

# Briefing note

## Forestry - the answer to your Net Zero questions?

### Key messages

- Many investors are setting Net Zero ambitions and considering ways to achieve this without damaging financial returns
- Forestry is touted as the solution to all of your Net Zero challenges – low or negative emissions combined with the potential to make a return
- However, there are a wide range of factors to consider first to ensure an investment will help to achieve any ambitions

Forestry is an asset class that has largely been ignored by the vast majority of UK pension schemes. However, it is now coming to the forefront of many investors' minds as they begin to ask how they might achieve their Net Zero ambitions.

Forestry is being touted by some as the solution to all your carbon problems. Growing trees takes carbon out of the atmosphere, helping to offset the emissions elsewhere in your portfolio. Whilst doing this, you can also earn a return, making it financially more attractive than purchasing offsets. But is it that simple?

### What are forestry investments?

Forestry, or timberland, investments involve the purchase of plantations and naturally occurring forests in order to grow and harvest wood.

Investors generally own the forest, including the land it is on, entitling them to the financial returns generated from the forest, whether this is capital appreciation or income from selling forestry products, such as timber. Forest owners can also take credit for the carbon taken out of the air by the forest, given they now own that stored carbon.

### What are the returns and what drives them?

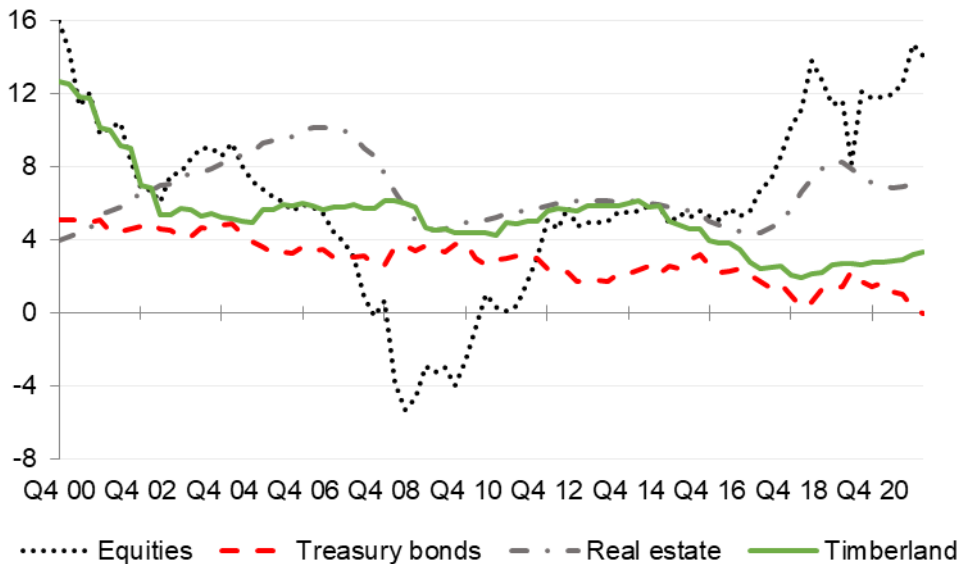
Returns from forestry are largely driven by:

- 1 **Capital appreciation from tree growth** – as trees grow, all else being equal, they become more valuable as the quality and volume of what can be produced from them increases.
- 2 **Income from the sale of forestry products** – as trees are felled and sold, this generates income for investors.
- 3 **Change in market value of the land** – the appreciation of the value of land has been a historic driver of returns for this asset class.

Forestry investments have historically provided strong diversification from traditional asset classes since trees grow regardless of financial market conditions. That said, a portion of the return on forestry is linked to the overall economy, as an expanding economy typically leads to increased demand (and prices) for timber. There is also potential for some inflation linkage, since timber prices tend to have some correlation with prices of end products featured in the calculation of the major inflation metrics. This diversification and potential inflation protection provide two attractive characteristics for investors.

The best long-term return series for the asset class is the NCREIF Timberland Index, a US-focused index that goes back to 1987. We show the real returns of this index below alongside the returns of more traditional asset classes.

**Chart 1: US assets rolling 10-year real return in \$ (% p.a.)**



Source: Refinitiv Datastream

Historic forestry has provided reasonable returns with less volatility than other return-seeking asset classes. It should be recognised that forestry's low volatility and correlation with other asset classes is reduced to an extent by the fact that forests are not subject to continuous market pricing; many of the NCREIF Timberland Index's constituents are appraised only annually.

An additional return may also be earned through the sale of carbon credits generated from ownership of the forest. However, the market for this is still in its infancy and the requirements which need to be satisfied are quite strict.

## What are the risks?

As with any investment, there are a range of financial risks. An obvious risk is in relation to the price of timber, as your investment will be worth less if timber prices are lower. However, one of the benefits of the asset class is the flexibility it can offer - when prices are low, felling can be reduced, and trees left to grow until prices rebound.

Forestry investments also face the risk of natural disasters, and there are some increased risks as a result of climate change. Most notably, some areas are seeing reduced rainfall, and other areas are experiencing too much rain. Whilst there has been an upsurge in wildfires in recent years, which could increase the risk of damage to investment value, most wildfires occur in unmanaged forests. Historically, the impact on the asset class from fire has been relatively low: institutionally managed forests have fire breaks and other measures in place to prevent the spread, have tinder regularly removed and limit use by the public; and value may be salvaged from some of the damaged wood. Insurance may also help to protect investors but comes at a cost.

Finally, there is the risk for an investor with a Net Zero ambition that the forest is not being managed in a way to sustainably capture carbon in an approved manner for the purpose of generating carbon credits, eg. growing new trees and/or a net increase in tree biomass.

## Will it help you achieve Net Zero?

A significant benefit of an investment in forestry from an emissions perspective is that it is a very low carbon-emitting asset class from a scope 1 and 2 perspective. This can form a key part of a plan to achieve a Net Zero ambition, particularly when moving assets from high emitting investments, without considering areas such as the removal of carbon from the atmosphere, or "sequestration", and carbon credits.

Having said that, the act of growing a tree sequesters and stores carbon from the atmosphere within the mass of the tree. Therefore, it makes sense that this activity should earn carbon credits for the owner of the tree. The more trees on

the Earth, and the longer they live, the more carbon is stored within the biomass of trees, and out of the atmosphere, helping to reduce the severity of climate change.

However, the question then arises of what happens to the trees. To leave them to stand would mean that carbon is trapped within the trees for the long-term; however, for an investor this challenges the main objective of any investment, making money.

There are two main sources of income return from a forestry investment:

- 1 The principal source of financial return is by felling trees and selling the timber, which can be a Net Zero-aligned solution under certain circumstances, depending on the use of the products.

If the wood is used to produce goods with long lives, such as in construction or furniture, then this will mean the carbon remains trapped within the timber, and kept out of the atmosphere, over the long-term. As long as the trees that are felled are replaced and the biomass of the forest continues to increase, the long-term sequestration of carbon can continue. The climate impact of a forestry investment will be highest where forests are enlarged or new forests are created. It's also noteworthy that older trees have a slower rate of growth than younger trees. If older trees are felled and replaced, this maximises the rate of carbon capture in the forest.

However, if the wood from the forest is instead used in products with short lives, for example being burnt as biofuel, then the carbon is being quickly returned to the atmosphere. Whilst this is generally viewed as being in conflict with Net Zero ambitions, if the biomass fuel is replacing the use of dirtier fuels, such as coal, it could be argued that it is relatively climate friendly. If an energy producer grows new trees to be burnt as their fuel, then this may be classed as being Net Zero over the long-term – they are only returning carbon to the atmosphere that they have already removed. However, the rate of carbon sequestration versus emissions will fluctuate from year to year.

- 2 Another source of income return is selling the carbon credits on an established trading platform. This is, however, currently in its infancy for institutional investors. Here, emitters of carbon are able to purchase your carbon credits to offset their own emissions. However, under this practice you would be effectively selling your claim to have reduced carbon in the atmosphere and limiting the investment's capability to assist you in achieving your Net Zero goal. There is also the secondary question of whether you are helping others to avoid decarbonising, as they are able to purchase your offsets instead. Here, there is a direct conflict between financial returns and reducing atmospheric carbon.

Whilst there is an apparent conflict between making a return on forestry and contributing to the achievement of a Net Zero ambition, the sustainable growth and felling of trees appears to strike the best balance. The opportunity of earning a return will make this option more attractive than purchasing carbon credits for many investors.

## Wider benefits of forestry investments

There are also the wider benefits that investments in forestry can have from a climate change perspective that won't fall within scope 1 and 2 emissions measures. For example, the construction industry has been identified as a key area to help the world transition to a low carbon economy, particularly its use of building materials. The increased use of timber, replacing high emission materials such as cement and steel where possible, would have a significant impact on global emissions. An investment in timberland may help to provide the supply of this material and maintain its affordability. Similarly, the felling and use of professionally managed forests reduces the need to fell natural woodland, such as rain forests.

It is also important that any forestry investment takes wider ESG issues into account, such as the impacts on waterflow and biodiversity, as well as societies in areas where new forests are being planted. The number of trees that can be grown in the world is limited and may eventually conflict with other societal priorities. The ESG credentials of the manager are important here to ensure that, by addressing carbon issues, further sustainability issues are not created further down the road.

## Summary

As pension schemes begin to grapple with how they can achieve Net Zero ambitions without impinging upon their fiduciary duty, forestry investments are an interesting opportunity. Primarily, they are relatively low-emissions assets on a scope 1 and 2 basis, which will help as a first step towards achieving any Net Zero ambitions and interim targets. If an investor's ambition is more urgent and sequestration is a requirement of an investment, to some extent the degree of carbon sequestration appears to be in conflict with the level of return you can earn.

The correct balance must be found for each individual investor. The removal of emissions from our atmosphere will take time and there are a number of risks that need to be considered and managed carefully to ensure forestry investments are genuinely helping to reduce climate change. However, the opportunity to earn positive financial return will make this a more attractive opportunity to many than the purchasing of carbon credits.



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