NORTHSTAR

ASSET MANAGEMENT

Client Letter 10 July 2014

Quarter End: 30th June 2014

Dear Client,

We are very pleased to report to you on an excellent twelve, six and three-month performance from your investment team at Northstar Asset Management.

Most general equity managers in SA produced outstanding returns in 2013 - the buoyant market ensured this would be the case. However, less than 20% of managers beat the market over the year and fewer than 15% outperformed the JSE over six and three months.

The difficulty faced by equity managers has been that resource shares, which are more cyclical and often avoided, were the highest returners over the year. Our Northstar portfolios have always contained a healthy blend of businesses covering resources, financials and industrials. We, in fact, bought Anglos in 2013 which played a significant role in our clients outperforming the general equity sector by healthy margins, over all the periods in question.

Whilst Northstar's returns have been outstanding, we must once again, issue a word of warning - our investment style is contrarian as it seeks companies offering potential where market prices do not reflect the inherent value in a company. This investment approach requires healthy hearts and the patience of Job but unfortunately, also renders glowing 12-month returns meaningless. Real skill can only be demonstrated over decades - not months nor a couple of years!

On the business front, we continue to invest in Northstar to improve our intellectual property and our service offering to our clients. In terms of skill enhancement, we have recently employed a young fixed- income analyst who was previously an underling to one of the top hedge fund managers in South Africa!

Activity levels in the business remain elevated, including thousands of hours spent researching new companies and one of our analysts also attended a three-day conference in New York, meeting the management teams from some of the world's most renowned companies. These measures aim to drive enduring investment performance and in so doing, create a company with which our clients, our staff and our suppliers feel proud to be associated!

In conclusion, we once again thank you for your patronage of Northstar and we look forward to continuing in the role as custodians of your wealth.

Adrian Clayton
and the entire Northstar Team

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Market summary:

Once again, 2014 has proven to be an outstanding period for long-term share investors. The JSE has returned 8.8% (dollars) and the MSCI World 6.5% year-to-date.

Our market has generated annualized returns of 21% in rand terms over 10 years, with this past year being the highest returning period over the last 7 years – a staggering 32.7% inclusive of dividends. Not only was there a shift in sector leadership on the All Share Index with resources gaining 39.1% and outstripping all other indices, but due to most other major JSE sectors rising, the All Share Index produced a bumper year! This is the first time in six years that resources have led the market higher. This performance has been beneficial to our clients - we refer our readers to the Northstar Market Report of 31 March 2013 which we dedicated to balancing industrial and financial exposure with selected resource counters although, at the time, an unpopular argument!

The global economic backdrop:

Through very loose monetary policy, central banks continue their mission of injecting hope into a fragile, yet recuperating, global financial system. Their undeniable goals have been to propel confidence, shore-up asset prices and promote lending, investment and consumption. Without this infusion since 2008, the economic system to which we have become accustomed, could have collapsed.

To appreciate the extent of the stimulus, an assessment of real interest rates needs to be made. The real interest rate is the rate of interest an investor will earn above inflation when investing into a bank or fixed income account. US PCE Core is presently running at 1.52% year-on-year – this is the inflation rate that the US Federal Reserve monitors. The Fed Funds rate - the official US interest rate - is currently 0.25%. Thus, the real interest rate - interest rates less inflation - in the US is negative 1.3%.

European CPI (inflation) is at 0.5%, yet the ECB (European Central Bank) has set policy rates at 0.15% which implies that the real interest rate is negative 0.35%. In South Africa, our headline inflation is 6.6%, whilst our official interest rate, the Repo rate, is presently 5.5% and consequently, we have negative real interest rates of 1.1%.

Our team assessed 18 emerging markets, 8 of which currently have negative real interest rates with Turkey (followed by SA) leading the pack! These negative interest rates are not coincidental - South Africa has the second lowest GDP growth rate at 1.6% and Russia has the lowest at 0.9%. The average emerging market is currently growing its annual gross domestic product at 3.7% – 2.4 times faster than South Africa!

This measure of real interest rates is important. A rational investor should demand a return on money above inflation, but with interest rates set so low, central banks are purposefully ensuring that cash invested in bank accounts generates suboptimal returns (returns below inflation). Central banks are motivating savers out of cash and safe haven investments and into riskier asset classes such as bonds, property and equities. The rationale is simple: escalating asset prices make investors feel wealthier, this drives confidence, they spend more, businesses make more money, employment rises and the entire economic system begins to slowly mend!

As the managers of your money, we must thus be cognisant of the real chance that central banks have the power to drive market values through their continual stimulus packages for a long while yet. However, this system has deep seated risks and we need to offset the idea of a 'high tide floating all boats', with a real appreciation of what assets are worth in a normal environment. As Buffett so aptly put it, "When the tide goes out you can tell who is swimming naked".

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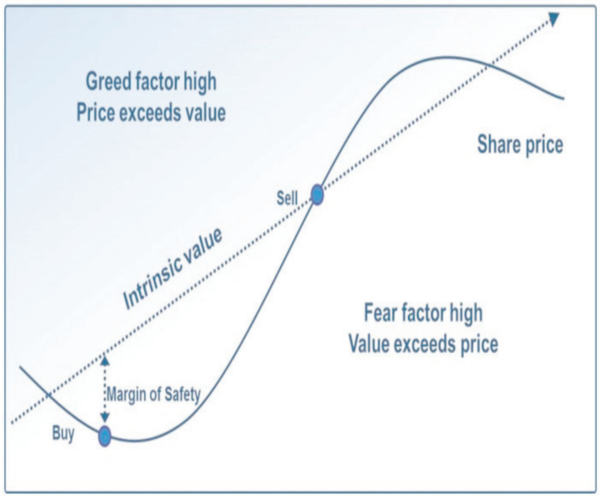
Market and stock valuations:

Whilst the intention of central banks is to buoy asset prices, an unintended consequence is the development of asset bubbles. One such bubble may be London high street real estate, but only time will tell. Based on valuations, in general, most markets around the world are not in bubble-like territory, but only a few are cheap! At Northstar, we have an unflinching belief that the only way to protect and build capital is to invest in assets where the market price does not do justice to the true value embedded in the instrument or company in question. The graph below, which we portray in all our marketing material, relays this message. We buy assets at discounts to their realistic values and we sell assets at premiums to their intrinsic or realistic values. Our buying occurs when fear is high and most investors want to escape markets. We sell when euphoria reigns and when investors feel most at ease holding equities.

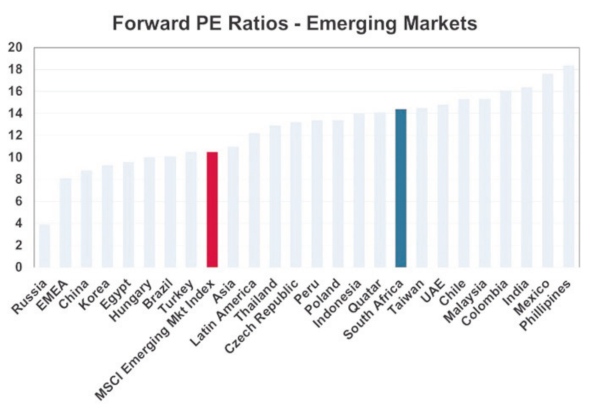


Value vs. Price

We have conducted an assessment of how cheap or expensive markets are and, with regards to emerging bourses, these are certainly not treated in a homogenous manner in terms of how market participants have rated them! Collectively, Latin American markets are on a forward P/E of about 16 times - this excludes Brazil, which has a P/E one year ahead of 10 times. EMEA (Europe, Middle East and Africa) markets trade at 12.5 times their earnings. We have excluded Russia, which is on a forward P/E of 3.9 times and Greece, which is on a P/E of 30.9 times, one year ahead. Asian markets are trading on forward P/E's of about 11 times, which looks very reasonable in our view.

Relative to most of the emerging markets on our radar, the JSE looks expensive - its forward P/E is higher than most and its price-to-book ratio is also higher than many competitor markets (a P/E is defined as the price of a share or market divided by the earnings that the company or market will deliver. It can be interpreted as the length of time it takes to get money back on an investment. A high number implies that an asset is expensive, a low number that the asset is cheap – all else being equal).

The graph below shows how our market stacks-up on a valuation basis against other emerging markets:



Source: Standard Bank

As our clients are aware, at Northstar we are not 'big picture' prognosticators and focus, instead, on the tough grind of in-depth company research. This is not the sexy, pulpit preaching, crystal-ball stuff that woos audiences, but we believe it is the only way to add value over time. On the subject of stock specific research, we undertook twelve new 'deep dives' over the quarter, this in addition to our ongoing maintenance research. Estimated time spent on these new companies was 1200 hours.

JSE company researched this past quarter ended-up on our 'Waiting for a lower price' list. All the offshore companies we researched were voted onto our 'Buy list' except for one, which also ended-up on the 'Waiting for a lower price list'. This confirms our view that more value is apparent in offshore stocks than we are presently finding on the JSE. We recommend that our clients converse with us in person on the subject of investing abroad.

Northstar's core values:

Northstar will remain steadfast to its core values – a highly focused, research-driven and client-centred manager of money. We believe our competitive advantage rests on two pillars. Firstly, our strong research process that is unwavering in its consistency of application and in so doing, has produced credible results for our clients over time. The second, being that our offering is to a select grouping of clients - investors who do not want to be just another number at a large institution and appreciate the personal approach offered by Northstar.

Through our client interactions, it has become increasingly apparent that we have one or two holes within our product range, yet abundant internal expertise to fill these gaps. At present, we use our fixed income skills in a balanced fund which we have managed for the past few years. These same skills can and should be deployed in an income fund to assist our clients with their income needs, especially when considering poor yields earned in savings accounts.

As we are determined to remain client-focused, we do not intend to launch many products. In South Africa, Northstar will only offer its current equity share portfolio service, its balanced fund and its income fund. Abroad, we will continue to offer our share portfolio service and will also be launching an offshore flexible fund. We see no need for additional products in the years ahead and believe that this simple product set adequately caters to the needs of our clients.

The Northstar Met Income Fund:

The Northstar Met Income Fund, launching in late July, will be managed by the Northstar Research Team and administered and distributed by the Momentum Group, who have identified Northstar as a Premium Partner in South Africa. Premium Partners are managers that Momentum consider to be the best in their class and likely to be industry-leading in the years ahead.

Conclusion:

As much as markets gyrate and pulse, our recipe remains the same – we are a research focused, value-driven and long-term thinking manager. We suspect that in the current euphoric markets, our style may soon prove unpopular, although such sentiment will not deter us from holding our line and doing what we know is right for our investors!