

# thebigpicture

guideposts for the private investor

Week Commencing 20 June 2005

## **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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## EUROPE: MARKET FIRST, THEN POLITICS

Anti-European sentiment in parliamentary elections last year, failure to adopt a new constitution this year, a budgetary impasse and differences of opinion among regional leaders have highlighted the fragility of the European Union. But the biggest gains in living standards were always going to be from eliminating market barriers not political union.

Europe-wide elections held last year brought the cracks in European unity to the surface with:

- 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 major European political figures have tried to maintain the political momentum. However, grassroots support for European political institutions seems to be flagging and, given the chance to scupper progress, voters in France and the Netherlands threw political reform into chaos by rejecting the new European constitution.

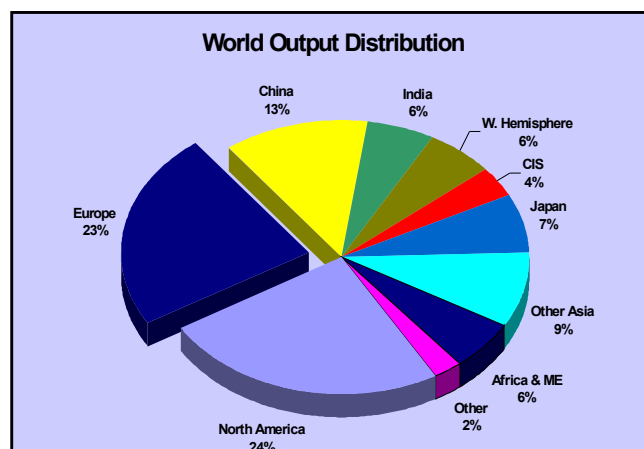
### **A Complex Set of Institutions**

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;

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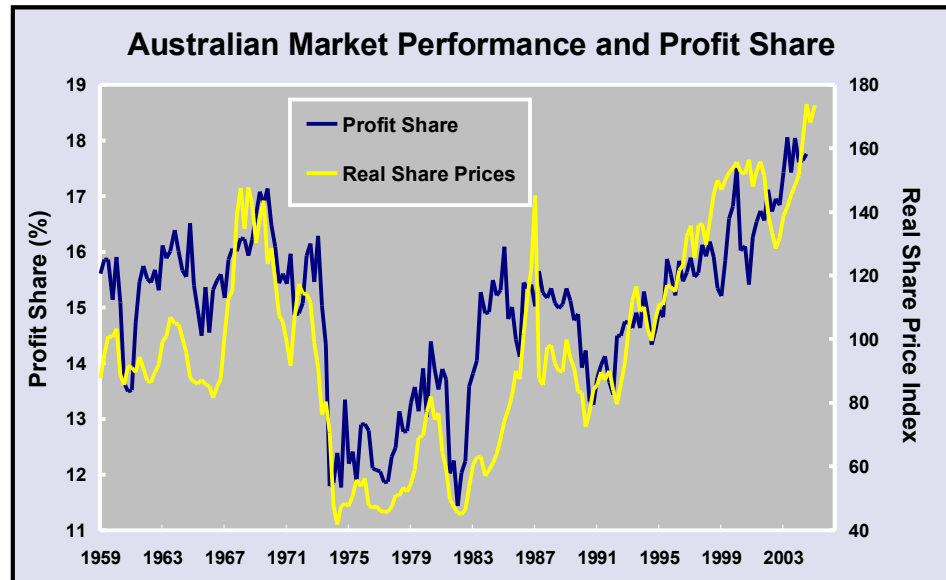
- a state council comprising representatives of the EU member governments;
- a monetary union to facilitate implementation of coordinated economic policies; and,
- NATO, the defence pact to which many European nations belong as the de-facto defence agency for Europe although controlled through national governments in conjunction with the USA.



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## THE WEEKLY CHART SPOT

The Australian Bureau of Statistics has updated its estimates of the corporate profit share, a key Australian market guidepost. It remains at near record levels supporting near record market values. However, the upward momentum in the profit share which would normally carry the market higher is not so evident.



Source: Australian Bureau of Statistics

## EUROPE: MARKET FIRST, THEN POLITICS CONT'D

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However, within 15 years, at current growth rates, China's economy would be about the same size as the US economy and Europe's would be about three-quarters the size. Politically, too, Asia is becoming a more potent force.

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 decline 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.

One of the reasons Europeans might be reluctant to embrace political union is anxiety over their current economic performance. The experience of political leaders

nearly everywhere is that reform is always more palatable in prosperous economic circumstances.

Reform, almost by definition, involves having winners and losers. Everyone is more willing to contemplate economic redistribution when the size of the cake to be shared is getting bigger.

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. By concentrating on building the economic benefits, they might be better able to persuade their constituencies to contemplate sharing the gains in different proportions to the current balance and, in doing so, concede some political power to others. ■

## EXECUTIVE OPTIONS: WHO'S TO BLAME? CONT'D

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Companies have adopted the Black-Scholes methodology because it has been recommended to them by their accounting advisers and, being risk averse, prefer a measure that is being used by others lest they draw attention to themselves. However, everyone - company executives, auditors, corporate regulators and analysts - knows that the anticipated benefit will be more than this. It is wrong to blame the company. Rather the fault lies with corporate regulators (and their

patrons in government) failing to spend enough time to come up with a more meaningful alternative.

Perhaps the CEO should be treated as a piece of (human) capital with his value shown as an asset based on the anticipated incremental contribution to the company's value with that value declining (and the difference being expensed) as his contact expiry nears and as he withdraws some of that value from the company for himself. ■

## EUROPE: MARKET FIRST, THEN POLITICS CONT'D

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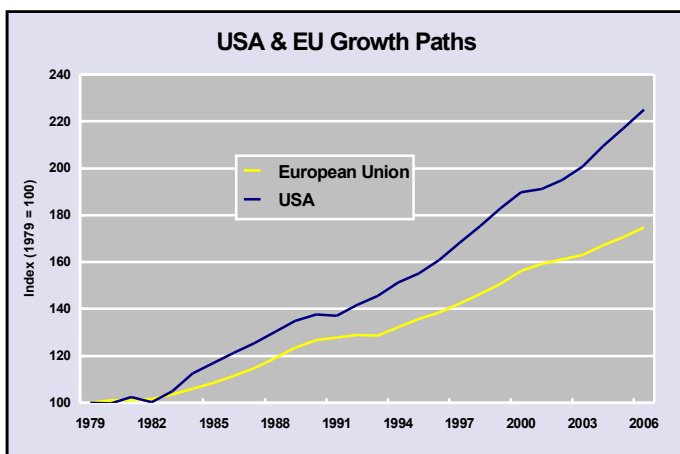
Decision-making reflects this complex organisational set-up. Even on matters squarely within the constitutional ambit of the European institutions, legislative proposals must be initiated by the Commission, voted on and accepted by the parliament and approved by national governments acting through the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

The cumbersome duplication of political institutions seems to have few friends outside the national leadership elite.

### Common Market Benefits

There is little doubt that Europe is better off with a unified market. Providing market access for goods as well as free movement of labour and capital across borders 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.

### Political v Economic Union

As Australia is proving with its negotiation of a free trade agreement with the USA and pursuit of similar market opening arrangements with other countries, political union is not necessary to achieve the gains which come with greater market access.

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.

More radically, the Chinese are showing how living standard gains come from economic reform rather than radical changes to political institutions, no matter how desirable they might be.

Closer to home in Europe, just to emphasise the complexity of the political alignments, devolution is occurring in Wales and Scotland at the same time as European centralism is being promoted. There are more violent tendencies toward political regionalism elsewhere in Europe.

### A Changing World

Subliminally, Europeans might be recognising that they could have the best of both

worlds: the economic benefits associated with liberalised markets while maintaining some of their more cherished cultural traditions, values and institutions.

Another sign that European political union matters less than it once did is the shift in the economic balance of the world. One of the original motivations for political union was to establish an economic and political counterweight to the USA.

Taken together, the 25 members of the European Union are roughly equivalent in size to North America, according to the output measures used by the International Monetary Fund.

However, the USA has outgrown the EU over the past 25 years. By the end of 2006, the US economy is likely to be 30% larger than it would have been if it had grown at the same speed as EU output.

*“The cumbersome duplication of political institutions seems to have few friends outside the national leadership elite.”*

(Continued on page 2)

## EXECUTIVE OPTIONS: WHO'S TO BLAME?

**Occasionally you see some muddled thinking from supposedly well qualified people. In this case, conclusions about executive remuneration from an organization called Proxy Australia qualify.**

The newspaper headlines and the electronic media introductions in mid-May suggested there was evidence of Australian companies misleadingly stating the size of executive paychecks.

This potentially scandalous behaviour was being brought to our attention by Proxy Australia, a business which monitors corporate governance practices and sells its analysis.

Its conclusion, in this case, was based on a review of 24 ASX 100 companies which showed a difference between:

- the stated value of options granted to executives and disclosed in company annual reports; and,
- the eventual benefit received by the executives after the options had been exercised.

The companies reviewed apparently disclosed average executive options worth \$1.08 million. However, when they were converted the average benefit amounted to \$3.57 million.

Westpac was cited as having the largest disparity. Westpac boss David Morgan had been granted options in 1999, valued at \$1.09 each in the company's accounts, when the Westpac share price was \$8.09. In 2004, when David Morgan came to exercise the options, the share price had risen to \$18.92 so that the 1.47 million shares received would have conferred a benefit of \$11.9 million.

However, the value ascribed by the company to the grant of shares had only been \$1.6 million. This near 90% understatement meant, according to Proxy Australia, that Morgan's employer was understating the value of the benefit paid to its chief executive and misleading investors.

Of course, the subtext here is that companies need to have a watchful eye kept over them otherwise they will misbehave.

This was the message implied in the newspaper and radio coverage of the report. In this case, however, Proxy Australia is guilty of playing on the anti-company bias of the news and public affairs media. For once, companies are not to blame for how they present themselves to investors.

### No Satisfactory Measure

Companies are now required to report the value of executive options granted to employees and new accounting standards require it to be expensed. Unfortunately, at the time an option is granted, the size of the eventual executive benefit is not known since the gain (or loss) will depend on what happens to the share price.

Obviously, executives enter pay agreements expecting the company share price to rise. The option package is intended to deliver a significant additional payment even to the extent that it might make the executive genuinely wealthy.

However, an executive would probably accept a lesser amount of cash with certainty than the uncertain payout associated with exercising the share option. He may lose his job, equity markets might be adversely affected by exogenous events or he might fail to meet the performance hurdles required by his contract. Each dollar of value from eventually exercising an option is not the same as the alternative of a dollar of cash with certainty at the time the option was granted.

The company, on the other hand, prefers the option to help focus on performance. The value of the option to the company is more than the value of the option to the executive.

The widely-used Black Scholes methodology for valuing options is something of a compromise. It was not intended originally to be used in this context. Its derivation was based on an assumption of a liquid market for shares through which volatility could be measured. However, the executive faces many constraints in trading the options or shares and can affect the volatility of the underlying securities through his own actions.

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