



**NORTHSTAR**  
ASSET MANAGEMENT

**Client Letter**

23 July 2002

**Quarter End: 30<sup>th</sup> June 2002**

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Dear Investor

Clients familiar with our market reports will know that we have for some time been highlighting the vulnerability of global markets and the fragility of (particularly US) corporate earnings. We were not trying to pick tops and bottoms in the market (a fools game) rather, on sound fundamental analysis, we argued that international markets were overvalued.

Just because global markets have now fallen, it does not make them cheap. Corporate earnings have collapsed and report of widespread accounting fraud in the US has rattled many investors.

Against this backdrop, South African markets have held up particularly well. They were never as overvalued as those abroad and are viewed by some as safe havens in these troubled times. The ability of asset managers to select shares for investment is now more critical than ever. Our preferred shares in the local market continue to perform satisfactorily.

We have long espoused holding sound companies with real assets, stable earnings growth, positive cash flows and attractive dividend yields. Additionally, we invest in companies whose management unlocks shareholder value. Such strategies, which significantly increase returns to shareholders, include: share buybacks, distributing exceptional profits, repaying surplus capital by way of cash dividends and dismantling of inhibiting control structures.

With the retracement of the Rand and a now 30% fall in their share price, we are cautiously buying back those dual-listed glamour stocks that we sold at much higher and overvalued levels. The prevailing stockmarket volatility may disconcert some investors, but, for us, it affords opportunity to exploit absolute and relative value discrepancies.

Despite last quarter's stock market declines, we were pleased to report that, once again, all of our clients again enjoyed capital gain. We believe that our clients' portfolios remain well positioned to withstand the current market volatility and will continue to provide pleasing returns.

Yours sincerely

**Alexander Otten**

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# NORTHSTAR

ASSET MANAGEMENT

## Market Report

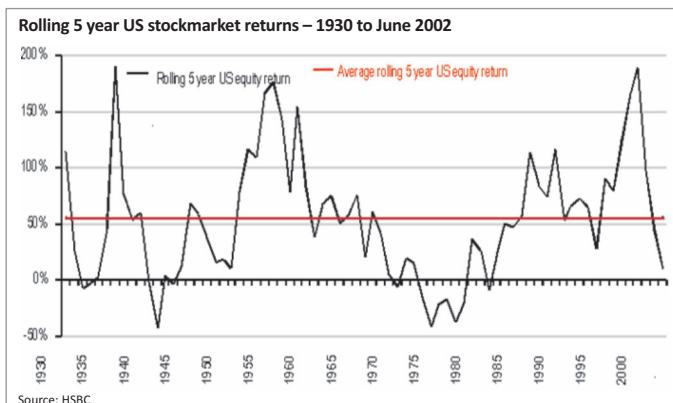
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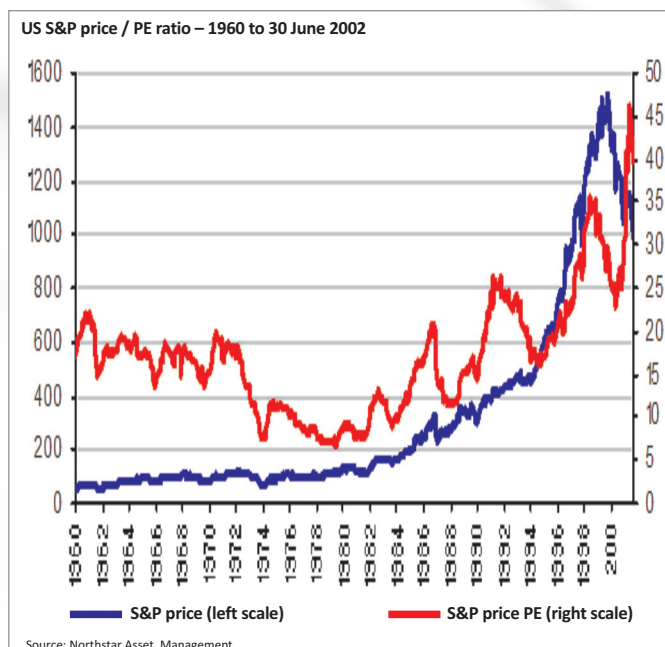
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The exact definition of a bear market may be moot. However, when the broadest index in the US – the US S&P top 500 companies index – which is down over 23% so far in 2002 and looks set to end the year down for its first three-year consecutive loss since 1941, few are interested in the semantics of the debate.

Since their recent peak the combined earnings of the top 500 US companies have fallen by 53% while the index itself has declined by 45% from its zenith. Earnings are back to 1993 levels and the stockmarket to levels last seen in 1997. Such a collapse in US earnings has not been seen since the 1930's depression.



This disparity in declines of earnings and price means that the P:E valuation ratio of the US stockmarkets has risen, making markets even more expensive now than at their peak.



A picture tells a thousand words. The blue line (left scale) is the price of the index of the 500 largest corporations in the US. The red line (right scale) is the P:E or “expensiveness” the market pays for those companies’ earnings. The latter has a forty, ten and five year average value of 17, 25 and 31 respectively. At its present level of 45, it is plainly above all of these.

Clients are aware of our views that the SA market was somewhat inexpensive while the international (esp. US) markets were very overpriced. Many local shares are selling at attractive valuations both on an absolute basis and particularly when compared to the alternatives facing global investors.

Global markets are coming under pressure and, as relative valuations become stretched, this pressure will spill over to the SA market. Notwithstanding, shares we have selected, on criteria as described in our attached client letter, provide excellent protection while speculative excess is purged from the markets.

Gold remains an attractive investment in these turbulent times. It has a long term inverse correlation of  $-0.87$  to the US S&P index and a negative  $-0.86$  correlation to the US\$. Simply put, when the US stockmarket goes up, gold goes down; and -like now- when the US stockmarket goes down, gold goes up.



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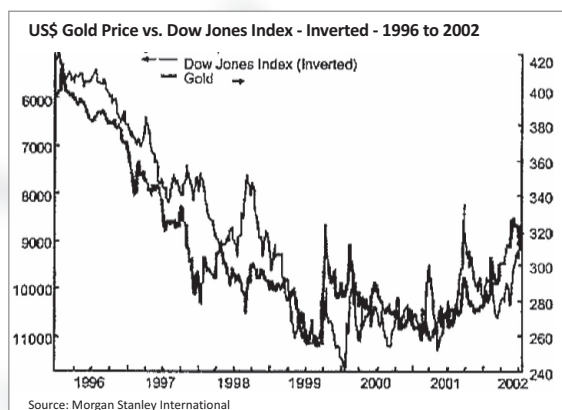
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When we started building the gold positions in our portfolios, the gold index constituted 3% of the JSE All Share Index (ALSI). With the subsequent rally that weighting has trebled. During this period we reduced our average portfolio weighting from being seven times over-weight the gold index to just double. The difference has been profit taken on the investment and a reduction of our absolute and our non-correlation risk.



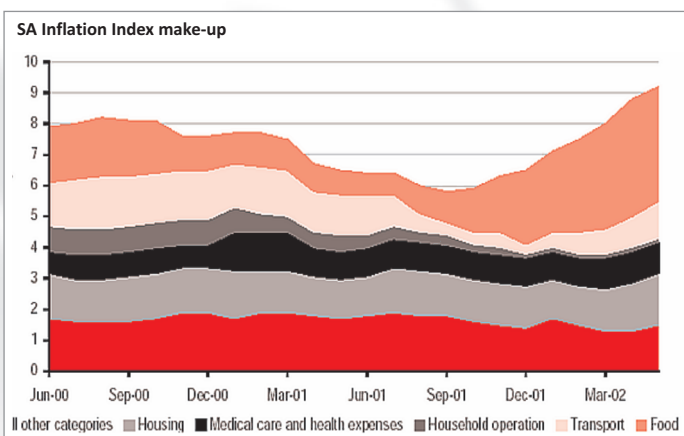
Until recently we held all our gold exposure in the unhedged, and most leveraged gold shares, Harmony and Goldfields. When these shares spiked in price in the past quarter, we substantially reduced our exposure to them. Now that the markets have retreated we believe that much of the easy money has been made in these stocks. We have begun to shift our exposure to hedged producers with huge reserves and which are more asset plays than pure directional bets on the price of the metal.

As existing hedges expire, these shares –which, understandably, did not benefit as much from the recent run-up in the metals price as did the unhedged producers- will enjoy higher attained prices for their production and will subsequently positively re-rate.

Shoppers will vouch that food inflation continues to gallop ahead. It is the largest single component of the Inflation Index and is the main culprit for the raise in general inflation. We turn this to our advantage by investing in food producers whose margins will be fattened. Tigerbrands, Illovo and OTK constitute more than ten percent of our portfolios.

Afrox, having diversified into healthcare has, in the past ten years, increased earnings annually and has quadrupled these over the period. However, its share price is little changed over the decade. As we wait for the market to re-rate this share we enjoy a 5.5% tax-free dividend yield.

As previously reported, we considered many of the internationally listed stocks to be overvalued and sold them. With Anglo's and Richemont having fallen by 35% we are slowly rebuilding positions in both companies. When the risk of capital loss outweighed the likelihood of future gains we sold. Now that the risk/reward ratio is reverting to favour holding these stocks, we cautiously accumulate.



Although the environment remains challenging, we are confident of continuing to providing our clients with satisfactory returns on their capital and at risk levels significantly below those of the market.