

# *thebigpicture*

guideposts for the private investor

Week Commencing 2 September 2002

## thebigpicture news

- The Japanese economy did not expand by 1.4% in the first quarter as originally reported. Revised data now show no change in GDP in the quarter. The first estimate of growth in the second quarter is 0.5 %. The Japanese government has also announced that industrial production fell by 0.4 % in July and core consumer prices fell for the 34th consecutive month. Meanwhile, the yen is higher against the US dollar, constraining the likely growth contribution from exports.
- In Johannesburg, more than 20,000 delegates are signed up to the UN Summit on Sustainable Development. World leaders (but not the US President) will attend this week. Will they make meaningful progress toward their stated goals of action plans to reduce poverty, redress global distribution imbalances or meet global environmental challenges? Unlikely.

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John A Robertson is publisher and author of *thebigpicture*. Working in Australia, London and New York, he has over 20 years experience in international financial and commodity markets, corporate strategy, financial analysis and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

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## EMPLOYEE SHARE OPTIONS: TOO QUICK TO JUDGEMENT

**The move to expense employee share options is a knee-jerk reaction which fails to come to terms with the fundamental problem.**

Disclosure of executive performance will continue to be at the whim of company boards and chairmen.

Employee share options were motivated by a threefold desire:

- to give employees some proprietorial sense and a coincidence of interests with shareholders - both would benefit if the share price rose;
- to avoid having to force employees to outlay cash for share ownership; and,
- to provide employees with some additional wealth potential without having to raise salaries permanently.

Generally speaking, greater employee share exposure was seen to be good for company performance and shareholders. It was widely encouraged. It was not generally seen by management as a way of avoiding the cash impact of higher remuneration. Indeed, in the most conspicuous examples of wrongdoing, employee share options were not substitutes for high cash salaries.

At the same time, accounting standards had barely come to terms with the time value of money. They had not grappled with how options should be valued nor how the value could be measured when contingent upon performance. There was no generally accepted approach to bringing them into the statement of financial performance.

However, there were requirements for quite detailed reporting of options entitlements both within the notes to the accounts and, more publicly, to the ASX. Shareholder approvals in some circumstances were also required so that the granting of options was difficult to conceal if that was ever a motivation.

So what was the failing in the system? The actual failing was in the linkage between the granting of options and individual performance. This was, of course, a matter of perception. For investors, already concerned about high executive salaries, options were seen as another reward which had not been adequately earned. In many cases, executives saw them as simply part of a salary package which needed to be paid to be competitive.

Adding to the murkiness was a reticence by company chairmen to make clear to shareholders what was reward for exceptional performance and what was simply necessary to attract a particular executive to the job. Perhaps, in many cases, the two were sufficiently blurred that an explicit explanation was not possible.

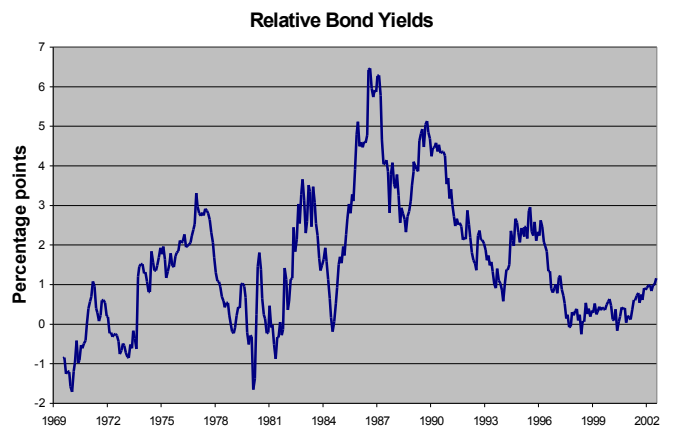
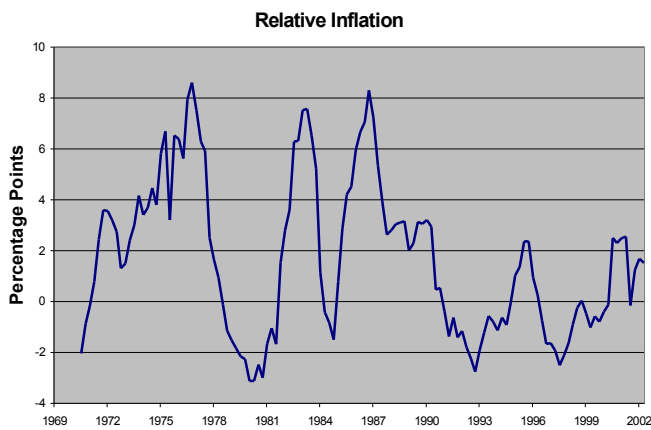
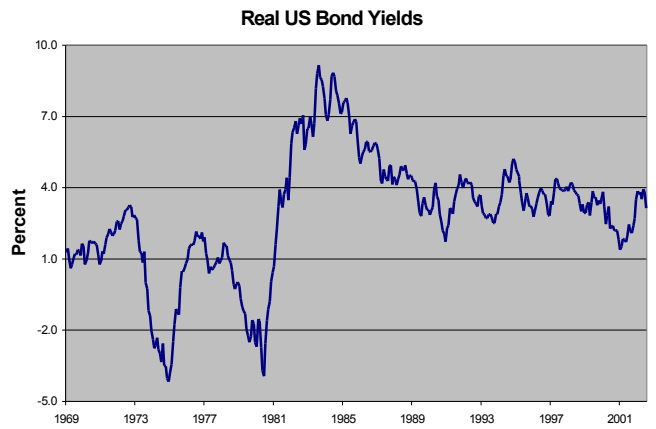
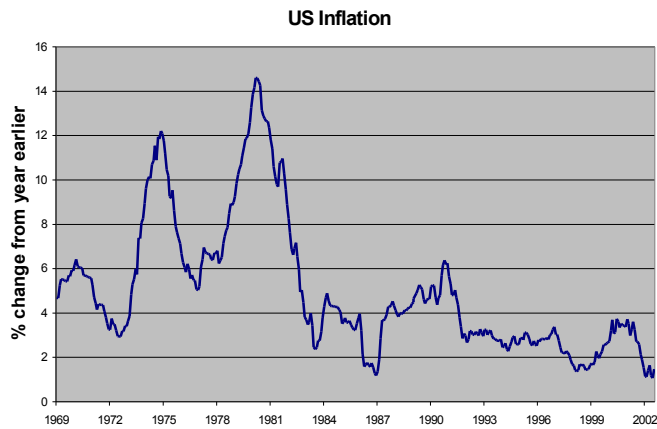
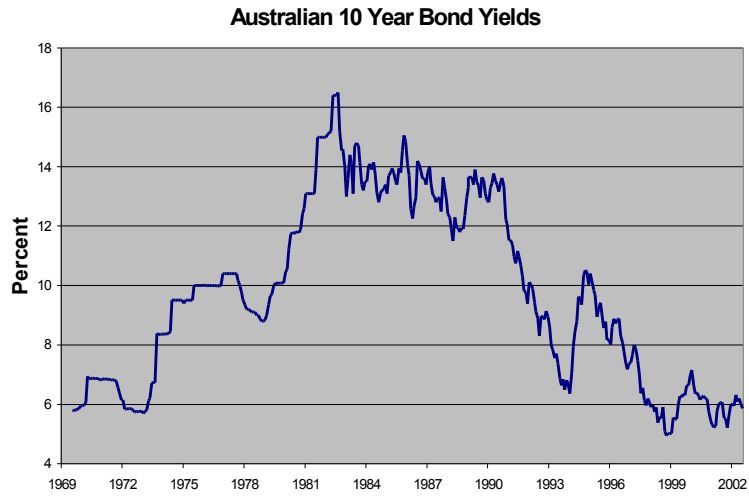
And, therein, lay the failing. It had little or nothing to do with how remuneration was being reported. Nor is this failing now being addressed by recent regulatory initiatives or foreshadowed changes to accounting standards.

Unfortunately, the odium emanating from conspicuous examples of riches being ac-

*"...the bandwagon against employee share options...is not in the best interests of investors."*

*(Continued on page 4)*

# Guideposts for Australian Bond Yields



Sources: Data for the charts are sourced from the Australian Bureau of Statistics, the Reserve Bank of Australia and the US Federal Reserve.

## BOND YIELD DIRECTIONS

*“Current bond yields are slightly to the low side of the expected range.”*

**The current Australian ten year bond yield at around 5.8 per cent is slightly below the big picture expected value.**

The big picture uses three guideposts to assess whether bond yields are "high" or "low" :

- US inflation
- the US real bond premium
- the Australian risk premium

Underpinning this view is that Australian financial markets are tied to the US markets.

Over the year to July, US consumer prices rose by 1.5 percent. *thebigpicture* expects that US inflation (see chart opposite) will be in the 2-3 percent range on an ongoing basis as the cyclical weakness in the US economy passes. The inflation upside will be limited by a central bank which will continue to err on the side of inflation control at the expense of growth, if the choice is required.

Real bond yields - the difference between nominal yields and inflation - have appeared to settle between three per cent and four per cent (see second chart opposite). The big picture is assuming, as a base case, 3%.

Australian bond yields have most often been at a premium to US yields. This premium is a measure of implied risk for the Australian economy and is affected by several factors but primarily

- relative inflation performance
- the balance of payments outlook
- government fiscal policy
- exchange rate volatility

Of these factors, the principal one is likely to be the relative inflation performance. While there are significant policy issues associated with each of the other factors,

they are likely to have a relatively benign influence over the foreseeable future. The balance of payments, while continuing to be higher than desirable, has stabilized. The government has reduced its claim on the financial markets through a combination of higher taxes and asset disposals. And, while the exchange rate is historically weak, it has apparently stabilized and there is some sense in markets that appreciation is more likely than depreciation.

Nonetheless, the spread between US and Australian bond yields is at a recent high point. Australia's relative inflation performance - affected by the impact of the GST introduction and the relative strength of the economy - would be a significant but transitory influence on this outcome. In the event that the gap in the inflation performance narrowed, as it is expected to do, it is likely that this premium would also narrow. The big picture is assuming a value most likely around 0.5 per cent.

These conclusions are summarised in the table.

Current bond yields are slightly to the low side of the expected range. The key differences and sources of a likely subsequent rise in yields are:

- the expected rise in US inflation
- a reduction in the Australian risk premium

From a timing standpoint, any change would be expected in the first or second quarters of 2003.

The risk that yields would move sharply lower from where they are seem likely to depend on a reappraisal of the Australian risk premium and it falling prior to an upturn in the US inflation rate.

The risk that yields move sharply higher from current levels (and beyond the limits outlined in the table) seems to depend on the US inflation performance deteriorating without any reappraisal of the riskiness of Australia.

The balance of factors seem to indicate that Australian bond yields will tend upward in the coming six months but only to around 6.5% reflecting the cyclical strengthening in the US economy.

### AUSTRALIAN BOND YIELDS

<i>percent</i>	Expected Range			Current
	Low	Most Likely	High	
1. US inflation	1.5	2.5	3.0	1.5
2. Real rate premium	2.75	3.5	4.0	3.1
= US yield benchmark	4.25	6.0	7.0	4.6
3. Australian risk premium	1.0	0.5	0.0	1.2
= Australian yield	5.25	6.5	7.0	5.8

## EMPLOYEE SHARE OPTIONS: TOO QUICK TO JUDGEMENT *CONT'D*

*(Continued from page 1)*

quired while shareholder wealth was falling now taints employee share options generally.

Of course, the real issue is broader than simply the treatment of employee options. It extends to bonus payments of any sort; indeed, to salary generally.

Putting aside measurement problems, assume that all remuneration payments are required to be reflected in the statement of financial performance no matter how they are delivered. Shareholders will continue to be aggrieved if those payments are made irrespective of the overall corporate financial performance or the performance of the company's stock price.

From an investor's standpoint, the priority is for more disclosure about remuneration levels and how they are varied in accordance with performance - either financial or market. There have been few complaints if executives receive higher rewards when they are accompanied by financial success and this is likely to be so in the future.

One test will be whether the defensive posture of chairmen at AGMs will be replaced by a more open and accountable approach to these matters.

Companies being required to report non-cash rewards in the statement of financial performance could actually disadvantage investors.

- It would get chairmen off the hook. They could go back to avoiding scrutiny by saying that everything is disclosed in accordance with accounting practices and sidestep having to explain to shareholders the basis of the payments.
- It would also make accounts more complex by including additional non-cash and one-off items which would probably be stripped out for analytical purposes in any event.

By diverting attention from the primary issues, the bandwagon against employee share options, which now includes politicians, professional directors and regulators, is not in the best interests of investors.

*“Disclosure of executive performance will continue to be at the whim of company boards and chairmen.”*

### **In brief .... RBA credit card reform**

The Reserve Bank released its long-awaited report on credit card fees. The report is expected to result in a significant reduction in bank revenues and reduced prices for consumers. Time will tell.

The recommendations are an unprecedented and radical attempt to introduce competition into the credit card market.

It seems unlikely that banks and credit card providers will accept the changes without seeking to compensate themselves in other ways. Subsequent to the proposed changes being announced, there was little change in bank share prices indicating some faith (based on past experience?) that they will not be affected detrimentally.

Will consumers get a discount for cash?

Given the already extensive use of credit cards in Australia, it seems hard to believe that the economy will move to the dual pricing system this would imply. But there may be other changes. Openings might emerge for larger retailers or alliances of retailers to more aggressively market their own credit cards and then to price differentially on the basis of their use.

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