FARMLAND OFFERS DISTINCT OPPORTUNITY AMONG REAL ASSETS

Institutional investors have increased exposure to real assets over the last several years as the low return, low inflation backdrop has fuelled demand for alternative investments as a source of income. While most of the interest and flows have gone towards property and infrastructure investments, farmland investments have so far been underrepresented in institutional portfolios despite boasting equally, if not more, appealing characteristics.

The key characteristics investors consider when investing in real assets are their potential for return generation, low downside risk (to the extent that they are a store of value), sensitivity to inflation and diversification benefits. Evidence suggests that investors typically embark on their journey into real assets by investing in assets they are familiar with and spatially close to, such as core real estate in their domestic markets.

That strategy has been effective for investors but we believe that now is the time to consider going beyond the core to seek a greater degree of diversification and to also benefit from a unique confluence of factors that should be very supportive for farmland assets going forward.

Arnaud Gérard, CFA
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THE RETURN CASE

The secular return case for the asset class is premised on increased demand for agricultural production in an environment of constrained supply response. The demand for agricultural commodities will grow as world population continues to expand. The supply-side, however, remains constrained due to a combination of short-term limits to growth and the availability of high quality land coming under pressure as climate patterns shift and resources, water in particular, become scarcer. These dynamics will place a premium on quality land in geographies with a comparative advantage that have the ability to grow their production and investors in those regions, we believe, will be rewarded.

INCOME GENERATION

Farmland assets are also a source of consistent income, which is generated either through leasing out the property to operators or directly managing the assets. The level of income from farmland investments varies by commodity, region and operating model and a well-diversified portfolio can potentially generate an attractive annual income.

INFLATION PROTECTION

The inflation protection that farmland provides is compelling and "inexpensive" when compared to other alternatives. Whereas inflation-linked bonds may provide the most reliable hedge, the return give-up for investing in them can be substantial and possibly unjustified in today's extremely low interest rate environment, making them an "expensive" hedge. Farmland investments, on the other hand, would be expected to have a high beta (or sensitivity) to inflation due to the quick response of commodity prices to unexpected inflation albeit being less reliable than an inflation-linked bond.

DIVERSIFICATION

Adding farmland assets to a broader portfolio should have substantial diversification benefits, compared to both mainstream and other real assets. Returns for farming are impacted by factors such as the climate, demographics, trade and government policy in ways which are unique to the asset class. Furthermore, farmland investments have substantially less correlation to economic growth than other assets. This is particularly contrasted with timber investments that have a high correlation to economic performance due to the linkage with the real estate sector.

TIMING

A tactical opportunity has been created following the sustained drop in commodity prices, which has resulted in downward pressure on farmland prices in many key geographies. Strong short-term supply shocks have resulted in record grain and dairy production over the last four years putting pressure on the prices of cereals, oilseeds and dairy products. The impact has been compounded by shifts in demand coming from China, in particular. Agricultural prices as measured by the Food and Agricultural Organisation's food price index have fallen by almost 30% since 2011. Against this backdrop, the currencies of key commodity producers have also declined sharply and in many instances without an equivalent offsetting adjustment to the price of the underlying asset, providing a currency tailwind.

RESPONSIBLE INVESTING

It is important to focus on responsible investment implications in relation to farmland investments and they should be a core consideration as agricultural production is an essential resource for society. From an investment perspective, the key advantage of doing so, we believe, is to enhance performance over the long term while at the same time mitigating downside risk.

Insight believes that the best approach is to embed responsible investment considerations throughout the investment process, from the investment selection phase, through to the day-to-day management and execution. The core of Insight's approach is based on Integrated Farm Management, a dynamic framework developed by Linking Environment and Farming, which aims to provide guidelines for effectively balancing farming's key objectives of productivity and profitability with environmental and other considerations.

Institutional investors and asset managers, including Insight, have been proactively looking to formalise guidelines for investing in farmland in a global framework. The main motivation for this has been to foster greater transparency and to encourage investment in an asset class which is deemed to be of long-term interest to institutional portfolios. The effort has now been incorporated within the UN Principles of responsible investing, of which Insight is a founding signatory.

SUMMARY

The case for real assets is well understood in terms of its potential in generating returns over the long term and for its role as a good diversifier. However, the opportunity for greater diversification within real asset categories exists and farmland should play a more significant role in this respect.

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