



NORTHSTAR
ASSET MANAGEMENT

Client Letter

16 October 2009

Quarter End: 30th September 2009

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Dear Investor

Through their coordinated actions, policymakers and central banks have staved off the threat to the global financial system and the current crises has been downgraded, from a depression, to a severe recession.

World economies are stabilizing and are about to begin their recovery. After an initial bounce, economies, along with company profits, may recover at a slower rate than many investors and analysts have pencilled in.

The recovery will not be to what was before. The propellants, such as abundant and cheap credit, which over-extended the prior cycle and company earnings, will little feature in the recovery. We are cautioned too by the significant increase in the number of unemployed, by ongoing consumer deleveraging and by the extent interest rates will need to rise to reach normalised levels; and expect these factors to weigh on the recovery.

The world has changed and so too have the economic drivers. The companies which led us into the crises will not lead us out. Just as the small-caps, post that bubble's bursting in 1998, and the IT companies, post the 'dot-com' crash of 2001, did not lead the market in those respective recoveries.

Unsurprisingly, our clients' portfolios bear little resemblance to what they looked like two years ago, when first we warned of the then impending crises. Our pre-emptive rotation spared our clients a great deal of the mauling meted out subsequently by financial markets.

In the past six months western markets have appreciated, from their lows, by around 50% in US dollar terms. The JSE, and some other emerging markets, have gained over 100% in US dollar terms. As share prices have increased, so too has value decreased.

Just as fish see the bait and not the hook; all too frequently, investors see the profit and not the peril. Given our cautious views on the strength of the imminent economic recovery, and on current market valuations, our clients will be unsurprised to note that their portfolios continue to be biased towards defensive, high quality companies with transparent and predictable future earnings.

We continue to shy away from unnecessary risk and until such time as there is greater clarity, we are more than prepared to exchange possible marginal returns for the certainty of increased protection against permanent loss of capital.

Yours sincerely

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
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Market Report

16 October 2009

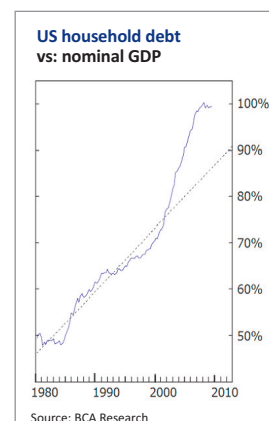
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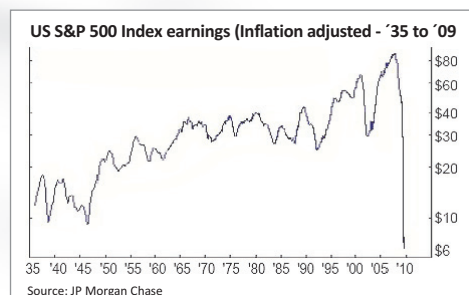
US consumers matter. They constitute around 65% of the US economy and 25% of global consumption. In the generation from 1980 to the present, the US economy doubled and nominal US household debt increased fourfold. As a percentage, US household debt grew from 50% of the GDP to 100%.

This borrowing financed over-consumption by consumers and over-production by producers looking to satisfy consumers' 'ever growing' demand. Even in areas such as homebuilding, the 'ever increasing' house prices led to a three years' oversupply of homes which need to be absorbed before house prices can meaningfully recover.

Right now, one in eight US homes is in mortgage delinquency or foreclosure, one in nine Americans receives welfare food-stamps and one in ten Americans is unemployed. A figure which jumps to one in every six Americans, if one adds back those who have given up looking for work, those unemployed for more than 18 months or who have accepted (often menial) part-time work - all of whom are considered no longer 'unemployed' by the US Department of Labor.



The recession devastated company earnings as evidenced by the average 92% decline in earnings recently reported by the 500 largest US companies which constitute the S&P 500 Index.



In terms of the economy, things are about as bad as they will get. From here we anticipate better economic news. Since their March lows, in US dollar terms, western stockmarkets (and Japan) have recovered by around 50%; the JSE, and many other emerging stockmarkets, have appreciated by over 100% (in \$) from their nadir.

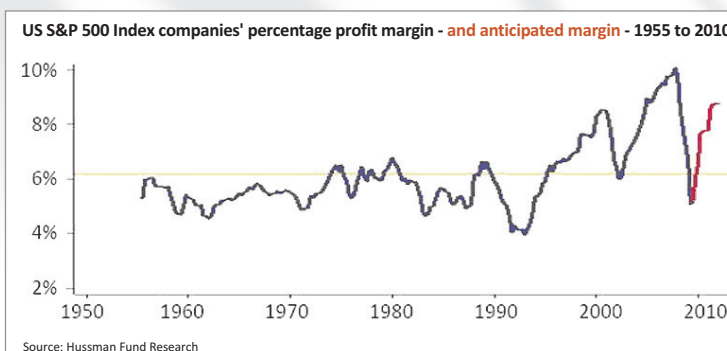
Much of the market's recovery, from their crises lows, is warranted on account of the passing of the eye of that storm. A further portion of the recovery is attributable to investors 'looking through' the current recession and pricing in anticipated increased earnings which will accompany the imminent economic recovery.

Earlier this year, companies surprised the markets when they reported earnings less-terrible than predicted by analysts - many of which had been based on the companies' own dire 'guidance'.

Companies achieved this by reducing costs; primarily through shedding labour, deferring capital expenditure, delaying maintenance and changes in accounting practices. Now we need to see companies increase not only earnings, but revenues as well.

Profit margins, after having been slashed by a half from their 2007, 55 year, peak of 10%, are expected by investors and analysts to recover in the next two years to around 8.5%.

Given that the S&P 500 companies' longterm average profit margin is 6%, some may regard these expectations, which have already been priced into the financial markets, as optimistic. Were companies to fail to meet these lofty expectations, we would expect their shares to adjust accordingly.





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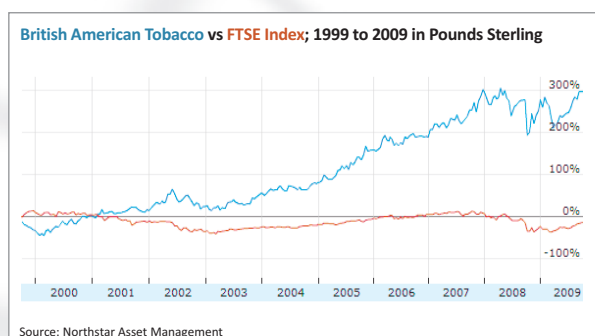
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Given our opinion as to the optimism already baked into global share prices, our clients will be unsurprised to note that their portfolios are skewed towards companies least at risk of possible downside earnings surprises.

British American Tobacco Plc (BAT), recently spun out of Richemont and Remgro, exemplifies our preferred investment route.

BAT listed on the London Stock Exchange in 1912. £1,000 invested in the LSE at that time would today be worth £24m. Although BATS outperformed the LSE by 'only' 1.56%pa compounded in that period, that same £1,000 invested in BAT would today be worth £93m.



BAT is an extraordinarily well managed company which continues to offer long term value on account of emerging market volume growth, successful brand management and continual cost savings.

Emerging markets account for >80% of volume growth and more than compensate for volume declines in developed markets. The company's product-mix allows consumers to move up and down the brand cost scale within the company.

BAT operates in 53 countries and no one country constitutes more than 8% of operating profits. Due to industry consolidation and bolt-on acquisitions, BAT manufactures in 51 factories and currently has the highest operating cost structure in the industry - allowing for significant cost cutting, in line with management's stated intent.

Since the Master Settlement Agreement in the US in 1998, global tobacco litigation has been on the wane. While continued regulatory challenges are expected, these are already in the price.

Despite continuous antagonistic regulatory challenges, BAT has increased earnings by over 10%pa over the past decade.

One of the most under-appreciated facts about financial market analysis is that, even more important than the growth in your market, is the growth and extent of competition that one might face.

The four largest tobacco companies control 92% of world (ex-China) sales. Social pressures, bans on tobacco advertising, and restricted distribution have done little to curb sales and profitability, but do restrain competition and constitute all but insurmountable barriers to competitors and new entrants.

As an industry, tobacco's profitability, consumers' brand loyalty and price insensitivity are legendary; and the content of countless business school case studies. Existing players have negligible capital investment requirements and are able to pass all cost increases onto their customers. Profits and cost saving from efficiencies and consolidation flow to investors by way of dividends.

In the year in which the largest 500 companies in the US reported earnings decline of 92%, BAT reported an earnings increase of 14% and, in the year in which Anglo American suspended its dividend for the first time in 70 years, BAT increased theirs by 26%.

Management remain committed to raising the dividend payout ratio to 65%, in addition to the £750m pa spent on share buybacks, effectively returning almost all earnings to shareholders. While many companies are wallowing in debt and seeking to deleverage their balance sheet, BAT has zero net debt, a powerful positive cash flow and one of the strongest balance sheets of any company.

Our research has increased our conviction of the investment case for BAT. This is further tempered by BAT's recent share price weakness (in Rand terms) on account of a currently weak Pound Sterling and due to more speculative investors abandoning the predictability of boring BAT, for more cyclical companies.