NORTHSTAR

ASSET MANAGEMENT

**Client Letter** 20 April 2004

**Quarter End: 31st March 2004** 

Dear Investor

The first quarter of 2004 proved to be relatively uneventful in the financial markets. The JSE closed the period a few percent higher as did our clients' portfolios. Over the past one year the JSE appreciated by 40% from low levels depressed by the shadow of the war in Iraq. As our clients' portfolios had not similarly declined, their performance over the past year was slightly below that of the market. Despite last year's recovery the JSE remains below its highs of mid-2002.

Within the market, recent trends towards more homogeneous pricing valuations were extended. Over the past few years there have existed substantial discrepancies in pricing of shares on the JSE. In 1998 financial and banking shares were the market favourites while resource shares where universally shunned. With the advent of Y2K, technology shares were market darlings and industrials and resource shares avoided like the plague. As the Rand weakened through to late 2001, Rand hedge shares became the flavour of the month and all others ignored. After having had their fingers repeatedly burnt by chasing the market, who could have blamed investors for moving into "safe blue-chip" shares at the expense of smaller capitalisation shares; only to witness the price of the largest companies on the JSE halve, while small caps advanced.

Over this period we have been able to avoid most of the mistakes made by followers of fashion attracted to the next "big-thing". Over the past two years the JSE All Share Index returned a loss of -2.2% while our clients have enjoyed gains of around 33% in their portfolios. Longer-term our relative out-performance is even more marked.

After all the volatility that we have experienced in the market over the past few years, we now find that the various sectors of the market are relatively similarly priced. On the margin it could be argued that resource shares are slightly more expensive than industrial shares, but the discrepancies are nowhere near as pronounced as they were over the past few years.

Consequently, in the immediate future in our quest for value, we will be less able to rely on sector pricing anomalies and will rely more on our share selection abilities. This suits us well, as our track record of selecting shares of solid companies which are trading below their intrinsic value is a good one. Shares such as Naspers, Afrox, AECI, Kersaf, MTN, Woolworths, Johncom and Tigerbrands have all contributed handsomely to our out-performance. Even our recent purchase of Tongaat-Hulett has proved to be judicious as the share appreciated by over 50% in the past quarter. More latterly we have identified shares in Nampak as an attractive long-term investment and have begun to build a position in our clients' portfolios.

With this in mind we look forward with continued confidence to managing our clients' capital and producing on-going pleasing returns.

Yours sincerely

Alexander Otten

**Alexander Otten**

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**Market Report** 20 April 2004

**Quarter End: 31st March 2004** 

US GDP Growth Rate - Treasury Bill Rate


Source: GaveKal Research London

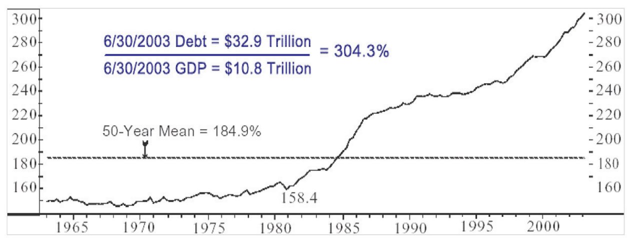
The recovery in the US stockmarket has been impressive. With negative real interest rates, US investors are getting poorer by leaving money on deposit and the temptation to participate in the gains offered by a climbing stockmarket prove difficult to resist. Succumbing increases demand and in turn propel the market still higher.

The weak dollar policy and the stimulatory effects of current low interest rates in the US have resulted in economic recovery. Inflationary monetary policy ensured that in 2003 global deflation was the dog that did not bark. However, as the recovery takes hold and inflationary pressures mount, the Federal Reserve will be obliged to raise rates, from their current fifty year low of 1%, to more normalised levels. If inflation averages 1% to 2% short-term US rates would be normalised at 3.5%.

After 20 years of declining interest rates, the US has painlessly increased its debt level to a record 304% of annual GDP. The US currently has a debt bubble of $35 trillion. A normalizing, and a possible trebling, of short-term interest rates, and the associated rise in longer-term rates, will add substantially to the US interest payment burden and will ensure that economic growth remains weak.

Higher interest rates will eat into disposable earnings of overextended US household and reduce the consumer's discretionary spending which has fueled the economic recovery. For corporate America, earnings will be hurt by having to pay higher interest rate charges. For government they will widen the record deficit still further and preclude new tax cuts and possibly require the reversal of last year's.

US: Total Debt as a % of GDP – 1960 to 2004




Source: US Federal Reserve / Ned Davis Research

US share price rises have been justified by forecasting models which extrapolate current trends and project them forward. Corporate America's profit recovery comes off a very low base. A year ago the war in Iraq held the specter of possible use of weapons of mass destruction and hints at global retaliatory strikes. No wonder the markets were depressed and the base low.

In a few quarters time US corporate profitability growth figures will be less impressive when compared with the more normalised current level of profitability.

A reversion to more normalised interest rates would be bad for bonds. Were bond yields to rise and stabilise at 5% or 6%, bond market investment could attract considerable capital from the share markets.

While the first quarter of 2004 has been a dull one, the next few quarters could well turn out to be very different.

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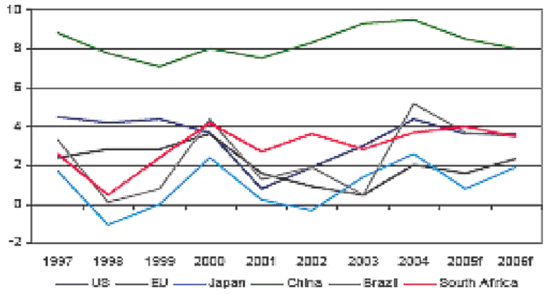
The mid-April surprise interest rate reduction by the Reserve Bank was aimed more at the currency than at the domestic economy, which will benefit from it none-the-less.

In announcing the rate reduction, the Governor of the SA Reserve Bank, Mr. Tito Mboweni stated that, in the foreseeable future, inflation is expected to remain within the 3% to 6% target band. However, he added that: "At current levels, the exchange rate seems to be creating some problems in the economy - we need a competitive exchange rate which does not bring about imbalances in the economy... I would like it to be at a competitive level and also stable."

**Annualised percentage change in Gross Domestic Product (GDP) growth**

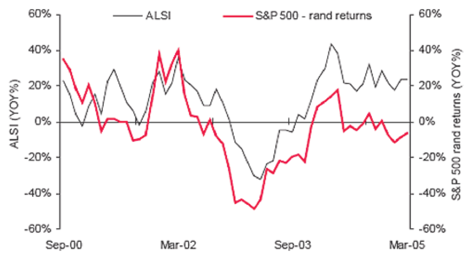



Source: Standard Bank of SA – Economic Research Division.

Just as the US Federal Reserve clearly telegraphed to the market its intention to raise US interest rates, so too has the SA Reserve Bank telegraphed its intentions for the SA currency. We expect our clients to benefit substantially from the implementation of this policy.

Over the past five years, SA investors would have done well to have invested their capital in the domestic stockmarket as opposed to the US stockmarket. And this period includes the Rand crash of late 2001. Going forward we could well see more of the same. While we are not pessimistic about the US stockmarket, we see little to persuade us that, over the long-term, returns there will exceed those attainable in the SA stockmarket.

**Returns generated by the JSE vs US S&P Index – in Rand terms**




Source: BJM Research

Our clients' portfolios have been designed to provide limited downside risk and, after its recent run, to have a low correlation to the SA stockmarket. While our short-term performance has kept abreast with the market in its powerful advance, our investment philosophy is directed at generating these gains at a lower than average market risk. Moreover, in selecting the particular shares which we have, we are confident of our continuing to provide superior long-term returns.

While our positions in Resource-based shares had prevented us from out-performing in the short-term, we believe that, in the longer-term, these companies offer very good value based on their normalised earnings. We have been adding to our clients' exposure to banking shares which remain attractively priced, offer high dividend yields and will be substantial beneficiaries of the recent interest rate reduction.

An increase in volatility in both global and local markets may well materialise. In that event, our clients will enjoy the protection of our portfolio design as well as the opportunity for us to acquire currently over-priced companies at more attractive prices. Recent price movements within the SA stockmarket have given rise to pricing anomalies which, over time, will further enhance returns on our clients' capital.

This will contribute to our mission on your behalf, namely to create meaningful capital for your future peace of mind.