



# THE NATURAL ALTERNATIVE

*Timberland's time horizons can match a pension plan's.*

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For many years, timberland has produced strong financial results, earning its way into the portfolios of major pension funds, insurance companies, corporations, foundations and endowments.

Timberland returns have averaged 14.1% annually over 30 years through a combination of income and capital gains. Better still, timberland volatility over the period was comparable to Canadian large caps, given the stabilizing effect strong cash yields have on timberland returns. Best of all, there is virtually no correlation between timberland returns and returns from equities or corporate bonds—even the correlation with real estate is surprisingly low. This means that timberland can dramatically improve the risk efficiency of a mixed-asset portfolio, allowing for reduced risk without sacrificing return. For growth and diversification, timberland is a natural.

Timberland investment is the equity ownership of trees and, usually, the land in which the trees grow. It's not too different from owning a company: think of the forest as the "factory" and the trees as "products". And, there are some important advantages: a reliable production process using sun and rain, inventories that never become obsolete and automatically keep growing, etc.

After careful research and well-informed due diligence, the investment manager buys a tract of forest from a forest products company, government, private individual or other group. The management team may also manage the forest and market the timber, making improvements where possible—reducing costs, increasing income, enhancing productivity and adding value to the property. Income derives mainly from timber and timberland sales, and leases to recreational users. Capital gains are achieved by growing the trees and selling the tract, or parts of it, for more than the acquisition price.

Private equity investment in timberland has grown 20% annually since the early '80s, to approximately \$16.8 billion, fueled by investor demand and a ready supply of timberlands being divested by forest companies

and governments. Privately-owned timberland investment properties are still becoming available through privatization and sale by forest product companies that want to concentrate on running their processing assets.

Investors choose timberland for numerous reasons: its history of strong returns and moderate risk, its value as a diversifier and inflation hedge, and its preservation of capital through biological growth. Although a relatively small niche market, timberland is not a high-risk sector, instead providing strong cash flows and significant "grounded" assets.

Timberland investing has much to recommend it to pension funds, particularly as they are likely to face mediocre returns in listed stock and bond markets over the foreseeable future. This makes it all the more important to invest in assets that reward the ability to invest large quantities of capital for significant periods of time.

Timberland offers the potential for 6% to 10% real returns (depending on the region of the world) with moderate risk and, since returns are uncorrelated with most other asset classes and offer a good hedge against liability inflation risk, adding timber improves the return on total asset-liability risk.

When first presented with this type of investment, pension trustee boards tend to be preoccupied with fire and insect risk, even though these risks detract less than 0.1% from average annual returns. As environmental issues also rank highly as a concern, it is important to invest with a manager focused on long-term sustainable forest management—one who works closely with environmental groups and forestry experts to conform to best practices.

The outlook for the sector is bright, with global demand for wood products on the rise as populations grow and economies mature. Advances in tree-growing technology and environmental methods have made timberland a sustainable, ethical and profitable business—and the natural alternative for pension funds looking to improve their return on total asset-liability risk. ■