Defined Contribution Investment Forum

3

ESG 2.0 SERIES

Turning the tide: The DCIF's guide to investing in natural capital

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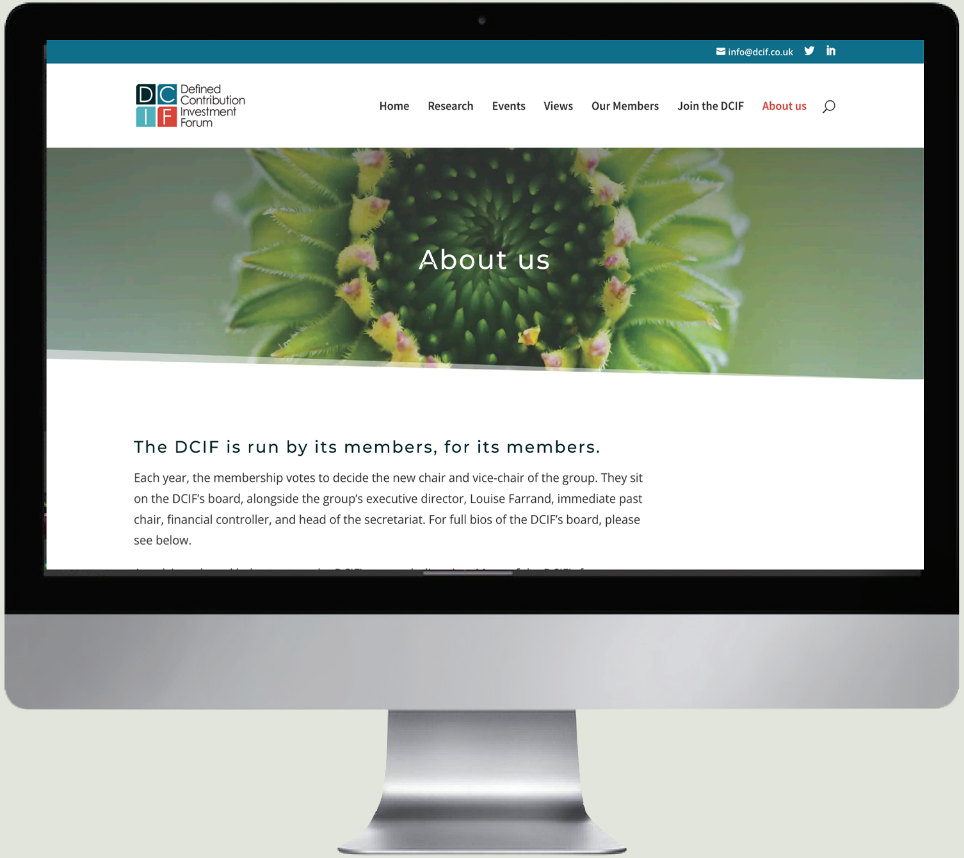

Who are we?

We're a group of asset managers who believe that a well-designed and diverse investment strategy has an important role in delivering a comfortable retirement for millions of DC savers.

A not-for-profit organisation, we commission and publish research which shines a spotlight on DC investment issues. We hope the people who determine DC pension schemes' investment strategies will use it to inform their work.

We also arrange events. From virtual roundtables to in person gatherings, they're a great way to learn more about DC investment issues and meet a like-minded community of trustees, pensions managers, investment consultants and more.

To find out more about our work and explore membership options, please visit: www.dcif.co.uk

Our members

Our members shape the DCIF's direction and steer research projects. They are:

abrdn
AXA Investment Managers
Baillie Gifford
CBRE Investment Management
Columbia Threadneedle Investments
First Sentier Investors
J.P.Morgan
J.P.Morgan Asset Management
Lombard Odier
MFS
Mobius Life
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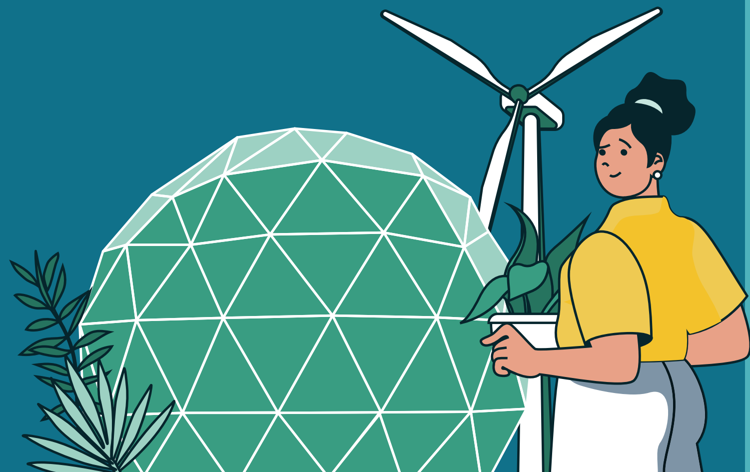
Northern Trust
nuveen
octopus energy generation
PGIM Private Alternatives
Phoenix Corporate Investment Services
Wellington Management

The DCIF's guide to investing in natural capital



To survive as a civilization, we need nature. From the crops we grow to the air we breathe, the success of the global economy heavily depends on nature. Yet as a society, many of us have become disconnected from nature and rely on the highly sanitised and convenient world we inhabit.

In developed countries, food appears in supermarkets as if by magic; clean water runs from our taps; we construct our houses with building materials we find on shelves in shops. This is all possible because of what experts term 'ecosystem services': nature, harnessed for our ends.

However, in recent years, it has become increasingly clear that nature is not a commodity upon which we can endlessly rely. We are overusing the earth's resources and crossing what the Stockholm Resilience Centre has termed 'Planetary Boundaries': nine processes which regulate the stability and resilience of the world. Scientists believe we have crossed six of the nine boundaries, disturbing the composition of fresh water, deforesting land and depleting our biosphere, to name just a few.

Cecilia Fryklöf, Nordea Asset Management's head of climate and nature, explains: "The loss of natural capital and biodiversity can pose significant financial risks across investment portfolios. Since investors have exposure across a vast number of sectors and geographies, consequently, investment portfolios are exposed to a wide range of biodiversity risks and opportunities which needs to be factored into the investment decision making process."

This can seem a long way from the concerns of the average UK DC pension scheme. But there are two reasons why you should care.

First, biodiversity is a financial factor which we haven't collectively worked out how to measure – but has a huge value. "Biodiversity barely features in valuations at the moment," says Adrienn Sarandi, Janus Henderson's head of ESG strategy and development.

Sarandi continues: "The funny thing about these types of capital is we only value human and produced capital in modelling. We assign zero value to natural capital, because we can't price it in our economic models. We can't price a good that we assume is going to be infinitely abundant and available free of charge."

That doesn't mean nature has no value. In fact, it's quite the opposite, Sarandi says, adding: "What is important to understand for market participants, investors and individuals is the fact that natural capital underpins our economic activity in society and human life is only possible because of nature."

Second, DC scheme fiduciaries should remember that the assets that they look after have a huge amount of power. Investing in natural capital is one much-discussed way that pension schemes can use their assets to bring about change and reverse the earth's direction of travel, while also – crucially – achieving a financial return for members.

Why should pension schemes invest in natural capital?

Natural capital offers many benefits to investors. Many assets which sit underneath the 'natural capital' umbrella are uncorrelated to the broader economic cycle, so it is often used as a diversification tool.

"Timberland and farmland have very low CO2 emissions," notes Gwen Busby, who leads global research and strategy for Nuveen Natural Capital. By investing in these asset classes, pension schemes can decarbonise their portfolios in a cost effective way.

Nuveen is one asset manager which invests in timberland, generating carbon credits which will diversify revenue and help pension schemes to improve their risk-adjusted returns, adds Busby. "I would say there's a really clear focus on carbon credits as a way to achieve climate targets, and a very clear focus on emissions reduction."

We are very much in the early stages of pension schemes investing in natural capital.

SOME QUESTIONS TO ASK YOUR MANAGER:

What is your strategy on natural capital?

Is natural capital integrated into your investments?

How are you gathering data?

What active research are you doing or participating in when it comes to biodiversity and natural capital?

What types of natural capital assets are you investing in?

Are you a signatory to the PRI Spring stewardship initiative?

Do you participate in Nature Action 100?

There is growing interest from pension schemes in the topic. Many scheme practitioners are interested in learning about the fundamentals, receiving training, and understanding how to think about the topic alongside climate change, as well as gathering information on how to invest in the space.

Joe Horrocks-Taylor, vice president, responsible investment at Columbia Threadneedle explains: "Part of this is driven by the Taskforce on Nature-related Financial Disclosures (TNFD). And people are aware of the future reporting burden as well. But I think there is interest at the investment level as well, particularly with how natural capital links into other macroeconomic trends. For example, moving towards regenerative agriculture, packaging reformation and the circular economy can all be linked to natural capital."

Where should DC pension schemes start?

"Chat to your manager" suggests Horrocks-Taylor, giving some ideas of questions to ask in the box on the left.

Think about what you need

Think about your pension scheme's objectives and how different natural capital assets might align with them, advises Gwen Busby. For example, timber and farmland often deliver stable income.

Consider your time horizons, adds Busby. "Are you a long term investor? These are not asset classes for high frequency traders. These are long-term investments. We're operating forests and farms over a ten, 20 or even 50-year time horizon, in some cases."

DC pension scheme clients are allocating to natural capital for a variety of reasons, adds Sophie Ballard, Nuveen's head of UK pension distribution. Some schemes are drawn to it from a sustainability angle, while others want to allocate because they strongly believe in the investment case.

Stay open to new possibilities

Be open to thinking beyond the obvious asset classes we associate with biodiversity and natural capital. "Initially [the mood among pension schemes] has been: 'Let's buy up farmland.' This can be impactful, but it is a fraction of the overall financial market," says Joe Horrocks-Taylor.

Indeed, the market has evolved beyond timberland and farmland, which have been institutionally investible asset classes for over 30 years and offer a strong track record of steady, income-like returns to investors. Busby says: "There's now a broader set of strategies that look at ways to combat climate change, they look at ways to address nature loss, and improve and even restore those natural capital assets, and the flow of benefits that come with them."

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Lalemi-Jacobs observes that natural capital comes into play in many parts of a pension scheme's investible universe, including consumer goods.

She says: "We've been discussing how we can allow investors to access some of these other opportunities within different asset classes. For example, in private equity, you can invest in small companies that are creating solutions that are helping natural capital. Farmers are using precision agriculture to help them to use less resources like water and pesticides, which all end up degrading natural capital. So, there's a space there where we can allocate capital."

There's also innovation in the fixed income space. Green, Social and Sustainability (GSS) bonds are growing in popularity, with various asset managers offering them. The Mexican government has even issued a bond which is aligned to the UN's Sustainable Development Goals, which was listed on the London Stock Exchange's Sustainable Bond Market. The bond was more than six times oversubscribed. >

[Mexico comes to London for sustainability conscious investors,](#) London Stock Exchange

> Gabriel Yorio Gonzáles, Mexico's deputy finance minister, told the London Stock Exchange in a case study, that "From a sustainability perspective … the bond is a way to demonstrate our commitment to the SDGs agenda".

The Seychelles Blue Bond is another great example of a pioneering project which will support marine and fisheries projects. The bond raised $15m from international investors, with help from the World Bank.

One of the Seychelles Blue Bond's investors was DCIF member Nuveen. At the time, Stephen M. Liberatore, manager of Nuveen's ESG fixed income strategies, said: "Sustainable development of blue economies such as the Seychelles aligns with our view that investing with a responsible approach is both prudent and financially rewarding in the long-term. We hope this transaction serves as a template for creative impact investment solutions in the future."

Lalemi-Jacobs is seeing more and more innovative examples like this across asset classes. "I would say that, more and more, understanding from a solutions perspective is becoming broader. We're not just looking at natural capital from a risk management perspective."

Horrocks-Taylor echoes this, adding: "We are starting to invest in natural capital through corporate debt and private equity positions."

> **"We are starting to invest in natural capital through corporate debt and private equity positions."**
> Horrocks-Taylor

What, if anything, is holding back decisions to allocate to natural capital? The market is still at an early stage of development, says Sarandi. "In nature we haven't even started identifying what it is we need to finance. The big issues include food security, water security, pollution, the circular economy."

Much more education is needed so that investors, regulators and asset managers all understand more about the challenges that face us, adds Sarandi. Only then will we be able to create and invest in solutions which will turn the tide.

Joining the dots is a challenge. "I don't think there's a scarcity of resources to invest in," adds Olly King, sustainable investing product specialist at Fusion, Data Solutions at J.P. Morgan. "I think being able to intermediate the investible asset class with the investor is probably the biggest issue at the moment. Joining Pension Fund A as an investor in Omani mangrove restoration projects. Both want each other, but it's about making the link and ensuring that due diligence works."

King concludes: "It's available as an asset class, but it's complicated and relatively sophisticated to access as an investible universe."

Elliott Harris: Measure the value of nature – before it's too late, United Nations, 2 March 2021

What are the risks?

Perhaps the biggest risk associated with natural capital is that of doing nothing. This is likely to materially disadvantage members' retirement outcomes, as well as risking the future of the world. As Elliott Harris, chief economist of the United Nations points out in an interview: "Unless we manage the natural world around us better, we are destroying the very foundation of our life on this planet. Ignoring nature imposes costs that have been in the trillions and that have been going on for decades."

Without turning the tide, we will move towards a world where natural disasters will destroy crops and decimate people's homes and livelihoods. Wildfires will lead to temperature rises and destroy ecosystems. Coastal erosion could lead to a whole host of risks for infrastructure and property assets.

Without pollinators, food production will be at risk. As Sarandi says: "In the UK, we are already borrowing bees. Sometimes we have to hand pollinate our crops. How much is that going to cost, versus protecting them, stopping using harmful pesticides and improving regulation in this area."

The risks of investing in natural capital will vary by asset class. As with any investment, it makes sense to avoid too much concentration in one area. A lack of diversification could leave investors vulnerable to myriad risks.

There is also the risk of miscommunication. As Robbie Epsom, CBRE Investment Management EMEA head of sustainability explains: "There is a perception risk associated. People may see rewilding initiatives as private investors buying up countryside to solve their greenhouse gas problems. There is a real communications element around this, in addition to getting the technical piece right."

The benefits of such initiatives outweigh the risks, Epsom is keen to emphasise. "The right trees, planted in the right place, with community access is brilliant. If you are putting forests back in places which haven't had forests for hundreds of years, then you are quite literally capturing or removing greenhouse gas emissions from the atmosphere. And so that's part of mopping up residual emissions, which every country on the planet is going to have to do."

The same piece of land can herald social benefits too, bringing people back to once-desolate, now rewilded, spaces, Epsom points out.

What does the regulation say?

"The regulatory obligation currently isn't as strong for nature as it is in climate," says Horrocks-Taylor. There is no specific regulation directed at nature for DC pension schemes to follow at present.

Mark Austin, Pensions and Insurance Executive, EMEA, Northern Trust Asset Servicing and chair of trustees for the Northern Trust (UK) Pension Plan, adds: "From a trustee point of view, we understand net zero and where we're going with that because we've been compelled to by regulation. We spend most of our time on ESG looking at: what is the regulation, what is the guidance we're being given by The Pensions Regulator and the FCA? We'd like to look at natural capital, but we have lots of other things to get to first."

That said, guidance has been published which schemes will find informative. The Taskforce on Nature-related Financial Disclosures (TNFD) has introduced a set of recommendations for the measurement and disclosure of risks and opportunities. It follows the well-established framework developed by its climate equivalent and has already gained significant investor adoption. The TNFD recommendations are currently voluntary but pension schemes may want to utilise the methods it lays out for identifying and managing nature-related risks.

The Financial Conduct Authority (FCA) published a handbook on nature-related risk in October 2024. While it is primarily aimed at financial institutions such as asset managers and insurers, pension schemes will find its guidance on integrating nature into risk management helpful.

FURTHER READING

The FCA's handbook on nature-related risk, including guidance on integrating nature into risk management (p22-27).

The Taskforce on Nature-related Financial Disclosures

The Principles for Responsible Investment (PRI) has produced a set of due diligence questionnaires to help asset owners to quiz their asset managers, here.

IRIS+ helps investors to translate their impact intentions into results by increasing data clarity and comparability, as well as providing practical guidance. Find out more here.

How does the nature crisis link to the climate crisis?

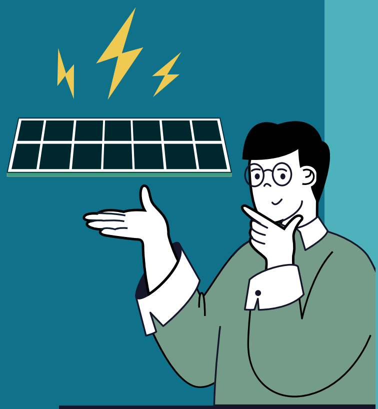
The two crises are interconnected. As Valeria Dinershteyn, Northern Trust's director of sustainable investment and client engagement EMEA, explains: "Climate change exacerbates biodiversity loss and biodiversity loss exacerbates the heating of the air and water. The two accelerate each other."

Climate change also fuels nature loss. It is the second biggest cause of biodiversity loss at sea, and the fourth most significant on land, according to the Intergovernmental Science-Policy Platform on Biodiversity and Ecosystem Services.

As with climate change, the longer we wait, the more drastic action will have to be, warns Sarandi. "We can't even begin to comprehend the physical risk over the long term, because we can't model tipping points," she adds.

Pension schemes which invest in natural capital and biodiversity could also help to mitigate the effects of climate change.

Closing thoughts



THREE ACTION POINTS FOR DC PENSION SCHEMES:

1

Get educated - seek support from advisors, managers and the industry to better understand the space before making any decisions.

2

If you haven't already, add natural capital alongside climate change as a key area of focus and risk.

3

Form a plan of action that covers reporting and possible investment goals.

When learning about the earth's rapidly declining biodiversity, it could be easy to feel disheartened. However, there are reasons for optimism, says Sarandi. "The good thing about this is we have a superpower we are not using very well: nature."

"Nature can regenerate, and we can see it everywhere. Chernobyl hasn't been humanly populated since the accident in the 1980s and now it is a wildlife haven – there are trees growing out of buildings and wild horses in the area. Coral reefs can be rehabilitated and you can save them. Wildlife can bounce back if you give it a chance. Biodiversity can be preserved but we have to work with nature, not against it – because who's going to be here in the end?"

However, global regulators, investors and the asset management community need to act soon. Sarandi finishes: "The longer we wait, the more abrupt and violent the moves will have to be, the more financial risk this is going to pose for us."