



Our ESG house score

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An aerial photograph of a large circular aquaculture net pen in the ocean. The net is a complex web of white lines forming a large circle, with a smaller inner circle. The water is a deep teal color. The net is anchored to a dark structure, possibly a barge or platform, which is visible along the inner edge of the net. The water shows some ripples and a slight wake from a boat or current.

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"The ESG house score was a cross-asset class initiative, led by the central ESG investment function and quantitative investment team. Its development was overseen by an internal steering group that included additional representation from our fixed income and equities colleagues. We are very grateful for the insights and contributions of our public markets teams. This has added significant value to our scoring approach."

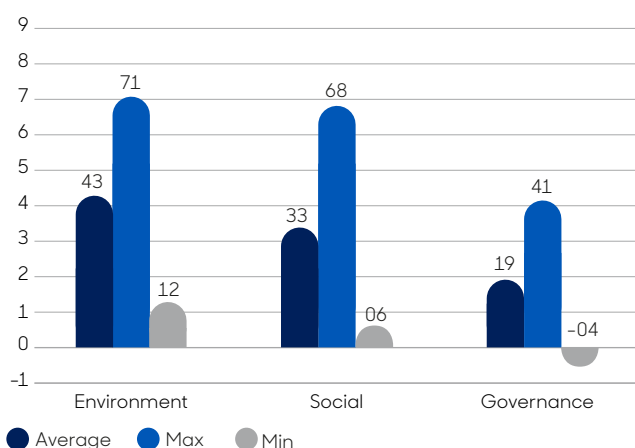
Introduction

At abrdn, our vision is to invest for a better future. We want to make a difference for our clients, society and the wider world – while also delivering strong risk-adjusted financial returns. Environmental, social and governance (ESG) considerations have been an integral part of our decision-making process for almost 30 years.

For a number of reasons, ESG analysis can be challenging. At times, for example, it may be difficult to access up-to-date data. In other areas of ESG analysis, a particular issue may not lend itself to a quantitative assessment, making qualitative judgement essential. Meaningful ESG assessment requires expertise across a range of issues. Carbon emissions, human rights and board independence are just a few of these.

Dedicated ESG data and scoring providers can help asset managers to assess corporate ESG issues more efficiently and on a larger scale. However, third-party providers' views of a company's ESG credentials often vary. According to research from Massachusetts Institute of Technology's Sloan School, average correlation¹ among the ESG ratings of six leading providers is 0.54.²

Average, minimum and maximum correlations of six ESG ratings providers



Source: Brandon, R. G, Krueger, P., Riand, N. and Schmidt, P. S. (2020) 'ESG rating disagreement and stock returns,' PRI Blogs, 27 March 2020 [Online]. Available at <https://www.unpri.org/pri-blogs/esg-rating-disagreement-and-stock-returns/5625.article> (Accessed 22 December 2020).

The European Corporate Governance Institute and Swiss Financial Institute found that for 'S' and 'G' issues, correlations were even smaller, at 0.33 and 0.19 respectively.³

At abrdn, we use many different sources for ESG investment insights. We often find that our view of the potential financial impact of a company's ESG performance differs from that of third-party rating agencies.

We respect and value the insights of third-party ESG data providers. However, as with our investment decision-making overall, we prefer to form our own view, based on our extensive in-house research and expertise. In support of our asset-class processes, we have designed a proprietary ESG house score. The score draws on available data from third-party providers while integrating the views of our in-house analysts. In 2020, we started rolling out our ESG house score with our equity and credit teams. We intend it to complement and underpin their own asset-class scores and ESG stock analysis. We are now using the scores to implement house-level sustainability thresholds in our range of sustainable investment strategies.

By putting ESG factors at the heart of our investment process, we believe we can generate better outcomes for our clients. This document explains our in-house scoring framework and methodology. It also discusses some of the challenges we continue to face with ESG data and our expectations for how this type of analysis may evolve over time.



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¹ Correlation is a statistic that measures the degree to which two variables move in relation to each other. The correlation coefficient has a value that must fall between -1.0 and +1.0. A correlation coefficient of +1.0 means that the variables move perfectly together and -1.0 means that the variables move in completely different directions.
² Berg, F., Kölbel, J.F. and Rigobon, R. (2019) Aggregate Confusion: The Divergence of ESG Ratings [Online]. Available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3438533 (Accessed 22 December 2020).
³ Gibson, R., Krueger, P. and Schmidt, P. S. (2019) ESG Rating Disagreement and Stock Returns [Online]. Available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3433728 (Accessed 22 December 2020).

Our ESG house score framework

Using our ESG house score, we can compare how companies around the globe manage ESG issues. The output makes it easier to spot the ESG leaders and laggards in each field. However, the ESG score combines many different, sometimes unrelated, factors. This means that while it offers a high-level view of the company's relative position, a single ESG score alone cannot provide a full picture.

For this reason, we have designed our scoring system so that we can break it down into more granular and specific themes and categories. The majority of ESG data providers split their scores into environmental (E), social (S) and governance (G) categories. However, we felt that it is better to understand ESG factors on two levels. First, we want to know how companies govern themselves; and second, we want to understand how they operate. We believe this method provides better insights to a company's management of ESG matters.

So the level immediately below the composite ESG house score consists of distinct operational and governance scores. These provide a more detailed and nuanced view of how each company manages ESG issues.

We have constructed our governance and operational scores to mirror our approach to ESG thematic research. Therefore, they cover six core areas: climate change, environment, labour management, human rights and stakeholders, corporate behaviour and corporate governance. Subject-matter experts in our ESG investment function support each of these areas.

Our ESG house score framework



The governance score
Assesses the company's corporate governance structure, and the quality and behaviour of its corporate leadership and executive management.



The operational score
Assesses how good the company's leadership team is at carrying out effective environmental and social risk management, and mitigation strategies, through its operations.

We break down these six core areas down into more specific risk categories. For example, within climate change, we consider the key risk categories to be greenhouse-gas (GHG) emissions and business-model resilience, air quality, and energy management. In each risk category, we have identified the relevant data points or key performance indicators (KPIs) to assess companies. Take GHG emissions and business-model resilience, for example. This includes KPIs related to scope 1, 2 and 3 emissions, carbon intensity and the aggressiveness of carbon reduction targets, to name just a few. In total, across all six key areas, our scoring framework includes over 100 potential KPIs.

ESG Score					
Operational score			Governance score		
Climate Change	Environment	Labour Management	Human Rights & Stakeholders	Corporate Behaviour	Corporate Governance
GHG Emissions & Resilience	Water & Wastewater	Labour Practices	Human Rights & Communities	Controversies	Board Issues
Air Quality	Waste Management	Employee Health & Safety	Privacy & Data Security	Policies & Practices	Accounting & Audit
Energy Management	Supply Chain & Materials	Engagement & Diversity	Product Quality & Customer Welfare		Remuneration
	Ecological Impacts		Supply-Chain		Ownership & Control



Methodology

All levels of the score incorporate an assessment of materiality, as described below.

Governance scores

Governance is relevant to every company. So, we assess every company that we score on all components of the governance framework. We selected the relevant scoring components using abrdn's longstanding expertise in corporate governance.

We standardise the governance score relative to the global universe. This allows us to quickly compare companies' relative standing on governance issues.

Operational scores

Our operational assessments are typically more complex because companies are involved in a wide range of industries and activities. For example, while environmental degradation and human rights are key issues for the mining sector, software companies are more likely to focus on privacy and data security. In developing our operational score, we used the Sustainability Accounting Standards Board sector-materiality mapping as a foundation. From there, we adjusted the mapping to reflect our in-house views and sector insights. The operational score also incorporates operating context by highlighting additional risk areas based on aspects of the company's home market.

This means that our operational score only assesses a company on the key risk areas we have identified for its particular sector or geography. These areas are weighted based on our ESG sector specialist's view of how significant the risk is for that sector and geography.

The operational score is standardised to the company's sector peers. This allows quick assessments of a company's relative standing compared with its industry peers.

"In total, across all six key areas, our scoring framework includes over 100 potential KPIs."

Analyst input

There are occasions when a quantitative score based on historical data does not properly reflect the reality of a company's risks and opportunities. When this happens, we can manually adjust outlying and anomalous scores to give a more accurate reflection of our internal ESG views. We can add insight through various mechanisms, including operational performance adjustments, governance health warnings and abrdn's voting records. As we roll out the score with our investment teams, the input from our analysts will initially focus on our sustainability funds. These use the ESG house score in their investment criteria.

Our ability to add in-house views to the system means that a regular feedback loop continually enhances our scores. A greater relationship with the company and the ability to gather detailed insights provides us with a more forward-looking view than some other score providers.

Disclosure scores

Disclosure scores are an important aspect of our ESG scoring system. The availability of ESG data is an ongoing challenge that is more acute in some areas than others. By including disclosure figures in our ESG scoring framework, we can quickly determine the extent to which the score is based on tangible data. Where data availability is particularly low, we can seek alternative data sources and engage with the company to fill in the gaps.

ESG scores

The final ESG score combines the operational and governance scores. The weights of operational and governance scores are driven by the company's home market. For companies in developed markets, operational factors contribute 55% and governance factors contribute 45% to the overall score. In most emerging markets, governance has proved to be a larger risk factor as standards are less well developed.⁴ For companies in these regions, governance and operational are both rated at 50% when calculating the overall ESG score.

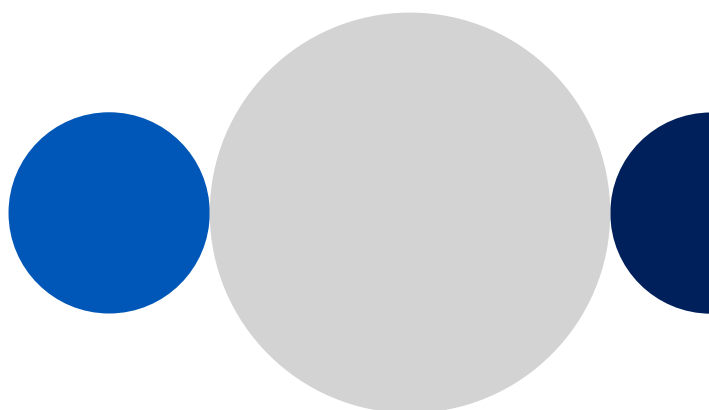
⁴ Further research in this area can be found at the following sources: Misra, S. (2019) "Corporate Governance in Emerging Markets," Harvard Law School Forum on Corporate Governance, 24 February 2019 [Online]. Available at <https://corpgov.law.harvard.edu/2019/02/24/corporate-governance-in-emerging-markets-3/> (Accessed 19 January 2021); Armitage, S., Hou, W., Sarkar, S. and Talaulicar T. (2017) Corporate Governance Challenges in Emerging Economies [Online]. Available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2954668 (Accessed 19 January 2021); International Organization of Securities Commissions (2007) Corporate Governance Practices in Emerging Markets [Online]. Available at <https://www.iosco.org/library/pubdocs/pdf/IOSCOP261.pdf> (Accessed 19 January 2021).

Our ESG house-score methodology

ESG score

(combination of operational and governance scores, absolute 0-100 score)

Absolute 0-100 score, standardised relative to global sector peers	Operational score (50% of Emerging Markets/Frontier Markets ESG score; 55% of Developed Markets)				Governance score (50% of Emerging Markets/Frontier Markets ESG score; 45% of Developed Markets)		Absolute 0-100 score, standardised relative to global universe
	Climate Change	Environment	Labour Management	Human Rights & Stakeholders	Corporate Behaviour	Corporate Governance	
Factor selection based on sector and country	GHG Emissions & Resilience	Water & Wastewater	Labour Practices	Human Rights & Communities	Controversies	Board Issues	All companies assessed on all factors
	Air Quality	Waste Management	Employee Health & Safety	Privacy & Data Security	Policies & Practices	Accounting & Audit	
Weighting based on risk materiality	Energy Management	Supply Chain & Materials	Engagement & Diversity	Product Quality & Customer Welfare		Remuneration	Weighting based on relative importance
		Ecological impacts		Supply-Chain		Ownership & Control	
Internal Analysis	Operational Performance Adjustment				Governance Health Warning		
	Disclosure score (% of data points available)						



How we use the ESG house score

We have designed our proprietary ESG house score to provide a unified view on a company's ESG risk. It does so by combining different data sources with the insights of our ESG investment team, quantitative investment team, and equity and credit teams. By stimulating discussion and allowing detailed ESG risk analysis, the scores will help inform our view of the investments we make. Created with the intention that it will continue to evolve over time, the score will allow us to integrate new ESG trends, themes and risk factors as they develop.

The house score supports and informs four main goals:

ESG integration

Our ESG house score enables us to identify key ESG risks at a company and portfolio level. Visual tools, including a map of operational versus governance scores, allow us to easily identify leaders and laggards at a granular stock level. At the same time, they provide a high-level picture of the fund's ESG footprint.

Transparency on every component of the ESG house score means we can easily see why key areas of risk are flagged. It also allows us to easily identify themes in our investments across a full range of ESG issues.

The score stimulates challenge and discussion among our investment professionals on ESG issues. We have designed it to complement and support the existing ESG analysis and frameworks already embedded within our equity and credit teams.⁵

"Transparency on every component of the ESG house score means we can easily see why key areas of risk are flagged. It also allows us to easily identify themes in our investments across a full range of ESG issues."

Product development

Client demand for sustainable investment products has grown significantly in the last five years. Our ESG scoring framework allows us to set clear, relevant and consistent parameters across funds and asset classes for our range of sustainable products. We are also able to target specific ESG themes and issues, in line with client requirements.

Our socially responsible investment strategies began using the ESG score in mid-2020 and our sustainable leaders strategies at the end of 2020. We are reviewing our other existing strategies and those still in development to consider how the score could support their specific sustainability criteria. The score will be a key input for many of our sustainability products in the future.

Governance and oversight

Our ESG house score supports more informed risk analysis. This empowers our governance and oversight teams to make more informed challenges on specific ESG issues. And, where we apply sustainability scoring to specific mandates, our ESG house scores enable us to demonstrate why companies may or may not meet these thresholds. They also help us to provide a consistent approach to funds across the house.

With respect to ESG issues, our existing governance and oversight processes predominantly focus on funds with specific sustainability criteria or thresholds. This ensures that we are adhering appropriately to the mandate requirements. But with the increased interest in ESG issues and their impact across all our investments, we recognise the need to extend this oversight across all of our funds. This will enhance our ESG integration efforts, which is a long-term focus for us. The score will provide a valuable tool for enhancing our governance processes.

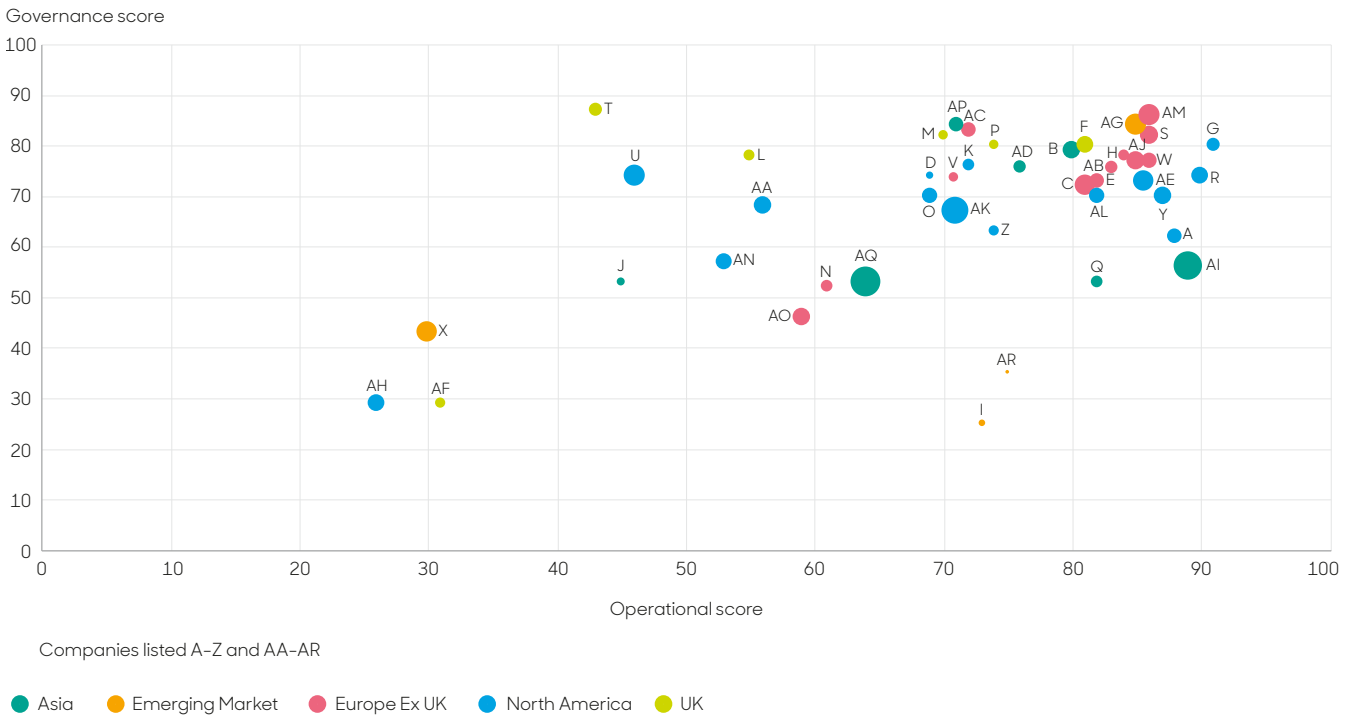
⁵For more detailed information, please see the ESG integration documents for each asset class on our website at www.abrdn.com/en/responsible-investing

Transparency

Our proprietary ESG house scores will also help us to become more transparent about our approach to ESG integration. Throughout 2021, we are working to enhance our ESG reporting capabilities in order to offer more options to our clients.

We have made significant progress in enhancing our ESG efforts over the past few years. With our proprietary ESG scoring system, we believe we are well positioned to continue making progress. For further information on our approach to ESG to date, please visit the Responsible Investing section of our website at abrdn.com.

A high-level view of a fund's ESG footprint Example fund used for illustrative purposes only.



Source: abrdn.
Sized per notional position.

"Often, it can be difficult to predict what will cause ESG risks to emerge. For this reason, we keep our framework under regular review. Doing so allows us to benefit from ongoing analysis based on our thematic, sector and company-level ESG research."

Rod Paris,
Chief Investment Officer



Challenges and evolution

We've put a lot of work and expertise into developing our ESG house score, but there is still more to do. Data availability will always be a challenge. Disclosure is gradually improving, however, and we continue to explore alternative data sources. These could help to fill some of the gaps we currently experience. We also recognise that companies face a plethora of different information requests. This makes it difficult for them to know what information is meaningful for investors. We have tried to focus our scoring system on the issues most relevant for companies, and we will use our engagement activities to encourage meaningful disclosure in these areas. These disclosures will feed into our scoring system to help improve its accuracy and relevance.

Predicting when various ESG issues will become financially material for companies is another persistent challenge. When assessing materiality within our scoring system, our teams have considered a timescale of three to five years. But some issues may materialise more quickly, perhaps because of changing regulations or consumer pressure. And others may take longer. In some cases, these timescales can change very quickly. At abrdn, we believe that ESG issues play a fundamental role in long-term value creation. We therefore expect all of the issues we have identified to become financially material over time. Our ESG investment function, together with our equity, fixed-income and quantitative investing colleagues, will review the material issues in our scoring system as ESG issues emerge and evolve.

Concluding remarks

Faced with the apparent paradox of data that is both insufficient and abundant, it can be difficult to isolate meaningful ESG information. Our proprietary ESG house score aims to cut through the noise and identify the real issues that affect our investments. It enables us to target key issues and companies for further research and engagement, and to efficiently assess the ESG risks and opportunities facing our portfolios.

The ESG landscape will continue to evolve, and we have designed our scoring system to evolve along with it. As ESG disclosures improve and our insights grow stronger, our ESG house score will become an increasingly powerful tool. It will help us to deliver positive outcomes for our clients and to invest for a better future.



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