

Insight: From the capital

Indices no guide to stocks

Wide disparities in stock performance produce flat index outcome



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Australia's small-resources share-price index has behaved very differently over the past year than the individual stocks sitting behind it. The difference in the pattern of returns has implications for the way investors should approach the sector.

The small-resources share-price index was virtually unchanged between mid-July 2013, after recovering from its lowest ebb at the end of June and the end of August 2014. The index, mostly covering companies with market values of A\$100 million-A\$1,000 million (US\$94-940 million), is the most representative sector index available for the Australian market.

Investors often look to market indices as neat summaries of what is happening to the underlying constituent stocks. There is usually some assumption that index movements are typical of the market or sector on which they are based.

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Small movements in an index could reflect small changes in the prices of stocks comprising the index, in which case the assumption would be accurate enough. Alternatively, large offsetting movements in stock prices could produce similarly modest changes in an index. When this happens, the index may offer little worthwhile insight into movements in share prices and market profit opportunities.

The latter appears to have been the case over the last year for the Australian resources sector. The average absolute share price movement between mid July 2013 and the end of August this year was 45%. Falls in excess of 40% were offset by rises in excess of 40%. Only 11 stocks of the 50 in the index produced returns within 10 percentage points of the index outcome.

An analysis of the share price movements also shows that any one of the stocks in the index bought in mid-July would have subsequently produced a positive return. The median share price gain between July and the subsequent peak price was 41%.

The choice of stock to buy would have been relatively straightforward. Any stock would have contributed a positive investment outcome. The real challenge was in knowing when to sell.

The decision to sell was important because, having gone up, the prices of all the stocks in the index subsequently fell. Every one of them was trading at a lower price at the end of August than at some stage in the prior 12 months. The median share price fall after hitting their post July 2013 peaks turned out to be 25%.

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The results from the broader market are at least as striking. An analysis of the nearly one thousand Australia-listed resources companies shows a median 62% rise between July 2013 and the subsequent peak price. Across the whole market, the prices of 99.5% of the listed stocks were higher at some stage in the subsequent year than in July. Consistent with the stocks in the index, the median share price fall from the peak price has been 47%.

A number of factors could be at work to produce these results. Investors could simply be fickle in their choice of stocks. Occasional fads such as those for companies with graphite, uranium or rare-earths exposures can push prices higher before investors move on to the next big idea.

There could also be more rational explanations. In an efficient market, investors might quickly re-price equities as circumstances change. The market could also adjust rapidly to any overshooting.

If an investor works within a genuinely long-term timeframe, these considerations may not matter. Buying a share now for A\$0.50 that may drop to A\$0.30 may be of no consequence if, five years later, the share price is going to be A\$3. As always, the risk profile of the investor should play a role in the decision to buy or sell.

Those investors most sensitive to short-term fluctuations, on the other hand, should remain reluctant to buy and hold, whatever the ultimate price target. Committing to



long-term positions should only be done if a portfolio can withstand the ensuing shorter-term volatility.

The pattern of outcomes over the past year would reinforce the merit of dropping a stock once it has risen significantly ahead of the index. The rational reaction should be to keep the portfolio turning over.

It must also be true that stock price movements were not highly correlated. Otherwise, the index itself would have been subjected to similarly wide swings in performance. This suggests that a macro view, for example, would not have helped in deciding when or what to trade.

The momentum investor might also be wary if the duration of share price upswings is going to be as limited as these numbers suggest. If the duration of the upswing was sufficiently long, investors could reasonably buy stocks that were already on the rise. Against the background of the evident market behaviour, the more rational response might be to buy those companies whose share prices are currently in the market doghouse.

Sensibly, some judgement about the quality of companies should be made before doing this. If, however, all stocks have a high probability of participating in a brief re-rating at some stage and those that have already risen face a high chance of falling, the balance of probability would favour buying stocks suffering depressed share prices but without any intention of holding them for long.

By all accounts, capital raising for smaller companies in the sector is somewhat easier than it had been. The price patterns described here suggest companies may continue to face capital raising headwinds. The patterns suggest likely near-term losses for anyone supporting a pitch from a company for additional capital after its share price has risen. ▼