

Morgan Stanley

INVESTMENT MANAGEMENT

Engage

AUTUMN 2021
ENGAGEMENT REPORT

International Equity Team

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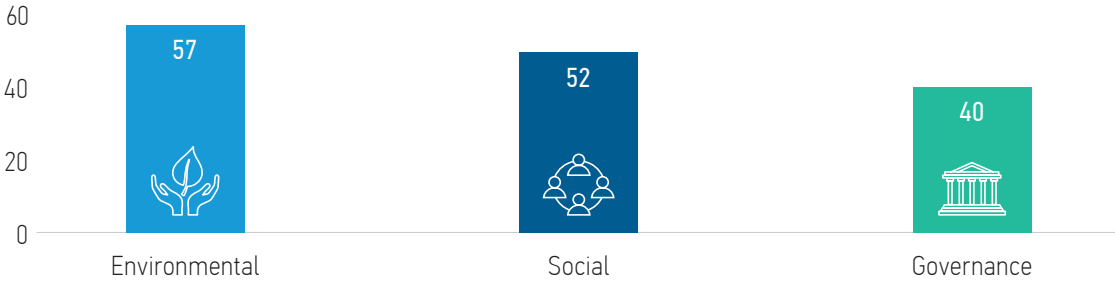
Engagement is our edge

Our investment process focuses on the sustainability and direction of future returns on operating capital because we believe that companies with sustainably high long-term returns should outperform. Active engagement informs us whether management can maintain these high returns while growing the business over the long term. This includes direct engagement with companies and boards to assess material ESG risks and opportunities.

We have engaged directly with companies on issues material to the sustainability of returns on operating capital for over 20 years. We recognise that dialogue with companies can take years and multiple engagements. As active managers with a long-term investment horizon, we believe we are well positioned to engage with management on material ESG topics and influence companies towards better practices.

In the first half of 2021, we engaged with company management on a range of themes, including decarbonisation, product quality, executive compensation, biodiversity, and supply chain management, amongst others. With the UN Climate Change Conference, COP26, on the horizon, we continued to pay close attention to companies' decarbonisation strategies, including encouraging those companies without targets to adopt them. Throughout the first half of 2021, we held 129 meetings with company management, of which 84 included discussions on ESG-related topics.

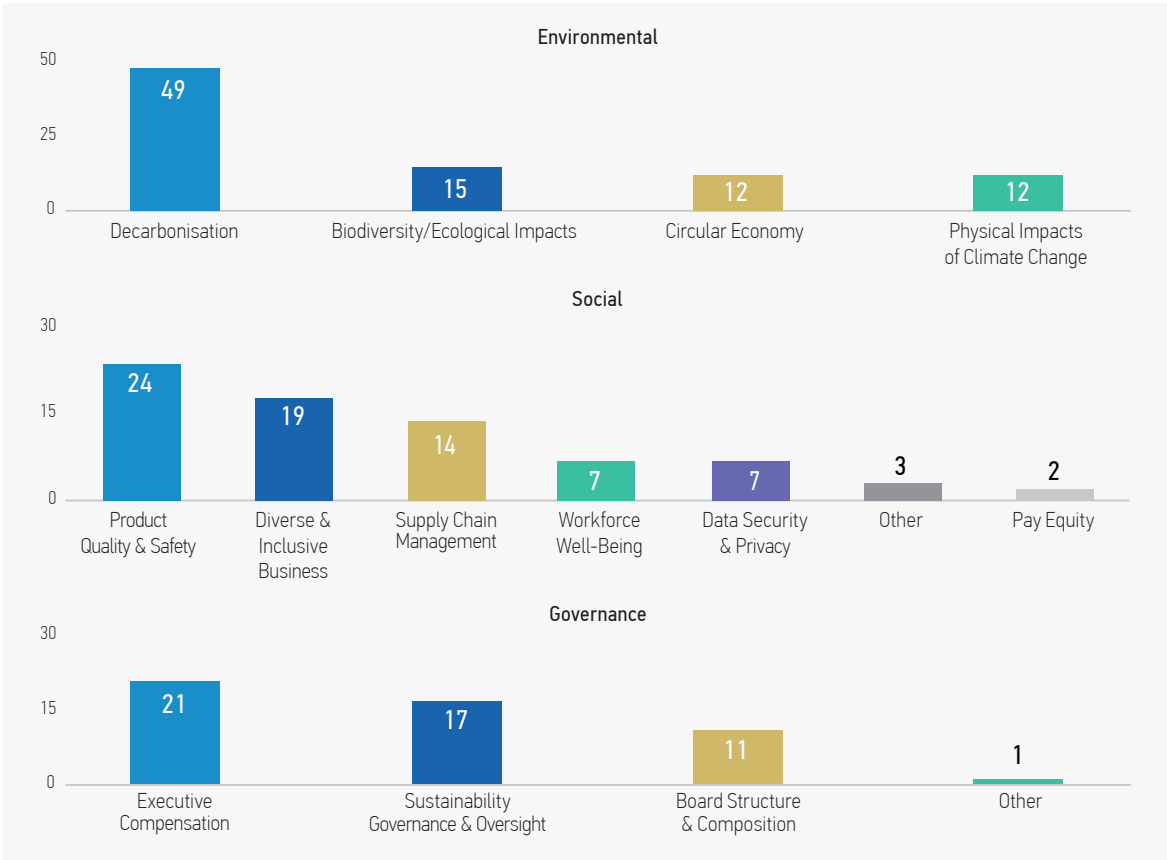
DISPLAY 1
Number of times ESG-related topics were discussed, 1H 2021^{2,3}



Our ESG engagements have three key purposes: assessment of specific ESG issues relevant to companies and their strategies to address these issues, monitoring of progress, and influencing companies towards better practices. In the case of the latter, we engage with specific objectives and track the company's response and progress, including but not limited to improved disclosure, behaviour change, and (where appropriate) target setting.

DISPLAY 2
Topics addressed during our engagements, 1H 2021^{2,3}

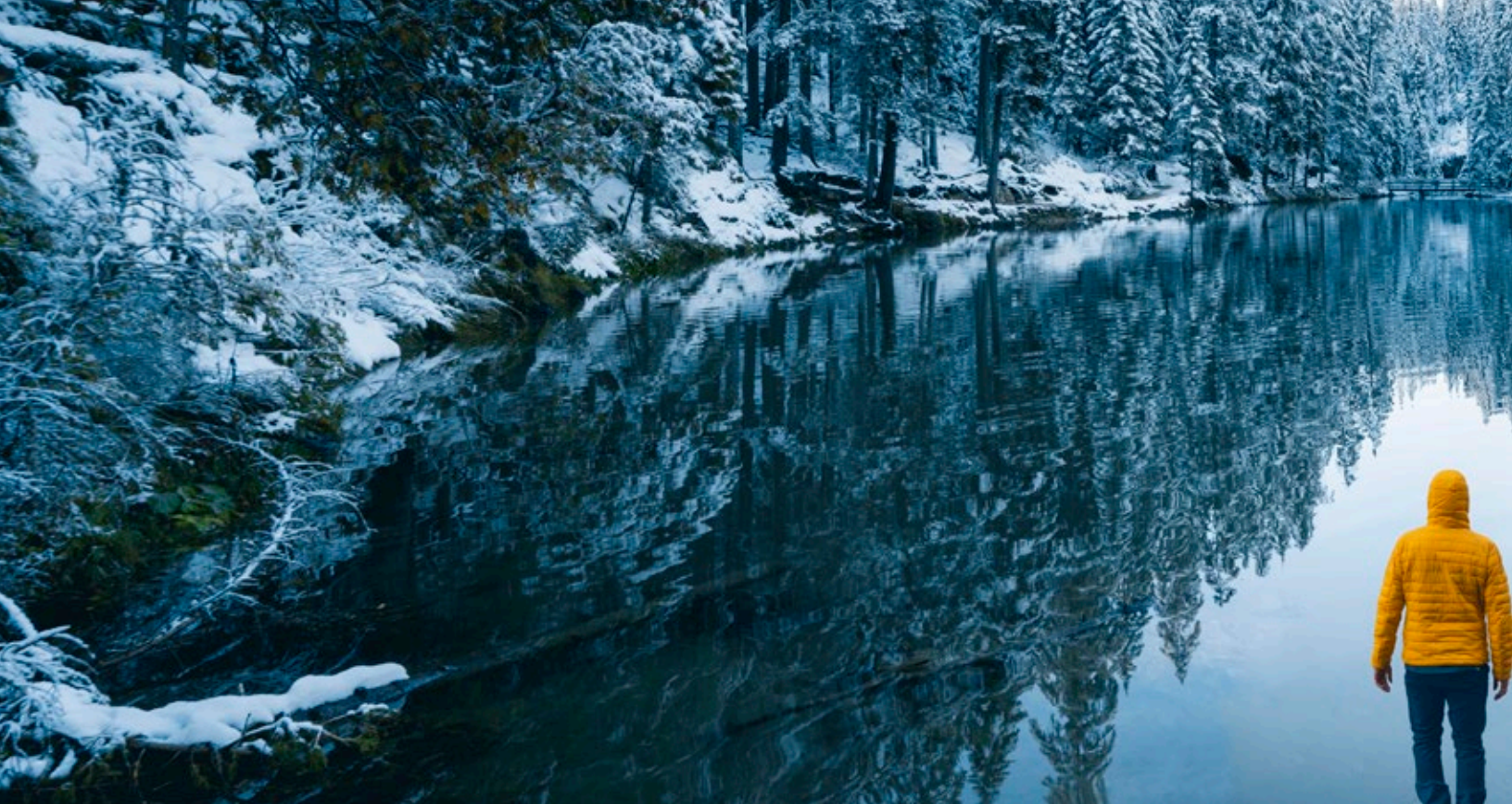
The following diagrams show a breakdown of our E, S, and G engagements by topic.



¹ The International Equity Team defines an engagement as an interaction with senior management or non-executive board members.

² Data shown is for the 6-month period to 30 June 2021.

³ Total count of ESG topics discussed is higher than total number of ESG engagements as more than one topic may be discussed in a meeting.



Keeping warm

(International Equity, International Equity Plus)

From its modest beginning selling mountaineering equipment in a French Alpine village, one of our holdings defined its future a few years later by specialising in clothing for extreme climates, subsequently becoming a globally renowned brand. We engaged with them to learn more about responsible sourcing, product quality and the circular economy – topics their materiality matrix identifies as most important to both them and their stakeholders.

Down, a natural product exclusively from white geese and procured as a by-product of the food industry, is at the heart of every jacket made. Each down batch undergoes a two-stage inspection to assess compliance with 11 quality parameters, including independent analysis and tests performed in the company's own labs. To ensure animal welfare, all suppliers must comply with the company's technical protocol, DIST (Down Integrity System and Traceability), which regulates farming standards, technical quality, and traceability.

In addition, the company audited 100% of their supply chain over three years for human rights issues, and they practise unannounced audits. We questioned if there was any exposure to Xinjiang cotton and were reassured that none of their suppliers are buying from the region. The company's new traceability system, ready for 2023, will confirm this, but until then we will continue to probe on this subject.



DECARBONISATION



BIODIVERSITY /
ECOLOGICAL IMPACTS



CIRCULAR ECONOMY



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Across the supply chain, the company maintains a zero-tolerance policy for major compliance breaches. In 2020 this resulted in 15 supplier terminations. Whilst the system is working, it highlights imperfections. We believe it important to track termination rates going forward and to assess the process for supplier take-on.

We learned that as part of their “think circular” initiative the company started recycling down this year. The quality is almost as good as new, with the added benefit of using 70% less water. Continuing the recycling theme, by 2025 50% of nylon used in manufacturing will be sustainable, and by 2030 80% of nylon scraps will be recycled. The company’s new range, Born to Protect, is made from ECONYL, a regenerated nylon created using ocean and land-based waste that produces 40% fewer CO₂ emissions than a traditional nylon jacket.

Single-use plastics are targeted to be phased out completely by 2023. Already, all shopping bags and e-commerce packaging are made from sustainable and recyclable materials. The hangers used in stores are also made of recycled plastic.

Regarding climate change, we would like to see greater transparency in greenhouse gas emissions reporting and questioned why they were not submitting data to the Carbon Disclosure Project (CDP). They offered this would be forthcoming this year; we will be looking out for it.

We also look forward to assessing the company’s new biodiversity strategy – to be published later this year in association with Fashion Pact – and the impact of the newly established Diversity and Inclusion Council, which will set out qualitative and quantitative targets.

“

This engagement demonstrated how the company has, through responsible sourcing and circular economy initiatives, integrated sustainable practices into its business. Looking ahead, we will continue to probe on compliance in the supply chain, and await their greenhouse gas emissions report and biodiversity strategy.

Broadening the scope

(Global Franchise/Brands, Global Quality, International Equity, International Equity Plus)

We met with one of our global consumer discretionary companies to explore their approach to reducing Scope 3 emissions, and to understand how they are engaging with their supply and value chain to encourage sustainability.

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.

Scope 3 emissions, measured as emissions per unit of added value, is 94% of the Group's total footprint, mostly captured by transportation and procurement. We are encouraged that the company includes Scope 3 emissions in its targeted reduction programme – currently relatively uncommon. Using the Science Based Targets initiative (SBTi), they target a 55% reduction in Scope 3 emissions by 2030 and aim to halve emissions from energy consumption by 2026 (from a 2019 baseline). We continue to press





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BIODIVERSITY/
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CIRCULAR ECONOMY



PHYSICAL IMPACT
OF CLIMATE CHANGE



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MANAGEMENT



SUSTAINABILITY
GOVERNANCE
& OVERSIGHT

for a commitment, at the Group level, to become carbon neutral. While in their view, an aspirational goal not backed by an action plan shouldn't be made a target, we disagree. We don't see carbon neutrality as an aspiration, but ultimately achievable.

For Champagne and Cognac, roughly 75% and 98% of volumes respectively are sourced from third party partners. Since many of these partners have century-long relationships with the firm, engagement to encourage sustainable procurement is relatively easy.

Regarding sustainable agriculture, the company has dedicated teams to give training to producers on sustainability. Currently, nearly 20% of suppliers are using regenerative agriculture techniques. Sustainable agriculture has a positive knock-on effect for carbon reduction – albeit difficult to measure – due to its lower use of chemicals and potentially higher rate of carbon absorption.

Sustainability also extends into packaging, where the company targets 70% recycled packaging materials by 2030. One third of glass, 75% of total packaging by weight, is already recycled. Six hundred tonnes of glass waste is produced by the Cognac House each year, which is ground into "glass cullet", a material used in ceramics, glass beads or reflective coating on roads, for example.

Turning to the physical impact of rising temperatures, we probed whether there was a potential risk to grape harvests. They forecast that in decades yet to come, challenges could arise in California and Argentina. In France (for their Champagne and Cognac) there is no material risk and, in the short term, rising temperatures may even improve product quality.

The company uses a number of approaches to encourage suppliers to increase sustainability, including paying a premium for sustainable supply, which varies from business to business. For example, for cotton suppliers the premium ranges from 10-20%; in wines and spirits they pay a premium for sustainable grapes.

“ We are heartened by the company’s sustainable efforts across sourcing, agriculture and packaging. However, while encouraged by the inclusion of Scope 3 emissions in the targeted carbon reduction plan, we will continue to press for a commitment to carbon neutrality.

Getting going

(Global Franchise/Brands, Global Quality, Global Sustain, International Equity Plus)

As part of our comprehensive carbon engagement programme, we identified the small proportion of holdings that have yet to release formal carbon targets. We wanted to know why – and when this would change.



DECARBONISATION



SUSTAINABILITY
GOVERNANCE
& OVERSIGHT



Our initial meeting with a U.S. based technology and industrial hybrid we own provided a mutual learning opportunity. The company explained why group targets were difficult for them, while we emphasised that no apparent attempts to measure, target or report on decarbonisation efforts could reflect poorly. While every company has a different starting point, there should at least *be* a starting point; a carbon plan was something that was achievable, in our view.

The challenge for the company is how to preserve the integrity of their highly efficient, independently run, asset light business models, and also measure, record and target various ESG initiatives across their 40+ independent businesses without making it onerous and bureaucratic. The company is not run top down, and so directives from “central” are not in its culture. There is, however, strong appetite at Board level to work out an approach to carbon, and resourcing for this at a senior Group level is in place.

In terms of climate change mitigation, a number of their businesses are already helping make a difference. For example, they make products used to research fusion energy, solar cell efficiency, and the use of marine algae as biofuel. They also

produce piston membrane pumps for better efficiency and longer life, and provide imaging systems to study aerosols and air pollutants that have significant impact on global warming.

The company very much welcomed our engagement and questioning on carbon; while they acknowledged investor interest is on the increase, our engagement was one of the first they had experienced on the subject.

We left the meeting confident a start would be made. Several weeks later, we were delighted to be invited by the company to participate in a consultation with a leading sustainability integration consultant to explore our views on ESG best practice. We stressed the importance of targets (including the development of Scope 3 emissions targets), supply and value chain engagement, better diversity and inclusion metrics, and a clear framework for cyber and data security. We also suggested they highlight more effectively the positive environmental and social initiatives many of their underlying companies are engaged in.



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The meeting offered a strong signal of intent, and we view it as a positive outcome of our initial engagement. We look forward to seeing their ESG roadmap develop over time.

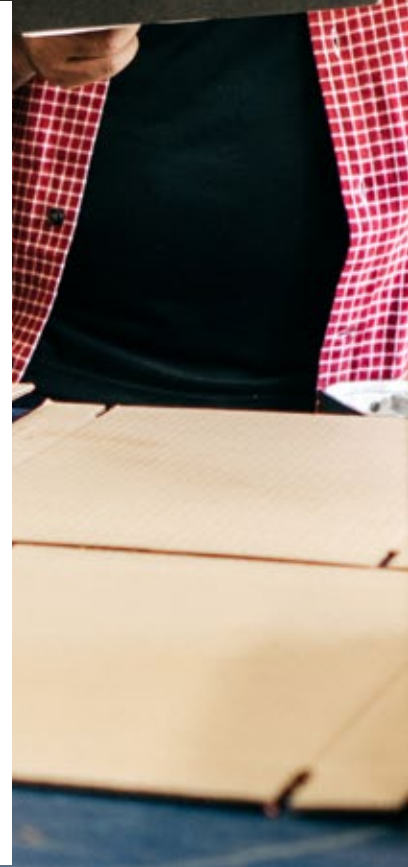


Rolling up the sleeves

(Global Franchise/Brands, Global Quality, Global Sustain, International Equity, International Equity Plus)

We engaged with one of our global household and personal care holdings on the subject of modern slavery and labour conditions in their supply chain more broadly.

Most large global companies have to deal with ESG risks outside their direct control because of their reliance on complex supply chains with outsourced production, mostly to emerging markets with lower labour costs. This has benefited the companies' bottom line and returns on capital, and in turn created significant economic opportunities for emerging countries. However, companies now have to manage the implications of this – low visibility and little direct control over labour conditions in countries with lower levels of regulatory focus on labour rights or social support.



Recent press and NGO allegations of labour rights violations involving the company's Asian third-party suppliers, including passport retention, poor living conditions and excessive recruitment fees for migrant workers, as well as use of child labour, was the focus of our engagement. We wanted to understand how the company dealt with the incidents and probe their monitoring and remediation capabilities.

We were encouraged to hear that the company had proactively addressed these specific supplier violations, in one case identifying problems via their own audit process ahead of the press reports. They commissioned independent human rights assessments and created specific remediation plans, for example reimbursement of recruitment fees, working with the suppliers, NGOs, governments and sometimes industry peers to increase leverage. In other instances, the company terminated suppliers that repeatedly failed to comply with its code of conduct, although we questioned whether the frequency of audits could be higher.

We then discussed their efforts to address the root causes of social and environmental problems in their emerging markets supply chain, rather than simply monitoring and reacting to incidents. This is a challenging task that requires an increased level of transparency and traceability, as well as an in-depth understanding of the unique circumstances farmers and workers face in different parts of the chain. The journey will be long, but the company is making progress. They have been partnering with several NGOs and a human rights research institution to conduct holistic assessments and create improvement plans, for example working with smallholder palm oil farmers to improve farming and labour practices.

Another recent achievement is their participation in the fair latex standard. The company and its partners help farmers to increase product quality and yield while producing latex more sustainably; they also pay a price premium. The aim is to improve farmers' livelihoods and to address the structural issue of rural poverty – a key driver of social and human rights risks.

We believe engagement is a marathon, not a sprint. It takes time to achieve a positive outcome. Therefore, we focus on whether companies are improving their practices to achieve a structural improvement in disclosure, monitoring and remediating systemic problems, even if progress is not instant.

“ Ultimately, we are encouraged by the systematic steps the company is taking to improve the monitoring of labour conditions in its supply chain. Of course, there is more to be done, and we will continue to engage with the company on this complex issue.



**SUPPLY CHAIN
MANAGEMENT**



**WORKFORCE
WELL BEING**



**SUSTAINABILITY
GOVERNANCE
& OVERSIGHT**

Sustainability is the new digital

(Global Franchise/Brands, Global Quality, Global Sustain, International Equity Plus)

We spoke to a leading consultancy firm about sustainability opportunities, diversity and inclusion (D&I) and employee welfare.



The company is currently exploring what could be a material long-term business opportunity – helping their corporate clients to measure, manage and report their environmental and social impact. With growing stakeholder and regulatory sustainability requirements, demand for such tools has ballooned. Although it is early days, given its long-established consulting relationships with the largest companies in the world, our holding is well positioned to take advantage of this natural adjacency to their traditional consulting franchise over time.

For their clients, sustainability management sits at the intersection of their manufacturing and digital processes, and the company has been adapting their existing tools to take sustainability metrics into account. For example, the well-known zero-based budgeting process can now show various supply chain trade-offs between cost savings and carbon footprint, human rights risks and diversity, giving corporates much needed visibility into what their impact is and the opportunity to minimise the negatives. The company has also been partnering with large tech companies to improve measurement and tracking of sustainability data more broadly. Within its own operation, the company has a net zero target by 2025 and aims to switch to 100% renewable electricity before that.

In terms of D&I, an interesting insight from our engagement was how COVID-19 made the company rethink their working practices. Remote or hybrid working has become more acceptable and face-to-face meetings with clients are no longer default. Apart from helping the company reduce emissions from business travel and employee commute, employees appreciate the increased flexibility. Our own research has shown that companies with flexible working arrangements tend to retain more women with carer responsibilities and as a result have better levels of female representation, especially in more senior positions. The company targets 50/50 gender parity in the workforce and for 30% of managing director positions to be held by women by 2025. They also have targets to increase ethnic minority representation in some key markets.

In our engagements on D&I, we probe companies on what real-life HR policies and practices they have in place to help them achieve their D&I targets. We were encouraged to find out that the company has a requirement for diverse candidate slates when recruiting, as well as holding managers accountable for promoting diverse candidates.

On a less positive note, we recently became concerned about employee welfare in the company's small digital content moderation business and raised it with them. While removing harmful content from digital platforms undoubtedly has a positive social impact, there have been complaints by human moderators about substandard working conditions and increased risks of post-traumatic stress disorder from exposure to disturbing images. Unfortunately, the company has not yet provided sufficient information about the scale of the problem or specific actions they are taking to resolve the issue. We will continue to engage with them on this.



DECARBONISATION



DIVERSITY
& INCLUSION



WORKFORCE
WELL BEING

“ Overall, we are encouraged by the company's material ESG opportunity and ambitious D&I goals. However, we recognise better disclosure and transparency of the content moderation business is needed. We will continue to press on this issue.

Room to improve

(Global Franchise/Brands, Global Quality, Global Sustain, International Equity Plus)

We engaged with a large US-based health care holding on, lobbying payments, D&I, and executive pay and governance. We discussed two shareholder proposals that asked the company to improve disclosure of their lobbying expenditures and provide a report on their efforts to improve racial justice.

On lobbying, although the company ranks well on a third-party index of political contributions transparency, detailed information on their lobbying expenditures is not always readily available. We felt shareholders would benefit from enhanced disclosure on this topical issue and that the company has some room to improve to become a top tier discloser. As such, we voted for the resolution.



DIVERSITY & INCLUSION



EXECUTIVE COMPENSATION



On D&I, while the company has already multiple initiatives in place to improve gender and racial diversity, and recently created a Chief Diversity Officer role, we encouraged them to improve disclosure (e.g. through providing the fundamental statistics on gender and ethnic make-up of the US workforce that the company already reports to the US government) and supported the shareholder resolution on racial justice. Subsequent to our engagement, the company published this information in their latest D&I report.

On executive pay, we continued to encourage the company to improve the structure and disclosures around their remuneration plan. While the company has made the plan more transparent recently, we pointed out that some of the management targets are still not explicitly disclosed. We also questioned the levels of the adjusted return on equity (ROE) target used in the plan. The actual achieved level of adjusted ROE is not disclosed, but we estimate it to be significantly higher than what the company targets. As such, we felt the bar was set too low. We also believe the plan rewards past performance given LTIP awards are determined by historical total shareholder return. In line with prior years, we voted against the pay plan.

Also in line with prior years, we voted for a shareholder resolution asking the company to have an independent chair of the board. We believe this to be a best-in-class governance practice which should benefit the company, especially given potential concerns about the influence of entrenched ex-CEO chairs at many US companies.

“

While we recognise that the company has made improvements to its executive compensation plan, our concern that their plan is somewhat backward-looking and lacks proper disclosure meant we voted against it.



Voting overview

Where proxy voting has been delegated to us by our clients, we take this responsibility extremely seriously, and always have. Proxy voting is one way we communicate with company management and forms an important part of our investment process. Our voting seeks to be consistent with our assessment of the materiality of specific ESG issues to companies' sustainability of returns on capital, our monitoring of company progress, and our efforts to influence companies towards better and/or more transparent practices.

Our proxy voting is predominantly related to governance issues such as management incentives and director appointments. Our team's long experience and heritage in evaluating the quality and calibre of management explains our expectations of management teams. Our voting seeks to be consistently applied to encourage long-term oriented management with strong ESG profiles and policies, that demonstrate integrity, protect shareholder rights, disclose information in an accurate, timely and transparent manner, offer independent board and committee structures and align incentives with long term interests of shareholders. We examine carefully and discuss proposals related to the election of directors, board structure, corporate transactions, changes in the capital structure, and dividend payments. We focus particularly on proposals relating to executive remuneration.

We also 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 likely impact. We generally support proposals that, if implemented, would enhance useful disclosure or improve management practices.

During the first half of 2021, we voted at 79 meetings and on 1239 proposals. Overall, we voted against management in 8% of cases, and 65% of meetings had at least one vote against management.

DISPLAY 3
Proxy voting overview (6 months to 30 June 2021)

Total number of meetings held	79
Total proposals voted	1,239
% votes against management	8%
% meetings with at least one vote against management	65%

Source: ISS Proxy Exchange; MSIM

The most common reasons for voting against management were related to executive compensation, board structure and shareholder ESG proposals.

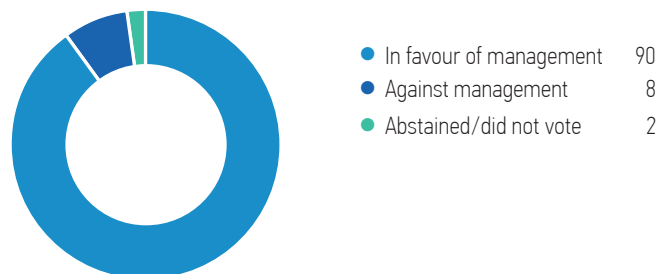
We continue to scrutinise companies' pay plans and engage on structure, metrics and disclosure of executive remuneration. Compensation-related proposals continued to stand out as a contentious voting topic, with our team voting against 28 (47%) executive compensation proposals.

To increase the impact of our engagement, in addition to voting against remuneration plans when we have had long-standing concerns without sufficient progress, we have started to vote against members and/or chairs of compensation committees.

We voted against members of nomination committees where we had particular concerns about board and company diversity, and against director candidates where we had concerns over their independence. We voted against 21 directors across all of our holdings.

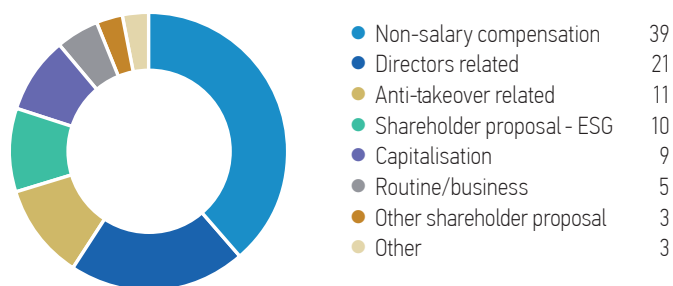
Our companies receive relatively few shareholder proposals compared to the broader market, but when they do, we analyse them carefully and engage with the companies to discuss them.

DISPLAY 4
Voting on 1,239 proposals
% by voting instruction



DISPLAY 5

% votes against management by topic^{4,5}



We voted in support of 11 (61%) ESG-related shareholder resolutions across our strategies. Issues included sustainability governance (including adopting sustainability as a performance measure for senior executive compensation), public health and well-being, and labour rights.

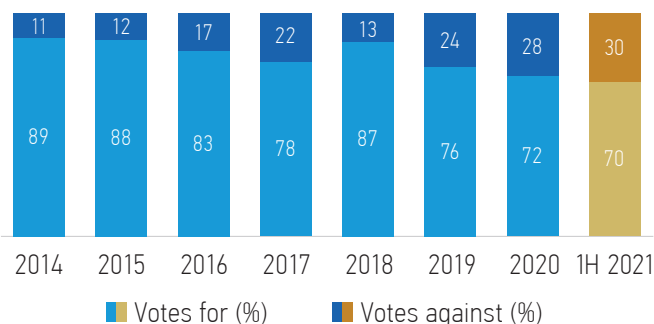
Pay X-Ray

The Pay X-Ray is our proprietary scoring tool, used to better compare company pay plans, facilitate team discussions and inform our voting approach. A streamlined scoring system, it enables us to flag good and bad practices and rank our holdings' remuneration plans. Each element of the plan receives a positive or negative score, rolled up into an overall company score.

The following chart illustrates the percentage of votes for and against management-sponsored say-on-pay proposals the team voted on during the period from 2014 – 1H2021.

DISPLAY 6

Votes on management say-on-pay proposals voted 2014 – 1H2021



Source: ISS Proxy Exchange; MSIM

Our team voted on 141 say-on-pay proposals during the six months to 30 June 2021. 30% of votes were cast against management.

Reasons the team voted against say-on-pay proposals included: excessive levels of pay, insufficient weight of performance-based remuneration, subjective or undisclosed targets for management, or performance incentives that are, in our view, not aligned with shareholders.

Proxy voting policy

MSIM votes proxies in a prudent and diligent manner and in the best interest of our clients, including beneficiaries of, and participants in a client's benefit plan(s) for which the subadvisor manages assets, consistent with the objective of maximising long-term investment returns. MSIM has retained research providers to analyse proxy issues and to make vote recommendations on those issues. While we are aware of the recommendations of one or more research providers, we are in no way obligated to follow such recommendations. The investment teams vote all proxies based on MSIM's proxy voting policies in the best interests of each client.

⁴ Expressed as a percentage of total votes against management.

⁵ Due to rounding, this may not add up to 100.

A+

In the 2020 UN PRI Assessment, MSIM received a straight A score card, including A+ for Strategy & Governance. In Listed Equity, MSIM scored A+ for Incorporation and for Active Ownership, the latter for a second year running, reflecting the firm's commitment to stewardship. MSIM is in the top scoring brackets (A and A+) for both investment managers globally and those based in North America across all of our PRI disclosure modules.

Signatory of:



Risk Considerations

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market value of securities owned by the portfolio will decline. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this strategy. Please be aware that this strategy may be subject to certain additional risks. Changes in the worldwide economy, consumer spending, competition, demographics and consumer preferences, government regulation and economic conditions may adversely affect **global franchise companies** and may negatively impact the strategy to a greater extent than if the strategy's assets were invested in a wider variety of companies. In general, **equity securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, and market risks. **Stocks of small- and mid-capitalisation** companies carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in emerging market countries are greater than risks associated with investments in foreign developed markets. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. **Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). Non-diversified portfolios often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. **ESG strategies** that incorporate impact investing and/or Environmental, Social and Governance (ESG) factors could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. As a result, there is no assurance ESG strategies could result in more favorable investment performance.

Any questions or comments?

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