Clime Capital Limited (ASX:CAM)

Quarterly Report

March 2015

www.climecapital.com.au

Chairman's Letter

Dear Fellow Shareholder,

In a quarter highlighted by a rate cut and the continuation of remarkably low bond yields, the Clime Capital portfolio achieved sound risk-adjusted returns that comfortably exceeded our 2.5% quarterly target. We live in unprecedented times, reflected by a historically low risk free rate of just 2.3%. As investors continue to seek out returns in excess of the paltry rates offered by government paper (globally), one must stop to consider the amount of risk being assumed to achieve satisfactory returns. To some degree, these influences continue to pose an investment dilemma.

Despite projections for world economic growth having been sharply lowered in recent weeks, the prices of stocks have held at elevated levels. As economic growth translates into company profit growth, it is reasonable to conclude that stock prices are currently buoyed by abnormal factors.

The obvious abnormal factor is the level of interest rates across the developed world. The setting and maintenance of low historic cash rates has moved out along the yield curve and is reflected in extraordinarily low bond yields. As introduced above, in Australia we recently saw ten year bond yields touch 2.3%. This is truly extraordinary. However, even more stark are the current ten year bond yields seen in Spain and Italy, with both falling below 1.4%. So much for poor sovereign debt ratings!

Low cash rates have been supported by the massive quantitative easing (QE) programs in the US, Europe and Japan. The purchasing of assets by major central banks has extended from bonds to mortgages and now to investment securities by the Japanese Central Bank.

World equity markets have been unusually volatile over the first nine months of financial year 2014/15. A review of major equity markets shows their direct responses to QE activity and central bank policy pronouncements. For instance we have seen a surge in Japanese and German markets as QE is rolled out, whilst in the US we have seen a stalling of the equity market once QE was "tapered".

This therefore begs the question: with so much monetary stimulation occurring, why have economies not rebounded into a strong growth cycle? Indeed the consensus of forecasters is that the developed world is falling into a growth hole.

It is a confusing and complex investment picture. Without doubt, short term market moves are stimulated by financial support, often in the absence of investment fundamentals. Whilst it is true that equity prices should move higher with bond prices, this only holds if current long term bond prices (driven by lower yields) can be considered as sustainable. The biggest risk for investment capital is that investors en masse become intoxicated by sustained low interest rates, chase price momentum and allocate too much capital to shares that are rising independent of earnings.

In this issue

From an Australian perspective, we have seen a solid lift in the equity market in response to a cash rate cut by the RBA (in February) and the devaluation of the $A. Thus from a currency and yield perspective, the market price moves can be explained. However the market moves are seemingly ignoring the substantial decline in Australia's terms of trade. The fall in the iron ore price, if sustained at below $60 a ton, will seriously dent the trade account such that our annual trade deficit will lift above 1% of GDP. The weakness in the $A will not translate into significantly improved export income because we have failed to develop export industries of any substance beyond commodities.

Overlaying the above concerns and observations is that the Australian equity market is overweight with financials and resource companies. The lift in equity prices of financial stocks in Australia is magnifying the risk of a correction should the declining terms of trade translate into lower national income and economic activity. These emerging issues are being masked by the surge in residential property prices on the east coast of Australia. Indeed it is important to understand that residential property prices are not indicative of economic success but rather of financial excess. Rising household debt into a surging housing market is not the basis of sustainable economic activity. It merely acts to conceal deteriorating underlying economic fundamentals such as low profit growth, higher unemployment, low wages growth and subdued consumer confidence.

The above leads to the conclusion that equity markets could struggle to lift much further this year unless they are buoyed by even more monetary or financial support of central banks. Recent history and central bank statements suggest that current support will be maintained until sustained growth emerges; arguably markets have already priced this in.

The missing link is sustained economic growth in the developed economies. Whilst it is easy to expect growth of above 5% in the developing world (dominated by China), it is hard to see growth in the developed world reaching 2%. Indeed given the high earnings multiples that equity markets now trade at, it could be said that the biggest risk to equity markets is not continued low economic growth but rather the emergence of faster economic growth.

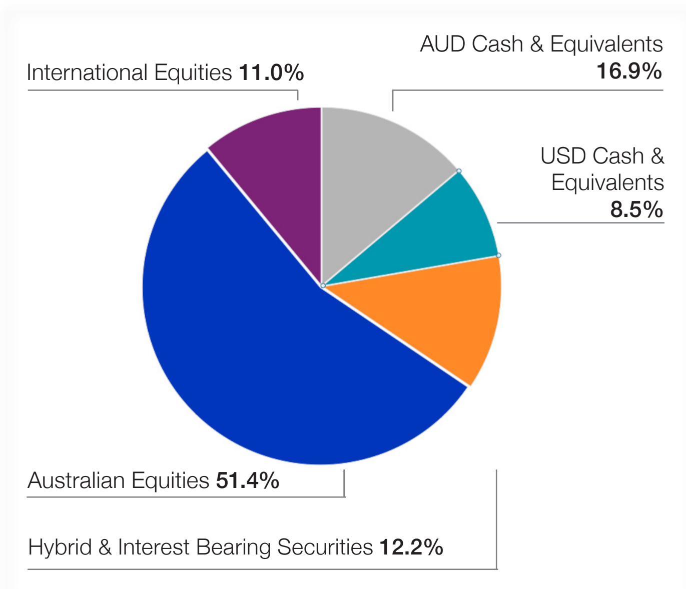
If the above conclusion sounds incongruent then take a moment to reflect upon the recent gyrations of the US stock market as traders contemplate the likely timing of rising cash rates. Bad news has become good news for markets and recently markets have been buoyed by bad news. That's an interesting dilemma, one we suspect will take considerable time to wade through.

Kind Regards,

John Abernethy
Chairman

Portfolio Summary at 31 March 2015

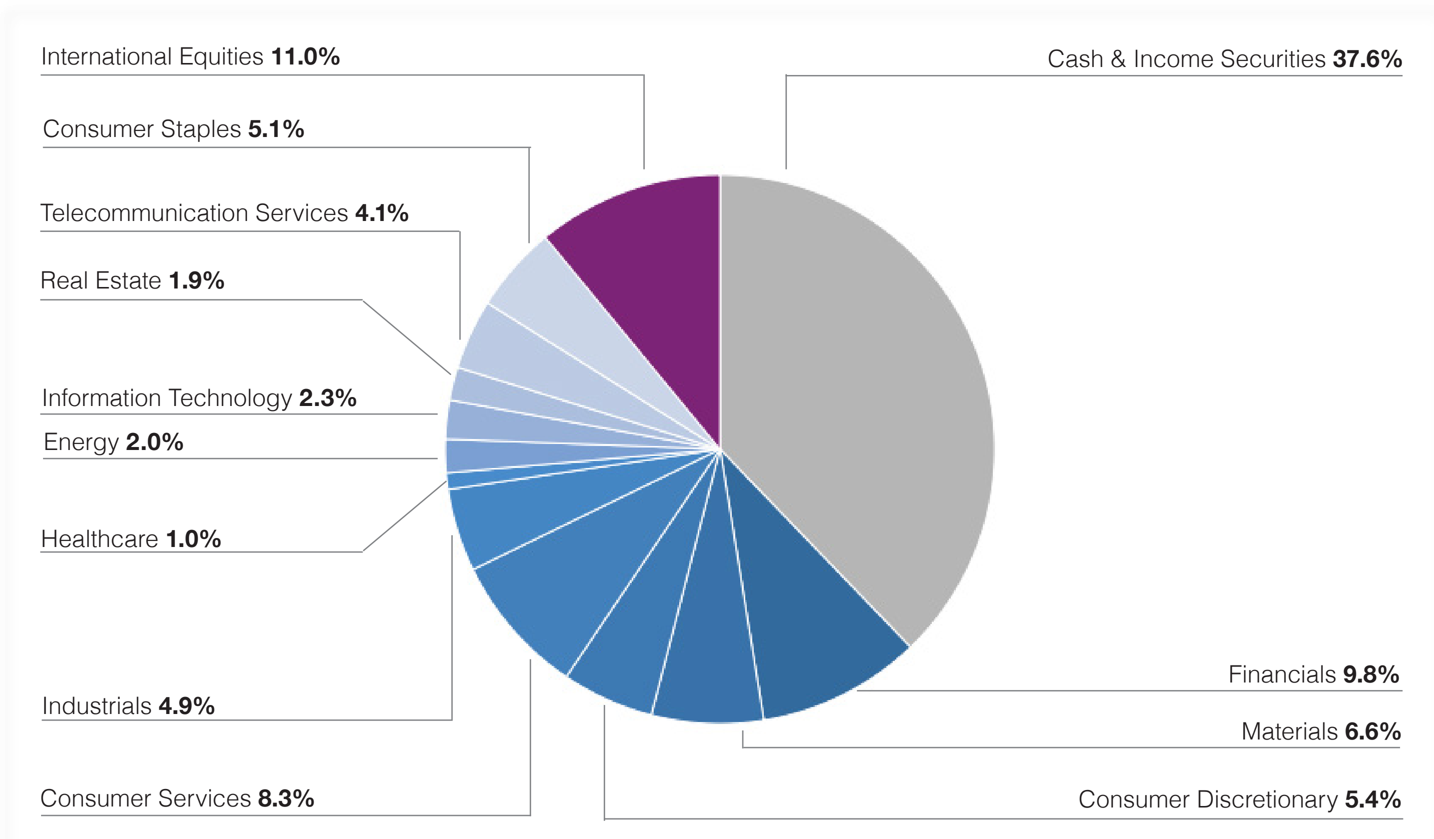
Asset Allocation



Top 10 Holdings (Weightings %)

Australian Equities	
Australia & New Zealand Banking Group	5.25
Woolworths Limited	5.10
Telstra Corporation Limited	4.14
The Reject Shop Limited	3.46
Macquarie Perpetual Notes	3.36
National Australia Bank Notes	3.20
McMillan Shakespeare Limited	3.01
Brickworks Limited	2.58
Westpac Banking Corporation Limited	2.51
Multiplex Covertible Note	2.44
International Equities	
McDonald's Corporation	1.88
General Motors	1.45
American Insurance Group	1.37
AUD Cash & Equivalents	*16.92*
USD Cash & Equivalents	8.45
Total	65.12

Sector Allocation



Australian Securities Summary

Despite the cautionary tone of the economic overview presented in the Chairman's Letter, we continue to actively manage the portfolio with an ongoing focus on two key principles. As shareholders are likely aware, these principles encompass (1) a focus on capital preservation, and (2) achieving an absolute target return of 10% per annum over the long term. It is important to reiterate that the targeted return aspiration will never occur neatly in a straight line. So while the March quarter results were sound, we caution against extrapolating recent results into the medium term.

Specific to the management of the portfolio, there have been a range of changes enacted during the quarter. Early in the New Year, UK-based global asset manager Henderson Group CDI (ASX: HGG) was added to the portfolio as a meaningful discount to value became apparent. HGG is a leading asset manager with global scale and an enormous diversity of product that encompasses equities, fixed income, property and alternatives.

In a sense, the stars have swiftly aligned for HGG in recent times. Sound investment performance, accommodative monetary policy settings, substantial inflows of higher margin retail FUM and thus the potential for positive operational leverage all added to the investment case for HGG. Importantly, these attributes were coupled with an attractive entry price. While the recent rerating has not greatly surprised us, the speed and quantum of the rally since initiating the position have both surprised on the upside. This unfortunately mitigated our ability to get fully set at our sub $4 target entry price. Nonetheless, with regards to this investment, a sound outcome has been achieved for shareholders in an unusually short space of time.

We have recently initiated a new position in specialist leisure and entertainment operator Ardent Leisure Group (ASX:AAD). Throughout Australasia, AAD operates health clubs, AMF and Kingpin bowling centres, the Dreamworld, WhiteWater World theme parks, SkyPoint and d'Albora Marinas. The Group also operates the Main Event family entertainment centres in the United States. After hitting an all-time high of $3.49 in the first half of financial year 2015, AAD has since traded back to the low $2s following a disappointing result in its health club division and a subsequent management reshuffle. With these factors arguably more than factored into the share price, we believe AAD represents good value for longer term investors.

While AAD includes a suite of good quality business units, substantial growth potential exists with the roll out of the Group's Main Event family entertainment centres. Importantly, this roll out is predominantly occurring across the southern states of the US, a market many multiples the size of Australia. In our view, AAD offers an exciting long term growth opportunity coupled with an attractive yield approaching 6.5%.

Despite the generally positive trend observed during the quarter, short term volatility in a number of high quality companies presented a degree of opportunity. Accordingly, we initiated small positions in CSL (ASX:CSL), Crown Resorts (ASX:CWN) and Flight Centre Travel Group (ASX:FLT) as discounts to forecast valuations became apparent. All are well positioned within their respective markets and to varying degrees offer above average growth profiles both domestically and internationally.

Income generation forms a core component of the portfolio. The maintenance of established positions in income securities such as Macquarie Income Securities (ASX:MBLHB), Multiplex SITES (ASX:MXUPA) and National Income Securities (ASX:NABHA) continues to provide a resilient quarterly income stream. The focus on sustainable income has been extended during the quarter with the addition of Australian Industrial REIT (ASX:ANI). ANI offers a sustainable yield in the region of 7.8%, which is in turn backed by a strong asset base. In line with this thinking, we also introduced a small position in leading child care centre operator G8 Education (ASX:GEM) towards the back end of the March quarter. In our view, GEM is priced somewhat modestly, offers an incremental growth profile backed by broader market tailwinds and a sound fully franked yield of approximately 7%.

One final new inclusion to the portfolio during the quarter was Dick Smith Holdings (ASX:DSH). DSH has high levels of brand awareness and an existing store network of 385 stores. We expect this to expand towards a sustainable network of approximately 450 stores over the coming 3 years. DSH has focused on reducing its cost of doing business whilst increasing the penetration of higher margin private label products. Both strategies should act to improve group margins over the medium term. In aggregate, we believe these strategies will drive earnings growth even in a tough retail environment. Importantly, the capital structure is sound: DSH has a strong balance sheet in a net cash position. DSH offers an excellent fully franked yield of 7% and currently trades at a meaningful discount to assessed intrinsic value.

Largely during the December quarter, we managed to build a reasonable position in the out-of-favour Seven Group Holdings (ASX:SVW) at a large discount to assessed value. Initially attracted by the contrarian value on offer, a high quality management team and what we perceived to be a sustainable yield, SVW grew to become a ~2% position in the portfolio. After reporting a better than expected first half result, highlighted by impressive growth in WesTrac product support revenue, SVW rallied strongly. Cash generation was strong while capital management initiatives including the announcement of a further buyback were also viewed favourably. SVW has since traded back closer towards our assessment of value and as such, we have progressively de-weighted the position.

One further rebalance occurred during the period following the substantial re-rating of Adelaide Brighton (ASX:ABC). ABC produced a stellar full year result highlighted by revenue growth and margin expansion. Cash flow again impressed which in turn facilitated a better than expected gearing profile as at 31 December 2014. In our view the revenue mix remains sound, both by sector and geography, whilst the expectation of further volume and price growth bodes well for the outlook. With that noted, in our view the market has now more fully reflected the positive outlook and attributes of ABC. As such, we have rebalanced our portfolio weight from what was once a 4% plus position pre the February result.

In a similar thread, several smaller positions were exited during the quarter as prices rallied towards (or beyond) assessed value. This included positions in Fantastic Holdings (ASX:FAN), IMF Bentham (ASX:IMF) and K&S Corporation (ASX:KSC).

Reflecting on the generally positive portfolio commentary above, it must be said that no manager operates without making mistakes. Of course, we are no exception. During the quarter, we also exited our small position in drilling product company, Imdex (ASX:IMD). Despite the best efforts of a committed management team, both value and our investment thesis changed following the rapid deterioration in market wide operating conditions.

While the decrease in commodity pricing was somewhat foreseeable, the swiftness and severity of this collapse has clearly impaired the medium term outlook for IMD’s core minerals business. These factors remain and in fact are intensifying following the less predictable and more recent collapse in the oil price. In aggregate, these events clouded the outlook to the point where it was decided the most sensible course of action was to close the door on what was, quite simply, an incorrect call.

We continue to hold positions in high quality ASX20 companies including ANZ Banking Group (ASX:ANZ), BHP Billiton (ASX:BHP), National Australia Bank (ASX:NAB), Telstra Corporation (ASX:TLS), Westpac Banking Corporation (ASX:WBC) and Woolworths Limited (ASX:WOW). In aggregate, these positions have positively added to performance during the quarter. As always, we continue to monitor these positions with a view to actively managing weights as and when our view on forward return profiles change meaningfully.

As noted previously, we retain our steadfast focus on delivering the goal of preserving and growing capital over the long term. As such, you can rest assured that we will not play the risky game of being unnecessarily fully invested alongside the herd. Whilst we have prudently deployed cash into a range of value based ideas, many of which are highlighted above, we continue to retain adequate cash reserves across the portfolio. In a sense, this can be viewed as working capital; it will be used to take advantage of further value should it emerge in the coming months.

Before we turn our attention to our international investments, we would like to offer some final thoughts. As a fellow shareholder, you may be wondering about the curious divergence between the CAM share price and per share NTA that occurred during the quarter. While per share net tangible assets were up circa 5% after paying out dividends on both the ordinary and preference shares, the share price actually receded by approximately 1% in the March quarter.

We must stress that our focus will always remain on managing the portfolio sensibly and diligently. We certainly cannot control the vagaries of the market but we do believe that in time value will be recognised. To this end, your managers have incrementally utilised the buyback during the March quarter to increase per share value when material discounts to NTA have become apparent.

We believe that the exciting yet measured evolution of your company to include high quality international investments continues to progress well. In a sense, we are well on our way towards our goal of sustainably growing shareholder value by offering something truly unique in the landscape of Australian listed investment companies. That is, to deliver value growth coupled with a consistent stream of fully franked income paid quarterly – all backed by exposure to some of the world's best companies, listed both here and abroad.

International Securities Summary

Clime's international holdings have continued to increase in both number and value during the March quarter. Notably, the total value of the portfolio has increased from about 10% of total assets to about 19.5% of total assets, an increase of about 95%. The manager made the strategic call to increase our exposure to U.S. currency and listed securities. This call has boded well thus far, with the AUD falling close to 7% against the USD during the quarter from $0.8168 to $0.7625.

During the period we added a number of new holdings to the portfolio. The largest include:

- American Express Company (NYSE:AXP)
- CF Industries Holdings Inc. (NYSE:CF)
- Emerson Electric Co. (NYSE:EMR)
- Harley Davidson (NYSE:HOG)
- IBM Corporation (NYSE:IBM)
- Microsoft Corporation (NAS:MSFT)
- Twenty First Century Fox (NAS:FOXA)
- Yum! Brands Inc. (NYSE:YUM)

Chevron Corporation (NYSE:CVX) was removed from the portfolio in line with the investment manager's decision to de-weight exposure to oil, which stood at 27% of the international portfolio as at January 1st 2015. Exxon Mobil Corporation (NYSE:XOM) remains in the portfolio at a smaller weight as we believe its capex strategy is better suited to a lower oil price environment. The small position in Gazprom OAO (ADR, ticker: OGZPY) was also reduced as geopolitical issues weighed heavily on the Ruble.

Looking at our other existing holdings, General Motors Company (NYSE:GM) and McDonald's Corporation (NYSE:MCD) weightings were both reduced after strong performances to bring them in line with targeted model weights. The portfolio doubled its holding of American International Group Inc. (NYSE:AIG), further reducing our cost base and also increasing the position towards our targeted model weight.

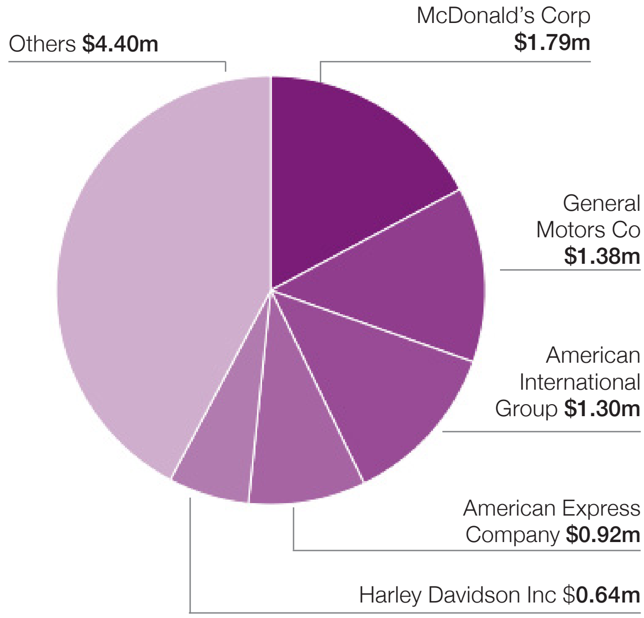
A number of smaller positions were also brought into the portfolio during the quarter. These have performed quite strongly since positions were initiated, which unfortunately resulted in some weights being lighter than what was initially targeted. These include Estee Lauder Companies Inc. (NYSE:EL), Yum! Brands (NYSE:YUM) and Baidu.com (ADR, NAS:BIDU). These are high quality companies with growing global scale. As such, we will consider increasing our holdings should more attractive pricing emerge in the months to come.

The cash weighting in the portfolio has increased substantially as a part of the Investment Manager's macro view on the U.S. dollar (USD). Whilst we continue to look for high quality companies to invest in, the Manager had a higher conviction in the appreciation of the USD than further gains to the U.S. markets during the period. During the quarter, the S&P 500 recorded a gain of less than 0.5%.

Our outlook remains that U.S. equity markets continue to be historically expensive, with any further gains in the near term most likely coming as the result of P/E expansion. Accordingly, we continue to invest judiciously and retain a healthy level of cash reserves. We maintain our view on a strengthening USD and will continue to have significant USD exposure. We will look to deploy the USD into the US market on any market correction.

Top 5 International Securities

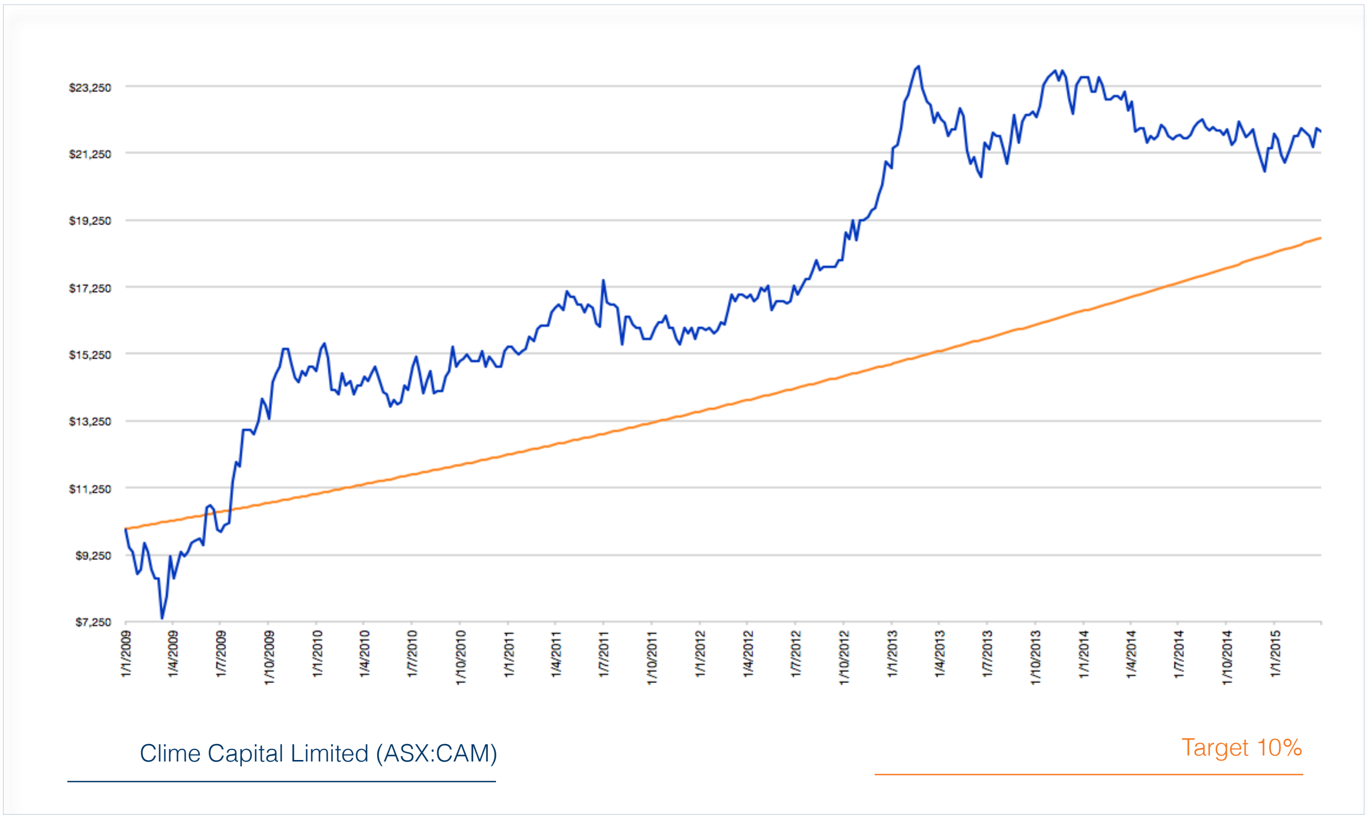
Total Equity Value: A$10.43m



Investments ($m)

	Mar '15	Feb ' 15	Jan '15	Dec '14	Nov '14	Oct '14
Listed Securities	$70.7	$73.5	$71.0	$66.8	$62.4	$68.1
Cash	$24.0	$21.5	$19.3	$23.6	$28.2	$27.1
Net Assets	$94.7	$95.0	$90.3	$90.4	$90.6	$95.2

Shareholder Returns: $10,000 (January 2009 to March 2015)



Data Source: Thomson Reuters

A focus on long-term performance

	3 Years	5 Years
Clime Capital Total Shareholder Returns	8.36% p.a.	8.85% p.a.
Actual Total Returns	27.23%	52.79%

Clime returns do not include the added benefit of franking credits which are attached to dividend distributions. Further, the returns reported for Clime are after all management and transaction costs and payment of preference dividends.

The Clime Capital offer to shareholders

Clime Capital Limited ("Clime") offers investors the opportunity to invest in a value focused "closed end" Listed Investment Company managed by a recognized top performing Value Equity Manager - Clime Asset Management ("the Manager").

The Clime investment company structure offers a number of key advantages to investors.

These are:

- Clime (through its Manager's decisions) will not be a forced seller of securities in difficult times;
- Clime will not be forced buyers at inappropriate times;
- Clime pays quarterly dividends to ordinary & preference shareholders;
- High levels of transparency by being listed on the ASX.

This allows Clime to focus on protecting and growing its capital over the longer term.

Clime invests in a diversified portfolio of Australian & International businesses, trusts and interest bearing securities.

Clime has a disciplined investment approach focused on the distinction between value and price. The allocation of investment capital into the market generally and stocks specifically is tempered by the Manager's continual macro-economic overlay. The company has the ability to hold elevated cash levels when market risks are considered to be excessive or value is not apparent. The Manager has the ability to look across listed asset classes to seek absolute returns. This is a unique offering in an environment where many managers are often forced to be fully invested in one asset class with asset consultants dictating weightings.

Clime benefits from a strong and experienced team of value focused investment professionals. The Manager is the largest shareholder in Clime and thus its interests are strongly aligned with shareholders.

Ordinary Shares Overview (ASX:CAM)

Share Price (at month end)	$0.95
Rolling 12 Month Dividend	4.6cps
Historical Dividend Yield	4.84%
Percentage Franked	100%
Grossed Up Yield	6.91%
Dividend Reinvestment Plan	Yes

Preference Shares Overview (ASX:CAMPA)

Share Price (at month end)	$1.92
Rolling 12 Month Dividend	19.0cps*
Historical Dividend Yield	9.89%
Percentage Franked	100%
Grossed Up Yield	14.13%
Dividend Reinvestment Plan	No

Converting Preference shareholders will accrue the bonus issue and upon conversion will receive 1.387 Ordinary Shares for every Converting Preference Share.

** With effect from June 2015 quarter, CAMPA dividends for future quarters has been revised to 4.5 cents (18 cents per annum) fully franked per share.*

About Clime Capital Limited

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Clime Capital Limited (ASX:CAM) was listed on the ASX in February 2004 to provide investors with the opportunity to participate in a long-term approach to portfolio investing using value investing principles.

The company's investment objective is to generate returns for shareholders by investing in businesses with understandable economics and excellent growth and income potential that are run by capable management.

The company was formed to provide access for all investors to a strategy intended to create long-term wealth by purchasing, at rational prices, a portfolio of businesses whose earnings are expected to increase over the years.

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