Insight: From the capital

'Speculative Buy' misses investor needs

Risk profiling might be a bridge too far for mineral explorers, but they are investment products

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'Speculative Buy' is a commonly encountered stockbroker investment recommendation for a mining company outside the S&P/ASX 200. It serves two conflicting purposes: it is at the same time a warning to stay away and an attention grabbing lure. The recommendation stands in marked contrast to the ordered assessment of risk normally demanded by financial advisers.

Virtually all information about investment products now comes with a warning for recipients to seek professional advice. The same exhortation to seek advice is usually in the fine print at the beginning of company presentations, too. The warnings are to ensure, as far as possible, that personal circumstances are matched with the differing risk profiles of potential investments when decisions are being made.

"It would be absurd for Greece to pretend it actually has all the attributes of the USA in selling its bonds, but this is what resources companies do when they paper over risk differences"

Professional advisers themselves are loath to act without their own sources of advice about the riskiness of investments. The bulk of investment products offered in the Australian retail market, for example, must be reviewed and rated by investment research houses. The researchers must characterise the nature of an investment product and how it might best fit a portfolio before financial advisers can offer it to clients.

Perhaps the best known of these review processes because of its media coverage belongs to Standard and Poor's. Its risk rating system (or the equivalent operated by Moody's and Fitch) scores debt instruments on a 20-point scale from AAA+ to C. The S&P rating is intended to measure the likelihood of default by the issuer of a rated security.

A low rating alone is not necessarily a recommendation to sell a security. An adverse change in rating might prompt or require disposal of a security, depending on the reason for its initial purchase. On the other hand, some investors might deliberately choose to hold lower-rated securities based on views about whether their anticipated returns can compensate for the risk characteristics being bought. Hence there are investors wanting AAA US government securities and others keen to find inexpensive 'junk'.

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Similarly, the managed funds that are so widely used by financial advisers to structure client portfolios are also rated. In framing an overall score, research houses make judgments about funds' risk characteristics and the likelihood of them meeting their objectives.

In marked contrast to this widespread attention to risk profiling in investment markets, the idea of identifying and matching risks to investor objectives is largely ignored when mining companies present themselves directly to investor audiences or are represented by intermediaries.

Companies usually talk as though there are no risks – that targeted results will come with near certainty. Asked about the chance of failing to meet a target, executives will usually argue strenuously why this will not happen despite the abundant evidence that some key deadlines along the path to development will almost certainly be missed. Some executives react to talk of risk with open hostility.

Oil explorers stand out in the resources sector for their formalised risk assessment models. Even so, it is possible to wade through an entire corporate presentation without being told a targeted well only has a 20% chance of success and that, once done, the company will not have sufficient cash to undertake any further drilling activity after spending tens of millions of dollars on a single exploratory well.

A 20% chance of success does not make a company a bad investment. It should simply prompt someone to ask whether the prospective return is adequate compensation for the risk. Correspondingly, the information provided by the company should allow this assessment to be made as easily as possible.

It would be absurd for a near bankrupt Greece to pretend it has all the attributes of the USA in selling its bonds, but this is what companies in the resources sector are trying to do when they paper over risk differences.

Being in constant denial about investment risks undermines and ultimately destroys the ability of investors to take rational decisions that reflect their risk appetites. Unsurprisingly, they simply stop trying if they are denied the tools they want to apply.

Stockbrokers are assisting this risk denial gambit. Brokerage firms usually have clear criteria for categorising a 'buy' recommendation but a 'speculative buy' is for stocks outside normal selection criteria. The 'speculative buy' is a lazy recommendation. It is a bucket for stocks whose risks are unmeasured and undifferentiated, leaving investors without a key decision making tool.

The "speculative" qualifier leaves brokerages with enough wiggle room in the event of an embarrassing investment flop to retain some credibility while the "buy" permits them to keep chummy with fee-paying, capital-hungry company executives. Ultimately, this serves the purpose of conflicted capital market intermediaries, but is a trap for companies because it gradually eliminates their access to important pools of capital where risk assessment is of primary importance.

All investors have decided to incur some level of risk. They usually want to ensure that the risk they are buying is well identified and compensated for by an adequate return. The professional adviser is there to guide that analysis. If only to protect themselves, advisers are most likely to recommend investments where a formal risk appraisal has been completed. That will usually mean avoiding the bulk of the mining sector despite it contributing nearly half the listed stocks on the Australian market.

If directors of small mining companies thought of themselves more as offerers of investment products and considered how product choices are usually made, they might go about positioning themselves in investment markets in a more effective manner. ▼

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