Morgan Stanley

INSTITUTE FOR SUSTAINABLE INVESTING

Morgan Stanley

INVESTMENT MANAGEMENT

Crafting a Dynamic Sustainable Investing Strategy

Four Building Blocks for Asset Owners

Executive Summary

With the COVID-19 pandemic, climate change and inequality collectively driving news headlines, political discourse and economic realities around the globe, institutional investors are facing increased pressure to responsibly manage—and even address—sustainability issues within their portfolios.

Meanwhile, the market for sustainable investing has hit an inflection point. Such strategies now account for over $30 trillion in assets under management globally[1]—up more than 30% since 2016 and nearly 70% since 2014. Moreover, 57% of asset owners practicing sustainable investing anticipate that in the next two to five years they will only allocate capital to managers that take a formal ESG approach.[2]

Yet, while sustainable investing is now firmly in the mainstream, many asset owners struggle to formulate a successful long-term strategy for their institution. Against a fast-moving backdrop of varied investment philosophies, wide-ranging stakeholder pressure and growing regulation, a host of questions often emerge. Among the most common: *What is the full spectrum of approaches to sustainable investing implementation? How should we define and communicate success? Who are our key stakeholders? Where is the right place to start within our investment portfolio?*

Over the past decade, Morgan Stanley Investment Management and the Morgan Stanley Institute for Sustainable Investing have collaborated with asset owners from around the world to define and advance their sustainable investing programs. Through this process, we have learned that constructing a successful sustainable investing strategy is complex, and one size does not fit all. However, in our experience, asset owners that intentionally apply the four-building blocks shown below are well positioned for the long term.

By following this roadmap, asset owners can take advantage of emerging best practices while avoiding common pitfalls in developing a sustainable investing strategy. This brief provides an overview for decision makers, including guidance and exploratory questions to help all institutions develop, implement and maintain a successful strategy.

FOUR BUILDING BLOCKS TO HELP CRAFT A DYNAMIC SUSTAINABLE INVESTING STRATEGY

1	2	3	4
Clarify the Motivations and Investment Philosophy driving your institution to pursue sustainable investing	**Identify the Implementation Approaches** that best align with your institution's motivations and investment philosophy	**Define the Investment Strategy**, including where sustainable investment criteria will be used across the portfolio	**Design the Operational Strategy**, including appropriate internal processes, governance structures and resources to support implementation

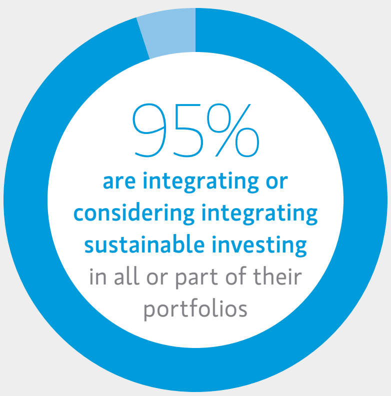
A Rise in Sustainable Investing

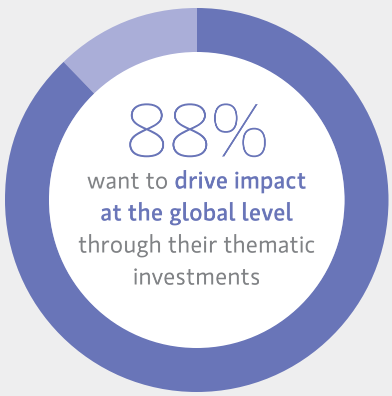
Global asset owners now routinely incorporate environmental, social and governance (ESG) factors in their investment decision making. The most recent Sustainable Signals survey of global asset owners by the Morgan Stanley Institute for Sustainable Investing and Morgan Stanley Investment Management published in 2020 revealed eight in ten asset owners actively integrate ESG factors into the investment process—up 10 percentage points in two years—while a further 15% are considering doing so.[3]

At the same time, sustainable investing remains relatively new for a majority of global asset owners. Our latest survey also found that 73% began practicing sustainable investing less than five years ago—and 21% within the last 12 months.

To best position themselves for the long term, institutions should be prepared to refine their strategies against a backdrop of evolving market dynamics and growing stakeholder and regulatory pressure. This includes, for example, decisions on which asset classes, approaches and sustainability themes to make their focus.

Among institutional asset owners:[4]





Avoiding Common Pitfalls in Developing a Sustainable Investing Strategy

A clear process, overseen and supported by senior decision-makers, can help institutions avoid the most common pitfalls in developing a sustainable investing strategy. Where such direction is lacking, institutions risk making one of two errors. They may over-plan, resulting in too broad a focus or too ambitious a strategy with insufficient resources and data to operationalize it. This can result in inaction and missed opportunities. Or, investors may respond too quickly to pressure from stakeholders such as employees, external beneficiaries, regulators, peers or non-governmental organizations. This often results in a patchwork approach that lacks a cohesive narrative, risking internal misalignment or reputational harm.

Four Building Blocks of a Sustainable Investing Strategy

The process put in place must also ask the right questions, develop clear answers with relevant internal stakeholders and mobilize the resources needed to operationalize the agreed strategy. In our experience, the institutions that maintain successful sustainable investing strategies over time adopt the following four building blocks:

1
Motivations and Investment Philosophy

Clarify Motivations and Investment Philosophy

WHY is our institution pursuing sustainable investing?

The first element of a successful sustainable investing strategy is to establish a clearly defined investment philosophy around sustainability based on the institution's priority motivations for taking such a step. All key internal stakeholders, including senior leadership and investment team(s) need to be engaged and on board. While motivations for adoption vary by institution and may change over time, they can be grouped into two main categories: financial and organizational.

Financial drivers of sustainable investing are regularly entering investment conversations, as a growing pool of evidence demonstrates that sustainability may support long-term value creation. For example, from 2004 to 2018 sustainable funds experienced 20% smaller downside deviation compared to traditional funds, according to a recent study by the Morgan Stanley Institute for Sustainable Investing.[5]

Such findings have led to a change in mindset among many asset owners who no longer view sustainable investing as a financial tradeoff but instead an opportunity to improve financial returns. In our most recent survey of global asset owners, four in five agreed that sustainable investing is not only an effective risk management strategy but can lead to higher profitability.[6]

Organizational drivers are also gaining more attention as asset owners face pressure to demonstrate the ethical, environmental and social attributes of their investments. Stakeholders pressing for action range from constituents—such as pensioners seeking to mitigate ESG risks or Millennials looking to achieve positive impact through their capital—to regulators requiring greater disclosure and transparency. As a result, some asset owners, particularly large public pension and sovereign wealth funds, are directing their capital to help drive real-world sustainability outcomes. We expect this trend to continue or accelerate in the post-pandemic environment, as investors seek to tackle the macro-economic impacts of global challenges such as climate change, public health and social justice.[7]

FIGURE 1: Asset Owners Have Many Motivations to Adopt Sustainable Investing

FINANCIAL DRIVERS

GLOBAL TRENDS AND OPPORTUNITIES
Making investment decisions informed by long-term sustainability trends such as population growth, water scarcity, energy use and carbon emissions

RISK MANAGEMENT
Seeking to avoid reputational risk or valuation impacts as a result of ESG issues

RETURN POTENTIAL
Using sustainability criteria to help identify sources of higher alpha—or lower beta—within a portfolio

ORGANIZATIONAL DRIVERS

REPUTATION
Mitigating headline risk and/or supplementing brand value for the institution

STAKEHOLDERS
Complying with industry regulations, aligning with global norms or industry coalitions, and signaling to other key constituents

POSITIVE IMPACT
Generating specific, positive social and/or environmental impact alongside financial returns

KEY QUESTIONS

- What are the core values of our institution and key stakeholders? Is there an opportunity to align our sustainable investing objectives with these values?
- How should we enhance our institution's investment philosophy to better communicate our commitment to a sustainable economy and society?
- Is there divergence or reluctance toward sustainable investing among our key stakeholders (for example, concerns about financial performance)?
- Can we prioritize our motivations as primary and secondary drivers?

2
Implementation Approaches

Identify Implementation Approaches

WHAT are the most suitable ways to align investments with our motivations and investment philosophy?

With underlying motivations clearly defined, asset owners can effectively consider the spectrum of approaches available to implement a sustainable investing strategy. As investors, they may decide to prioritize reducing tail risk, capitalizing on corresponding opportunities, or a strategic combination of both.

As shown in Figure 2, institutions can consider these implications across five primary approaches: restriction screening, ESG integration, thematic investments, impact investing and companies/issuers engagement. Typically deployed in combination across a portfolio, these approaches represent a dynamic implementation toolkit for sustainable investing, enabling investors to tailor activities by asset class and to evolve underlying criteria over time.

In our most recent survey of global asset owners, six in ten of those practicing sustainable investing use multiple approaches within their portfolio. ESG integration is the most common choice for these asset owners, with 92% employing this approach.[8]

FIGURE 2: The Investment Logic of Sustainable Investing

MINIMIZE NEGATIVE IMPACT → MAXIMIZE TARGET IMPACT

RESTRICTION SCREENING	ESG INTEGRATION	THEMATIC INVESTMENTS	IMPACT INVESTING
Intentionally avoiding investments in certain sectors or issuers based on values or risk based criteria	Considering ESG criteria alongside financial analysis to identify risks and opportunities throughout the investment process, which may lead to decisions to avoid, include or size certain investments	Tilting investments toward certain themes and sectors positioned to solve global sustainability-related challenges	Allocating to funds or enterprises intentionally structured to deliver a specific and measurable set of positive social and/or environmental impacts alongside the potential for market-rate financials returns

COMPANY/ISSUER ENGAGEMENT

Seeking to drive improvement in ESG activities or outcomes through proxy voting and/or active dialogue with invested companies/issuers

APPROACHES TO SUSTAINABLE INVESTING	MANAGE DOWNSIDE RISK/VOLATILITY	MANAGE & IMPROVE ESG QUALITY	CAPTURE UPSIDE OPPORTUNITY
Restriction Screening	✓	✓	
ESG Integration	✓	✓	✓
Thematic Investments		✓	✓
Impact Investing			✓
Company/Issuer Engagement	✓	✓	✓

KEY QUESTIONS

- Should our sustainable investing approach be guided by a focus on risk mitigation, upside opportunity, improved ESG quality, or a strategic combination of these outcomes? Which of these approaches reflect our core investment philosophy?
- What are the primary risks, benefits and potential trade-offs of each implementation approach?
- Will approaches be selected based on data-driven evidence, institutional beliefs, reputation, or a combination?
- Are there any themes, geographies or frameworks (such as the Paris Climate Agreement or the United Nations' Sustainable Development Goals) that should guide all or part of our strategy?

3
Investment Strategy

Define Investment Strategy

WHERE can sustainable investment criteria be implemented within our investment portfolio, initially and over time?

With an understanding of different approaches, asset owners can then consider where to initially apply sustainability criteria within their investments and/or the time horizon for integrating sustainable investing more broadly across the entire portfolio.

The early stages of adoption provide an opportunity for experimentation. Asset owners can take an opportunistic approach; for example, introducing sustainability criteria as existing investment mandates roll over or there is new cash to invest. Or, they could consider a dedicated carve-out, consisting of one or multiple asset classes that mirror an institution's overall asset allocation. The latter approach provides a more strategic means of building proof-of-concept internally, enabling the tracking of investment performance and investment selection processes.

Ultimately, achieving total portfolio integration will require a multi-year process, including calibration across asset classes and a supporting operational and governance approach. This transition process may also have implications for how an institution works with external partners, such as third-party investment managers or consultants.

In terms of asset classes, public equities have the longest tradition of sustainable investing; however, opportunities in fixed income are accelerating significantly with the advent of green, social and other labeled sustainable bonds, as well as expanded ESG data coverage for corporate and non-corporate debt issuers. A similar trend is playing out across private markets, real assets and hedge fund solutions.

FIGURE 3: **Integrating Sustainable Investing Across a Portfolio over Time**

EXPERIMENT — BUILD PROOF-OF-CONCEPT — FULLY INTEGRATE

OPPORTUNISTIC IMPLEMENTATION

- Standalone investments, made on ad-hoc basis
- A means to "test the waters" before making a formal commitment, though may lack strategic connectivity

DEDICATED CARVE-OUT

- Dedicated subset of holdings, across one or many asset classes
- Can be a strategic path to gain buy-in and establish processes internally

TOTAL PORTFOLIO INTEGRATION

- Encompasses multiple asset classes, strategies and teams
- Requires implementation and refinement over multiple years

KEY QUESTIONS

- What is the ideal pace and timeline for integrating sustainable investing across our investment portfolio? How can we best achieve our investment philosophy in each asset class?
- What is the most effective mix of internal and external implementation, based on our current in-house expertise and resources?
- How can we embed sustainability considerations into our asset manager due diligence to gain transparency into which partners can best support our sustainable investing strategy?

4
Operational Strategy

Design Operational Strategy

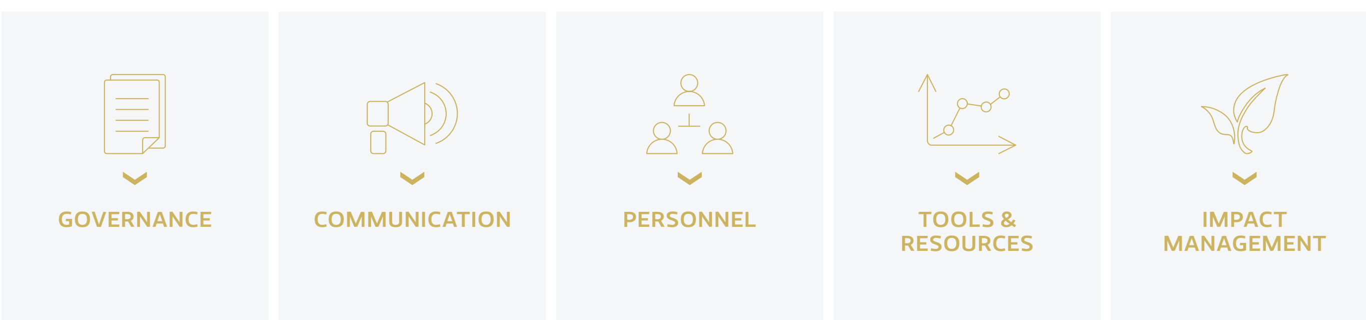
HOW will our organizational resources, governance structures and processes be deployed to support the sustainable investing strategy?

Effective sustainable investing strategies continue to evolve in response to market developments and new internal considerations. Within each organization, this requires an appropriate governance structure accountable for defining, communicating and meeting goals and an operational backbone to support implementation. As the case for sustainable investing has grown, organizational oversight at asset owner institutions has increasingly centered on senior leadership. Typically, this includes any or all of the CEO, CIO, Investment Committee, Risk Committee, and Board of Directors—often supported by dedicated specialists within the appropriate operational functions.

Asset owners should also consider setting formalized and documented sustainable investing goals. This helps ensure that internal and external stakeholders are not only aligned, but also prepared to act on the organization's strategic priorities, targets and preferred approaches. For example, a stand-alone vision statement or ESG policy statement can help align internal stakeholders such as investment committees, senior management and employees. An integrated investment policy statement that embeds sustainability considerations, or investment management agreements with defined ESG terms, can serve the same purpose for external partners, including third-party investment managers. Other channels, such as an annual sustainability report or website, can be helpful forums for communicating with other partners, peers and the general public.

Beyond governance and communication, decision makers must secure the needed resources—in terms of employees, skillsets, data and tools—to deliver the sustainable investing strategy and report on its impact.

FIGURE 4: **Operational Dimensions to Support a Sustainable Investing Strategy**



KEY QUESTIONS

- Which senior individuals or internal decision-making body should provide oversight and guide decisions about our sustainable investing strategy? Does a new governance body need to be formed?
- Who are our organization's primary stakeholders on the topic of sustainable investing? Are they internal, external, or a combination? Is there consensus on the best ways to reach them?
- How will success be defined, who is accountable for it and what metrics should be used to measure and report progress, both internally and externally?
- Do we need to invest in additional hiring, training, resources or internal processes to effectively deliver the sustainable investing strategy?

Bringing It All Together

This brief provides asset owners with guiding questions and an actionable overview of the key building blocks to help develop a successful sustainable investing strategy. However, this will be an iterative and ongoing process for each organization. To maintain success, institutions may need to revisit these four key steps over time to account for new resources, stakeholders or points of view.

As the range of sustainable investing approaches, themes and data points proliferate, asset owners increasingly seek partnership, resources and complementary expertise from like-minded organizations.[9] Representing a global financial services firm at the nexus of the sustainable investing market, the Morgan Stanley Institute for Sustainable Investing and Morgan Stanley Investment Management are well positioned to support asset owners in the development of a tailored sustainable investing strategy.

About Morgan Stanley Institute for Sustainable Investing

The Morgan Stanley Institute for Sustainable Investing is housed within the Global Sustainable Finance group and chaired by Morgan Stanley's Chairman and CEO, James Gorman. The Institute works to accelerate the global adoption of sustainable investing and finance strategies. Its Advisory Board, comprised of corporate, sustainability, academic and philanthropic leaders, helps ensure that our approach to sustainability and sustainable investing is comprehensive, rigorous and innovative.

Morgan Stanley Investment Management leverages and benefits from Morgan Stanley's decade-plus commitment to sustainable finance. Positioned at the nexus of the firm's business units and the broader sustainable finance market, the Morgan Stanley Institute for Sustainable Investing serves as a unique resource and partner on innovation, knowledge sharing and thought leadership.

About Morgan Stanley Investment Management

Globally, Morgan Stanley Investment Management (MSIM) actively invests more than $715 billion across public and private markets.* MSIM's mission is to serve clients by achieving their investment objectives, and providing a comprehensive array of investment solutions, competitive results and enduring relationships. The global suite of products and services offered span the risk/return spectrum across geographies, investment styles and asset classes, including equity, fixed income, alternatives and private markets.

Across MSIM's diverse range of investment strategies, the investment philosophy is to generate alpha through active management grounded in sound fundamental research and analytics. The portfolio managers' demonstrated expertise is built on innovative research, rigorous analysis and high-conviction investment decisions.

MSIM believes that ESG factors influence risk, return and opportunity, and our portfolio managers integrate them in a variety of ways in building client portfolios and making investment decisions. MSIM investment teams, and the Global Stewardship team, engage directly with companies to drive change and promote responsible investing practices. Working with the Institute for Sustainable Investing and Morgan Stanley's Global Sustainable Finance team, MSIM provides portfolio solutions that help clients meet their environmental, social and governance goals.

* As of September 30, 2020

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Notes

1 "2018 Global Sustainable Investing Review," Global Sustainable Investment Alliance, 2019 (http://www.gsi-alliance.org/wp-content/uploads/2019/06/GSIR_Review2018F.pdf; accessed on September 6, 2020).

2 "Sustainable Signals: Asset Owners See Sustainability as Core to the Future of Investing," Morgan Stanley Institute for Sustainable Investing and Morgan Stanley Investment Management, 2020 (https://www.morganstanley.com/pub/content/dam/msdotcom/sustainability/20-05-22_3094389%20Sustainable%20Signals%20Asset%20Owners_FINAL.pdf; accessed on September 3, 2020).

3 Ibid.

4 Ibid.

5 This is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** "Sustainable Reality: Analyzing Risk and Returns of Sustainable Funds," Morgan Stanley Institute for Sustainable Investing, 2019 (https://www.morganstanley.com/content/dam/msdotcom/ideas/sustainable-investing-offers-financial-performance-lowered-risk/Sustainable_Reality_Analyzing_Risk_and_Returns_of_Sustainable_Funds.pdf; accessed on September 9, 2020).

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7 "The Butterfly Effect & COVID-19: Six Implications for Sustainable Investing in an Interconnected World," Morgan Stanley Investment Management, 2020 (https://www.morganstanley.com/im/en-us/individual-investor/insights/investment-insights/covid-19-six-implications-for-sustainable-investing-in-an-interconnected-world.html); accessed on September 14, 2020.

8 "Sustainable Signals: Asset Owners See Sustainability as Core to the Future of Investing," Morgan Stanley Institute for Sustainable Investing, 2020 (https://www.morganstanley.com/pub/content/dam/msdotcom/sustainability/20-05-22_3094389%20Sustainable%20Signals%20Asset%20Owners_FINAL.pdf; accessed on September 3, 2020).

9 Ibid.

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