

In Depth



Financial fitness

Measuring stock against stringent qualifying criteria and site visits is critical to gauging investment value

key points

- It is no surprise that investors taking short-term plays in tumultuous [commodities and global resource] markets had their fingers burnt in recent weeks
- By feeding their insights into quality companies and structural trends in the resources sector, investors can diversify away from short-term commodity plays and focus on longer term structural market trends
- Stress testing forms an essential part of the investment process, both when a stock is selected and on an ongoing basis



Joanne Warner

Africa, before falling back as investors became concerned about the inflationary impact high oil prices would have on the shaky economic recovery.

Precious metals were similarly volatile, with silver rallying by 28.2 per cent in April to reach record prices before sharply declining in May, masking the extreme volatility investors experienced. Platinum has also been the subject of sizeable price swings in the first half, while gold has marched inexorably higher as safe-haven trades amid economic uncertainty were augmented by the apparent inability of the US government to raise its debt ceiling.

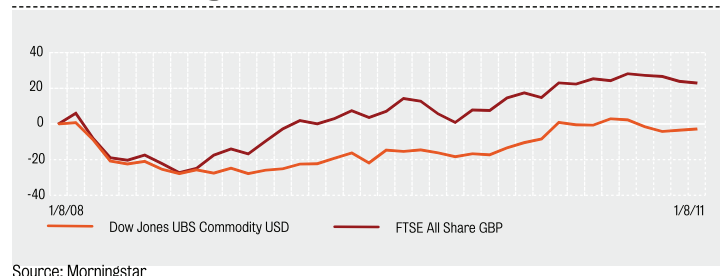
It is not a surprise, then, that investors taking short-term plays in these tumultuous markets had their fingers burnt in recent weeks. Mispricing and long-term growth opportunities abound in these markets, but it takes a discerning investor to identify them.

By feeding their insights into quality companies and structural trends in the resources sector, investors can diversify away from short-term commodity plays and focus on longer term structural mar-

industry commentators making predictions at the start of 2011 would have been hard-pressed to foresee the momentous events confronting investors in recent months, from natural disasters in Japan and New Zealand to political and social revolution in the Middle East. Events of this global magnitude underline the folly of trying to gauge short-term price movements, especially in volatile markets such as commodities and global resources.

Oil recently climbed to a 31-month high of more than \$113 a barrel as uncertainty clouded sentiment towards the Middle East and North

Dow Jones UBS Commodity against FTSE All Share



Source: Morningstar



ket trends. Copper, for example, is set to become increasingly sought after as Chinese industrialisation and globalisation drives demand for the metal, used in air conditioning units, wiring for housing construction and cars. Average copper grades are declining while the supply response is lagging, meaning long-term copper price assumptions are being

nudged higher.

Leverage

The recent global recession stemming in large part from excessive leverage in the financial sector has brought home to investors the very real catastrophes that can engulf a company holding too much debt.

Stress testing forms an essential

part of the investment process, both when a stock is selected and on an ongoing basis. One can perform a raft of financial stress tests using various financial models, and are most interested in the downside case. Fund managers want to ensure a company will not be over-leveraged or unable to service debt if commodity prices fall, exchange rates move in the wrong direction, or production or costs disappoint.

To maintain the quality and integrity of their portfolio, some managers measure all stocks against stringent qualifying criteria. Managers are looking for companies with cash production costs in the bottom half of world operating costs, and with real earnings-per-share growth over three years in excess of 5 per cent a year. Managers want to see a net debt-to-equity ratio of less than 50 per cent, interest cover greater than three times, and evidence of an improving price/operating cashflow ratio.

Company and site visits also play a vital part of getting to grips with a firm's business model and gauging its true worth as an investment. It is important that company management shows integrity and has high standards of conduct. In our view, it is difficult to form an objective view of any stock just from meeting talking heads at the company head office. Comprehensive visits to production sites and conversations with middle-level management, who are involved in day-to-day running of those sites, are crucial.

Investment opportunities within the resources sector often arise as companies propose new projects, for

which they require funding. A stock-picking approach is differentiated by both an ability to spot early-stage resource projects, and our conviction in building a position while the wider market has yet to make up its mind.

Often, the broader market waits until a project is completed and com-

“ Managers want to see a net debt-to-equity ratio of less than 50 per cent, interest cover greater than three times, and evidence of an improving price/operating cashflow ratio

missioning risks are reduced before reaching a decision on the merits of a stock. By contrast, the company will be considered while the feasibility study is underway, utilising our wide industry knowledge to judge a project's probable success.

Investors also seek companies which are looking for finance to build the project, as it often gives us a good opportunity to invest. And, because news flow is generally limited during the construction phase of a project, it is an ideal time to quietly consolidate a position in the stock.

Diversification

As we continue to focus on quality, low-cost companies, diversification is particularly important for a resources portfolio. Asset diversification helps mitigate the risks associated with cyclical downturn in commodity markets, the political, economic or

geological circumstances of particular regions and the production complications sometimes associated with immature companies. Portfolio diversification can be maximised by ensuring a breadth of exposure to different commodity types, geographies, markets and company maturities.

Currently in favour are large-cap diversified miners and we have heavy positions in a number of companies which can boast reliable earnings streams thanks to their diversified assets, comparing favourably to smaller cap, single asset companies. These large companies also provide exposure to a broad range of commodities, including iron ore, coal, petroleum products, copper, nickel, aluminium, zinc, manganese, ferrochrome, gold and other precious metals.

We are confident that investment in global resources companies offers good means of tapping into structural trends, while the tactic of eschewing short-term price movements unearths more meaningful investment opportunities over the longer term. This approach should help managers navigate short-term headwinds such as rising interest rates in China and India, sovereign debt issues in Europe, and the growth concerns afflicting the US economy.

Joanne Warner is manager of the First State Global Resources fund