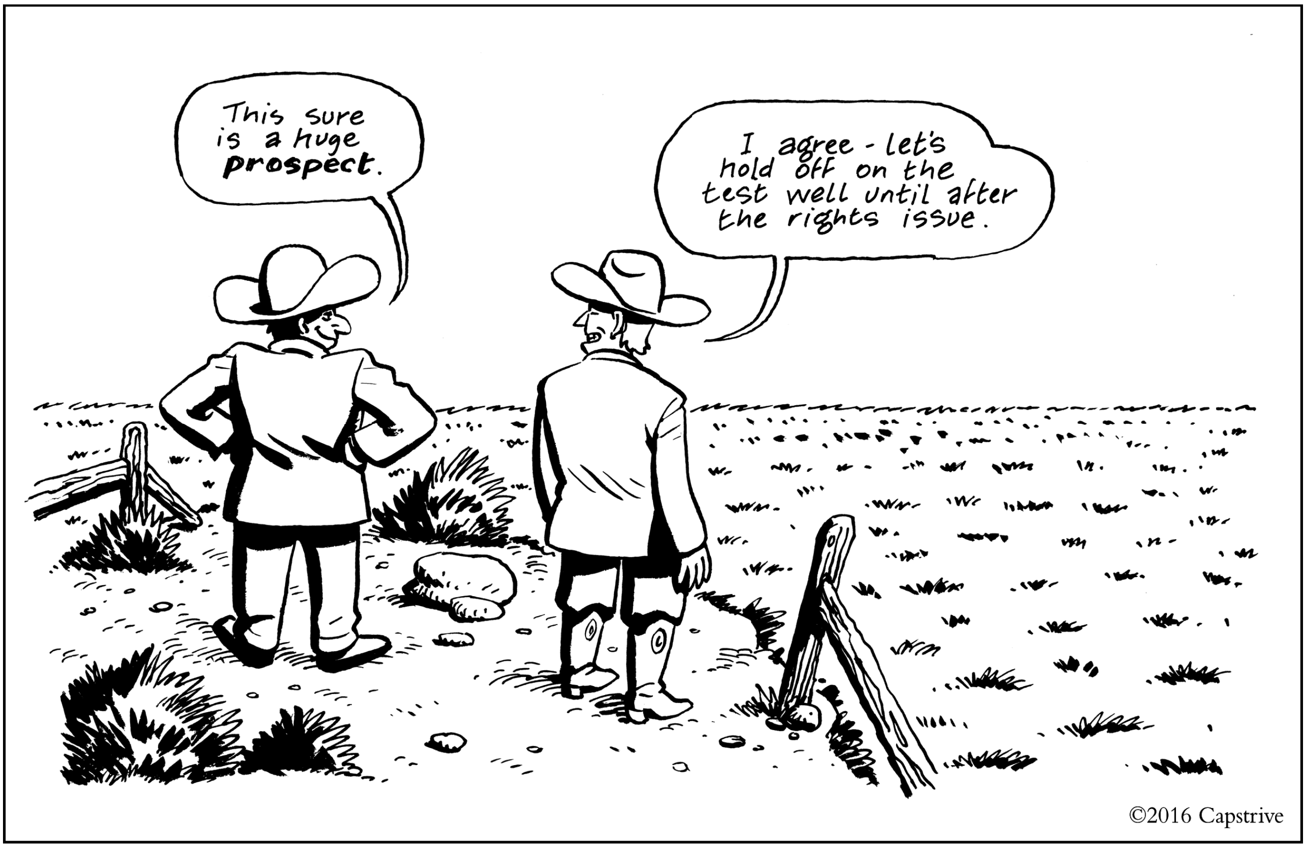

Commodity investing can be very rewarding, but for the most part it isn't. The most common definition of a commodity business is one which has no control over the sales price of its product. It is a price taker rather than a price giver. The obvious example is resource companies but lots of other businesses have no control over their average selling price. If one invests in a commodity company, and holds that investment for a long time, the gravity of poor industry returns virtually assures a poor result. There are exceptions of course, but on average commodity investing is an unrewarding endeavour. What follows is a brief exploration of the challenges of commodity investing.

Seven Challenges of Commodity Investing

Challenge #1: Anchor of Poor Industry Returns. Commodity industries are low return industries that act as an anchor/drag on returns for the majority of industry participants. Significant capabilities, effort or luck are required to avoid the industry dynamics for any sustained period of time.

Challenge #2: Low Returns attract Leverage. Because industry returns on capital employed are mediocre, commodity companies add leverage to get to a return on equity level that is sufficient to attract equity capital. Combining leverage and commodity businesses is an explosive mix that leads to boom and bust cycles. Fortunes can be made on the upswings that are quickly given back when the cycle turns. A commodity business is risky and leverage exacerbates the situation.

Challenge #3: Confusing Return of Capital for Return on Capital. When many investors look at valuation multiples like price earnings ratios for mining or exploration companies they fail to adjust for the fact that the companies have limited life assets. As minerals are extracted from the ground the company's assets are shrinking. Using Ben Grahams great analogy about the market being a voting machine in the short term, and a weighing machine in the long run, resource companies are rapidly losing weight, unless they are spending considerable capex on weight supplements.

Challenge #4: Compensating for Congenital Optimism. A colleague of mine once said that the best commodity company CEOs were 'optimists with stamina'. Having met dozens of resource patch CEOs I can relate to his sentiment. The industry seems to attract enthusiastic optimists with a zealous belief in their particular prospects. Stan Druckenmiller reportedly made the following wry remark at a Florida dinner in 2015:

"I don't mean to offend any Texans in the room, but if you ever met anybody from Texas, those guys know how to gamble, and if you let them stick a hole in the ground with your money, they're going to do it."

Challenge #5: Disproportionate re-investment Risk. Resource companies are continually re-investing so the value of the company you are buying is based primarily on the capital allocation skills of management. The quality of those skills is difficult to judge in an industry that is not conducive to re-investing at high returns.

Challenge #6: Market Timing. Very few people can call commodity cycles, yet to make outsized returns almost by definition requires superior market timing decisions for both the purchase and exit of investments.

Challenge #7: Valuation Error. The job of an investor is to value companies and buy their shares when they trade at a sufficient discount to assessed fair value. The valuation exercise for commodity companies is difficult with a high margin of error. In practice a probability based valuation approach is warranted and there will be a wider than normal distribution of possible valuation outcomes.

There are further challenges, some jurisdictional (rule of law, corruption) others geological (you never really know what you have until you have finished digging or drilling) which conspire to make commodity investing hard. It reminds me of a humorous Australian book called *Blue Sky Mines.* The common theme was to promote the great prospect but to never drill a hole! Here is an extract from back cover. The book is long out of print but second hand copies can be found through Amazon.

Given the above backdrop many sensible investors ignore commodity companies entirely, and, understandably, put commodity investing in the 'too-hard' basket. My preference is to retain a flexible mandate. The difficulty of making money in commodity investing does however put this category in the 'high-bar' basket. Capstrive sold all its energy related holdings in the second quarter (at modest, but arguably speculative, gains) with a view to raising the investment bar before re-committing our capital. Investments that are predominately based on rising commodity prices have a speculative element to them. This leaves one with the choice of recognising a speculative spade as a speculative spade, or preferably raising the bar in search of non-consensus investment insight.

L Endersen – 5th May 2016