BHP's investment lessons

by Roger Montgomery

BHP is arguably one of the companies listed on the Australian stock market that can best illustrate two very different approaches to investing in the stock market.

This last week BHP slumped to a record loss and slashed its dividend. The same week, the company declared that commodity prices have stopped falling.

Now, firstly, before you get too excited that now is the time to buy BHP, remember executives of the world's largest iron ore producers variously thought only a year or two ago, the long term average iron ore price would be somewhere above $100/t. In 2016 iron ore has already traded as low as $41/t. Never ask a barber whether you need a haircut!

Many investors try to predict the bottom for share prices of large 'blue chip' companies and had you purchased BHP recently at $14, today's share price around $21.00 would almost render you a very prescient investor indeed. But, remember, the company just reported a loss of $8.6 billion down from $4.4 billion in 2015. Total dividends of 40 cents are down from $1.61 last year and earnings per share of $1.35 are well down on the $3.69 earned in 2011.

In fact, it is over the longer term – the period over which we know a share price accurately tracks the performance of the underlying business – that we can properly asses whether BHP is the sort of business we'd like to own.

Suppose it was 2006 and I asked you to invest in a business I will run for you. You invest US$25 billion. We also decide that to be competitive we need a few more assets and so we borrow US$9 billion. After the first year of operations, in 2007 we generate a $15.8 billion profit. This is an extraordinary return of over 40% and you are obviously delighted.

Over the next 10 years you decide you want to 'grow' the business and directly and indirectly invest an additional $53 billion taking shareholder/owner's equity to $73 billion. Over the same decade, we have increased borrowings to $49 billion (from $9 billion 10 years ago).

Had you invested this extra equity and debt in a plain old vanilla bank account, and invested in a single rocking chair to sit on and wait, you would have produced a higher profit than back in 2006. The result of this additional capital invested in BHP however, over the last decade, produced a decline in profit! In fact, profit declined from $15.8 billion in 2007 to $4.4 billion in 2015 and to a loss of $8.6 billion in 2016.

So my question is this. Would you want to own such a business outright?

The answer, of course, is probably not.

Thanks to the stock market, we can convert ownership of a business into little pieces of paper that wiggle up and down on a screen. Instead of making money from owning the business we can gamble on the rises and falls of the share price and make money from spinning the roulette wheel rather than from the boring ownership over the long term of a business.

But it is still gambling.

BHP is a cyclical business that has destroyed a great deal of wealth over the last decade or so. The shares of course will rise and fall over time and we can try and pick the tops and bottoms and make money that way but we must understand that this is not the same as investing.

The alternative is to focus on those businesses that we are comfortable saying will be two, three or five times bigger in years to come and that they will be

able to grow by retaining large portions of their annual profit, while generating very high rates of return on that incremental capital.

You can ‘trade’ or gamble on stocks, or you can use the stock market as a venue to buy pieces of outstanding businesses, knowing that in the long run the price cannot help but reflect the underlying performance of the business.

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