

thebigpicture

guideposts for the private investor

Week Commencing 12 August 2002

thebigpicture news

- The ASX grudgingly accepts additional corporate governance surveillance responsibilities. The conflicts between these and its commercial responsibilities remain a worry.
- The policy bias among central banks swings sharply as weaker equity markets erode confidence in the growth outlook.
- The bears appear firmly in the ascendancy in equity markets - a good sign for future upside potential?
- The government is confused - it wants to reduce interference in Telstra by selling but regulates Qantas and reduces its capital raising opportunities.

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THE BUSINESS ETHICS DEBATE: WHAT IMPACT?

The recent concern about executive ethics should re-enforce some investment decision-making guideposts?

At one level, this is a risk with which all private investors must live. Even the likes of Kerry Packer with trusted surrogates at the Board table of investee companies are not immune.

The recent events simply reinforce the need for extra care. Entrust your savings to only those executives with the highest ethical standards and where there is demonstrable oversight, through an effective Board, of senior executives.

Things to look for:

- only one executive on the Board;
- no family connections between executives and non-executive directors;
- an internal audit team which has not been outsourced and has direct access to a non-executive chairman of an audit committee;
- a willingness to have at least half yearly (probably electronic) briefings which are open to all investors;
- more than two of the top eight institutional broking firms (without a client relationship) actively following the stock;
- remuneration explicitly at risk for senior executives in the event that the share price under performs the market;
- remuneration of the CEO being no more than four times the remuneration of any of his direct reports.

Of course, just as markets always over-react, there is an element of that at present. There is a risk that the emergent pressures, including possible government reactions, might usher an era of corporate timidity which could constrain growth and investor returns.

The decision points, however, for investors remain much the same as always. Compa-

(Continued on page 4)

SUFFERING FROM CERTAINTY

The incessant references by many commentators to 'uncertainty' is misleading and ultimately a destructive influence.

'Certainty' is more likely to signal a change in direction. Professional investors usually know this and position themselves to take advantage of these market turning points. Private investors tend to be the losers.

In Australia in the 1970s, one of the certainties was that Australia could not sustain a viable manufacturing industry. The motor car industry, in particular, would be swamped by an increasingly vibrant Philippines economy. Yes, the Philippines. The Australian

(Continued on page 4)

"Companies which communicate well-defined corporate objectives and which consistently report performance against those objectives are to be preferred..."

Top ten *thebigpicture* themes: ten structural trends affecting long term investment decision-making

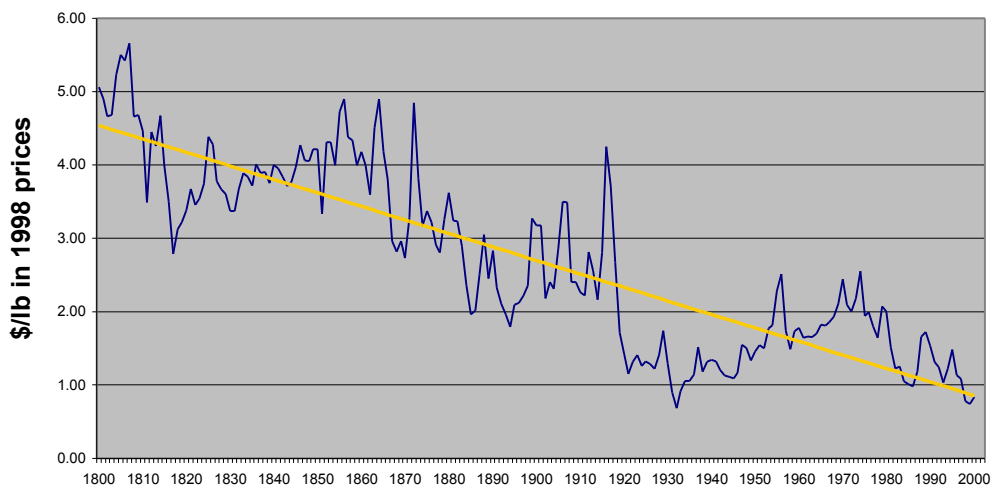
Theme	Key Consequences
The aging population	<ul style="list-style-type: none"> • Changing expenditure patterns, including: <ul style="list-style-type: none"> ~ reorientation of consumption spending to higher value branded goods ~ rising expenditure on healthcare ~ higher leisure expenditure • Rising taxation burden or recourse to debt funding • Pressure on individuals to stay in the workforce longer
Low inflation	<ul style="list-style-type: none"> • Historically low interest rates • Relatively low income growth rates • Monetary policy to err on the side of caution – lower growth • Pressure on managers to improve operational business performance; more frequent business and executive failures
Fear of Islamic fundamentalism	<ul style="list-style-type: none"> • Continuing geo-political tensions focused on Middle East <ul style="list-style-type: none"> ~ oil price and general market volatility • Risk of ‘war’ shocks or terror attacks in western countries • Higher defence expenditure <ul style="list-style-type: none"> ~ taxation or government debt and interest rate impact ~ opportunities for military equipment and service providers
Biotechnology research advances	<ul style="list-style-type: none"> • Ethics – the debate on the nature of life probably resolved in near term • Economics – who captures the value to be continuing debate • Difficulties in raising equity for commercialization • Demands for more government funding for research and subsidizing usage
Changing nature of work	<ul style="list-style-type: none"> • Review of government v private sector in <ul style="list-style-type: none"> ~ periodic retraining ~ educational infrastructure • Failure of companies to nurture internal skills will affect performance <ul style="list-style-type: none"> ~ corporate emphasis to swing back from cost cutting to intellectual capital development
Adoption of information technology	<ul style="list-style-type: none"> • Winners: users of IT as a tool to improve productivity • Losers: product developers facing low barriers to entry
Asian economic development	<ul style="list-style-type: none"> • Western companies will continue to seek ways to position themselves • Good volumes but little pricing power • Highly competitive markets to constrain global inflation • Australia to have advantages as high value service provider in region
Re-emphasis on corporate ethical standards	<ul style="list-style-type: none"> • Greater shareholder activism and public accountability for actions • Company growth rates to diminish • Greater reliance on operational improvement to boost earnings
High company valuations	<ul style="list-style-type: none"> • Market upside dependent on improvement in sustainable profit <ul style="list-style-type: none"> ~ less reliance on valuations effects from lower interest rates • Capital to remain relatively scarce
Emphasis on environmental issues	<ul style="list-style-type: none"> • New infrastructure developments • Relocation of carbon generating industries • More intense cost management pressures • Utility providers to review pricing options • Domestic recycling and industry packaging changes

These themes summarise the views which underlie the opinions expressed in *thebigpicture*. From time-to-time, the impact of these themes on investment markets will be reviewed in more detail.

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RESOURCE PRICES NEVER LOWER

Inflation Adjusted Copper Prices Since 1800



“Long term investors have great difficulty getting value from a resource investment...”

Currently at around 67 USc/lb, copper prices are near their lowest levels since 1932 in real terms. But 200 years of history says that they are on a downward trend - the yellow regression line shows real copper prices falling by an average of 0.8% a year- and could go lower.

Copper prices illustrate a broader point: over time, the prices of industrial raw materials are likely to decline. That is almost the definition of human progress. If untrue, genuine improvements in living standards cannot be achieved.

So what does that mean? If you are a mining company, you are battling against the inexorable pressure of human progress - manifested in a decline in output prices. That means facing constant pressure to reduce operating costs as you deplete your resource base - like being told to dance by the IRA after being "kneecapped".

Long-term investors have great difficulty

getting value from a mining investment unless it is continually replenishing its resource base or investing additional funds to reduce costs to compensate for the secular decline in market prices. Of course, the more investment, the more difficult it is to achieve an adequate rate of return.

A longer term equity investor has to carefully consider whether there is any place in a portfolio for companies with this sort of handicap.

Arguably, just as a company begins to exploit a mineral discovery, that is as good as it gets.

thebigpicture has prepared the very long term chart above, using data extending over 200 years, from various sources including the following US government agencies: the Bureau of Labour Statistics, the Bureau of Mines and the Department of Commerce.

AWAITING THE REVOLUTION

The US Department of Commerce has estimated that the value of e-commerce sales in the US in the first quarter of 2002 was \$9.85 billion. That was 69.4 percent higher than in the first quarter of 2000 and 19.3 percent greater than a year earlier.

And, as a proportion of total retail sales, e-commerce sales had nearly doubled since the fourth quarter of 1999, the first period for which the data were compiled. Even so, e-sales amounted to



only 1.3 percent of total retail turnover. The e-revolution is still to come.

e-commerce sales are sales of goods or services where an order is placed by the buyer or price and terms of sale are negotiated over an internet, extranet, electronic data interchange network, electronic mail or other online system. Payment may or may not be made online.

SUFFERING FROM CERTAINTY *CONT'D*

(Continued from page 1)

industry would largely assemble Asian manufactured products.

Throughout most of the 1970s and 1980s, Japan was regarded as the model for a modern industrial economy. The relationships between business and industry were regarded as a blueprint for success.

During the 1980s, it was certain that interest rates would remain in the double digit range.

Coming into the 1990s, it was certain that China would come to dominate the business life of all companies. This writer recalls the mantra of the time: if every Chinese person used just one of our widgets....

The 1980s was also the era of the entrepreneur. The staid, traditional businesses which lacked the financial engineering skills and the preparedness to incur large quantities of debt were ostracised. They would certainly not survive.

In the 1990s, executives were given more ownership incentive. This would ensure

that companies would perform better and management would act more in the interests of individual shareholders.

Throughout the last thirty years, the rise and rise of the large business services firms was regarded as an efficient model for bringing skills together for the benefit of client companies.

And then, it was absolutely certain that no company could survive unless it fully embraced the new information technologies. The internet would transform the way in which business was conducted. Failure to grasp its potential would mean that a new generation of businesses and entrepreneurs would quickly supplant the old.

Beware certainty. If a trend is so well advanced that everyone you know has acted upon it, wait!

On the other hand, periods of so-called uncertainty can represent important opportunities. See the next issue for *thebigpicture* approach to selecting equity investments in the current environment.

*"See the next issue for
thebigpicture approach
to selecting equity
investments."*

THE BUSINESS ETHICS DEBATE *CONT'D*

(Continued from page 1)

panies which communicate well-defined corporate objectives and which consistently report performance against those objectives are to be preferred to ones which do not.

In that context, *thebigpicture* has a strong belief that fundamentals will win. A company focused on achieving a rate of return better than its cost of capital and measuring its performance accordingly is one to be regarded as a serious investment option. Ethics failures are usually failures to follow this fundamental economic precept.

Try to attend the Annual General Meetings of the companies in which you invest (or watch the increasingly frequent webcast). If there is no mention of rates of return, sell! If there is no mention of the cost of capital, sell! If the Chairman or CEO repeatedly uses the phrase "shareholder value" but cannot define it precisely, sell!

These are the best indications that a

Board or management may not be acting responsibly or in the best interests of shareholders.

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