thebigpicture

guideposts for the private investor

Week Commencing 21 April 2003

HIH: COMPETENCE v DISHONESTY

The $40 million Royal Commission into the causes of the collapse of HIH may not have much general applicability. Even the deterrence value of subsequent prosecutions might be limited since the evidence suggests that the collapse was more a consequence of incompetence than premeditation.

In not throwing the book at anyone, the Royal Commission is recognizing that there are some inherent risks in the community ceding important commercial functions to private organizations. When the trust is misplaced, the community must carry the burden.

Media commentaries on the Royal Commission outcome are tinted with some disappointment that this is so and that incompetence was a bigger factor than dishonesty. The former is not contrary to the corporations law except in very extreme circumstances. Wrongdoing which could be subject to legal action appears to have occurred as the failure was imminent rather than being its root cause.

Insurance is about risk management. This is recognized by insurance companies having to operate within a regulatory framework requiring certain key prudential guidelines to be followed in the course of operations. In this case, It appears that the authority designated to police the regulations was insufficiently vigorous. Even then, there is a hint that this reflected a wish by the government for a light touch to the regulatory regime.

"There is, however, no oversight of the competence of the management and directors. This is something on which investors take their chances. It would be just as well for the government to admit this rather than pretend otherwise."

Without implying any hint of dishonesty, there is a long history of Australian insurance companies failing to fulfill some basic community expectations. National Mutual, AMP, GIO, FAI and HIH are just some of the examples of the insurance companies which have pushed themselves to the brink of oblivion (and beyond) in the past 20 years. A similar observation can be made about the major banks which exercise a similar community trust.

The difference between survival and demise in these cases has not been the nature of the failing so much as the availability of additional capital to avert a fatality.

What would regulators have to change to prevent a future HIH?

- A headstrong CEO who apparently dominated the organization. In some instances this might be a positive influence. Arguably, people like Rupert Murdoch or Frank Lowy or Kerry Packer who are larger than life personalities in the context of their organizations are beneficial. Is there a test which a regulatory authority can apply to CEO dominance? Should the position of CEO in financial services be confined to self-effacing individuals? Hardly.
- The balance between CEO and Chairman. A relatively compliant chairman is regarded as inappropriate but so too is a chairman who interferes in the running of a company at the expense of the authority of the CEO and other executives. Is there a test that the regulatory authority can apply which stipulates the right balance between these two groups? Hardly.
- Inappropriate offshore investments. The Australian corporate landscape is littered

(Continued on page 3)

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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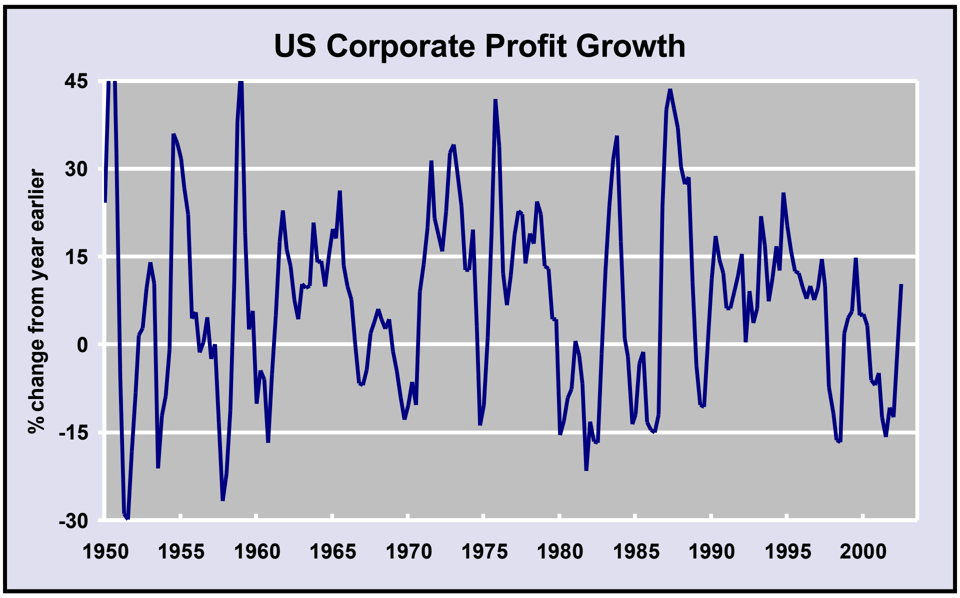
The Weekly Chart Spot



Source: US Department of Commerce, Bureau of Economic Analysis.

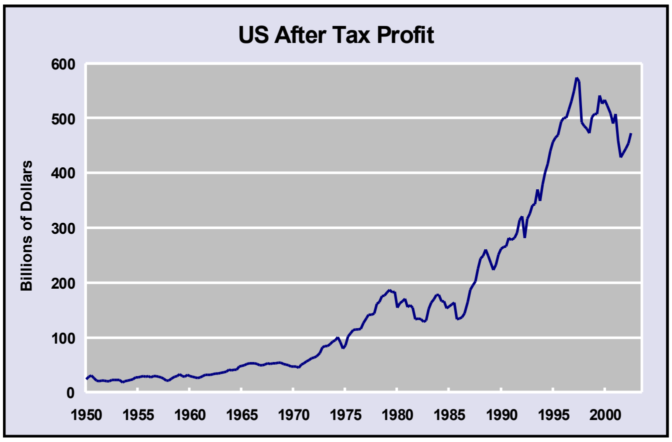
Statistics from the US Bureau of Economic Analysis show that after tax corporate profits rose by 4.1% in the December quarter to be 10.3% higher than a year earlier.

The improvement in profitability was consistent with the improvement in general economic momentum during 2002 which was highlighted in ***thebigpicture*** last week. In December, US business sales were 3.6% higher than they had been a year earlier.

Of course, the turn in activity has been relatively gentle by the standards of past recoveries and longer in coming. Despite the growth in the second half of 2002, profits were still down by 18% from their peak in September 1997.

That the fall from the peak remains so great indicates that the equity market performance is not simply about sentiment. Market values could do little but fall based on this profit performance. Nor should it be surprising that the fall in the market was so pronounced.

Between the September quarter of 1986 and the September quarter of 1997, after tax profit grew at an annual average rate of 14%. Prior to that, the long term average rate of profit growth had been 4.5% a year. Despite the growth being a quantum stronger in the more recent period, it did last long enough to create expectations in the minds of investors that the long term growth rate had permanently accelerated. And, even if the higher sustainable rate was not 14%, it might settle at something closer to 10% rather than 5%.



Previous articles in ***thebigpicture*** have highlighted the extent to which market values are highly leveraged to changes in the anticipated underlying rate of growth. A reduction in the assumed rate of growth from 14% to 5% could easily cut valuations by around 55%. This is so quite aside from any form of irrational exuberance associated with technology changes or emerging market investments.

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In fact, the S&P 500 market indicator reached a peak in March 2000 and closed at a low point of 777 in October 2002, a decline of 51%.

HIH: COMPETENCE v DISHONESTY CONT'D

(Continued from page 1)

with the remains of Australian companies which have ventured offshore to achieve growth that could not be generated from their local market exposures. Should any overseas acquisition plans be subjected to scrutiny by a local regulator to test their strategic viability? And, then, should the implementation of the acquisition be subjected to continuing tests to ensure that the claimed benefits from offshore expansion are actually being realized? Again, this is not realistic because it would effectively nationalize Australian industry with public servants and ultimately the government acting as super directors. Would they be any more able?

The Treasurer, in announcing the HIH findings, referred to the multiple layers of oversight now being put in place as affording greater protection for investors. There is, however, no oversight of the competence of the management and directors. This is something on which investors take their chances. It would be just as well for the government to admit this rather than pretend otherwise.

In his press conference, the Treasurer actually highlighted an important misunderstanding evident at the seniormost levels of policy makers. He referred to the "auditors who supervise the directors".

In practical terms, the auditor simply ensures that whatever decisions the company might take are reported in a prescribed fashion. Only when a company is on the verge of failure is the auditor obliged to question the commercial judgement of those running the company. Otherwise, shareholder value destruction can go on indefinitely without any adverse finding on the part of an auditor. There are ample examples of this among listed companies. Many are eventually purchased by predators at prices which reflect the poor performance. Two current examples are MIM Holdings and Goodman Fielder.

At the heart of this misunderstanding is a failure to comprehend what a company's objectives should be. From an investor's standpoint, those objectives should revolve around achieving an adequate return on the funds employed in the business. Anything less is value destroying.

Regrettably, adoption of a decision-making framework which adds value remains entirely voluntary. Nor are company directors forced to report in any rigorous way on what their objectives are, whether they are being achieved and what remedial action might be required if they are not being achieved.

If policy makers are at all serious about improving the protection afforded investors, these are the issues on which they should be taking a stronger stand.

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POPULATION GROWTH UPDATED CONT'D

(Continued from page 4)

is today.

- The median age of the population is expected to rise. It is thought likely to go from 37.3 to 45.2 years in the developed countries and from 24.1 to 35.7 in the less developed nations between 2000 and 2050.
- The population balance will shift toward Africa. It accounts for 36% of the anticipated global population growth despite suffering the consequences of AIDS.
- Eight countries (India, Pakistan, Nigeria, the United States of America, China, Bangladesh, Ethiopia and the Democratic Republic of Congo, in order of population increment) are expected to account for half of the world's projected population increase.
- The Asian region will remain important. It should account for 58.5% of global population in 2050 compared with 60.7% now.

Each of these changes are likely to have important political and economic influences with investment market implications. Of particular note is the shift implied in the international power balance and relative economic performance among the developed nations.

The population of the USA is projected to grow at slightly over 0.7% pa. In Europe and Japan, meanwhile, an average annual decline of 0.3% is expected over the projection period. The outlook is for a sustained period of relatively strong growth in north America implying a more vibrant investment environment and, without any other changes, gathering political muscle.

Population Growth Updated

Demographic trends are a critical element of the big picture. Just as rapid population growth in the second half of the twentieth century determined economic outcomes, so too will the aging and declining population in the developed countries affect outcomes in the current and coming decades .

The United Nations Population Division has revised downwards its global population forecasts to take account of likely fertility reductions and the HIV/AIDS epidemic. The review, announced at the end of February, resulted in a cut of 403 million from the UN's previous medium scenario population projection for 2050. The UN now projects global population to reach 8.9 billion people by mid century.

UN Population Projections			
Million people	1950	2000	2050(p)
Europe	547	728	632
Northern America	172	316	448
Oceania	13	31	46
Africa	221	796	1,803
Asia	1,398	3,680	5,222
Latin America & Caribbean	167	520	768
World	2,519	6,071	8,919

About half of the reduction reflects a fall in the projected number of births, primarily as a result of lower fertility levels. For the first time, the UN projects that future fertility levels in the majority of developing countries are likely to fall below the level needed to ensure the long-term replacement of the population.

The other half of the difference comes from an increase in the number of projected deaths, the majority (193 million) stemming from greater HIV prevalence.

The review anticipates a more serious and prolonged impact of the HIV/AIDS epidemic than the UN analysts had previously been assuming.

The UN estimates that by 2050 there will be some 479 million less people than if the AIDS epidemic had not occurred. In some of the most affected countries in southern Africa, the population is expected to fall from current levels.

While this is a more pessimistic outcome than had been assumed in earlier projections, this latest assessment of the AIDS epidemic could still be construed as conservative. While the assessment represents the outcome of a detailed analysis in which the impact of the disease is explicitly modeled for 53 countries, prevalence levels are assumed to decline after 2010 with modifications of behaviour reducing rates of recruitment into the high risk groups as well as the chances of infection among those engaging in high risk behaviour.

On the other side of the balance of risks, if fertility were to remain at current levels, the total population could increase from the present 6.3 billion people to 12.8 billion by 2050, an outcome 43% higher than the medium scenario projections.

Statistical revisions aside, some of the key conclusions from the earlier UN review remain.

- There will be a rebalancing of the population distribution. The population of the less developed regions are set to rise from 4.9 billion people today to 7.7 billion people in 2050 while the population of the more developed nations is expected to be smaller in 2050 than it

Median Age of Population			
No. of Years	1950	2000	2050(p)
Europe	29.2	37.7	47.7
Northern America	29.8	35.4	40.2
Oceania	27.8	30.7	39.9
Africa	19.0	18.3	27.5
Asia	22.0	26.1	38.7
Latin America & Caribbean	20.1	24.2	39.8

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