The Rise of Farmland as an Institutional Asset Class
by Cody Dahl, Ph.D.

Most institutional investors have yet to add farmland to their portfolios. Perhaps their hesitation is attributable to a cursory understanding of the benefits of investing in farmland. In this newsletter, we analyze the returns of stocks, bonds, and farmland during various periods between 1960 and 2012 and examine the historical performance of the farmland asset class in different inflationary environments. We also introduce Danielle Harris, Investment Analyst, and Addison Taylor, Southern Region Acquisitions Manager, and congratulate members of our team on recent promotions.

Introduction

With persistently low interest rates, sovereign debt concerns, and volatile equity markets continuing to alter the investment landscape, uncertainty prevails in the markets and many institutional investors are considering putting farmland in their portfolio.

Increasing numbers of investors found their way to the farmland asset class over the past 5 years. These investors were handsomely rewarded as farmland achieved an annualized total return of 13.32 percent between 2008 and 2012 according to the NCREIF Farmland Total Return Index.
Farmland price appreciation was particularly pronounced over the period, growing at a compound annual growth rate of 5.97 percent. The strong appreciation during the past 5 years, coupled with the recent softening of some farm commodity prices, and the looming concern of rising interest rates raises the question of whether farmland can continue to deliver competitive returns.

Whether farmland will continue to generate returns that are superior to other asset classes depends upon the future performance of the global economy. Because this state is unknown, it is important for investors to evaluate farmland from a portfolio context. Two well-documented dynamics of the asset class are 1) farmland returns have low or negative correlation with traditional asset class returns, and 2) farmland returns perform well during periods of high and rising inflation. Despite the recent strong return performance the Hancock Agricultural Investment Group (HAIG) believes these two features of the farmland asset class will continue to provide value for institutional investors moving forward. The remainder of this newsletter provides more information regarding the benefits of these two attributes of the farmland asset class.

**Portfolio Diversification**

Alternative assets in general and farmland in particular may reduce the correlation of a traditional stock and bond portfolio to the stock market and possibly diminish the impact of market volatility. Farmland assets are a particularly attractive diversifier because they have a long documented history of generating returns that have low or negative correlation with traditional asset class returns.

To support this argument, we examined the relationship between farmland returns and stock and bond returns over the 53 year period between 1960 and 2012. We divide this period into three sub-periods: 1960 to 1979 (Sub-Period 1), 1980 to 1999 (Sub-Period 2), and 2000 to 2012 (Sub-Period 3). The S&P 500 total return index and the corporate bond total return index by Morningstar are used as a proxy for stock and bond returns. The Morningstar total return farmland index is used as a proxy for stock and bond returns. The Morningstar total return farmland index is used as a proxy for stock and bond returns. The Morningstar total return farmland index is used as a proxy for stock and bond returns. The NCREIF total return farmland index is used between 1991 and 2012.

Examination of the summary statistics in Figure 1) indicates the farmland index generated an annualized return of 11.1 percent with a standard deviation of 7.7 percent between 1960 and 2012. These returns were higher and relatively less volatile than both the stock and bond indices during the period. The farmland index posted higher returns than the stock and bond indices during Sub-Period 1 and Sub-Period 3, while the stock and bond indices posted higher returns than the farmland index during Sub-Period 2.

While Figure 1) portrays how the annualized returns of the farmland index changed rank during the three sub-periods, Figure 2) portrays how one feature of the index remained constant: returns from the farmland index exhibit low or negative correlation with the returns from the stock and bond indices. The farmland index had negative correlation with the bond index during every sub-period, negative correlation with the stock index during Sub-Period 1, and considerably low correlation with the stock index during Sub-Period 2 and Sub-Period 3.

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Institutional investments in farmland assets were very low during the Sub-Period 1. But, during the high inflationary environment of the 1970s, with inflation averaging 7.4 percent, farmland assets performed extraordinarily well and the farmland index posted an annualized total return of 18.9 percent, garnering the attention of investors. In Sub-Period 2, institutional investors continued to show little interest in farmland investments as the performance of the stock and bond indices posted an annualized return of 17.9 and 10.7 percent respectively, which outshone the farmland index’s return of only 5.7 percent.

In Sub-Period 3, farmland investing expanded as a meaningful component in institutional portfolios on the back of investor acceptance. As a result of the secular bear market in equities that began in 2000, annualized returns of the stock and bond indices during Sub-Period 3 were 1.7 and 9.0 percent respectively. The increase in foreign demand for U.S. agricultural products in Sub-Period 3 pushed the farmland index to an annualized total return of 13.7 percent, before fees.

Farmland assets have a proven track record of generating returns that exhibit low or negative correlation with traditional asset class returns and this section showcases the value of utilizing farmland assets as a diversifier of traditional stock and bond portfolios. A tremendous amount of risk exists in the current market. Because the future state of the economy is unknown, disciplined institutional investors should value the potential diversification benefits of the farmland asset class.

Inflation Protection

Fiscal and monetary policy-makers around the world are currently pursuing policies to combat weak economic activity and deflation. Although inflation may not pose a significant threat in the near term, an indefinite continuation of the current low inflation investment environment is by no means assured, and prudent investors are considering options to counter the potential negative impacts that would accompany a resurgence of moderate to severe price inflation.

In theory, farmland should provide a good hedge against inflation. An increase in the aggregate price of all the goods in a country essentially reduces the purchasing power of each unit of the country’s currency. If inflation erodes the relative value of the U.S. dollar, then foreign consumers can purchase relatively more U.S. agriculture products and commodity prices must rise to ration demand. Higher commodity prices can lead to higher farm income, which can potentially increase the value of farmland capital. Inflation can also reduce the real interest rate, which potentially lowers the rate at which landowners discount future farm income and effectively boosts the present value of farmland.

In reality, farmland has historically provided a good hedge against inflation. Chart 1 illustrates how farmland assets generate relatively higher returns during periods of high inflation. Additionally, Figure 3 indicates the correlation coefficient between inflation and the farmland index was 0.63 during Sub-Period 1, the sub-period posting the highest level of inflation. The correlation coefficient is less pronounced in Sub-Period 2 and Sub-Period 3, falling to 0.32 and 0.30 respectively. As a result, the correlation coefficient between 1960 and 2012 was 0.33.

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To understand why the correlation coefficient is lower during the recent sub-periods it is important to know that inflation per se does not cause farmland returns to increase or decrease. Instead, inflation is a symptom of the underlying health of the general economy. The price of food tends to rise during inflationary periods, and thus, farmland returns tend to exhibit a positive correlation with inflation. Therefore, the relatively low correlation coefficient in Sub-Period 3 is likely the results of the fact that the recent increase in demand for U.S. agricultural goods coincides with a period of relatively low inflation. For example, Graph 1 illustrates the recent strong performance of agriculture exports, particularly since 2000. The real value of agriculture exports grew at an annual rate of 6.0 percent between 2000 and 2012. The relatively low correlation coefficient of 0.30 between the farmland index and inflation in Sub-Period 3 may exist because foreign demand for U.S. agricultural products increased domestic agriculture prices during a period when muted domestic consumer demand led to generally muted domestic non-agricultural prices. The correlation coefficients in Figure 4 provide rudimentary evidence supporting the argument that food prices and non-food prices deviate from their historical relationship during Sub-Period 3. For example, the correlation coefficient between food price inflation and non-food price inflation in the U.S. during Sub-Period 3 is 0.49, which is considerably lower than the correlation coefficients of .73 and 0.86 that occur in Sub-Period 1 and Sub-Period 2, respectively.

Theory suggests the same factors that would bring about a new wave of inflation could also increase commodity prices and put additional upward pressure on farmland returns. Thus, the farmland asset class should still offer investors effective protection against inflation in the future.
Looking Ahead

The unemployment rate in the U.S. remains persistently high at 7.0 percent as the end of 2013 approaches. The Chairman of the Federal Reserve Bank, Dr. Benjamin Bernanke, and his likely successor, Dr. Janet Yellen, have reiterated the Fed’s commitment to the dual mandate of supporting employment and price stability. Dr. Bernanke and Dr. Yellen have each indicated the current state of the U.S. economy is too weak to completely reverse accommodative monetary policy. As a result of the accommodative policy, bond yields continue to remain historically low while stocks are at an unprecedented high.

The future state of the economy is unknown and so too is the future performance of agriculture assets in the U.S. However, the farmland asset class has demonstrated its ability to generate returns that have low or negative correlation with traditional asset class returns. In addition, farmland assets have historically performed well during periods of high inflation and theory suggests the asset class should continue to provide investors with a hedge against inflation. Thus, despite the recent strong performance, HAIG believes that the farmland asset class should still appeal to disciplined investors who value portfolio diversification and inflation protection.

HAIG Employee News

HAIG welcomes Danielle Harris as Investment Analyst

In October, Danielle Harris joined HAIG as Investment Analyst, Asset Management. Ms. Harris assists with asset management and investment analysis. Prior to joining Hancock Agricultural Investment Group, Ms. Harris was an analyst with John Hancock's Real Estate Finance Group. In this position, Ms. Harris was responsible for property valuation, property inspections, and assisting in the disposal of troubled assets. She holds a B.S. in Business Administration with concentrations in Finance and Accounting from Northeastern University.

Addison Taylor

Mr. Taylor is responsible for sourcing farmland investments in the Southern United States. He previously worked as the Vice President of Farm-Land Strategies in Fayetteville, Arkansas in farmland sales and acquisitions and managed approximately 3,500 acres for investors. Prior to working for Farm-Land Strategies, he worked for B. N. Word Gin Company in Arkansas where he was responsible for leasing and managing 6,000 acres in Arkansas and the Mississippi Delta area. Addison is presently a Captain in the Arkansas Army National Guard. He completed a deployment in Zabul Province, Afghanistan where he was awarded the Bronze Star for meritorious service and the Combat Action Badge. He also worked with the local Afghanistan governments to improve farming practices and agricultural infrastructure. Addison holds a B.S.A. in Agricultural Business with a concentration in Marketing and Management from the University of Arkansas. He is a member of the American Society of Farm Managers and Rural Appraisers (ASFMRA) and a graduate of the ASFMRA Leadership Institute.
HAIG Employee News

Promotions

In recognition of their individual contributions to the group, HAIG is pleased to announce the promotion of Rich Bodio to Senior Investment Analyst and Melanie Arnold to Senior Portfolio Analyst.

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