Integrating biodiversity into fixed income portfolios – why and how

Biodiversity affects every part of our lives. This also means that the impacts of biodiversity loss could be felt across investment strategies. Looking specifically at fixed income, we see important reasons why investors should integrate biodiversity into their decision making.

By *Bruno Bamberger*

Biodiversity loss presents risks that could impact the performance of all investment portfolios, including those focused on fixed income. Specific risks we have identified include:

- **Physical risks** arising from the degradation of ecosystems and biodiversity, which can directly impact the performance of assets within fixed income portfolios.
- **Transition risks** related to companies that fail to adopt sustainable practices, exposing them to potential liability risks and higher operational costs.
- **Systemic risks** including inflationary pressures that could affect entire sectors and not just individual issuers.

Companies that don't proactively manage these risks may experience financial difficulties, impacting their ability to repay debts.

> 'The market for biodiversity-focused investments is poised for growth, offering opportunities that align with the global transition to a more sustainable and resilient economy.'

Growing interest in protecting biodiversity from asset owners

Aside from the need for risk management, there is rising demand from asset owners seeking to mitigate their negative impacts on biodiversity by reducing the biodiversity footprint of their investments. Estimates from entities like the Convention on Biological Diversity suggest that between $ 150 billion and $ 440 billion annually is needed to reverse biodiversity loss, indicating a significant gap between current financial flows and what is necessary.

Clearly, there is more work to do here, and harnessing financial markets can help plug this gap. Fixed income is such a huge asset class that it can create meaningful change, driving issuers to reduce their biodiversity footprint.

Assessing risks and integrating biodiversity

Effective integration of biodiversity into investment strategies requires good-quality data. The availability of biodiversity data is variable, but investors can still begin integrating biodiversity considerations despite this challenge. The available information isn't perfect, and portfolio managers should acknowledge this rather than let it become a hurdle to getting started.

A further complication for fixed income investors is the lack of specific instruments dedicated to financing natural solutions. Therefore, we focus on managing risks to preserve asset value in the long run through two sources of information:

- The Taskforce on Nature-related Financial Disclosures (TNFD) framework – to identify high-risk sectors.
- The Iceberg Data Lab's Corporate Biodiversity Footprint – to mitigate risks at an individual issuer level.

Strategies for integrating biodiversity

Within our organisation, we employ various strategies to integrate biodiversity into fixed income portfolios:

1. **Exclusions**
   Activities that are especially harmful to ecosystems can be excluded from portfolios at the security selection stage. For example, companies whose activities contribute directly to deforestation or natural ecosystem conversion are excluded from our portfolios investments

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due to the associated economic and environmental challenges.

2. **Engagement**
   Active dialogue with issuers is essential to encourage more sustainable practices. This engagement helps identify risk ‘hotspots’ and fosters awareness of biodiversity-related supply chain risks. We focus on issues like deforestation and pollution, and increasingly address water and circular economy topics, to promote best practice from the companies we invest in.

3. **Biodiversity reporting**
   Good information helps monitor the progress issuers are making to improve their impact on biodiversity. One example is the Corporate Biodiversity Footprint (CBF), a metric developed by Iceberg Data Lab, to evaluate the negative impacts of a company’s activities on biodiversity across its value chain.

Constructing portfolios with biodiversity in mind

Fixed income investors can enhance their biodiversity integration through several approaches:

1. **Portfolio tilting**
   This approach involves shifting investments away from issuers with high biodiversity footprints toward those actively reducing their impacts. This requires detailed issuer analysis.

2. **Bond maturities**
   This approach means investing in shorter-maturity bonds for issuers with significant biodiversity risks, allowing for re-evaluation and reinvestment only if the issuer demonstrates commitment to mitigating these risks.

3. **Use-of-proceeds bonds**
   A commons strategy is investing in bonds that directly contribute to biodiversity initiatives. Different types of use-of-proceeds bond available include:
   - **Blue bonds:** These finance marine and ocean-based projects, although their current market is limited, posing liquidity and diversification challenges.
   - **Sustainability-linked bonds (SLBs):** These bonds do not directly fund specific projects but set company-level sustainability targets. Failure to meet these targets results in increased costs, with the aim of providing financial motivation for companies to improve their practices.
   - **Green and sustainable bonds:** These bonds finance environmental projects, with approximately 25% of the green bond market linked to biodiversity. The green bond market is much larger than blue bonds, offering better liquidity and diversification.
   - **Blended finance:** This approach combines public and private funds to direct financing toward developing economies. Debt-for-nature are swaps emerging as a promising mechanism.

The road ahead

Biodiversity loss poses significant risks to lives, the planet, and the global economy, with over half of the world’s GDP dependent on nature. The fixed income asset class has the potential to play a critical role in mitigating these risks through various strategies. Investors can begin by assessing their portfolios for biodiversity impacts, excluding high-risk issuers, engaging collaboratively, and investing in sustainability-oriented bonds.

The market for biodiversity-focused investments is poised for growth, offering opportunities that align with the global transition to a more sustainable and resilient economy. By integrating biodiversity into fixed income strategies, investors can contribute to the urgent need to protect and restore ecosystems while also safeguarding their financial interests. ■

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SUMMARY

Biodiversity loss presents physical, transition, and systemic risks to fixed income portfolios.

Growing investor demand and funding gaps highlight the need for integration.

Exclusions, engagement, and biodiversity reporting are used to manage risk.

Tools like the TNFD framework and Corporate Biodiversity Footprint support analysis.

Strategies include portfolio tilting, use-of-proceeds bonds, and shorter maturities.

Fixed income can drive positive change and protect portfolio value long-term.