Investing in the power of nature

The crisis facing the world's biodiversity has become front of mind for policymakers and investors in recent years. Investing in natural capital—the world's stock of natural resources that combine to yield a flow of benefits—represents an exciting investment innovation that can achieve a range of positive impacts and create opportunities outside of traditional investment silos.

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From nature to natural capital

Nature is, quite simply, the natural world around us, including both living "realms" (biodiversity of ecosystems, species, and genes) as well as non-living ones—land, soil, water, air. Natural capital refers more to the function of nature as a store of wealth (asset) that confers benefits (ecosystem services) and is defined as the world's stocks of natural assets, which include minerals, soil, air, water, and all living things. It is from this natural capital that humans derive a wide range of services, often called ecosystem services, which make human life possible. From natural capital comes nature-based solutions—solutions that are inspired and supported by nature—that can offer viable and investable ways to mitigate climate change, protect biodiversity, and build resilience into ecosystems and communities. More specifically, they refer to sustainable management and use of natural features and processes to tackle socio-environmental challenges such as global warming and food security.

It's important to recognise that while natural capital is typically associated with particular asset classes—notably investments in sustainable forestry and agriculture—nature loss cuts across all asset classes, because they all depend on and impact nature, at least indirectly. In fact, we would argue that it's a systemic risk that should be widely considered as part of investment due diligence. As such, there's a natural capital 'angle' to many investments. But there's a difference between investing in natural capital and addressing nature loss—in theory you could invest in a forest without having any positive effect, or indeed damage it through poor management. We believe the power of investing in natural capital comes when such investments are used to address global sustainability challenges such as climate change, nature loss, and inequality. And since the idea of natural capital is most powerful when most broadly applied, it's also possible to invest in nature indirectly through public asset classes by investing in companies with revenue exposure and sustainable operations, and through green fixed income instruments, e.g., green bonds with specific funding allocation to projects focused on biodiversity.

Investing in natural capital for financial and fundamental value

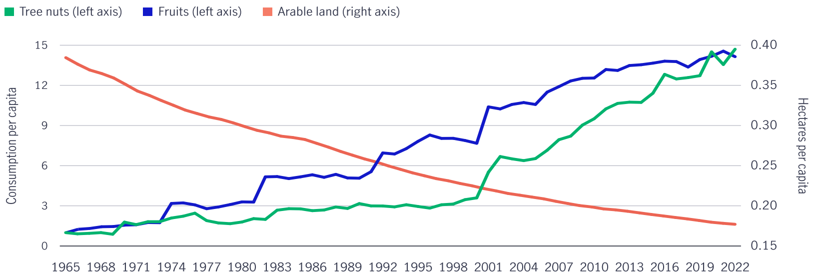
The pandemic made us take notice of nature as never before, and people began to understand that if the loss of nature continues, our society and economy will feel the consequences. The 2022 COP 15 UN Biodiversity Conference in Montreal and the advent of the Taskforce on Nature-related Financial Disclosures (TNFD) signified that we need to address the climate and nature crises *together*. The TNFD's recommendations, coming as a follow-up to the Taskforce on Climate-related Financial Disclosures, which is the gold standard for climate disclosures—sends a strong signal that investors must actively combat nature loss as well as climate change.

That the erosion of natural capital linked with biodiversity loss and environmental degradation creates significant and long-term risks to society, the economy, and therefore financial institutions, is becoming much better understood. Businesses, the public sector, and financial institutions are increasingly recognising that the widespread decline of natural systems is eroding both intrinsic and monetary value, and this is mobilising an unprecedented global business response. It's widely understood that we must act, and there's growing demand from major institutional investors who want to have a positive impact on biodiversity in their portfolios. In addition, assets that don't comply with environmental regulations run the risk of losing value and becoming stranded assets. Smart investors take a long-term view: Biodiversity is an area that's likely to be heavily affected by regulations in the future and failing to implement a positive approach to biodiversity and nature loss could be very significant for asset valuations.

Natural capital investing is here to stay

As regulators across the world enforce stricter sustainability directives, real asset investments have come to the fore as a viable tool for creating a net zero, nature-positive, more equitable society, whether investing in healthy buildings, renewable energy, sustainable agriculture, or forests. Furthermore, their robust long-term fundamentals are predicated on fulfilling basic human needs—food, feed, fuel, fibre, and shelter—all of which we can expect to grow in line with population and income growth.

Limited arable land feeding a growing population with higher demand



Source: USDA PSD, United Nations FAO, World Bank, as of 31 August, 2023

Granular and accurate data is still a major roadblock for investors, and the TNFD's new guidelines will facilitate integrated assessment and corporate reporting related to nature, just as for climate-related issues. We believe that the release of these recommendations will have a major impact on the market.

The strong investment case for natural capital

The investment case for timberland and farmland as traditional natural capital investments has long benefited from strong demand fundamentals and diversification potential alongside returns that have consistently hedged against inflation. High-quality carbon credits now offer a growing store of value, while sustainable management practices that support biodiversity, conserve water, and deliver climate benefits provide investors with further opportunities to enhance diversification, yield, and profitability while meeting their climate and nature commitments.

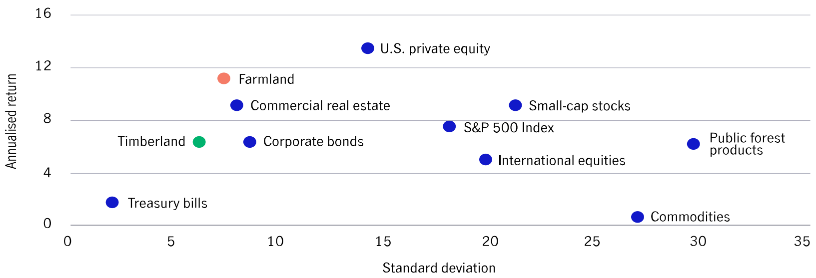
This trend toward nature-based solutions represents an evolution in investment objectives that combines an existing financial investment opportunity with tangible action to reverse climate change and nature loss. And as the world's largest manager of natural capital assets, we're able to provide investors with the opportunity to meet both needs by managing our existing assets in response to this demand by, for example, prioritising carbon sequestration over timber production in our sustainably managed forests. So, whether investors' current priority is financial or impact-driven, natural capital assets can be managed to provide a suite of options for meeting investors' needs. These nature-based solutions are a key driver of the trend that lends a "traditional" asset class such as timberland new options and ready-made scalability compounded by investors' growing obligations around climate change and nature loss.

Managing nature: as complex as nature itself

Specialisation in this field is fundamental table stakes because nature is complex, and managing it is complicated. Expertise is essential, both for managing the investment and understanding the asset itself, due to the complexity and variability inherent in natural capital assets. For example, from our decades of experience of sustainably managing natural capital assets we have a deep understanding of regenerative agriculture, but the variability of the data available for measuring carbon stored in soil still lags far behind that available for timberland. This dichotomy presents a challenge, even for experienced managers. But at least we're able to measure carbon—biodiversity is even harder to quantify. Nature isn't only very complex, it's very local, so its effects and dependencies can look quite different from place to place, which prevents a one-size-fits-all approach for measuring nature. There's no single metric for biodiversity in any setting, so the other challenge lies in being able to quantify, measure, and manage natural capital. Natural capital accounting seeks to address this by producing a balance sheet and income statement showing the value of elements of nature—such as water, soil, and species abundance—that can be translated in many cases into monetary value. From a public markets perspective, investors rely on corporate disclosure and will require greater issuer transparency provided by reporting frameworks such as the TNFD to better quantify the risks from nature loss and understand their financial impact. Better data availability can be encouraged through direct and collaborative engagement with issuers, other investors, regulators, and NGOs. For example, by engaging with policymakers we can encourage financial flows into nature-based solutions and regulation that prevents harmful impacts on nature.

Timberland and farmland's long history of low volatility and attractive risk-adjusted returns

U.S. historical return and standard deviation, 1998-2022 (%/year)



Source: Data for timberland is represented by the NCREIF Timberland Property Index, as of 12/31/22. Data for farmland is represented by the NCREIF Farmland Property Index, as of 12/31/22. Data for commercial real estate is represented by the NCREIF Property Index, as of 12/31/22. Data for small-cap stocks is represented by the Ibbotson series IA SBBI U.S. Small Stock TR USD Index, as of 12/31/22. Data for international equities is represented by the MSCI/EAFE International Equities Index, as of 12/31/22. Data for corporate bonds is represented by the Ibbotson series IA SBBI U.S. LT Corp TR USD Index, as of 12/31/22. Data for U.S. Treasury bills is represented by the Ibbotson series IA SBBI U.S. 30 Day Tbill TR USD Index, as of 12/31/22. Data for commodities is represented by the Goldman Sachs Commodity Index, as of 12/31/22. The S&P 500 Index series is from Standard & Poor's Financial Services LLC, as of 12/31/22. Data for U.S. private equity is represented by the Cambridge Associates U.S. Private Equity Index, as of 12/31/22. Data for public forest products is represented by the S&P Composite 1500 Paper and Forest Products series, as of 12/31/2022.

Generating natural capital accounting outputs

Natural capital assets that are owned, managed, or depended on	**Natural capital asset register—**Registry of all natural capital assets owned/managed/depended on
Flows of benefits that these assets produce	**Statement of physical flows—**Benefits, both for the organization and for wider society, in physical metrics
Value of benefits and to whom they accrue	**Benefit valuation statement—**In monetary terms where possible
Cost to maintain these natural capital assets	**Schedule of maintenance costs—**Relevant activities and their costs
Net impact on natural capital	**Natural capital balance sheet—**Sum of natural capital benefits over time versus the sum of costs to maintain the natural capital assets in a condition that generates the benefits

Source: "Developing corporate natural capital accounts", EFTEC in association with the RSPB and PwC, January 2015.

Tackling barriers to progress

Policy and regulatory action in line with the goals defined by the Global Biodiversity Framework achieved at COP 15 is required to give financial and corporate entities an economic reason to act in support of the framework's objectives. These landmark goals and targets lay the groundwork for properly mobilising capital markets at scale to halt and reverse nature loss. Regulation is already impacting corporate issuers: European policy developments such as the EU Regulation on Deforestation-free Products as well as the EU Corporate Sustainability Reporting Directive will require greater disclosure and due diligence from issuers on the effects of their operations and products on nature. A central challenge is to devise regulation that financially incentivises nature-positive actions because without it, pools of capital willing to invest will remain limited. However, we believe that regulation and reporting on nature will follow the carbon emission reduction focus of the past five years at an accelerated rate.

> **"The more access to data, the better the business case will be."**

Perhaps the biggest barrier to advancing natural capital investments is their long-term nature and the need for large upfront investment. Illiquidity, deal flow, and scale represent the most frequently encountered barriers to enabling the potential of natural capital investing. And while nature is increasingly incorporated into mandatory disclosures and regulations, the data collection for nature and biodiversity remains extremely difficult. Finding ways to measure nature and produce more consistent datasets will be key to allowing natural capital investing to take off. This is where the TNFD, and the ability to have a set of metrics, targets, and disclosures around material nature-related dependencies, impacts, and risks are key elements for scaling up natural capital investing. With consistent disclosure, it will be much easier to measure natural capital management performance over time: The more access to data, the better the business case will be.

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