FROM THE CAPITAL

Large-cap miners losing investment edge

Majors' stagnant performance could see investors look elsewhere for value

John Robertson

A cyclical transition in relative investment performance away from the big miners in favour of the smaller end of the market may have begun with recent market ructions.

The performance difference between larger cap mining stocks and their smaller counterparts has been a feature of the current cycle. In the Australian context, the small resources share price index is currently 50% below where it was in mid-2005. The S&P/ASX 100 resources stocks, dominated by BHP Billiton, are showing no change.

It has long been accepted investment market wisdom that size brings safety. Large balance sheets and long-life mines will offer a better chance of surviving a cycle to re-engage on the next uplift.

In Australia, investors cling to BHP Billiton like young children to their favourite teddy bear. It is the most widely held stock institutionally and among individual investors managing their own money directly or through their superannuation funds.

The validity of that role was starkly evident through 2013, when the small stocks fell 43% and the large-cap stocks, by comparison, hardly budged. The big guys were clearly winning the hearts and minds of investors.

The big stocks might have offered protection, but the smaller end of the market provides leverage. Between 2005 and 2008, the small end opened a favourable 50 percentage point investment performance gap with the market leaders.

Between 2009 and 2011, on the second leg of the cyclical upswing, the gap was exceeded by 75 percentage points.

At that time, the largest companies had one very important argument up their sleeves. They had the capital to attract institutional and private investors searching for income. The large stocks also used their public relations muscle to persuasively advertise their growth attributes. Dividends and growth proved a powerful investment lure.

At that time, too little attention was given to the growing capital commitments needed to underpin meaningful growth, which meant permanently favourable cyclical conditions had to prevail. This was always a dangerously optimistic assumption.

The large stocks also had the advantage of being able to morph into something different if conditions warranted change.

Take a load off… big miners have carried investors' mining-sector hopes. Perhaps no longer

Rio Tinto, BHP Billiton and Glencore have shown this corporate chameleon-like ability to match their habitat by the occasionally artful deal or balance sheet reconfiguration to buy time when capital market pressures intensify.

For some, this structural flexibility is an enviable strength. For others, it could just as easily be construed as a permanently futile search for a workable strategy. Getting bigger has been the goal until getting smaller was the priority. Commodity focus was vital until someone thought diversification was going to offer more. Vertical integration would create value until the evidence showed upstream investments were more lucrative. And so the history goes.

Recent days have shown how the biggest companies are struggling to keep the relative performance advantage with both BHP Billiton and Rio Tinto giving up 12-14% in London as Glencore slid 49%.

Dividends are under pressure and, as one analyst intimated, there were reasons to doubt even the much vaunted ability to survive until the next cycle.

Whether or not Glencore was actually at risk financially, the market reaction suggested investors were poised to sell. The reaction offered a flavour of the current temperament.

With the large-cap stocks now offering returns no better than any others, investment decision making needs changing whatever the unfolding scenario.

One scenario is the possibility of further cyclical deterioration. This is a realistic possibility as long as global growth rates remain stalled and a rising US dollar puts downward pressure on US dollar raw material prices. In this scenario, capacity to sustain dividends would be at risk, capital budgets would be trimmed further and future growth prospects truncated.

Earnings-based valuations would have to adjust to take account of the resulting rise in costs and contraction in output.

This would not be a happy case for a company of any size, but the largest ones are likely to have more to lose because they had been most optimistically priced.

The second scenario is a middle of the road outcome in which the cycle stabilises for the foreseeable future. This scenario might resemble the industry's 1990s experience. It might result in a multi-year stretch of zero or very low net returns across the sector. Importantly, however, volatility will have fallen. The benefit of this scenario is that companies getting the job done – most typically new mine developers – are more likely to receive market recognition for their efforts. This was the industry's experience in the 1990s.

Almost by definition, if net sector returns are unchanged, large-cap stocks will have failed to produce anything significantly different.

This would be an investment environment tailor made for stock pickers looking to reward sound corporate execution.

Scenario three is the beginning of a full-throated cyclical rise. This would rely on an acceleration in global growth, rising inflation expectations and a reversal in the direction of the US dollar exchange rate. This is the rising tide that normally lifts all boats. This is a scenario in which the large cap stocks would benefit, but one under which the smaller companies, as usual, would experience the greatest leverage.

In all three scenarios past this point, no matter what the relative performance outcomes in the past three years have been, the large-cap stocks will struggle to be the superior investment alternatives in the sector. This outcome typically evolves through the course of the cycle and, at some stage in every cycle, investors will have had to make the transition in thinking.

This is not to say large miners will be ignored. Their strong sector identities give them an ongoing advantage. And, more importantly, the largest investors in the world will continue to value size even, sometimes, at the expense of investment returns. But the large-cap miners may be in the midst of losing their comparative advantage as they are dragged back to the investment pack. ▼

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