

## **Power to the shareholders**

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The Reverend Dr Peter Mullen is Chaplain to the London Stock Exchange (LSE) and earlier this year he wrote an opinion piece for the Daily Telegraph in London in which he bemoaned the fact that the Church of England had adopted the "jargon- ridden claptrap of management-speak".

At meetings, that he called "fatuous ecclesiastical knees ups", his parish church (and presumably now the LSE) is required to have a "corporate vision" (or what he called a "semi-psychotic fantasy") about such things as reducing his "carbon footprint" (I am not completely sure that he understood what was meant by "carbon footprint").

Earlier this year Dr Mullen received an invitation from the church hierarchy to attend a conference called "Work/Life Balance: Learning to say NO with Confidence and Compassion".

The purpose of the conference was to teach the clergy how to refuse to attend conferences. Dr Mullen claimed to know how to do that already, so presumably he didn't attend.

As the main reporting season gets under way in Australia shareholders will soon begin receiving invitations to attend the annual general meetings (AGMs) of companies in which they hold shares.

I would like to encourage you to attend those annual general meetings. Many will be loaded with the jargon-ridden claptrap of management-speak (and some may even be fatuous knees ups) but it is important that shareholders consider accepting their legislated right to attend these meetings, listen to the presentations and then ask questions of the chairman and the other directors.

One of the most important ingredients for company success is to have the right people on the board of directors, for those directors to elect the right chairman, and for the chairman and CEO to have a good working relationship.

At the AGM you will have the opportunity to judge for yourself whether or not the chairman is the best man for the job, and to see how he relates to the CEO.

After the meeting you may even get the opportunity to speak to the other directors who will have listened carefully to your questions and comments during the various items of formal business at the meeting. I find this is a very important aspect of AGMs; you get to speak to the entire board.

You will need to prepare for the meeting and have your questions ready to ask at the appropriate point.

These days shareholders who have access to the internet can do almost all of their preparation at home. Major companies have websites that contain market announcements, annual reports going back some years and information about the company's businesses. Market announcements are also available from the ASX website. ASA policy positions and commentary on those positions is available from the ASA website.

Before the days of the internet we had to visit State based stock exchanges and ask to see the announcements book, and that could take a morning if you wanted to check the wording of just one company announcement. Today it takes only seconds to locate an ASX announcement on the ASX website.

At least a month before the date scheduled for the AGM you will receive or be advised of the availability of the annual report and a notice of meeting.

In most cases the chairman will have written a brief overview of the company and its activities during the preceding year. That will set the scene for your reading of the rest of the annual report.

**Tip 1 If the only commentary in the annual report is by the Chief Executive Officer (and there is no Chairman's report) you should ask yourself "Why".**

After reading both the Chairman's and CEO's reports you will probably come to the conclusion that, all things considered, the company has done pretty well and that all the quoted figures suggest you should stick with them for another year. That's not unusual; it was probably written by a "spin doctor" who is highly paid to get that message across.

**Tip 2 If these reports include a reference to profit "before this and that" go straight to the Income Statement and compare the diluted profit per share this year with the same figure for last year (at the bottom of the page) because, after all, that is what actually happened.**

As you read the annual report try and take a long term view of the company, its business and the industry in which it operates. Be aware of the risks for the company as you study the commentary. Retail shareholders understand that, because companies are taking risks on their behalf, a company will occasionally stumble and have a bad year, but that should not result in anymore than a temporary setback for an otherwise good investment.

**Tip 3 If the annual report strikes you as being jargon riddled with management speak claptrap other shareholders probably think the same and you should prepare your first "Can you please explain" question for the chairman at the AGM.**

Don't ever forget that as a shareholder you are a business owner and should think like a business owner. Does this business have a future and what are the factors that influence its earnings (and my future dividend distributions)? Do I understand the business and the risks involved?

**Tip 4 If you don't understand the significant drivers of a company's earnings go back over recent annual reports and try to determine progress.**

If, for example, you are already a shareholder in a company that announces to the ASX that it has a significant number of S+P AAA rated assets designated "Synthetic Collateralised Debt Obligations" in "conduit vehicles" it's probably time to write to the company and ask for a plain English explanation.

**Tip 5 Don't hesitate to write to the Company Secretary and ask for a plain English explanation of anything you don't understand and if you don't get a satisfactory answer you should prepare your second "Can you please explain" question for the chairman at the AGM (and if he asks someone else at the top table to answer it, that probably means he doesn't understand it either).**

Most companies comment on the outlook for their businesses at least half-yearly and annually, some more frequently. This is often provided by the CEO at an AGM. All listed companies are required to inform the market if there is likely to be any material variation from either their guidance or what is called the "market consensus" range of estimates for their likely annual results. These announcements are made under ASX Listing Rule continuous disclosure requirements and are not always reported in the daily press.

**Tip 6 Include the ASX announcements platform in your list of internet favourites so you can check the latest announcements by companies in your portfolio.**

If there is something you don't understand in the annual report or you have a question you would like to ask at the AGM you can always email ASA ([share@asa.asn.au](mailto:share@asa.asn.au)) who will be pleased to give you some guidance on one of the ways the question can be asked (we have been doing this since 1960 so we have had a fair bit of experience). It is better if you can put it in writing so a copy can be sent to our company monitor for advice.

If you don't want to ask the question yourself you should still send it by email to ASA who will then send it to the company monitor concerned for consideration. We can't ask every question we are sent but we certainly consider them all.

Every annual report must contain a corporate governance statement and most companies benchmark their corporate governance against the ASX Corporate Governance Principles and Recommendations that are available on the ASX website. If a company deviates from the ASX principles it will usually say so in the commentary.

**Tip 7 Wherever there is a deviation from the ASX principles and recommendations you should ask yourself why and decide whether or not that deviation is in the best interests of shareholders.**

The heightened risk that comes with investing in companies whose governance and actions depart from best practice without adequate explanation has been clearly demonstrated in recent months.

Boards without a clear majority of independent directors, a dominant founding executive director who has a large shareholding on which there is an undisclosed mortgage, a balance sheet that does not distinguish between current and non-current items, "mistakes" in disclosure of current and non-current liabilities (borrowings), large intangible assets resulting from overpayment for acquisitions, relatively large auditors "other service fees", borrowing short to purchase long-term assets and, in some cases, very large related party transactions (to name just a few).

As I said earlier the most important thing retail shareholders can do to safeguard their investments is to make sure they elect a majority of truly independent and knowledgeable non-executive directors to the board and that those independent directors then elect a strong and independent chairman.

That may be difficult where a board includes individuals with deep ties to the legacy of the business, and shareholdings significant enough to exercise some degree of control. However, it is in the interests of both that individual, and the other shareholders, that they have the benefit of an experienced non-executive independent chairman who can offer fearless advice and minimise the possibility of any one individual hijacking the board.

If you do nothing else next time you receive a notice of meeting for an AGM you should consider whether or not to vote for the independent non-executive directors up for re-election and whether or not the chairman is strong and truly independent, and then cast your votes accordingly. If you feel you can't decide you can always give your proxy to someone you trust to vote on your behalf. That could be ASA.

Let me now try and look forward to this year's AGM season and predict some of the issues that will be raised.

### **Margin Loans**

Very few of the top 300 companies listed in Australia have directors with potentially market moving quantities of shares. Even fewer are thought to have mortgaged their holdings so the risk that the decision to sell those shares will be taken by others is very slim indeed. It is however always a possibility as we saw with ABC Learning.

All companies are required to disclose their directors' share holdings in their annual report and it is easy for shareholders to see whether or not a director holds a potentially market moving quantity.

This year we have been asking companies whose directors hold large (but not necessarily market moving) quantities of shares for details of the protocols they have in place for dealing with margin loans and other forms of financing share purchases.

All the companies we have spoken to so far have suitable protocols in place. Usually directors are required to notify the chairman or company secretary of any financing agreements. If the chairman feels there is risk involved the matter is referred to the board Risk Committee for a recommendation to the board who then decide if disclosure is required under ASX Listing Rule 3.1.

We will continue to question companies about their protocols surrounding directors' margin loans during the coming AGM season.

### **Stock Lending & Short Selling**

We have made, and continue to make, representations to the various regulatory authorities regarding the disclosure of both stock lending and short selling practices.

While we believe that under many circumstances short selling is a useful market tool we acknowledge that we know so little about the extent of the practice that we are unable to make any policy decisions in relation to either stock lending or short selling.

We have taken every opportunity to ask companies that may be engaging in these practices whether they are and, if so, whether they consider the rewards adequate for the risks involved.

Of the listed investment companies to whom we have spoken Argo and Milton do lend stock and regularly assess the risks involved. Of the insurance companies QBE does not lend stock but financial services provider AMP, claiming to be a small player, does. Macquarie Bank lends as a "broker". Australian Foundation Investment, Djerrivarrh, Sylvastate and Whitefield all claim not to lend stock on the grounds that they don't believe their shareholders would want them to do so.

If you have a view on this could I encourage you to make a written submission to the National Office ([share@asa.asn.au](mailto:share@asa.asn.au))?

### **Directors' Trading**

Company directors have been failing in their disclosure obligations in relation to share trading in the companies on whose boards they sit.

Under ASX Listing Rules directors are required to disclose their share trades within 5 days.

We have already done some work in this area and those of you who read CEO, Stuart Wilson's, weekly column in "The Australian" will know what I am talking about.

Corporate Governance group, Regnan, published some information on this recently but did not "name and shame" so we are doing that and will recommend an AGAINST vote when any director who did not disclose in time comes up for re-election at an AGM this year.

## **Executive Directors' Pay**

Shareholders are always interested in the remuneration payments for directors and especially executive directors. They understand that directors should be well paid (that's self interest at work) and the best people available for the job.

Shareholders do not like:

- Badly constructed remuneration packages that do not link pay and performance
- Excessive payouts for failing to perform
- Packages skewed to short term bonuses
- Inadequate hurdles for long term incentives

Let me make some observations about directors' remuneration in Australian listed companies:

- Since the introduction of the non-binding vote on remuneration at AGMs there has been a gradual realisation by company directors that they need to listen to their shareholders in relation to this matter, even though the result of the vote is "non-binding".
- Pay deals that are "on the nose" are now more likely than ever to attract a significant AGAINST vote and shareholders are beginning to realise that they can vote AGAINST the chairman of the Remuneration Committee next time he or she is up for re-election.

The market has turned, and during the AGM season we are likely to see numerous "top-up" proposals for CEOs in particular. Such proposals will of course uncouple any alignment that might have previously existed between shareholders and executive directors and will almost certainly signal that the board is hostage to the CEO.

Non-executive directors may seek fee increases while dividends fall. Many shareholders will think this unfair and will need to weigh up the proposals on a case by case basis.

ASA company monitors are generally not in a position to judge the fairness or appropriateness of the quantum of executive pay, but they can judge the link between pay and performance, the fairness and construction of incentive schemes and take into account any special circumstances that might apply.

We believe shareholders want the best directors, and that directors must be suitably rewarded which is why we have developed a set of guidelines by which each company's Remuneration Report is judged. Any company that breaches those guidelines will attract an AGAINST vote for the undirected proxies we hold at an AGM.

## **Conclusion**

Could I urge you all to become shareholder activists?

Read your annual reports and Notices of Meetings.

Attend AGMs and ask questions.

Keep the directors on their toes by asking questions and making comments.

And please do not put off asking a question because you think it might be considered stupid. The fact that you don't understand something probably means other shareholders don't understand either so you have the opportunity to also ask the question on behalf of all shareholders.

Thank you.

I am happy to take questions.

Stephen Matthews  
Director  
Australian Shareholders' Association

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Email: [arbury@bigpond.net.au](mailto:arbury@bigpond.net.au)