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Small Cap Resources Sector in Focus - Australian Bauxite (ABZ)

The small caps have significantly underperformed the broader market this year as global macro fears have sent investors running for the exits. As seen in the chart below the ASX Small Cap Resource (XSR) sector has underperformed the benchmark ASX 200 (XJO) by roughly -32% since May which reflects the sharp falls seen in commodity markets and the Chinese stock market.

However since the major central banks announced that they would step in with unprecedented measures to support markets, there has been a notable turnaround of this trend. The Small Cap Resource Index has broken up through its well established downtrend of underperformance for the first time in seven months suggesting a change of the guard in terms of stock rotation.

The recent break out in the US Russell 200 Index (RUT) which measures the performance of small cap stocks in the US suggests this phenomenon is not isolated to Aussie stocks. Since August, the Russell 2000 Index, is up over +11.5% while the S&P 500 index is up a little more than 6%.

The last time small caps started this kind of outperformance was in October of 2010 and 2011. In both occasions, the S&P 500 index rose about 17% in the following six months. The Russell 2000 Index rose 26% on average, outperforming the market.

While we have been talking about the plethora of good news that is now priced in to the market this is not the case for the small cap resource stocks. Many investors are staying out for fear of a hard landing in China and relapse in commodity markets. It's easy to get caught up in the gloomy headlines and fears of a coming crash but it seems the stimulus announcements are trumping all other fundamental concerns and the truth is the market is forward looking.

The recent rally in small caps and underperformance reversal suggests the sector will continue to move higher. With the kind of performance small caps have had lately, the writing on the wall is that we could see some big upward moves in small resource stocks in the next six months. The bottom line is if you are a contrarian investor now is the time to increase your allocation to small-cap stocks.



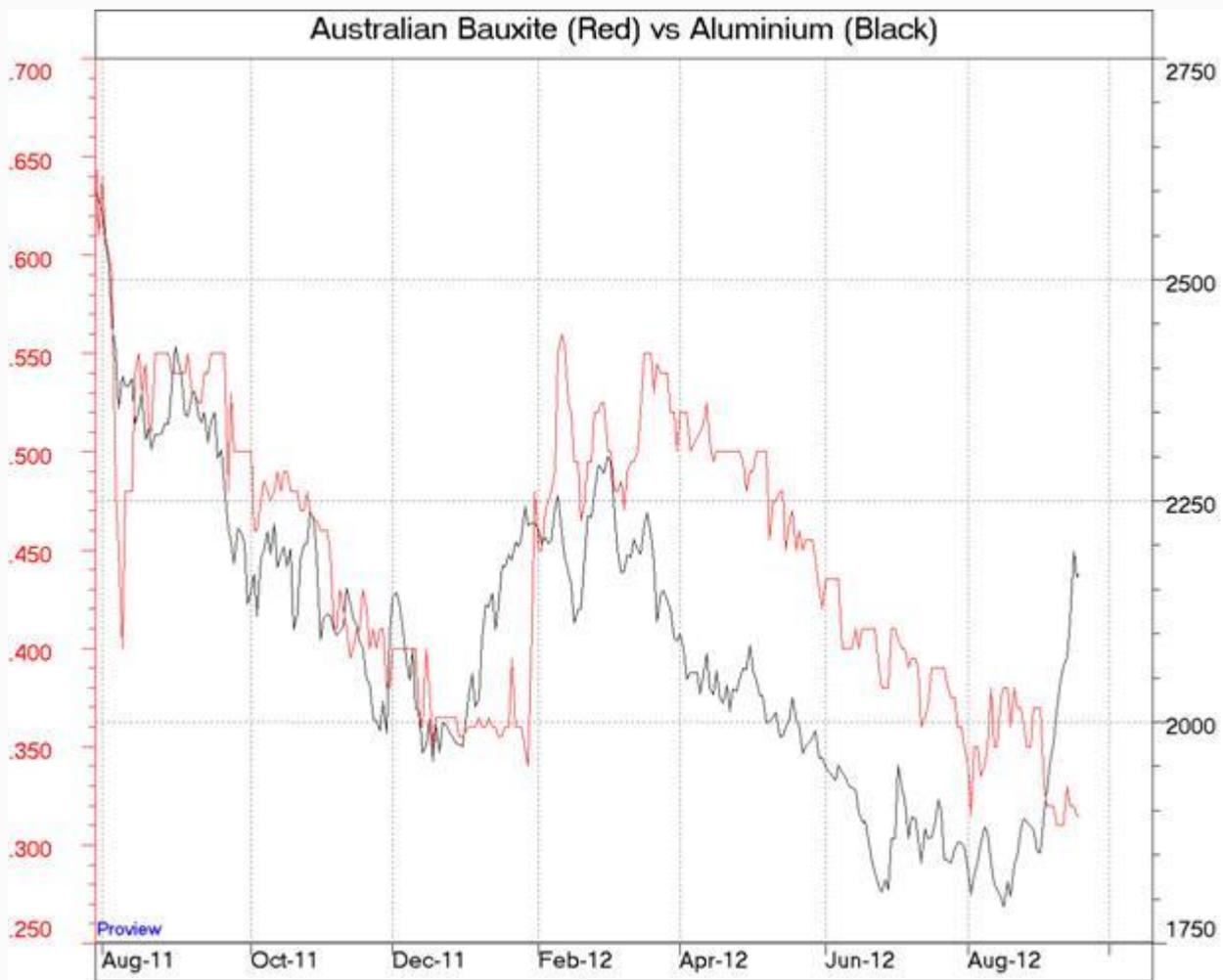
One stock that we have had a good deal of success with over the course of the past few years and in our view is overdue for a relief rally is Australian Bauxite (ABZ).

The company is swiftly making the transition from successful explorer to a producer of high quality product and the stated business plan is to prove up the largest tonnage of high quality bauxite resources of any comparable company. The idea is to market premium-priced bauxite products into both the rapidly growing Asia-Pacific region (especially China) and the large eastern Australian aluminium industry.

ABZ has a market cap of A\$33 million. The company has around A\$3 million in cash which should be adequate to fund development and exploration for the next few 12 months and we feel will see a positive re-rating as it proves up its resources.

Bauxite is one of the key ingredients in the manufacture of Aluminium so it's only natural that the stock has a strong correlation with the Base metal. Looking at the chart below it is evident that Aluminium prices have taken off rallying 20% since the 16th August lows and yet ABZ remains anchored around its lows. We feel this divergence will not last and are taking a speculative bet that the stock will begin to play catch up over the coming weeks.

A similar scenario unfolded late last year when ABZ failed to mirror the pick-up in the Aluminium price. It was about a month after Aluminium price bottomed that ABZ started to rally. On that occasion the stock put on +65% in little over a month.



This morning the company announced Drill Success at its Tasmanian Deposit DL-130 with the discovery of a 6 Metre Bauxite deposit, Near Port. Scoping Feasibility Study & Offtake Discussions Have Begun.

The main points of the find include;

- **Drilling ahead of schedule in Tasmania discovered good quality bauxite at DL-130**
- **Thick bauxite, up to 6 metres thick found at DL-130 in cleared plantation blocks**
- **97km trucking distance to Bell Bay deepwater port on heavy duty highway**
- **Economic potential is positive and socio-environmental setting is sustainable**
- **Community consultation about potential development is positive**
- **Scoping feasibility study commenced early and local contractor interest is positive**
- **Discussions with potential offtake customers have commenced**

The company is drilling ahead of schedule in Tasmania and given thicker than expected bauxite has been encountered over a wide area ABZ believes that the project could commence production earlier than anticipated with minimal impacts.

ABZ also holds the core of the Eastern Australian Bauxite Province with more than 37 tenements in Queensland, New South Wales, Victoria and Tasmania covering over 8,200km² all selected on three firm principles.

- **Quality – Good quality bauxite with potential for significant resource tonnage.**
- **Proximity – Easy Access to infrastructure connected to export ports**
- **Accessibility – Free of socio-environmental or native title land constraints.**

All tenements are 100% owned and free of obligations for processing and third-party royalties. ABZ has already discovered significant bauxite deposits and new discoveries continue as knowledge and expertise develops.

Managements aim is to identify bauxite resources in excess of 200 million tonnes in one of the world's best bauxite provinces. The mining company has the potential to create three state significant bauxite processing projects, one each in Queensland, New South Wales and Tasmania - and has several bauxite

deposits that are favourably located for direct shipping of bauxite to export customers.

The technicals are yet to show any meaningful bullish price action with the stock trading within the confines of a well defined downtrend. Provided Aluminium prices can maintain their upward bias we believe it's only a matter of time before ABZ gets a move on and starts to factor in higher earnings for its product.

Key levels to watch are \$0.33 initially (we are looking to buy on confirmation of a close above this level with a 5% portfolio weighting). A break of these levels will bring higher levels of \$0.38 in to play followed by \$0.47/\$0.50 (+50% above current levels). A move below \$0.28 will be the trigger to exit the trade and it is around these levels that we will place our Stop.



Kind Regards,

The Investment Team

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