

Sustainable Reality

Strong Inclusive Growth Performance Drives Down Risk for Bondholders

With the global economy on the rebound, corporations have a critical role to play in delivering an inclusive recovery that addresses the glaring social and economic disparities exposed by the pandemic and the renewed focus on issues of social justice in the U.S. Grasping this opportunity brings benefits to society and can also potentially improve risk and return profiles for bonds, as demonstrated by new research from the Morgan Stanley Institute for Sustainable Investing.

KEY INSIGHTS

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Corporations have far-reaching impacts on society, their stakeholders and economic growth through the decisions they make across four key areas of business: their employees, products and services, operations and management practices. Their choices can either support or hinder inclusive growth that delivers broad-based economic gains and opportunity. This brief introduces the Institute's proprietary Inclusive Growth Score, which measures company performance across these four key areas. When we applied the metric to the U.S. corporate bond market, we found that investors, on average,

viewed bonds issued by high-scoring companies as less risky than bonds issued by low-scoring companies during 2020's severe market volatility.

These findings reinforce [previous Institute analyses](#) showing that investment funds incorporating social and environmental criteria can outperform their traditional counterparts.* Our Inclusive Growth Score offers a valuable new quantitative metric to support investors, corporate decision makers and other stakeholders as they pursue a sustainable and resilient post-pandemic global economy.

* Past performance is not a guarantee or indicative of future performance.

Inclusive Growth in Context

The turbulent events of 2020–2021 have placed heightened expectations on companies to respond to societal challenges. C-suites face growing scrutiny as they respond to stakeholder concerns ranging from employee health and changing workplace practices to diversity, equity and inclusion, income inequality and climate change.

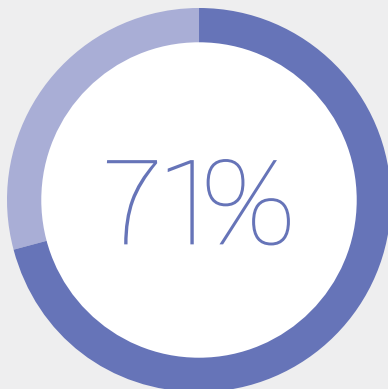
Seven in ten U.S. adults (71%) now believe corporations have a role in responding to social justice, according to research firm Opinium.¹ Among investors, four in five institutional asset owners,² nearly half of U.S. individual investors³ and three quarters of asset managers⁴ now practice [sustainable investing](#).

With consumers, investors, employees and communities all demanding corporate leadership on societal issues and sustainability, corporations face new risks and opportunities in support of inclusive growth. In 2017, the Morgan Stanley Institute for Sustainable Investing published [Inclusive Growth Drivers: The Anatomy of a Corporation](#) which demonstrated how the specific decisions businesses make about their employees, products and services, operations and management practices can have wide-ranging impacts on society and economic growth. We identified business levers in each of these four key areas for promoting inclusive growth and supporting stakeholders including employees, communities and customers.



WHAT WE MEAN BY INCLUSIVE GROWTH

Inclusive growth delivers economic gains that are broad-based, sustainable and provide opportunity for all. This begins with income, but also includes access to health, education and economic advancement opportunities regardless of gender, race, ethnicity or geography. Interest in inclusive growth is spreading from economists and policy makers to business leaders and the investment community. Benefits for companies can include improved business operating environments and greater consumer purchasing power.



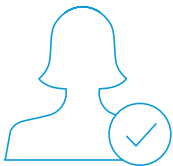
Seven in ten U.S. adults (71%) now believe corporations have a role in responding to social justice, according to research firm Opinium.¹

There is growing evidence that investing in such policies can deliver significant benefits for companies in areas like employee retention and engagement (Figure 1). However, the perception persists among companies and investors that inclusive growth practices can harm the bottom line.

To address this, we developed a proprietary quantitative metric to evaluate companies' performance on adopting policies and practices that drive inclusive growth. On the following pages, we describe the methodology and our findings when applying the Inclusive Growth Score in a real-world context—to credit risk performance in the corporate bond market.

FIGURE 1

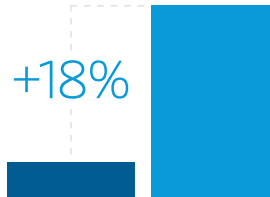
By the Numbers: How Inclusive Growth Benefits Companies



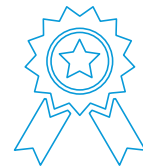
Firms with higher **gender diversity** have outperformed their less diverse peers by **3.1%** per year from 2011–2019, based on Morgan Stanley's Holistic Equal Representation Score (HERS).⁵

+36%

Companies in the top quartile for **racial and ethnic diversity** are **36%** more likely to achieve returns above national industry medians.⁶



Business units in the top quartile for **employee engagement** were **18%** more productive than their bottom quartile peers.⁷



On average, stocks of companies named to Glassdoor's **Best Places to Work** earned **20.3% per year** between 2009–2019, compared to 12.9% for the S&P 500.⁸

Quantifying Corporate Performance on Inclusive Growth

The Morgan Stanley Institute for Sustainable Investing developed the Inclusive Growth Score to provide a comprehensive assessment of inclusive growth performance. It offers a simple snapshot, backed by granular data points, to guide investor and corporate decision making. The better that companies treat their stakeholders, and the more they pursue practices that support equitable workplaces, responsible products, inclusive operations, responsible supply chains and transparent governance, the higher their score.

The Inclusive Growth Score is a proprietary metric made up of 36 key performance indicators (KPIs) drawn from the framework first published in *Inclusive Growth Drivers: The Anatomy of a Corporation*, and are categorized under the four key areas for corporate influence on society: human resources, products and services, operations management and firm management and governance (Figure 2). By combining multiple data points,

the Inclusive Growth Score attempts to go beyond standard metrics used in trying to assess inclusivity to deliver unique, quantitative-driven insights.

The KPIs within each of the four pillars are equally weighted in the calculation of their respective scores. Scores from each of the four areas are then also equally weighted in the calculation of the overall Inclusive Growth Score.

FIGURE 2

Anatomy of a Corporation: Inclusive Growth Drivers and Indicators

(Inclusive growth indicator areas: illustrative examples)



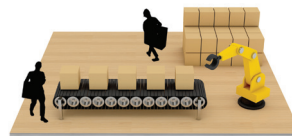
HUMAN RESOURCES

- Workplace diversity (e.g. Has an equal opportunity policy or equivalent to ensure gender diversity)
- Job security
- Equitable compensation



PRODUCTS AND SERVICES

- Product advertising (e.g. Responsible marketing score)
- Product safety
- Market pricing



OPERATIONS MANAGEMENT

- Supplier capacity building (e.g. Has a supplier diversity program)
- Business continuity
- Cybersecurity



FIRM MANAGEMENT AND GOVERNANCE

- Board structure and management (e.g. Percentage of independent board members)
- Corporate strategy
- Community relations

Using data from May 2019 through May 2021, we tested our proprietary scoring process on constituents of the Bloomberg U.S. Corporate Bond Index to understand the relationship between inclusive growth performance and investment performance. This index represents approximately 800 issuers and is one of the most commonly used benchmarks for taxable fixed income investors. We chose to evaluate credit spreads—namely, option-adjusted spreads—for a corporate bond index as they are typically good indicators of how investors view risk. In addition, significant work has been done looking at stock price performance for high and low ESG companies⁹ and gender diverse companies,¹⁰ but comparatively little has been done in the fixed income markets which is where we have chosen to focus. It is worth noting that when we applied the Inclusive Growth Score to equities, we saw a similar pattern emerge to that of fixed income.

Our interest in focusing this analysis on corporate bonds also stems from the prevailing low interest rate environment that has defined fixed income markets for years. These low interest rate conditions have contributed to an extended period of highly compressed credit spreads. The pandemic-induced market shock in March 2020 led to a significant decompression of credit spreads, offering a unique opportunity to observe the relationship between inclusive growth and corporate bond performance during a time of extreme volatility.

Based on the availability of data from third party providers, we assigned an overall Inclusive Growth Score to each company. We then divided these index constituents into decile groups based on their overall Inclusive Growth scores and compared the credit spreads of bonds for the highest and lowest scoring 10% of issuers.

The results, summarized in the next section, shed light on how the financial markets respond to companies that promote or hinder inclusive and sustainable practices.



ABOUT CREDIT SPREADS

Credit spreads represent the difference in yield between bonds with the same maturity but differing credit quality. They reflect investor perception of how risky a bond is relative to a seemingly risk-free asset with the same maturity. Bonds with higher credit spreads are seen as riskier than bonds with lower credit spreads. Credit spreads typically use U.S. Treasuries as a benchmark as they are considered risk-free assets. Our analysis focused on option-adjusted spreads as they allow for more accurate comparisons between bonds with and without embedded options, provisions that allow investors or issuers to take specific actions, such as redeeming a bond prior to its stated maturity.

ABOUT THE BLOOMBERG U.S. CORPORATE BOND INDEX

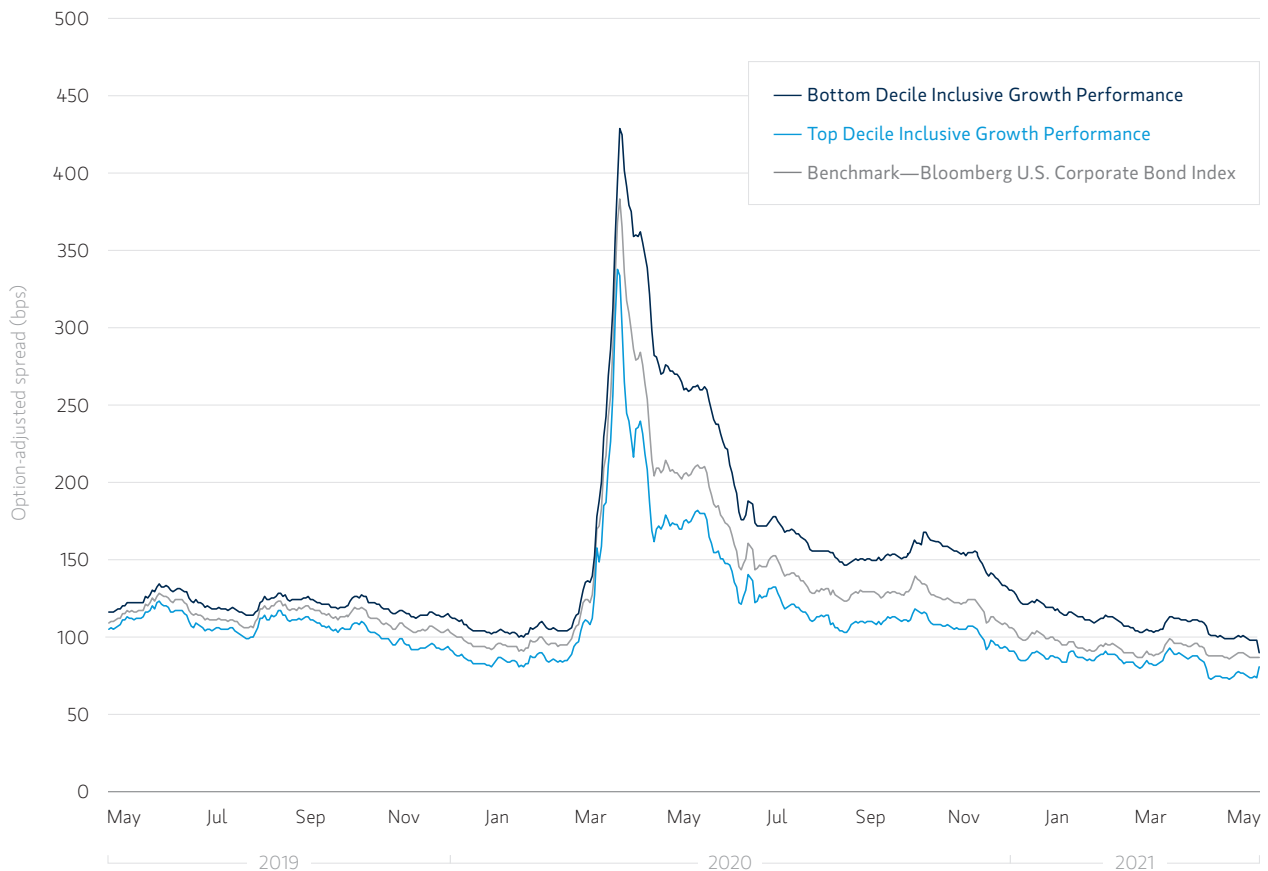
The Bloomberg US Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers. An investment cannot be made directly in a market index.¹¹

Our Findings

Our findings suggest that bonds issued by companies that treat their employees and other stakeholders well and run their business responsibly are considered lower risk by investors. This in turn can impact corporate bond performance, especially in times of severe market volatility.

FIGURE 3

Corporate Bond Performance for Top and Bottom 10% of Inclusive Growth Scorers



Specifically, our analysis of the Bloomberg U.S. Corporate Bond Index from May 2019–May 2021 reveals that:

1 Bonds from companies with the highest Inclusive Growth scores, the top 10%, had lower (better) credit spreads than bonds from companies with the lowest Inclusive Growth scores, the bottom 10%, throughout the 16 months.

2 When the pandemic jolted market volatility in March 2020, credit spreads decompressed significantly, reflecting investors' increased risk concerns. However, at their peak, credit spreads for bonds from companies with the highest Inclusive Growth scores were 146 basis points lower (less risky), on average, than bonds from companies with the lowest Inclusive Growth scores.



These early findings from our pioneering Inclusive Growth Score suggest that investors should take note of the ways in which companies treat stakeholders—including employees, suppliers and communities—as they evaluate risk. Our proprietary Inclusive Growth Score demonstrates how corporate performance can be quantified across a wide range of responsible business practices—and have a potentially material impact on investment performance.

The results of our analysis also reinforce other evidence that consideration of social and environmental factors can potentially lead to outperformance, especially in volatile markets. For example, the Institute's [previous Sustainable Reality](#) update revealed how U.S. sustainable equity and bond funds outperformed traditional peer funds by a median of 4.3 percentage points and 0.9 percentage points respectively during 2020.¹²

Conclusion

Corporations are critical drivers of economic growth. The Institute's research continues to suggest that when companies use their reach and influence to support broad-based inclusive and sustainable economic gains and opportunities, corporate financial performance can improve. Our latest findings, showcased in this brief, indicate that investors can also benefit from evaluating inclusive growth practices, especially in times of market turbulence.

As the world emerges from the pandemic and confronts inequality, the decisions companies make about their employees, products and services, operations and management practices could significantly influence how inclusive economic recovery and growth will be shaped around the globe.

With investors, consumers, employees and other stakeholders demanding corporate action to address societal challenges, now is the time for companies to embrace business models and practices that help deliver sustainable economies built on opportunity for all. Our proprietary Inclusive Growth Score offers a valuable quantitative tool to support investors and corporate decision makers on this journey.

Notes

- 1 https://www.opinium.com/wp-content/uploads/2020/07/Opinium-US_June_Brand-Study_Responding-to-BLM.pdf
- 2 "Sustainable Signals: Asset Owners See Sustainability as Core to the Future of Investing," Morgan Stanley, 2020 (https://www.morganstanley.com/content/dam/msdotcom/sustainability/20-05-22_3094389%20Sustainable%20Signals%20Asset%20Owners_FINAL.pdf; accessed on June 17, 2021).
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- 5 "Rise of the SHEconomy," Morgan Stanley, 2019 (<https://www.morganstanley.com/ideas/womens-impact-on-the-economy>; accessed on July 13, 2021).
- 6 "Diversity wins: How inclusion matters," McKinsey & Company, 2020 (<https://www.mckinsey.com/featured-insights/diversity-and-inclusion/diversity-wins-how-inclusion-matters>; accessed on July 13, 2021).
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- 10 "Rise of the SHEconomy," Morgan Stanley, 2019 (<https://www.morganstanley.com/ideas/womens-impact-on-the-economy>; accessed on July 13, 2021).
- 11 "US Corporate Index," Bloomberg, 2021 (<https://assets.bbhub.io/professional/sites/27/US-Corporate-Index.pdf>; accessed on July 13, 2021).
- 12 "Sustainable Funds Outperform Peers in 2020 During Coronavirus," Morgan Stanley, 2021 (<https://www.morganstanley.com/ideas/esg-funds-outperform-peers-coronavirus>; accessed on July 13, 2021).



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An investment in an exchange-traded fund involves risks similar to those of investing in a broadly based portfolio of equity securities traded on exchange in the relevant securities market, such as market fluctuations caused by such factors as economic and political developments, changes in interest rates and perceived trends in stock prices. The investment return and principal value of ETF investments will fluctuate, so that an investor's ETF shares, if or when sold, may be worth more or less than the original cost.

Investors should carefully consider the investment objectives and risks as well as charges and expenses of a mutual fund/exchange-traded fund before investing. To obtain a prospectus, contact your Financial Advisor or visit the fund company's website. The prospectus contains this and other information about the mutual fund/exchange-traded fund. Read the prospectus carefully before investing.

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