Natural capital and the role investors can play

What is Natural Capital?

Natural capital is a concept which can be defined in many ways, and its definition is constantly evolving. It is most often defined as the world's stock of natural assets such as air, water, soil and all living things. Human life is possible because of the wide range of benefits we derive from these natural assets. These include not only the food we eat, the water we drink and the air we breathe, but other vital processes for human survival such as climate regulation, flood defences and carbon storage. These assets, and the ecosystem services we derive from them, are difficult to protect and even harder to value, and, as is often the case with shared assets, they have been exploited and used wastefully for many years. This is not only a 'tragedy of the commons' but in the words of Mark Carney a 'tragedy of the horizon', as a lot of the damage is cumulative and persistent. In addition, individual issues cannot be considered in isolation as their combined effect can be catastrophic, as ecosystem productivity and resilience declines.

Why is it important to investors?

As the world's natural capital is made up of diverse assets, there are many ways these can be damaged and the number of companies, industries and sectors causing this damage is vast. This makes it clear that all investment decisions are ultimately dependent on natural assets and the services derived from them. Investors must appreciate that changes to these natural assets, accompanied by changing environmental regulation, are going to create both risks and opportunities in the years ahead.

Monetising externalities

Natural capital depletion has been discussed by conservation campaigners and impact investors for many years. Through payment for ecosystem services schemes, such as REDD+, they have tried to protect these natural assets. The success of these schemes has been questioned due to the difficulty of valuing the underlying assets that they are aiming to preserve, but significant progress has been made in recent years in an attempt to value the world's natural capital. In 2014, a study published in the journal of Global Environmental Change, estimated the total value of the world's ecosystem services was $124.8 trillion per year, almost twice as much as global GDP. There have also been efforts to estimate the 'environmental externality' costs with Trucost on behalf of The Economics of Ecosystems and Biodiversity (TEEB) suggesting that the world's primary production and processing sectors alone are responsible for costs of $7.3 trillion per year. With these new perspectives comes the opportunity to hold companies accountable for the damage they are doing and require them to provide financial compensation for their exploitation of natural assets. Since the full cost of environmental damage is often significantly higher than the narrow costs of preventing or limiting pollution, taking into account 'environmental externalities' is likely to lead to a more efficient allocation of capital globally.

Portfolio implications and the role investors can play

Clearly these pressures could ultimately increase operating costs and reduce the profitability of whole industries and so there is now a strong case for all investors to consider natural capital issues. In addition, it is important for investors to consider not only the impact of natural capital on individual companies, but also the impact on their own portfolios. This can be assessed using scenario analysis with recommendations provided by the Task Force on Climate-Related Financial Disclosures and the CDP (formerly the Carbon Disclosure Project). These focus on issues such as how a portfolio would react to lower water availability or a higher carbon price.

In order to preserve and protect the world's natural capital, we need to develop valuation techniques and methodologies to allow businesses to quantify the impacts they have and the extent to which they are dependent on natural assets. Recently, there have been important steps towards achieving this which has led to businesses becoming more aware of their impact and dependence on natural assets. However, there are still many questions about the rationale and consistency of the metrics being used. It is only when these metrics can be linked to traditional valuation metrics, that it will be possible for investors to fully evaluate a company's impact on natural capital.

Conclusion

For investors, natural capital is no longer only an environmental concern, but also a financial one and clearly cannot be ignored. The pressures are accelerating fast and it is important to consider these issues now. The changes will affect entire sectors, but there are also opportunities for efficient companies to benefit and for new industries to develop. As such, it remains in investors' best interests to review their portfolios to protect themselves from the negative impact on returns that these pressures will bring, but also importantly, to take advantage of all the opportunities that will come with it.

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