NORTHSTAR
ASSET MANAGEMENT

**Client Letter** 14 January 2011

**Quarter End: 31st December 2010** 

Dear Investor

In the last quarter, the world's financial markets have largely behaved themselves. As would be expected, they lost their footing once or twice along the way, but on-going government intervention stabilised them. The American monetary authorities continued to pump billions into their markets to keep them on track. The Europeans did likewise when Ireland threatened to spoil their, and the global, party. The spill-over from these actions is evidenced in South Africa by the lowest domestic interest rates in a generation being accompanied by a problematically strong rand currency.

The continued direct government intervention in the markets results in the price-making forces of supply and demand being artificially skewed towards the latter. Risk is being rewarded at the expense of value. Asset prices are at best underpinned or, at worst, over-inflated. Detached from fundamentals, elevated prices can be today's free lunch paid for doubly tomorrow. While it need not end badly, that possibility is one from which we seek to protect our clients' capital.

Rather than follow the herd, we undertake our own rigorous research to identify value and opportunities. We tend to gravitate to businesses which have higher returns on their assets. This usually means lower fixed assets and more stable and predictable cash flows. At current prices, we are finding that these high quality profitable businesses, so-called value investments, are not trading at the premium they deserve as compared to merely average companies. While this situation may continue for some time, it is unlikely to endure.

By our measures, a great deal of optimism is baked into the current share prices of many companies. We are having to search harder to find attractive investment opportunities for our clients' portfolios and, in so doing, are constructing portfolios which offer reasonable upside opportunities without the full downside risk of the overall market.

It remains our privilege to have the responsibility of managing our clients' capital. It is a task to which we apply all our energies and expertise and which we relish doing well. We know of no better manner of expressing our gratitude than continuing, over the long term, to deliver our clients above market returns at lower than market risk.

Yours sincerely

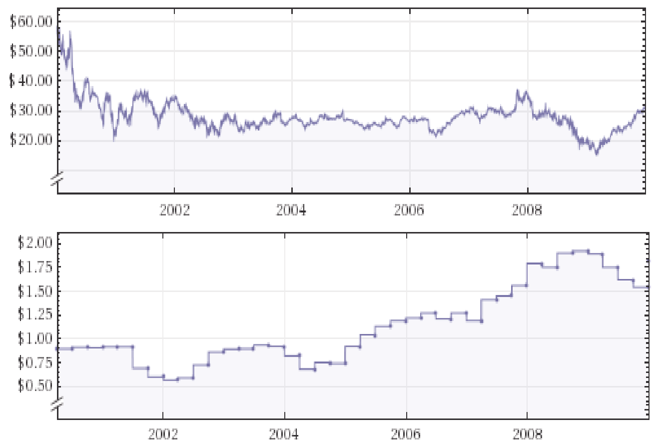
Alexander Otten

**Alexander Otten**

NORTHSTAR ASSET MANAGEMENT (PTY) LTD.
4 Chester Drive Bishopscourt 7708 South Africa
Tel: 021- 797 8184 Fax: 021- 797 4706
email: info@northstar.co.za web address: www.northstar.co.za

Company registration number 1996/001423/07
Member of the Fund Managers Association of South Africa
Regulated by the Financial Services Board of South Africa
VAT registration number 429 01 666 46
Member of the Investment Analysts Society of South Africa
Authorised Financial Services Provider - License number: 601

**Microsoft Corp. share price in US Dollars 2000 to 2010 –below, earnings per share**




Source: Northstar Asset Management / Wolfram Alpha

It matters to the measure where it starts. In our previous Client Letter we reminded ourselves that "price is what you pay, value is what you get".

One of the biggest mistakes we, as investors, can make is to overpay for an asset. At purchase, it is rarely obvious that one is overpaying. In time that error becomes, slowly and painfully, apparent. In investing, what starts well, usually ends well; and vice versa. Overpaying at the outset hobnails all future returns.

Since 2000 Microsoft's earnings per share have doubled. An investor might be pleased to know this and assume it to have translated to the doubling of the company's share price. This has proven to not be the case. Indeed, despite the doubling of earnings, Microsoft's share price has halved in this period.

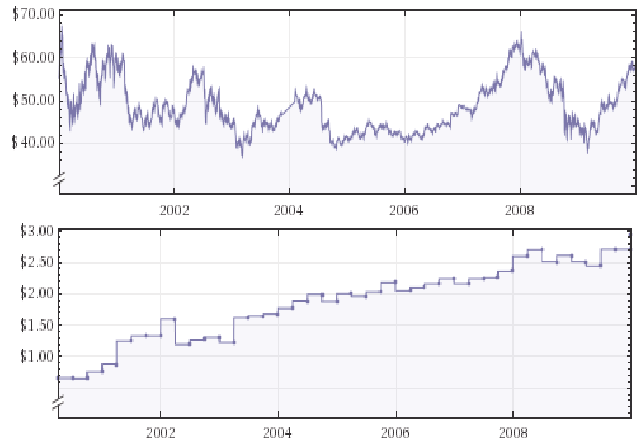
In 2000 Mictosoft's share price had priced in expectations which were not met. Put another way, in 2000 the share price of the then darling of the market was, based on analysts' and investors' over-optimistic expectations, simply the wrong price. If today's price is the right one, then the share price in 2000 was some 400% higher than was warranted by the company's actual earning prospects in the past decade.

The same can be said for Coca-Cola which, since 2000, has seen its earnings steadily increase by 350%. Despite this, its share price has declined by more than 20% from its then level.

This analysis applies, likewise, to the Walt Disney Corporation, Johnson & Johnson and a number of diverse large US corporations. These are well run companies with great products, but we are highlighting now, as we did then, how badly the market mispriced them a decade ago. Ironically, after disappointing investors for ten years, presently unloved, we are now finding intriguing opportunities in suchlike companies.

When company share prices increase ahead of what might be justified by its fundamentals, shareholders might cheer, but all they are doing is eating tomorrow's lunch today.

**Coca Cola Corp. share price in US Dollars 2000 to 2010 –below, earnings per share**




Source: Northstar Asset Management / Wolfram Alpha

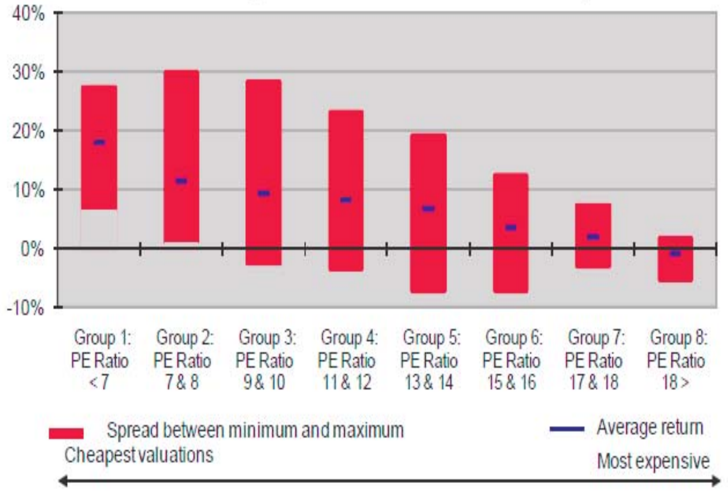
These examples illustrate why we seek to avoid the investment crowd and shun fashionable trends. We are more comfortable investing away from the herd, in unloved opportunities, and knowing that we have not eaten tomorrows rewards today.

Just as when individual companies' share prices can be calculated to be expensive or cheap, relative to the universe of probable future returns which an investor might achieve, so too can various tools be applied to the market as a whole in order to determine likely future returns from the overall market.

Using a simplistic tool such as the current Price:Earnings (PE) ratio of the market we are able to assess, based on historic data, the likely returns which an investor will enjoy.

In a study covering the 50 years from 1960 to 2010, researchers analysed the actual average five year return which South African investors received at eight separate PE valuation entry points. These range from, in Group 1, an overall market PE of less than 7 to Group 8, with an entry PE of greater than 18.

**JSE All Share Index historic 5 yr returns, 1960 to 2010 based on entry PE valuations**




Source: Johannesburg Securities Exchange / Plexus

A number of interesting inferences can be drawn from this table but, for now, we wish to focus on the most obvious and most critical; the inverse relationship between initial investment valuation and probable future returns.

The only time we have certainty on calculating valuations is when historical data are used. However, this is not unlike using the rear view mirrors to navigate what may be ahead. Current valuations and, all the more so, future valuations are dependent on company 'guidance' and analysts' forecasts of what companies are expected to earn per share in the year/s to come.

Currently, the JSE is trading on a very full PE multiple of 17.7 as compared to its post 1989 average of 14.2. Analysts' consensus forecast is that earnings of JSE listed companies will grow by an average of 31% over the next 12 months.

Within the respective sectors, analysts are penciling in 13% earning growth for the financial sector, 23% for the industrial sector and a 49% growth in earnings for the resource sector.

Fully, 80% of next year's anticipated earnings gain have already been baked into prevailing share prices. With the high administered price inflation, above inflation increases in input costs such as electricity and labour and the headwind of the strong rand, we are somewhat sceptical of companies, and in particular of resource companies, being able to achieve these expected optimistic increases in earnings.

Extraordinarily, analysts continue to have a 'Buy' rating on 85% of all resource stocks which they cover even though, as we have detailed, current share prices already discount the bulk of the expected 49% increase in next year's earnings. Should companies fail to achieve these elevated targets, share prices could well come under pressure.

Given these scenarios we are, understandably, not relying on the overall market to deliver pleasing returns for our clients. In order to achieve these, we are focusing on the prospects of selected high quality companies with predictable earnings and which are offering a comforting margin of safety. These selected companies are trading at a discount to their intrinsic value and certainly at a discount to the overall market.