

thebigpicture

guideposts for the private investor

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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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DIRECTORS: WHAT SHOULD THEY DO?

The recent experience of National Australia Bank has raised questions about the roles of directors. Directors are becoming more like executives in terms of the expectations to which they are being subjected. This will not be good for corporate performance.

The role of listed company director has been in continual evolution. Directors were once owners or people with strong affiliations to management sometimes through family or other business interests.

Over time, the role of professional non-executive director emerged. This role was to fulfil four important tasks:

- to appoint a competent chief executive and monitor his performance;
- to act as an informal sounding board for the chief executive and other senior management;
- to ensure that strategic decisions were fully tested by experienced senior executives with a broad range of alternative experiences; and,
- to represent the interests of the shareholders in decisions which might affect the value of the company.

Most of their activities reflected these four core jobs. Business performance was generally in the hands of the executives. They were accountable for successes and failures and their salaries reflected this risk.

Progressively, and at an accelerated rate following catastrophic corporate failures such as HIH, in Australia, and Enron in the USA, the demands on directors became more burdensome. They still might not be able to claim credit for what was going well but it was clearer that they were the ones who were going to take a substantial part of the blame for corporate missteps.

This predicament was partly of their own making. The symbolism at the annual general meeting when private shareholders most often observe their directors was overwhelming as they interposed themselves on the stage between shareholders and management. In public, chairmen pretended that they were running the company not just chairing a meeting.

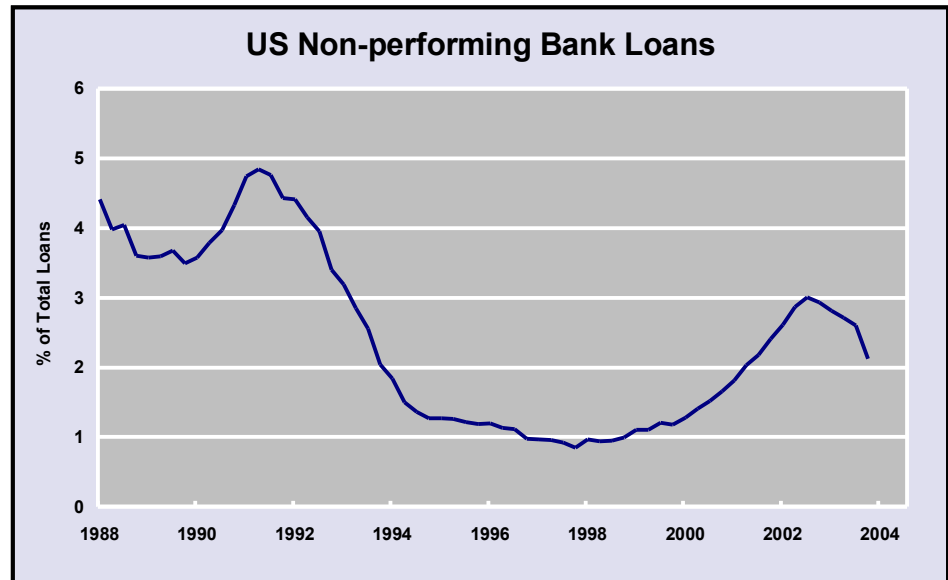
The National Australia Bank experience has taken the burden of responsibility one step further. Now a director could be responsible for the incompetence of an individual with whom he or she might never have any contact and whose contribution to the business might be relatively small.

The history of the National Australia Bank directors has not helped the lot of directors as a group. Successive blunders in handling corporate business failures was a factor in several losing their jobs. Whatever the circumstances, however, they have now established the principal of directors being responsible for activities over which they have no direct executive authority.

‘If employees are sufficiently determined to create havoc and escape the attention ...of colleagues, management, internal risk managers and external auditors, can directors be expected realistically to compensate through their greater vigilance?’

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THE WEEKLY CHART SPOT



Source: US Federal Reserve

“...US businessmen have been especially conservative in their management approach during the most recent recession and recovery... [t]he level of non-performing loans is one indicator of the more solid position of business (and the banks providing the loans).”

One indicator of an improving US economy is the decline in non-performing loans at US commercial banks.

The Federal Reserve released data last Thursday showing that non-performing commercial loans were equivalent to 2.12% of total commercial loans at all insured US banks at the end of December. This was a decline from 2.60% at the end of September 2003. The recent peak in the ratio had been 3.01% at the end of September 2002. Non-performing commercial loans are those commercial loans that bank managers classify as 90-days or more past due.

Other statistics show that US businessmen have been especially conservative in their management approach during the most recent recession and recovery. There has been an unusual emphasis on cost reduction to rebuild profitability (and correspondingly less emphasis on employment expansion with the descriptor ‘jobless recovery’ being applied widely to the economic upswing).

Debt reduction and balance sheet strengthening has also contributed to reducing business risk at a time when risk aversion has been an important motivator for business and nations alike. The level of non-performing loans is one indicator of the more solid position of business (and the banks providing the loans).

Nonetheless, on this measure, conditions were noticeably more comfortable as recently as four of five years ago. With that memory relatively fresh, further evidence of improved business conditions might be necessary for businessmen to be completely at ease with financial circumstances and, consequently, more prepared to invest and employ people.

AN AUSTRALIAN MIRACLE: NO WAY! CONT'D

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1990s to something like 0.2% by 2020.

Rather than the 3.25% average GDP growth which prevailed over the past 20 years, Australia’s growth is likely to sink to close to 2% if there are no offsetting policy measures taken. For investors, this will be a constraint on profit growth and potential returns from equity investments.

Whatever the growth outlook, the lesson from what has happened and what is

ahead is that outcomes are no accident. There are some very definite influences which have delivered the outcomes in the past and will deliver outcomes in the future.

Pretending that there is some form of supernatural influence creating miracles can be counterproductive. It is better if people see the results as being the consequence of sensible decision-making rather than luck or divine intervention.

DIRECTORS: WHAT SHOULD THEY DO? CONT'D

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So how far does this open-ended responsibility go? If there is no end to it, how can a director of a large company sleep easy at night? And, if their responsibility is so great, why shouldn't they be paid as much as a full-time executive and get comparable additional rewards if there is no catastrophe on their watch?

It is no longer simply the role of the director to act as an adviser and sounding board giving the management, in many instances, the benefit of the doubt in choosing among alternatives. This new level of responsibility actually requires them to second guess executive management.

Now, the regulatory authorities are saying that the National Australia Bank board should contain directors with meaningful experience in the industry in which the bank operates. They are no longer there as a check from a different perspective but as an alternative.

Once established as the guidepost for what goes as good corporate governance, risk aversion will dictate that other companies will recruit their directors with a similar bias. Foster's will recruit wine makers, Coles Myer retailers, Telstra will have media and communications experts, etc.

Forcing this upon companies could simply create confusion and tension at the seniormost levels of organisations as up to a dozen people are empowered to second-guess one another to avoid being held responsible for a mistake.

However skilled a director might be, can

a part-time individual ever be in a position of knowing enough about an organisation to prevent a serious risk being realised?

If employees are sufficiently determined to create havoc and escape the attention (at least initially) of colleagues, management, internal risk managers and external auditors, can directors be expected realistically to compensate through their greater vigilance? Hardly!

Therein lies the problem for investors. They are being fooled into believing that they have an added layer of protection which does not exist. The occasional example of forex trading gone bad is a salutary lesson that these organisations are continually taking risks. The risk can generally be managed but never eliminated.

After the event, it is all too easy for people to find fault and to impose penalties and new standards. That is not being especially smart or wise. In practice, that should provide no comfort that misdeeds can ever be caught before substantial damage occurs.

And, of course, these observations are not confined to financial services companies. A director can no more cope with bad foreign exchange outcomes than with a retail store employee stealing women's dresses from stock or a storeman taking beer from the brewery or a metallurgist taking copper from a smelter.

At the end of the day, directors remain dependent on someone within an organisation recognising wrongdoing and reporting it. If investors think that they are now more protected than this, they have been misled.

"The symbolism at the annual general meeting when private shareholders most often observe their directors was overwhelming as they interposed themselves on the stage between shareholders and management. In public, chairmen pretended that they were running the company not just chairing a meeting."

AN AUSTRALIAN MIRACLE: NO WAY! CONT'D

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iff which prevented goods being imported competitively.

During the 1970s, Australia's policy economists were arguing that a more open and competitive economy would deliver stronger economic growth, lower inflation (and lower interest rates with a more stable currency) and less volatility from aggressive policy adjustments.

And guess what happened when these policies were pursued? Australia got stronger growth, lower inflation and less volatility.

The only surprise has been that everyone acts so surprised and is so reticent to ascribe credit where it is due (including to those who had to endure many of the costs of making these changes).

As long as there is no reversion to the mistakes of the past, this superior economic performance can persist, although only up to a point. Australia, in common with the rest of the developed world, will face a slowdown in growth over the coming decade as the expansion of the population slows from around 1.2% a year in the late

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AN AUSTRALIAN MIRACLE: NO WAY!

References to Australia's miracle economy miss the point. Its relatively strong growth in recent years has been the result of considered policy changes not simply luck or divine intervention.

The 17 March issue of the Australian Financial Review, the nation's leading financial journal, again referred to Australia's "miracle economy", in this case as likely to lose some of its lustre.

Similar references are continually made which seem to ascribe the relatively strong economic performance of recent years to good luck or forces which are beyond normal comprehension. Unfortunately, such references in the public discourse hide from people the true reasons behind the superior economic performance.

For it to continue it is best that its source be better understood.

There is no miracle about the Australian economy. Its performance has reflected much-needed changes forced upon it to make it better able to adjust to changing conditions.

In the 1970s, Australia's economy was characterised by:

- a heavy reliance on the state of the resources industry;
- a manufacturing sector receiving high levels of assistance directly and indirectly through the tariff;
- a centralised wage fixing system with an emphasis on cost of living adjustments to wages and correspondingly little consideration to productivity growth;
- exchange rate levels which were fixed by government; and,
- monetary policy which was also influenced by the government of the day.

Policy economists did not believe this was tenable and generally argued strongly for a more open economy including a floating exchange rate and abandonment of the wage system in favour of more decentral-

ised bargaining with a heavier emphasis on productivity in determining wage levels.

Through the 1980s, these views gained ascendancy and, at a political level, were championed conspicuously by the Federal Labor Party.

Complementing these changes was the 1989/90 recession which sufficiently shocked the economy that it opened the way for more change. Particularly important was its impact on the financial sector. It forced Australia's banks to revalue inflated property assets and restructure their risk profiles. By 1998, when the Asian crisis hit, the Australian financial system had already coped with the same changes and was in considerably better shape to withstand the pressures and take advantage of its relatively secure position in the world.

The recession also broke the back of inflation. Australia had been an inflation prone economy for the prior 20 years. During the recession, inflation was brought to heal.

Progressively, the Reserve Bank was also given increasing independence to conduct monetary policy without reference to the government of the day. This helped change expectations of Australia's inflation outlook.

Meanwhile, Australia would benefit from the burgeoning growth among the Asian regional economies. The emergence of this strongly growing part of the world on Australia's doorstep would have many effects. One has been to keep Australian industry competitive and the only way to do that has been to ensure that it uses whatever technological or other advantages it can to support its business activities.

As the levels of financial assistance for Australian industry were also reduced, companies were forced to depend more on their own management skills for their business success. Managers could no longer paper over their misjudgements with higher prices to be validated by a tar-

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