



ABERFORTH PARTNERS

ESG integration framework

Environmental, social, and governance (ESG) analysis is integrated into Aberforth's investment process alongside all other matters relevant to a company's valuation. The main influence on the composition of the portfolio is the prioritisation of companies with the highest upside from the prevailing stockmarket price to Aberforth's target price. Aberforth's approach is rooted in the view that a company's system of governance is crucial to how all risks and opportunities – ESG and others – are identified and managed.

In recent years, growing awareness of environmental and social issues has accentuated their effects on stockmarket valuations. Aberforth contends that the perception of ESG deficiencies can create valuation opportunities, as the stockmarket often under-estimates the ability of small companies to take effective remedial action. Aberforth further contends that valuation discounts related to ESG issues can be challenged through a programme of active engagement to encourage the issues to be addressed. Aberforth is well positioned in this regard: engagement has always been a core element of the investment process. It is achievable because of the firm's commitment to a high level of dedicated and experienced investment management resource.

Aberforth's view is that the evaluation of ESG issues cannot reliably be outsourced to a third-party. This is because of a lack of consistent methodology and inadequate coverage of the small UK quoted companies amongst the data providers. This view is tested periodically through assessment of the service provider market.

Aberforth therefore relies on internal resource and processes that have been tailored for investment in small UK quoted companies. Its ESG and stewardship policies and practices are managed by the Stewardship Committee, which is a sub-committee of the Partnership Committee, Aberforth's ultimate governance body. Since its formation in 2020, the Stewardship Committee has overseen the firm's signatory renewals with the FRC Stewardship Code 2020 and the UNPRI, in addition to the disclosure of case studies relating to engagement and voting. Policies are put into action by the investment managers, two of whom sit on the Stewardship Committee. The firm's ESG activities are supported by the Head of Sustainability and Investor Relations, who is also a member of the Committee.

The following paragraphs explain the methodology underpinning Aberforth's framework for assessing companies' ESG exposures. The framework is an essential element of the integration of ESG considerations into the investment process, allowing relevant issues for all investee companies to be described, quantified, and tracked. The data is stored in the ESG module of Aberforth's investment database. This is helpful in setting engagement priorities for companies. As at 31 December 2023, three years of ESG data and analysis have been collected for all investee companies.



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The methodology

The framework is based on a risks and opportunities analysis of 12 environmental, social and governance sub factors, which are detailed in the table below.

Factors	Environmental	Social	Governance
Subfactors	Climate change	Employee culture	Board composition and succession
	Pressure on natural resources	Health and safety	Effectiveness
	Pollution and waste	External stakeholders	Remuneration and alignment
		Product liability and consumer protection	Capital allocation
			Ethics

The framework is built around two scores: a **risk** score and an **evaluation** score.

The **risk** score is the starting point of the analysis and is influenced by inputs from several external third parties including the materiality research of the Sustainability Accounting Standards Boards. This score is determined by Aberforth's Stewardship Committee and is applied at the sector level. Appendix A shows the current framework of sector risk scores. The purpose of the risk score is to identify the material subfactors for the sector's typical constituent. 1 denotes the best score and 5 the worst score. Companies in the chemical sector, for example, have a 'Pollution and waste' score of 4, recognising the higher environmental risks associated with the disposal of by-products and their implications for the environment. Risk scores are subject to annual review.

The **evaluation** score uses the same scoring scale, but unlike the risk score, it is influenced by the materiality of the subfactor as it relates to the specifics of the investee company and its business model. The assessment is part of the fundamental analysis applied to all companies and is conducted by the investment manager responsible for the sector. Using the risk score as a reference, subfactor evaluation scores are influenced by the materiality of the risk in question, mitigating practices, targets for improvement and product opportunities.

The process of refreshing evaluation scores occurs annually following the release of the annual report and other sustainability disclosures. This review brings attention to subfactor evaluations that are improving or are declining and that might require engagement. A year-on-year comparison will not always merit a change in the overall factor evaluation scores. To provide a subtler indication of progress over the year, the module allows each factor to be flagged as either "Improved", "No Change" or "Weakened".

Consistency of scoring among the investment managers is helped by an annual oversight meeting conducted by the Stewardship Committee, which identifies and discusses outliers in the data. With the benefit of these findings, a broad view of the portfolio evaluation scores can help to direct engagements with portfolio companies.



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The table below shows how the methodology works in practice. The company used in the example is Dialight, a manufacturer of LED fixtures and fittings for use in heavy industrial operations such as oil refineries and construction equipment plants. The risk scores across all environmental subfactors are high, reflecting the exposure of the electronics and electronic equipment sector to potentially energy-intensive manufacturing footprints. However, the specifics of Dialight's business model offer opportunities to the company that arise from the transition from fossil fuels. Environmental legislation and cost reduction incentives are likely to increase demand for Dialight's products over the years ahead. In addition, the company has set clear goals for the decarbonisation of its own operations. For these reasons, the evaluation score is improved relative to the risk score for each environmental subfactor. The subfactor risk and evaluation scores can then be equal weighted and converted to a percentage: a score of 3 is equal to 60% as it is 60% of the worst score possible of 5.

Stock example - Dialight

Score: 1 (best) – 5 (worst)

Subfactors	Climate change		Pressure on natural resources		Pollution and waste	
	Risk	Evaluation	Risk	Evaluation	Risk	Evaluation
	4	3	4	3	4	3

Factor	Environmental	
	Risk	Evaluation
	80%	60%

As part of the evaluation process, investment managers also record several data points in the ESG module. These data are likely to influence evaluation scores for relevant subfactors. The datapoints, which are shown in the table below, are aggregated to show disclosures across the portfolio.

Environmental	Social	Governance
GHG emissions – Scope 1, 2 and 3	% Female in workforce	% Overall board female
Use of carbon offsets	% Female senior managers	% Executive board female
Freshwater consumption		% non-Executive independent
Net zero target year		Ethnic diversity of board
Use of sustainability linked loans		Policy & targets in place for female representation
Science Based Targets Initiative (SBTi) membership		Policy & targets in place for board ethnicity
Task Force on Climate-Related Financial Disclosures (TCFD) compliance		Remuneration linked to ESG

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