Morgan Stanley

INVESTMENT MANAGEMENT

Engage

AUTUMN 2022
ENGAGEMENT REPORT

International Equity Team

GLOBAL FRANCHISE/BRANDS | GLOBAL QUALITY | GLOBAL SUSTAIN | INTERNATIONAL EQUITY
INTERNATIONAL EQUITY PLUS | AMERICAN RESILIENCE | INTERNATIONAL RESILIENCE

ENGAGEMENT IS OUR EDGE

We have engaged directly with companies on issues material to the sustainability of returns on operating capital for over 20 years. As active managers running concentrated portfolios and with a long-term investment horizon, we believe we are well positioned to engage with management on financial and material ESG topics and encourage companies towards better practices.

We seek to deliver better outcomes for our clients through producing attractive returns over the long term. To do this, we must invest with a conscious eye on whether companies can deliver not just today, but five, 10, and even 20 years from now. We back companies that have the characteristics needed to lead in the long run, like recurring revenue, pricing power and strong management, and importantly also invest to manage and improve their ESG performance. Direct, portfolio manager-led engagement is, in our view, vital to understanding whether companies and management can deliver across financial and material non-financial areas.

By its nature, quality is less exposed to potential adverse events compared to an average stock in the index. We cannot change or even predict the macroeconomic or political or regulatory environment, but we can aim to ensure that those we hold are the most robust we can find—and that the companies we select have management teams that are more likely to anticipate, mitigate and manage resiliently through adversity. Active portfolio managers that own stocks for the long term rather than just rent them are used to filtering out short-term noise and data for relevant and material drivers of long-term returns.

Meeting with company management matters. That means thorough preparation and a pragmatic use of the chance to meet CEOs, CFOs and Chairs of some of the world's leading companies, and using these interactions as opportunities to test our hypotheses, gauge integrity and understand management's strategy, capital allocation and commitment to returns on operating capital, and how they get paid. Beyond the solely financial topics, in the first half of 2022, we continued to engage with company management on a range of ESG subjects, including diversity, equity and inclusion, decarbonisation, biodiversity, executive pay, and supply chain management, amongst others.

Our holistic approach means we typically engage with companies on more than one topic in any given meeting. Environmental topics featured in 65% of our ESG engagements[1], while social and governance topics presented in 38% and 40% of engagements respectively. Over the next pages we share some notable engagement case studies that took place during the first half of 2022.

[1] The International Equity Team defines an engagement as an interaction with senior management or non-executive board member. Engagements may also be those with companies' investor relations and/or sustainability teams.

LIGHT AT THE END OF THE TUNNEL

GLOBAL FRANCHISE/BRANDS | GLOBAL QUALITY | GLOBAL SUSTAIN
INTERNATIONAL EQUITY | INTERNATIONAL EQUITY PLUS | INTERNATIONAL RESILIENCE

Executive compensation has been an ongoing subject of engagement with one of our UK-based consumer staples holdings. Our long history of portfolio manager-led engagement with companies on the subject of pay means we understand how incentive schemes ought to be structured to prioritise longer-term success over short-term tactics. We know what works – and we know what threatens long-term compounding potential.

AUTHOR

NIC SOCHOVSKY
Managing Director

E S G

EXECUTIVE COMPENSATION

Challenges

In our view, most managers tend to do what they are paid to do, meaning **incentives** need to reward behaviour that is aligned with shareholders' interests. As we look to own companies for the long term, we are wary of incentive schemes that rely too heavily on earnings per share (EPS) as an evaluation metric. If management is paid on EPS, it can be tempting to manipulate earnings using short-term tactics – such as increasing debt or making acquisitions – at the expense of shareholders' long-term returns. We also try to avoid schemes that award high pay for ordinary or even poor performance. We don't believe that time served or the ability to show up every day is a good enough reason for a high reward. Instead, we like to see management compensated for achieving return on capital targets, as well as progressing environmental and social objectives.

Actions

We have been seeking changes to the company's executive compensation structure for a while. In previous engagements, we had argued that their fixation with EPS in their long-term incentive plan (LTIP) was not conducive to long-term performance, and that the lack of measurable environmental and social metrics would hinder progress in these areas. We also expressed our concern over the quantum of pay (given the potential value of the options package), which we felt was misaligned with the corporate's recent performance. We have previously voted against their pay plan to signal our dissidence.

"… driving meaningful change is an iterative process, requiring patience and perseverance

Outcomes

We are well aware that change will not happen overnight. We understand that driving meaningful change is an iterative process, requiring patience and perseverance, but as active managers with a long-term investment horizon, we are willing to put in the work.

In our engagement with the head of the remuneration committee earlier this year, we were pleased to hear that EPS targets have been dropped from the pay plan, and that targets for decarbonisation and sustainable product innovation now constitute a meaningful portion of the LTIP. In addition, the company has reduced the maximum LTIP opportunity available to executive directors.

We recognise that there is still a way to go, and we intend to keep pushing for more sensible operating metrics that we believe should help share price performance in the long run. However, in an imperfect world, seeking perfection should not cloud what is reasonable, particularly when there is year-on-year improvement. We consider that the plan is now relatively well balanced, including a sales growth, returns and ESG component. To signal our encouragement for the company's progress, we voted in favour of this year's pay plan.

AUTHOR

FEI TENG
Senior
Associate

FISHING FOR INFORMATION

INTERNATIONAL EQUITY | INTERNATIONAL EQUITY PLUS

We met with a Norwegian consumer staples company we own to encourage better management of biodiversity and climate risks in aquafeed (fish food) and support broader industry change to build industry resilience.

E S G

BIODIVERSITY/ ECOLOGICAL IMPACTS

PHYSICAL IMPACTS OF CLIMATE CHANGE

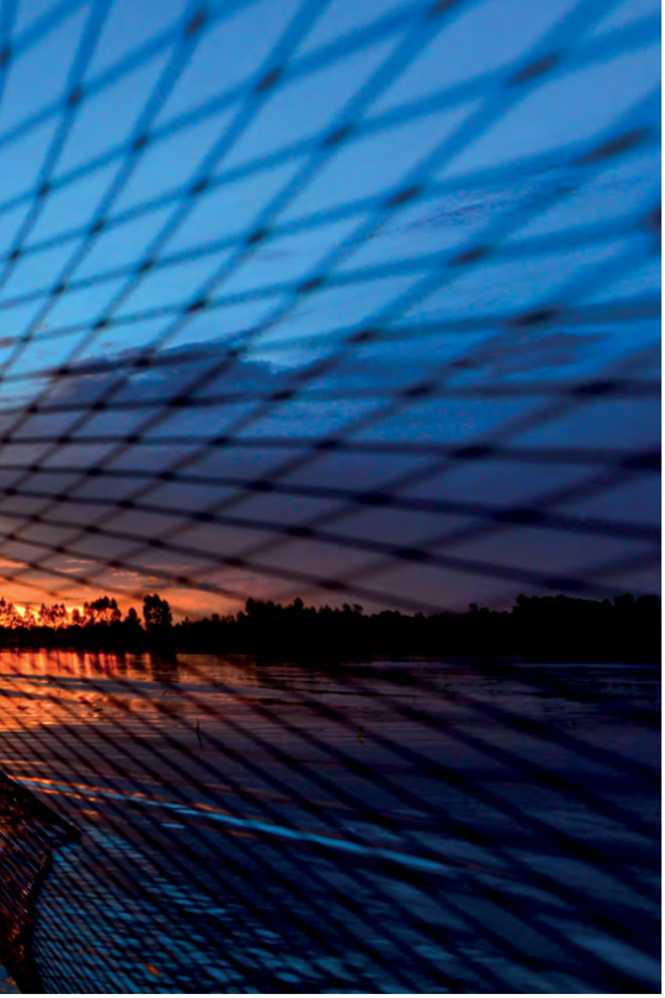
Challenges

Aquaculture – the practice of farming seafood – is a fast-growing food production sector, accounting for more than half of all fish consumed by humans, with salmon making up a considerable proportion of this. Once considered a luxury foodstuff, salmon consumption worldwide is now three times higher than it was in 1980.

Salmon aquaculture is less resource intensive than many other protein sources – 6-10lbs (2.7-4.5kg) of feed are required to produce one pound of beef versus 1.15-1.7lbs (0.5-0.8kg) of feed to produce a pound of salmon. Nevertheless, the sourcing of that feed presents a material risk to the industry.

Why? Key ESG-related issues linked to aquafeed production are already having, or beginning to have, a financial impact on companies operating in this sector. The main components of fish feed are fish meal and fish oil (FMFO) and vegetable ingredients such as soy. The use of fish meal puts pressure on wild fish stocks (a key ingredient) and marine ecosystems, with a third of stocks now considered overfished[2] while extreme weather conditions are contributing towards volatile fish meal prices, which have increased by 118% since 2006. This can have a considerable impact on the salmon-farming industry given the cost of feed can account for up to 50% of production costs. Meanwhile, the increased use of vegetable ingredients has led to an increase in greenhouse gas emissions, heightening the prospect of reputational risk related to deforestation and increasing

[2] Source: FAIRR 2022: Oceans and Biodiversity Impact Report)



greenhouse gas emissions. According to the investor initiative FAIRR (Farm Animal Investment Risk & Return Initiative), if the current approach to feed formulation continues it will act as a limiting factor, capping potential production at 14.4 million tonnes (versus the seven million tonnes currently produced). We therefore believe it is key that aquaculture companies understand these risks and take steps to manage and mitigate them to avoid soaring costs, supply chain disruption and potential reputational damage.

Although our holding is ranked by FAIRR as the most sustainable animal protein producer in the world, our aim was to better understand how our holding was approaching the material long-term risks that feed presents to their business.

Actions

Focused on managing biodiversity and climate risks in aquafeed, the engagement took place as part of FAIRR's collective engagement on sustainable aquaculture, which featured 75 investors representing total AUM of U.S $16 trillion. Targeting eight global salmon companies, this phase of the engagement series involved asking them to develop and disclose strategies for diversifying feed ingredients towards lower impact, more sustainable alternatives in order to enable production growth, reduce climate risk exposure and ensure that the risks associated with sourcing FMFO and soy are adequately managed. In turn, this should result in greater resilience for companies against rising prices, supply chain constraints and reputational risk, all of which should benefit investors in the long term.

The engagement series is currently in phase 2, focused on increasing transparency, and the aim of this engagement was to understand the company's strategy, targets and performance milestones. While the company in question was the first to set a target for emerging feed ingredients by 2030, during the engagement we pushed for further disclosure on their strategy to achieve this, and the milestones that will be used to measure progress. We also encouraged the company to provide more disclosure on their research and development of novel feed ingredients, including risk assessment studies, the sustainability credentials of the ingredients and spending.

Outcomes

In terms of novel ingredients, the company shared that a significant amount of money was spent in 2020 on developing emerging feed ingredients, which include insect meal, yeast cells, single cell proteins and algae. However, they all pose their own challenges, not least cost, while availability also remains low given a lack of production scale. The company wants to build a more diverse raw material basket to allow greater flexibility when formulating feed, although were reluctant to go into too much detail, arguing that the information was at present proprietary.

Meaningful engagements take time to see results, and this is just as true for collaborative engagements. Following the conclusion of this phase of FAIRR's collective engagement they have recently published a report of their findings, while next steps are yet to be discussed. We continue to support this initiative and remain open to joining further collaborative engagements where they can add value and where the initiative aligns with our philosophy of in-depth bottom-up research, constructive discussion and encouraging change.

A NOTE ON COLLABORATIVE ENGAGEMENTS

As a well-resourced team with a long-term ownership mindset, we tend to favour portfolio manager-led engagements with the companies that we own. However, we recognise that in some instances, it can be beneficial to work in collaboration with select partnerships. As a reflection of this, during the first half of 2022 we joined three initiatives: the 30% Investor Group, FAIRR, and the World Benchmarking Alliance (WBA).

We believe these initiatives complement our own engagement activities. Whilst we continue to conduct our own engagement programme, which makes up the majority of our engagement activities, these initiatives can offer opportunities around biodiversity and social issues, including diversity, equity and inclusion (DE&I). For example, the WBA has a gender benchmark and a ranking on nature and biodiversity and covers many of the companies we own.

NEW, BUT NOT BEHIND

GLOBAL FRANCHISE/BRANDS | GLOBAL QUALITY | GLOBAL SUSTAIN
AMERICAN RESILIENCE | INTERNATIONAL EQUITY PLUS

AUTHORS

RICHARD PERROTT
Executive Director

VLADIMIR DEMINE
Head of ESG Research

DEFINITIONS

Science-Based Targets (SBTs)

SBTs provide companies with a clearly-defined path to reduce emissions in line with the Paris Agreement goals. The Science Based Targets initiative (SBTi) is a collaboration between the Carbon Disclosure Project (CDP), the United Nations Global Compact, World Resources Institute and the World Wide Fund for Nature.

Power Purchase Agreements (PPAs)

A contract between energy buyers and sellers in which they agree to trade a predetermined amount of energy generated by renewable sources.

Renewable Energy Certificates (RECs)

A market instrument, one REC represents 1 MWh of renewable energy produced and embodies the associated environmental benefits. As these can be trades, they provide an economic incentive for generating electricity from renewable energy.

EEO-1

U.S. only. A mandatory annual data collection that requires all private sector employers with 100 or more employees or federal contractors with 50 or more employees to submit demographic workforce data, including data by race/ethnicity and gender.

STEM

Science, technology, engineering, mathematics.

E S G

DECARBONISATION

PAY EQUITY

WORKFORCE WELL BEING

DIVERSE & INCLUSIVE BUSINESS

EXECUTIVE COMPENSATION

We engaged with a financial technology company, a newcomer to the portfolio, to discuss decarbonisation and to learn more about the diversity, equity and inclusion work they are doing.

Challenges

As discussed in our Global Equity Observer (GEO), "Climate Change: Everyone's Business", our Carbon Transition Engagement Programme saw us meet with 95% of our global holdings in 2021 with the aim to ascertain our portfolios' resilience to a low-carbon future. We have continued this engagement programme in 2022, and as a new holding we wanted to establish where this company was on its **decarbonisation** journey. With the company having already set Scope 1 and 2 targets to be achieved by 2025, we wanted to determine its progress on achieving these, and whether they had identified any decarbonisation targets post-2025.

Diversity, equity, and inclusion (DE&I) is another area of increasing focus for our engagement activities. As outlined in our GEO "Diversity – Asking Difficult Questions", research has shown the positive impact a diverse workforce can have on a business' performance, and we are keen to learn how the companies we own are approaching DE&I in their business. The company had previously publicly acknowledged that they were not doing enough to drive change in DE&I. We were keen to learn where the company felt it could do better in terms of advancing DE&I, especially given the appointment of a Chief Commercial Diversity Officer.

Actions

Decarbonisation

We queried whether they would consider targeting net zero and science-based targets (SBTs) across Scope 1, 2 and 3 to signal a clearly defined pathway for carbon reduction and more closely align with the goals of the Paris Agreement. We also discussed renewables, stressing that power purchase agreements (PPAs) are preferable to renewable energy certificates (RECs), given that PPAs are a genuine offset mechanism that both reduce and/or avoid emissions and provide funding for incremental renewable projects. RECs on the other hand neither avoid nor reduce emissions. Finally, we questioned why, despite having management compensation tied to progress on DE&I objectives, the company didn't also have compensation-linked environmental goals.

DE&I

We also queried the lack of specific and measurable diversity targets which would enable shareholders to compare and measure the progress of the company's DE&I initiatives. We also emphasised the importance of conducting comprehensive pay equity and pay gap analysis, enquiring whether the company had completed any. Finally, we encouraged them to publish the employment data they have collected for their EEO-1 submission. Such data, while imperfect, serves as a useful indicator of a company's diversity and culture.

Outcomes

Decarbonisation

With regards to our questioning on SBTs and net zero commitments, we were pleased to hear that the company has engaged a management consultancy firm to work with them on a science-based net zero strategy which will include Scope 3. Once published, this will replace their existing 2025 targets.

Our query on environmental-linked compensation led to a long debate with the company; they argued that climate did not merit inclusion as it was not a main component of their materiality study. We countered this, making the point that given they take climate change seriously – as evidenced by working towards science-based net zero targets – acknowledging it in their incentive programme would both encourage progress and act as a method of accountability. We were pleased that the company took our argument on board, and we shall follow up on their progress at our next engagement.

DE&I

The company explained that the appointment of a Chief Diversity Officer was a signal of intent and seriousness. Nonetheless, intentions are not good enough if they are not supported by a coherent and executable strategy. Thus they have been working on strengthening their associate programmes and best practices, including disclosure, policies, and procedures.

Regarding their next steps on DE&I, the representation of women at more senior levels is an area of focus, especially in STEM roles, given the challenge posed by low female representation across the industry. Increasing the presence of underrepresented groups, such as Black and Latinx employees, was also identified as a priority by the company, who aim to push the diversity goals they have already accomplished at the board and executive level more widely throughout the organisation.

Our bringing up the subject of pay gap and employment data reporting was acknowledged. While the company does report pay gap analysis in the UK per the legal requirement, it does not do so elsewhere. They explained that reporting of employment data is under review and acknowledged that questioning and interest from investors helps to highlight its importance and encourage action.

A FAIR TRIAL

INTERNATIONAL EQUITY | INTERNATIONAL EQUITY PLUS
INTERNATIONAL RESILIENCE

AUTHOR

HELENA MILES
Senior Associate

We met with a British-Swedish biopharmaceutical company to learn more about their efforts in improving diversity in clinical trials and to encourage greater disclosure to investors. We also took the opportunity to discuss the company's decarbonisation plans as part of our ongoing carbon transition engagement programme.

E S G

DIVERSE & INCLUSIVE BUSINESS

DECARBONISATION

EXECUTIVE COMPENSATION

Challenges

Diversity in clinical trials

Clinical trial efficacy is, to a large extent, determined by the **diversity of the trial population**. Failure to effectively incorporate a suitable degree of diversity in population samples limits understanding of the safety and effectiveness of new drugs and therapies, leading to further entrench health disparities across populations. As an example, in the clinical trials conducted for new drugs approved by the U.S. Food and Drug Administration (FDA) in 2020, 75% of participants were white – yet 40% of the entire U.S. population is from ethnic minorities[3]. Meanwhile, research in 2014[4] uncovered that approximately 20% of new drugs approved in the six years prior demonstrated differences in exposure and response across racial and ethnic groups. A clinical trial is often the only way for a patient to gain access to the most advanced treatment, and so underrepresentation of certain populations may mean patients are locked out of potentially beneficial therapies for a long time.

If the goal is for better health outcomes across the board, this issue needs to be addressed. In 2020, the FDA published its final guidance on enhancing the diversity of clinical trial populations. We were interested to learn how the company's current trial recruitment process measures up to the regulatory guidance. This is a subject we have been engaging on with all of the pharmaceutical/pharmaceutical-related companies we own in our portfolios as we seek to get a fuller picture of the larger issue, and to enable us to compare and contrast the different approaches being utilised.

[3] US Food and Drug Administration 2020 drug trials snapshot. Summary report. https://www.fda.gov/media/145718/download

[4] Diversity in clinical trials: an opportunity and imperative for community engagement – The Lancet Gastroenterology & Hepatology

A clinical trial is often the only way for a patient to gain access to the most advanced treatment; underrepresentation of certain populations may mean patients are locked out of potentially beneficial therapies

Decarbonisation
The company has a very ambitious **carbon reduction plan** in place, aiming to eliminate Scope 1 and 2 emissions by 2025, and Scope 3 by 2045. They have science-based targets (SBTs) along the value chain, with the aim of encouraging 50-95% of suppliers (as measured by spend) to establish SBTs versus the 7% that currently do. The range is due to their intention that 50% of travel and transport suppliers have SBTs and 95% of purchased goods and services. We wanted to hear more about the company's general carbon reduction strategy.

Actions

Diversity in clinical trials
We questioned the company on their trial recruitment process, wanting to understand how they were currently approaching the issue, and any enhancements they intended to make in the future. In terms of measuring improvement, we queried whether any numerical targets had been set, and whether their intention was to share this data publicly.

Decarbonisation
We discussed RECs versus PPAs, and we made clear our preference for the use of PPAs. We were particularly interested to learn more about the company's Scope 3 reduction plans, as well as their ambitious target to have suppliers adopt SBTs. We consider company a leader in terms of their decarbonisation approach, and so were keen to hear more about their experiences in implementing their targets in the value chain and across suppliers – did it require a change in suppliers, for instance? Finally, we were pleased to see that the company currently captures Scope 1 and 2 reductions in the LTIP and wanted to encourage the company to include Scope 3 as well.

Outcomes

Diversity in clinical trials
The company shared that they currently measure diversity within each individual trial and, while they aim to improve diversity, they did not have quantitative targets tied to these plans. Their focus initially is on capturing the right data, and to that end they plan to roll out their new diversity measurement tool at the end of 2022. When pressed on what this tool would actually involve, the company explained that it would provide a geographical assessment of the makeup of clinical trial populations, with the aim of tracking progress on diversity within the trial populations. They believe that at this point it is difficult to set numerical targets for improvements in diversity without first capturing accurate data. We queried whether they intended to publish this data, and the company stated that there was the potential to do so. We strongly encouraged them to share the data publicly, emphasising that while we welcome their focus on improving diversity, without knowing the starting point it is difficult to appreciate any progress.

Decarbonisation
Scope 3 makes up 95% of the company's greenhouse gas emissions. They currently have 5,000 addressable suppliers; in 2022 they are focusing on the top 1,000 suppliers which represent most of their spend and footprint, and to whom they have already communicated their intent. They have been in touch with the first 250 of these, the majority of whom already have carbon targets in place. The company explained that rather than replace them, they would prefer to work with their current suppliers to help them embed sustainability within their own businesses. With all new contracts, sustainability forms part of the selection process. In terms of challenges to their Scope 3 reduction targets, the company acknowledged that as they progress through their "tiers" of suppliers those in the lower tiers may not have the targets they are looking for in place, but identified their main challenge as access to renewables within developing countries.

One of the purposes of our ESG engagements is to monitor and track progress to ensure the companies we hold are moving in the right direction. Not all engagements result in definitive outcomes , particularly when the company is already on track and progressing their ESG efforts as we would expect. In the case of this company and their decarbonisation targets, we felt they had a good appreciation of the challenges and are engaging with the relevant stakeholders to resolve any issues.

RISING TO THE CHALLENGE

GLOBAL FRANCHISE/BRANDS | GLOBAL QUALITY | GLOBAL SUSTAIN
AMERICAN RESILIENCE | INTERNATIONAL EQUITY PLUS

AUTHORS

RICHARD PERROTT
Executive Director

MARTE BORHAUG
Head of Sustainable Outcomes

As part of our ongoing decarbonisation engagement programme, we met with another new addition to the portfolio – one of the world's largest elevator manufacturers – to understand how they intend to address carbon emissions in their production and value chain. We also took this meeting as an opportunity to discuss the importance of gender diversity in their workforce and their executive compensation structure.

E S G

DECARBONISATION

PAY EQUITY

DIVERSE & INCLUSIVE BUSINESS

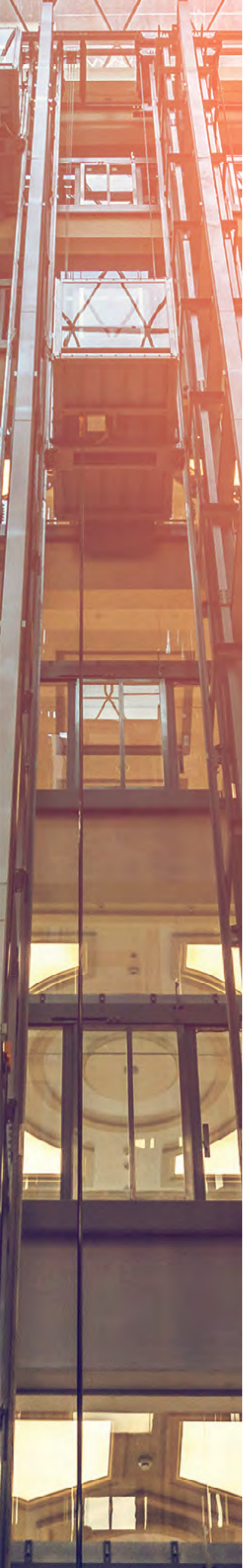
Challenges

Decarbonisation

With nearly 70% of the world's population expected to live in urban areas by 2050[5], cities are more important than ever in driving a sustainable future. Compared with other building operational systems including lighting, heating and cooling, commercial elevators pose a low environmental impact, consuming on average between 5 and 10% of a building's total energy use.[6] Nevertheless, they do play a role in increasing energy efficiency in buildings. According to the UN Environment Programme, the built environment's energy intensity – a measure of how much energy buildings use – must improve by 30% by 2030 to meet the goals of the Paris Climate Agreement.[7]

The elevator manufacturer we invest in is targeting a 50% reduction in **Scope 1 and 2 emissions** by 2030. Albeit a signal of good intent, it is neither net zero, nor science-based. Given that roughly half of the company's Scope 1 and 2 emissions originate directly from their own servicing fleet, we felt more could be done.[8] Regarding the use of renewables, the company's non-manufacturing locations are broadly distributed, making it difficult for them to establish a general renewable target for all firm-used electricity.

[5] https://www.un.org/development/desa/en/news/population/2018-revision-of-world-urbanization-prospects.html
[6] Why I stopped taking the lift | World Economic Forum (weforum.org)
[7] Global Status Report 2017 (worldgbc.org)
[8] OTIS ESG Report 2021 (otisinvestors.com)



Although our holding is yet to disclose its **Scope 3 emissions**, the company's closest competitor estimates their Scope 3 emissions to be 100 times larger than their Scope 1 and 2 emissions combined. Currently, the company has attributed the greatest usage of overall energy consumption to the usage phase and the extraction of raw materials in manufacturing. We wanted to know if and how the company was working to understand, measure and mitigate their Scope 3 emissions, and encourage them to set a target for Scope 3.

DE&I

On the topic of **diversity, equity, and inclusion (DE&I),** the protests against systemic racism in the U.S. prompted the company to strengthen their efforts by committing to an independent evaluation of their DE&I strategy in 2020. The review revealed some key areas for improvement, including greater gender diversity at all career levels, particularly among field workers. The evaluation also emphasised the need to enhance diversity reporting, eliminate bias from the talent lifecycle and implement more accountability through tying executive compensation to performance on social metrics.

Actions

Decarbonisation

We discussed how they plan to meet their Scope 1 and 2 emissions reduction target and encouraged them to consider making this net zero and science-based. The likely materiality of their upstream and downstream emissions meant we also pushed for improved disclosure on Scope 3 emissions.

DE&I

On the diversity side, we pressed for better disclosure on gender pay gap reporting and increased transparency on their explicit targets for fair hiring, especially since women account for just 12% of workforce positions at present.

Executive Compensation

Finally, we provided feedback on their executive compensation scheme, noting that while the bonus was well-structured, the long-term incentive plan (LTIP) was insufficiently performance-linked and the vesting period was too short. We also encouraged greater transparency on the inclusion of ESG metrics in the plan.

Outcomes

Decarbonisation

This engagement reassured us that the company is headed in the right direction. Given their ~20,000 fleet vehicles are responsible for approximately 50% of their Scope 1 and 2 emissions, they are targeting a fleet emissions reduction of 60% by 2030 largely through the adoption of electric vehicles. We understand the company's decision to stick to their own decarbonisation roadmap rather than abandoning efforts at this stage, but we were encouraged to hear that they are open to subsequently adopting net zero and science-based targets. For renewable energy, currently they have a factory-based target; we will continue to encourage more comprehensive renewable targets that include electricity use in non-manufacturing locations, especially since these are significantly larger than the factories.

The company is concentrating on improving reporting and deepening their understanding of their value chain emissions as it relates to Scope 3. Encouragingly, they have also begun laying the groundwork for better disclosure and informed us that they expect to report Scope 3 emissions in their next CDP report. In terms of reducing downstream emissions, the company is delving into the considerable opportunities that exist in energy-efficient elevators, for instance one of their elevators uses just 30 watts of energy on standby – in line with a domestic appliance. We will continue to encourage development in this space.

DE&I

Acknowledging as the first investors to bring up the topic of pay gap reporting in an engagement, the company was receptive to our questions. They explained that they conducted a global pay-gap analysis in 2021, however are yet to make it public. We urged them to do so, especially as they already disclose EEO-1 data, something we regularly ask of our holdings. On representation targets, the company is targeting gender parity in their executive ranks by 2030 and they believe this is achievable in time across their office-based white-collar roles. They recognise the male bias in field roles is an industry-wide issue requiring greater levels of collaboration to effect change, nonetheless, this has not prevented them from prioritising education, internship and apprentice programmes, and other hiring and retention efforts. We will continue to press for better transparency on hiring targets and initiatives.

Executive Compensation

Finally, we were pleased that the company was receptive to our feedback on their executive compensation scheme. They acknowledged our thorough review of their pay plan, and we offered additional time to discuss this topic with them. We will follow up to review their compensation changes in due course.

A QUESTION OF SOURCING

**GLOBAL FRANCHISE/BRANDS | GLOBAL QUALITY | GLOBAL SUSTAIN
AMERICAN RESILIENCE | INTERNATIONAL EQUITY PLUS**

AUTHORS

NATHAN WONG
Executive Director

VLADIMIR DEMINE
Head of ESG Research

We met with a sporting goods company we own to discuss supply chain issues following a shareholder proposal tabled at the 2021 company AGM and to discuss their decarbonisation targets.

E S G

DECARBONISATION

SUPPLY CHAIN MANAGEMENT

Challenges

Supply chain management

Many large global companies have to deal with various degrees of ESG-related risks outside of their direct control due to the **complex supply chains** they have created over the decades from outsourcing production and raw material sourcing, often to emerging markets with cheap labour. This has benefitted companies' bottom line and returns on capital, and enabled emerging countries to take advantage of the economic opportunities such moves offer. However, these same companies now have to deal with 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 infrastructure. Using our proprietary ESG scoring tool, the Material Risk Indicator (MRI), we identified sourcing practices and supply chain management as key ESG risks faced by some of the high quality consumer-facing companies in our portfolios.

The company in question was named as one of the well-known global brands whose suppliers allegedly used forced labour in their supply chain. Following this, a shareholder proposal was tabled, requesting that the company release a report on the human rights impact of its cotton sourcing practices.

Decarbonisation

As part of our ongoing carbon transition engagement programme we took the opportunity to engage with the company on their progress, as well as to learn more about how they intend to achieve the **net zero target** they have set.

Actions

Supply chain management

We voted in favour of the shareholder proposal, against management and ISS recommendations. ISS suggested voting against the shareholder proposal as they felt the company provided sufficient disclosure related to its human rights policies and sustainable sourcing practices, and that the company was not lagging its peers in terms of human rights disclosure. However we chose to support the proposal as we disagreed with the ISS assessment and believed it was important to apply pressure on a subject that posed a large supply chain risk and where information was scarce. We then engaged further on the subject with the company, pressing them for information on their cotton sourcing policy and any progress they had made on the traceability of the cotton they used.

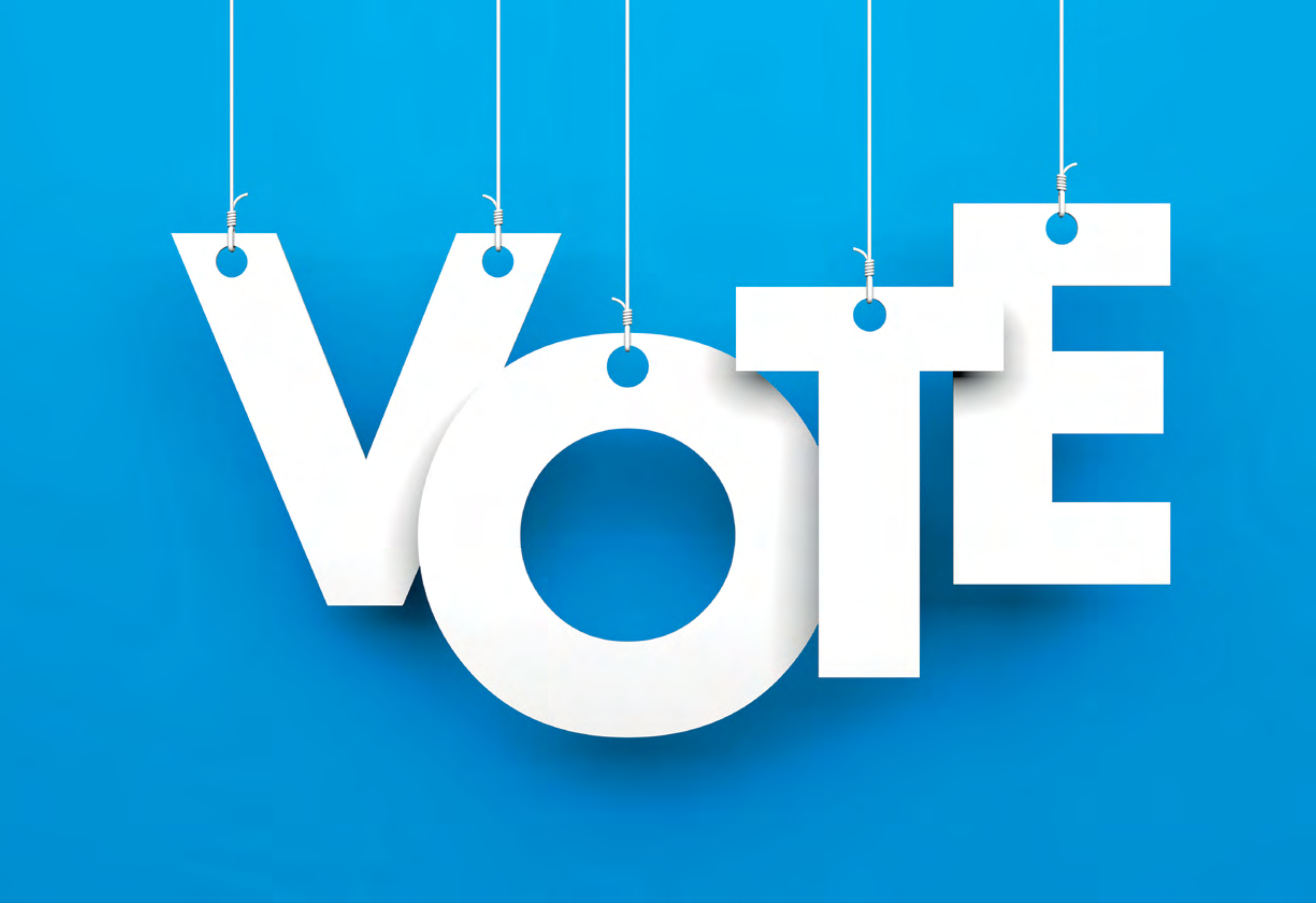
Carbon Targets
The company had already set Scope 1 and 2 targets to be achieved by 2025, so we wanted to know how they planned to make the significant leap to net-zero by 2050, and encouraged greater disclosure. We also queried whether they intended seeking SBTi validation for the various overlapping targets.

Outcomes

Supply chain management
The company stated their commitment to no sourcing from Xinjiang, and outlined the actions they had taken with their suppliers regarding sourcing. They shared that they were actively working on tools to verify suppliers' claims on sourcing, and had added two senior positions within the firm. We consider this evidence that the shareholder resolution on the social risks of cotton sourcing – despite not passing – has led to positive changes. We strongly encouraged the company to look into working with a sustainable cotton NGO that offers traceability tools and a company providing a new technology helping verify the origin of raw materials. We have continued to follow up on the subject of supply chain management with the company since this engagement.

Decarbonisation
The company confirmed that their 2030 target was SBTi validated. They highlighted their progress in the energy space, ranging from efficiency enhancements to increased commitment to renewables especially in south-east Asia where they are lobbying for more renewable PPAs (power purchase agreements) in China and Indonesia. We were pleased to hear of this progress but encouraged them to look at high quality nature-based solutions; without them we believe achieving Scope 3 neutrality would be difficult.

…outsourcing production and raw material sourcing may have benefited companies' bottom line and created significant economic opportunities for emerging countries, but these same companies must now deal with low visibility and little direct control over labour conditions



VOTING OVERVIEW

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 and never have.

Our voting seeks to be consistent with our assessment of the materiality of specific ESG issues 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. 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.

Given the second quarter sees the bulk of voting activity and AGMs, it's opportune to reflect on the last 12 months to 30 June. We are not afraid to disagree with management and third-party proxy advisers, such as ISS. During the 12-month period, we voted at 96 meetings (100% of all meetings held by our companies) and on 1,634 proposals (99% of all proposals). Overall, we voted against management in 9% of cases, and 68% of meetings had at least one vote against management.

DISPLAY 1

Proxy voting overview

(12 months from 01/07/2021 to 30/06/2022)

% total number of meetings held	96 (100%)
% total proposals voted	1634 (99% of all proposals)
% votes against management as a proportion of resolutions	9%
% meetings with at least one vote against management	68%

Source: ISS Proxy Exchange; MSIM

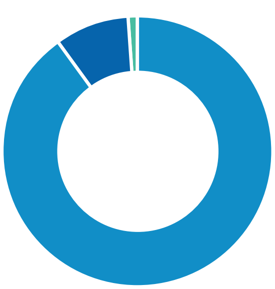
Common reasons for voting against management were related to compensation, election of directors and shareholder ESG proposals.

DISPLAY 2

Voting on 1634 proposals

(12 months from 01/07/2021 to 30/06/2022)

% by voting instruction

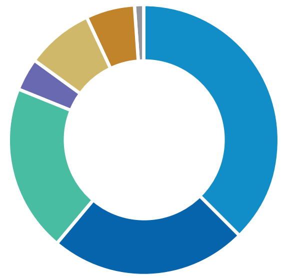


Source: ISS Proxy Exchange; MSIM

DISPLAY 3

% votes against management by topic

(12 months from 01/07/2021 to 30/06/2022)



Source: ISS Proxy Exchange; MSIM

Shareholder Resolutions

This voting season has been particularly active on ESG matters and several social-related proposals have attracted significant support for the first time, including those addressing racial equity, sexual harassment concerns and gender pay equity. Interestingly, majority support has been more muted this year, particularly for environmental proposals that were seen as too prescriptive.[9]

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 impact. Across our strategies, we saw 50 ESG-related shareholder proposals covering topics including climate change, diversity and employee and shareholder rights. Overall, we supported 62% of shareholder ESG proposals across our strategies, and voted against management in 56% of cases. There were also a number of resolutions relating to shareholder rights where, for example, we voted in favour of lowering the minimum ownership threshold to call a special meeting. We believe that lowering the threshold would enhance shareholder rights and allow important issues to be raised with management.

Beyond resolutions, executive pay remained a key focus. We voted against 26% 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 30 directors in the last 12 months.

[9] Source: FT. https://www.ft.com/content/48084b34-888a-48ff-8ff3-226f4e87af30

VOTING CASE STUDIES

Gender Pay Disparity

Over recent months, we have been encouraging greater gender pay gap (GPG) disclosure among our holdings through both our engagement and voting activities, given it serves as a useful indicator of a company's diversity and culture.

Today, one of the U.S.-based technology conglomerate we own reports the representation gap of various groups at different seniority levels within the firm. They also report 0% 'same pay for same work' gap. However, this does not address the gender pay disparity issue – underpromotion of women to senior, better paid jobs.

At the company's annual general meeting, we **voted in favour** of a shareholder proposal asking the company to report on their mean and median unadjusted pay gaps across race and gender. Apart from helping us meet the EU SFDR[10] requirements which requires this level of disclosure, the single unadjusted pay gap measure encapsulates the economic loss by the underrepresented groups in one number, which is a useful indicator. It also enables our portfolio managers to compare and measure the progress of the company's diversity and inclusion initiatives. This measure is supported by the UN, International Labour Organisation and the U.S. government.

DE&I Policies

Regarding diversity and inclusion policies, the protests against systemic racism in the U.S. have garnered international media attention, prompting the topic to become a major focus of stakeholders. We believe that for one of our U.S. Communication Services companies, a racial equity audit would help mitigate reputational, regulatory, legal and human capital risk, particularly in light of discrimination allegations that the company has faced.

We **voted in favour** of the shareholder proposal, urging the Board of Directors to commission a third-party, independent racial equity audit analysing the company's adverse impacts on Black, Indigenous and People of Color (BIPOC) communities. We believe that having a third party conduct this assessment would be particularly beneficial and instil confidence in the results.

Board Diversity

As part of our regular engagement with company managements on board diversity, we use our Diversity, Equity & Inclusion checklist as a tool to push for better data, greater transparency, aligned incentives and credible pathways for change. A U.S. Communication Services company we own has reached the minimum goal articulated by the 30% Club. Yet while the holding is not lagging U.S. peers in terms of board diversity, we felt that there was still room for improvement, given that the board's diversity is not yet reflective of the company's customer base (27% are women and 18% are underrepresented minorities, versus the demographic makeup of the U.S. at 51% women and 32% underrepresented minorities).

We **supported the shareholder proposal** asking the company to report annually on its policies and practices to help ensure the company's elected Board of Directors attains racial and gender representation that is better aligned with the demographics of its customers and intend to engage further with the company on this topic.

Say on Pay

Our long-term investment horizon encourages a close eye on incentive schemes that appear too short-term in their outlook. We are also alert to schemes that award high pay for ordinary or even poor performance.

At the annual general meeting of a European multinational software company owned in our global portfolios, we **voted against the company's remuneration plan** due to the inclusion of non-IFRS[11] earnings, the short vesting period, and an insufficient degree of performance-based targets. While the company had moved away from rewards being cash settled to shares, we were not convinced this was sufficient to warrant a 'for' vote, given aspects of the plan could detract from long-term shareholder value.

[10] Sustainable Finance Disclosure Regulation
[11] International Financial Reporting Standards

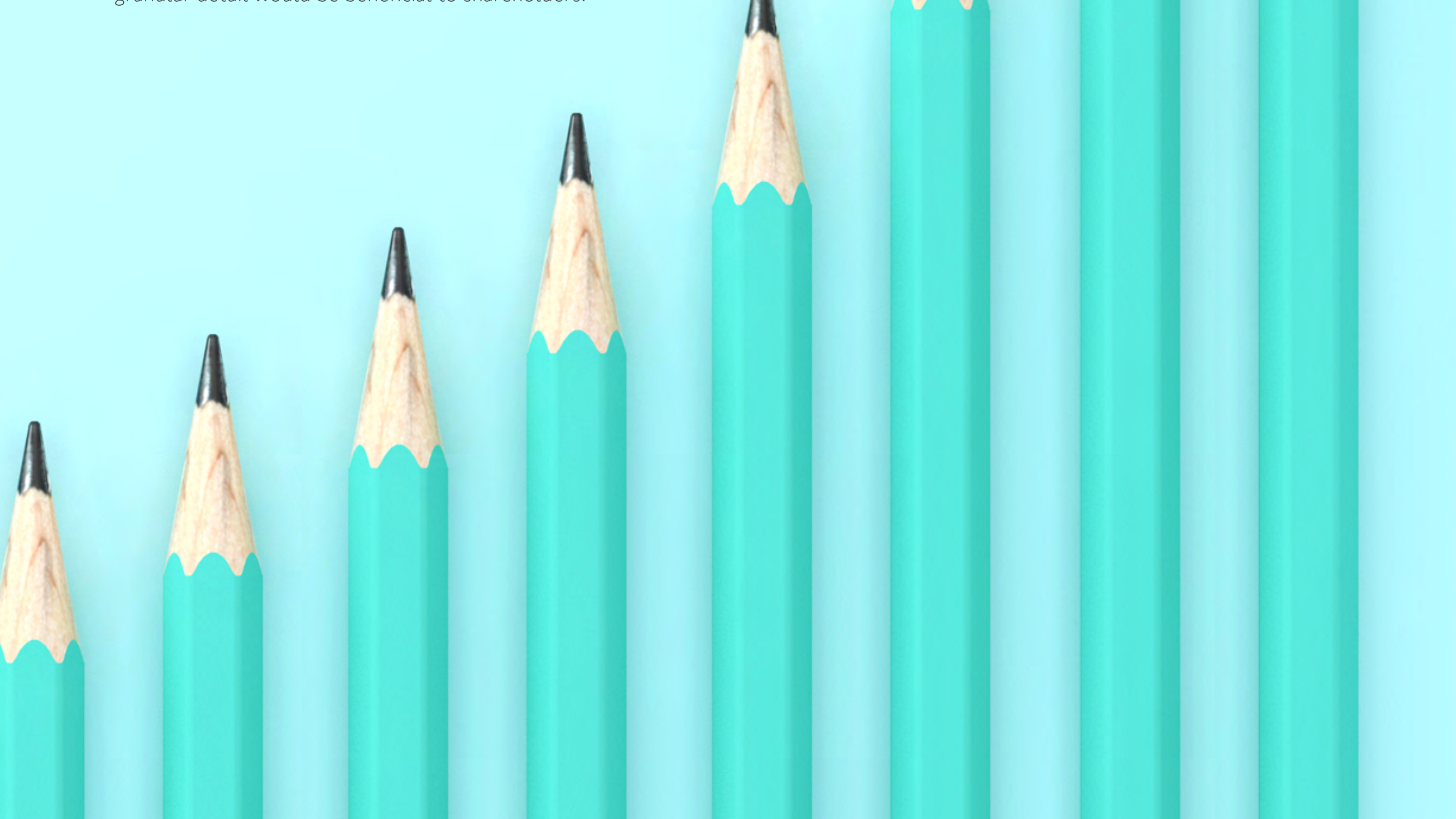
Decarbonisation

As detailed in our January Global Equity Observer, “Climate Change: Everyone’s Business”, we have been conducting an ongoing carbon transition engagement programme, aiming to understand the climate profiles of the companies we own, and encourage progress. This could involve seeking better transparency and accountability, challenging well-meant targets that lack credible pathways or, for those already on the right track in terms of disclosure, targets and actions, engagements are used to track performance and encourage continued leadership. We also use voting to reinforce their support of the companies in their portfolios taking positive actions in relation to climate change.

A multinational technology conglomerate we own received a number of shareholder resolutions for its 2022 AGM. Two of these proposals were climate related: one requesting the company report on climate lobbying and another requesting the company produce a report on physical risks of climate change.

The **company advocated a vote against the proposal** requesting a report on climate lobbying, arguing that its comprehensive lobbying disclosures provide shareholders with all necessary information to understand the scope of the company’s lobbying activities. However, while the company publicly supports the Paris Agreement, and discloses a list of its memberships of trade associations and policy-focused non-profits, it doesn’t disclose sufficient information as to how it ensures lobbying proposals (both directly and indirectly via these groups) align with the Paris Agreement’s aims. Particularly concerning are industry and policy groups that represent businesses but present obstacles that impede global emissions reductions. A review of the company’s disclosed memberships reveals inconsistencies with the company’s actions on, and commitments to, the Paris Agreement. We therefore **chose to vote in favour of the proposal**.

The **company** also **recommended a vote against** the second climate related proposal, which requested that it publish a regular assessment on its resilience to the physical risks of climate change, including the measures the company is taking to mitigate these risks. The company argued that given the existing environmental and climate change reporting it already produces, such an assessment would not be a good use of company resources. However, while the company discloses the physical risks it has identified, it doesn’t provide much disclosure in terms of its adaptive planning in relation to these risks. **We chose to vote in favour** of this proposal, believing that more granular detail would be beneficial to shareholders.



THE INTERNATIONAL EQUITY TEAM

INVESTMENT TEAM

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Head of the International Equity Team

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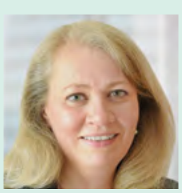

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