

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

SETTING STANDARDS: ACCOUNTING V VALUE

Australia's accounting standards do not measure up according to an international accounting expert. Australian equity investments risked being ostracized. But do accountants really know what constitutes value? That is the key issue for an investor trying to judge the debate.

Sir David Tweedie, the visiting chairman of the International Accounting Standards Board, was critical in the past week of local accounting practices suggesting that Australia could scare off investors if it did not make changes.

He was particularly scathing about how Australian authorities allow companies to treat intangibles on the balance sheet. Using some imprecise language which belied his profession, Tweedie asserted that "Australia has got the worst record in intangibles in the world".

If Tweedie was right about Australia's "deplorable" record, of course, this would greatly disadvantage local investors more so than those offshore since they would always have somewhere else to go – if other countries' standards were any better than those in Australia, that is.

Of course, the local standard setters who have had their role relegated to a mere cipher for the international body pointed out politely that the Australian standards might be different but are no less demanding for that. Indeed, in some cases, Australia will be deferring to less tough requirements by adopting the international rules.

Only in the case of accounting for intangibles were Australian rules more lax than those in the USA or Britain, according to the Chairman of the Australian Accounting Standards Board.

More specifically, accounting for internally generated intangibles was where the difference lay and there was a fixed timetable for Australian companies to conform to the international standard so that there should be no cause for complaint.

For other intangibles, the Australian standards are arguably stricter than those elsewhere. Goodwill on acquisitions must be amortized typically over a shorter period than in the USA or Britain. Any company will have lower reported earnings operating under the Australian jurisdiction than under the US regime.

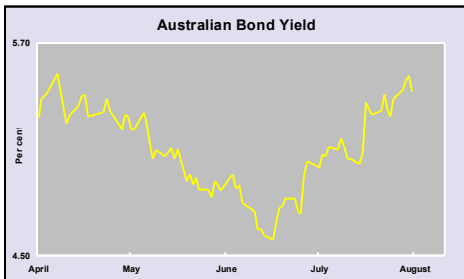
Tweedie's expressed concern echoes the perception overseas that Australian companies have had too much freedom to decide intangible asset values. This is part myth and part truth. There have been some conspicuous examples through Australia's corporate history of companies boosting balance sheets to suggest a more secure future than might actually be the case. Usually, that has been to fool their banks. That said, no jurisdiction has been free from the determined felon.

Among the general run of business, there has been little abuse evident. To capitalize research expenditure, the standards already require a high degree of certainty of the benefits being imminent.

In the case of other internally generated assets such as brand values, there are few examples to cite insofar as it usually takes many years for brands to achieve significant

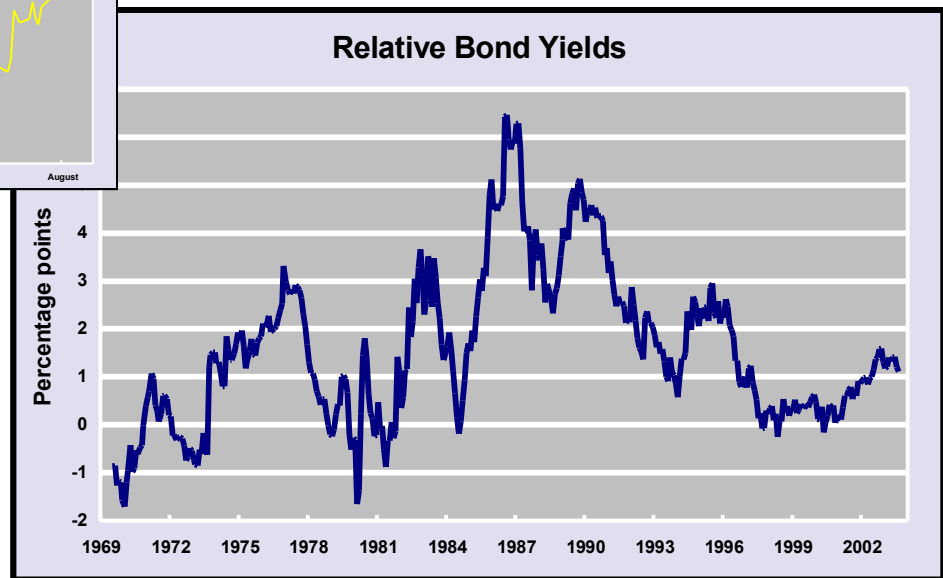
"The economics of the firm are not likely to be changed by the accounting approach. Accounting measures history. The market values the future."

(Continued on page 3)



The sharp reversal in Australian bond yields since mid-June (see above) has simply reflected a changed view of US monetary conditions. Relative bond yields have changed little with local yields still having a 100+ point risk premium compared with those in the USA.

THE WEEKLY CHART SPOT



Source: US Federal Reserve and Reserve Bank of Australia

FUND MANAGERS: KEEPING IN STYLE CONT'D

(Continued from page 4)

intermediary and incur additional costs to compare performance and charges meaningfully.

The complaints are being addressed. Many of them reflect changed market conditions and altering expectations. Fund managers themselves are realizing that it is in their own best interests to respond to the complaints of their clients. For some, there might also be a chance to steal a competitive advantage by appearing to be more responsive.

Nonetheless, they will not be left to themselves to improve accountability. For example, the ASIC has published guidelines on how historical performance data should be used. Beyond that, the ASIC, the ACCC, the Australian Consumers' Association, the Shareholders Association and the Investment and Financial Services Association (among some others) have all joined the fray to decide how fund managers should report their fees and charges so that meaningful comparisons can be made by investors needing to make a choice.

Now, sources reportedly close to the SEC are saying that 'style drifting' will be subject to closer surveillance. Deviations from stated style undermine an investor's choice and constitute misleading behaviour, according to the critics.

One concern is that funds which are ad-

vertised as having a certain style might stray from their stated approach to boost performance. While better performance might ostensibly be in the interests of investors, it can usually only be achieved with the assumption of greater risk and that is not in their interests.

The advocates of change also contend that effective investment decision making including diversification and risk management depend on being confident that a fund is investing consistently based on a stated style. However, current disclosure rules in the USA (and in Australia) prevent investors from readily identifying and protecting themselves against style drift.

A spokesman for the SEC was quoted in Institutional Investor magazine this past week as saying that "we are going to have the ability to compare a fund's performance to expectations based on the fund's disclosures about its style". This could represent a major rebalancing of the power between investor and fund manager.

One of the symptoms of style drift will be a fund manager achieving significantly better performance from markets than its peers. Thus fund managers will be put in the position of having to justify relatively good performance, something for which they would have sought credit in the past.

Testing for style drift is likely to require

(Continued on page 3)

SETTING STANDARDS: ACCOUNTING V VALUE CONT'D

(Continued from page 1)

value. Foster's, Victoria Bitter and The Sydney Morning Herald might be examples among listed Australian companies. In other words, discretion about brand values is usually confined to long-standing companies which are able to demonstrate substantial ongoing cash flowing from use of the brands.

Nonetheless, some Australian companies might have to make sizeable adjustments to their balance sheets on adoption of the international accounting standards.

To illustrate by way of a simple example, a company with net equity of \$100 million and internally generated brand values of \$50 million might be required to eliminate the value of the brands reducing its net equity value to \$50 million. If the accounting concept of net equity were to be the prime determinant of value, the market price of the company should halve. This would be disastrous for an investor. But this puts too much emphasis on accounting and not enough on what actually drives value.

The economics of the firm are not likely to be changed by the accounting approach. Accounting measures history. The market values the future. To that extent the functions performed are different. When the accountants say that adoption of their standards will affect how investors view the Australian market, they are overstating their importance in life.

FUND MANAGERS: KEEPING IN STYLE CONT'D

(Continued from page 2)

fund managers to report more frequently. More frequent reporting will make it more difficult to dress up performance at the end of a period. It will ensure more emphasis on performance consistency.

Against this, the fund managers are arguing that more frequent public disclosure of portfolios could actually harm investors. This is an argument being mounted by larger managers whose investment decisions might have a material affect on markets. According to them, more frequent reporting might facilitate outside investors trading ahead of large funds or gaining the benefits of research and investment strategies that are paid for by the investors in the funds.

Even so, there seems to be broad recognition in the USA among all parties that

Value ultimately arises from future cash flows (net of funds which are required to be reinvested to sustain the business). The value of assets declared in the balance sheet does not enter into the calculation of value in any substantial way.

If that is so, why bother about the accounting standards? The main argument for accounting standards is that they help investors by assembling all the information to be declared in the same order across all companies. This reduces confusion and facilitates ease of access.

Uniformity constrains those directors who might otherwise choose to mislead investors by adopting unique or unusual disclosure forms or approaches which are not comparable across years.

The emphasis here is on having uniformity rather than any particular standard. Uniformity could be achieved with any number of standards. However, none of the changes contemplated move any closer to identifying for investors the key determinants of shareholder value.

Much of the analytical effort within financial markets, therefore, will continue to involve company accounts being prepared in accordance with generally accepted standards and then being dismantled and reformatted so that value can be discerned more easily for investment decision-making.

some reporting constraints are going to be added.

In an era when information is being conveyed at ever faster speeds, fund managers will have to conform to the changed expectations. Just as companies are being forced to disclose continuously so that informed decision-making can occur, more will be required of fund managers.

Depending on how aggressively investment style is eventually policed, fund managers might adopt less specific statements of their investment styles to allow them more flexibility. Even so, the mystery of their craft is likely to be scrutinized more closely as investors become less trusting of those managing their funds and more determined to seek out investments consistent with their needs.

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FUND MANAGERS: KEEPING IN STYLE

Fund managers are under attack. They are being asked for greater accountability on fees and performance. Behind these demands is an ongoing attempt to rebalance market power in favour of individual investors. Having sought more shareholder friendly corporate directors, investors are now turning their attention to fund managers.

The US SEC, the regulator of the funds management industry in the USA, has now flagged a more subtle means of constraining the power of the industry: it will measure deviations from stated style objectives. What might appear a relatively innocuous change has the potential to be the most significant constraint on the industry's behaviour.

Fund managers were already being attacked on several fronts.

- Performance has sometimes been disappointing. Not only have markets fallen short of expectations but some fund managers have done worse. Why this is so is not always clear. Sometimes their communications have been faulty.
- Fees are often high or unclear. Fees were less a worry when markets were rising. However, with severe market falls and the prospect of relatively low returns even modest fees are now seen to be a disproportionate amount of the expected return.
- With asset consultants becoming more actively engaged in investment decision-making, the value of the fund manager in the investment chain is becoming more blurred.
- Fund managers have mis-

leadingly used historical performance measures to attract investors.

- Fund managers have used their strong brand identities to distribute products and to paper over performance inadequacies.
- Comparability of funds managers has been hard for a private investor who must often engage another layer of

What Is Style?

Investment style is intended to describe how a fund manager approaches the investment decision-making task and the level of risk he is prepared to incur.

Active v passive

A passive manager will attempt to tie his performance to that of a particular broadly based benchmark index. He might have a stated aim of delivering performance in line with the ASX 200. Investors would have him manage funds with the expectation that the resultant performance would not deviate significantly from that of the broader market. In the event that the market fell so too would the value of the funds under management.

An active manager on the other hand will attempt to produce returns above the market averages. With this goal will come some greater risk. Investors would have to accept additional volatility. As fund managers grow in size, they become less nimble and it becomes more difficult to perform better than the market.

Growth v value

A value-oriented manager will focus on buying shares in those companies whose current market price does not adequately reflect the existing business performance. When the price has re-adjusted, the shares will be sold and other undervalued investments sought.

On the other hand, a growth-oriented manager will buy those companies whose existing businesses cannot justify the current share price but whose anticipated growth profile is such that it is likely to deliver superior capital gains.

Some managers will stake out one or other of these styles as their specialization and will receive funds to be managed in that way. Some will claim that their adopted style will produce superior returns over the longer term. Others will say that one or other of the two styles will perform better at different points in the economic cycle and seek to adjust their holdings accordingly.

Hedge Funds, Ethics, etc

Other style choices include hedge funds which are able to take long and short market positions to be able to profit from both rising and falling markets.

There is also a small but growing proportion of funds committed to investing in ethical companies which can demonstrate a commitment to certain standards of behaviour or which are screened to exclude producers of deleterious commodities or services which are socially damaging. Investors in companies with a commitment to sustainable development can choose a fund manager which uses this as a criterion in making investment decisions.

Most of the style choices arose in the US market where the plethora of choice offered a better chance to categorize companies than in Australia where relatively few companies in a sector constrain the choices and the style distinction.

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(Continued on page 2)