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How to bet on a resources recovery

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Few sectors of the market are as challenging as resources. Almost one in two ASX-listed companies is in minerals, energy or resource services, but the vast majority are too speculative. Portfolio investors need smarter ways to gain resource-sector exposure.

Long-term investors might ask: why bother with resource stocks? The S&P/ASX 300 Metals and Mining index, heavily weighted in BHP and Rio Tinto, has a five-year average annualised total return (including dividends) to October of 6 per cent. Over three years, the average annualised loss was 9 per cent.

Mining stocks badly underperformed the S&P/ASX 200 index over five years, despite a once-in-a-generation commodity price boom. The gold sector, in particular, has had a knack for destroying shareholder wealth, and it showed why investors are often better off avoiding gold companies and gaining pure exposure to the metal through an exchange-traded commodity.

I've heard compelling bull and bear arguments regarding resource stocks. Bulls argue the sector had fallen almost as far it could by July, when valuations for small and mid-size miners were thrashed. After plunging 80 or 90 per cent from their all-time price high, many explorers offered outstanding value.

The bears countered that any recovery was simply a bounce in a long-term sector downtrend. With China slowing and commodity prices coming off record peaks, the odds favoured a multi-year sell-off in mining stocks, with misplaced bouts of optimism that would inevitably burn investors.

Both views look too strong. Still, there's enough to suggest the resource sector can narrow the performance gap with the broader market in the next 12 months as confidences builds that China can maintain high economic growth and as the global economy slowly improves.

Traders might find more opportunities in the next few months as the market heads into the traditionally stronger Christmas/New Year period, and as the kerfuffle about the US debt ceiling fades, at least for a while. China's recent stronger-than-expected growth is cause for optimism.

Rather than punt on individual mining stocks, traders can "buy the sector" through a new breed of resource-focused exchange-traded products (ETPs). The DIGGA Australian Mining Fund is a good example: it tracks an index of up to 70 of the largest, most heavily traded mining stocks.

Issued by Chimaera Capital, the DIGGA ETP provides important diversification and, unlike other resource indices, is not skewed by heavy weightings in BHP and Rio Tinto shares. The index's biggest constituents are Fortescue Metals Group, Illuka, Alumina and Whitehaven Coal.

Specialist mining ETPs have been a long time coming, possibly because of liquidity issues with small and mid-size mining stocks in their underlying index. DIGGA's 100 basis point annual management fee, high by ETP standards, reflects the challenges in constructing and maintaining an index of smaller resource stocks.

DIGGA's recent performance topped league tables, although it is still down 22 per cent over one year. The fund rose 19 per cent in third-quarter 2013, followed by the BetaShares S&P/ASX Resources Sector ETF (18.7 per cent) and SPDR S&P/ASX 200 Resources ETC (17.5 per cent), according to the Morningstar ETF Investor report.

"Mining stocks did well as the slowdown in Chinese data abated, and bulk commodities rallied, iron ore prices rebounding well above US$100 per tonne," wrote Morningstar. If these trends continue into the New Year, as I expect, resource-sector ETFs should have a good fourth quarter.

Another new option for resource-sector exposure is the Market Vectors Australian Emerging Resources ETF, based on an index of junior energy and mining stocks. It's an interesting idea: rather than try to pick junior resource stocks that can rally in the next few months – and take on huge risk – the ETF gives exposure to 63 small mining stocks. Again, the strategy is about buying the sector rather than picking individual stocks, but the index should still be considered speculative.

Those ETFs suit traders and active investors, but self-Managed Superannuation Funds and other long-term investors need a different approach to resource-sector exposure. Depending on their timeframe and risk tolerance, long-term investors should consider allocating a small portion of portfolios to hard and soft commodities, to improve portfolio diversification, via ETFs.

As to stocks, portfolio investors should stick to ETFs providing exposure to ASX 200 mining stocks, and take care with ETFs based on indices over speculative miners. Be careful not to duplicate asset holdings with direct shareholdings: for example, holding BHP Billiton and Rio Tinto directly when the ASX 200 resource ETFs already have a heavy weighting in those stocks.

Of course, investors with a strong view on a mining stock will favour the direct approach to maximise gains. Those who simply believe the resource sector has fallen too far, and has further to recover as Chinese economic growth stabilises, could do worse than use a resource ETF to buy the sector. Risks are high, but not nearly as high as holding a few small resource stocks directly.

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Tony Featherstone is a former managing editor of BRW and Shares magazines. This column does not imply any stock recommendations or offer financial advice. Readers should do further research of their own or talk to their adviser before acting on themes in this article. All prices and analysis are October 24, 2013.

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