NORTHSTAR
ASSET MANAGEMENT

Client Letter 15 January 2015

Quarter End: 31st December 2014

Dear Client,

We trust you are well and hope that you have had a safe and joyous festive season with a new-found enthusiasm for 2015.

2014 proved to be another year in which Northstar portfolios were resilient against a turbulent economic, political, social and investing landscape. The year was full of twists and turns which included: an unsecured lending failure in South Africa; deflation in Europe; a change of direction by OPEC in terms of managing oil markets; and let us not forget, the Crimea crisis.

We ascribe the resilience of Northstar portfolios to a deep-seated anchor within our investment process – namely that we only own companies that we believe will outlive all of us. Although not a forgone conclusion, we have found that the future tends to be easier to predict in companies with very long pedigrees – those that have stood the test of time despite experiencing wars, famines and dictators, yet remain in business today.

Whilst we suspect that 2015 is going to be very tough, this is irrelevant within the context of time. We at Northstar remain committed to the same deep DNA that has driven our business for the past two decades – work very hard, work very smart and keep things simple.

The attached Northstar Quarterly Report covers major economic themes which are expected to occur within the markets in 2015. These have been contextualized within a frame of history and also address what could happen should market expectations not be met.

We wish you a prosperous 2015 and thank you for your ongoing patronage of Northstar.

Kind regards,

Adrian Clayton
and the entire Northstar Team

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The complexity and opaqueness of macroeconomic forecasting highlights, once again, why this is an activity on which we spend little time and, instead, focus our attention on unearthing great investment opportunities for our clients on an instrument-by-instrument basis.

That being said, 2015 could well be a watershed year for markets, with possible shifts in monetary and fiscal policy occurring in different parts of the world. Whilst the focus of our newsletters is not usually on economics, we felt it an appropriate topic in 2015, as the changes could have a real market impact. Unfortunately, due to the brevity of this document, we can only focus on two large economic developments – the direction of US interest rates and monetary easing by the European Central Bank (ECB) and the Bank of Japan (BOJ).

The Federal Reserve is expected to increase US interest rates in 2015:

Unpacking the past US interest rate cycle:

On 18 September 2007, the Fed cut interest rates for the first time since 2003 (by 0.5% with the rate moving from 5.25% to 4.75%) in response to tectonic shifts in the international financial system, fearing the onset of a financial crisis. On 7 August 2007, BNP Paribas terminated all client redemptions from hedge funds, stating that liquidity had completely dried-up in the market, which signaled ‘D-day’ for financial markets and the onset of the Great Global Recession.

The Federal Reserve’s September 2007 cut was the beginning of a seven-and-a-half year cycle of zero interest rates – by December 2008, the Fed had created a ‘target range’ for the Fed funds rate of between 0% and 0.25%.

At the time of the first cut, the S&P index was at 1485, whilst the financial crisis caused it to fall to 680 in March 2009. However, by December 2014, it had gained 210% off its lows of 2009 and was at 2090. By December of last year, the S&P was also 41% higher than the pre-crisis levels of 2007.

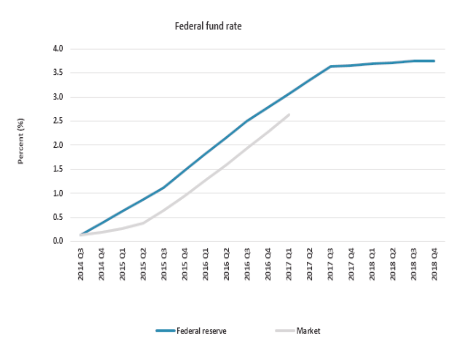
The Great Recession rather than the Great Depression:

As we know, the Great Recession not only affected Wall Street, it also affected Main Street. Leading up to this crisis, unemployment in the US was below 4.5% (May 2007 - 4.4%) but by October 2009, this figure had reached 10%. In December 2014, the official US unemployment rate was back down to 5.6%. The Federal Reserve views a jobless rate between 5.2% and 5.5% as full employment in the US and a fully employed work force is inclined to demand higher wages, which leads to inflation - this is why the Fed focuses on the level of employment/unemployment. This figure, coupled with an inflation rate of around 2%, is a key factor that will drive a change to higher interest rates in the US.

The Fed’s actions, which were aggressive and early (September 2007), staved off a Great Depression and maintained market stability. A consequence of this action is that market participants have become accustomed to an environment of benign interest rates over an extended time period – an obvious question is whether markets are really prepared for a higher future cost of money?

What the market expects from the Fed in 2015 and onwards:

The consensus is that US rates will rise in June or September 2015 but at an extremely slow pace of 0.25% increments at a time, with interest rates reaching 1% in June 2016 and finishing below 3% in 2019 (see the attached graph). What is concerning is that the Federal Reserve’s view of their interest rate glide slope is significantly more aggressive than how the market sees rates rising in the years ahead. This ‘difference in opinion’ is a real risk to asset price stability.



Source: Northstar Asset Management & Bloomberg

Implications for investors:

What are the implications of the Federal Reserve's interest rate policy in the years ahead? We will discuss these briefly under two scenarios - firstly, if the Fed raises rates at a faster pace than what the market deems appropriate and, secondly, where rates increase at a very slow pace or do not increase at all.

The Federal Reserve raises interest rates aggressively:

- The US dollar strengthens against the euro, the yen and emerging market currencies. The rand will remain very weak.
- Commodity prices stay under pressure. The gold price heads lower.
- Interest rates in emerging markets are forced higher to retain or attract foreign capital.
- Economic growth slows in the US and the initial boom for countries that compete with the US on exports will, in time dissipate, as their economies experience slower growth.
- Riskier assets perform poorly.

The Federal Reserve does not raise rates:

- The US dollar loses its shine. Emerging currencies strengthen.
- Commodity prices rally hard. The gold price surges.
- Interest rates around the world stay lower for longer.
- Economic growth continues to surprise on the upside in the US.
- Riskier assets perform very well.

The ECB and BOJ are expected to implement further aggressive loose monetary policy actions in 2015:

The next theme pervasive in markets is that the European Central Bank and the Bank of Japan will continue on a path of actively stimulating their economies and maintaining market stability through monetary easing and asset purchases.

Unpacking the BOJ's monetary activities:

The BOJ decided on the 4th of April 2013 to implement an aggressive new plan of monetary easing to reverse the effects of 15 years of deflation. Reading through the bank's news release at the time, it was quite apparent that they aimed to 'encourage a further decline in interest rates', which would achieve a 'price stability target of 2% in terms of the year-on-year rate of change in the consumer price index'. To achieve this, the bank would manipulate money market rates and actively acquire Japanese assets, including bonds, exchange traded property funds and listed equity indices.

Japanese firepower – introducing the GPIF into the reflation game:

Japanese monetary authorities have not pacified their approach and, in October 2014, the Government Pension Investment Fund (GPIF), the largest fund of its kind in the world ($1.1 trillion), decided to redirect their capital towards riskier assets, designed to buoy markets further. The fund had an allocation of 50% in domestic bonds in September 2014; the new intended exposure would be 35% - the difference being allocated to equities and other riskier assets. We calculate the Nikkei 225 to have a market capitalization of $2.67 trillion, assuming the GPIF moves 15% of its total assets into Japanese equities, this will account for flows of $165m or 6% of the total market size.

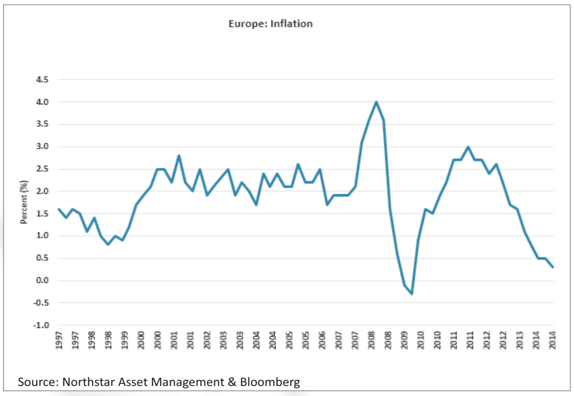
Challenging times facing the ECB:

Although the European Central Bank is encountering a degree of internal squabbling regarding its plan to expand its balance sheet back to levels last seen in 2012 of €3.1tn from its current €2.1tn, the committee voted to make this happen in October 2014. This provided ECB President, Mario Draghi, with another weapon to fight European deflationary forces (see the graph below) and continued rising unemployment in Europe (see the graph below). Whilst European bond rates are at all-time low yields already, the extra fire power will, hopefully, maintain low interest rates and, similar to what occurred in the UK and US, fuel economic activity and create price stability. The ECB, like the BOJ, is targeting an inflation rate of 2%, in-line with the average inflation rate recorded in Europe from 1991 to 2014 of 2.15%. In December 2014, Euro Area inflation was recorded at -0.2%.

Europe has a serious unemployment problem

Source: Northstar Asset Management & Bloomberg

Europe faces deflation similar to Japan



Source: Northstar Asset Management & Bloomberg

What the market expects from the ECB in 2015:

The stock market anticipates that European Qe will begin soon and that the program will kick-off with €500bn. To understand the size of this market intervention relative to others, consider the behavior of the Bank of England (BOE) from 2008. The BOE acquired 25% of the outstanding UK debt when they implemented their Qe program. Should the ECB activate the €500bn program in the coming months, this will account for less than 6% of the total size of outstanding European sovereign debt, which is approximately €9tn.

We want to understand the implications of the Bank of Japan and the European Central Bank's behavior on asset prices. Again, we approach this from two angles - the first is assuming that they go ahead as planned whilst the second is where no action is forthcoming.

Implications for investors:

The BOJ and ECB implement further monetary easing as expected:

- Both the yen and the euro weaken initially, which is precisely the outcome that both central banks want. A weaker currency stimulates growth and increases imported inflation. The rand will remain very weak in this environment, as over 20% of SA exports go to Europe.
- Initially, commodity prices might rally on sentiment, but the strong dollar relative to the euro and yen tends to dampen demand on a medium-term view. Given time however, should monetary policy actually achieve the objective of stimulating GDP growth, commodity prices will enjoy some reprieve. Improving economic conditions, accompanied with a strong dollar will not be gold friendly.
- Interest rates in emerging markets stay lower for longer.
- Economic growth revives in these low growth and deflationary regions.
- Riskier assets perform well.

The BOJ and ECB fail to push through their monetary stimulus packages:

- This could initially result in euro and yen strength, although it will be short-lived as investors concern themselves with economic growth in these regions. Both currencies will remain weak against the dollar for a longer period of time. The rand will be weak against the dollar and ambivalent against the yen and euro.
- Commodity prices remain under pressure. The gold price is a tricky one as it will be buoyed by deflation fears but pressurized by the strong dollar.
- Interest rates around the world will be higher by default.
- Economic growth will be weak, particularly in Europe, Japan and emerging countries relying on these zones for exports – South Africa being a prime example.
- Riskier assets perform poorly.

There are many moving parts in the economic landscape of 2015.

We conclude with the same message with which we introduced the topic of forecasting – it is a seriously tricky business. Consequently over the long-term we believe that our efforts are best spent finding **QUALITY** investments which are trading at fair **VALUE**, leaving **TIMING** to the powers that be. Inevitably, great companies trade at the right price!

The Northstar Research Team

Northstar – Company update

We believe that Northstar's success boils down to two key factors - firstly, understanding that our clients have personal needs that are not generic, as no two clients are the same. This can only be achieved if the focus of our business is on quality as opposed to size – as we have always said, we aim to be the best and not the biggest! Secondly, our clients expect us to work hard and be smart so as to produce market-beating returns over time.

With this in mind, we felt it appropriate to dedicate a small section of our Northstar Market Report to inform our Northstar clients of internal developments within our business. The feature for this quarter is, in fact, one of our funds. As you are probably aware, Northstar does not have many products as we believe that simplicity is a key factor to success. We do, however, manage a handful of products, each catering for specific client needs – our Northstar Met Income Fund being one of these.

What is the Northstar Met Income Fund?

The Northstar Met Income Fund is a collective investment scheme (a unit trust) managed by the Northstar Research Team. The administration for which is undertaken by Metropolitan, which is part of the Momentum Group, a JSE listed company.

Why did we launch the Northstar Met Income fund?

Firstly, we were not happy with the returns that our clients were receiving on the cash we held in their portfolios on the JSE (with stockbrokers) and felt obligated to improve these yields.

Secondly, many of our clients had requested a low risk-fund that would out-perform their bank accounts over time.

Thirdly, buying the correct instruments that would provide higher yields for our clients was impossible on a client-by-client basis. We felt that we needed to bulk the capital in a fund and buy these assets collectively.

Finally, at Northstar we are fortunate to have a fixed income team that has an exceptional long-term track record in managing such a product and it made sense to utilize these skills to benefit our clients.

What is the objective of the Northstar Met Income Fund?

The fund is designed to provide income to our clients regularly and is set-up to beat inflation over time, whilst not taking too much risk. It pays income 4 times a year.

What is the benchmark of the Northstar Met Income Fund?

The benchmark of the fund is money market rates. This fund is designed to beat money market rates over 3 years. For our technical clients, the objective is 110% of STEFI Call.

What do we do within the Northstar Met Income Fund to beat money market rates?

Instead of simply holding cash in the bank which yields very low returns, this fund buys many different instruments that enhances yields for our clients. We choose to avoid high risk situations – this fund had zero exposure to African Bank in 2014 and we currently have zero exposure to Edcon (Edgars – the SA retail company) instruments, which we deem to be in trouble.

When was the Northstar Met Income fund launched?

The fund was launched on the 22nd of July 2014.

How has the Northstar Met Income fund performed?

Legally, we are only able to show the performance of a fund once it has been in existence for 6 months, which occurs just one week after writing this report. What we can say, however, is that the fund is doing precisely as intended, demonstrating low risk and healthy returns. We are having a particularly good start to 2015.

Who should make use of the Northstar Met Income fund?

When clients invest with us, unless stocks are very cheap, we tend to hold cash and reduce this exposure as and when opportunities arise. This fund gives us the scope to follow this approach. We also view the fund as an excellent alternative to cash in a bank account, particularly for lazy cash with a time horizon longer than one year. It is also the correct vehicle for our clients with an income need.

Conclusion:

We are very excited about the Northstar Met Income fund. Many of our clients are using the fund and Northstar has been approached by various institutional investors requesting that we manage similar products for their specific needs. We look forward to keeping you abreast of developments within this fund and other areas of our business.