Pictet-Timber

Notes from the Advisory Board

June 2010

The semi-annual Advisory Board meeting took place in Geneva. The most important items to come out of the meeting are summarised below.

North American housing market

Since the Pictet-Timber Advisory Board met last time, in September 2009, what was then a market with well-filled timber inventories has changed significantly. A lot of the inventory has been taken off of the market, as logging conditions were rather tough in H1/2010. Lengthy periods of bad weather hindered additional logging activities in North America and as a result prices for lumber have since recovered strongly over the past months. In North America, this favourable upward trend in lumber prices was more due to bottlenecks in the supply than to an improvement in the housing market, which remains at depressed levels. The current economic woes – with the uncertainty of whether the U.S. and the global economy will have to deal with another recessive period and the double-dip scenario will finally turn out to become a reality – is too much of a decelerating force. Since the bursting of the US housing bubble in 2008, most of the lumber consumption in housing has been for repairing or re-modelling existing homes.

Government support for wood-based energy

The US government has toyed with the idea of introducing subsidies for the production of wood-based energy. In contrast to traditional fossil fuels, as well as low-carbon energy resources, wood is a carbon-neutral energy source. All the CO_2 that is given off in the process of burning wood for heating or energy production is captured during the lifetime of the facility. The goal would not be to use high-quality lumber, but rather low-value wood that is predominantly used for pulp and paper. This is where the paper industry comes into the picture. The paper industry's decision to divest from timberland not long ago stripped them of direct access to their production raw material. In hindsight, this may have been the wrong decision. The industry does not really like the idea of new competition emerging to compete for the same raw material. Competition for a relatively scarce good normally means that prices increase, which is bad for an industry that today already has to cope with low margins due to production overcapacity. Any additional price increase for the basic material will put even more pressure on these margins. As a consequence, the pulp and paper industry is lobbying hard in Washington D.C. to kill the talks. The beneficiaries of such subsidies would of course be the timberland owners.

Does the market misjudge the value of wood land?

At the time of the last Advisory Board meeting, there was a lot of uncertainty about what investors would do with their timberlands. As they had incurred enormous losses in other investments outside the sector, the fear was acute, that they would have to find liquidity by selling assets that had not declined in value. The industry developed scenarios about what would happen if large timberland owners would sell their most fundamental assets: forest land.

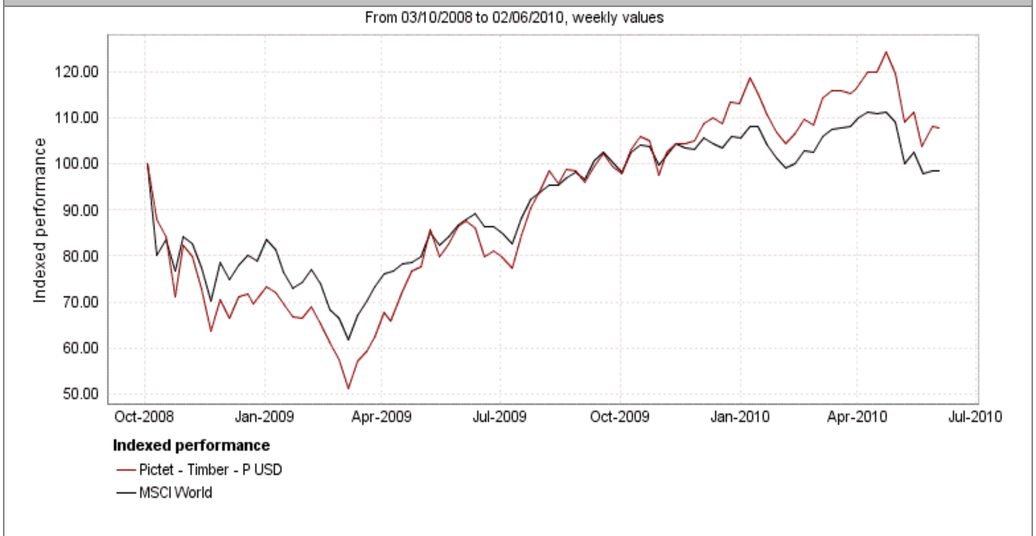
Today, we do know that this did not happen. Our conviction that the timber industry, the more upstream, hence closer to the resource timber, one goes in the value chain, is a business with a real long-term orientation. As much as investors fear inflation, demand from new buyers comes back. One of the basic assumptions we put forward at the launch of the fund - that timber investments incorporate an implicit inflation hedge - seems to have prompted investors to look at timber in times of increased inflation pressure.

Besides, nature plays an important role too in this equation. The plague from the Mountain Pine Beetle, which devastates huge forest areas at the western flank of the Rocky Mountains, in British Columbia, will have a growingly negative impact on the supply side. Which in turn will drive prices up. This may be a gradual process, but nevertheless needs to be carefully considered in the coming years, more than ever before.

Performance

Since the fund's launch end of September 2008, it outperformed the MSCI World, its reference index, by a margin of 6.88% until end of May 2010 (in USD). Also on the shorter term, since the beginning of 2010, it is ahead of the index, by 2.27%, again in US-dollar terms. More recently, the fund performed in line with the world equity markets during the May correction, a quite remarkable fact given its large outperformance in the past quarters. The best performers of the month were Sino-Forest, Empresas CMPC and Empresas COPEC, which are all emerging market companies and sizable positions in the fund's Top 10. Pure timber companies were in line with the fund on average. Louisiana Pacific corrected after its huge run as OSB prices started to fall. The high prices were due mostly to wet weather conditions in the US South, which made access to wood difficult. Fibria and Suzano again underperformed, which now brings valuations to very interesting levels. The valuation of timber stocks is compelling. Demand for timber products is growing because timber is a material that cannot be substituted and is used increasingly as emerging countries develop. At the same time, forest areas are shrinking at an alarming rate. The value of timberland implied by equity prices is often 30 to 40% below comparables on the private equity market. At this price, the cash-flow yield from timber sales, even in a difficult housing market, is attractive. Also, market pulp prices are still trending upwards, providing good upside potential to our pulp makers, especially those based in South America that benefit from their low cost base and fast-growing plantations.

PERFORMANCE PICTET-TIMBER FUND SINCE INCEPTION VERSUS MSCI WORLD (IN USD)



Source: Pictet

Long-term drivers intact

The aim of the fund is to invest in timberland-rich equities. Having identified all stocks worldwide that are active in the Timber value chain, we then identify the value of each of their forest holdings. To a large extent, this value determines their weight in our portfolio. We like the biological growth characteristic of timberlands, an asset that grows in size and value over time, regardless of economic conditions. We favour companies that own timberlands (in contrast to those that have long-term leases), especially in countries where the land is scarce, and that offer additional capital appreciation over the years. We also focus on companies located under the tropics, where trees grow at a very fast pace, providing a low cost structure.

Participants

1. Professor Michael Köhl, World Forestry Professor, University of Hamburg

Head of Institute for World Forestry German Research Centre for Forestry and Forest Products (Hamburg, Germany)
2. George Weyerhaeuser, Chairman of Forestry Advisory Council, University of British Columbia (Canada), Former Chairman & Senior Vice President of Technology Weyerhaeuser Comp. (Washington, USA)
3. Gabriel Micheli, Investment Manager, Pictet Asset Management S.A.
4. Christoph Butz, Sustainability Expert, Pictet Asset Management S.A.
5. Guillaume Chagnard, Product Manager, Pictet Funds S.A.

Contact

Pictet Funds S.A. Route des Acacias 60, 1211 Geneva 73, SWITZERLAND	**Pictet & Cie (Europe) S.A.** **Succursale Italiana** **Via Fratelli Gabba 1/A** 20121 Milan, ITALY
Pictet Funds S.A. Zurich Office Freigutstrasse 12, 8002 Zurich, SWITZERLAND	**Pictet & Cie (Europe) S.A.** **Sucursal en España** Calle Hermosilla 11, 28001 Madrid, SPAIN
Pictet & Cie (Europe) S.A. Niederlassung Frankfurt Neue Mainzer Strasse 1 60311 Frankfurt am Main, GERMANY	**Pictet & Cie (Europe) S.A. Succursale de Paris** 34, avenue de Messine, 75008 Paris, FRANCE
Pictet Asset Management Ltd Moor House, Level 11, 120 London Wall, London EC2Y 5ET, UNITED KINGDOM	**Pictet (Asia) Limited** Room 3901-10, Edinburgh Tower, The Landmark 15, Queen's Road Central, HONG KONG
Pictet & Cie (Representative Office) Sheikh Zayed Road - Park Place, 12th Floor PO Box 125567, Dubai, UNITED ARAB EMIRATES	**Pictet Funds (Europe) S.A.** 3, boulevard Royal, L-2449 LUXEMBOURG

Tel. 0041 58 323 30 00 - www.pictetfunds.com