WELLINGTON MANAGEMENT®

Our approach to biodiversity

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OUR APPROACH TO BIODIVERSITY

Biodiversity is an indicator of a healthy ecosystem, and when the industrial use of nature disrupts ecosystem symbiosis, the resulting imbalance can have a range of negative consequences, including for human health and economic activity. As markets increasingly recognize the value of biodiversity and the financial risks associated with biodiversity loss, natural capital such as water, soil, and forests may no longer be considered free inputs for industrial production, but as assets with associated values and costs that should be preserved and/or managed.

VIEWS ON BIODIVERSITY

We see biodiversity research as the next logical step in assessing the potential impacts of climate change on the economy and markets.

A growing body of evidence on the negative impacts of biodiversity loss has begun to spur action among regulators, industry standard setters, investors, companies, and consumers. More than half of the world's economic output is moderately or highly dependent on ecosystem services, and financial stakeholders are taking a closer look at the associated relevance of biodiversity to risk management, business strategy, and investments.

Our climate and biodiversity research, along with our commitment to the Net Zero Asset Managers (NZAM) initiative, support the view that, "In line with the best available science on the impacts of climate change, we acknowledge that there is an urgent need to accelerate the transition toward global net-zero emissions and for asset managers to play our part to help deliver the goals of the Paris Agreement and ensure a just transition."[1] Our efforts are grounded in the belief that markets will increasingly recognize the risks associated with climate change and price them accordingly. Further to that belief, we see preserving biodiversity, ecosystem health, and natural capital as critical steps to achieving a just transition and preserving the value of assets that support a low-carbon economy.

There are many ways in which companies — intentionally or not — contribute to biodiversity loss. The most direct disturbances stem from the exploitation of natural capital, including from resource extraction and cultivation. In addition, supply-chain operations may indirectly affect ecosystem services, preventing crop pollination, degrading soil quality, weakening erosion control, and other impacts. At the same time, companies are often highly dependent on nature. Consumer product and construction companies, along with utilities, for example, already have direct gross-value added (GVA) that is highly dependent on nature. Companies in other sectors may have "hidden dependencies" on natural capital throughout their supply chains. For all these reasons, biodiversity is an increasingly important topic for investors to understand.

RESEARCH OBJECTIVES AND APPROACH

Consistent with our data-driven approach to ESG and climate research, our biodiversity work focuses on financial materiality across asset classes, regions, and securities over the long term.

[1] Net Zero Asset Managers initiative.

As active managers and fiduciaries for our clients, we believe it is important to understand environmental, social, and governance (ESG) factors — including biodiversity — that may be material and relevant to forming a more complete picture of a security's value and risks. Each of our investment teams develops its own philosophy and process (P&P) for its investment approach. ESG research and tools at Wellington are centralized and available to all teams to incorporate into decision making in a manner consistent with their individual investment P&P. Where appropriate, investment teams and research analysts may also engage with companies and issuers to help mitigate their potentially negative financial impacts.

Engagement and target setting

We believe company engagement is our most powerful tool to achieve better investment outcomes while pursuing robust climate-risk management. Pursuant to enterprise risk management and strategic planning to reduce the potential financial impacts of climate change, we encourage companies to establish credible, science-based decarbonization glidepaths. In our view, setting the expectation that companies should include Scope 3 emissions in their target-setting connects climate-mitigation strategies to the consideration of biodiversity and land use. For example, if upstream Scope 3 emissions from supply chains are material, companies seeking to decarbonize will need to commit to making purchasing decisions that limit and ultimately eliminate deforestation, in collaboration with suppliers. These types of interconnections underscore the mutually reinforcing nature of managing the climate transition and biodiversity risk.

Scientific research collaborations

Working with our climate-science partners at Woodwell Climate Research Center and the Joint Program on the Science and Policy of Global Change at the Massachusetts Institute of Technology (MIT), we seek to understand the relationships among biodiversity, climate change, and capital markets and how biodiversity-related risks may impact securities. With these research partners, we focus on the two primary types of biodiversity risk:

- Physical risks associated with companies that depend on declining ecosystem services
- Transition risks associated with companies whose business activities negatively impact biodiversity and ecosystem services

Tools and resources

As an extension of this research, the Climate Research Team aims to integrate more biodiversity assessments into its research on physical risks and has begun to evaluate relevant data sets and investor tools for conducting security-level analyses, particularly regarding water usage and deforestation.

Using our Climate Exposure Risk Application (CERA), for example, we have globally mapped water scarcity measures and can determine which geographies or municipal-, company-, and supplier-specific locations may have the greatest potential exposure to this biodiversity risk.

In 2021, as an extension to our *Physical Risks of Climate Change (P-ROCC)* disclosure framework, we published *P-ROCC 2.0: A call for location data.* Disclosing the physical locations of operational and supplier locations may help investors better integrate climate- or biodiversity-risk considerations into investment decision making.

Finally, we have used the Exploring Natural Capital Opportunities, Risks, and Exposure (ENCORE) tool to help assess location-specific biodiversity issues, and we are evaluating the efficacy of applying those findings to industry- and corporate-level analysis. We continue to explore other third-party resources designed to improve data and transparency on ecosystem health and industrial impacts.

ESG sector specialization

Our ESG Research Team is also critical to biodiversity risk assessment. Because our ESG research analysts are aligned by sector, they can evaluate biodiversity risks at a granular level. Their ESG materiality frameworks include bottom-up investment-led insights that are based on extensive knowledge of their coverage areas. As a result, materiality assessments of biodiversity risk can vary widely from sector to sector. This approach provides portfolio management teams with highly relevant information, helps prioritize company engagements, and can inform voting decisions.

ENHANCING OUR EDUCATION AND EFFORTS ON BIODIVERSITY

To deepen our collective understanding of biodiversity risks, we have taken many steps aimed at helping investors across Wellington consider these risks in their investment process, as appropriate to their P&P.

Several internal Wellington resources are now dedicated to supporting investor training and internal and external reporting on climate and biodiversity. To oversee these efforts, we have established a biodiversity working group, led by senior leaders at the firm, to expand subject-matter expertise.

As with any rapidly evolving area, we continually strive to interpret changing client, market, and regulatory priorities around biodiversity — particularly for disclosure and risk management — and expect to align our platform with nascent industry frameworks, such as the Task Force for Nature-based Financial Disclosures (TNFD). Last, but not least, we have joined several industry groups to learn from and contribute to practitioners' perspectives on developing policies and practices. These include the TNFD, the Partnership for Biodiversity Accounting Financials (PBAF), Ceres' Working Group on Land Use and Climate, and the FAIRR Initiative.

As tools, frameworks, and company disclosures develop, our research teams will continue to provide Wellington investors with the information about biodiversity that they may need to help inform investment decisions. Companies and their stakeholders may increasingly consider action to stem biodiversity loss as a means of reducing potential long-term risk exposure. Historically, benefits from the use of nature accrued to producers and users, with the costs externalized across the rest of society. As biodiversity research and data expand, it is possible that the market will reevaluate the use of natural capital and ecosystem services.

Biodiversity in focus: Examples of recent action

- The European Commission has proposed sweeping regulation aimed at addressing deforestation and forest degradation. The Regulation would set mandatory due-diligence and disclosure rules for certain commodities traders and operators whose procurement processes typically drive deforestation. The rules could potentially apply to non-EU-domiciled entities selling into the EU market.
- The Dutch central bank recently ran a stress test to identify businesses located in areas that fall under the country's 30% land-protection scheme. The test found that the Dutch financial sector had €15 billion in exposure to companies operating in protected areas.
- A leading agriculture company we engage with is incorporating biodiversity preservation into its corporate strategy. The management team increasingly views ecological stewardship as a competitive advantage and has been steadily increasing investments in supply-chain traceability.
- In 2022, researchers at the Cambridge Institute for Sustainability Leadership found that farming companies with large operations on degrading land in Brazil saw their market value drop by 13% after an extreme weather event. Companies operating on tracts with healthy, biodiverse soil, however, saw their value rise by 6%.