Morgan Stanley
INVESTMENT MANAGEMENT

Engage

ENGAGEMENT REPORT | AUTUMN 2024

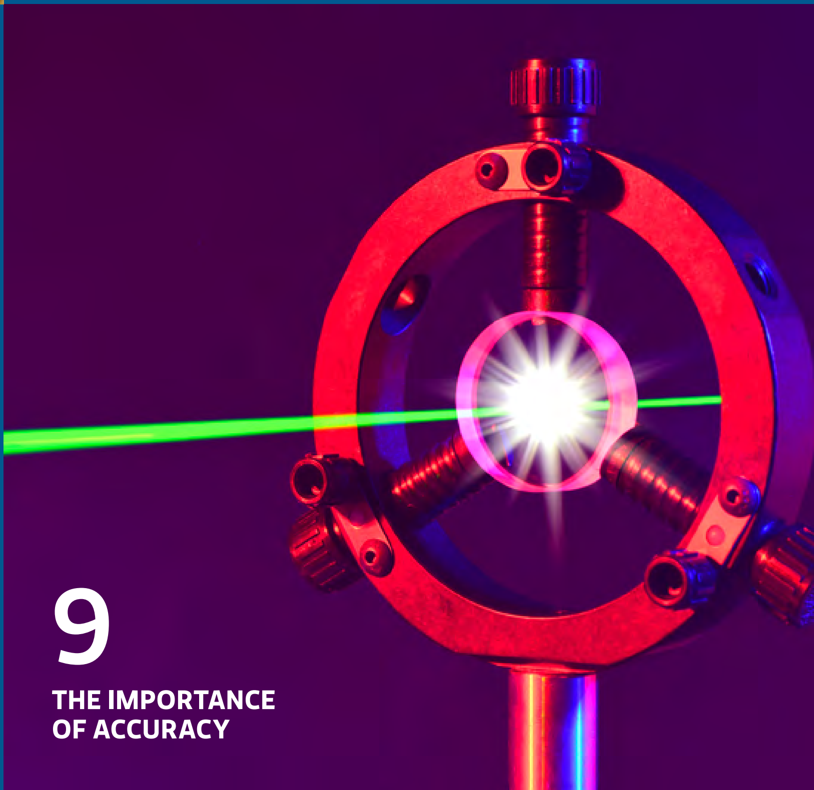
INTERNATIONAL EQUITY TEAM

Contents

Scope of Report

This report covers the engagement activities of the International Equity Team, acting on behalf of its clients in the strategies set out below. The engagement case studies and/or proxy voting activities included in this document are examples of the type of engagements and proxy voting the team carries out with companies on matters it believes are potentially financially material risks or opportunities.

This report relates to activities carried out in the period 1 July 2023 – 31 December 2023, unless otherwise stated. As at the date of publication, the International Equity Team manages the following strategies: Global Franchise, Global Franchise Equity Income, Global Franchise ex Tobacco, Global Quality, Global Quality ex Tobacco, Global Sustain, International Equity, International Equity Plus, American Resilience, and International Resilience. These strategies are made available through different vehicles globally as well as segregated mandates. The activities in this document may not be applicable to all strategies or vehicles.



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THE IMPORTANCE OF ACCURACY

Sixty Second Snapshot

Accounting for all costs

Our decade-long engagement on pay with a German multinational software company we hold in our global and international portfolios concluded satisfactorily with the company's decision to include share-based compensation (SBC) in its earnings. In this piece, we look at the increasing prevalence of SBC in employee compensation and why excessive use of it can be problematic.

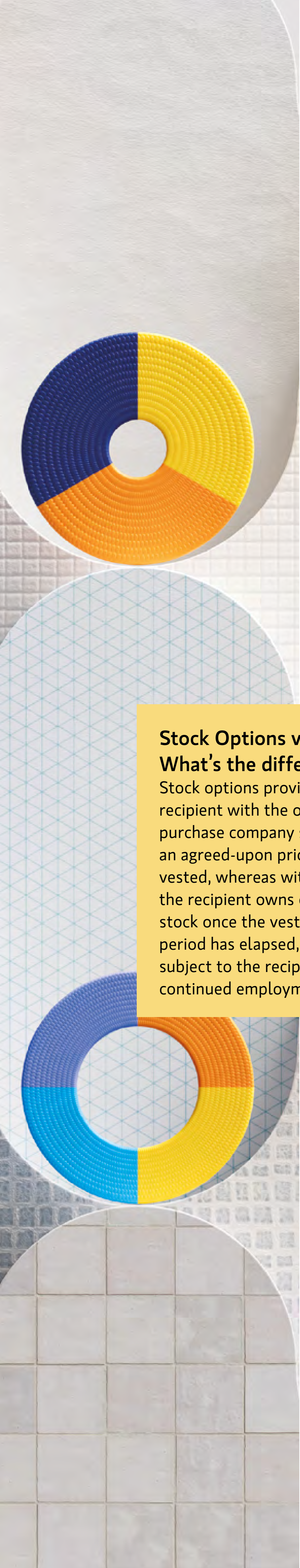
The importance of accuracy

The reporting of inaccurate data can pose a potentially financially material risk to credit rating companies, including litigation and reputational risks, as these companies play a key role in helping creditors make decisions about granting individuals loans. In this engagement, we met with one of the credit rating companies we hold to discuss accuracy in credit reporting.

Seeing the wood for the trees: EUDR 101

With potential fines for companies of up to 4% of total European Union (EU) turnover, the EU Deforestation Regulation (EUDR) has the potential to pose financially material risks to companies doing business in the EU. In order to understand the risk facing companies in our portfolios, we set out to assess the exposure of companies we own and engage directly with those we consider to be at potential risk. In our engagements, we focused our discussion on the visibility and transparency of companies' supply chains today, as well as any planned changes to meet the new rules.

Accounting For All Costs



AUTHOR

BRUNO PAULSON
Managing Director

E S G

EXECUTIVE COMPENSATION

Our decade-long engagement on pay with a German multinational software company we hold in our global and international portfolios concluded satisfactorily with the company's decision to include share-based compensation (SBC) in its earnings, as formally announced at the end of 2023.

Stock Options vs RSUs: What's the difference?
Stock options provide the recipient with the option to purchase company stock at an agreed-upon price once vested, whereas with RSUs, the recipient owns company stock once the vesting period has elapsed, typically subject to the recipient's continued employment.

SBC 101

While for many companies cash is the primary way employees are compensated, SBC in the form of stock options and restricted stock units (RSUs) is becoming more prevalent, particularly among U.S. tech companies.[1] SBC can be a useful tool: as a deferred method of compensation, it allows companies who are short on cash to offer competitive incentives to attract and retain talent. It also offers a form of ownership, more closely aligning shareholder and employee interests who want to see the company's share price increase.

Excessive use of SBC, however, can be problematic. A common and generally well-acknowledged issue is dilution, as increasing the number of company shares available reduces the value of existing shares and investors' proportional ownership. To overcome this problem, companies may periodically engage in stock repurchasing programmes, or buybacks, to neutralise the share count increase, though this is at the cost of the cash spent to buy the shares.

Another issue is the additional complexity that comes with calculating the impact of SBC on a company's fair value. Given the effect on capital structure, one might expect SBC to be a standard feature in financial reporting. Indeed, the IFRS[2] requires companies to recognise share-based payment transactions in financial statements, and GAAP[3] requires SBC to be included as a non-cash expense on income statements, though as a non-cash item it is not deducted from free cash flow. Unfortunately, companies' preferred methods of reporting don't necessarily mesh with preferred standards, meaning

[1] According to a report by Barrons, average stock-based compensation has increased five-fold from just 4.2% of revenue in 2012 to 22.5% in 2021: https://www.barrons.com/articles/okta-confluence-snowflake-tech-stock-based-comp33588231.

[2] International Financial Reporting Standards (IFRS).

[3] Generally Accepted Accounting Principles (GAAP).

earnings are often reported 'adjusted', i.e., excluding the cost of SBC. But pretending that stock compensation isn't a real cost distorts historical earnings and clouds consensus estimates on potential profitability, when analysts' forecasts are intended to do the opposite and provide some degree of transparency around a company's outlook. Just because SBC isn't always visible as an accounting line doesn't mean that the cost is non-existent. As Warren Buffet said: "*If options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And if expenses should not go into the calculation of earnings, where in the world should they go?*"

Better Numbers Lead to Better Decisions

As a team, we generally include SBC as a cost when conducting investment analysis of a company, deducting it from both adjusted earnings and free cash flows, and we encourage the companies we own to include SBC in reporting. Why?

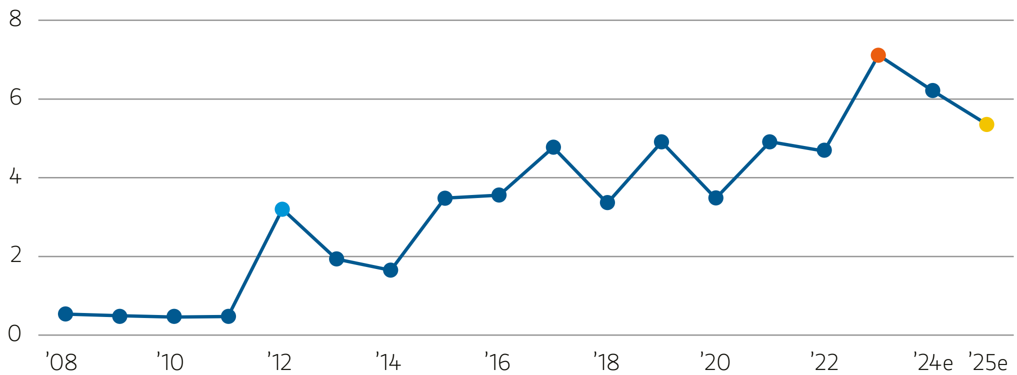
- **Excluding SBC from cash flow statements means earnings are overstated, given that payroll costs would have been higher had employees been settled with cash.**
- **Over time, the expense associated with share buybacks – made necessary as an attempt to rectify the dilutionary effect of shares paid out in SBC – can make a profound difference to a company's cash flows, impacting a company's long-term compounding potential.**
- **Not accurately accounting for SBC leaves room for the cost to go unchecked. After all, management can't manage what isn't measured, and nor can an investor…**
- **Considering SBC in financial reporting provides a clearer set of numbers for investors and management to guide towards.**

For the company in question, while we have already seen some positive outcomes from our prolonged engagement on pay (as reported in "Show me the money", Engage Spring 2023 and "A vote in favour of progress on pay", Engage Winter 2023), we have continued to express our ongoing dissatisfaction that the company's targets were still based on non-IFRS numbers, which exclude SBC.

Over the last decade (2013-23), as shown in Figure 1, SBC rose from 1.9% to 7.1% of total company revenue, representing a quarter of operating profits by 2023. Company management didn't count it as a real cost, as such, it didn't feature in consensus numbers or in compensation targets.

FIGURE 1

SBC as a percentage of company revenues[4]



- 2012-13: 25th company anniversary saw management gift employees shares
- Awarded employees shares in 2021 as a means of retention: shares did very well in 2023
- 2023-25: SBC awarded in actual shares rather than notional. Expected to come down due to better accounting going forward

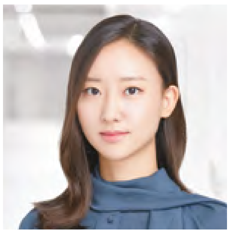
[4] Source: FactSet

In March 2023 the company appointed a new CFO, who in conversation has been quite clear that he views SBC as a cost. In 2023 the company switched from awarding notional shares, which transformed to cash after three years, and paid the bulk of SBC in actual shares. To our satisfaction, at the end of 2023 the company announced that from 2024, SBC will be accounted for in earnings. Following that announcement, the forecast SBC cost for 2025 has fallen from €2.6 billion to €2 billion, down to 5.3% of revenues, as management has announced its intention to use it more sparingly and have it falling as a percentage of revenues. Given that company management compensation will now be affected by SBC numbers, we consider this another good example of incentives driving outcomes. The reduction in forecast SBC has also added over 5% to 2025 earnings estimates and contributed to the strong YTD share performance.

Conclusion

We are no strangers to the fact that successful engagement takes time and perseverance. The inclusion of SBC in the company's earnings is the result of a decade-long conversation with the company on how it pays its executives and employees, and the changes we wanted to see. Our message was consistent, passed on via both active, investment team-led engagement and in our proxy voting activities. We are pleased that this combination of patience and consistency has resulted in a successful outcome.

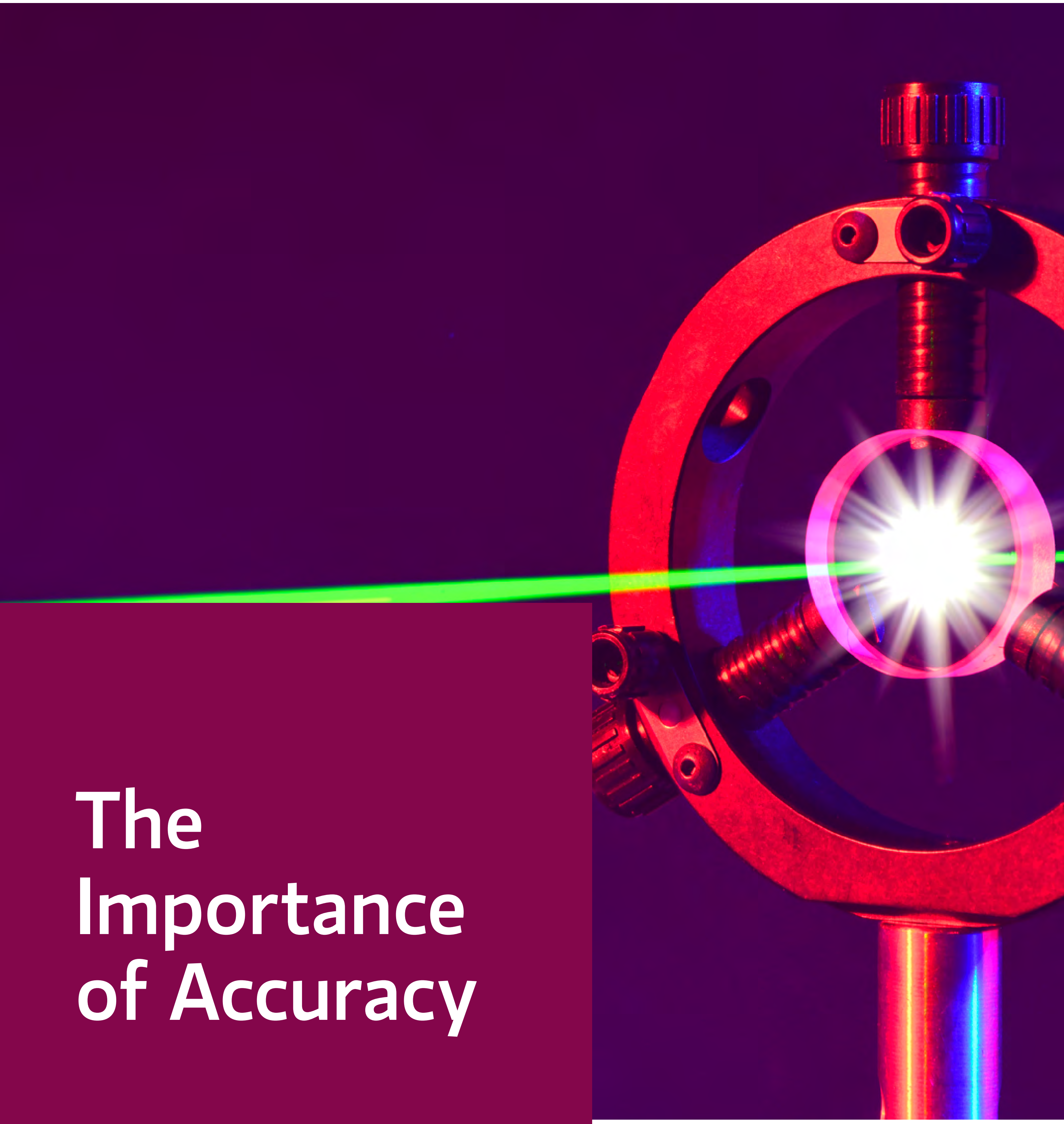
AUTHOR



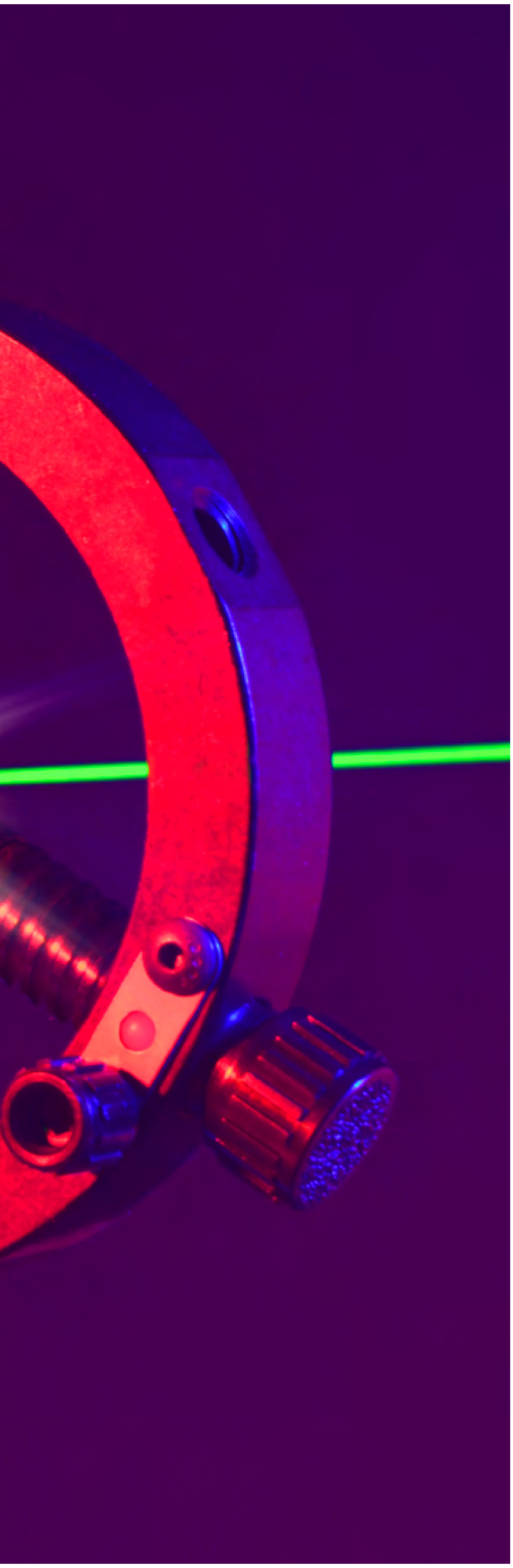
JINNY HYUN
Associate

E S G

DIVERSE & INCLUSIVE BUSINESS



The Importance of Accuracy



The reporting of inaccurate data can pose a potentially financially material risk to credit rating companies, including litigation and reputational risks, as these companies play a key role in helping creditors make decisions about granting individuals loans. In this engagement, we met with one of the credit rating companies we hold to discuss accuracy in credit reporting.

The Issue

Incorrect credit report data can hamper access to credit. Perhaps the most obvious impact is to the customer, who may then struggle to access the many products that require a credit report, from phone contracts to loans, credit cards to rental agreements or mortgages. There is also precedent for this issue to be a financially material risk to companies. As an example, in 2022, a coding error at the company in question saw inaccurate reports shared with lenders, inflating the costs for thousands of consumers looking for loans and insurance.[5] This resulted in an almost $500,000 settlement with the Pennsylvania Attorney General's Office. Other litigation around the accuracy of credit reporting includes a different credit provider named in a class action lawsuit settlement having falsely reported some customers as deceased.[6]

Credit reporting is under increasing scrutiny from regulators and other stakeholders focused on financial inclusion. Customers are also becoming increasingly aware, thanks to media and ongoing settlements, that inaccuracies in reporting can occur, with the number of complaints about credit mistakes on the rise.[7]

When completing the Material Risk Indicator (MRI) for this company,[8] access to credit – and the impact that credit reporting

[5] https://www.cbsnews.com/pittsburgh/news/pa-attorney-general-secures-nearly-500000-in-settlement-with-equifax/

[6] https://topclassactions.com/lawsuit-settlements/closed-settlements/cic-mortgage-credit-inaccurate-reporting-385k-class-action-settlement/

[7] https://www.nytimes.com/2021/02/19/your-money/credit-report-errors.html

[8] The MRI is our team's proprietary ESG framework which aims to identify and assess the financially material ESG risks and opportunities facing each company. For further details, please read our MRI white paper, "The Material Risk Indicator: A proprietary framework for assessing ESG risks and opportunities", available here.

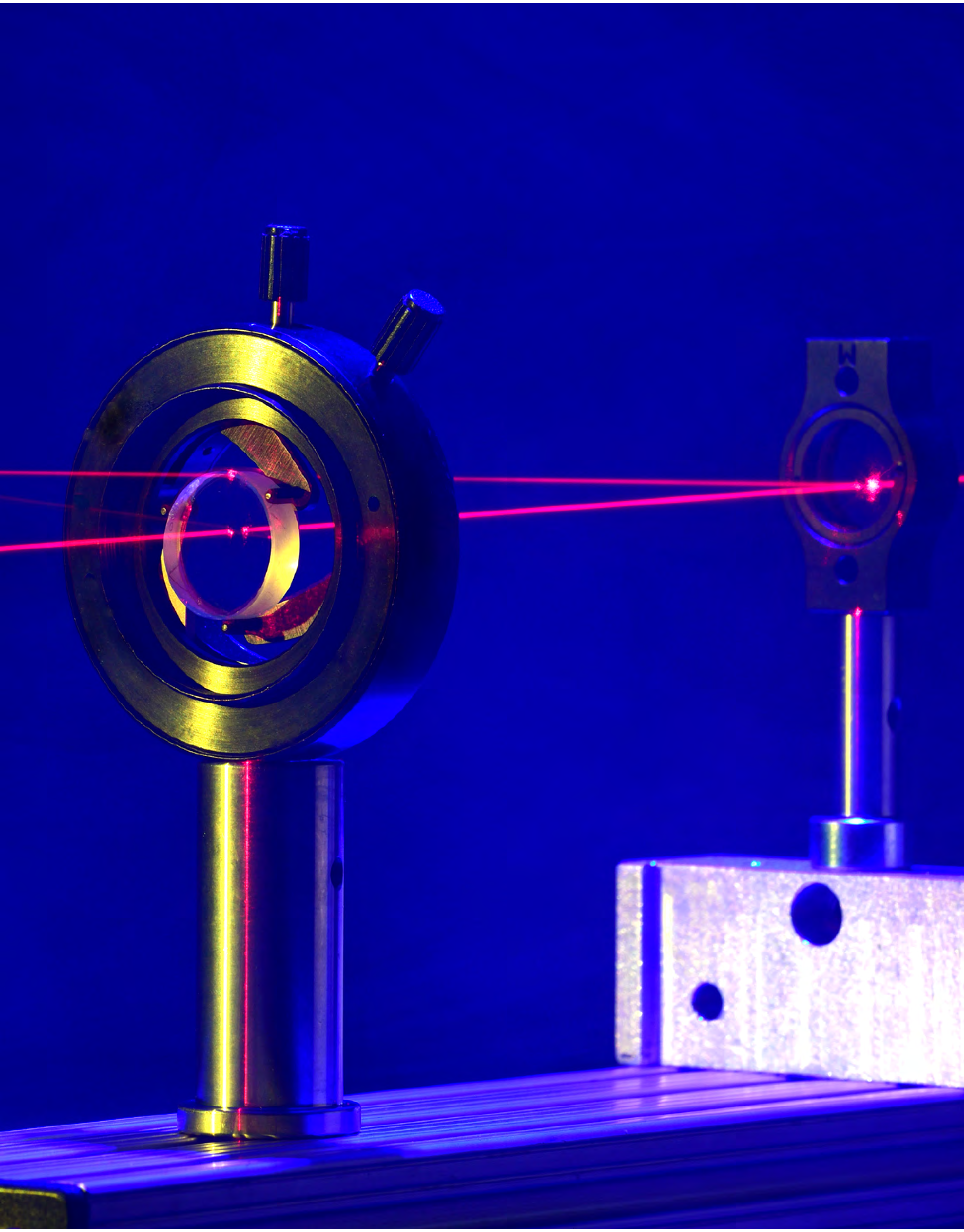
data has on this access – was flagged as a potentially financially material risk at the industry level. We believe that reporting on accuracy levels provides transparency to customers and stakeholders, and helps keep the company accountable to fair and accurate practices. During a previous engagement meeting in Q3 2023, we asked that the company start publishing data on the accuracy of its credit reports. At the time, while not publicly reported, the company informed us that it had approximately 99% data accuracy. While this sounds reasonable, in our view, when considered in the context of the real numbers of end users, a 1% room for error was still too high.

What We Learned

In this meeting we were pleased to learn that the company has started publishing data on the accuracy of its credit reports, in line with our suggestion. We believe this will provide greater transparency over the regulatory and reputational risks of inaccurate data. The company reported accuracy of 99.7%, with 0.3% confirmed errors. On closer questioning, the company explained that management and the board has spent time overseeing processes and governance. While the majority of data errors come from external data sources, its new task force focused on four key initiatives–, including automated review of data files to look for illogical conditions in data and the use of plain language when dealing with customer disputes–, should help combat inaccuracies and improve resolution.

What Next?

The company intends to keep publishing data on the accuracy of its reporting and expressed the hope of continued progress. The company shared that it is looking at AI tools that could potentially “iron out” errors. We asked the company to report historical data in addition to the current data it is now reporting, to allow investors to assess progress. After all, investor trust in the accuracy of reporting is key; disclosures can help to reassure investors that errors are being effectively managed. We will continue to monitor the company’s progress.



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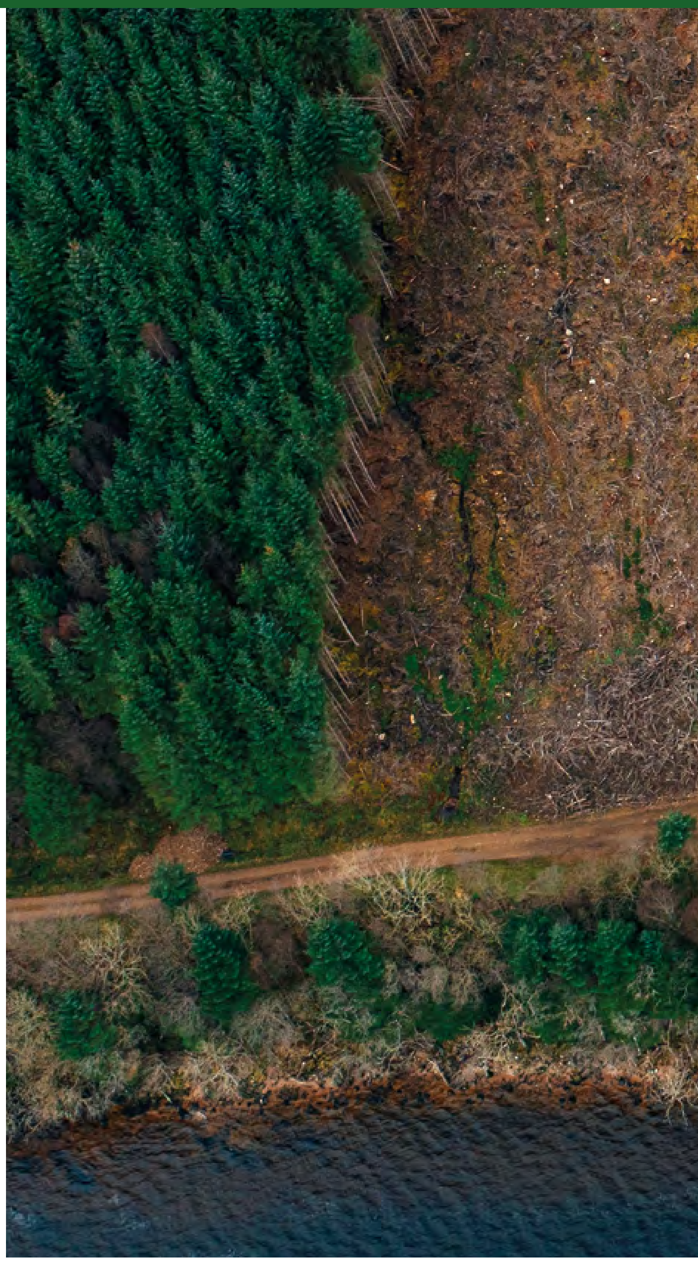
NIC SOCHOVSKY
Managing Director

E S G

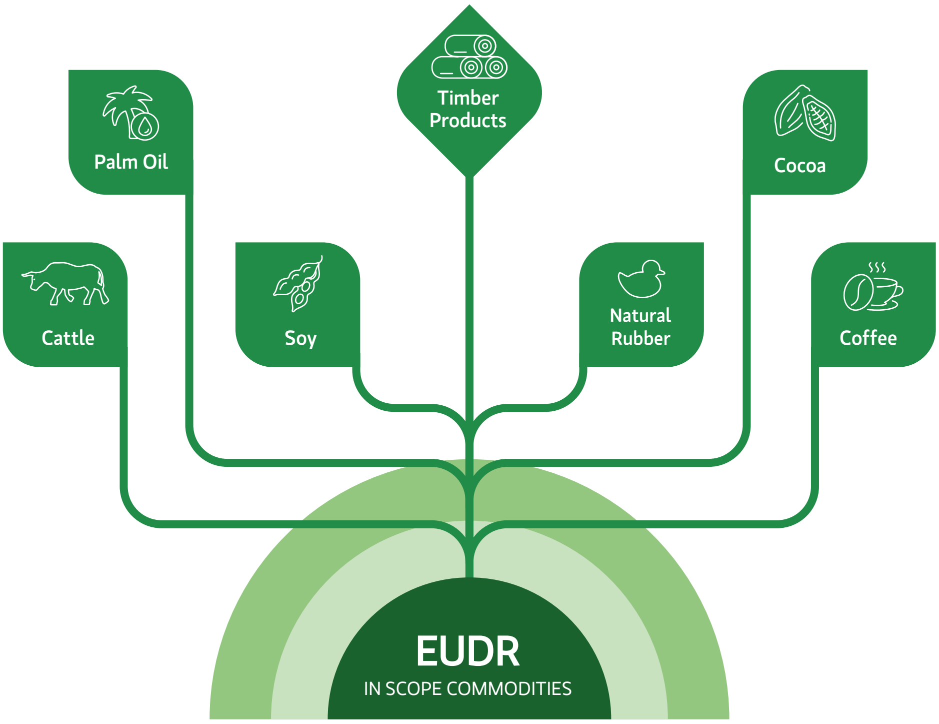
BIODIVERSITY/
ECOLOGICAL IMPACTS

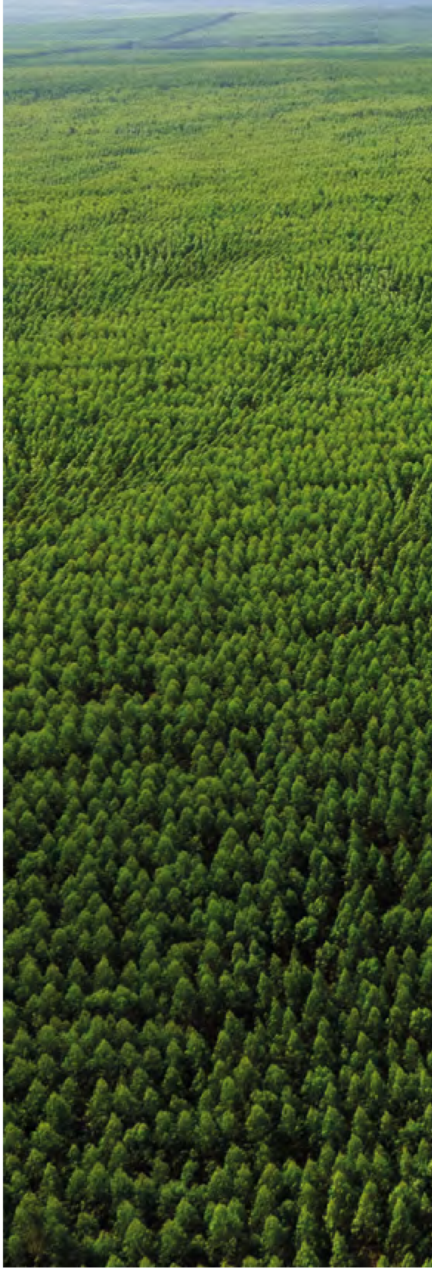
Seeing the Wood for the Trees: EUDR 101



With potential fines for companies of up to 4% of total European Union (EU) turnover, the EU Deforestation Regulation (EUDR) has the potential to pose financially material risks to companies doing business in the EU. In order to understand the risk facing companies in our portfolios, we set out to assess the exposure of companies we own and engage directly with those we consider to be at potentially greater risk. In our engagements, we focused our discussion on the visibility and transparency of companies' supply chains today, as well as any planned changes to meet the new rules.

The threats posed by deforestation – biodiversity loss, climate change, soil erosion and water cycle disruption – are well reported. Since 1990, some 420 million hectares of forest have been lost through conversion to other land uses.[9] What is perhaps less well known is that agricultural expansion is the main driver of deforestation, and that more than half of all agriculture driven deforestation between 2001 and 2015 was due to the production and consumption of just seven commodities:





Overview: What is EUDR?

With the intention of curbing the EU market's impact on global deforestation, the EU implemented a new anti-deforestation law in June 2023 covering the deforestation-linked agricultural commodities listed above. The regulation requires any company that places any of these commodities or products on the EU market, or exports them, effectively to prove that their supply chain is deforestation free. From the start of 2025, companies will need to be compliant or face potential fines.

Engagement With Companies and Stakeholders

We engaged with eight companies in our portfolios that we considered at risk and sought out stakeholders via the World Benchmarking Alliance to speak to experts in the field.

Within our portfolios, our key commodity exposure is palm oil, a key ingredient for household and personal care products. Our consumer staples companies are taking several actions:

- As they are buying palm oil-based products from suppliers in the EU rather than outside the EU, the primary risk sits with the ingredients companies – the suppliers – bringing the palm oil into the EU.
- Companies are shifting the purchase of palm oil for the EU to large plantations. These are already vertically integrated with their own refining mills and so able to provide traceability data and physical segregation.
- As the cost of compliance rises, consumer staples companies are looking to substitute palm oil for synthetic ingredients.

[9] Source: https://www.unep-wcmc.org/en/news/earths-biodiversity-depends-on-the-worlds-forests

The shift to purchasing from larger suppliers who already have the infrastructure in place to meet the rules is taking business away from smallholders, who are in fact the primary cause of deforestation as they seek to increase their acreage to generate a greater income to support themselves and their families. The companies we hold in our portfolios are continuing to invest in satellite monitoring to help mills eradicate deforestation and, along with NGOs, work with smallholders on ways to improve their income using direct payment, via smallholder credits.

Our assessment suggests our consumer staples holdings are not at material risk for the other commodities in scope. In the case of timber, paper and pulp is purchased in the EU where due diligence and traceability is extensive. And with no investments in food manufacturers, the risks posed by coca, coffee and soy are negligible.

A European luxury fashion house we own does have exposure to cattle (leather), as the company produces leather goods on European soil. At present, finished goods containing leather (i.e., shoes and bags) are not covered by the regulation. Even so, the company has stopped purchasing leather from the Amazon basin – a major deforestation hotspot – and for the past several years has been working on a traceability process that includes leather. The latest data shows the company can trace 80-90% of its leather to the country of origin, and it is rolling out an in-house traceability system which, the company reports, will give full geolocation traceability in leather.

Conclusion: Management Prepared

We acknowledge that some degree of potentially financially material risk may still exist given the difficulties companies – even industry leaders – face to ensure full traceability. For the companies we are invested in, which are generally more exposed to palm oil and timber, our meetings have provided us with assurance that, while the regulatory risk exists, it should be manageable.

AUTHOR

MARTE BORHAUG
Head of ESG

Outlook – Adaptation and Complexity

Looking back at the developments in the ESG landscape, the recent period has been a time of adaptation. Regulation and expectations around ESG have both increased and diverged, making getting ESG "right" more complex for companies, investors and the wider industry. At the start of 2023, we believed the following three themes would play out:

Acceleration of energy- and nature-related solutions
We have observed more markets seeking to make climate commitments into policy reality, putting in place regulation and fiscal incentives to meet their carbon reduction targets. This included the implementation of the Inflation Reduction Act in the U.S., and various "Green Deal"-related measures in the EU.

Increased regulations and reporting requirements have, in some sectors and for some companies, resulted in new investment opportunities related to ESG. For instance, a software company expanding its business by providing ESG reporting capabilities, an exchange launching a commodity traceability service, or a manufacturing company growing its client base by offering more energy-efficient options. Companies that can effectively tap into the growing demand for ESG products and solutions may be presented with potentially material long-term opportunities to grow their businesses.

Seeking the value add

We anticipated greater attention paid by investors to the materiality of any benefits of ESG-related proposals. In the 2023 voting season, while the number of environmental and social shareholder proposals filed continued its upward trajectory, average investor support declined, with far fewer proposals receiving majority support.[10] This may be a signal of reduced investor appetite for performative ESG-related action, particularly when the result of the proposal is of little quantifiable financial benefit to companies. During the 2024 U.S. proxy voting season, the decision by one of the world's largest asset managers to back none of the 400 environmental and social proposals put forward by shareholders, citing that proposals were either "overly prescriptive" or did not tackle financially material risks, demonstrates that this trend has only continued in 2024.[11]

Scrutiny of sustainability claims

In 2022, we saw several global financial institutions fined for greenwashing. With regulators proposing new rules and greater enforcement action to ensure that claims made by companies and investors could be evidenced, our expectations of increased scrutiny were proved correct. The U.K. FCA's Sustainability Disclosure Requirements, the U.S. SEC's Names Rule and the EU's ESMA name guidelines all set out specific requirements of asset managers using ESG-related product names in order to prevent greenwashing.

[10] https://insights.issgovernance.com/posts/2023-united-states-proxy-season-review-environmental-and-social/

[11] https://www.investmentweek.co.uk/news/4353110/vanguard-rejects-400-esg-shareholder-proposals-2024-proxy#:~:text=Vanguard%20backed%20none%20of%20the,not%20tackle%20financially%20material%20risks

What next?

While these themes have continued to play out in 2024, other ESG-related trends have emerged.

Divergence from global harmonisation

Navigating deviating rules around ESG matters has become an increasing challenge. 2023 initiatives such as the Task Force for Nature-related Financial Disclosures' (TNFD) final recommendations and the International Sustainability Standards Board's (ISSB) new global rules for climate disclosure[12] sought to encourage global alignment. However, divergence at the country level, combined with a weaker policy environment for transition-focused technology e.g. the rollback of sustainable aviation fuel mandates in Sweden and weakening subsidies for fuel pumps in Germany and Italy, means we are far from a consistent global approach. With 2024 a significant year for elections – around half the world's population will have been invited to vote by the end of the year – changes in governments may well mean that the "quilt" of regulatory frameworks becomes even more complex.

A close eye on supply (chains)

In recent years there has been an increase in legislation forcing companies to pay closer attention to supply chains, with consequences of inaction including the confiscation and destruction of goods at borders, as well as fines. The U.S. Uyghur Forced Labour Prevention Act, Canada's Bill S-211 Fighting Against Forced Labour and Child Labour in Supply Chains Act and the recent EU Deforestation Act (discussed earlier in this report), was joined in spring 2024 by the EU's new Corporate Sustainability Due Diligence Directive. The new directive takes due diligence a step further, requiring large EU and non-EU companies who conduct significant business in the EU, to conduct environmental and human rights due diligence across their operations, subsidiaries, and supply chains. Not only must companies understand what is material to their own operations, but they must also understand, manage and mitigate any negative impact on people within their supply chains. With EU member states due to adopt and publish the necessary laws and regulations to comply with this directive by July 2026, the increased scrutiny of corporate supply chains very much looks set to continue. The next few years may see increased tensions as companies try to balance meeting stricter ESG regulations and the need to be more competitive.

[12] IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information and IFRS S2 Climate-related Disclosures, issued by the ISSB in June 2023, are the first IFRS sustainability disclosure standards.

Artificial Intelligence and ESG

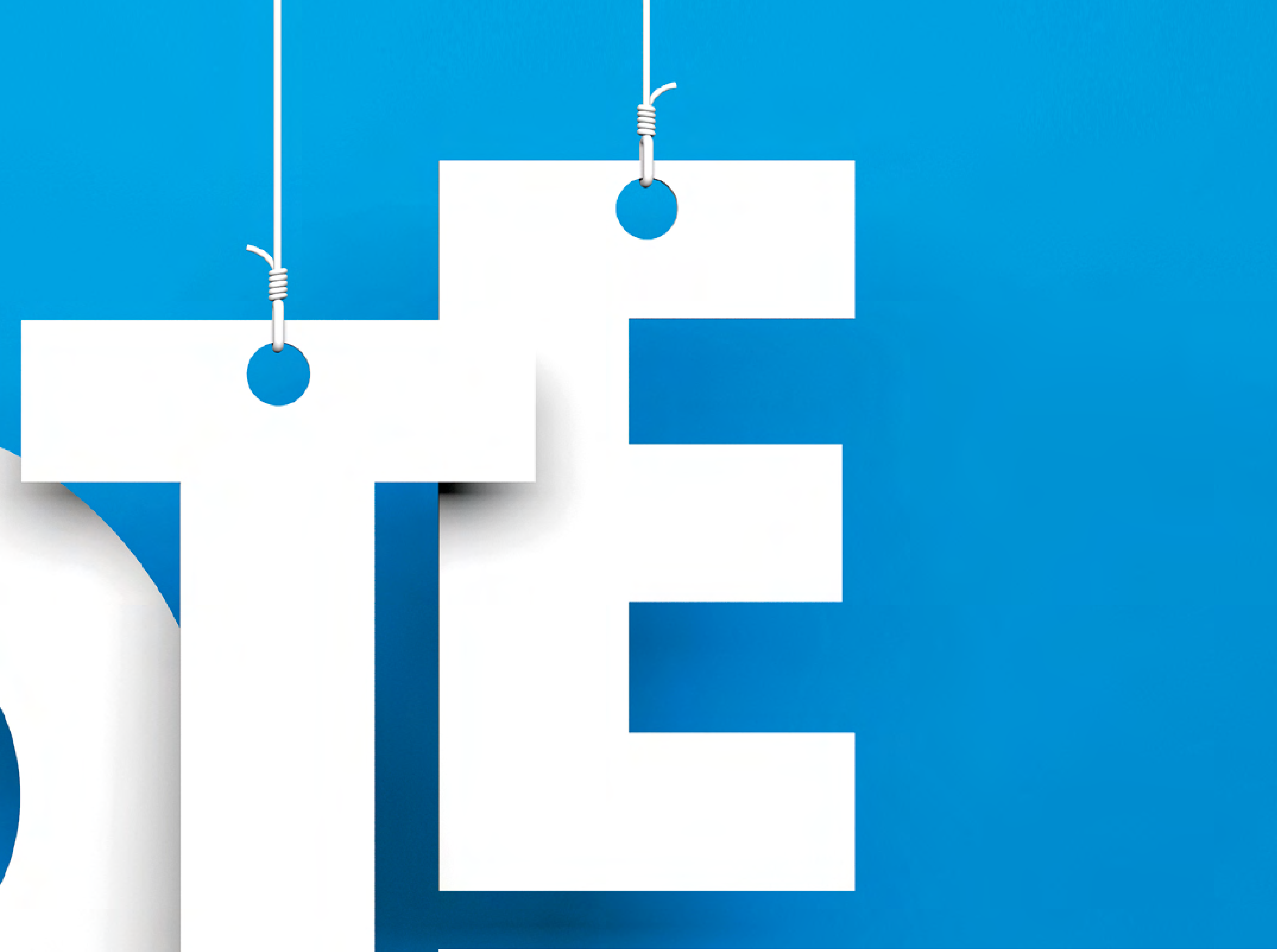
As with many great opportunities, the advent of generative AI (GenAI) also comes with risks. This includes bias in algorithms, data privacy concerns, as well as social tensions around the impact of AI on intellectual property, jobs and democracy.

Regulators are paying close attention. Laws around AI have already been implemented at the state and even city level in the U.S., while at the same time the Federal Trade Commission, Department of Justice, Consumer Financial Protection Bureau, and Equal Opportunity Employment Commission have issued a joint statement on enforcement efforts against discrimination and bias in automated systems. Meanwhile the EU AI Act came into force in August 2024, the first comprehensive regulation on AI by a major regulator, which takes a risk-based approach to regulating the different types of AI systems. We anticipate regulation to continue to evolve as GenAI is adopted by companies for a variety of use cases.

An additional ESG-related risk posed by AI is energy consumption. The immense computer power required for GenAI means that, on average, a ChatGPT query requires nearly 10 times the electricity to process as a search conducted via a standard search engine. Research published by Goldman Sachs estimates that data centre power demand will grow by 106% by 2030, and that carbon dioxide emissions from data centres may more than double between 2022 and 2030.[13] As companies continue to experiment with use case adoption for GenAI, how does this balance with ambitious carbon reduction goals? And as increased power demand puts greater pressure on electricity grids, how will governments and regulators ensure improved grid connectivity and capacity over the coming years?

[13] https://www.goldmansachs.com/insights/articles/AI-poised-to-drive-160-increase-in-power-demand

Proxy Voting



As long-term investors with an owner's mindset, we value the role that proxy voting can play in enhancing long-term investment returns – and the increased attention paid to it by company boards and management. This means we do not outsource proxy voting decisions and never have.

Our voting seeks to be consistent with our assessment of the materiality of specific issues (ESG or other) to the sustainability of companies' returns on capital, our monitoring of company progress, and our efforts to encourage companies towards better and/or more transparent practices.

Our portfolio managers seek to vote in a prudent and diligent manner and in the best interest of our clients, consistent with the objective of maximising long-term investment returns. Our proxy voting is predominantly related to governance issues such as management incentives and director appointments. As relevant, we consider how to vote on proposals related to social and environmental issues on a case-by-case basis by determining the relevance of the issues identified in the proposal and their materiality. We generally support proposals that, if implemented, would enhance useful disclosure or improve management practices on financially material ESG issues.

We are not afraid to disagree with management and third-party proxy advisers, such as ISS. In the 12 months to 31 December 2023, we voted at 96 meetings (100% of all meetings held by our companies) and on 1,715 proposals (100% of all proposals). Overall, we voted against management in 9% of cases, and 70% of meetings had at least one vote against management. Common reasons for voting against management were related to compensation, election of directors and shareholder ESG proposals.

DISPLAY 1

Proxy Voting Overview

(12 months from 01/01/2023 to 31/12/2023)

% total number of meetings held	**96 (100%)**
% total proposals voted	**1,715** (100% of all proposals)
% votes against management as a proportion of resolutions	**9%**
% meetings with at least one vote against management	**69%**

Source: ISS Proxy Exchange; MSIM.

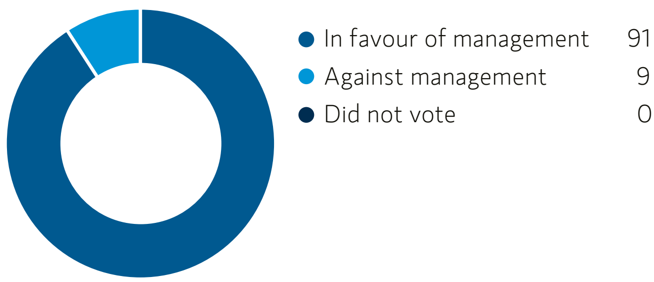
Common reasons for voting against management were related to compensation, election of directors and shareholder ESG proposals.

DISPLAY 2

Voting on 1,715 Proposals

(12 months from 01/01/2023 to 31/12/2023)

% by voting instruction



Source: ISS Proxy Exchange; MSIM.

DISPLAY 3

Votes against management by topic

(12 months from 01/07/2022 to 30/06/2023)

Topic	Votes
Compensation Related	54
Directors Election Related	30
Shareholder Proposal – ESG	29
Routine/Business	12
Takeover Related	11
Capitalisation	7
Director Related	5
Company Articles	5
Other Shareholder Proposal	2
Non-Routine Business	1

Source: ISS Proxy Exchange; MSIM.

Shareholder Resolutions

When we receive any environmental or social related shareholder proposals, we carefully consider how to vote on them by determining the relevance of the issues and the likely financial impact and its materiality. Overall, we supported 49% of shareholder ESG proposals across our strategies and voted against management in 49% of cases.

Say on Pay

Executive pay remained a focus. We voted against 21% of management say on pay resolutions. Additionally, where we have had long-standing unresolved concerns over pay, we voted against members of remuneration committees to make our message heard. We also voted against nomination committee members if we have had concerns over diversity. In total we voted against the election of 28 (4%) directors in the last 12 months.

THE INTERNATIONAL EQUITY TEAM

INVESTMENT TEAM

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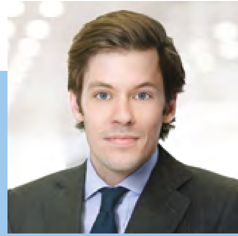
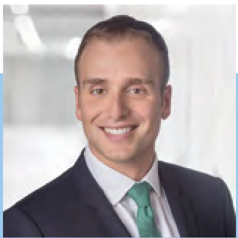
Managing Director
Head of the International Equity Team

BRUNO PAULSON
Managing Director

NIC SOCHOVSKY
Managing Director



MARCUS WATSON
Managing Director



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RICHARD PERROTT, CFA
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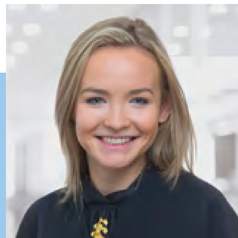
ISABELLE MAST, PHD
Executive Director

ANTON KRYACHOK, CFA
Executive Director

MARTE BORHAUG
Executive Director
Head of ESG

ALESSANDRO VATURI
Vice President



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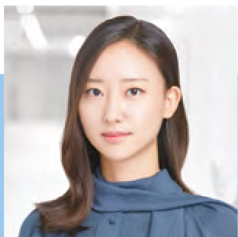

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