

# 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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**thebigpicture Economics**  
ABN 71 040 787 936  
PO Box 333, Malvern  
Vic 3144

## INSIDER TRADING: THERE MUST BE MORE

The prosecution of Rene Rivkin for insider trading provides a welcome signal that authorities are trying to level the investment playing field. But there are many weak spots along the corporate information chain. This prosecution might simply be a lucky stab in the dark for those seeking to protect investors from the effects of insider trading.

Coming across Rivkin's insider trading activities was apparently a windfall for ASIC, the corporate regulatory agency. According to its head, David Knott, Rivkin's trading was discovered after ASIC's attention was drawn to apparently abnormal Qantas share trading volumes around the time Impulse Airlines and Qantas had struck their deal to merge at the beginning of May 2001.

Rivkin's purchase of 50,000 Qantas shares, some on behalf of clients, seems to be small fry in the context of daily volumes of several million shares. In the normal course, Rivkin's trading would not have been noticed. The obvious inference is that there were others who also boosted the volumes and were not caught in the net.

That is not an excuse for Rivkin (although he might legitimately feel the odd one out) but prompts a question about the reaction of other culprits. Will they be comforted by the thought that they can escape the net as long as they lack a Rivkin-type public profile? Alternatively, will Rivkin's treatment convince them, despite no others being discovered, that the risks of being caught are rising to such an extent that they should refrain from repeating their offences?

Unlike other forms of corporate fraud, there is an ambivalent attitude to insider trading. There is actually some academic debate about whether insider trading is contrary to the interests of investors. At a more practical level, the culture of market speculation encourages the discovery of information which others might not have. In some markets, this is entirely acceptable behaviour.

A mining company anticipating a loss of production, for example, can make futures market purchases to satisfy its obligations prior to the information being commonly known. This might disadvantage sellers who were not privy to the same information. This is a part of the culture and function of these markets. Similarly, it is not unknown for speculators in mining stocks to be seeking out information which might give them some greater insight into a potential mineral discovery or production disruption. Tipped to the likelihood of such an announcement, many would undoubtedly purchase or sell shares, taking advantage of the limited knowledge in the market.

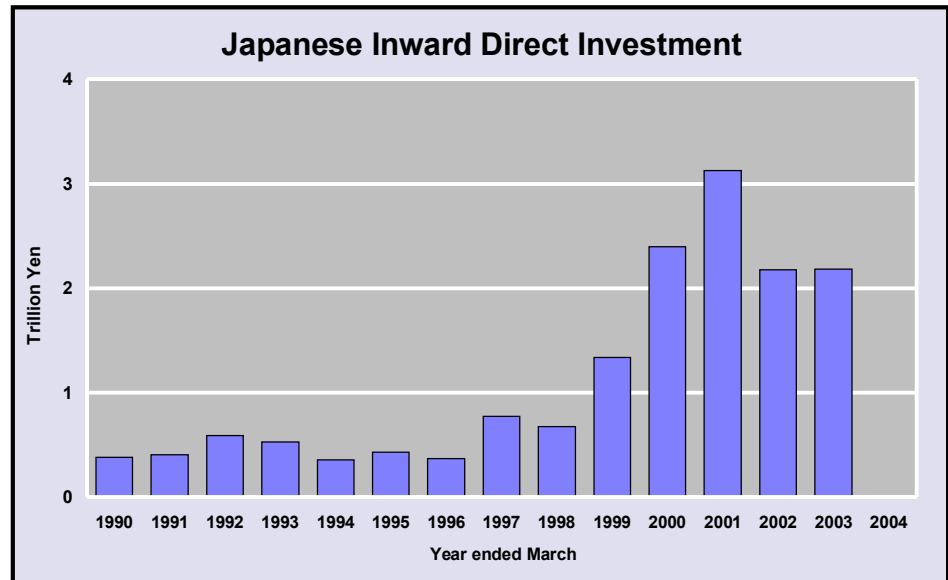
One interesting sidelight in the Rivkin case is that there is apparently no opprobrium attaching to an individual who betrays the trust of others by leaking sensitive information despite the risk that someone (or many) may use it for their benefit.

Every time corporate information is communicated, an opportunity is created for it to be used contrary to the interests of investors. There are five further examples (excluding a CEO spilling the beans to the person from whom he is buying a house).

*"...these examples indicate what a daunting task it is to control the use of inside information. Finding the occasional offender might not make much impact."*

(Continued on page 3)

## THE WEEKLY CHART SPOT



Source: Japanese Ministry of Finance

*“Direct investment in some sectors such as motor vehicles, which might have once been unthinkable, were allowed and the first significant acquisitions of Japanese companies occurred.*

*Now the Japanese government is seeking to raise its profile further as a destination for foreign capital.”*

Japan’s role in the world economy is being transformed. From being a driver of global growth, it is becoming dependant on other parts of the world to help accelerate its growth profile.

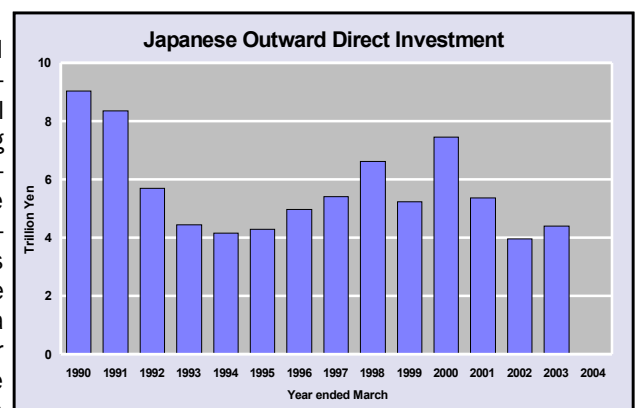
Fifteen or twenty years ago, capital from Japan was helping to fund businesses in Europe and the Americas and transforming Asia into a manufacturing location for the rest of the world. However, Japan was on the verge of its own transformation which would be reflected in a halving of the Nikkei 225, a recession prone economy, a banking system which was widely regarded as being on the brink of failure, an aging population and a political and policy paralysis which would stymie any headway in solving its structural problems.

Since then, direct investment by Japan in other countries has halved. Japan’s Ministry of Finance has reported that the level of outward direct investment in the financial year ended March 2003 was 4,393 billion Yen. This was an 11% rise over the level of outward investment in the previous year but still over 50% lower than it had been in the year to March 1990.

Over the same period, the level of inward direct investment increased sixfold. This radical change reflected an increasing openness. From being an economy which was notorious for the difficulty it posed foreigners wishing to participate, opportunities began to emerge. Some came from international pressures for a level playing field: access similar to what was granted to Japanese companies in other countries. In

parallel, some industries were recognizing that their own survival required access to foreign capital. Direct investment in some sectors such as motor vehicles, which might have once been unthinkable, was admitted and the first significant acquisitions of Japanese companies occurred.

Now the Japanese government is seeking to raise its profile further as a destination for foreign capital. Prime Minister Junichiro Koizumi has stated an aim to double direct inward investment in five years to help revitalize the economy. The bureaucracy is also being organized to ensure that all departments are directing their efforts toward this goal.



## INSIDER TRADING: THERE MUST BE MORE CONT'D

*(Continued from page 1)*

Briefing advisers about material transactions creates additional points of potential leakage as the circle is widened. The leakage could be malicious or accidental. There are examples of meetings between a company and its advisers triggering the first speculation that a transaction might be in the offing. The intent might be different but is there a difference between an executive trading in anticipation of a transaction (clearly illegally) and someone using the knowledge gleaned from seeing the visitors book at reception or identifying the meeting participants at a local hotel in terms of the impact on those in the market who are unaware of this information.

Sounding out capital raising prospects creates another weak link. Sometimes a transaction might be canvassed among institutional investors to assess their willingness to participate. In theory, this information should not be used. But even refraining from investment in another company to preserve funds in anticipation of a placement is acting with inside information and creating an unbalanced playing field.

An executive conducting an interview with a journalist is another weakness in the chain. Again, in theory, the executive should repeat only information which is already available to the market. And yet, in reality, a journalist will generally be looking for some special insight or piece of information which is valuable to his readers. Confirmation of existing market guidance might itself be news. Executives might feel that providing information through this conduit is one way of maxi-

mizing the number of people who will be aware of it. And yet, for a period between interview and publication, this is information which has a limited circulation.

Financial analysts are similarly positioned to have access to information in this way. And yet they are now the most heavily regulated part of the market. Once they would have made their professional reputations by uncovering a piece of information during a meeting to which the market was not generally privy. Now, receiving such information is cause for panic and reference to the compliance manager.

Often matters of financial significance are conveyed by people at an operational level. For example, an engineer at a meeting of professional peers or a marketing executive at a product conference can make price sensitive information available to limited audiences. This is information which can flow quickly even when it is done overseas and seemingly out of the limelight.

Such examples indicate what a daunting task it is to proscribe the use of inside information. Finding the occasional offender might not make much impact.

Of course, the more radical but closely targeted form of control would be to take action against those who pass material information to unauthorized parties as well as those who use it to gain an advantage. Executives who are careless with material information arguably disadvantage investors as much as someone who uses the information. The system might be more effective if the former were more fearful of reprisals.

*“One interesting sidelight in the Rivkin case is that there is apparently no opprobrium attaching to an individual who betrays the trust of others by leaking sensitive information despite the risk that someone (or many) may act on the information.”*

## CONSPIRATORS OR MARKETS CONT'D

*(Continued from page 4)*

that there is a conspiracy.

Since executives at all the companies allegedly involved would be well versed in the legal consequences of explicitly entering an agreement to jointly cut production, it seems hardly plausible that they have done so.

On the other hand, since all the large miners have been confronted by exactly the same set of circumstances, it is entirely plausible that they have reacted similarly.

Of course, if you are an investor in any of the companies concerned, which include

BHP-Billiton and Rio, a cut back in production when demand is weak is exactly what you would want to have happen. Too often, miners have been criticized justifiably for being insufficiently speedy in reacting to changes in demand and allowing inventories to accumulate with a depressant effect on prices.

If the market works, a shortfall in metal supplies from reduced production will cause inventories to fall and, subsequently, an improvement in prices. Eventually, output will be restored, stimulated by strengthening demand, and so the cycles will continue.

## CONSPIRATORS OR MARKETS

### Are copper miners conspiring or simply doing what the market requires?

European competition authorities are reported to be investigating whether copper miners have conspired to support their profits by cutting back production.

Copper miners can sell their output in two forms: as refined metal or as semi-processed concentrates. Concentrates are sold to smelters which process them to produce their own refined metal.

A miner might choose to sell concentrates if its does not have its own smelting facilities or if it is mining more than its own smelting capacity can accommodate. Sometimes, it might also be cheaper to have someone else refine the metal because of the relative cost structure of the miner's plant.

In some places, notably Japan and Europe, where there are only limited opportunities to mine copper ore, but where large quantities of metal are used, smelters have been built which rely on a ready supply of surplus concentrates which are purchased and traded on international markets.

In selling concentrates, the miner will receive a payment for the copper metal which is contained in the raw material less an amount which is intended to reflect the cost of the additional processing required to extract the metal from the raw material. This charge has two elements: a smelting component measured in US dollars per tonne of concentrate and a refining charge measured as cents per pound of refined metal.

These charges are subject to negotiation and reflect how readily available concentrates might be. For example, if there is an abundance of concentrates the balance is in favour of the smelter which can strike a harder bargain and charge higher smelting and refining fees. On the other hand, if concentrates are in short supply, the smelters must agree to a relatively low charge to be able to attract material to their facilities perhaps at the expense of

other plants which are unwilling to reduce their charge by as much.

Allegations have been made that miners have acted jointly to reduce their production to support higher prices. While some production cuts have been made, growing demand from China and India has also diverted material there and reduced the supply which might have otherwise been available in Europe or Japan.

The effects are illustrated in the table. A 25% increase in the copper metal price, which is comparable to the change in price since late 2001, has been associated with a decline in treatment charges which imply a 50% reduction in the revenue received by the smelter. On the other hand, compared to the period when prices

Value of a Tonne of Copper Concentrate		
	Low price conditions	Shortage conditions
Copper content (%)	30	30
Volume of contained copper (lbs)	661,380	661,380
Copper price (USc/lb)	60	75
Value of contained copper (US\$)	396,828.00	496,035.00
Smelting charge (US\$ per tonne of concentrate)	35	15
Refining charge (USc/lb contained copper)	6	3
Total charges (US\$)	39,717.80	19,856.40
Net payment to miner for tonne of concentrate (US\$)	357,110.20	476,178.60

were generally weak, the miner receives a 33% boost to its revenues.

Not only are the earnings of smelters highly sensitive to changes in the concentrate market balance but they have been unable to participate in the improved industry conditions. This is the crucial backdrop against which the antitrust allegations are being played out.

Smelters in Europe and Japan have had to concede very low smelting and refining charges in order to attract raw material. The charges have been so low that some have been forced to make losses to continue. Unsurprisingly, they are alleging

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