KNOCKING ON WOOD

Court Washburn on why timberland investing makes sense

Sadiq Alladina, CFA

As institutional investors have focused more attention on alternative assets to improve diversification and enhance returns, timberland has grown in popularity and earned a place alongside more established alternative assets such as real estate, commodities, and private equity. Court Washburn is managing director and chief investment officer of Hancock Timber Resource Group (based in Boston, Massachusetts), the world's largest timberland investment manager, with assets under management totalling over US$11 billion. Court sat down with us to share his insights and comment on recent issues surrounding timberland investment following his luncheon presentation "Farmland and Timberland 101: Everything You Need to Know," held by the Risk Management & Alternative Investments Committee on June 11, 2014.

Where do you see timber prices going over the next five years?

Fundamentals look positive in the near to mid term. On the demand side, you have the U.S. housing sector recovery, expectations of continued increases in demand from China and India, and even a recovery in Europe, which are helping to prop up demand. On the supply side, the mountain pine beetle is having a negative effect on mid- to long-term supply. However, there are sources of increasing supply in coming years, such as the U.S. South, which has built up inventory. So there is a ready supply of timber in some of these traditional regions, which may partially offset the pine beetle issue. We see room for meaningful price increases in the U.S. South, where we're at cyclical low levels. In other regions such as the U.S. Pacific Northwest and New Zealand, we have seen significant price increases in recent years, but there is less potential for future price increases compared to the southern U.S.

How do we effectively benchmark timberland? The National Council of Real Estate Investment Fiduciaries Timberland Index serves as a useful benchmark, but it is only suitable for investments in the U.S. How do we benchmark timber investments in other countries?

There is some work being done by the National Council of Real Estate Investment Fiduciaries ("NCREIF") to create non-U.S. indices, though it's still a ways from bearing fruit. Interestingly, there are quite a few institutions—even those with investments in the U.S.—that don't compare their performance to NCREIF, for whatever reason. It's really an informational exercise. Investors that have fee structures with incentive compensation are benchmarked against a pre-set return level. Internationally, most investors have decided to live with the absence of a global timberland benchmark, and it is not likely to be there for the mid term. So if they had to benchmark, they would use the NCREIF U.S. Index or benchmark to an absolute return.

Given the characteristics of this asset class, especially the relative illiquidity, what type of investor is this not suitable for?

For most pension plans—they can live with illiquidity, unless the plan knows it is winding down and can only invest in highly liquid investments. An important factor is the vehicle: if they are investing in a fixed-term commingled fund, the secondary market is rather thin. If the investor has a separate account, we can sell all or a portion of the properties in a separate account in about a year. In this case, timberland has reasonable liquidity for a privately traded asset.

How does one typically add value to timberland holdings?

There are a variety of ways. One thing we do is manage our forests as a standalone investment, meaning that we attempt to make all the investments in forestry and tree-growing that are accretive to value and choose not to do things that aren't. So plantations may be productive, but they could be made more productive by being financially disciplined and intensive. We also attempt to generate the best prices we can for the trees we sell by trying to time timber sales according to price fluctuations supported by a proprietary view of the future. We look at timber price forecasts from third parties, but we ultimately arrive at our own view.

"One thing we do is manage our forests as a standalone investment..."

What tools do you have at your disposal to manage natural risks? Do you frequently take out insurance on fire, insects, disease, etc.?

Most of the natural risks are managed through diversification of investments. Also, there is active and intensive management of forests. These natural hazards would pose a greater risk in a natural, unmanaged environment than in the environment of a managed plantation. In the U.S. South, for instance, there are always pine beetles causing damage somewhere, but you can handle that. If you see a cluster of trees with beetle damage, you would harvest everything in a sufficient area surrounding that tree. Because the beetle needs to move from tree to tree, harvesting enough timber surrounding the infestation will stop it. We generally don't use insurance to provide protection against natural hazards. Insurance is used for catastrophic losses, and we don't expect that in our investments, so in most cases it doesn't make sense to buy insurance.

The mountain pine beetle has devastated forests in the western U.S. and Canada. In B.C., it has ruined 18 million hectares of forest. How do you mitigate this kind of risk and address the current problem? What impact will it have on the asset class?

The large bulk of the damage has been in Canada, and the infestation has moved down to the Rocky Mountain States in the U.S. But that's a secondary area for commercial timber production. The mountain pine beetle hasn't damaged forests where institutional investors hold forest land. If you look across the landscape where institutions invest, we aren't invested where you would expect those kinds of outbreaks. I don't think it has caused, or will cause, a negative reaction to timberland investing.

Harvard Management Company has been forced to address criticism levelled at the management of its timberland plantations in Argentina. For the record, Harvard Management asserts that the criticism is full of factual errors. Does this asset class attract more negative PR than others?

There is the potential for negative PR, but investing in timberland also has the potential for more positive PR than most other investments. The large majority of the environmental community views it as a positive activity, as long as timberland investment managers pay attention to a wide variety of stakeholders in the forests that we manage. We, for instance, have ongoing meetings and maintain relationships with a variety of these groups and solicit their views. We won't necessarily do everything they ask, but we listen to them, engage in a dialogue, and have developed good relationships with the environmental community. All of our lands are certified as being sustainably managed.

As this asset class continues to gain in popularity, investors will invariably look outside the U.S. for opportunities. What countries are most likely to be targeted by institutional investors?

Countries such as Australia, New Zealand, and Canada were originally targeted. Now people are looking at South America. There are some countries there, such as Chile, parts of Brazil, and Uruguay, that you could categorize as developed for timberland investments. There is also increasing interest in emerging South American countries such as Colombia. Africa has been a region of interest primarily in southern countries such as Mozambique. In Asia, some investors are currently targeting Malaysia, Indonesia, and Vietnam.

Sadiq Alladina, CFA, is a commercial real estate investment professional and a member of the Risk Management and Alternative Investments Committee of CFA Society Toronto.

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