

## MSIM Fixed Income Engagement Strategy: Integrated, Insightful, Influential

**FIXED INCOME TEAM** | SUSTAINABILITY INSIGHT | APRIL 2025

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

### The Growing Imperative for Fixed Income Engagement

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

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

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- The vast majority of primary market financing is conducted in the debt market rather than in the equity market, giving fixed income investors a regular and direct interface with issuers seeking their capital.
- The magnitude of debt financing requirements increases in stressed scenarios, increasing the frequency of such issuer/investor interactions and their importance in shaping issuer strategy.
- Fixed income portfolios typically hold a large number of securities and a range of issuers, in contrast to the more concentrated nature of holdings in active equities portfolios, giving investors a broad scope of engagement opportunities where appropriate.

- Fixed income investors are uniquely positioned to engage with and influence issuers that do not have public equity outstanding, including Sovereigns, Supranationals/ Agencies, many High Yield Companies, Securitised issuers, and state-owned enterprises.

### MSIM's Rationale for Fixed Income Engagement

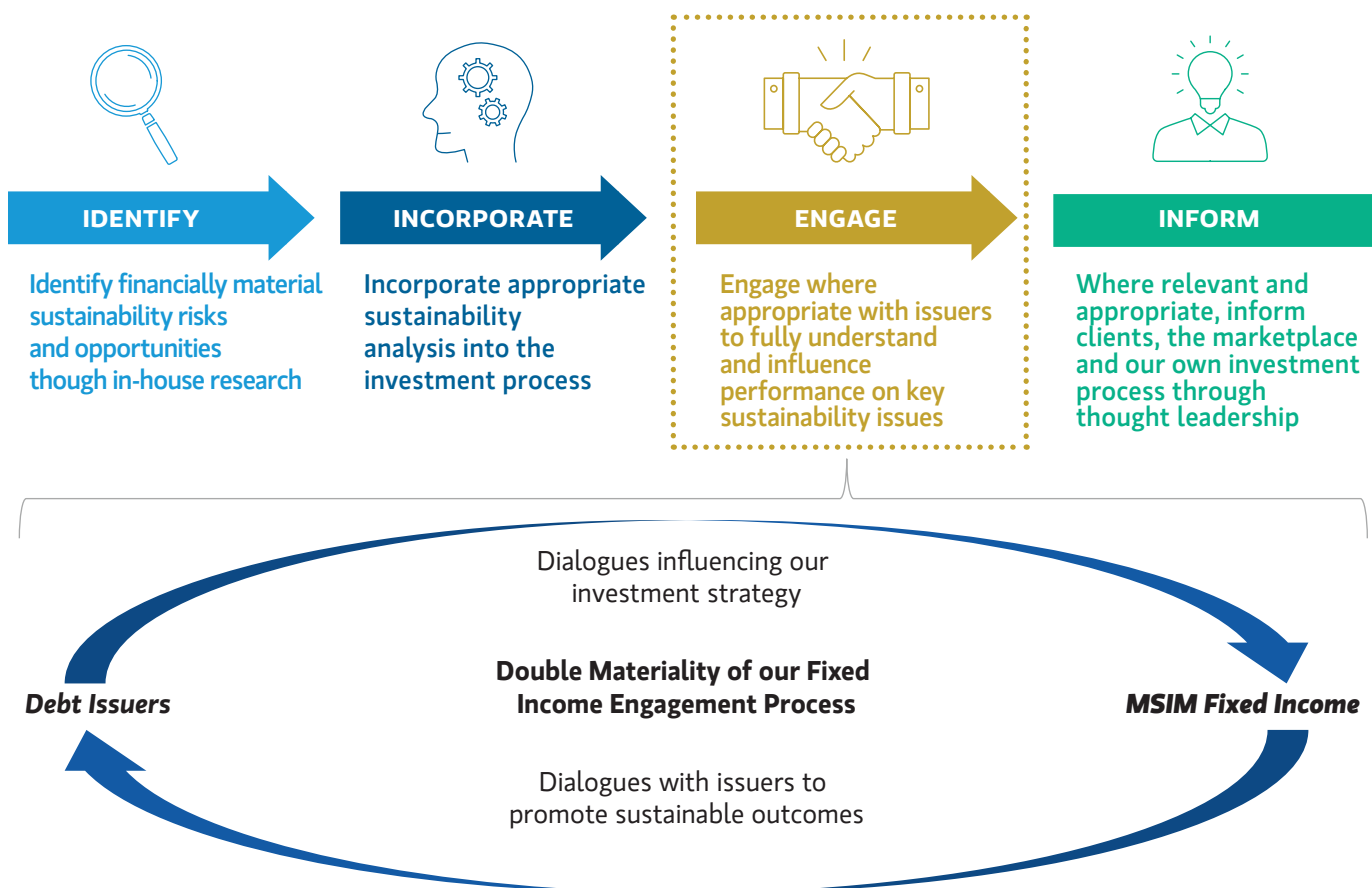
Through our proprietary ESG research, we seek to identify the financially material themes or key performance indicators (KPIs) relevant to an issuer's ESG performance, in the context of its peers. Our Fixed Income engagement programme aims to achieve the following three main objectives:

1. Deepen our insight of financially material issues affecting the issuer, in the context of its sector and/or peers;
2. Where appropriate, push for better sustainability outcomes; and, ultimately;
3. Capture alpha opportunities that may not be fully appreciated by the market, and where appropriate gather sustainability-related information as an input into investment decision-making.

Insights from the engagement process can potentially result in changes to our Credit Analysts' assessment of the issuer. This determination may contribute to our decision to participate in a new issuance, increase or reduce our existing holdings in outstanding bonds, or pass on a new issue.

#### DISPLAY 1

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



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

Finally, we strive to provide the same level of transparency that we expect of issuers. We therefore track and report our engagements on a quarterly basis, including in terms of thematic and sector breakdown, and influence on our investment view or understanding of an issuer's sustainability trajectory.

### The MSIM Fixed Income Approach to Engagement

At MSIM Fixed Income, we view engagement as an indispensable and powerful component of our ESG integration approach (see *Display 1*).<sup>1</sup> This is aligned with our 100% active management model and our duty as responsible stewards of capital.<sup>2</sup>

To this end, we have established an active engagement strategy that is based on three pillars (see *Display 2*) and is applied

across fixed income asset classes. This structure is intended to:

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

### 1. INTEGRATED PROCESS LED BY CREDIT ANALYSTS

Financially material ESG topics are included in our touchpoints with issuers' management and during roadshows, based on the thesis that we can be more impactful in our engagement by regularly following up with issuers on financially material ESG issues, as opposed to conducting sporadic, diluted sessions on a broad range of sustainability topics. Gathering financially material sustainability-related information, and formalising relationships with issuers, can sometimes be the factors that move the needle on an investment decision.

For this reason, our fixed income engagement process is led by the Credit Research team based on a qualitative, analytical approach to evaluate ESG risk

#### DISPLAY 2

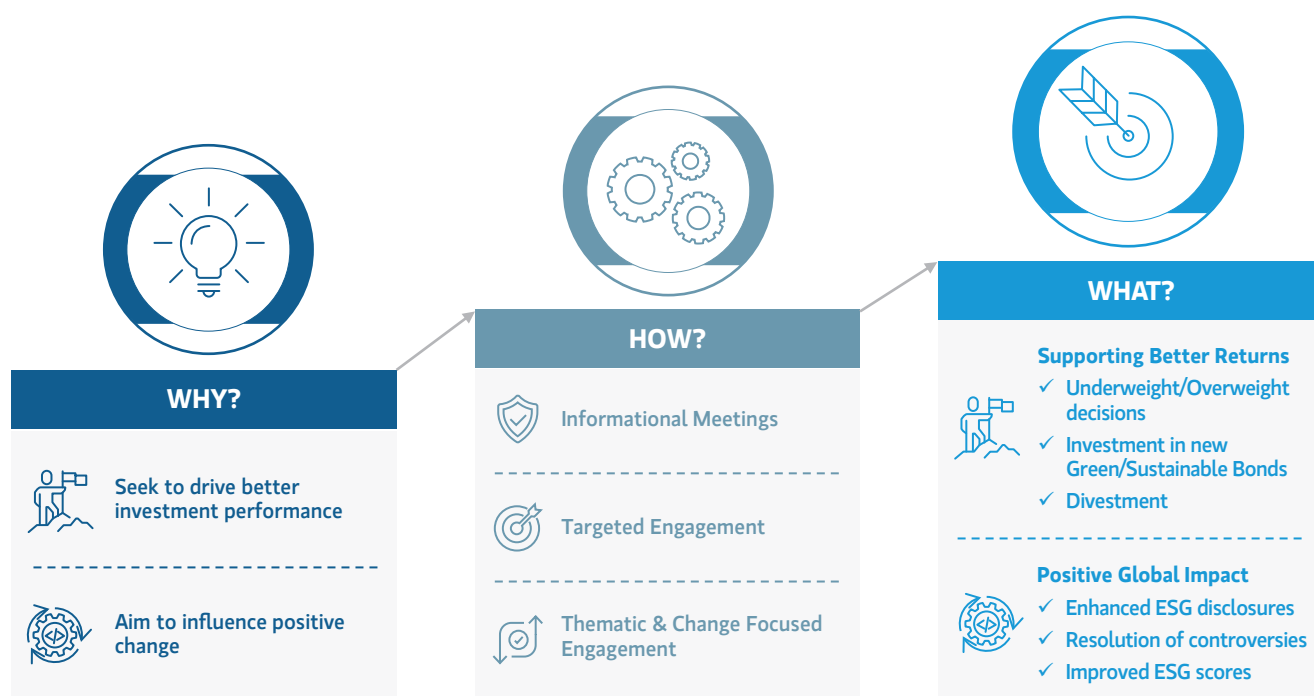
#### The MSIM Fixed Income Three-Pillar Engagement Strategy



This represents how the portfolio management team generally implements its investment process under normal market conditions. Individual funds and client accounts may have specific ESG related goals and restrictions.

<sup>1</sup> See Morgan Stanley Investment Management's Sustainable Investing Policy, ([link](#)).

<sup>2</sup> See Morgan Stanley Investment Management's Engagement and Stewardship Principles ([link](#)).

**DISPLAY 3****Fixed Income Engagement Philosophy & Outcomes**

for the targeted issuers. Our analysts have a deep understanding of the companies they cover, and the engagement topics complement their comprehensive approach. The Fixed Income ESG Specialists may contribute specific ESG expertise, through helping to set thematic priorities, ensuring consistency across engagements, and coordinating with the broader engagement ecosystem internally and externally.

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

## **2. TARGETED ENGAGEMENT — INVESTING TO IMPROVE SUSTAINABILITY OUTCOMES AND RETURNS**

We request meetings with issuers where we believe there is a need to address a specific and financially material ESG matter, relying on our proprietary research capabilities to identify key themes and assess how an issuer is managing key ESG risks in comparison to peers. In

these meetings, we seek to provide recommendations where relevant, such as improving public disclosures or policies, or remediating controversies.

In addition to engaging with ESG laggards, we adopt a strategic outlook on sectoral sustainability opportunities, and where appropriate engage with issuers that we believe have the potential to benefit from those positive tailwinds. Our goal is to identify those ESG improvers, whose progress might not yet be reflected in their public reporting and third-party ratings, as a potential source of alpha generation. Finally, we also engage in conversations with ESG leaders that already have advanced sustainability credentials, to encourage them to share best practices across their sectors, support the adoption of new disclosure standards, and promote innovative sustainable solutions.

On an annual basis, the Fixed Income ESG Specialists identify an “engagement pipeline” of issuers that we intend to meet or follow up with. The list is determined by a set of criteria, including, but not limited to:

- Size of our bondholding across portfolios, particularly in ESG-focused accounts;
- Poor sustainability performance, determined through our proprietary ESG research;
- Inputs from fundamental credit analysts, including on feasibility of engagement; and,
- Severe controversies, or red flags, such as violations of international norms, or broader governance issues.

We understand that the various fixed income asset classes are at different stages of development of their sustainability practices and ESG disclosure, and we adapt our engagement approach and expectations accordingly (as presented in *Display 4*).

## **3. THEMATIC ENGAGEMENT SERIES FOCUSED ON SALIENT ESG RISKS AND OPPORTUNITIES**

Across MSIM, we have established a framework that maps sector-level considerations to five “macro” environmental and social themes, presented in *Display 5*, which help us define the desired outcomes of our dialogues with



issuers and report on progress. These engagement priorities are based on salient ESG risks and opportunities, reflecting our Credit Analysts' sector specialisation and our broader approach to ESG analysis, and form the basis for select thematic engagement series. Credit Analysts, together with the Fixed Income ESG Specialists, use these thematic engagements

to benchmark issuers versus peers, make targeted recommendations, and encourage long-term positive change from issuers. The engagement series serve as deep-dive analyses into relevant, sector-specific topics, such as biodiversity for paper & packaging companies, or human-rights across the supply chain for retail.

Our thematic framework informs not only engagement, but also the active security selection process in our fixed income strategies, and is part of our broader commitment to support investments that positively contribute towards the UN Sustainable Development Goals (SDGs).

#### DISPLAY 4

### MSIM Fixed Income Engagement Approach across Asset Classes

#### INVESTMENT GRADE CORPORATES

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

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

#### HIGH YIELD & EMERGING MARKETS CORPORATES

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

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

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

#### SECURITISED DEBT

In the securitised market, a rigorous due diligence process allows our teams to collect deal-level data and information, including on the environmental and social characteristics of underlying assets and loans (e.g. energy performance certifications of buildings, type of borrowers and costs). We then integrate this information in discussions with originators and servicers, to better understand their lending and servicing practices, as well as property owners' behaviour. This is an essential component of our assessment across types of securitisations, as we aim to avoid exposure to predatory lending and to mitigate litigation risk. Conducting direct engagement with issuers of securitisations continues to be challenging due to the nature of the asset class. We seek to conduct more systematic dialogues with issuers of securitised debt, to assess ESG practices and provide our feedback where relevant.

#### SOVEREIGN ISSUERS

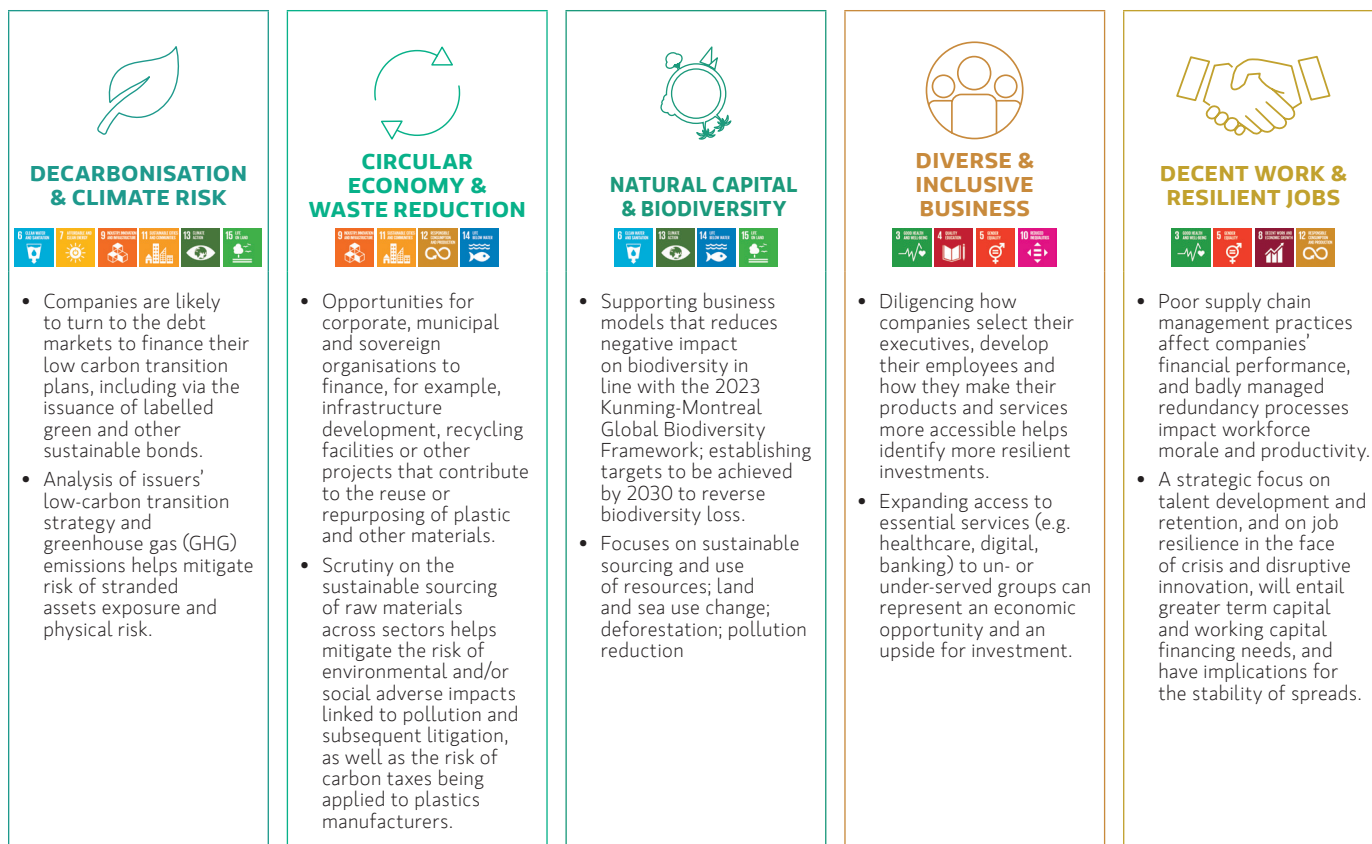
Sovereign engagement presents some challenges for investors when it comes to demonstrating a direct impact of one-on-one dialogue on the issuer's strategy. Our approach is to encourage Debt Management Offices to align their financing priorities with the United Nations Sustainable Development Goals (UN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

#### SUPRANATIONALS, AND AGENCIES

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

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

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

**DISPLAY 5****MSIM Fixed Income's Priority Engagement Themes**

This diagram represents how the portfolio management team generally implements its investment process under normal market conditions. Individual funds and client accounts may have specific ESG related goals and restrictions. Please refer to governing documents of individual vehicles to understand their binding ESG criteria. MSIM Fixed Income engagements do not include the engagements conducted by the Calvert Corporate Engagement Team. Source: MSIM, UNDESA. The content of this publication has not been approved by the United Nations and does not reflect the views of the United Nations or its officials or Member States" See <https://www.un.org/sustainabledevelopment/sustainable-development-goals> for more details on the Sustainable development goals icons.

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

In addition to our one-on-one engagement programme with issuers, and internal collaborative processes, we also collaborate with external

partners and stakeholders to promote the adoption of best practices and international standards for sustainability disclosure, as shown in *Display 6*.

**DISPLAY 6****MSIM Fixed Income's Collaborative Engagement Initiatives**

As part of the PRI Collaborative Sovereign Engagement on Climate Change, MSIM and other international investors have been engaging with various stakeholders in the Australian government. This initiative, which we joined in 2023, aims to provide a platform for investors to collectively engage with sovereigns to mitigate climate risks and capitalise on potential opportunities.

In addition, MSIM Fixed Income is a member of the PRI Advance Collaborative Stewardship Initiative, a joint investor engagement initiative, where institutional investors are working together to escalate engagement on human rights and social issues in the mining and renewables sectors.



Through MSIM's participation in the work of the European Leveraged Finance Association (ELFA) to increase transparency in High Yield, we also systematically encourage companies to address material issues in their governance, business strategy and planning, risk management and public reporting to promote value creation, in line with our thematic focus.



Our Fixed Income ESG Specialists take part in the working groups of the International Capital Market Association (ICMA)'s Green and Social Bond Principles Working Groups,<sup>2</sup> among others. In this collaborative spirit, we also share our feedback with issuers and structuring advisers of sustainable bonds to increase the transparency and quality of these instruments in the market.

**Genuine Dialogue Means Both Sides Become Wiser**

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

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

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

<sup>2</sup> Morgan Stanley was a founding signatory of the Green Bond Principles and was selected to join the Advisory Council in 2019. Morgan Stanley and MSIM representatives participate in a number of GBP/SBP working groups, including those on Sustainability-Linked Bonds, and Impact Reporting. The third party websites are provided for informational purposes only. Morgan Stanley has not reviewed any of the content supplied, and does not guarantee any claims or assume any responsibility for the content provided by the sites.

## Risk Considerations

ESG ratings are relative and subjective and are not absolute standards of quality. Ratings apply only to portfolio holdings and do not remove the risk of loss. There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to **market risk**, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events.

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

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market.

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