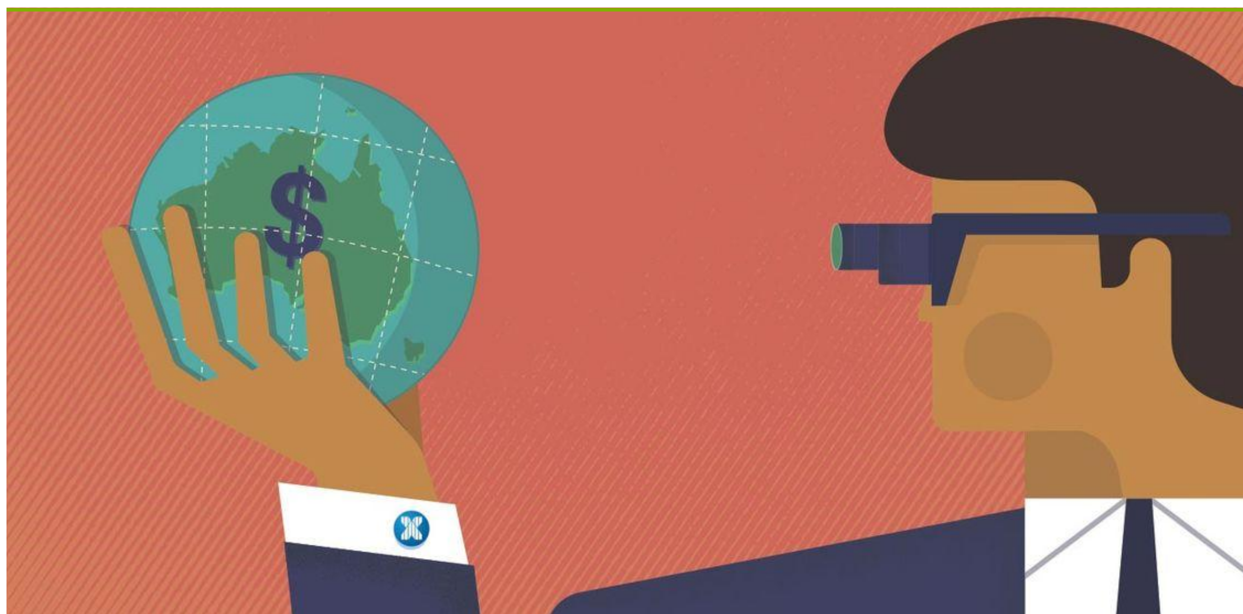
Mining Journal

‘Buy and Hold’ strategy likely to fail

Share-price performance over the past year has shown once again why investors do not gain from a buy and hold approach to Australian miners.

John Robertson*



27 July 2018

Last week's ‘From the Capital' column highlighted the 10 ASX-listed companies with the best investment returns during the latest Australian financial year - the 12 months ended June 2018.

Overwhelmingly, the highest achieving companies had exposures to battery related or new technology metals. One did have an iron ore connection, albeit with a twist, pursuing an integrated steel opportunity in Nigeria. Another was nearing first production from an Australian zinc mine. Otherwise, cobalt, lithium, vanadium, tungsten and manganese, albeit straddling both old and new, were the routes to success.

A second common feature was the inability of these strong performers to sustain gains averaging as much as 854% within the year. All ended the year with share prices below their best. The average retreat was 28%. All but one has suffered further losses in July.

The temptation to put the intra-year pattern of performance down to temporary overshooting, without any serious implications for future investment outcomes, misses an important bigger picture.

Certainly, in thinly traded markets, a favourable change in corporate circumstances leading to a flurry of buying can easily carry prices beyond what cooler heads might think sensible.

Whether very large price gains are justified or not, the temptation to take profits, without an influx of new investors to balance the pressure, will push prices lower.

Market fatigue is especially potent in the current cycle. Weakly capitalised companies, investors have learned, will use buoyancy in their share prices to refresh their cash positions with historically expensive capital. In trying to minimise the dilutive impact, raisings are often too modest to finish tasks at hand. With further capital needs already evident, portfolio investors become increasingly reluctant to stay.

Unusually strong performance is a precursor to subsequent randomly distributed outcomes

Stronger cyclical conditions have eased some capital market pressures but the benefits of resulting asset allocation decisions have flowed disproportionately to the market leaders leaving hundreds of small companies largely untouched.

The largest stocks have now fully recouped post-2010 cyclical losses of more than 60%. Beyond this handful of companies, half the universe of ASX-listed stocks continue trading at prices more than 80% below levels at the end of 2010.

Many investors will still conclude that a temporary retracement of 28% is a small price to pay for a possible 854% gain. Companies promoting the idea of longer-term gains as they try to entice investors to support their cause even point to prior superior performance as a precursor to future outcomes.

Unfortunately, available evidence does not support the wisdom of the buy-and-hold approach urged wishfully upon investors by stock promoters.

The statistical evidence points to the batch of top performing stocks from 2017/2018 succumbing to a strong tendency to mean reversion to produce average sector returns in the future.

The performance rankings of those stocks that comprised the top 10 in 2016/2017, for example, were spread evenly across the distribution of returns in 2017/2018. Each of the top-10 performers occupied one decile in the following year with one exception. Two fell into the ninth decile.

None of the top-10 from 2016/17 made the top 10% of performing stocks in the just completed financial year.

In common with best-performing stocks in prior years, the return rankings of the 2017/2018 leaders had been randomly distributed across the distribution of returns for the universe of ASX-listed miners a year earlier. Ten stocks were spread across 10 deciles.

The same pattern of stock return rankings is evident for the universe of ASX-listed stocks in every calendar year since 2010. The results are almost identical. The statistical correlation between return rankings in successive years has been zero.

A top decile stock in one year has had a 10% chance of being in any of the 10 performance deciles in the second year. Conversely, a bottom decile stock in any year has had a one in 10 chance of being in any of the 10 performance deciles in the following year. The same has been true for stocks selected from any decile.

This history suggests investment outperformance can only be replicated by continually refreshing a portfolio. A buy and hold strategy will lead to increasingly mediocre performance the longer a portfolio goes unchanged.

This pricing pattern has special significance for institutional investors or professional money managers who are judged against their ability to achieve above average returns from portfolio holdings not just

once but continually over multiple time horizons.

An example can illustrate why the tendency for serially uncorrelated one-off price adjustments is not a market fault and likely to persist.

Let's say that a company with a $20 million market capitalisation makes a previously unanticipated mineral discovery that could underpin a future value of $500 million. Let's assume, also, a 60% chance of a project being successfully completed in eight years and a 10% cost of equity (as a measure of expected opportunity cost).

Given these assumptions, the market value, adjusted for risk and opportunity cost, could reasonably move promptly from $20 million to $140 million in response to new information. Initial post discovery returns in the order of 500-600% could be analytically sound, even after anticipated new issues of shares for working capital have placed downward pressure on share prices.

Beyond this initial adjustment, further price changes would be dictated by perceived changes in the probability of success and, less importantly, on cost of capital changes. Readjustments are likely to have a downward bias. Both sources of influence on price movements will have relatively modest and possibly highly diffused impacts on prospective investment returns.

Unusually strong performance is a precursor, even in an efficient market, to subsequent randomly distributed outcomes.

Past performance, it turns out, is a guide to future performance. The best performing stocks in one year are doomed to subsequently produce average outcomes.

**John Robertson is the chief investment strategist for PortfolioDirect, an Australia-based equity research and resource stock rating group. He has worked as a policy economist, business strategist and investment professional for nearly 30 years, after starting his career as a federal treasury economist in Canberra, Australia*