Morgan Stanley

INVESTMENT MANAGEMENT

MSIM Fixed Income Engagement Strategy: Integrated, Insightful, Influential

FIXED INCOME TEAM | SUSTAINABILITY INSIGHT | AUGUST 2023

As active asset managers with a focus on long-term value creation and responsible stewardship, effective engagement is a critical part of our investment process and fiduciary obligations. Morgan Stanley Investment Management (MSIM) Fixed Income has developed a targeted and thematic engagement programme on environmental, social and governance (ESG) issues. Our approach is fully integrated into our research and investment processes to identify opportunities for improved risk management and alpha generation through constructive dialogues with issuers, while encouraging them to pursue positive sustainability outcomes.

AUTHORS

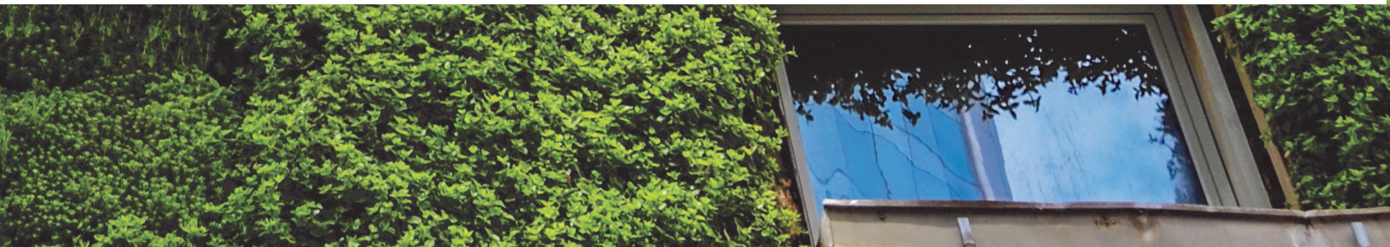
BARBARA CALVI
Executive Director
EMEA Head of Fixed Income
ESG Strategy & Research

ANUJ GULATI
Managing Director
Global Head of Fixed Income
ESG Strategy & Research

The Growing Imperative for Fixed Income Engagement

Fixed income investors have an important role to play in building a constructive dialogue with issuers and supporting them in pursuing positive sustainability outcomes while enhancing ESG disclosure and price discovery of the proper cost of capital when accounting for ESG risks. While engagement and stewardship have historically been an equity investor remit, we believe fixed income investors are uniquely positioned to have a positive influence on issuers for a number of reasons:

- The responses to some of the world's key sustainability challenges, such as climate change and access to basic services, are going to require large capital investments that are primarily financed via debt instruments, including with sustainability labels.



- The vast majority of primary market financing is conducted in the debt market rather than in the equity market, giving fixed income investors a regular and direct interface with issuers seeking their capital.
- The magnitude of debt financing requirements increases in stressed scenarios (such as the recovery phase after the COVID-19 pandemic), increasing the frequency of such issuer/investor interactions and their importance in shaping issuer strategy.
- Fixed income portfolios typically hold a large number of securities and a range of issuers, in contrast to the more concentrated nature of holdings in active equities portfolios, giving investors a broad scope of engagement opportunities.
- Fixed income investors are uniquely positioned to engage with and influence issuers that do not have public equity outstanding, including Sovereigns, Supranationals/Agencies, many High Yield companies and state-owned enterprises.

MSIM's Rationale for Fixed Income Engagement

Our Fixed Income engagement programme aims to achieve three main objectives:

1. Deepen our insight and understanding of the issuer and its sector;
2. Push for better sustainability outcomes; and, ultimately;
3. Capture alpha opportunities that may not be fully appreciated by the market.

Insights from the engagement process can therefore result in changes to our Credit Analysts' assessment of the issuer. This may in turn lead to a decision to participate in a new issuance, increase or reduce our existing holdings in outstanding bonds, or "watch-list" the issuer for our Sustainable Funds until more progress is made on the specific E, S or G issue of concern.

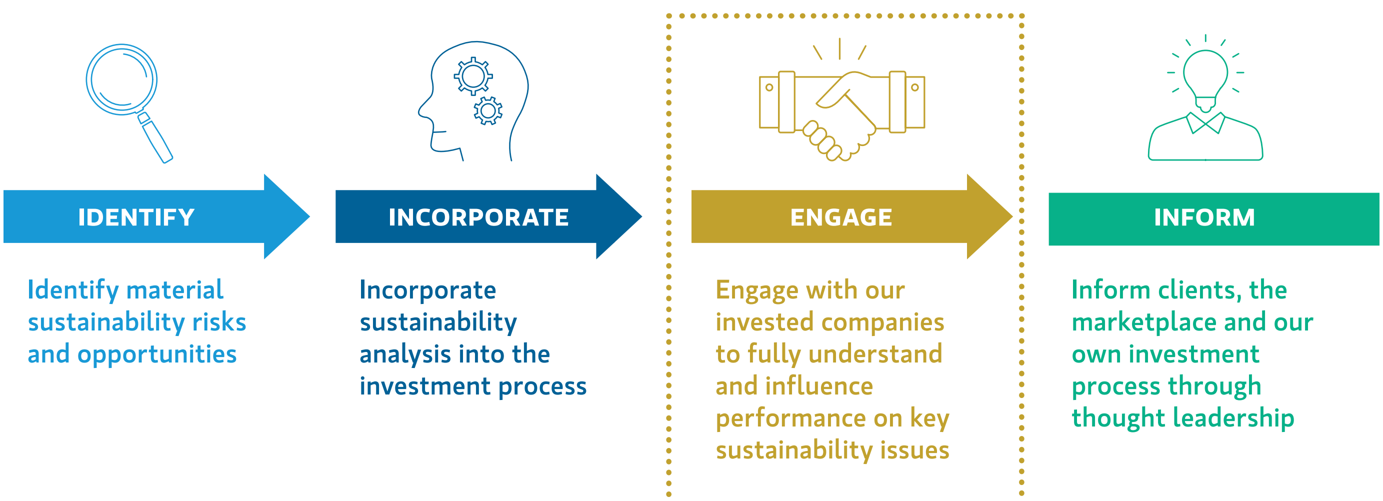
Finally, we strive to provide the same level of transparency that we expect of issuers. We therefore track and report our engagements on a quarterly basis, including their outcomes—i.e. whether they affected our investment strategy through the Analyst's recommendations or the Portfolio Manager's investment decision.

The MSIM Fixed Income Approach to Engagement

At MSIM Fixed Income, we view engagement as an indispensable and powerful component of our ESG integration approach and to implement our sustainable investing strategies[1] (see *Display 1*). This is aligned with our 100% active management model and our duty as responsible stewards of capital.[2]

DISPLAY 1

Engagement Is a Key Component of MSIM Fixed Income's ESG Integration Approach



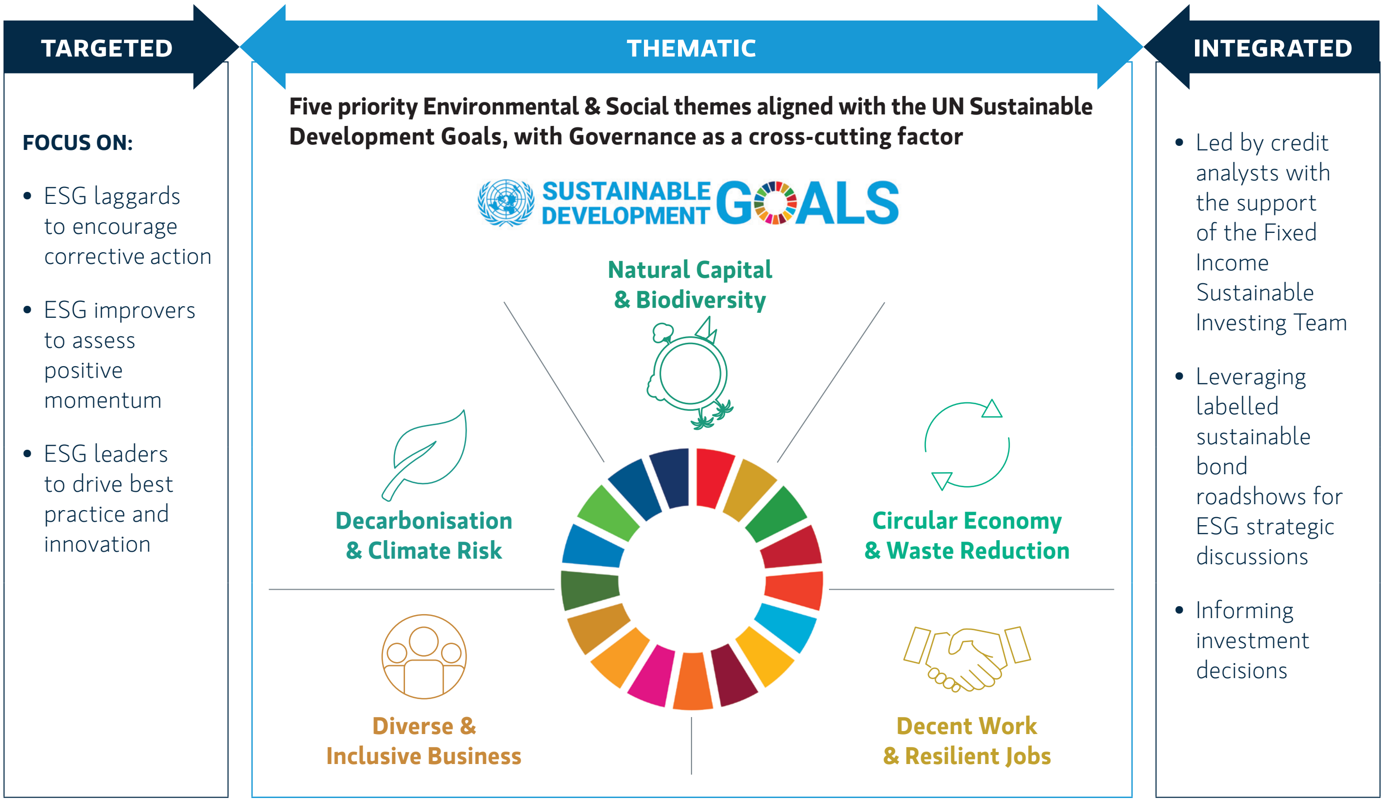
Individual funds and client accounts operating may have specific ESG related goals and restrictions that affects ESG integration. Please refer to governing documents of individual vehicles to understand their binding ESG criteria.

1 See Morgan Stanley Investment Management's Sustainable Investing Policy (link).

2 See Morgan Stanley Investment Management's Engagement and Stewardship Principles (link).

DISPLAY 2

The MSIM Fixed Income Three-Pillar Engagement Strategy



This represents how the portfolio management team generally implements its investment process under normal market conditions. Individual funds and client accounts may have specific ESG related goals and restrictions. The content of this publication has not been approved by the United Nations and does not reflect the views of the United Nations or its officials or Member States. See https://www.un.org/sustainabledevelopment/sustainable-development-goals for more details on the Sustainable Development Goals.

To this end, we have established an active engagement strategy that is based on three pillars (see *Display 2*) and is applied across fixed income asset classes. This structure is intended to:

- Help MSIM identify target companies for engagement based on material ESG considerations relative to their current stage of adoption of sustainability;
- Anchor the dialogue to a consistent set of thematic priorities that drive our key desired outcomes; and
- Implement engagement as part of our regular fixed income investment process, with Credit Analysts leading the dialogue with the support of the Fixed Income Sustainable Investing team.

1. TARGETED ENGAGEMENT—INVESTING TO IMPROVE SUSTAINABILITY OUTCOMES AND RETURNS

We select issuers to prioritise in our engagement programme based on the materiality of the ESG risks or opportunities they present. We rely on our proprietary ESG scoring models and research capabilities to determine and monitor any “red flags” on controversies or violations of international norms, and identify exposure to severe ESG risks. This risk mitigation-driven focus on ESG laggards is complemented by a strategic outlook on sectoral sustainability opportunities, where we engage with issuers that we believe have the potential to benefit from those positive tailwinds. Our goal is to identify those ESG improvers, whose progress might not yet be reflected in their public reporting and third-party ratings, as a potential source of alpha generation. Finally, we also engage in conversations with ESG leaders that already have advanced sustainability credentials, to encourage them to share best practices across their sectors, support the adoption of new disclosure standards, and promote innovative sustainable solutions.

We approach issuer engagement constructively and collaboratively. Depending on the impetus for dialogue, the MSIM Fixed Income team seeks to set clear expectations from the engagement process. These can include the disclosure of specific data points, promoting the adoption of recognised ESG reporting standards, or suggesting alternative practices where we are concerned with a certain course of action taken by the issuer.

We understand that the various fixed income asset classes are at different stages of development of their sustainability practices and ESG disclosure, and we adapt our engagement approach and expectations accordingly (as presented in *Display 3*).

2. THEMATIC FOCUS MAPPED TO THE UNITED NATIONS SUSTAINABLE DEVELOPMENT GOALS (UN SDGS)

Our engagement priorities are based on salient ESG risks and opportunities at a sectoral level, reflecting our Credit Analysts' sector specialisation and our broader approach to ESG analysis. We have established a framework that maps these sector-level considerations to five "macro" environmental and social themes,

DISPLAY 3

MSIM Fixed Income Engagement Approach across Asset Classes

INVESTMENT GRADE CORPORATES

Investment Grade corporates are at the core of our engagement programme. Due to their size and presence in debt markets, encouraging them to adopt sustainable business practices and to lead on transparent reporting is key to drive positive impact. For these issuers, our intent is to engage with senior executives about their sustainability strategy and targets, as evidence of the extent to which ESG principles are embedded into their core business. As part of our dialogues with these companies, we expect and encourage ESG leaders and improvers to:

- Set corporate-level targets in relation to the material ESG issues for the sector, with a focus on net zero carbon emissions targets in relation to climate;
- Develop an adequate Governance structure to deliver on those targets;
- Provide transparent disclosure of progress towards those targets and of key ESG data in line with recognised market standards, such as those set by the Sustainability Accounting Standards Board (SASB) and the Task Force on Climate-related Financial Disclosures (TCFD);
- Focus on impact and outcomes of the company's products and services, with robust monitoring and evaluation procedures, particularly in the context of labelled sustainable bonds.

HIGH YIELD & EMERGING MARKETS CORPORATES

The High Yield universe represents a significant opportunity for MSIM Fixed Income to induce positive change and benefit from engagement on ESG issues.[3] Our share of bond holdings tends to be larger compared to the Investment Grade market, providing us more direct access to companies' management and making our views more influential.

Many High Yield issuers lack external ESG ratings and provide limited disclosure, which makes the soliciting of material ESG information our engagement priority, in order to help us discern from ESG laggards and improvers. We then track specific ESG metrics over time, to hold issuers accountable to their commitments.

We apply a similar approach to Emerging Markets corporates, applying holistic considerations and expert judgement on specific ESG factors. For example, in certain locations, a longer glidepath might be necessary to achieve desired sustainability outcomes and minimise negative externalities (e.g. a longer phase-out period for fossil fuels in order to continue providing affordable energy to the broader population).

SECURITISED DEBT

In the securitised market, a rigorous due diligence process allows our teams to collect deal-level data and information, including on the environmental and social characteristics of underlying assets and loans (e.g. energy performance certifications of buildings, type of borrowers and costs). We then integrate this information in discussions with originators and servicers, to better understand their lending and servicing practices, as well as property owners' behaviour. This is an essential component of our assessment across types of securitisations, as we aim to avoid exposure to predatory lending and to mitigate litigation risk.

SOVEREIGN ISSUERS

Sovereign engagement presents some challenges for investors when it comes to demonstrating a direct impact of one-on-one dialogue on the issuer's strategy. Our approach is to encourage Debt Management Offices to align their financing priorities with the United Nations Sustainable Development Goals (UN SDGs) agenda as a globally recognised impact framework—specifically intended for states—to facilitate progress tracking. In addition, we use the growing issuance of labelled sovereign sustainable bonds as an opportunity to engage at a senior level with governments and policy makers on sustainability issues.

SUPRANATIONALS, MUNICIPALITIES AND AGENCIES

Our engagement with supranational organisations and agencies is focused on disclosure and impact reporting, primarily in relation to their sustainable bond programmes, which we evaluate through our proprietary Sustainable Bond Evaluation Model. Examples of engagement points with these issuers include the selection criteria for eligible projects financed via their sustainable bonds, particularly on the social side, the mapping of their projects to the UN SDGs and the publication of outcome-based reporting.

MSIM's Municipal investment team also engages directly with U.S. municipalities to enhance their disclosure on sustainability issues, with a particular focus on climate risk, as relevant by location, and on diversity & inclusion.

This represents how the portfolio management team generally implements its investment process under normal market conditions.

Individual funds and client accounts may have specific ESG related goals and restrictions. Please refer to governing documents of individual vehicles to understand their binding ESG criteria.

[3] See "Assess, Engage, Perform: The Value of ESG Integration within High Yield", Morgan Stanley Investment Management (link).

DISPLAY 4

MSIM Fixed Income's Priority Engagement Themes

DECARBONISATION & CLIMATE RISK

- Companies are likely to turn to the debt markets to finance their low carbon transition plans, including via the issuance of labelled green and other sustainable bonds.
- Analysis of issuers' low-carbon transition strategy and greenhouse gas (GHG) emissions helps mitigate risk of stranded assets exposure and physical risk.

CIRCULAR ECONOMY & WASTE REDUCTION

- Opportunities for corporate, municipal and sovereign organisations to finance, for example, infrastructure development, recycling facilities or other projects that contribute to the reuse or repurposing of plastic and other materials.
- Scrutiny on the sustainable sourcing of raw materials across sectors helps mitigate the risk of environmental and/or social adverse impacts linked to pollution and subsequent litigation, as well as the risk of carbon taxes being applied to plastics manufacturers.

NATURAL CAPITAL & BIODIVERSITY

- Supporting business models that reduce negative impact on biodiversity in line with the Post-2020 Biodiversity Framework
- Focuses on sustainable sourcing and use of resources; land and sea use change; deforestation; pollution reduction

DIVERSE & INCLUSIVE BUSINESS

- Diligencing how companies select their executives, develop their employees and how they make their products and services more accessible helps identify more resilient investments.
- Expanding access to essential services (e.g. healthcare, digital, banking) to un- or under-served groups can represent an economic opportunity and an upside for investment.

DECENT WORK & RESILIENT JOBS

- Poor supply chain management practices affect companies' financial performance, and badly managed redundancy processes impact workforce morale and productivity.
- A strategic focus on talent development and retention, and on job resilience in the face of crisis and disruptive innovation, will entail greater term capital and working capital financing needs, and have implications for the stability of spreads.

This diagram represents how the portfolio management team generally implements its investment process under normal market conditions. MSIM Fixed Income engagements do not include the engagements conducted by the Calvert Corporate Engagement Team. Source: MSIM, UNDESA. The content of this publication has not been approved by the United Nations and does not reflect the views of the United Nations or its officials or Member States" See https://www.un.org/sustainabledevelopment/sustainable-development-goals for more details on the Sustainable development goals icons.

presented in *Display 4*, which help us define the desired outcomes of our dialogues with issuers and report on progress.

As fixed income investors, we view governance as the strongest ESG driver of portfolio risk and return, and the pillar from which strong credibility is built across any sustainability-related topic. We therefore diligence corporate governance, transparency and accountability, and disclosure matters across our dialogues with issuers.

Our thematic framework informs not only engagement, but also the active security selection process in our fixed income strategies, and is part of our broader commitment, at MSIM, to support investments that positively contribute towards the UN SDGs.[4]

3. INTEGRATED PROCESS LED BY CREDIT ANALYSTS

ESG topics are included in our touchpoints with issuers' management and during roadshows, based on the thesis that we can be more influential in our engagement by regularly following up with issuers on a focused agenda of salient points as opposed to conducting sporadic, diluted sessions on a broad range of sustainability topics.

For this reason, our fixed income engagement process is led by the Credit Research team based on an analytical, data-driven approach to evaluate ESG risk for the targeted issuers. Our Analysts have a deep understanding of the companies they cover and the engagement topics complement their comprehensive approach. The MSIM Fixed Income Sustainable Investing team contributes specific ESG expertise, ensures consistency across thematic engagements, and coordinates with the MSIM Global Stewardship team for equity-side insights.

In cases where we identify significant sustainability risks or egregious conducts, we may conduct joint engagement with multiple MSIM investment teams, to leverage our broader business influence and address our concerns and expectations in a coordinated manner.

[4] See Morgan Stanley's 2022 Sustainability Report (link).

DISPLAY 5

MSIM Fixed Income's Collaborative Engagement Initiatives

PRI Principles for Responsible Investment	MSIM Fixed Income is a member of the Principles for Responsible Investment (PRI)'s ESG in Credit Risk and Ratings Initiative,[5] through which we participate in workshops with issuers and contribute our knowledge and views on the materiality of ESG factors in credit analysis across sectors.
European Leveraged Finance Association	Through MSIM's participation in the work of the European Leveraged Finance Association (ELFA) to increase ESG transparency in High Yield, we also systematically encourage companies to address material sustainability issues in their governance, business strategy and planning, risk management and public reporting to promote value creation, in line with our thematic focus.
The Green Bond Principles	Our Sustainable Investing team takes part in the working groups of the International Capital Market Association (ICMA)'s Green and Social Bond Principles Working Groups,[6] among others. In this collaborative spirit, we also share our feedback with issuers and structuring advisers of sustainable bonds to increase the transparency and quality of these instruments in the market.
Emerging Markets Investors Alliance — Actionable Intelligence for Responsible Investing	MSIM is part of the Emerging Markets Investors Alliance's ESG Initiative to construct a set of best practices for sustainable investing for EM sovereigns and corporates.
One Planet Summit — Asset Managers Initiative	As a member of the One Planet Asset Managers Initiative, MSIM has been actively involved in developing impact frameworks for Fixed Income.

Collaborative and Market-Level Engagement: Driving Best Practice and Standardised ESG Disclosure

In addition to our one-on-one engagement programme with issuers, MSIM Fixed Income also collaborates with external partners and stakeholders to promote the adoption of best practices and international standards for sustainability disclosure, as shown in *Display 5*.

Genuine Dialogue Means Both Sides Become Wiser

MSIM Fixed Income takes the view that the best form of issuer engagement is a process of dialogue, in which issuers are willing to consider alternative perspectives to help them evolve their approach to sustainability and investors are willing to change the assumptions and conclusions in their investment analysis.

We aim to maintain a regular dialogue with issuers where we deem it most material. Consequently, many of our engagements are ongoing over a multi-year time horizon. This approach takes into consideration the time lag required for issuers to endorse new policies and sustainability targets, measure ESG impact, and reflect this information in the following period's public reporting.

As responsible long-term investors, our goals from engagement are to support improving behaviour, facilitate meaningful change, and to use the insights we glean to drive returns for the benefit of our clients.

[5] The PRI's ESG in Credit Risk and Ratings Initiative aims to enhance the transparent and systematic integration of ESG factors in credit risk analysis (link). The third party websites are provided for informational purposes only. Morgan Stanley has not reviewed any of the content supplied, and does not guarantee any claims or assume any responsibility for the content provided by the sites.

[6] Morgan Stanley is a member of the Advisory Council of the Green Bond Principles and Social Bond Principles Executive Committee of ICMA, and part of the Working Groups on Social Bonds, Sustainability-Linked Bonds, Impact Reporting, and Climate Transition Finance (link). The third party websites are provided for informational purposes only. Morgan Stanley has not reviewed any of the content supplied, and does not guarantee any claims or assume any responsibility for the content provided by the sites.

Risk Considerations

ESG ratings are relative and subjective and are not absolute standards of quality. Ratings apply only to portfolio holdings and do not remove the risk of loss. There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to **market risk**, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events.
ESG Strategies that incorporate impact investing and/or Environmental, Social and Governance (ESG) factors could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. As a result, there is no assurance ESG strategies could result in more favorable investment performance. **Fixed-income securities** are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. **Longer-term securities** may be more sensitive to interest rate changes. Certain **U.S. government securities** purchased by the strategy, such as those issued by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of the U.S. It is possible that these issuers will not have the funds to meet their payment obligations in the future. Public bank loans are subject to liquidity risk and the credit risks of lower-rated securities. **High-yield securities (junk bonds)** are lower-rated securities that may have a higher degree of credit and liquidity risk. **Sovereign debt securities** are subject to default risk. **Mortgage- and asset-backed securities** are sensitive to early prepayment risk and a higher risk of default, and may be hard to value and difficult to sell **(liquidity risk)**. They are also subject to credit, market and interest rate risks. **Municipal securities** are subject to early redemption risk and sensitive to tax, legislative and political changes. The **currency market** is highly volatile. Prices in these markets are influenced by, among other things, changing supply and demand for a particular currency; trade; fiscal, money and domestic or foreign exchange control programs and policies; and changes in domestic and foreign interest rates. Investments in **foreign markets** entail special risks such as currency, political, economic and market risks. The risks of investing in **emerging market** countries are greater than the risks generally associated with foreign investments. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, and correlation and market risks. **Restricted and illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). Due to the possibility that prepayments will alter the cash flows on **collateralized mortgage obligations (CMOs)**, it is not possible to determine in advance their final maturity date or average life. In addition, if the collateral securing the CMOs or any third-party guarantees are insufficient to make payments, the portfolio could sustain a loss.

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MIDDLE EAST

Dubai: MSIM Ltd (Representative Office, Unit Precinct 3-7th Floor-Unit 701 and 702, Level 7, Gate Precinct Building 3, Dubai International Financial Centre, Dubai, 506501, United Arab Emirates. Telephone: +97 (0)14 709 7158).

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