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Jim Rinehart: The Case For A Stronger Timberland Index: As the forest products industry exits timberland ownership, timberland investing has passed into a more mature phase.

There has been much discussion of late about the NCREIF Timberland Index (NTI) – what it actually measures, its reporting protocols, the quality of its data, even its basic usefulness. The NTI has had acknowledged weaknesses since its inception but to date there has been little apparent progress in resolving them. A recent article in ***Land Economics*** **provides opportunity to re-examine the time-honored claim that timberland provides substantive diversification when held in an institutional portfolio. Perhaps of greater importance, however, is the light that it sheds on the NTI, the industry's only public measure of timberland performance.**

A basic attribute of timberland – and a favored marketing theme – is its claim to increased portfolio efficiency when combined with other assets, i.e., it decreases portfolio volatility (risk) at a given level of return through its low correlation with stocks, bonds, and similar financial assets. On the other hand, it is also acknowledged that the appraisal process, which is the only available means to assess value in capital appreciation, tends to "smooth" apparent returns, thus understating actual volatility. In their article, Professors Bert Scholtens and Laura Spierdijk apply a statistical "un-smoothing" methodology to the NTI to approximate how performance might look if appraisal bias were removed. [1]

If one accepts that their approach to un-smoothing is appropriate (which some analysts might challenge), their conclusion is that, in fact, timberland offers substantially less diversification than the smoothed data by a factor of 10. I.e., where the smoothed data suggest an increase in excess risk-adjusted return of 10 basis points per quarter, the unsmoothed data suggest 1 bp per quarter.

Along with absolute return and inflation protection, portfolio diversification is one of the industry's "sacred cows" and one of the mainstays of the popularity of timberland. Thus the findings of Scholtens and Spierdijk beg a response from the TIMO industry. Whether or not a valid argument for a claim of diversification can be shown, this discussion itself is healthy for a maturing industry and well-ordered further discussion from managers is anticipated.

Implications for the NCREIF Timberland Index

This recent analysis is technical by its nature - as is the claim to diversification itself. The authors have acknowledged that it is based solely on NTI data and stated that they will

[1] Scholtens, Bert and Laura Spierdijk, "Does Money Grow on Trees? – The Diversification Properties of U.S. Timberland Investments", *Land Economics*, August 2010, 86 (3): 514-529 (The authors are respectively professor and associate professor, Department of Economics, Econometrics, and Finance, University of Groningen, The Netherlands.)

rerun the analysis on an alternative data set if and as soon as it comes available. Given the nature of timberland and its inherent transaction infrequency even in the most active of markets, a direct method of valuation that does not rely on appraisal is unlikely, either for the NTI or for actual investor portfolios. Smoothing of volatility is likely inherent in the asset, which makes rigorous, standardized, and monitored valuations across managers essential if investors are to have confidence in them.

With regard to the NTI, the unexpectedly low decline in 2009 year-end value has resulted in some discussion of its accuracy, even its credibility. In a world where many investors lost 50% of real estate portfolio value, a loss of only 4.75% on timberland, however classified, has not rung true. Reported timberland portfolio values for total year 2009 varied widely, from losses approaching 20% to actual gains. Many valuations were "desktop" in nature performed by managers rather than third parties, and some properties reported as "not valued" were carried forward at a most recent appraised value of distant vintage. All of these practices are legitimate under well defined circumstances, but current protocols are not standardized and definitions are blurred.

Impetus for change will have to come from investors themselves, not their managers. Yet, with management fees increasingly based on invested capital and realized return, there is some argument that frequent and costly valuations are unnecessary. This conclusion presumes that measures of performance are useful only as a fee base. In fact, such valuations, where standardized and monitored, provide a finer-grained measure of performance when compared to a regionally based index. In the end, the cost of greater rigor is unlikely to noticeably impact performance. This is not to say that performance that exceeds or falls short of an index is necessarily "good" or "bad", but it does provide a basis for investor oversight during the holding period. Further, a more disciplined index provides for better informed acquisition analysis and a better means of assessing other measures of performance, such as diversification and inflation hedge. It's not all about absolute return!

With the exit of the forest products industry from timberland ownership, timberland investing has passed into its next, more mature, phase. Without a steady pipeline of arbitrage-based ownership transfer, the asset class will be less forgiving of lax acquisition analysis and performance monitoring. The Wild, Wild West has given way to Law and Order – and to an equally important but more sedate institutional asset. Investors need a stronger timberland index.

And – how else are we to respond to Scholtens and Spierdijk?