NORTHSTAR
ASSET MANAGEMENT

Client Letter 19 January 2012

Quarter End: 31st December 2011

Dear Investor

If you were an investor and had gone to sleep at the start of 2011 and awoken at its closing, you could be forgiven for believing that nothing much happened in the year. Global, and local, stock markets ended the year largely unchanged. However, this neither reflects what a difficult investment year it was, nor the capriciousness of the market which elevated volatility to 50 year record high levels.

In 2011, investors with short-term time horizons were punished. This is evidenced by the record number of professional investors who underperformed the market by more than 5%. Last year saw the average global fund lose 5% more than the loss experienced by the global stockmarket index. That so many investors have done so poorly in 2011 is on account of their investing reactively and along with the investing herd. It was John Maynard Keynes who said; "...it is better for reputation to fail conventionally, than to succeed unconventionally."

For the past fifteen years Northstar has been more comfortable, and has produced significantly superior returns, by being circumspect of market fashions and the investing herd. Although these may change, our investment philosophy never changes and we continue to focus all our energy on fundamental analysis such as normalised returns and intrinsic values.

We spend little time trying to predict the unpredictable. Overconfidence in one's own predictive prowess is usually the start of the process that separates an investor from their capital. We honestly do not know what the future of Europe or the Euro will be. We do not pretend to know who will win elections or what future currency exchange and interest rates will be. As Warren Buffet has said; "Forecasts tell you little about the future, but a lot about the forecaster".

For the calendar year 2011, the Johannesburg Securities Exchange (JSE) All Share Index (ALSI), our benchmark, returned a fractional loss, as compared to Northstar's clients who enjoyed positive returns which comfortably outpaced inflation and further added to our record of real wealth creation.

An investment of one million rand in the JSE ALSI ten years ago would today be worth R3.1m. This compares with the average Northstar client whose R1m investment has, over the past decade, grown to a current value of R6.0m.

Northstar's clients' superior results were achieved at lower-than-market risk, as is evidenced by our clients' less-than-market losses in periods of market declines.

While Northstar has continued to benefit from strong investor inflows, we carefully manage these to ensure that they do not distract us from our primary objective of managing existing clients' capital to the standard they have come to expect.

Broadly defined, our clients' portfolios remain defensively positioned. We jealously guard your capital as we do our own long-term track record. We know that investing is a marathon, and not a sprint race, and that patience and discipline are required to stay the course. It is our great honour to be entrusted with the responsibility to protect and grow your capital and nothing gives us greater pleasure than to reward your confidence and trust by delivering on-going pleasing returns.

Yours sincerely

Alexander Otten

NORTHSTAR ASSET MANAGEMENT (PTY) LTD.
4 Chester Drive Bishopscourt 7708 South Africa
Tel: 021- 797 8184 Fax: 021- 797 4706
email: info@northstar.co.za web address: www.northstar.co.za
Company registration number 1996/001423/07
Member of the Fund Managers Association of South Africa
Regulated by the Financial Services Board of South Africa
VAT registration number 429 01 666 46
Member of the Investment Analysts Society of South Africa
Authorised Financial Services Provider - License number: 601

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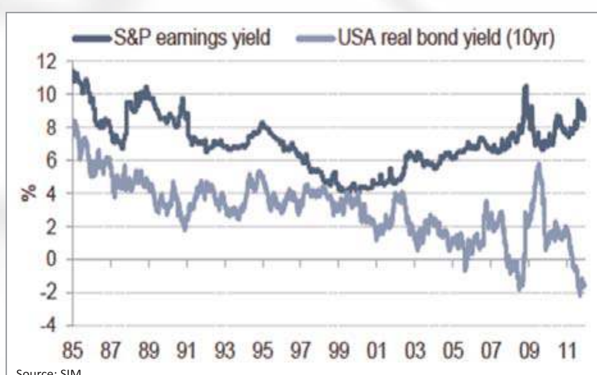
Investors and financial markets have not been particularly discriminating of late. The ebb and flow of the US and European economic and political woes have driven sentiment and financial markets, which have oscillated between 'risk-on' and 'risk-off', as investors react with alternating greed and fear to the latest news announcements. Under such conditions of high correlated returns, fundamental analysis, which would lead investors to discern between individual companies, has been neglected.

This leads to mispricing of individual company shares and can offer attractive opportunities to stockpicking investors such as ourselves.

2011 was a most difficult year in which markets were pummelled by a stream of worrying exogenous news stories. Some, such as the European sovereign debt crises, and associated concerns over the future of Europe and the Euro currency, remain unresolved.



Source: SIM

Many investors ended the year nursing nasty losses. The lack of investor confidence is reflected by the extreme flight-to-safety of bond investors who are investing in ten year US Treasury bonds and are locking in future yields that are lower than the inflation rate. Similarly, with negative nominal yields in Germany, investors are paying that government for the privilege of investing in its bonds.

Risk aversion is equally evident in the equity market. It is measured by the implied Equity Risk Premium (ERP) which reflects the excess return demanded by investors as compensation for investing in shares as opposed to 'risk-free' short-term government bonds.

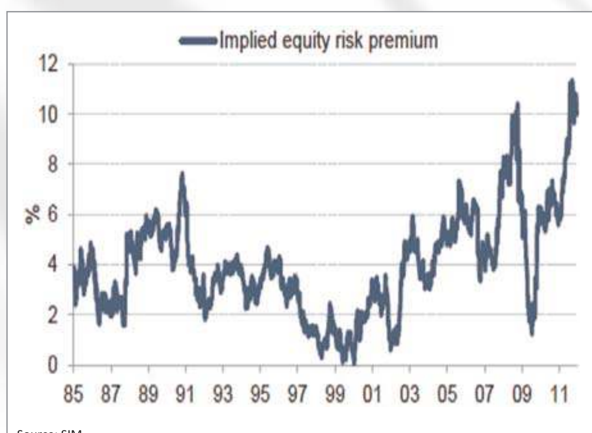
The ERP is calculated by subtracting the real yield (inflation adjusted) of the ten year government bond from the stockmarket's Earnings Yield (EY). The EY is the inverse of the Price Earnings Ratio; or, earnings per share, divided by the share price. The EY shows how cheap / expensive the market is. By this measure, the stockmarket is currently almost as cheap as it was immediately after the 2008 market crash and cheaper than it has been since 1990.

We can plot the US Standard and Poor's 500 Index EY and the US 10 year government Treasury real yield on a chart and track the extent of investors' risk aversion as the 'jaws' of the graph widen.

Alternatively, we can show the 'spread' or the difference in the respective yields which is expressed as the ERP. As can be seen below, financial markets have already discounted much of the bad news to which we were all exposed in 2011.

Current risk aversion of stockmarket investors is the highest it has been in 25 years. History tells us that contrarian investors who entered the market during periods of a high ERP were well rewarded. And, vice versa. In 2000, when the ERP stood at zero, investors received no risk premium for buying shares. That preceded the 2001 crash and the bear market from which US stocks have yet to recover.

Understandably, the ERP is but one of a gamut of measures we use to value equity markets. While reassuring, the above analysis in no way replaces the hard yards of the formal fundamental research we undertake to assess the normalised long-term prospects and intrinsic value of individual companies in which we invest our clients' capital.



Source: SIM

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Northstar's clients have long had significant and rewarding exposure to Naspers. As a conglomerate, Naspers holds significant, and mostly controlling, stakes in the operating companies within the group.

Principle businesses of Naspers and its operating subsidiaries are pay television, provision of related technologies, internet and instant messaging platforms, e-commerce platforms, publishing, distribution and printing of magazines, newspapers and books.

Activities are primarily focused on Southern Africa, and in several of the world's less troubled and faster growing economies.

Interestingly, while pay TV (mainly DStv), with 5.2 million subscribers, provides forty percent of the group's revenue, this translates to sixty percent of current profits. It is the cash flow from this stable, and relatively slow growing (16% in 2011), division which is used to finance investment in the fast growing (>50% in 2011) internet and e-commerce subsidiary companies.

The print media investments contribute less than 10% of company profits on wafer thin margins; as is reflected by its R5.4bn revenue contribution. This sunset industry is of little, and declining, financial importance to the company but does provide much needed content to add value to the internet publishing divisions of the group.

More critical is the QQ instant messaging, social networking, content, and gaming business run by Tencent, in which Naspers holds a 35% stake and which has its primary listing on the Hong Kong stock exchange. QQ has over 812 million registered customers and its servers have achieved more than 145 million simultaneous peak-time users. Unsurprisingly, 7,000 of Tencent's 17,000 staff are engineers.

In Russia, Naspers's subsidiary, 'mail.ru' handles more than 70% of all Russian language internet traffic and is mentored by Tencent, a partner shareholder in its own name, in adding value and content to users. This allows the company to leverage and monetise their customer relationship.

Through its Digital Sky Technologies Holdings, Naspers also has stakes, worth several billion dollars, in social networking company Facebook, games manufacturer Zynga and recently listed Groupon.

In financial year 2011, Naspers has spent over R1bn on bolt-on acquisitions as it bulks up some of its small, but fast growing, internet subsidiaries in Brazil, Poland, Ukraine, Turkey, India, Singapore, Thailand, Malaysia and Philippines.

In the past financial year, Naspers' internet and e-commerce divisions reported aggregate growth in excess of 50%.

Given the company's policy of, and historical success in, organically growing their internet subsidiaries, Naspers is currently undertaking a period of heavy investment in these fast growing, dynamic, global web based subsidiaries.

Development costs, which last year all but doubled from R635m to R1.1bn, are expensed directly through the income statement. This has the effect of dampening earnings during periods, such as now, of expansion and investment in future earnings.

We believe that the current slow-down in earnings will prove to be the 'pause that refreshes' and is part of a sound strategy that will stimulate long-term growth. Once completed not only will the heavy expense load be lifted, but patient shareholders will reap the rewards of the company's current investment in long-term infrastructure.

Naspers' share price is underpinned by sound geographically diversified businesses. It has a strong, positive, and growing, free cash flow and a low 1:6 debt to equity ratio. With almost 50% of its total earnings being derived from outside South Africa, the company will benefit from a weaker rand exchange rate.

While we would expect, on account of its conglomerate corporate structure, that Naspers would trade at a discount to its net asset value, the current steep 38% discount further provides us with a reassuring margin of comfort.

Uniquely among companies listed on the JSE, Koos Becker, the CEO of Naspers, receives a salary of just R1 (one rand) per year. His contract links his remuneration to the performance of the company's share price, thereby strongly aligning his long-term interests with ours.