

thebigpicture

guideposts for the private investor

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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 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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SHOULD DIRECTORS HOLD SHARES?

Holding shares is supposed to help directors feel more like the shareholders they are elected to represent. But it might be better for directors to feel differently about their company's performance.

The Australian Shareholders Association has taken directors of Coles Myer to task because some of the newly appointed members of the board have been tardy in buying shares in the company. A condition of appointment to the Coles Myer board, required by the company's Articles of Association, is that a director must purchase a parcel of at least 200 shares.

Of course, the Coles Myer requirement is purely symbolic. It is hard to imagine a professional director prepared to modify a decision for the sake of the \$1500 at risk.

The pressure to own shares is driven by the idea that directors will modify their decisions when some of their own wealth is at stake. By holding shares themselves, they would be more likely to take decisions favouring shareholders when confronted with a choice between shareholder friendly actions and alternatives which were less favourable to the accumulation of shareholder wealth. But is that necessarily so?

Ironically, Coles Myer directors sought to rid the board of a director who actually did have a substantial holding in the company and whose decisions about the company would have had an impact on his own wealth. His views about the company were not supported by the other members of the board.

As an example, let's say that all decisions flow into a share price impact fully so that an investment which adds, say, \$1 a share in fundamental value results progressively in a share price impact of \$1.

Now, directors are confronted with a decision. They have an investment alternative which adds \$1 in value over 12 months. They have an alternative investment option which adds 75 cents of value over the first 12 months and then 10 cents of value over each succeeding 12-month period for five years.

For which alternative should the directors opt? From a fundamental value perspective, the second would be preferable. However, the first would be preferred by anyone who wished to be able to liquidate their shareholdings in the first 12 months. And there will be shareholders in that situation. Whose interests are the directors there to represent?

This is not entirely unrealistic. The example goes to the heart of the difference of opinion between non-executive directors and the managing director of MIM Holdings recently while that company was subject to a takeover offer. The majority of directors opted to accept the offer because it would provide a more certain short term gain than the longer term gain to be had from the decisions of the management to improve value.

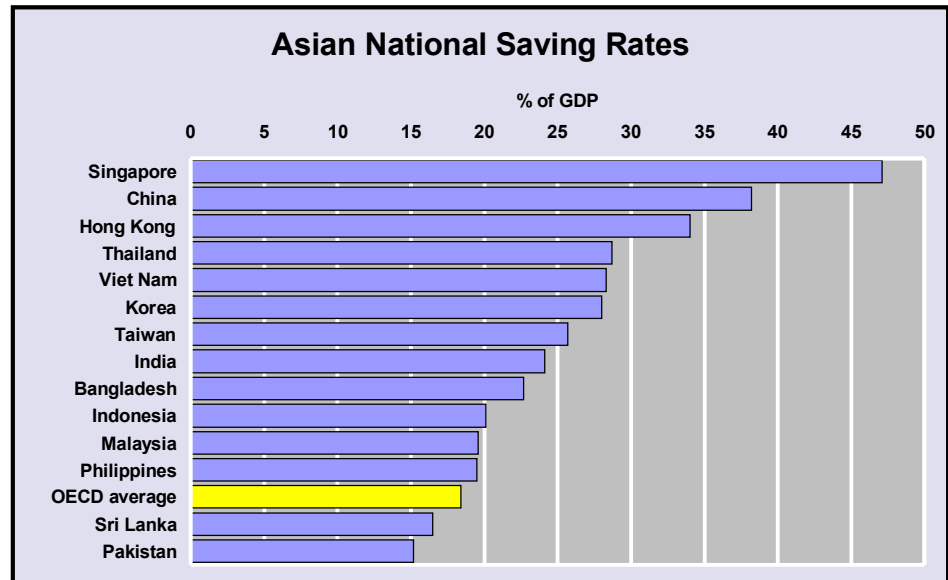
To the extent that directors see themselves as shareholders, they might be more prone to take decisions which add to the short term salability of the shares. In doing so, their

"...directors need not be shareholders. They need to be competent business strategists who have a clear idea of how to define shareholder value and who are able to ensure, when confronted with any decision, that they opt for the alternative which raises the fundamental value of the business by the largest amount."

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THE WEEKLY CHART SPOT

High national savings rates in Asia remain a key to the success of the region. Savings rates are higher than in the average advanced economy offering protection from external shocks and a capacity to fund necessary capital spending for infrastructure.



Source: Asian Development Bank & OECD

THE ENVIRONMENT: IT'S IN THE BAG

Governments and retailers have agreed that plastic shopping bags should be phased out of use. They have set a target 50% reduction in usage rates by the end of 2005.

Environmental activists had been arguing strongly that shoppers should pay for bags used to carry purchased merchandise. At a suggested 25 cents a plastic bag, this was expected to provide adequate disincentive for their continued use.

However, there was no guarantee that this could be achieved. After all, might consumers not simply elect to pay the extra amount for the convenience of being able to use the bags they had become used to having? Perhaps more important from the retailers viewpoint is that the charge might have represented a point of friction between customers and staff. Better to find another way of dissuading customers from using the bags with a lesser penalty.

There are, of course, several very successful models for achieving the goals of the environmental lobby. For example, relatively few aluminium cans are now found discarded and a high proportion of cans are made from recycled metal. Returnable glass containers are a feature around the world

Aluminium can recycling began to work once there was a financial incentive to recycle. That incentive came from deposits

on the can which could be collected when they were returned to a central collection point.

If every plastic bag were worth 25 cents when it was returned to a retailer or to a collection centre, a high proportion of bags would be collected and returned. This would be in contrast with the uncertain response after a charge is levied on the use of the bag and the continuing risk that, once purchased, bags would be discarded inappropriately.

Of course, collection requires an infrastructure. In the case of the aluminium can (and glass bottle), the manufacturer provided the recycling capacity. Similarly, the manufacturers of plastic bags need to be held responsible for their collection and recycling if the process is to be effective.

Penalizing individuals has never worked. The history of improved environmental performance occurs where companies are given incentives to change their habits and where the new incentives are directed at the point along the chain which is most capable of dealing with the fundamental problem.

In this case, the fundamental problem is that retailers and manufacturers are failing to offer collection and recycling capacity. The problem is not people wanting to carry their groceries in a convenient fashion.

HOUSING AFFORDABILITY: BE SERIOUS!

The decision by the commonwealth government to hold an enquiry into the affordability of housing smacks of political maneuvering. Getting lower housing prices is easy. Reduce the attractiveness of housing as an investment. But who dares do it?

The attractiveness of housing as an investment rests ultimately on scarcity. Despite iconic symbols to the contrary, Australia is a nation of large cities. And just like all large cities around the world, housing prices tend to be higher because of land scarcity of and the influx of people.

New York, London, Paris, Tokyo and other capitals demonstrate the capital city effect. People seeking to live in the major cities push up the prices of the available housing stock. Since the turnover is relatively low, the marginal house value is relatively high. Sydney has become one of these international cities.

Within Australia, the capital city effect is clearly evident. Thus prices in Sydney are higher than in Melbourne where they are higher than in Adelaide, etc. How easily one is able to afford a house depends on the city in which one resides.

Expectations are also important. People keep buying houses because the prices keep rising. The affordability tests are misleading. The likelihood of rising prices makes housing more attractive. Repaying a higher proportion of income is justifiable if prices are likely to continue to rise.

If the government wants to change this it simply needs to pull the rug from under the housing investment market. What does it need to do? Firstly, it could make land more available. Release any government land close to the centre of the met-

ropolitan areas. But this will be short-lived because it is a one-off step.

Secondly, reduce the investment attractiveness by taxing the profits. Yes, the dreaded capital gains tax could work. Rather than reducing the marginal rate of capital gains tax, increase it. Make the capital gains tax higher than personal tax rates and apply it to the value of the primary residence. Use the extra tax collected to subsidize the purchase of first homes.

Thirdly, place a limit on the proportion of assets banks can commit to housing. Unfortunately, lending for housing is relatively low risk making housing a preferred form of security.

Fourthly, direct the demand for housing into non-metropolitan centres. An Australian government simply does not have the ability to deliver an affordable house in metropolitan Sydney to all first home buyers for all future generations. Those who have come first have crowded out the later generations. Admit it.

Probably, none of these would be generally acceptable policies. Most people have a vested interest in policies which make housing more valuable. Even if someone does not yet own a house, they aspire to do so because of its wealth building effect.

In other words, suggesting that there can be something done to make housing more affordable is the height of political dishonesty and hurts people by raising unrealistic expectations.

When it comes to action, given the choice between sustaining the value of existing homes and making access more affordable, there is little doubt that any government will choose the first alternative.

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SHOULD DIRECTORS HOLD SHARES? CONT'D

decisions would be less consistent with the sustainability of the company.

Sound governance requires that directors be focused fully on the fundamental value of the business. Its sustainability should be their highest priority.

Whether that is also in the best interests of all the existing shareholders will depend on a myriad of factors including their investment time horizons. These will vary from the day trader to the trust established for an infant child and all in between.

To seek to have directors act in accordance with the preferences of all of these groups would invite chaos.

That is why directors need not be shareholders. They need to be competent business strategists who have a clear idea of how to define shareholder value and who are able to ensure, when confronted with a choice, that they opt for the alternative which raises the fundamental value of the business by the largest amount.

INFLATION FOR INVESTORS

Four times a year we are told what Australia's inflation rate has been in the prior quarter. What should investors be looking for when they pore over these numbers?

The quarterly inflation data were originally collected to provide a measure of how much incomes need to be adjusted to maintain purchasing power, an important function for many people receiving retirement benefits or government payments of various sorts.

That role survives but the highest profile is now given to the role of inflation in the financial markets.

Inflation can enter the investment decision-making framework in two ways:

- as one determinant of an investor's target rate of return; and,
- as a factor in determining profit growth outcomes.

There is another reason market economists follow the quarterly (or monthly in the USA) inflation data: to be able to speculate on the outcome. For these people, anticipating the outcome of a statistical release is an activity driven solely by the need to find another means of legal gambling and in doing so to add to their employer's trading profits.

For genuine investors, therefore, most inflation releases are irrelevant. The only releases which should have an impact are those which significantly alter an investor's long-term view and, by definition, this is likely to happen only with the build-up of information over time rather than through a single collection of new data.

A target rate of return should have three components:

- the real rate of return which is required without attracting any risk ;
- the expected inflation rate; and,
- the premium for risk (in the case of an equity market investment).

Prior to any tax considerations, the target rate of return for an individual investor should be currently around 11½% made up of a 3% real rate of return, a 2½% in-

flation component and a 6% risk premium. The higher the rate of inflation, the higher the required target rate of return (and the lower the price an investor should be willing to pay for any given equity investment).

Thus during the 1990s as Australia's inflation rate was significantly reduced, and the improved productivity outcomes indicated that the change was sustainable, there was a basis for a reduction in targeted rates of return. Consequently, investors could legitimately pay higher prices for their equity investments.

Now inflation has been in the range between 2% and 3% for some time and that outcome has progressively become part of investment decision-making. There would be no cause for action unless the most recent statistics showed that there was a need to reappraise the likelihood of this range of outcomes persisting.

For an investor, therefore, the key judgement to be made from any of the quarterly inflation reports is whether there is any new information which might alter one's view about the prospective inflation outcomes. If there is not, there is no reason to change the target return and no reason to change the target prices of any equity investments.

The inflation environment will also affect the ability of companies to achieve price increases and the extent to which profit can grow. In a macroeconomic environment in which inflation is running at about 3% and volume growth is about 4%, the rate of profitability growth would be around 7% unless the rate of cost increase is substantially different from the rate of output price increase.

Generally, there would be little reason to suspect that the rate of cost increase would be significantly different from the rate of output price increase although there might be scope for periodic differences as special initiatives are taken. In the longer term, too, the cost reduction activities of one company will likely be followed by others to ensure that they do not lose any competitive advantage to their peers among providers of capital.

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