

Wood This Be a Good Investment?

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From perfume, to crayons, to chewing gum, to musical instruments, to shaving cream and to baby food, wood and paper products touch many aspects of our lives. Due to timber's wide diversity of products and applications, the market for timber is growing every day with world demand for timber products forecasted to nearly double by 2050¹. With more than 5,000 products originating from harvested timber, timberland represents a dynamic asset class with many attractive investment characteristics. In fact, as of 2006, timberland had attracted more than \$20 billion from institutional investors alone², and there are a number of reasons why this long-term investment has been popular with pension funds, university endowments and charitable trusts.

- **Competitive total returns:** Cash distributions from timber harvests and lease income, appreciation in the value of trees and lumber and potential increases in land value contribute to target returns, which seek to be competitive long term with stocks.
- **Portfolio diversification:** Timberland's low-to-negative correlation with most major asset classes reduces portfolio risk.
- **Tax efficiency:** Most income is taxed at more favorable long-term capital gains rates, increasing the tax equivalent yield and after-tax return.
- **Partial inflation hedge:** Historically, timberland returns have been positively correlated to the rate of inflation, meaning that a long-term timberland investment may serve as an effective vehicle for capital preservation during inflationary periods (i.e. the 1970's when stocks were flat to down).
- **Renewable and sustainable resource:** Sound environmental practices help ensure that the trees and land are well-maintained, helping promote the opportunity for continual growth and overall value of the investment.

What Drives Timberland Returns?

Timberland investments typically realized two types of returns – income returns and appreciation returns. Most income returns are generated by revenues from timber harvests, while land and timber appreciation, along with non-timber revenues, contribute the balance of the return. Nontimber revenue sources include recreation leases for hunting and fishing, or cattle grazing leases and mineral extraction rights. There is also the opportunity to generate cash flow from the sale of higher-and-better-use lands, which may then be reinvested in replacement timberland or distributed to investors.

The sheer physical growth of trees typically offers the majority of the return, since trees generally become more valuable with size and age. The physical growth typically adds value on a consistent basis, because trees are continually being planted and replenished. In fact, the trees being planted today are genetically selected (genetically selected, not modified) and typically grow 3x-4x faster than the trees being harvested. Other components of the return could include favorable acquisition pricing, enhancements to the land and strategic sales. In addition, opportunities for value creation exist in the managed biological growth of trees, the increasing demand for lumber and other wood products and innovative management and harvesting practices.

But what, you might ask, happens if timber commodity prices fall? Simple, you don't harvest much that year. Your hand is never forced since the trees just keep growing!

Returns and Portfolio Diversification

We've written about correlation in many past articles but to recap: Correlation simply indicates whether investments move in the same direction, opposite directions, or randomly, given certain market conditions. The NCREIF Timberland Index has a correlation of .05 with the S&P 500 Index based on quarterly returns for the

past 20 ½ years. This means they moved randomly in relation to each other and means that the addition of timberland to your portfolio will likely reduce your portfolio's risk by a significant amount.

The charts below are not meant to demonstrate the out performance of timber over the S&P 500, but simply to demonstrate how the two indices in question do not move in lock step or anything even resembling it. This and the long term value proposition of timber are why we are so interested in this relatively new asset class.

	<u>5 Years</u>	<u>10 Years</u>	<u>15 Years</u>	<u>Since Inception</u>	<u>1995-1999</u>	<u>2000-2002</u>
U.S. Timberland ³	11.4%	8.4%	11.7%	15.0%	12.0%	0.3%
S&P 500 Ex Dividends ⁴	8.7%	5.4%	9.1%	9.3%	26.2%	-15.7%

Inception 12/31/1986

As of June 30, 2008

Annual Returns

	<u>NCREIF</u>			<u>NCREIF</u>	
	<u>Timberland</u>	<u>S&P 500</u>		<u>Timberland</u>	<u>S&P 500</u>
	<u>Index</u>	<u>Index</u>		<u>Index</u>	<u>Index</u>
1987	26.51%	2.03%	1997	18.91%	31.01%
1988	30.12%	12.40%	1998	5.88%	26.67%
1989	37.35%	27.25%	1999	10.92%	19.53%
1990	11.06%	-6.56%	2000	4.41%	-10.14%
1991	20.27%	26.31%	2001	-5.25%	-13.04%
1992	37.32%	4.46%	2002	1.88%	-23.37%
1993	22.36%	7.06%	2003	7.66%	26.38%
1994	15.45%	-1.54%	2004	11.20%	8.99%
1995	13.84%	34.11%	2005	19.35%	3.00%
1996	10.73%	20.26%	2006	13.68%	13.62%

Risks

The risks associated with timberland investments can be classified into two major categories: 1) Physical risks and 2) Economic risks. Physical risks include natural disasters, pest infestation, disease, animal damage and theft. Economic risks include price, supply, demand, regulatory changes and liquidity. Frankly, we are not too concerned with the economics risks due mainly to the reason we mentioned above; timber does not have to be harvested each and every year. If commodity prices are down due to a homebuilding slump, etc., the timber management company does not harvest and the trees continue to grow.

While you might be concerned about natural disasters such as forest fires, you can rest assured that in the hands of professional managers these risks can be greatly reduced. Preventive measures such as controlled burns, firebreaks, insect and disease monitoring and spraying and the selective removal of trees are employed. In fact the U.S. Forest Service estimates that the risk of having any one acre damaged by a natural risk is less than one half of one-percent. Moreover, privately managed lands are far less likely to experience forest fires than federally managed public areas. Additionally, timber purchases are never organized as one huge block, but as a series of blocks over a large area possible in different states and in different regions of the U.S.

Why Now?

Why have we not utilized investment in timberland in the past? Simply put, this type of investment has not been accessible by “retail investors.” Most of the timberland investments we’ve researched in the past have had minimum investments of \$5 million and up, a healthy sum especially when considering that we would not allocate more than 15% of your portfolio to timber!

Sources:

- 1. Food and Agriculture Organization of the United Nations.*
- 2. “Timberland Investments: Once a U.S. territory, now a global one,” bfinance, July 31, 2006*
- 3. The index performance does not reflect the deduction of fees and expenses; if those deductions had been subtracted performance would be lower. The historical data represented by the NCREIF Timberland Index reports actual performance of institutional timberland assets for three regions of the U.S.: the South, Northeast and Pacific Northwest. To construct the Index, NCREIF members submit information on the performance of every qualifying U.S. timberland property they manage. NCREIF staff banks these data and then aggregates the property-level information to produce rates of return for the asset class. In addition to total returns, the NCREIF Index reports income and appreciation returns.*
- 4. S&P 500 excluding dividends, source “Yahoo Finance.”*

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