

Diversification and Carbon Neutralization, All in One

Stockholm (HedgeNordic) – While market uncertainties loom in the bond and equity markets, institutional investors look for alternative investments with low correlation to the stock market. Meanwhile, the pressure to turn to more climate-friendly strategies is increasing, but most opportunities in the ‘ESG’ space are still in traditional long-only equity funds. Why not kill two birds with one stone and turn to the only asset class today, which offers a stable and low-correlated return, while showing a negative carbon footprint? Kari Kangas (*pictured*), fund manager of the **UB Timberland Fund** at United Bankers Asset Management, tells us why his fund can procure both.

With a doctorate in forestry economics, Kari Kangas is an expert in forestry, having worked with forests across the world, including with the United Nations in New York and Swedish pulp and paper company Stora Enso in Russia. With the UB Timberland Fund, Kangas can facilitate access to forest ownership for a larger number of people. Even those investors, who could access the asset class independently, benefit from the purchasing expertise and management experience of specialists like Kangas.

The risk-return profile of Timberland is attractive as an alternative to fixed income. Kangas estimates that the revenue from the fund’s forestland brings about four percent per year, while the price of the land is in line with inflation, which is currently around two percent.

The trends should remain fairly stable and decorrelated from the markets. Indeed, the volatility of timber prices has fallen in recent years, as the industry no longer depends on construction-driven demand. Instead, prices are supported by positive underlying demand, independently from market-driven trends. “There are several megatrends such as urbanization, demographics, consumer awareness and climate change, which all create huge opportunities and need for wood-based solutions,” Kangas explains. “For example, Finnish consulting and engineering firm Pöyry has estimated that the markets for wood-based products will increase by €200 billion, at a rate of 2.3 % p.a by 2030. We expect this strong trend to keep wood prices in real terms quite stable in the long run and the demand for timberland to exceed supply.”

From a sustainability perspective, adding trees to a portfolio is particularly effective in reducing carbon footprint, as despite modern innovation, they remain the most effective tool to capture carbon in the atmosphere and store it. However, as Kangas explains, forests need careful management to ensure longer-term carbon storage, but also a holistic approach to maintain a balanced ecosystem. “In our management, we apply ‘rational forestry’,” he says. “It means that the Fund uses all management procedures, which are covered in the Finnish Forestry Act, from even-age management to continuous-cover forestry. We select our management method for every site according to applicability and return on investment. Consequently, forest management costs in the fund are lower than on average and large-scale clear cuttings are rare.”

“We always prefer continuous-cover forestry when feasible,” Kangas continues. “It means that, in conducting our logging process, we select the largest and lower quality trees and remove them from the forests. Good quality, smaller trees have therefore more room to grow. This way, the forest will regenerate itself naturally and remain permanently covered. One positive collateral consequence is that biodiversity is higher than in traditionally managed forests and, for example, game finds more shelter as forests remain covered.”

"In the long run rational forestry and sustainable forest management increase carbon stock," Kangas says. "Forest management methods we apply aim at increasing the value growth of the forest which in effect also increase volume growth and carbon sequestration. The same idea is also built into forest certifications systems; standing stock must grow over the years. It is important to consider also lifecycle impacts. Especially wood construction is a long-term carbon sink."

Indeed, unlike products made of pulp and paper, which are likely to be burned and release carbon into the atmosphere within a relatively short timeframe, the wood used for construction will continue to store carbon, possibly over several decades. "The proportion of logs versus pulpwood is roughly 60/40. In 'rational forestry, we aim at maximizing log production. Most of the logs are used in the construction industry, nowadays also in multi-storey houses," says Kangas.

"During the past few years, there has been rising political will to enhance wooden multi-storey construction for example by modifying building regulations and, more generally, through promotion campaigns and policies favoring the use of wood. Technological and product advances such as cross-laminated timber CLT and laminated veneer lumber LVL have, together with fire-resistant substances, facilitated a renaissance of wood construction and enabled taller and taller buildings. The world's highest wooden building is under construction in Norway. With 18 storeys and 80 meters high it will bypass the 53 meters tall building in Vancouver, which held the record until now."

Kangas also points out that the pulp & paper industry has moved to much more sustainable processes and is now part of an important value chain that contributes to climate-friendly consumption. "New pulp and paper mills are less polluting than ever before," says Kangas. "For example, the new Metsä Group factory in Äänekoski, the largest forest industry investment in Northern hemisphere, is called bio product mill. It reflects a new thinking, where side-products are also processed on site. For example, a sulfuric acid plant has a high environmental impact, as it can significantly reduce sodium and sulphate emissions."

Packaging, in particular, is an area where pulp & paper products can help the environment. "Keep in mind that wood-based packaging reduces the use of plastic. Proper recycling is important, however. Packaging materials can be reused several times before burning if sorted and recycled," says Kangas. "Wood-based innovations are becoming delightfully frequent. Scientists and industry are searching for solutions to substitute non-renewable materials with sustainable ones.

National and international regulations to reduce plastic waste are promoting this development. Innovations replacing plastic will penetrate markets in a larger scale in 2020. For example, plastic-free paper cups are already about to reach industrial scale. Wood-based textiles are expected to be a big trend too in the future."

Wood, of course, also has the potential to answer the need for renewable energy, to some extent. "Wood residues are already used for energy production in combined heat and power plants and roundwood is used commonly in households for heating purposes. However, and according to the cascading use of wood, roundwood should be prioritized on value-adding non-fuel uses, re-used and recycled and finally burned for energy," Kangas adds.

For the manager of the UB Timberland fund, pursuing sustainable targets isn't so much an issue, as it is to find the right properties to add to his portfolio. "Finding suitable deals is the most challenging part of this job," he says. "We don't compromise our return targets. We aim at providing our investors a good night sleep. Decent sleep is definitely one of the benefits of this job."