FT WEALTH: A few diamonds that could be worth a closer look

By John Dizard

About a year ago a friend of mine tried to tip me about a nascent boom in diamond prices and diamond mine stocks. I barely managed to feign interest. Along with many others, I associated diamond mining with a near cartel and sleazy scam artists.

Three years earlier, James Passin, the managing partner of the $550m Firebird Global Fund, a New York hedge fund, thought the same way. "I'd been looking around for commodities other than oil, copper, or gold. I'd written off diamonds as a [market] manipulated by De Beers." The stain of a monopoly preserved by giant hidden reserves kept off the market was reinforced by pulp fiction, US Justice Department action, civil suit claims, and historical fact (US v DeBeers Centenary AG, 11 Harrowhouse).

De Beers, which controls about40 per cent of world diamond production and 60 per cent of diamond wholesaling, was taken private in 2001 by Anglo American, the Oppenheimer family and the Botswana government. This was a remarkable instance of good timing. The corporation, the family and the government seem to have picked a low point in the market to buy back shares from the public.

For the past three years there has been a stealth bull market in diamonds, with one in diamond stocks developing rather quickly in the past several months. The real diamond stock boom is yet to come, though. The trigger for that will be the renewed initial public offering ofDe Beers by the three shareholders, which is expected by informed outsiders within a year to 18 months.

Already De Beers has been preparing itself for the move. It settled its decades-old fight with the Justice Department back in 2004, and last year paid out $250m to settle the class action civil suit (without admitting liability) that had been brought by consumers alleging price-fixing. While still a private company, the extent of financial disclosure from De Beers management is comparable to a public company's, and people don't go through all that without a purpose in mind. Mr Passin says he doesn't own Anglo American shares in his fund but says buying Anglo now is a way to benefit from the coming IPO. He does expect to benefit indirectly, as "The De Beers IPO will trigger tremendous interest in diamond mining."

At present, he says: "It's hard to follow diamond prices, so there is no public awareness of the scarcity of diamonds relative to the demand."

Newly rich Asians and Middle Easterners are driving that increase in demand. The US market is large but slow growing, and the European market has been flat. The real money is made on larger stones. The unit price of 10 tonnes of gold is the same as 1 ounce but the price per carat of diamonds increases at an accelerating rate with increases in size.

Keep in mind that this is a sizeable, but not gigantic, industry. Annual world retail sale for diamonds is somewhere in the $60bn to $70bn range; the wholesale trade is about $10bn. The margins, howeverÃ¢Â?Â¦

The geographic distribution of the business has changed in recent years. Before the 1990s, diamonds were principally mined in South Africa, Botswana, Angola and Australia. Then development of Canada's mines in the Northwest Territories began. At the same time, the civil war in Angola resulted in the sale of large numbers of what were called "conflict diamonds", haphazardly gathered in frequently brutal ways by the roving forces. Less dramatically, Russian diamond sales were informally decontrolled in the Yeltsin years, and distributed by non-De Beers diamond merchants, notably in Israel.

Considering that Japanese luxury spending was weak at the time, these were not good years for the diamond establishment.

The Canadians figured a way to strike a moral pose against the blood cost of conflict diamonds as well as create a unique selling proposition. They devised an inconspicuous trademark for their diamonds. De Beers did the same thing, with its Forevermark. The Yeltsin years were followed by the reversion to more central control of markets under Vladimir Putin, and the independent diamond dealers were cut off from much of their supply. In the meantime, De Beers had been forced to buy large quantities of rough diamonds to put into its inventory. According to Mr Passin: "De Beers had about $5bn in rough diamonds in its inventory by 1999."

With the supply side increasingly under control by the early part of this decade, the increase in demand from the nouveaux riches in China and the Middle East soaked up those stocks. By now, Mr Passin says, "the stockpile is believed to be under a billion". That is close to a normal working capital level, rather than the excessive level needed to maintain an inflated price structure.

This month, De Beers disclosed its net earnings before the class action payment were $804m in 2005, up from $498m in 2004. Prices were up, on average, 9.5 per cent over the previous year. There have been a series of write-offs, special charges, and tax adjustments that look as though the financial display window is being cleaned up in readiness for the rumoured IPO.

Before that happens, though, the investor does have some publicly traded Canadian stocks. The largest pure play is Aber Diamond, which, along with its mining properties, owns Harry Winston, the New York based high-end jewellery retailer. Mr Passin, who owns Aber shares, says: "They were laughed at when they bought Harry Winston. Now that looks like it was a really good idea." Aber's shares hit a low of just over C$31 last May. Now they are more than C$44.

Below Aber there are a number of smaller, less diversified companies that constitute what might be called a "wild frontier" for investors.

Even so, there are real mines in the Arctic, and the quality of Canadian corporate governance has improved. "Sure, Canadian governance is questionable sometimes," Mr Passin says, "but you're talking to someone who invests in Russia. It's just as easy to lose money in a strictly regulated, SEC-supervised US company."

So it's probably a good time to look over the Canadian mines, with a magnifying glass, and to consider buying Anglo American for the embedded De Beers asset. The diamond play is developing later than the rest of the commodities world, so you have time to do your homework.