

Sustainable Reality

Sustainable Funds Return to Outperformance in First Half of 2023

Key Findings

In the first half of 2023, sustainable funds returned to their long-run trend of outperforming traditional funds, up 6.9% compared with traditional funds' +3.8%. Relatively stable market conditions compared to 2022 meant that sustainable funds' more growth-oriented focus was a positive driver for performance. Despite short-term fluctuations in performance, sustainable funds appear to be holding steady as patient capital for investors targeting longer-term horizons.

Sustainable funds' assets under management (AUM) continued to grow, exceeding \$3.1 trillion globally by the end of June 2023 (vs. \$2.8 trillion at YE2022) to represent close to 8% of total AUM. Periods of underperformance, as sustainable funds experienced in 2022, can lead to asset outflows, yet this largely did not play out. Overall, sustainable funds saw first-half inflows of \$57 billion at just over 2% of 2022 year-end AUM, although North America did see small outflows partly due to reclassification.

For the first time in the Sustainable Reality series, we include data on restriction screening. More than 20% of global AUM is now in funds using at least one restriction screen, up from 2% in 2019. The use of every type of restriction has increased, with nearly all of the rise attributed to Europe, where almost 60% of AUM uses screens compared with 8% in Asia and under 2% in North America. Controversial weapons, thermal coal and tobacco are the most commonly used screens.

SUMMARY

1 Sustainable Funds Return to Outperforming Traditional Funds >

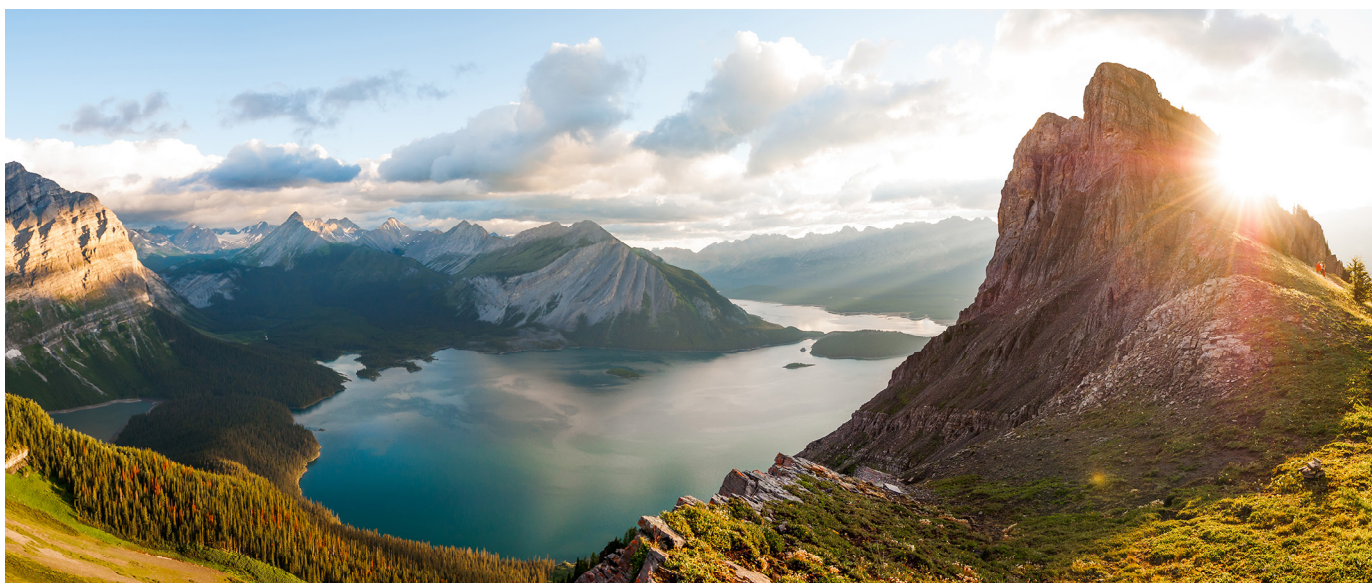
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METHODOLOGY

This report is part of the Morgan Stanley Institute for Sustainable Investing’s ‘Sustainable Reality’ series, which assesses the historical performance of sustainable funds against traditional funds over a specific timeframe using Morningstar data. This report analyzes performance for January 1, 2023–June 30, 2023.

The fund universe for this analysis includes closed-end funds, exchange-traded funds and open-end funds, taking the oldest share class, and excludes feeder funds, funds of funds and money market funds. In total, this analysis covered approximately 96,000 funds globally.

Morningstar classifies a fund as sustainable if “..in the prospectus or other regulatory filings it is described as focusing on sustainability, impact investing, or environmental, social or governance (ESG) factors. Funds must claim to have a sustainability objective, and/or use binding ESG criteria for their investment selection. Funds that employ only limited exclusions or only consider ESG factors in a non-binding way are not considered to be a sustainable investment product.”

This analysis takes each fund’s classification as of June 30 (for H1 data) and December 31 (for full year data) in each year; Traditional funds are those classified as ‘Not Sustainable’ by Morningstar. Morningstar’s ‘Sustainable’ classification can differ from the newer, and still broad, European Sustainable Finance Disclosure Regulation (SFDR) Article 8 and Article 9 definitions. Over 99% of Article 9 funds are also classified as Sustainable by Morningstar, while this only applies for around 30% of Article 8 funds.

Morningstar’s calculation of total return is expressed in percentage terms and is determined each month by taking the change in monthly net asset value, reinvesting all income and capital-gains distributions during that month, and dividing by the starting net asset value (NAV). This analysis builds on the 2019, 2020 and 2023 Sustainable Reality reports, now looking at global performance rather than just US.

Sustainable Funds Return to Outperforming Traditional Funds

1H23 saw sustainable funds return to relative outperformance, with median returns of +6.9% compared with traditional funds' +3.8%. This held true across all asset classes and geographies, with outperformance most evident in equities and in North America. Structural market factors, such as a growth focus in equities and longer duration in fixed income, helped contribute to sustainable funds' relative outperformance.

In 2022, sustainable funds underperformed traditional funds for the first time in five years. Underperformance was concentrated in the first half of the year and started to reverse in the second half. 1H23 saw sustainable funds return to outperforming traditional funds (Figure 1).

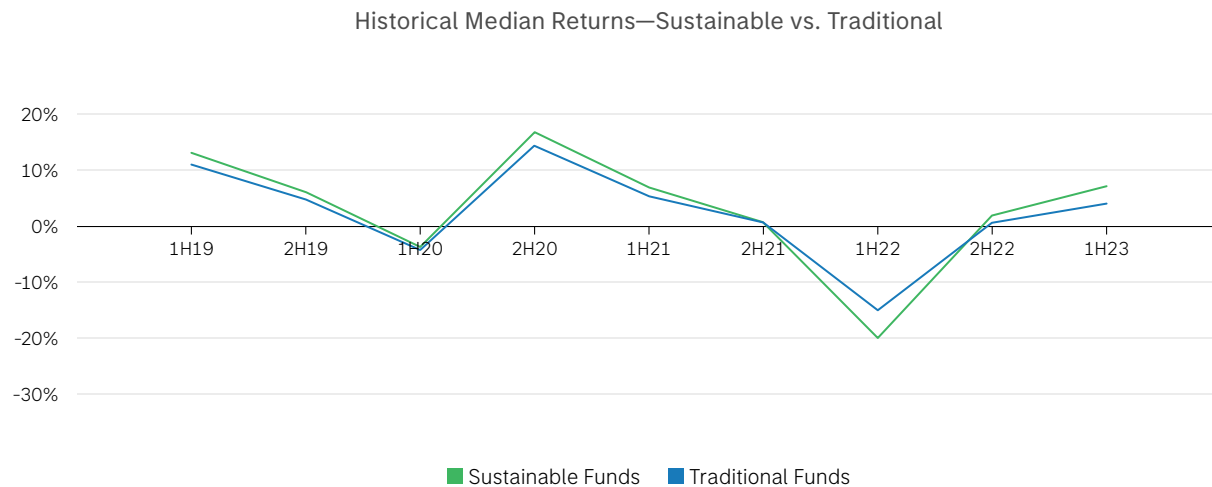
By asset class (Figure 2), sustainable equity funds saw the strongest returns (+10.9%), outperforming traditional

equity funds (+8.0%). Fixed income performance was more muted, with sustainable funds at +3.8% and traditional funds at +2.2%.

By region (Figure 3), sustainable funds outperformed traditional funds across all major geographies, with the greatest outperformance in Oceania (+3.7%) and North America (+2.5%).

FIGURE 1

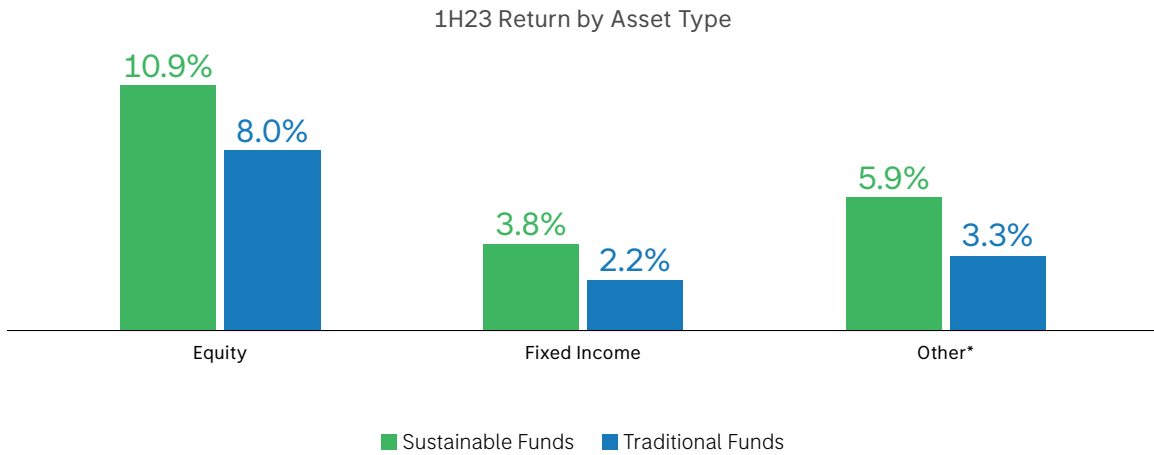
Sustainable Funds Modestly Outperformed Traditional Funds in 1H23



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data.

FIGURE 2

Equity Fund Performance Was Strongest in 1H23, With Sustainable Funds Outperforming Across Asset Classes

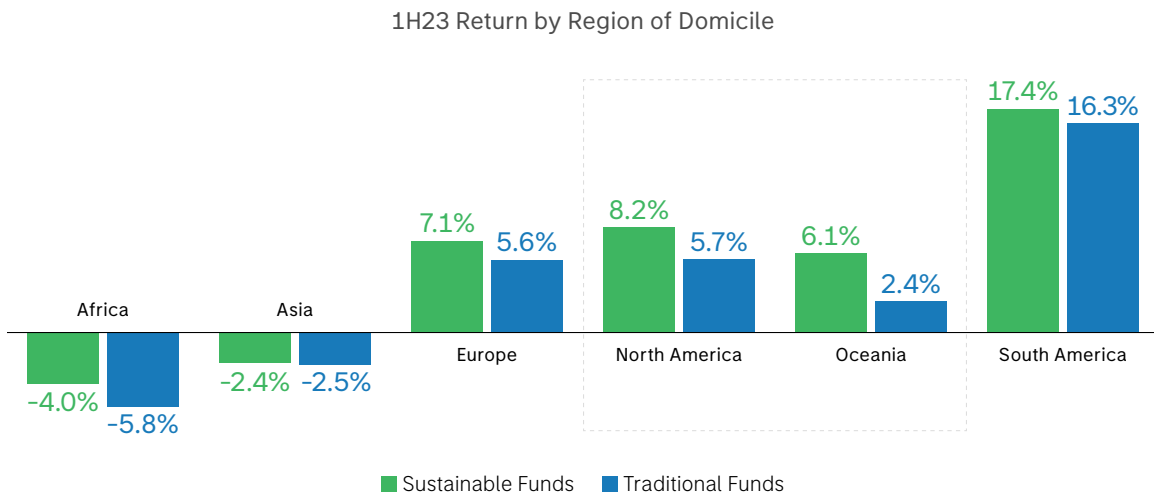


Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data.

**Other* includes multi-asset, property, commodities, and alternative fund types.

FIGURE 3

Sustainable Funds Outperformed in All Regions, Particularly in Oceania and North America



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data.

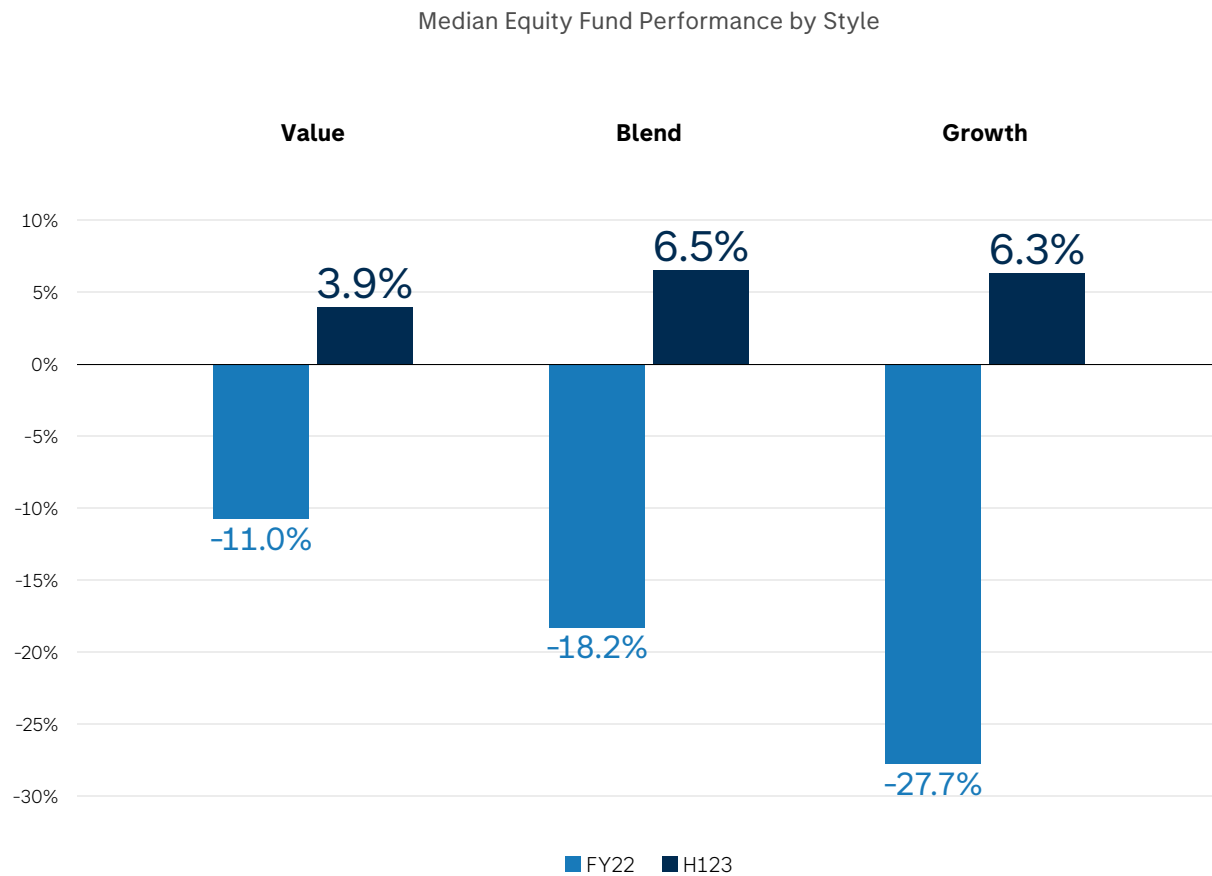
Structural Market Factors Were More Favorable to Sustainable Funds’ Positioning in 1H23

In 2022, a rapid rise in interest rates structurally benefited value styles of investing. However, the first half of 2023 saw more stable market conditions, favoring sustainable funds’ more growth-oriented, long-term positioning. For example, only 10% of sustainable funds take a value approach, compared with 22% of traditional funds, which is unchanged

from 2022. While market factors were not the only driver of sustainable funds’ outperformance in 1H23, it is important to note that a return to a wider market environment favoring value or shorter duration assets still has the potential to impact future performance for sustainable funds.

FIGURE 4

1H23 Saw Value Styles Underperform Blend and Growth, Reversing the FY22 Trend



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data.

EQUITIES

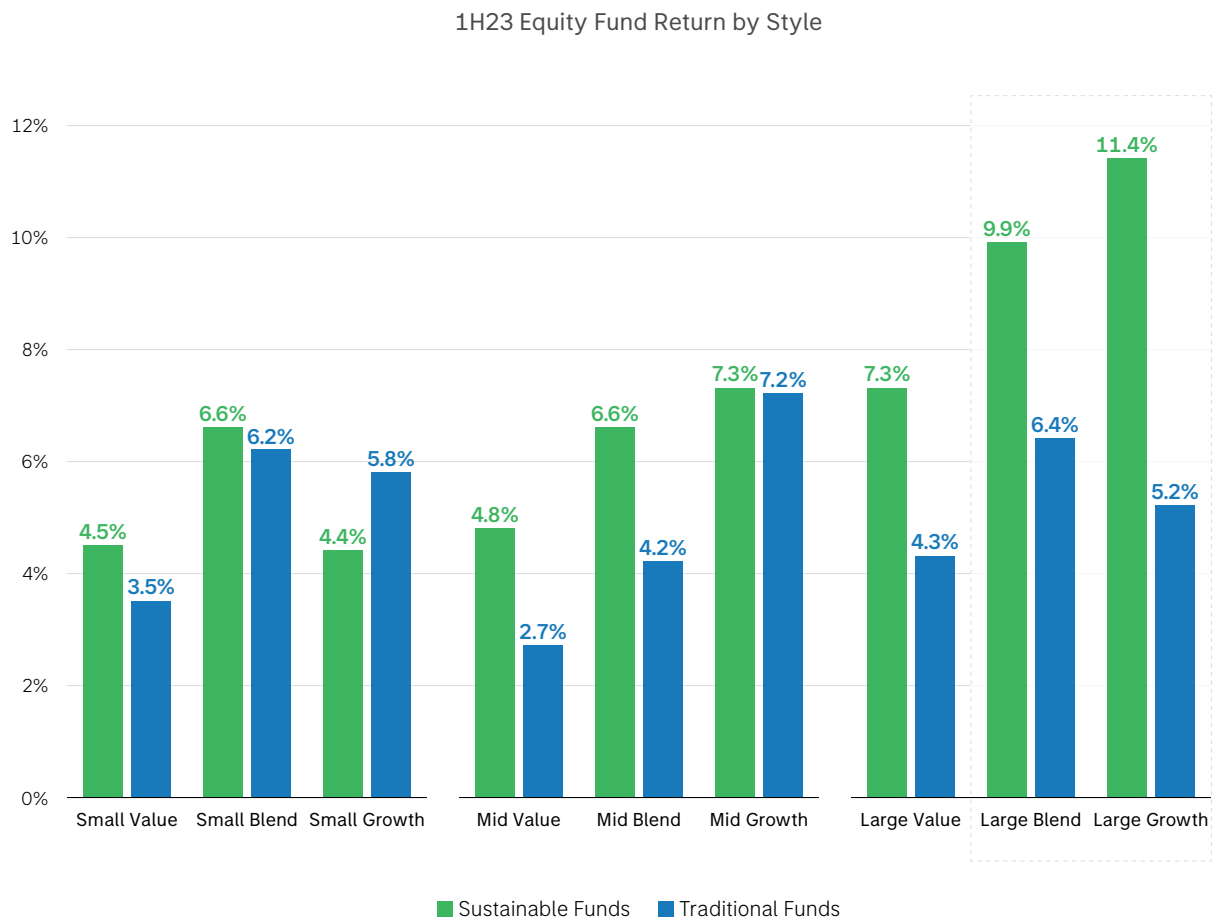
Sustainable Funds Outperform in Large-Cap Growth and Blended Categories

Sustainable funds outperformed traditional funds in most market cap and investing style categories (Figure 5).

This was particularly notable in the Large Blend and Large Growth categories, likely relating to specific stock or thematic exposures.

FIGURE 5

Sustainable Funds Outperformed in Large Blend and Large Growth Categories



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data.

Morningstar categorizes equity funds by market capitalization focus, from small to large, and style, value/blended/growth. Returns are median returns.

FIXED INCOME

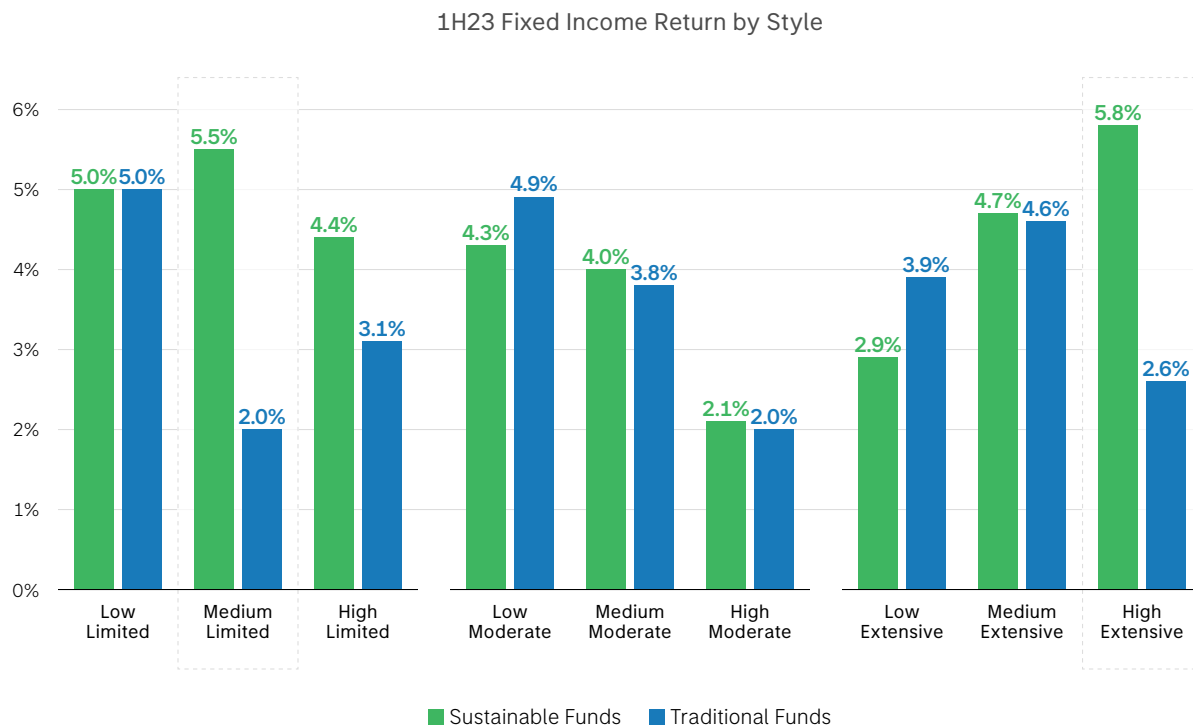
Sustainable Funds’ Longer-Dated Focus Offered a Small Advantage

Fixed income performance by style was less differentiated than in equities. The best performing funds were in lower credit quality categories (reversing the 2022 trend as markets stabilized), and in longer duration categories. Sustainable fixed income funds generally skew to the middle of the

credit risk spectrum and away from short duration, so wider market moves supported their relative performance in the first half of 2023. Sustainable funds were also notable outperformers in the Medium Limited and High Extensive categories (Figure 6).

FIGURE 6

Sustainable Funds Were Notable Outperformers in the Medium Limited and High Extensive Categories



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data.

This model is based on the two pillars of fixed-income performance: interest-rate sensitivity and credit quality. The three duration groups are short, intermediate, and long-term, and the three credit quality groups are high (AA rated and higher), medium (BBB to AA rated), and low quality (<BB, all high-yield bonds). These groupings display a portfolio’s effective duration and credit quality to provide an overall representation of the fund’s risk, given the length and quality of bonds in its portfolio. Nine possible combinations exist, ranging from short duration/high quality for the safest funds to long duration/low quality for the riskiest.

Investor Demand for Sustainable Funds Remains Strong

Despite challenging market conditions in 2022, investor interest and demand for sustainable fund opportunities remained strong in 1H23. Sustainable funds’ AUM as a proportion of total AUM continued to grow throughout the year, reaching record levels (7.9% vs. 7.6% in Dec. 2022). Similarly, sustainable funds saw net positive inflows, cumulatively \$57 billion by the end of June, while traditional funds saw small positive inflows.

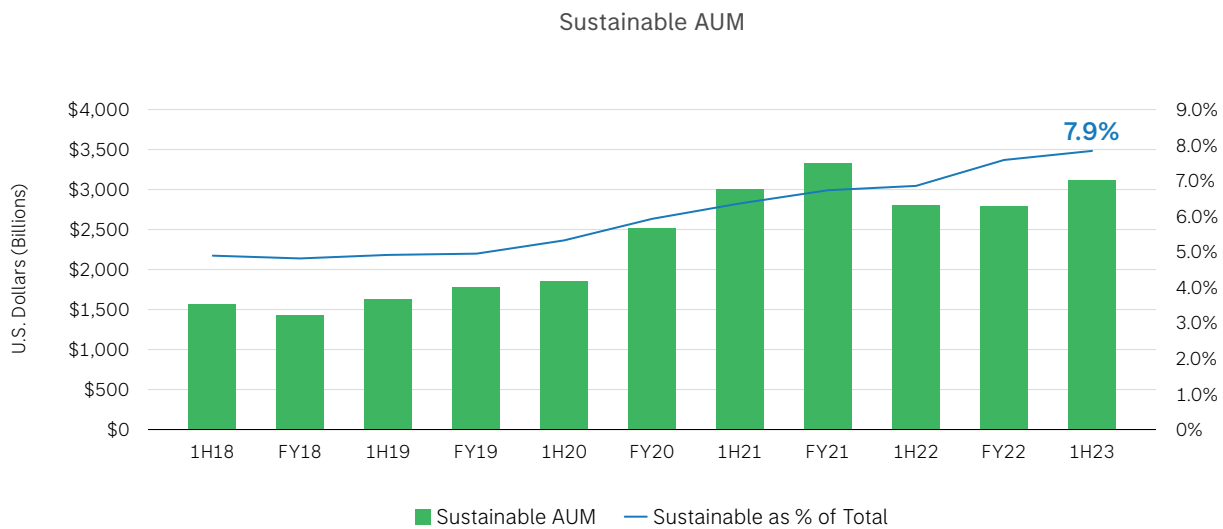
Sustainable AUM Continued to Grow in 1H23, Accounting for Almost 8% of Total AUM

By the end of June 2023, sustainable funds’ AUM had increased to over \$3 trillion, close to 2021 highs of ~\$3.3 trillion. The proportion of overall AUM in sustainable funds continued to increase, reaching close to 8% of total AUM (Figure 7).

7.9%
of total AUM classified as sustainable in 1H23.

FIGURE 7

Sustainable AUM Continued to Grow as a Proportion of Total AUM



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data.

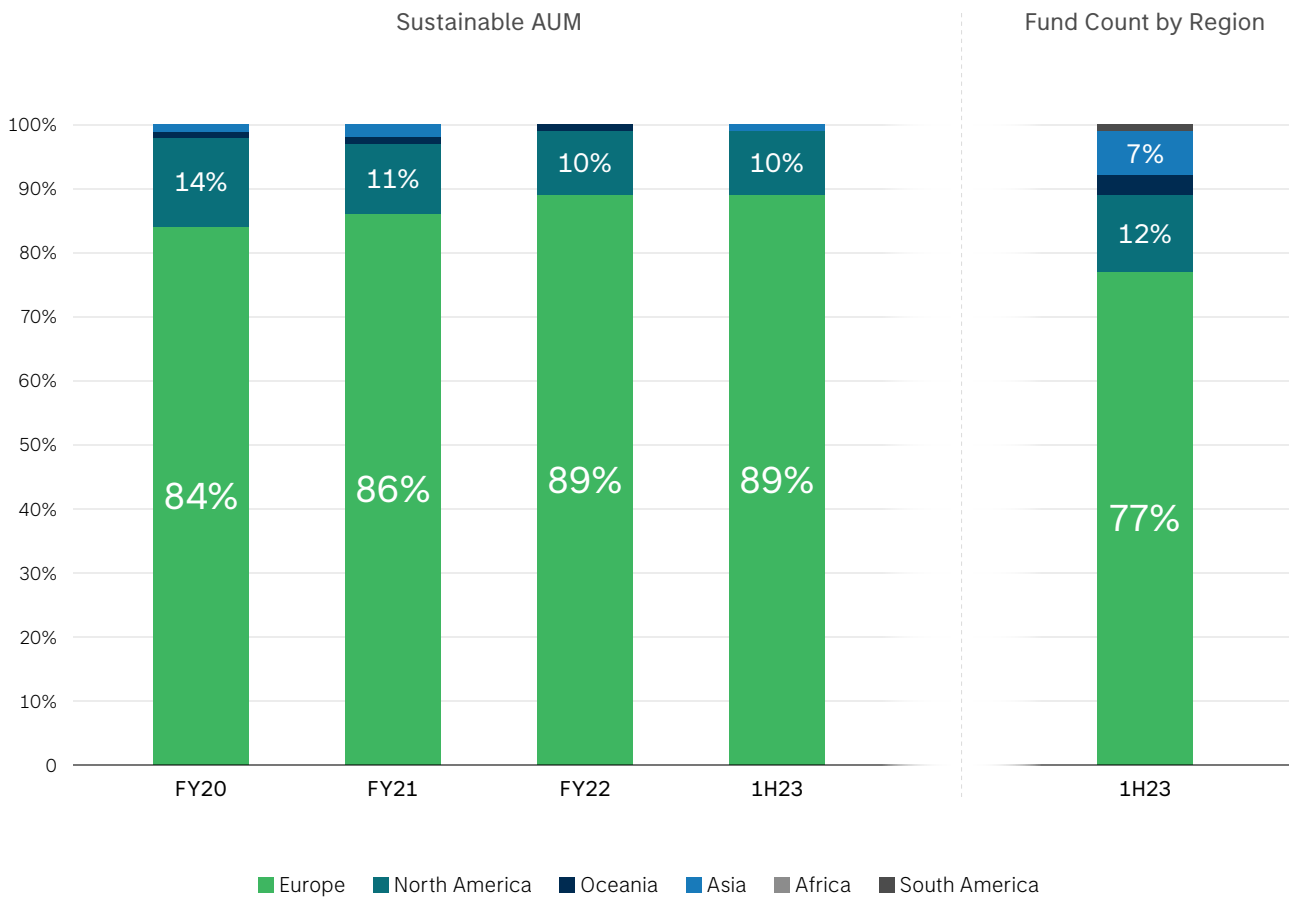
Regionally, Europe continues to outpace other geographies in terms of sustainable AUM and fund counts. 89% of total sustainable AUM are domiciled in Europe compared with 10% in North America and <2% in all other regions. By fund count, Europe is home to more than three-quarters of the world’s sustainable funds, followed by North America (12%) and Asia (7%) (Figure 8).

89%

of sustainable assets under management are domiciled in Europe, far outpacing other regions.

FIGURE 8

Europe Far Outpaces Other Regions in Number of Sustainable Funds



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data.

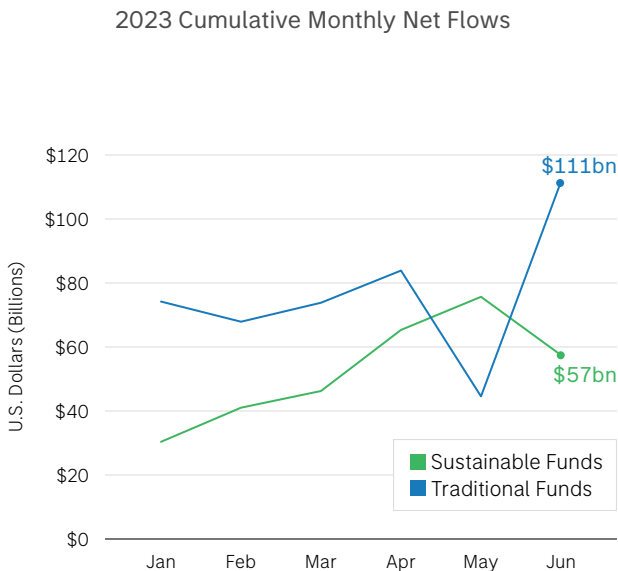
Sustainable Funds Saw Positive Inflows, Reflecting Strong Demand

Sustainable funds continued to see net positive inflows in 1H23—cumulatively \$57 billion for the year, or around 2% of 2022 year-end AUM. This was similar to the 2022 trend of around 3% of prior year AUM, indicating no significant impact on flows from the 2022 relative underperformance. Traditional funds saw proportionately smaller inflows at \$111 billion (0.3% of 2022 year-end AUM), a slight recovery from the strong outflows seen throughout 2022 (Figure 9).

By region, almost all flows were in Europe, with 1H23 net inflows of \$68 billion, 2.8% of 2022 year-end AUM (Figure 10). North American sustainable funds saw small outflows throughout the first half, at -\$10 billion (3.6% of 2022 year-end AUM), although around half of this was due to one fund’s reclassification.¹

FIGURE 9

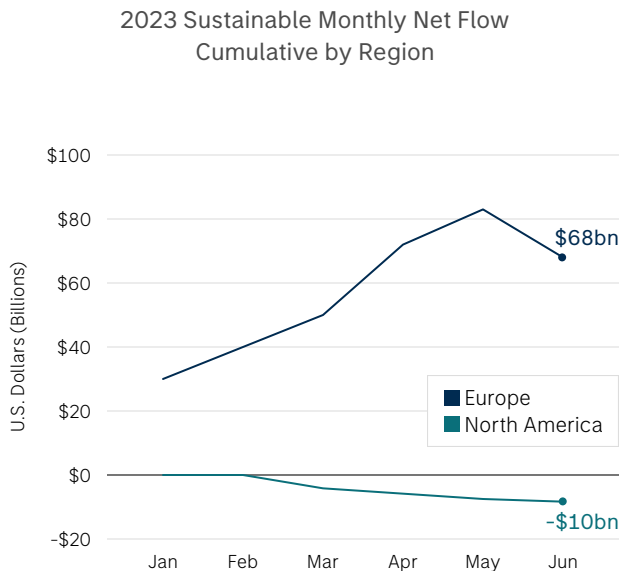
Sustainable Funds Continued to See Net Positive Inflows, Indicating that 2022’s Relative Underperformance Did Not Have a Significant Impact on Flows



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data.

FIGURE 10

Europe Saw Steady Inflows While North America Saw Small Outflows



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data.

¹ An ESG rating agency changed the credit rating requirements for fixed income funds, driving redemptions.

STATE OF PLAY

1H23 Performance and Demand for EU SFDR’s Article 8 and 9 Funds

The EU’s Sustainable Finance Disclosure Regulation (SFDR) sets out mandatory ESG disclosure requirements for asset managers with the goal of creating more transparency into sustainable investment strategies. According to the SFDR’s classification system, which went into full effect on Jan. 1, 2023, a fund will either be classified as Article 6 (funds without a sustainability scope), Article 8 (funds that promote environmental or social characteristics) or Article 9 (funds that have sustainable investment as their primary objective).

We look at the state of play for funds classified under Article 8 and Article 9 at the end of June 2023.

PERFORMANCE: Article 8 funds were up 5.9% in 1H23 with Article 9 up 6.4% (Figure 11). Both slightly underperformed the European funds within Morningstar’s ‘Sustainable’ definition (7.1%), but ahead of performance for European traditional funds (5.6%).

AUM: In total, Article 8 and 9 funds accounted for \$6.4 trillion in AUM at the end of June 2023, up from \$5.7 trillion at the end of 2022 (Figure 12). Of this, \$6.1 trillion was labeled Article 8, accounting for 45% of total European AUM. As noted previously, this is materially larger than Morningstar’s figure of \$2.8 trillion for European sustainable AUM, as only a minority of Article 8 funds currently fit the Morningstar ‘Sustainable’ category. Article 9 funds accounted for \$334 billion of AUM at the end of June 2023, a slight decrease from FY22 (\$357bn), despite the widespread reclassification of some passive funds from Article 9 to Article 8 earlier in the year.

FLOWS: Both Article 8 and Article 9 funds saw modest inflows in the first half of 2023, at \$28 billion² and \$6 billion respectively, or 0.5% and 1.6% of 2022 year-end AUM. This was slightly lower than overall sustainable fund inflows through the first half of the year but remained positive (Figure 13).

FIGURE 11

Article 8 and Article 9 Fund Performance Slightly Below the Narrower Sustainable Definition, But Still Slightly Ahead of Traditional Funds

1H23 Return by SFDR Classification

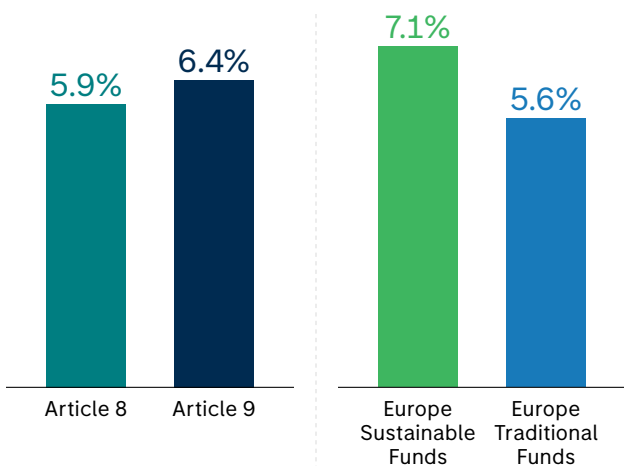


FIGURE 12

Article 8 and Article 9 Funds Accounted for \$6.4 Trillion in AUM

AUM by SFDR

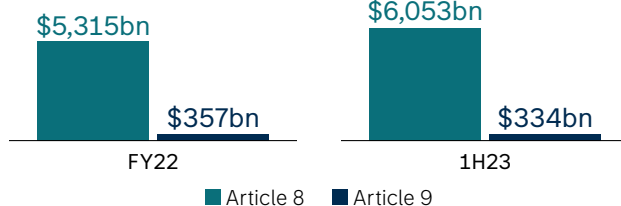
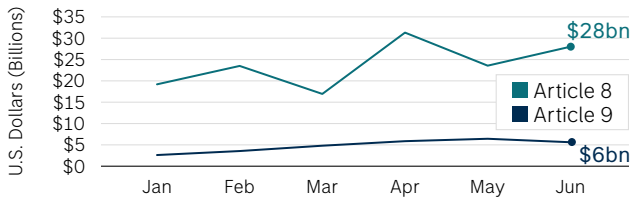


FIGURE 13

Both Article 8 and Article 9 Funds Saw Modest Inflows

Sustainable Monthly Net Flow Cumulative by SFDR



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data.

² Morningstar’s review of Q223 trends in Article 8 and Article 9 funds references small outflows for Article 8 funds during the quarter—[SFDR Article 8 and Article 9 Funds: Q2 2023 in Review | Morningstar](#). The variation in the data presented here is due to differences in the fund universes, and possibly some timing differences in when each dataset was generated.

A Fifth of Global AUM is in Funds Using Restriction Screening

Restriction screening has grown sharply in recent years, now covering just over 20% of global AUM, up from 2% in 2019. Controversial weapons (20% of global AUM), thermal coal (14%) and tobacco (14%) are the most used commonly screens, but screening rates are rising across all themes.

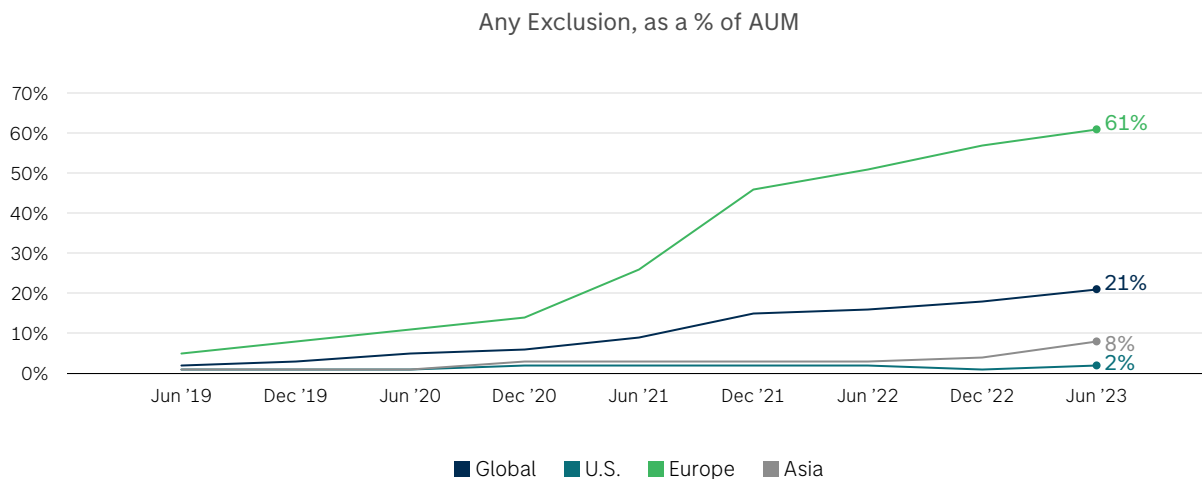
For the first time in the Sustainable Reality series, the Institute for Sustainable Investing explores Morningstar data on how funds are using restriction screening. Just over 20% of global AUM is currently in funds using at least one screen. This rises to 90% for sustainable funds and falls to 16% for traditional funds.³

While restriction screening is long-established in sustainable investing, its use has risen sharply in recent years. In 2019,

restriction screening covered just 2% of global AUM. By 2021, use significantly increased as SFDR came into effect for European-domiciled funds. Today, restriction screening is almost entirely concentrated in Europe, with nearly 90% of both Article 8 and Article 9 funds screening for at least one issue and over 60% of European AUM covered by some sort of screen. See the Appendix for an overview and definition of the restriction screens analyzed.

FIGURE 14

Rates of Restriction Screening Increased as SFDR Came Into Force in Europe in 2021

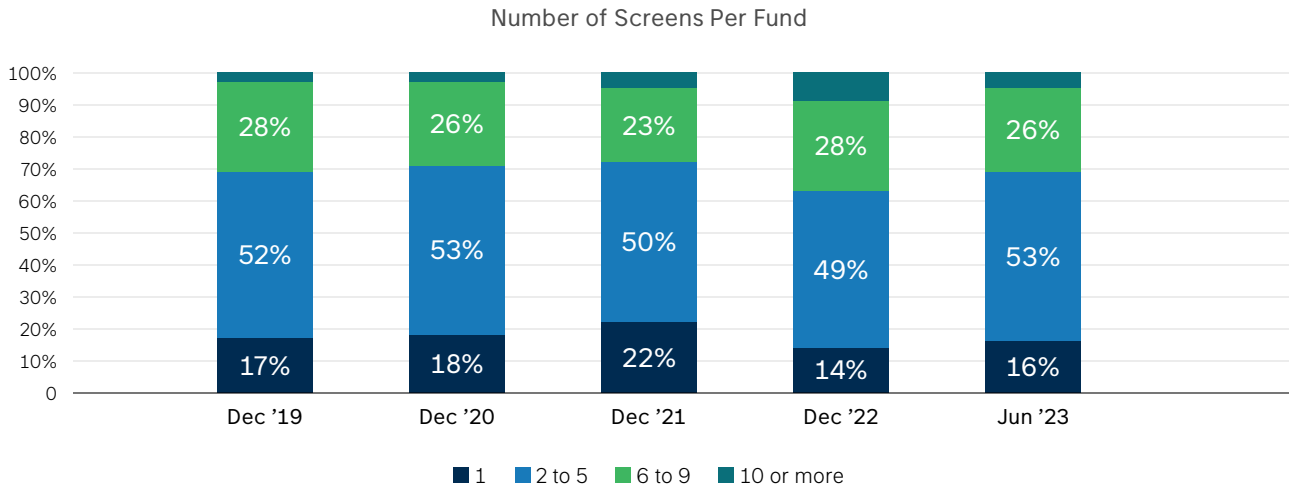


Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data.

³ Based on Morningstar's classification, as with elsewhere in this report.

FIGURE 15

Indicating Rise in Screening Comes from More Funds Adopting the Approach



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data.

FIGURE 16

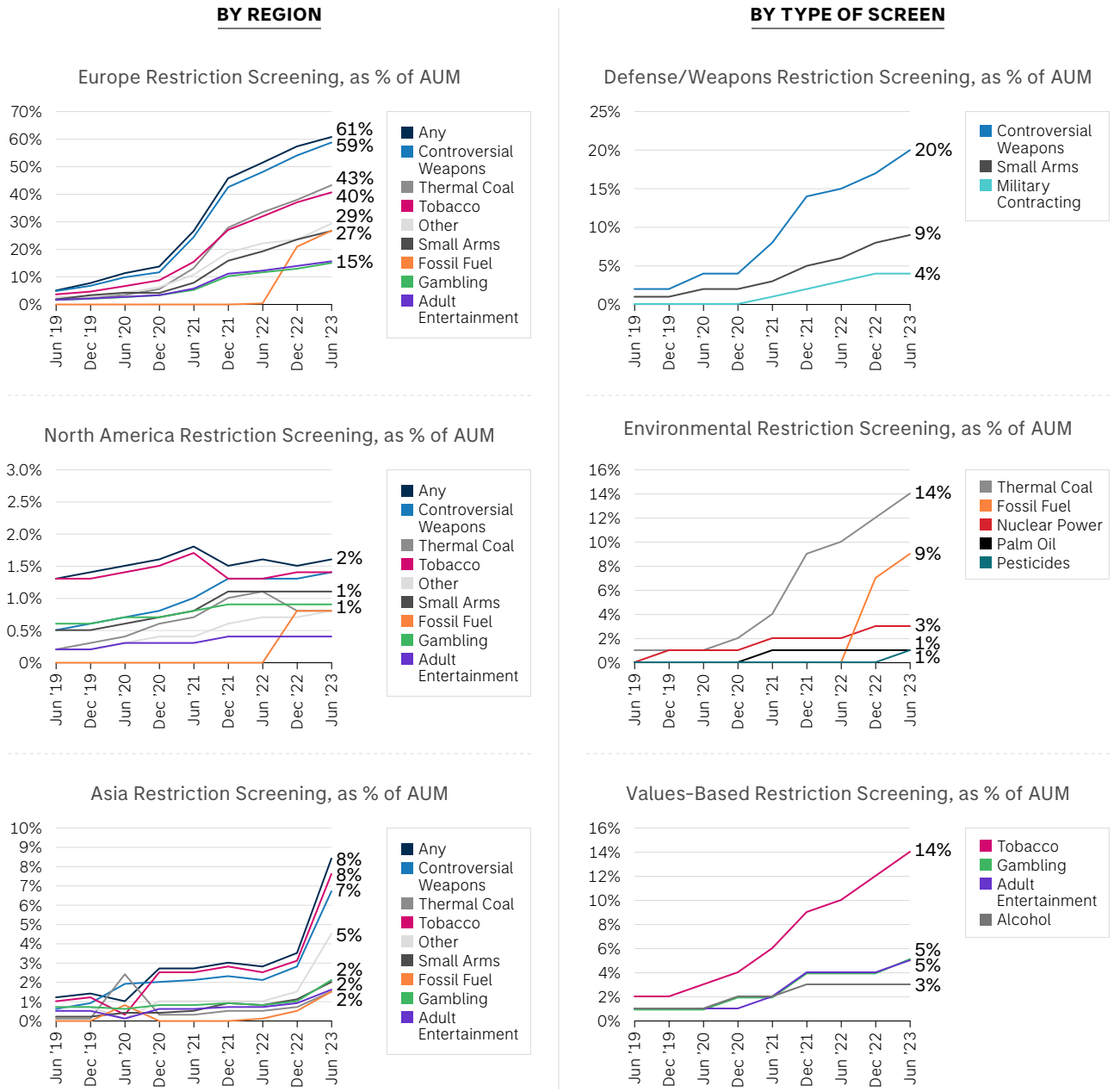
Controversial Weapons, Thermal Coal and Tobacco Are the Most Commonly Used Screens

RESTRICTION SCREENING AT JUNE 2023	NUMBER OF FUNDS	% FUNDS	GLOBAL AUM, \$BN	% AUM
Any	16,689	17.2%	\$8,780	20.7%
Controversial Weapons	15,199	15.7%	\$8,417	19.8%
Thermal Coal	10,663	11.0%	\$6,064	14.3%
Tobacco	11,393	11.8%	\$5,988	14.1%
Other	8,212	8.5%	\$4,259	10.0%
Small Arms	6,652	6.9%	\$3,909	9.2%
Fossil Fuel	6,364	6.6%	\$3,825	9.0%
Gambling	4,989	5.2%	\$2,290	5.4%
Adult Entertainment	4,733	4.9%	\$2,232	5.3%
Military Contracting	3,499	3.6%	\$1,828	4.3%
Alcohol	3,175	3.3%	\$1,372	3.2%
Nuclear Power	2,581	2.7%	\$1,356	3.2%
Palm Oil	1,021	1.1%	\$564	1.3%
Genetically Modified Organisms	1,082	1.1%	\$554	1.3%
Pesticides	483	0.5%	\$306	0.7%
Animal Testing	583	0.6%	\$227	0.5%
Fur and Specialty Leather	304	0.3%	\$148	0.4%
Abortion	477	0.5%	\$143	0.3%

Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data.

FIGURE 17

Overview of Restriction Screens by Region and Type*



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data.

*For definitions, please see the [Appendix](#).

Conclusion

So far, 2023 saw a return to form for sustainable funds after challenging market conditions in 2022. This outperformance had both structural and secular drivers: The market environment was more favorable to sustainable funds' positioning and there was material outperformance within style categories. Demand for sustainable funds remained strong, with positive inflows throughout the year—particularly in Europe—and no market reaction to the 2022 underperformance. Overall, sustainable funds appear to be holding steady as patient capital for investors targeting longer-term horizons.

Appendix

RESTRICTION SCREENING CATEGORIES	MORNINGSTAR DEFINITIONS
Excludes Abortion/Stem Cells	These are strategies that avoid investments in companies that derive revenue from abortion services, abortifacients, and/or the use of embryonic stem cells. Strategies that exclude human cloning are also included in this data point because of the use of embryonic stem cells and the issue's relationship to life ethics questions. While many strategies employing these exclusions also exclude contraceptives, the exclusion of the latter is reflected in "Excludes Other."
Excludes Adult Entertainment	These are strategies that intend to avoid investments in companies that derive a significant percentage of their revenue from adult entertainment. Strategies that identify specific exclusions of a subindustry, such as pornography, also receive this tag.
Excludes Alcohol	These are strategies that intend to avoid investments in companies that derive a significant percentage of their revenue from the production, distribution, or sale of alcohol.
Excludes Animal Testing	These are strategies that intend to avoid investments in companies that engage in animal-testing practices.
Excludes Controversial Weapons	These are strategies that avoid investments in companies that derive a significant percentage of their revenue from controversial military weapons, such as weapons of mass destruction, nuclear weapons, land mines, and cluster munitions. These do not necessarily preclude investments in companies with revenue from conventional military weapons but may include companies that produce materials used in controversial weapons.
Excludes Fur and Specialty Leather	These are strategies that intend to avoid investments in companies that derive a significant percentage of their revenue from the production, distribution, or sale of fur and/or specialty leather.
Excludes Gambling	These are strategies that intend to avoid investments in companies that derive a significant percentage of their revenue from gambling or casinos.
Excludes GMOs	These are strategies that intend to avoid investments in companies that are significantly involved in the use of genetically modified organisms.

(continued on next page)

RESTRICTION SCREENING CATEGORIES

MORNINGSTAR DEFINITIONS

Excludes Military Contracting

These are strategies that intend to avoid investments in military contractors or companies that derive a significant percentage of their revenue from non consumer military contracting or operations. Some strategies cite companies that derive a significant amount of revenue from working with military organizations or defense more generally. This category does not necessarily exclude nonmilitary companies that are involved in materials or components used in controversial weapons.

Excludes Nuclear

These are strategies that intend to avoid investments in companies that are significantly involved in the research or production of nuclear energy. This does not reflect exclusions of nuclear weapons, which are instead reflected in “Excludes Controversial Weapons.”

Excludes Palm Oil

These are strategies that intend to avoid investments in companies that derive a significant percentage of their revenue from the production, distribution, or sale of unsustainable palm oil and its products. This may not require the exclusion of companies that produce, distribute, or sell palm oil that has been shown to be sustainably sourced, including cosmetics and lotions.

Excludes Pesticides

These are strategies that intend to avoid investments in companies that derive a significant percentage of their revenue from the production, distribution, or sale of pesticides for environmental or biological concerns.

Excludes Small Arms

These are strategies that intend to avoid investments in companies that derive a significant percentage of their revenue from the production, distribution, or sale of personal weapons and small arms. These strategies most frequently exclude firearms but may exclude other personal weapons as well.

Excludes Thermal Coal

These are strategies that intend to avoid investments in companies that derive a significant percentage of their revenue from the extraction, distribution, sale, or use of thermal coal. Investments in companies exposed to metallurgical coal are typically not included in this category.

Excludes Tobacco

These are strategies that intend to avoid investments in companies that derive a significant percentage of their revenue from the production, distribution, or sale of tobacco and/or tobacco-related products.

Excludes Fossil Fuel

These are strategies that avoid investments in companies that derive a significant percentage of their revenue from the extraction, distribution, sale, or use of any fossil fuel. These strategies intend to avoid investments in companies that derive a significant percentage of their revenue from coal, petroleum, natural gas, oil shales, bitumen, tar sands, and heavy oils.

Excludes Other

These are strategies that intend to avoid investments in companies that are significantly involved in other products or practices deemed to be contradictory to the strategy’s values. Examples include companies with business operations in countries whose governments pose human rights concerns or more general language about companies whose products or services have a negative impact on customers.

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An investment in an exchange-traded fund involves risks similar to those of investing in a broadly based portfolio of equity securities traded on exchange in the relevant securities market, such as market fluctuations caused by such factors as economic and political developments, changes in interest rates and perceived trends in stock prices. The investment return and principal value of ETF investments will fluctuate, so that an investor's ETF shares, if or when sold, may be worth more or less than the original cost.

Investors should carefully consider the investment objectives and risks as well as charges and expenses of a mutual fund/exchange-traded fund before investing. To obtain a prospectus, contact your Financial Advisor or visit the fund company's website. The prospectus contains this and other information about the mutual fund/exchange-traded fund. Read the prospectus carefully before investing.

Because of their narrow focus, sector investments tend to be more volatile than investments that diversify across many sectors and companies.

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment. Companies paying dividends can reduce or stop pay-outs at any time.

Growth investing does not guarantee a profit or eliminate risk. The stocks of these companies can have relatively high valuations. Because of these high valuations, an investment in a growth stock can be more risky than an investment in a company with more modest growth expectations.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally, the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Debt instruments issued by U.S. corporate and municipal issuers that provide a return in the form of fixed periodic payments and eventual return of principal at maturity. Fixed income investments are advantageous in a time of low inflation, but do not protect investors in a time of rising inflation. Interest income on government securities is subject to federal income taxes, but exempt from taxes at the state and local level.

Bond funds and bond holdings have the same interest rate, inflation and credit risks that are associated with the underlying bonds owned by the funds. The return of principal in bond funds, and in funds with significant bond holdings, is not guaranteed.

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