NORTHSTAR

ASSET MANAGEMENT

Client Letter 26 April 2013

Quarter End: 31st March 2013

Dear Investor

It is heartening to be writing to you as we experience brisk tailwinds for the companies we own on behalf of our clients at Northstar, and to inform you of continued positive internal developments within our business.

Segments of our market have surprised even the most zealous equity investors this year, the Industrial index posting a very respectable 6.6% year to date return. Against this, commodities continue to be under severe price pressure, the Basic Materials index has fallen 7.3% from the 1st of January to the end of March. Overall, the JSE has gained a little over 2.5% in 2013.

Northstar clients enjoyed their 4th best ever relative performance against the All Share Index, this last quarter. Our strong bias towards quality industrial companies continues to reap dividends, and with hints of the global economy slowing down again, we view this defensive portfolio positioning as necessary. However, we are pairing back exposures to companies (even though we regard them as long-term core holdings), where these have grown to levels where the balance in the portfolio is being lost! While we regard industrial and financial exposure to be our preferred long-term positioning for clients, it would be myopic to ignore commodity/resource shares when, in certain instances, they are being valued as terminal patients. Although we consider the return profile for resource exposure to be very rocky and long-dated, the companies are cheap and we are marginally adding to existing exposures of Anglo American and platinum.

Northstar is doing well; we are constantly investing in our business to create a robust architecture that we deem in the best interests of our clients. This investment covers personnel, IT infrastructure and systems, research and relationships with specialist service providers. All our energies are being directed to what we deem to be our two business priorities - delivering sustainable long-term investment performance, and catering for our clients' individual financial requirements, which is what is expected when investing with an asset manager who has no interest in being the biggest. Our investments in Northstar are consistent with our investment philosophy, which pivots on three core pillars – TIME, QUALITY and VALUE.

The quarterly report covers our current thoughts on markets – we must confess to viewing most of the JSE as generally top-heavy, and we are cautious with respect to introducing much new cash to many of our preferred long-term companies at their current prices. However, we are actively researching quality companies across the market, our latest deep dive (detailed research report) being Pioneer foods – Pioneer is certainly the type of business we want to be invested in but, here too, the price is elevated. It seems that the majority of industrial companies fall into this camp, but we are actively searching and widening our net!

We hope you find our quarterly report of interest and we look forward to discussing our thoughts with you in person in the months ahead.

Yours sincerely

Adrian Clayton

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A real challenge when managing an investment portfolio, is finding the balance between owning companies revelling in the 'sweet spot' in terms of share price gains (usually accompanied by powerful earnings tailwinds) and gathering the unwanted, out-of vogue ugly ducklings that one day, will shine bright.

Making matters worse is that companies on the front foot often enjoy cycles significantly longer than considered possible. Conversely, those on the back foot tend to descend way below fair value and this process is often accompanied by heaps of bad news, fraying the nerves of even the steadiest investor that has meticulously studied a company.

There exists both art and science in this delicate act of holding onto quality companies that continue to outperform but may be approaching full value, and accumulating promising prospects with sagging share prices. It also requires courage to stick to a logical and informed investment philosophy and process based on assessing a company's true worth, when the share price is constantly retreating or rising.

In our portfolios at Northstar we have been overweight industrial companies for many years now, this has been the correct decision if one considers the returns that have emanated from the various sectors of the JSE.

Over the last 10 years, the All Share Index has delivered a mouth-watering 21.4% annualized return (this includes dividends); Industrials have been the fuel for these gains, with annualized 10-year returns of 27.8%. Resources, on the other hand, which account for 31% of the total size of our market, have only gained 14.6% annualized.

Five year numbers paint a clearer picture of return divergences between the sectors. The All Share Index has gained 9.3% annually, Industrials 19.5% and Resources -3.4%. This longer-term time series is a little misleading however, by dissecting the market into shorter time segments, what is illuminated is that commodity companies were the driving force behind the All Share Index's gains until the collapse in financial markets in late 2007.

Four commodity companies monopolised the returns on the JSE leading into 2008 with their prices completely disconnecting from their true underlying value. In a nutshell, these companies, which included Anglo American, BHP Billiton, Anglo American Platinum and Sasol, were grossly overvalued.

While commodity companies enjoyed investor attention pre-crisis, quality industrials companies were spawned by the market. Their prices were significantly lower than their intrinsic values - they were, at the time, grossly undervalued.

The credit crisis burst the commodity bubble and to this point, many commodity companies remain at a fraction of the prices reached in 2007. The following graph depicts the P/B (the price of the company versus the shareholder equity on the balance sheet – a very high number implies the company is generating high levels of profitability or it could simply mean that it is expensive) of Anglo American versus SAB Miller over the past 10 years. The graph reveals the parabolic nature of the share price of Anglo American in 2007/2008 and then the horrific descent to the current lowly level of 1x Price to Book ratio. At these levels, the market is telling us that Anglo American is unlikely to generate economic value over the long-term. We deem this an extreme indictment on the firm!

Source: Northstar Asset Management & Bloomberg

At the other end of the spectrum, the previously lowly rated industrials (in 2007 SAB Miller's price to book ratio was just over 2x) have been subsequently re-rated by the market. These quality franchises are finally being appreciated by market participants (SAB Miller now trades at a 3.5x Price to Book ratio).

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Further proof can be seen in the P/E valuation of SAB, in 2007, it traded on a forward P/E of a mere 10 times. One now buys SABMiller on a forward Price to Earnings multiple of 18 times. For our clients less familiar with market jargon, this means that in 2007, if one bought SAB, it would have taken 10 years to get all your money back, it would now take 18 years. SAB has become more richly valued by the market!

From this analysis, the conclusion can be reached that the underperformance of commodity companies relative to other parts of the market over the last 5 years justifies a blind buying spree. Extending this logic would lead to blanket selling of Industrial companies due to their rich prices.

Such a superficial assessment ignores the critical element of past and future profitability. When accounting for profit growth, the market has in fact been efficient in rerating SA industrial companies and de-rating commodity counters. Industrial company profitability has been vastly superior over the last few years, both in terms of relative growth rates and with respect to consistency of delivery. Assessing the immediate future profitability of most industrial companies on the JSE versus most commodity counters and this trend of better earnings from industrials remains intact.

At Northstar, we believe in creating balance in our client's portfolios and avoiding excessive concentration to areas of the market where valuations are stretched – this is largely the case for many SA industrial stocks. This balancing act is being achieved by carefully and selectively purchasing quality commodity counters. However, we remain well underweight the All Share Index commodity weighting and overweight industrials.

Our diversified commodity exposure is via Anglo American. Anglos is presently out of favour with the market, it is being penalised for its South African asset base and present weakness in commodity prices.

Anglo American's history is defined by poor management decisions reflected in inopportune capital allocation over time. However, the company owns excellent assets, many of which are late cycle in nature. The current share price is reflecting lower than current underlying commodity prices, and given the recent change in Management, we have decided to slowly increase our ownership of this business.

Quality Assets - Included within Anglos portfolio are quality exposures to platinum, metallurgical and thermal coal, copper, iron ore and diamonds. Importantly, Anglo American owns long-life mines and enjoys a robust prospective pipeline – it plans to increase production within certain underlying commodities in the next few years.

Late-cycle Assets - We also favour the unique constituents of the Anglo portfolio. Whilst we perceive Billiton, with its heavy base metal exposure as being more geared to the early part of a commodity cycle (the industrialization phase), we view Anglo American as having a portfolio that will also benefit when emerging economies develop to the point where they are driven by the consumer – (the consumerism phase). Diamonds and platinum we believe will be the two key beneficiaries of this trend.

Price lower than value – Finally, Anglo American's share price is presently at a deep discount to the actual real worth of the business. On our calculations, at the current share price, Anglos imputes an iron ore price which is less than half the market's spot price. On a sum-of-the-parts (calculating the worth of each underlying business unit on a conservative basis and then summing these to establish a value for the whole business) Anglo American is, in a normal environment, worth considerably more than the lowly price it is currently trading at.

The most notable short-term headwinds for South African listed commodity companies include: the CRB index (a global commodity index) continuing to weaken; the negative domestic political environment; and the stakeholders within these companies (SA Government, Management and Employees) mismanaging the industry and the companies participating therein. These issues could lead to a lengthy wait for shareholders before our commodity companies re-rate in terms of their share prices!

At Northstar, we are well aware of all these challenges and are not taking them lightly. We do however feel that Anglo American is too cheap to ignore and we see long-term merit to being invested in this company.