



REAL ASSET EQUITIES: MORE THAN JUST INFLATIONARY HEDGES

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Real asset equities often are perceived as inflationary hedges. While it is true that they can serve that role, they also can do much more.

The cyclical nature of energy and materials businesses and the project-focused nature of their business models typically means there is a window of opportunity for management teams to generate returns. If they miss the window, value destruction can quickly follow. This timing issue leads to a commonly accepted belief that it is necessary to time and understand commodity prices to capture returns. In this paper, we present evidence to the contrary.

Betting on mispriced and fixed-life real asset equities

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With real assets, perhaps more than any other equity, we are back at the horse track, maximizing returns by buying well instead of good. In other words, within real asset equities, the bets that win are not the bets on the horse that wins but the bets on the horses with the most mispriced odds. To find the horse with the most mispriced odds, you need to understand the nature of the race a particular horse will run. Does the horse like to take an early lead? Does the horse come on strong late in the race? Is the horse a lousy sprinter but has a lot of endurance? Put another way, what is the nature of the business model, and what types of mispricing relative to market expectations does the business model lend itself to?

The first step in diagnosing a real asset business model is determining if the business model lends itself to being understood as a project or a going concern. A project business has a beginning, a middle, and an end; think of a single asset mining business. Unlike a mine, a going concern business is not constrained in its life by the depletion of an asset (think a chemical or steel business). It can always build another steel mill when its current mill is too old. The life of the company can easily survive beyond its initial asset base.¹ The one caveat to this framework is that established E&Ps generally are treated in the market more as going concern type businesses than mining firms.

We tend to see two flavors of mispricing within real assets relative to market expectations. For going-concern businesses, the mispricings are relative to market expectations of the business's ongoing operational value within a snapshot of time. For project businesses, the mispricings are relative to market expectations of the absolute value of the project.

Let's think about real asset equities mostly falling into two buckets: energy and materials. We typically find more opportunities that revolve around mispricing relative to an operational value within a snapshot of time within energy. Within materials, the types of mispricings we look for hinge on whether the commodities are processed or depleting.

¹ Please note that this description is a framework for categorization of businesses at a simplified and theoretical level. It is for discussion purposes.



For depleting asset businesses (except for energy), we tend to find fruitful investments in equities that are closing the gap between price and a range-bound intrinsic value with a fixed life. In essence, the NPV of the project baked into the share price is wrong. For processed commodity businesses such as steel, chemicals, and aluminum, we tend to find investment opportunities when equities are mispriced relative to market expectations of operational value. The assets have value, just like a mine is an asset on a balance sheet that has value, but the value typically is derived more from the operation of the asset rather than the direct monetization of the asset.

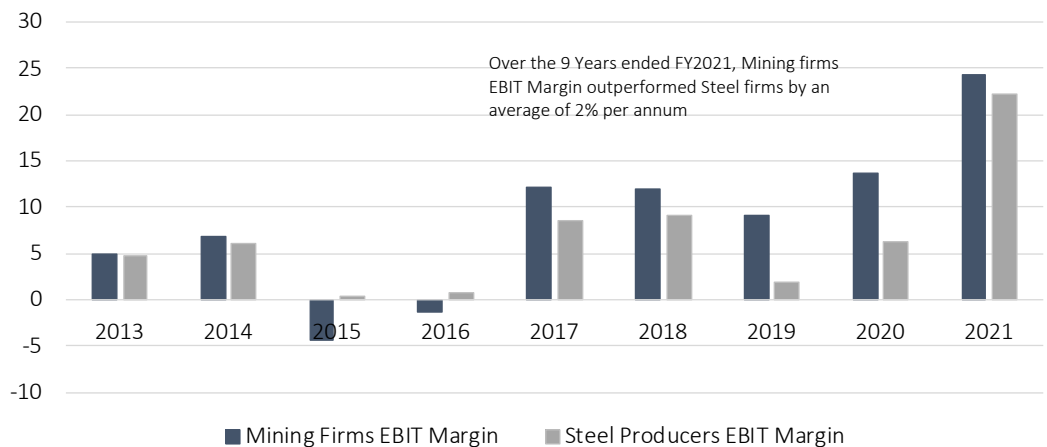
There are fundamental industry and business reasons to differentiate between processed commodities businesses and depleting asset businesses. The differentiation is tied not only to the potential life of the company — one being very much fixed, the other much less so — but also because of the way new supply is brought to market and how the cost curve of the industry shifts. For processed commodity businesses, new supply is almost always brought online at the low end of the cost curve. After all, who invests in building a brand-new low-efficiency steel mill or cement clinker?

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Depleting asset businesses have less consistency but tend to tilt toward new assets coming online in the middle or higher end of the cost curve. This is a function of the difficulty in finding and developing new assets — an ever-harder challenge as the easy and obvious monetizable natural resources give way to those that are hard to access and develop and necessitate a general rise in prices over time as the cost of production increases.

This nuance also tells us something about the margins of different types of commodity producers. The margins in depleting asset businesses tend to be higher than those in processed commodities, as adding supply to processed commodity industries tends to flatten the cost curve, reducing industry margin. However, new additions to depleting commodity businesses tend to steepen cost curves, thereby adding margin. In summary, depleting commodities tend to produce better returns than processed commodities over the course of a cycle.

Processed vs. Depleting Commodity Margins



Commodity prices aren't the only drivers of equity returns

Commodity producers are just like any other business: When examining them, it is important to focus on company-level factors that will act as catalysts, as commodity producers respond to catalysts in the same way any other type of business would. As such, investing in companies turning on an asset or making operational changes could impact the bottom line.

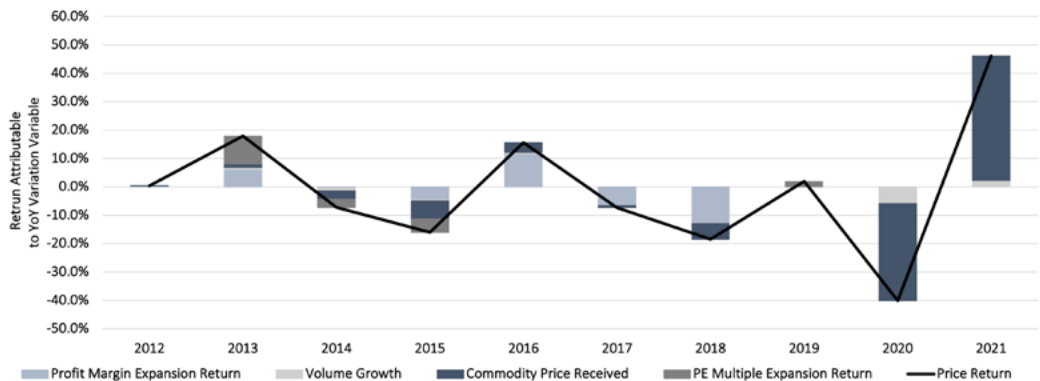
Many investors overlook the fact that commodity prices aren't the only drivers of equity returns.

It is common knowledge that commodity prices impact commodity producers. However, many investors overlook the fact that commodity prices aren't the only drivers of equity returns. Yes, real asset equity price movements in aggregate correlate closely with commodity price movements but decomposing the results of individual real asset businesses shows that equities often have a more diverse set of return drivers.

Consider Exxon Mobil's returns over the last ten years. The chart below breaks down the company's historical returns into individual variables and indicates how much of the annual return resulted from that variable. The commodity price is undoubtedly a significant and regular contributor to price formation and has been significant over the last two years, but it is not the only variable.

Return Decomposition

How to Read This Chart: The blackline represents the annual return, for example in 2021 XOM was up 46%. The bars add up to that return and break that return down into sources. So, in 2021 commodity price appreciation resulted in a 44% move in XOM stock and volume growth produced a 2% return, so commodity price and volume growth, or sales growth, accounted for 100% of the 46% gain in 2021.



The opposite of this company-focused approach — that is, a focus on commodity price forecasting — is what we usually see and what most people expect of an investment in real asset equities. Unfortunately, the history of commodity price forecasting is weak. Even futures curves don't have a strong history of correctly foretelling future prices longer than three months. Beyond the three-month mark, futures curves are, at best, a real-time sentiment read on market expectations and, at worst, just hot air.

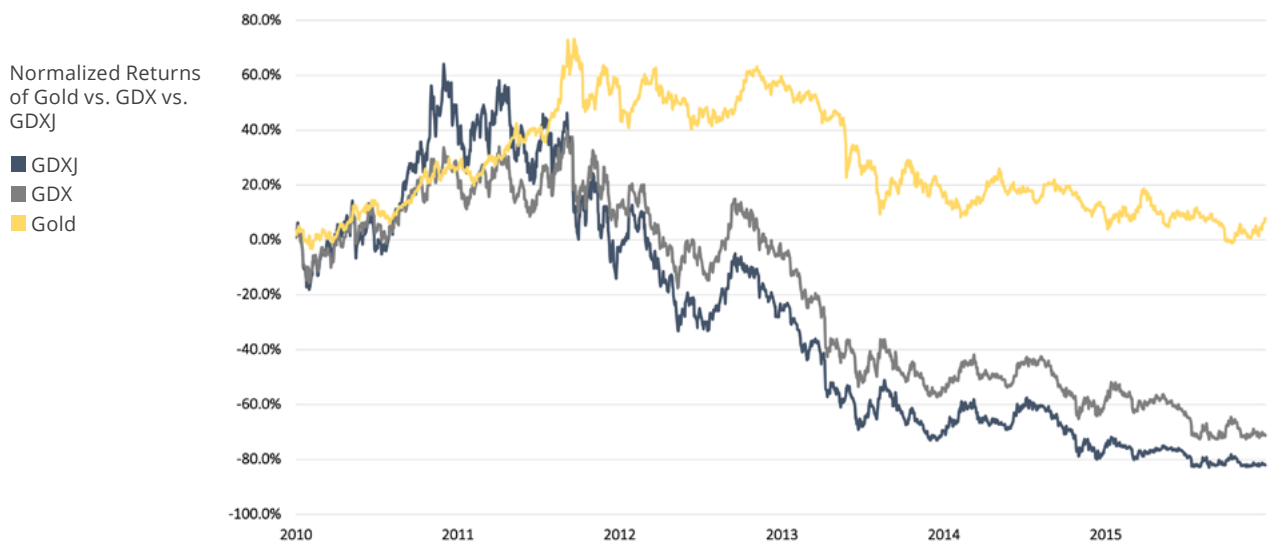
Commodity price forecasts are mostly a fruitless effort. As such, the resulting portfolio and investments tend to be equally weak. To make matters worse,



commodity price forecast-driven equity investments tend to be combined with timid bets. The resulting portfolios or position construction is usually a set of wagers on several large-cap names believed to have good exposure to relevant "commodity X" with less risk. Unfortunately, this rarely turns out to be the case.

Take, for example, the gold mining sector during the sell-off from 2011 to 2013. We can quickly compare performance via ETFs of senior producers (supposedly lower-risk equities) and the presumably sketchier junior producers (seemingly high-risk equities). Although their drawdown is not equivalent, nor is their movement perfectly correlated, they mainly act the same. Yes, we know the GDXJ drew down ~80%, and the GDX ONLY drew down ~70%, but, at that point, does it matter? On the other hand, the GDXJ peaked at +60%, while the GDX peaked at +40%. Perhaps that does not matter, but from our perspective, it does.

No Safety In Majors



Managing risk through good stock-picking

Within the context of the downside risk associated with the commodity-related cyclical of real asset equities, there is only one real refuge: good stock picking. This is even more important because, as there is little in the way of additional downside risk in aggregate for most junior real asset equities vs. majors, there is usually further upside. You can see some of this in this chart. In our experience, the more concentrated the industry is in a few majors, the more asymmetric the additional upside punch that can be found in juniors.

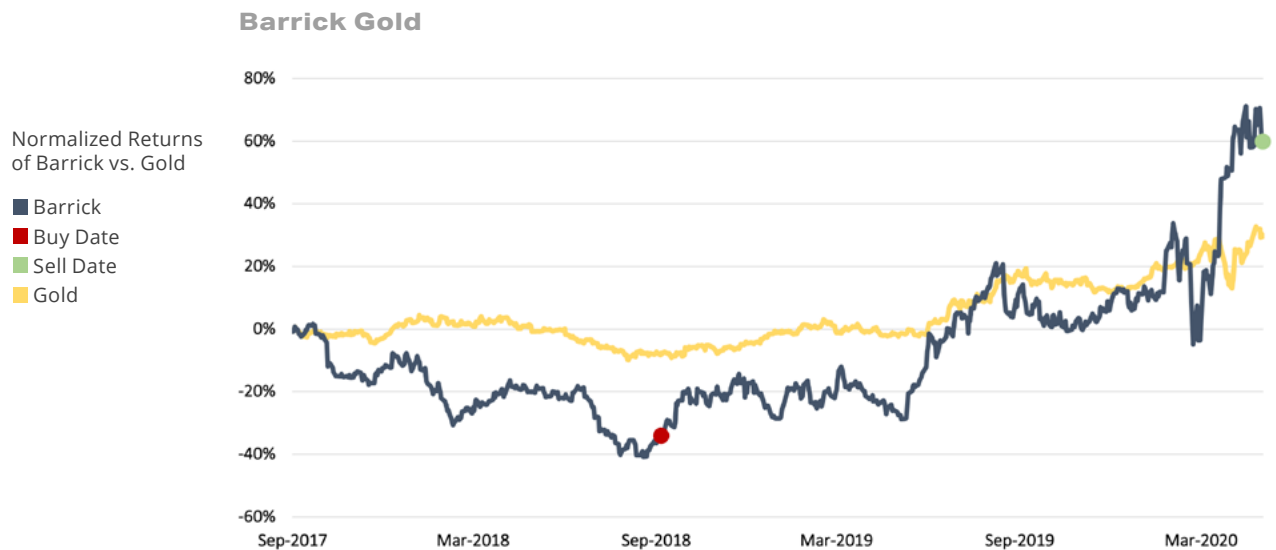
Thus, our preference is always to make bold bets on timid commodity forecasts, focusing on non-commodity price factors occurring at the businesses. We are not interested in making a bet on a producing copper miner that will double in value if copper reaches \$5/lb., but we are interested in the copper firm that will appreciate two, three, or four hundred percent when it turns on a mine that makes a decent return at \$3/lb. copper.

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Consider our 2018 investment in Barrick Gold, a mining firm that saw its equity closing the gap to a range-bound intrinsic value with a fixed life and overly negative market expectations. Our analysis of Barrick involved little beyond a simple DCF and an assessment of management, both of which convinced us that we were buying well.

At the time of our purchase (the red dot in the chart below), Barrick was trading at roughly \$10 a share. Utilizing the firm's production plans and cost estimates, published in excruciating detail for any publicly traded mining firm in a document (in this Canadian case) called a 43-101, we calculated the value of the business on that day as \$25 a share. We arrived at that price by running three DCFs, all at a 10% discount rate and all with static but different gold prices: \$800, \$1,000, and \$1,200. The net present value of the discounted cash flows was then probability weighted at 25%, 50%, and 25%, yielding a value of \$25 a share.



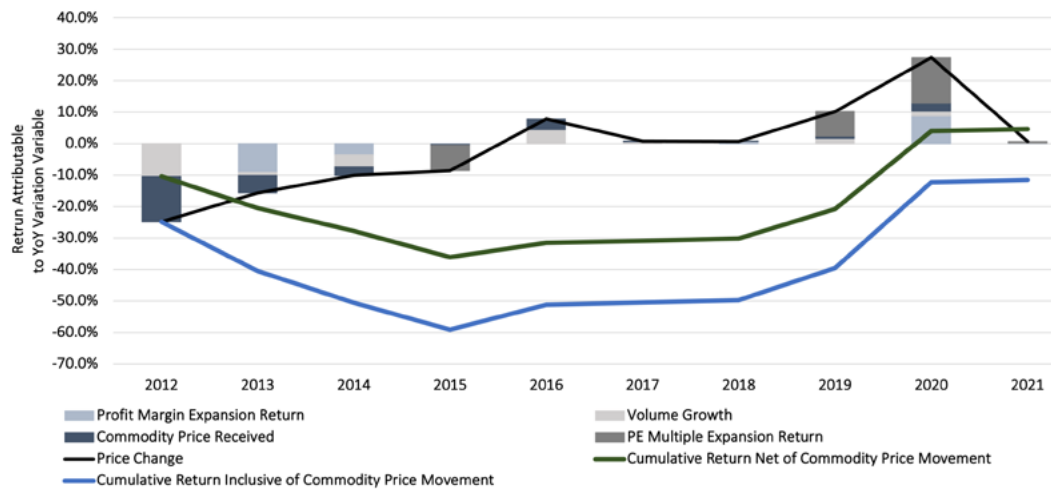
We did not spend time trying to forecast a gold price. We did not spend time trying to understand the supply and demand dynamics of gold. What we did do was ask four questions:

1. Is this a bad, good, or great management team?
2. Can they execute their plan to monetize their fixed resources?
3. How much margin of safety do we have regarding commodity price? That question is answered by taking management's plan for monetizing the assets and determining what gold price we have to plug in such that the NPV equals the current share price. We often then compare that to the AISC of production. Answering this question also helps us understand market sentiment.
4. Finally, what is the value of that plan across a spread of possible gold prices?

And, as we can see from the return decomposition, a lot was going on besides commodity price movement regarding equity appreciation.



Barrick Gold Return Decomposition



The importance of putting your money on good management teams

In the case of Barrick, the management team at the time of our investment was an unheralded gem. CEO John Thornton was such a big fan of Wilson Thorndick's book *The Outsiders* that he carried copies around to give employees. This makes sense, as he was considered an outsider within the insular mining industry, which dismissed him altogether and, in the process, wrote Barrick off as a lost cause. This is another example of how individual resource equities can trade on variables other than commodity prices.

The chart below shows the stock price movement between the day John Thornton was appointed CEO and the day of the announcement of Barrick's merger with Randgold which resulted in John transitioning to Chairman of the Board and Mark Bristow taking over the role as CEO. The market misread management, and Barrick's stock fell. While the company also had other issues, this was a driving factor.

Barrick Gold



The importance of management to real asset equities cannot be overstated.

The importance of management to real asset equities cannot be overstated. The combination of science and engineering with business and finance makes real asset businesses particularly challenging to lead. Industry cyclicality also presents challenges for these businesses. The cyclicality produces unique management styles we use to characterize management teams:

The Three Types of Management Teams



As we move away from the majors, management teams are no less important, but the questions we ask are slightly different. When assessing earlier-stage real asset equities, the critical question — and the only question worth asking — is, "can this management team build this asset (mine, wind farm, refinery, oil well, etc.)?" The answer is what moves the stock price.

While the questions change slightly, and the focus goes from operations to building, the nature of the mispricing does not change. Here, too, we are looking at closing a gap between the current price and a range-bound intrinsic value. This concept is easier to understand and recognize in a single asset mining firm's context than in a behemoth like Barrick.

Perception's role in price movements

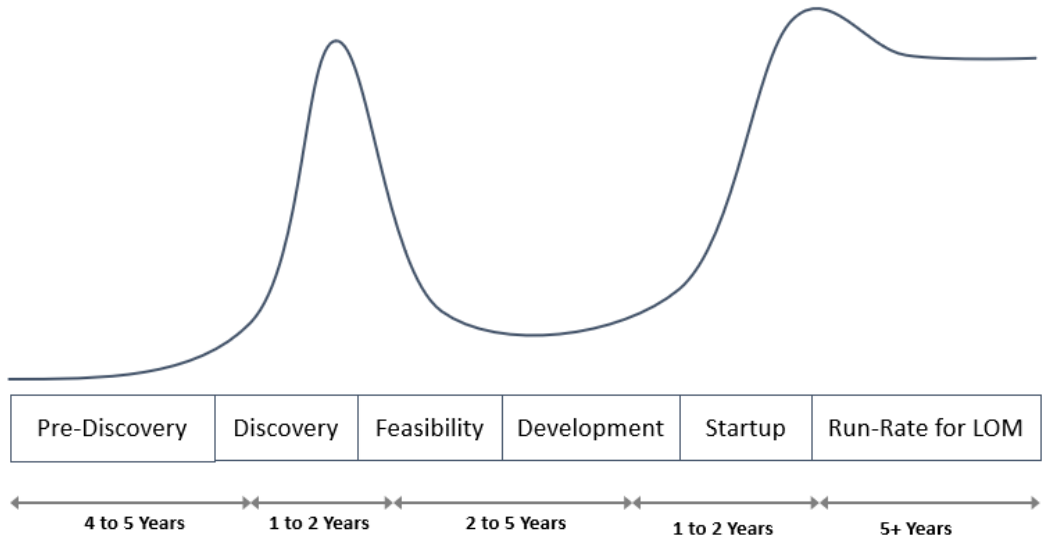
The project-focused nature of real asset businesses, whether mining, oil, or renewable power producers, means in early-stage development, the companies all have similar price movement patterns that we see repeatedly, which arise from the behavioral biases of investors.

Within the mining industry, this price pattern is called the Lasso Curve. However, we see it in all real asset businesses and frequently in any listed early-stage company. For a biotech company, a tech company, or a mining firm, it looks something like this:



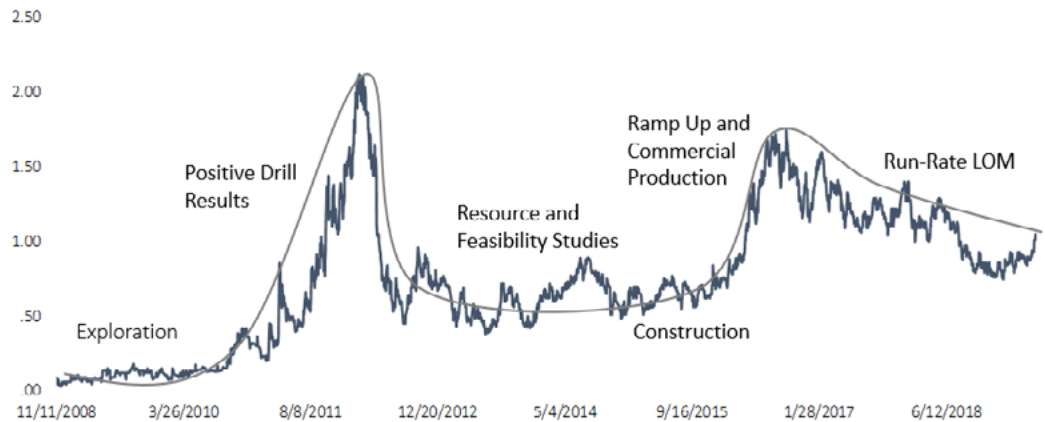
The Lassonde Curve

The Lassonde Curve shows Project Value vs. Project Stage, it is a framework for thinking about changes in perception of uncertainty and risk over the life of a project.



And here is what it looks like in real life:

RoxGold (ROXG: CN)



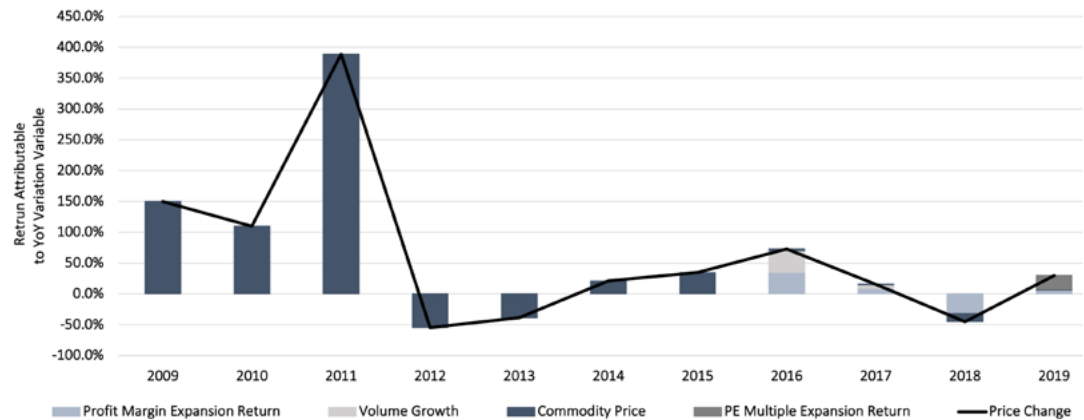
We often think better risk-adjusted returns are found in development, although this is not always the case if you find the right jockey to bet on.

What is of particular note here is the period of development studies and construction, not the exploration spike. While the exploration spike is a great move, making a bet during that phase requires an investor to understand the geology. More money is made with the drill bit, as the chart above demonstrates, but we often think better risk-adjusted returns are found in development, although this is not always the case if you find the right jockey to bet on. During the development period, investors are making a bet on permitting and construction. They are betting that management can turn the mine on — a bet that relies on commodity price forecasting even less than the Barrick example we provided earlier in this paper, where we did at least make a wager on a spread of commodity price outcomes.



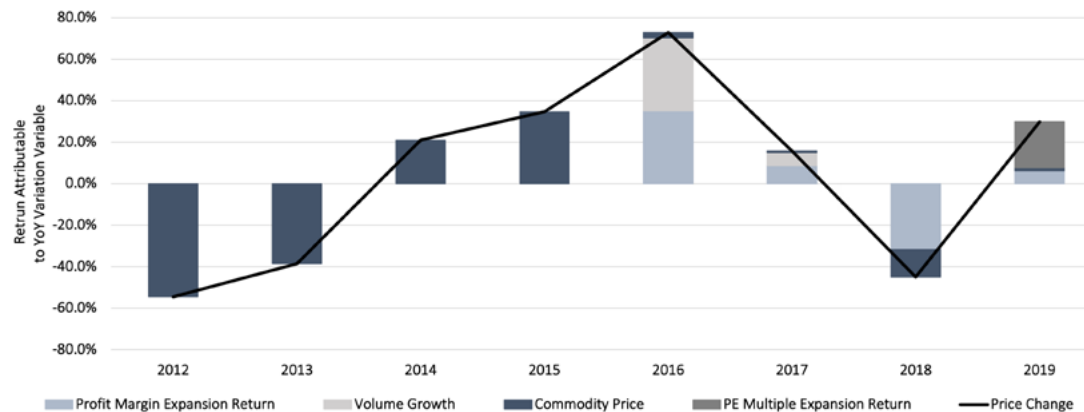
This is a good bet, as it provides an opportunity to take a perspective on operational and execution issues. Furthermore, throughout the development phase, if progress is made, the risk to the bet decreases. You can see this in the charts below; the pre-2016 movement was driven almost exclusively by commodity prices, but then a catalyst occurred, and management turned on the mine. The move in 2016 was driven solely by operational factors. That's the move we like to bet on most often.

RoxGold Return Decomposition



If we zoom in on the period at which the firm started production, we can see that the primary driver of that year's returns was production, which is a company-specific factor, not a commodity factor.

RoxGold Return Decomposition



All of this supports our thesis that finding the true winners within the real asset ecosystem requires looking beyond commodity prices and beneath the surface of real asset businesses. It also requires an understanding and awareness of the company-specific catalysts that can move real asset equities and how they can vary from business to business.

Learn more about Massif Capital's unique philosophy and approach to investing in real assets in our white paper "[Advantages of Investing in the Real Asset Ecosystem.](#)"



MASSIF CAPITAL

Massif Capital runs a long/short equity strategy focused on global opportunities in liquid real assets and industrials. We prioritize downside risk management by investing in businesses we understand operating in the Basic Materials, Energy and Industrial industries.

Q&A WITH PORTFOLIO MANAGERS

In a Q&A, Massif Capital portfolio managers explain the benefits of real assets, the role real asset industries will play in the transition to a low-carbon economy, and the ways a long-short strategy can capitalize on the shakeout from this transition.

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