



Morgan Stanley

INVESTMENT MANAGEMENT

Engage

SPRING 2022

ENGAGEMENT REPORT

International Equity Team

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

02

ENGAGEMENT
IS OUR EDGE

04

FIND, FIX,
PREVENT

06

THAT'S
THE SPIRIT

08

TWO STEPS
FORWARD

10

SCENTING
CHANGE

12

YOU CAN'T
MANAGE WHAT YOU
CAN'T MEASURE

14

TURNING UP THE HEAT
ON FINANCED
EMISSIONS

16

VOTING
OVERVIEW

2021 IN NUMBERS

51%

of engagements
included discussions
on ESG-related topics¹

94%

of our holdings
engaged across all
strategies

100%

of meetings voted
across all strategies

62%

of meetings with at
least one vote against
management

29%

of votes on say-on-
pay proposals against
management

6%

of votes against ISS
recommendations

¹The 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.



**MARTE
BORHAUG**

Head of Sustainable Outcomes, International Equity Team

Welcome to the latest edition of *Engage*, our team’s bi-annual report that reflects on key engagement and voting activities which took place over recent months.

Although most clients want and value strong stewardship, a question I am regularly asked by clients is how best to assess whether asset managers do it well. There is no standardised way to report on engagement and voting, but having worked in sustainability for over a decade, my experience is that clients value three things. Firstly, they care less about absolute numbers and want to understand the breadth of engagement: is it taking place across the whole portfolio? Secondly, they want to see depth and quality in the engagement, not just letter sending and ad hoc campaigns. Finally, they want evidence of outcomes.

In this report, we seek to demonstrate how we deliver on these three criteria. Thanks to our team’s approach – managing concentrated portfolios for the long term – we have the luxury of engaging with companies across the whole portfolio rather than focussing on only a few names, as many of our peers do. Few managers in the industry could claim that they engage with more than 50% of fund holdings, let alone close to 100%. Last year, our team engaged with 94% of the companies we hold across all our strategies. Our engagements are also done by our investment team members speaking to company management directly; holding an ongoing and consistent dialogue with firms to ensure management are held accountable on a regular basis. Rather than just ad hoc initiatives or campaigns that jump on the latest ESG trend, our engagement is holistic and considers the relevant long-term material E, S and G issues for the company in question.

In terms of outcomes, as a team we want to be more transparent about the outcomes we are seeking and delivering. We recognise the challenges in assessing and reporting on impact: besides the lack of industry standards on what is considered an ‘outcome’, it is also difficult to prove the impact investors have given the many stakeholders and pressure points companies face. For example, the transition to a low carbon economy is being navigated through government policy, regulatory scrutiny, consumer choices and employee preferences. No public market investor could credibly claim that their engagement singlehandedly changed a company’s trajectory. But while the industry works towards better, more transparent frameworks, we don’t want to wait. We have therefore adopted a new format in this report to be clearer about both the purpose and outcome of our engagements. I am particularly pleased to share examples of outcomes from our carbon transition engagement programme and the tremendous momentum we have seen from our global holdings to reduce their emissions and prepare their businesses for a low carbon future.

As bottom-up stock pickers, and with my role as Head of Sustainable Outcomes for the International Equity team, we’re determined to keep seeking better outcomes, to learn and improve our offering to you and to keep pressing for progress from the world’s best companies.

As always, we invite you to engage with us.

Sustainably,

Marte Borhaug

Few managers in the industry could claim that they engage with more than 50% of fund holdings, let alone close to 100%. Last year, our team engaged with 94% of the companies we hold across all our strategies.



ENGAGEMENT IS OUR EDGE

We have engaged directly with companies on issues material to the sustainability of returns 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 material ESG topics and influence companies towards better practices.

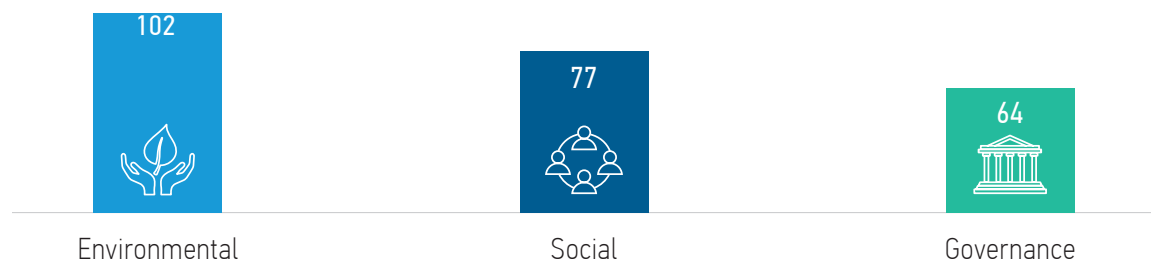
We seek to deliver better outcomes for our clients through producing attractive returns over the long term. To do this, we must invest with a conscious eye on whether companies can deliver better outcomes not just today, but 5, 10, and even 20 years from now. We back companies that have the characteristics 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 impact. Direct, portfolio manager-led engagement is, in our view, vital to understanding whether companies and management can deliver in these areas.

We prioritise our engagement and voting efforts based on what we believe are the most material long-term issues facing our companies. In the second half of 2021, we continued to engage with company management on a range of ESG themes, including decarbonisation, biodiversity, the circular economy, executive pay, and supply chain management, amongst others.² Throughout 2021, 51% of our engagements with company management included discussions on ESG-related topics (143 of 280 meetings).

Our holistic approach means we typically engage with companies on more than one topic in any given meeting. Environmental topics featured in 71% of our ESG engagements, while social and governance topics presented in 54% and 45% of engagements respectively.

DISPLAY 1

Number of engagements where we discussed ESG-related topics, FY 2021^{3,4}

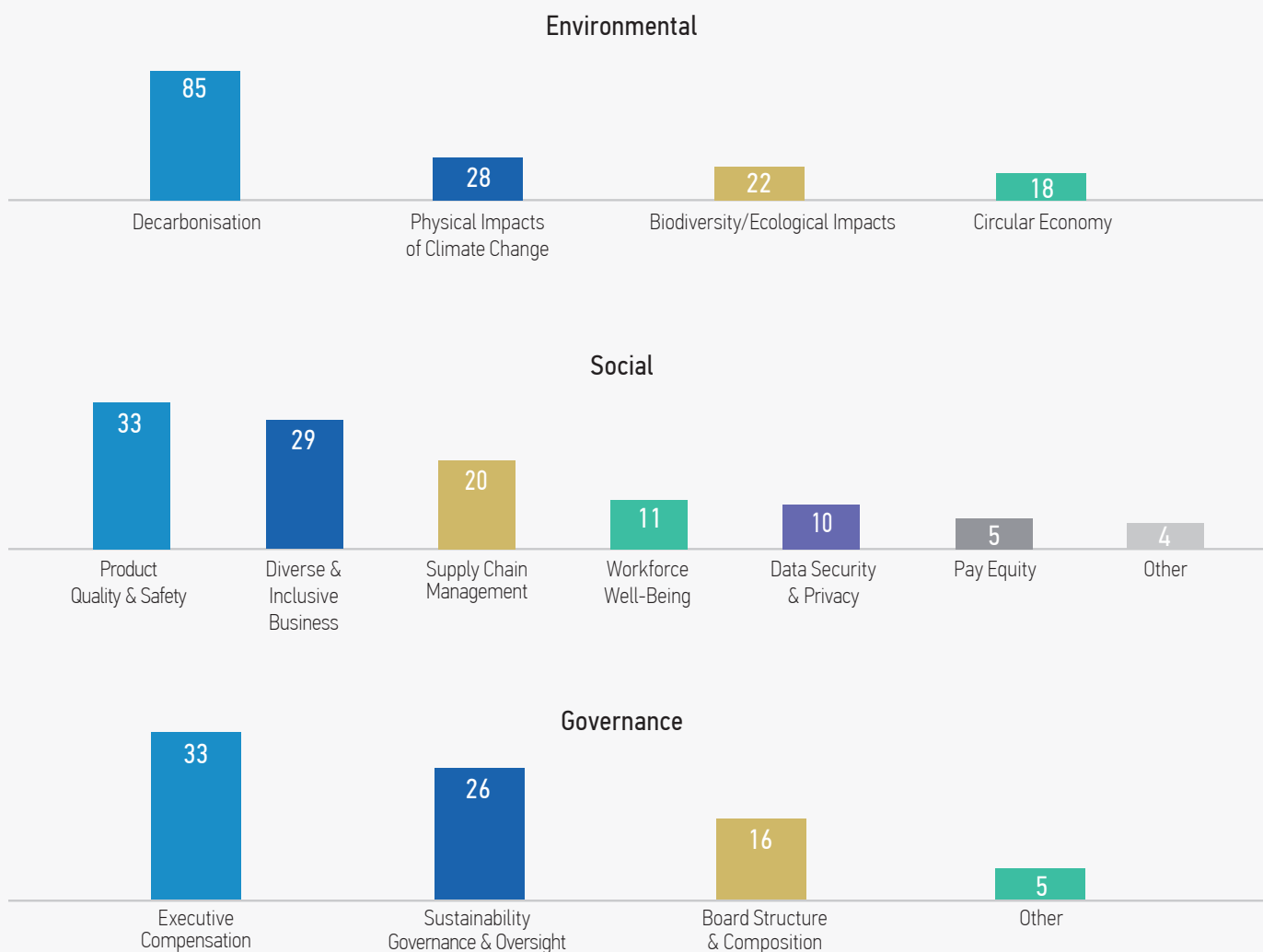




DISPLAY 2

Topics addressed during our engagements, full year 2021^{3,4}

Number of ESG-related topics discussed



² Read our January 2022 Global Equity Observer, [Climate Change: Everyone's Business](#) for more information on our carbon transition engagement programme.

³ Data shown is for the 12-month period from 1 January 2021 to 31 December 2021.

⁴ 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.



FIND, FIX, PREVENT

INTERNATIONAL EQUITY | INTERNATIONAL EQUITY PLUS

We met with one of our **global consumer staples** holdings to explore further their ambitious sustainability plan, which includes multiple environmental and social targets. We wanted to understand how the company intends to improve garment recyclability and labour conditions in the supply chain, and how they are engaging with their supply and value chain to encourage sustainable practices.

Challenges

The apparel industry has a significant environmental impact. Estimated to be responsible for 8% of global greenhouse gas emissions, it is also highly water intensive – making a single t-shirt requires up to 2,700 litres of water. Globally, only 1% of clothing is currently recycled, putting pressure on brands to find ways to make their products more circular. In addition, fashion retailers face a variety of social risks outside their direct control. The implications of complex supply chains, created over decades, must now be dealt with, including low visibility and little direct control over labour conditions in places with lower levels of regulatory focus on labour rights or social infrastructure.

The high profile companies we own within the sector are focused on monitoring and remediating incidents, however the complexity and scale of their supply chains means they can still happen. During our engagements, we focus not only on the strength of companies' monitoring and remediation practices but also on the ways they can contribute to the long-term improvement of their supply chains to minimise the occurrence of these risks, both environmental and social, in the first place – a combination we call 'find, fix, prevent'.



BIODIVERSITY/
ECOLOGICAL IMPACTS



CIRCULAR ECONOMY



SUPPLY CHAIN
MANAGEMENT



**NIC
SOCHOVSKY**

Managing
Director



**VLADIMIR
DEMINE**

Head of ESG
Research

“We focus not only on the strength of companies’ monitoring and remediation practices but also on the ways they can contribute to the long-term improvement of their supply chains to minimise the occurrence of these risks, both environmental and social, in the first place – a combination we call ‘find, fix, prevent’.

We continued our engagement with a British multinational food processing and retailing conglomerate that owns one of the largest global fashion retailers. The company’s production is outsourced to third-party factories, so our focus was on testing what practical levers the company is using to encourage suppliers to work towards its targets, and understanding the implications for company costs. In terms of attempting to make fashion more circular, the company is progressively using more recycled polyester and incorporating recyclability in garment design by removing blended fabrics or elements such as metal rivets, both of which prevent garments from being recycled.

Actions

The main aim of our engagement was to dive deeper into the fashion retailer’s **sustainability programme**, which includes multiple ambitious targets across both the environmental and social pillars. We also revisited how the retailer monitors **labour conditions** at suppliers’ factories. Finally, we raised concerns over the lack of robust company-wide **water use reduction targets**. Although there are initiatives in place – for example gradually switching to drip irrigation should reduce water consumption by up to 40% in their water-intensive sugar business – we would like the company to do more. We encouraged them to commit to more ambitious reduction targets.

Outcomes

We were pleased to hear that the company will be including more environmental and social metrics in their supplier scorecards, rewarding better performers with higher volume and visibility of orders. This should increase these factories’ capacity utilisation and profits, without needing to raise prices to offset the higher costs of living wages or more durable materials. In terms of circular fashion, while the company is aiming to increase the recycled and sustainable fabric content of their clothing, as well as increasing its recyclability overall, there are still significant technical and infrastructure challenges to scaling actual garment-to-garment recycling. On the social side, having piloted a worker grievance feedback tool, which uses an app to enable workers to give direct feedback, they have now rolled it out to all factories.

The engagement confirmed our existing view that the company’s sustainability plan is one of the most detailed and transparent in the industry, which is part of our ESG assessment of the company. Given the significant footprint of their supply chain, we understand that progress will take time. However, the company’s strong relationships with factories and commercial leverage should help them achieve much needed positive change. We will continue to engage to monitor progress and encourage more action on garment recycling and water use.

“The engagement confirmed our existing view that the company’s sustainability plan is one of the most detailed and transparent in the industry...the company’s strong relationships with factories and commercial leverage should help them achieve much needed positive change.

THAT'S THE SPIRIT

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

PORTFOLIO
MANAGER



**NIC
SOCHOVSKY**

Managing
Director

We engaged with one of the world's largest wine and spirits sellers to encourage greater ethnic diversity on its board, and the inclusion of ESG metrics into executive pay.

Challenges

A French beverage company that we invest in operates globally – but its board was composed entirely of white Europeans. We were concerned about this as we believed they risked missing out on the insight and experience a more diverse board could offer to the business.

The current lack of **diversity** in senior business roles across industries not only has an obvious negative impact on human capital development for those individuals who are underrepresented, but also poses a financial risk. Evidence shows companies that are more diverse at the top outperform those that aren't. Indeed, research has found that more diverse companies are better at innovating, attracting and retaining talent and managing governance risk. Given this particular company's global scope, it would seem to make sense to have board members with the knowledge and cultural experience of non-European markets.

On the topic of governance, our team has always paid close attention to **executive compensation** and engaged with companies to encourage improvements in remuneration practices. We would argue that for the types of high quality companies held in our portfolios, disciplined management is perhaps even more important than for other companies, given they have more degrees of freedom to make poor decisions when overseeing strong cash flow and intangible assets. Decisions made today, for better or worse, can influence returns on capital for years to come. We believe that having the right metrics and structure in place is crucial to help avoid short-termism and to incentivise disciplined investment by the C-suite.

“Owning companies for the long term – which we aim to do – brings a clear advantage given the opportunity for ongoing and regular engagement with management over the lifetime of the holding period.”



Actions

Owning companies for the long term – which we aim to do – brings a clear advantage given the opportunity for ongoing and regular engagement with management over the lifetime of the holding period. It allows us to be heard, to bring our view to the table and to lay the groundwork for change where we believe it is required.

We have been raising board diversity with the company for a while and continued to do so during our engagements in 2021. At later engagements during the year, we also pursued the company's hiring process, both when appointing new board members and at the group level.

In addition, we've been seeking changes to the company's executive compensation structure, with reservations regarding their use of options in their long-term incentive plan (LTIP) and questions around the lack of measurable ESG metrics for key performance indicators (KPIs).

Outcomes

As our engagements progressed, we learned that processes had been put in place to address the company's diversity issue. In November 2021, we were pleased with the appointment of a female board member of Indian heritage who brings business experience from Australia and Asia, including Malaysia and Myanmar. While we recognise that the company still has further to go, we are encouraged to see that a start has been made, and consider the board appointment a successful outcome. We will continue to engage with the company, following our diversity, equity and inclusion (DE&I) checklist, pushing for data, better transparency and credible pathways for change.

To our delight, following a review, the latest pay policy/plan published in November 2021 shows that the LTIP is now 100% performance-based shares – i.e., the options have gone – thereby incentivising long-term performance over short-term shenanigans. The company has also set measurable targets for carbon, water, diversity, and responsible consumption, enabling management to be held accountable to ESG-related targets, something that we welcome.

Examples of gender-focused questions from our DE&I checklist

- Has the company conducted a comprehensive pay equity and pay gap analysis?
- Does management align DE&I with Executive Compensation. If not, why not?
- Does the company have a hiring policy requiring a gender diverse slate of candidates for all leadership positions (e.g., 30% must be female)?
- Does the company have a hiring policy ensuring candidates are not required to disclose past pay information?
- Does the company have processes in place to ensure job descriptions are gender-neutral?
- Does the company regularly train recruitment professionals and interviewers to focus on more inclusive recruitment efforts?
- Does the company actively develop female talent through a leadership development programme or equivalent?
- Does the company provide sufficient flexible working and parental leave to both parents?
- Does the company use employee engagement surveys, and with what frequency?
- Does the company offer a 'Returnship' programme for females following a career break? What is the return rate from parental leave?
- US companies: Is Equal Employment Opportunity (EEO-1) representation data disclosed? If not, why not?



BOARD STRUCTURE & COMPOSITION



EXECUTIVE COMPENSATION



SUSTAINABILITY GOVERNANCE & OVERSIGHT

TWO STEPS FORWARD...

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

“We are glad to see the company significantly stepping up their carbon ambitions by adopting more stretching reduction targets.”

PORTFOLIO MANAGERS



MARCUS WATSON

Managing Director



MARTE BORHAUG

Head of Sustainable Outcomes

0.9% Sodium Chloride Injection USP
50 mL Partial F
in 100 mL Cont

NDC
REF

Each mL contains: Sodium Chloride USP 9 mg; Water for Injection
pH adjusted with Hydrochloric Acid NF
pH: 5.5 (4.5-7.0)
Electrolytes (mEq/50 mL): Sodium 7.7 Chloride 7.7
Calc. Osmolarity: 310 mOsmol/lit

Sterile, nonpyrogenic. Single dose container. For intravenous use only if solution is clear and container and seals are intact.

WARNING: Some additives may be incompatible. Consult with pharmacist. When introducing additives, use aseptic technique. Mix thoroughly. Do not store.

Recommended Storage: Room temperature (25°C). Avoid excessive heat. See Package Insert.

Not made with natural rubber latex, PVC or DEHP.



DECARBONISATION



CIRCULAR ECONOMY



DIVERSITY & INCLUSION



PAY EQUITY



SUSTAINABILITY GOVERNANCE & OVERSIGHT

We continued our conversation with one of our **U.S. health care** holdings, specialists in the production of IV fluids, to better understand how they were managing key ESG risks around decarbonisation, the circular economy, and DE&I.

Challenges

When it comes to **decarbonisation**, we believe tackling climate change is not only the right thing to do but also makes business sense. As investors, evaluating corporate carbon emissions risk is fundamental to our security analysis and stock selection. It is also recognised by our team as a top engagement priority. We were pleased that the company had set carbon reduction targets and wanted to better understand the actions they were taking to achieve them. We were also keen to know why no Scope 3 targets had been set.

Beyond carbon, **plastic pollution** is a serious and increasingly material environmental consideration for companies operating in the health care sector. COVID-19 has reinforced the notion that both single-use protective equipment and single-use medical equipment are safer, resulting in an estimated eight million tons of pandemic-associated plastic waste globally.⁵ Compounding the problem is that current recycling initiatives are expensive, particularly in hospitals inside the U.S. where the volume of waste is higher and the knowledge of recycling generally lower, meaning hospitals and end users tend to throw plastic away. Whilst the firm has programmes in place to tackle plastic waste, we felt the lack of disclosure around progress was making it difficult for us as an investor to assess the outcome of their actions.

Finally, the topic of **diversity, equity and inclusion (DE&I)** has typically been an area where the lack of measurement has resulted in a lack of decisive action. However, increasing focus by stakeholders on companies' diversity efforts has raised the bar, with heightened expectations for specific targets, concrete action plans, and demonstrable improvement. This holding missed its previously set diversity targets and the number of women and ethnic minorities in leadership positions has been decreasing. We were keen to explore actions they were taking to ensure they would meet their new targets. We also wanted to ask the firm to take action around equal pay. It is no secret that men are, on average, paid more than women: the World Economic Forum estimates that globally, the gender pay gap (GPG) sits at around 37% and the income gap (the ratio of the total wage and non-wage income of women to that of men) remains close to 51%.⁶ Even in advanced markets, deep-rooted labour market and workplace inequalities result in persistent income gaps (e.g. 35% in the U.S.). We wanted to better understand the situation in the company and encourage greater GPG disclosure.

Actions

We were pleased to see that at the start of 2021, the company committed to achieve carbon neutrality for their direct operations by 2040 and reduce absolute Scope 1 and 2 greenhouse gas emissions by 25% by 2030 (from a 2020 baseline). We welcomed

this but encouraged them to increase the target to align with the Paris Agreement, which would require a close to 50% reduction, and to ensure that this is independently approved by the Science Based Target Initiative (SBTi). We also asked about the actions they were taking to deliver on their targets.

We moved on to discuss formal reduction targets for Scope 3 and were encouraged to see that the company is already taking some action in this space. They have been reviewing their suppliers' sustainability data and ranking them accordingly and, while this programme is in its infancy, they are confident that differentiating suppliers based on sustainability will encourage positive action. The company is also implementing supplier responsibility audits, which should help. We will continue to monitor progress, including the setting of a Scope 3 target.

In a previous meeting we had raised the issue of plastics and encouraged the company to take steps to tackle plastic waste in their supply chain. In this meeting, we pushed them to disclose total plastic use so that stakeholders can better assess the impact of the company's circular efforts.

Given the company had missed previous DE&I targets, in this meeting we were keen to emphasise our support of their new targets, stressing the importance of better data collection and reporting in addition to practical policies which would spur progress. We also encouraged them to publish the GPG for their entire workforce, given they already report figures for their UK entity. We believe that while the GPG can be influenced by local labour market conditions (e.g., statutory parental leave and living wage entitlement), it serves as a useful indicator of a company's diversity and culture.

Outcomes

We are glad to see the company significantly stepping up their carbon ambitions by adopting more stretching reduction targets. To make the reductions in their own operations, they explained that they intend to use purchase power agreements and renewable energy certificates. For their upstream emissions, we suggested that electrifying their manufacturing base, which currently uses gas, may help them to meet their targets. The company confirmed that this is under consideration, something we will monitor.

On plastic, we were pleased to find out that the company is planning to recycle more in its own factories and is in the early stages of working with hospitals to collect empty Polyvinyl Chloride (PVC) bags and other packaging for recycling. We were particularly encouraged to see action being taken given that the company had previously told us they do not have enough leverage in the market to make a difference. The engagement demonstrated how the company has, despite initial hesitation, begun to implement circular economy initiatives more effectively across their business – something we welcome and will continue to monitor.

We will also continue to press for greater action to deliver on DE&I targets. We were happy to see the company engaging with us on the topic of the GPG, questioning us on why we think it is a useful and relevant data point. We hope that our explanation encourages better disclosure both on the GPG and other DE&I-related metrics.

⁵ Yiming Peng et al. 'Plastic waste release caused by COVID-19 and its fate in the global ocean', PNAS, Vol.118, No.47, 2021. <https://www.pnas.org/doi/10.1073/pnas.2111530118>.

⁶ World Economic Forum, Global Gender Gap Report 2021, Geneva, 2021.

SCENTING CHANGE

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

PORTFOLIO
MANAGER



**VLADIMIR
DEMINE**
Head of ESG
Research

We engaged with one of **the world's largest prestige beauty companies** to check in on their decarbonisation progress, as well as to discuss the importance of innovation in sustainable sourcing and the circular economy.

Challenges

As a team, we engage with our holdings for a variety of reasons, notably to raise issues we have specific concerns about or to effect change. But our engagements may also form part of our regular dialogue with a company, an ongoing conversation with the objective of checking that they are still moving in the right direction. Doing so helps us reaffirm our views of how well a company is managing the key ESG risks and opportunities they have identified, and how they correspond with those we have pinpointed using our Material Risk Indicator. Our engagement with this luxury beauty brand is a good example of this.

The reduction of **greenhouse gas emissions** is a topic we have engaged on extensively, including with holdings that are leading the way – this company has already reached 100% renewable energy use in the U.S., even selling excess power during the Texas blackout. However, we wanted to learn more about their plan for tackling Scope 3 emissions, which can be a significant proportion of companies' total carbon footprint. In addition, with the company's biggest suppliers recognised as leaders in speciality ingredients and fragrances, and their own ESG teams driving innovation in **sustainable ingredients**, we sought to explore the potential cost implications involved. Finally, we wanted to follow up on how the company is progressing on the challenge of removing **plastics** in their packaging.

Actions

We met the company in October as part of our regular dialogue. The objective was to keep up to date with the company's progress and encourage its continuation. Engagements such as these help us reaffirm our assumptions about a company and its management's commitment to sustainability. It also provides us with a benchmark for other companies we may own or be researching, as an example of what is possible to achieve.

Outcomes

The information we received in the meeting confirmed that the company continues to be managing its key ESG risks and meeting associated targets, while taking additional positive steps that reinforce its status, in our opinion, as an ESG leader.

On decarbonisation, based on unit of revenue, the company shared that their target is a 60% cut in Scope 3 emissions. Of course, to achieve this they must work in partnership with their supply chain, and so all of their key suppliers need to report and align with CDP disclosure practices (CDP is a not-for-profit charity that runs the global disclosure system for companies and others to manage their environmental impacts). Good carbon practice is the price of doing business with them.

We were glad to hear that it isn't just on matters of climate change that the company seeks to raise the standards of its suppliers. When it comes to sustainable ingredients and materials, rather than just cherry pick suppliers that represent today's leaders, the company seeks to encourage improvement in all of their suppliers. When making procurement decisions, sustainability attributes and needs are built into the process. Sustainable sourcing can come with premium costs, but this is where pricing power comes into its own; owing to the company's leadership and scale in luxury, it is able to pass such costs on to the consumer, something more challenging for those operating in the mass market. Consumers trust the company to deliver the best beauty performance, safely and sustainably.

Questioned on the use of plastics in packaging, the company shared that they are targeting 75-100% recyclable packaging by 2025, plus increasing their use of recycled or reuseable plastic in packaging by 66% in the same time period. They are using their size and status as leverage to drive change with their suppliers, citing as an example a partnership they have with a supplier which will see them working together to use molecular recycling technologies and Renew resin portfolio (with up to 100% certified recycled content) to develop packaging materials.

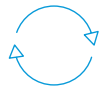
We were also pleased to use our engagement as an opportunity to congratulate the company on winning a leadership award at RE100 – a global initiative bringing together the world's most influential businesses committed to 100% renewable electricity. The company won for their approach to sourcing renewable electricity for 50% of their power by the installation of an onsite 5-megawatt solar array and investment in wind power. Engagement is not only about challenge, but welcoming and celebrating positive change when it happens.



BIODIVERSITY/
ECOLOGICAL IMPACTS



DECARBONISATION



CIRCULAR ECONOMY



When it comes to sustainable ingredients and materials, rather than just cherry pick suppliers that represent today's leaders, the company seeks to encourage improvement in all of their suppliers.

YOU CAN'T MANAGE WHAT YOU CAN'T MEASURE

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

PORTFOLIO
MANAGER



**BRUNO
PAULSON**

Managing
Director

As part of our carbon transition engagement programme, we engaged with one of our holdings, a **multinational consumer credit reporting company**, on decarbonisation and emissions reporting. We also discussed the incorporation of ESG targets in remuneration.



Challenges

This company is a good example of those of our holdings that are further along in their **carbon emissions reduction** journey, with science-based carbon reduction targets that are independently verified by the science-based targets initiative, commitment to align to TCFD (Taskforce on Climate-related Financial Disclosures), and a plan to reduce their direct and indirect emissions from activities under their control (Scope 1 and 2 emissions) by 50% by the end of the decade. It really seems to tick all the boxes. However, with targets in place already, our role as an investor changes from encouragement towards monitoring, implementation, and execution. Although their emissions are relatively small, we used our engagement to understand how they plan to achieve their targets and how they intend to tackle their upstream and downstream emissions, given that those 'indirect' emissions (Scope 3) are considerably greater than those of Scope 1 and 2.

Currently, only 34% of electricity used comes from renewable sources. The U.S. and UK represent about 80% of their total energy usage, and while the UK gets around two thirds of its electricity from renewables, the U.S. is lagging at only 20%. With the UK being the easy win, the challenge is in the U.S. and emerging markets. Here, infrastructure is less developed, suppliers are less engaged with renewables and for the U.S., there's the added complexity that energy supply is largely determined at the federal and state level. How can renewable energy usage be improved? We also queried the company's data storage facilities in Texas given very hot summers and harsh winters. We argued that, given their strategy TCFD risk matrix identifies rising energy costs from increased cooling and heating demand as their most significant risk, Texas-based data centres and storage appears counterintuitive.

The impact of an almost entirely office driven workforce being forced to work from home due to the COVID-19 pandemic resulted in a sharp decline in the company's electricity use, but it also prompted another challenge: how should home emissions be measured – Scope 1 or Scope 3?

The outcome we were seeking was evidence of progress that the firm is on track to meet their targets.



DECARBONISATION



PHYSICAL
IMPACTS OF
CLIMATE CHANGE



EXECUTIVE
COMPENSATION

Actions

We began our engagement looking at the company's Scope 1 and 2 emissions and discussing how they were approaching Scope 3 emissions. Given the company's focus on decarbonisation, we then moved on to enquire why environmental or social metrics aren't included in executive compensation targets.

Outcomes

Acknowledging our engagement as the most in-depth and detailed meeting on decarbonisation they have experienced, the company was receptive to our questions and suggestions. To meet the challenge of improving renewable energy sourcing in the U.S. and in emerging markets, the company outlined their proposed solutions. We were pleased to hear that these lie in their own efforts; actions such as the installation of solar roofs and the use of purchase power agreements should help them achieve a swift switch to renewable sourcing in the next five years.

In terms of Scope 1 and 2 emissions, they explained that data centres and storage constitute a meaningful amount, with their three main centres in the UK and U.S. accounting for 44% of total emissions. Of this, 40% is down to cooling. Regarding the use of data centres in Texas, the company informed us that they are actively considering their strategy here, something we will continue to question in future engagements.

In terms of Scope 3 emissions, the company explained that around 80% comes from their top 20 suppliers (mostly due to ancillary services). They outlined for us the comprehensive engagement programme they have already undertaken with these suppliers to assess their carbon position and how they plan to work with them to reduce their footprint. They are also partnering with a third party supplier to enhance the process. We questioned whether this enhancement had led them to consider their future relationship with any suppliers. At this time it has not, given the project is still in its infancy and remains focussed on gathering adequate data to enable the company to make informed decisions.

On the topic of remote working, the company shared that they have engaged a climate consultancy, EcoAct, to work with them on home emissions measurement, and to help them decide where such emissions should be counted. More broadly, the company explained to us that the carbon measurement process is not outsourced but rather conducted internally, and the results audited, which helps to give us the confidence in reporting.

Finally, following our suggestion that environmental and social key performance indicators be included in compensation calculations, they explained that when they last renewed the company's compensation model in 2020, there wasn't a huge push for it. However, they recognise that enhanced focus on ESG metrics by stakeholders means this attitude has shifted, and there is increasing demand for integrated environmental and social targets in management reward plans. We will continue to push for the adoption of environmental and social targets within executive compensation.

Acknowledging our engagement as the most in-depth and detailed meeting on decarbonisation they have experienced, the company was receptive to our questions and suggestions.

TURNING UP THE HEAT ON FINANCED EMISSIONS

INTERNATIONAL EQUITY | INTERNATIONAL EQUITY PLUS

PORTFOLIO MANAGERS



MARTE BORHAUG

Head of Sustainable Outcomes



ANTON KRYACHOK

Vice President

As the world transitions towards a low carbon future, banks are having to reckon with the climate impact of the companies they fund. We engaged with a **European bank** in our portfolio to ensure they're calculating and reducing carbon emissions across their portfolios.



DECARBONISATION

Challenges

Banks may not be the first industry that comes to mind for engagement activities around decarbonisation, but they are increasingly coming under scrutiny. Their challenge is not the emissions in their own operations, but rather how they contribute to climate change through their banking activities e.g. lending directly to businesses or helping firms to list or issue new debt.

These are called "**financed emissions**" and are basically a bank's Scope 3 emissions. Total financed emissions from financial institutions were, on average, more than 700 times greater than their operational emissions according to a report from the non-profit Carbon Disclosure Project, an advocate for environmental transparency.⁷

As an investor we need to understand these financed emissions because it's an important indicator for the bank's real climate-related risk. For example, if they are financing companies that might struggle to transition, this could lead to stranded asset risks. Perhaps surprisingly, 49% of financial institutions indicate they do not conduct any analysis on how their portfolio impacts the climate at all, while only 25% of disclosing financial institutions report their financed emissions.⁸ Calculating these emissions is a complicated task that involves understanding the greenhouse gas (GHG) emissions of the companies and their supply chains – complicated further given not all of a bank's portfolio companies may have information about their own emissions.

Actions

We raised the issue of financed emissions in an engagement meeting with the company in September, where we asked the bank for better disclosures on this part of their carbon footprint.

While we welcome the steps they have taken already, and we appreciate that their direct exposure to oil, coal and agriculture is limited, we want to see the bank do more to understand their financed emissions.

⁷ Based on data from 84 organisations that collectively managed \$27tn in assets; <https://www.cdp.net/en/articles/media/finance-sectors-funded-emissions-over-700-times-greater-than-its-own>

⁸ <https://www.cdp.net/en/articles/media/finance-sectors-funded-emissions-over-700-times-greater-than-its-own>

Outcomes

Analysing the bank's climate approach, it was clear they had taken concrete steps to improve. They have set long-term targets, including an overarching climate target to achieve net zero GHG emissions as soon as possible, and by 2040 at the latest. In addition, by 2025, at least 20% of the bank's lending is to be defined as "green" or contain conditions that contribute to a sustainable, measurable transition by the borrower. They have also committed to making sure these targets are independently verified by setting targets in line with the 1.5 degree target, in accordance with the Science Based Targets initiative. Importantly, they have begun changing their processes to deliver on these targets; for example, strengthening the credit process to improve their ability to assess their customers' climate risks.

When it comes to financed emissions, they have started their journey by joining the Net-Zero Banking Alliance, which brings together banks committed to aligning their lending and investment portfolios with net-zero emissions by 2050. They have also joined the Partnership for Carbon Accounting Financials to ensure their emissions are calculated according to best practice, as well as contributing to harmonisation and standardisation within this developing area. In 2021, they calculated the financed emission for real estate lending for the first time, for one of the countries where they operate (representing 30% of their total loan book).

We were pleased to hear that they launched a GHG lending book review in February 2021, which they indicated would take a year or two to complete. They believe this is an opportunity to differentiate themselves as well as to grow in the right areas of lending, positioning themselves to back the business opportunities presented by a low carbon future.

We welcomed the publication in December of the bank's first climate finance report for their lending operations⁹, but highlighted that we would like to see more data on Scope 3 emissions linked to lending activity and offered a follow up to share our thoughts on what we would like to see as an investor.

Ultimately, the outcome we seek is for the banks we own to have completed their assessment on financed emissions across their portfolio, put steps in place to manage these emissions in line with the Paris Agreement in a way that is independently verified, and provide disclosure of this to investors. We expect this to be a focus for our continued engagement with the bank and will be monitoring their progress.

⁹ The report was prepared in accordance with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) <https://www.handelsbanken.com/tron/xgpu/info/contents/v1/document/72-120091>



Analysing the bank's climate approach, it was clear they had taken concrete steps to improve. They have set long-term targets, including an overarching climate target to achieve net zero emissions of GHGs as soon as possible, and by 2040 at the latest.

VOTING OVERVIEW

Where proxy voting has been delegated to us by our clients, we take this responsibility 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.

The team's proxy voting is predominantly related to governance issues such as management incentives and director appointments as the high quality companies we invest in tend to face fewer climate-, environmental- or social-related shareholder resolutions than companies in other sectors.

Our team's long experience in evaluating the quality and calibre of management results in high expectations of management teams. We examine 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.

During 2021, we voted at 92 meetings (100% of all meetings held by our companies) and on 1,412 proposals (99% of all proposals). Overall, we voted against management in 8% of cases, and 62% of meetings had at least one vote against management.

DISPLAY 3

Proxy voting overview (12 months from 01/01/2021 to 31/12/2021)

% total number of meetings held	92 (100%)
% total proposals voted	1412 (99% of all proposals)
% votes against management as a proportion of resolutions	8%
% meetings with at least one vote against management	62%

Source: ISS Proxy Exchange; MSIM

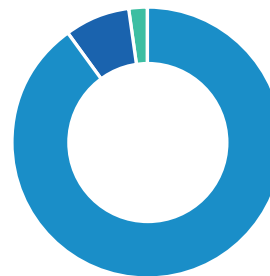
Common reasons for voting against management were related to compensation, election of directors and shareholder ESG proposals.

Compensation-related proposals continued to stand out as a contentious voting topic, with our team voting on 161 say-on-pay proposals during 2021; 29% 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.

DISPLAY 4

Voting on 1,412 proposals

% by voting instruction



- In favour of management 90
- Against management 8
- Abstained/did not vote 2

Source: ISS Proxy Exchange; MSIM

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 sometimes escalate the issue and 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 23 directors across all of holdings in 2021.

Although they occur less frequently, we carefully consider how to vote on any 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. Our approach follows at a minimum [MSIM's voting policy](#). In 2021, we voted in support of 14 (56%) ESG-related shareholder resolutions across our strategies and we voted to support the single climate-related shareholder proposal put forward amongst our global holdings.

Examples of Shareholder ESG Proposals

COMPANY	RESOLUTION DESCRIPTION	OUR VOTE	OUR RATIONALE
American medical devices and health care company	Shareholder Resolution: Report on Racial Justice	FOR	The company has committed to disclosing more information on diversity and inclusion, including adding EEO-1 type data. While we approve of this commitment, a vote FOR signals to the board and market the importance of this issue to shareholders.
American technology conglomerate	Shareholder Resolution: Report on Takedown Requests	FOR	We recommended a vote FOR as we believe shareholders would benefit from a better understanding of the constraints the company faces when handling government takedown requests, as well as its management of related risks.
American soft drink manufacturer	Shareholder Resolution: Report on Sugar and Public Health	AGAINST	In 2020, the proposal garnered the support of 7.7 percent of the votes cast. Reasons that we voted AGAINST the proposal were the same as last year: the proponent highlights a serious risk associated with consuming the company's products, but it is one that is already very well-documented by scientific journals and public health agencies. Having the company publish its own scientific report on the topic would not provide new information. Plus, the company has made strides to diversify its product line simply as consumer tastes change and as some local regulators (e.g. NYC) clamp down on the issue. This proposal would not add value to investors.
American business and financial services company	Say on Climate	FOR	The company reports in line with the Taskforce on Climate-related Financial Disclosures (TCFD), has 2030 carbon reduction targets for Scope 1&2 (50% reduction) and carbon neutrality by 2050 using science-based targets. We recommended a vote FOR the proposal at this time.

Pay X-Ray

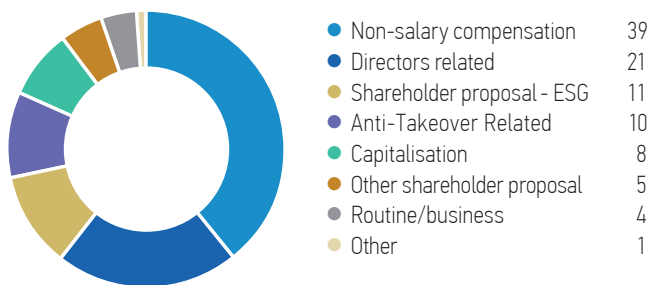
The Pay X-Ray is our proprietary scoring tool, used to better compare company pay plans, facilitate team discussions and inform our voting approach. A streamlined scoring system, it enables us to flag good and bad practices and rank our

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 to 2021.

DISPLAY 6

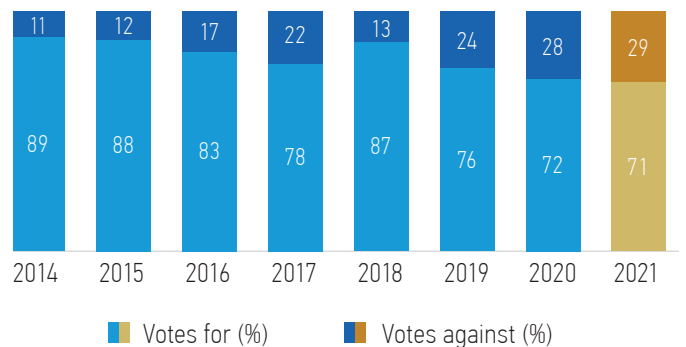
% votes against management by topic^{10,11}



Source: ISS Proxy Exchange; MSIM

DISPLAY 7

Votes on management say-on-pay proposals¹¹ voted 2014 – 2021



¹⁰ Expressed as a percentage of total votes against management.

¹¹ Due to rounding, this may not add up to 100.

THE INTERNATIONAL EQUITY TEAM

INVESTMENT TEAM

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Head of the International Equity Team

BRUNO PAULSON

Managing Director

NIC SOCHOVSKY

Managing Director

MARCUS WATSON

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NATHAN WONG

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Executive Director

MUNENORI YOSHIMI

Executive Director

MONICA CARTA

Executive Director

DAVID BERNARD

Executive Director

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Executive Director

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Vice President

JULIA FORDE

Vice President

TEPPEI ADACHI

Senior Associate

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