Building portfolio resilience with natural capital

Institutional investors are getting wise to the natural capital asset class. This is not surprising. It offers diversification benefits, ESG upside and potential for outperformance.

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Within our organisation, we define natural capital as all environmental infrastructure that is essential for life. In essence, that means the global stock of natural resources, which includes geology, soils, air, water and all living organisms. This natural capital is fundamental both for prosperous economies and for long-term planetary health.

Historically, people have tended to manage land and the broader spectrum of natural capital that resides within it for the purpose of economic exploitation. In doing so, they have often overlooked the important role it plays in delivering essential ecosystem services such as climate regulation via carbon sequestration, crop productivity via soil biodiversity benefits, or supply of clean water via soil filtration, all of which are fundamental to supporting environmental and economic prosperity.

'Natural capital is an excellent portfolio diversifier.'

Investing in natural capital encapsulates optimising working land to continue to produce high quality food and fibre commodities for human consumption, while enhancing the contribution of the asset to improve environmental and climate outcomes, ultimately delivering more resilient long-term financial returns in a resource-constrained world.

An asset class that has been overlooked

Agriculture, forestry and fisheries together contribute approximately 5% to global GDP. However, natural capital represents on average approximately 0.1% of institutional capital allocations.

As the importance of the natural capital sector to the broader economy is becoming more clearly understood, it is not surprising that institutional investors are starting to take notice that such a significant underallocation creates portfolio risk over the long term.

While the natural capital sector has traditionally been hard to access at scale for institutional investors, those now wanting to enhance their investment portfolio alignment to the underlying dynamics of the global economy have an opportunity to recalibrate allocations towards natural capital.

Enhanced investment in the sector generally has strong support from the underlying members on whose behalf institutional capital is managed as it has the potential to enhance wealth creation and environmental outcomes for future generations.

Diversification

Natural capital is an excellent portfolio diversifier. It has low correlation with the broader economic cycle and traditional asset classes such as equities and bonds, while having strong long-term correlation with inflation and asset valuations that are typically resilient through the economic cycle.

People need to eat, so there's inelasticity of demand across the sector and this supports the value of the finite pool of high-quality land that can be used for the production of food and fibre.

There is also a strong ESG upside to the natural capital sector in that it can deliver better environmental outcomes that are increasingly the focus of institutional reporting standards and offers exposure to nascent markets in biodiversity, water quality and carbon. This positions portfolios to enhance reporting around tightening climate change or biodiversity policies, while also capturing additional financial returns by monetising positive environmental impacts, as environmental markets increasingly seek to value the intangible services provided by natural capital.

Mitigating volatility and other risks

There is a certain element of volatility across food and timber production

PHOTO: ARCHIVE CLIMATE ASSET MANAGEMENT

cycles, and the weather is something we can't control. However, the assets' location, crop selection and the adaptation of land use management is a first layer of resilience building against environmental risks to mitigate volatility.

Active management is a differentiator to many passive strategies that entrust the land to an external operator for a fixed rent payment. This kind of short-term rent agreement can orient management practices around short-term profit generation, thereby reducing investment in long-term wealth creation.

Any remaining volatility risks which active management cannot offset, can be mitigated through diversification of the underlying asset portfolio, such as investing across multiple continental geographies, climatic regions and commodity sub-sectors. That builds in diversification to the portfolio and helps mitigate particular microeconomic risks that pertain to particular geographies, currency, climate or supply chains in a single investment, sector or region.

Ancillary biodiversity and climate benefits and incentives for early movers

Natural capital offers true impact and ESG upside, with clear improvements possible in biodiversity and carbon sequestration outcomes and better water management. 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 native habitat restoration, we can support biodiversity improvements. By upgrading irrigation systems, we can help reduce water consumption and allow more water to be returned to the environment. By applying cover-cropping strategies, we can help both micro habitats for insects and small reptiles at the bottom of the food chain and promote carbon sequestration and nutrient fixing into soils. Cover crops help improve soil quality, water-use efficiency and the underlying diversity of the plant species within a working landscape. Adjusting management practices increasing the land's resilience through the climatic cycle should ultimately improve its performance through the commodity supply and demand cycle.

For early movers, the supply and demand dynamics in natural capital investing are compelling. 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. On the demand side, the mega-trend of population growth and wealth creation is driving the need to produce more from less, all from the existing set of resources we have available on earth.

A growing body of regulation is pushing more capital into ESG-oriented strategies. This is happening in a very soft way, largely through disclosure and reporting. However, as more and more capital comes to the sector, those portfolios with an established 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.

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Nature is the new climate

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 that natural capital investing can deliver to support climate and nature.

If you consider where we need to be in terms of carbon sequestration and improved biodiversity outcomes by 2030 or by 2050, the natural capital sector has a significant role to play in ensuring we continue to prosper on a healthy planet. ■

SUMMARY

The agriculture, forestry and fisheries sector is a significant contributor to global GDP, but natural capital has historically been overlooked by institutional investors.

There is a real opportunity for investors to recalibrate their allocations to a sector which offers: portfolio diversification benefits, a hedge against inflation, ESG upside and potential for outperformance, while protecting the planet for future generations.