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Making the case for investment allocations to natural capital

Institutional investors are under-exposed to the natural capital asset class, which offers diversification benefits, ESG upside and potential for outperformance, says Climate Asset Management's Ben O'Donnell

***Environmental Finance:* Climate Asset Management is helping to lead the development of natural capital investing. How do you define the natural capital asset class?**

Ben O'Donnell: Natural capital is all the planetary infrastructure that's essential for life – the assets around the planet that contribute positively to a healthy world. As a broad statement, natural capital is the world's stock of natural resources, which includes geology, soils, air, water and all living organisms. On the land, that's roughly a third forestry, a third agricultural land and a third other habitats. Over the last 100 years in particular, people have increasingly managed land from the angle of economic exploitation and overlooked the role it plays providing essential ecosystem services, such as climate regulation via carbon sequestration, crop productivity via soil biodiversity benefits or the supply of clean water via soil filtration.

Investing in the natural capital space is about how we can optimise working land to improve environmental outcomes and contribute to better planetary health, while continuing to generate attractive risk-adjusted financial returns. That might be through a change of management strategy, and/or a change of use, coupled with participation in markets allowing the monetisation of positive environmental outcomes.

Ben O'Donnell

EF: Do you think natural capital, as an asset class, has been overlooked by mainstream investors? If so, why is that?

B O'D: Agriculture, forestry and fisheries contribute between 4 and 5% to global GDP. Institutional investment portfolios have on average around 0.1% of their assets invested in natural capital. If investors want to match an investment portfolio to the underlying dynamics of the global economy, a significantly increased proportion of capital should go into natural capital. It's a sector which is fundamental for prosperous economies and long-term planetary health.

As for why the asset class has been overlooked, one reason could be the lack of large-scale investment opportunities due to asset and industry fragmentation. This is likely exacerbated by the lack of sufficient sector knowledge and experience within mainstream investors' portfolio teams to screen, select and assess natural capital investment strategies and about how they're likely to benefit a typical institutional investment portfolio.

It's complicated to select from different strategies across geographies and commodities, and investors generally are not being presented with diversified portfolio opportunities. Finally, the uncertainties caused by climate change are making potential investors apprehensive when, in fact, the risks around climate change can be managed and can provide investment opportunities.

EF: What's the case for including natural capital in a diversified investment portfolio?

B O'D: Natural capital is an excellent portfolio diversifier in that

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it has low correlation with the broader economic cycle, although returns are correlated with inflation over the long term. People need to eat, so there's inelasticity of demand across the sector through the economic cycle, and particularly as it pertains to asset values, because of the scarcity of high-quality land that can be used for the production of food and fibre.

There's a strong ESG upside to natural capital in that it can deliver better environmental outcomes and offers some correlation with any increase in carbon prices. This can not only help make portfolios more resilient to increasing exposure to tightening climate change policies but can also capture additional financial returns by monetising positive environmental impacts on related environmental markets.

"Nature, like climate, is now firmly on the agenda for many investors"

EF: There is a perception in the market that natural capital assets are subject to high volatility. Is that true? Are there ways to mitigate that volatility?

B O'D: There is a certain element of volatility across food and timber production cycles, and the weather is something we can't control. However, the selection of assets' location, crop selection and the adaptation of land use management is the first layer of resilience building against environmental risks to mitigate volatility.

The remaining volatility risks which cannot be offset by active management can be mitigated through diversification of the underlying asset portfolio. We are investing across geographies, climatic regions and sub-sectors. That builds in diversification to the portfolio and helps mitigate particular microeconomic risks that pertain to geographies, currency, climate or supply chains in a single investment, sector or region. In this way, natural capital can act as a true diversifier within a broader investment portfolio, which we think is fundamental to getting more capital to positively participate in the sector and start to invest in a way that benefits both planetary outcomes and wealth creation.

EF: What other risks do investors in natural capital assets need to understand and get comfortable with?

B O'D: Climate volatility and risk can be both a pro or a con, depending on where the asset is located and how much work has been done in terms of water security, the resilience of the landscape and its participation within global supply chains. A shortage of a commodity in one region can lead to increased prices for producers in other parts of the world; that risk can be evaluated through appropriate due diligence.

The asset class can also be exposed to political and social risk. By investing across developed markets, we reduce the potential for significant geopolitical risk. In addition, we avoid the challenge of social displacement that you can find in emerging markets that typically have a much higher proportion of rural and regional jobs.

EF: What ancillary biodiversity and climate benefits can natural capital investments deliver to investors?

B O'D: This asset class offers true impact and ESG upside, with clear improvements possible in biodiversity and carbon sequestration outcomes and better water management, for example. Natural capital investing positions the asset in markets that are facing growing regulation intended to encourage landowners to improve environmental outcomes.

For example, by investing in increased buffer zones and set-aside areas, we can support biodiversity improvements. Upgrading irrigation systems can help reduce water consumption and allow more water to be returned to the environment. Cover-cropping strategies can both help micro habitats for insects and small reptiles at the bottom of the food chain while also promoting carbon sequestration and nutrient fixing into soils. This helps improve soil quality, water-use efficiency and the underlying diversity of the plant species within a working landscape. All this increases the land's resilience through the climatic cycle, which ultimately will improve its performance through the commodity supply and demand cycle.

These activities also provide future income generation opportunities from nascent markets in biodiversity, water quality and carbon, which represents upside to the base case investment thesis.

EF: What incentives are there for early movers in natural capital investment?

B O'D: The supply and demand dynamics for early movers in natural capital investing are very strong. On the supply side, land is a finite asset and its supply is being further constrained by ongoing urban development or degradation due to a combination of outdated management practices or climate impacts. We have an opportunity to create value through building smaller aggregations into larger, more efficient institutional-grade portfolios that optimise impact and returns.

On the demand side, we are seeing a growing body of regulation that is pushing more capital into ESG-oriented strategies. This is being done in a very soft way, largely through disclosure and reporting. But, as more and more capital comes to the sector, portfolios that have established a track record of delivering both impact and returns are going to be very well positioned to generate upside. That additional capital will be chasing a limited set of institutional scale and institutional-grade assets that we anticipate will drive significant additional value for early movers.

EF: How do you expect the market to develop over the coming year?

B O'D: While we don't expect to see the market move materially through 2024, the global challenges that we've experienced over the past 12 months pertaining to conflict and the economic cycle have definitely been acting as a brake on progress in terms of market developments and regulation.

That said, nature, like climate, is now firmly on the agenda for many investors. As economies pick up and people become once again more focused on the negative impacts that climate and biodiversity loss are having on the economy at large, increasing regulation will encourage capital to take action to improve the contribution natural capital investing can deliver to support climate and nature. If you look at where we need to be, in terms of carbon sequestration and improved biodiversity outcomes, the natural capital sector has a significant role to play in ensuring we continue to prosper on a healthy planet. ■

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