

INSIGHTS FROM
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Natural capital approach to sustainable investing

With biodiversity loss ranking among the top 5 global risks, institutional investors should act to protect it

IT WAS a sunny afternoon when I dropped off a beautiful bird in a wooded park in the middle of a concrete jungle of a city. The pitta bird is a rare sight in tropical forests, even to the trained eyes of birdwatchers.

Yet there she was just hours before, perched on the window of my condo, in a busy metropolis bustling with traffic and millions of pedestrians, miles away from home. Rather unoriginally, I named her Pitta. I hope she survives.

Biodiversity loss ranks among the top 5 global risks. That's according to *The Global Risks Report 2020* from the World Economic Forum. Of those top 5 risks, 3 were environmental in nature.

The numbers are stark: The total populations of wildlife species have plummeted 68 per cent between 1970 and 2016, and one million animal and plant species now face extinction.

This deterioration of biodiversity and related ecosystem services is the combined result of land and sea use changes, direct exploitation, climate change and pollution.

Let's explore why institutional investors should protect ecosystems and biodiversity and how sustainable investment strategies that offer risk mitigation and value creation opportunities can help accomplish this.

The case for sustainable investing

■ Institutional investors have a fiduciary responsibility to manage assets in the client's best interest. Failure to consider long-term investment drivers, including financially material environmental, social and governance (ESG) criteria, is a failure of fiduciary duty, according to the 2019 PRI Report.

■ The annual monetary value of ecosystem services is a whopping US\$125 trillion to US\$140 trillion. That's more than one and a half times global gross domestic product (GDP). A wide range of investable sectors rely on natural resources and ecosystem services and can have a potentially negative effect on biodiversity. These include agriculture, fisheries, extractives, fast-moving consumer goods (FMCG) companies, forestry and utilities, among others.

■ Can sustainable investing reduce risk and enhance returns? Research says yes. Several studies and meta studies indicate ESG issues can be financially material to companies' operational performance, lower the cost of capital, and potentially enhance alpha. Engaging with compa-

nies on ESG issues can create value for both investors and firms.

What investment approaches, asset classes and strategies are available?

Responsible investing strategies range from social investing with submarket returns to impact investing with market-driven return objectives to full ESG integration for long-term value creation.

Sustainable investments now extend across the full range of asset classes that compose diversified investment portfolios. These include stocks, bonds, real estate, private equity and venture capital.

A growing number of exchange-traded funds (ETFs) with ESG tilts are available as well. Sustainable investing assets in Europe, the United States, Japan, Canada and Australasia stood at US\$35.3 trillion at the end of 2020, according to *Global Sustainable Investment Alliance Investment Review: 2020*.

Alignment, integration and engagement: a necessary paradigm shift

Thus, for a client seeking risk-adjusted returns with a biodiversity focus, the investment strategy should align with their objectives and timeframes and integrate these longer-term risks and factors into its investment processes, namely:

Full integration: Full Integration extends investor objectives beyond risk mitigation to value capture and must occur across the financial system's entire value chain.

Time frames: Pension and sovereign wealth funds, among other institutional investors, have long investment time horizons. Fund managers and investee companies, however, measure profitability on much shorter time tables – quarterly, for example. This misalignment of interests requires a shift in perspective.

Explicit costs of natural capital and externalities: Understanding the value of both natural capital impacts and dependencies helps business and financial decision makers assess whether these issues affect their institutions and make more informed decisions.

The Dasgupta Review from 2021 recommends valuing biodiversity as an economic asset rather than a free resource as a

means of halting its depletion.

The cost of externalities: On the other side of the coin, the environmental impacts of products or services that are not explicitly priced in – externalities – can influence the wider economy and potentially investors' long-term total return. The solution? Internalise externalities through market-based instruments such as taxes, regulatory instruments like vehicle emission and safety standards, or such voluntary instruments as emission reduction agreements.

The value of engagement: By opening a dialogue, investors and institutions can encourage companies to become more sustainable, more efficient in their use of natural resources, and ensure that their current earnings do not borrow from their future earnings.

Policy dialogue: Whether institutional investors generate sustainable returns and create value is influenced both by market efficiency and the effectiveness of public policy. The European Union's taxonomy for sustainable activities is a critical example. Investors can work with regulators, standard setters, stock exchanges, and other stakeholders to design a sounder and more stable financial system that better integrates ESG into financial decision making.

Final thoughts

Let's loop back to Pitta. What can be done? Various financing initiatives that leverage public sector and development finance for sustainable agriculture, biodiversity conservation and the blue economy are emerging. Many of these are focused on vulnerable developing economies.

The Asian Development Bank and the World Bank, among other such institutions, are creating innovative financing products that support these efforts.

The World Bank's 5-year, US\$150 million Wildlife Conservation Bond, for example, is a form of biodiversity thematic investing that aims to protect South Africa's black rhinos while offering investors a competitive return based on achieving conservation success indicators. So, efforts are underway. Let's just hope they're enough. Stay safe, Pitta. We will try our best.

The writer, CFA, is a financial management specialist with the Asian Development Bank