

# *thebigpicture*

guideposts for the private investor

Week Commencing 19 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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## TELL EVERYONE; TELL EVERYTHING

Coincidentally, at the top three Australian listed companies, the best interests of investors are being subjugated to the self interest of others as needless information gaps raise investment risk. Despite the rules, investors are being forced to speculate.

Full information disclosure is at the heart of the Australian stock market. ASX listing rule 3.1<sup>1</sup> requires that the market is informed of any external event or business occurrence which comes to the attention of a company and which might have a material impact on a decision to buy or sell its stock.

The rule implicitly has two parts intended to ensure that:

1. the same information is available on equal terms to everyone contemplating an investment decision – the ‘tell everyone’ part ; and,
2. nothing of relevance to an investment decision is being concealed – the ‘tell everything’ part.

Both elements – ‘tell everyone’ and ‘tell everything’ – need to be present for the listing rule to have its intended effect.

Some overseas markets only require the first element with periodic reporting being used to fill the information gap. Where that is so, directors could take decisions with a material impact on a company, for example, without making an immediate announcement. Buyers and sellers could still be trading as long as they are doing so with the same information set.

The ASX system goes one step further. It requires a company to publicly announce the decision as soon as it is made (and sometimes earlier if prospective decisions are subject to rumours). Similarly, as soon as the management becomes aware of any information material to the business performance, steps to disseminate the information need to be taken.

When the system works properly, someone can buy or sell shares through the ASX confident that no more information is available which might modify the decision to buy or sell. This certainty is critical to retaining overall confidence in the market.

Unfortunately, recent events surrounding Australia’s three largest listed companies – National Australia Bank, Telstra and The News Corporation – have left gaps in the information flow making investment decisions about these leading companies more risky than they should be.

National Australia Bank and Telstra directors, it seems, have less than ideal relationships which are affecting the quality of their decision-making. Or, are they?

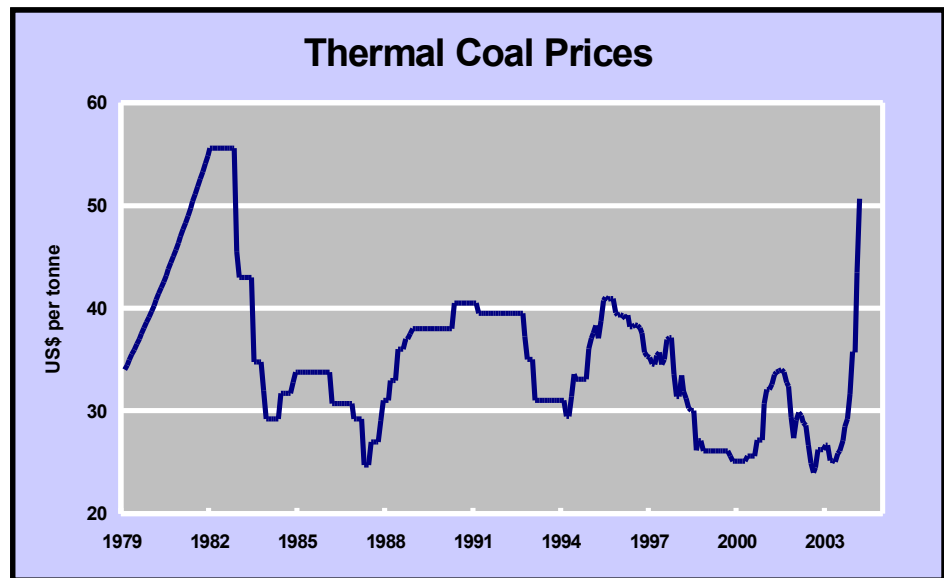
The differences at National Australia Bank have become clearer as directors have staked out public positions. Nonetheless, this was not intended. Even late in the piece, the press suggests, negotiations have been underway to avoid a public meeting of shareholders to fully air the differences.

The resignation of the Telstra chairman has also broken the information barrier. Again from press reports, it appears highly probable that there were significant differences at

*“...gaps in the information flow are needlessly preventing people from being investors and forcing them to become speculators.”*

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## THE WEEKLY CHART SPOT



Source: International Monetary Fund and World Bank

Average Australian thermal coal export prices reached US\$51 per tonne in March, a doubling from March 2003 prices, according to the World Bank's commodity price database.

Realisation of the speculation that this higher level will be the basis for contracts for the coming year, would push newly negotiated contract prices up by more than 90% over the previous year's contracted prices.

The thermal coal market is benefiting from a combination of:

- Asian region growth;
- a switch in energy sources as some countries seek to reduce their anticipated reliance on nuclear fuel; and,
- supply constraints after many years of low prices have curtailed industry investment programmes.

*“In the event that inflation is expected to rise, the required return is pushed up and market valuation is lowered.”*

### VALUE: GROWTH *v* INFLATION CONT'D

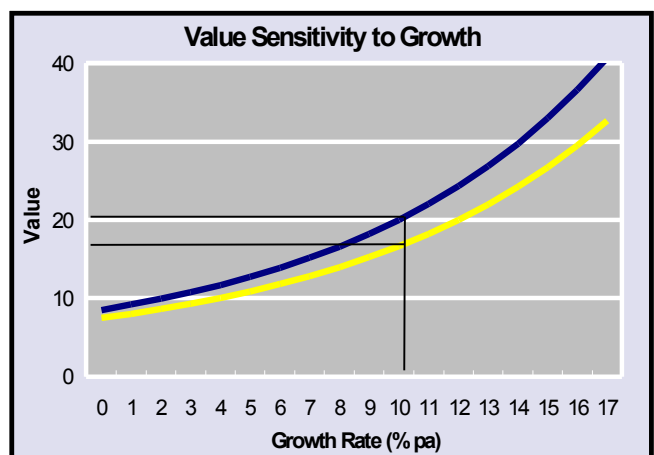
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For example, if market values imply 10% get return was to be 11½%, the valuation outcome would be shown in the lower yellow line in the chart opposite. The apparently small rise in expected inflation implies a 15% reduction in equity prices at growth rates around 10%.

To sustain prices, growth of around 12% would be needed to compensate for the higher inflation.

The model can be used as a framework to judge whether value expectations are realistic. Translating market values into underlying growth rates and inflation outcomes can sometimes make judgements about market values easier.

For example, if market values imply 10% growth and 1% inflation, investors who believe that the growth/inflation mix is more likely to be 5%/3% could legitimately conclude that the market is too expensive.



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## TELL EVERYONE; TELL EVERYTHING CONT'D

*(Continued from page 1)*

board level which led at least one director to disclose information to scupper a proposed transaction.

Large companies seem unusually prone to having board factionalism played out in the public arena. Its disclosure is rarely by the protagonists acting directly. More often, selective disclosure through the press gives investors their first inkling that something might be amiss.

Neither 'tell everything' nor 'tell everyone' are driving forces in these situations.

Despite being nominally representative of shareholder interests, directors can be forced from boards by their peers when there is disagreement amongst them. A departing director may be right or wrong in the views which have antagonised his colleagues. The accompanying statement of resignation might allude to some form of disagreement. Alternatively, it might be a bland statement about being too busy to attend properly to the needs of the company.

Only over time might the true reasons for the resignation emerge and this might follow a lengthy period of unstable board relations and poor board decision-making.

Paradoxically, directors can feel so strongly about an issue confronting them that they resign but regard it as insufficiently important that investors in the company should know the details.

Regulatory authorities are requiring directors to shoulder additional responsibilities for accounting standards, risk management and tax planning, where their involvement is sometimes peripheral. Where their own conduct is involved, however, the reporting standards appear far less exacting.

The News Corp information gap is of a different type.

News Corp has announced that it wishes to transfer its place of incorporation from Australia to Delaware in the USA. Motivated by a desire to tap mainstream US investment funds, News Corp directors are seeking to have the company included in the S&P 500, the key US equity benchmark index.

However, the beneficial effect of this might be offset by the company's removal from the principal Australian benchmark equity indexes.

If News Corp is removed from the ASX 200 due to the jurisdictional shift, the performance of the index will no longer be affected by News Corp and local fund managers seeking to link their returns to the ASX benchmark will have no reason to hold News Corp stock. A reduction in demand is likely to affect the price detrimentally.

Standard and Poors, the organisation responsible for the management of both indexes, is being coy about how it will react. Although unprecedented, it could keep News Corp in both indexes given its prospective legal standing in the USA and its unique connection with Australia.

In any event, the decision and its timing belong entirely to Standard and Poors which is not saying how it will amend its indexes until News Corp shareholders have decided to make the shift.

Consequently, shareholders will consider approving the transfer without knowing the impact of the strategically important decision they are contemplating. Nor, since there is only one authority, will they be able to seek an authoritative third party opinion in the same way they might on any other subject.

Because the ASX has sold the rights to its index composition, the primacy of the 'tell everything' rule is being set aside. If its rightful place was recognised, a prompt determination and immediate announcement would reduce investment risk and be in the best interest of investors.

In each of these three instances, gaps in the information flow are needlessly preventing people from being investors and forcing them to become speculators.

Sound practice would tell an investor to be disciplined enough to eschew companies such as these until the information gaps are filled however long that might be. But that solution may be little comfort to the investor already holding shares who, one way or another, is forced to take a decision knowing that there is information to which he is not privy simply because it is in someone's interest to withhold it.

Meanwhile, perhaps imperceptibly at first, people begin to lose faith that the 'tell everything' standard still applies. Another exception registers in the memory and the credibility of the market drops another notch.

*"When the system works properly, someone can buy or sell shares through the ASX confident that no more information is available which might modify the decision to buy or sell. This certainty is critical to retaining overall confidence in the market."*

1. ASX Listing Rule 3.1: Once an entity is or becomes aware of any information concerning it that a reasonable person would expect to have a material effect on the price or value of the entity's securities, the entity must immediately tell ASX that information.

## VALUE: GROWTH *v* INFLATION

**Good economic news. Sell!** The good news in the USA about its economic performance has prompted some selling of equities. This seemingly perverse reaction illustrates the trade-off between growth and inflation.

In the valuation model used by *thebigpicture*, value is a function of three factors:

- the existing profit base;
- future growth in profit; and,
- the target rate of return.

Better economic conditions should reduce the risk to the existing profit base. An economic growth acceleration should flow into stronger profit growth. On these criteria, growth is unambiguously beneficial for market values.

The target rate of return is made up of three additional elements:

- inflation;
- a risk free real rate of return; and
- a premium for equity risk.

Together, the first two of these factors are equivalent to medium to long term interest rates. Movements in the target return will be driven primarily by changes in expected inflation rates since the other two factors should not vary significantly in the short term.

A higher target rate of return means that an investor is more demanding and will pay less for any given level of profitability, lowering the market value of equities.

In the event that inflation is expected to rise, the required return is pushed up and market valuation is lowered.

How the benefits of growth and the possibility of higher inflation interact eventually determines the net change in equity prices.

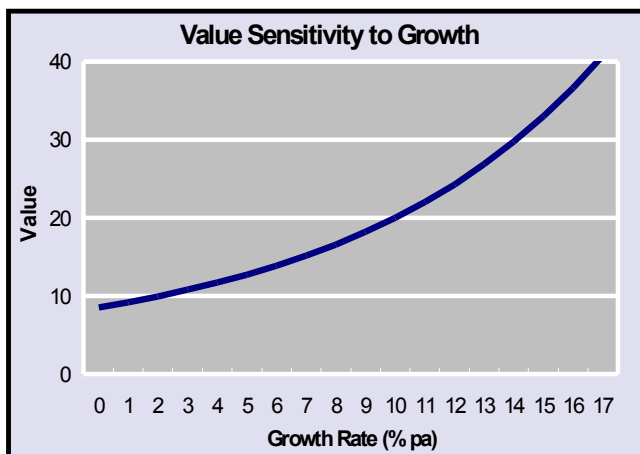
The chart opposite illustrates *thebigpicture* growth model. It shows different

growth rates on the horizontal axis. The vertical axis displays values for \$1 of net profit. On this example, if growth is thought sustainable at 10% a year, an investor could be prepared to pay up to 20 times earnings.

Higher growth delivers extra value. If growth was 15% a year, the value rises to 33 times earnings, a 65% uplift.

Correspondingly, with the prospect of demographic changes dragging growth rates lower, a 5% growth expectation implies values dropping to a multiple of 13 times profit, a 35% reduction in company value.

This leverage to growth shows why growth oriented companies are so frequently highlighted by investment advisers as a basis for investment choice. Equally, the model shows why values can fall so dramatically if actual performance falls below what had been expected from high growth stocks.



The valuation model illustrated in the chart is based on a constant target rate of return of 10%. This might be consistent with:

- inflation at 2½%;
- a 3½% riskless real rate of return; and,
- a 4% equity risk premium.

If inflation expectations were to rise to 4% as the economic cycle turns, and the tar-

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