

The case for commodities and common sense

John Baron explains the portfolios' increased exposure to this asset class – and highlights an important shareholder vote



JOHN BARON

Opinion is divided as to the outlook for commodities, with some suggesting the 2021-22 price bubble will continue to deflate given the sluggish outlook for economic growth globally. Such sentiment is perhaps holding sway because the sector is certainly looking good value. However, specific factors and longer-term trends suggest such concerns are overplayed. The portfolios have been adding to their exposure since the New Year. There is also one metal that perhaps deserves a special mention given both environmental considerations and the geopolitical outlook.

Sound fundamentals

Sentiment continues to trail the fundamentals. Commodity and energy companies usually trade at a market discount – the average having been around 25-30 per cent relative to the S&P 500 for several decades. The MSCI World Energy index is currently on a price/earnings ratio of 11-12 times. The market retains little faith in the sector. Economic concerns – particularly the current woes in China – weigh heavily on investors' minds. Of course, the sector hosts a broad range of metals and energy resources, each with their unique qualities and applications, but in aggregate valuations remain attractive relative to outlook.

Several tailwinds look set to reignite interest. A key factor remains the supply/demand balance. After a period of overexuberance, the sector has been proactive in putting its house in order in recent years. Companies have been much more focused on capital discipline. Exploration and extraction have been curtailed – and capacity reduced as a result. Balance sheets hold much more cash and less debt.

The sector is now generating close to record free cash flow. This capital discipline continues to constrain new supply. Meanwhile, a further supply factor is that the grades from some existing mines are declining as they mature.

On the demand side, various longer-term trends remain supportive. These include rapid urbanisation in Asia and growing populations, which require a greater investment in infrastructure. Governments around the world are also needing to increase infrastructure expenditure given the lack of investment in previous decades and the need to better facilitate economic growth. This will remain supportive for commodities for some time to come. The extent of investment by governments is perhaps illustrated by the sums earmarked by the US administration.

Meanwhile, despite the inflation picture improving over the course of this year, my long-held view that the level will remain higher over the medium to long term (with 3 per cent-plus becoming the new 2 per cent) should also be supportive of the sector. The column 'Preparing for inflation' (12 March 2021) explains the reasoning. The gradual introduction of more resilient and localised supply chains – in part due to geopolitical tensions, an increase in cash reserves to better deal with any crises, and the sourcing of cheap labour becoming more difficult – will all adversely impact corporate profitability unless prices rise.

40%

40 PER CENT OF THE WORLD'S URANIUM PRODUCTION IS BASED IN KAZAKHSTAN



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In addition, the inadequacy of many of our global organisations, the deflationary force that was globalisation 'stalling' if not reversing, the new balance between capital and labour, an ageing population gradually shrinking the supply of labour, and ongoing international tensions, all point to long-term structural shifts in the inflation equation. And while the correlation is not linear, natural resources have usually performed well during such periods – perhaps even more so today, when the nuances that usually facilitate international relations have hardened, and their place on the diplomatic chessboard has assumed more importance.

The net zero agenda is a further tailwind, despite the inevitable bumps in the road. Many minerals are important to helping governments reduce their carbon footprint. Despite sluggish economic growth, the pressing need to decarbonise economic activity in forthcoming decades will, for example, continue to create further pressure on all resources associated with the electrification of energy production and transportation – such as copper, nickel, lithium and cobalt.

Uranium is another interesting example. Nuclear power received widespread endorsement at COP28, with an international agreement to triple installed generating capacity by 2050. The ghost of Fukushima has been laid to rest. Nuclear power plants tend to be high-cost long-term investments, yet the spot price makes up just c5 per cent of production costs – demand tends to be price-inelastic. There is also a geopolitical consideration. With around 40 per cent of the world's production based in Kazakhstan, at a time of heightened tensions, uranium has become a strategic resource of the highest order. This will not hinder the price over time.

Portfolio update

A number of the 10 real investment trust portfolios managed in real time on the website www.johnbaronportfolios.co.uk – including the Growth and Income portfolios covered in this regular column – have been increasing exposure to commodities in recent months courtesy of the

following companies. This has been in part to help some portfolios achieve their diversification remits, given the sector has one of the lowest correlations of other assets to equity markets. Indeed, given geopolitical tensions, certain events could see the sector behaving very differently.

BlackRock World Mining (BRWM) invests in mining and metal assets worldwide, while up to 10 per cent of assets can be held in physical metals and 20 per cent in unquoted investments. Performance has been respectable against its benchmark, which was amended a few years ago. The managers are encouraged by the structural demand growth for a range of mined commodities resulting from the low-carbon transition. They also point to mining companies having low levels of debt and continuing to return capital to shareholders - but, while remaining positive, highlight a higher capital expenditure phase that may stymie some dividend payouts. Meanwhile, the 33.5p dividend equated to a yield of 6.6 per cent when bought.

CQS City Natural Resources Growth & Income (CYN) has a good track record of generating capital growth and income from a portfolio of global smaller mining and energy companies, and from associated fixed interest securities. Speaking recently with Keith Watson, the lead manager, the flexible mandate allows the company to shift portfolio weightings according to investment opportunities. In addition to oil and gas, exposure includes precious metals, lithium, uranium, coal, base metals, and rare earth minerals. The company trades on a c14 per cent discount, employs a modest element of gearing, and the regular dividend equated to a yield of 3 per cent when bought - the company also having recently paid a special dividend.

Geiger Counter (GCL) seeks capital growth through investment primarily in companies involved in the exploration, development and production of energy predominantly within the uranium sector - although up to 30 per cent of the portfolio can be invested in other resources. Speaking recently with Keith Watson, uranium mining companies are a geared play on the price - particularly those with fewer long-term supply contracts - and the outlook remains promising. While share price volatility should be expected, a discount of c25 per cent, which is towards the bottom of its 10-year range, together with a respected management team and excellent track record, suggest patient investors will be rewarded.

Abrdn Property Income shareholders' vote

On a separate note, **Abrdn Property Income (API)** is approaching an important shareholders' vote. Perhaps concerned about the company's size (c£200m market cap) and discount, the board recently recommended shareholders accept a bid from **Custodian Reit (CREI)**. Shareholders voted down the proposal. Given the result, and perhaps because the company and sector in general has struggled somewhat in recent years, the board is now proposing to wind-up the company - a process that may take 18-24 months. A vote on this latter proposal at an EGM is expected shortly.

API is held in several portfolios including the Income portfolio. The company presently stands on a c33 per cent discount, maintains a dividend that currently equates to a yield of 7.8 per cent and manages a quality portfolio of mostly industrial assets across the UK under its long-serving and respected manager, Jason Baggaley.

John Baron waives his fee for this column in lieu of donations by Investors' Chronicle to charities of his choice. As these are live portfolios, he has interests in all of the investments mentioned.

With interest rates set to fall, inflation helping to ensure progress on rents, the outlook for its key asset continuing to look encouraging, and poor sector sentiment, I suggest now is not the time to desert the sector.

This scenario is symptomatic of a wider conundrum for investment trust boards and shareholders. There is a view that as the wealth managers continue to consolidate and work from centralised buy lists, some will come to only consider large, liquid investment trusts - perhaps with a minimum market cap of £1bn, even if not announced publicly. Estimates suggest more than 100 investment trusts could be wound up or merge in the next one to two years.

I retain the view that there will remain an important role for the 'smaller' trusts - particularly those offering a specialism and good track records. The portfolios will certainly continue to seek best value and prospects, within the bounds of marketability - an endeavour that may actually be assisted by these managers should they indeed increasingly focus on more centralised lists. Let us hope boards, on behalf of shareholders, make the right decision rather than the easy one when considering the options.

The investment house, **Abrdn (ABDN)**, would certainly be supportive of API continuing and would support the board in activities to narrow the discount - as it has demonstrated with other investment companies in its stable. Meanwhile, management believes company and sector prospects look set to improve: "We expect the UK real estate market to bottom out in 2024 and start to improve in the latter part of the year and into 2025." As such, I will be voting against the board's recommendation to wind up the company. ●

PORTFOLIO PERFORMANCE

	Growth	Income		Growth	Income
1 Jan 2009 - 30 Apr 2024			YTD (to 30 Apr)		
Portfolio (per cent)	420.3	290.5	Portfolio (per cent)	3.6	3.7
Benchmark (per cent) *	262.2	172.9	Benchmark (per cent) *	5.	
			Yield (per cent)	3.1	4.3

*The MSCI PIMFA Growth and Income benchmarks are cited (total return)

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