Clime Asset Management Pty Ltd • 103 Beattie Street Balmain NSW 2041
ABN 72 098 420 770 • Australian Financial Services Licence No. 221146
Phone 02 9555 9700 • Fax 02 9555 9744 • Email info@clime.com.au • www.clime.com.au

clime
ASSET MANAGEMENT

Clime Capital Limited
August 2004 NTA Update

N.T.A. rises to 104.00 before tax and 102.40 after tax.

Dear Shareholder,

Net Tangible Assets

The pre tax NTA for Clime Capital Limited as at 31 August 2004 has risen to 104.00. If the entire portfolio were liquidated (it won't be), the NTA rose to 102.4 cents.

The NTA figures are after 1 cent has been removed to provide for the recently declared dividend.

We are pleased with the short-term performance of the shares we have selected but business performance takes much longer to impact intrinsic values. Please be aware that the share prices of the companies we own will wiggle up and down on a daily basis but the underlying values of the businesses we own will change much more slowly. Generally, investors are not rational (therefore the market isn't always efficient) and that means that prices can move well ahead of what the underlying business is conservatively estimated to be worth. We believe this is happening in a number of the companies in which we own shares. More importantly as owners of shares in Clime, you should care a great deal less about monthly NTA performance. We think that monthly performance measurement such as that also imposed on managers of unit trusts risks producing homogeneity and mediocrity. Expect our NTA to move in reverse as well as forward. Remember we have almost 10% invested in one company – Fleetwood. If Fleetwood's share price were to fall 10% or just 87 cents, Clime's NTA would fall to 103.00 cents before tax, all else being equal.

Clime's portfolio now stands at $20.3 million dollars and of this 32% is invested in listed securities. The increase from last month is the result of both buying and the aggregate rise in the share prices of the companies we already own.

The interest we are earning on the remaining 68% of portfolio held in cash continues to produce unattractive returns and unattractive tax consequences. We expect the returns on cash to rise slightly after the federal election regardless of who wins. Irrespective of the short-term cost of not being fully invested we remain convinced that the safety of cash is a better option than investing your funds in unattractive investments.

It remains true today that establishing a portfolio of businesses which we believe can materially increase earnings over the next five, ten or twenty years, at rational prices, would be aided by a substantial stock market correction. Indeed Clime would welcome a halving of the share prices of companies in which we already own shares – listed below.

As at August 31, 2004 Clime Capital's meaningful positions were:

Name	% of portfolio
Fleetwood Corporation Limited	9.78%
OAMPS Limited	5.331%
Sydney Futures Exchange Limited	2.037%
Nick Scali Limited	1.765%
Lipa Pharmaceuticals	1.297%
The Reject Shop	1.219%
Cash and Bank Accepted Bills	68.15%

Dividend
Clime Capital's directors recently declared a maiden dividend of 1 cent per share. Details can be found by viewing the announcements at www.asx.com.au

Please Note:
Clime Capital (CAM) is a long-term investor in businesses. Over time, Clime Capital's portfolio will be characterised by a small group of companies, each of which will represent a meaningful portion of that portfolio. Our job is simply to purchase, at a rational price, a portfolio of businesses whose earnings march upward over the years. Importantly CAM will not buy shares in businesses because it believes the share price will rise in the next six weeks or six months. CAM - through its Permanent Value Portfolio - is restricted to investing in those businesses that we believe will produce meaningful returns over many years. Therefore many years are required to allow the economics of the underlying businesses to generate commensurate share market returns. Only when new information changes our view or the performance of the business or the landscape in which it operates changes (in our view) adversely, will ownership be exchanged for the safety of cash.

We cannot take advantage of short-term movements in share prices simply because we believe upcoming earnings will exceed analysts' expectations. Nor can we participate in a float that we believe will list at a substantial premium to the IPO price, with the intention of selling shortly after listing. CAM is an investor in businesses not a trader of 'stocks'.

We wish to generate returns that are commensurate with the economic performance of the underlying business that we purchase and last month's commentary demonstrates, under certain assumptions, the relationship between the economic returns of a business and the returns to shareholders and that a long time frame is generally required for one to determine the other.

Commentary
The buy-back myth

Buy backs are currently being discussed again because they are an alternative within the capital management armoury available to management. We will leave aside Draft Taxation Determination TD 2004/D1, issued on 14 January 2004, which sets out the Tax Commissioner's preliminary views on the market value of a share in a listed company that is subject to an off-market buy-back and section 159GZZZQ(2) within it.

Importantly buy backs must be conducted at prices below intrinsic value. One advantage of a buy back is that a permanent reduction in the number of shares on issue may result. Ownership stakes are enhanced when management correctly observes that the company's shares are cheap and buys them back.

The reality however is that like any capital management option available to management, buy backs can be misused and abused. Sometimes paying down debt or paying suppliers is quite simply a better option.

If a profitable business with spare cash determines that the current price of its shares means an investment in itself will improve profitability, shareholder value is enhanced by a buy-back. If you own half a business considered to be worth $10 million, and your business partner is happy to exit his stake for $3 million, then, after the transaction is complete and the cash spent, you will own a business in its entirety worth $7 million.

But buy backs are not always wealth enhancing. Suppose instead the above business was worth $10 million but priced in the market at $15 million. Buying the half share for $7.5 million would result in 100% ownership of a business worth just $2.5 million. Buy backs can be useful when no other investments are available that represent better value. That is when a buy back is likely to produce the highest return.

Buy backs however can dilute economic value when, as in the above example, the shares are purchased at prices that exceed their economic value. Businesses are not simply valued on the cash in the bank so value is destroyed in other ways, as we will see.

The classic arguments for buy backs are varied but perhaps the most common are that they counteract the dilutive effect of options and that they enhance earnings per share.

Management have in the past at least installed buy backs arguing that the buy back is offsetting the dilution that results from the issue of shares from the option's exercise.

But what could be worse than selling your shares cheap and buying them back expensively? When a company is issuing significant quantities of shares through the exercise of options (at a cheap price) and buying them back (at an expensive price) the hapless shareholder suffers a consequence they did not intend. The argument then is flawed because the only time to buy back shares is when it is a wise investment in its own right.

The dilution from the issue and subsequent exercise of options will occur – that effect is locked in. Expenses - when the options are correctly accounted for as remuneration - will also be locked in. Importantly however, the option policy is a stand-alone issue that should be dealt with on its merits. Its adverse effect should not be compounded by the simultaneous announcement of a buy-back.

The buy back needs also to be made on its own merits and to eventuate whether that makes sense, one should assess whether buying shares in the business at the current price is a wise investment.

The second argument for a buy back fits neatly in here. The argument goes along the lines that a properly executed share buyback will increase earnings per share, assuming earnings stay constant, because there will be fewer shares outstanding after the repurchase. Using a classic example, a company has 100 shares on issue, each priced at $40. Its market capitalisation is $4,000. In the previous year, the company earned $200 in profits, or $2 per share. If we assume the company decided to use that $200 to buy back shares and repurchases 5 shares at $40 each the buyback reduces the shares outstanding to 95 shares. If in the current year the company once again earns $200 in profits, earnings per share increase to $2.105, rising slightly more than 5% because there are now only 95 shares outstanding.

Obviously, the company can raise the earnings per share by generating higher earnings or by supporting fewer shares. The argument for increasing shareholder returns in a stock buy back is that it raises the EPS for all the remaining shareholders. If a company buys back 5% of its shares as in the above example, its earnings on a per share basis rises a little more than 5%.

Is the arrangement however really beneficial for the shareholder in all circumstances?

Take the example of the above company with 100 shares on issue $200 in annual profits and trading in the market at 20 times its profits per share of $2.00. That is, a P/E ratio of 20 times and a price of $40. There are many companies in Australia whose shares are trade on similar multiples. Lets also assume the company has plenty of cash - $250 – in the bank.

Now assume the directors decide to buy back 1% of the shares on issue. That is, one share at $40 which it can comfortably afford. The profit is now spread over 99 shares producing an earnings per share of $2.02 a 1% increase. The typical argument ends there. Earnings per share have increased so shareholders are better off.

But instead of buying back shares, assume the company uses the $40 to purchase a Commonwealth Government Bond paying a coupon of 5%. Such an investment would produce a return of $2 per year. Add this $2 to the $200 in annual profits and we have raised profits again by 1%.

It is evident from the above example that a buy back needs to produce a return that is greater than can be achieved by investing the funds elsewhere, in this case 5%; granted a buy-back may be permanent. Buying back the shares at lower multiples however produces improvements in future eps of a greater magnitude. Using this basic arithmetic the decision should be based on whether a return greater than the earnings yield EPS/Price can be obtained elsewhere. If not, the buy back should be conducted.

On these metrics for Clime at June 30, 2004, we would need to be doubtful of achieving a return of 2.18% more than the rate being generated on the cash already to warrant a buy back using that cash. For Clime then, historically at least, shareholders would have probably been better served by investing the portfolio in property trusts than by conducting a buy-back. And so historically we have not chosen to conduct a buy back nor invest all of your Company's funds in property trusts.

It is the directors' responsibility to produce a higher return through a buy back than can achieved through investing those funds elsewhere. It is our belief however that intrinsic value is related to the return on incremental capital, which pulls together the return on equity and the payout ratio, not the earnings yield (the inverse of the p/e ratio used above) but the above example serves its purpose. Buy backs are not automatically the most sensible capital management policy to adopt and should be conducted when the price paid is lower than the value received or foregone. By definition, when the management of wonderful businesses buy back shares (not yours) at prices below what they are worth they should be applauded.

Roger J Montgomery
Chairman.