

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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CORPORATE GOVERNANCE OR A CLASH OF EGOS?

Shareholder activists are preparing for another AGM season. Directors are bracing their defences. As politicians sense a demand for their services, more regulations are being prepared. And, amidst the posturing, the real needs of genuine investors are largely forgotten. But there is a way forward.

Underpinning the public debate about corporate governance has been a nagging doubt about honesty. However, there have been few cases of criminal misconduct at the senior level uncovered in Australia.

Much more frequently, investors have seen their shares lose value while executives were behaving well within what the law required. Incompetence not dishonesty has been the scourge of investors here.

The effects of incompetence have been magnified by the failure of directors to be open, honest and accountable in their public reporting. Too often the glib statement, nimble evasion or colourful brochure has been allowed to hide the commercial warts which needed exposing.

Investors need help to get around these diversions. There needs to be a fresh approach which will identify shortcomings in management skill much more quickly. This is where far more attention should be paid by regulators, shareholder activists and directors alike.

Instead, the principal protagonists have been engaged in a slugfest more about ego than delivering better outcomes for investors.

Arrayed on one side are the shareholder activists. They have had four principal complaints:

- dishonesty has not been detected until it was too late;
- corporate salaries seem to have grown disproportionately measured against any community income standards;
- management incomes have often shown little relationship to business performance and, in some conspicuous examples, management failure appears to have been better rewarded than success; and,
- for small shareholders, the opportunities to meet and speak with management have been frustratingly few in marked contrast to the more open access and information afforded institutional investors.

Arrayed on the other side are company directors. They, too, have their complaints:

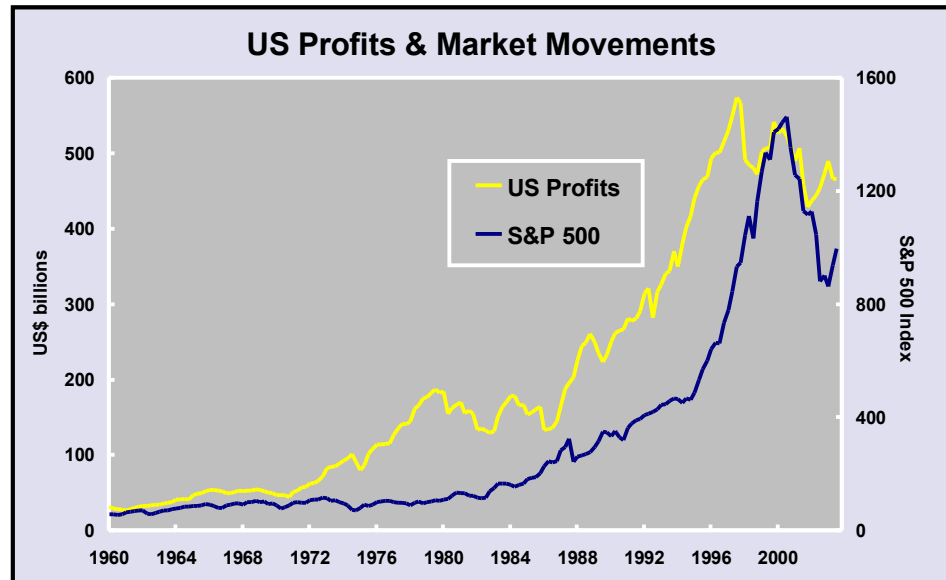
- shareholders, especially small shareholders, are attempting to hold directors responsible for matters beyond their control;
- the regulatory burden is growing increasingly heavy despite potential wrongdoers being few in number;
- regulators are misguided because they focus too much on process and insufficiently on outcomes; and,
- the growth of shareholder activism is becoming increasingly personal and, at

“As investors, we know what drives value higher. Unfortunately, people who have little interest in this being the principal point of discussion have hijacked the corporate governance debate.”

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THE WEEKLY CHART SPOT

“Until recently, stronger profitability may not have shown through in higher market values because the market was still adjusting to a different set of expectations....Past this point, we can have more confidence that further gains in profitability should show through in better market performance.”



Source: US Bureau of Economic Analysis and Standard and Poors

US corporate profits have been battling to mount a robust recovery. Not surprisingly, the equity market is also finding the going tough.

US after tax corporate profits were 8.7% higher in the June quarter than at their most recent low point in the December quarter of 2001, according to statistics from the US Bureau of Economic Analysis. However, they remain in a downtrend which commenced in the third quarter of 1997. They are still 19% lower than at their peak five years ago.

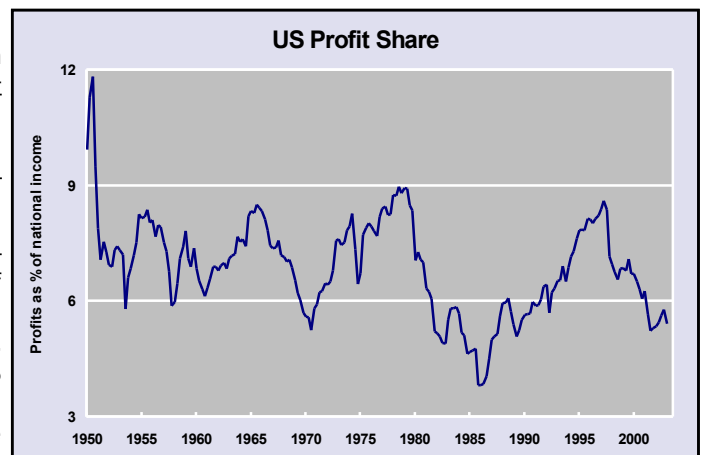
The broad stock market indicators are similarly subdued. The S&P 500 index is 32% below its September 2000 peak.

thebigpicture Economics uses the US corporate profitability data to assess relative market values. The model suggests that the market is now very slightly undervalued - within 5% of 'fair value'. In other words, market values and actual economic performance have converged.

Until recently, stronger profitability may not have shown through in higher market values because the market was still adjusting to a different set of expectations. Surprisingly, given how volatile markets appear to be, this can take a long time. In this cycle, it has been years.

Past this point, we can have more confidence that further gains in profitability should show through in better market performance.

Whether economic conditions are supportive of stronger profit growth is another matter. However, profits are now only 5.4% of national income, around the lowest levels of the past 50 years in the USA.



When economic conditions turn, there should be scope for a more rapid build in corporate profits than for the economy as a whole. This will provide further leverage for the market which would be driven by the short term profit improvement itself as well as the reappraisal of future profit which will come with more buoyant economic circumstances.

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times, irrational.

Some important background factors have also had an influence on the conduct of everyone.

- There has been no share price appreciation on average since 2000 causing significant angst for shareholders dependent on their investments to maintain living standards.
- The importance of superannuation as a determinant of retirement income has changed the relationship between corporations and private investors. Investors have begun to see themselves as permanent owners with the power to change managers. No longer do they only have a temporary interest which can be traded in response to poor performance.
- Politicians have gladly joined the fray with their only available weapon - more regulations.

Out of these cross-currents have emerged more strenuous policing of revamped accounting standards and forced adoption of a range of governance practices.

Unfortunately, the key indicators which drive investment performance - notably the returns generated from funds employed - are largely ignored by accounting standards.

In fact, accounting standards are becoming less investor friendly. One example: reported profit is becoming a more complicated mixture of income from ongoing activities and changes in asset values without any cash impact.

Meanwhile, the legal system is designed to click into action in the event of imminent catastrophic failure. There are no graded sanctions in the law for management performance which falls slightly short of complete failure or which is simply below average.

Companies are told how to report bad performance. They are not required to identify it and change.

Nor is there anything in the corporations laws - existing or proposed - which defines what a company's goals should be. Consequently, companies do little to address this most important of all elements of corporate governance.

Here's a test to prove the assertion. Find just one company among the top 100 Australian listed stocks that is able to say "yes" to each of the following guideposts.

- It announces publicly each year its financial performance goals for the year ahead.
- It identifies explicitly how senior executive remuneration will be tied to the achievement of these specific goals.
- At the end of the year, the company presents a scorecard to shareholders, based on the previously announced goals, analyzing its performance - showing both successes and failures.
- In highlighting where it might have fallen short, the company outlines why and unveils remedial action.
- At the same time, it publicly announces revised goals for the following year.
- Where these goals are different from those pursued in the prior year, it explains why that is appropriate.

All companies should comply with these simple, common-sense standards.

A company committed to such an investor friendly approach would quickly be recognized for its honesty. Its candour would reduce investment risk and the value of the company would appreciate.

For this to happen, there would have to be some attitude changes. For directors and management, saving face could no longer be a dominant influence on the way in which they communicate with the market.

Politicians would need to accept that their laws are for the legal exceptions - not to cover all cases.

Investors could then concentrate on the main game, namely, what sort of return is being generated on the funds they have subscribed. Do they meet the targets required? If not, what are the steps being taken to improve returns? Are the plans well enunciated and are deviations from plans well explained?

As investors, we know what drives value higher. Unfortunately, people who have little interest in this being the principal point of discussion have hijacked the corporate governance debate.

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GUIDEPOSTS FOR THE AGMS

It's AGM season. Should you bother? *thebigpicture* suggests you take the time to attend because AGMs can say a lot about a company - even when it is unintentional.

We know that any meaningful discussion with shareholders occurs behind closed doors. Votes represented by people physically attending an AGM are only a tiny proportion of the total so that passage of resolutions is not dependent on those present.

But for all the stage management of the proceedings, the AGM actually says a lot about a company and its governance.

Chairmen and executives show, within the AGM, what they know about the company, its objectives and its progress. Here are some guideposts by which to judge.

Guidepost 1: does your chairman refer repeatedly to shareholder value? Listen to see if he knows what "shareholder value" actually means. There will be references to growth, market share, strategic positioning and new products. There is, however, only one meaningful measure of shareholder value - achieving a rate of return on funds employed in excess of the cost of capital. Still, many companies are not managed to achieve this goal. If the chairman does not refer to it in these terms, it is a sign of poor corporate governance.

Guidepost 2: does your chairman allow directors to speak? Many chairmen refuse to allow directors to respond to questions directed to them. Despite directors being nominally responsible to shareholders for safeguarding their investments, Boards generally adopt a united front at AGMs against shareholders. This indicates inadequate acceptance of their responsibilities and, perhaps, an indication that they are either not in agreement with the company policies or insufficiently equipped to discuss them publicly. Shareholders are entitled to know which.

Guidepost 3: does your chairman or CEO report performance against objectives? It is now usual for a chief executive as well as the chairman to comment on strategic

issues and business performance. Often these presentations are little more than an animated corporate brochure. A meaningful approach is for objectives outlined in the previous meeting to be reviewed, performance against those objectives reported and, where required, remedial action described. Revised objectives for the upcoming 12 months should be presented.

Guidepost 4: does your chairman report on senior executive performance? In the context of reporting on business performance, the chairman should describe what, if any, bonus or performance-related remuneration payments were made and how those payments related to corporate outcomes. Where objectives were not met, the chairman should highlight how salary payments or other rewards were affected.

Guidepost 5: does your chairman and CEO give a separate press conference after the AGM? It is not unusual to see newspaper stories the day after an AGM which contain information which had not been imparted at the meeting of shareholders. This is treating shareholders with contempt. On the day of the AGM, there should be no reason to have a separate meeting for press from which shareholders are excluded.

Guidepost 6: does your chairman pay lip service to the value of the company's employees? There is usually a ritual acknowledgement of the contribution of employees to the corporate performance, generally at the end of the formal corporate presentation. One important measure of corporate sustainability is how management treats its employees. Give points to a company which highlights its employee activities first. Otherwise, see if your company provides details of even a single initiative to support the well-being of its employees through training or other development. Or, more likely, does it claim credit for creating redundancies?

Using these six guideposts, investors can gain a good appreciation of the progress of the company, its sustainability as a corporation and the standing of shareholders among directors.

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