

**GLOBAL RESOURCES»»** In a dynamic sector like global resources, the strength of the team and the hands on experience sets First State apart

# First State: where experience counts

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**F**or investors looking to gain exposure to the continued industrialisation of emerging economies, it is hard to look past resources as an asset class. Metals, minerals and energy are the building blocks of economic development and to the extent these emerging economies grow, so too does their demand for commodities. Whilst short term commodity prices will fluctuate on day-to-day news, the long-term structural trend of industrialisation and urbanisation is hard to overlook. What sets the First State fund apart from many of its competitors is the hands-on approach taken by the team. The head of this team, Dr Joanne Warner, who manages First State Global Resources Fund, firmly believes that the sector needs to be approached pragmatically, with a focus on understanding the key drivers and risks of the investee companies. The team is well resourced and includes four portfolio managers and four investment analysts, whose areas of specialism cover not only finance, but also mining engineering, petroleum engineering, agriculture, chemistry and physics. Dr Warner's team has conducted more than 1000 site visits in over 60 countries since its inception in 1997.

“We spend most of our time examining the key drivers and risks of current and potential investments,” says Dr Warner. “It is a major part of our investment process.”

“There is also the technical risk, which we are in an excellent position to assess given the team's strong technical background. To do due diligence for our investors properly, it is not enough to sit all day in an office looking at a Bloomberg screen or listen to PowerPoint presentations from senior company management. It would be easy to make a bad decision if that is all you

are relying on. We need to understand the underlying assets, management strength and the geopolitical environment in which the operation is based, even if it is listed in North America or the UK. We also need to be comfortable with the relationships our companies have both within the region and the local community.”

“We start our stock selection process by narrowing down our investment universe by screening potential companies for quality. In the commodities sector this equates to looking for companies with the highest margins and the best overall pricing and cost structures. This way we make sure that the fund is cushioned from the worst excesses of commodity price fluctuations.”

“We need to find robust businesses that in our view can best cope with fluctuations of commodity prices, not only when they go up but also when they are going down,” Dr Warner says. “We are looking for companies at the low end of the cost curve which are focused on their margins. Those two factors are important to the long-term health of the business.”

The next stage in First State's investment process is screening stocks for growth, seeking out companies that do not rely on continued strength of commodity prices for earnings momentum. Those type of companies tend to invest to grow production volumes, either through successful exploration, expansion of existing assets or developing new types of products.

“In terms of growth, Xstrata is a good example of a company with a strong track record,” Dr Warner explains. “Initially its asset base was not as high quality as BHP Billiton's or Rio Tinto's, but it executed a successful growth strategy through acquisitions followed by aggressive cost cutting and asset optimisation. This has helped to move lower quality assets into the bottom half

of the cost curve. The company has now embarked on the next stage of its life cycle and is delivering new production through organic growth. This will move the company even further down the cost curve.”

In addition to quality and growth, companies must also have strong balance sheets, the benefit of which was highlighted during the global credit crisis. The sharp correction in commodity prices in late 2008 revealed how vulnerable highly leveraged companies were. Even some of the largest companies in the sector struggled and had to undertake rights issues to shore up their balance sheets.

“Finally, we look for good management with a track record of making sensible decisions which maximise shareholder value,” Dr Warner adds. “By employing all of those screens we can eliminate the stocks that do not meet our selection criteria and can focus instead on the valuations of the companies that remain. “As active fund managers, we recognise that markets are not perfectly efficient. We understand that few companies trade at a fair valuation and there is always a premium or discount in place. The area where we spend most of our time is in understanding the risks associated with that company. We prefer to pay a premium for quality. We certainly do not buy companies that are cheap and nasty.”

Assessing the risks is undoubtedly helped by the team’s active site visitation schedule. This is facilitated by being part of a large institution like First State (it forms part of Australia’s leading fund manager), which allows an excellent level of access not only to senior management but to the underlying operations and managers running them on the ground. Visits are undertaken regularly to gain insight into the company’s operations, management strength and geopolitical factors which may influence profitability. Dr Warner says: “We like to sanity check companies by doing multiple site visits. In addition to examining the operations themselves, we also look at supporting infrastructure, such as roads, rail links, access to ports and power. Site visits also allow us to assess the ‘softer’ issues such as environmental management, government relations and community involvement. We can also see whether employees engaged at the operational level appear happy and motivated. “The sites of global resources companies tend to be located in remote locations and in a way it helps because it typically allows us to spend a significant amount of time analysing the operation each time we visit”.

One company the team has visited recently is Alacer Gold, which was

formed earlier this year as a result of a merger between Australian-listed Avoca Gold and Anatolia Minerals, listed in Canada. The fund had a holding in Avoca Gold because the team liked its West Australian gold operations and exploration. However, the Canadian company, which had just one asset based in Turkey, was deemed to be too risky an investment.

“Merging the two has proved to be an excellent fit and further production expansion is likely,” Dr Warner says. “The Australian part of the company is generating cash flow and the Turkish mine is increasing production. I spent a number of days visiting the gold mines in Western Australia, while our analyst in London is well placed to visit Turkey.”

Another of the team’s analysts recently visited Ivanhoe Mines’ operation in Mongolia, where the group is building what will be one of the world’s largest copper mines when it starts production in 2012. The visit provided insight into Mongolia, which is well placed to export commodities over the border to China. Interestingly, the analyst also visited some Indonesian coal mines on the way back to Australia, although the team is not currently looking to include them in the fund. However, these site visits provided excellent background information on the thermal coal market because Indonesia is a major coal exporter.

Dr Warner confirms. “We need to have a broad understanding of the industry to inform both our thinking about the portfolio as a whole and our future investment decisions.”

This investment process aims to create a well-diversified portfolio not dominated by a particular sub-sector. The fund is diversified by commodity, geography and company size, with a mix of large, mid and small caps in different stages of development.

Overall, Dr Warner believes that her fund is structured in such a way as to benefit from the long term growth story underpinning global resources, without taking on unnecessary risk or being overly exposed to movements in commodity prices, which in her view are notoriously unpredictable.

“We have a large team comprising members with a strong technical background. We base our investment decisions on firsthand experience. In the global resources sector, half the battle is avoiding the ‘landmines’ and the only way to do that is to see the company for yourself so you can pragmatically assess the risks.

“Ultimately our objective is to create the kind of a portfolio for our investors which allow us to sleep at night,” Dr Warner concludes.

# CV

## JOANNE WARNER

**2010** Head of Global Resources

**2006** Prime Portfolio Manager, Global Resources long funds in Australia, UK, Singapore and Hong Kong

**2003** Prime Portfolio Manager, internal Statutory Funds

**1997** First State | Back-up Portfolio Manager, Wholesale Global Resources Fund

**2007** Outstanding Achievement Award for Mining Funds Management at the annual Mines and Money Conference

Joanne has more than 15 years’ experience as a specialist Global Resources portfolio manager and analyst. She moved into the financial sector with the London based global mining specialist broker, T Hoare & Co, where she spent two years as an analyst before moving to Equitilink as a Fund Manager in the resources sector.

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