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Why do we still own the platinum miners?

Resources shares have contributed substantially to our returns over the last year. We have recently trimmed back our exposure to them, and now hold negligible positions in Anglo American and BHP Billiton, which together account for over 25% of the FTSE/JSE All Share Index. The platinum miners (Angloplat, Impala, Northam) have been big winners, but they still account for a significant portion of our clients' portfolios. This month's *GrayIssue* re-examines the investment case for the platinum miners.

The platinum mines produce not only platinum, but also palladium, rhodium, nickel and gold. The aggregate price of this group of metals (in the appropriate proportion) is referred to as the platinum group metal (PGM) basket price. PGM basket prices have reached a new record high when measured in real Rands. This does call for some circumspection, but it must also be said that today's PGM basket price is relatively low when compared to the base metals that are contributing a substantial portion of Anglo American and BHP Billiton's profits.

We are much more positive on the long-term outlook for PGM prices than for the other commodities produced by Anglos and BHP. This is informed by our analysis of the underlying supply and demand fundamentals for the metals. While all commodity prices have undoubtedly benefited from the recent rapid and synchronised economic growth around the world, demand for PGMs is being driven by additional independent factors, the most important of which is tightening emission standards.

Developed countries continue to ratchet down the maximum harmful emissions allowed by internal combustion engines. This requires increased loadings of PGMs on the catalytic converters that reduce harmful emissions from motorcars. Diesel cars will soon require additional components to reduce NOX and particulate matter emissions, and this will probably provide a further boost to PGM demand. Emerging market emission standards are somewhat looser than those of the developed markets, but they are tightening. The important aspect of tightening emission standards as a demand driver is that they are likely to continue to drive demand even if global growth and infrastructure investment in China slows substantially.

The platinum and palladium jewellery markets tend to be more price elastic, and as prices have risen, the jewellery markets have given up some metal for industrial uses. But if PGM prices were to fall, we would expect jewellery demand (particularly in China) to bounce back and thus limit the downside risk to the PGM prices.

On the supply side, 85% of the world's platinum reserves are located in South Africa and Zimbabwe. This supply is concentrated in the hands of the few major mining companies held in our clients' portfolios, and we believe the industry will be hard-pressed to grow production by more than 5% p.a. This is in contrast to most other commodity markets, which tend to be more fragmented and carry a higher risk of being over-supplied. In summary, we believe that the PGM prices contain more upside potential and less downside risk than do most other commodity prices.

There are two additional factors in favour of the platinum mines over Anglos and BHP. Firstly, the platinum mines have an extraordinarily long life. Secondly, the platinum miners have a far greater proportion of their costs denominated in Rands than do the globally diversified miners. This means that they will benefit to a much greater degree were the Rand to weaken in order to correct South Africa's current account deficit.

Commentary by Ian Liddle, Portfolio Manager, Allan Gray Limited