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Market Barometer	Total Return YTD % Change <sup>1</sup>
Wilshire 5000 Index (Entire market)	12.6
S&P 500 Index (Large-caps)	10.9
Lehman Aggregate Bond Index (Broad taxable market)	4.3
10-Year Treasury Note	5.1
NCREIF Farmland Index	18.1
Inflation <sup>2</sup>	3.3

<sup>1</sup>Through 12/31/04; <sup>2</sup>Consumer Price Index, seasonally adjusted annual rate through 12/31/04. Sources: Bureau of Labor Statistics, Lehman Brothers, National Council of Real Estate Investment Fiduciaries, Ryan Labs, Wilshire Associates

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## Month in Review

● **Iowa farmland values sprout new high.** Low interest rates, record farm income and strong investment demand combined to lift the average value of Iowa farmland 15.6% last year. *Page 2*

● **Asian soybean rust expands.** Asian soybean rust has now been confirmed in nine states since its initial discovery in Louisiana in November. Soybean production in northern regions could be attractive. *Page 2*

● **Peak play?** Pension funds are back plowing hundreds of millions of dollars into farmland. Is this smart money moving in, or an ill-timed chase into an overheated market? *Page 3*

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● **Interest rate watch.** The Federal Reserve's target for short-term interest rates could reach 3.75% by year-end. If long-term rates move up similarly, land appreciation will slow. *Page 6*

● **Farm program perils.** Agricultural subsidies will be a prime target for Congressional budget cutters. Commodity program cuts will put pressure on land rents and land values. *Page 6*

● **Databank.** Farm income and land values remain especially strong in the Corn Belt. But hints of softness emerge in the West. *Page 7*

# Iowa Farmland Values Sprout New High

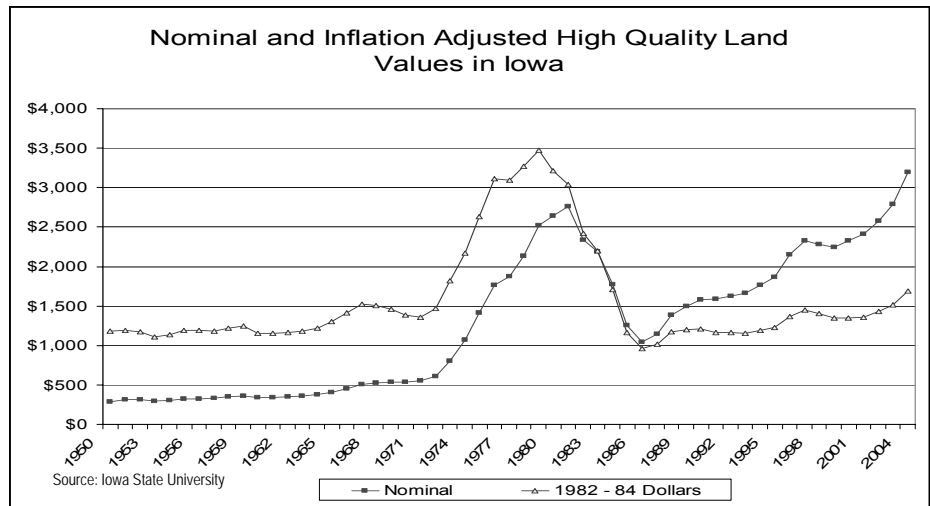
**L**ow interest rates, record farm income and strong investment demand combined to lift the average value of Iowa farmland 15.6% to \$2,629 per acre last year. That's the second year in a row prices have set a new high, according to Iowa State University, which surveyed real estate brokers and other individuals in November.

The strength in land prices was widespread across the state. All nine crop districts reported more than 10% gains in average land values.

Robust demand for ground showed no signs of easing. Indeed, survey respondents indicated that the land market appeared to be gaining strength throughout the year. In Scott County, farm ground averaged \$4,167 per acre—the first time a county average has exceeded \$4,000.

Existing farmers represented 56% of last year's sales. Farmer purchases were strongest in west central Iowa. Investor purchases made up 38% of land sales statewide and dominated transactions in the south-central region. Investors showed the least activity in the southeast Iowa.

Still, the price run up is well within the range of historic Iowa land values on an inflation-adjusted basis. Last fall's average value of \$2,629 is comparable to the inflation-adjusted value of land in 1973, the first year of the rapid rise of land values in the



1970s, according to the survey.

But there are storm clouds on the horizon. The biggest risk to Midwest farmland values is uncertainty over the future of government farm programs. Michael Duffy an extension economist at Iowa State University figures that 46% of the value of Iowa farmland can be attributed to government payouts.

Mr. Duffy predicts the U.S. will lose its appeal of the World Trade Organization's preliminary ruling that the U.S. cotton subsidy program violates international trade rules. "If cotton goes, then corn won't be far behind," he warns.

There will also be efforts to block extension of the Conservation Reserve program beyond 2007. The \$1.7 billion program provides annual rent and maintenance payments to farm owners

to idle 34.7 million acres of environmentally sensitive land.

In the near-term, the Iowa land market still appears to have upward momentum. "If we have a round of inflation to help finance the federal deficit, then I don't think we are at a top yet," observes Mr. Duffy. "If we have a clamping down and an increase in interest rates, then land will be under some pressure."

Almost half of Iowa survey respondents identified low interest rates as a factor bolstering land prices.

"If those rates start rising, even 1031 [tax-free exchange] money, won't be coming into agriculture," he cautions. ■

*Access the full report online at [www.extension.iastate.edu/agdm](http://www.extension.iastate.edu/agdm)*

## Asian Soybean Rust Expands

**A**sian soybean rust—a wind-borne fungus that reduces yield—has been confirmed near Memphis, Tenn. and in eight other states since its initial discovery in Louisiana in November.

Other states include Alabama, Arkansas, Florida, Georgia, Mississippi, Missouri and South Carolina.

Though Asian rust's effect on this year's crop remains uncertain, an in-

festation could cost U.S. soybean growers an estimated \$416 million to \$845 million in the first year, according to the USDA Economic Research Service.

Fungicide treatments to combat Asian rust average \$25 per acre, and can result in anywhere from a 1% increase to a 9.5% decrease in normal crop yields.

Scientists predict that the Eastern U.S. will be more susceptible to rust infestation because of temperature, relative humidity, and rainfall during the growing season.

Most soybean production occurs along the Mississippi River and the Corn Belt and Northern Plains, where climate is less supportive of infestation.

With beginning 2004/05 soybean stocks at their lowest level since 1977, Asian rust could make soybean production in northern regions attractive. ■

# Peak Play?

Pension funds are back plowing hundreds of millions of dollars into farmland. Is this smart money moving in, or an ill-timed entry into an overheated market?

Last month, Alaska's \$12.5-billion State Pension Investment Board bought the first parcel in a new \$200-million push into row crop and orchard investments. Alaska paid about \$1.7 million for a 1,200-acre row crop farm in Leflore County, Miss.

If the board's initial investments meet expectations, Alaska could eventually allocate 5% of its pension assets—or more than \$600 million—to farmland investments.

Further south, California Public Employees' Retirement System—the country's biggest pension fund at \$172 billion in assets—is investing \$200 million to buy pasture and other raw farm land in California, Washington and Oregon to develop into high-end wine vineyards.

In the Midwest, officials at the Illinois State Board of Investments are considering whether to boost their \$32 million of orchard and vineyard holdings by expanding into row crop land.

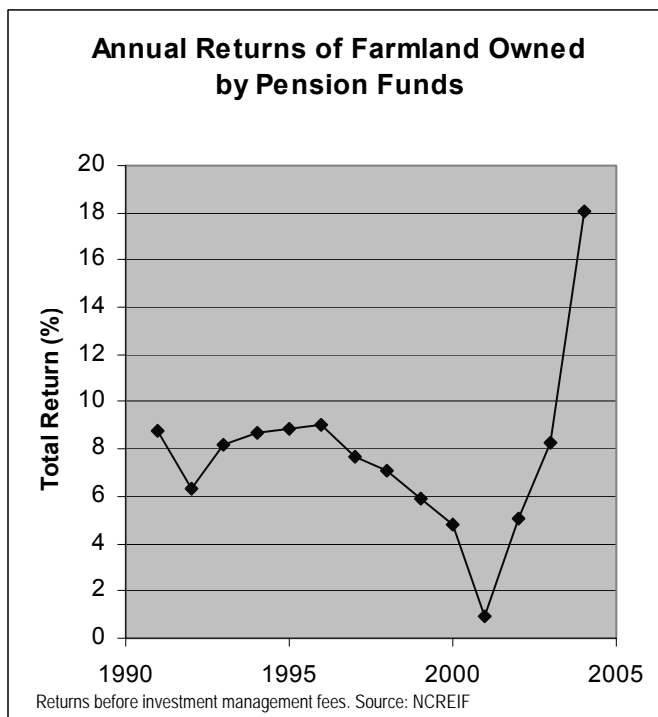
“Since 2000, everybody is much more pessimistic about stocks and bonds,” says William Atwood, executive director of the Illinois State Board of Investments. “So the question is where are we going to get our portfolio returns?”

After stagnating in the late 1990s, pension funds are back planting their money in farm ground. But their return comes at a time when land values are on a tear: Farmland held by pension funds generated an 18.1% return last year before investment fees, according to the National Council of Real Estate Investment Fiduciaries in Chicago. That's the best annual performance since NCREIF began tracking the farmland sector in 1990, and a full 5½ percentage points ahead of the broad stock market's performance last year.

The question for investors is whether the record prices in many parts of the country represent a new plateau, or are a sign of an overheated market.

Uncertainty over this issue hasn't damped the enthusiasm of investment managers. UBS AgriVest of Hartford, Conn.—which is co-managing Alaska's \$200 million agriculture allocation with Hancock Agricultural Investment Group—hopes to begin soliciting investors for a new \$100-million private real estate investment trust by midyear. “This will allow smaller pension funds that don't have \$200 million to invest in farmland to co-mingle their funds in an open-end fund,” says CEO Brian Webb.

Pension funds remain minor players in the overall farmland market. Their \$995 million in farm holdings represents just 0.25% of the estimated \$400 billion of institutional quality U.S. farmland. Still, their new allocations are likely to exert upward pressure on land prices in Calif., as well as the Southeast, Delta and Corn Belt states—all historically favored by such investors. Still, most individual investors aren't likely to find themselves bidding against institutions.



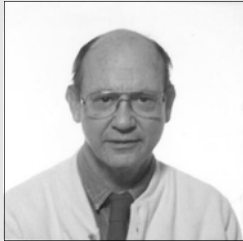
The average value of a farm property owned by a pension fund is \$3.1 million, according to NCREIF.

Institutional managers believe they can steer clear of overheated regions by monitoring local markets nationwide. For example, Mr. Webb says his firm isn't currently buying Midwest land for clients because it can't generate the 5% to 6% annual income returns he expects on cropland. But some pension funds are staying on the sidelines after studying the market. “We concluded that even though farmland prices had gotten high like the rest of real estate, there wasn't the mispricing that we had hoped was

there,” says Kevin Martin, a senior analyst at the Ohio Public Employees Retirement System.

To be sure, experienced institutions have continued

*(Continued on page 5)*



## New Buyer on the Block

Manager Michael Oliver explains what's driving the Alaska State Pension Investment Board's move into farmland.

**H**ow did the Alaska State Pension Investment Board become interested in farmland?

When I arrived in 2000, the board basically invested in domestic and international stocks, a little real estate, and had just begun their private equity program. Between 2000 and 2002, the stock markets got hammered. It became clear that we needed to get more diversification into our portfolios. So we embarked on a program to diversify, reduce volatility and increase returns over time. Our work on agriculture suggested that it is one of the industries most closely tied to inflation and that over a period of time, could provide a 5% real return over inflation. In addition, the correlations between the returns in farmland and the returns in stocks and bonds are very low. So if you want to diversify a portfolio, farmland is a very good diversifier.

*You're initially investing \$200 million in farmland. Do you expect to go higher?*

This is just to get our feet wet -- to see how long it will take us to get into the investments and what are the other opportunities. If we are happy with what we see, we will increase that allocation. Typically our consultants tell us that if you are not going to be 5% in a segment, you might as well not do it.

*Farmland values have risen sharply in the last two years. Are you concerned you might be buying in at a market top?*

Yes. But as a large pension fund that has cash coming in every day, we can't market time. So we practice dollar-cost averaging. We will be buying over the next two, three or perhaps the next 10 years. So on average, we will do very well. But there will be times that we are paying premium prices, and times we are paying discount prices. There are some places where farmland is expensive and other places where it is not. We'll be looking to our advisers who are experts in those areas to make those decisions.

*How will you decide whether to increase your investment?*

We will probably start talking about it again in a year and a half. We studied this almost for a year before deciding to invest in agriculture. But frankly, we are still learning. We need experience to figure out how many and what kind of deals we can expect to close in a given time period. We are looking to invest 90% in row crop land and 10% in permanent crop land. Maybe we will have to go 80/20. We also have questions about what is going to happen in the world economy and the impact on agriculture.

*What's unique about this sector for institutional investors?*

Over the last 30 years, farmland has produced only three years of negative total returns. There is no other asset class you could say that about. Clearly there are risks such as a crop failure and natural disasters. Permanent crops are subject to swings in consumer preferences. Two or three years ago, people suddenly stopped eating Red Delicious apples and the market disappeared. Red Delicious growers did terrible. Some things you really can't anticipate. We mitigate that risk as best we can by leasing the farms. We give up some of the upside, but we think that is the best strategy because we are risk averse.

*Is the market for buying and selling farmland efficient?*

First, it's a very local business. The most logical buyer for your farm is your neighbor. And your neighbor knows damn well what you are planting on it and what the costs are. In row crops, you are talking about 5% to 6% expected returns on leases. That is not a big number, and would indicate that it is a very efficient market. There really are no steals.

*How do management fees for agricultural land compare to other types of real estate?*

Farm managers generally charge 5% of the farm's revenues. As for other kinds of real estate, apartment management expenses are 3.5% to 5%; industrial properties cost 1% to 2%; office building and retail properties typically cost 5% to 6%. So farmland is within the average. ■

(Continued from page 3)

buying into the market. The Mormon Church—considered the country's biggest institutional investor in farmland—purchased 88,000 acres of farmland in western Nebraska last September. The \$17.6 million purchase was the Church's biggest addition to its estimated \$5-billion-plus farm and ranch portfolio in recent years.

The Alaska State Pension Investment Board and CalPERS are clearly sophisticated investors who have studied the market.

But they would do well to consider the experience of the Florida Board of Administration, which began buying farms in 1992 and has been one of the biggest players in the sector. Two years ago, the state's pension fund managers decided to begin exiting the sector because they couldn't put enough money to work.

"Farms typically are smaller valued assets and it wasn't productive for us to get the monies out that we needed to," says Doug Bennett, senior investment officer for real estate at the Florida Board of Administration. "We decided we could better meet our needs by devoting our attention to commercial properties."

Florida has earned an average annual 5.6% net return on its farm investments for the 10 years through December 2004. The pension fund currently owns 85,000 acres of row crop and orchard land worth \$214 million, managed by Prudential Agricultural Group and Hancock.

The Pennsylvania Public School Employees' Retirement System is also liquidating its farmland investments as part of a general portfolio-wide retreat from direct investments. The pension group's two portfolios of farmland generated inception-to-date net total returns of 6.2% and 6.3% through December, 2003. A spokeswoman for the group declined to provide more recent performance data.

Teachers Retirement System of the State of Illinois,

another big farmland investor with 48,085 acres worth \$270 million, is also uncertain whether it will invest beyond its current commitment to the sector. "Our whole portfolio theory is diversification," says Mike Bartletti, director of real estate investments. "We are about half way into the investment and the jury is still out as to whether it has been something we would do again."

About two-thirds of the Illinois teachers' farmland investments are in so-call "permanent" crops, including almonds, citrus, apples and wine grapes.

For the five years through December, their farmland portfolio has earned an average 4.1% annual net return—reflecting the higher capital costs of establishing the plantings.

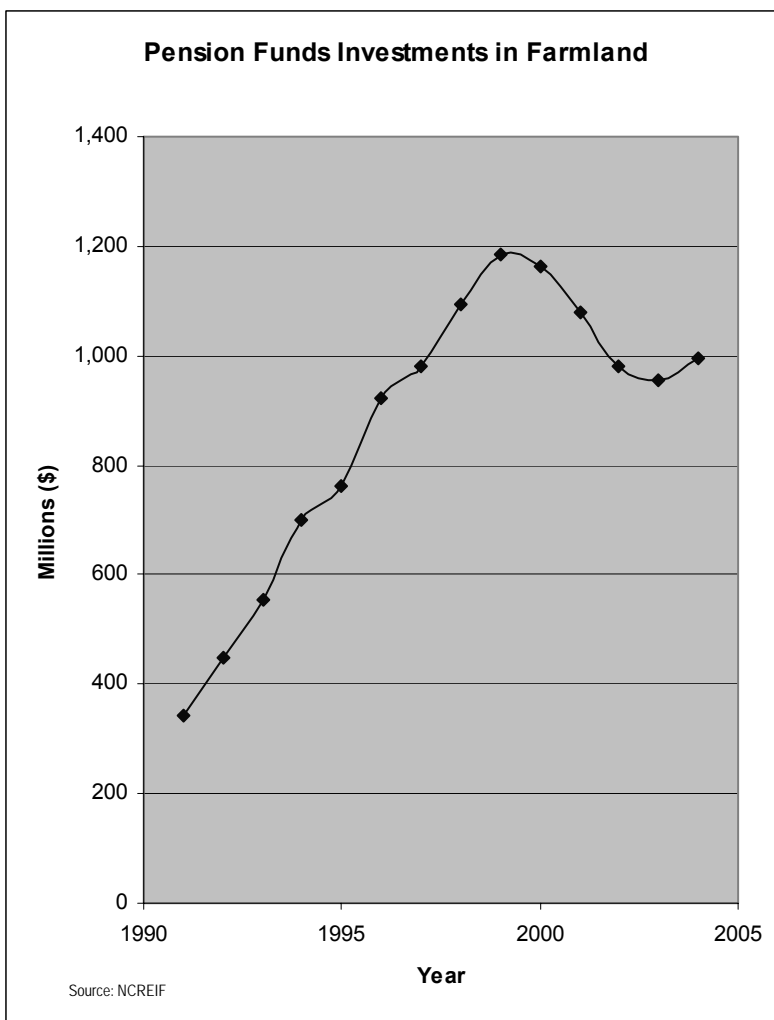
Alaska aims to earn a 5% real return over inflation, says Michael Oliver, investment officer for real estate and private equity.

Other institutions have much loftier goals. Premier Pacific Vineyards of Napa, Calif., the investment firm overseeing California Public Employees' Retirement System agricultural investments, predicts CalPERS average annual returns will exceed 15% when its vineyards are sold in four to six years. Internally, CalPERS aims to achieve a minimum 6.5% real rate of return after fees.

Alaska hopes to limit its financial exposure to crop failures, commodity price swings

and other production risks by leasing its farms. The risks of crop maladies are real: In 2002, the Illinois Teachers Retirement System was forced to destroy 1,940 orange trees on 13 acres when a central Florida grove became infected with citrus canker, a highly contagious disease that causes premature fruit drop.

But leases carry their own risks, especially on orchards and vineyards. "If the tenants don't take care of the trees," says Mr. Bennett of Florida, "you can be in big trouble." ■



After peaking at \$1.2 billion in 1999, pension fund investments in farmland languished through 2003, ending the year at \$953 million. Investment outflows followed shrinking farmland returns that slipped to 0.94% before investment fees in 2001.

## Competition for Indiana Land Spawns Dubious Ploy

**N**ear the close of last year, we visited southwest Indiana's Gibson County—a 30-minute drive north of Evansville and the grain terminal elevators along the Ohio River.

When the talk turned to land, farmers were shaking their heads over the recent auction of a 102.5-acre farm located three miles west of Haubstadt on SR 68.

The land was offered in 16 tracts, and included a 1,600-square-foot brick home, and a microwave tower with \$4,977 in annual lease income. The farm has road frontage on three sides.

One day before the farm's second public showing on Dec. 1, a farmer across the road erected two signs proclaiming "Coming Soon, Southwestern Indiana's Largest Swine Producer. Completion in 2005."

Most people discounted the signs since no building permits had been filed, says auctioneer Trent Sohn, of Sohn & Associates Ltd., who oversaw the sale.

Locals anticipated strong demand, despite the apparent ploy. "A lot of farmers had a good year last year and are actively looking for ground," says Mr. Sohn. "Demand is strong both from farmers and developers."

When the four-hour auction ended, a son of the neighboring farmer who had erected the swine building signs had bought the entire farm for \$1.056 million or \$10,302 per acre. Though not confirmed, locals report that the son had been knowingly bidding against his father.

More recently, Mr. Sohn reports he sold a 40-acre farm 25 miles northwest of Haubstadt for \$3,250 per acre. That farm is in a floodway and can't be developed.

But competition for agricultural land is intense throughout the region. In neighboring Posey County, a local farmer recently leased a 500-plus acre patchwork of fields scattered between Poseyville and New Harmony for \$205 per acre.

Many of the fields are small, 20-acre highly erodible pieces, making them inefficient to farm. The land had previously been rented on shares, and fertility levels had not been maintained because the landowner refused to help cover fertilizer costs, according to a local source. The farmer agreed to a three-year lease to secure the ground.

Is this the new floor for striking Posey County area lease agreements? Stay tuned. ■

## Quarter-Point Hikes Continue

**I**n raising its target for short-term interest rates another quarter of a percentage point earlier this month, the Federal Reserve Board signaled it plans to continue gradually increasing rates through the year.

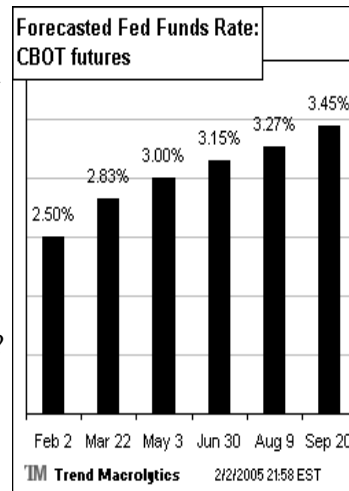
This latest increase lifts the federal funds rate to 2.5% and is the sixth quarter-point boost since the Fed began raising rates in June.

Investors expect the funds rate to rise to 2.75% at the Fed's March 22 meeting, to 3% on May 3, and to perhaps 3.75% by year end.

What do rising rates mean for real estate prices? To the degree that rates go up in 30-year mortgages and in 15-year mortgages, and now even in five-year and three-year mortgages

because the yield curve has flattened so much, you are going to see less fuel for run-ups in housing prices, notes W. Scott Simon, a managing director at Pacific Investment Management Co.

Expect a similar scenario to play out in the farmland market. Real estate prices will probably continue to go up through the beginning of 2005, but Mr. Simon thinks that appreciation will slow and eventually go to zero. Some of the really high-priced outliers in parts of the country will likely go down, but it is hard to know when, he adds. ■



## Subsidy Cuts Would Pressure Rents & Land Values

**A**gricultural subsidy programs are expected to be a prime target when the Senate Budget Committee sits down to attack the ballooning federal budget deficit.

"Farm groups are working both to forestall cuts to farm programs and to figure out where cuts should be made if they are inevitable," notes Bruce Babcock, professor of economics at Iowa State University.

Farmland owners will bear the brunt of cuts to commodity programs through a decline in land rents and land prices, predicts Mr. Babcock. ■

## Farm Income and Land Values Remain Strong, But Hints of Softness Emerge

Economic activity continued to expand from late November through early January, according to the Federal Reserve Board's latest Beige Book report.

Agricultural prices were generally higher. The Chicago district reported that net farm income jumped last year as a result of profitable live-stock operations and record corn and soybean harvests. Farmers managed to sell much of their crop at unusually high forward-contract prices.

Farm income was also supported by federal loan deficiency payments, which are tied to spot market prices.

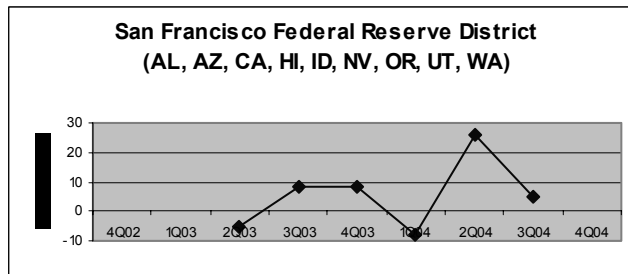
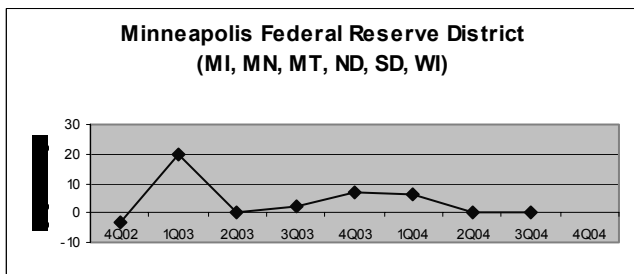
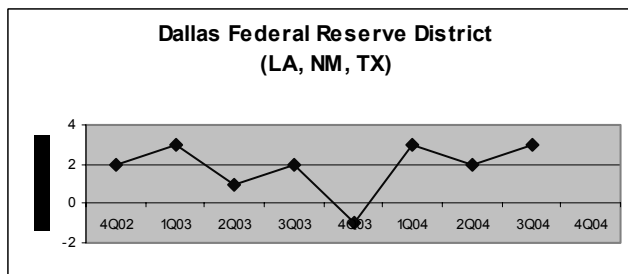
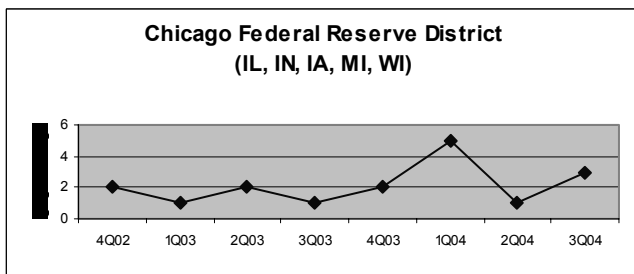
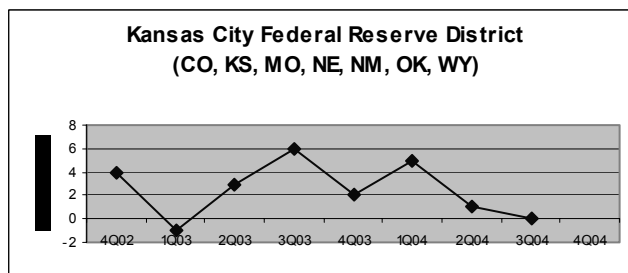
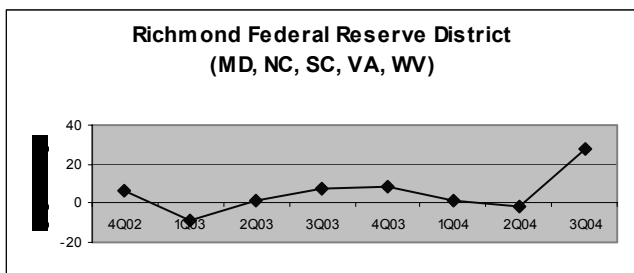
Direct government payments made up an estimated 21% of net farm income last year, according to the USDA.

Farmland prices in Illinois, Indiana, Iowa, Mississippi and Wisconsin advanced, driven by strong demand from non-farm investors and recreational buyers.

The Fed's quarterly survey of farm real estate values showed prices advanced in the Richmond, Chicago and Dallas Fed districts through last year's third quarter. However, the survey also showed moderating price gains in the San Francisco, Kansas City and Minneapolis Fed districts.

Though preliminary estimates of 2004 farm income in Colorado, Kansas, Missouri, Nebraska, New Mexico, Oklahoma and Wyoming indicate income will top the 2003 record high, Kansas City Fed survey respondents don't expect another big increase in capital investments this year.

In the west, agricultural producers reported strengthening demand for the November through early January period. Orders and sales of tree nuts were especially high, thanks in part, to favorable news coverage of their nutritional value, and tight supplies in other nut-growing regions. ■



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