pi ESG CLUB

Stewardship is core to sustainable asset strategies, but having a lot of ground to cover and rising misalignments between asset owners and their managers make the task harder. This month's ESG Club looks at how stewardship could be more effective.

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INDUSTRY BODIES IN CALL TO ACTION ON BIODIVERSITY

Investors need a robust escalation strategy to engage with nature, says report. *Andrew Holt* takes a look.

Responsible investment campaigner Share Action and the UN Environment Programme World Conservation Monitoring Centre (UNEP-WCMC) have launched a guide on how investors can strengthen their approach to protect some of the world's most important biodiversity-rich areas.

The guidance identifies the critical role investors need to play to help stop, and even reverse, biodiversity loss through their investment policies, capital allocation and portfolio stewardship processes – and amounts to something of a call to action for institutional investors on biodiversity.

It focuses on the particular approach needed when investing in or near areas that have been designated as protected by governments, due to their rich biodiversity.

These include areas such as the Central Amazon Conservation Complex and the River Dee in the UK.

It describes practical steps investors should take to incorporate protected areas into their environmental and social risk management processes, establish clear expectations for investee companies and follow escalation strategies where expectations have not been met.

Key recommendations for investors include assessing and mitigating biodiversity impacts across portfolios, but also recognising the additional importance of protected areas.

Investors should also assess if any assets or sites within their portfolios intersect with, or are adjacent to, protected areas.

Share Action and UNEP-WCMC say investors should therefore "set ambitious targets" to ensure that all assets within protected areas are only engaged in activities that align with the management plan or designation of the respective protected area.

Escalation and engagement

Investors should also have an escalation strategy that covers biodiversity engagement priorities. Escalation policies should also consider the "possibility of divestment" if biodiversity risks are not addressed, noted the guidance.

Alexandra Pinzon, head of biodiversity at Share Action, said: "We know investors are not doing enough to adapt their investment policies to tackle the destruction of important ecosystems in protected areas."

And she added: "To address the global extinction crisis and unprecedented decline of nature, investors must recognise the vital role of protected areas as a tool for biodiversity conservation and strengthen their investment policies and engagement with companies accordingly."

A number of reports and supranational bodies have warned of the dangers of not addressing biodiversity risks.

For example, a study by the United Nations Environment Programme: State of Finance for Nature 2023, estimates that around 37% of species will be threatened or extinct by 2100.

And the loss of biodiversity is listed in the top five global risks in terms of impact to the global and financial system by the World Economic Forum, a Geneva-based think tank.

Research from S&P Global Sustainable has also shown "that about 70% of companies in the S&P Global 1200 have at least one asset in a protected area", further highlighting that investors need to look at their investment policies, capital allocation and portfolio stewardship processes in addressing biodiversity.

"We need to see investors use the huge power they wield to reduce their nature-related risks and impacts, especially on internationally recognised areas of importance for biodiversity conservation," Pinzon added.

This, she said, would also be beneficial for investors, as the regulatory shifts required to deliver the ambitions of the Global Biodiversity Framework result in more stringent biodiversity protections and the expansion of protected areas, which could lead to stranded assets, reputational damage and other financial consequences.

Room for improvement

Over the last few years, Share Action has monitored the responsible investment policies and performance of the world's largest asset managers, assessing the ambition and transparency of their approaches to responsible investment, including policies to protect vital biodiversity.

The campaigner's latest benchmarking reports have shown room for improvement in the way asset managers and insurers protect against risk towards protected areas as well as their own financial returns.

They revealed that 64 asset managers and 50 insurers assessed by Share Action lack clear evidence of policies to manage risks associated to protected areas.

UNEP-WCMC is a global centre focused on addressing biodiversity and nature's contribution to society and the economy and operates as a collaboration between the United Nations Environment Programme and the UK conservation charity WCMC.

Neville Ash, director of UNEP-WCMC, said: "Asset managers and asset owners can drive positive impacts for nature through their investment decisions. For example, when they engage with companies and exercise their voting rights, they can be influential in ensuring that businesses respect and help manage protected area networks."

He therefore said the guidance helps to lay out the steps investors should take to reduce their risk associated with protected areas and drive positive change.

ESG INTERVIEW – DARRAN WARD

Rebalancing the Earth

The head of alternatives talks to *Andrew Holt* about West Yorkshire Pension Fund's pioneering investment in natural capital.

Your investment in Rebalance Earth, a boutique fund manager focused on natural capital, is unique. Why did you make that investment?

Last year we began updating our investment strategy, which resulted in a 5% allocation to alternatives across public and private markets.

Our alternatives mandate aims to provide the long-term, risk-adjusted and uncorrelated returns you would expect from a portfolio of alternatives. But it also prioritises our investment beliefs around climate solutions, sustainable cities and innovation, with a focus on regional and UK opportunities.

We have therefore been analysing many opportunities from venture, tech and life sciences through to residential, infrastructure and natural capital assets.

Within natural capital, we are particularly interested in nature-based solutions and Rebalance Earth's focus on nature as infrastructure struck a real chord with us. It combines uncorrelated long-term returns, innovation and a strategy targeting climate action, solutions and resilient cities, communities and companies.

Given the expertise and experience of the founders at Rebalance Earth, the scalable market opportunity and our strategic alignment, we explored the potential for direct investment in the company.

How long did it take to complete this investment?

We first spoke to Rebalance Earth back in 2023. As with all our private market transactions, we carry out in-depth analysis and financial, operational and legal due diligence alongside as wide an array of meetings with industry experts and potential stakeholders as possible – which, inevitably takes time.

Were there any stumbling blocks along the way?

There were certainly no major stumbling blocks or disagreements. We kept a regular, open dialogue throughout.

We had strong long-term alignment from the start, which I believe was essential and prevented any major stumbling blocks.

The investment specifically focuses on five problem areas within the ecosystem. Why they are important?

The key ecosystem problems many UK businesses face are flooding, drought, water quality, biodiversity and carbon. Flooding is a huge problem in the UK, costing businesses on average £82,000 a year and is only going in one direction.

Yet despite this, we also remain at risk of drought due to our built environment and degraded soils. Our rivers and coastlines are polluted and our biodiversity is depleted. Since 1970 we have lost 76% of our freshwater species and 69% of our wildlife. And we need to drawdown a huge amount of CO_2 from the atmosphere to limit climate change.

There are many other ecosystem problems, but we believe these five present the largest risk for UK businesses and impor-

tantly present the greatest incentive for businesses and investors to contribute towards nature-based solutions.

Are some of these five problems more important than others?

They are all important. And it's essential we work to solve all these issues, and many others, and not just in the UK. That said, flooding presents the clear and present danger for the greatest number of businesses in the UK.

The Environment Agency estimates that 185,000 commercial properties are at risk of flooding, as well as 1.85 million homes and 5 million people. That's a huge problem and a material risk that we urgently need to address.

Why is natural capital as an investment theme so important?

Very simply, nature underpins everything. It's the air we breathe, the water we drink and the food we eat, but it is also the global economy that our pensions rely upon.

Natural capital is critical in providing food, health and protection for human capital together with the natural resources and protection for produced capital, with all three forms of capital key to the global economy.

The issue is that we are depleting one form of capital, which in my mind makes the whole thing unsustainable. This is largely due to not paying for nature's ecosystem services adequately and not valuing natural capital correctly.

Closing the nature finance gap is arguably one of the key challenges of our time – estimated globally at around $150bn to $440bn per year. Regulations, markets and businesses are rapidly changing, and we see nature-based solutions as having a huge role to play addressing climate mitigation, adaptation and resilience, and therefore we see the whole sector as an incredible opportunity.

You have also said that natural capital is a business-critical infrastructure investment. What do you mean by that?

We have meaningful investments in business-critical infrastructure across our public and private markets portfolios, which provide us with long-term, stable cashflows, diversification and inflation protection. We see green infrastructure and grey infrastructure as providing essential services to society and businesses. Nature can serve as green infrastructure by proving cost effective and sustainable solutions for water management, disaster risk reduction and climate regulation, often outperforming grey infrastructure on cost and outcomes.

And in return, we believe green infrastructure can provide those long-term, stable, inflation-linked cashflows that institutional investors are looking for.

Where exactly does this investment fit into your investment beliefs?

As part of our overarching investment strategy statement, we have identified three sustainable development goal themes as being of particular focus: climate action and solutions; sustainable cities and communities; and economic growth and innovation.

We are looking to integrate these themes into our reporting and asset allocation process across the whole West Yorkshire Pension Fund portfolio over time, subject to improvements in methodology and data collection. But more immediately, we have expanded our alternatives mandate allocation to 5% of the fund, across public and private markets, to focus on opportunities addressing these key themes, and in particular across natural capital, infrastructure, living sectors, such as affordable housing, and venture growth with a strong emphasis on UK, regional and local place-based investments.

Whilst this won't always be the case, this partnership with Rebalance Earth fits across all three of our belief themes, with our direct equity investment in a UK early-stage company supporting 'UK growth' and Rebalance Earth's mission to use innovative, nature-based solutions to enable more resilient cities and communities whilst actively improving nature and the climate.

So how much will be allocated in total to this investment?

We have allocated 5% of the total fund to alternatives within the strategic asset allocation.

But decisions on tactical allocation and single-line investments are dynamic and fluid.

We have invested a relatively small amount of direct equity into Rebalance Earth – relative, that is, to our £20bn of total assets – and we will be hoping to commit more as a cornerstone investor to their initial Darwin fund, once launched subject to due diligence, alongside other investments in natural capital and beyond.

Flooding presents the clear and present danger for the greatest number of businesses in the UK.

Will you be looking to increase this?

Potentially, yes, as a limited partner in the Darwin fund, subject to further analysis and due diligence.

Do you have any further innovative investments like this in the pipeline?

Yes, we are discussing other direct and co-invest opportunities that are similarly aligned with our beliefs, vision and long-term risk-return objectives across natural capital, infrastructure, real estate and venture growth in the UK.

Do you think other big asset owners may follow your example?

That's for other asset owners to decide. We are fortunate to be of the right size, to have the strategy which emphasises UK alternative opportunities and importantly to have the in-house capabilities to carry out such direct investments with senior leadership and committee support.

We would like to do more and we are open to joint ventures with other similarly aligned large asset owners.

Does this place West Yorkshire Pension Fund as a pioneer within ESG investment?

The LGPS as a whole should be proud of its role in this space, due to its size, influence and commitment to ESG, responsible investment and net-zero pledges. We are proud to be part of that network and are keen to lead and share our knowledge and experience where we can.

As an engaged asset owner, with significant size and influence, West Yorkshire Pension Fund has long recognised the importance of the ESG characteristics of individual companies.

We are proud signatories of the Stewardship Code, have published our Task Force on Climate-Related Financial Disclosures report and have mapped our carbon emissions for the past five years. But importantly, we recognise that we and the companies we invest in need to do more, and will do more to ensure our pensioners have a world worth living in.

WEST YORKSHIRE PENSION FUND AND NATURAL CAPITAL

In September the West Yorkshire Pension Fund, which is part of the £60bn-plus Northern LGPS pool alongside the local authority pension schemes of Greater Manchester and Merseyside, made what is viewed as a pioneering investment in Rebalance Earth, the UK's first boutique fund manager entirely focused on nature as an investable asset class.

Rebalance Earth finances nature as infrastructure, which provides climate adaptation and resilience for companies, communities and cities across the UK. Rebalance Earth's strategy is to make a clear business case for companies to pay for nature restoration in their local areas.

This approach not only benefits the environment but also increases companies' operational resilience through nature-as-a-service contracts. These contracts function as long-term offtake agreements, generating stable cashflows that offer attractive risk-adjusted returns for investors.

During the next decade, Rebalance Earth aims to mobilise more than £10bn towards restoring nature across the UK.

BRANCHING INTO SUSTAINABLE TIMBERLAND INVESTMENT

BNP Paribas Asset Management takes a look at the investment case for timberland.

Forestry: an unrecognised economic force

Forests cover more than 4 billion hectares or around 30% of the Earth's land area and are composed of naturally regenerating forests and planted forests. These natural systems provide many goods and services, primarily timber but also products which contribute to human health and well-being – including food, medicinal plants and raw materials for pharmaceutical products – and outdoor recreation and culture, such as sports and tourism.

Aside from being a source of natural capital, the forest sector employs more than 33 million people, 1% of global jobs.

Forests also provide important environmental services like air and water purification, soil protection, nutrient recycling, carbon sequestration and climate regulation. And they are one of the most important harbours of biodiversity, providing a natural habitat for a vast range of animals, plants and other living organisms.

Despite pledges by world leaders to end deforestation by 2030, natural forests remain threatened by deforestation – in 2022 an area the size of Denmark was lost.

However, commercial timber plantations – known as timberland – are starting to play a more productive economic and environmental role.

Growing demand for sustainable supply

Timberland plantations only account for around 3% of the world's forest area yet produce a third of global industrial timber. What's more, commercial timberland is forecast to take up a much larger share of global wood production, with the FAO forecasting global demand for timber will increase by 37% to 60% between 2020 and 2050.

This heightened demand stems from multiple drivers, including world population growth, urbanisation, an increase in per capita income, the availability of wood, and product and technological developments. In addition, consumers are also increasingly demanding that wood be certified as sustainably produced, meaning it needs to be responsibly sourced and authenticated. These more stringent environmental regulations should further propel the supply of timber towards timberland plantations.

Fostering climate and biodiversity solutions

Sustainably managed timberland also offers a tangible way for investors to contribute positively to climate change adaptation and/or mitigation, as well as meeting several of the UN's Sustainable Development Goals.

Managed forests can play an important role in battling climate change. Firstly, they have the potential to reduce greenhouse gas emissions through the prevention of deforestation and forest degradation. Secondly, forest management and restoration can maintain or enhance forests' role as carbon sinks. Finally, greater carbon storage over the long term can be facilitated by the greater use of sustainable wood products and emissions can be avoided through the substitution of emissions-intensive materials.

Activities related to forest restoration, afforestation and reforestation alone could offer more than a third of the response options needed by 2030 to prevent an increase in global temperatures exceeding the 2C threshold set out in the Paris Agreement.

A climate and nature-positive investment option

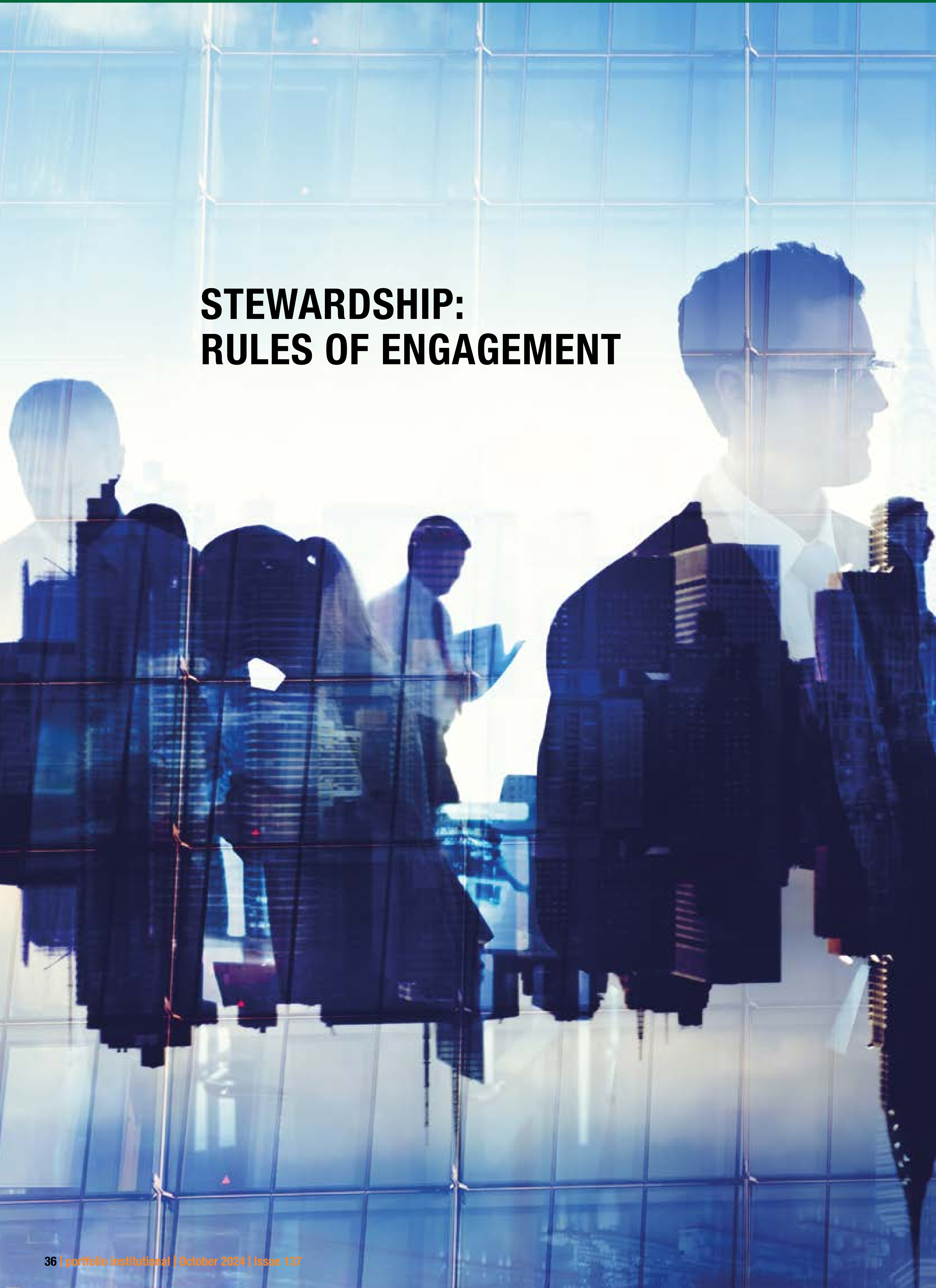
For investors looking to increase their exposure to greener investments in low-carbon, climate-aligned areas, sustainable forestry offers a palpable and readily available opportunity with an investible universe of around $200bn (£153bn).

Timberland is particularly suited to institutional investors, as its duration characteristics match the long-term liabilities arising from pension funds' and insurers' obligations. However, investment is not without risk. Market risks include the volatility of timber pricing; physical risks involve factors that can affect the volume and quality of timber, such as fire, storms, drought, insects and disease; while regulatory/legal and policy risks can arise from changes made to land use regulations, environmental laws, green certifications or tax codes that may have potentially adverse effects on timberland's investment returns.

These risks can largely be mitigated through portfolio diversification across geographies, species of tree, age classes, products and end markets.

A natural capital solution for a changing world

The positive trend by macro-economic factors – population growth, increase in per capita income, green transition – alongside its role as a natural climate solution and its attractive investment attributes mean sustainable forestry presents a compelling opportunity for investors.



STEWARDSHIP: RULES OF ENGAGEMENT

Investing in a company is only the first step in creating your desired portfolio, but the journey is far from smooth. *Mark Dunne* reports.

Investing with purpose is not easy. Institutional investors looking to build a more sustainable world and reduce inequality need to be resilient.

It could take years to change a corporate's operating practices to make your portfolio greener and fairer while creating long-term shareholder value. This is where investment managers play a key role through dialogue with a corporate's leadership and voting on an asset owner's behalf.

When it comes to stewardship, Brunel Pension Partnership's asset managers are its "first line of defence", says Brunel's head of stewardship, Vaishnavi Ravishankar. They are responsible for all of the pool's portfolio risks and engage on its behalf.

Brunel, which manages around £37bn of assets on behalf of 10 local government pension schemes in the South and Southwest of England, lists climate change, biodiversity and human rights as its top responsible investment priorities. The pool also wants its managers to focus on tax fairness, the circular economy and cybersecurity as well as diversity, equity and inclusion.

These systemic risks became priorities following discussions with its member schemes. Brunel now works closely with its investment managers to make sure these issues are considered when managing the assets.

"Our expectations are the floor, not the ceiling," Ravishankar says. This approach provides asset managers with the flexibility to employ various analytics and frameworks to meet the pool's expectations.

Different strokes

When it comes to how best to approach stewardship and engagement, there is no one-size-fits all model. It differs across asset classes and also depends on the investment style of the asset manager. "There is no single answer to what is good stewardship," says Michael Marks, head of stewardship and responsible investment integration at Legal & General Investment Management (LGIM).

The approach for an active equity investor is different to that of an active fixed income investor, which is different to a private equity investor, which is different to an index investor.

"In private markets, if you own a significant holding in a company then you have greater influence over its management," Marks says.

But stewardship is more important to index investors. "They cannot choose whether to own a company or not," Marks says. "Therefore engagement is the tool to help improve the long-term returns of the portfolio.

"If you are an index investor who thinks like a universal owner, you are looking to raise market standards across the board," he adds. "If you are an active boutique, you are looking at raising the performance of the individual company."

Stewardship is not easy but worth the effort when compared with what could be achieved. "If engagement is carried out effectively, it can be a powerful stimulator of change in company practices," Ravishankar says.

But the path to success is not straightforward and so requires resilience. "It's important to acknowledge that engagement progress can never be linear, and it often takes time to bear fruit," Ravishankar says.

Investors, therefore, need to understand the underlying process. For example, what's the theory of change? What escalation pathways are under consideration? When will they be used, and within which timeframes?

Getting round the table

One of the repeated concerns with stewardship is that asset managers may not be aligned with the wishes of asset owners when implementing climate stewardship on their behalf.

LGIM has six core investment stewardship themes when managing its clients' capital: climate, nature, people, governance, health and digitisation. Whether they build a greener world is not necessarily the main focus of the engagements they conduct on behalf of their clients; but generating long-term outcomes is and this may deliver a greener world, Marks says.

To examine the issue, an investor group was formed. Late last year, a review by the UK Asset Owner Roundtable, which counts Border to Coast, Brunel, Nest and USS among its members, found that such concerns are credible.

"The roundtable brought these sides together and we ended up having quite a constructive conversation," Ravishankar says. "There was an acknowledgement that a gap existed, and there was willingness from both sides to look at possible solutions.

"One of the key messages from asset managers is they want investors to have a collective voice when it comes to expectations around climate stewardship, because they were seeing a divergence in terms of their clients' views around this issue," she adds.

In response, a number of asset owners are putting together a statement on what they expect from managers in terms of climate stewardship. "We've taken this feedback on board," Ravishankar says.

Evolutionary times

All of this comes at a time when stewardship is going through a "phase of disruption", says Leanne Clements, head of responsible investment at People's Partnership, which provides The People's Pension.

The stewardship proposition has traditionally been led by fund managers, but Clements believes that could be changing. "What I'm seeing lately is a shift where asset owners are starting to rise in terms of their voice," she adds. "You're seeing evidence of that through the new stewardship propositions that are being presented by fund managers."

It's not just about individual asset owners. Disruptors also include the Taskforce on Pension Scheme Voting Implementation.

"Seven years ago, no fund manager was willing to talk about it. Well, today the landscape is an entirely different world, and it's creating a lot of disruption," Clements says.

"A lot of people are complaining about that, but I welcome it," she adds. "It's a necessary evolution to where we need to be as a demand-led industry with the owners of capital at the top of the chain driving what they need from their fund managers."

A targeted approach

In April, Clements said the days of "tea and cake engagement" have gone. Instead, she wants fund managers to adopt a targeted approach "routed in a robust theory of change", where limited resources are used as effectively as possible. This will include executing robust voting escalation strategies.

Yet it is too early to say if the message is getting through. "It's a work in progress," Clements says.

"It's just about consistently sending that signal through the monitoring program.

"Rome wasn't built in a day when it comes to these things," she adds.

Clements hopes that a targeted approach to stewardship will eventually be rooted in responsible investment policies and become part of monitoring programs.

"It is early days, but I can see a positive evolution with respect to it.

"It is not something where you can snap your fingers and it's going to happen overnight, but the conversations are happening. It's just a matter of embedding them into the processes. So let's talk [about this] in three years," she adds.

Let's work together

Another challenge with stewardship is that there's a lot of ground to cover. "Where we are failing is we are spread too thin," Clements says.

The answer, she adds, is to be clear with investment managers on the targeted areas you want them to focus on.

"With that spirit in mind, I'd love to get all of the key asset owners in a room and do a big mapping exercise of the barriers to the sustainable financial system to identify key focus areas where we could achieve maximum impact," Clements says.

"Then we need another mapping exercise of the industry, of who's doing what and where with respect to those focus areas, to see if there are any gaps."

The third phase is to identify leads within each focus area, depending on the skillsets of the asset owners. Then establish

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Vaishnavi Ravishankar, Brunel Pension Partnership

> **There is no single answer to what is good stewardship.**
>
> Michael Marks, Legal & General Investment Management

a working group for each focus area. "This is a case study to highlight what we need to do, which is sharing the workload," Clements says.

Asset owners engaging in targeted areas include the Church of England Pensions Board's work to improve environmental and social standards in the mining industry and Railpen's engagement on dual-class shares.

"We need more of these focal points and more people leading, like they are," she adds. "We will achieve much more maximum impact, as opposed to us all working in silos and spreading ourselves too thin."

This is what Clements sees as the way forward for the industry. There is a lot of work to be done here so more owners of capital will have to get involved. "It can't just be asset owners like Railpen, Church of England Pensions Board and Brunel carrying the load of addressing systemic challenges in responsible investment."

But this is not only about large asset owners. Those with limited responsible investment resource could also play a part. "The important role for them is to just lend their AUM [assets under management]," Clements says.

"So if there is any initiative coming out in which we need to exert influence through AUM, they can lend their AUM."

Ravishankar welcomes the idea of sharing the workload among asset owners. "From a point of efficiency, it's a no brainer," she says. "It enables significant progress."

Artificial support

Another area of progress within stewardship is the increasing use of artificial intelligence (AI). Brunel is using AI to improve the efficiency of its stewardship functions. "It's important to move with the times and embrace technology where we can," Ravishankar says.

So far, the pool has used AI to refresh and monitor the implementation of its voting guidelines, which, she says, "reduces time and effort".

"It also enables us to stay ahead of the game through picking up new issues and themes that maybe other asset owners or managers are working on.

"That's the direction of travel we expect in the coming years," Ravishankar says.

And it's a direction LGIM is taking. For instance, to build an accurate picture of a company's carbon emissions, data across thousands of pages from various company and sector reports needs to be digested.

"We use AI to trawl the internet for the data and categorise it to help inform our decisions," Marks says.

Time to say goodbye?

If all of innovations and approaches to stewardship mentioned throughout this article fail to produce the desired outcome, investors could always end their exposure to such companies.

But for Ravishankar, divestment does not mean that stewardship has failed. It is just one of the many tools in the stewardship toolbox.

"It is not appropriate to use [divestment] at the drop of a hat," she says. "Like any other lever, we use it deliberately and cautiously, particularly when other stewardship options haven't quite worked."

It is an issue on which asset owners and asset managers agree. "Divestment in its own right, is not an outcome," Marks says, adding that the threat of exiting an investment can be a powerful motivator.

If companies are not making enough progress on improving their operations or are refusing to take engagement with LGIM seriously, they could find themselves on the divestment list, which is published yearly.

"The publicity that goes alongside that is another tool in the stewardship armoury that helps engage companies," Marks says.

"We've had occasions where we have published the list and within 24 hours a company we have struggled to engage with have come to us asking what they have to do to come off of our divestment list.

"If you're not owning the company, you can't drive change," he adds. "So we believe in engagement rather than divestment, but as a tool it is powerful."

And it needs to be powerful. Change is needed in a world facing systemic threats such as climate change and nature loss alongside growing inequality. But this is not going to be easy, making the call for greater co-operation between asset owners, their managers and the companies they invest in appears a credible strategy.