

EXPERT COMMENTARY

Sustainable timberland investments offer investors traditional portfolio diversification benefits alongside new opportunities for positive impacts, say Manulife's Thomas Sarno, David Fortin and Mary Ellen Aronow



The fundamentals of sustainable forestry investing

Sustainable forestry investments can offer the opportunity to invest in natural capital strategies with competitive risk-adjusted returns, stable cash yield and capital appreciation potential. Additionally, they can provide diversification benefits when included in a multi-asset portfolio, potential inflation protection and an opportunity to diversify revenue streams and strategies to meet varied and evolving investor objectives.

These traditional investment fundamentals are augmented by the ability of sustainable forest management to create value well beyond the physical products generated by supporting global ecosystems and positively

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impacting climate, nature and people – bolstering today's compelling case for investing in timberland.

An expanding opportunity set

The first private timberland funds were launched in the mid-1980s, and institutional capital invested with timberland investment managers has grown to an estimated \$55 billion as of 2023. This compares with our latest estimate of the size of the global investable

universe of \$418 billion, indicating potential opportunities for growth in capital investment.

These institutional investments originally focused on key timber-producing regions in the US, which became cornerstone investment geographies within a globally diversified portfolio. Over the last 40-plus years, the investable universe has continued to expand internationally, supported by favorable long-term market fundamentals such as population growth, economic development and increasing urbanization driving demand growth unlocking new geographies for timberland investment.

Ecosystem benefits can expand the investable universe and support investor interest

In addition to the benefits of participating in traditional timber markets, the environmental and ecosystem benefits that have always been a feature of sustainable timberland investments are increasingly being assigned tangible value and augmenting returns.

Timberland naturally sequesters carbon and serves as a natural climate solution which represent low-cost climate mitigating strategies with potential to achieve nearly 40 percent of the emissions reduction required to keep global warming below the Paris Agreement goal of less than 2.0 degrees. Timberland assets can be managed to enhance or maintain carbon stocks and provide fiber for energy-efficient and renewable products with lower associated greenhouse gases emissions, such as biofuels and cross-laminated timber.

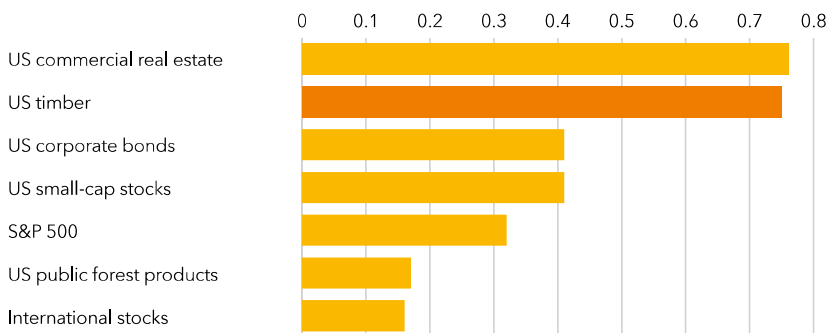
Sustainably managed timberland can also serve as the first line of defense for protecting and enhancing biodiversity, while offering gainful employment in rural areas and access to nature for health and recreational activities. These ecosystem benefits are valuable to society and the environment, and are expanding the timberland investable universe, diversifying revenue streams and have the potential to enhance returns.

A history of providing competitive risk-adjusted returns

As a long-term renewable biological asset with a diverse and expanding set of end-use markets, forests grow in volume and value over time, developing into higher-value products along with generally increasing productivity due to the implementation of new silviculture strategies and technologies.

Timber demand has trended steadily higher historically supported by providing for basic human needs including shelter and products such as tissue and packaging, in addition to renewable alternatives to petrochemical-based

Sustainable Forest Investments have generated competitive risk-adjusted returns (1999-2023) (Sharpe ratio)



The 25-year average return of US Treasury bills was used as the risk-free rate to calculate Sharpe ratios. Source: Macrobond, NCREIF, Bloomberg, Manulife Investment Management research as of December 31, 2023

products like plastics and synthetic textiles. However, as a biological asset, timber harvesting can also be deferred and value allowed to grow ‘on the stump’ when markets are weak.

These biological characteristics and sound demand fundamentals underpin timberland’s historical ability to potentially generate competitive risk-adjusted returns. Timberland is a total return investment, historically supported by relatively stable cash yields coupled with associated capital appreciation, which can align well with the long-term liabilities of institutional investors.

Over the past 25 years, timberland has delivered returns comparable with public equities with much lower associated volatility. This has enabled timberland investments to generate stronger risk-adjusted returns than many other major asset classes, with a Sharpe ratio double US equities and more than four times public forest products companies.

Timberland investment’s inflation-hedging potential

The historic performance of timberland investments demonstrates its ability to provide positive inflation-adjusted returns over the long term, with returns showing a moderate positive correlation with inflation over the last 25 years. This is partly due to participation in the commodity cycle through products derived from timber such as

lumber, biological characteristics that allow this asset class to grow in volume and value over time independent of the economic cycle and timber’s use for basic human needs.

This moderate longer-term correlation may understate the capability of timberland returns to provide inflation protection, especially during periods of average to high inflation. This was demonstrated as inflationary pressures accelerated in 2021-23, reaching a 40-year high in 2022, when the asset class generated strong returns bolstered by resurgent wood demand for residential construction and the growing adoption of natural capital investment strategies.

Timberland’s inverse correlation, or general independence of returns compared with typical financial investments, highlights its limited systematic risk and potential to reduce volatility and improve the risk-efficiency of a typical mixed-asset portfolio. Asset allocation decisions go beyond comparison of return and volatility. A mixed-asset portfolio seeks to select the combination of different asset classes that, given the investor’s risk tolerance, generates the optimum expected rate of return.

The role of timberland investment can be assessed by examining the correlation among rates of return for various classes of assets. In general terms, the most risk-efficient portfolio is formed by mixing assets with negative



Diversification benefits

Diversification within a timberland portfolio also proves beneficial.

Typically, diversification across geographies, forest types and forest age classes naturally leads to diversification in end-products, helps to mitigate the inherent risks within natural assets and smooths cashflows across the portfolio – all of which provide enhanced risk-adjusted returns and greater optionality for the investor.

Cash yield delivered by a portfolio of timberland properties during any given year depends in part on the maturity of the timber inventory, the harvest-timing decision of the timberland manager, opportunities for alternate land use and non-timber revenues.

As such, operating cash can be variable – yet a properly constructed diversified timberland portfolio can provide flexibility to suit the particular cash needs of individual investors. For example, portfolio cashflows can be front-loaded via the acquisition of properties with mature timber, or back-ended through properties with proportionately younger plantations.

Once timberland is acquired, harvest timing strategies can serve to smooth cashflows or increase variability in search of incremental total return. In addition, a diversified timberland portfolio helps mitigate the inherent risks associated with natural assets related to climate, weather, pests and disease, which can be further mitigated with proactive forest management.

Exposure to different regional and product demand-drivers can also boost returns and smooth risk. A timberland investment in New Zealand provides exposure to Pacific Rim markets via softwood log exports priced in US dollars, while a softwood timberland investment in Australia provides exposure to the Australian dollar and domestic markets, and low volatility cashflows due to typical long-term supply agreements with Australian sawmills. A careful mix of timberland properties of varying geographies, age classes and end-product markets expands the opportunity set, with potential to enhance returns, and help mitigate risk.

or weakly positive correlations.

The correlation between annual returns for timberland and other investments over the past 25 years demonstrates limited to negative correlation with returns of major asset classes

including public equities and bonds, and public forest products securities. While a portfolio might include indexed funds covering the forestry sector that provide exposure to forest products via investments in publicly traded forest

product companies, these may offer limited exposure to the timberland asset itself. This allows the addition of timberland to a multi-asset portfolio to potentially improve its efficient frontier and risk-adjusted return.

Meeting investor portfolio and sustainability objectives

While the traditional characteristics of timberland investment provide a sound rationale for its addition to a larger multi-asset portfolio, the evolving natural capital landscape offers opportunities to diversify revenue streams and seeks to further improve the investment case. With institutional investors increasingly seeking investments that can provide a positive impact beyond financial returns, timberland investments' proven capability to meet multiple UN Sustainable Development Goals addressing climate change, nature loss and rising inequality are increasingly sought after.

These capabilities include the ability to sequester carbon and generate natural climate solutions (carbon offsets), strategically repurpose specific parcels of larger timberland properties for alternate uses (eg, mitigation banking, conservation and renewable energy initiatives), and protect and enhance the natural environment.

This optionality is not new but is becoming more fully realized and augmenting returns. In our view, not only does this offer an opportunity to diversify and strengthen revenue streams with the ability to create individualized timberland portfolios to meet varied investor objectives, but it also attracts an expanding and more diverse set of investors and investment strategies. This could broaden demand for timberland, add liquidity to global timberland markets and enhance investment performance. ■

Thomas Sarno is global head of timberland investments at Manulife Investment Management. David Fortin is head of economic research, timberland and agriculture, and Mary Ellen Aronow is senior director, forest and carbon economics.