News & Views

September 2022

Why natural capital depletion matters

Risks from natural capital depletion, including the loss of biodiversity, are often overlooked as investment risks or are sometimes considered too broad to assess, prepare for or negate. Here, Insight Investment considers how such risks can be assessed and ways investors can work to mitigate them.

Every year, the World Economic Forum (WEF) publishes a paper entitled the Global Risk Landscape, which incorporates a survey of nearly 1,000 global experts and leaders on their perception of global risks.

The latest survey results, published in early 2022, identified the three most severe risks on a global scale over the next 10 years as climate action failure, extreme weather, and biodiversity loss respectively. Natural resource crises were also cited as one of the most severe risks on the same timeframe.

These risks are linked directly to the depletion of natural capital, the world's stock of natural assets. Natural capital typically refers to four types of assets:

- biodiversity
- water
- atmosphere
- soil and sediments

The benefits flowing from natural capital to people and businesses are known as ecosystem services. These services are fundamental necessities for human well-being and a bedrock of many aspects of the global economy.

While it is becoming commonplace for investors and asset owners to act on reducing climate change risk in their portfolios, natural capital risk has received less scrutiny. However, progress is being made. Initiatives are in progress to understand the specific implications for investors, such as the Taskforce on Nature-related Financial Disclosures (TNFD), which is developing a framework for disclosures and risk management[1].

In 2020, global consulting firm PwC estimated that over US$40 trillion of economic value generation (more than half of global total GDP) is moderately or highly dependent on nature and its services[2]. Of this, industries highly dependent on nature – such as agriculture, fishing, mining, and tourism – account for around US$13 trillion[3].

Businesses do not have to be based in an area of natural capital depletion to feel the effects of this dependency. Of the 20 countries richest in biodiversity, 11 are categorized as key global exporters[4]. Globalization means many businesses will have some potential risk exposure to these biodiversity-rich regions, be that a factory or an office space or a link through their wider supply chain.

[1] Taskforce on Nature-related Financial Disclosures. first beta version of TNFD framework for market consultation. 15 March 2022.

[2] PwC. Half of world's GDP moderately or highly dependent on nature, says new report. 28 February 2020.

[3] Science Based Targets Network. Science Based Targets for Nature. September 2020.

[4] Ibid.

BNY MELLON
INVESTMENT MANAGEMENT

Despite the clear importance of natural capital to the global economy, many have historically ignored the – often devastating – effect that human and business activities have had on the biome and the resultant unsustainable depletion of natural capital. A key measure of the depletion of biodiversity specifically is the WWF Living Planet Index. In 2020 it recorded that biodiversity declined by 68% between 1970 and 2016 resulting from land use change, land exploitation, climate change, pollution and the introduction of foreign species[5].

From an investment standpoint, there are challenges in effectively deciphering the natural capital risk associated with companies. There are no universally agreed metrics to assess a company's exposure to natural capital risk and it is likely be some time before there is such agreement.

Science-based targets (SBTs), a growing focus of interest within the financial industry, offer a potential way forward. SBTs are measurable, actionable, time-bound objectives, anchored in scientific evidence and research that can be aligned with goals and targets set by international bodies (for environmental, social, and governance (ESG) matters, the UN Sustainable Development Goals are one such yardstick).

There are potential ways to demonstrate that natural capital risk can be meaningfully analyzed, while exploring companies' dependency and impact on ecosystem services.

In considering this, disciplines such as the following may prove helpful:

- **Industry-level materiality assessment** – by taking a view on the risk facing a company's industry it is possible to analyze natural capital dependence and impact at an industry level and identify the industries most exposed to different risk types through their value chain.

- **Geospatial mapping** – assessing a company's geographic exposure to capital depletion risks by mapping the locations of company operations to capital depletion hotspots. It is important to do this as natural capital is not declining at the same rate globally and to capture the diversity of ecosystem services.

- **Mitigation analysis** – companies can take steps to both minimize their damage to the environment and to reduce their risk exposure to natural capital assets depletion.

Beyond this, investors can look to analyze and tackle natural capital risk within investment decisions. It can help to highlight some key risks faced by issuers and the potential impacts resulting from these factors on a longer time horizon which are not always adequately incorporated into traditional ESG analysis.

[5] WWF Living Planet Report 2020.

Disclosure

All investments involve some level of risk, including loss of principal. Certain investments have specific or unique risks. No investment strategy or risk-management technique can guarantee results or eliminate risk in any market environment.

Recent market risks include pandemic risks related to COVID-19. The effects of COVID-19 have contributed to increased volatility in global markets and will likely affect certain countries, companies, industries and market sectors more dramatically than others.

This material has been provided for informational purposes only and should not be construed as tax advice, investment advice or a recommendation of any particular investment product, strategy, investment manager or account arrangement, and should not serve as a primary basis for investment decisions. Prospective investors should consult a legal, tax or financial professional in order to determine whether any investment product, strategy or service is appropriate for their particular circumstances. Views expressed are those of the author stated and do not reflect views of other managers or the firm overall. Views are current as of the date of this publication and subject to change.

This information contains projections or other forward-looking statements regarding future events, targets or expectations, and is only current as of the date indicated. There is no assurance that such events or expectations will be achieved, and actual results may be significantly different from that shown here. The information is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons. References to specific securities, asset classes and financial markets are for illustrative purposes only and are not intended to be and should not be interpreted as recommendations. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed.

There is no guarantee that any strategy that considers environmental, social, and governance (ESG) factors will be successful, or that any strategy will reflect the beliefs or values of any particular investor. Because ESG criteria exclude some investments, investors may not be able to take advantage of the same opportunities as investors that do not use such criteria.

Investment advisory services in North America are provided by Insight North America LLC, a registered investment adviser and regulated by the U.S. Securities and Exchange Commission (SEC). Insight North America LLC is associated with other global investment managers that also (individually and collectively) use the corporate brand Insight Investment and may be referred to as “Insight” or “Insight Investment.”

No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission.

BNY Mellon Investment Management is one of the world’s leading investment management organizations, encompassing BNY Mellon’s affiliated management firms and global distribution companies. BNY Mellon is the corporate brand of The Bank of New York Mellon Corporations and may also be used as a generic term to references the corporation as a whole or its various subsidiaries generally.

© 2022 BNY Mellon Securities Corporation, distributor, 240 Greenwich Street, 9th Floor, New York NY, 10286

Not FDIC-Insured | No Bank Guarantee | May Lose Value

MARK-298669-2022-09-06

BNY MELLON
INVESTMENT MANAGEMENT