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**ACSI COMMITTEE OF MANAGEMENT
ENDORSES UN PRINCIPLES FOR
RESPONSIBLE INVESTMENT**

Since 2001, ACSI members have been building a consensus that ownership of equity in a company carries with it responsibility.

How a company manages its reputation and response to a range of factors including risks associated with the environment, society and governance is of critical importance to long-term investors.

It is now reasonable to assert that sound corporate governance should encompass best practice on Environment, Social and of course Governance (ESG) issues, as a means on which to build shareholder value in a sustainable way.

So, it follows that the opposite is true, the lack of attention to the range of ESG issues can cause detriment to sustainable growth and development.

That means where these issues constitute material risk to super fund investments, will we look to mitigate them, just as we look to mitigate other forms of investment risk.

WHERE TO START?

It does not make sense to "re-invent" the wheel in developing a broad framework on going forward and tackling these issues, when significant time and resources have already been expended by like-minded superannuation funds and institutional investors around the world.

A group of superannuation funds and institutional investors from across the globe have together with the United Nations paved a way forward by developing the Principles for Responsible Investment (PRI).

The framework has been developed taking into account the legal obligations of fiduciary trustees, in jurisdictions across the world, including Australia.

The PRI's six main principles provide a mechanism for signatories to integrate ESG issues into conventional investment analysis; to being active, responsible owners by promoting good corporate practice in these areas; and to reporting transparently on what actions have been taken in this area.

In summary the principles include:

1. We will incorporate ESG issues into investment analysis and decision making processes;
2. We will be active owners and incorporate ESG issues into our ownership policies and practices;
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest;
4. We will promote acceptance and implementation of the Principles within the investment industry;
5. We will work together to enhance our effectiveness in implementing the Principles;

6. We will each report on our activities and progress towards implementing the Principles.

Led by the United Nations, these investors, representing 16 countries and more than \$2 trillion in assets, including the Canada Pension Plan Investment Board (CPPIB), the California Public Employees' Retirement System (CalPERS), the New Zealand Superannuation Fund and ACSI members, VicSuper and the Catholic Superannuation Fund.

The principles "grew out of the understanding that while finance fuels the global economy, investment decision-making does not sufficiently reflect environmental, social and corporate governance considerations-or put another way, the tenets of sustainable development," UN Secretary General Kofi Annan said in April at a New York Stock Exchange event announcing the principles

ACSI will write to member funds encouraging them to consider becoming signatories of the PRI and work with the UN Secretariat to assist funds with developing an appropriate framework for going forward.

This is particularly important given the broad nature of these principles.

You should also be aware that the Joint Parliamentary Committee on Corporate Affairs has recommended unanimously, that superannuation funds should become signatories to the PRI.

Signing up therefore is not perceived to be a radical proposition by political leaders across the spectrum.

It should now be up to funds, to determine how best to apply the framework in light of resources, commitments and types of investment vehicles that are utilised.

For more information on the PRI visit www.unpri.org

ACSI TACKLES EXECUTIVE OPTION HEDGING ISSUE AT MANY LEVELS

In early August ACSI released a paper 'Disclosure Implications for Executive Hedging of Long Term Incentives'. The paper, researched and prepared by ACSI Research & Policy Officer, Ros McKay, considers whether the current disclosure regime under the Corps ACT, Accounting Standards and Listing Rules is adequate to identify situations where executives or other officers hedge their long term incentives.

The focus of ACSI's paper has been on executives because executives' long-term incentives are designed with the aim of aligning the interests of shareholders with executives.

This paper, and ACSI's inquiry into the matter came about in response to media coverage of the issue. ACSI wrote to the top 200 ASX/S&P regarding this issue in March 2006 and a summary of the responses is provided below -

- 120 responses were received to ACSI's inquiry.
- 86 respondents explained that they had a share trading policy i.e. 72%.
- Of those, 63 covered the issue of hedging and 22 of those in particular would allow hedging of incentives after they vest.
- 27 said it wasn't applicable and 7 said they wanted to consider the issue further.

Unsurprisingly no company explicitly commented that they allowed hedging prior to vesting.

ACSI does have concerns about the number of companies that did not respond to the inquiry and will revisit this issue again when looking at their remuneration reports during the upcoming proxy reporting season.

ACSI knows from its inquiry that companies allow hedging of incentives that have vested. The general position was that any such trading would be subject to companies' share trading policy and trading windows etc.

The arguments in favour of permitting hedging of vested incentives are easily understood. However, the issue remains that these executives and other officers are privy to information at times when shareholders are not and because there is no timely disclosure of these transactions it could undermine confidence in the integrity of the securities markets and perhaps even the role that these incentives play in aligning interests.

Investors do make decisions based upon a director's or executive's own trading behaviour and as the BT Financial Group paper on share trading pointed out "the perception of insider trading can be just as damaging as the reality."¹

There is also no question that just because the incentives have vested that the need for alignment of interests disappears.

So that led us to question that if executives hedge, why are they hedging, when are they hedging, on what basis are they hedging and most importantly when and how is the market informed about this transaction?

We also don't know who is paying for these hedging instruments. It's ACSI's view that the cost should be borne solely by the executive and not shareholders.

The paper has made the claim that the laws do not require the disclosure of hedging practices however, there is some argument that s205G(1)(b) of the Corporations Act 2001 would require directors to advise the ASX of relevant interests where a hedging arrangement would result in a physical settlement on the basis that it would require the delivery of shares. No analysis has been

conducted on our part into the appropriateness of the provision in terms of every type of hedging arrangement. Nor has ACSI conducted a review of compliance with this requirement.

This study has not identified if there have been any insider trading breaches in those companies which permit executives to hedge vested incentives. However, nor are shareholders in a position to identify if this is the case as the disclosure regime does not extend to cover the issue of executives and officers (other than directors) hedging their incentives

The research also has not identified the various hedging arrangements that can exist.

Our focus has been on executives and other officers and not directors and we have argued the following key points –

- That there should be a blanket prohibition of hedging of unvested incentives.
- We are of the view that annual disclosures for executives of movements in share and options holdings are not enough. Timelier disclosures that apply to Key Management Personnel (i.e. those most likely to have access to inside information) not just director share trading activity should be required, to improve investor confidence in the integrity of the securities markets.
- What we are recommending specifically is that section 205G of the Corporations Act (14 days) and ASX Listing Rule 3.19A (5 days) in terms of disclosure of relevant/notifiable interests be extended to apply to KMP's and the timing of disclosures be reduced to 2 business days.

We are concerned that where executives and other officers (KMP's) hedge their incentives it may break the nexus of aligning their interests. Investors do make decisions based upon a director's or executive's own trading behaviour and

¹ BT Financial Group, 'Position Paper – Director and Executive Share Trading' (2005)

more timely disclosure could potentially help identify if there are any trading irregularities or insider trading implications.

- ACSI also recommends a revision to section 300A of the Corporations Act to extend a company's annual disclosure obligations to require the disclosure of whether a relevant director and executive has utilised a financial instrument to hedge their vested long term incentives. This proposal may be in some way similar to Treasury's thinking in this area.
- We know that there has been problems with directors complying with their obligation to notify the market of their share trading practices, we also know that hedging arrangements are difficult to detect both from the companies and regulators perspective. As such we think more monitoring is required by the companies and the regulators in this area.

INTERNATIONAL GOVERNANCE COMMUNITY RECOGNISES AUSTRALIAN SUPERANNUATION FUND CONTRIBUTIONS TO GOVERNANCE

Australian superannuation funds and ACSI have been recognised by the international corporate community for their campaign and litigation in the News Corporation matter with the ICGN Award for Excellence in Corporate Governance.

Michael O'Sullivan has also been elected on the ICGN board. This is a three-year term. Michael is also involved on the Institutional Shareholder Responsibilities sub-committee.

Phil Spathis continues to be a member of the non-financial business reporting sub-committee.

THE ICGN CONFERENCE

The theme of the Washington ICGN Conference, "Creating Value – Building Trust, The New Agenda in Global Corporate Governance", sought to reaffirm the importance of corporate governance in creating shareholder value and enhancing confidence in shareholder markets.

There was a significant Australian investor contingent from Australia to ICGN.

As always with large conferences such as these, a key benefit of attending is the networking opportunities with pension fund representatives across the globe.

These networks have been critical to nurturing the trust between various organisations, that was vital to our collective campaign in News Corporation.

Outlined below are snapshots of some of the key presentations made at the ICGN.

Michael O'Sullivan presented an overview of ACSI and super fund involvement in the News Corp case, in a workshop together with Justice Jacobs of Delaware Supreme Court, and an attorney for the AFL-CIO Damien Silvers. Feedback from Mr Silvers, together with the views of attorneys of other pension funds has suggested that the decision of the Court of Chancery in Delaware, has had far reaching precedent implications with respect to the rights of shareholders, to be able to reach agreement and 'carve out' responsibilities usually reserved as a "managerial/board prerogative".

There are positive implications for shareholders who could more confidently propose a range of 'by-law' changes with improved confidence that the SEC (the US company regulator) may be dissuaded from effectively blocking shareholder resolutions and proposals on the basis that it cuts into managerial prerogatives of a Board.

KEY PRESENTATIONS

Ira Milstein

Senior Partner, Weil Gotshal & Manges and Senior Associate Dean, Yale Centre for Corporate Governance and Performance

"The Board – Governing Beyond where the Law Ends"

Ira cited examples of improved institutional investor activism over the last twelve months.

- ICGN's Shareholder Responsibilities Committee chaired by Peter Montagnon, whose work will be discussed at ICGN and was well received at the Yale Governance Forum;
- The European Commission's official proposal for a directive on shareholder rights, actively supported by ICGN;
- The New York Stock Exchange's "broker non-vote" proposal – again, the result of shareholder pushing, with ICGN there;
- The requirement of voting disclosure by mutual funds – and the subsequent use of that information to demonstrate a lack of connection to the wishes of beneficiaries. Actively supported by an alliance of shareholders initiated by some of the union pension funds;
- Majority voting reform in the United States, now gaining legs with the legal obstacles removed by amendments to the Delaware law and changes to the Model Business Corporation Act by the American Bar Association. Again, a reform process actively abetted by a meeting of the ICGN in Delaware, and the United Brotherhood of Carpenters and Joiners of America;
- The interesting result in Delaware achieved by Australian investors in the News Corporation case, is a sign that investors can be heard in Delaware to complain of a perceived absence of fair dealing;
- The publication of "Corporate Governance and Ethics" by the Corporate Governance Group established for the Government Pension Fund-Global of the Norges Bank Investment Management, an arm of the

central bank and one of the largest pension funds in the world. A model of aspirations and practicality to be adapted and emulated; and

- Rolf Breuer, Chairman of the Supervisory Board of Deutsche Bank, recognizing and appreciating the importance to Germany's economic growth of active and enabled investors in a landmark speech in Frankfurt at a joint meeting of DAI (Deutsche Aktieninstitut) and ICGN in February 2006.

Key themes of his address included:

- Reference to the shameless criticism by the "Business Roundtable" of a 'kabal' of public sector pension funds, Taft Hartley funds and proxy advisers who were impeding business in the US. It is time to be less polite to 'dominant business interests' who exhibit no shame despite the scandals and failures.
- Shareholders need to exercise informed judgements in selecting directors and communicating with them.
- Across a range of jurisdictions shareholders are not choosing directors well. In "no country do shareholders have an excuse for not impacting on the selection and influencing directors".
- Too many shareholders take the easy road of favouring management in proxy voting because that suits their business interests.
- Our fiduciary duty is to represent our beneficiaries' needs and values, not our own. The first duty of institutions is to their beneficiaries.
- The capital market system (that encompasses corporations and management, beneficiaries and institutions) have created a system that places pleasing the visible corporate customer over pleasing unseen beneficiaries.
- Institutional investors need to restore a balance that is currently tipped in favour of management. It requires alliances between investor groups.

- In short: Directors have broad discretion; it's not being exercised well; institutions have the duty and the power to change that by picking better, and/or communicating better, with directors. Where shareholders lack all the authority they think they need, they should focus on getting it, including removing very significant self-imposed obstacles. And remember, the duty of investors is to act for their beneficiaries' benefit, and not in their self-interest. All this may have to displease a few potential customers – and “bosses,” but it may restore balance on the scales.
- In a nutshell – boards have to balance shareholder and management interests, and institutional investors have to, at the least, balance customer and self-interest with their duty to beneficiaries. That's our future task. This is not about a battle of control but about choosing the right people to do the “balancing”.
- In response, to a question about whether shareholders can realistically judge the character of directors, he suggested that we should encourage boards to go beyond “marquee names” and look for solid achievers in a range of fields. We should also consider disqualifying directors who have a track record from not participating or being elected on boards.

Mark Anson
CEO, Hermes

Mark opened up with a Statement from the President of the United States:

“I see in the near future a crisis approaching. Corporations have been enthroned and an era of corruption in high places will follow until all wealth is aggregated in a few hands.”

This was attributed to Abraham Lincoln.

“The typical American stockholder is the most docile and apathetic animal in captivity. He

does what the board of directors tell him to do and never thinks of asserting his individual rights as owner of the business and employer of its paid officers.” Security Analysis, Benjamin Graham & David Dodd, 1934.

This statement about shareholder activity is according to Mark as applicable now as it was then.

“The choice of a common stock is a single act; its ownership is a continuing process. Certainly, there is just as much reason to exercise care and judgment in being a shareholder as in becoming one.” Security Analysis, Graham & Dodd, 1934.

Why Governance is Necessary

- All companies experience inevitable periods of stock price appreciation & decline.
- These periods will occur for both good and poorly governed companies.
- However, accountable governance may mean the difference between prolonged periods of underperformance and responding quickly to a new course of action.
- Shareholders must demand this accounting.

A Different term: Share Ownership

“Share Ownership embodies two important principles. First, the term **shareowner** reminds all interested parties - executives, directors, creditors - who is the ultimate owner of the company. Second, with the acknowledgement of share ownership comes the obligation to continue to exercise ownership rights in a public company.”

Ownership requires Prudent Activism

“For corporate governance structures to work effectively, **Shareowners must be active and prudent** in the use of their rights. In this way, Shareowners must act like owners and continue to exercise the rights available to them.” (emphasis added) “The Corporate Governance of Listed Companies:

A Manual for Investors," The CFA Institute, Centre for Financial Market Integrity, 2006.

The Equity Risk Premium

- The Equity Risk Premium (ERP) is the additional return that investors must earn to hold stocks over bonds.
- It is a forward-looking calculation that measures the level of **Investor Risk Aversion** in the stock market.
- The ERP is *implied* by current market valuations—it is not directly observable—but you can “back out” the ERP using current stock market valuations.
- It is an effective tool to determine whether the stock market is over, under, or fairly priced.
- There is a direct **inverse** relationship between the ERP and the level of the stock market: a higher ERP leads to lower stock market valuations.

What lessons can we learn from the ERP?

- The ERP has approached zero twice:
 - The portfolio insurance fantasy of 1987
 - The height of the Tech Bubble in 2000
 - In each case, the valuation of stocks was so inflated that investors viewed stocks as no more risky than Treasury Bonds—this cannot be!
- The highest point of the ERP came in 2002:
 - This demonstrates the highest level of investor risk aversion over the last 25 years.
 - The cause was the flood of corporate accounting scandals.
- Bottom Line: An egregious lack of corporate governance destroyed investor confidence, raised the equity risk premium, and eroded stock market values.

Observations

- A breakdown in governance can impact the whole stock market.
 - Good governance is practiced by few, but can impact many.

- More importantly, the converse is also true—it takes only a few poorly governed companies to erode value across the broader equity market.
- Good governance can reduce the long-term risk premium for a company.
- But Who is the Real Culprit?

Culpability Must be Shared

- Not all of the blame can be placed at the feet of corrupt corporations.
 - Unfortunately, short term investing remains the primary investment paradigm in the US and the UK.
 - Short-term investors rent stocks, they don't own them. The average annual turnover for a US mutual fund is 100%.
 - With such a high turnover rate, ownership does not apply.
 - Asset Owners put pressure on asset managers to produce quarterly and annual out performance vs. their benchmarks.
 - Asset managers, in turn, demand short term out performance of the companies in which they invest.
 - This puts pressure on public companies to focus on short-term earnings rather than long term growth.
 - A vicious circle results.

Paul Wolfowitz
President, World Bank

According to Wolfowitz, corporate governance is one essential component of building a healthy investment climate and boosting investor confidence. He said that, “We know that companies with well-defined shareholder rights, solid control environment, high levels of transparency, and disclosure, and an empowered board of directors, have no trouble attracting investors and lenders”.

He continued by referring to Studies including some of that we've done which show over

and over again that well-governed companies in fact perform better. One study of S&P500 firms over two year period show that companies with either strong or improving corporate governance, perform better by 19% than those of poor or deteriorating corporate governance. In Korea, well-governed firms trade at a premium of a 160% relative to poorly governed ones. So, it should come as no surprise that when institutional investors want to invest in developing countries or lets call them the emerging markets; they will turn to well governed companies. A World Bank study shows that US mutual funds were more likely to invest in emerging markets with strong shareholder rights, legal frameworks and accounting policies.

Within developing countries, governments are also starting to pay more attention to corporate governance. To attract domestic and International investors, India unveiled a new set of major corporate governance reforms early this year for its public companies. And in Mexico, a new law introduced a series of reforms to raise corporate governance standards and to improve investor protection.

Enforcing strong corporate governance standards not only improves the company's performance, it also helps guide against corruption by encouraging greater transparency, disclosure of information and independent oversight. When corporate governance standards are weak or absent, that creates an opportunity for abuse and for the misuse of power in corporate practices. Corruption is one of the biggest obstacles to development today and it can undermine private sector growth, especially in the poorest countries. It drains resources and discourages investment; it benefits the privileged and robs the poor. Corruption though, isn't just a disease of developing countries. Stop and think about it, in every corrupt transaction, there are at least two parties involved - a bribe giver and a bribe taker.

Paul Atkin S.E.C.
Commissioner

This session was one of the biggest eye openers of the ICGN.

This largely revolved around his defence of a practice known as "springloading". Springloaded options are priced the same day they are granted with companies aiming to build a quick, expected gain into a grant, by assuming that good news will push the share price up in the following days. He rejected claims that such awards amount to insider trading. He said that, "Boards in the exercise of the business judgment, should use all the information that they have at hand to make option-grant decisions. As insider-trading theory falls flat in this context, there is no counterparty who would be harmed by an options grant. The counterparty here is the corporation – thus the shareholders".

This of course, is on the back of recent scandals in the US on backdating of options which give recipients the right to buy a share at the set price, typically the closing share price on the date a grant is made. Companies that backdate are setting the grant date retrospectively to align with the share's low point creating an instant paper gain.

In the United States, broad-based stock options have been the catalyst for corporate success since they were pioneered by venture capitalists over four decades ago. Their theory was that stock option grants to employees, not just to executives, would result in a new owner class of employees who would be given an incentive to maximize the value of the company's stock. This theory proved correct, and employee stock options have been one of the main reasons that innovative corporations have flourished.

He pointed to a slew of stories regarding "alleged transgressions" in the granting of stock options. Indeed, some of the reported facts are grim — stories of executives and directors conspiring to manipulate stock option prices for their own gain, or

purposefully “backdating” options grants, in contravention of the company’s public disclosure, to avoid recognizing compensation expenses. If true, I expect there will be little sympathy for, and intense regulatory reaction to, these scenarios.

But it is worth taking a step back before we plunge headlong into wholesale condemnation of all options practices. We need to distinguish scenarios that are black-and-white fraud from legitimate practices that are being attacked with attenuated theories of liability. With respect to the former, there have been many reported stories of clear-cut doctoring of documents done knowingly by executives and/or directors. I will not quibble with the vigorous pursuit of the knowing perpetrators of this kind of activity: a fraud is a fraud. Attempts to evade legal obligations through intentional alteration of documents or deliberate flouting of internal controls cannot be tolerated, because they strike at the core of our system of corporate governance.

Atkin stated that backdating of options sounds bad, but the mere fact that options were backdated does not mean that the securities laws were violated. He believed that purposefully backdated options that are properly accounted for and do not run afoul of the company’s public disclosure are legal. Similarly, there is no securities law issue if backdating results from an administrative, paperwork delay. A board, for example, might approve an options grant over the telephone, but the board members’ signatures may take a few days to trickle in. One could argue that the grant date is the date on which the last director signed, but this argument does not necessarily reflect standard corporate practice or the logistical practicalities of getting many geographically dispersed and busy, part-time people to sign a document. It also ignores that these actions reflect a true meeting of the minds of the directors, memorialized by executing a unanimous written consent.

He referred to the accusations of insider trading by corporate boards in connection with options grants. Again, one has to ask whether there is a legitimate legal rationale for pursuing any theory of insider trading in connection with option grants. Boards, in the exercise of their business judgment, should use all the information that they have at hand to make option grant decisions. An insider trading theory falls flat in this context where there is no counterparty who could be harmed by an options grant. The counterparty here is the corporation — and thus the shareholders! They are intended to benefit from the decision.

He specifically stated that, “Practically speaking, because corporate boards are almost always in possession of material nonpublic information, it would be difficult (if not impossible) to require them to refrain from making options grants when they are in possession of such information. Along those lines, would we call it insider trading if a board chose not to grant options because it knew of impending bad news?”

This may be okay in theory, but how many boards, that are in fact run by executives will grant few options on the basis of pending good news that will bump up the share price.

Angel Gurria
Secretary General, Organisation for Economic Co-operation and Development (OECD)

Mr Gurria outlined that a major reason why the OECD is concerned with improving corporate governance is because of its link to increased investment and economic growth. Countries that wish to reap the benefits of global capital markets, and companies that want to attract patient, long-term capital, must foster good corporate governance practices that are well understood by investors and aligned with international expectations and principles.

Ultimately, corporate scandals jeopardise not only jobs and retirement incomes, but also

the credibility and public legitimacy of corporations and even of the market economy. As governments work to improve their own economies – and the global economy – through market-oriented reform, such as privatisation and liberalisation of markets, they must also pursue an unambiguous commitment to good corporate governance.

He outlined OECD programs across the globe to lift the standards of governance.

CMSF GLOBAL DIALOGUE

The CMSF Global Dialogue provided super funds and ACSI representatives with an excellent opportunity to engage in debate and have access to a high standard of speakers on issues that directly and indirectly impact on retirement income and pension policy.

Mavis Robertson and Fiona Reynolds together with their team are to be congratulated on its success.

A significant portion of the Global Dialogue dealt with governance issues, defined in both its traditional and its expansive sense that incorporates Environmental, Social, Governance (ESG) considerations.

There is a growing expectation that ACSI will engage with members to assist them with responding to the emerging ESG agenda, including providing a response to the framework for implementation of the UN Principles of Responsible Investing (PRI).

It was evident from the dialogue that there are real benefits for funds 'pooling' their resources to dealing with governance and CSR issues by promoting ACSI as a 'collective voice' where appropriate.

Sadly, such a collective approach is lacking in the US, with pension funds and other activists seeming to 'compete' for the same space without effectively co-ordinating their responses.

INTRODUCING "CLIMATE" THE NEWSLETTER

The Carbon Trust has produced a new quarterly newsletter 'Climate'. The summer issue includes data on emissions, as well as "Seven Questions for Every Shareholder" to pose to companies in their investment portfolios to test exposure to climate change risks. Funded by the UK government, the Carbon Trust promotes reduction of greenhouse gases and development of low-emission technologies.²

GETTING EXECUTIVE REWARD RIGHT

From page 11 onwards, you will find an abridged version of "Getting Executive Reward Right" by Denis Kilroy and Marvin Schneider of KBA Consulting Group for your information. While the ACSI Committee of Management have not necessarily endorsed the conclusions reached by KBA, we found their thoughtful analysis of key pay issues could be of significant interest to superannuation fund investors.

² Global Proxy Watch 'Climate' Vol X No 31, 1 September 2006.

AN ABRIDGED VERSION OF

Getting Executive Reward Right

Denis Kilroy and Marvin Schneider

The KBA Consulting Group

A clear understanding of the financial performance expectations embedded in a company's share price can be a powerful catalyst for considering a new approach to executive reward.

The past three years have seen the market value of companies in the ASX 100 increase by an average of 19 percent per year, delivering a Total Shareholder Return (TSR) of 23 percent per year once dividends are taken into account. This is well above that required to meet investor expectations.

Existing reward schemes have ensured that this uplift in market value has benefited many executives as well as shareholders. But there is an ongoing debate as to whether or not those schemes have distributed the benefits appropriately, or even encouraged the right behaviour. In some cases, there is a quite legitimate question as to how much of the increase in share price that has occurred is really attributable to executives. In other cases, good executive performance has gone unrewarded due to unreasonably high performance hurdles arising from a poor understanding of the dynamics of TSR.

A TSR that is well above market expectations is very positive for shareholders. This should tend to ease any tensions that might exist between executives and shareholders in relation reward. Nevertheless, if the market is valuing companies accurately, the very nature of the TSR metric means that it will tend to fall back to the point where it meets rather than exceeds market expectations. When this occurs, good management performance could mean conserving shareholder wealth, rather than creating it. This has significant implications for many executive reward schemes and signals a need to take stock and consider a new approach.

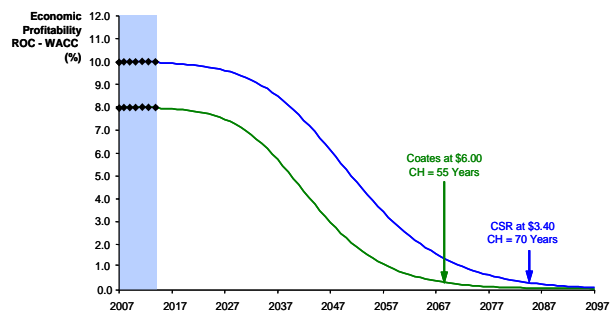
Conserving Wealth by Meeting Expectations

If we look at any company from an external capital market perspective, then embedded in the share price at any point in time is a set of expectations in relation to future financial performance. These expectations must be delivered in order to justify the current share price and by meeting them, management conserves shareholder wealth. In many cases, delivering these embedded expectations is not easy.

Figure 1 illustrates an important component of the performance expectations embedded in the share prices of Coates Hire and CSR in July 2006. It plots

expected economic profitability, which is the extent to which the return on capital is expected to exceed the cost of capital, over both a relatively short planning period and a longer term convergence horizon during which market forces act to drive returns back to the cost of capital.

Figure 1. Comparing Embedded Expectations for CSR and Coates Hireⁱ

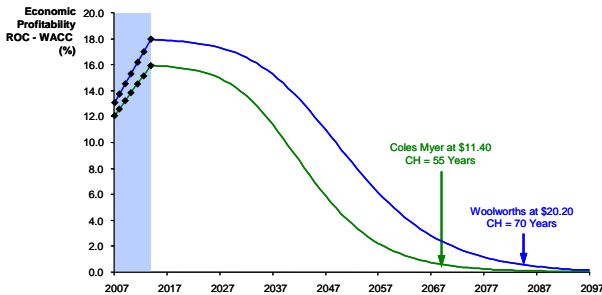


The market is expecting both companies to maintain their current high levels of economic profitability for quite a few years. Their executive teams must deliver this performance in order to justify the current share price and conserve shareholder wealth. Nevertheless, conserving shareholder wealth does not mean that the company's share price will remain static. When investor expectations are met, share prices rise naturally. The mechanism that causes this and the rate of growth in the share price are both explained in the unabridged version of this paper.

Every listed company has a unique set of performance expectations embedded in its share price, and each faces its own unique challenges in attempting to deliver these expectations. Some may consider that Coates Hire and CSR both have a real challenge ahead of them in order to conserve shareholder wealth. But as is demonstrated in Figures 2 and 3, the challenge appears far greater for a number of other listed companies.

Figure 2 presents an analysis of the expectations embedded in the share prices of Coles Myer and Woolworths in July 2006. Both companies are already achieving quite high levels of economic profitability. But investors are not only expecting these returns to be maintained; they are expecting them to increase considerably over the next few years and be sustained at quite high levels for an extended period. These observations point to some challenges ahead for the executive teams.

Figure 2. Embedded Expectations for Coles Myer and Woolworths

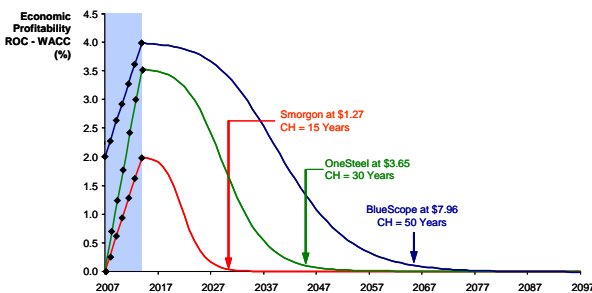


Note: The analysis for Coles Myer incorporates the disposal of the Myer business in 2006 with the cash proceeds being distributed to shareholders

Figure 3 presents an analysis of the expectations embedded in the share prices of Australia's three main steel industry participants – Smorgon, OneSteel and BlueScope.

Steel manufacturing and distribution are highly competitive industries in which it has proved difficult to achieve economically profitable returns in recent years. But the current share price of each of these companies incorporates an expectation of a significant increase in economic profitability over the next few years. It also indicates very different convergence horizons for each player, probably reflecting a combination of positive and negative market sentiment and different degrees of commoditisation in each company's business mix.

Figure 3. Embedded Expectations for Smorgon, OneSteel and BlueScope



Conserving shareholder wealth by delivering embedded expectations can pose a challenge for many executive teams – and not just for those we have chosen to use as illustrations. This is particularly the case if expectations have been inflated by positive market sentiment.

Creating Wealth by Exceeding Expectations

It goes without saying that if wealth conservation poses a challenge, then wealth creation will be a much greater challenge. An executive team will only create wealth for shareholders if it either delivers financial performance that exceeds current market expectations, or it convinces investors that it has a strategy in place that will enable it to do so.

Financial performance expectations can increase for two reasons. The first is the market's acceptance of a higher value strategy adopted by the executive team. The second is market sentiment.

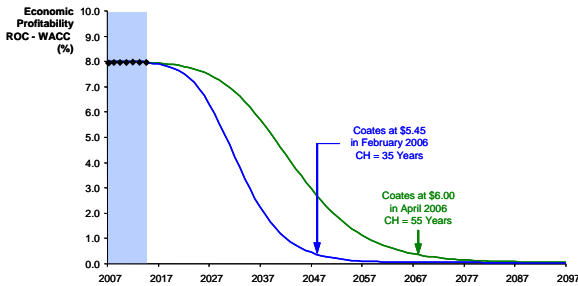
An executive team creates wealth for shareholders at a fundamental level through the development and the successful implementation of a higher value strategy. But it is also important to consider the impact of market sentiment. After all, the extent to which the adoption of a higher value strategy will be reflected in the share price will be influenced by the nature of sentiment.

Market sentiment can be positive or negative. It can sometimes play a major role in determining a share price at a particular point in time, and its existence affects the ability of a company to either meet or exceed expectations. But sentiment is inherently unstable. So its impact on share price can change over time – and sometimes over relatively short periods of time.

Much of the impact of a change in sentiment on a company's share price will be evident in a change in its convergence horizon. This can be demonstrated by examining one company over a relatively short period of time during which it has pursued the same successful strategy with the same fundamental economics.

Figure 4 shows that during the two months immediately following a half yearly results announcement on 20 February 2006, the share price of Coates Hire rose from \$5.45 to \$6.00. During this time there was no material change in strategy communicated to the market – just confirmation of the successful implementation of the current strategy and the ability of the company to meet the market's already high growth expectations.

Figure 4. Change in Convergence Horizon



With no material change in expectations in relation to medium term returns, much of increase in share price can be attributed to a lengthening of the convergence horizon. The question for investors is: *How much of this increase is due to an enhanced understanding of the long term economic consequences of the continued successful implementation of the current strategy, and how much is due to a positive shift in sentiment?* This is a difficult question to answer.

A positive shift in sentiment can certainly benefit existing shareholders. But its inherent instability means that any benefit could also be short lived. New shareholders can quickly become disadvantaged when sentiment shifts in the other direction. In addition, if positive sentiment embeds a set of expectations that are beyond the ability of an executive team to deliver, it can pose some real problems for all shareholders, as well as for executives and for the proper functioning of an executive reward scheme.

Regardless of the nature of market sentiment towards their company, the right path forward for the executive team will always involve the identification and the implementation of higher value strategies. To appreciate why this is the case, we need to understand the difference between the observed value of a business, and its underlying or intrinsic value.

Observed Value versus Intrinsic Value

There are really two views of value for any listed company – its *observed value* and its *intrinsic value*.

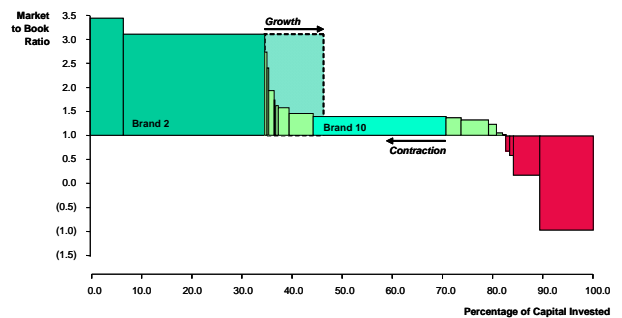
The observed value reflected in the share price is the value that the marginal investor is prepared to *pay* for a share of the business at a particular point in time. In a sense, it is the market's view of the value of the strategy being pursued by management.

The intrinsic value is the underlying value of the business. It is the value of the business that has been agreed between the board and the executive team, and is based on management's best estimate of future financial performance – taking account of both its strategy and its competitive position. In a sense, this is

the value at which the executive team is seeking to *sell* its strategy to the market.

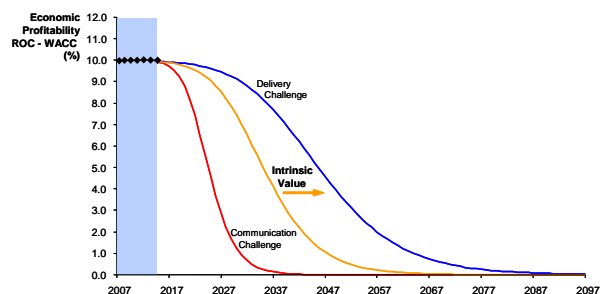
It is important for boards and their executive teams to understand the intrinsic value of their business – and to understand it at a disaggregated level. Without this understanding, it is difficult to build an organisation with the ability to create wealth for shareholders on an ongoing basis. Most higher value strategies are developed at a disaggregated level – often at the level of an individual customer segment. Figure 5 illustrates how an understanding of intrinsic value at a brand level was used by a wine producer to develop a higher value strategy involving the reallocation of quality fruit to a higher value brand.

Figure 5. Using Intrinsic Value to Guide Strategy Development



An important step in understanding intrinsic value is to explore its relationship with observed value. This relationship is illustrated in Figure 6. The amber curve represents intrinsic value. The blue curve illustrates a situation where the observed value is greater than the intrinsic value. The red curve reflects a situation where the observed value is less than the intrinsic value.

Figure 6. Comparing Intrinsic and Observed Value



If the observed value is greater than the intrinsic value, then the executive team must eventually find a way to justify that observed value. This means finding a way to deliver a level of performance higher than they believed was possible under the strategy currently

being pursued. They can do this by developing and implementing higher value strategies – and each time they do this successfully, the amber curve moves to the right.

If the observed value is less than the intrinsic value, the executive team needs to accept that the external capital markets might not understand the company's strategy. Consequently, it has a communication challenge to overcome. Alternatively, investors might lack confidence in the ability of the executive team to implement the strategy successfully, in which case there is an entirely different type of issue that needs to be addressed by the board. Dealing with these issues should result in the creation of wealth for existing shareholders. But beyond that, if executives are to create wealth for shareholders on an ongoing basis, they must again focus on enhancing intrinsic value by developing and implementing higher value strategies.

In the long run, observed value must be underpinned by intrinsic value. Through effective communication with the investment community, these two views of value should eventually align. This process of alignment operates implicitly through the communication of new strategies, new initiatives, and new earnings forecasts. It is then left to the investment community to interpret this information. At present, there is no direct mechanism available through which a board and its executive team can explicitly communicate their internal view of intrinsic value to investors.

An executive team has only one way to increase intrinsic value – through developing and implementing higher value strategies. But it has two levers with which to try to increase observed value. One is to enhance intrinsic value. The other is to attempt to influence sentiment.

A positive shift in sentiment will increase observed value for a period of time, and this will benefit existing shareholders as well as those executives whose remuneration is linked to observed value. But this benefit is derived largely at the expense of new shareholders. The resultant imbalance, combined with the inherent instability of market sentiment, can lead to a volatile share price. This volatility is likely to favour share traders at the expense of long-term investors.

It is in the interest of long term investors to have an observed value that always reflects the company's true, underlying or intrinsic value. Management processes and systems, including executive reward schemes, should therefore be designed to encourage executives to focus on increasing intrinsic value through the development and successful implementation of higher value strategies, rather than to focus on attempting to increase observed value directly by managing sentiment. This has some important implications for

existing executive reward schemes, most of which have an LTI component linked to increases in observed value.

If we are to implement processes and systems that focus on intrinsic value uplift, the first thing that must be done is for the board and its executive team to agree on a start-point value. Ideally, this would be the underlying intrinsic value of the business developed by the executive team based on management's best estimate of future financial performance. But if observed value is significantly higher than intrinsic value, the board must decide whether to accept the recommendation of the executive team, or impose a different starting value – perhaps even the observed value.

Later in this paper we will briefly outline a new approach to executive reward that is flexible enough to accommodate a range of different start-points – including the use of observed value. It can also be structured so as to minimise the risk of “gaming” through the suppression of start point values or the inflation of value uplift attributed to management action. Nevertheless it is useful to explore some of the potential behavioural consequences of adopting a start-point value with embedded expectations that are well above the executive team's ability to deliver.

It could be difficult to motivate executives if their remuneration system is geared to rewarding wealth creation, but the system starts from an observed share price with unrealistically high embedded expectations. This is because they will struggle to conserve wealth, let alone create it.

At the same time, executives confronted with embedded performance expectations that they believe are too high, may well be reluctant to communicate that view to the market – particularly if a significant proportion of their remuneration is linked to increases in observed value. Instead, they might focus on managing investor sentiment to try to ensure that the share price did not fall.

If the CEO of such a company reached the end of his contract at a time when the share price had embedded expectations beyond what he or she felt were achievable, it would be very much to his or her advantage. But this situation would create a real burden for a successor who would inherit those inflated expectations as the start point from which to set out to create shareholder wealth.

There are many potential problems with using the change in observed value as a measure of management performance or as a basis for executive reward. These problems are compounded by the employment of options-based payment mechanisms that are sometimes used to link long term incentives to

changes in observed value. Options-based payment mechanisms are highly sensitive to share price. Share prices can move, without there being a commensurate increase in observed value, when the number of shares on issue has changed – for example, as a result of a buy-back. Unless the exercise price embedded in an options-based payment mechanism is adjusted for changes in capital structure, buy-backs can lead to unintended outcomes from executive reward schemes – a point that is explored in more detail in the unabridged version of this paper.

All of these problems can be overcome through the adoption of intrinsic value uplift as the primary performance metric. But this can only occur if a capability to determine intrinsic value at different points in time has been established and is underpinned by robust business processes, and there is an up front agreement between the board and the executive team as to the start point from which increases in intrinsic value will be measured. Neither should be difficult.

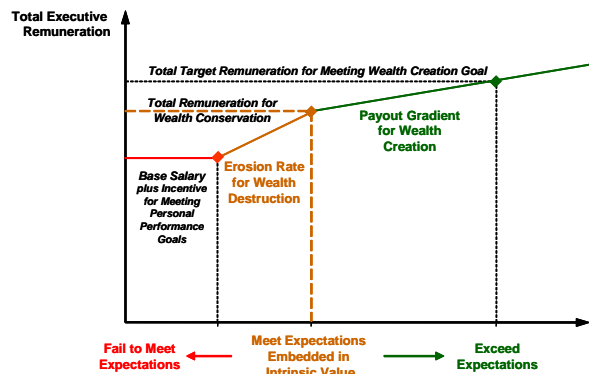
Every time the executive team and board consider an acquisition, they form a view as to the underlying or intrinsic value of a business which by definition, they know less about than the businesses they already own and operate. In executing such an acquisition, they put shareholders' capital at risk either on the basis of their view of the target's intrinsic value, or their view of the impact of the acquisition on their own company's intrinsic value. In many cases, the businesses acquired are not listed, so there is no observed value against which to calibrate. It is therefore not unrealistic to expect that a board and executive team could develop the capability to determine the intrinsic value of the businesses in their portfolio on an annual basis. The necessary information is already in the hands of the executive team, and the tools needed to enable them to make full use of that information now exist in the form of the MFV® software platform.ⁱⁱ A robust series of business planning, resource allocation and performance management processes that ensure analytical and process integrity also exist and are described in detail in the unabridged version of this paper. All that is required to move forward is an appreciation of the importance of understanding intrinsic value, and a desire on the part of both the board and the executive team to formally establish the capability to measure it.

The initial intrinsic value agreed between the board and the executive team provides the start-point valuation upon which a simple but effective remuneration system can be built that will help institutionalise the pursuit of higher value strategies. *How the ongoing pursuit of higher value strategies can be institutionalised is covered in the unabridged version of this paper.*

A New Approach to Executive Reward

An integrated executive remuneration scheme that rewards intrinsic value uplift is illustrated in Figure 7. It is centred on an agreed start-point intrinsic value and involves a base salary, a payment for wealth conservation and a further payment for wealth creation.

Figure 7. An Integrated Approach to Executive Reward



In Figure 7, the term wealth conservation means delivering the performance expectations embedded in the start-point intrinsic value. Wealth creation means exceeding those expectations, resulting in an uplift in intrinsic value. Wealth destruction means failing to meet those expectations, resulting in an erosion of intrinsic value.

This new approach permits a number of degrees of freedom in design. These enable remuneration schemes to be developed that can align the interests of shareholders and executives in ways that suit the unique circumstances of any company. For example if required, it can accommodate the use of observed or market value as the start point value – although the argument for doing so is not particularly strong (in contrast to what many readers may think). Additionally, it is entirely feasible to structure a scheme such that the traditional short term incentive (STI) component of reward is paid for wealth conservation, and the long term incentive (LTI) component is paid for wealth creation. While this is certainly not necessary, it may prove helpful for some companies in transitioning to the new approach.

The new approach has five fundamental design parameters.

1. *The start-point intrinsic value.* This anchors the scheme. It is represented by the vertical amber line in the centre of Figure 7. The expectations embedded in the start-point intrinsic value are those which must be delivered in order to conserve wealth

2. *The level of total remuneration for conserving wealth.* This is represented by the horizontal amber line in Figure 7
3. *The proportion of wealth creation that will be paid to executives.* This is represented by the green gradient in Figure 7. This can be calibrated in a number of ways, including setting a total target remuneration for achieving a pre-defined wealth creation goal
4. *The rate at which the expected total remuneration will erode in the event that wealth is destroyed.* This is represented by the amber gradient in Figure 7
5. *The extent to which expected total remuneration will be permitted to erode in the event that wealth is destroyed.* This is represented by the horizontal red line in Figure 7.

In setting the last two parameters, the fixed component of total remuneration is automatically defined.

Each company's remuneration policy can be implemented by setting these five design parameters. *How this can be done in a way that ensures both analytical and process integrity is described in detail in the unabridged version of this paper.*

Conclusion

There are many problems associated with existing approaches to executive reward. Perhaps the most telling indictment of existing schemes is that neither executives nor shareholders can determine in advance how much the executive team will be paid for a given level of wealth creation; for conserving shareholder wealth; or in the event of a particular level of wealth destruction.

The approach to executive reward we have outlined in this abridged version of our paper represents a fundamental shift – but it is a fundamental shift in the right direction. Firstly, it is simple in both concept and application. Secondly, its use both encourages and rewards ongoing intrinsic value uplift which is the fundamental driver of observed value and shareholder wealth creation. Thirdly, it balances the interests of executives and shareholders regardless of whether management action has resulted in wealth creation, wealth conservation or wealth destruction. Finally, it lends itself to being fully integrated with a value-based approach to business planning, resource allocation and performance management, in a way that helps establish and maintain a wealth creation culture. At the heart of that culture is the ongoing pursuit, followed by the successful implementation, of higher value strategies developed at either business unit level or at the level of an individual customer segment.

The unabridged version of this paper is much more comprehensive. It includes a number of other sections which were deleted for the sake of brevity, but which are important for anyone contemplating adopting or recommending the approach outlined. These sections include Understanding TSR, Understanding Market Expectations, Why Share Prices Rise Naturally, The Impact of Buybacks on Share Price, Institutionalising the Pursuit of Higher Value Strategies, Shortcomings of Existing Reward Schemes, Implementing the New Approach, and Setting Design Parameters. If you would like a copy of the unabridged version of this paper, please contact the KBA Consulting Group (www.kba.com.au) on +61 3 9867 1477.

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This newsletter is correct to the best of our knowledge and belief at the time of going to press. It is, however, written as a general guide so it is recommended that specific professional advice is sought before any action is taken

- i. All of the expectations analysis presented in this paper has been undertaken by The KBA Consulting Group using publicly available information and KBA's interpretation of published analyst reports.
- ii. MFV® is a purpose built software platform designed to provide both analytical and process support to "value-managed companies" and "value investors". See www.mfvsoftware.com