

Back to the Land

Direct ownership of farms and forests can offer the rare opportunity to protect against inflation and provide more income—all while you *literally* watch your assets grow.

As investments go, farmland and forests seem almost feudal, a throwback to agrarian economies of yore, when wealth was measured not by digits on a financial statement but by the scope of hereditary domain. Yet since the onset of the financial crisis, more and more investors worldwide have been drawn to arable land and forests. “We’ve seen a huge pickup in interest from clients looking for more information on land with crop and timber production,” says Christopher J. Wolfe, chief investment officer for the Private Banking and Investment Group at Merrill Lynch Wealth Management. One reason: straight economics. Farm prices in particular have skyrocketed as global demand for food, a series of weather-related production shortfalls, and the siphoning off of certain crops for biofuels pushed such staples as corn and soybeans to record highs. With commodity prices putting pressure on the prices of other goods and services, owning farm and timberland serves as a natural bulwark against inflation. It also provides portfolio diversification at a time when managing risk and exposure in core stock and bond holdings are at the front of many investors’ minds.

But there’s something more personal at work as well. After the global financial crisis and the recession, many investors are looking for more simplicity and clarity in their investments. “Some clients just want something that’s not so

exotic they can’t understand how it works,” says Dennis Moon, head of the Specialty Asset Management team at U.S. Trust, which manages farm and timberland holdings for ultra-high-net-worth clients. “They like real assets because you can actually see and touch them.” It’s the psychological benefit of land ownership, says Wolfe: “For some of our clients, land represents a mental-accounting safety zone.”

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—Dennis Moon, Head of the Specialty Asset Management team at U.S. Trust

A Varied Landscape of Opportunities

There are a variety of ways for investors to gain exposure to the resources produced by hard assets like farmland and timber. Many of them are indirect financial instruments, such as shares of agricultural companies, commodities futures, exchange-traded funds that track commodities indexes, and timberland REITs. All offer more liquidity and considerably lower barriers to entry than buying actual land.

Still, there are important benefits that come only with a direct investment. Farmland, for example, potentially provides investors with an annual income stream, usually through lease payments from tenant farmers. Timberland, meanwhile, offers

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one of the world's most efficient engines for appreciation: The trees literally grow in value each year, more or less on their own.

Moreover, a direct investment in farms or timberland has an intrinsic value that insulates it to a degree from the more extreme movements of the financial markets. It's the same aspect that attracts many investors to bullion or museum-quality art: Regardless of how markets perform, the physical article itself remains something that people treasure and have use for. "These days, clients want capital preservation as much as they want capital appreciation," says Moon, "and land has always been a very solid preservation vehicle."

Like any alternative investment, of course, a direct investment in farm and timberland carries some unique risks. Chief among them is liquidity. Property doesn't go on the market all that often, and finding buyers—or fairly priced sale opportunities, for that matter—can depend heavily on your network in a given geographical area. And while farms and timberland have a low correlation with equities, they do correlate somewhat more closely with the prices of the commodities they produce. For all these reasons, most advisors view farm and timberland as the ultimate in long-term, buy-and-hold investments. Wolfe and Moon recommend that investors think in terms of at least 10 years. Buyers should keep that in mind when considering the up-front commitment required for a direct farm or timberland purchase: A good minimum investment, says Moon, is \$5 million, an amount that allows for the acquisition of more than one tract of land and helps diversify across geographical areas and crop types or tree species.

Down on the Farm—With Steady Returns

The recent run-up in farm prices has sparked a debate among agriculture professionals about whether an asset bubble has formed. As early as last October, Sheila Bair, the outgoing chair of the Federal Deposit Insurance Corporation, warned of overheated farmland values, citing statistics that showed a 58% jump in prices from levels reported in 2000. This past spring, the president of the Kansas City Federal Reserve Bank, Tom Hoenig, cautioned that any significant rise in interest rates could slice land values by a third.

And yet if you believe in megatrends, even a price drop of that magnitude could be a relatively short-term hiccup. The world's population is increasing by 210,000 people a day, and rapidly expanding middle classes in emerging economies like China and India are boosting demand for new crop varieties from an ever-shrinking supply of arable land. It's become almost axiomatic, say the bulls, that farm prices will move higher over the long haul, albeit more slowly than during the last 12 to 15 months. Experience over the previous two decades would certainly seem to support that conclusion: Farm values in the U.S. have appreciated enough to beat the S&P 500 on an average basis for the past 20 years.

To make a direct investment in farmland, Merrill Lynch Wealth Management clients and their Financial Advisors can partner with Moon's Specialty Asset Management team at U.S. Trust, a Bank of America company. The staff sources lands, places bids, inks deals and helps manage the properties inside a client's portfolio. Just in January, for example, Moon and his farm and ranch manager were flying in a helicopter over a vast sugarcane plantation in South Florida, surveying the tract for potential investment.

One of the main objectives in building farmland exposure for clients, Moon says, is achieving crop diversity. Farmland is often broken into two categories: row crops (vegetable staples

Striking Oil

How to Put Rising Energy Prices to Work for You

Oil surged to the forefront of investors' minds once again this past spring, when political turmoil in the Middle East and the disaster at Japan's Fukushima nuclear plant put extra pressure on crude prices. Though fears of a double-dip recession have since gripped the markets, pushing benchmark crude prices below \$90 a barrel, the bullish long-term trends for energy remain unimpaired, with demand growth spurred by emerging economies expected to outstrip available oil supply eventually. Natural gas, too, has drawn intense investor attention, as the Appalachian shale-gas boom promises to quicken the transformation of this fossil fuel into a viable alternative to oil.

All of which would seem to make the case for investing in another land-linked category of real assets: oil and gas leases.

The problem is, there is no easy way for even most affluent investors to invest directly in oil and gas properties, which are extremely risky and fraught with liability. Limited partnerships (many of which are traded in Canada and sometimes classified as royalty trusts) spread the risk among professional wildcatters and groups of investors, but they're comparatively rare. More common are master limited partnerships (MLPs) in energy-production infrastructure—natural gas pipelines, for example.

Investors do have indirect ways of gaining exposure to oil and gas, including energy futures, exchange-traded funds and structured notes, in addition to traditional stocks in companies engaged in the various stages of production. Clients looking to hedge the risks and capture opportunities associated with today's volatile oil prices should talk with their Financial Advisors about which of these asset categories may make the most sense for their portfolios.

like corn and soybeans) and permanent crops (fruit and nut orchards in places like California's Central Valley). Ranchland, which might be thought of as another category, is really a different kind of investment altogether because of the more tenuous economics associated with ranching and the fact that, these days, ranchland is seen mostly as a real estate play by buyers who use the properties chiefly for recreation. Recently, Moon's team received a \$25 million mandate from a client in the Northeast wanting real asset exposure. Moon created a "blended" portfolio of timberland and farmland, breaking it down further by acquiring potato fields in Washington State, rice fields in Arkansas and corn acreage in Iowa.

While in some cases landowners form cooperatives with farmers, sharing in both the profits and the risk of raising crops, it's much more common for owners to lease back the land. The Florida sugarcane plantation that Moon recently looked at, for example, covered some 200,000 acres and included its own refineries and production facilities. Moon would likely never suggest buying the whole operation, but rather just a small portion—say, 1,500 acres—and then lease it to the professional operators for a set fee.

That sort of leaseback income has produced an average annual after-expenses return of 5% to 6% over the past few years, says Moon. Leases typically last three years, often with built-in escalations, and rarely if ever is there an issue of default. "We do a lot of upfront due diligence on the farmer," he says.

Seeing the Forest For the Trees

Because trees take years to reach maturity, timber doesn't provide the regular income potential of, say, sorghum or beets. Unless you have mature trees that can be harvested on an opportunistic basis, it's more about capital appreciation. "As long as you have the proper forestry practices in place,

trees are going to generate a biological return on an annual basis," says Moon. As the diameter of its trunk expands, the tree grows in value—by as much as 8% a year, depending on the species—and that, in a nutshell, is the inherent inflation hedge of a timber tract. "You're creating more inventory off the same plot of land," says Jim Bowden, managing director at Bank of America's Alternative Investment Group in Boston. "That is a key element of its return profile."

In the U.S., harvestable forests exist in four main regions or wood basins. By far the largest is the Southeast, whose pine plantations produce wood for everything from paper products to two-by-fours. Next are those of New England and Upstate New York, which boast the high-priced hardwoods used in furniture making, followed by the Pacific Northwest and the Great Lakes.

As with farmland, savvy investors diversify their portfolios as much as possible between the basins. They also strive to buy stands of varying ages. When the time comes to harvest, the manager of the property typically conducts a sealed bid process, and the highest bidder—usually a lumber company or mill—buys the right to cut the trees within a set time frame, which can be as long as a year or two. In any case, the tax implications are favorable, with money from the sale of hewed timber taxed at the lower capital gains rate, not income.

Of course, timber is inextricably tied to the housing market. For that reason, and unlike farmland, both lumber prices and timberland values remain below historical norms. That, to some observers, is a bullish signal. "It could be a buying opportunity," says Moon. Prices for wood products can fluctuate like any commodity, but part of the beauty of owning timberland is that owners have the option of waiting out the down cycles until prices recover. "You don't have to cut it," says Moon. "You can just continue to watch it grow."

Diversification does not ensure a profit or protect against loss in declining markets.

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