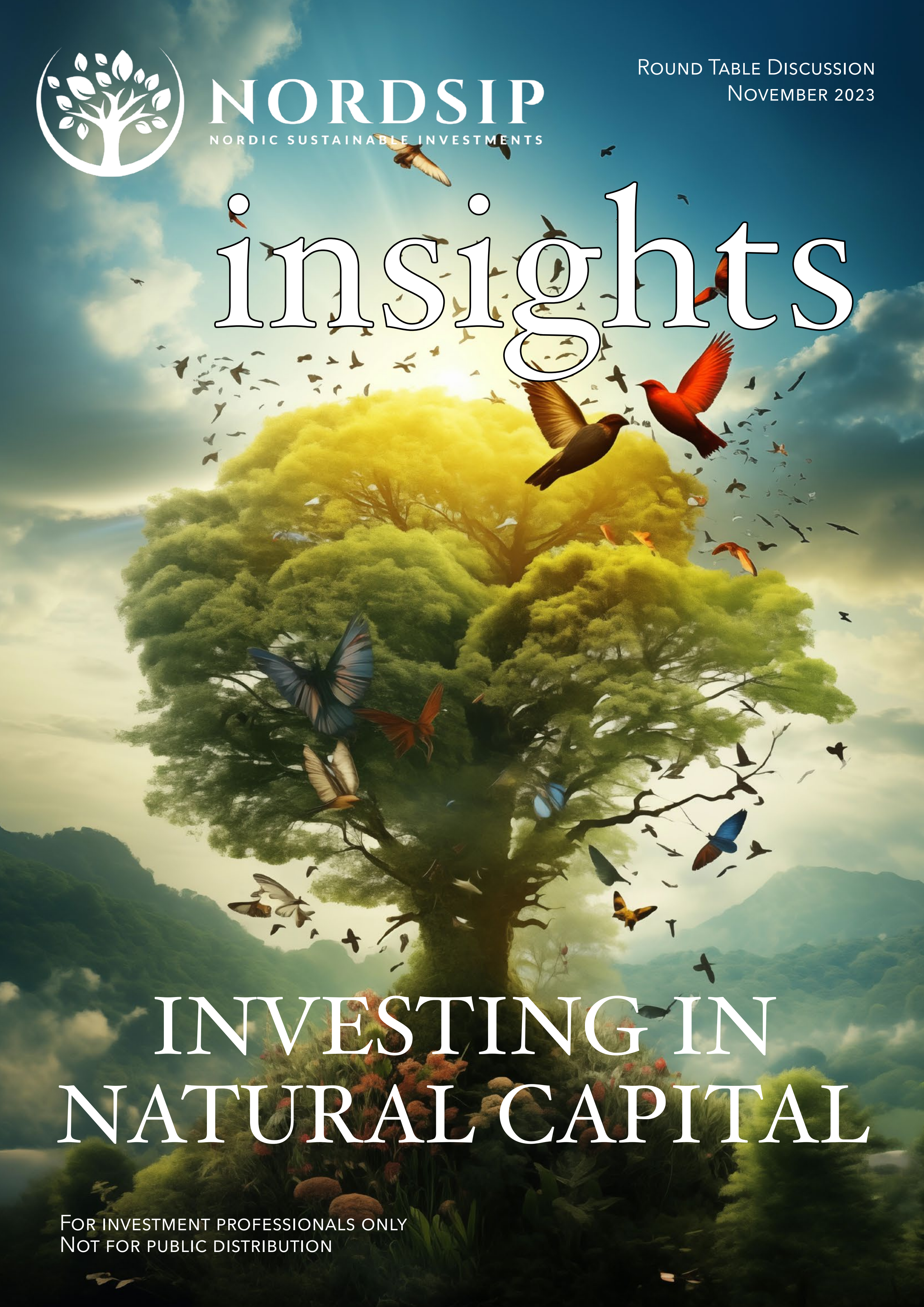
NORDSIP
NORDIC SUSTAINABLE INVESTMENTS

Round Table Discussion
November 2023

insights



INVESTING IN NATURAL CAPITAL

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The arduous path from climate to nature

Aline Reichenberg
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The post-2015 Paris Agreement era has seen the investment community earnestly grapple with climate risk and opportunities. This shift has significantly influenced how asset managers analyse their targets, design their products, articulate their strategies, and report to clients. Simultaneously, the repercussions of climate change have also affected asset prices and finance regulations, within the European context and beyond.

While scientists and ecologists have long been sounding the alarm about the precarious state of nature and biodiversity, the finance industry has found it more challenging to heed these warnings. This difficulty arises partly from the long history of human exploitation of nature, leading to a taken-for-granted perspective. Additionally, nature-related risks prove even more elusive to measure and quantify compared to more tangible factors like climate change and fossil fuel consumption.

The scarcity of significant returns associated with biodiversity-related business opportunities has further hindered the finance industry's responsiveness. In navigating this terrain and seeking tangible examples of how to integrate nature and biodiversity into the investment process, we have turned to the natural capital asset class. Who better than these investors to provide insights into the optimal strategies they've employed to safeguard their assets?

A captivating discussion unfolded during a late-summer lunch in Stockholm among six seasoned investors deeply engaged in the natural capital asset class. This collection of their expertise offers valuable guidance not only for those contemplating exposure to this asset class but also for those seeking inspiration to incorporate nature-related risks into their investment processes. Whether you are delving into this asset class or searching for innovative ways to address nature-related risks, we trust that this compilation of insights will prove invaluable.

who is who?

Andrew Dreaneen
Head of Natural Capital
Schroders

Andrew Dreaneen, has been with Schroders for 23 years. His work mainly focused on alternative investments, hedge funds and private markets. Throughout this time, he has helped build Schroders alternatives platform covering natural capital and carbon, hedge funds, fixed income alternatives, commodities and inflation strategies and hybrid public/private solutions. He was also active in manager selection, product development, product management, sales and marketing. Andrew has focused on biodiversity and natural capital for the last three years. He started his career in 1998 at alternative investment boutique (FMG) creating a number of real asset investment products linked to farmland, forestry, vineyards and property syndicates. Andrew holds a Postgraduate Diploma in Business Administration and a Degree in Business, Massey University New Zealand.

David Fortin
Senior Director
Manulife Investment Management

David Fortin, is an economist with more than 15 years professional experience modelling, writing and presenting on global commodity markets. He joined Manulife Investment Management as Senior Director of Economic Research in June 2022. Prior to this, he worked for 15 years in a number of functions at RISI-Fastmarkets, a cross-commodity price reporting agency in the agriculture, forest products, metals and mining, and energy transition markets. He is a graduate of the Brandeis International Business School's Masters degree in International Economics and Finance.

Hanna Ideström
Investment Director
Interogo Holding Long-Term Equity Advisor

Hanna Ideström is an Investment Director at Interogo Holding Long-Term Equity Advisors, the long-term equity team of Interogo Holding Group, the purpose of which is to support the Interogo Foundation to secure the independence and longevity of the IKEA concept and the financial reserves needed to ensure this. Hanna joined the company in the summer of 2023 from the Fourth Swedish National Pension Fund (AP4) where she was a Senior Portfolio Managers responsible for Alternative Investments for the better part of four years. Prior to this, she spent over eight years as an Investment Director the Buyout team of CapMan, a private markets pioneer in the Nordics. She graduated with distinction from the Stockholm School of Economics' Masters in Finance.

Fredric Nyström
Head of Sustainability & Governance
AP3

Fredric Nyström joined AP3 in May 2022 and has two decades of experience working with sustainable investing. Prior to joining the third Swedish National Pension Fund, he was the Head of Responsible Investment at Öhman Fonder between 2014 and 2022. He already brough extensive expertise to this role thanks to over eight years working in various functions at GES Investments Services, one of the founding providers of engagement services. Fredric holds a degree in Economics and Development Studies from the University of Gothenburg.

Rebecca Rehn
Head of ESG Analysis
Alecta

Rebecca Rehn has been the Head of ESG Analysis at Alecta since March 2022, in which capacity she is responsible for leading ESG integration across all asset classes. She joined the Swedish pension provider in 2019 as an ESG Analyst. Prior to this role, Rebecca was a Sustainability Manager for Espresso House Group between 2017 and 2019, and a Consultant on Climate Change and Sustainability Services for EY prior to that. Rebecca has also been based in the Permanent Mission of Sweden to the United Nations in New York during the final inter-governmental negotiations of the 2030 Agenda. She holds a Master's Degree in Sustainable Management and a Bachelor Degree in Business and Economics from Uppsala University.

Mitch Reznick, CFA
Head of Sustainable Fixed Income
Federated Hermes

Mitch Reznick, has over 20 years of experience investing in fixed income markets, including leveraged finance, investment grade credit, structured products, private debt and real estate. Mitch joined Federated Hermes Limited in 2010 as head of Credit Research and has been the Head of Sustainable Fixed Income since October 2019. He hopes to converting the principles of sustainability into investment solutions by designing, building, managing sustainable fixed income strategies. He is a Committee Member of the UN Global Compact CFO Coalition for the SDGs and Co/chair of the PRI's Credit Risk and Ratings Advisory Committee. Mitch holds a Master's Degree from the University of Cambridge's Institute of Sustainable Leadership.

From left to right: Morten Simonsen, Andrew Dreaneen, Hanna Ideström, Mitch Reznick, Rebecca Rehn, Marie Dalmark, Filipe Albuquerque, Aline Reichenberg Gustafsson, Fredric Nyström, Magnus Kristensen, Edson Fonseca, David Fortin

Investing in Natural Capital

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30 August 2023

starter

The issue with natural capital and biodiversity

To one degree or another, all life on earth and all businesses, are dependent on the shared goods provided by our planet. Despite the encouraging strides made in the fight against climate change, particularly since the 2015 Paris Agreement, the global consensus has taken a compartmentalised approach to the health of our planet. Policymakers, investors, and companies subsequently, have focused on climate change and pollution. But in practice, climate change and the climate and energy transitions are often treated as separate issues from natural degradation and biodiversity loss.

These issues have gained in prominence since the conclusion of the 15th conference of the parties to the UN Convention of Biological Diversity (CBD) in December 2022, and the agreement of the Kunming-Montreal Global Biodiversity Framework. The centrepiece of this framework is the COP15's 30×30 target, which refers to the goal of protecting 30% of the planet's surface by 2030.

To explore the implications of sustainable investments in natural capital and the role of investors in contribution to biodiversity conservation, NordSIP organised a round table event in Stockholm to discuss questions such as "What is natural capital?", "Why should investors care?", "What are the risks and the opportunities in this theme?", and "What partnerships and incentives are available to deploy capital in an effective and impactful manner?"

According to **Andrew Dreaneen**, Head of Natural Capital at Schroders, investment opportunities within natural capital can include opportunities where there's a real asset from nature which can compensate for CO_2 emissions and allow investors to support biodiversity via investment in forests and agriculture. This is part of the broader universe of natural capital which generally refers to the earth's stock of natural assets (e.g. forests, farmlands, wetlands etc) and the ecosystem services that flow from them from which humans derive a range of environmental, economic and social benefits (e.g. carbon sequestration, pollination, air purification).

"According to the IPCC, the scientific consensus suggests that agriculture, forestry and other land use are responsible for approximately 23% of global emissions. Of that total, 5.8 gigatons is occurring through forestry and other land use and 6.2 gigatons through agriculture[1]. This is unsustainable and needs to change. Underlying that shift, there is a 10 gigaton opportunity from natural capital, five gigatons through avoided emissions and about five gigatons through enhanced removals and carbon sinks. It's possible to reduce emissions by managing critical ecosystems, biodiversity hotspots, regenerating, regrowing, replanting, and reforesting via climate smart forestry and regenerative agriculture," Dreaneen says.

As senior director of economic research at Manulife Investment Management, a Canadian multinational insurance company and financial services provider and significant investors in natural capital, **David Fortin** is well placed to understand the nuances of natural capital and the assets in this class. "Timberland is a relatively small, and niche asset class and while awareness is increasing, it is still quite new to many investors. It offers an opportunity to earn competitive risk-adjusted returns. But more importantly, the products derived from timberland are integral to basic human needs. Forests provide wood for shelter, fibre for packaging, hygiene products, medical products, and textiles as an alternative to petrochemical-based rayon fibres. In addition, timberland and agriculture really offer an opportunity to use that natural capital to help address what we see as some of the major concerns or challenges facing the planet, such as climate change, nature loss, as well as rising inequality," Fortin explains.

The Appeal of Natural Capital

"Natural capital has emerged in investors' radars at a time when biodiversity and Sustainable Development Goals (SDGs) linked to communities and employment have come into focus. Natural capital investments definitely have a role to play into this greater thematic role regarding the alignment of portfolios to net zero or to biodiversity objectives. But it also meets a lot of clients' needs thanks to its rudimentary risk return profile, the inflation hedge, the decorrelation, and the low volatility," **Dreaneen** adds.

[1] IPCC Climate Change and Land, Summary for policy makers (2019), p.10

"The ecosystem is evolving, with better data, standards, methodologies, and new business models. We are at the nexus of a natural capital revolution that will play out over multiple decades. This is not a flash in the pan type conversation. It is one that is going to continue for a long, long time. The key is to determine clients' motivations and how sustainable they want to be," Dreaneen continues.

"The urgency of the climate and nature loss crises are of such a magnitude that we need large scale capital solutions, particularly considering that present funding gaps are on the level of several trillion dollars per year. Today, the top 500 asset managers around the globe oversee approximately US$115 trillion[2] in assets under management. The natural capital market, corresponding to forestry and farmlands managed by asset managers directly, is worth between US$230 billion and US$260 billion, equivalent to only 0.2% of global invested assets by investment managers. Natural capital is a niche sector. But it is an important niche, and one which is forecast to grow significantly as the industry is driven to align its portfolios with the SDGs," Dreaneen argues.

Mitch Reznick, CFA, Head of Sustainable Fixed Income at Federated Hermes Limited, points to research highlighting natural capital as an appealing investment opportunity. "Estimates[3] suggest that the value of ecosystem services and natural capital is between US$125 trillion and $145 trillion per year. Nearly half of the world's GDP is either meaningfully or explicitly tied to the health of biodiversity. This means that those ecosystems need to be preserved for the sake of preserving our planet but also that our economic and financial systems need to adapt in order to survive," Reznick says.

"Forests are one of the top sources of natural climate solutions and act as a major carbon sink. Sustainably managed timberland is inherently a contributor to biodiversity preservation. Institutionally and sustainably managed timberland can help mitigate the pressure to harvest wood from more sensitive areas as well," **Fortin** says.

"Nature, biodiversity, and healthy ecosystems are critical to the health of both society in general and businesses. But at the same time, humans and businesses contribute to nature loss and higher diversity loss. Society and institutional managers of natural capital such as ourselves need to find a way to combat that erosion of ecosystems. We believe that good stewardship is good business, and that effort is at the heart of

[2] wtw "Top 500 managers see assets drop by $18 trillion" (Oct 23, 2023)
[3] Costanza, Robert, et al. "Changes in the global value of ecosystem services." Global environ.mental change 26 (2014): 152-158.

managing timberland sustainably, and that these sustainable land management practices also create opportunities. For us, timberland and agriculture are inherently long-term investments that must be managed sustainably and doing so supports environmental welfare and biodiversity. As a fiduciary, we must manage the timberland we own and operate on behalf of our investors to generate returns but also as an opportunity to promote and protect biodiversity, which will not only support an ongoing healthy ecosystem, but are increasingly being assigned tangible value, adding optionality, and augmenting traditional timberland returns" Fortin adds.

The Natural Climate Leaders

Half of the round table participants represented organisations with experience in natural capital that had made commitments to integrate biodiversity and ecological conservation in their investment processes.

"Manulife has been managing forest lands for more than 40 years. As of end September 2023, we have around US$16 billion of natural capital assets under management, of which two-thirds is timber and the rest is agriculture. We operate globally in US, Canada, Latin America, Australia, and New Zealand. There can be a misconception that institutionally managed timberland is overwhelmingly plantation based and monocultures without biodiversity benefits. This is not the case with us. The entire job description with timber and agriculture is to manage natural capital. Across the 5.5 million acres of timberland in Manulife's portfolio, there are 63 different species of trees and only 15 of those are plantation based. Our approach is guided by the principle that 'good stewardship is good business'. 100% of the forest land that we manage, and 100% of the harvesting that we do is certified according to third party independent standards, be it Sustainable Forestry Initiative or Forest Stewardship Council. We do not acquire the assets and outsource the land management to a third party. We're a full-service private market business, with an integrated timberland management team. This integration allows us to align our objectives and implement a cohesive strategy to execute on these objectives across the entire business team," Fortin says.

"As a participant of the Global Canopy's Forest 500[4] since 2014, Schroders is one of the financial institutions committed to using our influence to mitigate the impacts of deforestation. . At the end of 2021, Schroders joined the Finance Sector Deforestation

[4] Global Canopy's Forest 500 identifies the 350 companies and 150 financial institutions with the greatest exposure to tropical deforestation risk, and annually assesses them on the strength and implementation of their deforestation and human rights commitments.

"Companies must focus on eliminating deforestation, supporting the transition to regenerative agriculture and investing in impactful nature-based solutions. We expect a substantial reduction in corporate contributions to the five drivers of biodiversity loss."

Action (FSDA) and committed to do our best to eliminate commodity-driven deforestation from our portfolios by 2025. In October 2022, Schroders published a new policy, committing to "eliminate forest-risk agricultural commodity-driven deforestation in the companies held in their investment portfolios by 2025," **Dreaneen** explains.

"As a global investment manager, we have a responsibility to mitigate risks in the portfolios we manage for our clients, this includes risks brought about by biodiversity loss. We use our influence to encourage the companies in which we invest to mitigate the damage they inflict on the natural environment in order to promote and preserve their financial wellbeing. In

September, we published five recommendations to governments to align nature and climate agendas. Among these, we ask that governments require companies, asset owners and investors to report on their risks, impacts and dependencies on nature by 2025," Dreaneen adds.

Schroders and Manulife are not alone in its positive stance towards sustainable natural capital investments. "In its 2021 'Our Commitment to Nature' White Paper, Federated Hermes highlighted its expectations and requirements for its investee companies on natural capital and biodiversity going forward. Companies must focus on eliminating deforestation, supporting the transition to regenerative agriculture, and investing in impactful nature-based solutions. We expect a substantial reduction in corporate contributions to the five drivers of biodiversity loss," **Reznick** says.

The Natural Capital Beginners

At the other end of the spectrum, AP3, Alecta and Interogo Holding Long-Term Equity Advisors are either waiting or only now taking their first steps in their natural capital journey.

"AP3 is at an early stage in its journey to integrate biodiversity and natural capital into its investment approach. We're still coming to grips with the issue of biodiversity, especially in the

listed equity space. In the alternative space we own forests and we have come up the experience curved there already," says **Fredric Nyström**, Head of Sustainability and Governance at AP3.

"We have a policy that was approved by the board last year with a focus on climate, human rights, biodiversity, and corporate governance. We have started to publish action plans on each of these policy areas. Action plans regarding climate, human rights, and corporate governance are already out and we will publish our action plan on biodiversity at the end of the year. AP3 is a relatively small organisation with three members of the sustainability team. Hence we strive to leverage our work through participating in different investor initiatives, for example nature action initiatives and the finance for biodiversity pledge, " Nyström continues.

"We have to prioritise where we engage, so our efforts have concentrated on trying to understand what the appropriate balance is. We want to influence change and achieve change and contribute to sustainable development. But it is not evident whether we should start with those that have high dependency or with those that have high impact," Nyström explains.

"AP3 is a relatively small organisation with three members of the sustainability team. Hence we strive to leverage our work through participating in different investor initiatives, for example nature action initiatives and the finance for biodiversity pledge"

"We are at a relatively early stage in what is a long and complicated journey. To date we have been working with biodiversity, specifically from an engagement perspective. We cannot consider biodiversity as a standalone topic. It's tied to climate change and pollution among other issue," **Rebecca Rehn**, Head of ESG Analysis at Alecta concurs. "Alecta will soon publish its viewpoint on biodiversity and specifically our expectations from companies regarding how to follow and report against the TNFD framework. We have been doing climate stress testing of the investment portfolio since 2018 as part of our solvency and risk assessment and have started thinking about doing broader risk assessments.

We might also integrate biodiversity into this process. This should lead us to engage with companies and help us consider the sectors and companies that we should prioritise. At the moment it appears likely we will focus on forestry, agriculture and mining, three sectors that have a high potential impact on biodiversity[5], and on the companies that struggle with reporting in these areas," Rehn says.

"There are also limits to how much we can engage and where we should do it. As Fredrik mentioned, it's impossible to do everything. We are probably going to focus on two or three particularly relevant sectors for us, such as forestry, agriculture, or mining, to understand where the risks are, which you can only understand by talking with the companies," Rehn adds.

Interogo Holding Long-term Equity Advisors is perhaps even more constrained regarding its ability to tap natural capital at the moment. "Our mandate is to advise on acquisitions of significant minority equity stakes in Western European sustainable companies, be they private or public. We have a few core sectors that we focus on but generally speaking, are sector agnostic. We'd like to deploy between €100 million and €400 million per investment. The overall purpose of the investment group we belong to, is to support our ultimate owner, Interogo Foundation, to secure the independence on longevity of the IKEA concept and the financial reserves needed to ensure this, **Hanna Ideström**, investment director at Interogo Holding Long-Term Equity Advisors, the long-term equity team of Interogo Holding, explains.

"Like Alecta and AP3, resources are scarce in our team. The responsibility for sustainability and ESG is completely integrated int our investment process for the purposes of selecting, screening and monitoring of investments. We don't have a dedicated ESG team. Our team of six investment professionals also responsible for those aspects. That being said, we are not as detailed as Alecta and AP3. We look at climate and our sustainable investment policy states that we are not allowed to make investments in company that damages the environment, but we are not looking at biodiversity or natural capital at the moment. Our focus is on managing risk and avoiding making mistakes that could impact our returns or our reputation," Ideström continues.

"Eventually, some of the natural capital investments that we're talking about today may well be in our investment pool once they become more mature, profitable and cashflow generative from an equity perspective. But for now, some of these investments remain off limits to us, given our mandate," Ideström adds.

[5] Top 10 Biodiversity impact ranking (financeforbiodiversity.org)

Finding a business model

The Planetary Point of View & the Balance Sheet Perspectives

Round table participants suggest that there are two complementary ways of looking at the problem biodiversity loss and natural capital: from the wider macroeconomic and planetary point of view or from the more microeconomic perspective of investors' balance sheets.

According to Reznick to guarantee that society can generate the economic value required to support a growing world population, earth's natural capital must be restored at a minimum rate at which it is being consumed. This is not the case today. Global consumption of natural capital meaningfully exceeds humanity's ability to restore it. "Our current linear economic thinking about production undermines our ability to create the food, goods, and services for the future. As populations are growing, we need to create wealth without depleting the earth's balance sheet. From a corporate perspective, this reality will pose a great challenge for companies in the sectors that are most affected by biodiversity loss, for example, agriculture and protein. This macroeconomic risk is just beginning to gain prominence in the eyes of global corporates, but awareness is gaining momentum fast," **Reznick** says.

"We live in a world with growing population that is not just expanding but whose incomes are rising. That population and income growth implies a rising in basic human needs. People need homes to take shelter in, fibre for hygiene products, food to eat and clothing to wear. Timberland is tied to these consumer needs and, when land management and harvesting is practiced sustainably, it can contribute to alleviating some of the environmental pressures caused by continued global economic development in some of the most ecologically fragile areas of the world," **Fortin** elaborates.

"There's a finite area of land globally, and we need to operate on an even smaller fraction of the surface of the planet that is not natural forest. This creates a juxtaposition of limited available timberland against growing economic demands. The increased productivity achieved via the practice of sustainable land management on institutionally owned timberland, allows for the sustainable production of more timber on less land to meet rising global demand," Fortin continues.

According to **Dreaneen**, Schroders sees investment in natural capital as taking one of three forms. "Investors can own forests and farmland outright. It's a scarce asset with embedded optionality to change, for enhancing both biodiversity and returns. It's also a well-established investment model which allows us to project economic trends into it. We can see that land is scarce, it produces food, fibre, and fuel and is facing growing demand. There's a very strong fundamental case behind this approach to natural capital," Dreaneen says.

"That being said, investors such as foundations, charities, philanthropic organizations or family offices often want to invest with very high impact. This often leads us into emerging markets which are perceived as riskier due to currency fluctuations, a lack of land ownership or tenure. There was a story I heard about the situation in a part of Brazil close to the Amazonian rainforest where there was ten times the number of land titles available for the land that's actually there. A novel opportunity that appears to be gaining popularity among corporates is the use of natural capital for carbon *insetting* as well as offsetting. However, it is not always clear whether governments would include that carbon as part of their Nationally Determined Contributions (NDC) to the Paris Agreement," Dreaneen adds.

"For investors who are happy not to own land, they can fund local nature-based projects that seek to facilitate environmental outcomes, such as carbon sequestration, improved waterways, or increased pollination. For investors looking to facilitate these sorts of projects, the length of the project and what happens afterwards are typically a big question. Many of these projects are planned to last thirty to one hundred years. Some level of pre-funding may be agreed for five to seven years, but it's often unclear what happens afterwards. Is there a market for that particular outcome? Did the price increase by orders of magnitude as is often forecasted or has it stagnated. Nature-based solutions have the potential for massive SDG alignment but returns are often difficult to predict and will likely be quite volatile," Dreaneen notes.

"Hopefully, the steady stream of EU regulations will provide a more standardised approach to how companies ought to report on sustainability issues, not least climate change and biodiversity."

Natural Capital Risks – Enterprise Value, Fires, Screens, Reputation and Benchmarking

Taking these complementary perspectives on the problems of natural capital and biodiversity conservation, round table participants highlight the connections between the planet's ecological balance and the ability of companies to generate returns for their shareholders and the cashflows necessary to replay their creditors.

“Fixed income investors have a clear interest in seeing enterprise value preserved. If enterprise value depletes, then credit risk goes up, credit spreads rise and therefore the value of fixed income assets decline. If biodiversity loss and climate change, which are fundamentally linked, begin to threaten enterprise value, there are very real investment considerations.”

“The increased awareness of the need for environmental stability matters for fixed income markets because the enterprise value of a company is as important to creditors as to equity investors. Fixed income investors have a clear interest in seeing enterprise value preserved. If enterprise value depletes, then credit risk goes up, credit spreads rise and therefore the value of fixed income assets decline. If biodiversity loss and climate change, which are fundamentally linked, begin to threaten enterprise value, there are very real investment considerations. As a signatory of the Finance for Biodiversity Pledge, Federated Hermes Limited analyses and engages on companies' exposure to these risks and how they are managing them.,” **Reznick** says.

Given the more conservative perspective of the investment strategy our team advises, Ideström highlights the benefits of ESG integration for screening out riskier opportunities. “We advise on equity investments and take a long-term ownership approach. We want to ensure we select the right investments in a concentrated portfolio. ESG and sustainability are very important aspects when screening for those investments. We want to invest in companies that will be winners in the long run, and we want to avoid disruption. Disruption is not necessarily only AI, technology, or unexpected tax changes. It can be climate factors as well. One of the things we have become more aware of in the recent decades is that there is a connection between environmental degradation and political upheaval and economic hardship. We want to identify those disruptive factors early on and avoid them so that we can find companies that are benefiting from long-term positive trends instead,” **Ideström** says.

Fortin highlights the real-world risks that timberland assets face in a world where climate change could result in a greater risk of forest fires and extreme weather events. Climate impacts so many facets of what we do day-to-day. Nowadays, we're experiencing more severe weather events which are occurring at a higher frequency. In the south of the US there are more and stronger hurricanes and in Australia and New Zealand the typhoons have become worse. Timberland is particularly exposed to fire hazard, so we are acutely aware of the fact that the weather is drier and hotter in the Pacific Northwest and in Latin America leading to an increased risk of fire. We're stewards of the land we manage and as fiduciaries for our investors we need to ensure that we are able to sustain the cashflows underlying the headline returns we offer our investors. When fire does happen, we need to have an efficient process to extinguish the fire, salvage the timber, sell it to the market, and replant and repair the area. We are also able to help diversify and mitigate investment risk by operating in multiple, geographically diverse, hyper-regional areas that expose us to different end-use product markets, with different environmental factors and different native species of animals and plants. Ultimately, it comes down to managing the portfolio's geographic diversification,” **Fortin** says.

“We're stewards of the land we manage and as fiduciaries for our investors we need to ensure that we are able to sustain the cashflows underlying the headline returns we offer our investors. When fire does happen, we need to have an efficient process to extinguish the fire, salvage the timber, sell it to the market, and replant and repair the area.”

Bringing the issue back to a more Nordic context, Nyström highlights the reputational risks of forest management in Sweden. “Our approach is very similar to what David described. But managing forests is a very challenging thing because it is a physical, palpable asset that people experience. In Sweden, people have the “allemansrätten” and people enjoy and are accustomed to taking walks in our forests and picking mushrooms. They feel that they have a stake in the asset and can react strongly when the time comes to harvest our assets. AP3 welcomes public scrutiny and welcome engagement from the wider public, but that also means that this is a very sensitive topic, particularly from a reputational perspective,” **Nyström** says.

“On the macro level, it is easy to identify climate change and pollution as risks. But our biggest challenge is when we focus on the detail at sector and business level as we engage with companies,

"Sustainable business practices are still a relatively recent phenomenon. Even though regulation is a key driver of this evolution in corporate behaviour, greenwashing exists."

because it is difficult to benchmark the companies against each other. Hopefully, the steady stream of EU regulations will provide a more standardised approach to how companies ought to report on sustainability issues, not least climate change and biodiversity," **Rehn** says.

Fixed Income Risks

According to Reznick, a top-down approach to fixed income risk shows that the process of creating a sustainable fund can introduce volatility due to its divergences from non-sustainable benchmarks. "In sustainability strategies, portfolio construction must also consider ESG thresholds in addition to risk and valuation thresholds. This additional criterion means that the characteristics of sustainable portfolios will differ from mainstream benchmarks, which will introduce tracking errors during periods when, for example, carbon-intensive sectors under or outperform. That said, since sustainability-aware companies tend to be better governed, we also believe that a sustainable portfolio will be populated by higher-quality, well-governed credits that are less likely to be sources of negative credit events," **Reznick** explains.

From a bottom-up perspective, "Sustainable business practices are still a relatively recent phenomenon. Even though regulation is a key driver of this evolution in corporate behaviour, greenwashing exists. Some companies present themselves as having fully embedded sustainability in their operations or products, but a deeper analysis shows that this might not be the case." Reznick continues.

"In addition to regulation as a force driving business models toward sustainability, investors must consider how companies are adapting to value chains shifting in the direction of sustainability. This is particularly relevant for large companies at the end of complex global supply chains, with strong presence in emerging market countries, many of which are face potentially large disruptions due the effects of climate change," Reznick adds.

"We need to not only eschew our linear approach to value creation in favour of a more circular understanding of the economy. For example, a biodiversity-positive approach to production would consider how to replenish what natural resources are consumed to create economic value. Our ecosystems are extremely complex and sustainability factors are connected. Climate change is inexorably linked to biodiversity loss, which can cause social stress. This

"There are several types of nature-based solutions available to corporates looking to create their own carbon credits going upstream, driven either by the scarcity of credits on the market or, more specifically, the scarcity of what they deem to be high quality credits."

downward spiral can disrupt business operations, increase costs, decrease revenues, and hinder profits. This is why global organisations, governments and regulators are introducing regulation that addresses climate change, wasteful manufacturing practices and biodiversity loss," Reznick argues.

Natural Capital Opportunities - Regenerative Farming, De-Risking Carbon Credits

Despite these risks, natural capital investment opportunities abound, from regenerative farming to natural investment hedges.

"I believe there are opportunities to have a positive impact on the environment along with having the opportunity to generate excess returns, as sustainable timberland and agricultural management can augment the traditional returns found in this asset class," **Fortin** says.

"Constructive dialog on sustainability matters—engagement, as it is known—is a key catalyst in encouraging companies and financial institutions to assess their company's impact on the natural world and society. For some this understanding of sustainability might be more advanced predicated on having set science-based targets. However, companies that draw heavily from natural resources at an earlier stage of environmental awareness might focus on biodiversity loss, recognising biodiversity risks and how they can be addressed. From a macro perspective, this is also about de-risking the overall economic system in general. Although each company might be small, ion aggregate they represent large swaths of the economy that are relevant for capital markets," **Reznick** adds.

"From extractive operations to brown-to-green transition, the range of opportunities is vast. Something that was historically damaging – such as intensive agriculture – can significantly help the transition through ground-breaking regenerative practices and payments for ecosystem services. Although it has been a topic of research in academia and a target of government policy action for some time, natural capital has only begun attracting a wider range of interested participants within asset management in the

last three years or so. Investors need to decide whether they want to take a back seat or be at the vanguard of this change and start investing today," **Dreaneen** says.

"We look at the real asset side as a more mature market that has more sizeable opportunities for deploying capital into forestry and farmland. There are several types of nature-based solutions available to corporates looking to create their own carbon credits going upstream, driven either by the scarcity of credits on the market or, more specifically, the scarcity of what they deem to be high quality credits, however, scaling is more difficult," Dreaneen adds.

Carbon credits are another intuitive opportunity for natural capital and investments in biodiversity. "Removals credits are in high demand, which is relevant for certain corporates specifically interested in sequestering carbon, as opposed to purchasing avoided deforestation credits. A corporate that emits a ton of carbon and compensates that by stopping a ton of CO_2 from allegedly being emitted through protecting against deforestation, is effectively still a net emitter of one ton of CO_2. A heightened focus on removals credits today by some of the large corporates puts forestry in a sweet spot if you like, in relation to that embedded optionality between timber and carbon, whether that's carbon offsetting or insetting," Dreaneen argues.

Another way to look at the opportunity set is to consider the synergies created by the sustainable management of natural capital. "One of the capabilities we bring to the table is active management. We are a vertically integrated forest owner, capable of imparting practices from the top down and bottom up with our timberland operations teams. We can help protect threatened and endangered species, repair riparian buffer zones, protect waterways, build better infrastructure within the forest system, improve access roads in and out, and prevent and extinguish fires," Fortin says. "I think the other part of the equation is the social benefit within timberland. Institutionally owned timberland tends to be located in more rural settings, which allows us the opportunity to offer rewarding employment opportunities that may otherwise be unavailable," **Fortin** adds.

"We have talked a lot about risk and avoiding taking risks and avoiding investments that can cause environmental harm or reputational risk or otherwise, but they're also opportunities. Companies need to be profitable and enjoy good margins and cashflow, but beyond that, our focus is on industry and company fundamentals, were ideally there should be an underlying positive growth trend supported by favourable legislation. We look actively for investments in renewables or recycling because we think they are positioned to benefit from the unavoidable paradigm shift. We have also invested in companies whose primary business is to support the climate transition, such as charging networks for EVs. At the same time, we are also mindful of the fact that established companies and even entire sectors need to be able to adapt to stay relevant. Companies also need to be mindful of regulation and take a constructive and intelligent approach to stay ahead of the curve," **Ideström** says.

Fixed Income Opportunities

Sustainable fixed income, including green, social, sustainability and sustainability-linked bonds, particularly those targeting forestry and agriculture are a particularly effective niche for investors looking to combine biodiversity conservation efforts of natural capital allocations with the relative safety of fixed income instruments.

"The sustainability bond market has accelerated over the last four or five years growing by roughly 30% on an annualized basis. Green bond issuance since 2018 amounts to approximately US$2 trillion. However, I estimate the percentage of those green bonds dedicated to biodiversity, based on the allocation to land and water projects, to be less than 10%. For sustainability-linked bonds this is even lower," **Reznick** says.

"Companies in the Nordic region are very advanced and ambitious. Relative to its economic size, the Nordic region is one of the largest investors in and one of the largest issuers of sustainable bonds. Approximately 6% of sustainability bonds come from this region. The Nordic region leans heavily on natural resources, and it has supportive regulation, which is not the case everywhere in the world." Reznick warns.

The Nordic region's interest is confirmed by AP3's Nyström. "We have set a target that 25% of our fixed income allocations should be into sustainability bonds. At the moment, the share is around 21%, equivalent to SEK23 billion. So, we are investing quite a lot in opportunities that finance the solutions that we need, mainly via green bonds. We also keep an eye out for sustainability bonds and on social bonds. The history and the issuers are well established, and the securities are well defined according to ICMA Principles. The market for sustainability bonds is still developing and we have quite a strict mandate with a focus on the European market.

According to Reznick there are three concerns that may be preventing the sustainability finance market from growing more quickly: a compartmentalisation of sustainable investments, complexity of key performance indicators (KPIs) and greenwashing.

"Biodiversity-focused bonds or sustainability targets are nowhere near as prevalent as climate-related bonds and targets. The low allocation to biodiversity uses or targets in sustainability bonds and sustainability-linked bonds is understandable, but it's a shame. We've tended to think about sustainability in silos and it's only now that investors and companies are beginning to think and understand the links between these so-called 'sleeves of sustainability'," Reznick argues.

"On issue driving the low percentage of biodiversity-focused debt instruments is the complexity of the underlying concepts used for monitoring. KPIs are both inconsistent and imperfect, methodologies are obstruse and measurements are not always uniform," Reznick says.

"Green washing in the impact bond market is also an issue. I don't want to suggest I am insensitive to that, but it's important to recognise that in an imperfect world, there will always be the risk that people exaggerate their claims. We have to be willing to accept that there's going to be some element of green washing. It's one of the risks of operating in this market. That's what sustainability analysts are there to tackle.

Whilst there certainly is a need for regulation, the risk of pursuing perfection in the market via regulation risks creating barriers to entry that are too high," Reznick continues.

"Given the increased discourse on biodiversity compared to even two to three years ago, I am optimistic that the proportion of sustainability bonds dedicated to biodiversity will grow. Certainly, the momentum is there. But we need all companies that attach themselves in a material way to the balance sheet of the planet need, to focus on biodiversity outcomes; this could be one factor of engagement," Reznick adds.

Blue Bonds – The Largest Source of Biodiversity

Considering that oceans, seas, rivers, and lakes make up two-thirds of the surface of the planet, blue bonds are also a uniquely good opportunity for natural capital investors.

"Blue bonds by sovereign issuers such as those of Belize and Ecuador are also an interesting opportunity. They are remarkable because they reduce debt, they create fiscal capacity for countries to allocate resources to solve sustainability issues, which if left unaddressed compound the pressure that's placed on the finances of the country anyway," Reznick argues.

Blue bonds have proved popular with asset owners. "Contrarily to AP3, we only have very limited investments in forestry, but we have invested in debt for nature swaps and blue bonds, which are instruments we see opportunities in going forward," Rehn says. At the start of 2022, Alecta had invested as much as SEK68 billion in green and social bonds, an intuitive target for natural capital investments.

"Blue bonds have been even trickier, as there was not really a framework when we did our investments. Now we see attempts to form such frameworks. Blue bonds are very interesting because they allow us to finance marine conservation projects. This is important given that most of the animal biomass of the planet resides in the sea, and that marine biodiversity underpins the provision of several ecosystem services that are key to human well-being. To date we have invested in two blue sovereign bonds; one from Belize and the other one from Ecuador that aims to preserve the Galápagos Marine National Park," **Rehn** adds.

"Debt for nature swaps and debt for climate swaps such as those included in the recent Ecuador blue bonds are very exciting. Sustainability bonds could be an opening for the blended finance opportunity, which is a way to leverage public capital to de-risk opportunities so that private

capital can get involved," **Reznick** adds.

These investments have also had the effect of bringing colleagues into sustainability that would otherwise perhaps not have a stake in the issue. Our fixed income team has really had the lead on Alecta's investments in green bonds, and from there they have continued to explore impact investments and blue bonds. The ESG team's role in these transactions, has been to assess the organisations involved in the projects included in these blue bonds" **Rehn** explains.

Natural Capital and Biodiversity Public Incentives

The panellists agree that the state - its government and its agencies – is one of the most important partners for environmental, natural capital and biodiversity investors. One of the main ways that governments can create accommodating fiscal environments for natural capital and biodiversity. "Given the underlying risks, investments in nature-based assets and biodiversity also require a degree of public support. This can vary. In some cases, local governments

"Government policy acts as the catalyst that bridges that gap when a sustainable project, technology, or business model are still making a loss in the short term, but it is doing what's best for the society in long term. (...) The trouble emerges when the cost of that support, including overregulation, is too onerous."

are the ones subsidising replanting projects or designing woodland creation. The UK is a good example of this including potential tax relief," **Dreaneen** says.

"The public sector has an essential role to play, not just as a catalyst for investments such as debt for nature swaps and debt for climate swaps. But this is a case where meaningful change in the global economy is likely to cause pain. Governments need to step in and help manage that pain because companies are unable to do that on their own. Even for those companies with the best governance and sustainability credentials where it is embedded in their policies, it can still be a challenge," **Reznick** adds.

"Governments can step in and be the catalyst to de-risk investments in a range of ways and help mute or mitigate some of the risks inherent to sustainable finance, including the problems that arise while addressing ESG problems. Governments provide a social safety net, they can help by providing financing, tax incentives, and yes, also via regulation. But it's important to take a holistic approach. That government is absolute essential partner in this. Even a small push towards evening the playing field

can make a big difference," Reznick argues.

"I completely agree with Mitch. Government policy when done well does exactly that. It acts as the catalyst that bridges that gap when a sustainable project, technology, or business model are still making a loss in the short term, but it is doing what's best for the society in long term. Government support can push it forward and accelerate the development of an economically feasible technology or practice. The trouble emerges when the cost of that support, including overregulation, is too onerous," **Fortin** concurs.

"Mitigation banking[6] is a particularly interesting example of a win-win story. We own property on behalf of one of our investors in Florida, a state that has seen population increases due to high paced migration, both from within the USA and outside. As this trend continues, real estate development is accelerating and increasingly encroaching on new lands and species. The gopher tortoise is one of those threatened and endangered species whose habitat is being destroyed. One

[6] According to the Florida Department of Environmental Protection, "mitigation banking is a practice in which an environmental enhancement and preservation project is conducted by a public agency or private entity ('banker') to provide mitigation for unavoidable wetland impacts within a defined region (mitigation service area). The bank is the site itself, and the currency sold by the banker to the impact permittee is a credit, which represents the wetland ecological value equivalent to the complete restoration of one acre. The number of potential credits permitted for the bank and the credit debits required for impact permits are determined by the permitting agencies."

of the properties we manage in Florida contains an area of land that provides a habitat that is very suitable to the needs of the gopher tortoise. We've been able to work with state and federal government and the mitigation banking to help develop a forever home for these gopher tortoises on a portion of the larger timberland property. We actively manage the timberland in such a way as to allow that space for them to thrive make their burrows, which other animals also live in," Fortin says.

"While supporting biodiversity and offering a home for the gopher tortoises, we generated return for our investor over and above the traditional timberland returns that we typically expect, while still managing the timberland outside of the gopher tortoise habitat for merchantable commercial timber. This solution generates mutual benefits for the local ecosystem, biodiversity, and the financial objectives of our investors. These additional investment benefits are in addition to the fundamentals of timberland investment that include competitive risk adjusted returns, minimal correlation to other asset classes, positive correlation to inflation and relatively stable long-term cash yields and overall return profile including land appreciation. The challenge here is that these opportunities, while not few and far between, are nevertheless best described as 'bespoke', which is why we have a team dedicated to searching for and exploring these types of opportunities that fall outside of traditional timberland management" Fortin adds.

Supportive natural capital policy can also spill over and benefit other markets. Dreaneen describes how integrating voluntary forestry carbon credits into compliance carbon regimes has driven an increased revaluation of land suitable for planting. "Countries or states with an active carbon market, such as New Zealand, Australia, or California, have compliance regimes that allow for forests or other forms of agriculture potentially to plug into compliance carbon regimes[7]. There is a very visible and direct correlation between the price of land and the carbon market. In New Zealand and the UK certain land prices suitable for planting trees have doubled in recent years. Carbon markets have added increased speculation to the valuation of certain natural capital assets," **Dreaneen** explains.

Natural Capital and Biodiversity Partnerships

Despite the appeal of carbon credits, investors need to be mindful of what activity is behind a carbon credit and whether the specific flavour of carbon credit they chose fulfil their goals. One of the main sources of partnerships is in data collection and project selection, where international organisation and research companies can provide on the ground expertise.

"Partnerships with data companies, academia and research institutes are also important because the science is always evolving, and the measurement of biodiversity is complicated. This is still an incipient market with a lot of work being done to develop biodiversity metrics. We recognize there have been lots of challenges to the market. There have been questions over some of these projects in terms of the leakage, the additionality or whether the assessment or forecast of how many tons would be avoided is correct and the crediting thereof," Dreaneen says.

"In 2022 Schroders partnered with Conservation International to create Akaria Natural Capital, one of the first dedicated natural capital impact investment managers in Singapore. In addition we bolstered our efforts by launching a nature practice within our impact specialist BlueOrchard. We are currently looking at several NBS projects including one of the largest forest protection projects in Indonesia, in a location with a wealth of biodiversity due to the fact that 65% of its pristine forest has never been logged before," Dreaneen explains.

"This was not the first such partnership. Two years ago, Schroders invested in Natcap Research, a business spun out of Oxford University that focuses on baselining natural capital. One of the things that they can do is to assess the potential biodiversity uplift[8] underlying an asset, thanks to a framework that's been used by extractive industries. It can assess mining and drilling sites and measure what their impact is on biodiversity for regulatory purposes. It can also assess critical ecosystems within the vicinity to offset that damage," Dreaneen continues.

Schroders is not alone in its partnerships. "In March 2022, Federated Hermes Limited partnered with the Natural History Museum in London to launch a Biodiversity Equity Fund classified as Article 9 according to the EU's Sustainable Finance Disclosures Regulation (SFDR). The Natural History Museum has developed a scientifically rigorous metric, the Biodiversity Intactness Index (BII) which estimates the loss of biodiversity across an area using a combination of land use, ecosystem, species, and population data to give a simple figure for 'intactness', that is, what percentage of the area's natural ecological community still persists there. Last year, the Museum opened the BII data through an online tool, the Biodiversity Trends Explorer, to enable users to compare the state of local ecosystem biodiversity among countries as well as how different possible economic futures will affect nature in developed and developing countries over the coming decades," **Reznick** says.

For its part, Manulife partnered with the World Economic Forum, Uplink, and several other organisations to launch the Sustainable Forest Economy Challenge. "The Challenge aimed to source innovative solutions across the value chain from the sustainable management of forests to the production and use of wood. The Challenge called for ecopreneurial start-ups that provide innovative and scalable models for sustainable forest management, the production and application of different wood products and enabling technology solutions. We received 109 applications from which a panel of experts (Manulife Investment Management is one of four reviewers), including a representative of the European Forest Institute, narrowed down to 12 winners. Winners included Lignum, a producer of high-performing and biodegradable bioplastic materials from forest and agricultural residue from South Korea, and Easy Housing, a Ugandan company focused on affordable housing projects in emerging African economies, utilising circular and climate-resilient building technology based on locally sourced timber," **Fortin** explains.

By partnering with other organisations and NGOs, we can hopefully create higher quality standards and help devise new methodologies and set new standards. But it is also key for managing the work on the ground. These are quite large landscapes with a lot of stakeholders to manage. Every little helps," **Dreaneen** argues.

[7] "Compliance carbon markets" refers to regulated regimes where polluters are effectively granted a 'license to pollute' a limited amount of greenhouse gases.
[8] According to the (UK) Local Government Association, Biodiversity uplift, also called Biodiversity Net Gain (BNG) is a concept that was introduced in the UK by the Environment Act 2021, which states that "all planning permissions granted in England (with a few exemptions) except for small sites will have to deliver at least 10% biodiversity net gain from January 2024."

dessert

The wish list

To conclude the round table discussion on natural capital and biodiversity, participants are asked what they would wish for if their request could be fulfilled at the stroke of a magic wand. Answers alternate between a global carbon tax, well-balanced regulation, a circular paradigm shift in economic thinking, accelerated mainstreaming, more blended finance opportunities.

"Regulation is absolutely key, because it is facilitating transparency, which is desirable. I also think we need to see more of it, although not only in Europe. Consider the example of Brazil, where we've seen a worsening in environmental matter over the last years. Fortunately, that is changing but not because companies have adopted a different stance. It's been because the regulators are changing back to a more environmentally minded approach," **Nyström** answers.

"A lot of the work on climate change is to engage with companies regarding how they influence public policy and the regulators, to ensure that the policy lobbying they do is in line with the Paris Agreement. I think that we have to do the same work on Biodiversity as well. Companies need to change their behaviour and business models, but they also need to consider how they interact with the regulators so that their policy lobbying is aligned with what they claim to be their goals. I think that's an important topic for investors to focus on, particularly given green washing concerns. It important to ensure that companies aren't saying one thing and then lobbying for the opposite. It's actually a very easy way to catch green washers," Nyström continues.

Fortin chooses to focus on the role of regulation to set standards and the need to take a holistic approach and on definitions.

"What are we measuring? How we are measuring it, and at what level? Is it ecosystem - or is it species-specific, is it flora or fauna? We need to be mindful of the fact that there are two types of risks underlying this issue. First, there's the risk that what are attempting to measuring is so nebulous we end up dissuading potential investors who sometimes write it off as something that no one is ever going to be able to measure. The other risk with measurement is that we err too much to the other side and become too specific. Biodiversity is so broad in scope and the range of its impact. We also need to be mindful of the whole landscape of opportunities and interconnectivity between solutions," Fortin says.

"Maintaining this wholistic approach, it is important to recognize that climate and nature are intrinsically linked. An example of this is the fact that in the voluntary carbon markets credit pricing that has high standards behind it and has biodiversity co-benefits are trading at a higher level than the average voluntary carbon market. The market has readily assigned value to the high-quality and biodiversity co-benefits. Realizing this link, the development of carbon markets could be used as a template or case study for the development of nascent biodiversity credit markets – and ideally emerging biodiversity markets can learn from the growing pains of carbon markets and their development over the last 25+ years. Hopefully we can learn from the development of carbon markets and leverage that interconnectivity and momentum to support the efficient and realistic development of biodiversity markets," Fortin adds.

Still on the topic of government action, Ideström wishes more global policy coordination, ideally in the form of a global carbon tax. "I know it's unrealistic because it's impossible to coordinate such issues globally, but the best thing for the environment, biodiversity and for all asset managers would be for there to be a global carbon tax. If there was a proper tax for the externality of damaging the environment and depleting resources, then companies and consumers would have to adjust how they consume those resources. I'm very happy to hear about examples that show that land prices have doubled because investors realize their value. I think that's what would happen over time if you had that tax," Ideström says. "My more realistic wish is for politicians to strike a balance of protecting the environment without undermining ownership rights, especially natural capital. There are conflicting interests and just because we want to increase biodiversity, we shouldn't be confiscating land and making it unproductive. I think respecting land ownership is really crucial in writing the right legislation and working with other incentives," **Ideström** adds.

Reznick wishes for two magic wands, one for paradigm shift in economic thinking and another for mainstreaming of biodiversity solutions.

"With one of those magic wands, I would wish for us to tear down the historical way we fundamentally think about natural capital as a linear and interminable resource and embrace the concept of "cradle to cradle". My wish would be to rewind, go back in time and think perhaps less so in the Friedmanian way and in a more sustainable circular economy approach. I wish it was normal for shareholders, managements, employees, and society at large to think about how to make everything circular or net positive (or net neutral at worst) from the beginning of the production process. With my other magic wand would be to mainstream some of the natural capital and biodiversity solutions we discussed today. Assuming that governments provide the kind of supports we discussed, it would be a lot easier for corporates to embrace these products that help them internalise the costs of natural capital," **Reznick** argues.

The remaining two round table participants each echo Reznick's points. "I agree with Mitch. We need a more circular way to think about economic activities and we need to mainstream natural capital. If I would add one more wish, it would be for Development Finance Institutions (DFIs) to be more active creating blended finance opportunities related to biodiversity," **Rehn** says.

Dreaneen also wishes for more natural capital mainstreaming. "Assuming that we can get the regulations right, that we can devise the right measurements, that externalities are appropriately internalised and that returns are aligned with the rest of the market, then my wish would be to mainstream natural capital and biodiversity. I want to see more investments," **Dreaneen** comments.

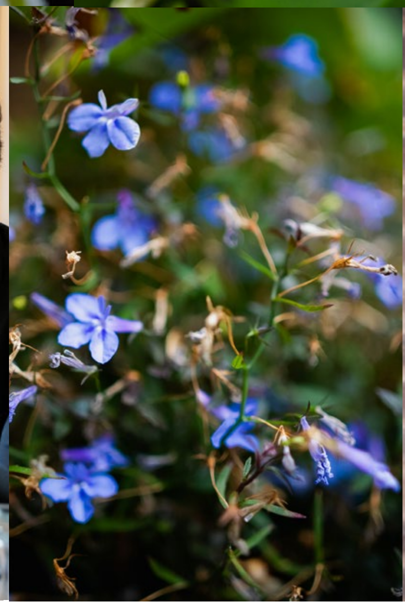
"We'd love clients to have a very large allocation to natural capital, to nature positive or to natural climate solutions. Today the investments in this segment amount to approximately 0.2% of the total capital. If that increased to 1%, it would amount to US$1.2 trillion. If it went up to 3% that would be well over US$3 trillion. That's a very large amount that could have a significant impact on the way in which land is being managed and how some of these biodiversity markets are being developed and measured," Dreaneen adds.

"Climate finance was worth approximately US$1.3 trillion last year, of which 50% was private sector and 50% public sector. Nature finance is only around about US$130 billion, 86% from the public sector and only about 14% in the private sector. We need to see market rates of return for nature to really scale," Dreaneen says.

"My wish is for nature to become mainstream. If there were people willing to invest in cryptocurrencies, which are so intangible, surely it shouldn't be impossible to find the capital for something as tangible as nature, for which everyone has an affinity," Dreaneen concludes.





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