AGRICULTURE

# The long-term challenge of feeding the world

Not many asset classes show as clear an upward trend as agriculture. With the world's population steadily increasing, rising demand for food is inevitable, and Pictet's Agriculture Fund is looking to take advantage of the considerable opportunities in this sector, reports Ceri Jones

Agriculture is in an underappreciated megatrend, with demand growth based on unavoidable long-term trends, such as population growth, changes in dietary patterns and huge demand from the production of biofuels.

Some 80m extra mouths have to be fed each year, helping to make food security a top priority for governments worldwide, yet the sector has suffered a history of structural underinvestment.

Swiss private bank Pictet & Cie is launching an Agriculture Fund at the end of May, to complement its existing group of theme funds investing amongst other in water, clean energy, and timber. The new fund comes at a time when global inventories of agricultural commodities are close to historic lows and the need for efficient farming is acute.

## LISTED EQUITIES

The fund offers exposure to agriculture through listed equities, and will not invest in physical commodities nor commodity derivatives.

The sector currently trades on a price earnings ratio of around 11x compared with an average of 14x for the MSCI World Index, allowing the fund to take advantage of the sector's undemanding stock valuations versus the long-term prospects.

High fragmentation of the industry also offers the prospect of consolidation across the value chain.

**Gertjan van der Geer is a senior member of the Theme Funds Team, and will co-manage the fund with colleague Cédric Lecamp**

The fund will focus on three main areas:

- farm inputs, such as seeds, chemicals and machinery
- farm professionalisation, such as crop farming and plantations
- supply chain and logistical services which include waste management, food testing and traceability

Of these, Gertjan van der Geer, the fund's lead manager, is most excited about farm professionalisation, pointing out that farmland is becoming an ever more scarce asset and increasingly valuable. The number of hectares of arable land per capita has steadily decreased from 0.4 hectares in 1960 to 0.23 hectares today and is expected to reach 0.15 hectares by 2050, driving the need for higher yields.

The fundamentals are so compelling that Mr van der Geer intends to strongly overweight this sector in the fund. The process of professionalisation will itself also increase efficiency and reduce wastage, while better access to capital will help reduce costs. Gradually, improved practices should decrease the estimated 20-40 per cent of yield lost to pests, inefficient techniques and the weather.

## BACK ON TRACK

Mr van der Geer highlights both farmland in Latin America and the fertile Black Earth region in southwest Russia for their huge potential to improve yields if the correct machinery, chemicals and crop rotation techniques are applied.

He points out that after the fall of communism, subsidies in the Black Earth region were slashed and yields collapsed but they are now recovering. He cites SLC Agricola and Cresud in Latin America, as well as Black Earth Farming in Sweden as examples of companies that will benefit from these trends. Fertilisers are an important part of this process, improving yields and correcting soil imbalance.

Nitrogen, derived from natural gas, is widely applied, but potash and phosphate tend to be under-applied. Demand growth for potash and phosphate will outpace demand growth for nitrogen fertilizer as a result.

Of the three main fertiliser groupings Mr van der Geer thinks that potash is the most attractive long-term play. Due to the fragmentation of the industry, mid- and small-caps make up a significant part of the investment universe. Farm machinery will lower the cost of production, modern seeds produced by companies such as Syngenta will improve yields, while crop protection reduces loss to pests and diseases. One contentious area, in particular, is genetically modified seeds, for which the managers have pro-actively decided to limit the fund's exposure.

## TRANSPORTATION

The supply chain and logistics segment will be familiar to most investors and include companies such as Bunge, Archer Daniels and Noble Group. Currently, transport, storage, and processing result in an estimated loss of 10-15 per cent of produce, studies show.

Storage infrastructure and international transportation to match supply and demand is a massive growth business, and again one where greater efficiency is capable of delivering enormous gains. Much of the excess demand for food is coming from Asia but the majority of the excess production takes place in the Americas, and as this mismatch intensifies, Mr van der Geer is confident that the infrastructure these companies have put in place will give them a huge and sustainable advantage.

Then there are the processing functions such as toxin removal, preservation, food quality control, and related services such as food testing, organic waste recycling, and traceability, which each have very strong legislative and regulatory drivers of their own.

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The food tastes of the emerging Asian middle classes are changing, as consumption of protein and vegetable oil increases in line with wealth.

According to consultants at McKinsey, about 1.1bn people will join middle class income groups in China and India alone between 2005 and 2025. This will result in shifts in demand away from humans consuming agricultural produce to animals. Biofuels are another exploding demand driver, which has led forecasters to predict that demand for crops will double in the next four decades.

As Pictet is aiming to offer as pure a play on the sector as possible, the universe of investment will only consist of companies having at least 50 per cent exposure to the theme, thereby reducing the universe of stocks from 700 to 280.

The fund will be based on a concentrated portfolio of about 50 stocks, with screening on liquidity and volatility. Pictet also emphasises each business' resource efficiency and sustainability in the stock selection process. For example, a great deal of energy is lost in the conversion of cereals to meat, so the manager will be overweighting companies operating at the base of agriculture, and underweighting meat producers.

Companies which derive more than 10 per cent of their sales from genetic modification will be excluded. Pictet has also made a commitment to avoid sensitive ecosystems. Neither are there any pure biofuel companies as these are seen as energy stocks.

## DIVERSIFICATION

Not many asset classes are in such a clear upward trend. A backtest shows that the investment universe has outperformed the MSCI over ten years by nearly 15 per cent annualized. "It will be key for us to deliver strong financial results, and we believe we can," says Mr van der Geer.

While this is not an SRI fund as much as an alpha-seeking investment fund with sustainable elements, the fund should appeal to those investors who are mindful that 2/3rds of the world's population experience hunger and malnutrition, and that investments in food efficiencies are therefore addressing a very real social need.