NORTHSTAR
ASSET MANAGEMENT

Client Letter 23 November 2015

Quarter End: 30th September 2015

Dear Client,

We really hope you are very well and have sight of your relaxing December break.

You are probably wondering why you are receiving your Northstar Market Report for the 3rd quarter of 2015 later than usual – the reason being that we needed to finalize certain developments at Northstar and felt it was important to share these with you.

The accompanying Market Report delves into the tricky markets of the past year. It has been a period in which we have worked harder than ever, but probably more importantly, smarter than before. Our research capability continues to improve and we feel that our greatest breakthroughs have occurred over the past six months. Since joining Northstar, we have researched 300 companies in detail and 100 of these have been in the last year. During 2015, we also included additional structures around portfolio construction – that is the art or science of constructing portfolios. We have worked tirelessly to build systems that will assist us in determining the correct weightings for different stocks and assess the risks we are taking. Considering the steps we have taken, we are convinced that the best is still to come from Northstar as we come of age!

Our determination to build an investment infrastructure and research DNA cannot be articulated in a letter and we encourage you to visit us and hear about these firsthand. That said, our toils are being recognized by significant players in the institutional market space who place sizeable amounts of money with the highest quality domestic managers. With Northstar being supported by our existing clients and new institutional clients, it provides us with the finances to invest in skills to the benefit of all our clients. In a landscape controlled by financial behemoths, we remain mindful of Northstar's culture of client care and our mantra that our clients will never become a number to our firm!

Further to the theme of developments at Northstar, we are very pleased to inform you that RMI Investment Managers Group, a company within the large listed RMI Group, has acquired a minority shareholding in Northstar Asset Management. For our clients that do not know RMI, it is probably best described as the Rolls Royce of listed financial companies on the JSE owning stakes and having helped incubate Discovery Health, MMI (Momentum and Metropolitan) and Outsurance amongst others. RMI contains the insurance interest of the Group whilst the banking interests exist inside RMB Holdings, with its main investment being First National Bank. The founding members are the highly regarded Mr. GT Ferreira, Mr. Laurie Dippenaar and Mr. Paul Harris.

Two obvious questions must be coming to mind. Firstly, why would a large firm acquire a stake in small Northstar Asset Management? Here we quote directly from CEO of RMI Investment Managers Group, Mr. Chris Meyer:

'We are very excited about partnering with and becoming a shareholder alongside investors with the calibre of Adrian and the Northstar team. RMI Investment Managers stands for the backing of good investment talent and entrepreneurs and our objective is to help Northstar become a great business. We intend helping the team in an engaged but non interfering way. RMI will bring its considerable capabilities in providing strategic, financial, operational and distribution muscle to Northstar with the intention of ultimately resulting in an excellent client experience for Northstar's existing and future clients. We look forward to embarking on this journey together with the Northstar team and its clients.'

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The second question is clearly why we have chosen to introduce RMI as a shareholder to Northstar? It is our view that RMI is a very high quality partner and has a value system which parallels ours. We want to remain independent and have no intention of disappearing into a large financial conglomerate. That said, the financial landscape is full of consolidation with financial giants emerging around us.

RMI is assisting us in our journey of independence but its active participation within our business will allow us to grow and become increasingly relevant in the domestic market. It is pleasing to be in business with a partner that is so encouraging and believes that Northstar has the making of a world class business. We believe this is a fantastic development for both you, as a Northstar client, and for the asset manager of your investments.

In conclusion, we would like to make you aware that Northstar has been involved with four social projects which we believe are making significant differences to the lives of the participants involved therein. In our December client letter, we will shed light on these, which we are sure will be of great interest to you.

We look forward to seeing you in person soon or communicating with you again in the quarter ahead.

Adrian Clayton
and the Northstar Team

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The JSE is showing polarized returns and exhibiting high levels of volatility:

Stock markets over the past year have been performing poorly, polarized with regards to sector diverging returns and exhibiting growing levels of volatility. This is evident in that, over that past nine months of 2015, markets produced negative returns over four months and in two of those months, losses were more than 3.5%.

Bar two months of the year, the basic resources index has moved up or down by more than 5% - in March, July and August it fell by more than 9%, whereas in February and April, it rallied by 8%.

This level of volatility has been pervasive throughout all JSE sectors - even previous year bankers such as Industrials lost 5% in July; Consumer goods fell 5% in August, but rallied 15% in September; Healthcare had three months in 2015 when falls exceeded 5% - this list goes on and on.

We have consistently felt that caution is warranted, writing in all our previous quarterly bulletins that many shares on our market were overvalued. Our approach was to launch lower risk income products to protect our clients by investing in a broad spectrum of income instruments. We also encouraged offshore investments. This approach has proven correct, as income instruments and offshore positions have outperformed the domestic stock market.

In a normal environment, the other obvious approach to reducing risk is holding a diversity of stocks. This is particularly important when managing individual private client portfolios which do not lend themselves to trading in and out of positions due to tax considerations. Our Northstar client portfolios are predominantly in very high quality industrial and financial companies that continue to perform outstandingly. We do however, hold a sprinkling of resource shares and some very cheap cyclical companies for balance.

The resources and cyclicals are struggling in a ruthless environment that can hardly be described as 'normal', with a confluence of factors such as a strong dollar, rapidly slowing Chinese growth and in certain commodities, a market oversupply, resulting in a mercenary onslaught against these businesses. We remain of the view that diversity is important and while our research illuminates that certain cyclical companies on the JSE are heavily undervalued, it is important to own those that have balance sheets strong enough to weather a storm that nobody could have predicted.

As a last word on positioning, a segregated private client portfolio is a fantastic investment vehicle in that it is low cost, allows an investor direct access to the market without layers of fees and, if well managed, will outperform the market and other higher cost investments over time. It is true however that, due to tax consequences, positions cannot easily be turned into cash which can have the effect of higher levels of short-term volatility, particularly in that position sizes tend to be large and concentrated. For example, we note with interest that our client portfolios surged in October after being under pressure in September. As the managers of these portfolios, we are defenceless against the randomness of short-term market gyrations. This is of course very well understood by our clients, most of whom have been invested with Northstar for decades, are disinterested in short-term market shifts and are focused on long-term capital growth.

A walk down memory lane – the history of investing:

Our motto at Northstar is that if we cannot value it, we do not want to own it. But how did we develop our approach to valuing companies and thus managing money? Was it something we simply created, or is it based on some longer standing investment theory?

Before 1934, most investment decisions were made based on speculation. Assets traded on various markets and traders would take bets that prices would either rise or fall – this is known as speculation.

In 1934 however, Benjamin Graham and David Dodd, two professors from Columbia Business School, wrote their seminal piece 'Value Investing' which paved the way for the second chapter to investing, known as security analysis. Their investment thesis was based on the concept that assets could be valued and they had three critical tenets:

1. Prices of financial instruments gyrate unpredictably on stock markets.
2. The price that an instrument trades at on a market is often not representative of what that instrument is actually worth.
3. Intelligent investors buy with a margin of safety paying less for an asset than it is actually worth. Graham liked to buy $1 of value and pay 50c for it.

In the 1950's, a new investment movement called 'Modern Investment Theory' came to the fore. Most students studying finance are indoctrinated with modern investment theory and the efficient market hypothesis. The central belief is that markets are highly efficient and that instruments are priced perfectly. This school of thought believes that it is impossible to outperform the market over time and is diametrically opposed to all the work undertaken by Graham, Dodd, Buffett and others. At Northstar, we do not believe in the purest form of Modern Investment Theory as there is more than enough evidence to disprove it!

In the 1980's and 1990's, 'Behavioral Finance' dominated investment discussions. This explored the psychological aspects of investing, addressing biases created by human emotions and the impacts these have on investment decision-making. We can all relate to these.

An example is recency bias, in which investors extrapolate recent investment experiences into the future indefinitely. This causes investors to push the stock prices of outperforming companies to extremes, believing that their historical excellent performance will be repeated. Equally, poor performing companies are actively sold down to extremes as investors view their underperformance as repeatable. Recency bias is one of many biases which have been shown to create distortions in markets and thus, misprice assets.

Northstar is a firm believer in traditional security analysis as undertaken by Benjamin Graham and the subsequent extensions of his science, which all involve valuing assets/stocks using fundamental analytical techniques. Investor greats such as Warren Buffett and Seth Klarman of the Baupost Group have applied Graham and Dodd techniques to become household names and multi billionaires. We are equally of the view that behavioural finance validly depicts the biases investors have and that these distort market prices. The combination of Graham's work and behavioural finance ensures that hard working investment teams can find opportunities on stock markets around the world and make money for clients.

In 1991, Seth Klarman again reminded us of the importance of focusing on what we know about a business now, rather than trying to make sweeping assessments about the future - a future that is opaque at best. From his 1991 best seller, 'Risk-Averse Investing Strategies for the thoughtful investor', Klarman writes: 'Since investors cannot predict when values will rise or fall, valuations should always be performed conservatively, giving considerable weight to worst-case liquidation values as well as other methods'.

With this in mind, we can inform our clients that our portfolios are impregnated with high quality companies that are stable, robust and capable of out-living the present bleak economic backdrop globally. Intertwined with our robust heavyweights are a few deep value stocks that would be real favourites of Benjamin Graham. We highlight the following point with regards to these companies - they are very cheap, but not devoid of risk and consequently, we hold small positions in these businesses and treat them as higher risk, high reward opportunities. An example of this being Group Five – the well-known SA listed construction company.

Group Five – a good firm in a bad cycle:

Group Five is one of South Africa's largest multidisciplinary construction companies operating in Africa and Eastern Europe.

<u>Construction is a brutal industry with poor structural dynamics:</u>

Construction is a notoriously volatile industry. The exogenous drivers of the industry – namely unpredictable economic activity, particularly within emerging markets, together with the poor structural factors within the industry, which stem from low barriers to entry and thus periods of heightened competition - contrive to make this a boom and bust business landscape.

<u>Northstar risk scores companies, ensuring smaller weighting to riskier companies:</u>

When it comes to our quality score, which ranks a company on its management, the industry in which it operates and the dominance of the business within its industry, we fail to score South African listed construction companies as anything other than low quality and relatively high risk investments. In fact, few of the current listed competitors to Group Five would pass our minimum required quality score, but Group Five does!

Another method we use to establish where a business fits into our quality bands is to ascertain the fan of potential outcomes that can arise in the future with regards its potential profitability. The greater the degree of variance in profitability, the larger the potential error in calculating what the business is worth and thus, the higher the risk score and lower the quality score we apply to the company in question. Group Five certainly has a wide potential fan of outcomes, so no matter how we look at it, it is not a business that should be the anchor in any portfolio. That said, the fact that Group Five does not make it into our highest quality band, does not mean it should be ignored. There are a number of reasons why we are willing to take a small bet on this company, these are:

It is extremely cheap:

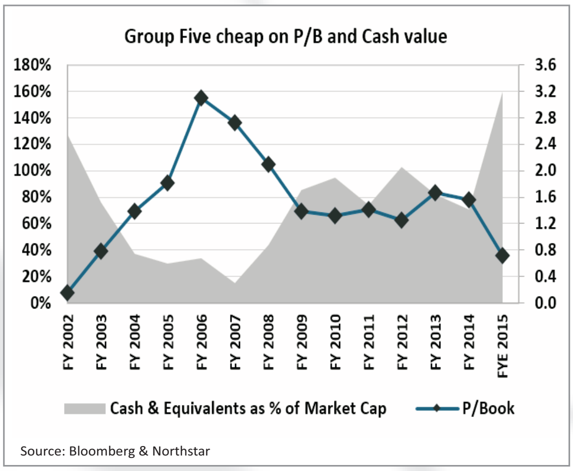
Group 5 trades on a forward P/E of less than 8 times its earnings and we believe its present level of profits are a lot lower than it could earn during better times for construction companies. In 2007, Group Five traded on a 25 P/E as construction stocks were the darling of the market. At the time, we were sellers of construction companies, to the dissatisfaction of many investors we might add! (Note: Recency bias).

Its market capitalization, which is presently R2.3bn, is also at a discount to the book value of the company and a large portion of this book is tangible (is in real assets such as cash), Group Five has R3bn of cash invested in various projects awaiting completion. Considering that a great deal of this cash is needed for guarantees, we conservatively believe that 50% of the current market capitalization, in a worst-case scenario, is cash.

Group Five also operates a toll road or concessions business in Poland, Hungary, South Africa and Zimbabwe, which we estimate accounts for 60% of the current share price – toll roads are excellent businesses, are usually very stable and generate solid cash flows. Considering that the combination of the cash and the concessions businesses are worth more than the current share price of the company, investors are receiving the rest of the construction business for free.

By historical standards, the construction cycle is at very depressed levels:

It is impossible to predict a turn in the construction cycle, but what we know about previous cycles is that, as profit margins reach very low levels, the industry is within a few years of turning for the better. The graph on the right shows the profit margins earned by Group Five showing that these are presently close to historical lows. It is true that margins can get worse, but in a highly competitive industry, firms 'compete' each other out of business and the strongest survive.

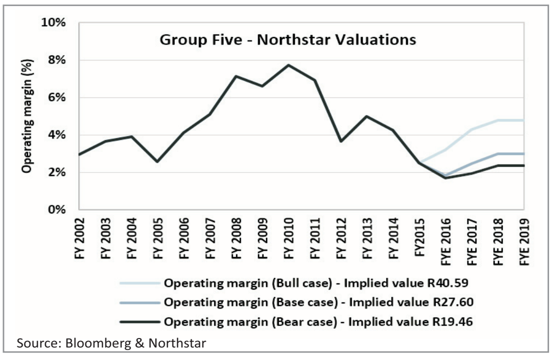


Source: Bloomberg & Northstar

Group Five is in better financial shape than the majority of the listed competitors due to the fact that it was more conservatively managed during the boom times when various competitors spent recklessly. Consequently, we believe that a number of competitors will leave the industry, reducing competition in time and thus, resulting in improving profitability for those left behind. We do not believe that this process is going to be an easy one and Group Five could well endure pain along this journey.

Our valuation work:

The best asset managers in the world have a 60% hit rate over time. This implies that for every 10 companies in which they invest, their investment thesis is wrong for four of these. In some years, the hit rate is higher and in others lower, but over the full term of managing money, anywhere close to six is outstanding. We acknowledge that Group Five is a tricky call and may well fall into our error bucket, but we have done our homework and what follows is some of the valuation work we have undertaken on the business assuming three different outcomes – a bear case (terrible scenario), a base case (most likely scenario) and a bull case (the most optimistic outcome). In order to create these various outcomes, we have used different profit margins which the company could earn, using history as a proxy.



Source: Bloomberg & Northstar

It is clear that in a more normal environment, Group Five is worth substantially more. Considering the solid underpin of value as against large upside potential should the industry improve, we view Group Five as a small bet that is well worth taking.

Adrian Clayton and the Northstar Team