Clime Quality Rating Overview

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Investing is the art of melding the qualitative and quantitative processes together. When an investor decides direct equity investment is appropriate for them, they are making a conscious decision to compete in an intellectual contest against some of the world's best minds and some of the world's worst. Markets are not always efficient, not all investors are rational, the playing field is not always level, access to information not always fair, financial incentives are often not disclosed. Satisfactory results are certainly not guaranteed.

In such a competitive space we need all the edges we can develop to aid our chances of success, after all if we are not beating the market the market is beating us! The key competitive edges investors can focus upon are a view on the business, its Quality and Value derived from a tested and rational approach.

Investing is simple however it is not easy. Just avoiding the poor businesses likely to stumble will greatly improve your chances of achieving above average long term performance. Focusing on strong businesses and purchasing them when Mr Market is in a despondent mood at large discounts to value, holding these shares with appropriate diversification while their quality remains and they do not trade at prices too far in excess of their current intrinsic value is the best approach to investing you are likely to find.

What is quality?

Quality is a somewhat subjective attribute and can be understood differently by different people. Business quality covers both quantitative and qualitative aspects.

Capitalism and business is all about taking risk and making calculated decisions to generate revenue and profits for shareholders. This risk is taken in expectation of higher returns relative to bonds and to protect the purchasing power of capital from the ravages of inflation. Shareholders that put their capital at risk deserve to be rewarded for

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taking that risk.

Company management and company boards should be the guardians of shareholders capital. Far too often, however, we have seen terrible decisions that destroy capital and lead their businesses to struggle under the burden of acquisitions that don't turn out as expected and shackle the acquirer with debt. This often leads to capital raisings or, in the worst cases, administration and liquidation.

Management may then offer every excuse in the book: a bad economy, high interest rates, market volatility, overcapacity, deregulation, competition from offshore, a weak or strong currency, hundred year floods, changes in the tax treatment of agriculture schemes where investors that no longer have 'tax problems' to be 'fixed', all of course very much outside their control. The ultimate cause of failure, however, is usually simply running out of cash with debt often playing a key role.

Fortunately businesses rarely collapse overnight. Signs of weakness are generally apparent well in advance for all to see. Despite the rosy outlook touted by the media, by management and by brokers recommending you buy a stock, a sound framework, a little effort and a disciplined approach will allow the investor to distinguish between the sound stocks and those headed for trouble.

Can quality be measured?

To a large extent, quality is measurable. The audited financial accounts provide our window into management decisions and actions. The accounts show the good the bad and the ugly. A company's accounts tell us all that is needed to spot a weak company that is likely to require a value destroying diluting capital injection or one that has a high probability of failure.

What is the CQR?

The Clime Quality Rating (CQR) is consistent, rational and quantitative. Based on 70 pieces of financial data taken from a company's accounts, the CQR separates companies *on the quality of their financial fundamentals at a point in time and over time.*

Each company has a unique CQR which is calculated twice a year from the audited accounts. The current as well as past CQR appears as a percentage in the Ratios page of the StocksInValue dashboard, while the current CQR is displayed as a 0 to 10 star rating on each valuation screen. *We encourage investors to shop for companies as they would hotels, the more stars the better!*

Score Description
0 - 3 Stars Financially weak, high probability of capital or solvency event. Avoid.
3 - 5 Stars Marginal financial strength, generally sub-investment grade
5 - 7 Stars Reasonable financial strength, possible investment grade
7 - 10 Stars Investment grade, sound financial strength

What does CQR measure?

The CQR is based on decades of academic study – see reading list below. Building on the works of numerous luminaries in the field, which focussed primarily on the balance sheet, we overlay our own views on particular metrics (notably cashflow, profitability & earnings manipulation) aiming to improve the separation of the strong from the weak. A total of 45 ratios are calculated twice a year to look at the performance and solvency of the business and determine the CQR.

Most investor's focus their attention on earnings when they are often best served bypassing the Profit & Loss account and focusing on the cash generating ability of the business. Even if a business is reporting accounting profits, it might be losing money on a cash basis. Strong cash flow gives management the ability to invest in the operations, reduce debt, buyback shares and pay dividends. If the company is spending more than it earns on a continual basis, this is a meaningful cause for concern with the inevitable need to raise capital via debt or equity or call the administrators.

When looking for quality companies we focus on finding businesses that can self-fund and create value without excessive leverage.

Self-funding means the business generates sufficient cash flow from operations to fund investment in the business and the payment of dividends. Creating value is defined as displaying a level of profitability (measured by Normalised Return on Equity) that exceeds a fair required return or discount rate. One dollar of retained earnings is only worth more than one dollar of value when it can be deployed to generate a return greater than one's required return. An ability to consistently self-fund and create value are key attributes of a quality business that we measure not just at a point in time but over time.

Debt is the great accelerator. It aids a company build a new plant, develop a new product or build a store network much faster than otherwise may be the available via retained earnings. Debt can be an accelerator in a negative way, when a business stumbles or the economic conditions take a turn for the worse. In these cases debt becomes a cash drain on a business reducing its financial staying power. When a business defaults on its debts the creditors have full recourse on the assets via a well developed legal framework. We are wary of companies that are overly acquisitive, particularly when using debt to fund acquisitions. We monitor changes in debt, goodwill and equity over time and look poorly on companies where goodwill and debt are increasing much faster relative to equity and profitability.

Cashflow is the life blood of individuals, companies and countries alike. We like to see repeatable cashflow and reward the companies that can display this. Negative cashflow occurs when a business spends more than it generates. If this situation occurs over a number of financial periods, the cash outflow will need to be supported by drawing down any available cash at the bank or available lines of credit. When these options run out, the only choice available to a business is fresh injections of equity (capital raisings). Often this weakness is picked up by the market and the share price is discounted meaningfully. When capital is raised after large share price falls, permanent reductions in value often result.

Companies with strong cashflow are the ones to be attracted too. These businesses have the ability to self-fund growth initiatives and pay healthy dividends to owners. This strength is not lost on market participants over the longer term and is rewarded via share price appreciation.

Earnings can be manipulated. Management make many decisions in the way a company's accounts are constructed. Accounting treatment is often grey rather than black and white. Whilst as minority shareholders we are not privy to the management discussions, we can observe the outcomes in the audited accounts. Poor management decisions can often lead to inappropriate capitalisation of expenses that inflates reported profits and intangible assets incorrectly. In an extreme case this leads to the popular 5 year 'big bath' accounting where a business declares a 'non cash' writedown of intangible assets, correcting the inflated previous profits declared (and taxed), before embarking on the same path of capitalising expenses and inflating profits once again. This is particularly popular when a new CEO takes the chair and is incentivised via options or stock grants.

Other areas of potential earnings manipulation include the relationships between revenue, receivables and inventory growth. Some companies have been guilty of 'front end loading' revenue that then flows through to accounting profits but sits on the balance sheet as receivables rather than arriving as cash flow from operations. There are inevitable timing differences but if this occurs over an extended period management may well be manipulating profits in a bid to keep the markets satisfied. Similarly if inventory is rising at a much faster rate than revenue it may be a sign that management is struggling to sell product and may be forced to discount stock for sale pressuring margins and future profits. In the worst case inventory may need to be written off as obsolete. Again observing this over time is important as at any point in time specific circumstance may be fair and reasonable.

We monitor these areas closely and penalise CQR's where suspect changes are occurring.

What does CQR not do?

CQR is one tool in an investor's tool kit for sensible investment. It aims to steer investors away from financially weak companies and toward financially strong companies. The CQR is based on historical information and is not predictive by nature. The businesses covered will still enjoy and endure their respective business cycles where short term profitability inevitably fluctuates. What investors seek to avoid is buying a weak business at a peak in the business or economic cycle as this all too often leads to capital destructive equity raisings or failure. Investors will be able to identify strong businesses at economic and market low points that will enable the confidence to drive the conviction to buy a stock when many market participants are selling.

Investors must still carry out the work to understand the business, the industry in which it operates and the financial statements it produces. Investors must understand the nature, history and incentives of management. Investors must understand the competitive advantage a business displays and what could occur that would damage its prospects going forward.

The CQR is not appropriate for businesses that make money in the business of money such as banks, finance companies and insurance businesses. The risk to these businesses is not found in the P&L, Balance Sheet or Cashflow Statement.

The key risk to banks is in the credit quality of their loans. If a bank fails to get just 10% of its loans repaid it will likely fail or be nationalised. The main thing a shareholder of a bank needs to know is the likelihood of the bank getting its loans paid back. The other significant risk is a bank run, as banks all hold deposits that are largely at call and lend to borrowers for much longer terms. Banking always has this inherent risk and especially so in times of uncertainty. Banking is a business where confidence is a key solvency indicator, important but not measurable.

With trading banks risks include the all too frequent rouge trader. The business typically finds out well after the fact. Barings Bank, founded in 1762, was once the oldest trading bank in the world until Nick Leeson in the mid 1990's brought it down with unauthorised derivative trading in Singapore.

With insurance companies, shareholders simply have no way of knowing if the business has got its potential liabilities right or wrong. Insurance is an essential business, however akin to gambling in its purest form. All too often the directors of these businesses find out they are insolvent moments before they call the administrator and minority shareholders find out in the press. Investors in these sectors need to be comfortable with these inherent but unquantifiable risks.

These risks are simply not identifiable from the audited accounts or even talking with senior management.

The CQR is suitable for operating businesses that make money in making, selling or providing a product or service for customers.

Who can use the CQR?

Traditionally quality rating tools have been used by banks in assessing the creditworthiness of borrowers, by short sellers looking to identify weak companies before the market so as to profit from selling the shares before buying them back at a cheaper price, and by institutional equity investors to screen a large universe of businesses to provide a short list of opportunities for further investigation.

StocksInValue's data feed now enables us to take an institutional tool, improve it, and make it available to retail investors.

Has CQR been tested?

"Time is the friend of the wonderful company, the enemy of the mediocre." - Warren Buffet

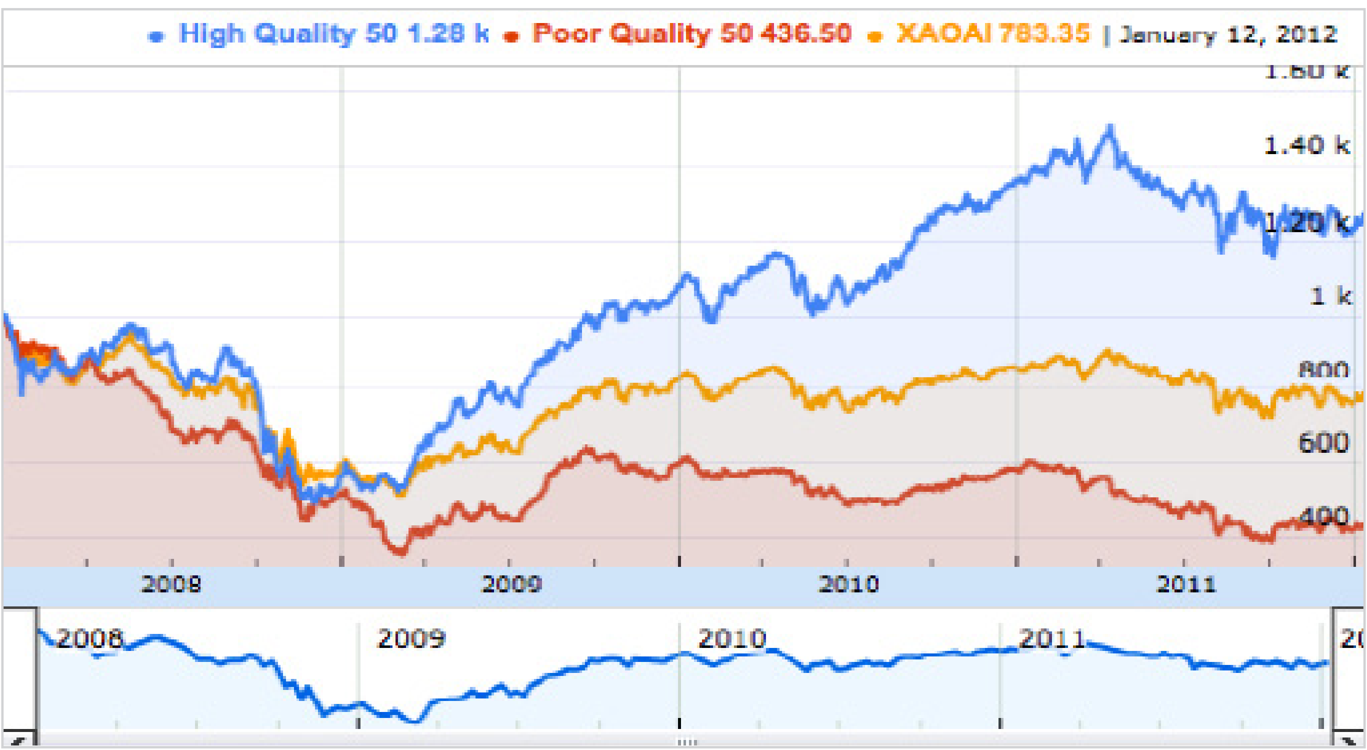
An independent focus on Quality and Value is essential. Investors need to seek businesses that Self Fund and Create Value. These are the keys to long term success and are forged into the Clime Investment Process.

In testing we analysed 10 years of fundamental data for more than 300 companies, separated into three groups. The evidence is clear, owning quality companies counts. It provides capital preservation while producing strong absolute and relative performance over the medium to long term - the goal of any investor.

We have constructed two equal weighted indices as a way to generate quality based ideas and track the performance of the process over time. One index titled 'High Quality 50' contains the top 50 CQR scoring businesses available within StocksInValue. The other 'Poor Quality 50' contains the bottom 50 CQR scoring businesses available within StocksInValue.

Each index will undergo rebalancing at the end of each quarter. Constituent inclusion/exclusion is driven by their CQR, with each stock assigned an equal weight.

We extracted the CQR scores for all 300+ companies covered for the years 2008 through to today, sorted each year's scores to find the High Quality 50 and Poor Quality 50 for each year. This was used to rebalance each index in each period. These two indices are then tracked against the All Ordinaries Accumulation index re-based to 1000 points at 1st January 2008.



Observing the performance above it is clear that when the market endures a sharp selloff there is nowhere to hide and indiscriminate selling of quality and value occur by . However when the clouds clear the market cannot keep quality stocks down and they bounce back like a spring recoiling. The poor stocks stay depressed or fail as capitalism purges the inefficient users of equity from the ecosystem, a classic Darwinian process.

As can be seen the High Quality 50 index has outperform over every time period relative to the benchmark. Over a reasonable 3 year period the High Quality 50 outperformance is meaningful relative to the benchmark and in an absolute sense, performance any fund manager strives for but few obtain. The Poor Quality 50 has shown underperformance during each period consistent with our expectation that financially poor quality stocks are likely to produce poor financial returns.

We will continue to monitor these indices over time, update the member companies at the end of each quarter and comment on the contributors to and detractors from performance.

The *'quality premium'*, or difference in return of high quality versus low quality is significant. To outperform the market index investors are wise to focus on 'High Quality' stocks and avoid the 'Poor Quality'. The businesses that fall between the two groups need more attention to pick the stocks likely to outperform.

We conducted in depth analysis into 25 of the most recent corporate failures in developing the CQR platform. The evidence shows that businesses with a low CQR (the average CQR at failure was 8.94%) are at an elevated risk of failure.

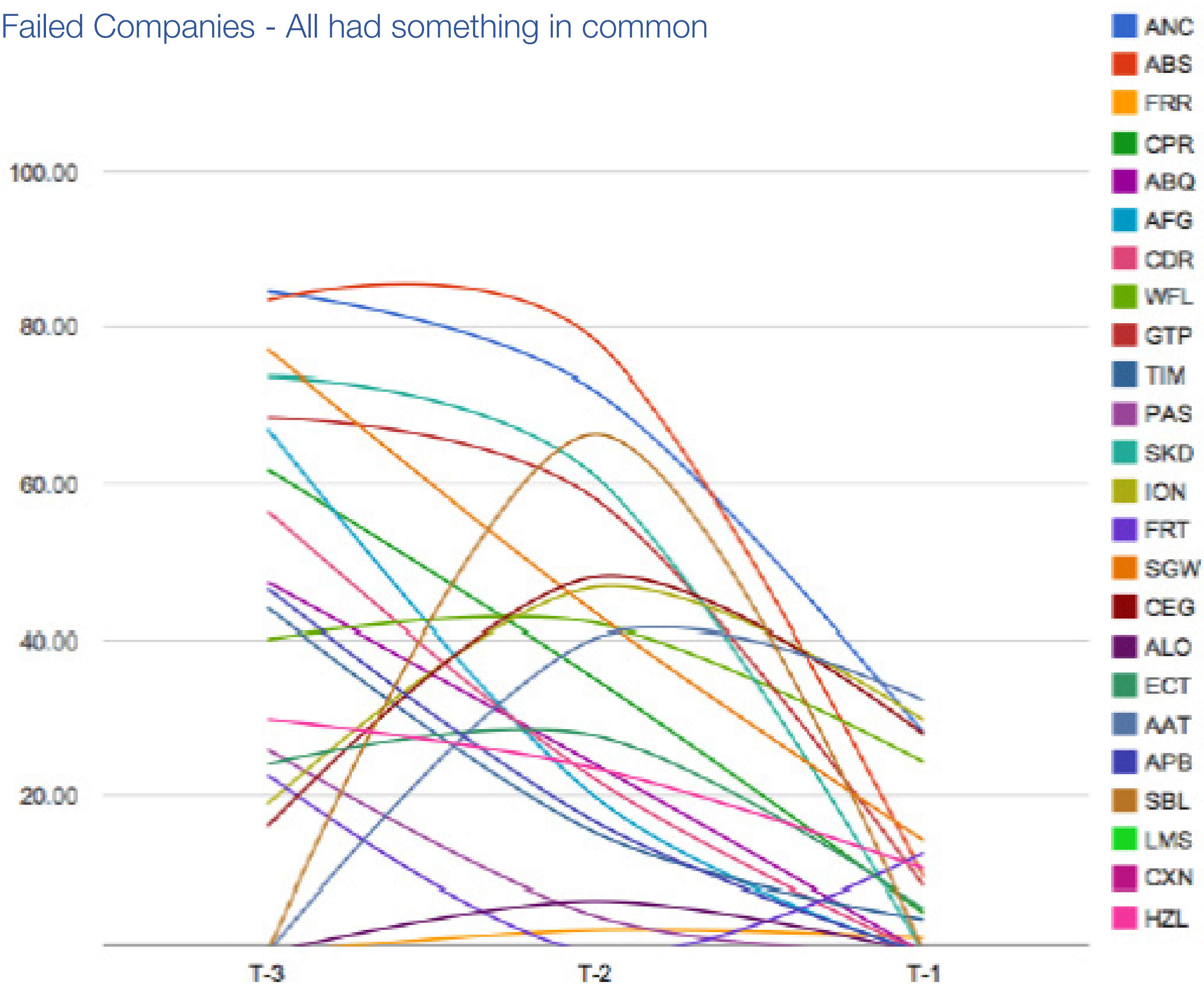
When looking to establish expectations for returns from equities we use a starting point of the 'risk free rate' which is around 5%. We anticipate an 'equity premium' of around 5-6%. Whilst historically observable this 'equity premium' must remain intact if our capitalist system is to survive. Bonds cannot

Average CQR	**2008**	**2009**	**2010**	**2011**
Top 50	87.94%	88.82%	89.85%	89.43%
Bottom 50	13.84%	11.08%	15.77%	12.65%

Total Returns 31 December 2011	**1 Year**	**2 Years**	**3 Years**	**4 years**
All Ordinaries Accumulation	-11.43%	-8.50% -4.35% p.a.	27.83% 8.53% p.a	-24.02% -6.64%
HIgh Quality 50	-10.34%	13.18% 6.39% p.a.	116.01% 29.27% p.a.	22.57% 5.22% p.a.
Outperformance	1.10%	21.69% 10.74% p.a.	88.18% 20.74% p.a.	46.59% 11.86% p.a.
Poor Quality	-28.16%	-29.65% -16.13% p.a.	-19.22% -6.87% p.a.	-58.02% -19.51% p.a.
Outperformance	-16.73%	-21.15% -11.78% p.a.	-47.05% -15.40% p.a.	-34.00% -12.87% p.a.

and should not outperform equities over the long term. Bonds represent contracts that are enforceable via the legal system. Equity on the other hand is permanent capital, has no guaranteed return and thus higher risk. This risk is compensated for via higher longer term returns. When directly investing in equities we seek to capture more than just the long term market return of 10-11%. We seek to capture the 'value premium' by seeking out and investing in undervalued securities. We also want to capture the 'quality premium' that is inherently available in the soundest stocks available on public markets. Over time we believe investors should be able to generate 4%+ returns above the broader equity market.

Failed Companies - All had something in common



Further Reading:

Corporate Financial Distress and Bankruptcy, Edward Altman & Edith Hotchkiss

Edward Altman - Recent Papers

Financial Shenanigans, Howard M. Schilit

It's Earnings that Count, Hewitt Heiserman

Quality of Earnings, Thornton L. O'Glove

The Numbers Game, Trevor Sykes

Where's the money gone?, Andee Sellman

The Art of Short Selling, Kathryn Staley

Creative Cashflow Reporting, Charles Mulford & Eugene Comiskey

Predicting the risk of corporate failure in Australian companies, Bill Wilkinson (doctoral thesis)