CCZ STATTON EQUITIES

INVESTMENT STRATEGY

THE CCZ STATTON INVESTMENT STRATEGY FOR RETAIL CLIENTS

Introduction

The CCZ Statton Investment Strategy is to advise its clients to invest:

1) In superior businesses

2) At reasonable prices

3) With regard to adequate diversification and an appropriate split between blue chip and second line shares.

We believe that there will always be companies that will do well, regardless of the economic or market outlook. Our strategy is to identify such businesses with good long term growth potential and to buy them at prices that are substantially less than their intrinsic value.

Emotions are stronger than reason so fear and greed can move stock prices above and below a company's intrinsic value. But over the long term, stock prices show a close relationship to the underlying value of a business. In the short term, the current stock price is not a good indicator of a company's fundamental value. It can take 3 to 4 years for the stock price to reflect the real value of the business.

The CCZ Investment Strategy is for long term investors (with a five year view) and is not for short term traders. The ups and downs of the sharemarket will be smoothed out over time (say three years) and volatility in share prices can be significantly reduced and returns sharply enhanced by a diversified portfolio of quality shares. We seek to invest with these odds in our favour.

No strategy can remove all uncertainty. Mistakes are part of the game. No system works all the time. History is a guide not a template. For these reasons, the CCZ Investment Strategy should be viewed as a series of general guidelines and should not be regarded as hard and fast rules.

1) When buying shares you are buying the earnings of the company or earnings per share. The question is how much should you pay for the earnings of a share, or what is an appropriate P/E multiple because the secret of successful investment is to invest in excellent companies **at reasonable prices**. One without the other is not good enough. All valuations are relative. There is no such thing as an absolute value. All value is a comparison to the available “risk free rate of return”. The guide to what is a reasonable P/E multiple comes from the available "risk free rate of return" in the form of 10 year Government Bond yields. The trouble is the “risk free rate of return” constantly moves around. Since this is the benchmark against which all income producing assets are measured, the valuation of businesses and hence shares is a moveable feast. Movements in bond yields have a powerful influence on share prices over periods of less than 2 years. However, we have been measuring the P/E multiples of blue chips, mid caps and small caps relative to bond yields and to each other since December 1996. The data we have collected enables us to measure the gap between the return on bond yields and the return on different types of shares. When the gap gets too wide, shares are a buy. When the gap gets too narrow, shares are expensive. Likewise, we measure the gap between the return on blue chip stocks and the return on mid cap stocks and small cap stocks to see if these are too wide or too narrow. The definition of “wide” and “narrow” is a question of judgment based on our data but this methodology helps us to identify stocks that are over or under valued.

2) The client’s aim should be to build a portfolio of 15-25 stocks over time of roughly equal size as good situations become apparent. If the price of a stock appreciates and the fundamental story has not changed or begins to deteriorate, sell the stock and replace it with a stock where the fundamental story is better and the price has not gone up. Spreading the client’s money in this way minimises risk.

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3) No holdings should exceed 15% of the total portfolio value for prudential reasons and no holdings should be less than 1% for managerial reasons. Once an individual investment grows to represent 15% of the portfolio value start to take profits. (1) You lock in a profit, (2) it forces you to look for better opportunities to replace investments which have reached much of their short to medium term investment potential. No more than 30% of the portfolio should be held in any one sector. These measures will significantly reduce risk without reducing the client's return.

4) The client's share portfolio should be spread through the following categories:

Type	Comment
70% Blue Chip Industrial	Generally household names which have been in business for a long time, have first class records of rising profits and dividends, have first class boards, solid balance sheets and are leaders in their area of operation. Dividend yields may be initially low but will increase over the years.
30% Second liners	These are growth stocks – hopefully the blue chips of tomorrow. They have not yet achieved the size, track record or creditworthiness to justify blue chip status. But the potential rewards are higher than with the blue chips because of the rapid growth they generate.

5) Resource stocks are commodity producers operating in wholesale markets. Generally they have no pricing power and therefore little control over the growth in their earnings. (The exception is when demand exceeds supply for a commodity, e.g. a genuine shortage of a commodity such as oil). They also pay low dividends and are vulnerable to exchange rate movements. For these reasons, resource stocks are not good long term "buy and hold" investments but should be regarded as shorter term trading stocks. Because of the low dividend yield, the only way to make money from resource stocks is to take capital profits when they are available. Buy them when commodity prices are low and sell them when commodity prices are booming before the increased supply in response to high prices runs down demand and prices.

6) The right companies to invest in are ones with powerful consumer franchises whose services we use in our day to day lives – banks, newspapers, TV, retailers, phone companies and power suppliers. These companies can maintain their pricing power and extract money from us on a regular basis, if not every day. See below for more detail.

7) Look for companies that pay dividends. The payment of dividends by a company provides a number of benefits to investors. In order to be able to pay dividends, a company must be making real profits. It must therefore have a real business. If it is able to maintain dividends each year, sustainably increasing them as the business grows, then this provides a good indicator to investors that they are investing in a quality business capable of being managed for sustainable growth. If companies do not pay dividends it can be difficult for investors to appreciate the quality of the business. In a low inflation environment, a return of 10% p.a. is pretty good. With a 5% fully franked dividend (the equivalent of 7.1% pre-tax) or with a 7%+ trust distribution (with some tax free/deferred benefits) you get the bulk of this return as cash in the hand. This is much less risky than relying on "paper" gains. With these sorts of dividends/distributions you only need capital gain of 3% to achieve a reasonable return. Some of this will come from inflation but, more importantly, capital gain automatically follows if dividends/distributions are increased each year. The exception is small growth companies which may not pay a dividend initially as they roll out their network but which will pay dividends once they hit the sweet spot of their growth curve.

8) Companies that make the best investments are those able to grow profits reliably and at a greater rate than the general market. Some businesses are inherently better than others because it is easier to make money in those businesses due to favourable conditions or circumstances or the nature of the industry. We look for these superior businesses.

   Superior businesses contain many or all of the following characteristics:

   - Earnings predictability and resilience, annuity style earnings streams

   - Dominant in their industry or sector; a great "franchise" with significant barriers to entry for outside competitors; a niche business that provides a valuable product or service better than anyone else;

- Single industry or single product business; simple businesses that we can understand

- Businesses with strong balance sheets and a high level of cash generation in excess of recurring capital expenditure and working capital requirements

- A high return on equity

- Earnings growth through pricing power, unit volume growth or sustainable efficiency gains rather than through acquisition

- A strong management team whose interests are very much aligned with shareholders (i.e. they own shares in the company and think like owners)

The best returns are to be found in good companies in good industries but even poorer stocks in favourable industries tend to outperform better stocks in unfavourable industries. So we look for industries and businesses where conditions are favourable or where the nature of the business is such that the company can generate cash flow surplus to its business needs that can be paid as dividends to its shareholders. A company may report strongly growing earnings but if these are largely re-invested in staying in business or maintaining competitive advantage then those earnings are of no value to shareholders. The greatest free cash flow generators have strong margins, good control over working capital and limited requirement for capital expenditure. Businesses we like include:

Companies that are able to generate growth at a low cost of capital. A company that can continually grow earnings at a higher rate than the level of capital required to be reinvested in order to stay in business will outperform the market over time. Such companies have three characteristics:

- A strong and/or improving balance sheet (low debt or net cash) and

- A sustainable and growing future free cash flow stream and

- Low working capital and capex needs (which tie up cash flow in the business).

Companies that Pay Dividends - in order to be able to pay dividends it must be making real profits. It must therefore have a real business. If it is able to maintain dividends each year, substantially increasing them as the business grows, then this provides a good indicator that it is a quality business capable of being managed for substantial growth.

Also fully franked dividends (which don't exist anywhere else but New Zealand) are cash in the hand and much less risky than "paper" gains.

Companies we encounter in our ordinary lives - banks, newspaper publishers, TV, retailers, phone companies, power suppliers, leisure companies, beer/wine companies – all have powerful consumer franchises (people use them regardless).

Businesses which extract a royalty on the passage of commerce (e.g. bank fees) – ASX, funds management.

Companies that can lock in their margins and fees regardless – funds managers.

Price makers rather than price takers.

Monopolies or quasi monopolies – ASX, SAI.

Companies with services we <u>must</u> use – if only occasionally, e.g. Invocare, SAI.

Companies that have pricing power - due to powerful consumer franchises, e.g. the banks. They can lock in their margins and fees and therefore can control their earnings.

Companies which are <u>not</u> commodity producers operating in wholesale markets. These have no pricing power and therefore little control in the growth of their earnings.

Companies with few competitors or high barriers to entry – ASX.

Companies with lots of customers – retailers, Invocare, SAI.

Companies with potential for growth in earnings from either:

- Cost reduction
- Increased production
- Raised prices
- Expansion into new markets (learns to succeed in one place and duplicates its success in other places)
- Selling more product in the old market
- Revitalising, closing or selling a loss making operation

Companies with sound balance sheets. Not too highly geared. If small companies get into trouble they can go broke.

Use of unlisted funds for investment in Australian shares

The CCZ Statton Investment Strategy also includes the **judicious** use of unlisted Australian equity funds where these funds have a similar approach to equity investment as CCZ Statton and they specialise in areas where CCZ Statton does not have sufficient resources to cover all opportunities. For example, S&P Global Research shows that over 70% of Australian mid-cap and small-cap equity funds outperform their benchmark index over three and five year periods.

International investment

The CCZ Statton Investment Strategy is that, at times when the A$ is vulnerable, up to 30% of a client's portfolio should be invested in international equities. This is to protect capital from an anticipated fall in the A$. It is also to enhance the prospects of generating increased purchasing power over time by taking advantage of investment opportunities in companies or industries which do not exist in Australia. The Australian share market represents a little less than 2% of global share markets so a bigger investment universe will make clients' returns more robust.

Overseas investments can be made by purchasing listed investment companies and ETF's on the Australian Stock Exchange. These listed stocks will capture global market returns. To complement this passive, broad market approach, the CCZ Statton Investment Strategy includes the **judicious** use of some high conviction funds managers whom we have interviewed and reviewed to ensure they have a similar approach to equity investment as CCZ Statton.