



NORTHSTAR
ASSET MANAGEMENT

Client Letter

20 July 2009

Quarter End: 30th June 2009

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Dear Investor

In the past few months global share markets made significant gains based on investors' perception that there are 'green shoots' foretelling economic recovery. As you will read in our market report, we are somewhat cautious of this view and, while the world economy will recover, we have yet to see concrete evidence of a rebound which fully justifies the price increase of the economically sensitive, and more risky, shares which have led the recent rally.

Although there may be more uncertainty in the near term, it may be worth reminding ourselves that in the 109 years, from 1900 to the present, global share markets have produced an average return, over and above inflation, of 5.8% per year. No other major asset class has produced a comparable return. \$1 invested in global stockmarkets in 1900 would, after inflation, today be worth \$466; some *fifty* times more than had that \$1 been invested in the global bond market over the same period.

Over the past 160 years, there have been 5 market crashes of the magnitude that was recently experienced. History teaches us that each one provided savvy investors with opportunistic entry points into the market as the average return in the five and ten year period, after the collapse in share prices, produced significantly above-average returns for investors.

In our market report we try to illustrate the perplexity of investing in the stockmarket under current conditions. While we are confident that share investing remains the asset class of choice for those seeking to build long-term real wealth, in the short term some uncertainties remain.

We know that stockmarket investing generates lumpy returns. However, we are serious long-term wealth creators and would far rather compound our clients' wealth with lumpy returns averaging 15% per year, than have smoothed bond or money market type returns of 8% per year.

No one enjoys market volatility but, with our value-orientated investment approach, we are not unhappy to see markets undergo periodic bouts of turmoil as these frequently provide the richest pickings for our clients. While we are unwilling and unable to predict near-term market movements, we remain confident that patient investors will continue to be well rewarded by the ongoing disciplined application of our proved and prudent investment management philosophy.

Yours sincerely

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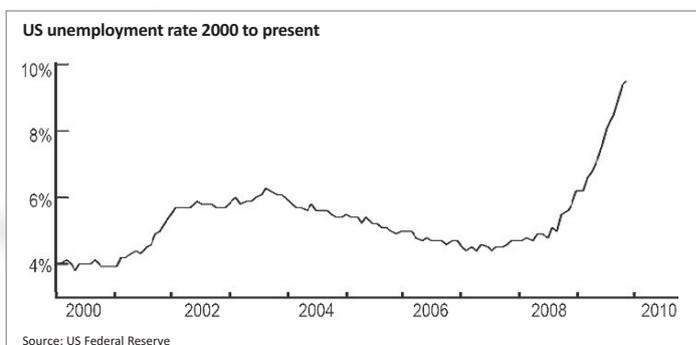
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The green shoots of recovery are allegedly being sighted by economists and politicians. Interestingly, they are less apparent to participants in the productive sector who see lower earnings, rising unemployment, increased bankruptcies and declining house prices.



Having flooded the global economy with money, central bankers have transferred much of the debt and risk from the private sector to the public sector. Government borrowings are ballooning and tax rates will increase to service the heightened levels of state debt.

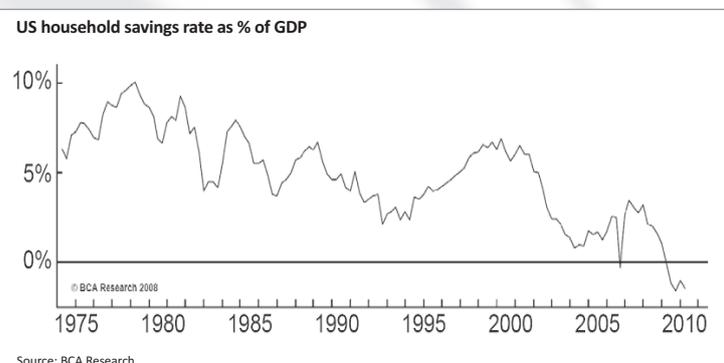
Awash with liquidity, and being told of green shoots sprouting all around them, investors, fearful of missing the bottom, have ploughed back into risky assets. Commodity prices have jumped, as reflected in the doubling of the oil price since February.

In January of this year we suggested that government debt yields were in bubble territory as risk averse investors crowded that market. Since then yields have all but doubled from 2.06% to 3.9% as bond prices collapsed. Those who joined that 'flight to safety' experienced bruising losses.

The talk now is of a "V" shaped recession; that is, a sharp fall matched with an equally sharp economic recovery. This belief is being increasingly priced into asset and share prices.

We are more sceptical. While we acknowledge that economies are stabilising, and that restocking is creating current demand, we need convincing that a recovery is underway. Firstly, economies are continuing to shed jobs at an alarming pace. While the rate of job losses may be decelerating, we are still nowhere near turning the corner and adding jobs. Secondly, when that does happen, we do not believe it will be at the rate at which those jobs were lost. Thirdly, US workers are working the lowest number of weekly hours ever recorded and, for the first time in over 50 years, US private sector nominal incomes have declined. These factors, along with the continuing decline in house prices, have left the average consumers, insecure in their jobs, feeling more vulnerable and poor.

Having depleted their savings in the boom that was before the bust of 2008, they are unlikely to revert to their profligate ways of old. Even if they wanted to, it is unlikely that they would quickly again have easy access to credit, as they had before 2008. Mindful that their homes are not a store of wealth, we would expect to see consumers increase their savings. Marginal discretionary income is more likely to go into a savings account (or to pay off historic debt) rather than be spent on a flat panel TV, holiday or new gas guzzler.



Ironically, those very indicators which imply a recovery; higher interest rates and commodity prices, combined with increased consumers savings, are the very things most likely to derail it.

For us, much of this is at odds with the "V" shaped recovery thesis. The more overconfident investors become, the more cautious we are inclined to be. We have not joined the stampede into risk assets as we are unconvinced that prospective near-term future earnings will support recently elevated prices.



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Over the past year the Johannesburg Securities Exchange (JSE) All Share Index (ALSI) has delivered a -27.5% loss. In the same period the average Northstar client experienced a loss of less than half that figure. This is the third time in 20 years that the JSE ALSI has produced an annual decline of this magnitude.

Despite these losses, over the past 49 years, the rolling 20 year return of the JSE ALSI is just shy of 20% per annum, compounded. Consequently, including the recent declines, over the past 49 years, local investors have seen their investment wealth (before inflation) double, on average, every 3.6 years.

Even after the recent fall in share prices, the JSE ALSI has more than doubled over the past 5 years and has returned over 230% over the past 10 years. And, as Northstar clients know, they have significantly outperformed these already impressive results.

We mention these facts not to brush aside the recent painful losses which the JSE and world markets have suffered, but rather to put the market's performance into perspective. Investors have a natural tendency to 'anchor' their start point at the peak valuation of their portfolios and to measure their wealth, gains or losses, relative to that. Whereas, a broader perspective may better reflect the facts.

If the stockmarket's performance is assessed on a one year timeframe, it is noted that actual returns can vary considerably and fluctuate between gains of 60% and losses in excess of 30%.

This apparent volatility hides the fact that over the long term the JSE ALSI has produced remarkably consistent gains. The longer the timeframe one uses, the lower the volatility and the more stable the compounded rate of return - as the red line reflecting the rolling twenty-year return of the JSE indicates on the below chart.

Another point worthy of note is the above average returns which investors enjoy in the years subsequent to a major decline such as that which average investors have recently experienced.

Just as we outperformed and earned greater than market returns in the rising market, so too have we managed to contain losses which our clients experienced in the recent declining market.

This outperformance by Northstar has, on average, added a little under 10%pa of real return, over and above the JSE ALSI, to the growth of our clients' wealth. The compounding of this outperformance has, over the past seven years, resulted in the average Northstar client enjoying returns nearly double those generated by the stockmarket as a whole.



While the current losses are painful to bear, we have no doubt that, in time, they will be recouped, and more.

As detailed in this Report, we have not yet detected evidence of a meaningful economic recovery being underway. We remain disciplined and our clients' portfolios remain significantly underweight those companies whose prospects are dependent on a favourable economic cycle. Their turn will come, but for now we hold the view that the risk of loss outweighs the potential gain that investors may achieve in holding these counters.

Rather, our clients' portfolios continue to be skewed towards defensive type companies in which we have a high degree of confidence in the sustainability, and growth, of their future earnings.