NORTHSTAR
ASSET MANAGEMENT

Client Letter 24 April 2014

Quarter End: 31st March 2014

Dear Client,

Once again, it is a great pleasure writing to you about the markets, our views thereon and how we are navigating the current environment on behalf of our clients.

To date, 2014 has been characterized by intrusive waves of news-flow-headlines that include Russia's invasion of the Ukraine, two high profile murder trials, the Chairman of the US Federal Reserve resigning, domestic election activity and a Boeing 777 that has mysteriously vanished from our globe.

In the midst of all of this, markets have moved about quite wildly with underlying sectors and stocks showing high degrees of price movement. Many of last year's winners have run out of steam and the action has shifted to previously unwanted areas.

In such a stew of activity, it is easy to be enveloped by the noise, but our dedicated research process ensures we never fall into such a trap and our goal is simplified into a single mission - PRICE DISCOVERY. This is a deep understanding of the true value of an asset relative to how an inefficient market is pricing it. On this note, in our Quarterly Market Report, we deal with an asset class - listed property - which we deem inefficiently priced by the market!

Since the beginning of 2013, we have investigated hundreds of different companies in South Africa and abroad and undertaken in-depth analysis on a large number of these involving thousands of hours of research. This process continues unabated and it has not been in vain. A great investment process drives investment returns and on top of 2013 being one of the best performing years for our clients, 2014 is proving thus far, to be a period in which we are outperforming the market and our competitors. That said, we do expect returns to be lower this year than last.

We must stress that markets are often irrational and misprice assets badly - this is usually a short-term phenomenon, but can also last longer than expected. Our decision making on the other hand, is always long-term with an anticipated pay-back period on investments counted in years, if not decades. The implication is that we are not always going to outperform the market over short time periods as this is impossible, but over time, we have shown a clear ability to generate market-beating returns.

We hope you enjoy our Quarterly Market Report and look forward to meeting with you, chatting about our views and answering any questions you may have.

Adrian Clayton
and the Northstar Investment Team

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Our March 2014 Quarterly Market Report is going to focus, albeit briefly, on two core themes. The first is a summary of the action seen in stock markets so far this year. The second is a discussion on listed property and our concerns around how the market is pricing this asset class.

Market movements in 2014:

The first three months of 2014 have not been the easiest for global investors. In dollar terms, emerging markets have produced negative returns of about 0.5%, with some particularly poor numbers emanating from China (-6%), Russia (-14.4%) and Korea (-2%). The JSE has gained 4.9% this year in US$ and 4.3% in rands – the difference being the slight rand strength seen since 1 January 2014. It's been a steadier ride for developed market investors. The MSCI World Free Index in dollars has gained 1.4% since 1 January 2014 and these gains have been predominantly driven from US markets.

The main theme, however, has been intermonth volatility within markets and across asset classes which we view as a time when trend seekers or momentum traders must, literally, have been 'chasing their tails'. Take the JSE for example - it is constructed from 38 underlying subsectors (e.g. Oil & Gas Producers; Chemicals; Construction & Materials; Automobile & Parts etc.), 13 of which delivered negative returns year-to-date, yet eight of these 13 subsectors produced positive returns in March. Clearly, attempting to identify a reliable, discernable and persistent trend must be proving tricky for those that manage money by switching around.

Gold bulls have finally had something to smile about with the JSE Gold Index up a whopping 42.6% over the past three months. To place this in context, the Gold Index is down 21.2% for 12 months against the stock market, which has risen over 20%. Trying to connect some underlying trend with the sudden rise in the index is tricky - since the Gold Index initiated its mini 2014 charge, the dollar gold price has gained just 6.7%, is down 19% over a year and fell almost 3% in March.

Our clients know that our investment team at Northstar are cautious on gold stocks and believe SA gold companies have secular (long-term) headwinds that make it tricky to ascertain what economic returns they can generate over time. That said, some of our long-standing Northstar clients do have a small and historical exposure to Pan Africa, a gold company that has done significantly better than most.

At the other end of the spectrum is the JSE Media Index, a high flyer in 2013 but a market sector that has been under severe pressure in March 2014 – this is constituted mainly by Naspers. Media was the third best performing sector of the JSE over the last year, but the third worst performing in March. We have done our homework on Naspers and, whilst we believe that it is a world class business, it is tricky to value, as 'new-age' technology companies invariably are. Our goal is to own Naspers for all our clients over time, but at a weighting and price that we feel accounts for the risk in this company.

In the midst of all these movements, our Northstar clients are doing well with our portfolios outperforming the JSE and our major competitors over the past year and again this last quarter. We feel at ease that we have diversified our clients' exposures across sectors and companies sufficiently to reduce the manageable risk within the portfolios. That said, we remain of the view that many companies on the JSE trade at elevated prices and that these need to retreat to more realistic levels in order to justify investing therein.

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Listed property – share prices do not account for the inherent risks:

Property yields should rise relative to bond yields:

We have done quite a bit of work on the listed property sector and this short summary is designed to provide insight into our views. This is an overview of the sector, as opposed to specifics on any one company. We must immediately acknowledge that not all companies should necessarily be tainted with the same brush and individual companies might justify being invested in, based on their own merits. We do, however, feel that the sector is enjoying a super spring tide (even after the severe correction of 2013) and share prices will, at some point, migrate lower to account for the changed dynamics within the industry.

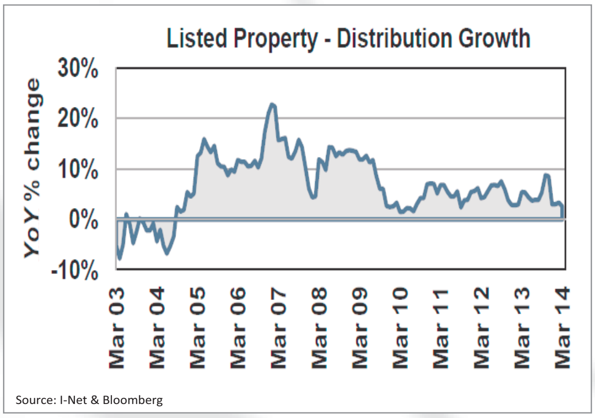
Our cautious view stems from two key areas: Firstly, we believe that listed property yields, relative to SA bond yields, are too low. Secondly, we believe that domestic interest rates (bond yields) are set to rise in this cycle, which is negative for property company returns.

The profile of income earned from listed property is not the same as that which an investor derives from bonds. Although the yield to maturity on a bond rises and falls depending on market conditions, the coupon on most nominal bonds is a set rate and determined on the date of issue. So, if an investor purchases a bond with a par value of R100 (which means the issuer will pay the lender R100 at some future date) and this bond has a coupon of R6 annually, then the investor earns R6 a year and will get R100 back at the end of the bond's term - the R6 does not change.

Property differs in that property companies aim to grow their rentals over time and this is achieved in two ways - by increasing their rental footprint (buying and building more space) and by lifting tenant rentals above inflation over time. In so doing, these businesses produce growing yields and, in theory, should be very attractive investments.

As is the case with normal equities, property companies also experience cycles in their profitability. Profits are particularly susceptible when the economy contracts or grows slowly, as under these conditions, tenants may not be able to absorb rental increases and vacancies often rise.

The attached graph (Listed Property Distribution Growth) depicts the swings in distributions of JSE listed companies since 2003. For the sake of simplicity, we consider profit growth and distribution growth as synonymous.

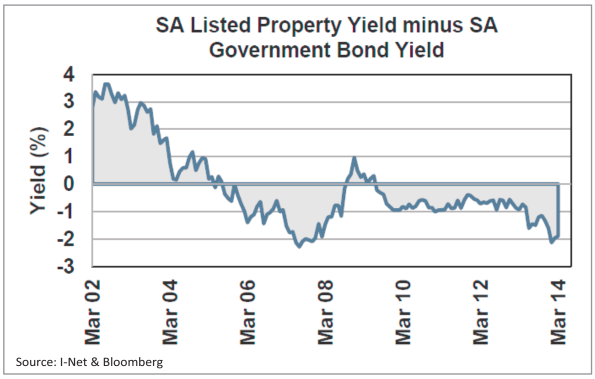


We see three distinct periods with respect to the rate at which property companies grew their distributions. The first is pre-2005 which represented a sluggish time for the domestic economy and what the graph depicts is that property company distributions actually fell year-on-year in 2003 and 2004.

The second period occurred from 2005 through to 2008 and coincided with a booming domestic economy. During this period, property distributions grew at double-digit pace (exceeding 20% in 2007) and investors were richly rewarded with growing income streams.

The third period initiated in 2008, but only really came to the fore from 2010 onwards. This we describe as the 'new normal' – much more pedestrian growth in distributions (single digit growth in fact) coinciding with a slow, grinding economy.

The second attached graph (Property Yields minus SA Government Bond Yield) compares the yields on the SA property index to yields on Government bonds. When above 0%, property yields are higher than bond yields and when below 0% the inverse is true.



Source: I-Net & Bloomberg

Just as in the first graph, there are distinct identifiable periods where property yields trade at premiums or discounts to bond yields. Before 2004, SA property yields were much higher than yields offered on Government bonds. From 2005 onwards, property yields sank and investors were happy to earn lower yields on property stocks than bonds. At the height of the property euphoria in 2007, investors happily earned yields 2% below the prevailing 10 year bond yield.

When the market crashed in 2008, property companies were dumped by investors and their yields shot higher, reaching levels in excess to that of bonds. Since 2008, property yields have again been retreating and, once again, are trading at almost record low yields relative to bonds – property yields are again almost 2% lower than bond yields.

We believe the market is not discounting enough risk in property stocks and the yields investors are demanding from property companies are too low considering the pedestrian growth displayed by these companies. We believe it is completely rational for property yields to be much lower than bond yields when property companies are enjoying super levels of profitability. When this occurs, investors do not mind earning low property yields initially, as these yields will grow with profit growth. However, when property companies are growing distributions at single-digit growth levels (as is the case at the moment), then the market should demand higher initial yields from property stocks and we feel that this will occur via the mechanism of lower property share prices over time.

Higher interest rates will not be property friendly:

Property companies, being yield orientated investments, compete with other yield generating assets, one of these being cash. We see higher cash rates (interest rates) in South Africa in coming years as interest rates around the world slowly normalize. It is our view that, as interest rates in South Africa rise, property yields will be forced higher and in so doing, property share prices will come under pressure.

Hurdle rate above expected returns:

In conclusion, at Northstar, we set hurdle rates (an expected level of return to justify the risk being taken) for each asset class that we can invest in on behalf of our clients. For property, our hurdle rate is 12% (inflation plus 6%) and at present prices, the prospective return for the property index does not meet our hurdle rate.