism suffers from the "principal-agent problem", given the differing interests of the owners of assets versus the corporate executives who manage them. The executive pay industry, with its complex packages of bonuses and performance shares, has evolved to try to align the interests of the two parties. The pay industry has certainly succeeded in increasing the rewards for chief executive officers, who the Economic Policy Institute claims are now paid 344 times as much as a typical worker, in contrast to 1965 when they only earned 21 times as much.[15] We would argue that there is still progress to be made in making sure that this extra executive compensation is matched by improved alignment.

As long-term investors, we want the companies our clients own to have pay plans in place that encourage long-term thinking over short-term opportunism. After all, we agree with Charlie Munger's claim that incentives drive outcomes.

Our fear is that the wrong incentives, for instance excessive focus on earnings per share (EPS), can encourage management to take decisions that boost profits in the short run at the expense of their companies' ability to compound over the long run. This may be a consumer company cutting advertising, or a firm making large acquisitions that, while "accretive", i.e., boosting short-term EPS, deploy a large amount of capital at low returns. By contrast, when compensation is managed effectively, it aligns key decision-makers' behaviours with the company's objectives, encouraging better performance and long-term returns to shareholders.

As a result, we take the process of assessing pay plans very seriously, using our proprietary Pay X-Ray scoring framework to evaluate pay schemes where relevant and possible, engaging with boards to improve them and voting against them where we are unhappy with the structures. Our attempts to effect change on pay schemes for the benefit of shareholders is helped by our well-resourced team and concentrated long-

[15] Source: Economic Policy Institute report on CEO pay in 2022. Published 21 September 2023.

term holdings in the companies we cover. This allows us to invest the effort and time required to improve pay schemes, and to get the access to boards to make our case. We have recorded successes, often after years of discussions, proving that perseverance can pay off. After all, we have been talking to companies about how they incentivise their executives for over 20 years, long before the concept of environmental, social and governance (ESG) investing came to the fore.

Asking the key questions

While there is no magic formula that can be uniformly applied to companies across all sectors and industries, we have established some principles based on our extensive experience of investment team-led engagement with companies about pay. We favour incentive schemes that align goals with shareholder interests, and which are structured on sensible and disciplined performance-based targets that cannot be easily manipulated in the short term. Looking beyond the technical details of each proxy, the fundamental questions investors should ask are:

- What kind of behaviour does the scheme incentivise: short term or long term?
- Are the incentives balanced, and do they make sense given the nature of the business – e.g., is a mature business incentivised to grow at the expense of returns? Is a growth business incentivised to underinvest, thereby missing growth opportunities?
- How could executive pay be gamed to the benefit of management? Can a seemingly good metric have negative side effects (e.g., can a cash flow key performance indicator disincentivise necessary capital expenditure)?
- Can we monitor management's actual behaviour to identify if the scheme is not working or is being abused?

DIAGRAM 1

Pay X-Ray at a glance

AREA	TYPE	IE TEAM VIEW	RATIONALE
Performance metrics: what is management paid on?	Return on capital	Positive	Based on company performance, not easily manipulated, and encourages compounding – a key factor the team focuses on when assessing company quality
	Earnings Per Share (EPS)	Negative	Can encourage leverage, low-ROIC investment and buybacks. It is also the last line of the P&L, therefore can be easily manipulated
Delivery mechanisms: how is management paid?	Performance shares (PSUs)	Positive	PSUs do not vest if targets are not achieved, therefore incentivise management to deliver on their targets
	Restricted shares (RSUs)	Negative	Although RSUs have a deferred vesting period, they are really just a payment for turning up so do not effectively incentivise management in our view
Vesting period: when is management paid?	Long	Positive	Our view is that the longer the better, as even a scheme with good metrics can be rendered useless by an insufficiently long-time horizon
	Short	Negative	
Shenanigans: what tricks are management up to?	Deferment of annual bonus into shares	Positive	Encourages a longer-term mindset and alignment of management and shareholders
	Easy targets	Negative	Easily met targets or targets that are changed ex-post are meaningless thresholds for the measurement of success

Assessing pay with the Pay X-Ray

We created the Pay X-Ray some years ago as a framework for a comprehensive and rigorous analysis of company schemes. We do use proxy voting data providers as resources for our efforts, but are in no way bound by their recommendations, given our in-depth knowledge of the companies and their management. The Pay X-Ray splits the detailed scoring of the company schemes into the four buckets shown below.

1. PERFORMANCE METRICS: WHAT IS MANAGEMENT PAID ON?

There are several measures we like, such as organic growth, margin and free cash flows. The ideal balance between them will depend on the strategic position of the company, for instance as it trades off growth and margin improvement. For consumer companies, we like any profit or margin metrics to be before advertising and promotion costs to remove the incentive to cut advertising to meet short-term profit targets. Generally, we are particularly keen to see return on capital included in the metrics, as it forces management to value capital and penalises low-return acquisitions.

We are less enthusiastic about total shareholder return as a measure, especially when using a broad index as a comparator, as much is driven by sector rather than company performance. We are not fans of EPS, as that can be boosted by "accretive" acquisitions, even if they are at low returns on capital, or by levering up the company.

2. DELIVERY MECHANISMS: HOW IS MANAGEMENT PAID?

Here we prefer the company to issue shares rather than options, as the asymmetry of options can favour excessive risk-taking, particularly once they are "out of the money". We also want those rewards to be performance shares, which require management to hit targets to get rewarded, rather than simple restricted shares — or "pay for stay" — where management merely has to avoid being fired to benefit.

3. VESTING PERIOD: WHEN IS MANAGEMENT PAID?

This is a case of "the longer the better", in our view, as it encourages management to strive for the long-term success of the company rather than simply hitting short-term targets. Even a scheme with good pay metrics can be rendered useless by an insufficiently long vesting period. We also like issuance of the shares to be delayed until after the end of the performance period. This is most notable in the case of departing executives, as we have been burnt by management plumping up the business for the point of their exit, with the bill later due for their successors.

4. SHENANIGANS: WHAT TRICKS ARE MANAGEMENT UP TO?

Along with the core metrics above, we worry about what we term "shenanigans" — the games management can play to get paid out. These include changing targets ex-post where there are "adverse circumstances" (you won't be surprised to hear that we do not find many cases where targets are toughened when the environment helps a company), targets that are too easy or where the numbers are not disclosed, ex gratia payments to management on top of the stated schemes, and massive payments for failure when management is dismissed.

Investment team-led engagement and voting are crucial tools

We look for companies to achieve a positive Pay X-Ray score, but also for signs of improvement. The results feed into our engagements with the companies. As much as 25% of our company engagements year-to-date (as of 30 September 2023) have included conversations on executive pay. As mentioned, we are privileged to gain access to management given our significant assets under management within concentrated portfolios: In our global portfolios, we hold at least 0.5% of the companies' free floats in 70%-85% of the holdings in our strategies.

In addition to talking to companies about pay, we vote on it. In the first half of 2023 we voted on 244 compensation-related proposals for 78 of the companies held across strategies we manage. We voted against 51 of these, or 21% of the time. Furthermore, 47% of the time we voted against management on at least one compensation-related proposal (37 companies).

The most common and often high-profile votes involve approving the compensation of a company's executive officers. These can be on an individual basis or for the whole executive team, depending on the company's jurisdiction. With occasionally significant sums involved, in our view the quantum of pay needs to be assessed both absolutely and relative to stated targets. There were 79 such proposals at companies held across our strategies in the first half of 2023, and we voted against 35 of these (44% of the time).

We don't restrict our voting to pay plans. If, having previously voted against a compensation proposal, we wish to underline our point, further escalation may include voting against the election of committee members. During the first six months of 2023, we voted against the election of the chair of the compensation committee at three different companies due to ongoing concerns with their pay plans. For one of these companies, our escalation went a step further: we also voted against the election of two directors who were members of the company's compensation committee.

Encouraging change on pay schemes for the benefit of shareholders requires an ongoing active and patient dialogue, as evidenced by the following case studies.

Case study 1 – A Vote in Favour of Progress on Pay

In our view, the pay plan of a European multinational software company we own was not aligned to long-term performance due to the inclusion of non-IFRS – or adjusted – earnings, the short vesting period of the awards, and an insufficient degree of performance-based targets. For these reasons, the team once again voted against its pay plan report at the Annual General Meeting in May 2022.

In September 2022, we met with the company's Supervisory Board to discuss changes to the executive compensation scheme. Improvements had been made, with greater disclosure on the quantum of targets and metrics employed in the plan. In particular, we considered the 20% deferral of annual bonus and the end of retention bonuses a positive outcome from our earlier engagement on the subject. On ESG metrics, we were pleased to see that 20% of both the long-and short-term incentive plan is now allocated to ESG targets (Net Zero 2030 and Diversity targets), having previously encouraged alignment with the company's relevant financially material ESG priorities and targets. Even so, we expressed dissatisfaction that targets are still based on non-IFRS numbers which exclude share-based compensation. The company also shared that the performance aspect of pay excludes mergers and acquisitions; we asked that they make this explicit in the pay plan.

As a result of these positive changes, at the company's Annual General Meeting (AGM) in May 2023 we decided to vote in favour of the forward-looking pay plan policy – though we once again voted against the backward-looking pay plan report. Via a mix of both engagement and voting, we intend to keep encouraging more sensible operating metrics that we believe should help the company's share price performance in the long run.

Case study 2 – Failed Vote Drives Deeper Dialogue

We had concerns about the pay plan at a large professional services company, including the fact that 20% of the long-term incentive plan (LTIP) was not linked to performance, and their short vesting period. As such, we voted against the plan last year. Ahead of this year's AGM, we engaged with the company to express our concerns and encourage improvement in key areas, including linking 100% of the LTIP to performance and increasing the length of vesting to at least five years. We also communicated our discomfort with stock awards made to the CEO that were unrelated to performance.

We further expressed our views at the subsequent AGM by voting against the company's advisory pay plan once again. As a sign of significant investor discontent, the pay plan vote failed, receiving 57% of votes against. Following this, the company requested a further conversation with us to discuss the subject and a meeting was arranged for Q3 2023.

We consider pay to be a key instrument in incentivising management to operate in the long-term interests of a company and its shareholders, given the principal-agent problem. It is therefore critical for boards and management teams to get it right. As active long-term investors we take our fiduciary duties in this area seriously, and believe it is important to hold company boards accountable for their actions through a programme of monitoring, engagement and voting.

Proxy Voting

As long-term investors with an owner's mindset, we value the role that proxy voting can play in enhancing long-term investment returns – and the increased attention paid to it by company boards and management. This means we do not outsource proxy voting decisions and never have.

Our voting seeks to be consistent with our assessment of the materiality of specific issues (ESG or other) to the sustainability of companies' returns on capital, our monitoring of company progress, and our efforts to encourage companies towards better and/or more transparent practices.

Our portfolio managers seek to vote in a prudent and diligent manner and in the best interest of our clients, consistent with the objective of maximising long-term investment returns. Our proxy voting is predominantly related to governance issues such as management incentives and director appointments. As relevant, we consider how to vote on proposals related to social and environmental issues on a case-by-case basis by determining the relevance of the issues identified in the proposal and their materiality. We generally support proposals that, if implemented, would enhance useful disclosure or improve management practices on financially material ESG issues.

We are not afraid to disagree with management and third-party proxy advisers, such as ISS. In the 12 months to 30 June 2023, we voted at 94 meetings (100% of all meetings held by our companies) and on 1,663 proposals (100% of all proposals). Overall, we voted against management in 9% of cases, and 69% of meetings had at least one vote against management. Common reasons for voting against management were related to compensation, election of directors and shareholder ESG proposals.

DISPLAY 1

Proxy Voting Overview

(12 months from 01/07/2022 to 30/06/2023)

% total number of meetings held	**94 (99%)**[16]
% total proposals voted	**1,663** (99% of all proposals)
% votes against management as a proportion of resolutions	**9%**
% meetings with at least one vote against management	**69%**

Source: ISS Proxy Exchange; MSIM.

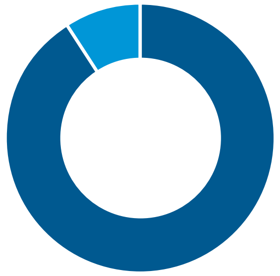
Common reasons for voting against management were related to compensation, election of directors and shareholder ESG proposals.

DISPLAY 2

Voting on 1,663 Proposals

(12 months from 01/07/2022 to 30/06/2023)

% by voting instruction



In favour of management	91
Against management	9
Did not vote	0

Source: ISS Proxy Exchange; MSIM.

[16]MSIM and the International Equity team did not vote one meeting due to shareblocking implications.

DISPLAY 3

Votes against management by topic

(12 months from 01/07/2022 to 30/06/2023)

Compensation Related	56
Directors Election Related	31
Shareholder Proposal – ESG	28
Routine/Business	11
Takeover Related	10
Capitalisation	7
Director Related	5
Company Articles	4
Non-Routine Business	1
Other Shareholder Proposal	1

Source: ISS Proxy Exchange; MSIM.

Shareholder Resolutions

When we receive any environmental or social related shareholder proposals, we carefully consider how to vote on them by determining the relevance of the issues and the likely financial impact and its materiality. Overall, we supported 51% of shareholder ESG proposals across our strategies and voted against management in 45% of cases.

Say on Pay

Executive pay remained a key focus. We voted against 22% of management say on pay resolutions. Additionally, where we have had long-standing unresolved concerns over pay, we voted against members of remuneration committees to make our message heard. We also voted against nomination committee members if we have had concerns over diversity. In total we voted against the election of 27 (4%) directors in the last 12 months.

SGH

SG HISCOCK & COMPANY

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ETL8936AU and ETL5737AU (hedged), and

MORGAN STANLEY GLOBAL SUSTAIN FUND

ETL9199AU and ETL5365AU (hedged)

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EMEA

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CRC 6168043 Exp. 31/01/2025 10537977 A4