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Northstar Asset Management
Market Report: Q2 2018

Page 1 **The big picture**
Are South African equities expensive?
Adrian Clayton and Rachel Finlayson

Page 4-8 **From the analysts: equities**
Why we like Boeing? Donovan Stefan
Reunert—Slow and Steady. Andrew Randles

Page 9 **Client corner & Northstar News**
How financial services firms depersonalise clients rather than creating a culture of care. Lian Lubbe

Page 11 **Corridor chatter**
Acknowledge the past, but let's own the future.
John Steenhuisen

Page 12 **Advisors corner**
Is 5% really a safe draw rate at retirement?
Adrian Clayton

Page 13 **Northstar social responsibility**
TEARS. Chantelle Clayton

Page 14 **Staff member profile**
Marshall Kanengebiza. *Servicing*

In our 2nd Quarter Northstar Market Report we cover a wide ranging set of topics, which we believe satisfy the varied interests of our readers. From addressing whether the JSE should deliver healthier returns after four flat years to explaining our investment thesis on Boeing, which returned about 100% for us in 2017, to explaining what a "safe draw-rate" is at retirement. We hope you find something which tickles your fancy.


THE BIG PICTURE

ARE SOUTH AFRICAN EQUITIES EXPENSIVE?

By Adrian Clayton (Managing Director & CIO) and Rachel Finlayson (Analyst)

For four years the domestic stock market has been moving sideways, testing even the most bullish local investors. See Figure 1. With this in mind, we use three approaches in the following article to provide some indication on whether the JSE is expensive or cheap. We also then look at our view of expected returns.

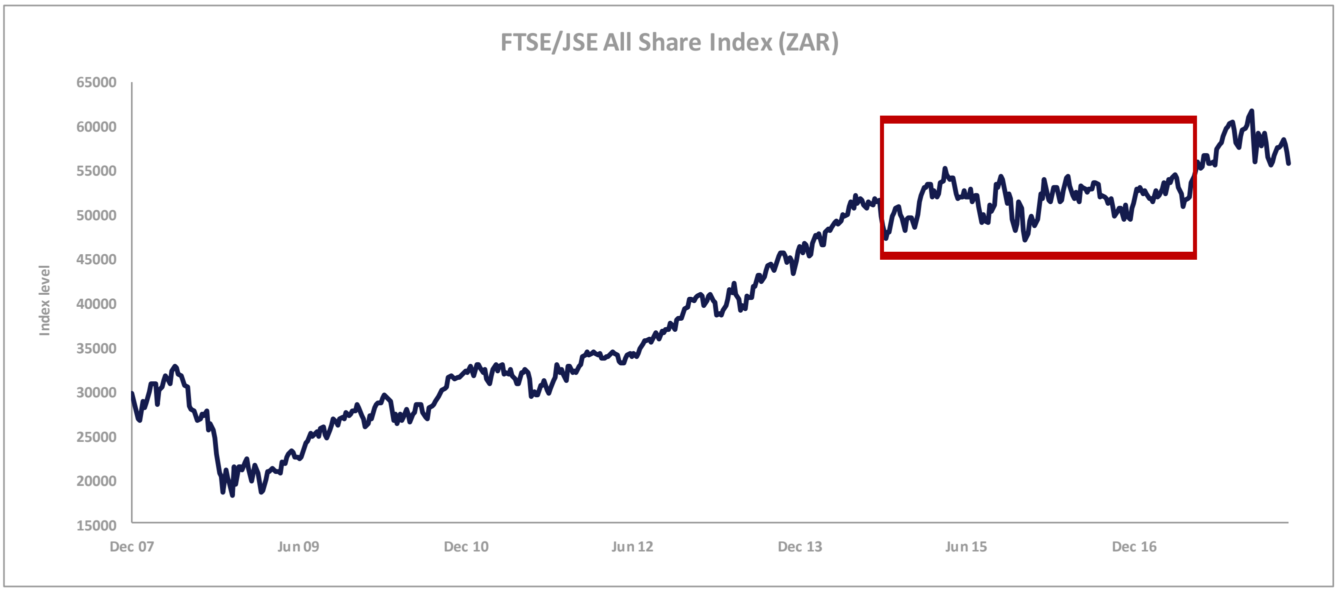

Figure 1. FTSE / JSE All share Index. Source: Bloomberg, Northstar Asset Management.

There is no simple framework for predicting market returns, this is not a perfect science and consequently, our approach does not aim at pin-point precision, it also is triangular in that we look at various inputs to reach sensible conclusions.

Historical valuation metrics

Relative historical P/E valuations against other markets

At its simplest level the JSE All Share Index can be assessed in terms of its P/E rating against other emerging markets (MSCI Emerging Market Index) and against the broader global market, including developed and emerging bourses. (MSCI All Country World Index)

Figure 2 shows that our market is trading above its long-term relative median price to earnings multiple (P/E ratio) against both these indices. However, the relative P/E has dropped significantly since its peak in 2016. Removing Naspers (19% of the JSE All Share Index) and Steinhoff changes the picture somewhat, doing this results in the JSE ALSI P/E being in-line with MSCI All Country Index and a 7.5% discount to the median MSCI Emerging Markets Index relative rating.

Of course, the problem with the above approach is the local market might in relative terms be reasonably priced against others, but all markets could simultaneously be expensive. Normalising anomalies in the P/E of the MSCI going back to 2005 shows that the MSCI World Index has averaged a P/E of about 17.2 times, being lower than the 19 times it is presently trading at. Emerging markets have had a P/E average since 2005 of 13.6 times versus 14.5 times now. This simple work indicates higher than normal market valuations and thus caution needs to be adopted when looking at relative valuations of one market against another. Worth mentioning is that markets have good reason for being elevated, earnings continue to be powering ahead and interest rates, albeit rising, are still very low relative to inflation from a historical perspective.

not far off their long-term rating as can be seen in the graph below. Excluding Naspers and Steinhoff takes the JSE rating to a slight discount to the historical norm of 1.4x bonds. Again from this simple work, equities look modestly priced.

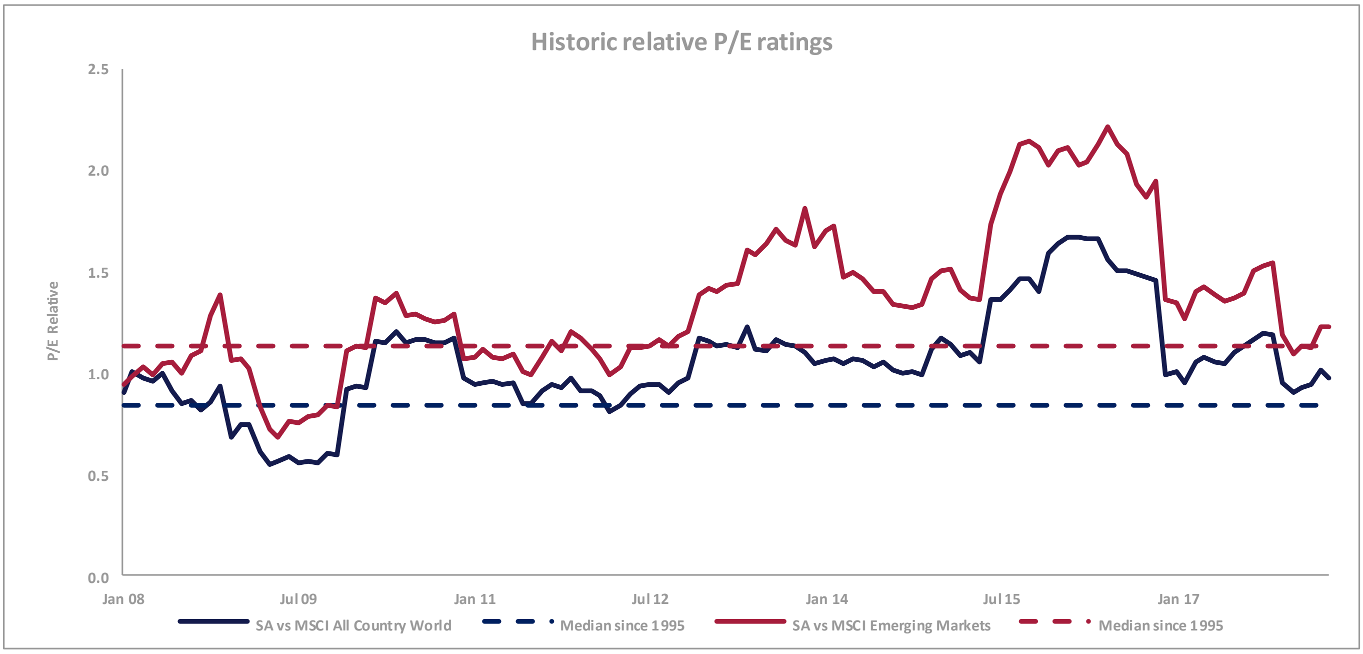

Figure 2. Depiction of markets trading above long-term relative median Price to Earnings ratios. Source: Bloomberg, Northstar Asset Management.

Relative historical P/E valuations against bonds

We then turn to the inverse metrics of the Fed model, but apply this approach to South African assets. The exercise involves comparing the P/E of the JSE ALSI to the implied P/E of long-term South African bonds. Above 1, equities are more expensive than bonds, but as shown in Figure 3, South African equities have historically traded at a P/E premium to bonds with an average of 1.4 times. Equities are

Potential market returns by incorporating earnings, dividends and P/E movements

The above approaches provide guidance on relative levels of cheapness or overvaluation, they do not estimate potential returns. However, it is theoretically possible to predict future returns. To do so, we arm ourselves with an estimate of profitability and dividends expected from the market in the foreseeable future together with a view on what

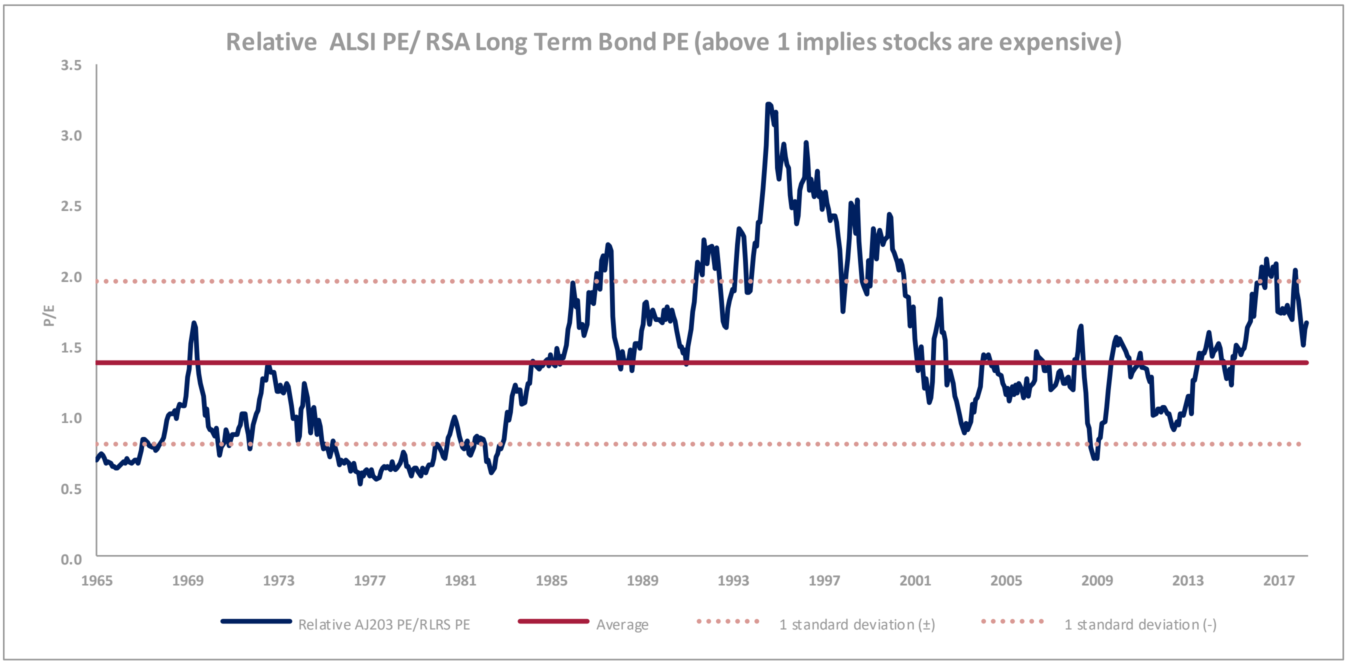

Figure 3. Relative ALSPI PE / RSA Long term bond PE. Source: Bloomberg, Northstar Asset Management.

P/E the market will trade at in the years ahead.

From our work (source: Bloomberg, Northstar Asset Management) earnings together with dividends for companies constituting the JSE All Share Index should collectively amount to 19.4% growth for the next 12 months – on the face of it, a great return! However, gauging returns also requires a point-estimate of what the 12-month forward P/E will be on the market. A higher forward P/E will add to returns whilst a falling P/E will detract from returns in accordance with the following formula:

12 Month return from ALSI = DY ALSI (12 months) + EPS ALSI (12 months) + P/E ALSI rerating/derating

At the time of this research, the P/E on the market was 17.1 times, significantly higher than the mean multiple since 1995 of 15.5 times. It was also market consensus that interest rates were likely to drop in SA over the next twelve months – this view has subsequently moderated. To estimate returns, we needed a view as to whether we should expect a higher or lower P/E ahead in the context of lower interest rates. To establish this, we looked back to 1960 to assess P/E movements during falling rate cycles. Our work covered multiple decade interest rate cycles and the unequivocal evidence was that the P/E of the market rises as rates drop 72% of the time.

However, our work further found that at all historical points when the P/E of the market was 17.1x or higher whilst interest rates dropped, the market's P/E never rerated (rose) from these elevated levels and in fact fell.

A rational investor should demand returns from equities of inflation plus 7% or about 13% annualised over the long-term at the current inflation rate of about 6%. If the P/E of the market derates to 15 from 17.1 and we add earnings and dividends, the 1-year return from the ALSI would amount to approximately 8%. This is below the 13% hurdle rate demanded by a rational investor. This return assumes the derating happens in 1 year, the market might instead derate over a few years, causing returns to be higher. Our analysis demonstrates the importance of investors moderating their return expectations for the market. It also explains why Northstar is cautiously positioned within our unit trusts, holding more cash than we would normally advocate.

Potential client returns by using the upside to intrinsic value from the Northstar "Buy list"

As a research-driven bottom-up manager, we are confident that the best estimate of future returns for Northstar clients stems directly from what we believe the companies we own are worth. When comparing our valuations versus market prices for each stock on our buy list, we get an upside to intrinsic value of 13% across our buy list. What we unfortunately cannot tell is when the companies our clients own will be correctly priced, it might take longer than a year, but what we are sure of is that our clients own undervalued businesses!

FROM THE ANALYSTS: EQUITIES

WHY WE LIKE BOEING

By Donovan Stefan (Analyst)

History

Founded in 1916, Boeing's success has and continues to be predicated upon the size and durability of its strategic competitive advantages (economic moats) and the high barriers to entry that characterise the industry. Boeing benefits from different economic moats including its distribution and operational scale, intangible assets (brand, patents and regulation), and switching costs. Today, Boeing is the leading aircraft manufacturer globally and operates in a

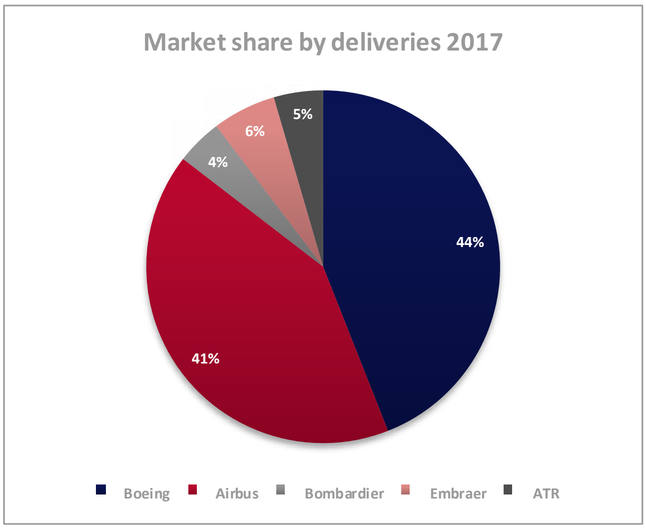

Figure 4. Market share deliveries 2017. Source: Bloomberg.

duopoly with Airbus, together commanding over 80% of the aircraft manufacturing industry.

Industry

Both the structure and stability of the Boeing-Airbus duopoly can be explained by high barriers to entry. There are four of these:

- The extremely high cost of developing aircraft programs where large losses can be incurred for many years before a program becomes profitable and delivers cash flow.
- Navigating a very complex supply chain that cannot be internally replicated.
- The intellectual property and technical know-how required to design, assemble and certify commercial aircraft, which requires excessive amounts of monetary and human capital investment and a long developmental time horizon.
- Stringent regulatory and administrative requirements issued by the Federal Aviation Administration (FAA), which are compulsory to certify airplanes for commercial use, are extremely costly and onerous. For instance, it can take years and require thousands of documents to prove that an aircraft meets safety and performance standards.

Since the recession in early 2000, the cyclical nature of the industry has been greatly reduced, making Boeing a more stable and steady quality compounder of value. This is attributable to Boeing's rational management with regards to production rates, which has led to an accumulation of a vast delivery backlog for aircrafts, equivalent to approximately 7 years at current production rates. Moreover, the nature of the backlog is very diverse from a geographical and customer base perspective (e.g. low cost carriers & network carriers) which, reduces concentration risk. The advantage of a vast backlog is evidenced by deliveries being virtually uninterrupted during the 2009-2010 financial crisis compared to 2001-2003 (Figure 5). Today, the backlog is even bigger than it was in 2009-2010 providing a greater margin of safety.

Strategic competitive advantage (Economic moat)

In addition to high barriers to entry, Boeing's strong competitive position is a consequence of the size and durability of the strategic competitive advantages it has been able to build to fend off competitors. Boeing's wide moat is derived from 3 primary sources:

- Its extensive operational and distribution scale allow it to provide its customers with timely worldwide technical expertise, which is critical given the nature of the industry.
- Boeing has strong intangible assets in the form of a brand that customers value and rely upon – their intellectual property and technical expertise (15600+ worldwide patents) are extremely difficult to replicate.
- Switching costs arising from the high cost of fleet groundings and aircraft crashes make customers reluctant to purchase aircrafts from an unproven aircraft manufacturer. There are also switching costs related to training pilots, crew members and maintenance staff.

Management

Boeing Management have displayed the ability to prudently allocate capital, which has led to strong free cash flow gen-

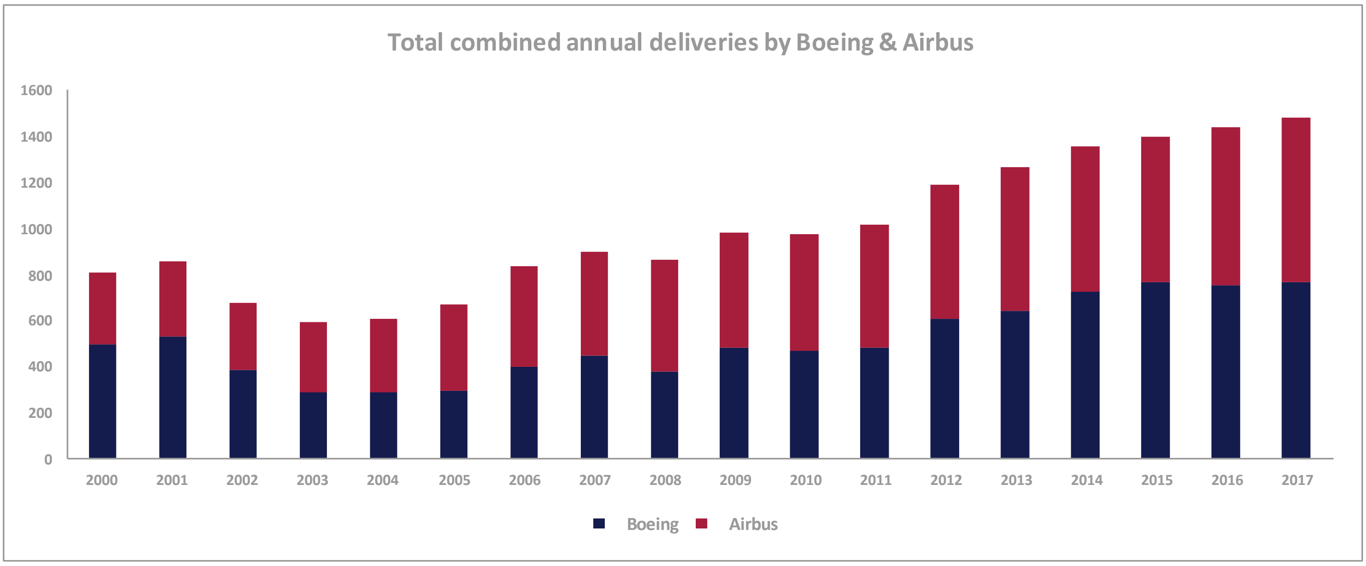

Figure 5. Total combined annual deliveries by Boeing and Airbus. Source: Company Financials, Northstar Asset Management.

eration and the subsequent return of vast amounts of capital to shareholders in the form of dividend and share buybacks. Over the last 5 years, dividends have increased more than 250% and in total Boeing has returned more than $40bn of capital to shareholders. Vast amounts of capital will continue to be returned to shareholders in 2018 with Boeing having a further $18 billion set aside for share repurchases. More impressively, Boeing have consistently delivered returns on invested capital (ROIC) substantially in excess of its cost of capital with an average ROIC of 31.9% over the past 5 years despite operating in a very capital-intensive industry.

Free cash flow, the primary driver of value

Boeing uses a unique accounting methodology known as program accounting. Program accounting causes a disconnect between Boeing's cash flow and earnings trajectories. In the early stages of a new aircraft program earnings are overstated relative to cash flows but as the program matures, earnings become understated relative to cash flows. As a result, earnings are a poor indicator of Boeing’s value and therefore likely share price performance. On the other hand, cash flow is a better indicator of Boeing’s value and therefore share price performance as evidenced in Figure 6.

Conclusion

In 2017, Boeing delivered 95% share price appreciation and in excess of 100% in total returns including dividends. Despite this stellar performance, we believe that it still has the ability to deliver steady free cash flow growth over the long-term due to its enduring competitive advantages, high barriers to entry and improving industry dynamics.

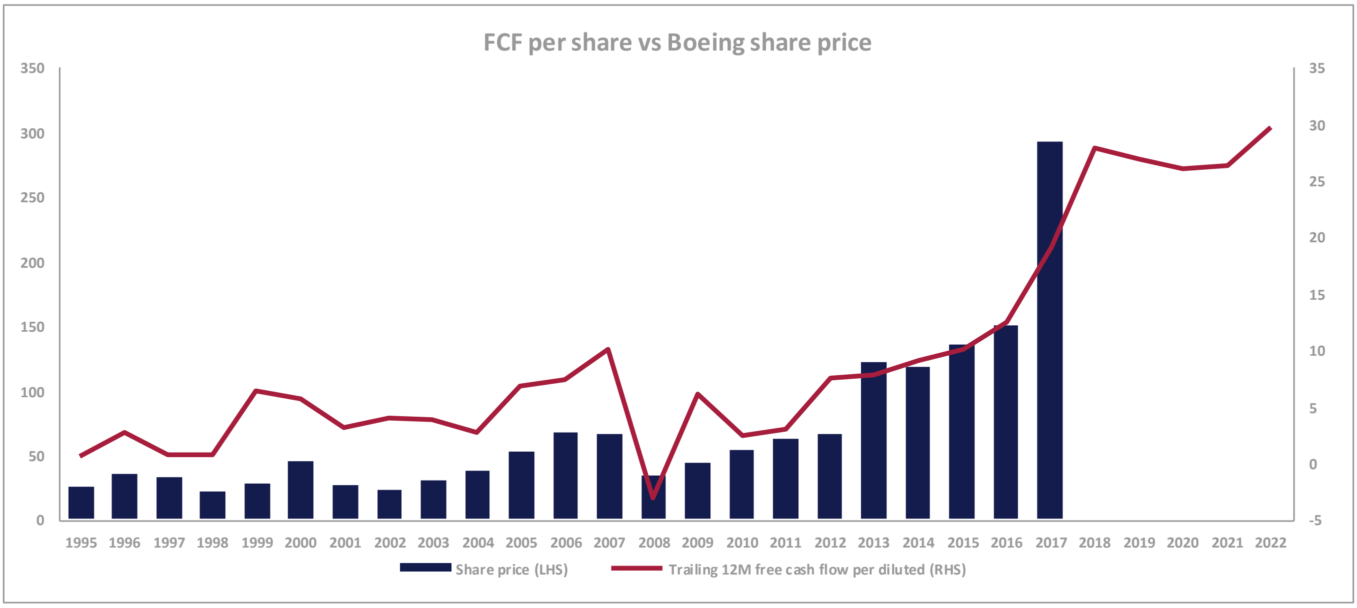

Figure 6. FCF per share vs Boeing share price. Source: Bloomberg; Northstar Asset Management estimates

FROM THE ANALYSTS: EQUITIES

REUNERT—SLOW AND STEADY

By Andrew Randles (Analyst)

History

Even though Theodore Reunert and Otto Lenz, formed "Reunert and Lenz" in 1888 by specialising in electric lighting, power and transmission, it wasn't until 1907 that the company made a name for itself by constructing a replacement steam-generated power plant for Johannesburg in a flabbergasting six weeks.

Today

The company we know today as Reunert is a manufacturing conglomerate with exposure primarily to South Africa, as well as smaller operations in Australia, Lesotho, Sweden, the USA, Zambia and Zimbabwe.

The Group's operations span high, medium and low voltage cable manufacturing that powers sub-Saharan Africa, tailored information communication technology (ICT) services and products catering to 55 000 customers, as well as a host of intellectual-property rich manufacturing businesses.

Capital Allocation

In 2014 Reunert's Management Team changed the fate of the company by selling-off the Nashua Mobile subscriber base for R1.79bn; leaving the business flush with cash (R2.7bn in 2015) and nascent opportunity.

We believe management teams are perpetually faced with the following capital allocation decisions - invest in their existing business, acquire outside businesses or return capital to shareholders via share repurchases or traditional dividend payments. The outcome of these decisions are measurable and reveal themselves in terms of the returns that shareholders receive on their capital invested.

Reunert's Management Team takes a pragmatic approach to capital allocation by not investing internally or externally below a 13.5% Internal Rate of Return (IRR) and adding higher hurdles for elements of risk including cyclicality, liquidity and size etc. An IRR acts as a hurdle that must be earned in order to invest shareholder capital in a project, higher risk projects demand higher rates of expected return.

Although the company has been deploying capital into pockets of opportunity in the existing businesses that show growth potential, what has impressed us is Reunert's management culture of conviction and rigidity in allocating capital over time. A case in point being the smart share buybacks of Reunert stock over time (2004, 2011 and 2017). Warren Buffett wrote about share buy backs in his 1980 letter to Berkshire shareholders: "If a fine business is selling in the market place for far less than intrinsic value, what more certain or more profitable utilisation of capital can there be than significant enlargement of the interests of all owners at that bargain price?"

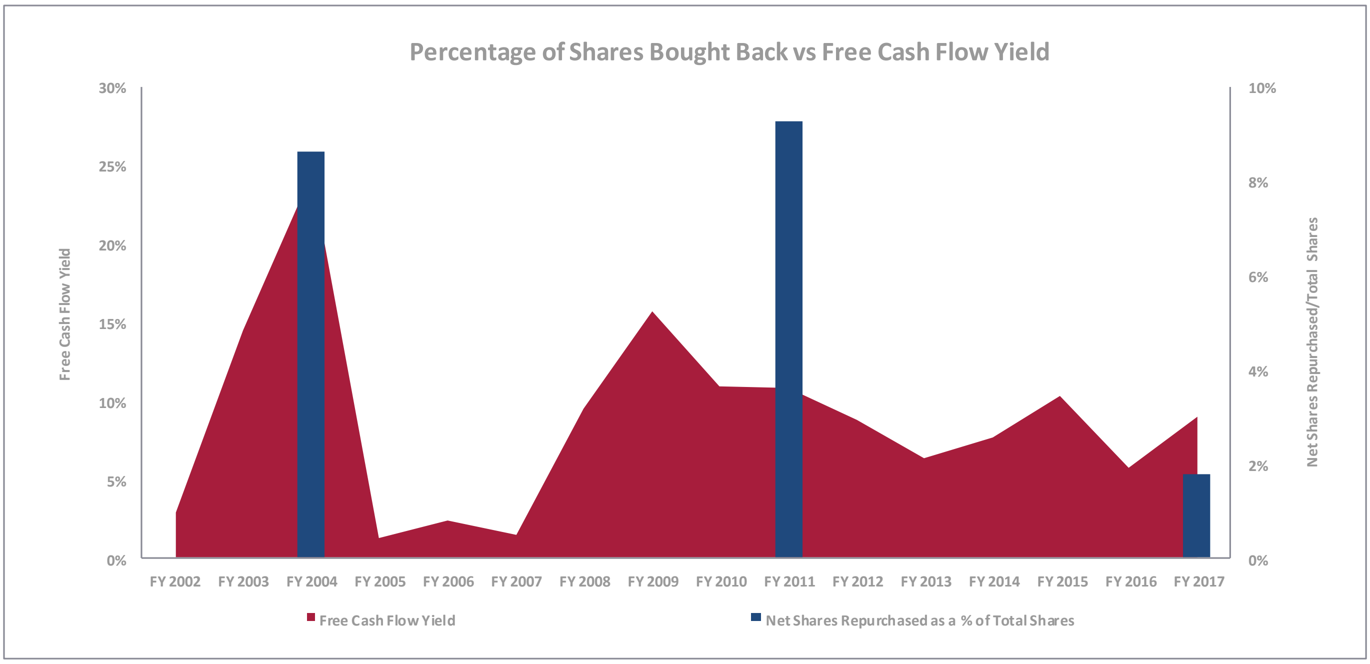

Figure 7. Percentage of Shares Bought Back vs Free Cash Flow Yield. Source: Northstar Asset Management.

Figure 7 shows the free cash flow yield of Reunert over time and when Management bought back shares as well as the yield that they bought these back at. Free cash flow is defined as the cash a company earns after paying for all the expenses and investments required to run the business. The free cash flow yield is free cash flow divided by the company's share price - the higher this yield, the better for shareholders. The graph depicts very clearly that Reunert bought back large amounts of shares when the share price was cheap/undervalued at a high free cash flow yield.

Patrick O'Shaughnessy, CEO of O'Shaughnessy Asset Management, statistically proves in his 2015 research piece "High Conviction Buybacks" that firms that buy back 5% or more of their shares at a time when free cash flow yields are high (high conviction buyers), tend to outperform the market by 4.7% annually, on a risk adjusted basis[1].

Acquisitions to Strengthen the Moat

In the various business segments, Reunert has been undertaking very specific and we believe well considered acquisitions to strengthen their business moats.

Electrical Engineering

The Electrical Engineering segment (37% of operating profit), which predominantly manufactures cables and circuit breakers has traditionally not had a competitive advantage/moat. Reunert created a relative competitive advantage for the business by acquiring ZAMEFA (Metal Fabricators of Zambia) in 2016, a cable manufacturer. This purchase has allowed them to process copper cathode into copper rod or finished cable onsite thus allowing for cost savings on transporting cable or raw materials to South Africa or to export partners.

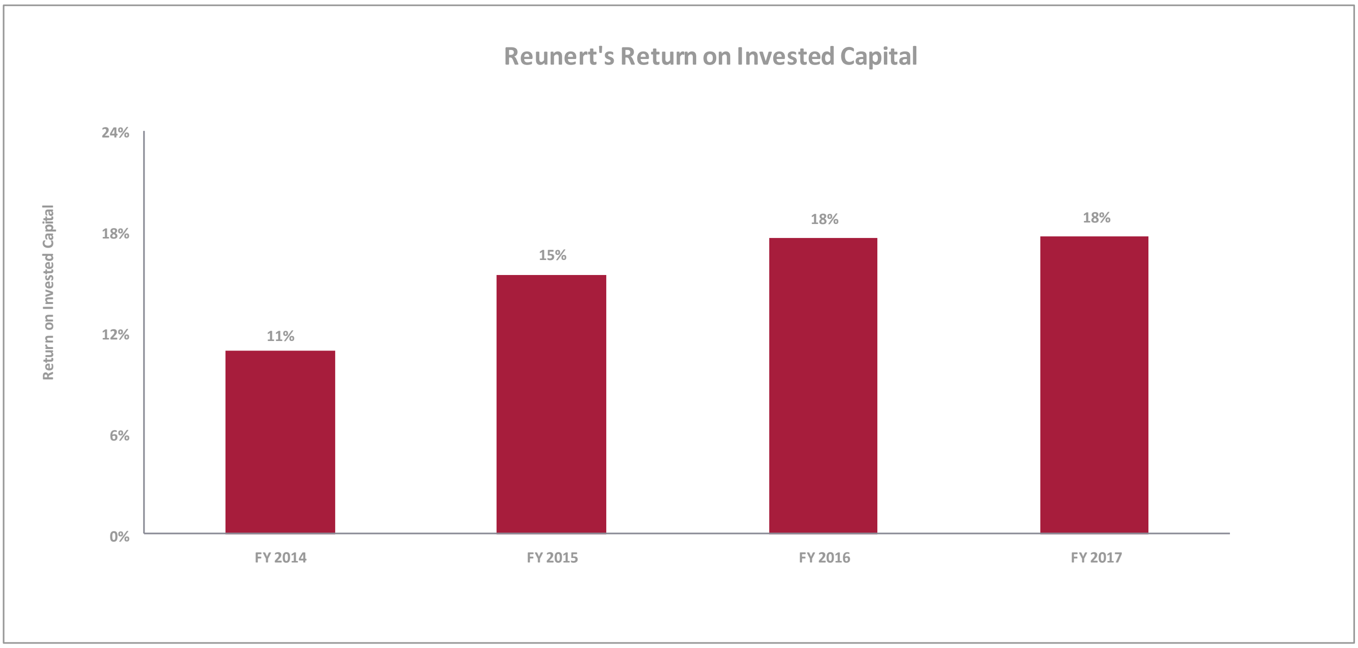

Figure 8. Reunert's return on Invested capital. Source: Company Financials.

In addition to the share buy backs, the Reunert Management Team have also paid an average dividend yield of 6.3% for the last 16 years and have been particularly generous with dividends while there was a shortages of investing opportunities either in the Group or through acquisitions.

Returns

Sound capital allocation with astute management of the firm, albeit within a very tough domestic economic environment has resulted in Reunert delivering impressive returns on invested capital over the years. Figure 8 is a visual perspective of this sound management of the business in favour of shareholders.

The Future

Since the sale of the Nashua Mobile subscriber base in 2014 the company has been acquiring a range of businesses that either strengthen their competitive advantage in a given segment or gain exposure to an area of the economy at an attractive price.

Information Technology Communications

Reunert's competitive advantage in their Information Technology Communication segment (53% of operating profit) is two-fold in our opinion. Firstly, the company has an asset -backed finance arm called Quince Capital, which offers favourable rates to customers in order to facilitate asset purchases (multi-purpose printers etc.). Financing hardware creates longer-term albeit tentative "hooks" into clients.

Secondly, the company is creating a one stop-shop for SMEs (Small and Medium Enterprises) for all of their ICT needs. This offering has been enhanced with the acquisition of SkyWire which offers broadband access. Large ICT operators are presently not servicing this segment of the market. Reunert has traditionally, through their copier business, had lengthy relationships with these clients.

Applied Electronics

The Applied Electronics segment (10% of operating profit) produces high tech products such as military grade radar and communication equipment. In recent years, the Group has acquired companies such as Rynonic Robotics, Nanoteq, Omnigo, and Terra Firma. New acquisitions have business models varying from providing robotics systems to developing cryptographic products and solutions to meet cyber security and cyber defence needs. These new additions are rich in intellectual property, are growing fast and should act to even-out the boom-bust cycle of defence manufacturing. Currently, the segment has a healthy order book.

A low-risk option on South African growth

President Cyril Ramaphosa has committed to bringing a target of R1.2 trillion in new investments into South Africa over the next 5 years. We believe that Reunert would prove a major beneficiary if this transpired, particularly if this new investment was accompanied by infrastructure development. However, our investment thesis for the company has in the past transcended this requirement and instead rested on Reunert's focused management culture, consistent long-term dividend-paying strategy, opportunistic share-repurchase program and smart investments in value accretive growth opportunities. Having owned the company for a while, the share price has risen considerably and at current levels, we believe the stock is fully valued!

[1] This analysis was conducted (U.S. Large Stocks Universe, 1987–2014) by O'Shaughnessy Asset Management, Report Titled: "High Conviction Buybacks", by Patrick O'Shaughnessy, CFA: August 2015

CLIENT CORNER AND NORTHSTAR NEWS

HOW FINANCIAL SERVICES FIRMS DEPERSONALISE CLIENTS RATHER THAN CREATING A CULTURE OF CARE

By Lian Lubbe (Client Servicing Manager)

We have spent time studying how the financial services industry is grappling with the needs of clients and where this requires change to services rendered. This article shares what we gleaned from this exercise and how Northstar is working to improve our client offering.

In the world of financial services, most companies compete by selling an intangible product. Banks sell the safety of a client's deposit whilst asset managers offer the prospect of investment performance. Companies in financial services cannot compete with the likes of Apple where cell phones and laptops provide the user with an identity and an instant "feel great factor". BMW's latest sports car usually delivers instant pleasure, enjoyment and status. Not so for a unit trust or share purchase!

The nature of dealing with clients in financial services, more specifically asset management, is far more relational than transactional, the offering also has many parts that are not visible and unfortunately, instant happiness is simply not on offer.

With this in mind, investment firms need to work that much harder at building trust, part of this is driving investment competency that delivers long-term returns, part of which is acting morally and honestly in a client's best interests. When acting as the custodian of an investor's hard-earned savings, client centricity is the alpha and omega, and the overall client experience must be exceptional.

An evolving environment with challenges

This is of course easier said than done! Asset managers globally and in South Africa face margin pressure across the value chain: the industry is characterised by a challenging operating environment, numerous regulatory changes, evolving demographics of investors and rapid technological change.

Over time, as companies have faced these challenges, an inward focus has taken hold in the form of operational efficiency and product, rather than client experience. Client perception studies reveal the deficit in client experience between financial services and other industries – other services have long ago realised the importance of placing the client at the centre of the relationship! Most asset managers, when asked "what experience do you want to create for your clients?" are not able to articulate the more emotive aspects of the experience. Client experience includes all the rational, emotional and sensory aspects of interactions that a client has with a company and its brand. It is often not about how a client feels about the brand but much more about how they feel about themselves in an interaction with the brand – does the brand represent and understand what the client holds dear?

In a recent article by Deloitte (Wealth Management Digitisation) evaluating the impact and importance of technological change impacting financial services, Deloitte highlight that clients simply do not care about regulatory issues or outdated "legacy" systems that firms have to deal with. Ultimately, it is up to each business to keep the client's experience front-of-mind in all its endeavours: quality of service, availability of tools, suitability of products and overall support to any of their financial needs.

Companies tend to underappreciate the value of consistent, reliable and thus an excellent customer experience. This is more than evident from scanning "Hello Peter" – the website provides clear and damming evidence of the dire state of client service in the financial services industry in our country.

Deloitte's research highlighted that what matters most to customers is efficiency and speed of service coupled with friendly and knowledgeable employees. Most importantly, customers stated that they would go elsewhere when they lost trust in their investment firm of choice.

Getting to the crux of client experience

So what do we need to do at Northstar Asset Management to engender your trust? In our view, we see the following as critical in this regard:

- In our strategic thinking, ensure that our business goals are consistent with your interests - our aim is to be the "best and not the biggest firm", we believe, this aligns your interests with ours. The comings and goings of clients in a behemoth firm has little impact on the future of that firm. We never want to get to a size where a client's decision to join us or a client's decision to leave us, means little to Northstar!
- Act honestly – Northstar does not own any other business other than an asset management company. This focus does two things, it makes us experts in one area in the interests of our clients and it ensures that we are not conflicted by earning "other commissions and fees" such as stock-broking fees that are earned by many of our competitors. We see conflicts around multiple fees as an issue in our industry in which we refuse to participate.
- Invest in research – maintaining our own research

team makes Northstar significantly less profitable than firms that have chosen a different approach. However, our clients expect us to be deeply knowledgeable on the investments we make on their behalf – this is only possible with detailed, clear, proprietary research. After 6 years of hard work, we have built competency in terms of both our South African and offshore research – this has helped us avoid Steinhoff and the Resilient Group of companies. Research competency will drive our ability to produce sound returns in the years ahead and in so doing, will create trust with our clients.

- Invest in client service – we have employed numerous high quality staff, their only function is to support the needs of our clients.
- Invest in technology – our team has been working for three years to introduce technology that we believe will improve all interactions that you have with our firm. This will be launched in 2018.
- Choose the right clients – Seth Klarman from Baupost superbly articulates his view on clients: "We have great clients. Having great clients is the real key to investment success. It is probably more important than any other factor in enabling a manager to take a long-term time frame when the world is putting so much pressure on short-term results". Although not often spoken about, good managers of money need to be careful when taking-on clients. Like Seth Klarman and his Baupost Group, at Northstar we also have great clients! Consequently, we owe it to our Northstar clients to avoid new clients that sap our energy, that do not understand long-term investing and thus prevent us from working hard on research to generate market-beating returns.

In conclusion, we appreciate the gravity of the role we play in your investment journey. Yes, it involves managing money properly, but equally important is offering you a quality service to build and sustain a relationship of trust. Our action plans are very clear in terms of delivering in this regard, they emphasise investing in relationships, personalising every interaction and ensuring that our own efficiency and performance become hygiene factors in a highly competitive landscape.

CORRIDOR CHATTER

ACKNOWLEDGE THE PAST, BUT LET'S OWN THE FUTURE!

By John Steenhuisen (Political Analyst)

American human rights campaigner, Malcom X said that "education is the passport to the future, for tomorrow belongs to those who prepare for it today". For a country to own the future, it needs to be future focused, always preparing, not only for the immediate challenges of today, but also through a vision-oriented approach with a keen eye on the challenges and opportunities of tomorrow. Government should be playing its role by initiating debates that point our nation towards the future and the innumerable challenges and opportunities that lie ahead of us. The legislation we pass, the debates we have and the policies we implement should be preparing our country and our citizens for the immediate domestic challenges that we face now, but also for the global challenges and opportunities that will confront us going forward. This is what makes the current decision of the national minister of education to suddenly prioritise history as a compulsory subject in our schools rather odd.

Our country should be on the very cutting edge of the debate, on artificial intelligence, biotechnology, the internet of things, coding and rapid advancements in technology and big data applications. With the disruption of the fourth industrial revolution looming, the current job market is going to change significantly in the coming decade. Jobs and work as we know it today will simply not exist. The World Economic Forum report on the future of jobs and skills in Africa, published in May 2017, projects that by 2020 in South Africa alone, "39 percent of core skills required across occupations will be wholly different to what was needed to perform those roles in 2015." We need to prepare our country and our people for its impacts and position ourselves to take advantage by leveraging the massive opportunities that come with any disruptive moments.

Major advances and changes in key technologies, are going to force South Africa to compete even more than ever before to attract investment. But we cannot compete if we are not even having the debates to prepare us for the future. We cannot compete if we are still indulging in backward looking analogue debates on the past, in a rapidly evolving future-focused digital era. We have a golden opportunity to leap the technological divide, we must grasp it without delay.

The major constraint however is that our education system is broken. Despite the large proportion of national expenditure it receives, its performance and outputs are continually ranked amongst the lowest not only globally but also continentally. Our ability to generate skills and technological capacities is hamstrung. Our schools are producing learners who cannot read or compute, and our universities are churning out graduates who simply do not have the skills to find employment or grow our economy. Policy failure and poor planning has left our citizens, particularly our youth, massively vulnerable.

Nowhere is this more noticeable than in our performance in maths and science, subjects that underpin the knowledge economy. The 2016 Global Information Technology Report released by the World Economic Forum Ranked South Africa last in maths and science for the third consecutive year. The South African Institute of Race Relations in 2017 found that only 33% of matric candidates achieved a pass in maths with a grade of 40% or higher. The 2015 Trends in International Mathematics and Science Study (TIMSS) ranked grade nine pupils 38th out of 39 countries assessed.

Our education system is disjointed and outmoded, with the early childhood development, education, skills development and the research and development function scattered across four different government departments. They all need to be massively overhauled and re-aligned in a way that will give South Africa the competitive edge in the new economy to come. Instead of focusing romantically on subjects like history, our school curricula should be refocused, in a laser like manner, on dramatically improving our capacity in the key STEM subjects (science, technology, engineering and maths). It is these subjects that will give our citizens an opportunity to compete in the economy to come.

With the right mindset and determination we can build a skills and technological powerhouse that can harness the key levers of change in order to allow the youth of our country to ride the wave of the disruption to come and cash in on being world leaders in key modern industries. But we can only do this if government, legislators, business and our universities and colleges start leading that debate, fixing education and prioritising skills development.

If we fail to do so, we will be failing our country and our people, particularly our youth, who will be left hopelessly behind. Our economy will risk sliding even further into decline and our citizens will be unable to compete globally. Moving South Africa boldly and bravely into this new era should become our obsession, it is the very best thing we could do for the future of our country.

ADVISORS CORNER

IS 5% REALLY A SAFE DRAW RATE AT RETIREMENT?

By Adrian Clayton (Managing Director & CIO)

Advisors have deep insights into structuring their clients' wealth to meet their retirement requirements. We do not want to regurgitate what highly competent planners already know, but considering the perilous state of markets over the past five years (please see our first article: Are South African equities expensive?), we thought it worthwhile to test the widely held view that drawing 5% of capital at the end of a hard working career would always lead to safe and happy retirement. Figure 9 shows the probabilities of an investor's capital rising in real terms (after inflation) when drawing an annual income of 5% of starting capital. This draw-rate is assumed to grow by inflation each year. Cash is represented by the blue line and a balanced portfolio (SA Equities, SA Bonds, SA Cash and Offshore assets), the red line. The obvious observation is that cash over all the rolling years has less than a 25% probability of growing an investor's capital base in real terms when drawing 5%. It only produces real returns of about 1.7%, so draw rates need to be low, no higher than this level, if cash is used as the retirement asset of choice.

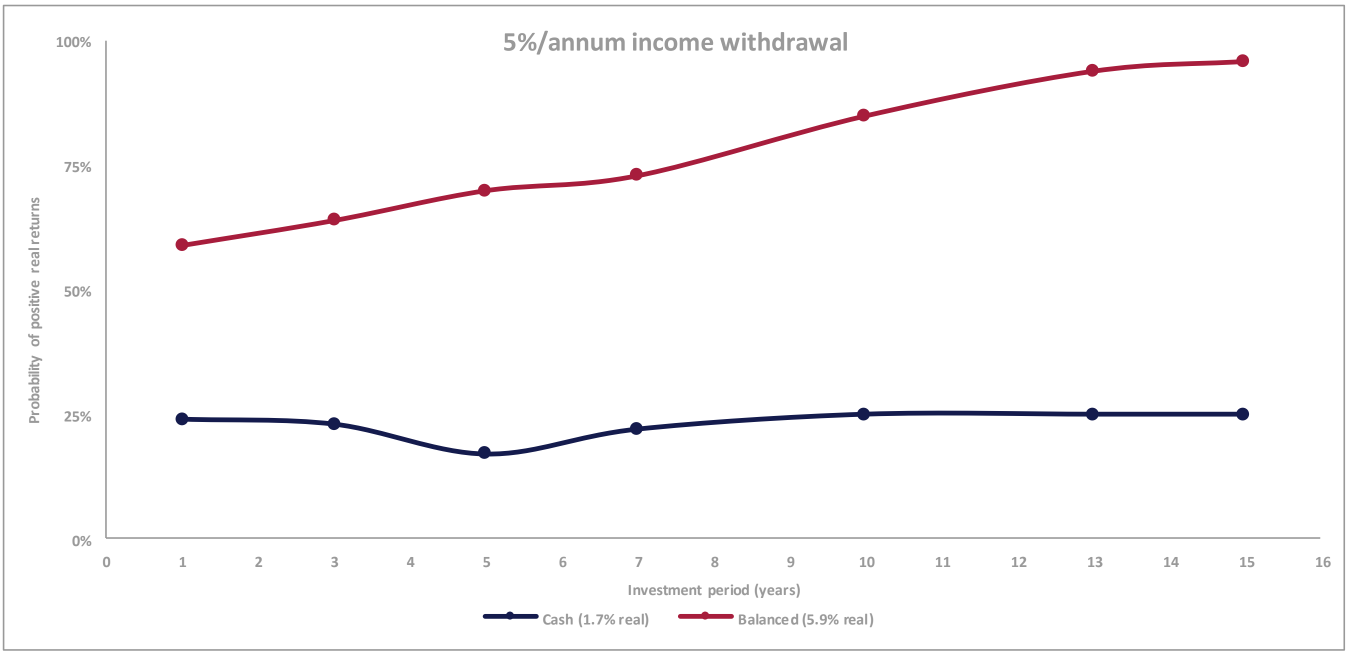

Figure 9. Probabilities of investment. Source: Northstar Asset Management.

In the shorter-term, the balanced portfolio's inflation-beating prowess is just above 50%, but once past 7 years, the numbers stack nicely in the retirees' favour and the odds shoot through 75%. Clearly, capital is well-protected from inflation in a well-managed balanced portfolio even when drawing 5%. Although it is sound advice to inform a client that the longer the investment time horizon the greater the probability of achieving a desired return, but is "long-term" a slam dunk?

In the below chart, note that the probability of achieving real returns whilst drawing 5% does not reach 100% - the max probability gets to 96%, so there have been times historically where a balanced portfolio over 15 years has retreated in real terms as 5% is drawn annually. This tells us that a draw rate of 5% can be too high!

With this in mind, we assessed our data series and noticed that in 1968 when the market had high P/E's and low DY's and was expensive, the subsequent 10 year returns were negative in real terms to investors drawing 5%. We thought planners would want to know what the maximum draw-rate would have been historically to ensure a client's capital remained intact with the knowledge that they could retire comfortably and so we did this exact work. The answer is 4.1% annual draw on the original capital base.

We have not included all our workings in this article, but should you be interested in this, we are very happy to share our analysis with you. In time, Northstar will be making our financial planning tools available to our supporting advisors. These tools work in conjunction with our risk-constructed suite of products which we have launched over the years.

NORTHSTAR SOCIAL RESPONSIBILITY

TEARS—MASIPHUMELELE

By Chantelle Clayton (Marketing Consultant)

Our clients are aware that Northstar Asset Management has a deep social conscience. This is not something that is legislated upon us, it is instead our choice to involve ourselves in good deeds and this is deeply embedded within our DNA. We simply want to make a meaningful difference in the lives of disadvantaged children and animals. Needless to say, our charities do not win us government points or seats at fancy board meetings, often a reason why corporates do sponsor charities, but they do give us a deep sense of changing lives where we can and others won't!

The Emma Animal Rescue Society (TEARS) was founded in Masiphumelele in 1999, a poverty stricken area, home to a growing population of people struggling to feed not only themselves, but the dogs and cats in their care. Sterilisations of animals or medical interventions such as vaccinations, de-worming or tick and flea prevention was simply not a possibility for desperate local communities, even with the best will in the world. TEARS started out as the dream of three friends Ms. Emma Geary-Cooke, Ms. Joan Brown and Ms. Marilyn Hoole but today is a well-established and sustainable non-profit organisation. They have over 60 staff members caring for a large contingent of dogs and cats.

Janet Laurie introduced Northstar Asset Management to TEARS in 2008 which is when our support began. This support has over the years focused not only on financial contributions but also time – Janet gave up her time to participate in the charity. These days volunteers get to assist the organisation throughout the week except on Thursdays and Saturdays which are adoption days. TEARS is such a place of hope, take the walking and outing days, dogs can be heard barking in excitement with the knowledge that they will get to explore new places with the volunteers!

Northstar's ongoing financial support of TEARS assists with their mobile clinic, feeding the animals, provision of advertising banners and sponsoring staff clothing. In conclusion, when we asked Ms Katie Hoy, previously having worked in financial services and now fully dedicated to TEARS how she manages the emotional upheaval of working with abused animals, her comments touched home. "It's the animals outside of TEARS who we should feel for, the animals in here have hope."

Northstar Asset Management is proud to be involved with TEARS.

TEARS are always in need of support please visit www.tears.org.za.

Figure 10. Janet Laurie and Katie Moy at TEARS.

tears™ ANIMAL RESCUE

Figure 11 & 12. Pia and Milo, 2 of Janet's / Northstars rescued dogs.

Figure 13 & 14. Current facilities for puppies and adult dogs at TEARS.

NORTHSTAR ASSET MANAGEMENT

STAFF MEMBER PROFILE

MARSHALL KANENGEBIZA

By Adrian Clayton (Managing Director & CIO)

When did your interest in financial markets start?

My interest began at high school when I studied economics as one of my commercial subjects.

What did you study and why?

As mentioned above, I'm naturally orientated towards numbers and consequently, I chose to study accounting. I am currently finishing my ACCA (Association of Charted Certified Accountants) accounting program.

What do you think equips you to do this job properly?

I believe "no man is an island", the team I am a member of and the systems we utilise equip us to achieve our goal of caring, high impact service to our clients. Coming from a tax/accounting and hospitality background, helps me look at situations differently and gives me a nice mix of communication and numerical skills – both are needed!

What do you love about investing?

The magic of watching our investment team make rational, well-researched decisions that maintain the purchasing power of our clients' money.

What do you find the most challenging part of your role?

Private client servicing and operations is administratively complex, often clients need unique assistance with little standardisation. Trying to standardise outcomes can make clients feel unloved but non-standardisation can lead to errors – again making clients feel unloved. Unique client requests places our team under pressure. These are our challenges – finding the happy balance of care and standardisation. We set high standard for ourselves!

Why do you think clients will do well under you and your research team?

It's more than just work for us as a client servicing team, there's a level of excellence and ownership in what we do and consequently we always do our very best - our clients will definitely benefit in the long-run.

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Collective investment schemes in securities are generally medium- to long-term investments. The value of participatory interests or the investment may go down as well as up. Past performance is not necessarily a guide to future performance. Sanlam Collective Investments (RF) (Pty) Ltd (the manager) does not provide any guarantee, either with respect to the capital or the return of a portfolio. The manager has the right to close certain portfolios to new investors, in order to manage it more efficiently, in accordance with its mandate. Collective investment schemes are traded at ruling prices and can engage in borrowing and scrip lending. The collective investment scheme may borrow up to 10% of the market value of the portfolio to bridge insufficient liquidity.

Annualised returns are period returns re-scaled to a period of one year. This allows investors to compare returns of different assets that they have owned for different lengths of time. Actual annual figures are available to the investor on request. Income distributions, prior to deduction of applicable taxes, are [included/not included] in the performance calculations. NAV to NAV figures have been used for the performance calculations, as calculated by the manager at the valuation point defined in the deed, over all reporting periods. Investment performance calculations are available for verification upon request by any person. Reinvestment of income is calculated on the actual amount distributed per participatory interest, using the ex-dividend date NAV price of the applicable class of the portfolio, irrespective of the actual reinvestment date. The performance is calculated for the portfolio. The individual investor performance may differ, as a result of initial fees, the actual investment date, the date of reinvestment and dividend withholding tax.

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