

Focus versus diversification

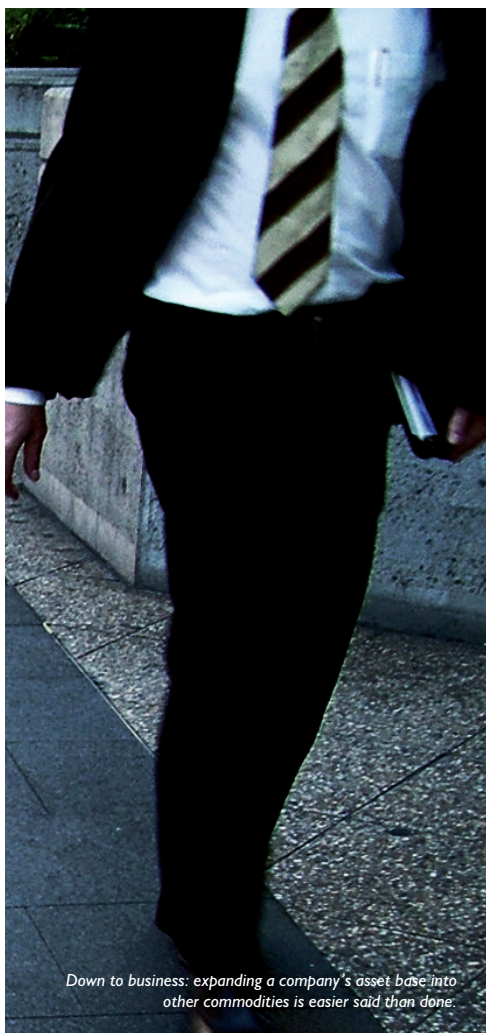
The question often arises when investors are considering investing in mining companies: should they target companies that focus on a single commodity or those whose operations are exposed to multiple commodities? **David Noort** discusses the issue



David Noort, Momentum Partners: "some mineral commodities are more attractive than others."

Whilst I would not espouse myself as the most wizened industry observer, I have been involved in the mining industry for some 20 years now.

In that time I have seen and been involved in a number of successful and not so successful ventures. I maintain a keen



Down to business: expanding a company's asset base into other commodities is easier said than done.

interest in evaluating the likely success or failure of various company strategies (in fact my livelihood now depends on it).

Whilst no one would doubt that commodities follow the "what goes up must come down" paradigm, some would say that some mineral commodities are more attractive than others. There is strong evidence to support this.

Commodities that have significant barriers to potential competitors such as iron ore are in fact structurally predisposed to higher profits than those with lower barriers such as gold. Over the 15-year period to 2003, the iron ore industry reported average returns of some 25% compared to the gold industry, which reported returns in the 5-15% range.

Following this rationale, it would seem a sound strategy for a mining company to find a way of establishing or refocusing itself in these current buoyant commodity markets. But barriers to entry make it difficult to get a piece of the action.

So, assuming you are one of the "have-nots" in terms of having exposure to commodities that generate high returns, what are the options available to expand your asset base to provide more value for shareholders?

One possibility is to protect your company from the devaluing effect of cyclical fluctuations in individual commodities prices, by diversifying into other mineral commodities. However, this may only offer partial insulation from the impact of a downturn in commodity markets, as mineral products and commodities in general tend to trend up and down collectively on the global stage.

Of course, expanding a company's asset base into other commodities is easier said than done, and requires significant levels of expertise, not to mention the costs

involved, to make any expansion viable.

A starting point for a company looking to diversify its commodity exposure may be to adopt an investment approach of relaxing restrictions on pursuing investment options in only a single mineral commodity, so consideration of other investment opportunities that have the potential to provide attractive returns can be assessed.

While systemic isolation from cyclical price fluctuations is difficult to achieve in the minerals industry, another alternative may be to diversify further, into non-commodity based industries that traditionally perform well when commodities don't, such as property, technology or service-based industries (in fact, just about anything except commodities).

These types of investment strategies preclude evaluation by statistical analysis.

In absence of any factual base for this argument, I would like to quote someone who should know a thing or two about this topic – Warren Buffet: "Diversification is a protection against ignorance. It makes very little sense for those who know what they're doing."

I agree with Warren on this one.

What experience has taught me is that those companies that can outperform others in the long run are the ones that can understand that any previous success was not based on a fundamental predisposition to greatness, but rather derived from products and/or services in which they recognise they have a strong inventory of experience-based knowledge.

This is what management theory would refer to as having a "competitive advantage".

Momentum Partners is a Perth-based management consulting firm focused on servicing the mining sector.