Insight: From the capital

Exploration allocation

Australian investors prevented from buying explorers

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Despite there being many hundreds of Australian Securities Exchange-listed mineral exploration companies clamouring for attention, more often than not, none will end up in model equity portfolios. Suggesting a modest 5-10% exposure, in the Australian investment context, is a radical call.

A recent look at investment returns from exploration companies suggested that their risks had been overstated. Even so, in arguing for more tolerance toward this part of the market, I suggested investors employ a portfolio approach with a relatively small proportion of total portfolio value allocated to this segment of the market.

An alternative point of view is that an investor should not dilute his holdings in this way.

Why not just buy a single stock or a small number with a large portfolio allocation to maximise the benefit of exploration success?

From an analytical standpoint, an investor should keep adding stocks until the volatility of the portfolio stops declining for any given level of targeted investment return.

The optimal number of exploration stocks in a standalone portfolio in which an investor is seeking to minimise volatility is in the range of 11-13. The number of stocks in a portfolio may need to be larger than this depending on how much emphasis is placed on liquidity. A large portfolio may require more holdings to ensure that stocks can be bought and sold as needed in a market in which liquidity is typically constrained.

The tolerance for volatility and liquidity is an individual choice and there is no right or wrong decision. Choices should be dictated by investment objectives.

Sourcing advice

Implicit in both views are particular investor profiles and how different investors source their advice.

In the small print surrounding any financial product is almost always an important disclaimer. It rightly says something along the lines of proper investment recommendations being possible only after an assessment of the personal circumstances of the individual investor. The disclaimer will also normally urge an investor to get professional advice.

In theory, there will be an infinite number of combinations of individual risk tolerances and investment horizons to match against a similarly large number of security or asset combinations.

In practice, in the Australian market, there is a tendency among advisers to divide retail investors into those living through their accumulation phase and those nearing or in retirement.

The former will place a relatively heavy emphasis on capital gains as an investment objective. The latter group will place more emphasis on capital protection and a regular income stream.

A similar categorisation of investors involves identifying where along a continuum they sit between "aggressive" at one end and "conservative" at the other. A typical aggressive model portfolio would have a heavy equity loading (both Australian and international). A "conservative" portfolio would be weighted toward (or even exclusively comprised of) fixed interest.

Portfolio composition is generally determined by providers of model portfolios who, in turn, are prone to recommend broad-based equity-managed funds.

Providers of financial advice have generally been reluctant to build portfolios around sectoral themes despite ample evidence of Australian market outcomes being dominated by one single sectoral judgement, namely, whether banks are going to outperform the resources sector.

Together, the financial services and resources components of the market could account for as much as two thirds of index weightings, but the split between the two can vary greatly and frequently does overwhelm investment returns.

Since 1980, there have been 12 periods in which there has been at least a 40 percentage point difference in 12-month returns between the large cap bank stocks and the large cap resources stocks. This implies an opportunity to make a wealth defining decision every two or three years.

Within the resources sector, there is also a judgement to be made about the difference in returns between the largest resources stocks and the smaller end of the market. At times over the past year, this has amounted to 50 percentage points.

These two decisions – whether banks are going to perform better than resources stocks and whether large resource stocks will offer better returns than smaller resource stocks – will largely determine how well an investor performs no matter how much effort is put into understanding retailers or utilities or manufacturers or any of the other lesser market sectors.

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Perversely, index aligned investors will be buying

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Stock information on an electronic board at the ASX

Photo: Bloomberg News