NORTHSTAR
ASSET MANAGEMENT

QUARTER 3, 2023 MARKET REPORT

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Closer to the truth

As much as things change, they also stay the same

Adrian Clayton, CIO

Over almost 3 decades of managing client investments, it is undeniable that our industry has become increasingly sophisticated – asset management has always attracted the smartest people, but these days, new comers have education that is acutely investments specific and they are armed with more technology. Yet, experience cannot be substituted for, and in this article, we take a look back at past stock market dislocations and their underlying causes. The common denominators driving short-term pricing are greed and fear and we question whether this will ever change.

In August 1995, I entered the asset management industry with a crop of newbies, all wide-eyed, full of bravado and glued to our Ferguson Brothers terminals. Investec later bought Ferguson Brothers. It was 'game on'! We, 'the untouchables,' were ready to imprint our DNA on the global financial system.

Things were going gangbusters. Asset management was easy. The summer of 1997 was all about Long Island teas at Café Caprice and rampant markets compounding at 16% annually. Nobody spoke of Benjamin Graham. Instead, we all lapped up every utterance of Abby Cohen.

Then, the first shudders started. It was July 1997 when Thailand devalued its baht as the country buckled under the magnitude of its foreign debt. The JSE dropped 18%, but this felt more like cramps at half-time than a life-threatening injury. Within a year, the local indices had recovered, and we were back to the races.

May 1998, I will never forget, devoid of experience or able mentors, we were forced to muddle our way through the 40% collapse in asset prices as Russia defaulted on its debt. The South African Reserve Bank hiked the local repo rate from 15% to 22% to protect the rand that got clobbered by 20%. It was real for emerging markets. I visited Indonesia just after the Asian and Russian ruble crises, and I met taxi drivers who were executives at multinationals a year earlier.

Then, there was the tech implosion in May 2002. Our market fell 34%, but in truth, a lot of this pain was specific to the sector. Those investors who had not learnt to model quite deservingly endured the pain. The 2008 crisis felt like 1998. It was white knuckle stuff capable of shifting the entire system over the precipice.

The lesson in 2008 for me was less about valuations and earnings and more about balance sheets. Old Mutual proved the poster boy bugger-up. Its stock fell 82%, a business in tune with capital mismanagement. The Bermuda products spoke to the malaise. Fortunately, Fed Chairman Ben Bernanke, President of the New York Federal Reserve Timothy Geithner, and Treasury Secretary Henry Paulson engineered the financial system out of the morass.

I feel the most for the market millennials and Gen Zers. Navigating storms requires experience, which most of this generation has not gone through! The February 2020 Covid meltdown of 31% was like an unsavoury sushi hors

d'oeuvre. It was full of bacteria that caused a night of hell, but new-age fiscal and monetary medicine transformed a potential financial catastrophe into a stock market carousel. Indices turned north by the 28th of March of the same year, and we remain, to this day, in the stratosphere.

The common denominator of each correction mentioned above has been a dislocation of market prices from underlying economic reality. In 1997 and 1998, Asian economies grew their property capital bases excessively with foreign debt, which diluted the region's prospective returns. Vacant buildings popped up long before the stock market latched onto this reality.

The dot.com stocks were another dislocation. An example is Boo.com, which launched as Europe's budding e-tailer. It created an insatiable demand for its products with magazines and public relations, but it forgot one key criterion – to build a functioning product ordering and distribution capability. Boo raised $135m and at its height was valued at $390m. Founded in 1998, Boo was gone by May of 2000!

Most of us understand 2008, excesses in the property market and investment banks operating with balance sheets geared at 60 times. The USA's 2008 was Japan's 1988, proof that markets do not respond to the cognitive in the heights of greed and fear.

To understand the unwind, look no further than Bank of America. Its stock price in 2006 was $53 and reached $2.60 in June 2009. Importantly, its net income collapsed from over $21bn in 2006 to about $4bn in 2008. The stock took 12 years to exceed its 2006 earnings!

So, what about now? Money cannot be made for clients by expecting a spook to manifest around every corner. Doing so would imply zero risk, equating to zero returns.

As professional money managers, we must make calculated and educated bets for clients, and we are! But, it is equally important to identify trends and similarities with the past. This is the benefit of experience.

Yet again, excesses are manifesting in the system: high property prices across multiple geographies, stretched equity valuations in certain market sectors or real estate overcapacity in Asia. Against this, market participants have adopted a laissez-faire attitude towards this cycle, believing that we are at an inflection point for improving economic prospects.

In contrast to this expectation, the real economy is showing signs of slowing down, be it negative purchasing manager index readings, diminishing credit provision by banks, shrinking money supply or even negative earnings revisions. Also, there is usually a twelve-month lag between yield curve inversion and a recession – the yield curve inverted last July.

Yet another disconnect is occurring between the real world and the virtual world of markets.

Time will tell how this turns out!

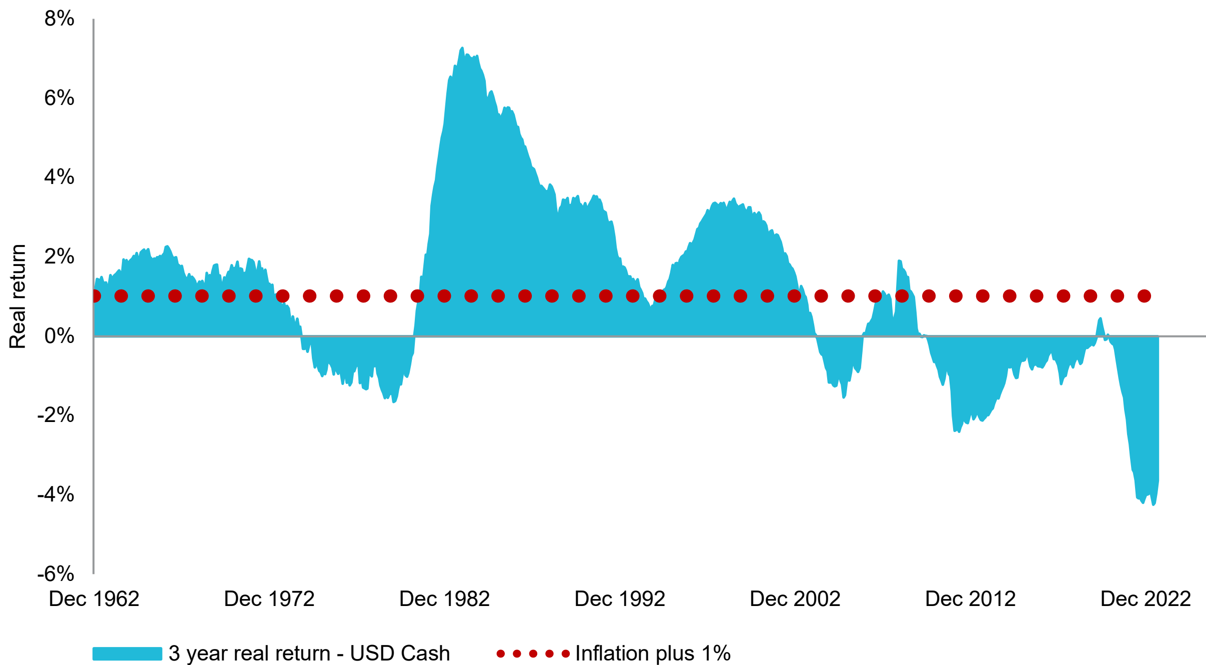
A challenging decade for fixed-income is finally over

Mark Seymour, Director of Fixed Income

As a tumultuous decade for global fixed income draws to a close, valuations are attractive, making it an ideal time for low-risk investors to enter the global market. Northstar has taken this opportunity to complement its current offshore offering with the launch of the Northstar Global Income fund. This multi-asset class fund aims to deliver a 2% real return and provide a stable income for investors with a low-risk mindset.

In absolute and real terms, returns for global fixed-income assets have been terrible over the last decade. This unfortunate dynamic has been a direct consequence of monetary policy globally. By anchoring rates at the zero bound, the Federal Reserve capped returns at close to zero for cash investors, resulting in negative real returns. Investors who ventured into other fixed-income assets, such as treasuries and corporate bonds, managed slightly better returns for some years. These investors, however, experienced catastrophic losses when the Fed switched tack and raised rates aggressively in response to higher inflation. Compared to history, real returns for US cash and global bonds have been as bad, if not worse, than those experienced during the inflationary period of the 1970s (see charts below).

Chart 1: Three-year rolling real returns (USD)



Source: Iress, Northstar AM (31 August 2023)

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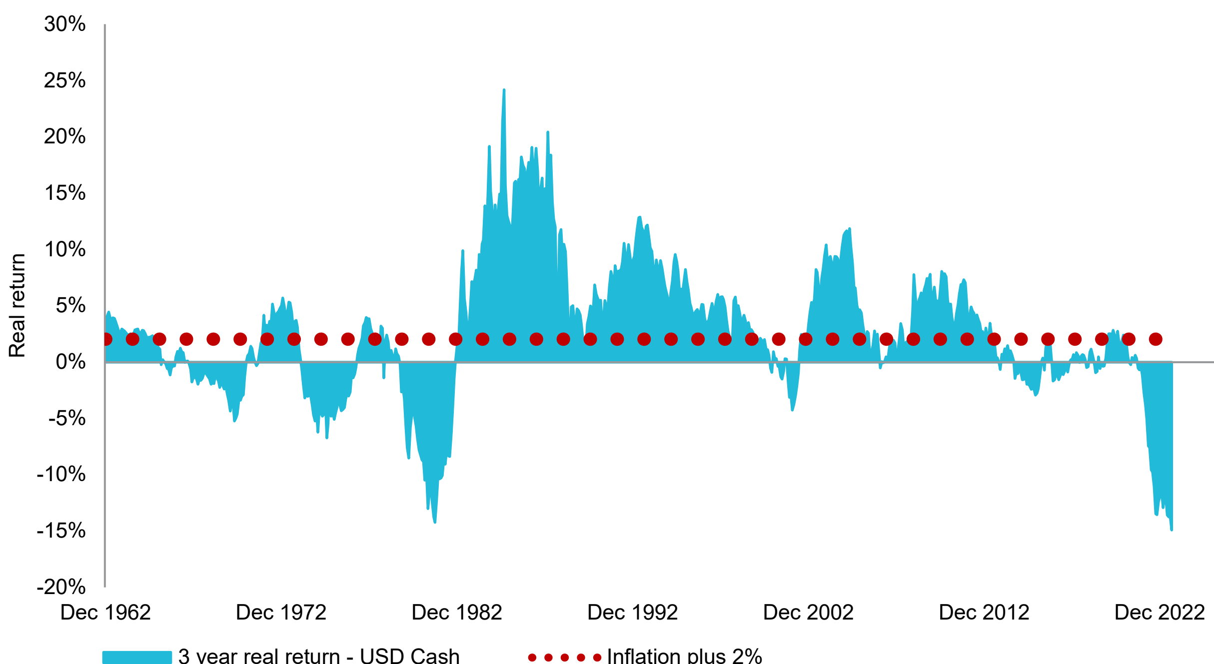
Chart 2: Global bonds three-year real returns (USD)



Source: Iress, Northstar AM (31 August 2023)

Fixed Income assets are offering value, as real yields turn positive

The good news is that valuations have improved as yields have risen along with moderating inflation, providing conservative investors an attractive entry into the fixed-income market.

In response to elevated inflation and a strong economy, the Federal Reserve has been able to raise rates by 5.25% without growth grinding to a halt. The Fed funds rate has taken eleven steps to rise from 0.25% to 5.5%, with the US 10-year bond yield climbing from its lows of 0.32% to 4.33%. In contrast, inflation has moderated from 9.1% to 3.7% and is on track to reach 2.5% within a year.

As a result of the restrictive monetary policy position, the economy will likely slow, allowing the Fed to cut rates by 2% over three years. This outcome will be a tailwind for cash and bond investors, with returns between 4.3% and 5.7%, relative to average inflation of 3.1% (see table below).

Table 1. Bull, bear and base case returns for cash and US treasuries

3y annual returns	Yield	Bull case | US Gov Bonds 3y time frame - Annual return as at 19 Sep 23	Base case | US Gov Bonds 3y time frame - Annual return as at 19 Sep 23	Bear case | US Gov Bonds 3y time frame - Annual return as at 19 Sep 23
Cash	5.53%	3.67%	4.26%	4.81%
3y	4.79%	4.74%	4.74%	4.74%
5y	4.51%	5.44%	4.94%	4.44%
7y	4.47%	6.19%	5.12%	4.06%
10y	4.37%	7.00%	4.99%	3.05%
20y	4.60%	10.75%	5.70%	1.12%
30y	4.43%	12.22%	4.54%	-1.95%

Source: Capital IQ, Bloomberg, Northstar AM (19 September 2023)

Selective value on offer in other asset classes

Other income-producing assets, such as corporate bonds, inflation-linked bonds, and equities, reflect different levels of value. However, identifying value in these assets requires deeper scrutiny at a sector, company, issuer, seniority or maturity level. For example, credit spreads are generally very compressed, resulting in a high potential for capital losses in the event of any distress or liquidity event in the market. Within credit, short-term spreads on Financials are markedly positive, whereas spreads on IT companies are profoundly negative. Short-term TIPS (inflation-protected treasuries) have recently spiked, reflecting great value in the event of inflation averaging above 2% over the next couple of years.

Of increasing interest are strong dividend-paying stocks like British American Tobacco, 3M, Goldman Sachs, Medtronic, and United Parcel Service etc, which are trading on an average dividend yield of 4.5% and growing their dividends at 5%. Typically, these companies have strong balance sheets, steady revenue growth, stable margins, and excellent cash flow, ideal for navigating more challenging economic conditions.

Northstar launches a Northstar Global Income Fund (USD)

Given the higher yields and the economic conditions described above, Northstar is excited to announce that we recently launched the Northstar Global Income Fund, a perfect investment for low-risk clients looking for hard currency (USD) income. Since launch, the fund has been performing well versus peers and is trading on a yield of 4.65% with a duration of 0.2 years. The long-term aim is to deliver a real return of 2% while maintaining high capital stability.

Meet the team

Hlelo Giyose
Chief Investment Officer/Portfolio Manager (First Avenue)

When did your interest in financial markets start?

I purchased my first share at the age of 12 on the recommendation of my mother. By then, she had already introduced me to a savings account at the bank and encouraged me to use up some of my bank savings to buy shares. Thankfully, she told me to buy shares of things we use in everyday home life. The two of us settled on shares of Chubb International, a security company.

What did you study and why?

My foray into bank savings and investing led me to develop an interest in businesses. In any case, my mother was an accountant and always talked aspects of the business, a wholesaler, she worked for. So, I enrolled for a BSc. Business Administration degree, with a double major in finance and economics. I remember in one of my freshman classes, a professor, Bill Wetzell, asked the class why we wanted to study business. Ninety-nine percent of the class said they wanted to make money. I said I wanted to understand how businesses work.

What do you think equips you to do this job properly?

Managing money requires several critical skills (quantitative abilities, inverted thinking, and a great temperament). Of those, temperament reigns supreme. Setting out your investment philosophy, enhancing the process by which you enable that philosophy, and possessing the temperament not to be distracted by other ways in which market participants make money are key. Simply appreciate that the time for your approach will come more often than other approaches to making money.

What do you love about investing?

As Investing is a profession made up of a combination of disciplines, one needs to be multi-disciplinary to do it successfully and enjoyably. Investing bestows upon you the responsibility to understand the world, and act to the best understanding there is in the world. Since no one is omniscient, you should not only know the major principles of the major disciplines, but also make connections between them for the purpose of investing and, only in the circle of competence produced by connecting these major principles. If someone makes money from what you do not know, do not be envious. Simply appreciate that they are extracting economics from areas where they have connected the dots, so to speak. Stick with your dots. Your time will come.

What do you find the most challenging part of your role to be?

The most difficult part of managing money is aligning the manager's consistency in risk appetite with the client's fluidity in risk appetite. Often, clients will abandon their risk appetite in both bull and bear markets out of greed or fear respectively. It is difficult to stick to your knitting, as it were, and accept that you could lose a client. Yet this is the price a manager should be prepared to pay. So high is this price though that Warren Buffett dispensed with it by using public, rather than institutional or private wealth assets, to invest.

Why do you think clients will do well at Northstar and First Avenue?

The combined organisation possesses an enviable diversity of cognitive abilities while engendering transparency as a means of cultivating trust among staff and clients. This quality is a valuable input as our goal is to be the best manager, not the biggest, to our clients.

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NORTHSTAR GLOBAL INCOME FUND (USD) DISCLOSURE

This Fund is a cell of PIM Capital Ltd PCC, duly authorised by the Mauritius Financial Services Commission (FSC) on the 28th of October 2014 to operate as a Collective Investment Schemes (SEC-3.1 Cv) under section 97 of the Securities Act 2005 with license number C114013528. PIM Capital Fund Services, the CIS Manager of the Fund, is registered with the Financial Services Commission under section 72(6) of the Financial Services Act as a Collective Investment Schemes Manager in Mauritius. The Fund is approved under Section 65 of CISCA by the Financial Sector Conduct Authority of South Africa.

Prospective applicants for shares should inform themselves as to the legal requirements and consequences of applying for, holding and disposing of shares and any applicable exchange control regulations and taxes in the countries of their respective citizenship, residence or domicile. Independent professional financial advice should always be sought before making an investment decision as not all investments are suitable for all investors. If you choose to appoint an adviser, advice fees are contracted directly between you and the adviser.

Collective Investment Schemes (CISs) are generally medium to long term investments. The value of participatory interests or the investment may go down as well as up, and therefore the CIS Manager does not make guarantees with respect to the protection of capital or returns of the investment. Past performance is not necessarily a guide to future performance. CISs are traded at ruling process and can engage in borrowing and scrip lending. The portfolio may include underlying foreign investments, and may as a result be expose to macroeconomic, political, foreign exchange, tax, settlement, reporting or illiquidity risk factors that may be different to similar investments in the South African markets. The underlying foreign investments may also be adversely affected by foreign investment policies, restrictions on repatriation of investments and other restrictions and controls that may be imposed by the relevant authorities of the relevant countries. The CIS Manager reserves the right to close the Fund to new investors if it is necessary to limit further inflows for it to be managed in accordance with its mandate.

Investors in the Fund are not protected by any statutory compensation arrangements in Mauritius in the event of the Fund's failure. The Mauritius Financial Services Commission does not vouch for the financial soundness of the fund nor for the correctness of any statements made or opinions expressed regarding it. In certain circumstances, a participant's right to redeem his shares may be suspended.

Applicants are assumed to have read and understood the Prospectus and accept the risks of an investment in PIM Capital Ltd PCC. It is understood that they are aware that the portfolio of securities is subject to market fluctuations and to the risks inherent in all investments, and that the price of shares and any income from the shares may go down as well as up, and that the fund may be subject to volatile price movements which may result in capital loss.

No guarantee is provided, either with respect to the capital or the return of the Fund. Excessive withdrawals from the Fund may place the Fund under liquidity pressure and in such circumstances, a process of ring-fencing withdrawal instructions and managed pay-outs may be followed. Commission and incentives may be paid and if so, will be included in overall costs. Actual investment performance will differ based on the initial fees applicable, the actual investment date and the date of reinvestment of income.

Fund valuations take place at approximately 12h00 (MUT) each business day and forward pricing is used. Instructions must reach the CIS Manager before 16h00 (MUT) on the Dealing Date. You can expect to receive withdrawal pay-outs five business days after the dealing day. Large investments or redemptions (exceeding 5% of fund value) may be subject to an anti-dilution levy to defray dealing costs and expenses. This levy, where applicable, is applied fully for the benefit of the fund. A schedule of fees and charges and maximum commissions is available on request from the CIS Manager.

Additional information such as daily fund prices, brochures, applicable forms and a schedule of fund fees and charges is available on request from the CIS manager.

Prime Collective Investment Schemes Management Company (RF) (Pty) Ltd ("Prime CIS") is a registered Collective Investment Schemes Manager under section 5 of the Collective Investment Schemes Control Act (CISCA) and is the South African representative office for this fund. Prime CIS is a wholly owned subsidiary of Prime Financial Services (Pty) Ltd ¬ a full member of the Association for Savings & Investment SA (ASISA).