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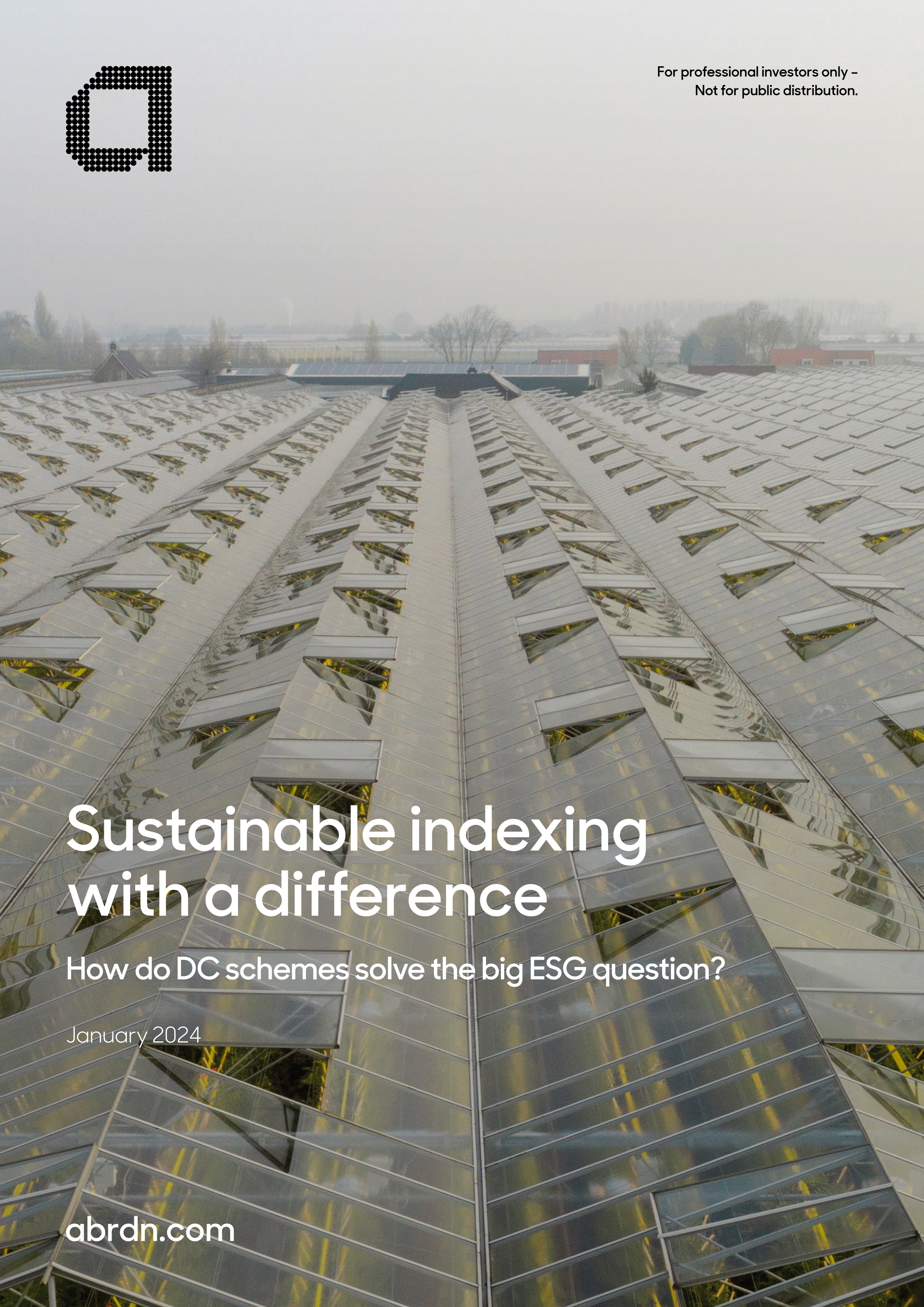

Sustainable indexing with a difference

How do DC schemes solve the big ESG question?

January 2024

abrdn.com

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How can DC schemes deliver on performance, sustainability and cost?

Sustainable index funds may be the answer

Incorporating environmental, social and governance (ESG) factors into decision making is one of the hottest topics for institutional investors.

Defined Contribution (DC) pension schemes are no exception. What's required for trustees in terms of applying responsible investment principles in the context of the fiduciary duty is now better articulated and clearly defined. The risks of failing to take sustainability seriously are clearer than ever.

Increasingly, regulators want benefit providers to demonstrate their commitment to responsible investing, supporting government obligations on international agreements. These cover a growing range of requirements for trustees, including managing ESG risks, disclosing exposure to climate risks, the stewardship policies they have in place, and how well they take members' views into account when they design investments.

Indeed, members increasingly expect their pension assets to cause less harm to the planet and its inhabitants, and even to present an opportunity to do some good.

To satisfy these demands, DC scheme trustees need to find responsible investment solutions that balance returns with avoiding the bad, improving the good and driving change for the better.

At abrdn, we believe that sustainable index funds are a practical and effective way for DC schemes to do just that.

Here we outline:

- The different options for incorporating ESG into DC investments
- The benefits of and potential challenges with using sustainable index strategies
- Why abrdn's Sustainable Index strategies are different to alternatives on the market
- How our Sustainable Index Equity Funds can help DC schemes achieve both investment outcomes and improved sustainability

What are the options for incorporating ESG into DC investments?

DC schemes can incorporate responsible investing considerations into their investment strategies in various ways. Often a combination of these works best.

Many trustees have already taken important steps to ensure that the active managers they use embed ESG integration into their investment processes.

Investment managers do this by assessing the practices of individual companies they invest in from a sustainability perspective.

While this may be sufficient in itself, some schemes may decide to make more explicit commitments to meet sustainable objectives.

Another approach is making a dedicated allocation to target a particular ESG outcome.

Thematic funds can be used to supplement the core holdings within a portfolio. These funds focus on a particular area where they aim to have an impact, often related to reducing climate risk.

These are, however, unlikely to be suitable on a standalone basis.

Ethical funds meanwhile, which make use of exclusions based on certain principles, may suit the preferences of some scheme members, but not others.

For trustees that want a more dedicated approach to ESG but wish to avoid the specificity of impact funds, sustainable strategies could be of particular interest.

These typically seek to maintain exposure to broad asset classes, such as equities, to deliver similar risk and return characteristics to their traditional alternatives. However, they make use of certain ESG criteria, such as exclusions and sustainable targets, to produce an improved ESG outcome.

Instead of ethical or moral constraints, they target a broad reduction in ESG risk and an enhanced overall ESG score for the portfolio compared with investing in the asset class without restrictions.

Sustainable strategies can help fiduciaries balance the challenge of managing ESG risks, targeting broad sustainability improvements and delivering positive financial outcomes.

And **sustainable index strategies** are an attractive option from a cost and governance perspective.

A closer look at sustainable index strategies

Traditional index funds are an attractive option from a cost perspective and can offer many potential benefits.

By ensuring that members have exposure to potential returns from the wider market, index strategies can provide an efficient solution during the accumulation "phase". In addition, their performance is easy to measure, so trustees can provide easy-to-understand information to members on returns. Given their obvious benefits, it's not surprising that there are a growing number of sustainable equity indices to choose from.

However, their design can often lead to a compromise on the outcome.

Many sustainable index strategies strategies are designed for a highly specific purpose. These approaches often introduce a performance differential and greater index/portfolio turnover in comparison to the parent index.

Considerations when choosing a Sustainable Index

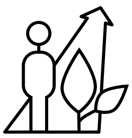
Plus	Minus
Low cost	Financially-based decisions
Broad market diversification	Higher tracking error versus parent index
Easy performance measurement	

At abrdn, we've created sustainable index solutions for institutional and DC clients that offer these potential benefits while managing the downsides.

How is the abrdn Sustainable Index Equity Strategies range different?

To ensure no undue trade-offs, we engaged the index provider MSCI to co-design a range of customised MSCI sustainable equity indices for our funds to track. The indices are an innovative and transparent solution to sustainable indexing, and are licensed exclusively to abrdn.

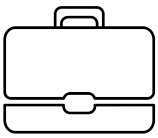
Using these customised indices, our strategies provide institutional investors with an opportunity to target broad improvements in sustainable outcomes. Meanwhile the use of risk controls helps retain the benefits of traditional indexing.



Many existing sustainability indices use a simple tilting process where constituents are weighted up or down.

This approach can be useful when constructing an index with a single objective such as higher ESG scores (relative to a parent index) or lower carbon emissions (relative to the parent index).

However, it doesn't easily allow for the simultaneous delivery of multiple sustainable outcomes, whilst at the same time controlling the risk exposures and minimising portfolio turnover the risk exposures (unintended bias) or turnover.



At abrdn we use a top-down, optimised approach to better manage outcome targeting and risk control, which we view as important for our broad-based sustainable indices.

The portfolio optimisation process uses MSCI's proprietary risk model and seeks to control tracking error, while satisfying broad sustainable targets, risk constraints (stock, sector, country and risk factors) and turnover constraints.

"Our strategies aim to deliver index returns in the most repeatable, pragmatic, scalable and risk-controlled manner. An optimisation process is built into the design of the index, which seeks to ensure that the targeted sustainable outcomes are delivered at a low tracking error and low turnover."

Oliver Wood-Clark
Head of Equity Indexation

How can we help DC schemes?

Our strategies offer seven building blocks, including global, regional and local strategies, so that investors can set their own asset allocation.

- World Equity
- Emerging Markets Equity
- Asia Pacific (ex-Japan) Equity
- European Equity
- American Equity
- Japan Equity
- UK Equity

All strategies are open to anyone in a segregated account and, we also have three of these funds launched in pooled funds. **abrdn Sustainable Index World Equity Fund, abrdn Sustainable Index UK Equity Fund** and **abrdn Sustainable Index American Equity Fund.**

The funds are avaiable in a tax-transparent Authorised Contractual Scheme (ACS) vehicle, and more recently have been added to our insured fund ranges (Standard Life Trustee Investment Plan and abrdn Life).

The other five strategies are currently available on a segregated basis only, but can be launched as pooled funds depending on clients' interest.

The funds are available at a single competitively priced OCF (ongoing charges figure), making them particularly suitable for inclusion in a DC offering.

Global	
World Equity[2]	0.15% pa OCF[1]

Country Specific	
American Equity	0.15% pa OCF[1]
UK Equity[2]	0.15% - 0.17% pa OCF [1]

Source: abrdn, December 2023.

What sustainability outcomes do the funds target?

We target funds specific outcomes relative to their respective parent indices. The outcomes include:

- an improvement in MSCI ESG score
- a reduction in carbon intensity
- an improvement in green revenue sources

abrdn Sustainable Index Fund

abrdn Sustainable indices vs Parent indices

10-20%
Improvement in MSCI ESG score

50%
Reduction in carbon intensity

50%
Improvement in green revenue sources

Source: December 2023.

[1] The On-going Charge Figure (OCF) is the overall cost shown as a percentage of the value of the assets of the funds. It is made up of the Annual Management Charge (AMC) in addition to other charges. It does not include any initial charges or the cost of buying and selling stocks for the funds.

[2] World, UK and American Equity strategies are also available as funds. Emerging Markets fund is currently unseeded. Please refer to the ACS prospectus for further information.

How do we achieve these targets?

Our Sustainable indices aim to **avoid the bad** (excluding investments from a market capitalisation index), **improve the good** (through a broad improvement in sustainability metrics), and **drive change for the better** (by being active stewards of the assets we hold and regularly engaging with the companies we invest in). Our Equity Indexation team then tracks closely those indices in our portfolios.

Avoid the bad

We exclude controversial investments

Our Sustainable Index Equity funds avoid the use of ESG screens which compel investors to take moral or ethical stances and can result in constraining the breadth of the investment universe.

Instead, our focus is on sustainability-driven financial considerations and managing risk in the portfolios.

We focus exclusions on a range of criteria driven by regulatory requirements and include the four main areas of concern:

- severe controversies
- controversial weapons
- tobacco[3] production and distribution
- thermal coal[3] and unconventional oil/gas

Improve the good

We target sustainable leaders

We target improved sustainability outcomes, as measured by higher overall ESG scores compared to the parent index.

We do this by tilting the funds' allocation towards companies that are industry leaders, and away from industry laggards.

Ratings companies use a seven-point scale to identify the leaders and laggards according to their exposure to ESG risks and how well they manage those risks relative to peers.

The funds also focus on both climate risks and climate opportunities, aiming to materially reduce carbon intensity and exposure to green revenue relative to the parent index.

Drive change for the better

We encourage better ESG corporate behaviour

As long-term holders of capital in our index business and as a large active manager, we have an important role to play in driving better ESG behaviours. We seek to be active stewards of every investment we make and to be a global leader in ESG investment.

Our Sustainable Investments team excercise voting rights in line with abrdn's bespoke policy.

The recommendations we consider are more closely aligned to the abrdn approach.

We regularly engage with the companies in which we invest, holding more than 1,000 company meetings a year.

You can find out more about how we approach voting and engagement at **abrdn.com/en/uk/investor/responsible-investing.**

A unique feature of the solution is that these outcomes are targeted in a way that keeps the index risk controlled. The advantage of portfolio optimisation is that it can:

- Account for each stock's individual volatility and index-relative risk exposure
- Provide exposure to multiple sustainable metrics, including conflicting sustainable exposures, when setting stock weights

[3] Companies generating more than 5% of their revenue from.

We can use our extensive ESG experience to help DC schemes

As greater commitment to ESG principles continues, DC scheme trustees need to navigate the dynamically evolving choice of investment options available to find the combination of approaches that best works to meet their objectives. Combining investment returns, sustainable outcomes, and finding a suitable choice of core holdings/default portfolios presents a challenge.

Due to targeting broad sustainability outcomes and providing value for money, index-based options may be particularly well suited for this purpose. However, they need to be well designed to avoid unintended tracking errors or a large portfolio turnover.

ESG considerations have been an integral part of our decision-making process for more than 30 years. Our Sustainable Index Equity proposition builds on this expertise to help achieve the right outcomes. The funds are designed to provide institutional investors with an opportunity to address their sustainability concerns through traditional indexation and provide a practical, effective and low-cost solution for DC schemes.

For further details on our DC solutions and services please get in touch.

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