cio investment club

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Is natural capital set to be a major global investment trend?

The term 'natural capital' is not new; first used by economist E.F Schumacher in the 1970s it has been around for decades as a catch-all for the world's stock of natural resources. But as climate change mitigation has moved into the mainstream, a broader understanding of the world's finite resources and the value of natural capital has come to the fore.

Natural capital's value lies in the ecosystem services it sustains, without which human life would not be possible. These include food, water, fuel, building materials and medicines, as well as ancillary services such as the natural flood defences provided by forests. But natural capital is also integral to national finances; the UN Environment Programme estimates that half the world's GDP is dependent on nature. However, natural resources are being used faster than they can be replenished. Indeed, the World Bank estimated the global economy could lose $2.7trn by 2030 (compared to business as usual) if ecosystem services such as pollination, carbon sequestration, fisheries and timber provision, collapse.

Sowing the seeds

As organisations, countries, regulators and companies are grasping the importance of natural capital, so too are asset owners, who are also starting to recognise the investment case for allocating to natural capital. However, until recently, investors have remained largely in the exploratory phase.

A Pensions for Purpose Impact Lens report, commissioned by Gresham House and published in June 2023, found few asset owners were investing intentionally in natural capital solutions. Pension funds tended to bundle biodiversity in with climate change concerns, meaning those showing an interest in biodiversity and natural capital solutions were mostly pension funds implementing climate mitigation strategies as part of their journey towards net zero.

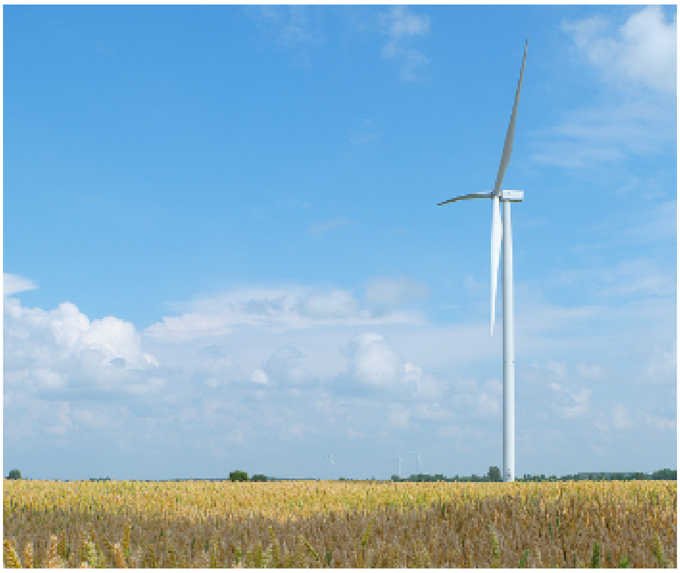
However, a more recent report by Gresham House and mallowstreet, published in May 2024, found half of UK asset owners now invest in natural capital or plan to in the next 18 months, prompting Ally Georgieva, head of insight at mallowstreet, to comment that she expects to see a "significant evolution [of natural capital] over the coming years as best practice emerges and becomes more established".

"It is clear there is growing interest in the area from UK asset owners," she added. "As the asset class continues to mature, asset managers, owners and regulators need to purposefully work together to establish the frameworks and approaches needed to drive further long-term investment and deliver positive impacts for nature."

Education has also been a driving factor in the uptick in interest, Rebecca Craddock-Taylor, director, sustainable investment at Gresham House says.

"Education has had a part to play over the past 12 to 18 months with the investment industry arming potential investors with information explaining natural capital, what it means for them and how they can access it. While many investors are still at the exploratory stage, investors are beginning to allocate to natural capital…Over the past eight months, the number of requests we've received to speak to institutional investors about the natural capital markets has really ramped up."

Product providers seem to be responding to growing appetite accordingly. Rosalind Smith-Maxwell, director at Quinbrook, notes that as many as 50 products badged with 'natural capital' have been launched over the past 18 months, according to market research.



Natural evolution

Barnett Waddingham has identified natural capital as one of four mega trends – a long-term trend set to drive the trajectory of the global economy over the next few decades – as businesses and governments seek investments that allow them to meet targets.

Sarah Lochlund, partner and senior investment consultant at Barnett Waddingham, noted the Taskforce on Nature-related Financial Disclosures (TNFD) and accountancy practices (such as the UN's System of Environmental-Economic Accounting) will also "elevate both prices and demand for natural capital".

The 30x30 target – a worldwide initiative launched in 2022 that has seen more than 190 countries commit to designate 30% of Earth's land and ocean area as protected areas by 2030 – is another measure likely to drive asset owners' engagement with the preservation and restoration of natural capital, says Tessa Younger, Better Environment Lead at CCLA.

"As more investors are beginning to engage with companies' approach to natural capital, improvements in company strategies and actions will over time be better recognised and valued," Younger says. "By incorporating a focus on natural capital, investors can not only align with global sustainability goals but can also strengthen resilience and value across their portfolios."

Gemma Corrigan, head of policy and ESG Integration at Federated Hermes, anticipates natural capital themes will continue to move up companies' agendas in 2024, with the UN's biodiversity conference – COP16 – later this year "key to delivering the commitments needed for change".

"Countries will be expected to deliver national biodiversity strategies and we will be pushing governments to deliver on both their 30% by 2030 goals and the more detailed targets outlined by the Global Biodiversity Framework…Existing companies should consider how they are impacting and dependent on nature, and how they can restore the subsequent damage."

What gets measured gets managed

The first step for investors is assessing the materiality of natural capital across portfolios, according to Doug Clark, head of research and solutions at Brightwell. However, he cautions natural capital is more complex than its better-known parent climate change.

“CO2 emissions provide a relatively simple, measurable and geographically homogenous metric but natural capital has multiple sub-strands – such as water usage, land degradation and deforestation – with measurability challenges and different impacts from country to country.

“For example, the loss of an acre of rainforest in the Amazon has a more profound impact compared to planted monoculture woodland in the UK. To manage natural capital impacts, we first need to measure and monitor it effectively and the industry is still at a relatively embryonic stage in this journey. A key area is developing data metrics, measuring portfolio dependencies and impacts from nature, then managing the risks and opportunities appropriately.”

Investors beginning to allocate to natural capital tend to start with well-established natural capital markets such as forestry and agriculture, which have a track record as well as attractive characteristics such as a positive correlation to inflation and diversification from other markets, Gresham House’s Craddock-Taylor says.

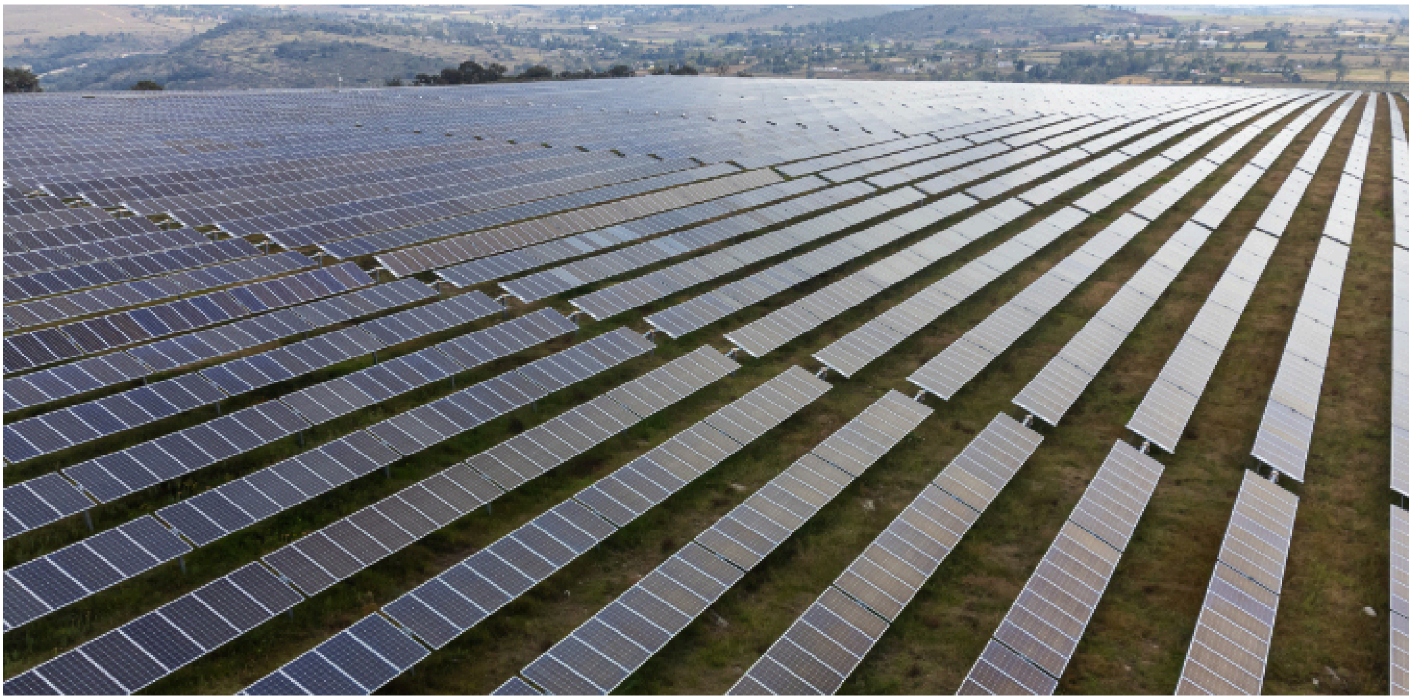
“Many of these investors will start with what they know, and then look to branch out as other natural capital markets mature. For example, the generation of carbon credits through afforestation is linked to forestry, both across the voluntary and compliance carbon credit markets. But there's a lot of variability in that market, which for institutional investors is quite risky, so while they can access afforestation and carbon credits, they probably wouldn't want more than 10% to 20% of returns being reliant on carbon.

“That said, it’s a good transition from forestry into carbon. If investors can access a forestry fund that's involved in both sustainable forestry management and afforestation, they have the potential to generate timber revenue and carbon credit revenue.”

Another area of growing interest to asset owners is biodiversity credits, Craddock-Taylor notes.

Biodiversity Net Gain (BNG) – part of the Environment Act – came into force in February, requiring UK developers to generate a 10% biodiversity net gain on their development sites, either onsite or through the purchase of credits via organisations such as the Environment Bank, which the Gresham House British Sustainable Infrastructure Fund invests in.

Parallel to this, there are numerous organisations, companies and research groups looking at how a voluntary biodiversity market (VBM) might be established, Greta Talbot-Jones, director covering natural capital within Aviva Investors’ real assets team, points out.



"Although there is a lot of anticipation in the wider natural capital and impact spaces for the VBM, greater clarity will be needed in how they will operate at scale and interact with the VCM," Talbot-Jones says. "It would be fair to say the market is yet to see the same demand drivers for VBM that drove the expansion of the VCM as a result of global voluntary net-zero commitments, but it is an area that could present future opportunities and we are tracking developments closely."

However, Quinbrook's Smith-Maxwell, raises the question of whether nature should be monetised or whether – in the case of biodiversity net gain – it should be included in returns and handed back to investors.

"Quinbrook fundamentally invests in energy transition projects – such as solar and storage and synchronous condensers – but we have sought to deliver biodiversity net gain from an impact perspective. It's an incremental cost that we believe will deliver additional benefits long term," Smith-Maxwell says.

Meanwhile, Craddock-Taylor asserts the growth of the BNG market "is a good representation of how new regulatory requirements can drive new nature markets".

"New regulatory systems are what we desperately need to see more of globally. Moving nature restoration from voluntary requirements to mandatory requirements is crucial for investors to increase their allocations to natural capital."

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