

BHPB loses diversification advantage

Investors will find that while the album cover is the same, the music has changed



John Robertson
Melbourne, Victoria

Australian investors are effectively forced to buy shares in companies digging up iron ore and copper in preference to miners with exposures to other commodities. While largely a historical accident, this predicament is also mistakenly justified by claims that the iron ore-copper mix of commodity exposures offers investment diversification.

Amid threats of Chinese iron-ore and copper destocking, Australian portfolio investors face a peculiar set of risks. The stock most widely held by Australian retail and institutional investors is BHP Billiton (BHPB), whose iron-ore and copper sales account for the bulk of its income. In the six months to December 2013, US\$9.9 billion out of total operational profits of US\$12.9 billion came from these commodities.

Copper and iron ore are yet to have the cyclical slide experienced by other commodities. If, consistent with historical market adjustments, iron-ore prices reverted to US\$80/t, for example, and copper prices dropped to US\$2/lb, BHPB would see over US\$9 billion stripped from its net profit, which was running at an annualised rate of US\$16.2 billion in the first half of the current financial year.

On its own, BHPB accounts for 45% of the S&P/ASX 200 Resources share price index. Rio Tinto, whose own iron-ore and copper sales contributed 98% of its income in 2013, makes up another 11%. The iron ore-copper combination accounts for over half the sector weighting.

BHPB and the four largest banks together account for 39% of the key S&P/ASX 200 benchmark most frequently tracked by institutional investors. This is the core of Australian equity portfolios. The balance of the finance sector and Rio Tinto make up an additional 17% of the primary investment benchmark against which performance is judged.

Finance market theoreticians have a plethora of arguments for index-based investing. To shore up their case, they will argue that fund managers have not beaten market indices consistently enough to warrant attempts to keep trying. These are arguments that, in an Australian context, are equivalent to saying 'just keep buying BHPB'.

BHPB also gets support from less formal sources. The company's continuous presence over 125 years adds to its branding mystique. For many, BHPB had long been a proxy for



the Australian share market. It was the largest company as well as having a direct exposure to the ebbs and flows of the Australian economy. It retains some of that aura.

Of course, BHPB has changed greatly over the years. Through many iterations it has moved from being Australia's largest silver and lead producer in its earliest days at Broken Hill to being the mainstay of Australia's iron and steel industry before converting itself into a global miner with only a trivial exposure to Australian dollar revenues.

Many long-time retail investors are holding the company in their portfolios for reasons bearing little resemblance to what the company is doing today.

Mining companies are hardly ever branded in the same way as a bank, a retailer or a consumer product business. A recognisable corporate catchphrase is rare among the miners. BHPB is the exception. It relishes the 'big Australian' tag and promotes its diversification, describing itself as "the world's leading diversified resources company".

Business reporters, like those on Australia's national broadcaster, habitually refer to both BHPB and Rio Tinto as "diversified" as they offer unpaid support to reinforce the company identity. To be true, this mistake is not only made by the more popular media. Otherwise serious analysts often err in the same way.

The implicit advocacy on behalf of BHPB transcends important changes in the risk characteristics of the company. References to diversification are rooted in a bygone market.

In the late 1980s and early 1990s, investment analysts and strategists began distinguishing between "bulk commodities" and "base metals" to reflect the prices of coal and iron ore being negotiated annually, while the prices of non-ferrous refined metals were set daily in London or New York. The former was treated as a more risky exposure than the latter.

Between 1980 and the end of 2003, the

correlation between monthly average copper price levels and iron-ore prices was 0.11. The correlation between monthly movements in the two prices was a negligible 0.03. The difference in average return between the two commodities was slightly over one percentage point in favour of iron ore, but the volatility in copper prices was twice as high.

These statistical characteristics implied investors seeking to minimise risk should focus on bulk commodities. At the same time, low return correlations allowed different mixes of copper and iron ore to create different risk/return characteristics to match variations in investor risk appetites. In other words, there were potential benefits from diversification.

With iron-ore arrangements swinging progressively toward daily pricing, the relationship between the risk profiles of the two commodities changed dramatically. Iron-ore price volatility tripled. The correlation between the prices of the commodities has leapt to 0.87.

The days when copper and iron ore moved to a different beat and it made sense to distinguish metals from bulk commodities have gone. Prior to 2003, exposure to both copper and iron ore permitted risk diversification within a portfolio or under the same corporate umbrella. Now, there are virtually no advantages to be had from holding both copper and iron ore. Statistically, they are increasingly behaving like the same commodity.

In practice, copper and iron ore face the same macro forces originating in China that have kept their prices well ahead of most industry production costs in the cycle so far, but now threaten to drag them back to the pack. The convergence in pricing behaviour poses a problem for nearly everyone with exposure to an Australian equities portfolio. The most widely held stock and the two sector leaders are being bought on a mistake.

Their much touted diversification is an illusion perpetuated by little more than repetition. ▼