

Investing in Natural Resource Stocks

Volume 1,
Number 215

From the
T. Rowe Price
Information
Library

It's not an exaggeration to say that much of the world's history has been shaped by the drive to find, develop, and control natural resources. For centuries, individuals and nations have competed vigorously for these prized assets—sometimes peacefully, but often through conquest.

Natural resources have provided some of the world's most lucrative investments. Their value has derived in large part from their direct role in the long-term rise of global living standards. In addition, real assets, especially gold and other precious metals, have often been the first line of defense against the erosion of wealth caused by inflation or debased currencies.

Companies that own or develop natural resources provide an important source of diversification for stock investors seeking capital appreciation over time. Investing a portion of an equity portfolio in natural resource-related stocks can provide:

- participation in global economic growth;
- exposure to the potential rise in value of finite resources essential to modern industry; and
- a hedge against a return of high inflation levels.

For these and other reasons, natural resource investments should be considered for every well-diversified portfolio. However, they also involve some special risks. A look at their general characteristics, advantages, and disadvantages can help investors understand how natural resource stocks may fit into their investment picture.

Industry Characteristics

Although the natural resources sector comprises a vast array of industries—precious metals, industrial metals, energy, land, and forest

products are several major categories—most share some of the following distinctive characteristics.

■ *Concerned With Scarcity.* The old saying about land (“They don’t make it anymore”) applies to most natural resources. While more of a resource such as gold or oil may be discovered, none can be created. Scarcity imparts a measure of intrinsic value to these resources and explains their traditional role as inflation hedges when financial assets become devalued. Gold, for instance, is scarce; paper money can be printed indefinitely. Although recycling can mitigate the depletion of resources like base and precious metals, most natural resources are finite. The major exception is timber, which is a renewable resource in the long run (the length of time needed to grow a tree to maturity) but may be regarded as having a fixed supply in the short run.

■ *Capital Intensive.* Finding and developing natural resources requires vast amounts of “real” capital (plants, equipment, technology). Small-scale mining, for instance, is seldom economical. Most resource-based companies are very large, and many control all phases of production from the raw material to the final product.

■ *Mature.* In developed nations, most natural resource industries are relatively mature and likely to grow at average rates based on worldwide economic growth and steady demand for resources. In contrast, natural resource industries in emerging countries may be less mature and companies may be growing rapidly.

Just as maturity of the industry is not uniform across nations, the pace of resource consumption also varies. In developed countries,

consumption tends to grow at a slower rate than the global average and follows the ups and downs of economic cycles. In developing nations, consumption tends to accelerate as the industrial economy evolves and standards of living rise. Not only do these countries accelerate the use of their own natural resources, but their rapid growth also augments the global demand for resources.

■ **Highly Visible.** Natural resource-related businesses have always been highly visible in the public domain. As such, they have often been subject to political scrutiny, the shifting winds of national politics, and international power struggles. In recent decades, the political efforts of the environmental movement have affected the operations of numerous companies.

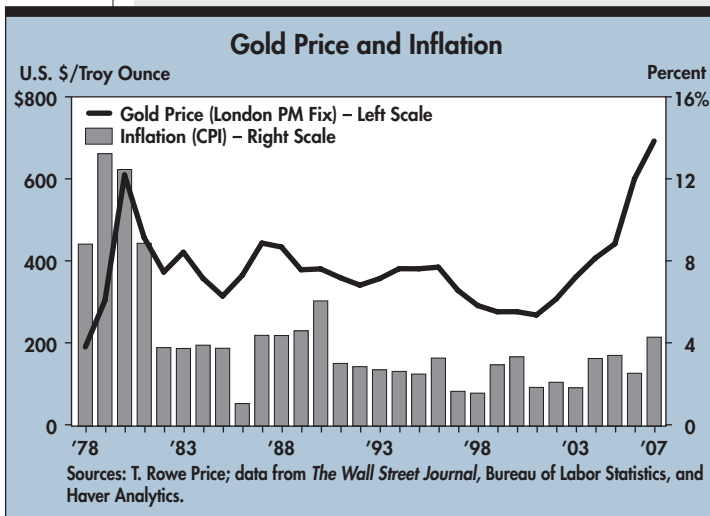
Investment Advantages and Disadvantages

These characteristics lead to others of particular interest to investors: Some are advantageous, while others may be less so. On the plus side, the demand for most natural resources has never dried up completely, although it fluctuates with the business cycle. In the long run, the use of natural resources rises with living standards. Therefore, demand for most resources should increase as long as the global economy continues to grow.

Another advantage is that the value of known reserves and existing development capacity tends to rise over time for several reasons: most of the more promising raw material sites have already been explored; capital costs continue to rise; political problems complicate exploration and development in many countries; and environmental standards are becoming more restrictive and costly, particularly for new ventures.

Though the long-term benefits may be substantial, natural resource investing also entails some risks. While nonrenewable assets may become more valuable over time, total depletion could be a serious problem. The more productive a company becomes, the sooner it may run out of raw material.

Another consideration is that these companies are subject to rapid changes in fortune. A major discovery of new resources or the onset of a recession may have a large impact, as can the political and regulatory environment. A third risk is that natural resource companies, many of which are global entities, can be affected by factors outside the U.S. Unfavorable currency fluctuations can have a negative impact on the value of foreign companies or the earnings of U.S. companies that develop resources abroad. Also, erratic governments



Gold

The demand for gold stems from its use in jewelry and industry, as well as from its historic role as a hedge against inflation and political instability. The chart to the left shows the relationship of gold prices to U.S. inflation since 1978.

Although neither inflation nor international crises have vanished from the scene, the present U.S. inflation rate is tame compared with the double-digit rampage of the 1970s. However, should inflation rise sharply, gold and other precious metals could be the investment of choice for those seeking to preserve asset values.

At present, concerns over the U.S. housing market and the weak U.S. dollar are boosting the price of gold.

Energy (Oil)

While there are numerous sources of energy, oil is probably of the greatest interest to investors. No natural resource has had as great an impact on the modern world as oil, and perhaps no resource-related industry has experienced so acutely the hazards of high public visibility.

In our energy-dependent world, a moderately rising demand for oil is likely, despite conservation efforts, as long as global economic growth continues and no practical substitute is found for gasoline-powered engines. In fact, the pace of oil exploration has accelerated in recent years because of strong demand from emerging countries modernizing their economies.

Oil prices reflect supply and demand in the long run but are difficult to predict in the short run due to national and international politics and weather patterns. With sustained demand and ultimately limited oil production capacity, oil price

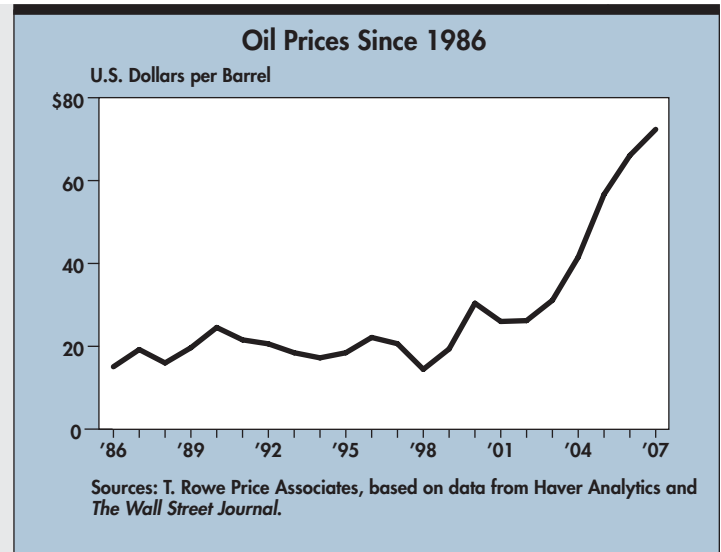
could disrupt business for companies that operate in emerging countries.

Lastly, in addition to cyclical, most natural resource companies face problems common to basic industry—limited pricing flexibility in commodity products, environmental concerns, sporadic labor difficulties, and so on.

Mapping an Investment Strategy

The challenging aspects of natural resource businesses by no means preclude superior investment results over time, but they do highlight the importance of company selection. Charles M. Ober, a T. Rowe Price portfolio manager who has been specializing in this area for over 20 years, looks for the following characteristics.

- **Good Management.** The most successful firms will be those that achieve some measure of control over their operating environment. Companies dependent on nonrenewable resources, for example, must look far ahead to secure future sources of supply. A strong exploration effort is particularly crucial for energy and mining companies, since discoveries enable them to increase production and diversify into new materials. Geographic diversification and the potential to add to the existing resource base can also help reduce the company's vulnerability to local or national politics.



are likely to remain high for the next few years—a positive trend for companies in the industry.

Good management can create opportunities for growth as well as reduce the impact of the inevitable slowdowns or recessions through product differentiation, diversification, and innovation. For example, managements that can harness new technologies should be able to improve efficiency, identify untapped pockets of resources, and reduce the costs of extraction.

Producers with low unit costs should be better able to maintain profits in industries, such as gold mining, where a single company has little control over commodity prices. Likewise, a low-cost producer should be in a better position to increase market share during slow-growth periods.

- **Favorable Commodity Trends.** While difficult to predict, the likelihood that production can expand and that price increases can be sustained will have a major effect on a company's near- and intermediate-term performance.
- **Good Asset Quality and Strong Financial Position.** The size and nature of a company's proven natural resource reserves are obviously important to its future prospects. A strong financial position is also vital because (1) most real investments take a long time to pay off, (2) capital may be hard to raise from outside sources, and (3) as in any business, a company

Forest Products

This major industry has two main sectors, wood products and pulp and paper. Some companies emphasize just one or the other, but a few are major players in both. Since a principal activity of the wood products sector is the production of lumber and plywood for construction, demand fluctuates with the homebuilding cycle. This cycle often starts to turn up before the rest of the economy, since it is sensitive to interest rates, which usually decline in a recession.

The pulp and paper sector covers the gamut from basic linerboard used in boxes to newsprint and on to the dynamic area of fine specialty papers. Product demand as well as company revenues tends to track the business cycle. Several companies have diversified extensively to try to reduce their sensitivity to cycles, mainly by increasing their presence in specialty papers. But, on the whole, these stocks are still regarded as cyclicals.

without heavy fixed obligations has an advantage over those with weaker finances during economic slumps or unexpected business disruptions.

Of course, each natural resource industry has distinctive characteristics that affect its investment appeal. The sketches of a few major groups (see boxed inserts) provide some idea of their differences and general investment behavior.

Summary

Since the earnings of natural resource companies can be irregular because of their sensitivity to business cycles, forces of nature, and politics, careful stock selection from diverse resource industries is necessary to cushion price swings. Combining these stocks with those of efficient, nonresource, growth companies provides an investor with good appreciation potential as well as some resistance to economic cycles and problems associated with inflation.

Industrial Metals

This group, which includes iron, copper, aluminum, lead, tin, and many other metals, is at the very core of “basic industry.” Since demand for these metals is entirely derived from consumer spending on a vast array of end products—from autos to pencils to canned goods—companies in this group are closely tied to the U.S. business cycle.

Generally, revenues and profits in the basic metals will lag slightly behind the economy’s turning points. While companies in this area are also subject to trends in global commodity prices, those that can reduce or control the impact of pricing swings on their profits tend to be the most successful. Cost efficiencies can have a major impact on the “bottom line.” Many metals companies are fully integrated, operating mines, transport facilities, and smelters, as well as manufacturing finished products.

Global growth rates are increasingly important to the success of these industries as most operate worldwide or are directly affected by worldwide demand for final products. Copper companies, for example, benefit from the spread of electric power (using copper wire) around the world; aluminum producers profit from the growth of the airplane industry and fuel conservation efforts of auto manufacturers.

In recent years, many companies in this sector have rigorously cut costs and modernized their facilities. A significant increase in merger activity in this sector is consolidating supply in the hands of fewer and larger producers, which augurs well for better pricing power as global metals demand continues to grow.

Insights reports provide background information on many aspects of investing.