

thebigpicture

guideposts for the private investor

Week Commencing 18 July 2005

Publishing and Subscription Information

thebigpicture guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial and business evaluation and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

To subscribe to the newsletter, go to www.thebigpicture.com.au or send an e-mail to: admin@thebigpicture.com.au.

Newsletter subscribers may also subscribe to *thebigpicture* premium content which includes tailored analysis and seminars on economics, business and policy issues affecting investment decision-making. Further information can be seen at www.thebigpicture.com.au.

◆◆◆◆◆◆◆◆◆◆

thebigpicture Economics
ABN 71 040 787 936
PO Box 333, Malvern
Vic 3144

HARNESSING RESOURCES GROWTH

One challenge for investors (and their advisers) is to tap the growth of relatively fast growing parts of the local economy without compromising their risk tolerance.

Output from the Australian mining industry is set to grow by 4.4% a year over the six years to 2009/10 according to the Australian Bureau of Agricultural and Resource Economics. The sector will once again be growing faster than the Australian economy just as it did on average through the 1980s and 1990s.

The mining industry can sustain this sort of outperformance. While the growth of telecommunications and business and financial services also outstripped the pace of overall economic growth during the 1990s, the fortunes of those sectors are ultimately tied to those of the Australian economy because this is where their customers are located.

It is possible for the mining industry to expand faster than the local economy almost indefinitely because its customer base is outside Australia and likely to be growing at a much faster pace for several decades at least.

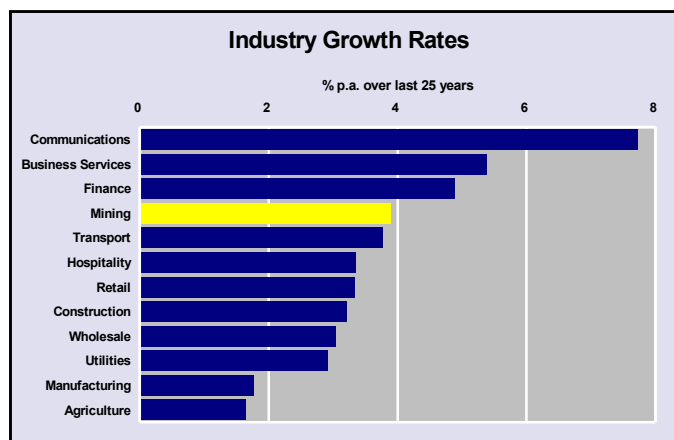
Too Risky and Not Enough

Unfortunately, too often, the sector is seen to be much riskier than other parts of the equity market. With the flurry of takeover activity in recent years and the consequent demise of some of the country's highest profile mining houses, there is also a paucity of well-known stocks on the market through which investors can gain their exposures to the sector.

One upshot of the takeover activity (and the simultaneous strong growth in the services sectors) is that stockbrokers and fund managers have been putting less analytical effort into the mining industry. With the necessary skill-set to analyse the sector gone missing, many investors and their advisers feel additional discomfort in committing funds to it.

Of course, there are some good reasons to treat mining investments cautiously. Companies engaged in exploration activity use up capital without always finding a commercially worthwhile mineral deposit. The investment risks can be considerable.

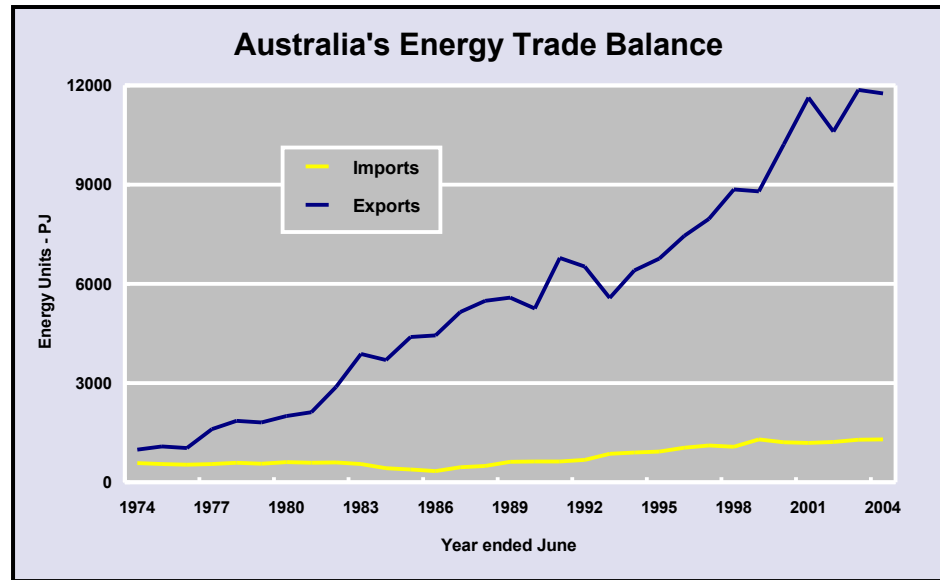
"...there is a way to tap a potential source of above average growth without having to rely on exotic instruments..."



At the other extreme are companies with their growth behind them. Mining a depleting resource means their fortunes are tied to hard-to-predict movements in commodity prices or, even more daunting, changing expectations about price movements.

(Continued on page 3)

THE WEEKLY CHART SPOT



Source: Australian Bureau of Agricultural and Resource Economics

Australia's natural resource base gives it a strong energy trade surplus. Measured in common units of energy content, Australia's energy exports are over nine times the level of its imports.

In 2003/04, according to the Australian Bureau of Agricultural and Resource Economics, Australia produced 15,689.7 petajoules of energy products domestically, imported a further 1,294.9 petajoules and exported the equivalent of 11,759.1 petajoules in various forms of product but predominantly black coal and uranium.

The 5,345.7 petajoules available for domestic use has grown at an average rate of 2.4% a year over the past 30 years. The pace of growth was less than the 3.3% a year underlying growth in the Australian economy over the same period reflecting conservation measures and the decreasing energy intensity of the Australian economy as the switch toward a more service oriented production base continued.

Meanwhile, exports grew at 8.6% a year as major new developments were funded and as the Asian regional demand for energy continued to expand driven by industrialization and urban development. ■

“...there is little chance of making change without a broad enough coalition of voters understanding the choices...”

REFORM: RECOGNISING THE COSTS CONT'D

(Continued from page 4)

might make them better off if the duration of their unemployment is reduced even if it comes at the expense of some specific employment conditions being seemingly less attractive.

Regrettably, reform does not usually come without having to give something up. Experience also suggests there is little chance of making change without a broad enough coalition of voters understanding the choices and accepting that the gains are going to be worthwhile.

By failing to admit the tradeoffs between employment and labour costs explicitly, the government actually risks watering down the changes to the extent that the

potential benefits may be lost.

That leaves us with a somewhat false debate as the government tries to downplay the significance of changes it has been promoting for the past decade as it tries to avoid conceding that any existing conditions of employment might be lost.

Its opponents, on the other hand, are suggesting that the changes are so radical they are likely to have a meaningful impact on employment costs.

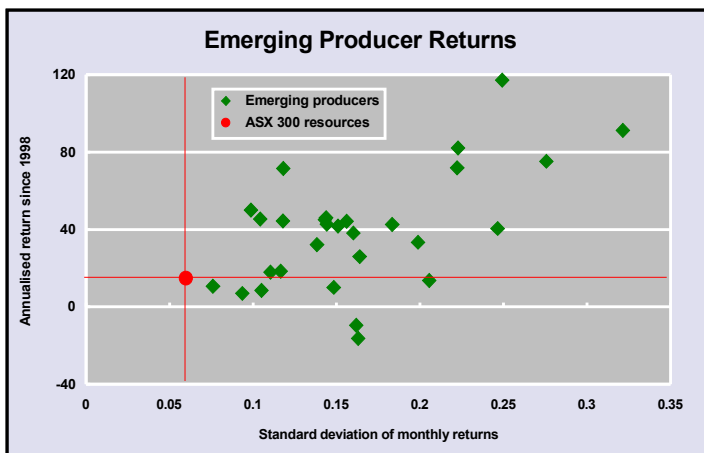
The irony is that if the unions are right, the changes are likely to facilitate a higher employment rate. If, on the other hand, the government is right and the changes are minor and being overstated by its opposition, one wonders why it should bother. ■

HARNESSING RESOURCES GROWTH CONT'D

(Continued from page 1)

Emerging Producer Opportunities

There is a middle ground, however, on which investors should look more favourably. This is made up of companies that already have a resource to exploit. They also have the skills, finance and technology to do the job over two to three years.



From a share market perspective, these emerging producers can generate some outstanding returns albeit with significant volatility. The first chart on page 3 shows the rates of return since 1998 for a selection of companies which would have qualified as emerging producers. The returns are superior to those an investor would have got from the resources sector in general. However, this group is also an excellent example of how higher returns come with more risk in equity markets. There is a positive correlation between returns and market volatility.

For some, the first chart provides enough grounds for eschewing investment even within such an apparently lucrative sector. The additional risk is too much. However, *thebigpicture* Economics has used the historical data to back test how this risk can be managed.

A Portfolio Approach

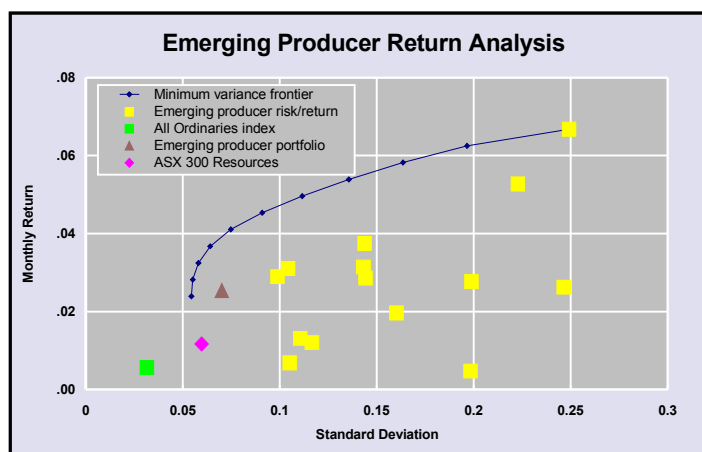
The second chart on this page illustrates the effect of well-considered portfolio construction techniques. By choosing stocks with the appropriate growth profiles and ensuring a spread of commodity expo-

sure, it is possible to construct portfolios with substantially lower risk than displayed by the individual stocks but with returns higher than the market averages. The second chart highlights how this would look using a Markowitz-type portfolio construct.

The portfolio is made up of stocks which fit the emerging producer definition (i.e. they

exclude early stage exploration companies and more mature, commodity price reliant companies). Moreover, the portfolio is constructed to ensure that at any time it has exposure to all the principal commodity groupings covered by the Australian industry, namely, energy, non-ferrous metals, gold, industrial minerals and steel making materials.

The triangle symbol in the chart represents the risk/return positioning of a portfolio of equally weighted stocks. It still offers the chance for significantly higher returns than available from the broader market but with a sharply lower risk profile than might attach to trying to find a small number of individual stocks as the basis for investments in the sector.



Of course, even in the portfolio context the choice of stocks still requires special skills reflecting the breadth of technological and commercial considerations which apply in assessing the viability of mining projects. However, the analysis suggests that there is a way to tap a potential source of above average growth without having to rely on exotic instruments or hard to understand trading techniques. ■

“By choosing stocks with the appropriate growth profiles and ensuring a spread of commodity exposures, it is possible to construct portfolios with substantially lower risk ...”

REFORM: RECOGNISING THE COSTS

For industrial relations reform to boost employment, some existing employment conditions will have to be given up. Ultimately, good policy will acknowledge the trade-off explicitly. That will let people decide their positions on the merits of the argument.

There is ample evidence that lower wages help to produce more employment. One indicator of this is shown in the first chart. Employment growth on the vertical axis



tends to be highest when real wages, on the horizontal axis, are increasing least strongly.

There is a considerable dispersion in the relationship. Moreover, real wages are not the only relevant indicator of employment costs.

Sometimes, employers will be willing to take on more people even when wages are rising quickly if, for example, additional sales or productivity improvements more than compensate for the additional labour costs.

Nonetheless, the empirical evidence suggests that the probability of employment gains is greatest when real wages are least likely to increase significantly. This is the backdrop against which the government's drive to reform labour laws is occurring.

Of course, the government wants to claim credit for initiating more employment but hardly wants to concede that employment gains will come at the expense of existing conditions.

In theory, it should be possible for those in employment to have their conditions safeguarded while more flexibility is allowed in setting the conditions of the marginal employees who might not otherwise be given a job. This would be beneficial. However, even the trade unions know that market incentives usually work. At the margin, employers will seek to discard the more expensive existing employees in favour of the less expensive employees who can be recruited under the new terms and conditions.

Managing The Debate

Now the government is trying to back off, saying that the magnitude of the reforms is far less than people are making out. We will have to await the detail of the legislation to assess whether that might be the case.

The most unfortunate part of the debate is the reticence of the government to come clean about

what it wants. Part of the government is clearly driven by an anti-union sentiment which cares little about what the impact on employment might be. For those, removing the last vestiges of union power is enough motivation.

For others, there is a more considered view that further employment gains need lower employment costs especially if inflation pressures are to be lessened as the unemployment rate is driven lower.

Unfortunately, the employment/labour cost trade-off might not have been explored fully enough in public debate for this idea to have caught on.

The Cost of Reform

Meanwhile, there is research which shows that the welfare costs of unemployment for the lowest paid workers are likely to be greater than for higher paid workers because the former find it harder to get work again when they lose a job. Making the lower paid workers more attractive financially by reducing their employment costs

(Continued on page 2)

“...the probability of employment gains is greatest when real wages are least likely to increase significantly.”