Trading on a name

BHP Billiton is relying on its role as a portfolio management tool to attract investors as it struggles to produce the superior financial characteristics that would warrant inclusion on its investment merits.

John Robertson* | 01 Sep 2016 | 6:49 | Opinion

The name, reputation and traditional portfolio function of BHP has ensured buying despite a lack of genuine return

Once upon a time, BHP was known fondly and with some pride as 'the big Australian'. It was not only the most widely held stock among Australians but, as a proxy for the Australian economy, BHP attracted international investors looking for Down Under exposure.

Today, BHP continues to occupy a prized place among investors despite no longer being representative of the Australian economy and having endured a succession of chief executives trying unconvincingly to extract more from an unwieldy asset base.

The resulting strategic zigzagging has not deterred money managers globally using BHP as a go-to stock when they want exposure to the cyclical conditions that periodically dominate mining industry outcomes.

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The major performs a portfolio role that relies on its size rather than its financial performance. Market liquidity that meets the needs of large institutional investors and is not easily replicated guarantees it a portfolio role.

The company's investment popularity now rests heavily on a rich history to which individual investors are attached and continuing dominance of the principal ASX sector indices to which institutions and professional financial advisers are drawn.

"German government bonds with a negative yield look more appealing than an investment in the world's leading miner"

Rio Tinto is BHP's most directly comparable competitor for portfolio space though, in many instances, managers use both to fulfil their investment needs.

The stock market fate of the two companies has been dictated in part by cyclical conditions but day-to-day outcomes for both are dominated by the ebb and flow of funds responding to changes in perceptions of market risk.

BHP and Rio display eerily similar share price patterns, as a result. Since the beginning of 1999, near the bottom of the last cycle, the BHP and Rio share prices have risen at annualised rates of 13% and 12.9%, respectively. The daily correlation in share prices over the same period has been a near perfectly synchronised 97%.

Almost certainly, the market values of these two companies will continue to swing with the cycles or, more precisely, with the daily changes in perceptions about their onset.

BHP will continue to plug a gap in portfolios in need of resource sector exposure and requiring sufficient liquidity to keep transaction costs in check.

Meanwhile, the BHP financial results for the year ended June 2016 warrant wariness about the company's investment credentials.

Analysts' 'buy' or 'sell' stock recommendations are underpinned by specific commodity price forecasts. While these forecasts are usually disclosed explicitly in research, it is often hard to judge how much an investment recommendation depends on an assumption about future conditions or on whether existing unrecognised value can underpin future capital appreciation.

Rarely do analysts or companies talk about financial performance in the context of a return on the capital already at risk so as to allow investors to judge the sources of future anticipated returns and whether they adequately compensate for the risks being incurred.

One way to fill this analytical gap is to look at how much capital must be allocated by investors to facilitate an existing earnings outcome and to compare the current and potential future return with that of alternative investment benchmarks.

Based on the results recently reported by BHP, investors would have to outlay around US$110 billion in today's equity and additional capital over 10 years to access the 2015/16 operating outcome consistently for a decade. In doing so, they would get back something like US$112 billion before tax.

Take out tax and suddenly German government bonds with a negative yield look more appealing than an investment in the world's leading miner.

Of course, an investor putting capital at risk in BHP would be expecting a future cyclical uplift to raise earnings by enough to validate a higher market value.

The PortfolioDirect modelling of the current BHP business suggests that an immediate 50% rise in the prices of the company's main outputs (with an assumed 20% accompanying rise in the Australian dollar exchange rate) would lift operating income by approximately US$12 billion a year.

Such a value uplift – immediate and sustained over 10 years – would be equivalent to investors buying bonds with a yield only slightly below 6%.

In a world of record low interest rates, this might be more acceptable than at other times in market history. However, the same conditions that might precipitate such a dramatic cyclical improvement would most likely come with higher bond yields and returns on other assets, which would negate the improved investment attractiveness of BHP.

In short, even with a meaningful cyclical uplift, BHP is hard pushed to be a competitive investment.

The mining giant may be able to invest to improve these returns but, given its current size, meaningfully affecting the overall corporate outcome is tough no matter what the quality of the incremental assets.

BHP is in the midst of a very lengthy transition from being a globally recognised proxy for the Australian market to being a rather mediocre resources sector investment with neither strong financial returns nor abnormal leverage to changes in cyclical conditions.

It is relying on the lingering effects of size and history to retain investors and continue to attract portfolio managers who want a liquid exposure to cyclical conditions often regardless of underlying investment credentials.

Most companies would have been re-priced already to reflect this financial malaise. BHP's historically privileged position has delayed such a fate. Many investors are clinging to the hope that this good fortune will last indefinitely.

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