

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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THE SHRINKING AUSTRALIAN MARKET

Pan Pharmaceuticals, MIM Holdings, OPSM, AMP and Neverfail: more companies which have either fallen from grace or which seem destined to be put out of the reach of Australian investors.

The big news of the past week, the Pan Pharmaceuticals fiasco, has exemplified again how little is actually known about publicly listed companies and the extent to which an individual investor must rely on the good faith of those managing the company.

There are at least three issues of general applicability which emerge from the Pan experience:

- i. the questionable effectiveness of continuous disclosure requirements;
- ii. the added risk of investing in regulated businesses; and,
- iii. the role of former owners or substantial shareholders as managers.

Continuous disclosure can fail under extreme circumstances just when the value of disclosure is actually greatest.

Companies are obliged to inform the market when their circumstances might be inconsistent with information conveyed previously or inconsistent with a widespread understanding of the company's situation. For most companies, changed circumstances evolve and an announcement based on a single event is unusual. The internal processes to recognize one and prepare an appropriate reaction are not always in place.

In the case of Pan, there was apparently a period of time during which the market continued to trade while information had been released by the industry regulator about action to be taken. Continuous disclosure implies that there is an instantaneous reaction by the company. But that is hardly realistic. There will always be some form of delay as the information is conveyed internally and decisions taken about how to respond.

While not their direct responsibility, perhaps industry regulators should be aware of the impact of their decisions in the context of public companies and assist in achieving a desirable public policy outcome by co-ordinating their announcement with an announcement to the stock exchange. Co-ordination of announcements when more than one party is involved is not at all unusual in other circumstances.

The unanticipated crisis or killer blow for a company remains one of the great challenges for investors. How can they ever hope to gather enough information to put themselves in a position to react speedily to avert a value loss? Of course, as another example showed in the past week, using information which is not generally available is illegal no matter how small the financial gain. In other words, *investor beware!*

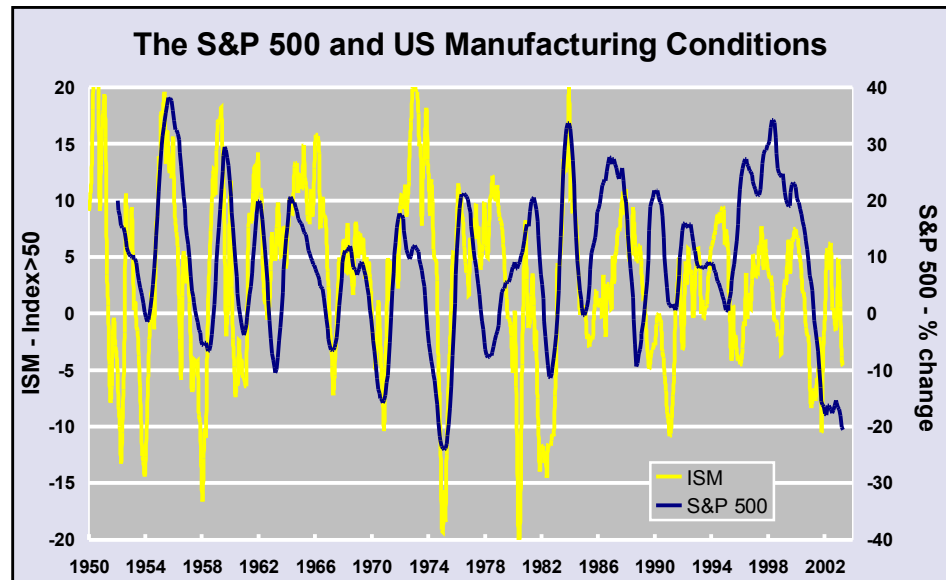
Companies which operate within the confines of a regulatory framework are more likely to face all-or-nothing outcomes. Regulators are not bound by any continuous disclosure requirements. The market is not privy to the evolution of their thoughts. One of the starkest examples of this was the shutdown of Ansett by the air safety regulators. There was some discretion on their part about how they might act. Sometimes judge-

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THE WEEKLY CHART SPOT

"...the uncertainty of the business response... seemed to be preoccupying the Federal Reserve Chairman when he was testifying before Congress during the past week....[H]e noted that any improvement is likely to unfold only gradually and that "in the interim, we need to remain mindful of the possibility that lingering business caution could be an impediment to improved economic performance"."



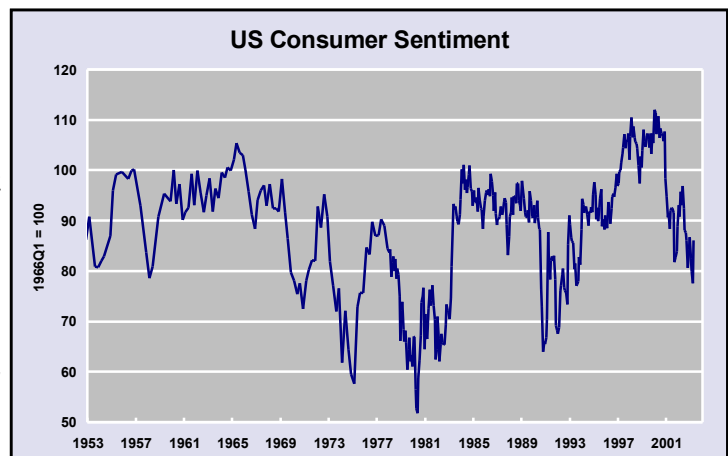
Sources: US Institute of Supply Managers and Standard & Poors

The index of manufacturing conditions compiled by the US Institute of Supply Managers fell to 45.6 in April. An ISM index below 50 generally signals a contracting manufacturing sector. The yellow line in the chart shows the extent to which the index is above or below a reading of 50. There is a long history of movements in the ISM index being associated with changes in equity values (shown in the blue line in the chart).

The chart highlights the presence of one of the most prolonged market turning points in the past fifty years. The duration of the preceding peak was also unusually prolonged so that a lengthier than normal adjustment could have been expected. Complicating matters have been a series of geopolitical events in the past two years including, most recently, the war in Iraq which have supposedly sapped confidence at a critical juncture in the economic cycle.

With the war over, consumer and business confidence should be in better shape. Some of the monthly compilations of consumer expectations do show some bounce. The chart shows the University of Michigan's indicator of consumer sentiment. It rose in April from 77.6 to 86.0. Another widely followed measure, the US Conference Board index of consumer confidence, jumped 20 points to 81.0 in April, the largest monthly increase since March 1991.

At a business level, however, the picture is less certain. The equity market appears past the low points hit in March and the flow of corporate profit information appears to have been taken positively by the market. Nonetheless, it was the uncertainty of the business response which seemed to be preoccupying the Federal Reserve Chairman when he was testifying before Congress during the past week. While he did identify some more positive influences on business thinking, he noted that any improvement is likely to unfold only gradually and that "in the interim, we need to remain mindful of the possibility that lingering business caution could be an impediment to improved economic performance".



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THE SHRINKING AUSTRALIAN MARKET CONT'D

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ments are being made based on a wider agenda for the regulatory authority such as when the ACCC raided the offices of petrol companies searching for evidence of wrongdoing which, if proven, could have had an adverse financial impact.

Ongoing regulatory risk is also evident in the case of Telstra. Despite its partial privatization, Telstra remains subject to decisions about its pricing arrangements and business structure which can affect greatly its profitability and value. This is a risk whether or not the government sold its remaining shareholding. A similar risk is faced by other companies managing what are generally regarded as public utilities and whose prices are determined by statutory bodies without negotiation.

The extent of regulatory risk is something investors should bear in mind when assessing prospective returns.

The dominant CEO is increasingly seen as a sign of corporate weakness rather than strength. The founder or former owner as chief executive is a variant of this.

Former owners are not necessarily adept at recognizing that they have a broader public duty once a company acquires external shareholders. The former owner's risk profile might not match that of his new shareholders. The risk for the shareholders is that the former owner continues to exercise the same proprietorial rights over the company as before the change in structure and remains more of a risk taker than a professional manager would be under the same circumstances.

An evangelical former owner can often attract new investors through his passion and enthusiasm. Often the same standards of analysis which apply to other longer standing public companies are not applied as rigorously. The entrepreneur tends to demand more trust. Again, this increases the investment risk.

Of course, there are some who have combined management and ownership successfully with News Corporation, Publishing and Broadcasting and Westfield Holdings being outstanding contemporary examples. But even these cases have not been without their periodic shocks from business approaches which more risk averse individuals would have eschewed.

Leadership failings are not confined to smaller companies. AMP, BHP, Southcorp

and Mayne Group are companies which have had to recognize in recent times that the dominant CEO is not a model which is conducive to a sustainable business.

How does an investor react to these circumstances? In essence, an investor needs to understand the nature of the risk and to adopt a portfolio approach to investment choice. Computershare, Pan Pharmaceuticals, Southcorp and News Corporation, for example, might appear to be very different companies but they have had a common risk of which investors need to be aware when they are constructing their portfolio.

MIM Holdings: Now Who Thinks Short Term?

Despite some reticence by a few shareholders, MIM seems set to be taken over by Xtrata, a European based company with connections to the South African resource industry and partly funded by Swiss-based trading companies.

Of interest in this transaction is the difference of opinion between the chief executive of the target company and his non-executive directors.

The former is of the view that the bid should not be recommended to shareholders since the business improvements he has implemented are just beginning to have an impact and the bid price does not reflect the progress adequately. To that degree, the potential buyer is receiving a free ride at the expense of shareholders who invested to gain from the changes.

The non-executive directors, on the other hand, are saying that if it had not been for the bid, the share price would likely be lower. The CEO might be right that there is a value increment in the pipeline but there are no other offers available for the whole company. Even then, it might take some time, if ever, for that extra value to be recognized in the share price.

This is a classic choice: the certain return today against the uncertain larger return at some future time.

Company directors have been ready to criticize professional fund managers for the way they make this choice. Indeed, the Australian Treasurer took up this theme in the past week in a speech in Europe arguing that the community would

"...short-termism must be catching... non-executive directors are taking the low risk route to managing their role in the takeover. Not much different to the fund managers."

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benefit if the decision-making horizons of fund managers were longer.

But short-termism must be catching. Here we have directors opting for the short-term choice. The professional manager who has been employed by the Board for his operational and strategic skills is prepared to stake his reputation on the value being higher at a later date. The non-executive directors are taking the low risk route to managing their role in the takeover. Not much different to the fund managers.

Neverfail and OPSM: Less Choice Ahead

The bids for Neverfail Springwater and OPSM are disappointments of a different type. These are two smaller Australian industrial companies which have staked out positions in Australian business. They are successfully developing consumer brands.

In the past three years, they have reported a combined profit of just under \$100 million on revenues of \$1.7 billion. Both companies have been able to achieve returns on funds employed of around 20%, well ahead of the average for Australian companies.

Shareholders will feel buoyed initially by the bids which are at 20%+ premiums to the prices at which the companies were trading recently. After that comes the choice: what to do with the funds released

by the transactions. Are there other similarly successful or prospective companies to which the funds can be directed? There probably are some but we are losing above average performers. They rep-

PAN PHARMACEUTICALS: A LESSON IN PLACING ORDERS

Large price movements, as occurred following the breaking news about Pan Pharmaceuticals, expose the dangers of one widespread market practice.

One newspaper article in the aftermath described an individual investor who ended up buying Pan shares while the market was falling because he had left an order to buy at a price significantly below the market price at the time the order was placed. His order was filled as the bad news hit and the price plummeted.

True, others had information to which this investor was not privy and, to that extent, he has a legitimate complaint. His approach, however, is bad practice for an investor who cannot ensure that he is in front of a news screen at all times.

It is often wishful thinking, if a stock is trading at, say, \$1 a share, to place an order to buy at 80 cents. For the order to be filled, the share price has to fall. One has to ask why the price will fall by 20%. The answer has to be that there will be an event which the market currently does not anticipate.

If you have some special knowledge that this will happen, you are probably acting illegally in placing the order. If you do not have special knowledge, you are creating a risk for yourself. Why will that unanticipated event stop the price at 80 cents? Why won't the price go to 50 or 40 cents? Having touched 80 cents, why would it bounce back? Trying to outsmart the market in this way is dangerous.

If you believe that a stock is overvalued and that you can only justify buying it at a lower price, be disciplined. Stay away. Wait until the share price falls. Ensure, then, that all the information you had is still relevant; that there is nothing new which might affect your original judgement about value. If that is so, go ahead. If not, take advantage of the opportunity to avoid a poor investment decision.

resent a minority and every time one is removed from the market the choice becomes more limited.

Beyond the limits on choice, however, Australia becomes a less interesting place for foreign fund managers. This is an important consideration for a capital importing country. Dynamic young Australian companies are necessary to sustain interest in the Australian market by persuading investors that there are growth opportunities here from which they can benefit.

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