

COMMENTARY

Opportunities in commodities

Commodity prices have rallied hard in recent months as concerns over a renewed downturn in the global economy have given way to increased optimism on future growth. **ROBERT ADAIR**, Fund Manager of the United Global Resources Fund, takes a look at the growth potential and investment opportunities within the commodities sector going forward.

Economic data remains mixed, particularly in developed markets but global policymakers seem committed to ensuring a recovery in their respective economies.

In particular, the United States is pursuing a combination of low interest rates and high financial market liquidity ("quantitative easing") to revive its domestic economy. The majority of commodities have benefited from the US Federal Reserve's actions to boost inflation expectations and global economic growth.

One side-effect of US policy is that companies are taking low interest rate US dollar loans and investing the money in potentially higher return projects in developing economies. This is positive for commodity prices for two reasons. Firstly, US dollar-denominated commodity prices are rising to compensate non-US produc-

ers for the falling value of the US dollar. Secondly, gross domestic product (GDP) growth expectations have increased for developing economies, which have higher commodity demand relative to developed economies.

INCREASING DEMAND FROM DEVELOPING COUNTRIES

Developing economies such as China, India and Brazil are becoming increasingly important in the global economy. As these countries industrialise and urbanise, their per capita consumption increases for a broad range of commodities. This creates a very favourable outlook for future consumption. However, while the long-term picture is positive, there may be near-term volatility and investors should be prepared to deal with this uncertainty.

PROTECTING AGAINST DOWNSIDE RISK

Historically, commodity prices have often been characterised by sharp price gains and equally sharp corrections.

One method of reducing volatility is to avoid direct exposure to actual commodities and instead invest in companies that produce these resources.

Listed commodity companies give investors additional leverage beyond the underlying commodity price movement. This comes about in various ways, such as through operational leverage, production growth and reduction in operating costs. For example, gold analysts currently forecast that a 10 per cent movement in gold price will produce a 20 per cent movement in the aggregate underlying discounted cashflow-based valuations of gold producing companies.

However, investors need to be comfortable with the financial position of each

company and be certain that its financing needs are reasonable in relation to its cash flows and debt capacity.

One way to reduce risk when buying listed commodity companies is to identify low-cost producers that can still be profitable in an economic downturn and to select companies with a rising production profile that will benefit from volume gains. It may be a good idea to invest in diversified producers who produce a range of commodities. Following the investment adage of risk diversification, it is better to spread investments across a range of commodities rather than a single commodity.

By contrast, any company with a heavily-gearred balance sheet, with financing that is not reflected in the balance sheet (hence not transparent to investors), or that makes frequent changes to business strategy generally proves to be a poor investment choice. It is often a good idea to avoid companies with high debt levels or sizeable future capital expenditure requirements.

In terms of individual commodities, investors should consider investing in resources which are in short supply in China. The continued industrialisation and development in China means that such resources are likely to see strong demand growth. This could include commodities such as copper, coking coal, crude oil, nickel and uranium.

INCREASING MERGER AND ACQUISITION ACTIVITY

Higher commodity prices also mean that listed resource companies are seeing significant improvements in their balance sheets. Companies that had relatively highly debt levels at the time of the 2008 financial crisis are now in a much stronger financial position. In turn, this means that

merger and acquisition activity is picking up, resulting in some large share price gains for the targeted company.

For example, BHP Billiton is the world's largest listed mining company and is expected to be in a net cash position by next month. It recently attempted a US\$40 billion (\$52 billion) acquisition for Potash Corporation in Canada, with Potash's share price jumping immediately after BHP Billiton made its bid.

Although the Canadian government has now blocked this bid, it is probable that BHP Billiton will attempt another acquisition this year. In the meantime, BHP Billiton's strong cashflow has enabled the company to increase its dividend payment and launch a share buyback programme.

While BHP Billiton's latest bid may have failed, this year has seen many successful acquisitions involving gold companies, coal producers, copper mining companies and oil and gas exploration companies.

CONTINUING UNCERTAINTY IN FINANCIAL MARKETS

Finally, precious metals are likely to benefit from continued concerns over the stability of financial markets. Some investors are worried that the US and other countries are over-spending, given existing national debt levels and Budget deficits. Gold-related assets have the unique ability of benefiting from both potential inflationary and deflationary pressures in the months ahead.

In conclusion, despite the commodity sector's traditionally higher volatility when compared to more conservative investments such as stock, bonds and property, the sector presents potential investment growth opportunities for the astute investors. ■