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Timber Investment Case Study

A new alternative asset class – timberland



In September 2000, the Research and Economics Department of the Ontario Teachers' Pension Plan Board (OTPPB) was preparing an analysis for presentation to the board of directors concerning possible investment in a new alternative asset class: timberland. Timberland investments were like investing in a "tree factory" and represented a unique opportunity to diversify the fund. However, North American institutional investment in timberland was only US\$12 billion, a small fraction of institutional investment compared to traditional asset classes such as equities and fixed income securities. There were also numerous problems in attempting to measure the potential returns and risks associated with such an investment. OTPPB's Research and Economics Department needed to present a complete analysis of both the pros and cons associated with timberland investments and, ultimately, recommend whether such an investment was worth considering. If so, how it would be implemented and, if not, what should OTPPB consider in order to meet the objectives set out in the fund's investment policy statement?

Like many public pension plans, OTPPB's objectives included maintaining or reducing contribution levels, maintaining an asset-liability surplus, and achieving a sufficient return on assets. In particular, they needed to consider exceeding an internal benchmark annual real return of 4.5 per cent over a four-year period while maintaining a non-excessive risk exposure. Achieving these objectives required frequent reassessment of the plan's overall asset allocation. At the time this was 60 per cent in equities (public, private, and derivatives), 10 per cent in fixed income, and 30 per cent in an inflation hedge class (real return bonds, real estate, and commodities). Timber investments would potentially replace some of the existing assets in the inflation hedge category.

Timber investments were attractive for a number of

reasons. Historical timber returns appeared attractive and comparable relative to other traditional asset classes such as equities. Returns offered a number of unique features including land price changes, product price changes and, most importantly, biological growth (since trees become more valuable as they grow bigger). As well, timber had a low correlation with Canadian equities and a negative correlation with U.S. and non-North American equities – a desirable attribute in achieving the key diversification benefit of higher returns for every unit of risk exposure.

A primary issue with any timber investment concerned benchmarking. While a number of benchmarks existed, benchmarking timber returns was problematic. Unlike stocks and bonds, the timberland market was not liquid, leading to potential market inefficiencies. There was physical variability across timberlands and no consistent tradable unit. While some historical timber return data existed, it was quite limited. As well, measuring income generated from timber investments was difficult. However, an alternative benchmarking method was available: comparing timber returns to out-performance relative to a real return target plus inflation.

After considerable analysis, OTPPB's Research and Economics Department recommended investing in timberland. The board approved an initial allocation of up to one per cent of the fund for timberlands in the U.S. and Canada. A plan was forged for timberland investments to replace lower-yielding real return assets. Two timberland managers were hired. One manager was chosen due to their size and presence in the U.S. timberland marketplace and the second manager was more of a niche player looking to invest in smaller timberland properties or to develop their own timberland assets. Since timberland is viewed as real property, foreign investors income and gains are taxable as a result of the Foreign Investment in Real Property Tax Act (FIRPTA). OTPPB needed to be aware of the impact taxes could have on return when implementing its investment in U.S. timberland. ■