Rapport

Think Before You Jump

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Think Before You Jump

The stock market correction of mid-May caught many by surprise, triggering nervous selling by investors large and small. In instances like this, it is best to take a deep breath and think the equation through before jumping to conclusions. While you are at it, why not attend to a number of other back-burner concerns. If and when you do, you may come to the realization that we were due for a pullback as the broader averages had gotten a bit ahead of the fundamentals, and that's all. It is certainly no time to toss in the towel!

REASONS WHY EVERYTHING COULD GO JUST RIGHT

Apart from the increasing burden of taxation, an inept public services system, declining school standards resulting in graduates who are functionally innumerate and illiterate, and a relentless wave of crime, all is not lost. But it could be if we fail to admit to our folly and respond in a constructive manner. In keeping with the recent federal-provincial discussions, I am all in favour of a common national securities regulator, harmonization of provincial sales taxes with the GST, a general reduction in barriers to trade, and labour mobility. The message is unmistakable, if the premiers want the quid, they must come up with the quo!

We must never take consumer confidence for granted, and growing worries about employment prospects, rising utility bills and very expensive gasoline may eventually take their toll. Small investors are pouring money into mutual funds. But when taxi drivers start giving tips on the stock market, beware. The top might be just around the next street corner. Though there are six savers to every debtor, the over-borrowed could well threaten economic stability. In a few markets, house prices are detached from reality. For some poor souls, the roof above their heads is sheltering chaotic personal finances. Repossessions, a sure sign of distress, look set to rise even further. Despite a change in political leadership, fiscal discipline is still lacking. Some would say expenditures are out of control. Let us hope the prime minister has the gumption to realign budgets, rather than have us continue to mourn the chronic waste of taxpayers' money.

In the private sector, business investment is not yet what it needs to be to put our manufacturing sector back on its feet, and government subsidies will only delay and encumber the process. However, despite what the screamers may claim, Canadians, as a whole, are getting richer. Disposable wealth available in households, consisting mainly of savings, shareholdings and accessible housing equity, net of mortgages and other debt, is on the rise. The high-flying loonie not only adds money to the pot, it has rekindled the country's pride. It should also help to keep inflation and interest rates in check. Why even

some of the sternest bears are finally coming out from cover. Nearly 70 percent of reported earnings are better than expected. The level of mergers and acquisitions is robust, new issues are many, exports are expanding, and employment is strong. Can the S&P/TSX composite index continue to outperform the S&P 500? Yes, it can! So even though there are a growing number of so-called experts suggesting it may be time to invest in the U.S., I would rather keep my powder dry and my money in Canada for the foreseeable future.

ON THE INTERNATIONAL FRONT

China's exchange rate was recently allowed to breach the psychological threshold of eight renminbi to the U.S. dollar for the first time in a dozen years. While its officials continue to worry that wild fluctuations in its currency could undermine the country's fragile banking system, they pledged to further improve the exchange rate mechanism in order to be more responsive to market supply and demand pressures. Many hope such will help to reduce the trade surplus with the United States and the rest of the world, which hit a record high in 2005. Given the upturn in economies about the globe and the scale of new manufacturing facilities coming on stream in the People's Republic, I very much doubt such will come to pass. Nor do I think the U.S. politicians will ever stop complaining. It is their way of trying to blame others for their own shortcomings. Fortunately, we Canadians are in a sweet spot, bailed out by our wealth of natural resources!

CHANGING SOX

It has been said that one definition of insanity is doing the same thing over and over again and expecting a different result. Why is it that Canadian investors repeatedly accept inept securities regulations? Typically, the wishy-washy Canadian versions of tougher American standards do little to enhance the fortunes of investors. Many of our guidelines read as though they were crafted by the wrongdoers, because those are the parties from whom the authorities primarily take their marching orders. For example, the Canadian Securities Administrators recently decided not to proceed with an earlier proposal that would have required issuers to obtain an opinion from their external auditors with respect to management's evaluation of the effectiveness of internal financial-reporting controls. Nobody in senior management opined about the advantages of such an investment of time and money, probably because it has little to do with measures upon which executive compensation is currently based. Furthermore, many of these folks seem to think we are either much more honest than the Americans or, as I would suggest, we just choose to believe we are. Is it not time the insanity stopped before the next downturn in the stock market hangs us all out to dry in the overbearing heat of well-deserved criticism?

Until just a few years ago, the appointment of non-executives to a board of directors was a shadowy business, blighted by suspicions of cronyism. Although companies denied the allegations, investors and other skeptics often wondered if some owed their positions more to their friendship with the chairman than any skills or insights they had to offer. Others with fine names and distinguished pasts seemed to have little in the way of a contribution to make. In the wake of scandals, the authorities have significantly tightened boardroom rules, clarifying and increasing the responsibilities of directors, creating new requirements for the audit and compensation committees, all intended to protect a company from an overlording CEO or chairman. In addition, the recruitment process has become more formal and professional than ever before. As a consequence, a goodly

number of bright and feisty executives have been drawn to the more freewheeling world of private equity, where they might receive financial rewards commensurate with the investment of their time and money without having to cope with as much red tape.

Corporate responsibility is of strategic and financial importance to every enterprise. Despite a rising stock market, the pressures have not eased. Commentators are questioning whether issuers are managing growth properly by ensuring they have controls in place to limit and deal effectively with risk. They are also concerned about the impact they may have on the staff they employ, the societies in which they operate, and the environment. Transparency in these matters is vital so as to allow investors to make informed decisions. It can also lead to other advantages: greater efficiencies, cost savings, an improved corporate image, and better recruitment. Unfortunately, quite a number of major corporations still do not get the message, to the detriment of their shareholders or unitholders.

As to the somewhat draconian Sarbanes Oxley Act, many fear that the baby may be thrown out with the bath water now that both gentlemen will soon retire from the U.S. Congress. Intended to improve the quality of corporate governance in the wake of the collapse of Enron Corporation and WorldCom, Inc., and scandals at other companies, many say the costs of complying with the requirements of section 404 far exceed the benefits. American investment bankers and securities exchanges are losing market share to overseas rivals because companies can avoid its burdens by doing their capital raising beyond the statute's reach. Some suggest it has turned red-blooded entrepreneurial managers into risk-averse pussycats by creating a climate of fear. Notwithstanding, the auditing profession is likely to dig in its heels, as it has been a profit bonanza, the clients having no choice but to grin and bear their charges.

Complicating matters is the surge of interest in executive compensation. Next to the weather, everyone likes to complain about the huge sums chief executive officers are taking home. In particular, the past chairman of Exxon Mobil Corporation's goodbye award of U.S.$400 million, which includes payment of his country club dues. (As though he could not afford to pay them himself!) Whereas there is little question his management skills contributed to the outfit's 223 percent return to shareholders in the past decade, soaring crude oil prices and a massive share-buyback programme were major reasons why such came to pass. In Canadian terms, a recent survey of 207 companies revealed that CEO compensation increased by 39 percent in 2005, to about $4.3 million. Those who cashed in stock options averaged $4.5 million apiece. According to the Economic Policy Institute the average take in the United States was U.S.$11 million. While many may have reason to challenge the appropriateness of these sums, some of us are also bothered about such things as change-of-control premiums, particularly for conversions into trusts, and allowances paid for such silly things as relinquishing part of one's title. Worse still, most directors are doing little or nothing to recoup these unmerited gains. Though such excesses are characteristic of boom times, when CEO egos often run amok and old-fashion values, like duty, honour, and respect, are cast aside, very few ever take less than they could. Nor do investors concur with the practice of time (versus performance) vesting, backdating, or granting additional stock options at still lower prices to senior executives whose company's shares have fared rather poorly, whether they be impacted by bad management decisions, a bear market, or both. If the mucky-mucks honestly feel the time is ripe to buy more shares, they, like any other investor, should simply step up to the plate and do so with their

own money. While it may be true that many of the killjoys are simply jealous of all this good fortune, and companies may claim that if they fail to pay up key employees will quit, when the going gets tough and the chips are down, it will be too late to challenge executive gluttony. It has already gone way too far!

So it is little wonder the supporters point to SOX as a way to effectively contain conflicts of interest between management and the shareholders if common sense will not do! Obviously, politicians are prepared to respond if the voters come to believe that executive compensation is excessive. The act may also have resulted in a more sensible approach to mergers and acquisitions. The premiums now paid are but half those characteristic of years gone by. Interestingly, recent deals have outperformed the market, whereas the results of earlier takeover booms fell significantly short of projections. It would appear that today's independent directors favour increasing shareholder returns over size of transaction. Their efforts have also had a positive impact in terms of transparency, capital formation, and share price. While the Sarbanes Oxley Act may have its flaws, tinkering around the edges, rather than caving in to its critics, seems to be the better way to proceed in the future. We should also never forget that, were there integrity, there would be no need for such rules!

THE MARKET IS ABLAZE WITH IPOS

With investor confidence on the rise, and not having to comply with the arduous, new accounting and auditing rules that are giving American public companies headaches, the Canadian IPO market is ablaze. This year is shaping up to be the busiest for new issues since before the tech bubble burst in 2000. The downside to this is quite a number of dumb deals, as greedy underwriters turn a blind eye to glaring inadequacies. Therefore, investors need to assume more of the responsibility for due diligence so as not to be sold a bill of goods. In recent years many large initial public offerings were so-called reverse leverage buyouts – underperformers that were bought by private equity firms betting they could be turned around and sold back to the public at a substantial profit. More recently it has been a case of fast-growing upstarts with projections of rapid sales and earnings increases. When promising companies have an easier time forming capital, the economy as a whole benefits, or so they say!

The percentage of profitless new issues fell from 80 percent during the tech boom of the 1990s, to just 40 percent during the bust. The average age of companies going public shot up from four years in 1999, to fifteen in 2002, the year the stock market hit rock bottom and investors were only willing to support those capable of earning their keep. It slipped to eleven in 2005, and it is headed still lower as investor enthusiasm is rekindled, or until the reverse-IPO pipeline starts flowing again. Given the booming private equity market, which is fueling more and bigger leverage buyouts, this phenomenon is set to do so if the stock market continues to do well. As it does, those initial public offerings emphasizing market share growth over cash flow and profits will be squeezed out, particularly if investor confidence weakens and saner heads prevail once again. So rather than wait to have the underwriters clean up their act, investors would be wise to stick to the tried and true, and not put their money into companies or income trusts whose CEOs are having trouble keeping their heads above water!

GETTING THE LAST LAUGH

Ever since I can remember, dual-class equity structures have been a stick in many people's craw, to the point where some have sworn off ever owning one or the other class of shares. Critics have often said that if the CEO needs voting control to stay in power, the company's shares are not worth owning. If he or she does not, there is no need for such shares to exist. While I have definitely had my doubts at times, it seems to me that patient investors like the sense of continuity so provided, the short-fused types do not.

A case in point is Teck Cominco Limited and its bid to take over Inco Ltd. The target company's CEO has come forward to suggest that the acquirer's dual-class share structure is undemocratic, and the nickel producer's investors should take a dim view of the takeover offer as a result. Unfortunately, he is talking with a forked tongue. As those of us with a few grey hairs can attest, Inco's track record is fraught with failure over the past many decades. Teck's, on the other hand, is not. Apart from strong corporate governance policies that guard against abuse by its controlling shareholders, the two consecutive generations of the Norman Keevil family have done a marvelous job creating shareholder wealth. Inco's many successive CEOs have not. While they may have been well-dressed and well-connected to all the right people in high places, they have been a bust when it comes to making money for the shareholders. Funnily enough, many of Inco's shareholders are institutional investors. Most of Teck's are not. So once again the big boys bought the wrong stock. The clued in and patient individual investors will inevitably get the last laugh!

As it now stands, Inco is a day late and a nickel short of remaining an independent entity. So think before you jump aboard as it is tossed from one persuer to the next. Whether or not Phelps Dodge Corp. is successful in acquiring the target company or not, is anybody's guess. Whatever happens you may still be better off owning Teck shares, be they multiple voting or not.