NORTHSTAR

ASSET MANAGEMENT

Client Letter 17 October 2012

Quarter End: 30th September 2012

Dear Investor

The third quarter of 2012 saw the local stockmarket further extend the year-long gains which have taken the market to record levels and which have allowed us to further build our long-term track record. As our clients would expect from us, these gains have accompanied much brow furrowing and hand wringing on our side.

We believe that we are seeing the beginning of the end of the European crises. Whether, or nor, Greece exits the European Union at some future date is a mere distraction from the affirmation that the Union itself will not unravel. European Central Bank President Mario Draghi's pledge to do 'whatever it takes' to save the Euro and the EU is a game changer. While it has a long way to play out, this commitment has drawn a line in the sand as the ECB has both the firepower and balance sheet to defend that line.

This ECB's policy was supported by the US Federal Reserve announcing open-ended purchases of $40bn per month in that country's mortgage market until such time as the US housing market and unemployment rate improves.

While we are comforted that we are seeing light at the end of the tunnel, by definition this suggests that we are, for now, still in the tunnel. We look forward to when greater normalcy returns to financial markets; to when markets revert to being driven by fundamentals, rather than knee-jerk 'risk-on / risk-off'reaction to politicians' utterances and by central banks' intervention.

While we are not displeased with the on-going above market returns which we have generated for our clients over these recent turbulent years, we are more comfortable investing in markets in which we are able to depend on our fundamental research and analysis. We focus on picking one stock at a time, with valuations as our guide. We seek opportunities in the stockmarket where we are able to invest at a substantial discount to our estimate of a company's intrinsic value and to patiently wait to reap the rewards on behalf of our clients.

Complacent, we most certainly are not. As has been the case for the past 15 years, we place greater emphasis on our defence than our offence. And, we expect this to continue. Our investment style is not to swing for the fences, but rather to manage risk and incrementally grow and compound our clients' wealth. When compared to the overall market, it has been our privilege to produce for Northstar's clients, returns that have been both smoother and significantly greater, than those delivered by the general market.

Yours sincerely

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Central banks globally have broadly the same mandate. Always it is to protect the value of the country's money and sometimes there are additional mandates such as to promote economic growth and / or employment.

In the midst of the global economic crises the central banks aggressively injected emergency liquidity and intervened to counter the structural threats to the economic system and to re-establish order in malfunctioning financial markets. In so doing, they rescued not only a teetering financial system, but also investors from what would have been irrecoverable losses.

Much of the early intervention was to counter the disruptive 'left tail' of deflation and recession. Markets responded favourably and both these risks receded.

Now central banks are aiming at a more ambitious target: to deliver better economic outcomes as defined by growth, jobs and stable low inflation. Such is their concern of a possible relapse, that they have made it clear their intention to continue intervening in the economy even once it regains traction.

While we are cautiously optimistic of economic recovery, we remain circumspect of the power of central banks to dictate both the pace and magnitude of that recovery through unconventional policies. Expressions such as 'pushing string' come to mind. Moreover, they are engaging in extreme policy experimentation which has no precedence and thus no historic data against which we can measure its effectiveness.

By intervening, the central banks are driving a policy wedge between market prices and underlying fundamentals. Investors globally have benefitted handsomely, across all asset classes, from this policy. In many cases asset prices have been taken up to what would normally be regarded as bubble territory.

Assets, such as sovereign bonds, which are closest to the point of central bank intervention, have experienced greatest price distortion. Next affected are the bonds of government agencies, financial mortgages, banks and corporates. Even the junk bond market, where spreads have tightened as yield hungry investors have been forced further down the credit food chain, has seen a powerful rally.

Fortunately, we do not invest our clients' funds in these most affected asset classes. Notwithstanding, pricing distortions from those markets do ripple through to some quarters of the equity markets, in which we do invest on behalf of our clients.

Many investors have done well, of late, by pre-emptively positioning themselves to benefit from central bank pronouncements and the anticipated effects of policy implementation. The advantage of this style of investing is that very little analysis needs to be undertaken as investment is based on following momentum rather than exploring and analysing fundamental value of the investment thesis. These investors are surfing the wave with 'risk-on' exposure.

The longer this persists, the greater the probable dislocation of the price of those assets from their valuation and the greater the risk of collateral damage. It will be difficult to wean these markets off the succour they receive from the central banks.

We are not alone in recognising these perils, but we do not share the confidence of those participants in this crowded trade who believe they can wait for these distorted markets to peak, before smoothly exiting. We believe this form of risk management works better in theory than in practice.

While we cannot ignore central bank policy and financial currents in global markets, we focus all our efforts at calibrating our clients' investments against the fundamental benchmarks of intrinsic value, positive cash flows and strong balance sheets.

Investment returns which we bank for our clients are based on inherent value and will endure long after the central banks' waves of intervention have dissipated.

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Nine months ago we featured Naspers in our December 2011 Market Report. Our clients had, and still have, large exposure to this company and we detailed our investment case in that Report. Since that time Naspers' share price has appreciated by over 50% from R355 to R550. All well and good.

Six months ago, in our March 2012 Market Report, we presented our investment case for Impala Platinum. In our 'salami slice' style of position building, we had, at that stage, acquired a modest position in Impala at around R155 in our clients' portfolios. Six months hence and Impala's share price is trading at R150.

The Naspers investment thesis has unrolled even better than we anticipated, while the Impala one has not. We learn more from the Impala investment than from the Naspers one.

It may be that we are not wrong about the Impala investment case, but we were just too early. By our measure, there remains easily quantifiable inherent value to be found in the sector which is currently both deeply out of fashion and experiencing extraordinary headwinds – which is just when we like to buy.

Longstanding clients will recall that we had previously made very handsome investment gains in Impala and had sold all our clients' shares (in salami slices) in Q4 2007 and Q1 2008 and at prices at between R260 and R360 per share. At the time we were selling, commodity assets were all the rage with investors and Impala was enjoying record high earnings.

In those happier times all platinum producers were trying desperately to add to capacity to maximise the benefit of the then record prices. As we know, 'high prices are the best cure to high prices' as they attract competitors and substitution. Additional capacity takes a few years to engineer and, in the perfect storm, the platinum market was tipped into supply surplus just as demand from the equal consumers of the metal, jewellery and catalytic converters, collapsed after the financial crash of 2008.

Catalytic demand for platinum comes mainly from Europe where diesel fuel is widely used in the car market. (In the US and Asia, where petrol is more prevalently used in the car market, they are able to use other Nobel Metals in their catalytic converters). The European crisis has hurt sales in the world's largest car market.

At present producers are trying to add to output simply to maintain earnings and keep shareholders happy. South Africa produces and controls just over 85% of new global platinum supply. 'New' because the then high prices encouraged recyclers, who now provide around 20% of global supply, to enter the market.

South Africa's platinum industry is currently experiencing a very tough operating environment. Problems of labour unrest, wildcat strikes, in addition to above-inflation cost increases for the past 10 years on the supply side, are further aggravated by stagnant and falling prices on the demand side.

It is an unsustainable situation in which the largest producing region of this rare metal is unable to generate positive cash flow, let alone meet its cost of capital. The resultant margin squeeze is driving the highest cost, and many smaller, producers out of the industry. Aquarius Platinum Ltd, the world's 4th largest producer recently placed two mines on 'care and maintenance' and suspended production on a large Anglo Platinum joint venture which produced 53,000 oz. of platinum in the last financial year.

In addition to these closures, operating mines are cutting capital expenditure. This will lead to lower future production which will lead to a tighter market, and higher prices, in the long run. (Should this constriction in supply coincide with a recovery in jewellery and European catalytic converter demand, prices could multiply) Industry survivors, such as Impala, will benefit as they are well positioned on the cost curve, have no debt and are well managed.

In our analysis, based on normalised platinum group metal prices and our estimate of its intrinsic value, Impala remains an attractively priced investment opportunity for our clients to hold.