Summary
- Natural capital can be thought of as an investment opportunity in biodiversity.
- It is attracting growing interest because of the huge impact climate change is having on biodiversity.
- Pension funds investing in natural capital should look closely at the assets they are investing in to better understand how financial returns will be delivered alongside environmental impacts.
- Observers believe there must be a massive increase in natural capital investment for the transition to net zero to happen.

Investing the natural way

Abigail Williams explores how pension funds are increasing their investments to natural capital

In recent years, a growing number of pension funds have begun to invest in natural capital assets. So, what exactly is meant by the term 'natural capital'? Why is there currently an increased focus on these assets as an investment opportunity for pension funds? And how best can pension funds invest in these opportunities?

Biodiversity investment

According to Pensions for Purpose's director, Karen Shackleton, natural capital can be thought of as "an investment opportunity in biodiversity" that is attracting growing interest because climate change is "having a massive impact on biodiversity".

"The two are inextricably linked – investing in natural capital investments is also a way of capturing carbon, so many pension funds see this as linked to their climate action investment strategy," she says.

Elsewhere, MFS Investment Management' senior managing director and global head of sustainability strategy, Vishal Hindocha, explains that the term natural capital refers to the elements of the natural environment that provide valuable goods and services to society, including soil, air, water, grasslands, forests, wetlands, rocks, minerals, and all living things.

In this analysis, the value of natural capital includes ecosystem services such as water for agriculture, natural filtration for clean drinking water, crop pollination, carbon sequestration and flood or storm protection.

"It is vital for economic activity. The World Economic Forum has estimated that $44 trillion of economic value depends on natural resources, which is the equivalent to more than half of the global GDP," says Hindocha.

While natural capital is "worth considering in its own right", Hindocha also stresses that its link to climate change makes it all the more important right now – and that sustainable investing continues to increase in importance for scheme sponsors.

"Several large UK schemes, representing over £400 billion of assets, have committed to cut portfolio emissions in half by 2030 and bring them to net zero by 2050. While the list includes some of the preeminent funds in the UK, the pensions industry has a long way to go to meet the goals set out by the 2015 Paris Agreement," he says.

"Meeting the goals of the Paris Agreement will require halting and indeed reversing nature loss. Land use and forestry changes amount to just under a quarter of human-caused greenhouse gas emissions. Forests and oceans absorb vast amounts of carbon dioxide, but this is diminishing due to acidification, biodiversity loss and plastic pollution. As we approach various tipping points, the impact of this impairment of natural capital becomes more important," Hindocha adds.

Investment strategies

In Shackleton's view, one of the most important steps for a pension fund investing in natural capital is to look closely at the assets in which they are investing, so that they understand exactly how the financial return will be delivered alongside the environmental impact.

"A number of funds have historically invested in agriculture, and also in timberland, but I think most of the recent natural capital funds that have been launched are still in their fundraising phase – this is still quite a new area. South Yorkshire *[pension fund]*, Flintshire *[pension fund]* and Environment Agency Pension Fund are among the leaders in impact investment," she says.

In terms of strategy, Hindocha believes trustees should consider discussing natural capital with their investment managers and consider making a specific allocation to projects that preserve and protect natural habitats and incorporate the investment impact on natural capital while assessing risks and allocating assets.

"Engagement with companies would also help them to understand the impact and reliance on natural capital, as well as create a dialogue that would encourage incorporating such factors into a shift towards more sustainable approach," he says.

Although he thinks natural capital, along with the ecosystem services it provides, poses a "material systemic risk", Hindocha also believes it presents opportunities in several key sectors. Moreover, although assessing these risks is "harder than assessing those associated with climate change", he is encouraged to see more conversations starting to happen.

"Factors such as supply chain location, local consumption and local resource stress might all be considered. While the data are still largely unavailable or remain poor-quality, organisations such as the Science Based Targets for Nature (SBTN) and the Taskforce on Nature-related Financial Disclosures (TNFD) are beginning to gather momentum, providing more structured frameworks for assessing natural capital," Hindocha says.

He observes that pension funds can gain access to natural capital opportunities by investing directly in projects supporting activities such re-forestation, coastal restoration, marine and wildlife support, and sustainable agriculture.

Nature positive solutions

Elsewhere, WTW global head of research, Luba Nikulina, says: "Nature-positive solutions present an increasingly interesting opportunity for pension funds. The opportunity set has been narrow, which is a barrier, but it's increasing rapidly which presents an opportunity. There has been a clearly increasing level of attention to this area, both from asset owners and asset managers.

"Existing opportunities where pension funds already have some exposure include sustainable agriculture and reforestation. An area that is gradually gaining prominence is investing in nature-based carbon projects that underpin high quality carbon credits. For example, the regeneration of mangroves, wetland and peatland."

As with other impact investments, Impact Investing Institute deputy chair, Jamie Broderick, observes there are an increasing range of opportunities to invest in natural capital, both in the UK and internationally, across asset classes, sectors and geographies.

"UK pension funds, including Local Government Pension Scheme funds, currently invest in timberland and forestry. Lyme Timber is the best example, as its credentials are good, and it has been used by Snowball and the Environment Agency, and it is increasingly looking for investment strategies focused on delivering social and environmental benefits," he says.

"Forestry offers pension funds a combination of income and growth returns that generally fit well with pension fund objectives, as well as diversification," Broderick adds.

Huge increase required

Looking ahead, Cushon strategic adviser, Julius Pursaill, highlights the "exciting innovation" of blue capital, which includes a number of ocean-based investment strategies.

"This might include sea grass – a source of food, fertiliser and a highly efficient means of carbon sequestration – and mangroves, similarly effective at sequestering carbon and excellent as a mechanism for coastal defence, a benefit it may be possible to monetise," he says.

Moving forward, Shackleton expects "better and more standardised reporting of the impact actually being delivered", as well as closer scrutiny of how funds are investing and "whether or not they are genuinely delivering to the twin goals of impact investments", coupled with a blending of environmental and social impact.

"So, a fund investing in biodiversity will also try to impact the local community positively. For example, by developing a nature reserve or a play area within the site," she says.

Given the growing importance of sustainable investing, Hindocha predicts that governments are likely to establish regulatory frameworks that would serve as a critical element influencing where capital is deployed.

"Such incentives and mechanisms would make the risk-return profile of green investments more appealing to investors – including pension funds. Introduction of investment grade policy may also play a role. Other ways that would support and encourage investing in natural capital assets might be introduced such as modification of the energy markets rules or tax rules, creation of carbon markets or promotion of certain equity or debt investment," he says.

Ultimately, the Impact Investing Institute chief executive, Sarah Gordon, believes that there needs to be a huge increase in investment in natural capital for the transition to net zero to happen.

"At the moment, this transition is not only not happening, but we are going fast in the wrong direction. Private capital needs to be mobilised, at scale, to invest in the transition, and natural capital investments are a key part of this strategy. Everyone, from individual investors and savers, to public and private asset owners and managers, to governments and multilateral agencies, needs to be engaged in this challenge," she states.

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