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Tobacco – our approach for investments

Aberdeen Standard Investments acknowledges that investment in tobacco is one of the most debated, divisive and sensitive issues across the spectrum of responsible investing. Today, the exclusion of tobacco companies from portfolios is one of the most common exclusion criteria in responsible-investment strategies. Many institutional fund managers and asset owners have introduced what would have been unthinkable only a decade ago: the formal exclusion of tobacco from the entirety of their investment portfolios.

The issue

Historically, tobacco companies have provided portfolios with strong income and investment returns. More recently, however, the sector's ability to continue this trend has been challenged. It is widely acknowledged that the tobacco industry faces social and structural challenges. Increasing global regulation and greater consumer education on the dangers of smoking have been significant factors in the recent decline of global tobacco sales.

What are the ESG risks associated with tobacco?

Public health

Given the scientifically proven evidence of the significant individual and public health issues caused by tobacco consumption, tobacco investments have long come under scrutiny.

It can be argued that the taxes levied on tobacco products go some way towards covering this huge externality. These costs are largely borne by the consumer, however, and not by the company. This is because nicotine's addictive qualities mean that tobacco generally has an 'inelastic' demand curve. When prices rise, there is little decline in the quantities sold.

For tobacco companies, these public health risks manifest as investment risks. This is largely due to the costs associated with litigation and the omnipresent threat of increased regulation, despite the fact that this sector has been heavily regulated for many years.

With more extensive regulatory initiatives being applied more broadly worldwide, authorities have been seeking progressive public-health outcomes. Tobacco companies are now investing

significantly in next-generation products (NGPs) in the hope that these will capture lost volume growth. The NGP market share remains small, however, and its growth has stalled.

Supply-chain human and labour rights

In a report issued in March 2017, the International Labour Organisation noted that tobacco is produced in 124 countries, including in many of the world's poorest and least developed nations.¹ For investors, this raises reputational risks around tobacco companies' exposure to child labour or even modern slavery. It is a complex area as there is little doubt that children are required to work on family tobacco farms to ensure ongoing production. Many international tobacco companies are now required by legislation to produce a modern-slavery report to measure the effectiveness of their human-rights supply-chain monitoring.

Water

As an agricultural crop, tobacco requires significant amounts of water to grow. This can represent risks for tobacco companies in the form of increasing water costs or overexposure to regions that are susceptible to droughts and irregular rainfall patterns. Climate change is exacerbating this risk as weather scenarios are becoming less reliable.

Business ethics

The sector has long been tarnished with incidents of poor business practices. Accusations of smuggling, bribery, dubious marketing practices and tax avoidance have historically plagued the industry. While many large tobacco companies have worked hard to clean up their business practices and adopt a responsible approach, the harm caused by the underlying product makes the acceptance of this extremely difficult.

Our approach to tobacco investments

Exclusion

In 2019, Aberdeen Standard Investments undertook an extensive study to determine whether tobacco, as an industry, should be formally excluded from the universe of potential investments. We concluded that we would not apply a tobacco exclusion across all of our funds. The sector is a strong generator of dividend income, making the investment view mixed at this time. In addition, there was a full spectrum of views on tobacco exclusions from our clients across the globe. Both these factors led us to conclude that client and investment rationales are not yet strong enough to justify a house-wide tobacco exclusion.

Nonetheless, we have endeavoured to increase the number of tobacco-free investment funds that we offer to our clients. This includes our Ethical and SRI Fund ranges, which are tobacco-free, alongside other investment restrictions. We will continue to review all our exclusions policies on a regular basis, and we have set up an internal governance framework to support this process.

Engagement

As a large global investor with a strong commitment to the issue and resources devoted to our role as stewards of our clients' capital, we use our position as a shareholder to engage with companies to address ESG risks and opportunities in our portfolio.

For each of our tobacco-company investments, our analysts and portfolio managers are now being asked to assess the following:

- Historic and forecast revenue-volume growth rate;
- The significance and likelihood for increased litigation and regulatory pressure on the company;
- The level of pricing power that the company has;
- How advanced the company is in the development of NGP/ non-combustibles and how successful uptake has been.

These questions aim to incorporate the global regulatory response to tobacco's public health impacts and how this is affecting the investment case for the industry. We need to understand how well companies within the industry are able to respond to these challenges.

Proxy voting

For our equity investments specifically, we diligently exercise our voting rights on behalf of our clients at all our investee tobacco-company general meetings that cover issues such as director elections, executive remuneration and capital raisings. As a general observation, the tobacco companies to which we do have investment exposure have sound governance structures and practices. In recent years, we have generally voted in favour of these related resolutions. We will continue to closely monitor the issue of tobacco investment and will update our position accordingly.

Responsible investing at Aberdeen Standard Investments

As a leading global asset manager, we believe that investing responsibly can help generate long-term value for our clients. We offer an extensive and growing range of investment solutions, as well as the very highest levels of service and support.

When investing our clients' capital, ESG considerations are an integral part of our decision-making. By understanding how ESG factors affect our investments, we believe we can generate better outcomes for our clients, society and the wider world.

To help us achieve this, our dedicated, 20-strong ESG Investment team works closely with colleagues across all asset classes to support this work. A further 30 dedicated ESG asset-class analysts provide an additional layer of expertise.

For more detail, please visit our [website](#).

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