

# thebigpicture

guideposts for the private investor

Week Commencing 12 April 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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## WHAT IS SHAREHOLDER VALUE?

Shareholder value is a term bandied around investment markets by companies and investors without there being a lot of agreement about its meaning. There is a clearcut definition which investors should bear in mind when making their decisions.

Wesfarmers, The News Corporation, Foster's and Biota, to use some examples of different company styles, all claim that they are pursuing shareholder value. And, yet, each of these companies is very different in their business approaches and financial outcomes. All are laying claims to public funds in a competitive market and investors must make choices from among them. Is there a solid basis for the comparison?

Ultimately, an investor is concerned about share prices and dividend flows. However, a company is unable to influence the share price directly. Its management has the capacity to influence its share price only indirectly through its financial and business performance.

So, a key question for any company board is 'what measure of value should be targeted to maximize the chances of a favourable stock price reaction?'. For an investor, the equivalent question is 'how can I judge whether a company is committed to adding value to underwrite future share price increases?'

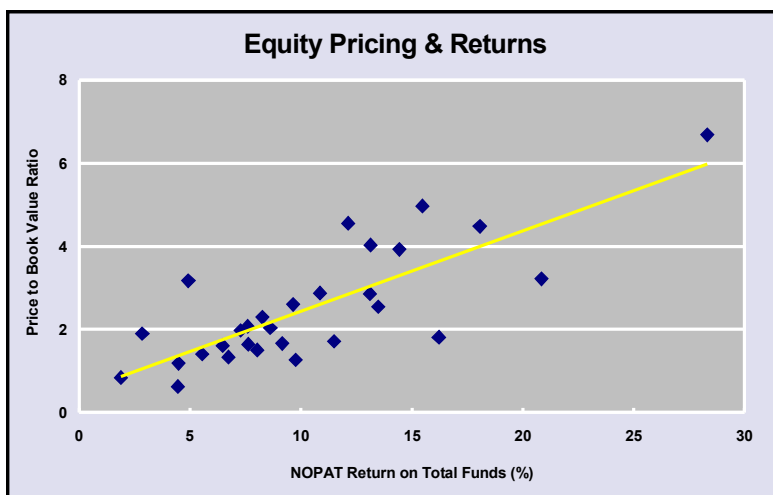
*thebigpicture* is an enthusiast of the return on funds employed as the basis for measuring shareholder value.

Public companies combine funds subscribed by equity investors with debt to pursue their business objectives. These debt and equity funds come at a cost.

Debt funds are charged for explicitly. Equity funds must be drawn from a competitive market and must return at least what could be received from alternative investments.

ABC Limited can raise debt at 6.5%, with an after tax cost of 4.6%. Its cost of equity funds is 10% - bond yields are 6% to which it needs to add an equity risk premium of 4%. This is a proxy for the return equity investors ought to be able to get through alternative investments. ABC has an average risk profile so that there is no need to apply any above average risk premium. With its total funds employed being half debt and half equity, ABC has a cost of funds (after tax) of 7.3%.

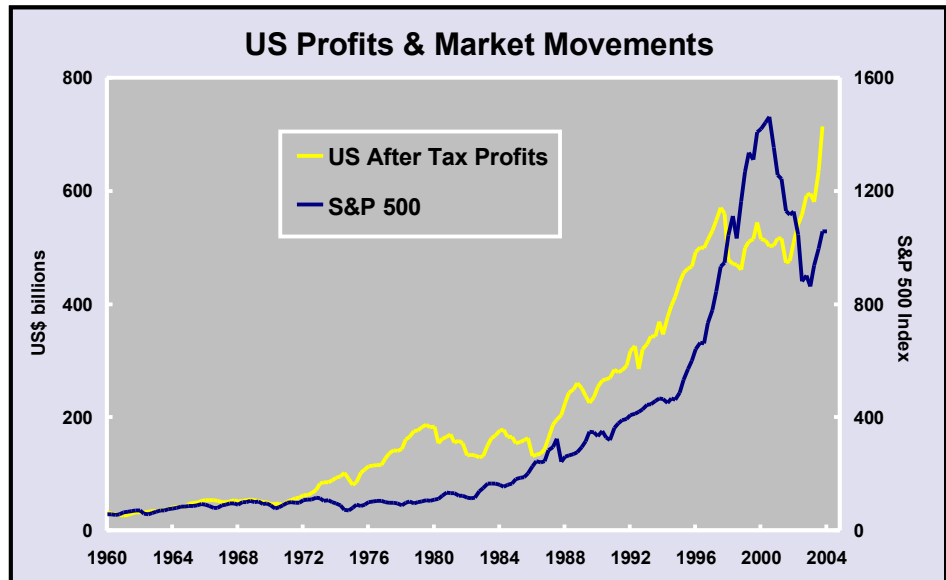
To cover the cost of the \$100 million of funds it is using, ABC needs to be generating an operating profit, after tax, of \$7.3 million. If it falls short of this, its stakeholders would



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## THE WEEKLY CHART SPOT

US corporate profits have continued to stage a strong recovery. After tax profits increased by 20.7% over the year to the December quarter. If anything, the US market seems to be lagging the improved profit outcomes. Politics, international affairs and concerns about interest rate rises might be sapping some strength. Importantly, though, the profit base is being put in place for future gains.



Source: US Bureau of Economic Analysis and Standard & Poors

### WHAT IS SHAREHOLDER VALUE? CONT'D

(Continued from page 1)

be better off placing their funds with alternative users.

Anything over \$7.3 million could be categorized as adding to shareholder value since it would exceed what they could receive from other investments with the same risk.

There is ample empirical evidence that company share price performance is stronger when company returns are higher.

The chart on page 1 shows rates of return (on the horizontal axis) for thirty of the largest industrial companies on the Australian market and their market prices relative to book values (on the vertical axis).

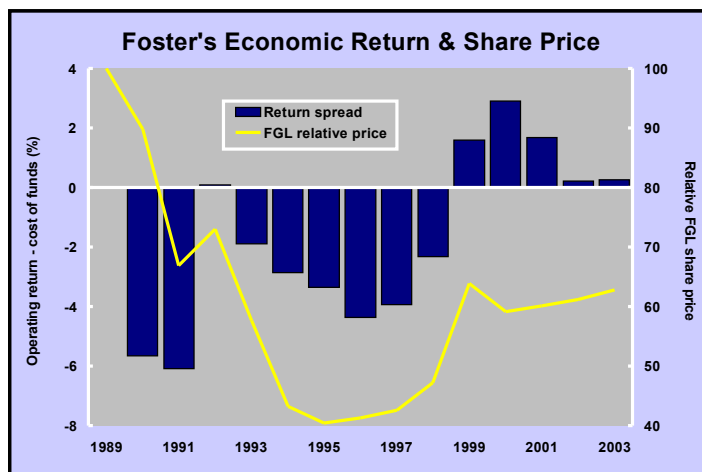
Investors are more likely to pay premium prices for companies with higher returns on the funds employed in their businesses.

The chart below illustrates the same phenomenon over time using the specific case of Foster's Group, one of Australia's largest industrial companies. The blue bars show the extent to which the rate of return exceeded or fell short of the group's cost of funds in each of the past fourteen years. The yellow line shows movements in the Foster's share price relative to the market as a whole. A rise signals that the Foster's share price was rising faster than the market.

The message in the chart is clear: improving rates of return are associated with superior share price performance. Shareholder value losses are reflected in weak share price performance.

In recent years, the company's financial performance has slipped. Its share price has been slightly stronger than the overall market because it is still adding value but the return margin is skinnier and the price momentum has been held back accordingly.

In short, investors should remember the obvious guide to shareholder value: whether a profit of \$100 million is satisfactory depends on the funds needed to generate it. Requiring \$1,000 million makes the performance only mediocre. There are probably better alternatives. Needing \$100 million makes it exceptional. Buy! Doing it with \$10,000 million makes it a blatant failure. Sell!



## US ECONOMY: BLOSSOMS IN SPRING CONT'D

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The Fed had been concerned that the tepid recovery might be reflecting a more intractable force – such as the wealth effect of weaker stock markets – than simply the lag between monetary stimulus being applied and its effect being noticed.

A particular concern had been employment. While it is usual for employment to lag other measures of performance, growing numbers of jobs are necessary to ensure confidence building among consumers and growth in household incomes. Improving employment had been conspicuously missing on this occasion.

The flip side of the missing employment was the unusually strong productivity growth. Employers seemed to be seeking alternative ways of meeting demand increases, particularly through use of more advanced technologies, and were less keen on employing more people.

The latest statistics on our key guideposts show some more robust outcomes. A more meaningful recovery does appear to

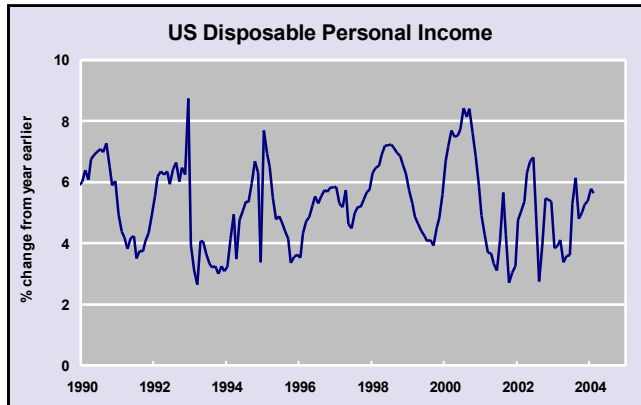


be taking hold as the US economy enters its springtime.

The momentum of employment has improved considerably. During the first quarter of 2004, employment levels increased over the year for the first time in the cycle. The data for March was especially strong. The 0.2% increase in non-farm payrolls in the month was the largest monthly employment gain since May 2000.

However, the employment recession has been so broad and long that the number

of jobs available in March was still less than the number on the payrolls in December 2001 and 1.5% lower than the number



employed at the peak of the most recent economic cycle.

Industrial production in February was 2.7% higher than in February 2003. Manufacturing was relatively strong. Its 3.2% gain over the year was higher than the 0.8% mining expansion or the 0.1% contraction in the output of utilities. The latter was affected by weather conditions returning to more normal seasonal patterns.

Household income growth was strong with positive signs for consumption spending. Disposable personal income was 5.6% higher in February than in February 2003. Growth in consumption spending has also accelerated. Its 5.8% annual growth rate in February was more consistent with the growth rates in the mid 1990s.

Business sales in February were especially buoyant. The 7.8% increase over the year to February was the highest rate of increase since April 2000.

In the short term, this run of better data will increase speculation about an interest rate rise since there will be less need for the Federal Reserve to maintain its accommodating policy stance.

There might be some temporary stock market weakness as markets become used to the change in the direction of the interest rate cycle. However, markets rarely fall consistently in the face of rising profits. That is especially so if inflation remains corralled. A more strongly growing economy will underwrite further profit growth.

*“The latest statistics on our key guideposts show some more robust outcomes. A more meaningful recovery does appear to be taking hold as the US economy enters its springtime.”*

## US ECONOMY: BLOSSOMS IN SPRING

There are now clearer signs of a more robust US economic recovery. Beware some equity price volatility as the market gets used to this fundamentally good news.

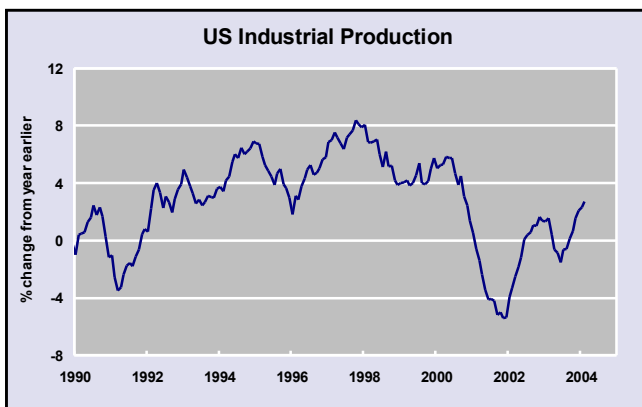
**thebigpicture** has been tracking the condition of the US economy over the past year using four guideposts:

- employment,
- industrial production,
- disposable income, and
- business sales.

These four indicators are consistent with the principal activity measures used by the National Bureau of Economic Research (NBER) as guides to the position of the US economy in the economic cycle. The NBER is the organization that officially defines whether the US economy has been in recession or is expanding.

Another reason for the choice of these four indicators is the need to track the same set of guideposts over time to ensure consistency in judgements. It is better to make a wrong judgement and know why than make a correct call and have no idea why.

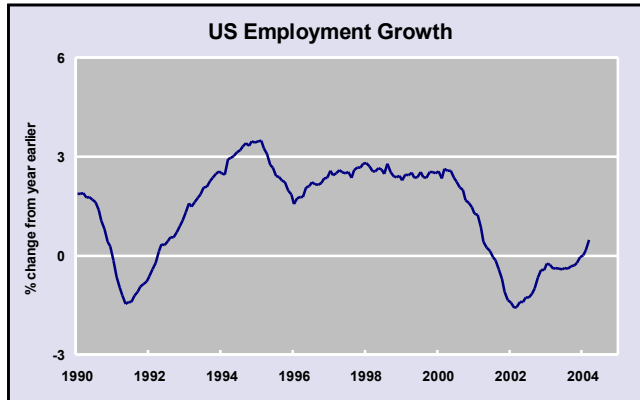
Sticking with a select number of indica-



tors, provided their original choice was well founded, allows for continual reappraisal of why decisions were made.

Over the past year, the evidence seemed

to show that the US economy had been past its worst but that the momentum was not particularly strong. The following comments track **thebigpicture** conclusions about the state of the US economy in April, July and December of 2003 based on the same set of four activity indicators:



**April:** "... some of the outcomes are not particularly robust. Nonetheless, the balance is tilted towards the positive implying an economy past its worst and gradually building up some momentum."

**July:** "Among the four key indicators which help distinguish between recession and growth in the US economy, the balance has turned less optimistic."

**December:** "Despite this improvement, the growth rate is more consistent with an economy in the latter stages of expansion rather than one bouncing from underperformance into the early stages of an expansion.... A more rapid expansion, with the help of supportive Federal Reserve policy, might still be ahead but the existing evidence is insufficient to draw that conclusion."

This patchy and unconvincing flow of data, including some apparent reversal in momentum in the middle of 2003, also persuaded the Federal Reserve to hold interest rates low for longer to give growth a chance to take hold.

(Continued on page 3)

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