NORTHSTAR
ASSET MANAGEMENT

Client Letter 14 October 2010

Quarter End: 30th September 2010

Dear Investor

In the past quarter global financial markets experienced very strong gains across all asset classes. In September alone, the US Standard and Poor's 500 Index rose by 8.8%, its strongest gain for that month since 1939. The Johannesburg Securities Exchange (JSE) All Share Index (ALSI), gained over 12% in the quarter and was lifted by renewed global investor confidence and appetite for emerging markets.

It is of interest to note that these powerful advances are occurring in what is characterised as an anaemic and jobless global economic recovery. When markets move indiscriminately and in unison, plainly it is not a function of intrinsic value but is rather a consequence of extraneous factors. In this instance, the buoying of the markets is on account of a tide of liquidity washing into them. What is happening at the moment is the opposite of what occurred in the liquidity / credit crises of 2008 when a tide of money washed out of the global financial system and all financial assets experienced a highly correlated decline in prices.

The current positive tide is being fuelled by governments and central banks who, fearing a 'double-dip' economic recession, are lowering interest rates to record low levels and are opening the spigots to pump vast amounts of additional money supply into the global financial system. As this money seeks a home, all asset prices rise.

What this tells us is that assets are being priced less on their intrinsic value and more on their relative value; if A has gone up, so too should B. Our investment approach couldn't be more different and focuses solely on our assessment of the intrinsic value of individual companies. The benefits of our philosophy are usually more evident in the event of market declines, when intrinsic value separates investors from speculators and becomes the measure which protects investors against permanent loss of capital.

It may be worth reminding ourselves that; "price is what you pay and value is what you get". Hence strong price gains, which are not fully justified by fundamentals such as increased earnings and free cash flow, tend to result in less value being acquired by the buyer. At current elevated levels we are comforted by the increasing margin of safety between the intrinsic value of our clients' portfolios and that of the overall market.

It remains our great honour to have the responsibility of managing our clients' capital and we remain committed to protecting and growing your wealth.

Yours sincerely

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In a world of anaemic economic recovery, emerging markets have become the new darlings for investors wanting to benefit from their higher yields and superior growth prospects.

Net foreign purchases of SA government debt 1996 to end Aug 2010 in rand billion

Source: JSE / South African Reserve Bank

In 1995, the Financial Rand was abolished and South Africa's markets were reopened to the international community. In the subsequent 14 years to 2009 (inclusive) foreign investors bought a net R13 billion of SA government bonds.

In the last two years global investors have bought over R90 billion worth of SA government bonds. This has created a perfect storm; a virtuous cycle in which the demand for the currency has forced the rand up by over 30% since the beginning of 2008, and investor appetite for bonds has driven bond yields to their lowest level in a generation.

The strengthening rand has kept import inflation in check. SA's most recently reported rate of inflation has eased to an annual 3.5%, well below the Reserve Bank's 6% upper target limit. As inflation slows, speculators, eyeing opportunity for further interest rate reductions, increase bets of still higher bond prices and thus the virtuous cycle continues.

Most of the international professional traders and speculators participating in these trades are using money borrowed in near-zero cost currencies such as the US dollar or Japanese yen to play this so-called bond carry trade.

The same holds for the SA stockmarket. Foreign investors, seduced by superior growth prospects, have piled into local companies' shares and are now majority owners of most of the largest companies listed on the JSE.

Since 1995, the two periods in which foreign investors were significant sellers of South African assets (2000/1 & 2008) both coincided with meaningful declines and lows in the local stockmarket. For prudent investors, who had preserved their capital, these were great buying opportunities.

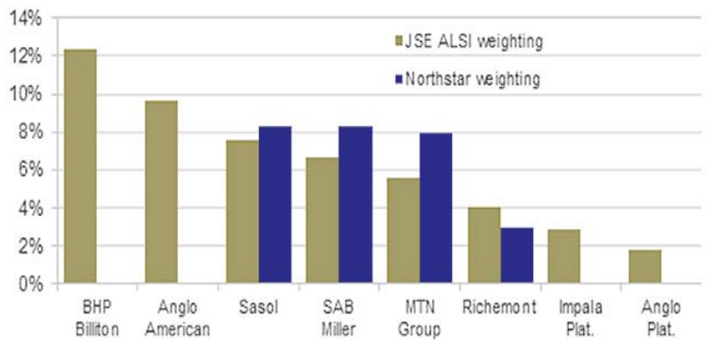
At current price levels, valuations are not nearly as attractive as they were then and consequently expectations for future returns cannot be extrapolated from those achieved subsequent to these market lows.

When the global economy begins to recover, central banks in the US, UK, Europe and Japan move to normalise their interest rates from current record lows. At that time their bond and share markets will again offer competition to emerging markets. The question is: 'who will buy those South African bonds, shares, and rands, that the foreigners will then be selling?'

Then the virtuous cycle could (as in 2000/1) turn into a vicious cycle and the reversal of investment flows could again coincide with a significant local & emerging market low. Once more, for astute investors who have judiciously managed their capital, this may well prove to be another opportunity.

As contrarian value investors, we are quite comfortable to take a road less travelled. While we do not wish to forego investment returns, we would rather take the other side of the currently fashionable trade and use prevailing conditions to further add to our clients' defensive positions which, should the tide turn, have less risk of permanently impairing their capital.

JSE ALSI vs. Northstar client weightings by market capitalisation - Sep. 2010



Source: JSE / Northstar Asset Management

It is not our intention to be different purely for the sake of being different. Rather, it is the consequence of our value orientated and risk averse investment analysis. For some time now the makeup of our clients' portfolios has been significantly different from the makeup of the Johannesburg Securities Exchange (JSE) All Share Index (ALSI) or, for that matter, the general equity investment fund.

While the top 8 listed companies, by capitalisation, constitute 51% of the weighting of the JSE ALSI, these same companies make up just 28% of our clients' portfolios. Indeed, Northstar's clients hold zero exposure to four of the eight largest companies. Big is not necessarily better, safer or more profitable as was attested by Anglo American when it suspended its dividend last year and its share price declined by more than 75% in 2008/09.

We are pleased to discover the extent of the difference between our clients' portfolios and our benchmark, for without this difference it would, over the years, have been impossible to have generated returns for our clients which have been pleasingly different from those of the overall market.

However, what has surprised us, over the recent past, is that despite this difference in underlying makeup, our clients' portfolios have generated results so closely matching those produced by the JSE ALSI. As the effects of central banks' liquidity infusions and participation in financial markets dissipates, this correlation is unlikely to endure.

The SA stockmarket, along with global markets, has made a remarkable recovery from the 2008 price crash. Currently, the JSE ALSI is a little over 10% below its peak level attained in early 2008. Share prices have recovered more than have company earnings, and what we find interesting is that on a Price to Earnings ratio (P:E) of 16.8, the JSE ALSI is more expensive now than it was immediately prior to its pre-crash peak value.

Price : Earnings Ratio – JSE ALSI 2006 to present

Source: JSE / Northstar Asset Management

Given that the long-term average PE of the JSE ALSI is around 12, the market appears to be particularly optimistic about the future company earnings.

High input cost increases for labour, electricity and raw materials are crimping margins. The strong rand is a headwind for exporters unable to raise prices without losing market share. Additionally, in the recent recession, the SA economy shed around 1 million jobs and until reversed, we have difficulty seeing consumer spending driving near term company earnings.

In view of this, unsurprising, we continue to believe discretion to be the better part of valour and are of the view that defensive, prudent and predictable companies with low borrowings and high free cash flows continue (for now) to offer the most compelling investment opportunities.