June 2020

Diversified Assets Responsible Investing

Key Facts

Putting ESG considerations at the heart of our investment process.

Our process in underpinned by high-quality research and in-depth investment understanding.

We look at ESG factors within asset classes, as well as in the asset allocation process.

There are more than 20 experienced specialists in ASI's Stewardship and ESG Investment team, supporting more than 50 responsible investment champions around the business.

Responsible investing at ASI

At Aberdeen Standard Investments (ASI), everything we do as an organisation is focused on generating the best long-term outcomes for our clients.

In order to create the right outcomes, we invest with conviction across all asset classes. That conviction is informed by the research and engagement that we undertake. ESG (environmental, social and governance) factors are integral to the process.

Our investment philosophy is built on the following beliefs:

- by putting ESG considerations at the heart of our investment process we are able to generate better client outcomes
- high-quality research and fundamental investment understanding underpin sustainable outperformance
- connected teams deliver better innovation and investment results
- all our investment decisions should benefit from our ESG insights
- positive investment outcomes are consistent with positive outcomes for society and the environment.

We research, analyse and engage with our holdings around the world. For us, ESG integration improves our understanding of our investments. As such, it is part of our mainstream process.

> "In order to create the right outcomes, we invest with conviction across all asset classes."

Investing responsibly in Diversified Assets

We analyse the risks and opportunities, including those influenced by ESG factors, for every investment that we make.

In the Diversified Assets team our focus is on providing genuine diversification. We do this by identifying and capturing the best long-term opportunities across a broad range of asset classes. Typically, we access alternative asset classes through listed investment companies and traditional asset classes through specialist teams within ASI. Our tailored approach considers ESG factors within asset classes as well as in the asset allocation process. It is supported by our centralised Stewardship and ESG Investment team.

Stewardship and ESG Investment team

This central team of more than 20 experienced specialists based in Edinburgh and London provides ESG consultancy, support and insight for all asset classes. Taking a global approach both identifies regions, industries and sectors that are most vulnerable to ESG risks and also those that can take advantage of the opportunities presented.

The team supports more than 50 responsible investment analysts and champions carrying out research and making investment decisions within investment teams. It provides a number of essential inputs including thematic research and company engagement. It also provides oversight of our ESG approach and ensures the quality and consistency of our regional ESG analysis.

Aberdeen Standard Investments

ESG considerations in asset allocation

Our asset allocation is informed by extensive research on long-term expected returns for different asset classes. It is conducted by our Strategic Asset Allocation (SAA) team[1]. We believe that asset allocation and ESG are closely linked. Environmental and social change should shape the way we allocate capital to generate long-term returns. The relationship works the other way, too: asset allocation can direct private capital to where it's most needed to help alleviate the most pressing social problems.

As the following examples indicate, ESG factors can have a substantial cumulative impact on investment returns over the long term.

- Standard economic explanations of the structural decline in real interest rates in recent decades are grounded on views about aging populations and rising inequality driving a global 'savings glut'. Our long-term view is that these structural trends are likely to continue to depress government bond yields in the coming decade. This is a key driver of the need for alternative sources of diversification.
- The structural changes in corporate governance we have seen in Japan and some emerging economies have resulted in a higher return on equity. This informs our return forecasts for these regions.
- The global financial crisis - one of the biggest events for asset prices over the last 80 years - was largely caused by systematic failures of governance in the global banking industry. One lesson from the crisis is the need for long-term asset allocators to be more attentive to systematic governance risks.
- Efforts to mitigate climate change are driving large economic shifts in economies. Fossil fuels and other carbon intensive sectors are likely to see slower growth, while renewable energy is likely to grow rapidly. We factor this into our thinking and use state-of-the-art climate scenario techniques to inform our long-term return forecasts.

Our SAA team incorporates these and other macro-ESG factors into their forecasts for expected returns. This drives our regular portfolio optimisation reviews which are a key input into the asset allocation for our funds.

Responsible investing in listed alternatives

In our Diversified Assets portfolios we make significant use of listed investment companies to access a range of attractive alternative asset classes. These include: investments in social and renewable infrastructure; asset-backed securities; insurance-linked securities; healthcare and music royalties; specialist property; and litigation finance.

For every listed investment company in our portfolio we produce a structured ESG research note. We assign each ESG factor a score from 1 to 5. Our overall ESG rating for the company reflects a balance of the factors.

"We make significant use of listed investment companies to access a range of attractive alternative asset classes."

Name	International Public Partnership Limited (INPP UN)
Last update by, date	Kevin Glover, 24/02/2020

Rating						
(1) serious negative issues (2) some negative issues, (3) average / acceptable, (4) above average, (5) best in class						
Governance			**Environment & Social**			**Overall Rating**
Board/ Management Engagement	Discount Control	Continuation Vote	Policy & Reporting	Risk Management	Benefits & Costs	
3	2	1	5	5	5	4

This analysis contributes to our broader investment view on the company. It also acts as a basis for ongoing engagement with the company – we can press for areas of weakness to be addressed and monitor progress over time. In itself, the ESG score does not drive our investment decision, but a low score makes it far less likely that we would invest in the company.

[1] See **aberdeenstandardforecaster.com** for the latest Long-term Investment Outlook book produced by the SAA team.

Governance

One of the advantages of the listed investment company structure is that the independent board is responsible for safeguarding investors' interests. The companies that we invest in are almost always members of the Association of Investment Companies (AIC) and comply with the AIC Code of Corporate Governance (the AIC Code). This complements the UK Corporate Governance Code and provides a framework of best practice for listed investment companies.

When we evaluate governance, we consider a variety of factors:

Board/management engagement

- We review the board composition and governance structure. We assess whether the board is appropriately diverse in terms of background, experience and gender.
- We look at how the board and management are aligned with shareholders, assessing if there is appropriate "skin in the game" and whether fees are appropriate and well structured.

Discount control

- We consider the discount control measures that the board can take, should the share price fall to a discount to net asset value (NAV), and whether these have been implemented appropriately.

Continuation vote

- We consider the company's continuation vote policy, which covers whether or not shareholders can vote on allowing the company to continue to exist. This can be another way to prevent widening discounts.

Boards and managements are operating in an unprecedented environment due to long-lasting effects of the Covid-19 pandemic. High quality corporate governance will be critical to help companies steer their way through the period of upheaval. Whether they can uphold existing reputations and relationships will be down to their handling of the crisis. It will define whether they can extend their social licenses thus their future success. And all the while they must maintain engaged workforces, reliable supply chains and loyal customers.

Environmental and social

We focus on three key areas that capture the management of environmental and social risks:

- **Policy and reporting**
  We believe that a company in which we invest should take ownership of its own ESG policy, and work to incorporate ESG issues into its investment analysis and decision-making process. An ESG policy, along with appropriate reporting, has the potential to encourage greater focus on the United Nations-supported Principles for Responsible Investment (UN PRI) and Sustainable Development Goals (UN SDGs). We assign the highest ratings to those companies with the most comprehensive environmental and social (E&S) policies.
- **Risk management**
  In our view, a company must recognise the importance of identifying and actively monitoring the financial and non-financial risks facing its business. It should pay regard to the materiality of relevant E&S risks. If a company identifies such risks, it needs to assess them in terms of probability of occurrence, potential effects on financial performance and movements in the relative significance of each risk from period to period. Then it should take appropriate action to improve its management of those risks.
- **Benefits and costs**
  We believe that what is measured tends to be managed. A company should attempt to report performance against what it sees as key E&S issues. This helps it to set targets and provides a clearer line of direction.

Practical engagement

Where we, and other investors, have most influence is when a company is looking to raise its initial capital. As significant investors in the listed alternatives market we are invariably approached for feedback on a proposed IPO at an early stage. This allows us to help shape the proposition. Typically, we can provide input on factors such as governance, fees, discount control mechanisms and ESG policies.
For existing companies, the framework above provides a strong basis for us to engage with them. We do so regularly, either with management or directly with the board. Below are some brief examples of how we have engaged with companies and/or recognised best practice in ESG policies.

Renewable energy investment

In order to meet the goals set out in the 2015 Paris climate agreement[2], investors need to allocate an estimated additional US$1.5 trillion[3] per year to renewable energy and other low-carbon projects. This has created a significant investment opportunity which has the potential to deliver attractive investment returns as well as environmental benefits. We access this opportunity through listed investment companies that own windfarms, solar parks and other renewable assets. This sector has grown dramatically since the first company was launched in 2013 and now offers a broad range of investments diversified by geography and asset type.

These investments benefit from a favourable regulatory backdrop, with governments keen to encourage new investments. However, in our investment process we still take into account several ESG risks related to these investments. These include:

- The risks of subsidies on existing assets being retroactively removed by governments. While there is no political or social drive to do so at the moment we need to be mindful of the possibility that this changes in the future.
- The impact of the build-out of renewable energy on the power price received. There are two aspects to this:
  1. The average power price could be lower than expected in the future if there is a much faster build-out of renewable assets than is currently factored in.
  2. There is a mismatch between when renewable energy is produced (i.e. when the wind blows or the sun shines) and the peak periods when it is needed. Without significant investment in energy storage this could result in renewables receiving far lower prices than gas and other forms of energy that can respond to demand.
- The risks associated with individual companies not having a defined ESG policy. We engaged with Greencoat UK Wind, asking it to put such a policy in place. It subsequently did so. Among other things, the policy covers compliance with applicable laws and regulations, and mitigation of adverse environmental and social effects.

[2] United Nations Framework Convention on Climate Change (Paris Agreement)
[3] McCollum, D et al (2018) Energy Investment Needs for Fulfilling the Paris Agreement and Achieving the Sustainable Development Goals. Nature Energy.

International Public Partnerships

International Public Partnerships Ltd (INPP) is a listed investment company with a diversified portfolio of primarily social infrastructure projects. INPP rates highly in our ESG framework, given its clear and proactive focus on E&S issues. This includes:

(a) promoting a focus on health, safety and wellbeing;

(b) a commitment to protecting the environment including monitoring energy usage and implementing energy savings initiatives; and (c) identifying and actively monitoring the financial and non-financial ESG risks facing the business.

Summary ESG reporting from INPP interim report 2019

Health and Wellbeing

- **100%** Investments have a Health, Safety and Wellbeing Policy in place
- **88%** Investments with at least partial access to greenspace
- **83%** Investments with provision to support active transport

Commitment to Protecting the Environment

- **1.5GW** Offshore wind energy transported
- **92%** Investments monitor their assets' energy usage
- **92%** Investments with an Environmental Management System

Supporting Public Sector Clients

- **>190,000** Number of pupils at schools within the portfolio
- **79%** Ofsted rating of 'Good' or above
- **>1,400** Management meeting hours with public sector

Commitment to Skills and Employment

- **96%** Investments have an employee development/training progamme
- **94%** Investments are influenced by an Equality, Diversity and Inclusion Policy

Investing in the Community

- **63,460** Out of hours community use
- **>3,250** Permanently employed staff on social infrastructure projects

Source: Getting to Zero Coalition, 2019.

Tufton Oceanic Assets

Tufton Oceanic Assets Ltd is a listed investment company with a portfolio of second-hand commercial vessels. While we considered many aspects of the investment proposition to be attractive, we were aware of the environmental and regulatory risks surrounding the industry, given that international shipping emits around 2-3% of total global greenhouse gas (GHG) emissions. We engaged with the company on these issues, discussing the risks that tighter environmental regulations pose to its business model and how it proposes to combat these risks.

Following our discussions, and talks with other investors, Tufton Oceanic has joined the 'Getting to Zero Coalition' – a partnership between the Global Maritime Forum, the Friends of Ocean Action, and the World Economic Forum. The Coalition prescribes that international shipping must reduce its total annual GHG emissions by at least 50% of 2008 levels by 2050.

This example demonstrates that, through engagement, we can influence change towards higher environmental standards, reducing investment risks and leading to better outcomes for clients. It also serves to demonstrate that investment in less environmentally friendly industries can be used a catalyst for positive environmental change.

* Companies have been used for illustrative purposes only to demonstrate the investment management style and not as an indication of performance or investment recommendation.

Responsible investing in ASI capabilities

Responsible investing is a key element of ASI's approach across all asset classes. Our holistic risk and opportunity assessment means that we consider ESG factors at every stage.

Listed equities

The core approach for listed equity exposure is our Sustainable Core Equity strategy. The strategy targets returns in line with those of the MSCI AC World Index, with a focus on sustainability and responsible investing. This includes a portfolio ESG score of at least 110% of the index, a carbon footprint of 50% of the index and green revenues of 150% of the index. It also excludes tobacco, coal, aerospace & defence, and companies involved in severe controversies.

This strategy is managed by our Quantitative Investment Strategies (QIS) team and has been developed in conjunction with our ESG team. It also includes input from external ESG specialists such as Sustainalytics and Trucost. For context, we estimate that an ESG score of 110% places the strategy in the top 15% of a broad peer group of global equity funds.

As a firm, ASI is actively involved with voting and engagement. Where we are authorised to do so by our clients, we work to exercise all proxy votes at shareholder meetings. We report on our proxy voting decisions, engagement activities and findings.

Sovereign debt – emerging and developed markets

For sovereign debt, investors usually look at the following when they assess a country's creditworthiness and ability to sustain economic growth:

- public debt
- inflation
- fiscal deficits
- current account balances

However other socio-economic issues also influence a country's ability to sustain economic growth. This includes inequalities, education, health systems, quality of infrastructure and environment, and resource constraints. Often they are intertwined and mutually reinforcing – and they can amplify macroeconomic fragilities.

We therefore believe that sovereign creditworthiness is best assessed by taking a holistic view of ESG and political factors. The teams assess each country according to 18 separate indicators spread across four pillars (see chart below). The scores they give to each country indicate where it lies, relative to the average, for each indicator. In addition, they predict a 'direction of travel', indicating whether they think each country is on an improving or deteriorating ESG and political trend. To do this, they use internal research, and where possible, direct engagement with the sovereign issuer. Using a combination of the scores and the direction of travel, the teams assess whether the ESG and political factors have been fully priced in and if the bond in question is good value.

Sovereign debt - assessing ESG and political factors

Pillar	Weight	Indicator	Source
Environment	15%	Air Quality	Yale Uni and Columbia Uni
		Access to improved water sources	World Bank Development Indicators
		Natural Hazard Risk Index	INFORM
Social	35%	Time to get Electricity	World Bank Development Indicators
		Quality of Infrastructure	World Economic Forum
		GINI Coefficient	World Bank Development Indicators
		Gender Inequality Index	UNDP
		Infant Mortality Rate	World Bank Development Indicators
		Life Expectancy	World Economic Forum
		Primary Education Enrolment	World Economic Forum
		Secondary Education Enrolment	World Economic Forum
Governance	25%	Ease of Doing Business	World Bank Development Indicators
		World Bank Governance Index	World Bank Development Indicators
		Open Budget Index	International Budget Partnership
		Strength of Legal Rights	World Bank Development Indicators
Political	25%	Corruption Perception Index	Transparency International
		State Fragility Index	Fragile State Index
		Press Freedom	Reporters without Borders

[4] https://www.globalmaritimeforum.org/getting-to-zero-coalition/
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Credit

ASI's credit team believe that analysing ESG risk factors is an integral part of our investment process. Each one systematically analyses ESG risks and opportunities as part of the research output on each company.

By engaging with a company's management team we can fully understand the case for investing and build a forward-looking view of its ESG strategy. By analysing the ESG risks and opportunities a company faces and how they are being managed, we are able to assess the effect they could have on our valuation of its bonds.

Our credit analysts factor in ESG considerations and apply a risk rating to each issuer. The assessment is based on the current and potential risks that arise from ESG factors and the management team's ability to deal with or mitigate them over the life of the investment. ESG risks can relate to a whole sector, or be specific to an individual business. We assign a low, medium or high risk rating to each issuer:

Low	The issuer has successfully mitigated ESG risks and these do not have a material negative effect on the team's credit assessment.
Medium	The team has identified one or more ESG risks as having a potentially negative effect on the issuer's credit assessment. The issuer's management has not addressed the risk(s) or is unable to sufficiently mitigate it/them.
High	The team has identified one or more ESG risks as having a potentially material negative effect on the issuer's credit assessment. The issuer's management has not addressed the risk(s) or is unable to sufficiently mitigate it/them.

We can invest in all three categories but a high ESG risk rating is considered a potential credit risk and in these circumstances we will require sufficient potential return in order to invest. It's a robust, repeatable research process which ensures we are rewarded for risk.

Summary

All clients invest to create a better future for themselves and their families. This may be to fund their lifestyle or for their own retirement. Now, they can invest to promote a better future for our planet and for subsequent generations, by embracing ESG. Our Diversified Assets approach is designed to target that better future for our clients and to help towards building a sustainable future for generations to come.

Mike Brooks,
Head of Diversified Assets

"For each asset class, ESG considerations are an integral part of our decision-making. That's because we believe this results in better investment outcomes as well as better outcomes for society, the environment and, ultimately, our clients."

Important information

Risks of investing:

Multi-Asset: Investment in multi-asset involves diversification across a wide range of asset classes including equities, fixed income, real estate and certain alternative investments - all of which involve different degrees of risk.

Diversification does not necessarily ensure a return or protect against a loss. This is not a complete list or explanation of the risks involved and investors should read the relevant offering documents and consult with their own advisors investing.

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*(entities as at 1 January 2020)

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121041524 04/20 | DH: GB-220620-119770-1

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