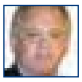
Insight: From the capital

Divergent returns are good news

Disparate performances below flat market surface a good sign for investors



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Appearances can be deceiving. Beneath the apparent stability in resource sector market conditions since the middle of 2013 have been some marked disparities in performance. Divergent returns are one sign macro influences that had dominated sector outcomes are loosening their grip.

At the close of markets in Australia on May 23, the small resources share price index was at the same level as on July 9, 2013, around 10 months earlier. This index, which measures the performance of the mid-sized stocks in the sector, despite its name, is the most representative measure of sector performance for the Australian market insofar as it is not dominated by the impact of BHP Billiton.

The recent stability shown by the small resources index has been highly unusual. In the prior two and a half years, the index value fell 46%. And, over the six years before that, it had experienced a succession of annual swings averaging 52%. Not since 1998-2002, when the annualised rate of change in the index was just 0.7%, has the market, at least measured by the headline index values, displayed such apparent tranquillity.

While reduced volatility would be widely welcomed as a sign of lowered market risk, it may not be what it appears. Sometimes, an average is indicative of what is happening to its constituent parts. In this case, the average is the product of markedly divergent outcomes offsetting one another.

Among the 50 mining and oil and gas stocks in the index, there was a 301 percentage point spread between the best performing stock and the worst in the unchanged index outcome. Sixteen stocks produced returns in excess of 20%, including seven with gains of 70% or more. Fourteen stocks had share price declines in excess of 20%, including eight with losses of more than 50%.

An unchanged index was hardly typical of the action below the surface. Even so, the pattern of stock price movements could also be signalling important changes in how the market is now pricing individual business outcomes.

For the best part of three years from early 2011, macro drivers had tended to dominate investment returns. There was a sense that an individual company had to be doing something very special to escape the re-pricing effect blanketing the entire sector. Now, having a similar number of gains as losses within the index could signal the loosening grip of the macro forces and a rising chance of companies receiving more reward for effort.

Saracen's investment return was head and shoulders above the rest as its share price more than doubled through the first six weeks of 2014

Of the seven stocks whose share prices rose by more than 70%, Saracen Mineral Holdings Ltd, Northern Star Resources Ltd, OceanaGold Corp and Papillon Resources Ltd had gold in common. Their share prices display some noticeable similarities. The average pairwise correlation co-efficients in their daily prices, for example, was 0.89.

The high correlation does put a dent in the inference that macro forces mattered less. The correlation statistic seems to suggest that stock choice was less important than latching onto the right market theme, in this case some recovery in gold equity prices.

Even so, Saracen's investment return was head and shoulders above the rest as its share price more than doubled through the first six weeks of 2014 and, importantly, held onto the bulk of the gains following acquisition of the Thunderbox gold operations and favourable exploration outcomes.

Among the other stocks in the top seven was Aquila Resources Ltd, which took a joint bid for its outstanding shares late in the piece from a subsidiary of China's Baosteel Group Corp and Aurizon Holdings Ltd, Australia's largest rail freight operator. Aquila had the lowest pairwise correlations among this group of stocks.

Tiger Resources Ltd got into the top group through a 140% share price increase during July-October 2013. Early in this period, slightly better copper prices would have helped performance, but the company was also ramping up production at its Kipoi copper operations, reporting good progress toward copper cathode production in mid-2014 and producing positive operating cash flows.

The remaining constituent of the top seven was Syrah Resources Ltd. Syrah was also playing to a different beat as it made steady upward share price progress buoyed no doubt by positive sentiment about the outlook for graphite producers.

A succession of milestones, including fresh funding, positive metallurgical test results and growing resource estimates not only kept interest alive but confirmed continuing valuation gains that could underpin a better share price.

On balance, those at the top of the performance pile benefited from some favourable macro winds but were also getting the job done.

At the other end of the performance league ladder, two stocks – Red Fork Energy Ltd and Nexus Energy Ltd – dropped more than 70%. Another six gave up more than 50%.

There seemed to be a strong energy flavour among the biggest losers. Karoon Gas Australia Ltd, Paladin Energy Ltd, and Maverick Drilling and Exploration Ltd were among these, but for reasons identifiably specific to each company.

Lynas Corporation Ltd and Western Desert Resources Ltd filled out this group of the worst performers.

The Western Desert performance has some similarities with other smaller iron-ore exposed companies, but its share price also lost as much as 20% at the time of a large capital raising in March and after pulling back its production guidance.

Lynas has faced unique problems in trying to persuade investors about the long-term viability of its Malaysian rare-earths processing plant, while the market's romance with the rare-earths industry segment waned for the most part and concerns about financial strength gathered force.

It might be going too far to say all the companies in this group fully deserved the market treatment they have received but the connection between market price and shortage of value underpinnings is hard to miss.

A pattern of offsetting divergent returns may not excite everyone waiting anxiously for the next big cyclical move, but is good news for stock-picking investors and those companies getting the job done. ▼

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