NORTHSTAR
ASSET MANAGEMENT

Client Letter 25 April 2015

Quarter End: 31st March 2015

Dear Client,

We really hope you are well and the first few months of the year have been prosperous and happy.

In our first Quarterly Report for 2015, we take a candid look at the environment with which we are faced as the managers of your money. On the one hand, markets continue to gain and our clients are certainly benefitting in this regard. Against this, it takes a deep sense of naivety to underappreciate that central bankers have supercharged the financial system, resulting in even the least sea-worthy of assets having risen to levels that most rational investors would never have thought possible in 2008!

We at Northstar remain steadfast in our approach, which is to focus on realistic valuations for companies, constructed from our analysis of normalized profits. On this basis, for large portions of the JSE, companies are expensive. Based on this view, we deem it increasingly important to be positioned in assets that have lower downsides than the general market, as against simply finding companies that have large upside potential in their share prices. The concept of preserving capital as opposed to growing capital takes precedent as stock prices rise above realistic fair valuations.

It is our responsibility to always offer valid solutions to our clients and we have moved actively to reduce risks where possible. This has involved:

1. De-risking portfolios by reducing overvalued shares in favour of cheaper ones.
2. Offering an income fund which is designed to protect capital.
3. Offering offshore products in which the universe of stocks is larger and, on various markets, valuations are much more reasonable than in South Africa.

We encourage you to engage us should any of these options interest you. We hope you find our Quarterly Report useful and we look forward to being in contact with you in the months ahead.

Kind regards,

Adrian Clayton
and the Northstar Research Team

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Making money on markets – how does it actually happen?

Ratings, dividend yields and profits – the three sisters:

Over the long-term, equity returns emanate from three sources – dividends, company profits and market participants' perspectives or opinions of a company, which either rises or falls and is captured by the rating that is placed on a company (the P/E).

Corporate profitability is notoriously volatile in the short-term, but classy companies have superior long-term earnings power and their business models bounce back. As analysts, our goal is to purchase companies that have fantastic profit generating capabilities which are not being reflected in the current share prices, quite possibly because the company has encountered a short-term dip in its profits which the market has exaggerated and unduly punished.

Low share prices, together with unsustainably depressed levels of profits which will normalize over time, create the ultimate opportunity to buy into stocks and this is when risk levels for investors are at all-time low levels. Ironically, these moments are when share prices are falling or have fallen and investors are at heightened points of fear.

Unfortunately, low points in share prices do not regularly coincide perfectly with low points in the profit cycle and in fact, it is quite possible for expensive markets (high P/E's) to continue surging (not dissimilar to the JSE Industrial Index), and for 'cheap markets' (low P/E's) to continue falling (not dissimilar to the JSE Resource Index). Expensive markets rallying or cheap markets falling occur when profit expectations are exceeded or are not met and when investors change their appetite towards risk. Competent analysts see through short-term profitability spikes or collapses and focus on what companies would earn at a normal point in their cycle - the goal is to value the company on normal levels of profits, ascertaining whether it is correctly priced on this basis. Please see the graph on the right showing the earnings growth from the various JSE Sectors.

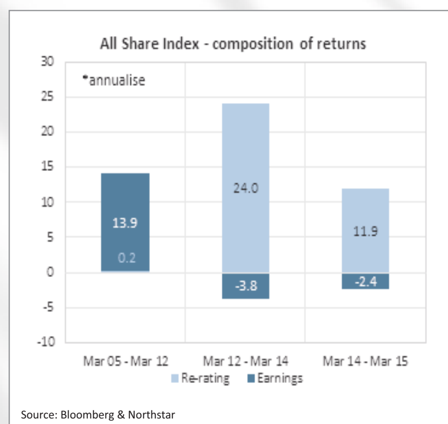
Source: Bloomberg

We conclude this discussion as follows - when the composition of returns is skewed towards dividends and profits and away from a market that has 're-priced', the possibility for an extended period of returns from equities remains intact. However, when returns have relied on share prices inflating without a concomitant increase in profits, the potential for future returns diminishes exponentially.

The JSE's returns – where have they come from?

With this analysis in mind, we look back at the JSE's returns over the past decade and segment the market's performance into two periods – the first seven years and the last three years. Ten years ago, the JSE was on a P/E of 11.6 times, so assuming constant profits, an investor buying the JSE All Share Index in March 2005 would receive his or her money back in 11.6 years.

By historical standards, a P/E of 11.6 was not high and in 2005, in addition to the attraction of a cheap market, company profit levels were relatively depressed and cash flows were robust – investors were enjoying a 3% dividend yields on our market. The stars were aligned and savvy investors were saying to themselves, 'heads I win, tails you lose' – the JSE was ripe for the picking. The best part about the first seven years of the last decade, is that the P/E on the JSE hardly budged and by March 2012, the market was still on a P/E of 11.8 times, yet investors had enjoyed annualized returns from the index over those seven years, excluding dividends, of 14.1%. How could this be? Well, companies had generated fantastic profits at an annualized growth rate of 13.9%. This was the perfect time to be an investor on the JSE – returns were a free ride on profits and the market did not re-price higher! See our graph on the right (the composition of the JSE's returns from 2005 to 2012), showing the rising profits from stocks and excellent returns investors made, but how the rating of the market did not change over 7 years!



Source: Bloomberg & Northstar

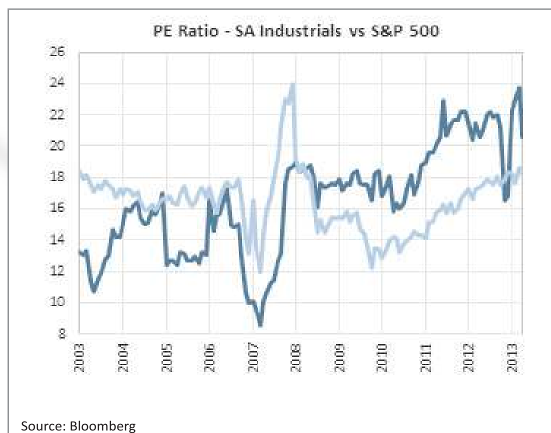
A very different picture emerges when we assess the last three years however. In March 2015, the JSE is at a P/E of 20.3 times and whilst investors have enjoyed phenomenal annual price appreciation of 15.9% from the index excluding dividends over these three years, this has no longer been purely on profit growth. The market has been re-priced by almost 20% per year whilst earnings on the JSE have fallen more than 3% on an annualized basis – mostly due to the collapse in earnings from commodity companies. So the latter years of the bull market have not been driven by profits, investors have priced the market higher and in so doing, the risks embedded within the local market have risen too. We show the extent to which the JSE's valuation has escalated in the graph below – the composition of the JSE's returns from 2005 to 2015.

Concerns we have currently:

We focus on finding companies that offer value and the good news is that even in expensive markets, stocks that we view as undervalued, given a feasible time period of at least five years which allows a profit cycle to play-out, can be found. On the whole, however, we believe the JSE is expensive and our concerns are as follows:

High ratings:

The P/E ratings of all major indices (excluding resources) are at multi-year highs. The JSE All Share Index is at the highest level it has been since 1996. The JSE Industrial Index was previously at these levels in 1999 and before that, in the 1970's. The JSE Financial Index is touching its peak rating of the past decade.

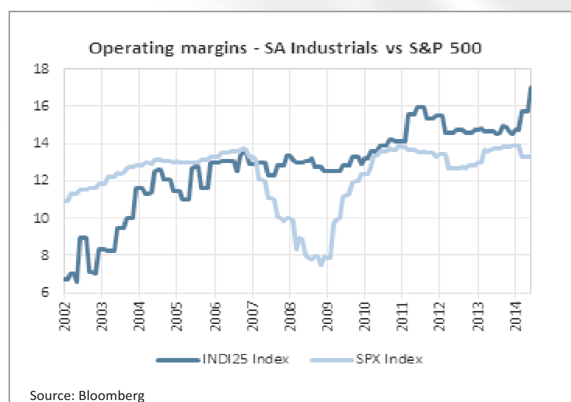


Source: Bloomberg

High profit margins:

Industrial and Financial companies in South Africa are operating extremely well and there is good reason for this. The pre-1994 political landscape allowed certain businesses to build impenetrable moats, their business models becoming deeply entrenched and thus positioning them perfectly when domestic economic activity improved.

Banks began to 'bank the unbanked' and cash-flush consumers, many receiving social grants and others, fueled by rising public sector employment, poured into retailers. The strong domestic base has also allowed various SA companies to externalize their business models and compete with the biggest and best on the globe. This stew of circumstances has led to super profits for many SA industrial and financial stocks.



Source: Bloomberg

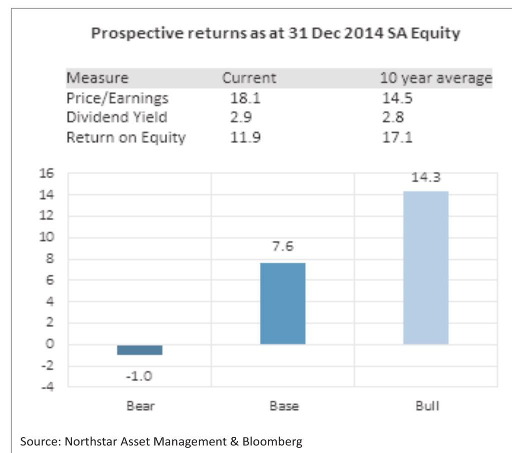
Northstar believes that this step-up in profitability for the best South African companies is real, but that even the best companies will incur rises and falls in profits and caution is required when super profits are being earned. Profit margins for SA industrial companies have moved from depressed levels in 2002 of about 7%, to the heady levels of 17% currently – please see the graph on the left showing Operating Margins of the JSE Industrial 25 Index versus the S&P Index. For comparative sake, we have superimposed the operating margins of the S&P onto the same graph. An argument could be made that, in South Africa, operating margins should be higher than for US multinational companies, but we wonder if the extent of variance can be warranted! We reiterate our view that chasing high profits on already high valuations is a risky, long-term investment strategy!

Our view of expected returns in the next few years:

We conclude this quarterly report with our synopsis of possible prospective returns which the JSE All Share Index could produce for the following three years. We calculate these returns based on what we view as a normal P/E rating for the market, we then add dividend yields and establish a sustainable growth rate for stocks.

We calculate a bear case (a negative possible outcome), a base case (what we deem to be the most likely outcome) and then a bull case (if markets follow a high road). The graph on the right (Prospective returns from the JSE) depicts these three outcomes in detail. Suffice to say, we believe that it is very likely, based on the current level of the market, for returns on an annualized basis to be single-digit over next three years, and our estimated annualized return from the JSE is 7.6%.

With a thorough analysis of companies and deploying capital to the best Northstar-researched ideas, we believe that we will continue to outperform the JSE in the years ahead.



Source: Northstar Asset Management & Bloomberg

The Northstar Research Team