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Falsehood and deception as investment tools

A tight capital structure, skin in the game, an experienced board, a low enterprise value compared with peers, plenty of news flow and a tier one location sound like the makings of an ideal investment, if company presentations are any guide.

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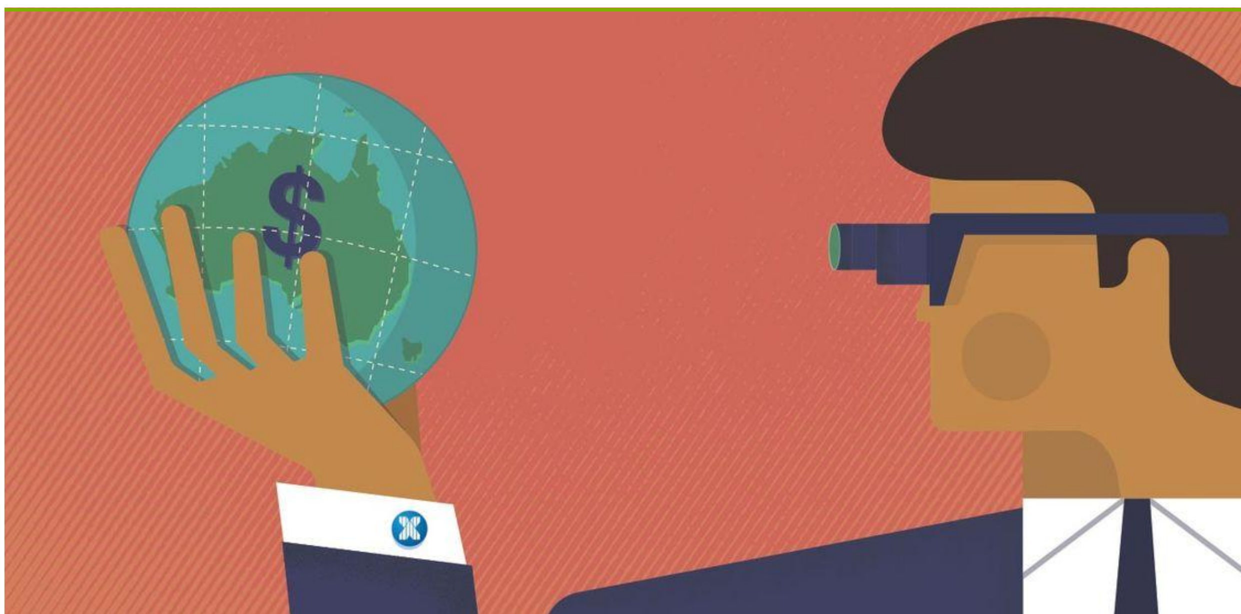

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I was reminded in the past week of a speech by former Australian prime minister Gough Whitlam in which he said, "any government which continually misrepresents the facts will come to believe its own falsehoods and to make policy based on its own self-deception".

Much the same is true of investment markets. Claims about market behaviour repeated often enough gain adherents irrespective of the empirical evidence. Widespread acceptance of even highly dubious investment propositions can eventually influence strategic corporate decisions.

The need for a tight capital structure to support superior investment performance is an example of a widely accepted idea repeated without regard to the empirical evidence by companies in the junior mining space.

Surprisingly large numbers of retail investors, otherwise well versed in the sector and on whom companies rely for funding, will refuse to buy into stocks with large numbers of shares on issue.

The expectation that the best performing stocks are likely to have fewer shares on issue was turned on its head, by a large margin.

Market liquidity aside, the number of shares on issue is simply a scaling factor. A $10 million dollar gold explorer with one billion shares on issue should produce an identical return to one with 100 million shares on issue in response to the same exploration outcome.

Low market liquidity imposes costs on investors seeking to buy or sell. If anything, a company with fewer shares should trade at a permanent discount to a stock with greater liquidity to reflect the additional trading costs and transactional risks attaching to the company with fewer shares.

The superficial appeal of the tight capital structure argument rests on the idea that investors will bid up prices to enter a register where selling is infrequent. If true, one should expect to see the best performing stocks display relatively low numbers of shares on issue. Market laggards should have relatively large numbers of shares on issue.

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In 2019 the top 20 performing mining stocks listed on ASX produced returns of between 217% and 1,400%. The average number of shares outstanding among these 20 stocks at the start of the year was 878 million.The median number of shares outstanding was 611 million.

At the other end of the performance ladder, the 20 worst performing stocks in the sector had an average number of shares outstanding of 606 million and a median share issuance of 205 million.

Among the 20 stocks sitting either side of the median investment performance in 2019, the average number of shares on issue was 709 million. The median number of shares outstanding was 598 million. Stocks with middle-of-the-range performance had middle-of-the-range numbers of shares on issue.

The 2019 performance results present a clear picture of the relationship between market performance and shares on issue. The lower the number of shares on issue, the poorer was the investment return.

Of course, there were exceptions. Stavely Resources was within the top-10 performing stocks in 2019 but had only 156 million shares on issue at the beginning of the year and before reporting outstanding exploration results in September.

Investors pushed the Stavely market value from near A$40 million to as high as A$290 million within little more than one month while turning over two-thirds of the shares on issue.

A tight capital structure will have contributed to the share price gain only if an investor outlaying $1,000 last October would have been unprepared to spend as much if a larger number of cheaper shares were on offer. There is no evidence for this. Nor does it make sense.

Another example of how company promoters ignore empirical evidence can be found in frequently used peer group valuation comparisons. A favourite measure of valuation is a company's enterprise value adjusted for the amount of gold in its resource base.

Gold development companies commonly use charts ranking like companies to emphasise their own investment appeal. Those at the lower end of the range use the valuation benchmark to show the extent to which their market values could appreciate.

Of course, companies near the top of the valuation range never accept the analytical usefulness of such a comparison.

Expecting companies with larger resource bases to have larger market values makes sense only to the extent that future cash flows are related directly to resource size. That qualification is rarely if ever addressed by those using the data in this way.

In mid-March, some 40 ASX-listed gold companies had a median enterprise value of A$26 per oz of gold contained in measured, indicated and inferred resources, on my reckoning. No two of the companies had the same valuation. As usual, no tendency to a central value was evident in the data.

However directors may try to construe the enterprise value measure, the charts inevitably show the opposite of what they are trying to demonstrate.

If all but one of the 40 companies had the same valuation, the single outlier could legitimately make a

claim that a price re-rating was warranted, in the absence of any obvious reason for the disparity.

In the absence of any tendency for convergence in valuations, on the other hand, one conclusion is irrefutable: resource size is not the determining factor in market pricing. Other considerations like management track records, funding access, deposit location, ease of mining and jurisdictional risk must be influencing valuation outcomes.

Similarly, claims about having skin in the game, an experienced board, plenty of news flow and a tier one location as drivers of investment success prove spurious when looked at against the data.

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