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The Global Inflation Story: A Look at Global Resources Equities

Executive Summary

- **The inflationary phenomenon is taking its aim globally, pushing natural resources prices higher.**
- **Investing in a global resources equities fund as opposed to direct exposure to a pure commodity fund will mitigate the inherent commodity risks associated with commodities futures.**
- **Apart from the rising global inflation, emerging economies will play a key part in driving the future demand of natural resources.**
- **First State Global Resources fund and UOB United Resources fund invest in equities in the natural resources and energy sectors world-wide.**

Introduction – From Global Recession to Global Inflation

The latest inflation rate numbers from Singapore, China and Great Britain may be hinting that the inflationary phenomenon may continue to pick up through the rest of the year. With Singapore's yearly increase in CPI standing at 5.0 percent, the local policymakers may have their work cut out trying to cool the surging economy.

Equivalently in China, consumer prices rose at an annual rate of 4.9 percent pace in February, above Chinese government's 4.0 percent target. At the same time, producer prices jumped 7.2 percent in February, the most since September 2008.

Inflation in Great Britain also accelerated to the fastest pace in more than two years. Consumer prices rose 4.4 percent from a year earlier after a 4.0 percent increase in January. Retail-price inflation, a measure of the cost of living, stood at 5.5 percent in February, the fastest pace since July 1991.

As the inflation chatter picks up within the financial airwaves, how can investors benefit from a potential surge in global inflation? We feel that global resources companies may be one of the sector for consideration. Major resources companies are enjoying back to back impressive profits, helped by rising commodity prices over the last 24 months.

Earnings on Mining Giants

According to Bloomberg, BHP Billiton Ltd., the world's largest mining company posted a 72 percent surge in its half year profit. The net income was at US\$10.5 billion in the six months ended 31 Dec 2010, up from US\$6.1 billion a year earlier. An almost threefold gain in iron ore earnings was the key driving factor for its outstanding performance. At the same time, the company is expanding its existing share buyback program to US\$10 billion. BHP shares traded near its 35-month high.

BHP's closest rival, Rio Tinto shares jumped nearly 13 percent over the past year, outperforming the broad market. Earlier, Rio Tinto also announced its half year profit (ending 31 Dec 2010) more than tripled as a global economic recovery with net income rising to US\$8.5 billion.



Moving forward, major mining companies are poised to expand at an unprecedented pace. BHP is planning a US\$80 billion 5-year expansion plan on mines and oilfields. Planned mining and carbon taxes are unlikely to impede the sector's overall growth.

The Case for a Global Resources Equity Fund

The story so far: Inflationary pressures, surging demand from emerging markets, and supply issues pushed prices of various resources sharply higher. A host of agricultural products including sugar, corn and soybeans climbed sharply higher. Gold repeatedly set new record highs, alongside with impressive returns from silver.

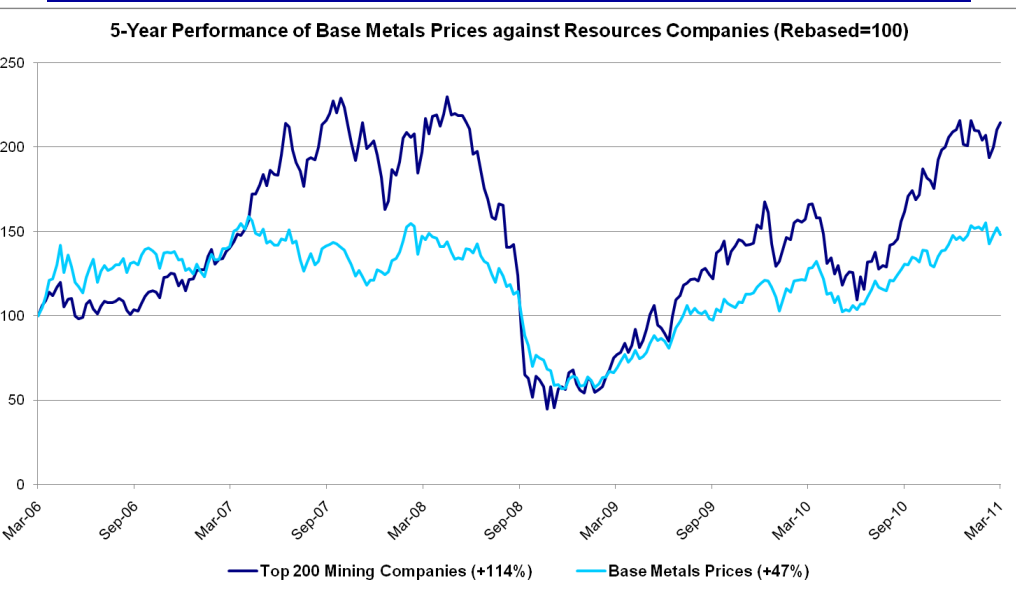
Unit trusts or funds focusing on global resources equities typically invest in companies (e.g. BHP Billiton and Rio Tinto as mentioned earlier) engaged in the extraction and sale of natural resources as well as the production process.

The production quality of ore has been declining for years. Global resources companies are forced to mine lower-quality grades of ore. Average ore grades have fallen about 26 percent over the last two decades, according to estimates from Deutsche Bank. Australia's Macquarie Bank calculated that the 2011 copper ore production shortfall could be the largest since 2004. Lower production quality should add further upward pressure on prices, boosting profits at the company level.

Investing in a global resources equities fund as opposed to direct exposure to a pure commodity fund will mitigate the inherent commodity risks associated with commodities futures (contango risk). Commodity funds invest in futures contracts written on respective commodities, which have an expiration date. These contracts will be "rolled over" come expiration into longer-dated ones. When futures markets is in contango, futures expiring further into the future are more expensive. The roll process can mean selling low and buying high, eroding future returns on investors.

In recent times, resources equities outperformed the rise in physical commodities prices over the most recent 5 year period (See Chart 1 below).

Chart 1: Performance of Top 200 Mining Companies vs Base Metal Prices



Natural resources companies outperformed the physical commodities over the 5-Year period.

Source: Bloomberg, as of 04 Apr 2011



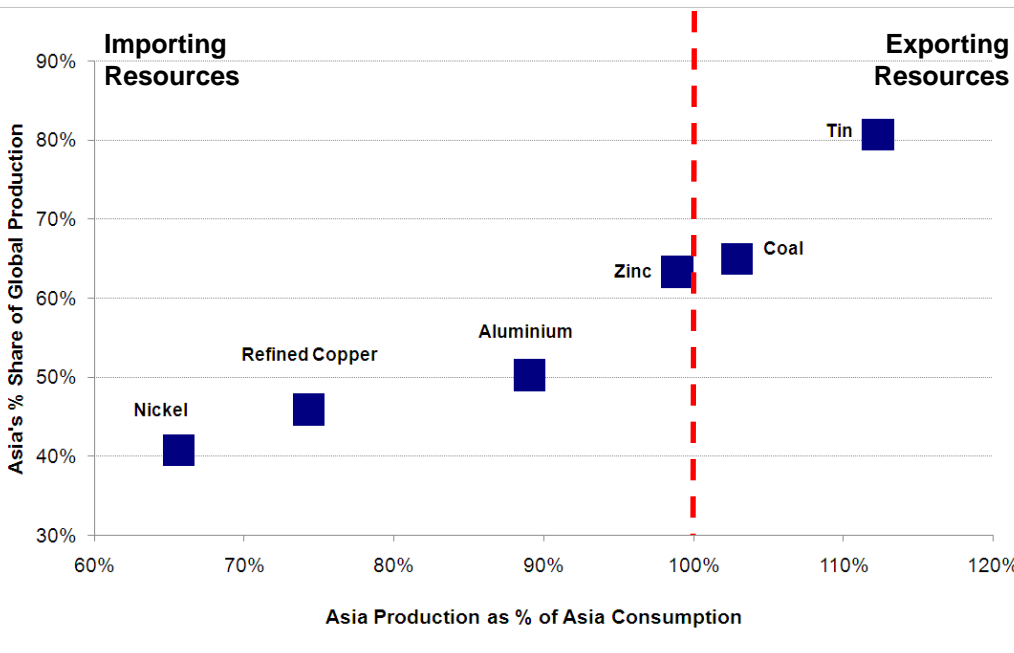
Looking Ahead: Global Mega Trends – The Rise of Emerging Markets

Apart from the rising global inflation, emerging economies will play a key part in driving the future demand of natural resources. Demographic changes through rapid urbanisation as well as economic growth in many emerging markets will result in greater demand for infrastructure building and increasing consumer spending activities. Global resources companies will be the provider of these much needed natural resources in the form of upstream and downstream activities.

Facts and Figures:

- Global consumption for copper climbed 8.6 percent to 18.76 million tons in 2010. China made up more than one-third of the copper demand. – *Source: Bloomberg*
- The total per capita power consumption in China and India is only about 20 percent of the United States. – *Source: U.S Energy Information Administration*
- The world will need to increase global oil production by 64 million barrels a day by 2030. – *Source: U.S Energy Information Administration*
- During the 20th century, the population in the world has grown from 1.65 billion to 6 billion. By 2030, 60 percent of the world’s citizens, including nearly 2 billion from rural migration, will be living in cities. – *Source: United Nations Organization*
- Chart 2 below suggests that Asian nations will be increasingly looking beyond their borders to meet supply deficiencies. For instance, Asian production of nickel is about 66 percent of Asian consumption, indicating a state of deficiency. In this case, Asian nations will be required to fill in the remaining 34 percent by importing from other parts of the world.

Chart 2: Natural Resources Production and Consumption in Asia



The figures on Asian consumption and production of natural resources suggest that the Asian nations will be increasingly looking beyond their borders to meet supply deficiencies.

Source: Bloomberg, as of 04 Apr 2011



Global Resources Funds

At PhillipCapital, we distribute two global resources funds: First State Global Resources and UOB United Global Resources.

First State Global Resources

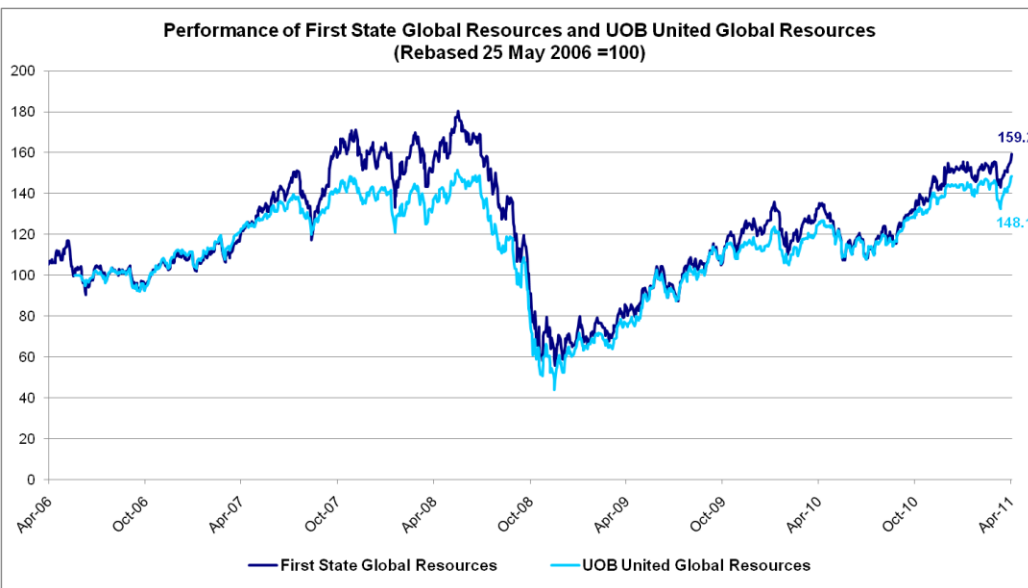
Fund was launched in mid-2005 and has been investing in equities which are exposed to the natural resources and energy sectors world-wide. Fund has achieved a total return of 0.86 percent over the 3 year period. Fund has a comparatively lower Total Expense Ratio (TER) at 1.62 as of end Dec 2010.

The fund takes concentrated bets with single company exposure as high as 9.1 percent in the portfolio.

UOB United Global Resources

Fund was launched in mid-2006 and is similarly exposed to the natural resources and energy sectors. We feel that this fund offers better diversification with single company exposure at 3.6 percent, according to the latest portfolio holdings percentage. The fund has been performing well over the 3 year period, up 8.05 percent. However, the higher expense ratio (2.58) as compared to the First State Global Resources may be a drag to investors.

Chart 3: Performance of Global Resources Funds (5-Year)



Global resources funds are enjoying a strong run-up since bottoming out in end-2008.

Source: Bloomberg, as of 06 Apr 2011

Table 1: Comparison between Global Resources Funds

Name	1 Yr Return	3 Yr Return	1 Yr Volatility	3 Yr Volatility	TER
First State Global Resources SGD	15.81	0.86	25.31	42.40	1.62
UOB United Global Resources SGD	17.89	8.05	21.94	40.79	2.58

Global resources funds performed well over the 1-Year and 3-Year period, while exhibiting higher volatility as well.

Source: Financial Express, as of 05 Apr 2011

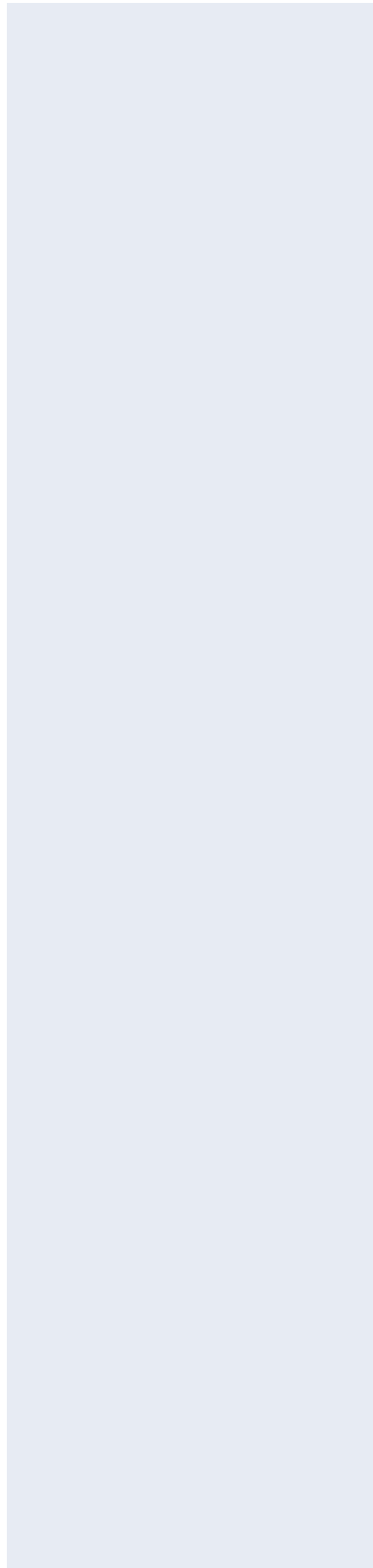


Conclusion – Risks and Opportunities

Investing in the global resources sector often involves a higher risk level as compared to investing in global equities. On top of general equity risks, the overall global resources sector is susceptible to single sector risk such as the previous mining and carbon taxes imposed by the Australian policymakers. Therefore, global resources funds tend to exhibit a higher level of return volatility, as compared to an average global equity fund. As shown in Table 1 on the previous page, the 3 year volatility can be as high as 42 percent. Higher volatility is generally associated with higher risk.

Also, companies engaging in the extraction of natural resources operate on high capital expenditures and exploration costs. In many cases, the profitability of individual mines will determine the overall revenue of a global resources company. High exploration costs and start-up costs can put a dent on the company's profitability.

Nevertheless, we believe that commodity prices will remain high for most part of this year. Higher commodity prices will boost profitability to the resources companies in particular. Additionally, with increasing demand volume, miners will be able to reap high economies of scale helped by a high operating leverage. All in all, global resources companies may be potential winners on the back an inflationary global environment.





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