No rewards for loyalty

Market tests strategic mettle of even the best-credentialled exploration companies

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Sheffield Resources Ltd, one of the best-performed mining companies on the ASX, illustrates a dilemma facing investors. The chances of companies maintaining strong share-price momentum are low. As a result, investors backing a company for the long haul can face significant opportunity costs.

Sheffield is one of the best-endowed exploration companies listed on the ASX. It took out the Best Emerging Company award at Kalgoorlie's annual Diggers and Dealers forum in August last year and was named Explorer of the Year at the Australian Mining Prospect awards in November.

While some companies struggle to ever come up with a single property to justify ongoing investor support, Sheffield has at least three.

The company has been involved in mineral-sands exploration since it listed in December 2010. Drilling results at its Thunderbird prospect near Derby in the Kimberley region of Western Australia (WA) in late 2012 pointed to a high-grade zircon-rich zone extending over a strike of 6km with an average thickness over the deposit of 20m. Some 40% of the total resource was less than 3m deep.

In the Fraser Range area of WA, the company has two contiguous exploration blocks located 20km south of the Sirius Resources Nova-Bollinger nickel discovery and a further four tenements covering prospective geophysical targets north-east of Nova-Bollinger. The hope here is to replicate the Sirius discovery.

In October, the company reported promising iron-ore exploration results at Mount Vettel, 150km from Port Hedland and only 20km from the Atlas Iron and Altura Mining Mount Webber development. Very high-grade bedded iron formations at Mount Vettel stand out from the majority of Pilbara region production for their quality. The grades could justify the trucking expense to Port Hedland if Mount Webber was not the destination.

The company holds other prospects, including a number of resource positions west of the historic Eneabba mineral-sands mine south of Geraldton, a talc resource at Moora and a hard-rock potash prospect near Morawa, also north of Perth.

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Smart sifting… Sheffield investors in a dilemma

assemblage of mineral assets. Over the course of the current cycle, the Sheffield Resources investment return puts it in the top 2% of ASX company returns in the sector.

Investors are incessantly told that prior performance should not be taken as any guide to what might happen in the future. This is nowhere truer than in the market for Australian resources stocks.

The empirical evidence from the Australian market says there is little tendency for carry-through momentum among top-performing stocks. As a general rule, companies are re-rated over relatively short periods before subsequent performance reverts to the norm for the sector. The modelling of intra-sector momentum by EIM Capital Managers suggests the same pattern over varying durations and at different phases of the market cycle.

"The Australian market has recognised Sheffield's impressive assemblage of mineral assets"

Of the 100 best-performing stocks in 2012, for example, only nine were ranked in the top 100 in 2013. The average ranking of the top 100 performers from 2012 was 499 (out of about 1,000 stocks in the sector) in 2013. Similarly, of the 100 stocks either side of the median return in 2012, 10 were ranked in the top 100 in 2013 and the average ranking was 505.

Of the 100 weakest-performing stocks in 2012, 20 appeared in the top 100 in 2013 and the average ranking in the next year was 491.

The correlation between performance rankings in 2012 and 2013 was literally zero. Whatever the 2012 outcome, the subsequent performance tended to revert to the sector median result. Past outperformance was no guide to future outperformance. If anything, there was a larger chance of one of the most poorly performing stocks being among the top ranked in the following year.

An investor's ability to beat the market seems to require abandoning a buy and hold strategy no matter how much that might run counter to a sense of loyalty to companies doing a good job.

Sheffield Resources investors face this dilemma, as do all investors holding stock in the best-performing companies. The dilemma is not removed by the company's unusually high quality and diverse range of exploration assets.

While each of the prospects being worked on by Sheffield Resources – mineral sands, iron ore and base metals – may justify investment as standalone activities, it does not automatically follow that, wrapped into the one corporate entity, the whole is an equivalent or better investment than the sum of the individual prospects.

Exploration is expensive and, due to constraints imposed by capital markets, choices must be made. With just A$3 million in the bank, it is unlikely that Sheffield will have the financial capacity to meet the needs of all of its ventures simultaneously. Management stretch might also be a consideration in husbanding such a diverse portfolio.

The diversity of prospects raises the risk that disappointing results from one will tarnish investor support for the others. One challenge for investors is to gauge whether one of the prospects is likely to prove more important than the others in influencing investment outcomes. That would guide decisions to both buy and sell.

Without having a clear fix on what is most likely to drive the share price in the future, investors could be seduced into staying longer than made investment sense. A continuing stream of test results or assays from a long list of projects could be a trap to hang on indefinitely and not a sign of corporate strength.

These might be harsh judgements to make about a company that has fulfilled its investment obligations in such exemplary fashion. As it happens, Sheffield Resources will have results from a new drilling programme at Mount Vettel scheduled for mid-2014 with which it could buck the sector trends and lift its investment performance to a higher level but, without that, the invisible hand offers no rewards for loyalty. ▼

John Robertson is a director of EIM Capital Managers, an Australian-based funds management group. He has worked as a policy economist, business strategist and investment market professional for nearly 30 years after starting his career as a federal treasury economist in Canberra, Australia.