Global Asset Management

Measuring the 'S' in ESG

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"There is a strong case for putting more emphasis on positive aspects, such as companies that are focused on creating an engaged and resilient workforce."

Within ESG, much of the focus historically has been on the environment ("E") and governance ("G"), as climate change has taken centre stage. Social factors ("S") have received less attention and have generally been viewed as harder to define and measure.

There are a number of factors which contribute to this. These are:

1. **Lack of a unified framework:** while the UN SDGs provide some interesting perspectives, there is no standard framework for measuring a company's social responsibility efforts.
2. **A negative focus:** ESG assessments have tended to focus on risk and reputation i.e. the more negative angle. There is a strong case for putting more emphasis on positive aspects, such as companies that are focused on creating an engaged and resilient workforce, demonstrating progressive policies and producing socially-useful products.
3. **Cherry picking:** many companies will cherry pick the ESG measures they report on, however this does not mean that issues do not exist. This is particularly true for social factors, under which a wide range of issues can be captured. When a company overstates its commitment to responsible social practices, it is known as 'bluewashing'.
4. **Supply chain complexity:** one key area where company disclosure is frequently lacking on the social side is with regards to supply chains. More often than not, companies themselves are unaware of the issues, or worse, they choose not to disclose them. The complexity of supply chains and their importance to many industries makes this a particularly complex issue.

Independent research

For the reasons outlined above, we believe that there is no substitute for rigorous, independent research.

When we measure a company's social responsibility, our process focuses on the strength of its franchise and the quality of management. We ask the company whether its products and/or services have a positive impact on society, whether these products and services offer good value for money and whether production processes emulate best practice and encourage improving industry standards. We also ask questions to deduce a company's integrity, such as whether employees are paid enough, whether the company communicates effectively with all stakeholders in the business and whether it has built scalable infrastructure.

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These questions ensure that we can have confidence that the companies in which we invest prioritise the interests of their workers and end-users, as well as the communities and societies in which they operate. The score we give a company is subjective but given the level of detail and number of questions we ask, the score will be all-encompassing and a fair reflection of how we view the efforts a company is making in its social responsibilities. We also consider third-party ratings but use these more for cross-checking purposes against our own scores.

Companies in certain industries, where supply chains have a reputation for being dubious and/or complex, often use third-party audits. These include audits such as RMI (Responsible Minerals Initiative), which sets the standards of minerals supply chains, the SMETA (Sedex Members Ethical Trade Audit) and Sedex (Supplier Ethical Data Exchange) which has over 60,000 members, mainly in the retail sector, and conducts supply chain checks for this sector.

The electronics sector created the RBA (Responsible Business Alliance) in 2004 to instill integrity into the supply chain, after it was found that despite the sector having more quantifiable and visible supply chains than other sectors, issues such as forced labour, poor working conditions and child labour could still be practiced[1]. We encourage the use of these third-party audits by the companies in which we invest.

Third-party ratings

A back-tested study conducted by Bank of America Merrill Lynch, which looked at the "S" by region, found that social factors are prioritised (in descending order) in Europe, the U.S. and then Asia[2]. This shows that, as a rule, companies based in Europe will have their share prices driven more than other regions, by strong social practices. Conversely, social factors tend to be less important in Asia. While this makes sense intuitively given that Asian regions comprise a large proportion of EM, where social factors that are recognised in more developed nations are not yet fully considered, it also shows that if we want to measure a company's social efforts adequately, metrics will need to become much more standardised.

[1] About the RBA (responsiblebusiness.org)
[2] "ESG from A-to-Z: a global primer", Bank of America Merrill Lynch. Data as at 8 November 2019.

Standardisation: the Social Taxonomy

There has been an attempt in Europe to standardise social metrics through the creation of a **Social Taxonomy**. While draft legislation was published in February 2022, it is currently on the back-burner. This is because the focus on the "E" has been accelerated in Europe due to the need to be energy self-sufficient in renewables, the importance of which was made clear with the onset of the Russian-Ukraine crisis.

Regardless of the delay in implementation, the draft proposal of the Social Taxonomy can help us gain an idea of the types of questions we should be posing to our investee companies. The taxonomy aims to achieve three goals – decent work, adequate living standards, and inclusive and sustainable communities and societies (Exhibit 1). Each of these objectives is targeted at three different stakeholder groups – workers, consumers and communities – and each is aligned to the UN SDGs. For example, SDG 8 "Decent work and economic growth" is a key goal for EU companies.

The EU Social Taxonomy aims to standardise certain key performance indicators ("KPIs") for companies, through its objectives and sub-objectives. The three objectives shown in Exhibit 1 also have precise sub-objectives, for example, objective number two, which promotes adequate living standards and wellbeing for end-users, has implications for the products a company manufactures. The products must be durable and recyclable. When it comes to products sold on the internet, the company must ensure privacy protection for the consumer.

KPIs relating to objective number one mean that companies must ensure gender diversity and the continuous re-skilling/furthering education of their employees. Some of the other sub-objectives include avoiding precarious working conditions, health and safety, social protection, skilling and education and prohibiting child labour. The above examples show how the EU Social Taxonomy could have significant implications for companies, through KPIs, and the requirements could be placed on them going forward, with regards to how they make a positive social impact.

Although not fully developed in Europe, investors in both DM and EM can start to make use of this social taxonomy framework. Companies can begin mapping products, services and activities to the three objectives. Voluntary reporting on each of these is likely to be viewed as best-in-class practice from a social perspective.

Further optimism can be derived from the fact that EM countries will adopt social taxonomies, as certain sectors will have financial incentives to do so. The sectors in EM that would benefit the most from a social taxonomy are: housing (affordable housing), electricity, healthcare, transportation, food and telecoms. These sectors are used to reduce inequality, and companies operating in any of these six sectors will be able to raise social bonds (which are similar to green bonds in that the costs are lower), the popularity of which increased significantly in 2021.

While we can be optimistic about the long-term adoption of a social taxonomy, in the shorter term the Russia-Ukraine crisis will be an impediment to adoption, as the EU focuses on energy independence. For now therefore there is, as yet, no standard framework with which to measure the "S".

Exhibit 1: The EU Social Taxonomy objectives

Three social objectives of the EU Social Taxonomy	Targeted stakeholders	SDG alignment
1. Decent work (including for value-chain workers)	Workers	1, 4, 5, 8, 10, 17
2. Adequate living standards and well being for end-users	End-users/consumer	1 to 4, 6, 8
3. Inclusive and sustainable communities and societies	Communities and societies.	5, 6, 10, 11, 17

Source: Ec.europe.eu "Final Report on Social Taxonomy" – European Commission. Data as at 23 February 2022.

Summary

As part of our checklist of questions described earlier, we already address many social issues such as good working conditions, product quality and recyclability, gender diversity, anti-monopolistic practices and whether a company communicates with all stakeholders, including local communities and societies. However, given the ongoing and constantly-developing focus by the EU taxonomy on social aspects, driven by the underlying SDGs, we continuously monitor and update our findings.

As an example, our latest checklist includes questions on supply chain integrity, following the deep-dive survey we performed on our holdings. We asked each of the companies we hold how they guarantee the integrity of their suppliers and how their supplier contracts ensure fair treatment of labour, avoid forced labour, and provide adequate working conditions. We asked them whether they subscribe to an independent audit of their supply chains and whether any past contracts had been terminated due to an inability to ensure the integrity of the supplier.

> **"We address many social issues such as good working conditions, product quality and recyclability, gender diversity, and anti-monopolistic practices."**

While we await the longer-term adoption of social taxonomies in EM, we continue to do our own in-depth analysis. We continue to evolve and do conduct periodic follow ups and cross checks, as it becomes apparent that best-in-class practices are rewarded not only by better productivity and happier stakeholders, but ultimately better profitability.

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