Real Assets

Addressing the SDGs with the long term in sight

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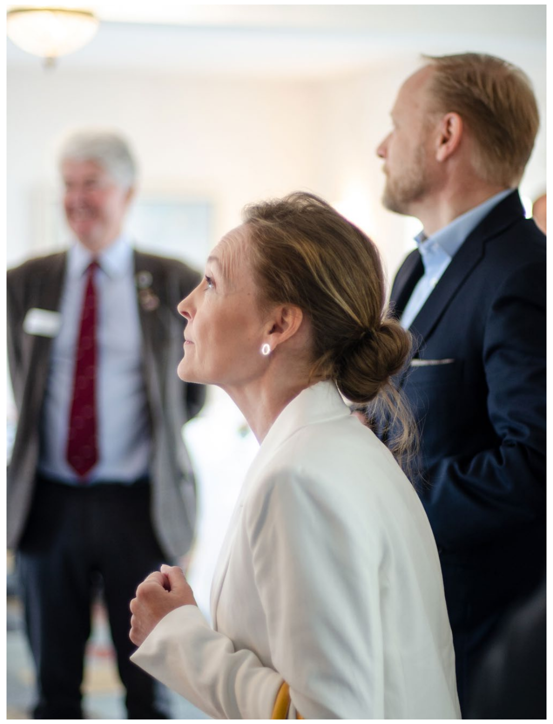
Achieving the Sustainable Investment Goals requires long-term capital commitments, which is sometimes difficult to accomplish through liquid investment vehicles. At a recent event in Gothenburg, on the west coast of Sweden, NordSIP found three real asset investment strategies which contribute to the SDGs in different ways. While the managers have not chosen to highlight the goals specifically, we found a strong fit with some of the goals' underlying targets for each strategy, and not necessarily the easiest to address profitably.

Nick Tapp,
Craigmore

Goal 2 – Zero Hunger

Not many investment strategies can relate to such an important goal as goal 2 "Zero Hunger". "A profound change of the global food and agriculture system is needed if we are to nourish the 815 million people who are hungry today and the additional 2 billion people at risk of undernourishment by 2050. Investments in agriculture are crucial to increasing the capacity for agricultural productivity, and sustainable food production systems are necessary to help alleviate the perils of hunger," the UN states.

Nick Tapp at investment manager and farmer, Craigmore, makes a compelling argument for why investing in New Zealand agriculture is a sound choice, both from a financial and from a sustainability point of view. While the underlying fundamental demand trend is strong, the asset class is particularly unusual for several reasons. In several countries, the government impose restrictions on institutional ownership of farmland, for instance. The revenue may be uncorrelated to equity markets, but the inherent exposure to the weather, commodities market and even political risk requires a particular type of expertise. These risks are well known, they can be analysed and controlled for, but too few perform the needed work, according to Tapp.



New Zealand is particularly attractive for agricultural investments. It is politically secure, and its geographical location is ideal: it enjoys the sunshine of Spain and the rainfall of Ireland. Rain provides reliable irrigation, and since grass grows abundantly all year round, cattle can graze on natural feed, which is more cost effective, more climate-friendly, and healthier than the soy- or maize-based feed most other countries rely on. This means that New Zealand has a global competitive advantage to provide low-cost dairy. Without the weight of water, powdered milk can be shipped to deliver cost-efficient animal proteins to feed people around the world, particularly to neighbouring Asian countries.

SDG Target 2.4 aims at "ensuring sustainable food production systems and implement resilient agricultural practices that increase productivity and production (...)" Interestingly, Tapp points out, New Zealand has abolished farm subsidies. This means that agriculture has become a highly innovative, competitive and more productive industry. This radical change in government policy has encouraged the industry to focus on what the farms can do well. Young entrepreneurial minds are attracted by the challenges and opportunities offered by this dynamic agricultural sector, instead of concentrating on urban jobs.

For Tapp, agriculture can develop competitive advantages by focusing on details. "Have you ever tried a 'golden kiwi'?" he asks. "It is transformational! Demand for this fruit has become stratospheric." The breeding of this new variety of kiwifruit illustrates what the agricultural sector is capable off when they are given the means to invest competence in generating sustainable revenues. Such adaptability becomes increasingly crucial, as climate change disturbs the meteorological balance agriculture relies on to optimise food production.

At Craigmore, ESG management doesn't stop at avoiding risks, but it is an integral part of the business culture. The farmers that manage properties owned by the Craigmore Partnerships are co-owners and together work on long-term targets that are aimed at improving the environment and communities.

Goal 15 – Life on Land

"Forests cover 30.7 per cent of the Earth's surface and, in addition to providing food security and shelter, they are key to combating climate change, protecting biodiversity and the homes of the indigenous population. By protecting forests, we will also be able to strengthen natural resource management and increase land productivity," say the United Nations about goal 15, "Life on Land".

At Finnish-based United Bankers, Kari Kangas has been in charge of the UB Timberland fund

Kari Kangas
UB Timberland
United Bankers

Peter Lindbom
Obligo

since inception in 2016. He has a strong background in forestry and firmly believes in the benefits of responsible forest ownership. In Finland, 632,000 private forest owners currently own 60% of the forests, while 26% belong to the State of Finland, 9% to companies and 5% to the church, municipalities and other smaller entities. Kangas and his team are some of the few professional investors active in consolidating the market, and professionalising forest management, by practising what United Bankers call "Rational Forestry."

One driver of the philosophy is, of course, the Finnish Forest Act, which requires age management and continuous cover forestry. This means that the practice of clear-cutting (i.e. cutting down entire sections of a forest) has become rare, which is essential for the preservation of biodiversity, for example. The second target of SDG 15 specifically states the importance to "promote the implementation of sustainable management of all types of forests." Operating sustainably can also generate positive financial performance. Management costs in the UB Timberland fund are lower on average than for other owners who do not apply UB's forestry management practices.

The second leg of UB's Rational Forestry is the Program for the Endorsement of Forest Certification (PEFC), an international forest certification system promoting ecologically, socially and economically sustainable forestry throughout the world. To meet the organisation's certification requirements, forest management must satisfy specific standards concerning biodiversity, forest health and maintenance, as well as recreational use.

Furthermore, net forest growth must also remain positive over more extended periods, which contributes to an increased carbon sink. In other words, forests store more carbon dioxide than it releases into the atmosphere. Overall, Finnish carbon storage reserves as a function of timber and soil, continue to grow and represents over 100 million m3 per year. As such, timberland investments also contribute to mitigating climate change and represents a partial solution to achieving more climate-neutral portfolios.

When considering the entire value chain forestry belongs to, pulp production location and carbon leakage must also form part of the equation when talking about climate change. Keeping production capacity local, close to the forests, is critical in strengthening climate change mitigation efforts. A responsible owner of forest land must, therefore, support initiatives for domestic production and supply of raw materials from local properties. When trees are used as wood for construction, they will continue to store carbon dioxide for many years. When they are transformed into pulp and paper products, they may not last so long, but they may significantly contribute to replacing plastic in consumer and industrial products and packaging. Goal 12 "Responsible Consumption and Production" includes target 12.2, which prescribes to achieve sustainable management and efficient use of natural resources by 2030. The use of renewable forest-based products can take a significant part in that equation. Investing in timberland, therefore, not only represents a positive climate investment today, but it will likely benefit from positive demand shifts going forward.

Goals 9 – Industries, Innovation and Infrastructure

Infrastructure may come to mind quickly to any investor thinking of linking the SDGs to real assets. Whether in developing countries or mature economies, infrastructure needs to be upgraded to accommodate a larger world population and gain efficiencies. Goal 9 "Industries, Innovation and Infrastructure" is probably the most obvious of the 17 goals for this asset class. Target 9.4, for example, aims at "upgrading infrastructure and retrofit industries to make them sustainable, with increased resource-use efficiency and greater adoption of clean and environmentally sound technologies and industrial processes" (...) by 2030. Goals 6 "Clean water and sanitation" and 7 "affordable and clean energy" are also central for many infrastructure projects.

Regardless of the SDGs, Infrastructure investments are long-term in nature. Sustainability is, therefore, a necessary feature in any project. Some investors cite investments made only 10 or 15 years ago, that increased environmental concerns have already made obsolete. At Obligo, an Oslo- and Stockholm-based specialised manager focused on real estate, infrastructure and shipping, ESG integration resides at the centre of the investment process. The company is also the first Nordic signatory of GRESB Infrastructure, an investor-led organisation which benchmarks ESG performance for real assets. It also provides a standardised ESG reporting methodology specially targeted at infrastructure, as well as data, screening criteria and selection process.

In recent years, infrastructure as an asset class has increased in popularity among investors looking to diversify from highly valued real estate and hoping to capture some additional return from a long-term illiquidity discount. Given the nature of infrastructure projects, however, the asset class remains mostly accessible only to investors with substantial portfolios. While direct investments require a high degree of expertise and significant amounts of capital, infrastructure funds offer better access, but minimum investments remain high, and the internal manager selection and monitoring processes are costly.

Obligo proposes, therefore, a fund-of-funds strategy, which also presents better diversification characteristics than many investors can achieve on their own. Given that the time horizon of infrastructure funds typically exceeds that of other private equity vehicles, obtaining a suitable vintage mix can prove particularly challenging for single investors. The high level of required expertise also results in sector concentrations, which may be challenging to diversify when minimum investments are so significant. The costs of a fund-of-fund may worry some organisations, but the benefits on an asset allocation over time may prove substantial, nonetheless. As Peter Lindbom showed investors in Gothenburg, a 15% allocation to OECD infrastructure to a conservative institutional portfolio composed of bonds, equity, real estate and cash, can improve historical returns over 20 years by 70 basis points, while reducing maximum annual drawdowns and historical volatility.

Investors looking at allocating capital to the SDGs can find opportunities in all asset classes, but few funds can address goals 2, 9 and 15 as effectively as real assets while providing relatively safe returns and very low correlation to equity and fixed income markets.