



StockVal informer

Issue 9 - November 2007

"Only buy something that you'd be perfectly happy to hold if the market shut down for 10 years."-

Warren Buffett



StockVal: **INFORMED**

Find out why StockVal is the best value investment tool in the world

The recent market volatility has proven yet again the importance of investing in quality businesses only when their shares trade at cheap prices. But **how do you know when a wonderful business is cheap?**

At Clime Asset Management, we value businesses just like Warren Buffett. Unlike the P/E ratio, which is simply the market price of a company's shares divided by its earnings per share, Buffett's formula does not use price to calculate value.

To accurately estimate the value of a business, and therefore the level below which an acceptable entry price exists, you need to understand how much equity is required to produce the reported profit. While earnings might be growing, it may simply be because you're putting more money in. If a company is retaining profits rather than paying dividends, earnings had better be going up. And if a company is raising capital from shareholders, growing earnings is even more paramount.

Increasing earnings is nothing special. You receive earnings, in the form of interest, from a bank account. You can achieve higher earnings by putting more money into the account.

It's the same in a company. If you put more in, at a minimum, you should be getting more out. The key therefore is not profit, but profitability.

So how do you identify the wonderful companies from the mediocre ones?

Assessing a company's balance sheet is the first step. At Clime, we analyse net profit, return on equity, dividends and capital raisings to calculate intrinsic value.

A wonderful company has a rising return on equity, little or no debt and is able to grow profits without tapping shareholders on the shoulder and asking for more capital.

The next step is to meet with management and determine if their actions are in the best interests of the company and its shareholders. As a private investor, this is not always possible. However, as fund managers, Clime diligently follows a strict investment process to ensure our clients' investments are held in the safety of cash until wonderful investment opportunities are identified.

With StockVal you will:

- Discover what your shares are really worth
- Make more **informed investment decisions**
- Discover undervalued & overvalued ASX listed businesses
- **Reduce your risk** by identifying only quality investments
- **Learn the value of over 400 listed businesses**
- Be certain and successful





StockVal: REVIEWED

Understand our analysts thinking with a review of one of the best managed insurance groups in the industry, QBE Insurance Group Limited. This review was written by Clime Asset Management equities analyst Russell Muldoon on 25 September 2007 and published in Issue 14 of StockVal's fortnightly members newsletter, *Fundamentally StockVal*.

QBE Insurance Group Limited (QBE)

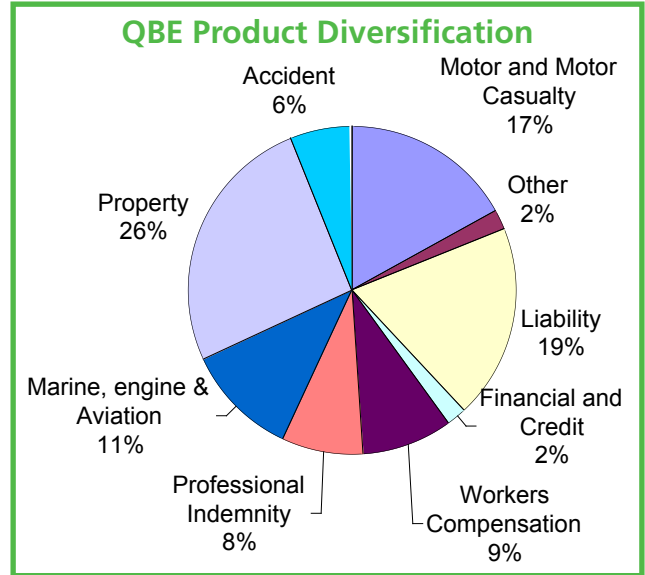


QBE's history all started back in 1886 when a Scotsman by the name of James Burns looked at ways in which he could protect his company's ships and cargo against damage and loss. As a result, The North Queensland Insurance Company was formed. In only four years of operation, Burns' company established 36 agencies across Australia, Hong Kong, London, New Zealand, Singapore and the Pacific Islands. Together with the merchant and shipping endeavours established by his father (Burns Philp), these agencies leveraged local trading economies to become a worldwide force. The company later made a number of landmark acquisitions and finally became known as QBE Insurance Group when Queensland Bankers & Traders Insurance merged with Equitable Life & General. QBE's rapid growth and global expansion has characterised the company's 100+ year journey. Today, QBE is recognised and respected globally.

On Australia's stock exchange, QBE is the largest international general insurance and reinsurance company. QBE operates in 45 countries and employs more than 10,000 staff. In terms of operations, QBE underwrites commercial, industrial and individual insurance policies. It also manages Lloyd's syndicates and provides investment management services to retail and commercial customers alike.

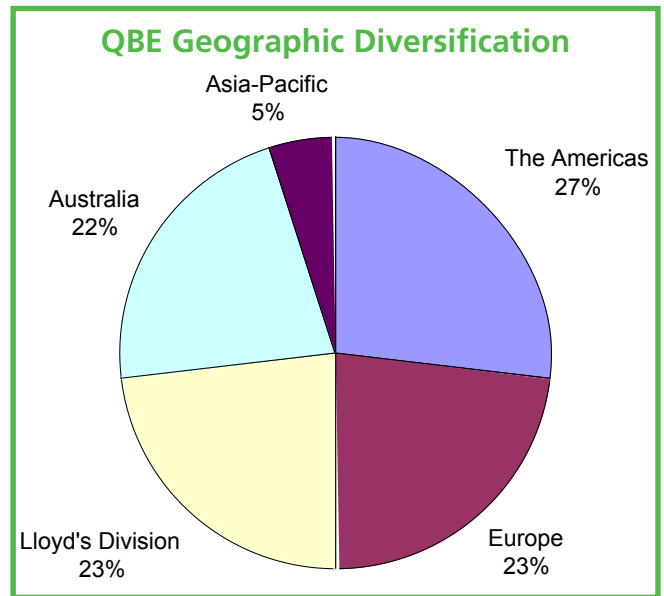
QBE offers a variety of insurance products; from professional indemnity for corporations to general motor vehicle insurance for the public. In deference to the company's roots (shipping and cargo), it also continues to offer Marine and Engine insurance.

Graph 1



As expected for a global company, QBE offers these products in formidably competitive and cyclical markets. In Australia, the company's primary competitors are Insurance Australia Group (IAG), Suncorp, CGU and Allianz. Through a range of growth initiatives though, the company continues to operate as a leader in its field. Most recently, QBE acquired Praetorian Financial Group, Winterthur US and Seguros Cumbre SA de CV; a small Mexican insurance company. Combined, these are expected to produce over \$3.6 billion of premium income in the first full year.

Graph 2



Insurance Economics - The Insurance Cycle

In the absence of large payout events, insurance companies generate high underwriting profits. As these profits from the previous year are put to work underwriting new business – the result is greater competition, lower insurance premiums and lower underwriting profits. Then along comes a catastrophe and the marginal players suffer while the larger participants ratchet up premiums and the cycle begins again.



Table 1

	2002	2003A	2004A	2005A	2006A	2007F	Totals
Amortisation of Goodwill		20.0	22.0	3.0	0.0	0.0	45.0
Abnormal Gains (Loss)		-109.0	-400.0	-32.0	44.0	0.0	-497.0
Net Profit inc. Abnormals less Pref Divs		572.0	820.0	1,091.0	1,483.0	1,951.0	5,917.0
Dividends on Ordinary Shares Only		244.0	276.0	427.0	614.0	944.0	2,505.0
% of Dividends Franked		22%	40%	50%	55%	49%	
Grossed up Dividends		267.0	323.3	518.5	759.3	1,140.2	3,008.3
Opening Equity		2,621.0	3,254.0	3,924.0	4,985.0	6,175.0	2,621.0
Retained Profits		328.0	544.0	664.0	869.0	1,007.0	3,412.0
Change in Reserves		-109.0	-400.0	-21.0	66.0	0.0	-464.0
New Ordinary Share Capital		414.0	526.0	418.0	271.0	967.0	2,596.0
Ordinary Capital Buybacks		0.0	0.0	0.0	16.0	0.0	16.0
Closing Ord. Equity Ex Minorities	2,621.0	3,254.0	3,924.0	4,985.0	6,175.0	8,149.0	8,149.0
Normalised IRR Cash Flows	-2,621.0	-147.0	-202.7	100.5	504.3	8,864.2	6,498.3
Normalized Earnings		615.0	889.3	1,196.5	1,650.3	2,147.2	6,498.3
Normalized ROE		21.7%	25.3%	28.9%	32.3%	32.2%	28.1%

Insurance Economics - The Basics of Float

Float is money that doesn't belong to the insurer but is temporarily held. Float arises because premiums are paid upfront though the services provided – namely insurance protection – but delivered over a period that usually covers a year and; (2) loss events are not immediately compensated through paying claims, as it sometimes takes many years for losses to be quantified, reported, negotiated and settled.

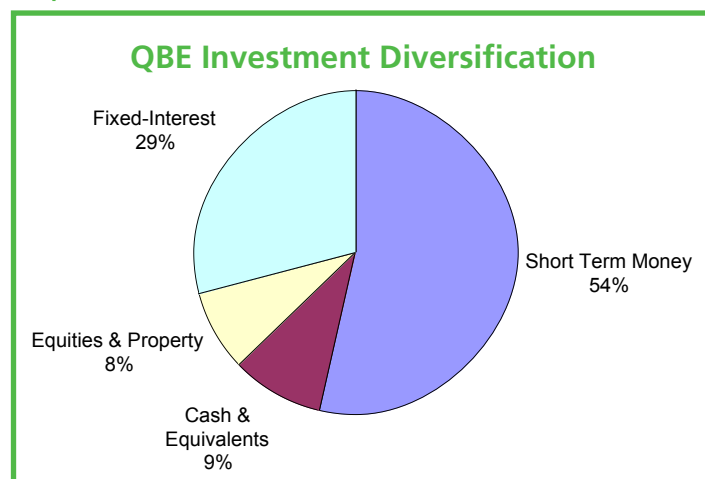
According to Warren Buffett; "Float is wonderful - if it doesn't come at a high price." The cost of float is determined by underwriting results – either profits or losses - the difference between premiums received and expenses and losses that are ultimately paid. When an underwriting profit is achieved the float is free or better than free. When an underwriting profit is achieved, an insurance company is actually paid for holding other people's money. Its better than a bank.

According to Warren Buffett, insurers have generally earned poor returns for a simple reason: "They sell a commodity-like product. Policy forms are standard, and the product is available from many suppliers, some of whom are mutual companies ("owned" by policyholders rather than stockholders) with profit goals that are limited."

"Moreover, most insureds don't care from whom they buy. Customers by the millions say "I need some Gillette blades" or "I'll have a Coke" but we wait in vain for "I'd like a National Indemnity policy, please." Consequently, price competition in insurance is usually fierce. Think airline seats."

From an internal perspective, QBE mitigates and minimises its own business risk by utilising reinsurance contracts. In keeping with this low-risk theme, the company has relatively low exposure to equity markets through its investment books, as shown in graph 3.

Graph 3



QBE's retail clients generally deal directly with one or more of the company's ubiquitous service centres. Conversely, most corporate and government customers transact through agents or insurance brokers. Whilst loyalty of the company's retail and commercial customers is a monument to the company's legacy, sponsorship also forms a large part of QBE's brand awareness and public exposure.

Business Performance

Table one provides a clear insight into the underlying economics of QBE, including a forecast as to how the business is expected to perform in 2007. We begin in 2002 with a global insurance business comprising \$2,621 billion dollars in shareholders equity (net assets).

This equity was invested in various resources (i.e. people, furniture, computers, and buildings, policies) - all those resources required in carrying on the operations of an insurance business. After management's decisions ensured the employment of this equity, by the end of



2002, a net profit after tax of \$572m was delivered and shareholders received dividend income of \$244m (\$267m after taxing into account the benefit of franking credits).

To grow the business (employ more staff, expand overseas), \$328m of after tax profits were retained and a further \$414m in equity was raised from investors (shareholders). QBE didn't have any trouble finding individuals to stump up additional capital when they were generating a return on equity of 21.7% (we note the value of the business would be higher if no dividends had been paid and less dilutionary equity raised).

As all of the net assets (equity) and resources available are again fully employed, net profit after tax increased in 2004 and a larger partially franked dividend (profits earned from overseas operations do not get the benefit of franking credits) is paid. Again, a portion of profits were retained and further capital raised to fund expansion. Incremental capital is now being compounded at even higher rates of return on equity – 25.3%.

The business continued expanding operations both locally and overseas through 2005 and 2006, employing retained profits and new ordinary share capital. Table 2 provides a snapshot of the growth in the level of shareholders equity (net assets) being employed.

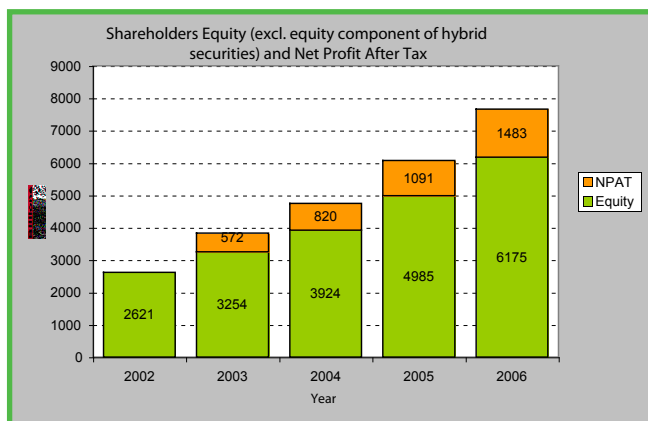
Future Prospects

Based on past performance, QBE is a well-managed insurance company with a solid history of steadily increasing after tax profits and dividends whilst retaining, raising and compounding significant amounts of incremental equity at high rates of return. StockVal's forecast for 2007 the financial year (the company's balance date is December) shows this trend should continue for this year at least.

Profitability will continue to be driven by the company's strong positions in Europe and American markets where a large part of QBE's property, marine and energy sector premiums have experienced strong increases – these sectors make up a significant proportion of the group's product portfolio.

A strong market position has been further enhanced by the acquisition of Praetorian Financial Group, Winterthur US and Seguros Cumbre SA de CV. It is conceivable that management will continue to search for further global opportunities (100 acquisitions have been made in the past 25 years) in line with their stringent criteria to maximise shareholder wealth.

Table 2



A reflection of excellent management, low level of natural disasters and catastrophic loss events, is that profitability as measured by return on equity has risen as more capital has been employed.

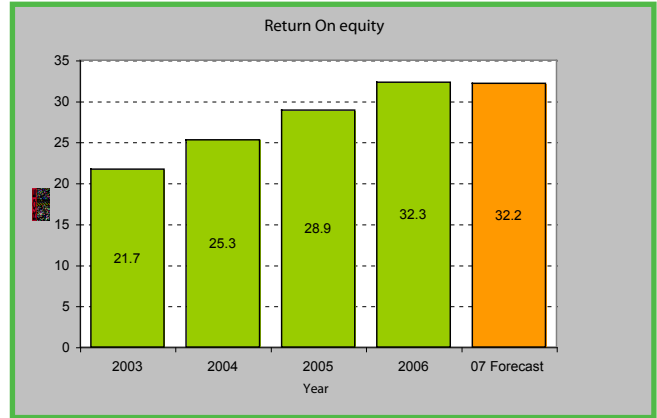
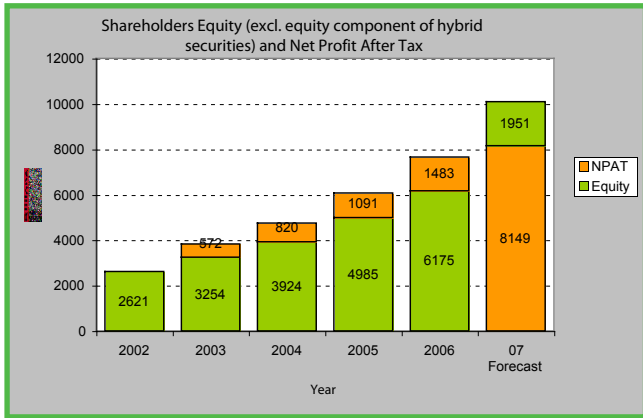
From 2002 to the most recent full financial, shareholders equity in the business has grown by 135% over the past 5 years to almost \$6.2b, return on equity has increased from 21.7% to 32.3% and dividend cheques are 1.5 times larger than those being paid in 2002. Few companies have the ability to achieve these results.

As QBE continues to grow, increased levels of premium income (subject to the cycle discussed earlier will see the investment team continue to manage larger and larger amounts of funds – hence higher levels of investment income. Whilst there is an expectation of paying out a portion of those premiums under insurable events, QBE's investment strategy is conservative. This ensures the preservation of capital and a highly liquid investment portfolio to meet future claims / liabilities.

The main risk to QBE is a series of catastrophic events creating a spike in insurance claims. It is agreed by many in the industry that global warming could materially change the probability of catastrophes, increasing both the frequency and intensity of storms. Whilst such events (i.e. natural disasters) are unpredictable, a globally diversified insurance portfolio, maintenance of an equity portfolio at less than 10% of total investments, coupled with derivative protection to minimise interest rate risk on a significant fixed interest portfolio and conservative



Table 3



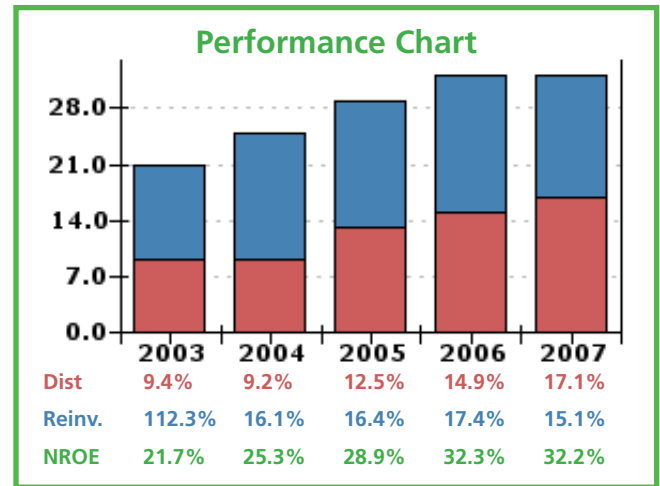
provisioning for losses, are all factors that drive confidence in management's ability to mitigate controllable risks. The company however will need to carefully set premiums in future years based on new probabilities rather than based on past occurrences.

Business Valuation

An investment in QBE has outperformed the ASX All Ordinaries Accumulation Index with a 12 –month growth rate of 58%. The company has also outperformed the index with a compound average annual growth rate of 42% over five years, 22% over 10 years, and 24% over 20 years, creating significant wealth for shareholders. While short-term share price movements often reflect market sentiment more than fundamental value, such stellar performance over a 20 year period is testament to the quality of QBE.

At present levels, QBE's share price of \$35.19 is only slightly higher than StockVal's valuation of \$33.15. As the market gyrates, long-term investors will be given the opportunity to purchase this great business at a great price.

Table 5



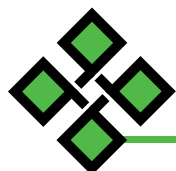
During the August 16th correction (which was exacerbated by the temporary close of the Sydney Futures Exchange), the share price of QBE dipped as low as \$25.55. Compared to the current StockVal valuation of \$33.15, this represented a 23% discount to intrinsic value. However, disasters within stock markets are not the only opportunity to purchase insurance businesses at great prices. Since the industry returns are highly correlated to large-scale catastrophes, mispricing often follows such events. As 'short-termism' sets in, markets tend to value insurance businesses based on their disaster-affected financial performance. For long-term investors, this short-term mindset presents the perfect opportunity to invest in a business with excellent long-term prospects. Businesses such as QBE are much more valuable than their performance at their most vulnerable time. Our only caveat is QBE's business writers need to be very careful about how they price premiums in a world that is warming and thus increasing the frequency and size of possible claims (through more frequent and severe storms).

Table 4



Table 5 reveals the last four years of QBE's economic performance. Also shown is the split between profits retained in the business (blue upper portion of each bar), those amounts being paid out to shareholders as dividends (red lower portion of each bar), and StockVal's forecast for the full 2007 financial year ending December 31. The recent financial data is one reference to what the business and management might achieve going forward.





Where's the Value? seminars

Where's the Value? is a two hour evening seminar presented by Roger Montgomery and covers everything you need to know to become a more certain and more successful value investor.

Over two hours you will learn how to apply Clime's common sense, long-term approach to investing that aims to purchase part shares of wonderful businesses at rational prices. Using case studies as examples, you will discover the importance of return on equity in calculating a company's value and learn how to distinguish a wonderful company from a mediocre company.

Cost: \$65 per seat and includes Roger Montgomery's DVD on value investing that explains how to use StockVal to value businesses and invest in wonderful companies.

PLEASE NOTE THE MANLY SEMINAR HAS BEEN POSTPONED TO 27 FEBRUARY 2008

Date	City	Venue
Thursday 8 November	Parramatta	Parramatta RSL Club
Wednesday 21 November	Wollongong	Steelers Club
Wednesday 20 February	Gold Coast	Courtyard by Marriott
Thursday 21 February	Brisbane	Brisbane Polo Club
Wednesday 27 February	Manly	Manly Golf Club
Thursday 13 March	Penrith	Penrith Panthers
Thursday 1 April	Gosford	Gosford Golf Club
Thursday 15 May	Albury	Sundowner Albury Paddlesteamer
Thursday 5 June	North Sydney	Vibe Hotel North Sydney
Thursday 12 June	Sans Souci	St George Motor Boat Club
Thursday 19 June	Melbourne	Telstra Conference Centre
Thursday 31 July	Perth	The Chifley on the Terrace
Thursday 14 August	Adelaide	Mecure Grosvenor Hotel
Thursday 28 August	Bowral	Bowral Golf Club
Tuesday 21 October	Caloundra	Caloundra RSL Services' Club
Wednesday 22 October	Tweed Heads	Twin Towns Club and Resort
Thursday 23 October	Ballina	Ballina Beach Resort
Thursday 20 November	Orange	Orange Ex-Services' Club

Would you like to meet the StockVal Team in your town?

If you are involved in an investment group or know of investors in your area who would like to attend a **StockVal** Q&A or Where's the Value? seminar, please email Vanessa – vanesa@clime.com.au with your preferred location.

Climb with Clime seminars

Do you have an experienced investment partner?

If you would like a professional fund manager to manage a portion of your portfolio, an investment partnership with Clime may offer the perfect solution.

At **Climb with Clime**, Investor Services Managers Matthew Perreau and Daniel Sciberras will provide an overview of Clime's managed investment services, including the Discrete Share Portfolio Service and Clime Value Growth Fund, and explain how you can begin an investment relationship with Clime.

Location	Date	Time
Melbourne	Tuesday 20 November	6pm - 7.30pm
Sydney	Wednesday 21 November	12pm - 1.30pm
		6pm - 7.30pm
Adelaide	Tuesday 27 November	6pm - 7.30pm
Perth	Wednesday 28 November	6pm - 7.30pm
Sydney	Thursday 6 December	12pm - 1.30pm
		6pm - 7.30pm
Sydney	Wednesday 6 February	6pm - 7.30pm
Melbourne	Tuesday 19 February	6pm - 7.30pm
Gold Coast	Wednesday 20 February	6pm - 7.30pm
Ballina	Thursday 21 February	6pm - 7.30pm
Sydney	Tuesday 4 March	6pm - 7.30pm
Brisbane	Wednesday 5 March	6pm - 7.30pm
Toowoomba	Thursday 6 March	6pm - 7.30pm
Perth	Tuesday 18 March	6pm - 7.30pm
Mandurah	Wednesday 19 March	6pm - 7.30pm

Please note that seats are limited so bookings are essential - call Investor Services on 1300 788 568 to reserve your place today.





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