



Timberland and Inflation

Introduction

Timberland is widely considered to be an inflation hedge. This is due to two characteristics of timberland returns:

- Timberland returns are more strongly correlated with inflation than are returns from many other assets.
- Timberland returns exceed inflation in all ten-year periods between 1987 and 2010.

High Correlation with Inflation

Timberland returns are highly correlated with inflation. Figure 1 shows the correlation coefficients for the returns from a number of asset classes (including timberland) and inflation. Over the period from 1987 to 2010, only the returns from a basket of commodities, as represented by the Goldman Sachs Commodities Index, are more strongly correlated with inflation than are timberland returns.

Timberland returns are highly correlated with inflation over many different analysis periods. This is important because correlation coefficients can change significantly when different time periods are used in the analysis. But, the correlation between timberland and inflation is almost always positive, and usually strongly positive, across any analysis period. Figure 2 shows the correlation between the two for every ten-year investment period since the NCREIF Timberland Index was published. (Ten year periods are used here because that is a common life for many investment funds.)

However, a positive correlation only tells part of the story. Most people forget that correlation coefficients measure more than just direction. Also, a positive correlation, doesn't mean that total returns are higher than inflation. To gain a more complete picture, we need to look at both correlations and total returns of timber versus inflation. Therefore, we next analyze timberland's total returns.

Returns Higher Than Inflation

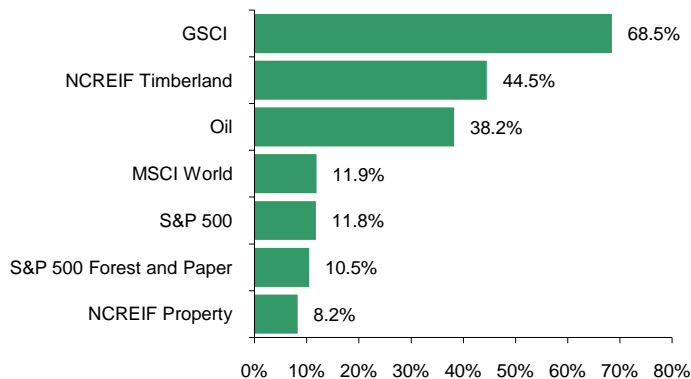
Figure 3 shows that timberland returns have exceeded inflation over every ten-year analysis period since 1987 regardless of the correlation coefficient for the period. This means timberland preserved capital during the 1990-1999 period even when the correlation was negative. Over those 10 years, the compound annual rate of inflation was 2.9 percent, while timberland produced a compound annual return of 16.4 percent.

Why Are Timberland and Inflation Correlated?

While much has been written about the positive correlation between timberland returns and inflation and how timberland can conserve capital, little has been written about *why* this is the case. In short, timberland investments conserve capital because:

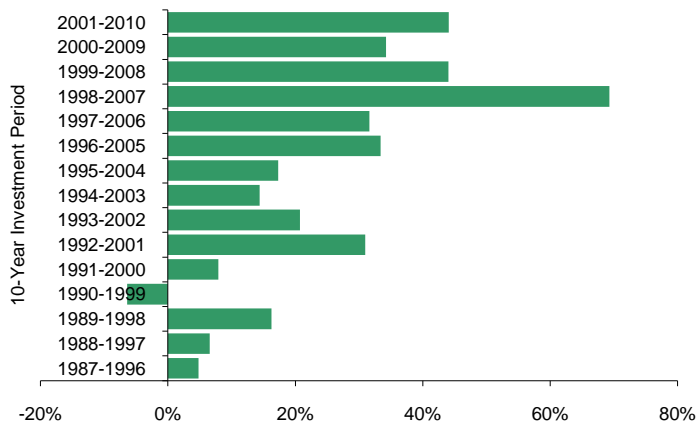
1. The values of the primary timberland components, timber and land, keep pace with or exceed the inflation rate over the long term.
2. The volume of timber on the investment keeps increasing.

Figure 1. Correlation of Asset Classes with Inflation, 1987-2010



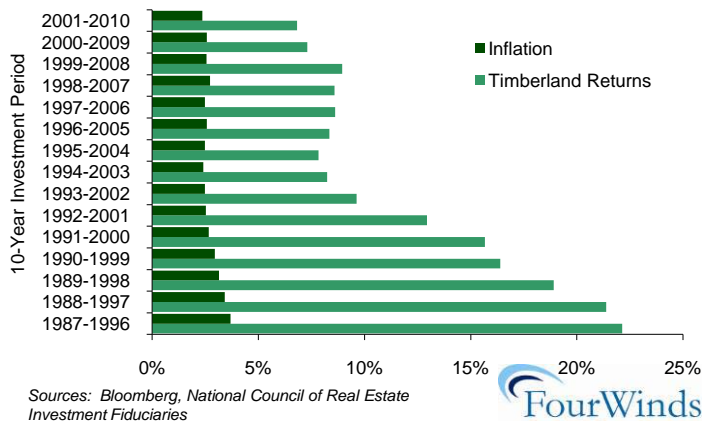
Sources: Bloomberg, National Council of Real Estate Investment Fiduciaries

Figure 2. Correlation of Timberland and Inflation Over 10-Year Investment Periods



Sources: Bloomberg, National Council of Real Estate Investment Fiduciaries

Figure 3. Timberland Returns and Inflation Over 10-Year Investment Periods



Sources: Bloomberg, National Council of Real Estate Investment Fiduciaries

Timberland and Inflation, cont.

Timberland Component Values

Timberland is a complex asset consisting of several components, including:

- Higher value timber (sawtimber)
- Lower value timber (pulpwood—including fuelwood and panel wood)
- Land
- Miscellaneous revenue sources, including
 - Development and subdivision rights (sometimes significant).
 - Mineral and oil and gas rights (not usually significant).

The components are not always highly correlated.

While each timberland component has experienced a decline in real prices from time to time, most keep pace with or exceed the inflation rate:

- Real (inflation-adjusted) land values in many countries show long-term price appreciation rates—US rural land values usually increase faster than the US rate of inflation.
- Real timber prices are often mean-reverting, which means they keep pace with inflation over time.

Timber Growth

Regardless of where timber prices and land values are going, trees grow.

- Growth can be stored on the stump, increasing the volume, and value, of the stand.
- Growth can be cut, providing income, while maintaining the volume, and value, of the stand.

Timber growth contributes to the positive correlation of timberland returns with inflation

- Timber growth can offset the effect of declining timber prices and maintain positive returns on timberland.
- Timber growth is always positive, inflation is usually positive.

Limited Application

It is important to note that the timberland data above are for a geographically diversified timberland portfolio. A timberland investment that is concentrated in a single region in the US would produce different results. Historically, the three major US investment regions (South, Pacific Northwest and Northeast) have not been perfectly correlated with each other and an investment in a single region may not hedge inflation to the same extent that a more diversified portfolio would.

The data above show US timberland returns and US inflation. US timberland investments are clearly an inflation hedge for investors subject to US inflation. However comparable data are not available for most of the world -- there are no published timberland returns for any other countries except the UK. The IPD UK Forestry Index is highly correlated with the NCREIF timberland index and UK and US inflation. This suggests UK or US investors would find timberland investments in either country would function as inflation hedges. The results for other investors would depend on how their inflation was correlated with US or UK inflation.

Summary

Timberland can serve as an inflation hedge. Though published data are limited, returns for geographically diversified timberland portfolios in the US are strongly correlated with inflation, and have exceeded the inflation rate over all 10-year investment periods since the NCREIF Timberland Index has been published.

Timberland provides some protection from inflation because the various components (land and timber) keep pace with, or exceed, the inflation rate over long periods of time. Tree growth can add value even during times when timber values are declining.

Figure 4. Higher Value Timber (Large Logs)



Radiata pine logs from Matariki

Figure 5. Lower Value Timber (Small Logs)



Eucalyptus destined for charcoal production from Mata Mineira

Figure 6. Land



Rural land in Uruguay on Pradera Roja



About FourWinds Capital Management

FourWinds is a specialist in global commodities and natural resources with products investing across energy, metals, agriculture, timber, water, waste, and alternative energy.

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About the Fund

Phaunos Timber Fund Limited is an LSE-listed investment fund (PTF) managed by FourWinds Capital Management. It invests in timberland and timber-related assets that enhance its timberland returns. For additional information on the fund, please visit www.PhaunosTimber.com.

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Fundamentals of Phaunos Timber Fund

Listing Date	20-Dec-2006
Shares outstanding (Ordinary)	537.1 m
C Shares converted to Ordinary Shares	08 June 2010
Latest NAV (30 June 2010, estimated)	\$1.04
Number of investments/countries/continents	11 / 9 / 6

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