NORTHSTAR
ASSET MANAGEMENT

**Client Letter** 20 April 2010

**Quarter End: 31st March 2010** 

Dear Investor

Although Northstar's clients have enjoyed very strong absolute results for the past year, we are compelled to highlight that we have underperformed our benchmark, the Johannesburg Securities Exchange (JSE) All Share Index (ALSI) in this relatively short period. Interestingly, on account of Northstar's clients' having lost considerably less than the market in the crash of 2008, we have had less ground to make up in order to reclaim our pre-crash peak values, as compared to the JSE which remains around 16% shy its pre-crash value.

While we would prefer to outperform under all market conditions, we know of no investment approach which is able to predictably deliver such results. In the past, we have occasionally lagged the market in some years that were positive for the stockmarket. However, our clients' portfolios have always performed better than the market in those years in which the market delivered losses. In sporting parlance it could be said that our defence is better than our offence. As a whole this investment strategy, which has led to our clients enjoying greater than market returns at lower than market volatility, can be relied upon to continue to deliver these pleasing long term results.

In the past year the riskiest shares have rebounded the most and, as our clients are well aware, this is an area of the market in which we are reluctant participants and which is underrepresented in our clients' portfolios.

Additionally, our clients' portfolios have heavy weightings to large international companies which conduct the bulk of their business outside of South Africa. While these companies' share prices have gained over 50% in hard currency terms, their Rand share prices have faced the stiff headwind of the Rand exchange rate which, in the past year, has gained around 40% against major global currencies. While possibly frustrating in the short term, we welcome the very strong Rand as an opportunity to further increase our clients' exposure to high quality global companies at increasingly attractive Rand prices.

Despite the above, over the past year our clients have enjoyed very strong absolute growth in their portfolios and it remains our great honour to be entrusted with the onus of managing our clients' capital. It is a responsibility to which we enthusiastically devote our energies and from which we draw much satisfaction in meaningfully building our clients' wealth.

Yours sincerely

Alexander Otten

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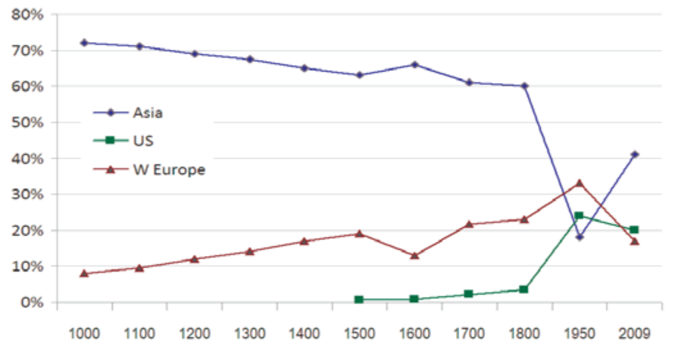
Winston Churchill said: "The longer you can look back, the further you can see forward". Over the past 1,000 years the global economic landscape has experienced extraordinary change. One thousand years ago Asia dominated the 'global economy' - such as it was prior to trade and travel. Asian economies, and their societies, were far more advanced than their Western counterparts.

The advent of colonialism, and subsequently capitalism, fuelled Western economic growth pretty much at the same time as China stagnated. From a mere 2% in 1800, the US grew to constitute 26% of the global economy by 1950. In the same period, Asia's contribution to the world economy fell from 60% to less than 20%.

Just as the Twentieth Century was undoubtedly the 'American Century' so too is it suggested that the Twenty First Century will be the 'Chinese Century'. Or, at very least, the 'Asian Century'. One half of the world's population live in Asia and, as their economies modernise and expand, so too will their internal market.

**Share of World GDP, % at purchasing power parity - 1000 to 2009**




Source: International Monetary Fund (IMF) Data Archive / Northstar Asset Management

Despite this, our clients are not particularly heavily invested in the region, or in companies that benefit from doing business in that region. Once again our risk averse contrarian approach discourages us from investing heavily in crowded trades.

That Asia, and particularly China, is booming at present is without doubt. However this boom is already reflected in the price of base metals, coal and other commodities being hoovered up by China at an truly impressive rate. Fully, 60% of all seaborne iron ore is China bound, as is 40% of all seaborne coal.

Mining houses, feeding this seemingly insatiable appetite, are currently enjoying abnormal and unprecedented margins and profits.

A ton of iron ore is extracted from the earth at a cost of around US$20 and sold on at US$120 per ton. With such enticing profit margins existing miners are increasing capacity to maximize revenue and new entrants, attracted by payback times of as little as one year, have joined the scramble. In truth, there is little shortage of coal and iron ore in the earth's crust.

Should demand remain at these elevated levels, increased supply will surely result in a reversion to historically normal prices and margins. If demand should falter, over-supply could see prices collapse. Either way, in time, we expect profit margins to normalise and revert to their mean.

Even though the 20th. Century was the American Century, it was not without its challenges; including the World Wars, the Depression of the 1930's, the Vietnam and Korean Wars and the oil shocks and galloping inflation of the 1970's. In the American Century that country suffered no fewer than ten economic recessions.

China recently reported an astounding 11.9% increase in its GDP over the past 12 months. We were sceptical when we were told that 'things were different' for Japan in the 1980's, or for the NASDAQ in the 1990's. Again now are we unconvinced that things will be different for China. It is not that we are betting against China, but rather we are simply saying that trees do not grow to the sky.

China will take its rightful place at the global table, but just as the US had setbacks in its Century, so too will China. In our analysis, many "China play' companies' shares are pricing in an awful lot of good news for an awful long period of time ahead. Experience has taught us that things do not always work out that way.

Over the past year the South African stock market has delivered a virtuoso performance, largely driven by the recovery of the share price of some of the largest companies that make up the All Share Index (ALSI) and which had also experienced some of the greatest declines in the crash of 2008.

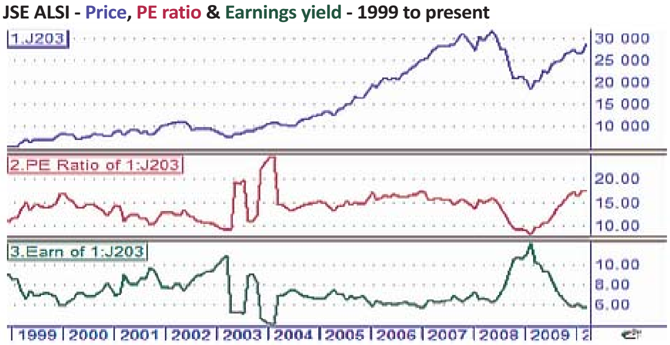

Although Anglo American's share price has more than doubled in the past year, it remains some 43% below its 2008 peak value.

Rising share prices please investors who see their wealth grow. For us though, rising share prices mean nothing if they are not accompanied by a corresponding and sustainable increase in company earnings and profitability which would mathematically warrant the share price appreciation.

The Johannesburg Securities Exchange (JSE) ALSI is currently trading at a historic Price:Earnings (PE) multiple of 18. A significant premium to its long term average PE multiple of 12. Equally, the market's present dividend yield, at 2.1%; almost exactly half of its long term average.

Plainly investors are pricing in substantial increases in average company earnings which will have the effect of both reducing the overall market's PE ratio and will (hopefully) also allow companies, on average, to double their dividend payments to shareholders.

**JSE ALSI - Price, PE ratio & Earnings yield - 1999 to present**




Source: Northstar Asset Management

These assumptions are already baked into the price of the average company listed on the JSE.

Given the record base commodity (iron ore, copper, coal etc) prices, we do know that the earnings of related companies will be strong over the next year or two, but we are unconvinced that the actual growth in earnings will sustainably meet the very high level which these companies' share prices are anticipating.

Investing in these companies at this stage of the cycle is, to our mind, more akin to speculation than investing. The canny investor Warren Buffet said of these companies that: it's a bit like being Cinderella at a ball and knowing that, at midnight, everything will turn back to pumpkins and mice again. It is just that there are no clocks on the walls of the ballroom.

While our clients enjoyed very considerable returns at the beginning of the commodity cycle, at this late stage we shy away from, and are inclined to be sellers of these companies which are experiencing a confluence of extra-ordinary circumstances. Unprecedented demand for their products, unprecedented margins, unprecedented volumes and unprecedented profits. Should any one (let alone more than one) of these exceptional circumstances normalise (or worse), the impact on earnings, and their share price, could be severe.

Rather than deliver our clients rollercoaster returns, we are concerned at the quality of the returns which we deliver. Our individual company analysis allows us to drill down into the company's financials and gives us confidence that future earnings are transparent, predictable and sustainable. If we were to have to choose between being the tortoise or the hare, we would always be the tortoise for, as our long standing clients know, in the end, the tortoise always wins.