Seeing the trees: European interest in forestry has increased

ASSET CLASS » With moderate risk and attractive returns, forestry's profile has steadily risen. But there is still much to learn

Perceptions surrounding forestry

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European investors have shown increased interest in forestry in recent years because of its moderate risk profile and attractive returns, which include both income and capital gain.

These returns have a low correlation with those of other financial assets, making it an effective portfolio diversifier, and its inflation-hedging attributes also provide capital preservation benefits.

Nevertheless, investors are still learning about the asset class and some of their most common misperceptions are discussed below.

➤ Perception: Forestry has matured as an asset class and few opportunities exist for new investors, particularly in the United States

Reality: Approximately 15 per cent of the world's investment-grade forests are managed as institutional investments. On a market capitalisation basis, almost 75 per cent of the world's investable timberland (an estimated $212bn (£130.96bn) out of a total of $290bn) is in the US, which has the deepest, most diverse and most fragmented land and timber markets in the world.

By comparison, Brazil, Chile, Australia and New Zealand combined represent less than $60bn of the world total. Of the 64m hectares of forest available for ownership in the US, only 20 per cent are currently owned by institutional investors. In short, opportunities still exist in the US market and any timberland investment program is likely to be strengthened by a US allocation.

This is also true for those concerned about FIRPTA (Foreign Investment Real Property Tax Act of 1980) because, even allowing for the tax's impact, the US market still provides most investors with attractive risk-adjusted returns.

➤ Perception: Forestry investment is not environmentally responsible

Reality: Forests are biological assets that must be actively and sustainably managed to ensure that their investment potential is optimised. In the case of natural mixed-species forests, which are often found in colder climates, this often entails promoting natural regeneration and employing techniques that protect soils and promote residual tree growth.

In the case of plantation forests, which are normally found in warmer climates, the use of intensive forestry practices, planting single tree species as crops and cultivating them on shorter growth cycles, is the norm. Regardless of the circumstances, forests are renewable assets and one of the few green investments that actually reward investors for practicing responsible stewardship.

➤ Perception: Global diversification is the key to reducing risk

Reality: Geographic diversification is important, but achieving it does not require owning timberland around the world. Portfolio risk can be reduced by 21 per cent by owning forests in five different countries. However, the same results can be achieved by investing in just five of the 21 subregions of the US South, which has the world's largest investable land base with 35.2m hectares.

Furthermore, such a portfolio is less expensive to manage and poses fewer political, regulatory, tax and currency challenges.

➤ Perception: Forestry is less liquid than other alternative assets

Reality: Forests are no less liquid than many other types of alternative investments and the asset class continues to experience significant capital inflows. In addition, the capacity to generate ongoing income from the sale of timber and non-timber products reduces the holding risks associated with a forest investment, a feature with unique optionality.

A forest is both a factory and a warehouse. It produces increasing amounts of higher-valued timber through time because of biological growth (larger trees are more valuable than smaller trees because they can be used to produce more and higher-valued products) and it stores that value on the stump, providing investors with the ability to time the monetisation of cashflows. This means even when timber markets are challenging, a timberland investment can increase in value. By comparison, when a traditional commercial real estate asset loses lease income due to vacancy, that income can never be recovered.

➤ Perception: Forestry investments with higher biological growth rates produce higher returns

Reality: There is no direct relationship between higher growth rates and higher returns. Under a common discount rate, prices for timberland assets adjust to account for higher or lower levels of biological productivity.

➤ Perception: Forestry's capacity to serve as an inflation hedge is speculative

Reality: Like agricultural commodities, precious metals and oil and gas, forestry is a real asset and real assets are proven inflation hedges. Wood-based products permeate every sector of the global economy and according to recent analyses comparing the US consumer prices index against timberland returns (as measured by the NCREIF Timberland index) there is a strong association between the two over periods of five years or longer.

➤ Perception: Natural risks like weather, fire and insects are the greatest threats to performance

Reality: Estimates vary, but in an average year, institutionally managed US forestry sustains financial losses of less than 0.03 per cent due to such natural events. Fire danger is reduced by maintaining fire breaks and access roads, while disease and insect infestations are managed by monitoring forest health and by promptly harvesting affected trees. Finally, while catastrophic events like hurricanes and tornadoes are impossible to avoid, these risks are mitigated by diversifying holdings over broad geographic areas and by developing salvage harvest plans that can be implemented quickly in response to such events.

➤ Perception: Timber Reits and exchange traded funds offer greater liquidity and the same benefits as private market options

Reality: The actual liquidity of such vehicles depends on their size and market capitalisation and whether they are subject to exchange restrictions, all of which impact trading volume. However, when compared to private market options, such vehicles provide far less control over the asset composition of one's timberland allocation because investors cannot influence investment strategy.

Furthermore, many such vehicles are not "pure-play" timberland investments because they also own manufacturing and distribution assets.

Finally, returns for timber Reits and other exchange traded funds are highly correlated with the performance of broader investment markets, which means they do not offer the same portfolio diversification and inflation-hedging benefits of private market options.

Forestry is an expanding and exciting investment sector. Looking ahead, as it assumes a more prominent profile in institutional investment portfolios, investors will acquire a more informed perspective of its risk and return characteristics and there will be far greater understanding of its unique operational and investment attributes.

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key facts

» Timberland investments have historically provided competitive returns relative to its risk profile. Such returns hold up well against many traditional asset classes, including stocks, bonds and real estate

» Because of its unique nature, timberland often performs differently from securities or other investment assets. So it can offer an excellent opportunity for diversification when added to a broad portfolio of investments

» Timberland is a renewable and biologically growing asset and represents an array of advantages among alternative investments

» It is estimated that institutional investors – including fund management houses – globally now own about $35bn worth of timberland.

» Of that amount, about $25bn is invested in the US, which represents the world's largest producer and user of timber products