



## **Timber as an Asset Class: If a Tree Falls in the Forest, Should you Buy It?**

By Charlie Curnow  
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"If the sun shines and it rains, the trees grow about on schedule," wrote Jeremy Grantham, chairman of Boston-based investment firm Grantham Mayo Van Otterloo, in his quarterly newsletter in April 2007. Back then, as the housing bubble neared bursting and the S&P 500 stock index approached its post-9/11 high of 1,562, timber was one of the veteran investor's favorite picks because of its safety, high real returns and history of rising during all great equity bear markets.

Three years later, as equity markets face another correction on the heels of a year-long run-up, timber is still one of Grantham's favorite investments, alongside high-quality stocks and emerging markets. During an address at last month's Ira Sohn Investment Research Conference in New York, the GMO chairman said he expects timber to earn 6 percent annually over the next seven years.

Grantham's enthusiasm for timber, however, may be excessive, despite the fact that, on the surface, historical data seems to support Grantham's optimism. Between 1987 and 2009, the most common measure of the performance of timber as an asset class – the National Council of Real Estate Investment Fiduciaries (NCREIF) Timberland Index, which tracks a large pool of individual timber properties acquired in the private market for investment purposes only – earned a compounded annual return of more than 14 percent. The S&P 500, by comparison, has returned about 9.4 percent in the same period.

Timber also has a history of uncorrelated returns. The correlation of the NCREIF Timberland Index with the S&P 500 since 1987 has been approximately 35 percent, while the correlation of the timber index with the Barclay's Aggregate Bond Index has been just 15 percent. The correlation between the timberland index and the consumer price index during the same period has been 45 percent, suggesting that timber has been a good long-term inflation hedge.

Despite its impressive history, however, we are unconvinced advisors should overweight timber as an asset class. There is no "pure" timber investment with a long track record that is accessible to non-institutional investors, and many wood and paper products face a grim long-term economic outlook. Moreover, timberland's status as a real estate investment in a post-bubble economy is also cause for caution. Indeed, the outlook for timber investments is so murky that many potential timberland investors may be better off seeking more traditional sources of income or uncorrelated returns, such as bonds.



Before exploring our reasons for caution, let's look at the timber-related investment vehicles available to advisors and their clients.

### **Three ways to invest**

Timber investors have three main options: timberland investment management organizations, real estate investment trusts, or exchange-traded funds.

Timberland investment management organizations are a form of private equity, in which investors become direct owners of specific plots of timber-bearing land. The steep initial cost of these investments, however, tends to price out all but the wealthiest investors. Directly owned land is also highly illiquid relative to other investment alternatives. Ownership agreements are often fixed for specific periods of time, and any holdings investors wish to offload must be sold to new buyers.

Real estate investment trusts are corporations that allow smaller investors to pool their financial resources by offering shares of large timberland purchases. The big advantage of investing in these trusts is liquidity: Investors may sell their shares at any time. The big disadvantage is that the land is ultimately owned by the trust rather than the investor. This makes corporate management a major determinant of future returns, although by law REITs must distribute at least 90 percent of their profits back to investors in exchange for lower tax rates. Plum Creek, Rayonier and Potlatch, the nation's three largest timber REITs, all of which are publicly traded, currently offer dividend yields in the range of 4.4 to 5.4 percent. There are also a number of privately traded timberland REITs. An example of a trust in this category is the Wells Timberland REIT, which was founded in 2006 and has attracted \$200 million.

REITs vary in their purity as timber investments. While Rayonier, for example, lists the ownership, leasing and management of timberland as its core business, some subsidiaries of the firm also buy and sell commercial real estate, while others produce commercial fibers for consumer products, such as LCD monitors for televisions and computers. Plum Creek runs manufacturing facilities for the production of lumber, plywood and fiberboard, as well as a subsidiary real estate development business. Potlatch produces coated printing papers, bleached paperboard and private-label tissue products.

This involvement with a wide range of industries exposes these trusts to a number of external factors that are not directly related to the growth and harvesting of trees, including ups and downs in the housing market and demand for books and newspapers. Indeed, timber REITs seem to track the equity markets more closely than direct timberland purchases. Plum Creek's correlation to the S&P 500 has been 0.55 over the past 15 years, for example, and Rayonier's has been 0.5.

Timber exchange-traded funds are the newest way to invest in timber, and they may be the most attractive option for many individual investors because of their flexible, stock-like



properties. Claymore launched the first timber ETF, Claymore/Clear Global Timber ETF (CUT), in 2007. CUT is a passive fund that tracks the performance of firms that own or lease forested land and harvest timber for the commercial use and sale of wood-based products such as pulp and lumber, as well as processed or finished goods such as paper or packaging. Barclays launched the iShares S&P Global Timber & Forestry Index Fund (WOOD) in 2008. WOOD tracks the performance of the 25 largest publicly traded companies that own or manage the upstream supply chain of forests and timberlands.

Many advisors are still hesitant to invest in these funds, however, because of their short track records. Neither timber ETF escaped the financial downturn unscathed. CUT has lost 9.96 percent of its value since its 2007 inception, while WOOD has lost 6.78 percent since its launch.

As with the REITs, these ETFs lack purity as timber investments. Stora Enso, the largest holding in the CUT ETF at a 5.32 percent weighting, for example, isn't a timber company at all; it's a paper company that produces book paper, newsprint, magazine paper, fine paper, consumer board, industrial packaging and other wood products. Over 9 percent of CUT's holdings are in companies classified by Morningstar as being in the financial services industry; in the case of WOOD, it is over 16 percent.

### **But is it a buy?**

The more one examines the long upward march of average timberland prices, from about \$1,000 per acre nationally in 1999 to \$1,780 by 2007 according to Timber Mart-South, a timber industry newsletter, the more apparent it is that the general real estate bubble explains at least part of timber's ascent. The rapid increase in housing construction stoked unsustainable new demand for wood, and it likely helped prices for the timberland itself as well.

Now that the bubble has burst, the future for timber is much dimmer. Indeed, a correction in timberland prices has already begun. In 2009, the average price for an acre of timberland was \$1,395, down 23 percent from just two years earlier.

Buz Livingston of Livingston Financial Planning in Santa Rosa Beach, Florida, agrees. In an email exchange, he related an encounter he had with the man who incorporated timber into Vanderbilt's endowment program, who was a speaker at the 2007 National Association of Personal Finance Advisors (NAPFA) conference. After his presentation Livingston approached him and asked, pointedly, "How much of the return is due to land prices increasing?"

He grinned, "Well a lot."

"The timber management investment company promoters simply have not impressed me," Livingston said.



Flagging housing and real estate markets are not the only reason to approach timber investments with care. As digital technologies continue their conquest of nearly all media (our publication being just one example), a growing number of paper products are quickly becoming obsolete. Between 1993 and 2004 U.S. consumption of paper pulp dropped by 2 percent, according to the American Forest and Paper Association. Japan's consumption fell by 11 percent during the same period. Unfortunately for producers of paper pulp, who account for 45 percent of non-fuel timber sales, this trend will probably continue, and may even accelerate, in the coming years.

Most investors buy timber for safety, income and diversification. The question that potential timber investors must ask is whether timber is a better way to achieve those goals than other alternatives, such as traditional fixed-income investments or high-quality dividend-paying equities. No asset class is devoid of risk. In timber, that risk is embodied in its cyclical nature as a commodity, which has been masked, until the last two years, by decades of rising land values. Lower projected global economic growth will clearly dampen the demand for housing and paper, forcing timber investors to accept returns lower than those they have historically experienced.

Diversified investors get a dose of timber in any case, since Plum Creek and Weyerhaeuser are both part of the S&P 500. Whether one wants to overweight this asset class depends on more than just whether sun and rain will foster the growth of trees, as Grantham says. More importantly, it will depend on whether those trees that fall in the forest are being turned into pieces of paper or two-by-fours to frame houses. That's not such a safe bet.

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