

# thebigpicture

guideposts for the private investor

Week Commencing 23 September 2002

## thebigpicture news

- Argentinean GDP contracted by 13.6% over the year to the second quarter. There was some good news in that GDP did expand by 0.9% during the quarter.
- The malaise confronting Europe was again evident with a 0.9% contraction in the region's industrial production in July.
- UK inflation slowed to 1.9% in August taking it below the Bank of England target and providing some policy flexibility although no monetary easing is currently expected.
- While not changing their monetary targets, the Japanese authorities announced that they would facilitate a reduction in banks' equity holdings to help shore up their financial positions. This will add to bank liquidity and take some pressure off the Japanese equity market which have been affected by the banks' selling.

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*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 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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## Corporate Sustainability: Capital v People

### Organisational sustainability could be put at risk by attitudes towards employees.

This is an aspect of governance which is being largely ignored but which could have a far more significant impact on corporate performance than the current superficial focus on business ethics and conflicts of interest.

Confronted with a choice between a compassionate concern for the well-being and dignity of his employees and the capacity to raise the share price by 15 per cent, which way will the CEO move?

Should investors be concerned about how companies treat their employees?

Does the treatment of employees signal anything about company performance?

It is now commonplace to assert that the nature of work has been changing. Part-time v full-time, consulting v salaried, long hours v the 38 hour week, family v work, support for working women v minimising business costs, work sharing v long term unemployment are among many of the debates defining how people are treated in the workplace.

That these are matters being discussed so avidly reflects, in many cases, genuine lifestyle choices by a more affluent and older society. In many other cases, however, changes being sought have not been voluntary. They have been forced upon employees by companies choosing to put a higher priority on the return to capital than the return to labour.

For this, many executives have been cheered by the financial markets and rewarded handsomely.

Even members of the Australian Shareholders Association ran a campaign at the last round of AGMs to seek explanations from many companies as to why the value of physical assets and goodwill on acquired businesses had been written down. However, they did not appear similarly concerned about the value of the people.

Without any competing viewpoint from either private or institutional investors, involuntary employment reductions, for example, are not seen as a sign of failure. Yet employing someone is an explicit management decision in much the same way as a decision to invest in new plant. There is some irony in a write-down in the value of plant being a more despicable act than retrenching previously employed people.

Despite the (usually annual) rhetoric about the value of employees, they have generally been seen as a cost of doing business, ideally to be minimized, whereas physical capital has been seen as an asset and recognised as such in the financial accounts. True, many academics and management consultants have argued in favour of recognising intellectual capital or knowledge as an

**ABC Limited Annual Report:** "Our people are our most important resource."

**Newspaper report:** "The ABC Limited share price rose by 15 per cent today after news that the company is to reduce its workforce by 3,000 people."

"... the high profile chief executive whose arrival is accompanied by expectations of radical change could well be a destroyer of value over the longer term."

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## Corporate Sustainability: Capital v People cont'd

*(Continued from page 1)*

asset but this is entirely discretionary. There is still nothing contained explicitly or formally in the company statement of financial position which indicates that it has any value. Nor is there any substantial move to achieve that.

Changes at the top have aggravated the pressures on employees.

- The decision-making time horizon of CEOs has shortened considerably as their average tenure has been reduced.
- CEOs have been able to realise income expectations over a very short period. Even failure and separation is probably rewarded more fulsomely than they had once imagined possible as a reward for even a successful career.
- As an external appointment, the CEO may not have had any previous contact with the people already employed nor, perhaps, with the industry within which they find themselves together.

These factors have made the CEO (and many of his inner circle of advisers) remote from the employees. There is, therefore, little cultural empathy. The company is a temporary location to be treated as a set of financial variables. And the aspirations of employees are accorded a lower priority than they otherwise would have been.

One implication of these tendencies is the erosion of the knowledge base of the organisation. This has been camouflaged by companies being able to decrease their formal employment base but increase the informal base by continuing to utilise former employees as consultants, often at a lower cost and through higher numbers of hours worked.

In these cases, the company has continued to live on its own previously fostered knowledge base. The critical question now is who trains the next generation. Where is the infrastructure which delivered the first generation its knowledge base and on which the company's survival has always depended?

Of course, many will argue that public companies (to which these remarks are not confined) have a responsibility to maximise financial returns and that anything else is a luxury or an abrogation of responsibility. That implies that employee dignity and corporate profitability are incompatible. The contrary might be truer.

Professor Carlos Cavallé recently addressed a symposium hosted by Warrane College at the University of New South Wales on the subject of work and human values. Through a series of case studies, Professor Cavallé showed how managers, confronted with a choice between a short term decision to shore up the value of capital at the expense of labour, had opted for the non-conventional reaction and favoured labour to produce more sustainable and more highly profitable business organisations.

The choice, however, seemed to require senior manag-

ers or proprietors having a strong empathy with employees in the organization..

Professor Cavallé holds the chair of Business Administration at the highly respected IESE, Graduate Management School of the University of Navarre in Spain where he was Dean from 1984 to 2000. He is also currently the chairman of the accreditation committee of international business schools. He is widely experienced not only as an academic but as a corporate and financial adviser and as a founder of a European venture capital investment company.

Looked at more closely, therefore, the high profile chief executive whose arrival is accompanied by expectations of radical change could well be a destroyer of value over the longer term. Long-term employees who have been trained appropriately could well underpin more sustainable organisations. Shortened tenure with external appointments to key positions should be questioned rather cheered as the harbinger of prospective change.

Hopefully, now that the shareholder activist groups have dealt with the superficial issues such as the composition of the audit committee, they can become more concerned with some of these more fundamental value-based matters which define the nature of organisations.

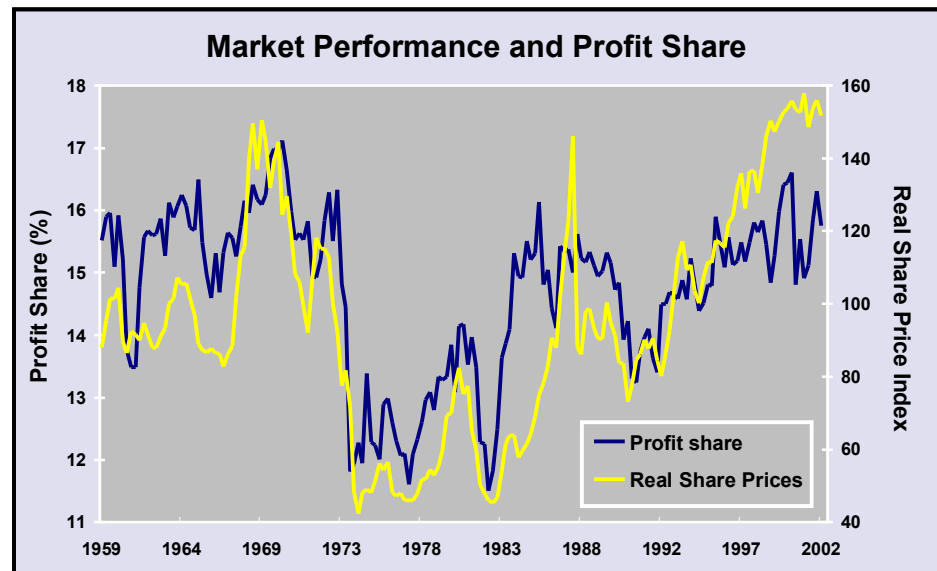
Here are some guideposts against which companies should be judged.

- **Retrenchments:** any occurrence should be seen as a sign of failure and a reason to be critical of management, not something to be applauded. Executives should lose performance pay if sackings are thought necessary.
- **The hero CEO:** is there a culture of the CEO as hero and dominant influence manifested in a large disparity between the salary of the CEO and others in the organization?
- **Empathetic managers:** do senior executives and directors hold themselves to a high level of performance accountability manifested in a substantial loss of salary in the event of business under-performance?
- **Commitment:** how many of the senior management are long-term employees of the organization?
- **Training:** how many of the senior management have been given periods of additional formal and informal training including sabbaticals during the course of a career leading to executive management positions?

Of course, none of this deals with the important question of how employees who are not a part of the senior management group are treated but, if there is no manifestation of employee dignity at the top, chances are it will not be apparent anywhere else either.

## Weak Australian Corporate Profitability

*“...the level of corporate profitability would need to be 20-25 per cent higher to provide confidence that the current market levels are sustainable.”*



**The underlying profitability of the Australian economy still seems inadequate for the level of the Australian market. Recently released data were disappointing.**

The national accounts data for the June quarter released by the Australian Bureau of Statistics on 3 September showed that the gross operating surplus of private corporations was 12.3 per cent higher than in the June quarter of 2001 but decreased by 2.2 per cent in the latest quarter.

Gross operating surplus is equivalent to earnings before interest, income tax, depreciation and amortisation. It does not include overseas sourced profits. It is also an economy-wide measure in which listed companies are a sub-set of the total.

Nonetheless, over the last 40 years, movements in the Australian market have been broadly consistent with movements in the profitability of the corporate sector measured in this way.

In the chart, profitability is measured by the share of gross operating surplus in total non-farm gross domestic product. That is, the blue line will rise if the growth in corporate profits outstrips the growth in the economy as a whole.

The level of the Australian market has been adjusted for general price movements so that the yellow line shows the extent to which the market is rising faster than or more slowly than the general price level.

Historically, when profit growth has exceeded the growth in the economy (a rising blue line), the value of the share market has risen more strongly than the general level of prices (a rising yellow line).

Based on the historical relationship, the level of corporate profitability would need to be 20-25 per cent higher to provide confidence that the current market levels are sustainable.

This does not necessarily mean that the Australian market is going to fall. Other factors - including international growth prospects and the trend in domestic interest rates - will also play roles.

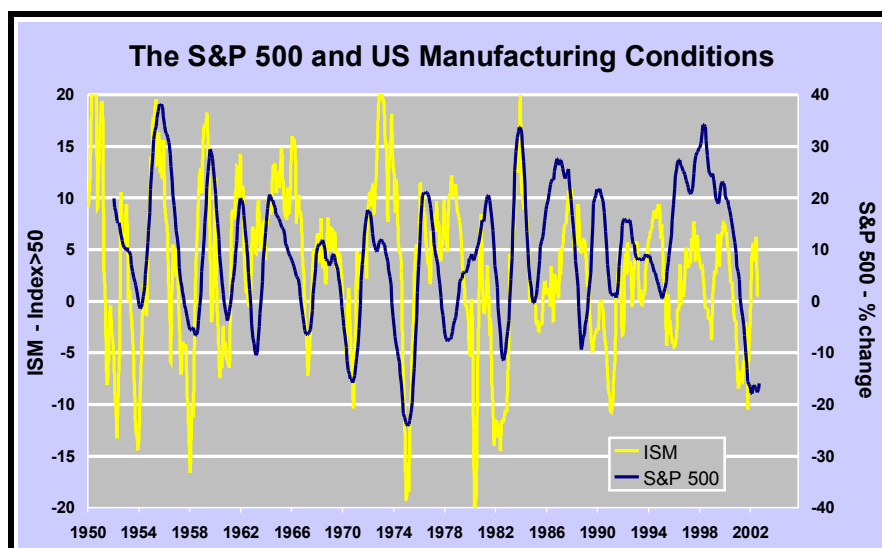
The market could remain around current levels while profitability catches up during the coming year. Indeed, recovering profitability will be a key to the market being put on a firmer footing, initially, then being able to move higher to the extent that further profit growth is sustainable.

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## Economy Not Helping US Market (and vice versa)



### Weakening US manufacturing conditions are signaling further weakness in US equity markets.

US manufacturing conditions have been a significant guide to movements in the broadly-based S&P 500 index.

Manufacturing conditions had improved through the first half of 2002 implying some likely support for the market. However, as the blue line in the chart shows, the US market has taken longer to turn in this cycle than at any other time in the last 50 years.

The slowness of the turn has been associated with several well-documented factors, including the September 11 attacks and the US business ethics scandals.

## Late Breaking News

### CLERP9

The government released details of proposals, prompted by recent corporate governance concerns, for changes to the corporation's laws. The most conspicuous change foreshadowed has been for rotation of audit partners.

It is unclear whether this would have solved any of the more egregious moral failures which afflicted HIH, Enron, *et al* in recent years and, as *thebigpicture* argues in its lead article this week, there are issues of more fundamental importance.

Now, the turn has been so prolonged that its effect is feeding back to the real economy. Consequently, there has been an ominous decline in manufacturing conditions with the measure in the chart (yellow line) now approaching a 'zero' reading. Every occasion this measure has turned negative has been associated with a weakening market.

Sources: The manufacturing conditions measure is based on the Institute of Supply Management (ISM) monthly survey of business conditions. The chart shows deviations from a reading of 50 in the ISMs composite index for manufacturing. The S&P 500 is compiled and published by Standard and Poor's.

### Taxation Inspector

The government has introduced legislation providing for an Inspector of Taxation. This will complement the Commissioner of Taxation, the Board of Taxation, the Taxation Ombudsman, the Taxation Board of Review, the Federal Court system and the parliamentarians who have oversight responsibilities. Very thorough.

Meanwhile, the International Monetary Fund seemed to see the forest: cut the top personal marginal tax rate, it said in its report on Australia.

*"...there has been an ominous decline in manufacturing conditions ... [e]very occasion this measure has turned negative has been associated with a weakening market."*