Cuffelinks
Connecting investors with ideas

Edition 130, 16 October 2015

This Week's Top Articles

Sustainable, responsible or ethical – what's the difference?

Warren Bird

There is a lot of confusion when the subject of 'responsible' investing comes up. The term is often used as an alternative to 'ethical' investing, though these aren't necessarily the same thing. To add to the confusion, so-called 'impact' or 'social benefit' investing are different again. This article aims to shed some light.

Responsible investing involves ESG

Responsible investing is a broad church of investment processes that have one important feature in common: when they make the usual investment decisions – stock picking, etc. – a 'responsible investor' explicitly takes account of environmental, social and governance factors (ESG).

- An example of E might be: is the business involved in an industry that creates a lot of pollution and thus might be the target of changes in government regulations or tax regimes?
- An example of S might be: does the business have a poor workplace health and safety record, which could result in it having low staff morale which can adversely affect customer service?
- An example of G might be: does the business have a poorly articulated process for selecting Board members and thus may struggle to implement strategy successfully.

ESG considerations are in addition to the usual financial and macroeconomic drivers that analysts look at. Adherents believe that these sorts of factors have an effect on how a company will perform over time for its shareholders and debt investors. Responsible investors also believe that focussing investments on positive ESG-rated companies is good for business because it helps to enhance the world in which the company operates.

This is why responsible investing is often called 'sustainable' investing – the idea that a company with strong ESG ratings will be a more robust business that not only contributes towards sustaining the environment and the health of society, but is therefore a sustainable business. It's not just about surviving the economic cycle, but the trends in society that are addressing issues like: more honesty and positive ethics in business;

cleaner air and abundant water for everyone; and a better partnership between labour and capital than the acrimonious relationships of the past.

Use of ESG rankings

The responsible investment universe is occupied by a wide field of individual styles and approaches. For instance, you can have equity managers who favour growth stocks and those who favour value stocks, and there are many different ways that ESG ratings on companies are taken into account.

The most common is to attach a higher risk factor to the return projections for the lower ESG ranked companies. Under this approach, the manager will still invest in a poor ESG rated company, but only if the share price is low enough to provide a higher expected return for the risk. (If it's a corporate bond being looked at, a wider credit spread would be needed to compensate for risk.)

Another approach is to use ESG rankings to bias the degree of overweight or underweight position the fund will take in a company. High ESG ratings enable a larger overweight to a company with positive financials and short term return prospects than low ESG ratings.

Yet another is to use ESG ratings as a screen – excluding the bottom X% of ESG rated companies in a sector, for instance. This is where the issue of fossil fuel divestment comes in. Some managers believe strongly enough that this particular 'E' factor warrants exiting these investments. Mostly this isn't because of a 'moral crusade', but a view that governments around the world are likely to move towards policies encouraging less use of fossil fuels and that this will result in the assets of these companies falling in economic value over time.

Whichever of these approaches a manager may take, most of them also use ESG research as a tool to guide their engagement with the companies they invest in. For example, they hold shares in company B that has a poor 'S' rating because of poor compliance with workplace health and safety requirements. Rather than selling their shares, they will meet the management and discuss the negative impact of this on the company's performance, encouraging them to lift their game. If you don't own shares you can't engage in this way.

What are 'ethical' investors?

Among those who use ESG as a screening device may be found the majority of ethical investors. Ethical investors usually screen out certain companies because they're involved in activities with negative 'S' characteristics (eg they're involved in gambling or illicit drug supply) and explicitly favouring of certain types of businesses regarded as being positive for society. Some ethical investors also screen out on 'Environmental' grounds as well, though not all use 'E' factors in that way.

Ethical investing is a minority group within the responsible investment universe. It's an approach that doesn't translate well into the public offer managed funds space. There's a place for it and some fund managers are achieving some success with ethical offerings. However, the question of 'whose ethics do you use?' tends to get in the way of them being broadly accepted. Even among ethical investors, the list of excluded and preferred activities varies.

Ethical approaches are common when all the funds being managed are 'in-house' in some sense. This can range from an individual's SMSF through private family office funds to self-contained institutions like church denominations where the synod or assembly agrees the ethical principles to be adopted.

Impact investing is different again

Impact investing is about making decisions that, while sound financially, also have direct, measurable and meaningful social outcomes. Normally it requires government involvement as it's usually government that wants the cheapest option for delivering social policy outcomes and is prepared to pay the income on an impact investment if the programme is successful. For example, if a programme to help rehabilitate prisoners is successful then that will save governments money from not having to return those people to jail. If the programme is funded by private investors, then their return comes from government payments that reward the success of the programme.

A personal comment

My former employer was one of the first Australian signatories to the United Nations Principles of Responsible Investment (UNPRI). They thus committed to incorporating ESG into their processes.

They are one of the largest fund managers in Australia. My current employer is not one of the largest, but requires the church's investments to be in accord with a set of ethical principles that reflect the values of the members of the denomination. In both cases, the funds these organisations manage deliver strong, competitive returns to investors. It doesn't prove the case by any means, but in my experience, being a responsible investor in no way detracts from investment performance.

Warren Bird is Executive Director of Uniting Financial Services, a division of the Uniting Church (NSW & ACT). He has 30 years' experience in fixed income investing. He also serves as an Independent Member of the GESB Investment Committee. This article is general education and does not consider any personal circumstances.

Don't have retirement village regrets

Rachel Lane

The stories of people moving into a retirement community and suffering buyer regret years later when they realise what they get back have been well told. The ABC's 7.30 programme highlighted the issue again recently with a story about children who had seemingly done the right thing and read the agreement yet were shocked at the actual cost when their mother's unit was sold six years later and the village operator received circa $76,000.

Such stories also contribute to the other type of buyer regret – people who wish they had made the move sooner.

Understand the arrangements before you move

No matter which type of regret, it is too late to do anything about it now. You can't wind back the clock and move into the village sooner and if you are at the point of leaving the village it is too late to negotiate a different financial arrangement. What they needed was to identify the village or villages that would meet their lifestyle needs and have the legal and financial aspects explained to them well before they moved in.

Of course, that's easier said than done as many of the legal and financial arrangements are complicated.

Let's start at the start.

Retirement communities can be broadly grouped into Retirement Villages and Over 55 Communities (sometimes called Manufactured Home Parks). Retirement Villages operate under the relevant state or territory legislation, often The Retirement Villages Act, which sets age requirements and deals with some but not all financial arrangements. A small number operate under residential tenancy laws. Over 55's, on the other hand, operate under caravan park or residential tenancies arrangements or a combination of the two.

The legal contract for a Retirement Village unit can take a number of forms, from strata title to the more common leasehold and licence arrangements. In some cases, company share and unit trust arrangements give the right to occupy a unit in exchange for the purchase of shares in a company or units in a trust. In an Over 55's community, the contract is over the land rather than the unit - the purchaser owns the unit and has a leasehold or lease over the land. Of course, there is a big difference between having a 12 month lease and having a 99 year leasehold arrangement. It also creates the interesting situation of being a homeowner and a tenant at exactly the same time.

Costs associated with different structures

Whether the person lives in a Retirement Village or an Over 55's community, the form of legal ownership will dictate their rights and responsibilities in relation to their unit and the costs associated with it while they live in the community **and** after they leave - so it's important to understand.

The costs can be broken down into the ingoing, the ongoing and the outgoing.

The ingoing is the amount the person pays for their right to occupy their unit together with other costs such as contract preparation fees or stamp duty.

The ongoing costs will include the expenses associated with the facilities and management of the community. In a Retirement Village, these are often called general service charges or recurrent charges and in Over 55 communities they are known as site fees as well as the resident's own personal expenses. In many retirement communities the operator delivers (or engages with external providers to deliver) extra services, such as domestic help, meals and in some cases, care. These services are normally offered on a user pays basis and are in addition to the other costs. Residents are normally responsible for their own utilities as well. Making a budget that incorporates all the costs including pension entitlements, rent assistance and other income is a good idea.

The cost of leaving a retirement community normally causes the greatest confusion. There are many different exit fee models, most based on either the purchase price or the sale price and are for a percentage multiplied by the number of years the resident stays in the village. A common model historically has been 3% per year for 10 years based on the sale price. In more recent times, exit fee models have tended to be higher, and anywhere between 35% and 45% is not uncommon.

What many people fail to appreciate is that there is more to the exit fee calculation than just the percentage-based cost, often referred to as the Deferred Management Fee or DMF. There can be sales commissions to the village or to an agent and refurbishment costs to bring the unit up to the current standard within the village. Understanding all of the fees and charges and putting them into dollar terms is important, although it often involves the imperfect science of predicting how long the resident will live in the village and what their unit will be worth when they sell.

The Retirement Living Handbook

To help people navigate the maze and avoid some of the traps, Noel Whittaker and I have teamed up again to write The Retirement Living Handbook. It covers the important aspects of moving to a retirement community from finding the right retirement community to the different forms of legal contract and financial arrangements through to the impacts on pension entitlement and eligibility for rent assistance. There's more than a dozen case studies from Australian retirement communities so you can see how the theory plays out in practice.

We will be hosting a book launch in Sydney on Monday 19 October 2015 and would like to extend a personal invitation to Cuffelinks readers to attend. The event will be held at 2pm at Club Central, 2 Crofts Ave in Hurstville. Noel and I will be sharing our top tips and you can have your copy of the book signed. To rsvp call 1300 855 770.

Rachel Lane is the Principal of Aged Care Gurus and oversees a national network of financial advisers specialising in aged care. This article is for general educational purposes and does not address anyone's specific needs.

Investment newsletters: making sense of stock recommendations

Arnie Selvarajah

Investors find themselves awash with financial information. It flows from an array of sources – the ASX, companies, journalists, brokers and colleagues – imploring investors to buy or sell a dizzying array of securities, from blue-chips to small-caps and everything in-between.

While many investors turn to financial planners and fund managers to make sense of it all, the growth of SMSFs shows that some people prefer to do it themselves.

And by their side is often an investment newsletter.

Do newsletters deliver results?

These scribes – and there's no shortage to choose from – promise to guide investors through the financial maze. But which ones add value? And, how can an investor cope when inundated with hundreds of stock picks a year, often from the same newsletter?

Outperforming the market has never been harder. An incredible 90% of the world's data has been produced in the last two years according to IBM. It is a major driver behind the 'paradox of skill': absolute investor skill has risen but relative skill has fallen.

Before 1990, 14% of US equity mutual funds delivered true alpha (or outperformance), according to University of Maryland research. By 2006, the outperformers had dwindled to just 0.6%, even as the total number of mutual funds had increased. By 2014 in Australia, the majority of active managers in all categories (barring small-caps) failed to beat their comparable benchmark indices over the three and five-year periods ended 2014, according to the SPIVA Australia Scorecard.

In this environment, expecting a hot stock tip to lead to riches is an unrealistic expectation – yet this is how many investors use investment newsletters.

The upside down funnel

Too many investors begin with stock recommendations and only then begin the research process by evaluating a security's underlying fundamentals.

It effectively creates an upside-down funnel which limits the breadth of investment choice and leads an investor into unwitting behavioural biases. These include confirmation bias (where investors overvalue information that confirms pre-existing beliefs) and availability bias (where investors give greater weight to recent information).

Instead, investors should take a step back and first define their personal investment goals and beliefs.

It need not be a complex exercise. The starting point to finding out who you are as an investor can often mean defining who you're not.

For example, most SMSF trustees have a long-term investment horizon, want to generate income, and don't want to risk heavy capital losses. This type of investor should be wary of investment newsletters which have a track record of returns built on recommending volatile or speculative stocks.

Knowing who you are ultimately rests on a knowledge of the fundamentals. At its core, stock picking advice begins with an analysis of a company's financial data. Analysts run those numbers and, in combination with their own qualitative view, rate a stock a 'buy', 'sell' or 'hold'.

Most investors don't pay enough attention to those numbers. For example, a value-oriented investor should analyse factors such as where the price-earnings ratio, or price-book ratio, ranks relative to the company's sector and the broader market.

However, a growth-oriented investor should be more focused on the company's (realistic) earnings and dividend growth potential, which is partially captured in the PEG ratio (price-earnings ratio divided by growth), as well as factors such as return on equity.

Those examples are purposefully simplified. Each investor's exact criteria can only be defined through careful study and personal experience. Without that, an investor will be doomed to automatically act on recommendations which will inevitably lead to poor outcomes because they don't truly understand the basis on which they were made.

There is another benefit to knowing your own investment style – a far broader array of securities can now be filtered across the entire market. It immediately rules out unsuitable recommendations or the latest hot stock grabbing media headlines. 'Decision fatigue' is also reduced when an investor no longer has to weigh up dozens of stock recommendations and opinions.

The funnel is now the right way up.

Fine-tuning the advice

From here, an investor can start to fine-tune the flow of information to maximise the value they receive from investment newsletters.

It can be confusing to subscribe to several newsletters offering conflicting trading advice. A better strategy may be to use one stock-picking newsletter (aligned with an investor's own investment beliefs) and supplement that with investment newsletters offering a different intent. Cuffelinks, for example, promotes discussion around market dynamics and various investment strategies, while some others are centered on the expertise and personality of one individual. For example, the Switzer Report's Peter Switzer (generally bullish) or the Eureka Report's Alan Kohler or John Abernethy (generally bearish). Which type of investor are you?

Similarly, some sources have particular areas of expertise, whether it be specific stock sectors or just a broad economic perspective. Bell Potter's TS Lim is a highly respected bank analyst and his advice is well-followed, but investors don't turn to him when they're assessing resource stocks.

This type of deep quantitative analysis on a sector-by-sector basis is usually more revealing than qualitative analysis, just as original sources of information tend to have more value than aggregators (which often impart their own spin and leave out the original data).

Finally, judge an investment newsletter on its success. No-one can outperform all the time, but over the long-term, skill always shines through. Investors can also take some comfort when experts are also investors who back their recommendations with their own money because they're on the same ride too.

There may be no shortcuts to investment success but using market information in the right way is a great start.

Arnie Selvarajah is the Chief Executive of Bell Direct. See www.belldirect.com.au.

The reality of roboadvice

Steven Nagle and Anthony Saliba

The impact of digital innovation has been felt in many parts of the global economy and the financial planning sector is not immune. Recent turbulence in the advice industry, coupled with an increasingly engaged and digitally-aware public, has created the perfect environment for digital disruption. Technology has a key role to play in improving the availability and consistency of financial advice and one area in particular that has been receiving a lot of interest is the use of roboadvice.

While the term robo-advisor could be taken to imply a robot or algorithmic digital tool designed to perform all of the tasks of an adviser, Australia has yet to see a roboadvice tool which comes close to offering the full services of a traditional financial adviser. The scope and sophistication of financial planning software and online calculators is increasing, but they are still essentially support tools or algorithms. If we look to the US, where the phrase robo-advisor was coined and where they have had the most success, we see that the majority of these services focus on portfolio construction and rebalancing. However, this activity is a very narrow subset of what is usually referred to in Australia as advice – that is, assessing an individual's financial position and proposing holistic strategies to improve that position – so we are a long way from replacing human advisers with machines.

Benefits and limitations of the roboadvice model

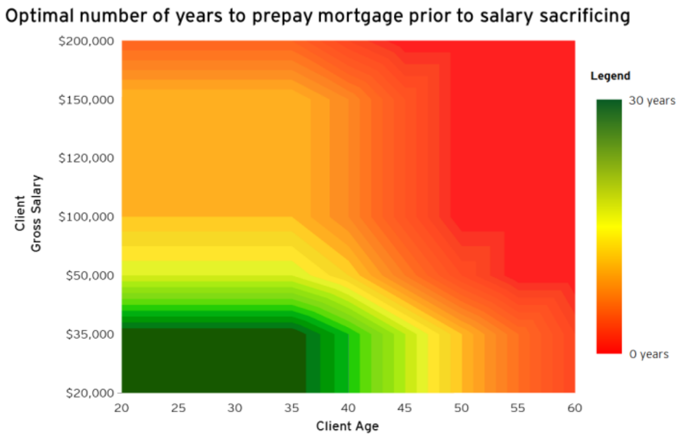
Complex advice algorithms have many benefits, but they also have their limitations. To illustrate the challenges in bridging the gap between algorithmic roboadvice tools and the more holistic work of a financial adviser, we have explored a typical, seemingly simple, advice scenario.

Suppose an advice client currently has a mortgage on their family home and is considering the following two options:

1) Making prepayments on the mortgage to pay if off sooner; or

2) Entering into a salary sacrifice arrangement to build up their superannuation savings.

To provide insight into the level of complexity required to deal with what appears to be a relatively simple question, we illustrate the results of our algorithmic calculations in the figure below.



Note: This chart was constructed using many different assumptions about various client types and economic assumptions and should not be relied upon for financial advice. It is provided for illustration only. For example, we have assumed that client age is a proxy for remaining mortgage term.

As the chart shows, there is no one-size-fits-all solution. For many people – such as those who are closer to paying off their mortgage and are on higher marginal tax rates – paying off their mortgage with free cash flow may not be the optimal strategy. They could stand to be in a better financial position at retirement if they were to salary sacrifice this free cash flow instead. Conversely, younger individuals on lower marginal tax rates may be better off financially if they elect to prioritise paying off their mortgage.

Not a trivial calculation

Even by restricting our analysis purely to the objective of maximising net wealth at retirement, arriving at the best solution for the client is not a trivial task and requires the exploration of multiple scenarios to arrive at an appropriate strategy. While this can be achieved with commonly available planning tools, it is a time-consuming process, especially if a high degree of accuracy and consistency is required. This provides an opportunity for 'next-generation' algorithmic tools that can perform the mechanical operations quickly and in a way that gives the adviser confidence in the accuracy and consistency of the results. The adviser would then be able to generate a reliable strategy and talk the client through it in one sitting.

However quick and accurate they may be, algorithms on their own are not enough as there are many variables that must be addressed, some of which are subjective. For example, the algorithm used to generate the output above does not capture liquidity preferences, the risk of breaks in employment, possible changes in salary, bequest motives or other sources of uncertainty, such as a potential spike in interest rates. While some of these considerations can be addressed by developing smarter algorithms, others require higher level thinking. An example of this would be factoring in an individual's preference to reduce their leverage as quickly as possible, to achieve greater peace of mind. This is more than a numerical optimisation exercise; it requires human-like intelligence.

Who will be the winners?

What does this mean for the future of robo-advisors? We expect to see the development of greatly enhanced algorithmic tools to support advisers, with benefits including:

- Speed and efficiency of advice
- Reduced cost to serve and increased proportion of the population serviced by the advice industry
- Increased consistency of advice and the potential to enhance documentation and record keeping
- The retention of advice data in readily-accessible digital formats to assist with compliance functions, client engagement and trend identification.

As for the term roboadvice, while great for headlines, it is a little unhelpful when it comes to understanding the reality of the advantages that automated algorithms can bring to the advice industry.

We are still many years away from robo-advisors having sufficient artificial intelligence to replace financial advisers. However advisers do need to acknowledge that they are part of a rapidly changing industry which is adopting algorithmic tools of increasing sophistication. This is both a great opportunity, as well as a threat to those unable to adapt quickly. Early movers who take advantage of these advances in technology will attract more clients, increase productivity, drive down costs and serve previously unadvised segments of the market.

As with many technological advances, the ultimate winners are likely to be the end consumers. With such a large portion of the population currently unadvised, and no let-up in the complexity of our financial system, this can only be a good thing.

Steven Nagle is a partner in EY's Oceania financial services practice. Anthony Saliba is a manager in EY's Oceania actuarial services practice.

The views expressed in this article are the views of the authors, not Ernst & Young. The article provides general information, does not constitute advice and should not be relied on as such. Professional advice should be sought prior to any action being taken in reliance on any of the information. Liability limited by a scheme approved under Professional Standards Legislation.

Roboadvice disruption – you won't see it coming

Donald Hellyer

Cuffelinks' article, "Scenes from a roboadvice pitch to angle investors" provoked much comment. There was an air of cynicism in the feedback that roboadvice would never really replace current incumbents. The client acquisition costs (CAC) were too high and existing franchises would prevail.

But predicting the future is very difficult and even futurists, while entertaining at corporate conferences, have limited success. The Washington Post recently ran an article about what people in the 1900s thought the 2000s would look like. Their predictions were comical.

The financial industry is locked in its current mindset and sees no immediate danger. But we forget that there are many more institutions that touch the mass market, probably materially more effectively than financial service companies. Who said Coles, Qantas or Telstra can't take a crack at our industry? Roboadvice will materially reduce the cost of entry for many players. Traditional providers will need to be wary of disrupters buying a minority stake in a roboadvice start-up and offering very low-cost product to their sizeable client base.

Here is my prediction how an ordinary person may relate to financial services in the near future, having been tempted away from traditional providers. As with the people in the 1900s, my imagination is constrained by what I know is technologically available now. But there is a huge amount being refined by the day.

A glimpse at a possible future for Tracy

It's raining outside as Tracy catches the 400 bus from Randwick Hospital to Bondi Junction. It's been a long shift as a nurse, her energy spent on a full ward with the usual number of distressed patients and family.

Sitting on the bus Tracy looks at her iPhone and sees a few messages from friends and a couple of notifications on NursePlus. The first notification advises Tracy of new job positions at the nearby St Vincent's Hospital and the second notification tells her that her total wealth changed by $3000 last month and to click through to see why.

The NursePlus app is an increasing favourite of Tracy's since she downloaded it three months ago. Her friend recommended it to her and by registering Tracy was in the draw for two tickets to the upcoming Cold Chisel concert.

NursePlus keeps Tracy in touch with the major events occurring in her industry including changes in accreditation rules, union activity, and nurse discussion blogs and chats. Tracy particularly likes the special deals, including discounted tickets, Coles specials and women's fashion.

NursePlus shows how Tracy and her husband spend their money in an easy to understand way. She is impressed with NursePlus's ability to combine transaction data from her Credit Union with those from her husband's Westpac account. As she thumbs through the expenditure categories Tracy realises how much repairs and maintenance are now costing on the second car. "Time to sell", she thinks.

No wonder NursePlus is prompting her to save more if she wants to retire at 65. That's only five years away. Tracy has played with NursePlus's retirement tool and realised she could come up short. NursePlus has shown her she has at least a 25% chance of not having sufficient superannuation if she wants to go on her overseas trips every three years and give $50,000 to her daughter to help with her house deposit in a couple of years' time.

Tracy decides to transfer her super to NursePlus. She thinks, "Why not?" Tracy never visits her old superannuation fund website and NursePlus seems more in tune with her personal and financial needs. Tracy could never afford one of those fancy financial planners and NursePlus provides all she needed.

To move her super, Tracy uploads a picture of her driver's licence and Nurse's ID. She electronically signs her authorisation to allow NursePlus to manage the funds transfer. With a push of a button Tracy knows NursePlus will handle all of the paperwork. These days, electronic signing and authorisation make life so much easier, she thinks.

Tracy feels in control

For the first time, Tracy feels in control of her finances. She can see where she can make savings and if she is on track to retire. She can see on one screen what she has in the bank, super fund, term deposits and that rental property she owns. She can even see her frequent flyer miles and flybuys.

Tracy sees another notification from NursePlus. There is a 'two-for-one' offer at the Event Cinema at

Bondi Junction. She hits the button to buy the tickets. Tired as she is, a night out at the movies sounds great. As Tracy relaxes on the bus, she wonders if her husband has signed up to BusinessPlus, the accounting app she showed him.

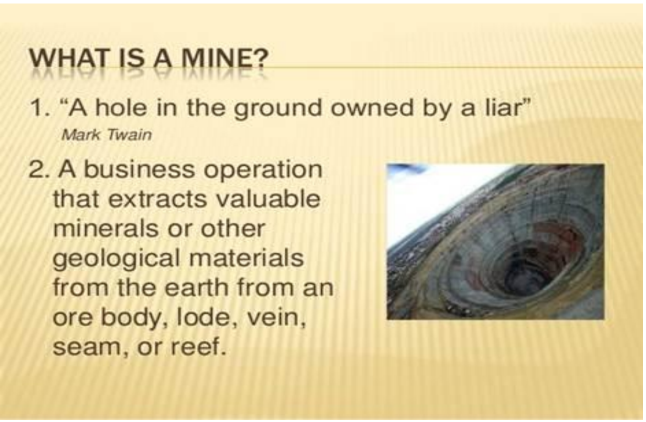
Donald Hellyer is Chief Executive of BigFuture. See www.bigfuture.com.au.

What to do with resources

Hugh Dive

On Monday, 28 September 2015 a broker in the UK put out a research note on Swiss-based Glencore suggesting that equity in the company could be worthless thanks to its US$50 billion debt burden. Shares in the company, which runs over 150 mining, oil production and agricultural assets and employs about 180,000 people, fell by 29%, caused BHP and Rio Tinto to fall 6.7% and 4.6% respectively on one day and contributed to wiping A$50 billion off the market capitalisation of the ASX.

Like all fund managers we follow the resources sector closely, as it is the biggest sector in the ASX after the banks. Over the last year, we have travelled to both the hot and dusty mines of the Pilbara and to the Dickensian dark satanic steel mills of North and Western China. In the press there has been much written about the end of the mining boom, and whilst we see that the boom days are over where marginal mines were making supernormal profits, we don't see that the wholesale dumping of mining stocks is the right move for investors, especially at current prices.



Resources on the ASX

In pure numbers, metals and mining make up the largest sector on the ASX with 602 mining companies listed. If you exclude the 'zombie' companies with market capitalisations less than $20 million, the number reduces to 157 and from this set a mere 16 mining companies listed on the ASX are profitable and pay dividends. Surprisingly, even at the end of the China-led mining boom, there remains A$30 billion of market capitalisation tied up in small unprofitable mining companies.

In any boom there is a transfer of wealth from investors to stock (mining or tech) promoters, stock brokers and service providers (lawyers, bankers and accountants), as hundreds of new companies are spawned. Typically the easiest companies to float are those that either have a project or are exploring for the hot mineral *du jour*. When I was a chemicals analyst at an international investment bank, I fielded many calls about junior phosphate plays as this was the hot commodity in 2010. Whilst phosphate was a sexy story in 2010, the common theme was very low phosphate ore grades which equate to high processing costs and wildly optimistic estimates of what it would cost to build the necessary infrastructure in the highest cost construction market in the world. For example Legend International (LGDI) estimated that the costs of building their required plant would be only $600 million when the true figure would have been around $1.5 billion, a pretty big ask for a company with $25 million in cash and burning through it at a fast rate. In 2011 this company had a market cap of $200 million and a range of positive broker reports (current market cap $5 million, share price $0.01).

I suspect that for these unprofitable mining companies, the best chance that shareholders have of seeing a return is if their mining hopeful is used by a sexy IT or biotech company as a shell for a backdoor listing on the ASX. Like a stolen Subaru WRX, the ASX-listed shells of tech companies from the late 1990s were re-birthed as mining companies in the mid 2000s and some are likely to turn up as fintech companies in the next few years.

Key factors to look for in resources companies

Prefer the big diversified miners

We prefer to hold our mining exposure in large diversified miners (Rio Tinto and BHP), rather than single commodity stocks such as Newcrest, Fortescue or Alumina. Through the cycle, their diversification by geography and commodity type will give investors fewer headaches than the higher risk pure plays. These companies are well-managed, low cost commodity producers with unhedged reserves in the ground, predominately located in politically secure areas of the world.

Own producers rather than explorers

When investing in junior miners, often one of the best things to do is to sell out before they start producing, as this is when the glorious blue sky is interrupted by the harsh reality of construction cost blowouts or miscalculations as to the mine's ore grades or levels of impurities become apparent. Further as we happen to prefer actual dividends now to promises, we want to own companies producing now rather than those still building major projects or prospecting.

The dramatic fall in the oil price over the past 12 months highlights the desirability for current cash flows over potentially higher returns in an uncertain future. Cash in hand put companies like Woodside in the position to pay off debt, reward shareholders and buy assets off motivated sellers, whereas Origin Energy's shareholders are facing a dilutive $2.5 billion capital raising done at a 73% discount to where the company's share price was one year ago.

Low cost volume wins

Whilst higher cost iron ore miners may give the investor the greatest upside exposure to recovering markets, they also give the strong possibility that they won't survive a prolonged downturn. Every mining boom is littered with the financial wreckage of companies that either had higher costs or were late to the party in bringing on their projects. In August both BHP and Rio reported solid production lifts and production costs per tonne of iron ore of US$16 and US$15 respectively. Significant volume from these large low cost producers will have pushed down prices and will force high cost operators both domestically and in China to cut production and abandon new projects.

Key commodities we look for

At this stage in the resources cycle, investors have to be aware of the market conditions for the various commodities. It is no longer 2006, when China had an insatiable appetite for most commodities. At a mineral level we prefer oil, coking coal and iron ore to aluminium, thermal coal, gold and base metals, primarily due to the superior market structure and limited Chinese domestic supply.

Sustainability of dividends by the majors

Whilst there has been much debate around the sustainability of the dividends for BHP and Rio Tinto, our recent meetings with the management teams post the results in August 2015 gave us comfort as to both the determination of the management teams to maintain these dividends and the ability of the companies to fund them. For example, BHP in 2016 is expected to generate over US$7 billion in free cash flow (after taxes and capital expenditure) which is US$500 million more than the cash flow required to pay a dividend of A$1.75 per share.

Hugh Dive is a Senior Portfolio Manager at boutique investment manager Aurora Funds Management Limited, a fully owned subsidiary of ASX listed, Keybridge Capital. This article is for general education purposes and readers should seek their own professional advice before investing.