

# thebigpicture

guideposts for the private investor

Week Commencing 21 June 2004

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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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## EUROPE: THE ENTHUSIASM DIMS

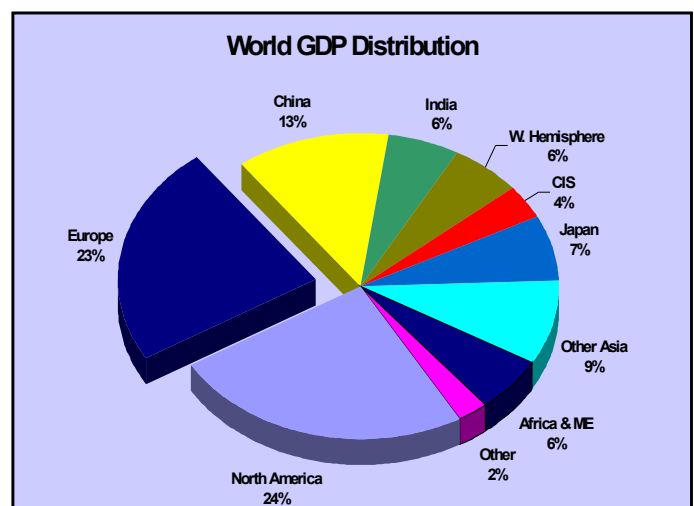
Is a united states of Europe a lost cause? Last week's European parliamentary elections highlighted why Europe will not rival the USA as a political institution on the global stage. But the biggest gains in living standards were always going to be from eliminating market barriers not political union.

Little commitment to the new European political order was evident in the Europe-wide elections held last week. They showed in various measures:

- Euro-sceptic candidates doing better than those espousing pro-European views;
- apathy about the electoral process with especially weak turnouts (less than 30% of potential electors) in the new EU member nations; and,
- hostility toward incumbent politicians supporting European institutions with many fringe and previously unrepresented groups gaining seats.

The European nation-state endorsed by the political leaders of the major European nations, conspicuously Germany and France, is a complex layering of institutions. There is:

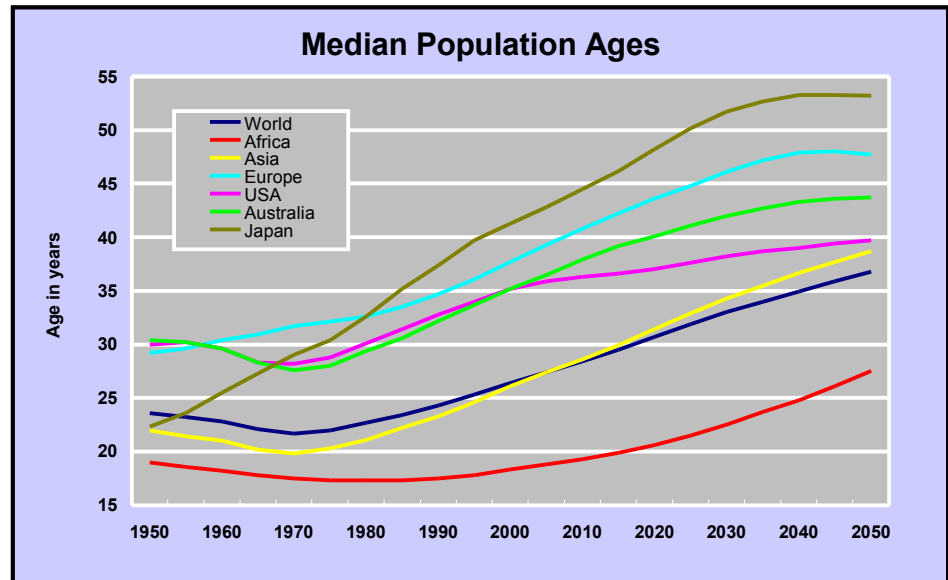
- a customs union with freedom of movement for goods across national boundaries;
- the European parliament made up of popularly elected politicians from all the EU member countries;
- the European Commission housing the bureaucrats responsible for decision making about matters including foreign policy, business regulation and human rights;
- a state council comprising representatives of the EU member governments;
- a monetary union to facilitate implementation of coordinated economic policies; and,
- NATO, the defence pact to which many European nations belong as the de-facto defence agency for Europe although controlled through national governments in conjunction with the USA.



Decision-making reflects this complex organisational set-up. Even on matters squarely within the constitutional ambit of the European institutions, legislative proposals must be initiated by the Commission, voted on and accepted by the parliament and approved by national governments acting through the state council. National parliaments must subsequently modify their own pre-existing legislation to conform to any changed Euro-

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## THE WEEKLY CHART SPOT



Source: United Nations

The United Nations population research programme has projected that the average age of the global population will increase from 26.4 years in 2000 to 36.8 in 2050. The rising average reflects the interaction of fertility changes world-wide, the strong post World War II growth in population and improving health standards which are prolonging life expectancies.

The changes will add to government budgetary pressures and create difficulties for policy planners setting spending priorities since there will be fewer taxpayers on average supporting the people requiring assistance through the government budget. This issue is becoming more widely understood.

Companies are also beginning to confront some important decisions. This is less well appreciated by financial analysts forecasting company performance. Sometimes the structural changes are being confused with a temporary cyclical movement by the companies themselves.

Aging palates mean that food producers face having to make changes to their product mixes. The pressure to adequately fund later years will also mean a reappraisal of individual spending priorities. Paying a premium for fancy packaging might not make sense. Preferences between home brand goods and premium products can change. Turnover of consumer durable goods might decline. Financial services providers will see less demand for funds for buying consumer goods and housing assets. Asset sales and use of existing assets to fund ongoing spending needs will become more common needs.

*“The change of a chief executive and his perceptions alone should not be enough to precipitate a change in values.”*

## ASSET VALUES: THE NEW BROOMS CONT'D

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better job than they actually are.

There will be a lingering memory of a company which failed to deliver the advertised value from its investment activity. However, accounting standards offer little assistance to investors in keeping track of these losses.

Investors are soon persuaded to forget about the impact and treat a company with a history of asset write downs as being equivalent to one that achieves its returns without artificially deflating its capital.

This goes to the heart of the anti-investor bias in accounting standards. Companies are not required to achieve an adequate return on funds employed. Nor are they even required to record it as a measure in their accounts despite it being the most fundamental measure of value for a company.

No individual would buy a business without confidence that the return will cover the cost of funding the acquisition. And, afterwards, if it does not, reducing the value of the capital to get him there will not be a feasible option. That is the simple test.

## EUROPE: ENTHUSIASM DIMS CONT'D

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pean standards.

In some instances, such as in Wales and Scotland in the UK, devolution is occurring at the same time as European centralism is being promoted.

This cumbersome duplication of institutions now seems to have few friends outside the national leadership elite.

However, the common market is at the heart of what makes Europe work. Providing market access for goods as well as free movement of labour and capital facilitates economies of scale in production. This was one of the advantages long held by US companies through the size of their domestic market and coveted by European business people.

Economies of scale support lower-cost more competitive industry underpinning more jobs and improving the purchasing power of European residents.

Having broken down the barriers to the transfer of goods, capital and labour, European leaders could simply step aside and let commercial incentives take their course. And that might be what last week's voter reaction was saying they should do.

As Australia is proving with its negotiation of a free trade agreement with the USA, political union is not necessary to achieve the gains which come with greater market access (although some might argue only half facetiously that Australia has a *de-facto* political union with the USA already more complete than anything likely amongst the European nations).

Similarly, north American free trade arrangements among the USA, Canada and Mexico have occurred without more overt political ties. Although these national economies remain highly interdependent and function increasingly as a single economic unit, there are no consequent pressures for a political union despite considerable cultural convergence.

Indeed, among these three countries, the desire to differentiate political institutions and respective histories is strong. The market union can flourish because people are not being asked to make more deep-seated cultural concessions to their neighbours.

Perhaps Europeans, too, would like the

best of both worlds: the economic benefits associated with liberalised markets accompanying the personal security which comes with maintaining cultural traditions and values.

From a purely analytical standpoint, this can be an option. To that extent, the response of Europe's electors might be a rational reaction to Europe's political leaders forcing the pace of non-economic union.

The election results might prompt some of the senior European politicians to confer with their electors to assess how far the latter are prepared to go.

One of the motivations for bringing Europe together was to have it act as a countervailing force to the USA in economic and political matters. Without broad-based support, however, there will be no one able to commit Europe to a single purpose and its ability to influence geopolitical outcomes will be correspondingly limited. Ultimately, if the European people do not embrace the political union, it will not work.

If moves toward a broader union are aborted or limited by popular apathy, it might not be a matter of any great concern for the rest of the world, the convenience of a European-wide currency aside.

Taken together, the 25 members of the union are currently of approximately equivalent size to the north American market measured in terms of economic output, according to the International Monetary Fund.

However, their relative position is already being threatened. Within little over a decade, at current growth rates China's GDP will be about the size of the US economy.

In the longer term, Europe's relative position will be eroded further due to the likely decline in its population. The United Nations has estimated that over the coming 25 years Europe's population will have declined by 6% pulling the rug from under its potential growth while Asia's population will have increased by 33% supporting a much stronger relative economic performance.

Japan, too, is facing a similar constraint with its population set to fall by 5%. Its relative position will also slip. However, its proximity to China and the faster growing Asian region should provide it with some support Europe will not share.

*"Having broken down the barriers to the transfer of goods, capital and labour, European leaders could simply step aside and let commercial incentives take their course. And that might be what last week's voter reaction was saying they should do."*

## ASSET VALUES: THE NEW BROOMS

**Asset revaluations on the accession of a new chief executive are now commonplace despite being contrary to the interests of shareholders.**

It is now almost standard practice for a new chief executive to foreshadow a review of the business he is inheriting, creating speculation immediately that there might be some adjustment in balance sheet asset values as a result. The practice has become so commonplace that speculation about asset write-downs occurs almost immediately a new appointment is foreshadowed.

The really skilled executives (and their advisers) are also able to persuade market commentators that reducing the value of assets on the balance sheet is actually desirable. Somehow it indicates an infusion of fresh blood and a new approach to management. The symbolism of a fresh start is promoted as a harbinger of better future outcomes.

The strength of the symbolism and the favourable light it throws on otherwise poor performance is biased against shareholders. A business acquisition might be wholly debt funded. Sometimes, the same advisers who initiated the purchase might also fund the acquisition. From that, they can get large fees. And, yet, if anything goes wrong and the transaction values are proven to be overly optimistic only the shareholders take the hit.

This uncritical conspiracy against shareholders is abetted by the business press and financial analysts whose livelihoods depend on news being generated and who, therefore, encourage anything giving them an excuse to opine on the valuations of the business. And, as usual, once speculation begins, there is disappointment if the anticipated changes do not eventuate.

Balance sheet values are intended to reflect recoverable amounts either through future operational cash flows coming from using assets or through their sale. With new accounting standards, greater emphasis is being placed on justifying asset values using more sophisticated valuation techniques.

More frequent appraisal of values is also being promoted so that changes in prospective business conditions should be reflected more gradually in balance sheet values. The change of a chief executive and his perceptions alone should not be enough to precipitate a change in values.

Asset revaluations have most frequently been used as a management tool where recent business acquisitions are reappraised. Generally, older assets benefit from inflation and a rising replacement value. The older the asset the less likely it is to have its value impaired.

A recent example of the 'new broom' phenomenon was the write down in the value of wine related assets by international beverage company Foster's Group.

Once Foster's had decided to take a strategic stake in the international wine industry, in the late 1990s, there was pressure on it to purchase scarce high quality assets quickly. Coincidentally, as this was near the top of the investment cycle, it was forced to pay prices higher than could be justified in the medium term. More recently, a surplus of grapes and a change in the pricing structure within the industry also caused it to reappraise the income which could be generated from the assets it purchased.

This is not to suggest that the initial decision was faulty. However, very frequently such momentous company transforming investment decisions involving the purchase of publicly listed companies pay their way over more than one cycle rather than in the two to three years which are normally flagged as the period in which suitable returns are to be generated.

Immediately following the decision to write down asset values, the Foster's share price rose. Arguably, the decision signalled that a solution for a troublesome part of the business was being addressed. Foster's, like other companies following this course, will be able to report improved returns from the reduced funds employed in its business even without any improvement in underlying profitability. The managers will appear to be doing a

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