

Morgan Stanley

INVESTMENT MANAGEMENT

GLOBAL SUSTAIN

STRONG ON ENGAGEMENT.
LIGHT ON CARBON.
BUILT ON QUALITY.

25-50 of the
Highest Quality
Stocks in the World

Selecting Sustainable
Compounders

ESG
Scores
Comparing
apples to
oranges

Pay
X-Ray
Evaluating
management
incentives

Governance
Without it,
all else fails

Value of
Engagement
Understanding
management quality

Engage with us



There is no doubt in my mind – ESG matters. Whether you are a company or a consumer, an asset owner or an asset manager, ESG is not a subject that you can afford to ignore. As a team, we are well known for our commitment to investing in sustainable compounders. We believe that integration of ESG is essential for long-term compounding, which is reflected in our investment processes and in the launch of Global Sustain.

As Head of ESG Research for the International Equity Team, I analyse issues that may affect the sustainability of the returns on operating capital of our investments. I work with the other portfolio managers on the team to assess ESG topics that are relevant and material to the sectors they cover. We have a long history of investor-led engagement — we engage, we don't outsource it — and this is where our experience and access give us an edge.

We're delighted to share with you this selection of our current thinking on ESG – the risks we believe exist, and the opportunities that it presents for those that not only adapt but embrace the increasing challenges of our complex world.

We invite you to engage with us.

Vladimir Demine
International Equity Team
Morgan Stanley Investment Management



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VALUE OF Engagement

Understanding management quality



When we interact with a company's management, we raise issues we consider material and relevant. This helps us assess management quality and their short- and long-term priorities.



BY WILLIAM LOCK
Managing Director

For over 20 years, we have emphasized the importance of understanding management priorities and corporate governance in our investment process. It is not enough to have a profitable company with phenomenal returns if those returns are not sustainable. For this reason, after identifying high-return companies, we ask: Is management focused on maintaining a company's returns by allocating capital wisely? Is it incentivized to strive for long-term returns over short-term earnings?

HIGH-QUALITY COMPANIES REQUIRE EXTRA SCRUTINY

For the types of high-quality companies held in our portfolios — including Global Sustain, the latest addition to our global equity strategies — these questions matter even more because management has discretion over how to deploy large amounts of cash flow. The decisions they make can influence returns over years to come.

That's why we believe governance is central to sustainable long-term performance. Also, if

a company does not get the governance factor right, it is unlikely that it will be on the right side of the two other ESG pillars: environmental and social factors. And that's why investor-led engagement is so valuable.

Much of the 'governance industry' concentrates on scoring what is easily measured and ends up ticking boxes, neglecting the human element. As such, we see Governance Scores from the likes of MSCI and Sustainalytics as having

limited value beyond raising potential flags. We support corporates having a separate Chair and CEO, but this is of limited use if the Chair is somehow in the CEO's pocket! From an opportunity perspective, new management or changes in management often present the most interesting investment opportunities.

WE ENGAGE DIRECTLY — AND OFTEN

We held 466 management meetings in 2018, 215 of which included ESG engagements. We also liaise with the firm's corporate governance

team on proxy voting and specific engagements with companies.

The assets we manage and the concentrated nature of the portfolios give us significant influence in our engagement program: We control over 1% of the free float in more than half the companies in the Global Sustain portfolio, our newest strategy. As long-term shareholders, our portfolio turnover is low, allowing us to build long-term influential relationships with management teams.

GOVERNANCE

Without it,
all else fails

Governance refers to how well a company is managed and to the oversight of its management. Without good governance, there is no assurance that management will promote innovation, preserve intangible assets, reinvest profits or allocate capital wisely.



BY BRUNO PAULSON
Managing Director

Though somewhat counterintuitive, we see governance as more important for the high-quality companies we focus on than for other companies. This is partly because management has more degrees of freedom when overseeing strong cash flow and intangible assets. Three main risks can arise from poor governance: short-termism, capital misallocation and excessive risk-taking.

SHORT-TERMISM

Management teams may prioritize short-term measures over longer-term success. This may be an excessive fixation on quarterly results, revenue growth or this year's earnings per share. The end result is destruction of long-term compounding power. The problem is even worse if the short-termism is encouraged by poorly structured incentive schemes.

Managing a business for the long term confers huge advantages. Companies with a short-term perspective lose touch with their stakeholders and are not sustainable. Eventually, their return-generating potential becomes curtailed. Witness the lack of innovation that led to the demise of Polaroid, Blockbuster, Kodak, Nokia or Blackberry. Consider the challenges facing a company that finds itself shadowed by the dark cloak of a major internet retailer and struggles to become digitally relevant.

For high-quality companies, earnings can be easy to "massage." For instance, consumer staples companies tend

to have large advertising budgets. Management can trim these costs to inflate short-term profits, but failure to promote the business comes at a cost of the franchise later.

CAPITAL MISALLOCATION

A further threat comes in the allocation of capital. Investing capital at low returns, either through paying too much for acquisitions or expanding into lower return businesses, can undermine the overall quality of the business and impair its ability to compound over time. For high-quality, high-return companies, the high levels of free cash flow give rise to temptations for misallocation.

EXCESSIVE RISK-TAKING

Finally, poor governance may lead to excessive risk-taking. High-quality companies have more to lose in this regard, simply because the greater value of the franchise means there is more at stake. For example, misconduct in environmental and social issues – two ESG pillars – could be more likely if a company is not grounded in the third pillar, governance.

We think our focus on governance has led to a portfolio of companies whose management have relatively long-term perspectives, are judicious risk managers and allocate capital better than the market as a whole. Global Sustain, the latest addition to our global equity product suite, benefits from this long-standing emphasis on governance.

ESG SCORES

Comparing apples to oranges



BY ALEX GABRIELE
Executive Director

Specialist research on environmental, social and governance (ESG) factors can be useful. But we find that data providers, such as MSCI ESG and Sustainalytics, are sector relative and subjective on the materiality of ESG-related risks or opportunities. This information may serve as inputs into our analysis, but it doesn't drive our stock selection.

When we identify potential risks that threaten the sustainability of returns, we contact senior management directly. We engage with managements and the boards of companies across our portfolios, including those in Global Sustain. On a case-by-case basis, we discuss material ESG factors that could impact sustainable high returns on capital. These could include issues that may help ensure companies remain relevant with customers, improve employee engagement and stay on the right side of governments and regulators. These factors could include, where relevant, environmental issues, such as carbon emissions, raw material sourcing and packaging. They may also include social issues, such as supply-chain labour standards or product quality.

RICHEST ESG RESEARCH COMES FROM DIRECT ENGAGEMENT

Many years of investing have shown us the world is grey, not black or white – meaning that, over time, companies can have environmental, social or governance issues in a variety of types and magnitudes. Their severity and plans for resolution are key. We look to see sensible solutions and monitor progress on issues over time.

To succeed in this effort requires more than data-driven ESG scoring. We review ESG information from data providers—the most useful of which is a compiled history of a company's controversies—but only as a supplement to our own research. In our view, understanding management quality requires direct engagement with company management. This is so important that for over 20 years we have engaged directly with companies on all kinds of material issues, assisted where relevant by our firm's global stewardship team.

SECTOR-RELATIVE SCORING HAS SHORTFALLS

One of the challenges of ESG risks is that, by their nature, they can be unexpected and with potentially enormous consequences. Examples include oil spills or product recalls. Certain industries have inherent risks but, even with these known risks, it can be extremely difficult to assess the investment implications of unexpected, low-frequency, high-impact events before they occur. Quantitative scoring systems do not offer sufficient perspective for assessing the likelihood of such events. Through engagement, we seek to mitigate these risks by understanding the priorities of a company's management.

While the scores in individual areas from MSCI and Sustainalytics may point out areas to study, we are wary of scoring that evaluates companies relative to their sector and industry peers rather than on an absolute basis, inclusive of all industries. The problem with evaluating companies versus sector peers is that, if a software company scores unfavourably versus other software companies, it may end up with a worse environmental score than a mining company that scores favourably versus other miners on environmental issues. This makes little sense to us. In addition, we find many of the scores fairly unconvincing, as they can depend more on the corporate's engagement with the process of measurement than with the underlying issue. We do not select companies based on their scores.

THE ULTIMATE SCORE IS WHETHER THE COMPANY IS A SUSTAINABLE COMPOUNDER

More fundamentally, the ultimate measure of sustainability is the long-term success of the company. We believe that good environmental and social behaviour brings financial rewards over our long-term investment horizon. For all of these reasons, we do not outsource ESG analysis to a team of ESG researchers, within or outside the firm. The responsibility for ESG analysis sits directly with each portfolio manager. This applies to Global Sustain, the newest addition to our lineup, as well as all of our strategies.

Consumer Staples

Responding to consumer demand

A company's environmental and social policies can help drive its returns and manage risks. Companies that get it right differentiate themselves from competitors – in the eyes of both consumers and their own employees. Those that don't can suffer reputational damage or punitive fines that undermine their ability to compound.



BY NIC SOCHOVSKY
Managing Director

Many companies in the consumer staples sector seize opportunities to produce innovative goods that consumers want. Examples include products less harmful to the environment, healthier products, or those that appeal to an emerging demographic. By pursuing these opportunities, firms can increase market share or enhance their pricing power – both of which preserve or improve profitability.

INNOVATIONS IN PACKAGING

A number of the consumer staples companies we own are committed to developing and producing consumer-friendly, environmentally responsible packaging improvements. While PET (polyethylene terephthalate) bottle recycling is spreading globally,

contamination caused by hard-to-remove sticky labels can reduce the quality and therefore usability of the end material. In an effort to encourage the growing circular economy, a German chemical and consumer goods company that we own has developed certified removable labelling adhesives to ensure the highest recycled

Companies that get it right differentiate themselves from competitors.

plastic quality. Another of our holdings, a major American manufacturer of household products, has worked closely with its suppliers to create innovative packaging that can be easily recycled while still meeting products' needs.

SUSTAINABLE SOURCING

A French personal care company that we own uses renewable natural ingredients in its products. This has a triple effect: good for the consumer, good for the supply chain, and good for those who typically cultivate the crops. For example, the company sources Argan oil from Morocco, shea butter from Burkino Fasa and galangal leaves from Vietnam. Most of the harvesting and processing of these ingredients is done by women. Acknowledging the harvesters' many climate-related challenges -- including water scarcity, poor soil health and desertification – the company has developed sustainable sourcing projects to help farmers overcome climate-related risks and improve their livelihoods. In doing so, this large cosmetic company is reducing the environmental footprint left by its primary cosmetic ingredients and protecting the supply sources of these ingredients in the future. It's a great example of stakeholder alignment.

RECYCLING

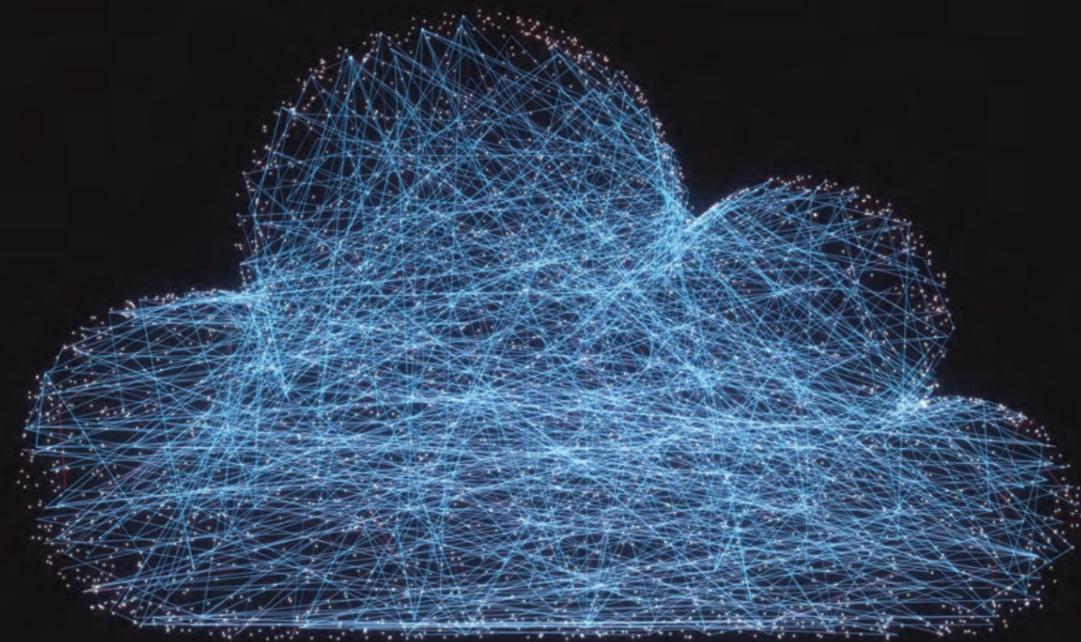
An American soft drink manufacturer that we own was, in 1991, the first company to introduce plastic bottles with recycled content. 88% of

their packaging (and 100% of PET bottles) is recyclable. They have invested heavily in recycling infrastructure; the recycling plants built in Mexico have helped increase the rate of PET bottle recycling from 9% in 2002 to 60% today. By 2030, this company aims to recycle 100% of packaging used. An American manufacturer of household products that we own has partnered with the Sustainability Packaging Coalition to include How2Recycle labels on their North American packaging, informing consumers how each package can be recycled. Over 20 billion padded mailers are used in e-commerce packaging each year, but bubble wrap mailers are not recyclable. A German consumer goods company has collaborated with key e-commerce players to create a new generation of all-paper padded mailers that can be recycled. Flexible pouches are used to package all sorts of consumables, from coffee to dishwasher tablets, but the layered nature of the packaging material means that the valuable aluminium within them is impossible to recover. Working in partnership with recycling companies and key flexible packaging manufacturers, the same German company has created unique adhesives that enable the separation of layers at recycling facilities, turning waste into value.

SOCIAL RESPONSIBILITY

The American beverage company we own has responded to increasing global interest in reduced sugar consumption by aggressively reformatting recipes to reduce sugar, promoting low- and no-calorie beverage options, and investing in systems to make smaller packages more available. As a result of this innovation, in the 2017/2018 period, the company removed 425,000 tonnes of sugar from its products. Another of our holdings, a multinational consumer goods holding, sets itself apart through its 'purpose-led brands'. The company launched its Sustainable Living Plan in 2010, which lays out three goals. By 2020, they aim to help more than a billion people take action to improve their health. By 2030, their goal is to halve the environmental footprint of their products. By 2020, they hope to enhance the livelihoods of millions of people. The plan includes eliminating deforestation from the commodity supply chain by 2020, establishing sustainable agriculture as a mainstream initiative and universal access to safe drinking water. In 2018, this company retained its top ranking in the Sustainability Leaders survey from GlobeScan/ SustainAbility for the eighth consecutive year. No other company has maintained top recognition for so long in the 20-year history of the survey.

These are some of the common themes we are seeing in our global portfolios from companies with environmental and social policies that are driving both revenues and consumer satisfaction.



Software & Services

Engaging the workforce

Having an engaged workforce is extremely valuable. The software and services companies held in our global portfolios engage their employees by promoting responsible values and with initiatives that make a difference.



BY NATHAN WONG
Executive Director



BY RICHARD PERROTT
Vice President

A multinational professional services company we own seeks to embrace diversity in its business, not just within its own workforce – in 2018 they were ranked number one on Thomson Reuters Diversity and Inclusion Index, for the third consecutive year – but also in its supply chain. By the end of 2018, its Diverse Supplier Development Program had developed 144 small, medium and diverse suppliers towards its target of 170 by 2020.

Another one of our holdings, a German multinational software company, creates a culture of inclusion with its groundbreaking Autism at Work program, integrating people with autism into the workforce where

their skills add value. 93% of the company's employees acknowledge the importance of pursuing purpose and sustainability. The company's Corporate Social Responsibility (CSR) scheme has three main pillars: building digital skills, accelerating best-run nonprofits and social enterprises, and connecting employees with a purpose to help ensure everyone can participate in and benefit from the digital world. In 2018, its digital skills and coding programs trained 34,000 teachers, engaged 2.8 million young people and spanned 93 countries. In addition, environmental and charitable activities, such as using GPS technology and in-memory databases to preserve endangered elephants and rhinos, all add to their employees' sense of purpose. As too do the philanthropic efforts of an American multinational technology company, which gives broadly to priority areas of education, human services (affordable housing) and family-friendly arts and culture.

Creating a sense of purpose around the role of the company, above mere profitability, can foster a culture of innovation and development, help with engagement, and even enhance productivity.

Further, an American multinational financial services company we own focuses specifically on financial inclusion. It offers access to finance and is committed to collaborating with partner banks to provide bank accounts to 500 million people by 2020. They have reached 40 million people with their free financial literacy programs, using their technology and global reach to provide free, accessible and innovative financial education resources.

When companies understand that social, environmental and economic activities and performance are interlinked, and reflect this in their culture, it can strengthen employee engagement, and have a positive impact on recruitment and retention.



Health Care

Positive science

A number of the health care companies we own in our global portfolios report their contributions to UN Sustainable Development Goals (UN SDGs) as part of their annual reporting. While we don't seek out companies with an explicit ESG agenda or score in mind, we welcome corporate engagement with the 17 UN SDGs and 169 specific targets. Here we discuss three of the UN SDGs most commonly supported by the health care companies we own: Zero Hunger (Goal 2), Good Health and Well-Being (Goal 3) and Clean Water and Sanitation (Goal 6):



BY MARCUS WATSON
Executive Director

Contemporary society demands that organizations operate with a sense of social and ethical responsibility and, in the case of health care, use science and technology to address health needs.

ZERO HUNGER

Two billion people are affected by micronutrient malnutrition; half reside in countries where rice is a staple food. Fortifying rice can make a real difference to improving nutrition. Scientists at an American health care company we own are working with a nonprofit organization to improve

rice fortification technology and have succeeded in both reducing costs and improving nutritional value. This rice is distributed as part of a school lunch program in India targeting 450,000 children and will be able to help many more in the future. The German multinational life sciences company we own has introduced "high-quality food for all" as a central tenet of its sustainable development program. The company aims to help overcome the challenge of feeding an increasing number of people using increasingly scarce arable land using its innovation in seeds and in biological crop protection solutions.

GOOD HEALTH AND WELL-BEING

The health care companies we own support SDG 3 by using science and technology to address health needs, and by making their products affordable and available. A British multinational

pharmaceutical company we own has trained over 21,000 health care professionals on responsible antibiotic use. The same company donated 8 billion tablets in 2017 to treat neglected tropical diseases, and provided hundreds of millions of vaccines at heavily discounted rates to the world's least developed countries. The Kids and Diabetes in Schools (KiDS) Project run by another of our holdings, a French biopharmaceutical company, has reached more than 45,000 children and 4,400 teachers in Brazil, Egypt, India, Japan, Pakistan, Poland and the United Arab Emirates. The project aims to foster a safe and supportive school environment for children with diabetes. A third holding, an American medical technology company, has a pipeline of products in development to help reduce maternal mortality and preventable newborn deaths, while its technologies are integral to the diagnosis and management of infectious diseases.

CLEAN WATER AND SANITATION

The British pharmaceutical company we hold has robust controls in place to manage the risk of pharmaceuticals, particularly antibiotics, entering the environment via water pollution. The company works with its supply chain and peers to share best practices on managing environmental discharges. Meanwhile, the American health care company we own supports SDG 6 by developing innovative products that can be used safely even when clean water is scarce, supporting communities in water management and working to reduce its own water footprint.

The UN SDGs present a useful framework for companies to help assess and improve their impact on the environment and on society. Our preference is for medical technology and animal health versus pharmaceuticals where government focus on affordable pricing presents challenges to pricing power. We don't select companies on their ESG credentials – we do focus on companies' sustainable long-term returns. Through proactive social and environmental policies, companies can work to safeguard their reputations and sustain their long-term returns.

SELECTING SUSTAINABLE COMPOUNDERS



BY DIRK HOFFMANN-BECKING
Executive Director



BY JILL YTUARTE
Executive Director

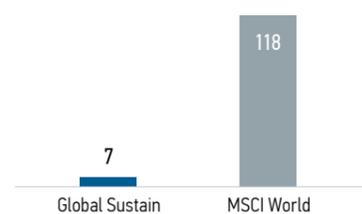
Very few companies make the grade to be included in the Global Sustain portfolio, which we believe to be one of the highest quality ESG portfolios available. We only invest in businesses we believe can generate high, sustainable returns on operating capital. These high-quality companies are rare.

SUSTAINABILITY OF RETURNS

We explicitly exclude capital-intensive, low-return companies that are unable to sustain high returns on operating capital. Our focus on high-return companies with pricing power and limited cyclicality means that typically carbon-intensive sectors, such as energy and materials, would comfortably fail to meet our requirements were they not explicitly excluded.

Instead, we prefer high-quality companies that we believe will be able to grow steadily over the long term at sustainable high returns on operating capital - compounders. These are companies that possess strong intangible assets, such as brands and networks, and recurring revenues which hold up in tough times. Health care, the software and

Global Sustain is carbon-light¹...
Tons CO₂e/\$m Invested



services subsector of information technology and the consumer staples sector are rich sources of the compounders we seek.

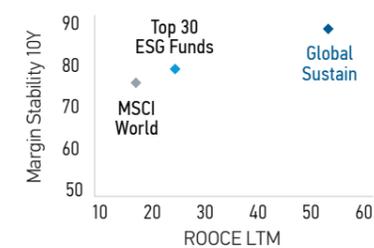
We screen the universe for high-quality companies with attractive valuations. As part of our research and engagement with companies, we consider material ESG issues that could either enhance or disrupt a company's sustainability of returns. These issues include energy sources for data centers, the sustainability of

supply chains, packaging for fast-moving consumer goods companies, consumer relevance, data privacy/security and product quality.

A PORTFOLIO THAT AVOIDS CONTROVERSIAL SECTORS

Global Sustain was built for investors who want to avoid contentious sectors. It excludes tobacco, alcohol, gambling, adult entertainment, controversial weapons, bulk commodities, fossil fuels, gas and electric utilities. In addition, the portfolio is carbon-light, with a carbon footprint 94% lower than the MSCI World Index per \$1 million invested (chart on the left). The resulting Global Sustain portfolio remains rooted in quality, comparing favorably to ESG peers in terms of two key quality metrics: margin stability and returns on capital (below chart).

...and higher quality than ESG peers²
Global Sustain versus ESG Peers



Source: Factset, MSCI ESG, Morgan Stanley Investment Management; as of June 30, 2019.

¹MSCI ESG Research defines a portfolio's carbon footprint as the carbon emissions (Scope 1 and 2) of a portfolio per million dollars invested. They sum up all the emissions in a portfolio based on the investor's ownership share, using reported or estimated emissions data.

²ROOCE (Return Operating Capital Employed) = EBITA (Earnings Before Interest, Taxes and Amortization)/PPE (Property, Plant, Equipment) + Trade Working Capital (excludes goodwill), ex-Financials. Margin Stability is based on earnings before interest and taxes and is calculated using this formula: (1-(std deviation)/mean). 10-year averages to December 31, 2018.

Pay X-Ray

Spotlight on Incentives



Company management generally tend to do what they are being paid to do, which means incentives need to reward behavior that is in the interest of shareholders. How do we monitor this? The Pay X-Ray.



BY VLADIMIR DEMINE
Executive Director

Given our long history of investor-led engagement with companies on the subject of pay, we have identified certain compensation scheme practices – such as earnings adjustments – that we believe to be red flags.

We are wary of incentive schemes that rely too heavily on earnings per share (EPS) as an evaluation metric. If management are getting paid on EPS, it can be tempting to manipulate those earnings using short-term tactics – such as increasing debt or making unwise acquisitions – at the expense of shareholders' long-term returns.

We are equally sceptical about compensation based on "adjusted" earnings, the adjustment meaning that things such as write-offs, costs associated with environmental blunders, or the decision to cover expenses by issuing shares aren't taken into account when pay is being decided. No wonder we tend to refer to them as 'earnings before the bad stuff.'

There are other compensation scheme tactics we prefer to avoid. We try to steer clear of companies

that award high pay for ordinary, or poor, performance. Time served or the ability to show up every day is not a good enough reason to award shares, in our opinion. Moving performance goal posts to suit current circumstances is also frowned upon. For example, a global company with exposure to multiple currencies choosing to reward management when currency movements boost earnings but ignoring or discounting any negative effects of currency moves.

ALIGNMENT WITH SHAREHOLDER INTERESTS

What we prefer to see in the companies we invest in are clear, ambitious goals that are aligned with shareholder interests. We like to see management compensated for achieving return on capital targets, and regularly engage to encourage this. Our engagement has resulted in such practices being adopted in a number of the companies that we invest in.

We support minimum levels of management share ownership and actively engage to encourage such ownership requirements stay in

place for a period after executives retire. Having such an arrangement in place prevents any temptation to inflate results in an unsustainable manner, ensuring a high payout for the executive on exit but damaging long-term shareholder returns.

THE PAY X-RAY

Every company pay scheme is different, so we created the pay x-ray to provide a more level playing field. Using a proprietary scoring mechanism we can compare the pay plans of all of the companies we invest in and make decisions on those we will vote in support of, and those we won't. In addition, the pay x-ray creates discussion within the investment team, as well as highlighting specific issues for engagement. Our *Engage report*, published twice yearly, provides examples of this in action.

In a deeply imperfect world, we do not want our search for 'perfect' to get in the way of the reasonable, especially if our pay x-ray shows the reasonable is improving year-on-year.

KNOCK-ON EFFECTS

We focus on factors that may materially influence the sustainability and direction of future returns, which is why scrutiny of material ESG risks and opportunities is fully integrated into our investment process.

Instant global communication and the immediacy of social media can leave a company's reputation in tatters within hours. For this reason, we believe it is important to identify and understand any material reputational issues – including environmental and social - that might impact the sustainability and direction of future returns for the companies in which we invest.



BY LAURA BOTTEGA
Managing Director

As we explained previously in "ESG Scores: Comparing Apples to Oranges," we do not use scores to determine potential ESG considerations, but prefer to consider each company (and any environmental or social factors) individually as part of our fundamental stock selection process. We believe the key is to concentrate on material risks that can have a significant impact on the fortunes of the company. While we take a bottom-up approach to assessing companies, there are common issues that we see within sectors.

PRICING MATTERS

An obvious material concern in the health care sector, for example, is U.S. drug pricing, which has captured the headlines and been used as a campaign tool. Even though prescription drugs account for only 10% of U.S. health care expenditure, politicians have seized upon the issue, amplifying the social consequences for companies.¹ We monitor the risk of negative headlines about drug prices for the health care sector and individual companies within it.

There are some health care companies – notably high-quality medical equipment companies – that have managed to sustain high returns on capital without relying on excessive pricing. Big data, for example, is emerging as an effective way to help hospitals to reduce costs by understanding population health trends. On the other hand, this increases the risk of data security issues.

PRIVACY, PLEASE

Portfolios aiming to grow capital and reduce downside participation need to tread carefully along the fault lines of digital ethics. Rapid data-driven technological change is transforming how we live and work. Should governments eventually decide to seriously curb the flow and use of personal data due to political and social concerns (fake news and election meddling, social media/smartphone addiction, privacy), this would damage business models reliant on monetizing it (see a certain social media giant's problems with U.S. Congress, the U.K. government and the European Union [EU]).

Fines for breaches of data privacy can hurt companies in any sector but primarily in information technology, health care and financials (e.g., health insurance). The EU's GDPR regulation has exponentially increased potential fines, especially for highly sensitive data like health records. Companies could be caught unprepared for this completely new risk. Additionally, bigger companies represent a bigger 'threat surface' for cyberattacks unless they invest.

However, this could present an opportunity for large cloud providers if they can prove to clients that data security in the cloud is better than in on-premise storage. The security of customer data held by corporations, privacy issues relating to how data is being monetized and cyberthreats are leading to increased spending on security software. These evolving trends will open up new markets, new risks and potential opportunities. We invest in companies that we believe are more likely to benefit from these material opportunities and avoid those who rely on the monetization of data as the driver of revenues.

CHANGING TASTES, CHANGING FORTUNES

We avoid owning consumer staples companies where management is failing to position their firms for future consumer demand – for example, U.S. food companies. As an industry, food manufacturers face multiple and fast changing challenges. If management is short-sighted about changing tastes, then their company will struggle. Take the increased interest in healthy eating, and the desire for food with recognizable, more natural ingredients. This has led to consumers concentrating their shopping on the outer aisles of supermarkets, where the fresh, natural and whole foods are stored and avoiding the middle aisles that are home to more processed food items. Failure to adapt resulted in the top 25 U.S. food and beverage companies losing \$18 billion in market share over a five-year period, according to Fortune (2015).

We want to understand the return drivers behind every stock we own. When we discover issues that are material – especially when they have knock-on effects that could jeopardize the sustainability of a company's long-term returns on operating capital – we look deeper, and we engage.

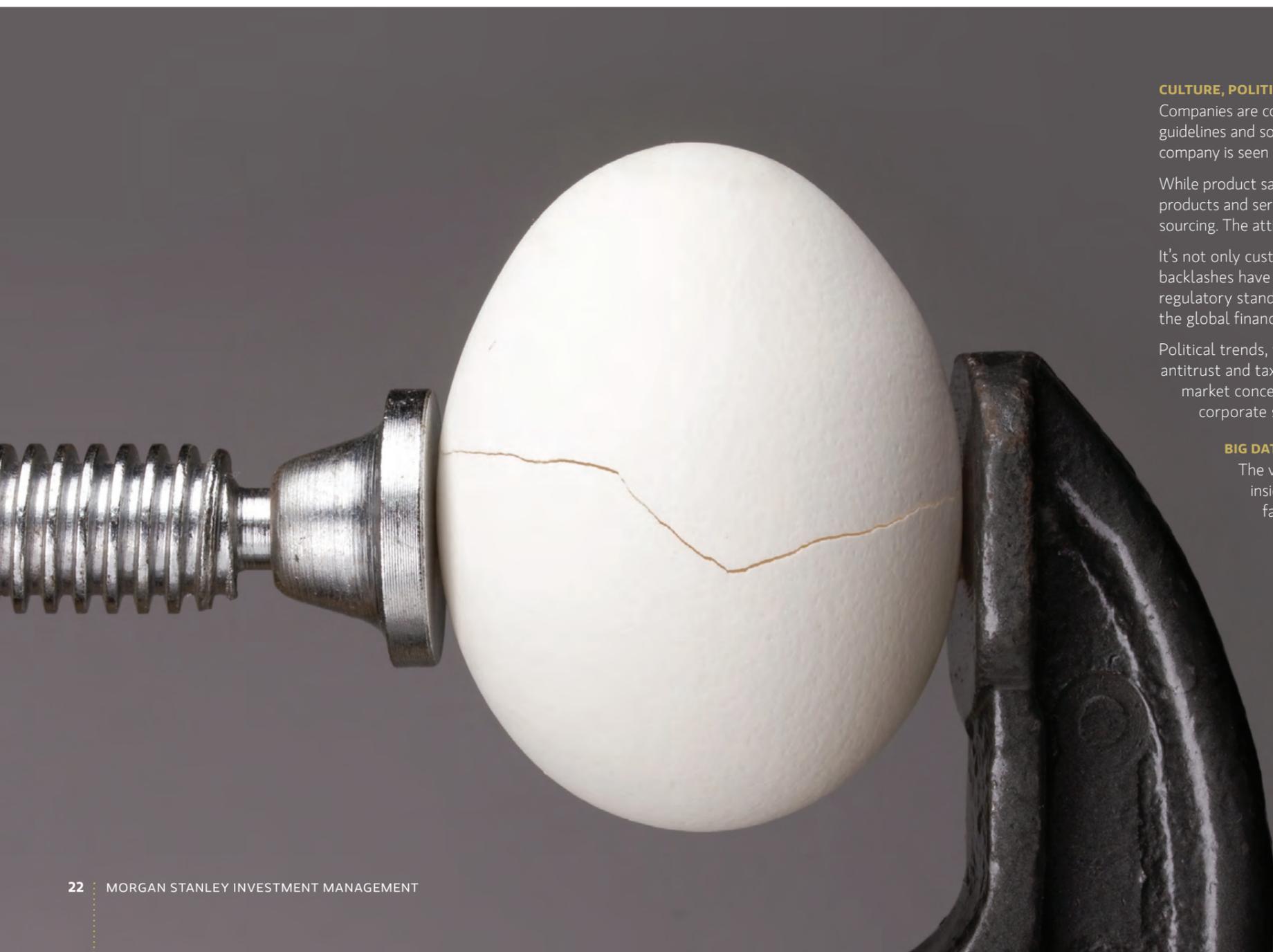
¹ Source: National Health Expenditures Report, cms.gov, 2017.

CORPORATES Under Pressure

Environmental and social issues are a significant risk to the continued success of compounders, along with other changes, such as technology. Companies that fail to look after their relationships with customers and regulators are playing fast and loose with their core intangible assets.



BY BRUNO PAULSON
Managing Director



CULTURE, POLITICS, REGULATION

Companies are coming under increasing pressure from all sides to meet a growing number of standards, guidelines and social demands. Failure to meet them can trigger public backlashes or boycotts when a company is seen to have failed. The resulting publicity can be devastating to a firm's reputation and profits.

While product safety has always been a key concern there is now additional focus on the impact of products and services on the environment and society, including climate change and ethical and sustainable sourcing. The attitude of the company on equality and discrimination can also be a source of vulnerability.

It's not only customers that companies have to please – governments too are weighing in. Regulatory backlashes have become increasingly severe towards companies that break the law or fail to meet regulatory standards – just ask the banking sector, which has been hit with \$300 billion in fines since the global financial crisis in 2008.

Political trends, too, suggest a less benign environment for corporations, especially in the realm of antitrust and taxation. Strengthening populist movements are giving a voice to those concerned about market concentration and tax avoidance, notably by large technology companies with complex corporate structures.

BIG DATA, BIG RESPONSIBILITY

The volume of data available about all of us has exploded in recent years. According to insideBIGDATA, human and machine-generated data is experiencing an overall 10 times faster growth rate than traditional business data, and machine data is increasing even more rapidly at 50 times the growth rate. While such proliferation has generated significant opportunities – for example, health care companies using big data to understand population health trends – with big data come risks. If a company is seen to misuse or neglect the security of customer data, it jeopardizes its reputation, customer loyalty and market value, as demonstrated by the drop in share price of an American social networking company and a multinational consumer credit reporting company when news emerged of data breaches and hacking. Meanwhile, regulations such as the General Data Protection Regulation (GDPR) have ushered in a tougher era for companies operating too close to the line.

Our investments in the technology sector tend towards "enterprise staples" that are typically less exposed to direct consumer data risks.

Regulatory and technological changes have made environmental and social concerns even more important than before. We would argue that a company's ability to deal with them effectively is central to quality management, to governance and to sustaining high returns.



Tackling Plastics



BY VLADIMIR DEMINE
Executive Director

Plastic is high on the corporate agenda. We looked at the companies within our portfolios to assess how this topical issue might influence their sustainability of returns on capital. We believe that by addressing their plastic consumption, companies not only benefit the environment, but also create opportunities to differentiate themselves.

The world is drowning in plastic. A 2016 report (The New Plastics Economy: Rethinking the future of plastics) by the Ellen MacArthur Foundation predicts that, based on current trends, there will be more plastic in the oceans than fish come 2050.

Around half the total plastic produced is used for consumer goods packaging, usually single use, and very little is recycled, whether due to economic or technical reasons.

We believe taxes on plastic packaging, including outright taxes on virgin plastic, higher waste processing fees, and the introduction of deposit return fees, may all have a material effect on consumer staples companies in the future, unless they manage to adapt.

In terms of cost, we have identified two main ways in which plastic may impact fast-moving consumer goods (FMCG) companies, in addition to reputation or brand damage.

PLASTIC TAXES AND REGULATION

The aim of a plastic tax is not to raise revenues or reduce plastic use, but to encourage an increase in recycled content, e.g., a tax is levied on any packaging with less than 30% recycled content. We would anticipate any such tax being large enough to be noticed by packaging manufacturers (with their low margins) and their FMCG clients, but not so large that it would hurt final consumer demand if passed on.

The tightening of extended producer responsibility (EPR) rules would have a similar impact to the introduction of a tax. EPR means that companies producing any kind of waste have to pay the costs of dealing with it. The most comprehensive scheme is in Germany where brand owners are compelled by law to pay 100% of the net cost.¹ Meanwhile, in the U.K., the system only covers about 10% of the cost, although this is currently being reformed.² The EU, too, is reviewing EPR requirements across the bloc. To quantify the effect, we calculated the potential cost impact of such a scheme on an American beverage company we own. Should the whole world move to the German model,

it would cost this company 4% of sales, while a move to the average EU cost would have an impact of 1% of sales.

Strong consumer brands have significant pricing power and have historically managed to pass a substantial proportion of their input cost inflation to their customers. We believe this would also apply to plastic. Similar to raw material inflation, if regulation increases companies' costs, every company in a given country will be impacted similarly and will likely try to pass cost increases onto consumers. Given low price elasticity in consumer staples, we believe the volume impact of such industry-wide price increases would be limited.

INCREASED COST OF RECYCLED MATERIAL

There are over 350 signatories to the Ellen MacArthur Foundation's New Plastics Economy Global Commitment, representing around 20% of global plastic packaging use. Their aggregate commitments to increase recycled content amount to five million tonnes of additional demand for recyclate by 2025-2030, compared to current market demand of what we calculate to be around three and a half million tonnes. Such a significant increase in demand may, in the medium term, push the premium up until enough capacity comes on stream.

With consumers ever savvier about responsible corporate behavior, our engagements with the FMCG companies we invest in show they are taking plastic waste seriously and, in preparation for the upcoming impact of stricter regulation and plastic taxes, have dramatically increased their commitments to virgin plastic reduction. Plastic may not currently represent a material risk to the sustainability of returns of consumer staples companies, but the potential of it doing so in the future, not to mention reputational damage, is too high to dismiss.

In April 2019, Morgan Stanley launched its Plastic Waste Resolution, committing to facilitate the prevention, reduction and removal of 50 million metric tonnes of plastic waste from rivers, oceans, landscapes and landfills by 2030.

¹ Source: LSE Research Online: "Packaging waste recycling in Europe: is the industry paying for it", Ferreira da Cruz et al.

² Consultation on reforming the UK packaging producer responsibility system, Department for Environment, Food and Rural Affairs.

25-50 of the Highest Quality Stocks in the World



Global Sustain is a high-quality, low carbon portfolio using bottom-up fundamental analysis and active engagement with company management, when appropriate, to identify material environmental, social and governance risks to and opportunities for the sustainability of long-term company returns.

THE PORTFOLIO

- 25-50 of the highest quality compounders in the world at reasonable valuations
- A carbon-light portfolio that avoids low-return polluting sectors, such as materials, energy and gas and electric utilities
- Excludes contentious industries, such as tobacco, alcohol and controversial weapons
- Exposure to companies leading the way in consumer and staff engagement through a focus on key social and environmental issues
- Invests in companies demonstrating capital discipline driven by capable management and a sound governance structure

WE BELIEVE

- The best way to compound shareholder wealth is by owning very high-quality companies with sustainable and high returns over the long term: 'sustainable compounders'
- Integrating ESG is essential for successful long-term compounding
- Investing in sustainable compounders requires focusing on minimising the risk of permanent loss of capital rather than chasing upside
- Material social and environmental risks to the sustainability of long-term returns, and therefore compounding, are more important than ever, given political and technological change
- Leading the way on social and environmental issues can be a positive force for corporate success, driving consumer, employee and stakeholder engagement
- The higher the quality of a business, the more important governance is, as management has more degrees of freedom to mismanage the business
- Investing with a conscience doesn't have to mean sacrificing the potential for attractive long-term returns

WE BRING

- A history of more than two decades of successful investment in sustainably high-return compounders
- A disciplined process focusing on the risks and opportunities facing currently successful businesses
- The scrutiny of material environmental and social risks and opportunities fully integrated into the investment process
- A key focus on good governance and a successful record of engagement with companies

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