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A guide to natural capital

Natural capital represents the physical assets and processes of the natural environment, which provides us with the resources we need to survive and thrive.

Our economic system in its current form depletes natural resources while producing waste at an unsustainable rate – exacerbated by population growth and increasing demand for goods and services. As we continue to remove and damage natural assets without taking steps to preserve, protect or regenerate them, we jeopardise the benefits nature provides, creating global problems like climate change and biodiversity loss.

These concerns have increased the global focus on natural capital, which, in turn, presents opportunities to invest in assets that contribute to its preservation, while producing positive returns. In this guide, we describe natural capital's investment characteristics, explaining how it can fit into portfolios. We also lay out the three main groups of investment opportunities that we've identified.

Natural capital includes:

- Renewable resources (trees, plants and wildlife)
- Non-renewable resources (fossil fuels, minerals and water)
- Ecosystems (forests, oceans, wetlands and grasslands)

Ecosystem services are provided by natural capital which provide benefits to people and the economy by sustaining life, livelihoods and wellbeing. These are:

- **Provisioning services –** supplying raw materials for consumption and production inputs.
- **Cultural services –** non-material benefits, such as recreation, aesthetic value and spiritual enrichment.
- **Regulating services –** carbon storage, flood control and pollination.
- **Supporting services –** such as nutrient cycling or soil formation.

For example, forests can provide timber while also filtering pollutants from the water supply, assisting with pollination and biodiversity, and mitigating climate change. Forests are also a source of recreation, providing cultural services.

Why invest in natural capital?

Investment in natural capital can be used to support an investor's financial and/or impact aims. We see the key drivers for considering investment in natural capital as:

Return potential

- **Increased demand for sustainably managed natural capital assets and products** due to population growth, natural resources being finite and an increasing focus on the role of renewable resources like timber in the long-term transition to a low-carbon economy.
- **Additional return sources** from the growth in carbon markets and the potential development of biodiversity markets, allowing investors to monetise value from regulating services.

Risk management

- **Diversification** of return sources – natural capital assets tend to be driven by longer-term trends not directly linked to the economic cycle. This often provides negative correlation with traditional assets.
- **An indirect link to inflation -** as a source of raw materials, products made from natural resources are key inputs to inflation calculations.

Creating impact

- Many natural capital investments aim to create measurable, positive environmental outcomes.
- **Climate change -** Investments that focus on, and can effectively measure, carbon reduction/ sequestration could contribute to a scheme's net zero targets.
- **Biodiversity -** Investment could be allocated towards companies that actively promote biodiversity or to real assets with biodiversity KPIs.

In focus - creating impact

Investing in natural capital is just one way to work towards specific ESG or impact aims. Other actions investors can take include manager engagement or allocating to companies based on their carbon or biodiversity footprint.

When investing in assets with the aim of making impact, it's important to understand the specific focus and strategy of any investment, relative to the impact you want to make.

Example – Timberland:

- An investor could make a timberland investment to achieve 'impact' in a particular area, such as carbon reduction or biodiversity protection. But investors shouldn't assume that any timberland investment will be automatically creating positive, measurable impact across the intended areas.
- Careful questions should be asked of each manager to understand their specific aims, how they measure and report on key areas of impact, and any unintended negative consequences of the investment (eg ensuring land chosen for new planting could not have a more beneficial use).

Accessing the theme

As a theme, 'natural capital investing' sits across both traditional and private asset classes. Some options for accessing this theme are well established, with long track records. But other, newer options may take years before they offer sufficient scale for meaningful institutional investment.

Investment in the natural capital theme can generate returns through three broad mechanisms.

Investing directly in natural capital assets

- Returns are sourced through the direct use of natural capital assets, usually via the sales of resources provided and products grown, or through leasing the assets.
- Key examples are farmland and timberland.

Financial credits (carbon and biodiversity)

- Monetising the ecosystem services provided, eg through carbon or biodiversity net gain credits.
- Carbon markets are relatively nascent, and biodiversity markets are even less well developed.

Technology supporting natural capital

- Investment in companies/ businesses directly supporting or innovating in the area of ecosystem services – eg agriculture technology, carbon capture and sustainable packaging.

In focus - carbon credits

What are carbon credits?

A carbon credit is a certificate representing one metric ton of carbon dioxide equivalent[1] that's either removed from or prevented from being emitted into the atmosphere. Some natural capital assets, such as timberland and farmland, can remove or avoid emissions above and beyond those removed as part of business as usual. Managers can apply to receive carbon credits for these extra emissions reductions.

To gain carbon credits, managers must submit their project to an accreditation body, which assesses it based on the amount of carbon that's expected to be removed/avoided and how long this carbon will be locked up. Credits can be sold on to other parties who wish to offset their own positive emissions.

Risks of carbon credits

Carbon markets are relatively nascent, and returns are uncertain, with a wide range of assumptions for the expected future price of carbon. Factors influencing the value and availability of carbon credits include new guidance and frameworks, political risks and alternative solutions.

For any investment involving carbon-credit generation, it's important to understand:

- The extent to which any manager's strategy is relying on returns from carbon credits, versus more traditional sources of return like timberland sales, and the manager's assumptions about the price of those credits.
- How each manager intends to manage carbon credits ie by selling them as soon as granted, keeping and selling opportunistically, or offering to investors to retire. Asset owners need to consider their fiduciary responsibilities, and we expect that carbon credits will be monetised by investors.

[1]Carbon dioxide equivalent is the amount of carbon dioxide (CO2) emission that would cause the same integrated radiative forcing, over a given time horizon, as an emitted amount of a GHG or a mixture of GHGs.

Natural capital in portfolios

There's a broad range of funds that could potentially be categorised as a 'natural capital' investment – each looking to access one or more of the mechanisms above via nature-focused investment into traditional or private asset classes. This can range from listed equity and debt strategies through to illiquid real assets such as timberland.

Below we look at how the three mechanisms can be accessed through investments in different asset classes.

Investing directly in natural capital assets | **Financial credits (carbon and biodiversity)** | **Technology supporting natural capital**

Real assets

- **Direct investment** in illiquid assets eg timberland and farmland.
- In timberland, managers own and sustainably manage commercial forests, which may include planting new forests (afforestation, reforestation) to **create carbon credits**.
- With farmland, managers own agricultural land, which they can lease to farmers or directly manage.
- Well established with long track records.
- Allow transparent reporting of ESG aims and metrics.

Private equity and debt

- Tend to focus on **supporting a specific area of natural capital** eg providing equity/debt to projects making improvements to protect the ocean, looking to build and run carbon-capture facilities or companies developing solutions for more efficient food production.
- Can also provide equity and debt to assist with the **direct investment in natural capital assets.**
- May be in more niche and untested technologies, bringing higher risk and potential return.
- Allow investors to target specified impact areas. However, their impacts can be less easily measured than real assets, with lower levels of ESG and emissions data.

Listed assets

- A more liquid alternative that provides exposure to established individual companies contributing positively to solutions and **supporting natural capital.**
- Some listed funds also available with underlying **investment into natural capital assets.**
- Although ownership is less direct and wider ESG impacts are less measurable, emissions data tends to be strong for listed assets. Asset owners can also exert pressure on managers and companies through shareholder rights.

Building an allocation

Investors will have different goals in terms of risk, return, liquidity and ESG characteristics, all of which must be considered.

Where possible, we advocate a focus on better established natural-resources strategies for initial investments, in real assets like timberland and farmland, with smaller allocations to emerging private equity or debt strategies that have a limited track record and are much higher risk.

However, all investors will have different requirements. An initial allocation to a liquid equity mandate focused on a particular area of natural capital can also be a good place to start for investors seeking greater liquidity.

We expect that, over time, further investment opportunities will arise. Some of the current, more niche and untested options may become more suitable for institutional investment.

Contact us

We have the skills and resources to help you explore all these areas. Please get in touch if you'd like to discuss how to investigate natural capital as an investment opportunity in your asset portfolio.

Get in touch

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Important information

General Investment Risk Warning

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