

Comment on positioning in Anglo American and BHP Billiton

Short-term relative performance driven by Anglo American and BHP Billiton

Our underweight position in the large diversified mining shares has negatively impacted our relative performance over the past year. The outperformance of Anglo American and BHP Billiton is especially significant as these two shares account for 29.8% of the FTSE/JSE All Share Index. It would be fair to say that the strong growth in Chinese basic materials demand over the last decade and its impact on commodity prices has surprised us. We continually reassess our fund positioning and in the light of ongoing commodity price strength it is prudent to question whether we should remain underweight these shares.

Is the commodity price strength sustainable in the long-term?

The mining industry is going through an unprecedented boom with profit margins and returns at record levels due to abnormally high commodity prices. These high commodity prices are a consequence of the growth in Chinese demand for raw materials and the shortages that have resulted. This period of strong demand follows a twenty year period of lacklustre demand growth, depressed commodity prices and low profitability. Commodity producers cut back on exploration and investment during this period, leaving the industry ill prepared to meet the call for more production. The result is a tight market and high prices. This situation could continue for some time as Chinese demand continues to grow at high rates and delivery problems slow the supply response. However the high returns are attracting capital and in time this additional capital will depress returns. The returns will most likely reduce due to lower prices as supply increases, but this could potentially be exacerbated by softer demand (which may happen even if China continues to grow, but at a slower pace) and higher costs as the super profits flow through the system to labour, taxes and input prices. Super profits are not sustainable in the long term and we invest our clients' funds with a long-term view.

Our position reflects the extent to which we believe current earnings are above normal

That China will continue to grow and commodity markets will likely remain firm in the short to medium term does not alter the observation that commodity prices are currently very high. Prices could halve for most industrial commodities and the price level would still be above the incentive price (the price which incentivises investment in new productive capacity) as well as the long-term average. There are certain exceptions, for example aluminium. The low forward price earnings multiples of the diversified miners reflect that earnings are above normal but we believe the extent to which the earnings are above normal is not reflected. Considering both the level of earnings and the price earnings (PE) multiple we do not see value in the shares.

We focus on long-term valuations rather than index weighting or short-term earnings potential

Some may argue for holding Anglos and BHP because they have large weightings in the index and have strong earnings prospects for next year. We believe the shares are overvalued on a long-term view and thus do not hold the shares.

Selected Commodities Prices

		Spot	40 year average*	2002 Price (Cyclical Low)
Copper	USc/lb	3.97	1.99	0.71
Nickel	USc/lb	13.07	6.47	3.09
Aluminium	USc/lb	1.28	1.25	0.62
Iron Ore	USc/dmtu	137	55	28
Metallurgical Coal	\$/tonne	300	100	48

*The average is in real terms.

Source: INET, USGS

Our view of 'normal' commodity prices is closer to the long term averages than either the spot or cyclical low prices.

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