

Health Care Property HCP

Morningstar Rating	Last Price	Fair Value	Consider Buy	Consider Sell	Business Risk	Economic Moat	Stewardship Grade	Industry	Sector
★★★	\$31.55	\$33.00	\$25.40	\$41.30	Average	Narrow	B	REITs	Financial Services

We're fans of HCP's acquisition of CNL Retirement Properties.

a cheaper basis than peers.

by Heather Smith
Stock Analyst
Analysts covering this company do not own its stock or those of its closest competitors.

Report updated on September 06, 2006.
Data and Rating updated as of October 20, 2006.



Thesis 09-06-06

Health Care Property is the largest and most diversified health-care real estate investment trust in the nation. We like its strong balance sheet, relatively low-risk properties, and high return on investment.

We believe the firm's offer to buy CNL Retirement Properties--one of the largest owners of private-pay health-care facilities--will enhance its return on assets. CRP's relatively young properties leased to high-quality tenants will improve HCP's property mix and lower its exposure to Medicare and Medicaid. This acquisition will also boost HCP's presence in urban markets that have high barriers to entry, which should enable the company to raise rents at a faster rate.

HCP makes money by developing or buying health-care facilities and renting them out at about 7%-9% of the purchase price. Rents generally increase in line with inflation, and some leases contain bonus rental provisions tied to an operator's revenue. Most tenants sign long-term (six years on average) triple-net leases, which hold the lessee responsible for most operating expenses, and drive fat net operating margins.

The company invests in numerous health-care facility types--hospitals, skilled-nursing homes, assisted-living facilities, medical office buildings, and specialty laboratories; no asset class accounts for more than one fourth of net operating income. And HCP derives more than 60% of its rental income from the more stable private-pay sources rather than Medicare and Medicaid, which are notorious for cutting reimbursement for certain services. HCP also leases to multiple health-care operators, with the largest tenant representing a relatively low 11% of revenue. This emphasis on diversification shields the firm from property and operator-specific downturns. Additionally, credit-rating agencies look favorably on diversification, allowing HCP to issue debt on

Using its low-cost debt, the firm regularly makes accretive acquisitions. And when a property no longer fits with its portfolio, or has aged significantly and does not command a premium rent, HCP sells the facility, booking a large gain on sale. This enables the company to recycle capital into higher-return parts of the business and continue earning a large return on real estate assets, which, at more than 12%, leads most of our REIT universe.

We believe HCP is a cutting-edge REIT with a top management team, and we would not hesitate to pick up the shares at the right price.

Valuation

We're raising our fair value estimate to \$33 per share from \$30 following an impressive first half of the year for HCP. Rental revenue surged 19% in response to the company's \$600 million-plus in investments in 2005 and same-store (properties held for one year or more) net operating income growth of 3%. We believe the company's knack for spotting great properties and the strong performance of its existing facilities will drive growth. With rent bumps built into most leases, we expect rents to increase at the rate of inflation, about 3% annually. Occupancy should also trend higher, as demand swells with aging baby boomers and supply remains constrained with low construction starts. We estimate HCP's five-year return on real estate assets to average about 13%, above our 9% estimate of the company's cost of capital, indicating that HCP is creating shareholder value.

Risk

With about one third of operators receiving some revenue from government programs, the company is exposed to changes in Medicare and Medicaid funding. Additional rent for these tenants is based on gross revenue, which is affected by the amount of reimbursement the tenant receives from third parties.

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Close Competitors	Market Cap \$Mil	TTM Sales \$Mil	Oper Income \$Mil	Net Income \$Mil
Health Care Property	4,332	531	5	165
Ventas	4,015	384	156	134
Nationwide Health Propert	2,223	237	73	72
Senior Housing Prop Trust	1,583	167	6	58

Morningstar data as of October 20, 2006.

Bulls Say

- The company has increased the dividend every year for the past 20 years. The current annual dividend is \$1.70 per share, yielding about 6%.
- Health Care Property's portfolio is diverse not only by property type, but by geography as well. No one state accounts for more than 20% of net operating income, with California (16%), Texas (13%), and Florida (10%) coming in the highest.
- According to the Health Forum, publicly traded health-care REITs own only 2% of the estimated \$750 billion U.S. health-care property market. The potential for growth and acquisitions is enormous.
- To reduce its exposure to Medicare and Medicaid, HCP has lowered its net operating income derived from skilled-nursing homes to 22%. This should drop to an impressive 9% after the CRP deal closes.
- Certificate-of-need laws, which are strictly enforced in most states, limit the construction of new skilled-nursing facilities and lead to higher occupancies.

Bears Say

- HCP's large size requires management to raise rents significantly or make constant acquisitions to sustain growth. Attractive buying opportunities might not present themselves with asset prices high.
- Integrating CRP may be a challenge; the purchase will nearly double HCP's property count.

Financial Overview

Growth: Annual rental revenue growth has been 8% over the past five years thanks to regular acquisitions. We estimate internal rental growth of 3%, though, owing to the inflation-tied rent increases built into most leases.

Profitability: Net operating income margins are nearly 100% as a result of the firm's triple-net leases. We believe they will not deviate from this range as operating costs remain constant, rental rates tick higher, and overall occupancy approaches 85%.

Financial Health: HCP is in great financial shape, with a fixed-charge coverage ratio of 2.7, a debt/capital ratio of 35%, floating debt at 14% of total debt, and lease terms matching its debt maturity schedule.

Company Overview

Profile: Health Care Property is the nation's largest health-care REIT, with \$4.4 billion in real estate investments in 42 states. Its real estate portfolio consists of 534 buildings, with medical office buildings (182), skilled-nursing facilities (155), assisted-living/continuing-care facilities (143), and hospitals (29) constituting the bulk of its assets. About 8% of HCP's income comes from nonproperty holdings, specifically loans backed by health-care real estate.

Strategy: Management strives to maintain portfolio diversification while managing a conservative balance sheet. HCP uses its strong credit to seize attractive buying opportunities. The company predominantly acquires private-pay facilities with long lease terms (10 years or more) and generous rent bumps (2%-4%). The firm has also branched out into specialty lab space, a property sector we find attractive.

Management: Since taking the reins in 2003, CEO and

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chairman James "Jay" Flaherty has brought in a talented group of real estate professionals, such as chief investment officer Paul Gallagher, who spent 15 years with GE Commercial Finance in the real estate group. Flaherty has made great strides in corporate governance. Board members now face annual rather than three-year staggered elections. Health Care Property also added four independent directors--making more than three fourths of the board independent--and removed its poison pill. Compensation is another hallmark of the firm's reforms. Flaherty's salary in 2005 was about \$560,000, and his bonus consisted entirely of stock. The remaining officers receive most of their compensation in the form of equity grants. Trustees and executives collectively own 3% of the company. Our only complaint is that Flaherty shares the chairman and CEO titles; we'd prefer these positions to be split.

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Analyst Notes

08-01-06

Strong 2Q for Health Care Property

Health Care Property turned in an excellent second-quarter report in which revenue jumped 19%. Rising occupancies, inflation-based rent bumps, and additional rents from recent acquisitions boosted revenue growth significantly. Costs remain well-contained thanks to the company's triple-net lease structure (which passes operating expenses on to the tenant), and net operating income increased by 18%.

The firm's \$5.2 billion acquisition of privately held CNL Retirement Properties is proceeding well, with an anticipated close in early October. We remain pleased by this transaction given CNL Retirement Properties' position as the nation's largest owner of private-pay health-care facilities. The deal will add 185 senior housing facilities and 86 medical facilities to HCP's already 500-plus property

portfolio. Like HCP, CNL Retirement Properties leases its facilities on a triple-net, long-term (generally 15 years) basis. We believe that CNL Retirement Properties is a great fit for HCP, and we expect the combined company's higher-private-pay revenue mix to enhance revenue growth in future years.

We continue to believe that HCP is a top health-care real estate investment trust, and we stand by our \$30 fair value estimate. The firm's outlook is better than peers, bolstered by the CNL Retirement Properties purchase and encouraging developments such as Tenet Healthcare's--a large tenant of HCP--resolved dispute with the federal government.

05-02-06

Big Buy for Health Care Property

Overshadowing its solid first-quarter results, released Monday, Health Care Property announced plans to buy CNL Retirement Properties (CRP) for about \$5.2 billion in cash and stock. CRP owns 262 health-care facilities in 33 states, bringing Health Care Property's portfolio to almost 800 properties in 44 states--nearly twice the size of its next-largest competitor. The purchase price equates to a capitalization rate (or initial return) of 6.8% based on 2007 net operating income--a fair price, in our opinion, for CRP's institutional-quality real estate. We do not believe Health Care Property overpaid for these assets, and we are maintaining our \$30 per share fair value estimate at this time. Pending new information regarding the acquisition--specifically, how the cash portion of the transaction will be financed and what management expects in terms of cost efficiencies--we will revisit our fair value estimate.

As the third-largest health-care real estate investment trust, CRP owns the largest collection of newly constructed, private-pay health-care facilities in markets with high barriers to entry. About 80% of its portfolio consists of assisted-living, independent-living, and continuing-care communities, and 20% consists of medical office buildings. This infusion of quality, private-pay facilities will bring Health Care Property's exposure to skilled nursing homes--where most revenue comes from variable Medicare and Medicaid reimbursement--down to 9% of revenue. This will mean more stability for Health Care Property's cash flows and more opportunities for rent increases. Additionally, the company's exposure to troubled tenant Tenet Healthcare will decrease from 11% to 6% as it gains new CRP operators like Sunrise Senior Living and Horizon Bay.

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Analyst Notes (continued)

We believe Health Care Property is the most innovative health-care REIT in the industry, and this acquisition firms our opinion.

Disclaimers & Disclosures

No Morningstar employees are officers or directors of this company. Morningstar Inc. does not own more than 1% of the shares of this company. Analysts covering this company do not own its stock or those of its closest competitors. The information contained herein is not represented or warranted to be accurate, correct, complete, or timely. This report is for information purposes only, and should not be considered a solicitation to buy or sell any security.

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Sales Mil \$531 **Mkt Cap Mil** \$4,332 **Industry** REITs **Sector** Financial Services

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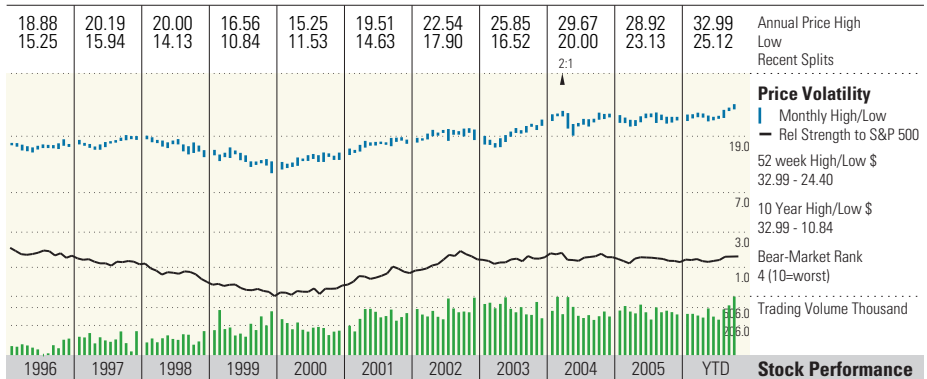
Growth Rates Compound Annual					
Grade: B+	1 Yr	3 Yr	5 Yr	10 Yr	
Revenue %	11.3	9.9	7.7	16.3	
Operating Income %	-5.8	-70.4	-50.6	-24.2	
Earnings/Share %	-1.0	1.9	-0.9	-3.2	
Dividends %	34.1	0.7	2.3	4.3	
Book Value/Share %	-3.2	-1.0	-0.8	3.3	
Stock Total Return %	31.6	17.2	19.1	15.2	
+/- Industry	-7.4	-10.4	-5.2	-0.9	
+/- Market	15.4	7.8	14.1	8.3	

Profitability Analysis				
Grade: A+	Current	5 Yr Avg	Ind	Mkt
Return on Equity %	14.7	11.9	9.6	19.7
Return on Assets %	4.7	4.4	3.0	7.8
Fixed Asset Turns	0.2	0.2	0.4	7.6
Inventory Turns	—	—	3.5	11.6
Revenue/Employee \$K	6393.1	—*	2434.9	832.7
Gross Margin %	—	—	85.8	33.4
Operating Margin %	0.9	24.3	28.0	17.9
Net Margin %	31.1	31.4	21.5	11.3
Free Cash Flow/Rev %	-49.9	-8.4	-38.2	11.0
R&D/Rev %	—	—	0.1	4.5

Financial Position			
Grade:	12-05 \$Mil	06-06 \$Mil	
Cash	21	21	
Inventories	—	46	
Receivables	13	12	
Current Assets	—	—	
Fixed Assets	3242	3451	
Intangibles	39	61	
Total Assets	3597	3859	
Payables	—	—	
Short-Term Debt	—	—	
Current Liabilities	—	—	
Long-Term Debt	1957	2196	
Total Liabilities	2198	2467	
Total Equity	1400	1392	

Valuation Analysis				
	Current	5 Yr Avg	Ind	Mkt
Price/Earnings	29.2	23.8	46.6	20.9
Forward P/E	15.8	—	18.7	18.1
Price/Cash Flow	13.6	11.6	—	14.8
Price/Free Cash Flow	—	—	31.2	24.6
Dividend Yield %	5.4	—	3.6	1.7
Price/Book	3.9	2.7	3.7	4.1
Price/Sales	8.1	7.2	7.5	2.9
PEG Ratio	2.9	—	3.0	1.7

Morningstar Rating ★★ ★ **Last Price** \$31.55 **Fair Value** \$33.00 **Business Risk** Average **Economic Moat** Narrow **Stewardship Grade** B



Year	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	YTD	Stock Performance
Annual Price High	18.88	20.19	20.00	16.56	15.25	19.51	22.54	25.85	29.67	28.92	32.99	Annual Price High
Low	15.25	15.94	14.13	10.84	11.53	14.63	17.90	16.52	20.00	23.13	25.12	Low
Recent Splits	2:1											
Total Return %	6.6	15.7	-12.4	-14.4	39.1	32.5	14.4	43.9	14.5	-1.6	29.5	Total Return %
+/- Market	-13.7	-15.3	-39.1	-33.9	49.2	45.5	37.8	17.5	5.5	-4.6	19.9	+/- Market
+/- Industry	-29.3	-5.7	-1.3	-10.8	8.2	13.9	7.4	5.8	-17.6	-15.0	1.7	+/- Industry
Dividend Yield %	6.6	6.5	8.5	11.6	9.8	8.6	8.5	6.5	4.5	6.6	4.1	Dividend Yield %
Market Cap \$Mil	1004	1143	953	1230	1523	2002	2260	3292	3684	3473	4332	Market Cap \$Mil

Year	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	TTM	Financials
Revenue \$Mil	120	129	162	225	330	332	360	400	429	477	531	Revenue \$Mil
Gross Margin %	—	—	—	—	—	—	—	—	—	—	—	Gross Margin %
Operating Margin %	64	66	79	91	127	127	146	165	4	4	5	Operating Margin %
Net Income \$Mil	53.2	51.7	48.7	40.7	38.6	38.1	40.5	41.2	0.9	0.8	0.9	Net Income \$Mil
Earnings Per Share \$	61	64	79	78	109	96	112	122	148	152	165	Earnings Per Share \$
Dividends \$	1.06	1.10	1.27	1.13	1.07	0.89	0.97	0.97	1.11	1.12	1.21	Dividends \$
Shares Mil	1.15	1.23	1.31	1.39	1.47	1.55	1.63	1.66	1.25	1.68	1.69	Shares Mil
Book Value Per Share \$	57	57	61	69	102	107	116	126	133	135	136	Book Value Per Share \$
Oper Cash Flow \$Mil	5.87	6.36	6.57	9.03	8.53	8.54	8.43	8.79	8.45	8.18	8.06	Oper Cash Flow \$Mil
Cap Spending \$Mil	91	88	112	124	206	201	224	257	273	282	316	Cap Spending \$Mil
Free Cash Flow \$Mil	-115	-200	-412	-241	-22	-155	-273	-223	-341	-447	-581	Free Cash Flow \$Mil
	-25	-112	-299	-117	184	46	-49	34	-68	-165	-265	

Year	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	TTM	Profitability
Return on Assets %	8.5	7.5	6.8	4.1	4.5	4.0	4.3	4.2	4.8	4.5	4.7	Return on Assets %
Return on Equity %	17.9	17.6	19.8	12.3	12.1	10.5	11.4	11.3	12.9	13.5	14.7	Return on Equity %
Net Margin %	50.4	49.4	48.7	34.9	33.0	29.0	31.3	30.4	34.5	31.8	31.1	Net Margin %
Asset Turnover	0.17	0.15	0.14	0.12	0.14	0.14	0.14	0.14	0.14	0.14	0.15	Asset Turnover
Financial Leverage	2.1	2.3	2.9	3.0	2.7	2.6	2.6	2.7	2.7	3.0	3.1	Financial Leverage

Year	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	06-06	Financial Health
Working Capital \$Mil	—	—	—	—	—	—	—	—	—	—	—	Working Capital \$Mil
Long-Term Debt \$Mil	112	453	709	1180	1159	1058	1334	1407	1486	1957	2196	Long-Term Debt \$Mil
Total Equity \$Mil	337	442	595	1200	1145	1247	1281	1441	1419	1400	1392	Total Equity \$Mil
Debt/Equity	0.33	1.18	1.74	1.27	1.33	1.09	1.33	1.22	1.31	1.76	1.99	Debt/Equity

Year	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	TTM	Valuation
Price/Earnings	16.5	17.3	12.1	10.6	14.0	20.3	19.8	27.0	26.9	25.1	29.2	Price/Earnings
P/E vs. Market	—	0.7	0.4	0.3	0.4	0.9	1.0	1.3	1.4	1.5	1.4	P/E vs. Market
Price/Sales	8.3	8.5	5.8	3.7	4.6	5.9	6.2	8.0	8.6	7.3	8.1	Price/Sales
Price/Book	3.0	3.0	2.3	1.3	1.8	2.1	2.3	2.9	3.3	3.1	3.9	Price/Book
Price/Cash Flow	11.1	12.4	8.4	6.7	7.4	9.7	9.9	12.5	13.6	12.3	13.6	Price/Cash Flow

Quarterly Results						
Revenue \$Mil	Sep 05	Dec 05	Mar 06	Jun 06		
Most Recent Period	124.4	126.2	141.7	140.1		
Prior Year Period	111.2	113.8	108.4	118.5		
Rev Growth %	Sep 05	Dec 05	Mar 06	Jun 06		
Most Recent Period	11.8	10.9	30.7	18.2		
Prior Year Period	8.0	5.1	10.5	10.6		
Earnings Per Share \$	Sep 05	Dec 05	Mar 06	Jun 06		
Most Recent Period	0.29	0.24	0.32	0.24		
Prior Year Period	0.23	0.29	0.24	0.25		

Industry Peers by Market Cap				
	Mkt Cap \$Mil	Rev \$Mil	P/E	ROE%
Health Care Property	4332	531	29.2	14.7
Ventas	4015	384	31.1	—
Nationwide Health Pr	2223	237	34.1	—

Major Fund Holders		
		% of shares
American Funds Capital Inc Bldr A		2.67
American Funds Inc Fund of Amer A		1.78
Cohen & Steers Realty Income A		0.81

*3Yr Avg data is displayed in place of 5Yr Avg

Morningstar's Approach to Rating Stocks

Our Key Investing Concepts

- ▶ Economic Moat
- ▶ Discounted Cash Flow
- ▶ Discount Rate
- ▶ Fair Value
- ▶ Business Risk
- ▶ Margin of Safety
- ▶ Consider Buying/Consider Selling
- ▶ Stewardship Grades

At Morningstar, we evaluate stocks as pieces of a business, not as pieces of paper. We think that purchasing shares of superior businesses at discounts to their intrinsic value and allowing them to compound their value over long periods of time is the surest way to create wealth in the stock market.

We rate stocks 1 through 5 stars, with 5 the best and 1 the worst. Our star rating is based on our analyst's estimate of how much a company's business is worth per share. Our analysts arrive at this "fair value estimate" by forecasting how much excess cash--or "free cash flow"--the firm will generate in the future, and then adjusting the total for timing and risk. Cash generated next year is worth more than cash generated several years down the road, and cash from a stable and consistently profitable business is worth more than cash from a cyclical or unsteady business.

Stocks trading at meaningful discounts to our fair value estimates will receive high star ratings. For high-quality businesses, we require a smaller discount than for mediocre ones, for a simple reason: We have more confidence in our cash-flow forecasts for strong companies, and thus in our value estimates. If a stock's market price is significantly above our fair value estimate, it will receive a low star rating, no matter how wonderful we think the business is. Even the best company is a bad deal if an investor overpays for its shares.

Our fair value estimates don't change very often, but market prices do. So, a stock may gain or lose stars based

just on movement in the share price. If we think a stock's fair value is \$50, and the shares decline to \$40 without much change in the value of the business, the star rating will go up. Our estimate of what the business is worth hasn't changed, but the shares are more attractive as an investment at \$40 than they were at \$50.

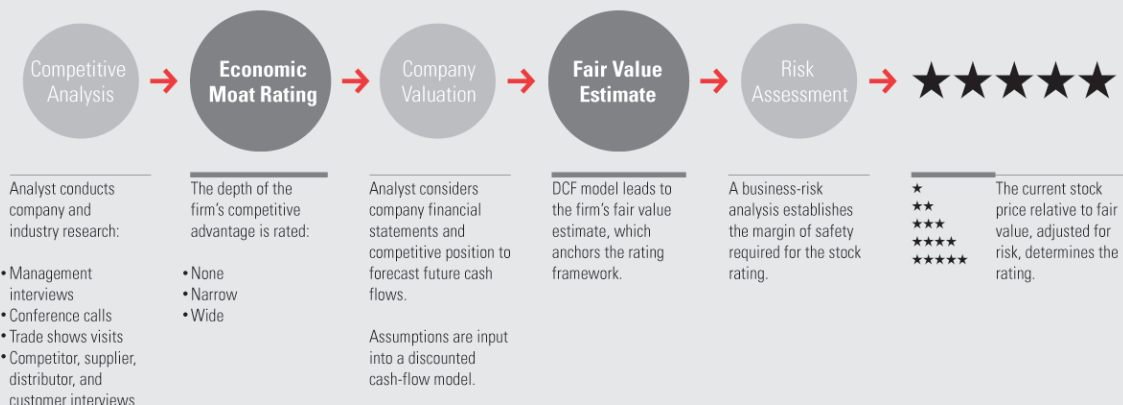
Because we focus on the long-term value of businesses, rather than short-term movements in stock prices, at times we may appear out of step with the overall stock market. When stocks are high, relatively few will receive our highest rating of 5 stars. But when the market tumbles, many more will likely garner 5 stars. Although you might expect to see more 5-star stocks as the market rises, we find assets more attractive when they're cheap.

We calculate our star ratings nightly after the markets close, and issue them the following business day, which is why the rating date on our reports will always be the previous business day. We update the text of our reports as new information becomes available, usually about once or twice per quarter. That is why you'll see two dates on every Morningstar stock report. Of course, we monitor market events and all of our stocks every business day, so our ratings always reflect our analyst's current opinion.

Economic Moat

This is our assessment of a firm's ability to earn returns consistently above its cost of capital in the future, usually by virtue of some competitive advantage. Competition tends to drive down such economic profits, but companies

Morningstar Research Methodology for Valuing Companies



Morningstar's Approach to Rating Stocks (continued)

that can earn them for an extended time by creating a competitive advantage possess an economic moat. We see these companies as superior investments.

We're big fans of companies that are low-cost producers, create high switching costs for their customers, or have strong brands or long-lasting patents, because all of these characteristics allow companies to protect their competitive position. For example, Tiffany is far more profitable than a run-of-the-mill jewelry chain because it has a strong brand that creates a moat around its business, allowing it to charge more than competitors.

Discounted Cash Flow

This is a method for valuing companies that involves projecting the amount of cash a business will generate in the future, subtracting the amount of cash that the company will need to reinvest in its business, and using the result to calculate the worth of the firm. We use this technique to value nearly all of the companies we cover.

Discount Rate

We use this number to adjust the value of our forecasted cash flows for the risk that they may not materialize. For a profitable company in a steady line of business, we'll use a lower discount rate, also known as "cost of capital," than for a firm in a cyclical business with fierce competition, since there's less risk clouding the firm's future.

Fair Value

This is the output of our discounted cash-flow valuation models, and is our per-share estimate of a company's intrinsic worth. We adjust our fair values for off-balance sheet liabilities or assets that a firm might have--for example, we deduct from a company's fair value if it has issued a lot of stock options or has an under-funded pension plan. Our fair value estimate differs from a "target price" in two ways. First, it's an estimate of what the business is worth, whereas a price target typically reflects what other investors may pay for the stock. Second, it's a long-term estimate, whereas price targets generally focus on the next two to 12 months.

Business Risk

Based on fundamental factors such as cyclical, leverage, competitive strength, and profitability, we divide our coverage universe into four broad risk categories: Below Average, Average, Above Average, and Speculative. Unlike some risk ratings, ours is not based on the volatility of the firm's shares, but rather the predictability and strength of the underlying business.

Margin of Safety

This is the discount to fair value we would require before recommending a stock. We think it's always prudent to buy stocks for less than they're worth. The margin of safety is like an insurance policy that protects investors from bad news or overly optimistic fair value estimates. We require larger margins of safety for less predictable stocks, and smaller margins of safety for more predictable stocks.

Consider Buying/Consider Selling

The consider buying price is the price at which a stock would be rated 5 stars, and thus the point at which we would consider the stock an extremely attractive purchase. Conversely, consider selling is the price at which a stock would have a 1 star rating, at which point we'd consider the stock overvalued, with low expected returns relative to its risk.

Stewardship Grades

We evaluate the commitment to shareholders demonstrated by each firm's board and management team by assessing transparency, shareholder friendliness, incentives, and ownership. We aim to identify firms that provide investors with insufficient or potentially misleading financial information, seek to limit the power of minority shareholders, allow management to abuse its position, or which have management incentives that are not aligned with the interests of long-term shareholders. The grades are assigned on an absolute scale--not relative to peers--and can be interpreted as follows: A means "Excellent," B means "Good," C means "Fair," D means "Poor," and F means "Very Poor."