

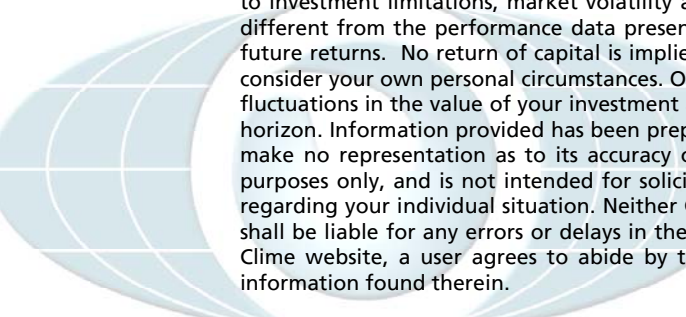
Clime Asset Management Pty Limited
Established 2002

Managing Director
Roger J. Montgomery



How Clime Strives to Generate Returns above the Index

How we Plan to Invest Client's Money



Performance data provided herein relates exclusively to simulated models developed by Clime Asset Management Pty Limited. These models have the same investment objectives as the models utilized by Clime Asset Management for the management of the Private Discrete Portfolio Service and are managed using investment strategies and techniques substantially similar, but not necessarily identical. However, Clime's Discrete Portfolio Service is subject to investment limitations, market volatility and circumstances that may result in performance that is substantially different from the performance data presented herein and as such cannot and should not be used as a guide to future returns. No return of capital is implied. Our services will not be suitable for everybody and we suggest you consider your own personal circumstances. Our objective of strong capital growth means that significant short term fluctuations in the value of your investment are inevitable so all investments should have at least a seven year time horizon. Information provided has been prepared from various sources and data we believe to be accurate, but we make no representation as to its accuracy or completeness. Data and information is provided for informational purposes only, and is not intended for solicitation or trading purposes. Please consult your tax and legal advisors regarding your individual situation. Neither Clime nor any of the data provided by Clime nor its content providers, shall be liable for any errors or delays in the content, or for the actions taken in reliance therein. By accessing the Clime website, a user agrees to abide by the terms and conditions of the site including not redistributing the information found therein.

Securities products and services are offered by Clime Asset Management, a dealer and investment advisor, 103 Beattie Street, Balmain, NSW 2041 (612 9555 9700). Our Services can only be offered by completing an investment agreement and risk disclosure document. For copies, which contain important information including investment objectives, charges, risks, and expenses, contact Clime www.clime.com.au . Read the documents carefully before you invest or send money. Securities are subject to investment risk, including possible loss of principal invested.

Dear Investor,

There is a large and growing body of empirical evidence, collected over statistically significant periods of time, indicating that most equity investment managers have failed to outperform their respective benchmark or index.

In the United States, Professor Burton Malkiel, author of *A Random Walk down Wall Street* and Professor at Princeton University, found that the S&P500 beat 70% of all equity managers retained by pension plans over the 1975-1994, 20-year period. A study by the former Chairman of Capital Guardian Robert Kirby indicated that out of 113 US equity mutual funds that were in business for more than three decades, only 36% beat the S&P500 by any margin and only 20% beat that index by 1% or more per year.

Before rushing headlong to start up an index portfolio it is important to realise that beating the market by even a small margin over long periods of time, can result in substantial outperformance in capital growth as those marginal increments compound. For example, a mere 1% annual outperformance over 20 years can result in 21% more money at the end of the period. Seemingly small improvements in returns per year to the investor can result in substantially different financial outcomes. For this reason Clime Asset Management strives to do two things: firstly, we strive to beat the market by a significant margin; and secondly, we strive to keep costs low. The combination of these two goals should, we believe, serve to result in a larger quantum of the returns we generate being passed directly to the investor - you.

By providing research results of studies into outperformance, conducted by some of the world's best investing names, this short booklet attempts to provide some insight into the factors that can result in outperformance as well as present perspective concerning the year-by-year variability of returns. For example it is useful to know that investing for two years, in companies that have less debt than book value, and Earnings Yields that are at least twice that of the government bond yield, produces an average annual return of 38% (see step 1.). It is however imperative to know that returns from this strategy can vary significantly from year to year and may even produce substantial losses in individual years.

Morningstar, one of the best-known mutual fund research and rating services, analyzed the asset growth and total returns of 219 U.S. stock funds, tracked over a five-year period ending May 31, 1994.

Morningstar compared each fund's average annual return, which it called the **Investment** return, with the return on the average dollar that was actually invested, which it called the **Investor** return. The investment return, then, is the total return of the fund while the investor return is the return that people actually earned based on when they bought and when they sold.

The study's average annual **investment** return over the five years was a positive 12.5%, but the average annual **investor** return was a negative 2.2%. How could investors have lost money when the investments themselves made money?

The answer is simple. Investors bought their funds after hearing that they did well (meaning they bought when the price was high) and then panicked during market declines, thereby selling when the prices were low. When the market picked up again, investors jumped back in.

If the average annual return produced by a strategy over a long period of time is 38%, the only investor who can hope to obtain such a return is the investor who follows that strategy for a similarly long period of time.

This booklet goes some of the way to explaining the methods and the strategies we intend to implement with our clients' money, but it also serves as a ready-reckoner of the essential elements to long-term successful investing and the bumps to expect along the way. If this booklet serves to keep you on your path, especially when there are some bumps, then we at Clime have served you well.

Yours Sincerely
Roger J. Montgomery
Managing Director
Clime Asset Management

“To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights or inside information. What’s needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework.”

Warren Buffett,
Benjamin Graham, *The Intelligent Investor* HarperCollins, Fourth Revised Edition, 1973

1. Invest in companies with characteristics that have produced market-beating performance in the past.

There is an enormous and growing body of research based on various approaches to investing in groups of securities with common selection characteristics – the approach which we use at Clime. The earliest work appears to be that of Benjamin Graham, the author of the 1930’s classic *The Intelligent Investor* and perhaps infamously, the lecturer at Columbia University of the star pupil, Warren E. Buffett. Benjamin Graham tested a strategy that involved the purchase of stocks priced at 66% (2/3rds) or less of a company’s underlying current assets (cash, receivable and inventory) net of all liabilities and claims senior to a company’s stock (current liabilities, long-term debt, preferred shares, provisions for tax and other provisions). For example, if a company’s current assets are \$4.91 per share and the sum of current liabilities, long-term debt, preferred shares, provisions for taxation is \$4.41 per share, the net current assets would be 50 cents per share. Graham would pay no more than 2/3rds of 50 cents or 33 cents per share. Graham reported that the average return, over a 30-year period, on diversified portfolios of his “net current asset” stocks was about 20% per year.

Net Current Assets

In an article in the *Financial Analysts Journal*, Nov-Dec 1986, “Ben Graham’s Net Current Asset Values: A Performance Update”, Henry Oppenheimer, an Associate Professor of

Finance at the State University of New York, examined the investment results of a strategy that bought stocks selling at or below 66% of net current asset value during a 13 year period from December 31, 1970 through December 31, 1983.

The study assumed stocks were purchased on December 31 of each year, held for one year and replaced on December 31 of the subsequent year by stocks meeting the same criteria on that date. During the test, the number of stocks held in any year varied from 18 to 89 companies. The mean return for the 13-year period was 29.4% per year versus 11.5% per year for the NYSE-AMEX Index. One million dollars invested in the model on December 31, 1970 would have increased to \$25,497,300 by December 31, 1983 compared to \$3,729,600 for the NYSE-AMEX Index. The study also compared the results of firms within the Net Current Asset companies that operated at a loss to those operating with positive earnings; 31.3% per year for the unprofitable companies and 28.9% per year for the profitable companies.

High Dividend Yield

Chairman and CEO of O’Shaughnessy Capital Management, Inc. in the United States, James O’Shaughnessy examined the investment results of stocks selling with high dividend yields from the period December 31, 1952 to December 31, 1996. Large Stocks were selected, being those with a market capitalization greater than the

Compustat database average or approximately the top 16% of the database by Market Capitalisation. The 50 highest yielding stocks were purchased and held for one year and replaced on December 31 the following year, at which time the stocks representing the 50 highest dividend yielding stocks were selected again. The mean return for the 45-year period was 13.43% per year versus 13.23% per year for the all-stock universe. One million dollars invested in the model on December 31, 1951 would have increased to \$290,239,785 by December 31, 1996.

In the 1998 Edition of *What Works on Wall Street*, James O'Shaughnessy commented on the technique:

"...Indeed, in the multifactor section, we'll see that when other criteria are included – such as strong cash flows, large sales, and large numbers of shares outstanding – large stocks with high dividend yields offer the best risk adjusted returns available."

Michael Keppler examined the relationship between dividend yield and investment returns for companies throughout the world in "The Importance of Dividend Yields in Country Selection", *Journal of Portfolio Management*, winter 1991. Keppler's study assumed an equal weighted investment each quarter in each of eighteen Morgan Stanley Capital International equity indices (including Australia) over the 20-year period, December 21, 1969 through December 31, 1989. Each quarter, the country indices were ranked according to dividend yield and sorted in four quartiles. The total investment return was measured for each of the four groups over the subsequent three months.

The study indicated that the most profitable strategy was investment in the highest yield quartile. The compound annual investment

return for the countries with the highest yielding stocks was 18.49% in local currencies over the twenty-year period. The least profitable strategy was investment in the lowest yield quartile.

High Dividend Yield Market Leaders

James O'Shaughnessy examined the investment results of stocks selling with high dividend yields from a Market Leaders selection pool or universe. The Market Leaders were companies that came from the Large Stocks database, have more shares on issue than the average company, have cash flow per share exceeding the average of all stocks and have sales that are 1.5 times the average. As before the top 50 yielding stocks were held for one year and replaced with the top 50 yielding stocks at the beginning of the subsequent year. The mean return for the 44-year period was 16.68% per year versus 13.11% per year for the large stock universe. Fifty thousand dollars invested in the model on December 31, 1951 would have increased to \$51,737,915 by December 31, 1996 compared to \$12,779,536 for the Large Stock Universe.

Low Debt, High Earnings Yield

Henry Oppenheimer, in "A Test of Ben Graham's Stock Selection Criteria", *Financial Analysts Journal*, September-October 1984, examined the investment performance of the high Earnings Yield (EPS/Price) stock selection criteria developed by Benjamin Graham. Benjamin Graham's stock selection criteria called for the purchase of securities of companies in which the earnings yield (earnings per share/price) was at least twice the AAA bond yield, and the company's total debt (i.e. current liabilities and long-term debt) was less than its book

value. Graham also suggested that each security that met the selection criteria, be held for either two years, or until 50% price appreciation occurred, whichever came first.

Screening securities on the NYSE and AMEX on March 31 of each year from 1974 through 1980, an investor who followed the approach would have received a mean return of 38% compared to 14% per year, including dividends from the market index.

At Clime Asset Management we believe consistently adhering to a strategy that involves choosing companies with historically market-beating characteristics, holding those companies' shares for periods of at least one year and rebalancing using an equal-weighting methodology provides the opportunity to beat the market over long periods of time. Each of the above studies focused on characteristics that would produce a list of companies that would be described as 'value' stocks. To that extent Clime Asset Management may be described as following a value approach to investing. Clime Asset Management however also believe that growth is essential to long term success and so the approach adopted by Clime does include measures of a company's internal performance that are believed to contribute to growth.

In each of the above studies, only James O'Shaughnessy provided information beyond the long-term average performance. For the remainder, no information about the consistency of returns has been provided. For example the variation in annual returns is not provided nor is the magnitude or length of a period of losing years or underperformance. For example, was the performance boosted by an earlier but very short period of very strong outperformance followed by decades of underperformance? Only James O'Shaughnessy's studies provided this

information and for the "50 highest yielding stocks from Market Leaders", the strategy's compounded annual return outperformed in 64% of annual periods, 85% of 5 year periods and 97% of ten year periods.

It is essential to be aware that studies examining the correlation between securities possessing a common characteristic, or combination of characteristics, and investment returns **cannot be relied upon as a guide to future returns.** Nevertheless there have been patterns and relationships over very long periods of time, that suggest some insight can be provided into the strategies or investment techniques that *may* lead to investment outperformance.

It is certainly the intention of the management at Clime Asset Management to own companies that possess one or more of these characteristics and others that have previously been associated with excellent returns.

Market Capitalisation and Liquidity

We have been able to produce simulated results that significantly outperform the markets in many different ways, using portfolios constructed by way of factor models. Some of the highest results however are moot. For example, between September 30, 2001 and September 30, 2002, the ASX S&P 300 Index fell 6.4%. Selecting the top 15 industrial companies by earnings yield produced a capital return of 23%. Some of the companies in the portfolio however were trading at less than 5 cents and with a market capitalization of less than \$1 million dollars. Such results are difficult to replicate in reality, simply because depth and illiquidity prevent the purchase and sale of a meaningful quantity of shares at the desired price.

All factor models developed and implemented by Clime focus on larger capitalization companies and must necessarily take depth and liquidity into consideration.

2. Invest For the Long Term

Investing in the share market is different to investing in cash or in property. With cash you never see the balance fall (unless you make a withdrawal) and with property, because the price doesn't fluctuate on a screen minute by minute, you don't see the price of your property actually dropping. If, however, you were to auction your home every weekend or even every day, you would probably notice frequent variations in the price of the property. Shares are different. Shares represent part ownership or parcels of a business and because those parcels are bought and sold by individuals with different financial needs and in different financial circumstances, the prices reflected by the trading of those shares may change dramatically, sometimes without any changes to the underlying business. For this reason short term movements in shares are often random. In the short term price movement is based largely on expectations, but over the long term price changes reflect the realization or otherwise of those expectations. Basing or measuring performance over short time frames – one year or less – becomes largely irrelevant.

Table 1.1 demonstrates that the probability of outperformance lies with shares over longer periods. While the past is not an indication of future returns, the historical results suggest that being an owner of a business is preferable to being a lender to one. The results also clearly demonstrate that the longer the time frame the greater the balance of probabilities, that shares will outperform.

Table 1.1

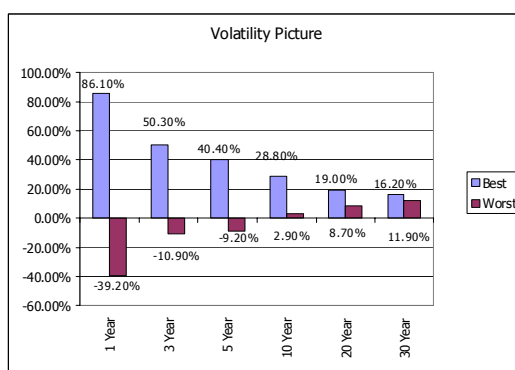
Frequency of Outperformance
Jan1, 1950 - Dec 31, 2000

Length of Period (years)	Australian Shares	10 Year Bonds	Cash	5 Year Term Deposits
1	55.60%	21.60%	13.80%	9.00%
3	61.00%	16.50%	17.20%	5.40%
5	70.90%	14.80%	13.00%	1.30%
10	68.80%	21.70%	9.50%	0.00%
20	97.60%	1.90%	0.50%	0.00%
30	100.00%	0.00%	0.00%	0.00%

Source: AndexCharts Pty L.td

Investing in the share market over longer periods of time also results in declining volatility of returns when those returns are averaged over the life of the investment. As figure 1.1 reveals, using data from 1950 through December 2000, the magnitude of swings between gains and falls decreases as the time frame is extended. When Warren Buffett and Charlie Munger said that over the long term '*volatility takes care of itself*', this is what they were referring to.

Figure 1.1



Source: AndexCharts

Finally, some things simply take time. The benefits of compounding require time to weave their magic on account balances no matter how great the talent or the effort. As Warren Buffett once quipped: "*You cannot make a baby in one month by getting nine women pregnant.*"

3. Expect Short Term Under-Performance

Under-performing an index 30% to 40% of the time is a normal part of long-run investment success. In Columbia University's *HERMES* magazine, spring 1986, an article entitled "Are Short-Term Performance and Value Investing Mutually Exclusive? The Hare and the Tortoise Revisited", V. Eugene Shahan analysed the investment records of seven investment managers with exceptional long-term track records, which were described in a well-publicised article by Warren Buffett, "The Superinvestors of Graham-and-Doddsville", *HERMES*, Magazine of Columbia Business School Autumn, 1984. Each manager mentioned in the article followed a value-oriented approach to investing and had investment returns that exceeded either the Dow Jones or the broader S&P500 by between 7.7% and 16.5% per year over periods ranging from slightly longer than 13 years to 28 years. Notable was that none of the seven managers outperformed the market each year. Six of the seven managers underperformed either the Dow Jones or the S&P500 from between 22.1% to 42% of the years covered. The average period of underperformance was 33.3% of the time. Outperforming the index 60-70% of the time for these managers should be considered normal. Unfortunately there is no way of distinguishing an underperforming manager who will turn around and outperform from one who will continue to underperform. Consistency in the approach however is part of the key.

See also Appendix 1. Benjamin Graham's "Mr. Market"

4. Own Fewer Stocks

"Wide diversification is only required when investors do not understand what they are doing."

Warren E. Buffett

Diversification is important, however diversification must not become an end in itself. Positive, absolute returns are obviously the goal, so it is important that diversification be adopted for the purpose of improving returns. We don't diversify for it's own sake.

The economist John Maynard Keynes wrote a letter to a business associate, F.C. Scott, on August 15, 1934 and said: *"...It is a mistake to think that one limits one's risk by spreading too much between enterprises..."*

Robert Hagstrom of the Legg Mason Value Trust in the US and author of *The Warren Buffett Portfolio* (J Wiley & Sons 1999), conducted groundbreaking work on the benefits of what is described as "focus" investing.

Hagstrom's* study of 12000 randomly selected portfolios, evenly divided amongst portfolios with 250, 100, 50 and 15 shares, looked like this:

3,000 portfolios containing 250 stocks
3,000 portfolios containing 100 stocks
3,000 portfolios containing 50 stocks
3,000 portfolios containing 15 stocks

The results were surprising. After calculating the average annual return for each portfolio over 10 years and 18 years Hagstrom discovered the average return for each portfolio was about the same: 13.75% for the 15 stock portfolios rising to 13.91% for the 250 stock portfolios.

Startling however was the maximum and minimum returns from each of the groups.

Hagstrom's results were as follows (10 year period 1987 – 1996)*;

	Min RoR	Max RoR
15 Stock Portfolios	4.41%	26.59%
50 Stock Portfolios	8.62%	19.17%
100 Stock Portfolios	10.02%	18.32%
250 Stock Portfolios	11.47%	16.00%

(18 year period 1987 – 1996)

	Min RoR	Max RoR
15 Stock Portfolios	8.77%	25.04%
50 Stock Portfolios	13.56%	21.80%
100 Stock Portfolios	14.71%	20.65%
250 Stock Portfolios	16.04%	19.20%

From Hagstrom's work it appears obvious that the 15-share portfolios offer the best possible returns and conversely the worst possible returns. A little further analysis however by Hagstrom helped to more accurately define the picture. By comparing returns to the broader market and by examining the question of diversification from a probability perspective, Hagstrom has enabled all investors to reconsider the extent of diversification required.

Here is what he found:

Out of 3,000 15-stock portfolios,
808 beat the market

Out of 3,000 50-stock portfolios,
549 beat the market

Out of 3,000 100-stock portfolios,
337 beat the market

Out of 3,000 250-stock portfolios,
63 beat the market

Hagstrom submitted the above results as "convincing evidence" that the probability of beating the market, goes up as the number of stocks in a portfolio goes down.

Finally Hagstrom noted that his study did not factor in transaction costs, which, with a 250-share portfolio would be significantly higher than a 15 stock portfolio. These higher transaction costs would make it even more difficult for the more broadly diversified portfolios to beat the market.

There were a higher number of 15-share portfolios that beat the market and it was the 15-share portfolios that offered the best average return and the highest overall return.

In the *Journal of Finance*, another study conducted by JL Evans and SH Archer revealed that the benefits of diversification (lower beta et al.) continue to accrue as more stocks are added to a portfolio. These benefits however cease to accrue at a significant rate after 15 different companies are added to a portfolio.

The more stocks you add to a portfolio, the lower the volatility. Eventually, when you could own as many stocks as the index, your portfolio would look exactly like the index and so there is no volatility over and above that generated by the index itself. Importantly however it is essential that you understand your portfolio WILL NOT beat the market. True, it won't do worse but it cannot do better.

5. Stay fully Invested

Empirical research locally and worldwide has revealed that a large part of investment returns comes from a small period of time. Indeed some studies show that 80%- 90% of investments returns have come from less than 10% of the total length of time of the holding period.

The twenty years between January 31, 1981 and the final quarter of calendar 2001, the All Ordinaries Accumulation Index produced an average annual compounded return of 12.11%. Removing the 10 best performing months produced a return of just 7.20% per annum. A \$100,000 investment without the ten best performing months produced \$423,815. A buy and hold investment over the same time frame, which included the 10 best performing months produced a total return of \$1,071,816.20, 153% more than missing the ten best months. More dramatically, between December 31, 1991 and December 31, 2001, the All Ordinaries Accumulation Index produced an average annual compounded rate of return of 7.36%. Missing the 10 best performing **days** (easy to do if you are attempting market timing) produced a return of just 3.63%p.a. Less than half of 1% of all the days produced almost 51% of the returns.

6. Expect greater than market volatility

A portfolio of fewer holdings, necessary to provide the opportunity to produce significant excess performance, produces higher volatility than the market from which it is constructed. This volatility is the finance academic's measure of risk. Risk for finance professionals is the value of the volatility compared to the market - the portfolio's relative volatility - and is referred to as *beta*. Many managers concern themselves greatly with minimizing it but forget that the dictionary's definition of risk is quite different from their own. Surrounding beta, managers build complex but arcane investment and capital allocation theories forgetting that beta produces absurdities. A company whose intrinsic value is \$100 million is certainly a more mouth-watering purchase at \$20 million than at \$50 million even though the beta has risen and the shares have supposedly become 'riskier'.

The strategy we adopt precludes us from following the standard theories and maxims associated with reducing 'risk' through diversification and as such our peers may describe our process as 'riskier'. But volatility produces opportunities to purchase companies whose shares fall to historic lows and we posit that it is better to pay \$1.00 for 50 cents of earnings than it is to pay \$10.00. Only volatility can provide the contrarian or value investor with the inputs required to generate excess returns and by marrying the strategy to a truly long-term view, we believe the combined opportunity may indeed reduce the [dictionary definition of] risk.

7. Keep overheads low

It is with a great deal of interest that we approach our research. We are particularly interested in generating very high returns on small amounts of capital. When selecting a researched investment program for implementation however, the program that produces the highest return must not tempt us. For example, a trading program that buys and sells the Dow Jones index and produces a return of 15% per annum is of little use, if buying and holding the same index returns 12% per annum. After transactions costs are taken into consideration, including brokerage, slippage and gaps, the trading strategy will produce sub optimal returns and certainly a great deal more anxiety than the simple buy and hold approach. We approach the operation of our business the same way. If we can aim to generate 15% returns with a small office, four staff, four computers and one photocopier, why should we aim to produce 16% with 100 staff, dozens of computers and glamorous corporate offices? After taking those costs into account, our investors would be worse off.

The following account by our acquaintance, Mr. Brian McNiven after viewing a videotaped excursion through the offices of Buffett's Berkshire Hathaway should be remembered when figuring what your management fees are paying for:

"...He opens each door off the corridor to reveal an executive's office, which is no bigger than a generous broom closet. Some of the desks are simply a raised bench, about half a metre wide. The sparsely furnished boardroom is tiny. The cheap looking table and chairs look like they were trade-ins at Mrs. Blumkin's (Mrs. B) Nebraska Furniture Mart, which Berkshire now owns. The piece de resistance jammed into a corner is a Coca-Cola dispensing machine, which appeared to be of the coin operated variety. The width of the boardroom is such that it seemed that one would need to be quite nimble to squeeze into a chair between the wall and the table. Perhaps it was just an optical illusion. Yes, one definitely gets the impression that overheads are under control at Berkshire... one could not help drawing a comparison to Coles Myer's (a tiny company compared to Berkshire) head office nicknamed 'Starship Galactica' for its spacious luxury and splendour. One could not help being reminded that corporate culture, good and bad, is established at the top and in permeating through to the core of every business decision, manifests itself in the performance of the business."

B. McNiven *A Wonderful Company at a Fair Price*, 2002 John Wiley & Sons

At Clime our offices are also spartan. Banks of live-blinking screens, squawk boxes and electronic ticker tapes are eschewed, making room for foldable chairs used in the in-house workshops designed to explain to investors our methods and philosophy. The patient quantitative approach requires no live data feeds or subscriptions to expensive news services reporting every minute's changing sentiment. By removing these things we also

remove the temptation to gamble and instead focus on the business of long-term investing.

8. Forget the index

Josef Lakonishak PhD, University of Illinois, in a paper entitled *What Do Money Managers Do?* states:

"the process of selection and evaluation of money managers may actually distort their investment strategies."

Judging and rating managers, particularly over a short time frame such as three or six months or a year, forces those money managers to group their stock picks towards the median of the benchmark to avoid tracking error (diversion from that benchmark). In so doing, sticking to popular stocks makes outperformance almost impossible. In the United States, Robert Kirby, former Chairman of Capital Guardian was once quoted as saying "if you look like the benchmark you can't beat the benchmark".

The investor who seeks to beat the benchmark must first seek to create their own. It is often said that beating the benchmark is difficult, if not impossible because the index is always invested in the best performing sector. This is true. In order to be true however, the converse must also be true - beating the benchmark simply requires the removal of the worst performing sector.

Quantitative models that hold companies for at least one year may be considered by some to reflect indecisiveness. These people see activity as decisive. Activity however raises transaction costs. More importantly, we hold our companies because we like what we own and besides, predicting which

sector will outperform or underperform, especially in the short term, is impossible.

Benchmarking is important for managers with business risk. Business risk in money management firms is the risk that the business suffers because investors withdraw their funds. Investors will withdraw, if the manager is being rated publicly every three months and fails to outperform the index or significantly underperforms it over this time, investors will become suspicious and terminate the manager. And so it is the investor, with a short-term outlook, that forces the manager to index his portfolio, reducing tracking error and providing little hope of outperformance.

The focus portfolio approach – owning fewer shares - involves much higher tracking error. There is a strong possibility that in the short term, underperformance will occur. Without the tracking error however, it is impossible to significantly outperform over long periods of time – and that to us is significantly more important. By accepting the short-term risk of underperformance, we attempt to avoid the long-term risk of underperformance. Understandably this approach will not suit all investors. Those who require funds for personal use in the short term – 5 years or less, should consider the above remarks before investing in a quantitative focus manager such as Clime.

9. Keep transactions down

Transaction charges are a thief, stealing precious percentage points from returns. Brokerage, bid/offer spreads and slippage are all directly correlated to trading activity. As one increases trading activity, the returns required to offset these increased costs must also rise and indeed these costs can amount to fully 10% of earnings produced by the holding. Reducing transaction activity forms

part of the quantitative approach we intend to adopt with our client's funds and through its consistent implementation a greater quantum of the markets return may be returned to our investors. Perhaps the low transaction approach is best summed up by Warren Buffett who said: *"Lethargy bordering on sloth remains the cornerstone of our investment style"*.

10. Focus (stocks not bonds or cash)

We are by nature contrarian investors. Being contrarian – swimming against the tide - is riskier than swimming with the crowd. There is security in numbers and being wrong along with everyone else, is less expensive personally and professionally than being out on your own. But contrarian investors we are. We are excited when QBE falls from \$11.00 to \$3.30; we are thrilled to hear that the Dow Jones has dropped 5% overnight. For us it simply means we can buy 50 cents of earnings cheaper than the day before. In Australia when petrol is discounted, drivers queue, when retailers hold their annual stocktake sales, throngs of shoppers turn up and if beer was half price you can be sure of generating pedestrian traffic. Interestingly when shares fall 50% many investors turn away from the market all together. We prefer to follow a strategy that forces us to invest in companies producing good dividends and potential for growth at cheap prices. By focusing on this approach year after year, we believe outperformance will come.

We focus on shares. We don't invest in cash, junk bonds, hybrids, premium income notes, bonds or anything else.

When the global economy is uncertain, people can be tempted to put their investments into cash. Although all

investment portfolios should include some cash for diversification, too much cash can be a mistake. Returns on cash have been at record lows for years. Moreover, returns from cash are easily eroded by inflation and tax. While in the short term it may seem safe to

hold cash, over the long term such a strategy seems to us incredibly risky.

Appendix 1.

"Ben Graham, my friend and teacher, long ago described the mental attitude toward market fluctuations that I believe to be most conducive to investment success. He said that you should imagine market quotations as coming from a remarkably accommodating fellow named Mr. Market who is your partner in a private business. Without fail, Mr. Market appears daily and names a price at which he will either buy your interest or sell you his.

Even though the business that the two of you own may have economic characteristics that are stable,

Mr. Market's quotations will be anything but. For, sad to say, the poor fellow has incurable emotional problems. At times he feels euphoric and can see only the favorable factors affecting the business. When in that mood, he names a very high buy-sell price because he fears that you will snap up his interest and rob him of imminent gains. At other times he is depressed and can see nothing but trouble ahead for both the business and the world. On these occasions he will name a very low price, since he is terrified that you will unload your interest on him.

Mr. Market has another endearing characteristic: He doesn't mind being ignored. If his quotation is uninteresting to you today, he will be back with a new one tomorrow. Transactions are strictly at your option. Under these conditions, the more manic-depressive his behavior, the better for you.

But, like Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice: Mr. Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom that you will find useful. If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence. Indeed, if you aren't certain that you understand and can value your business far better than Mr. Market, you don't belong in the game. As they say in poker, "If you've been in the game 30 minutes and you don't know who the patsy is, you're the patsy."

Ben's Mr. Market allegory may seem out-of-date in today's investment world, in which most professionals and academicians talk of efficient markets, dynamic hedging and betas. Their interest in such matters is understandable, since techniques shrouded in mystery clearly have value to the purveyor of investment advice. After all, what witch doctor has ever achieved fame and fortune by simply advising, "Take two aspirins"?

The value of market esoterica to the consumer of investment advice is a different story. In my opinion, investment success will not be produced by arcane formulae, computer programs or signals flashed by the price behavior of stocks and markets. Rather an investor will succeed by coupling good business judgment with an ability to insulate his thoughts and behavior from the super-contagious emotions that swirl about the marketplace. In my own efforts to stay insulated, I have found it highly useful to keep Ben's Mr. Market concept firmly in mind.

Following Ben's teachings, Charlie and I let our marketable equities tell us by their operating results – not by their daily, or even yearly, price quotations – whether our investments are successful. The market may ignore business success for a while, but eventually will confirm it. As Ben said: "In the short run, the market is a voting machine but in the long run it is a weighing machine." The speed at which a business's success is recognized, furthermore, is not that important as long as the company's intrinsic value is increasing at a satisfactory rate. In fact, delayed recognition can be an advantage: "It may give us the chance to buy more of a good thing at a bargain price."

(Warren Buffett, Chairman's Letter to Shareholders, Berkshire Hathaway, 1987)