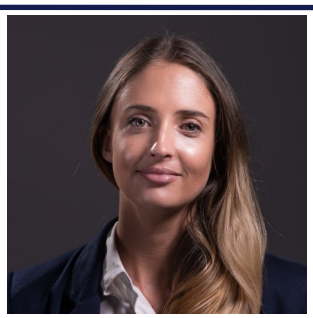
In our 2nd Quarter Northstar Market Report we cover a wide ranging set of topics, which we believe satisfy the varied interests of our readers. From addressing whether the JSE should deliver healthier returns after four flat years to explaining our investment thesis on Boeing, which returned about 100% 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.

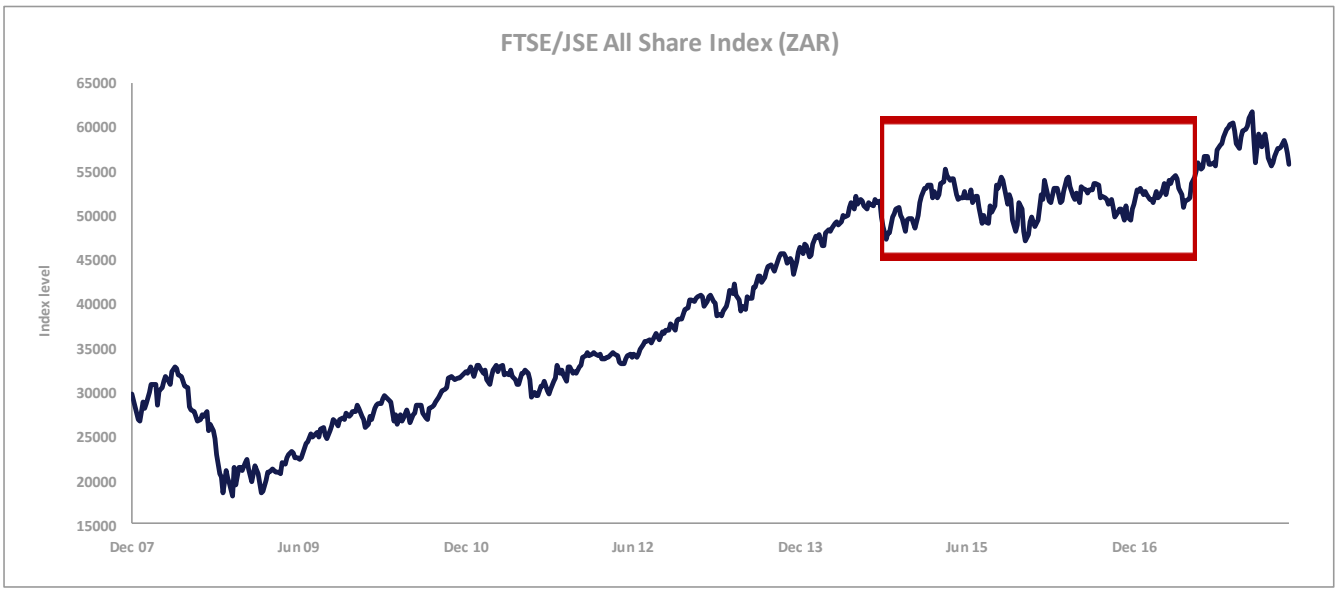


Figure 1. FTSE / JSE All share Index. Source: Bloomberg, Northstar Asset Management.

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.

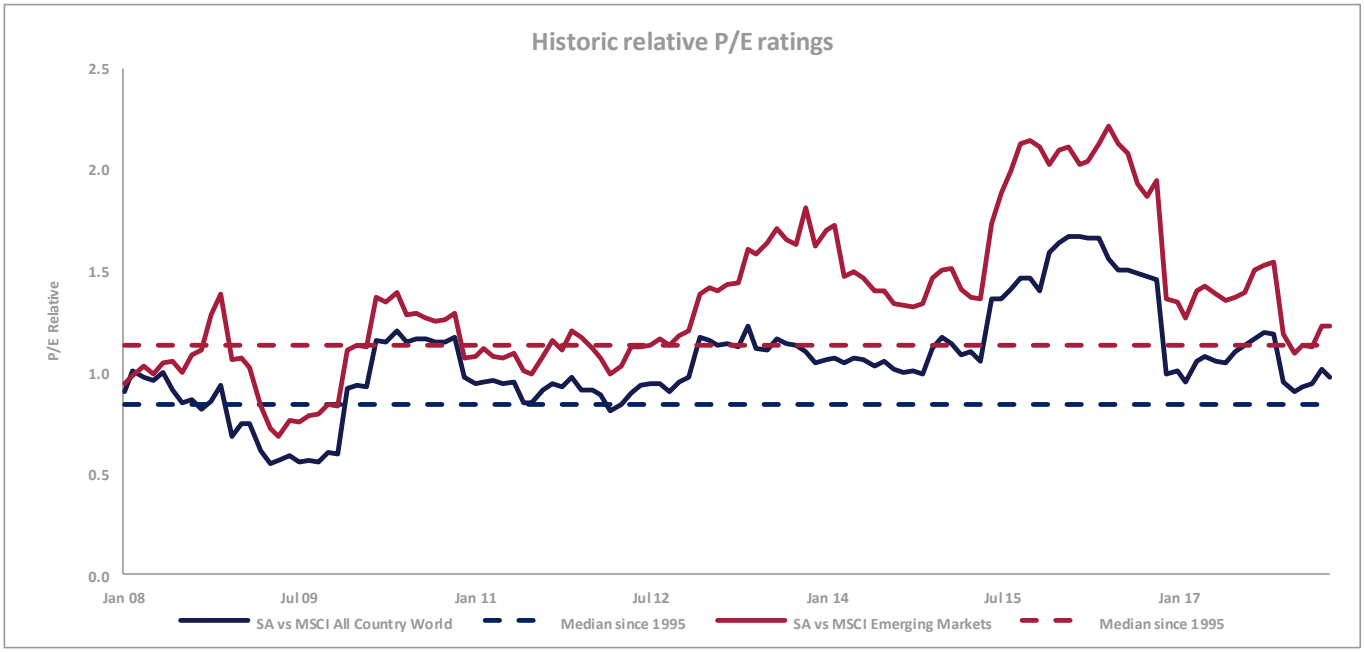


Figure 2. Depiction of markets trading above long-term relative median Price to Earnings ratios. Source: Bloomberg, Northstar Asset Management.

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

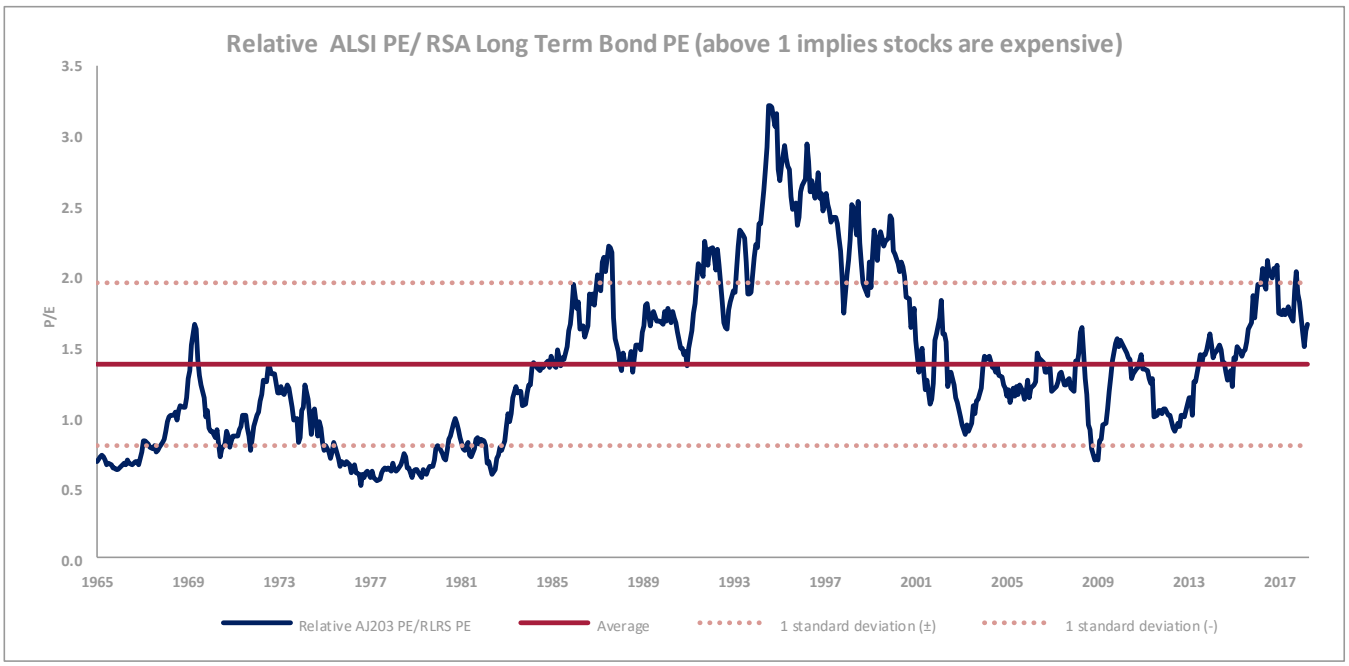


Figure 3. Relative ALSPI PE / RSA Long term bond PE. Source: Bloomberg, Northstar Asset Management.

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!

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NORTHSTAR ASSET MANAGEMENT

Northstar Asset Management (Pty) Ltd
Registration No. 1996/001423/07 | FSP number 601
Suite 1A, Madison Place, Alphen Office Park, Constantia Road,
Constantia PostNet Suite #784, Private Bag X16, Constantia 7848
Tel +27 (0)21 810 8400 | Fax +27 (0)21 794 2885
info@northstar.co.za | www.northstar.co.za

SANLAM COLLECTIVE INVESTMENTS

Sanlam Collective Investments (RF) (Pty) Ltd
Registration No. 1967/00865/07
2 Strand Street Bellville, 7530 PO Box 30, Sanlamhof, Bellville, 7532
Tel +27 (0)21 916 1800 Fax +27 (0)21 947 8224
service@sci.sanlam.com, www.sanlaminvestments.com
Please refer to our website for directors & company secretary details

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