NORTHSTAR

ASSET MANAGEMENT

Client Letter 09 January 2014

Quarter End: 31st December 2013

We have come to the end of 2013 - a year that has surpassed our expectations in terms of gains with our market returning 17.8% net of dividends.

Our average client portfolio outperformed the JSE All Share Index by 7.6% for the year, which can be compared to the long-term annual average outperformance of Northstar client portfolios of 5.8%. Of the top 40 best performing JSE companies for 2013, our portfolios contained 13 of these stocks. Of the 40 worst performing stocks on the JSE for the year, we owned just two companies. Considering our average portfolio holds about 17 companies, the stock 'hit rate' has been very high. Having said this, we are frustrated at having missed one or two opportunities, which highlights the importance of constantly learning and honing our skills.

Performance has come at a price and we estimate that hours spent on research annually is approximately 10 000. It takes about 100 hours to understand a company properly and we undertake in-depth research into at least 100 companies per year. This excludes the many hours spent on general market research and seeking quality companies on which to initiate research. We thus look back at 2013 with some sense of achievement - the hard work translated into sound returns - although we are very cognizant that from the 1st of January 2014, the dial returns to zero and a new year with new challenges awaits.

Our quarterly market commentary attached explores the concept of long-term investing and patience, but it also touches on how the JSE is priced right now, which is on the high side. With this in mind, we need to find a careful balance between owning companies that are world-class businesses (and that we view as core positions within our clients' portfolios) and ensuring that these have not been overpriced. It is also imperative that we actively seek to invest in undervalued assets, but not those that are 'cheap for a reason' and likely to be eternal 'value traps'.

A key theme for the year ahead is the rand, as our currency plays a meaningful role in deciding which companies should be contained within a portfolio. This is the fine art of combining rand hedges (companies that do well when the rand depreciates) with rand plays (companies that do well when the rand appreciates). We deem the rand as fairly valued at its current level, based on our calculations of Purchasing Power Parity.

So as we can see, 2014 is full of challenges and although these may be configured differently to previous years, none that we foresee are new! Our approach remains steadfast and consistent and encompasses applying logic over emotion, always scrutinizing, never guessing and directing our repeatable investment process towards unearthing quality ideas that can populate our clients' portfolios, irrespective of short-term market gyrations.

We wish you a healthy and prosperous 2014 and look forward to playing a meaningful role in you achieving this.

Kind regards,

Adrian Clayton

and the Northstar Investment Team

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TIME – the free and often neglected option for investors:

Research must be focused on valuing the asset, not trying to time the entry:

One of the central pillars of value-based investing is the concept of TIME. The ethos of research driven investing is to ascertain which companies are cheap relative to their intrinsic values and not to try and guess when this value gap will close. To a large extent, we are forced to become TIME agnostic. Inevitably, markets will gravitate to undervalued companies, usually when news flow turns positive around those businesses and in turn, driving share prices higher. Equally, markets tend to shun the winners that are overpriced when they disappoint at some stage, usually when profits do not meet heady and unrealistic heights expected by investors. To time all of these outcomes is impossible - the best we can do is work actively to understand which assets within our investing universe are undervalued and which are overvalued, be positioned in undervalued spaces, avoid overvalued areas and leave timing to the gods.

Criticisms of Value Investing:

One of the often cited drawbacks of classic value-based investing is that investors find themselves invested in undervalued companies whose share prices are static and not 'in vogue' – that is, the market has no interest in these companies. Concurrently, it might well be that these very same investors could be 'missing out' on other companies where infatuation levels are high and share prices are escalating, even though valuations are at stratospheric levels. This line of thinking is deeply flawed as it fails to comprehend that market timing is impossible. Attempting to find 'tops' and 'bottoms' in markets is tantamount to gambling and we know of no literature where any trader has demonstrated a clear ability to consistently make money using such a strategy.

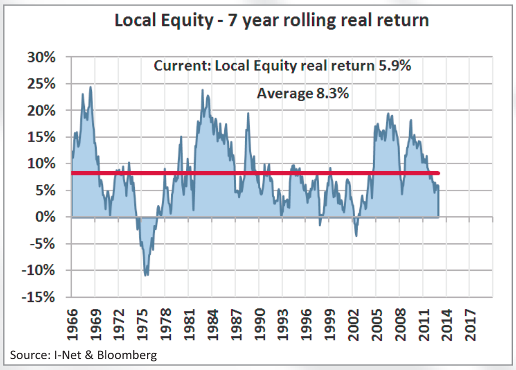
Avoid emotions, rely on logic:

Long-term sound investing avoids emotional biases and relies on logic – hence, it is a numbers game. The best approach to wealth creation is to understand or appreciate that returns occur in explosive bursts and equity gains are not linear (do not occur in a straight line). Because of this, what is often needed is a long waiting period with potentially dull returns followed by a period of excessive pay-back for the wait.

TIME in the market and the current level of the JSE:

In this quarterly report, we explore and illustrate two key themes. The first is the importance of being invested in equities over long periods of time – this will add credence to our comments above – it's all about TIME in the market, rather than TIMING the market. The second is whether it is worth being invested on the JSE at this point in time, considering current valuations (level of pricing) on the domestic market.

All the statistics point to the importance of long holding periods:



Source: I-Net & Bloomberg

Our attached graph depicts real (inflation adjusted) returns on the JSE using seven-year rolling periods and dating back to 1966. The following points are worth highlighting:

1. By investing for this long period, an investor's money would have grown by an annualized rate of 8.3% real – 8.3% above inflation.

2. There have only been three periods over this 48 year span when equities have produced negative real returns over seven years – this happened in the mid 1970's, in the mid to late 1990's and in early 2000's.

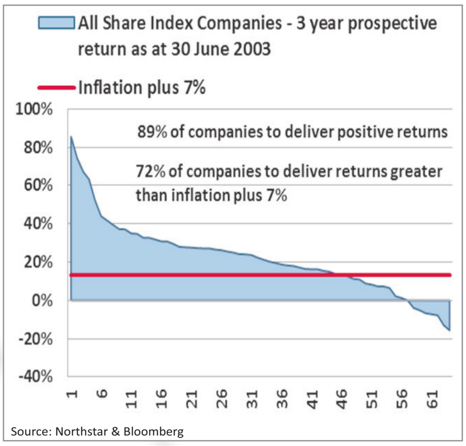
3. Clearly, provided an investor has a time span of at least seven years, equities become a low risk asset class. In fact, we would argue that various other asset classes (such as cash), if held for periods of seven years, are very risky as they do not have the inflation beating characteristics which exist within stocks or shares.

4. It should also be clear that, although the market produces incredibly consistent long-term returns, it exhibits extreme levels of volatility or unpredictability in the short-term. The market's short-term gyrations are effectively random. This adds substance to our view that the only intelligent investment approach relies on understanding when companies are cheap, buying them, holding them until they realize their true value (which normally takes many years) and then selling them!

How expensive is the JSE now?

One of our research tools at Northstar is our 'Prospective Returns Screen'. This model attempts to assess prospective or future returns that are available from stocks which constitute the JSE and is based on a number of inputs which we cannot explore in detail in this report – suffice to say it acts as a rough gauge of future returns. Below are two graphs representing two periods, the first dates back to the 30th of June 2003. Based on stock valuations at the time, we attempt to ascertain what likely future or prospective three-year annualized returns would come out of stocks listed on the JSE. Our findings are as follows:

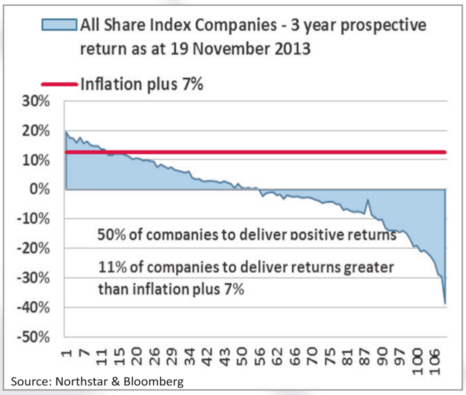
- 89% of companies should provide annualized returns above 0% for the following three years.
- 72% of companies should provide annualized returns above inflation plus 7% for the following three years. (The JSE All Share Index has produced very long-term returns of approximately inflation plus 7% and hence using that as a benchmark).
- The best performing company should deliver an annualized return of over 80% for the following three years.
- The worst performing company should deliver an annualized return of about -20% for the following three years.
- Based on these findings, an investor should have actively deployed cash into the stock markets in 2003 – the odds were stacked in favour of outstanding future returns. Ironically, at the time, most investors were very cautious and missed out on much of the gains that followed.



Source: Northstar & Bloomberg

Adopting the same analysis to the JSE using current valuations (looking at the market in 2013 and at 2013 stock prices), our analysis reflects a completely different picture.

- 50% of companies should provide annualized returns above 0% for the following three years.
- 11% of companies should provide annualized returns above inflation plus 7% for the following three years. (The JSE All Share Index has produced very long-term returns of approximately inflation plus 7% and hence using that as a benchmark).
- The best performing company should deliver an annualized return of about 20% for the following three years.
- The worst performing company should deliver an annualized return of about -40% for the following three years.



Source: Northstar & Bloomberg

- Based on these findings, an investor should approach the current market with caution. Although the RIGHT companies should provide sound future returns, these will likely be lower than what was enjoyed from 2003 onwards.

We conclude 2013 with a summary of what has been discussed above:

- The case for investing for lengthy periods of time in equities is indisputable – equities or stocks are the most efficient and effective means to beat inflation.
- The JSE is not as cheap as it was ten years ago and future returns will be lower than investors have become accustomed to this past decade.
- The market is, however, not a homogenous mass and there will always be specific opportunities which must be capitalized upon.
- Beating the market requires thorough research, holding the right companies and understanding what they are worth. This is precisely what we do at Northstar

2013 was one of the top performing years in Northstar's long history. Whilst we feel that the immediate years ahead will not be quite as enriching, we intend working harder and smarter than ever to deliver market beating returns for our clients.