Where are we in the cycle?

Time to get up to speed

In the first of what we plan to be a regular series of articles focusing on a particular area of the investment company market, we are looking at the Specialist Commodities and Natural Resources sector. It is a sector that has not been doing particularly well, yet it is a sector that has a habit of experiencing swift reversals of fortune. We thought investors might appreciate the chance to get up to speed with these funds while they are still out of favour.

We asked the managers of three of these funds to tell us why they think the sector might be interesting now. Their comments are on page 4.

There is a relatively large number of investment companies investing in this area but, mostly, they are fairly small. This is largely because they were launched at or close to the height of a bull market and they have been hit since it turned. To illustrate the savage nature of these declines, below we show graphs of the prices of some key commodities.

Savage downward moves in prices

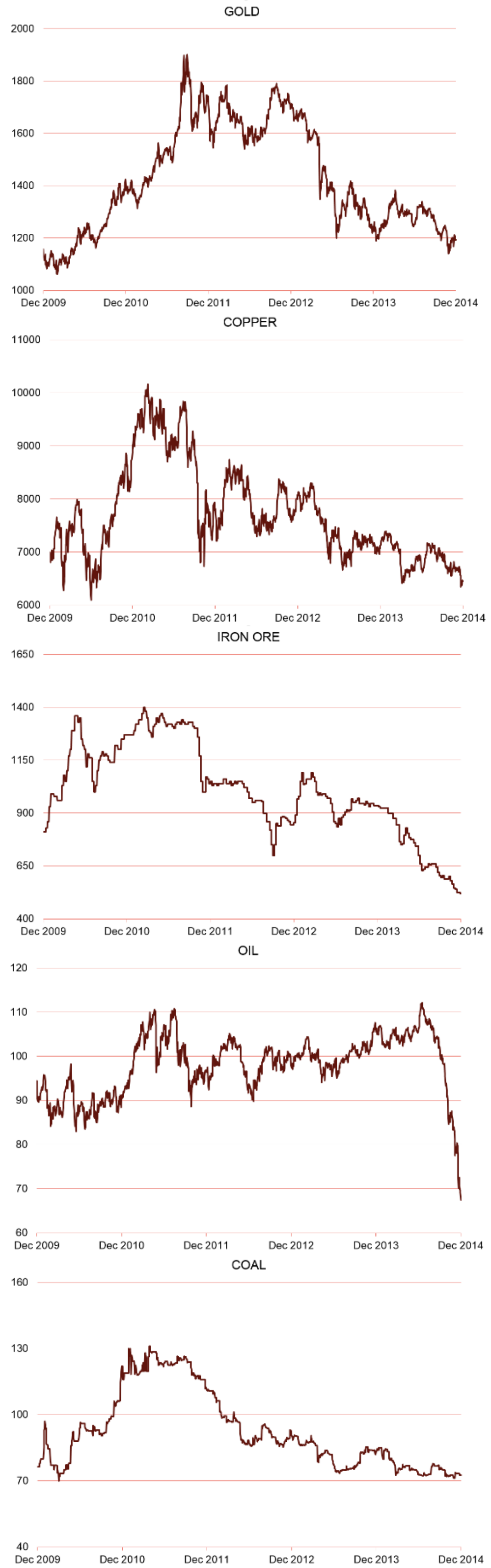
As you can see from each of the graphs, each of these commodities is trading well below its peak. Sometimes, as is the case with the oil price in recent weeks, these declines have been sudden and savage.

The price for each commodity is reacting to a range of factors but there are some common themes; falling Chinese demand, sluggish growth, the shale boom in the US (which has hit oil and gas prices) and a perception that too much supply was due to come on stream.

The gold price ran up after the credit bubble burst on fears that the measures adopted by central banks to stabilise markets, especially quantitative easing, would trigger inflation. In the event, the trend has been towards deflation.

In recent weeks the oil price in particular has been hit hard as Saudi Arabia resolved to keep pumping oil instead of adjusting production to maintain prices.

The commodity price falls have unnerved companies and they have cut back hard on expenditure. In the long run this should restrict supply and should help underpin price rises when demand returns.



Source Bloomberg: Gold (Spot), Copper (LME), Iron Ore (China import Qingdao) Oil (Brent), Coal (Rotterdam)

Remember this is a risky sector

There are factors in this sector that can make it quite a risky place to invest. Exploration companies can sink huge sums of money into prospecting for resources that turn out not to be there. In many cases the easiest to reach resources have already been exploited and so companies are forced to look in areas with high political risk or areas that are hard to access. The marginal cost of production (the breakeven price) can be quite close to the commodity price – leading projects to swing violently between loss and profit. And, perhaps crucially, companies have no control over the end price for their projects so they can invest considerable sums of money only to find that the price of that resource now makes the project unviable.

Comparing funds in the sector

The falls in the prices of resources have hit this sector hard – just look at some of the discounts to net asset value that these companies are trading on. Many of these funds are also now quite small. It is wise to remember that this has an adverse effect on their average running expenses as a percentage of net asset value (the ongoing charges ratio in the table).

	Discount to NAV	Dividend Yield (%)	Ongoing Charge (%)	Market Cap (£m)	1 year NAV (%)	1 Year Share Price (%)
Altus Resource Capital	-6.6		2.5	22.0	-18.0	-19.3
Baker Steel Resources Trust	-33.1		2.2	23.0	-26.7	-26.7
BlackRock Commodities Income	4.8	6.3	1.4	100.0	-7.9	-5.1
BlackRock World Mining	-11.7	6.4	1.4	580.0	-20.1	-21.2
City Natural Resources High Yield	-13.8	4.8	1.7	77.0	-9.4	-9.3
Geiger Counter	-14.7		3.0	17.0	-13.0	-6.3
Global Resources Investment Trust	-50.9		n/a	11.0	n/a	n/a
Golden Prospect Precious Metals	-9.9		2.4	16.0	-18.4	-19.0
International Oil & Gas Technology	-69.6		4.4	9.0	-23.8	-58.3
New City Energy	-15.7	8.5	3.4	13.0	-29.7	-22.4
Origo Partners	-55.5		5.8	25.0	-29.2	-10.5
Polo Resources	-77.9		2.1	20.0	4.1	-66.7
Praetorian Resources	-22.3		3.6	3.0	-48.4	-16.7
RAB Special Situations	-25.9		4.3	7.0	-19.6	2.5
Riverstone Energy	-15.01		0.9	665.0	7.2	-8.7
Tiger Resource Finance	-24.2		24.1	2.0	-38.7	-40.0

Source QuotedData,
figures supplied by Morningstar

*you can access up to date figures **here***

The sector is shrinking

Some of these investment companies are struggling in these market conditions. **Altus Resource Capital** lost a continuation vote on 4 December – its shareholders rejected the idea that it continue as an investment company and its Board of Directors now has four months to come up with proposals for the future of the fund. **Praetorian** said in June that its Board was "searching for strategic opportunities to bring renewed positive momentum and scale to Praetorian". **Tiger Resource Finance** had a portfolio worth just £1.7m at the end of September which may be too small to be viable (its admin expenses in 2013 were over £0.5m). **Origo Partners** is facing a vote called by an aggrieved shareholder who is looking to change the Board and accelerate the process of selling off its investments. **International Oil & Gas Technology** is already well into that process.

Large, diversified companies can be less risky

Large companies with diversified exposure to many different projects, exploiting many different resources in many different locations tend to be lower risk. Mature, long-life, low cost projects can throw off attractive levels of income. Some funds set out to have a bias to these areas of the market. Three funds (**BlackRock Commodities Income**, **City Natural Resources High Yield** & **New City Energy**) were set up to pay investors a reasonable level of income.

The largest fund in the sector, **BlackRock World Mining,** has adopted this policy in recent times. It started providing project finance to some companies in return for royalty income – the idea was that this would enable it to pay higher dividends to its shareholders. However in October 2014 it had to write off its £52m exposure to its first and largest royalty deal, London Mining, as that company was hit by falling iron ore prices and the impact of Ebola on its mine in Sierra Leone. The Board of BlackRock World Mining said that it would use its revenue reserve to maintain its final dividend to the same level as in 2013 but we will have to wait to see what the long-term impact will be.

The other big investment company dedicated to the sector is about a year old. **Riverstone Energy** is funding big energy projects in North America. So far it doesn't seem to have been impacted much by the falling oil price but, as most of the capital it raised is yet to be invested in projects (although over half has been committed), the weak oil price might be good news as it can negotiate better deals. There might be a worry though that many of the shale oil projects it wants to invest in are only marginally profitable at the current share price – so far Riverstone Energy hasn't commented on this.

Many smaller companies need cash badly

With the sector so out of favour, anyone who can provide finance to the resource companies that need cash is in a great position. Many junior resource companies are sitting on projects that have already had much capital sunk into them and have huge potential but they are struggling to access the capital needed to get these projects into production.

A number of investment companies were set up to address this problem. A good recent example of this is **Global Resources Investment Trust** "GRIT" which swapped shares in itself for shares in resource companies so that these companies could sell their GRIT stock for much needed cash – we have written a long piece of research that explains how this company works. **Polo Resources** just announced it would invest up to £4.7m in copper mining company, Weatherly and **Baker Steel Resources** is asking its shareholders to approve a vast expansion of its fund so that it can invest from a position of strength.

What do the managers think?

We asked the managers of three funds in the sector why they thought the resources sector might be interesting now:

Global Resources Investment Trust fund manager, David Hutchins, said: "*Everything that usually happens at the bottom of a cycle is happening. Specialist funds are closing down. The large cap stocks are focusing on cost control and returns to shareholders. Medium sized companies are going bust where they have not got the momentum to survive through their downturns.*

You can bounce along the bottom until you get a sustained uptick. That is the difficulty with the sector at the moment. Most people probably agree we are at or near the bottom, but what is going to make it turn? It is a relatively small sector so when it does turn and turns significantly, it will turn quickly."

Baker Steel Resources fund manager, Trevor Steel, said, "*Smart money is mobilising into funds that are targeting investment in the depressed resources sector such as Mick Davis's x2 Resources. In a sign of the value in public mining equity markets, Semafo recently made a move on Africa focused gold company Orbis Gold, and Antofagasta offered to acquire listed copper mine developer Duluth metals, at premiums of 77% and 284% respectively to their share prices before the bids. A resources focused private equity fund, QKR, is rumoured to be interested in buying Canadian listed miner Nevsun Resources for a billion dollars."*

In my view capital markets are currently very unreceptive to development companies' need for capital and such companies are therefore currently being particularly undervalued due to perceived financing risk. Therefore, it is timely to seek to exploit this opportunity through carefully selected investment with a preference toward companies with late stage development projects requiring the last tranche of capital to reach positive cash flow from operations."

New City Investment Managers senior fund manager, Will Smith told QuotedData: "*City Natural Resources High Yield Trust's current positioning reflects an aversion to bulk commodities, while it is overweight agriculture and the unconventional oil and gas sectors.*

Whilst acknowledging that a strengthening dollar provides a testing headwind for investors, we believe that the resource sector's current absolute and relative low valuations provide a compelling opportunity. With commodity demand growing, we are focusing on those areas where we see looming supply deficits such as copper, nickel and uranium. The

Company has a 15% weighting in gold and silver, focusing on the low cost producers."

In summary

QuotedData says: "*The management teams behind the investment companies are starting to call the bottom of the commodities cycle. Of course you could dismiss this as them "talking their own book" but, if they are right, the sector could be cheap.*

Some of the smaller investment companies may disappear over the course of 2015. Baker Steel Resources' actions though, as it tries to put itself in a much stronger position to provide finance to struggling resource companies, point to the potential of an exciting future for the sector

Investing in areas such as these, where you really do need to take a long-term view, is much better suited to investment companies than open-ended funds as managers can invest for the long-term rather than having to worry about finding money in a hurry to finance redemptions (as would be the case for an open-ended fund)."

Please remember that we aren't allowed to give advice to people who aren't professional investors so we aren't advocating doing anything. If you want to know more about any of the companies in the sector, there is a basic factsheet on each of them on our website, links to news items on them and, where our data partner Morningstar, has them, links to important documents such as annual accounts.

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