NORTHSTAR
ASSET MANAGEMENT
Market Report

Northstar Market Report – Q3 2016

Our September 2016 Market Report covers four topics. The first is herding and the reversal in market psychology which has occurred this year. We also look at rational ways of capitalising on this market dynamic. Secondly, we share a few investing lessons and how these have moulded our thinking when we deploy capital. Thirdly, we delve into BREXIT with a specific focus on possible outcomes for the United Kingdom. Lastly we discuss ING, an offshore bank which we believe is undervalued.

Herding – capitalising on this market dynamic

Feeling comfortable – often a nasty red flag

Repeated patterns play out in markets which originate behaviourally rather than cognitively. One of these is 'herding' which is where investors flock to an area of the markets that tick their psychological comfort boxes. Human beings feel less exposed in congregations and consequently herding is endemic in investment markets. The most recent example of this is the narrow focus on companies that exhibit the following characteristics: perceived stability, attractive share price charts, celebrity management teams, earnings consistency, regular cash generation and products that are easy to relate to.

Price is equally important to quality

Although the above factors are attractive qualities they do not in themselves justify allocating capital to a stock. Equally important to appreciating quality attributes in a company, is an understanding of what it is actually worth. Profitable investing demands an ability to value a business and assess whether the ruling market price is inflated. In an environment influenced by herding, it becomes apparent that certain companies are over-loved, but that those companies not emotionally satisfying investors, are utterly unloved and usually badly mispriced. Their worth is more than the market values them at.

Generalisations and assumptions

A highly stable company such as British American Tobacco sits at the opposite end of the spectrum to a deeply cyclical business such as Kumba. During acute periods of herding, we believe that the market generalises by treating the majority of companies as residing at either extremes of this spectrum, whereas in reality, most companies have moderately cyclical profit cycles.

Capitalising on lumpy profits requires a slightly extended time frame

The outcome is that investors shun moderately cyclical businesses inappropriately and refuse to warrant them enough time to wait on their more lumpy and bumpy profits to be released. This is symptomatic of investors having time-frames which are too short as well as feeling comfortable in groups or herds. Consequently, they fail to capitalise on mispricing events and perceived comfort is, in effect, a dangerous red flag!

Since 2011 growth has outperformed value

In the attached two graphs, we show the performance of the Value Index (weighted towards more cyclical companies on the JSE) versus the Growth Index (weighted towards more growth or "quality" companies on the JSE) over two varying periods. Figure1. looks at both indices since Aug 2011 and it is clear that the Growth index has significantly outperformed the Value index. In fact, that outperformance reached extreme levels between August 2014 and August 2015. Coincidentally, these indices performed similarly before 2011! The 2014/2015 year was the least comfortable time to own the Value index and the most comfortable time to own the Growth index and in our view, reflected an extreme level of herding within growth companies. That said, it was also the most opportune time to selectively purchase undervalued value stocks.

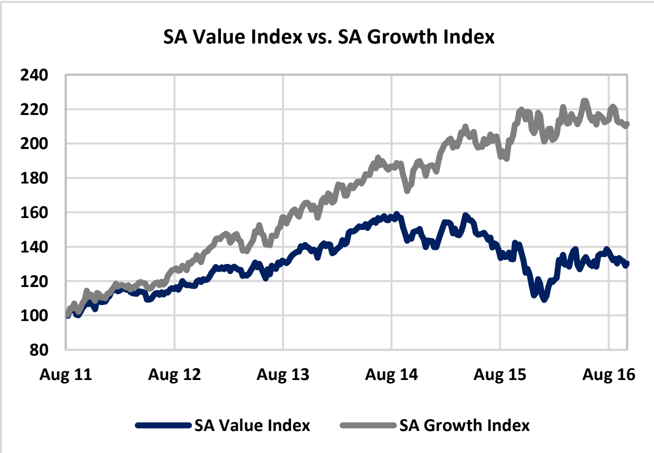

Figure 1. SA Value Index vs. SA Growth Index Source: Bloomberg

In 2016, value is outperforming growth

In Figure 2, over the page, what is evident is that in 2016 the markets have inverted. Market participants have begun to exit traditional growth companies and have started to acquire value businesses. The effect has been that value stocks and thus the value index has dramatically outperformed the more stable, high quality and in many cases, overvalued growth stocks this year. The reason is simple, growth companies were irrationally over-priced and value companies were irrationally under-priced. Given enough time, the market always reprices assets to rational levels. This is exactly why equity investments require a time-frame of multiple years, if not decades.

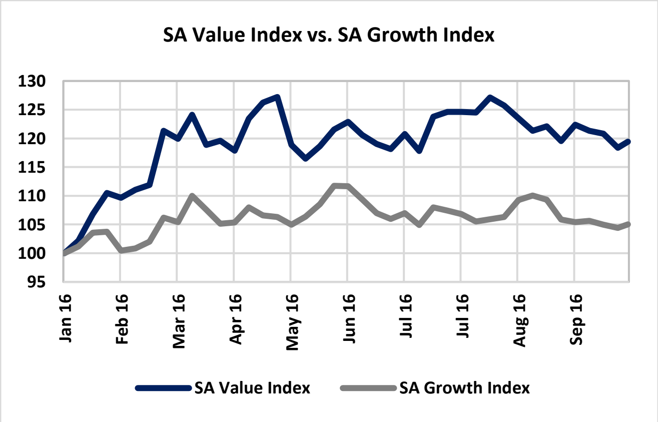

Figure 2. SA Value Index vs. SA Growth Index Source: Bloomberg

How can we capitalise on these trends for our Northstar clients?

We only invest in companies that pass two measures or tests. The Northstar "advantaged test" and the Northstar "valuation test". A company is advantaged if it achieves a certain rating based on its Management, the Industry in which it operates and the Competitive advantage which it enjoys within that industry. The valuation test assesses whether it is mispriced.

These two tests ensure that we are unlikely to invest in disadvantaged companies or in businesses that are overpriced, based on the information at our disposal at the time. Our work allows us to assess the investable merits of stable companies as well as businesses that produce their profits in lumpy and bumpy clusters. Armed with our homework, together with the fact that, at times cyclical companies offer substantially higher prospective returns than traditional stable businesses, we remain strong advocates of having a blend of companies within a portfolio. Where investors insist that all cyclical exposure must be avoided, we warn that this approach will coincide with lengthy periods of underperformance against the market index!

Investment lessons

Considering our newsletters act as our platform to distil our thinking around managing your money, we deemed it appropriate to add a section on the investment guidelines which we adopt. Much of what we know is constructed through years of trial and error, but a lot can also be garnered from the writings of other professionals too. In this section, we share five of the many rules which we apply to reduce our error rates and improve our hit rates:

- Be wary of companies obsessed with growing revenues (often through acquisitions) with little focus on the returns that are being generated on the capital used to grow revenues.
- Spend time thinking about the probabilities of a business' success. Higher risk businesses must be accompanied by very high pay-off profiles. In other words, if a high risk bet is taken, the expected pay-off must be stratospheric. On this note, it is important to realise that most investors overestimate business success.
- Avoid highly indebted businesses that require multiple events to unfold favourably before the investment case can be realised.
- Leverage (debt) magnifies returns during good times. The corollary applies when market conditions turn sour. Highly indebted businesses add exponential risk to portfolios.
- Seek-out smaller companies that produce a ton of cash with little or no debt and management teams obsessed with producing high returns on capital invested. Spend time visualising what these businesses should look like in the future.

We conclude this section with the comment that we are specifically avoiding certain companies on the JSE as we apply these rules. Equally, we are targeting domestic and offshore companies based on the final lesson stated above.

BREXIT – assessing the impact

A stroll down memory lane

Before covering BREXIT, we thought it appropriate to provide a summary of the rich financial heritage enjoyed by the United Kingdom, with a particular focus on their unit of transacting, the Great British Pound. In so doing, we aim to contextualise current developments against this extended history.

The pound is 1200 years old, it was born in approximately 775 AD – at this point in time, 'sterlings' or silver pennies were the main currency in the Anglo-Saxon Kingdom. Two hundred and forty of these pennies or coins equated to one pound of weight.

As is applicable to most national treasures, Sterling or the British Pound evokes deep emotions and particularly so when under threat. In 1124, a disgusted Henry I had 94 mint workers castrated for producing bad coins. Modern responses to a stressed exchange rate have been more muted involving financial engineering as against physical threats. This includes attempts at pegging the currency and repetitive devaluations as peg levels have failed. Through the life of the pound, the tricky times that the UK economy has experienced over many decades can be observed.

Sterling underwent severe devaluations in 1949. After Bretton Woods, the British Government was forced to devalue the currency by 31% as the economy was uncompetitive at a dollar/pound exchange rate at $4.03. The devaluation took the rate to $2.8.

Sterling was again the focus of the markets in 1961, 1964 and 1966, in all cases the currency was deemed overvalued. 1966 saw extreme pressure on Sterling and the UK Government imposed exchange controls to protect the currency's value, finally succumbing to the inevitable and devaluing the unit again in late 1967 by 14%.

In 1972, Europe took steps towards a single currency – the four lead currencies involved were Sterling, Deutschemark, the French Franc and the Italian Lira. Once again, Sterling struggled to sustain its level within this tetrad and the system collapsed within six weeks. In 1976, Sterling fell for the first time to a level below $2 which is when the UK approached the IMF for financing to defend the currency.

Exchange controls were lifted in 1979, 12 years after imposing them and shortly thereafter the Thatcher regime led to very buoyant years for the British economy and concomitantly, the currency, to the point where it was dangerously overvalued in the early 1990s. The booming economy forced the then Chancellor of the Exchequer, Nigel Lawson, to raise interest rates in order to cool things off. The result was a collapsing property market, reduced consumer spending and a recession. The pound weakened again!

The British economy was once again revived, this time by lowering interest rates and by joining the ERM (a European exchange rate mechanism which dictated that currencies had to trade in thin bands relative to each other). John Major was the new Chancellor and implemented these changes. Once again, this led to Sterling becoming grossly overvalued and it precipitated the famous Black Wednesday event on the 16th of September

1992 where George Soros attacked the currency (it is estimated that his gains exceeded one billion pounds) and the British Conservative Government was forced to withdraw Pound Sterling from the ERM.

Since 1992, the United Kingdom has targeted inflation as against pegging the currency to any benchmark. This has proven an incredibly successful approach, creating one of the world's most stable economies. As we show in the attached chart, the two largest sterling moves against the dollar since Black Wednesday, have occurred in 2008, the Global Financial Crisis and in 2016 – due to BREXIT.

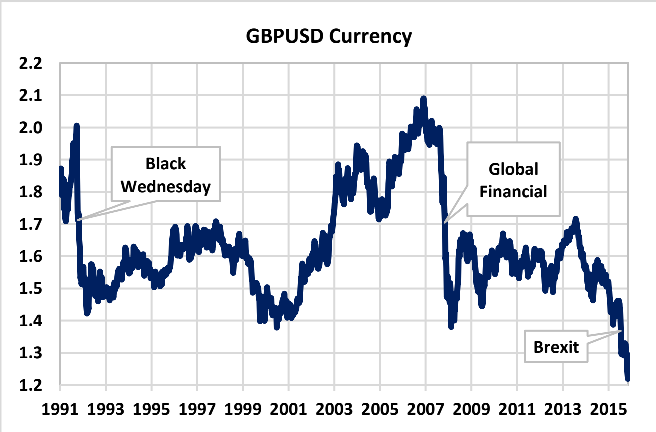

Figure 3. GBPUSD cross rate Source: Bloomberg

BREXIT

On the 23rd of June 2016 the British public voted to leave the European Union. 30 million people voted (a 71.8% turnout) in a hotly contested referendum with the 'Leave' vote outdoing the 'Stay' vote by just 2% - 52% of voters opted to Leave.

The impact of the vote

The psychological impact and concomitant uncertainty that has arisen from this decision is best reflected by looking at the market behaviour and the attached graph showing the S&P (US market) versus the FTSE (UK market). It reveals the immediate sell-off in the FTSE. Its subsequent recovery is a function of sterling weakness, in dollar terms, the FTSE has grossly underperformed since the BREXIT vote.

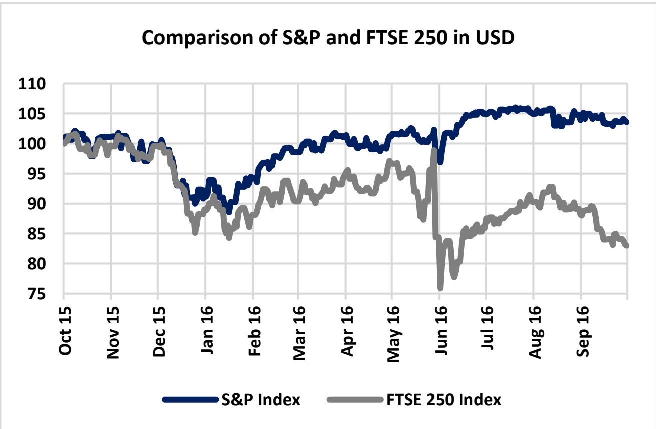

Figure 4. S&P 500 Index vs FTSE 250 Index based in USD Source: Bloomberg

Once again, the currency market has been the ultimate gauge of collective sentiment with respect towards economic developments in the UK. The correction in sterling since BREXIT has been -13% to the end of September 2016 (end of the Northstar quarter). As we write this Quarterly Market Report, the correction now exceeds 17%. By any standard this is a severe move for the fourth largest globally traded currency. So the obvious question is why has this occurred? We look at the varying factors that led to BREXIT unfolding and how it could affect the UK economy in the years ahead.

Labour

The annual migration of Europeans into the UK reached 183 000 people in March 2015. This was double the numbers that entered Britain in 2012. The impact was that the UK labour market grew by 0.5% annually.

The BREXIT vote is thought to have been heavily influenced by the fear of surging migrants, yet the irony about the economy is that its very success is a function of attracting phenomenal global talent as well as cheap labour. It is widely recognised that inflation and interest rates have remained subdued in the UK as a result of the consistent movement of cheap labour into the economy.

The current post-BREXIT thinking with respect to migration seems to revolve around sanctifying the anti-migration sentiment and the market is concerned that May and her party will adopt an increasingly isolationist stance towards foreigners. This could have the effect of denuding the UK of talent. The counter argument by pro-BREXIT lobbyists is that a new labour regime based on skill requirements will be implemented. In so doing, only the best individuals will be allowed to immigrate into the United Kingdom.

Trade and manufacturing

Exports account for 30.5% of UK output of which the EU absorbs about 45% (this was 55% in 1999) of these goods and services. Thus goods and services traded with the EU account for approximately 15% of the UK's total economic output. If one includes exports from the UK to other countries which have free trade agreements with the EU, then the United Kingdom exports 63% of its goods to EU destinations. In return, 18% of the European Union's exports head to the UK.

Being part of this pact certainly has its benefits, the EU agreement is that goods and services must conform to a specific standard and consequently, these are allowed to move freely within the trade block. Similarly, capital (money) and people enjoy this free movement status. There are also no tariffs for these products and services. This is all designed to reduce the cost of doing business and increase wealth creation for member countries.

It is possible, however, to enjoy many of these trade advantages without certain of the stifling political and legislative rules and regulations applicable to those countries with full EU status. Norway, Iceland and Liechtenstein operate within the European Economic Area but are not European Union members.

Clearly the United Kingdom would like to negotiate a similar status to those countries enjoying European Free Trade Association (EFTA) membership whilst pushing for a different set of rules around labour migration. This is quite different to other EFTA members that have to conform to EU standards on people and capital mobility. Clearly this is a point of extreme friction as far as BREXIT negotiations are concerned. If the UK fails to negotiate a free trade deal, what are the costs of trade with the EU likely to be? The main cost is that UK goods and services will face tariffs and these are approximately 4% on manufactured goods – the tariff was 8% in the 1990's. Tariffs escalate on food and drinks to significantly higher levels.

There is no doubt that the United Kingdom, particularly in the first few years, will feel the financial stresses of a hard BREXIT deal – one where little concession to their goods and services is offered by the EU. However, given time, the financial blow could well dilute as Britain actively arranges beneficial trade deals with many countries that have felt stymied by the EU rules and regulations and would welcome more liberal arrangements with the 5th largest economy on earth.

Financial services and foreign investment

The impact on financial services, the property market and capital flows into the United Kingdom are certainly the greatest areas to be concerned about with respect to BREXIT. London, together with New York, are the undisputed financial hubs of the world and London has a time advantage over New York in terms of trading times with the EU, which has lured the best minds to the British capital.

The UK exports in excess of 20 billion pounds of financial services into the EU, six times the amount of services that the EU exports back into the UK. Britain enjoys so-called “passporting rights” to the EU, which means that UK businesses can sell their products freely into Europe without being required to set-up branches in Europe. This has resulted in Britain being a prime foreign direct investment (FDI) destination by foreign financial firms accessing the European Union.

Approximately one third of all FDI in the UK has been directed at financial services. The EU has been a significant participant in the UK’s receipt of investment, accounting for almost half of its FDI.

BREXIT threatens the United Kingdom’s stronghold in financial services. Already various other countries are lobbying global financial giants to consider alternate investment destinations, the most notable of these being Switzerland and the US. The Swiss enjoys healthy beneficial ties with the EU and are also on the front foot with respect to having command over the English language. We believe the focal point for investors will be capital flows and if these begin to leave the UK, anecdotal evidence of businesses’ mood will be the extent to which corporations move offices out of the UK and into the EU.

BREXIT concluded

Our findings fail to find upside to the BREXIT vote. From purely an economics perspective, BREXIT makes no sense and the key driver of the current folly looks to be British pride as against anything rational. That said, the United Kingdom has proven an uncanny ability to bounce back from adversity, it has done so historically through change of heart (entering and exiting financial unions) or by simply reinventing itself – its shift from an industrial powerhouse to become the financial epicentre of the Anglo Saxon World confirms this.

In the short to medium term, BREXIT looks to remain a painful process with further economic pressure and currency stresses, however, we remain very optimistic on the long-term prospect of investing in the UK and Sterling already looks undervalued on a longer-term view.

ING – an undervalued offshore bank

One of the points we always make at our investment meetings is that it is critical to be able to describe the investment case for a business in an uncomplicated and succinct way. In the case of ING bank, three factors have piqued our interest and these are:

1. The business is positioned at the forefront of a secular trend away from branch banking to direct on-line channels.
2. It has sold various non-core businesses resulting in excess capital (it has a strong balance sheet) in an industry where certain competitors do not have sufficient capital.
3. It is on the front foot in terms of its growth profile, this, in addition to its strong capital position will result in high dividend payments to shareholders.

Management

ING Management are smart, post 2008, they responded to a changing business landscape and did so early. We rate them highly based on foresight. After the 2008 crisis, the banking environment was characterised by three factors.

- Regulation – undue risk taking by banks before and during the financial crisis in 2008 resulted in many of these institutions requiring government bail-outs. In response to this, regulators increased the regulatory framework within which banks have had to operate. It also became mandatory for banks to beef-up their balance sheets – to hold more capital. This had the effect of raising the cost of doing business and reducing returns. ING Management responded to this issue by selling down non-core businesses to strengthen their balance sheet.
- Customer behaviour - although the cost of doing business was rising, customers increasingly demanded better service at lower fees. Customers were also looking for new channels through which to interact with financial services firms.
- Technology – banks began to improve their online capabilities. This resulted in competition escalating across previously impermeable borders. ING responded to this by driving down the road of virtual banking as against following the high costs approach of an expensive branch network.

These larger strategic initiatives were accompanied by detailed annual targets focused on restructuring, customer experience, operational excellence, lending growth, cost-to-income, leverage, dividend pay-outs and return on equity. It has been impressive to monitor the constant progress in this regard.

Industry

Clearly banking is an extremely competitive industry, Europe is certainly overtraded and Mario Draghi (the President of the European Central Bank) made detailed suggestions around the need for consolidation in this space just a few weeks ago.

Encouraging with respect to ING however is that it has dominant market positions in more consolidated markets within Europe, such as the Netherlands, Belgium and Luxemburg. In fact, in the Netherlands, ING controls 40% of current account deposits. In certain markets such as the Netherlands, it does have a branch network, but in new markets in which it intends to compete, it is doing so using a lower cost direct or on-line banking approach.

The attached chart demonstrates how perfectly ING is positioned within the European banking industry with respect to secular trends taking place. It shows the extent to which customers are shifting away from traditional branch banking (over 40% banked through branches in 2005) towards mobile and digital channels (less than 5% of customers now use branches.)

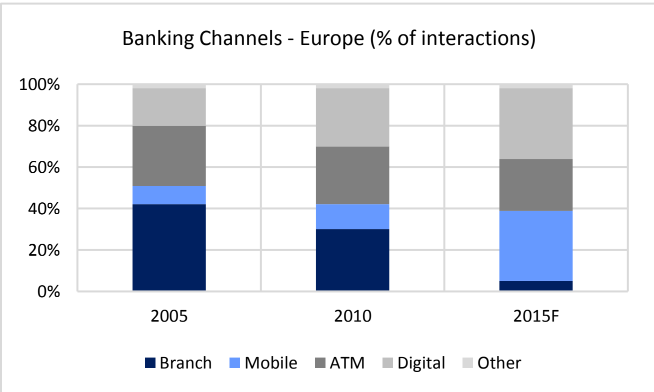

Figure 5. Banking channels in Europe Source: Bloomberg & Northstar

Moat

At face value banks are seemingly moatless, but in reality client persistency for banks is very high. Persistency describes the extent to which clients move between banks and irrespective of how poor banks might be at service delivery, clients tend to remain loyal to their respective financial institution.

The obvious question is why this is the case? It is widely believed that a high degree of friction is apparent when a client 'ports' an account. Friction refers to the hassle factor which includes FICA, debit and stop order transfers and even the resistance to learning new systems and structures – stay with what you know.

For this reason, new banks struggle to attract clients away from existing players and often have to enter or create new markets (e.g. Capitec in SA focusing on unsecured lending) or they persuade clients to open a second account at low cost or no initial cost and in time try and lure clients to make them the primary provider.

With this in mind, ING has high ownership of its traditional markets in the Netherlands, Belgium and Luxemburg. One could thus argue that in the Netherlands in particular, its moat is a function of first mover advantage.

As the bank moves into new European markets, it is doing so with its on-line product. Here ING enjoys a scale advantage. McKinsey research points to the direct channel requiring significant deposit and loan levels (exceeding 80 billion euros) before a bank begins to enjoy real scale benefits. ING's online scale is leading to natural barriers to entry which should bode well for the Group in the years ahead.

Valuation

Our work indicates that ING was trading below our bear case valuation earlier this year (the stock price dropped to below 9 euros), which we view as unjustified for a well-positioned business enjoying secular tailwinds. It was clearly being affected by general negative sentiment in the European banking industry – Deutsche Bank woes were impacting all financial stocks. It has subsequently rallied very hard to 12 euros, but remains below our base case valuation.

Conclusion

ING certainly ticks our boxes with respect to being advantaged and is trading below our view of fair value. We look forward to watching the investment thesis unfold for this bank.