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Is Farmland a Good Investment?

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Market Report	Yr Ago	4 Wks Ago	5/11/01
Livestock and Products, Average Prices for Week Ending			
Slaughter Steers, Ch. 204, 1100-1300 lb Omaha, cwt	$72.25	$79.86	$74.89
Feeder Steers, Med. Frame, 600-650 lb Dodge City, KS, cwt	92.58	100.72	93.00
Feeder Steers, Med. Frame 600-650 lb, Nebraska Auction Wght. Avg	98.07	104.33	110.36
Carcass Price, Ch. 1-3, 550-700 lb Cent. US, Equiv. Index Value, cwt	116.19	121.10	115.00
Hogs, US 1-2, 220-230 lb Sioux Falls, SD, cwt	48.00	49.87	53.00
Feeder Pigs, US 1-2, 40-45 lb Sioux Falls, SD, hd	58.97	57.75	40.00
Vacuum Packed Pork Loins, Wholesale, 13-19 lb, 1/4" Trim, Cent. US, cwt	117.20	115.95	125.40
Slaughter Lambs, Ch. & Pr., 115-125 lb Sioux Falls, SD, cwt	103.25	78.00	84.37
Carcass Lambs, Ch. & Pr., 1-4, 55-65 lb FOB Midwest, cwt	210.00	171.00	*
Crops, Cash Truck Prices for Date Shown			
Wheat, No. 1, H.W. Omaha, bu	2.96	3.22	3.28
Corn, No. 2, Yellow Omaha, bu	2.08	1.92	1.70
Soybeans, No. 1, Yellow Omaha, bu	5.14	4.16	4.21
Grain Sorghum, No. 2, Yellow Kansas City, cwt	3.67	3.57	3.20
Oats, No. 2, Heavy Sioux City, IA , bu	1.29	1.40	1.39
Hay, First Day of Week Pile Prices			
Alfalfa, Sm. Square, RFV 150 or better Platte Valley, ton	92.50	115.00	115.00
Alfalfa, Lg. Round, Good Northeast Nebraska, ton	47.50	85.00	82.50
Prairie, Sm. Square, Good Northeast Nebraska, ton	70.00	105.00	105.00

* No market.

It is frequently questioned how farmland as an investment can maintain its value while seemingly generating such low returns per dollar invested. Often a parallel is drawn between investing in farmland vs. a relatively riskless but higher return investment such as U.S. Treasury notes. Risky investments are expected to require a risk premium (higher returns) compared to a less risky investment. Yet it often appears that farmland returns are less than the return from relatively risk free opportunities. Further, farmland and other real estate investments are generally considered less liquid compared to other investments.

The investment market is complex. However, there are three aspects which help our understanding of the worth of an investment. These are 1) the pattern of returns from an investment, whether in the form of annual returns (dividends), capital appreciation or both, 2) income tax effects, and 3) risk. These are discussed in turn.

Pattern of Returns

A $1,000 risk-free investment which yields a $50 annual return (5%) appears to be a better investment than farmland which, assuming for the moment, has an annual return of 2%. The current U.S. Treasury note rate is roughly 5%. However, we must consider the real (inflation free) value of the investment at year's end. If in the first case the face value of the investment remains at $1,000 and inflation is 3% over the year, the real return is only about 2%, because the face value declines in real terms. On the other hand, suppose that farmland increased in value by the rate of inflation for the year, maintaining its real value. The

2% annual return is equivalent to the first alternative because farmland did not decrease in real value.

Looking at the period 1923-99, farmland value increases have almost exactly matched the Consumer Price Index. Of course, for any year or series of years, farmland values do not necessarily follow the rate of inflation. Still, over the long-run, farmland values tend to follow inflation levels. This tendency for farmland values to maintain their real value is important to consider in evaluating farmland as a investment.

At another extreme is a security which has no earning record and perhaps only a history of losses. Its value may increase faster than inflation based on expected future returns. In the last half-decade there have been some dramatic examples of this in technology securities, where investment value increases occur in the absence of dividends. The nature of the distribution of returns, whether in the form of dividends or retained in the firm leading to increased asset value, is important in the evaluation of investment worth. Farmland has its characteristic return distribution made up partly of annual net returns (dividends) and growth in the form of land value increases.

Taxes

How the overall return from an investment is taxed also affects its value in the marketplace. An investment which yields only dividends such as a CD, has returns taxed annually at an ordinary income tax rate. On the other hand, where part of the investment return is in the form of increased investment value, the growth is only taxed when sold and then at a capital gains rate. If never sold, investment value gains do not involve any taxable income. Farmland characteristically is held for long periods, thus it incurs additional value because only part of its overall return flow (annual return plus change in land value) is taxed annually. This after-tax advantage of a growth investment must be kept in mind when analyzing investment value. Of course, tax free bonds are the extreme example of investments which have important after-tax characteristics.

Risk

The impact of risk on investment values is the most difficult aspect of all factors influencing asset values. This is because risk can be defined in various ways, along with different opinions of how risk impacts asset values. One perspective of asset risk is the volatility of its returns. A second view of investment risk is the potential for the investment to lose its entire value or suffer a major decline in its value. This issue appears to be less important for real estate than for corporate security investments. A third concept is how an investment fits with other investments in a portfolio from an overall risk standpoint. Agriculture has been traditionally viewed as a risky business. Yet risk from owning farmland as an investment is a different issue, and its risk must be viewed relative to the risk of alternative investments.

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