Performance of ASX Resource Stocks

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Executive Summary

Investment in resources is often seen as a poor cousin to the more highly promoted industrial companies of the Australian stock market. This paper analyses the performance of resources as an ASX Sector, finding there is good investment potential if you know where to look.

The crux of the comparison is that averages can be misleading as an indicator of sector performance. In addition, resource investors exhibit a rare quality — being able to correctly anticipate commodity prices of the next 1–2 years.

ASX Investment Sectors

The global perception of the Australian market is that it is a resource-based economy. This is not true, as demonstrated from a breakdown using the 10 sectors of Global Industry Classification Standard (GICS). The Financials Sector in particular dominates the Australian market, while sectors such as Energy, Healthcare and IT are poorly represented (Figure 1).

The Resources Sector comprises the Energy Sector plus part of the Materials Sector (S&P, 2003). The Materials sector aggregates many sectors from the old ASX system, including Gold, Other Metals, Diversified Resources, Building Materials, Chemicals and Paper.

As a percentage of the ASX All Ords, Resources have declined from over 60% during the 1980s to about 14% today (S & P, 2003). Resources have largely been displaced by growth of the Financials Sector, many from the rush of privatisations during the 1990s.

Resources vs ASX All Ords and Industrials

The cumulative price performance over the last 13 and 20 years of resource stocks, compared with the ASX All Ords and Industrials, is presented in Figures 2 & 3. (Monthly price data is sourced from ASSIRT Library, April 2003 version).

For the first half of the 1990s, performance of Resources was similar, or better than, Industrials and the All Ords. During the late 1990s, Resources performance fell away during the Asian financial crisis, but has since regained some ground. During the mid-1980s, there was another period of significant under-performance.

Since 1983, Industrial stocks have returned compound 10.5% pa compared with Resources 6.4% pa. Note this price performance does not include re-investment of dividends.

On the face of it, the significant out-performance of Industrials makes one wonder: If you want to make money,

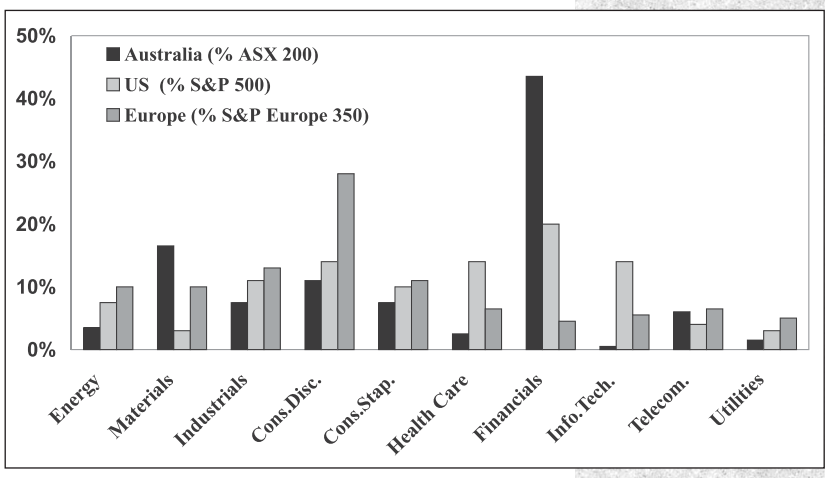

Fig. 1. World stock market proportions in the major sectors; Australia is over-exposed by financials and under-exposed to IT, Healthcare, Utilities.

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sensitive to changes in water content. GPR could also be used to map major root systems if ground conditions permit, but the usefulness of this data is questionable if parts of the root system are inactive. Mise-à-la-masse shows much promise in doing the well nigh impossible: mapping the active root boundaries. However, interpretation of the results and technique refinement requires more investigation.

Our research is a first pass at many issues and we can't expect to get it right the first time. The fact that so many positives have come from such exploratory work indicates clearly that there is a role for geophysical methods in the scientific studies of trees and their root systems. In addition, following success in scientific studies there is a likely a role for geophysical methods in forestry management and rehabilitation via tree planting.

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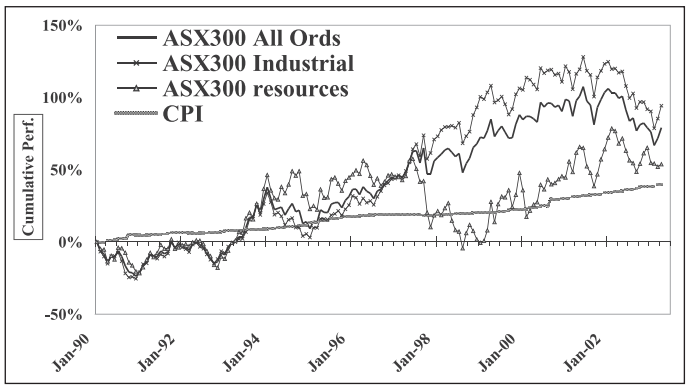


Fig. 2. Performance for resources, industrials, ASX during 1990 – 2003;resources were competitive for first part decade, then lagged after the Asian financial crisis.

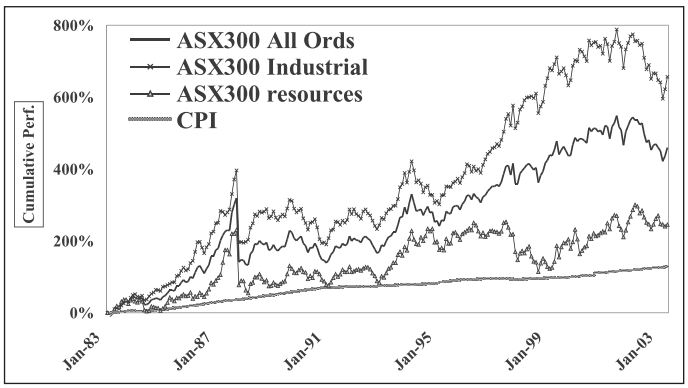


Fig. 3. Performance for resources, industrials, ASX during 1983 – 2003; two periods of resources significantly under-performing occurred in mid 1980s, late 1990s.

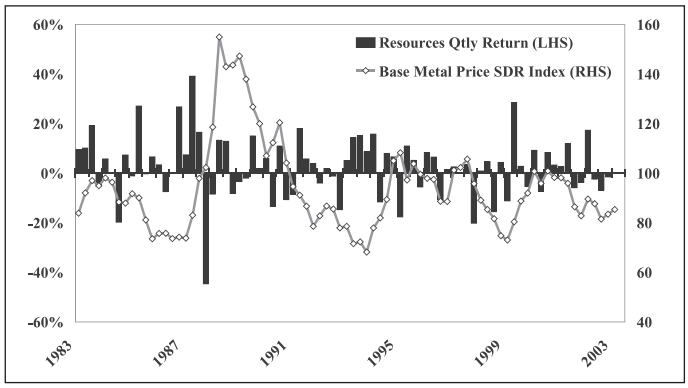


Fig. 4. Quarterly performance for resources and base metal price index; no direct correlation is apparent.

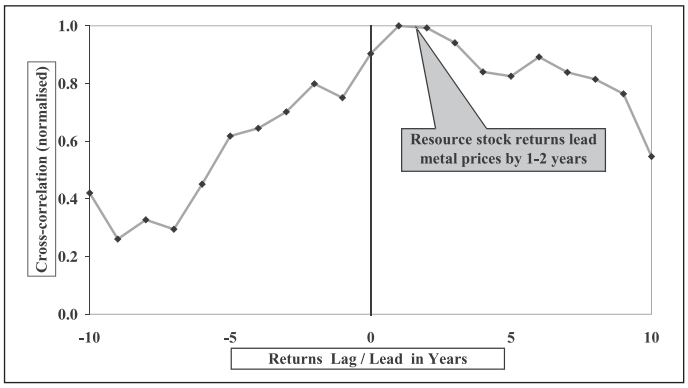


Fig. 5. Cross correlation of resources and base metal price index; a strong correlation is apparent, with returns leading commodity price index by 1–2 years.

is Resources the place to invest? An answer will be suggested later in this review.

Drivers for resources returns

The main driver for resources is health of the world economy. When economies are performing strongly, there is demand for resources, and vice versa. This controls commodity prices, in a demand and supply fashion.

Figure 4 shows the correspondence between commodity prices and resource returns. The Reserve Bank website publishes an index of commodity prices, one of which is an average of base metal prices in foreign currency terms (defined in terms of special drawing rights, the SDR index). This commodity price index is plotted against Resource returns (from Assirt Library), determined at quarterly intervals since 1983.

No correlation between the two series is apparent (in fact, the correlation is -0.1). This lack of correlation may be misinterpreted to mean the two series are not related.

Figure 5 shows a more appropriate measure of cross-correlation between the two series, which determines if there is any lead/lag time between them. (The two series are smoothed with a rolling annual filter, with the stock returns run past the commodity prices).

The cross-correlation shows the series are related, with stock returns anticipating *correctly* commodity prices by 1–2 years.

I find such a strong relation a little surprising. The general investing public is more noted for reactionary and herding tendencies, instead of being anticipatory, let alone correct. Typically, I would have thought resource returns would lag, or be in phase with, the commodity prices. Not so!

Therefore, may we conclude resource investors are more sophisticated than the general public?

Analysing performance — beware of averages

When comparing performances among sectors, a common pitfall is to assume average performance is representative of the sector. (Such an assumption may be applicable when returns of individual companies within each sector have a symmetrical distribution, with the same standard deviation).

Figure 6 shows the cumulative percentage for the top 5 companies by capitalisation in the major Australian GICS sectors (S&P, 2003).

It is apparent only a few companies dominate that Resources Sector (Energy & Materials). In the Energy Group, the top 3 companies by capitalisation (Woodside, Santos,

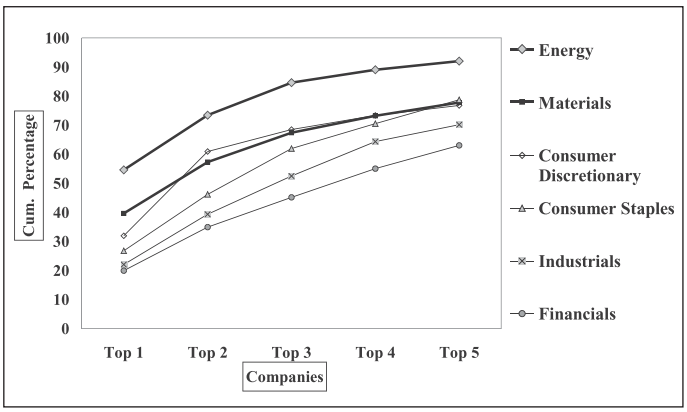


Fig. 6. Capitalisation weight of top 5 companies in major Australian sectors; note that Resources (Energy & Materials) are dominated by a few companies.

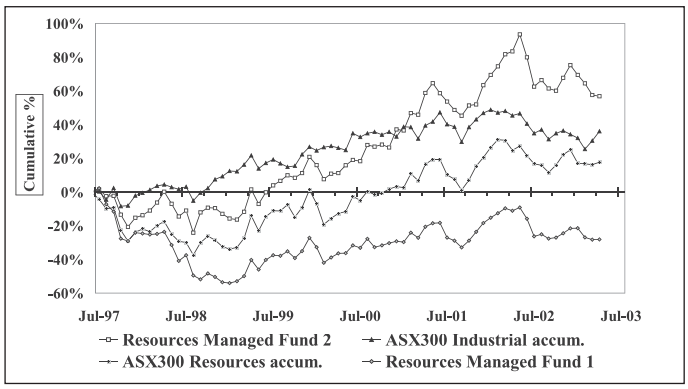


Fig. 7. During the last 5 years, resources and industrials had similar performance; subsets of resources stocks, using managed funds, significantly out-performed or under-performed industrials.

Origin) comprise 85%; in Materials, the top 3 companies (BHP Billiton, Rio Tinto, WMC) comprise 67%.

The weighted average return for the Resources Sector would be diluted by the returns of many small companies. Consequently, an average return may not be indicative of the best performers in that sector.

This concentration of production in only a few resource companies is a worldwide phenomenon, with the number of mergers increasing significantly since the early 1990s. The implications of mergers on the rate of exploration should be a topic for active discussion in the industry.

Quoting an average return for a sector can be misleading, as illustrated in Figure 7. Over the last 5 years, Industrials and Resources finished with similar compound performances (around 5% pa).

However, a subset of resource stocks, using managed funds specialising in resources, can have quite a different return. Managed Fund 1 has under performed the Resources index. On the other hand, Managed Fund 2 has returned 10% pa, significantly outperforming the Industrial index. (It should be noted this managed fund also includes international resources companies).

Figure 8 shows the annualised 3-year performance of the top 3 companies by capitalisation, where available, in each GICS sector, together with ASX500 accumulation index. We see that Resources companies, highlighted in black, were well placed, compared with the ASX index.

Ranking sectors by average returns may miss good investment opportunities. While it is acknowledged that most resources companies have not provided a return commensurate with the ASX, some resource companies have outperformed the ASX. As we shall see, these out performers are often not the larger companies. Finding the good future performers is a challenge for astute investors.

Where's the Next Resources Generation?

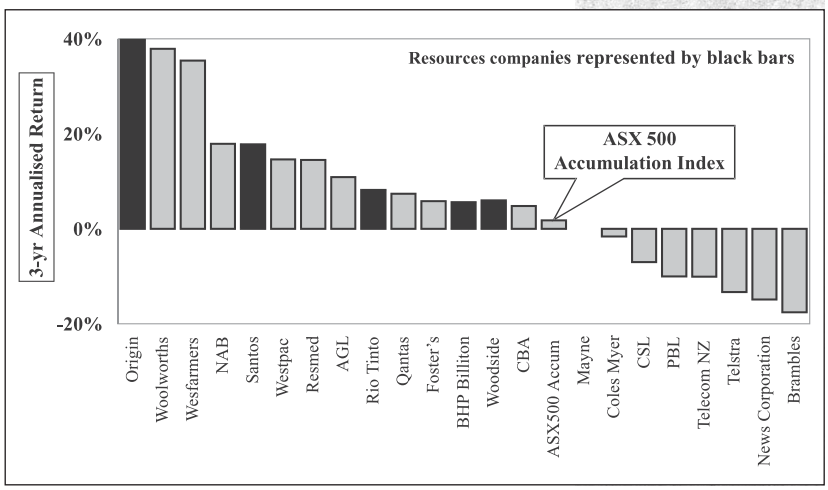
Resource investment is controlled by capital flows that "are determining the future of companies and countries. The world's major investors are focussing their investment on fewer and fewer companies in any industry. They are choosing to invest in those companies with sustainable and relatively stable earnings, and with the potential for significant growth" (WMC, 2001).

This focus on sustainable earnings reduces opportunities for smaller explorers, with adverse flow on effects on the rate of green-field exploration. Raising necessary capital will always be a challenge for small companies.

Given the decreasing number of resource companies after takeovers and mergers, the question arises: *Where will the next generation come from?*

The good news is that the next resources generation resource has been born, but is yet to be noticed by the general public. While the proportion of resources companies in ASX100 is about 14%, the remaining 1,200+ companies in the ASX comprise about 27% resources (Acorn, 2002). This suggests large potential for resource exploration.

Fig. 8. Ranking of top 3 companies in each GICS market sector. Resources companies were well placed compared with ASX accumulation index.



Why haven't we heard about this multitude of companies? Stockbroker and institutional research usually covers only the top 200–300 companies in the ASX. The remaining 1,000+ "microcap" companies are mostly left to their own devices. The total contribution of Microcap companies is not small: an estimated 350,000 employees, generating $40b in goods and services (Acorn, 2002).

Potential investor rewards from the microcaps are large. If 10 years ago a prescient investor chose 50 ASX stocks that were to be the best performers for the next decade, 46 would have been microcaps (Officer, 2003). Of these, 10 were resources (all metals).

All is not doom and gloom. Investors and employees of larger resources companies can take hope!

Future for resources stocks?

We now look into our crystal ball for future performance of resources stock. There are two trends to disentangle — commodity prices in the medium and long term. (Only people who don't mind seeing predictions regularly proved wrong should try forecasting short-term prices).

Firstly, the very long-term trend for commodity prices is not encouraging. "Over the past 140 years real world commodity prices have declined by about 1% each year on average... As incomes rise, it is likely that a smaller percentage of income will be spent on commodities. Technological advances have increased the supply of commodities, while demand has been tempered through the replacement of products by newer and more effective alternatives. With strong productivity gains and changing demand, it is not surprising to find commodity prices trending downwards" (Government Budget, 2002/03).

This is not of concern if all industries become more efficient. Profit margins are not necessarily threatened since resources companies also have lower operating costs.

The trend in the medium term for commodity prices is not clear. Given there is greater economic uncertainty now than at most times, the risks of a more prolonged economic downturn are increasing. Apart from the unquantifiable influences of the Iraq war and SARS, traditional barometers of economic activity are slowing in the USA, Europe and Asia ex-China.

The biggest X-factor in commodity prices is China's import demand for its massively developing economy. Booming Chinese demand rescued commodity markets from the worst effects of economic downturn in 2001 and 2002. While contributing 5% to the world's GDP and 6% of the world's trade in 2002, China consumed close to 20% of the world's basic materials and so contributed to over 50% of the materials growth in 2002 (Whitten, *pers. com.*).

In 2003, Chinese demand growth may be more subdued as the pace of economic activity abates and surplus inventories are absorbed. There are also questions about the sustainability of growth.

However, on the positive side, should world economic growth recover more strongly than expected and China keeps growing, this should drive global consumption to peak cycle levels and correspondingly higher prices.

In summary, the medium term outlook for resources is unclear. Resources returns 1-2 years ago were moderately positive... only time will tell if the resource investors continue to correctly call the trend for commodity prices.

Conclusions

This paper contends it may be misleading to compare the average returns of the resources industry with industrial companies. There are some periods when high commodity prices allow investors to gain good returns from many resource companies. However, over the longer term only a limited number of resource companies are likely to post returns comparable with industrial companies.

Resource investors can pat themselves on the back, as they exhibit an unusual ability to correctly anticipate movement of commodity prices. This skill provides hope to employees of the resources industry - their employment is a vital part of the process of delivering results when market conditions are favourable.

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