

# *thebigpicture*

guideposts for the private investor

Week Commencing 8 November 2004

## **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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## AGM SEASON: WHY YOU SHOULD BOTHER

It's annual general meeting season. Should you bother? *thebigpicture* suggests you do take the time to attend shareholder meetings 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. These days, even the Shareholders Association, putative voice of the ordinary investor, expresses its concerns privately by letter and face-to-face meetings.

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 and artificiality 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.

Many companies are not managed to achieve this goal. If the chairman does not refer to shareholder value in these terms, it is a sign of poor corporate governance. You will not be able to rely on him or his board to be acting in your interests.

**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 by hearing what they have to say.

**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 at the AGM. Often these presentations are little more than an animated corporate brochure.

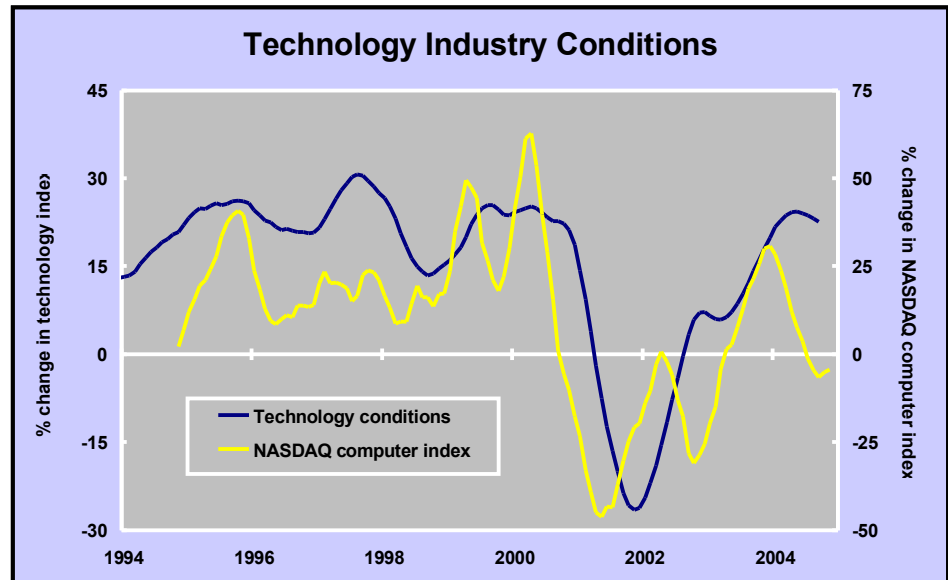
A more meaningful approach is for objectives outlined in the previous meeting to be reviewed, performance against those objectives reported and, where required, remedial action described. Revised objectives for the upcoming 12 months should be presented.

Hardly any boards do this. Beware companies which pretend but change performance

***“Management concern for employees is an important measure of corporate sustainability. Give points to a company which highlights its employee activities first.”***

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## THE WEEKLY CHART SPOT



Source: Federal Reserve Bank of New York, NASDAQ

The technology industry conditions indicator for the USA produced by the New York Federal Reserve Bank is now showing growth rates similar to those prior to 2001 when the first signs of industry recession became evident. The industry seems to have recovered from an arduous three year adjustment.

In contrast, the Nasdaq computer index has fallen in recent months. The index has tended to lead changes in underlying conditions but its reactions to forthcoming changes can be exaggerated.

One of two alternatives now seems likely. The Nasdaq market could have overestimated the likelihood of a deterioration in technology industry conditions. If so, the equity market will recover in the near term to reflect the better than anticipated conditions. The other alternative is that the market is right, foreshadowing a deterioration not yet evident in the fundamental data. ■

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## AGM SEASON: WHY YOU SHOULD BOTHER CONT'D

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benchmarks from one year to the next. Usually, directors avoid the commitment this guidepost requires, wanting the flexibility to opt out in case everything does not go as planned. Exercising this option comes at the expense of their obligations to shareholders.

**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 conclude his address by mentioning that the employ-

ees are the most important part of the business? If he believed that, he would have mentioned them first.

Management concern for employees is an important measure of corporate sustainability. Give points to a company which highlights its employee activities first. Otherwise, see if your company cites even a single initiative to support the well-being of its employees through training or other development. Or, more likely, does it seek to titillate the investment market by referring to cost reducing redundancies?

Using these five guideposts, investors can get a good appreciation of a company's progress, its sustainability as a corporation, the clarity of thought among directors and the standing of shareholders among those appointed to represent them. ■

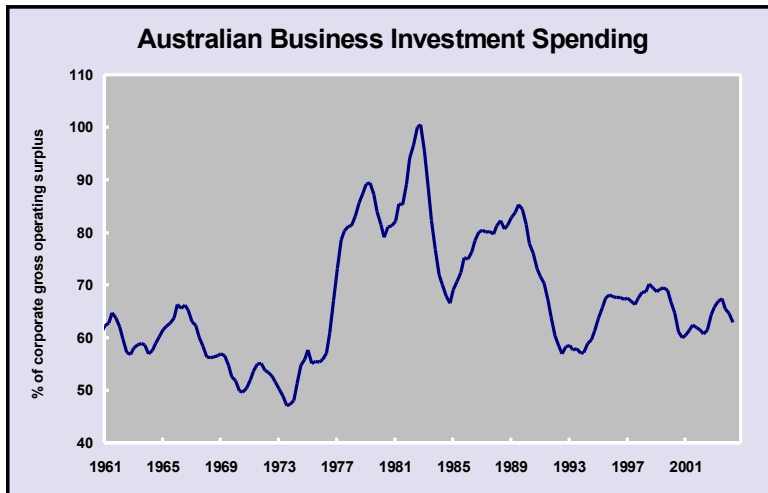
## GROWTH &amp; RATES: TOO CLOSE CONT'D

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typically exceeded the growth rate. On average, nominal GDP growth was 8.4% a year and the bond yield was 11.6%. Not surprisingly, in this environment, growth started to slow and by 1990 the Australian economy

growth profile. There would still be a risk of investment activity being constrained and, in turn, limiting longer term growth prospects.

Interestingly, this picture is not confined to Australia. The same relationships are evident in the USA.



However, US growth might be sustainable at a higher level than in Australia since the population growth outlook there is stronger.

That might imply a sustainable 6% outcome compared with 5% in Australia. That means that the potential gap between growth and yield

had been pushed clearly into recession.

- **Phase three** is the shortest and began around 1998. Since then, bond yields averaging 5.7% have again been lower than the growth rate which has averaged 6.4%. In principle, this is a more favourable environment for investment activity.

However, better is not the same as good. Australian growth might not be sustainable above current bond yields.

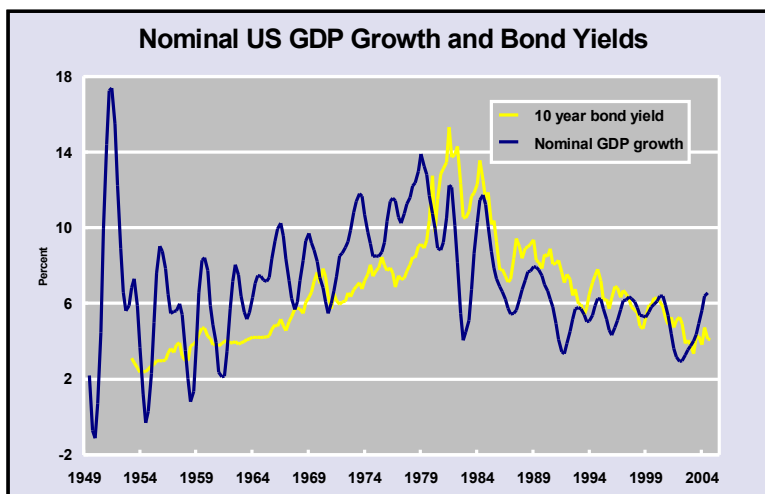
With population growth of around 1%, slightly under 2% productivity growth and 3% price increase, growth in the value of output would be just under 6%.

With the population contribution to growth set to at least halve over coming years, sustainable growth is more likely to be near 5% and the gap between growth and yield will have been eliminated.

Despite interest rates being generally lower now than a decade ago, the step down would barely be consistent with the

will be greater and the investment environment more attractive.

Interest rates are prices which ration investment activity. Commentators on short-term interest rate movements tend to assume that current rates are about right for prevailing growth conditions. With that assumption, stronger growth always im-



plies higher rates. However, if the adjustment to lower rates has been incomplete, this view of rising rates is misleading.

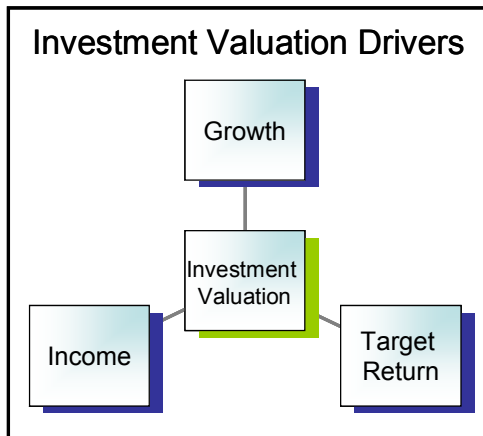
A wider historical perspective might suggest that they should be a good deal lower so that those undertaking investment activity can be encouraged to take more risks. ■

*“...the growth prospects for the Australian economy have changed radically .... If interest rates have not fully adjusted to the change, they might still be too constraining for investment activity.”*

## GROWTH & RATES: TOO CLOSE

The longer term prospects for economic growth in Australia suggest that interest rates might still be too high to make investment attractive.

Ideas about what constitutes a normal level of interest rates are still influenced heavily by the experiences of the 1980s and early 1990s. We have just had an



election campaign in Australia which had as its centrepiece the memory of 18% interest rates.

And, yet, the growth prospects for the Australian economy have changed radically since they occurred. If interest rates have not fully adjusted to the change, they might still be too constraining for investment activity.

If investments are not able to deliver a return at least equal to the government bond yield (plus an appropriate premium for the risk of moving away from government paper), they should not be made.

Government bond yields set the standard for the returns which have to be generated from investments whether the investor is a small anonymous shareholder or a multibillion dollar corporation.

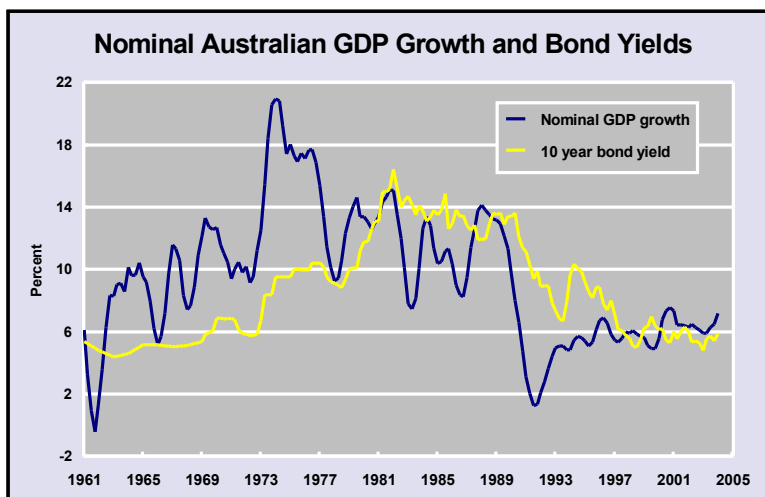
The lower the bond yield, the more an investor should be prepared to pay for an investment, everything else being unchanged.

Everything else, of course is not going to be unchanged. Growth is also a key factor in an investment valuation. The higher the anticipated growth rate, the more an investor will be prepared to commit, for any level of current income and bond yield.

If growth falls significantly enough, it might not be able to compensate for the prevailing cost of capital (i.e. the targeted return) dragging down the value of an investment and deterring investment activity.

At a macroeconomic level, the history of Australian growth and bond yields over the past 40 years is summarized in the following chart. The chart shows three phases:

- **Phase one** from the early 1960s through the 1970s was a period of volatile growth during which the bond yield was generally at a significant discount to the growth rate. On average, nominal GDP growth was 12.0% a year and the bond yield was 6.9%.
- **Phase two** continued through most of



the 1990s. Although high interest rates had started to decline in the latter part of this phase, bond yields

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