NORTHSTAR
ASSET MANAGEMENT

Client Letter 19 April 2011

Quarter End: 31st March 2011

Dear Investor

In our client correspondence we intentionally avoid discussing our clients' short-term results. At best, short-term results tell us something about overall market sentiment but contribute little to assessing the success or failure of our long-term investment thesis. At worst, short-term results constitute little more than statistical noise.

If they are of so little interest to us, why are we raising the subject? Well, when they are superior to the market, we dismiss them, but when, as now, they are little different from the overall market's result, clients may get fidgety and be pleased for some explanation.

While we have significantly added value to our clients' portfolios over the long term, in the two years post the 2008 market crash (which our clients largely sidestepped), our results have been little different from those of the overall market. To be frank, considering how hard the market has run in this recovery period, and how much less-than-market risk our clients' portfolios are carrying, we are very satisfied to have matched the market's recent rewards.

Just as a mountain climber who reaches the summit without safety ropes can dismiss the risk of his climb, so too is the selected level of risk that we include in our clients' portfolios only evident when the market tide goes out. Over the past 15 years our risk containment has been demonstrated, time and again, in the numerous market pull-backs and crashes.

While the Johannesburg Securities Exchange (JSE) All Share Index (ALSI) remains below its 2007 pre-crash levels, our clients' portfolios are around 20% higher than their pre-crash values. This extra performance came from our assuming the risk which we chose to take, rather than from simply assuming overall market risk.

In our investment philosophy, our number one rule has been, and remains, to minimise the risk of permanent loss of capital. This is also our number two rule. And, only third comes the rule to assume risk in the pursuit of reward. While it may lead to less stellar returns in strong markets and market bubbles, this approach has served our clients well in protecting capital in weak ones.

Over the complete market cycle, our methodology of taking on selected risk rather than overall market risk, has produced demonstrably superior returns for our clients and will continue to add value and drive pleasing returns in the years ahead.

We remain honoured by the on-going confidence and responsibility which our clients place in us and know of no more sincere a manner to express our appreciation than to diligently, prudently and profitably shepherd your capital.

Yours sincerely

Alexander Otten

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Market Report 19 April 2011

Quarter End: 31st March 2011

While most investors approach investments on the basis of potential rewards, we spend much of our time looking at the flip side of that coin and apply our thoughts to potential risks.

Risk is a great deal less frightening when it is understood and managed. While those who are oblivious to risk may blunder in, and those who discover it may be paralysed by risk; those who understand risk, and manage it, sleep peacefully.

We are reluctant to assume even market neutral risk unless we assess that we will enjoy greater-than-market returns. We usually find ourselves assuming less-than-market risk with a view to reaping greater-than-market returns. This is the holy grail of investing.

Not for us then the stomach churning peak-to-trough volatility of returns that most investors experience. We are more inclined to seek measured, more predictable and consistent rewards.

The term 'risk-premium' refers to the additional reward that investors expect to receive with each additional unit of risk. If there were no marginal reward, no investor would consider owning more risky investments. The converse also holds true.

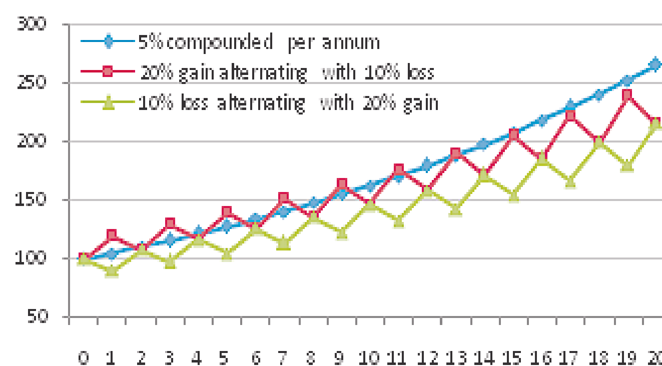
To see the corrosive effect of risk consider three hypothetical investment scenarios:

A – an investment which compounds at 5%pa every year

B – an investment which alternates between gaining 20% in odd-numbered years and which loses 10% in even-numbered years.

C - an investment which alternates between losing 10% in odd-numbered years and gaining 20% in even-numbered years.

Return on risk scenarios A, B & C over a twenty year time period



Source: Northstar Asset Management

While all these scenarios will generate an average return of 5% a year, the actual annualised returns will vary ever more significantly with the passing of time. Investment A, taking into effect compounded returns, has an annualised return of 5%, while investments B and C, because of their biennial losses, compound at an annualised rate of just 3.9%pa – a difference of more than 1%pa. The riskless investment A easily outperforms the risky investments B and C, even though they all have the same expected average return.

Over time this difference produces significantly different investment outcomes. Over a 20-year period, R100 invested in each scenario would generate R265.33 in investment A, while investments in scenarios B and C would be worth R215.89. The graph (above) shows that the differences between B and C clearly illustrate our mantra that it matters to the measure from where it starts.

Risk is important for another reason; uncertainty increases with risk. In reality, we would not know ahead of time that investment B and C were going to alternate with regular +20% and -10% annual returns. A more realistic scenario would say that B and C had an even chance of going up by 20% or down by 10% in any given year.

While the long-term statistical outcome would be unchanged, along the way there could be a period in which the investment kept going down in value and one might start doubting the assumption that it had a 50% chance of going up. And, even if one had absolute conviction that the investment would recover its value, one might not have the time or inclination to wait for that to happen. In which case, the investment would be sold at a significant loss. This risk of experiencing such a large loss simply isn't there for investment A.

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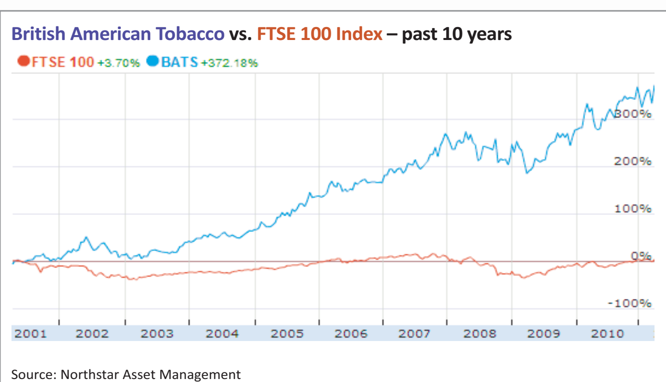
As investors we seek the higher returns which the stockmarket, as an asset class delivers, and accept that these greater returns will be lumpy in nature. However, we aim to minimise the peak-to-trough volatility through our selection process. In this race to returns we would always rather be the tortoise than the hare for we know that, at the end of the day, it is a race which the tortoise always wins.

British American Tobacco Plc. (BAT) is our clients' largest single investment holding. The risk characteristics of this share illustrate well our overall approach to risk. When we presented our investment thesis in our 30 September 2009 Market Report, we did not highlight the risk characteristics of the investment.

Like any other investment, BAT is not without risks. However, we have spent a great deal of time studying and understanding the risks associated with the investment and have a very high conviction (as reflected in our clients' position size) that, over the long term, investors will be more than compensated for the risks which they assume in holding the company's shares.

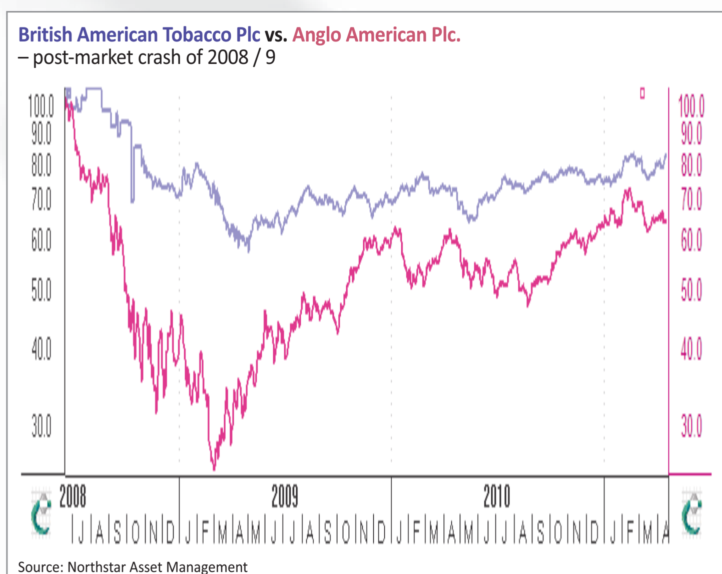
British American Tobacco vs. FTSE 100 Index – past 10 years



Source: Northstar Asset Management

One can back-test the validity of the risk conclusions and the investment thesis by examining the company's share price performance track record. BAT has its primary listing on the London Stock Exchange and a secondary foreign inward listing on the JSE.

British American Tobacco Plc vs. Anglo American Plc.
– post-market crash of 2008 / 9



Source: Northstar Asset Management

In the past decade the London Financial Times Stock Exchange 100 Index (FTSE 100) appreciated by 3.7% while shares in BAT increased by 372% - a one-hundred-fold out-performance. Additionally, BAT pays a predictable and growing dividend yielding 4.5%, almost exactly double that of the FTSE 100.

BAT was listed on the London stockmarket in 1912, and in the past 100 years, £1 invested in BAT would have delivered a return four hundred percent greater than that enjoyed by an investor who assumed overall market risk and had bought the FTSE 100 Index.

In the crash of 2008/9 Anglo American Plc. lost more than 75% of its share price, and the company suspended its dividend. In the same period, BAT lost 40% of its share price but it increased its earnings by 14% and their dividend by 26%. Well illustrating the robustness of its earnings and the lower level of risk that BAT investors enjoy.

In the post-crash period, even excluding dividends paid, BAT shares have recovered to 83% of their pre-crash value while Anglo American's remain at 64% of their pre-crash level.

Going forward, BAT, which has a market capitalisation 20% greater than Anglo American, has pledged to pay 65% of its earnings to shareholders by way of dividends and has a R8bn per annum share buy-back program, which further enhances shareholder value.

While past performance may reassure, as investors, it is future performance that interests us. BAT has a transparent, strong, growing, predictable and smooth future earnings stream and will, for the foreseeable future, deliver superior results to investors, in both absolute terms and on a risk adjusted basis.