

# *thebigpicture*

guideposts for the private investor

Week Commencing 3 February 2003

## **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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## *thebigpicture* THEMES: STILL RELEVANT

*thebigpicture* top ten themes (see page 3) summarise the views of the author about some of the longer term trends which are affecting investment market outcomes. The themes, originally published last year, have been reviewed with no changes.

Every new year brings with it events which, with the benefit of hindsight, can be seen to have shaped economic and financial outcomes. Most frequently, the more dramatic they have been the less likely that they were anticipated.

The most vivid example of this, of course, is the attack on the people in the World Trade Centre in New York in September 2001. A similar example was the Iraqi invasion of Kuwait in August 1990. The collapse of Enron in November 2001 and its aftermath, in a different way, has been a similarly defining event.

At the same time, there were other influences. If the events of 2001, for example, had not occurred after there had been a clear slowing in the momentum of economic activity and after markets had been so greatly overvalued, perhaps their impacts would have been different. The events themselves might simply have been catalysts precipitating some of the more fundamental economic forces.

*thebigpicture* top ten themes are intended to comprise the structural trends affecting long term investment decision-making and which are most influential in the conclusions and tenor of the commentary in the weekly newsletter. They would be expected to drive outcomes over many years rather than over quarters or months.

From time to time, the nature of these forces and their impact on investment markets is reviewed in more detail. Near the beginning of the year, however, it makes sense to review what was published last year and to assess whether there is anything happening which ought to prompt a change in the world view which underpins our day-to-day thoughts.

Happily, all ten of the themes continue to strike the chord they did when originally adopted. None has been changed and the list has been reproduced for readers to review on page three of the newsletter.

## GOLD PRICES: IRRELEVANT BUT FASCINATING

**There is probably no financial market indicator as widely reported and as irrelevant as the gold price. Even so, it continues to fascinate.**

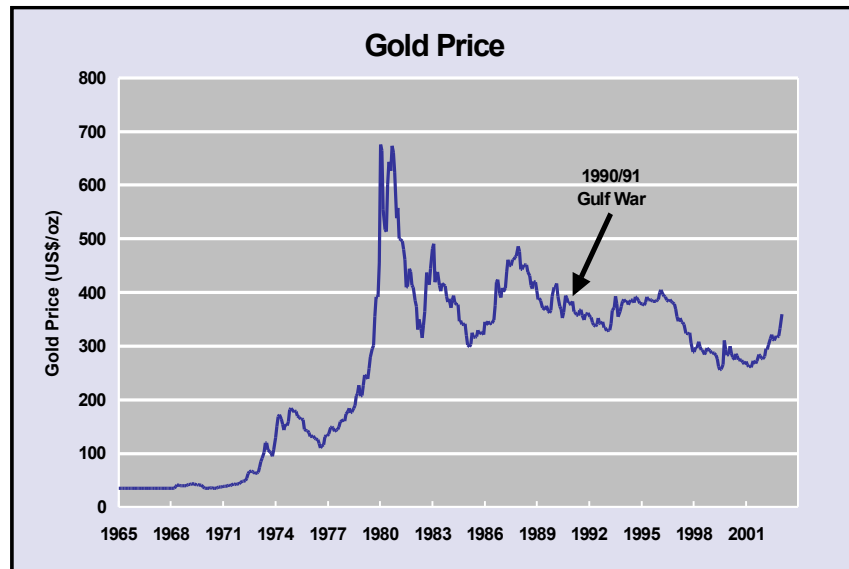
Friday's daily radio news reports that the gold price traded at US\$367 an ounce on the London market. This was 41% higher than the \$260 average price in April 2001. The newsreader asks: could it again get to \$400 an ounce.

And yet, it would hardly matter if gold ceased to exist. Coal and any number of other commodities are more important for global living standards than gold. True, that was not always so but the reasons for its relevance have well and truly passed.

Gold has lost its role as an international medium of exchange. The US dollar has that role. The euro and yen are also aspirants. With deregulated global financial markets, its role as a store of value for people whose assets were subject to appropriation by unscrupulous governments or the ravages of inflation is being superseded.

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## THE WEEKLY CHART SPOT



(Continued from page 1)

Today, the agricultural workers in the Ukraine, just like so many others around the world, have access to a range of alternative currencies, banks, securities and a greater range of goods on which to spend their income with correspondingly less need for the facility which gold once uniquely provided.

Also, looked at from a fundamental standpoint, the pressure on gold is considerable. It is never used to the point of elimination. Virtually all the gold ever mined is still available in one form or another. The ebbs and flows between deficit and surplus which keep other commodity markets alive do not affect the gold market so greatly.

The speculative attraction of gold rests in part on its history and partly on the relatively small size of the gold market compared with other financial markets. Relatively small flows in funds in or out of the currency or bond markets can have disproportionate impacts on the gold market.

There are two forces thought to be in play currently. One is the uncertainty associated with war in the Middle East. Having said that, it is not necessarily true that the gold price should rise under these circumstances. For example, the gold price was in a consistent downtrend between January 1990 and March 1993 despite the invasion of Kuwait in August 1990 and the first Gulf War in January and February 1991.

The difference today is that the US dollar is weakening against the main non-dollar currencies. US dollar weakness is a signal of a turning point in US dollar denominated commodity prices. At the margin, demand for commodities priced in US dollar should rise with a weaker dollar. Also, as the dollar declines, financial managers will attempt at the margin to change their mix of assets to afford some protection against further currency weakness. In anticipation of these factors, speculative funds do flow in the direction of gold.

These are at best tenuous reasons for gold's apparent buoyancy and therein lies the risk for an investor. All of these factors could just as easily be reversed and a change in price direction could be precipitous.

Nonetheless, there are opportunities which could be pursued, depending on one's investment objectives and risk profile, provided there is due recognition that:

- attempting to make money from gold price movements has more than the usual element of speculation attached to it;
- price movements can be swift and decision-making needs to match their speed; and,
- gold price changes are probably being influenced by changes in the prices of other financial assets rather than specific events so that action needs to be taken to ensure that the returns anticipated from a gold price move are not being eroded by a change to some other price.

*“These are at best tenuous reasons for gold’s apparent buoyancy and therein lies the risk for an investor. All of these factors could just as easily be reversed and a change in price direction could be precipitous.”*

# TOP TEN *thebigpicture* THEMES

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

## WHY ABANDON EMPLOYEE OPTIONS?

**Decisions by directors to terminate employee share option schemes in favour of other forms of executive rewards do not necessarily represent progress in reforming executive remuneration standards.**

The criticism of share options as a means of rewarding executives was very much a knee-jerk reaction to some egregious examples of corporate excess. There is nothing to stop similar excess through other reward schemes.

Moves to expense the value of options granted also pollute an already murky set of accounts whose profit reports have diminishing value for investors as an indicator of corporate performance. Consider that a profit outcome can now be some combination of:

- operating performance through the production and sale of goods or services with a direct cash impact;
- capital gains or losses arising from the sale of an asset or part of a business which may or may not have any cash impact; and,
- remuneration without any cash impact and which will be subsequently (in another accounting period) reflected in the balance sheet when new shares are issued.

This inconsistent treatment encourages the development of parallel accounts produced either by companies or by analysts which purport to show a more meaningful picture for investment purposes. This is at the heart of some of the ethical issues which have eaten at the equity markets in the past year or so.

The existence of these parallel accounts with their various adjustments to 'normalise' earnings creates misinformation insofar as they are not available to all investors equally. Also, they create opportunities for unscrupulous directors to use them when they want to direct attention away from activities or outcomes they might seek to conceal.

Because they do not have any formal stature within the reporting system, there is no commitment to use the same format in

subsequent periods to allow effective comparisons to be made. This heightens their potential use for concealment.

Generally, investors have not been objecting to executive remuneration because of its form. The criticism generally is that those receiving the benefits might not be deserving of them and, in attracting such largesse, are bilking the shareholders.

Ultimately, there is only one way in which to avoid this possibility. Remuneration needs to be tied to individual performance and results reported publicly. Increasingly, the first step is in place. Company chairmen in the last round of annual meetings made much of how their executives' remuneration was being tied to performance more explicitly than had been the case before.

Invariably, however, chairmen were also most reluctant to quantify the nexus between performance and reward. This is a failing. Avoiding this critical next step is a missed opportunity to achieve greater transparency and remove an important shareholder grievance.

**thebigpicture** favours a three step approach to executive remuneration being set and having it monitored by shareholders.

- The Board should set objectives consistent with the company improving its economic returns.
- These objectives should be reported on at the next AGM with an explanation of how remuneration is to be tied to these outcomes.
- A report should be made at the subsequent AGM on:
  - ~ the prior year's performance and its remuneration consequences, and
  - ~ the new set of objectives for the coming year.

The problem with this suggestion in the eyes of many is that it would limit the discretion available to boards in rewarding executives. This, too, is its advantage and the reason investors should be keen to have it adopted widely.

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