

# *thebigpicture*

guideposts for the private investor

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## **Publishing and Subscription Information**

*thebigpicture* guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial and business evaluation 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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## BOARD COMPOSITION: THE NEED FOR DIVERSITY

**Events surrounding the election of Coles Myer directors and debates at other recent Annual General Meetings have highlighted arguments about appropriate Board composition. I**

Are companies (and investors) better off having directors with strong personal interests in the fortunes of companies or is the professional and disinterested director the better alternative?

And, even if the professional director is preferable, should she or he have a background in the industry in which the company is engaged?

Further, should there be some limit to the number of directorships which an individual should hold, an excessive number indicating insufficient attention to the affairs of one or more companies?

Implicit in this discussion is that Board composition does potentially bias decision-making and, therefore, business outcomes which, in turn, are reflected in market value.

For larger listed companies, the now common belief is that directors without any prior connection with the company are preferable. This allows current management to pursue its goals unfettered by its predecessors' vested interests in alternative policies. It also prevents prior service providers sitting in judgement on their own advice. Nor is industry background any longer a necessity for Board members, the argument being that there are ample industry specific skills within the company from which a director can draw for advice and information.

Implicit in this view of directors is that they are present only for oversight of the broadest governance issues. To the extent that they are expected to participate in decision making, it is only at the highest level where their generic knowledge of business can be applied to a problem.

They will gain some industry and company specific knowledge vicariously over time. However, here, too, there are pressures in the same direction with moves to limit the terms of directors. Applying term limits will reduce the extent to which a Board can build specialized knowledge and might perhaps reduce the incentive for individual directors to do so.

And yet, this view conflicts with that of private shareholders and policy makers, among others. They see directors as having a more direct role in setting strategy, monitoring performance and taking responsibility for the overall standing of the company. The popular view of directors is that they are the most senior executives in the organization and, if required, ought to be able to commit as much time as is necessary to the well-being of the company.

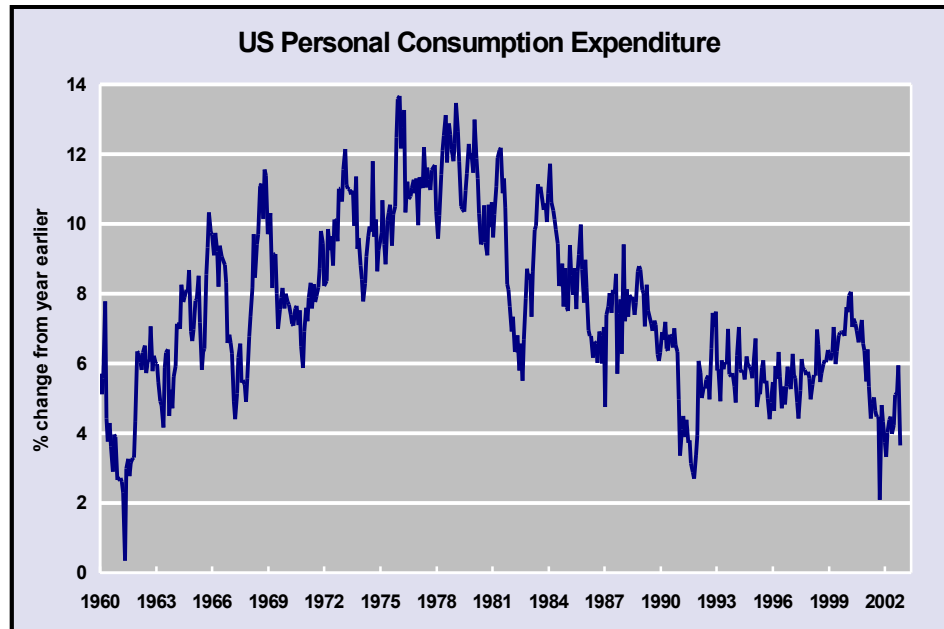
This has led to concerns being expressed that some professional directors are unable to devote sufficient time to all the Boards of which they are members. This has been a much repeated criticism by the Shareholders Association, for example. In response, John Ralph, one of the targets of its criticism, has argued that how many boards a director can service depends very much on the individual. Ian Thorpe, by analogy, according to Mr Ralph, should not be confined to one race at the Olympics simply because more than that is beyond the capacity of the average competitor.

There are exceptions to the general pattern outlined here notably amongst smaller com-

*(Continued on page 3)*

## THE WEEKLY CHART SPOT

*“During the 1990s, consumers appeared willing to run down the proportion of their incomes which was saved as strong equity and real estate markets allowed them to build significant wealth without recourse to savings from income.”*



US personal consumption expenditure remains relatively weak. Over the year to October 2002, it increased at a rate of 3.7% compared with an average rate of growth through the 1990s of 5.7%.

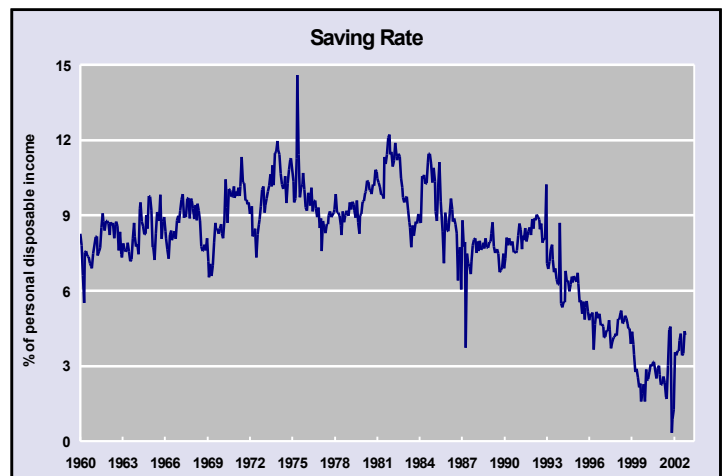
Income is, however, growing more strongly. Personal disposable income in October was 7.5% higher than a year earlier. That is higher than the 5.1% average rate of income growth during the 1990s.

A low savings rate is one factor which remains a drag on more robust consumption spending. Prior to the 1990s, savings averaged 9.0% of disposable income. The savings rate fell to a low of just 0.3% a year ago. Since then, it has increased to just under 4½%.

During the 1990s, consumers appeared willing to run down the proportion of their incomes which was saved as strong equity and real estate markets allowed them to build significant wealth without recourse to savings from income. Now, with equity markets subtracting from their wealth and with greater employment risk, consumers are less likely to reduce their savings voluntarily.

Consequently, despite the relatively robust growth in income, growth in consumption expenditure remains subdued and, without a significant change in underlying mood, is unlikely to rebound strongly until consumers have made some further headway in rebuilding their balance sheets.

Data sources: U.S. Department of Commerce, Bureau of Economic Analysis



## BOARD COMPOSITION: THE NEED FOR DIVERSITY CONT'D

panies and those where continuing family interests have a prominent position on the register. Nonetheless, the pendulum is swinging in the direction of Boards of major listed companies being composed of independent directors supplemented by one or two executives. The tendency has gone so far that we are probably getting it very wrong or very right.

*thebigpicture* has argued in earlier issues that director independence is to be valued and that appointees should not have been former executives or current or former suppliers of goods or services. Nor should family members of senior executives be appointed to Board positions and vice versa. Nor should being a substantial shareholder entitle someone to be a listed company director. To accept that implies one of two alternative problems better solved in other ways. Either the existing directors or management are not sufficiently capable or there are interests to protect which are not consistent with those of the majority of shareholders.

However, it is widely recognized that the independent directors are being drawn from a relatively small pool of talent. If the background of directors is an important influence on their decision-making, the same logic implies that the current group of professional directors also has a decision-making bias.

Despite companies commissioning executive search firms to find directors when vacancies become available, there is almost an identikit director emerging. When you see the likes of David Crawford, Geoff Tomlinson and Dick Warburton, for example, appear so frequently it is hard to believe that there is any great imagination being applied to the task of finding directors. They fall into a limited range of categories represented by a limited number of individuals.

The choice of directors is being dominated by former chief executives and former senior corporate advisory personnel. One implication is that fewer directors have had direct operational experience either within the industry in which their companies are engaged or more broadly. Former divisional general managers with strong operational, international or change management experience, for example, appear unlikely to become board members.

When it comes to strategic decision mak-

ing, therefore, does this make Boards more likely to opt for the financial engineering alternative which we have seen applied so frequently amongst Australian companies in recent years rather than the more arduous operational improvement which can deliver a more sustainable improvement in shareholder value? Does the presence on Boards of people who made their reputations as advisers on 'smart transactions' bias decision-making in this way?

Perversely, at the same time as their knowledge of the company is diminishing and their spread of interests broadening, the legal and fiduciary responsibilities of directors are rising. So, those choosing directors are likely to become even more risk averse and professional directors, themselves, are also likely to become more risk averse in their approach to decision making. This would not be an unusual reaction or one which, at an individual level, could be criticized but it does bias the nature of corporate decision making as a whole.

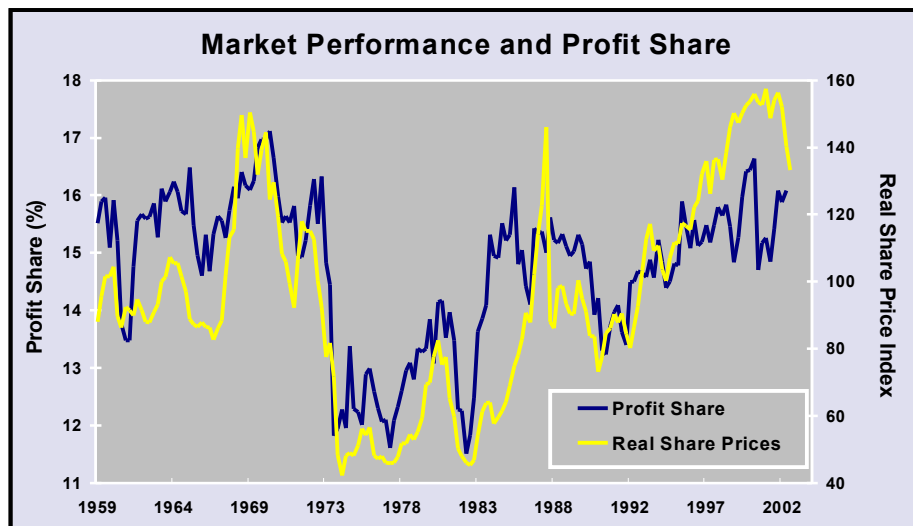
As always, one must be wary of the instinctive herding tendency which afflicts markets. At any point in time, there is a prevailing fad. We have had the entrepreneurial corporate leader, the salaried chief executive, the foreign CEO the 'incentivised' chief executive. This time, in the name of corporate governance, there might be a risk that Boards are being emasculated in pursuit of the identikit director.

Proliferation of the identikit director limits opportunities for individualism and flair to show through. It potentially drags companies back to a median standard performance.

Generalization will always be afflicted by exceptions but the whole tenor of the corporate governance debate is that corporate culture does affect outcomes and that, in the interests of the common good, some general principles should apply to the conduct of all corporate activities. There is no reason to believe that the same laws of nature do not apply in the case of Boards lacking breadth of experience. On balance, therefore, Board selection criteria should emphasize the importance of independence but they should be extended to include diversity as a criteria with equivalent status.

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## AUSTRALIAN PROFIT UPDATE



**There has been above average profit growth reported for the September quarter.**

The quarterly national accounts released by the Australian Bureau of Statistics showed that private corporate gross operating surplus was 3.3% higher in the September quarter compared with the June quarter and 16.2% higher than in the September quarter of 2001. This compares with a long term average rate of growth of 10%.

As government ministers are prone to advise, this is a relatively robust performance against the backdrop of a sluggish world economy and a reducing rate of overall growth within Australia.

For investors, the numbers are of significance because there has been a historical connection between this overall measure of profitability and the performance of the stock market. One perspective on this is shown in the chart above which is drawn from the national accounts data.

The blue line shows the share of corporate profits in non farm gross domestic product. It shows the extent to which corporate profits on an economy wide basis are growing faster than the overall economy. Looked at another way, it shows the extent to which profits are growing at a faster rate than other forms of income. To the extent that there is a trade-off be-

tween profits and wages, it could also be construed as a proxy for business margin expansion.

In the latest quarter, gross operating surplus was equivalent to 16.1% of total non farm product up from 15.9% in the June quarter and 14.8% in the September quarter of 2001.

In the chart, the All Ordinaries index has been deflated by the GDP deflator published in the national accounts. The yellow line shows the extent to which the stock market is rising at a faster rate than the general level of price increases.

There has been some convergence between the profit share and equity market values since early 2002. The convergence has been associated with a rebuilding of business profitability and a decline in market values.

The chart emphasizes that the market had run ahead of the underlying profitability of the economy in the late 1990s. The balance between the two now appears to be more appropriate. However, the impression from the data is that, at current market levels, there is still some need for the process of profit rebuilding to continue before there can be reasonable comfort that the market is on solid foundations and that further profit growth can be reflected in an appreciation in market values.

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