Mining Journal

Viewpoint > From-the-capital

# Betting against winners

The best-performing mining stocks in 2017 are unlikely to be among the best in 2018.

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18 JANUARY 2018

The top five ASX-listed mining stocks in 2017 produced returns of between 1,000% and 1,500%, largely as a result of the frenzied re-pricing of mining properties connected with battery metals.

Only one of the companies in the top seven fell outside the cobalt-lithium space.

Draig Resources, with a gain of 1,105%, was the odd one out. It announced in mid-November that it had intersected visible gold including 5m at 37.5g/t Au within its Bellevue gold project in the northern part of the Norseman-Wiluna belt in Western Australia. Further drill results were still pending at the end of the year.

Avonlea Minerals, the company with the best returns, has assembled a portfolio of lithium exploration interests in the Democratic Republic of Congo, describing one as being the "Escondida of lithium". The company has outlined an aggressive development timetable that only the most experienced of managers in the most favourable locales is likely to achieve.

Australian Mines, with a 1,400% gain, was queried by ASX in October about why its share price had risen so significantly. All the company could offer was that it was catching up with others with a nickel-cobalt exposure.

In addition to a nickel-cobalt deposit in New South Wales, Jervois Mining announced that it had taken a stake in Elementos, a Tasmanian-based tin mine developer. The company cited the connection of both tin and cobalt to the expected growth in the number of electric motor vehicles (EVs) to explain its investment.

The company had A$2.2 million (US$1.76 million) in cash at the end of September after a $1 million capital raising in the quarter but had spent only $75,000 on exploration. Spending on staff and administration was expected to be three times higher than its slightly increased December quarter exploration budget.

> “ **The most optimistic investors face less competition, leading to strong and often unwarranted price rises**

Auger Resources (now Collerina Cobalt) was on the rise from early 2017 after announcing its intention to evaluate its central New South Wales tenements for cobalt mineralisation. It wanted to seize an "opportunity to capitalise on [the] current strong and future forecast cobalt price". Only a few months earlier at its 2016 annual meeting, the $3.8 million company with just $100,000 in the bank had described itself as an emerging gold and copper producer.

Overall, there was less steak than sizzle among the best-performing stocks in the sector over the past year.

Extraordinary gains among a handful of stocks contributed to a flattering average return for 2017 of 48% across the entirety of the ASX-listed mining universe, while the S&P/ASX 100 resources index rose 20% and the ASX small-resources share-price index, a measure of mid-size company performance, increased 36%.

The median gain across the nearly 800 stocks that traded throughout the year was a more miserly 4.1%. Just 51% of companies produced positive investment outcomes for the calendar year. Nearly half of the remainder gave up as much as 25%.

In common with prior years, 2017 investment rankings were uncorrelated with rankings in 2016.

Correlations between the annual return rankings of ASX-listed miners have repeatedly been a near perfect zero (see my January 16, 2015, Mining Journal column on the futility of adopting ‘buy and hold' strategies in the sector).

A top decile finish in one year, for example, has meant a 90%-plus chance that the same stock would finish outside the top decile a year later and a 10% chance it would end up in the bottom 10%. The same pattern is evident across the entire distribution of returns.

Less than one-tenth of the top 10% of stocks in 2016 were among the best performers in 2017. Only 40% of stocks from among the 10% of best performers in 2016 were better than the median in 2017.

An almost identical pattern was evident at the bottom of the market. Ten percent of the stocks from the worst performing decile in 2016 featured among the top decile of performers in 2017.

The absence of any significant correlation in return rankings from year-to-year suggests a prevalence of overpriced winners and underpriced losers requiring subsequent adjustment.

This Australian mining industry experience goes against more general research findings that abnormally-high equity market returns in one year are associated with higher future abnormal returns.

Behavioural finance literature, typically based on the performance of US-listed companies, puts the persistence of abnormal returns down to an initial underreaction or delayed overreaction to news that might have implications for the fundamental value of a company.

A paper entitled ‘Overpriced Winners' by Kent Daniel, Alexander Klos and Simon Rottke (DKR) presented at the 2017 annual meeting of the American Economic Association helps clarify why the observed momentum effect is statistically absent in the case of Australian mining companies.

The DKR paper, also based on US companies, categorises them according to their levels of institutional ownership and scope for short selling. For a small set of firms for which arbitrage opportunities are limited by low levels of institutional ownership and little scope for short selling, DKR find, high past returns precede strongly negative future abnormal returns.

DKR reason that, among the most liquid stocks, a change in sentiment attracts both more optimistic as well as pessimistic investors. The interaction of the two groups delays the speed at which a price moves and the time required for a price to reach a new equilibrium point.

In less liquid situations, in which short selling is unavailable or too costly, the most optimistic investors face less competition, leading to strong and often unwarranted price rises.

Australia's listed miners are dominated by companies with low institutional ownership and infrequent short-selling opportunities. In throwing fresh analytical light on the nature of price formation under these conditions, the DKR market modelling and findings provide an analytically rigorous warning against betting on winners.

Despite the industry's determined efforts to capture shareholders prepared to back multi-year exploration and development plans, the DKR analysis cautions against such buy and hold strategies especially for those investors being judged against external performance benchmarks.

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