Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

Insta-engagement

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Effective engagement needs time. Expecting instant results from an engagement is as senseless as expecting instant alpha. Just as we look for steady and consistent growth in the companies we own, we value steady and consistent improvement in their approach to environmental, social and governance (ESG) issues over zigzagging in policy to satisfy short-term appetites and box-ticking.

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As a team, we have engaged with company managements and their boards for over 20 years. In recent years, we have become more structured about our engagements, focusing on dual discussions with the C-suite as well as sustainability representatives of our investee companies. These engagements have provided useful insights, especially regarding company responses to and priorities during the pandemic. We have also become more systematic about the crucial area of management incentives, creating our proprietary Pay X-Ray scoring framework. This has enabled us to better compare and discuss company pay plans and inform our voting approach. In 2020 we voted against management on 30% of say-on-pay resolutions. In the bulk of these cases our stance was in disagreement with ISS, which supported management.

Our efforts to engage are helped by our long-term holdings of significant stakes in companies. The resulting access makes us less dependent on news presented at public annual general meetings or investor relations events. We reserve our hardest questions for private meetings, not the podium or the press. We believe the right questions asked in the right way can garner thoughtful consideration of our position and drive the agenda of future engagements. However, we are not afraid to vote against management, as was demonstrated by the 68% of the 2020 shareholder proposals that we supported.

Remote working has meant that both asset managers and companies have had to get used to digital and video-conferenced engagement. We found, in the main, that companies were responsive to our requests during lockdown. We held some 369 meetings in 2020, and 205 of those specifically included an ESG engagement on topics ranging from decarbonisation, diversity and data security to supply chain questions from fast fashion to semiconductors. That said, we are looking forward to meeting companies face-to-face again whenever this becomes possible.

Discussions with companies in the fourth quarter of 2020 included carbon emissions targets, deforestation, diversity and inclusion, board risk controls and safety. For example:

- With Reckitt Benckiser, we probed how their recent pledge to be **net zero carbon** by 2040 can be achieved. We were encouraged by their policies and actions around **palm oil**.
- We had a very detailed discussion on **deforestation** with Procter & Gamble, to understand their initiatives in sustainable paper product sourcing. They have taken a number of concrete actions, but we voted for the shareholder resolution to improve disclosure.
- Our discussions with Baxter International centred on **product safety,** given past concerns. They aim to be in the top quartile on safety among global companies and have achieved a good reduction in product complaints through improvement to their inspections. We also examined their **diversity and inclusion** measures and encouraged them to disclose their gender pay gap. We believe Baxter is making progress and will continue to monitor them.

We encourage you to learn more about these and our other engagements through our Engage newsletter, published semi-annually, available at www.morganstanley.com/im.

The question of "whose opinion matters?" has never been more germane. Ultimately, while all stakeholders matter, the top line starts with the customer. Any major concerns relevant to the customer should be high on the agenda of company management. In this context, it is important to be clear about one's own principles, priorities and values. For our carbon-light, high-quality global portfolios, we pay particular attention to companies' efforts to meet low or net zero carbon targets.

We're also pragmatists. We recognise that universal problems may require collaborative solutions to hasten progress. MSIM's support of the One Planet Summit asset manager initiative since January 2020, which aims to advance the understanding of climate-related risks and opportunities in long-term investment portfolios, is an excellent example. In the United Nations Principles for Responsible Investment 2020 Annual Report, MSIM scored "A" across modules and "A+" in Listed Equities for both Active Ownership and Incorporation, a result we are delighted with.

As companies look to emerge from the crisis, we will continue to ask the hard questions. Many of them are company or industry specific, be it around plastics for consumer staples, product safety for health care or data security for information technology, but there are some more universal themes coming out of the crisis:

- What are the main lessons from the pandemic? How have companies evolved their attitude to risk as a result of the crisis?
- Will the company's supply chain be the same as or different from before the pandemic? Has the company accepted that it is deemed responsible for its supply chain—from employee health and safety to resourcing?
- How will capital allocation and balance sheet decisions differ going forward?
- How have remuneration decisions been affected by the shock of the pandemic? Will the board take into account any capital raising, dividend cuts or take-up of government support?
- How is the company placed for the new era of greater government intervention? Is there significant exposure to potential new tax regimes?
- How does the company perceive the impact of remote working on innovation or product safety, or prioritise topics such as gender and racial diversity under tougher economic conditions?
- How are companies weighing up the balance between the ever-increasing demands for sustainability and their long-term returns on operating capital employed?

Globally, the call for greater transparency and disclosure of companies' and fund managers' activities, as well as in-depth portfolio reporting, is finding its way into industry bodies and regulation. As we navigate the ESG journey, we believe it pays to avoid faddy "tickboxery" and instead to maintain investment discipline, to focus on robust stocks and on relevant, meaningful long-term engagement.

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