Mining Journal

Viewpoint > From-the-capital

Analysts too conflicted to ask tough questions

I have a test for how to judge a sell-side analyst but there is one problem. No one meets the standard.

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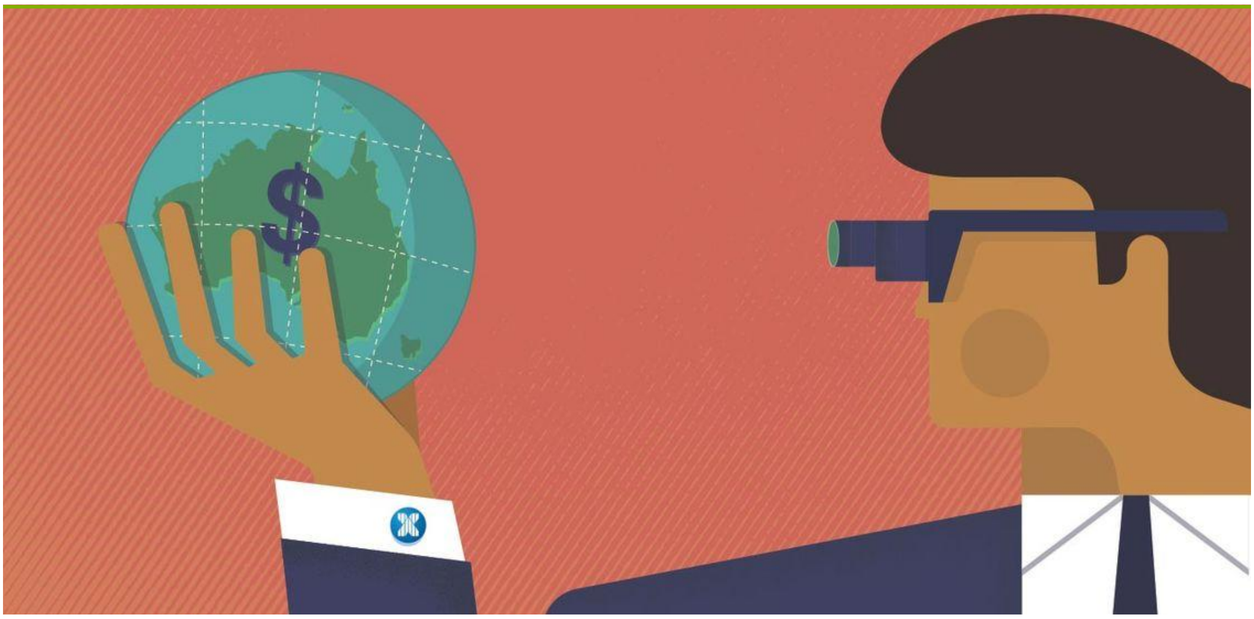

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Fearful about the prospects for my own mortality, I was compulsively drawn to a recent 'View from the West End' column in Mining Journal headed 'Analysts dying a rapid death'. The column lamented the demise of stockbroking analysts as investment gatekeepers leaving "no-one to ask the inconvenient questions".

Certainly, inconvenient questions are too infrequently asked, not least because of commercially conflicted roles, but I have not been aware of sell-side analysts in the mining space doing a noticeably effective job. The venerable columnist from the West End seemed to be heaping praise, albeit faint, on the undeserving.

A combination of trends has put the standing of mining research analysts on a decades-long downward slide. For a start, the mining industry has failed to offer investment propositions of sufficient heft to warrant investment banks maintaining the analytical firepower to cover the sector, as competing investments and shrinking commissions forced changes in analytical priorities.

In the Australian context, the composition of the equity market has changed radically on many fronts to the detriment of mining analysis. Falling bond yields, boosting bank valuations, gave financial institutions greater prominence in benchmark indices. Privatisation of government-owned assets created new investible companies. Conglomerates disgorged previously inaccessible subsidiaries as the fad for multi-industry holding companies diminished. Opening the Australian economy to greater competition has fostered local companies able to prosper in overseas markets. A growing national population is creating more diverse business opportunities.

Losing the likes of Western Mining, MIM Holdings, North, Pasminco, Comalco and Australian operating arms of multiple international companies - themselves no longer operating independently - added impetus to the loss of mining analyst prestige, further diminished the sector's claim on research budgets and removed incentives to nurture high quality talent to service the industry.

> **The ability of sell-side analysts to promote stocks of choice is what binds them to company executives**

Of course, among many smaller broking firms and capital market intermediaries, mining remained a focus of attention not least because the vast majority of companies in the sector needed to periodically replenish capital resources.

Unsurprisingly, commercial self-interest was the coarse sieve used to select which of more than 800 companies would be chosen as research targets. The resulting deserved scepticism about the motivation behind research killed the chance of broking analysts being thought of as neutral arbiters of value.

The drive for fees also meant a largely uncritical appraisal of the skill bases available to companies. After 2003, the number of Australia-listed resources companies more than doubled. The available skill base - already sparse after a dozen years of poor industry conditions - was spread ever more thinly and unequally.

The distribution of skills is assiduously ignored by research analysts, just as it is in reports from independent experts opining on value and consultants compiling feasibility studies. Universally, shamelessly and without cause, skill is assumed to be evenly distributed with ample supplies underpinning every development endeavour, lest anyone be offended.

Summaries of previous employment histories in a broker report are not the same as an assessment of how well individuals are likely to cope with the challenges they will confront in the specific circumstances being reviewed. Why should someone who had unsuccessfully sought zinc mineralisation in central Australia make a fist of exploring for lithium in Argentina? Why did they fail in the first instance? Where is the analytical value if such fundamental questions are studiously avoided?

Freer availability of information has also sapped the value of broker research, which overwhelmingly comprises summaries of public disclosures. Critical appraisals of how mineral resources, skill attributes and funding access interact to produce competitive investment returns are sometimes entirely absent.

As technology has torn down barriers to information access, the broker report is no longer the most convenient, comprehensive or cost-effective source of investment information.

Pressures on analysts to cultivate links with companies have resulted in viewing them in isolation from their peers and greatly limited the opportunities for credible comparative analysis. The adopted analytical style erodes the value of much contemporary research product.

There is a well-established model for a more consistent and risk-aware approach to assessing investment attractiveness with a heavier emphasis on ranking investment attributes.

Large variations in investment quality are not peculiar to mining. In financial markets, investors can buy lowly-rated Greek government bonds as well as top-of-the-range US government paper. Corporate bonds ranging from high quality to those explicitly described as ‘junk' are similarly available.

S&P, Moody's and Fitch run businesses based on ranking investment risk and quality against established benchmarks. Mining industry investors must make judgements about asset quality and market risk without similarly agreed frameworks.

Directors, keen to avoid conclusions that other companies might have more favourable quality or risk characteristics, seem happy enough to conspire with analysts to prevent a change in the way sector research is conducted.

As a fund manager, finding sell-side research for the vast bulk of sector offerings unhelpful because of its largely uncritical review of its subjects, I developed an assessment framework myself that balanced risk and quality to produce an overall investment rating. To the extent professional money managers want to spend time on the sector, this will occur more widely or they will rely on contracted research outside the bounds of the investment banks.

The ability of sell-side analysts to promote stocks of choice is what binds them to company executives and underpins their incomes. Whether that contributes to sound investor decision making or enhanced investment returns is another matter. There is one conclusive test for how well they contribute: ask them to demonstrate their willingness to make 'Sell' recommendations.

Since 2010, the median return from surviving ASX-listed mining stocks has been minus 89%. Nearly a quarter of companies have experienced share price falls of more than 95%.

The stunning absence, in these circumstances, of 'Sell' recommendations is proof sell-side analysts have no role to play as gatekeepers or guardians of investor interests.

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