THE INVESTOR'S GUILD

Northstar: "We strongly try to avoid running on intuition"

In this exclusive article written for Investor's Guild members, I chatted to Northstar Asset Management's Mark Seymour and Sebastian Holzbach about the firm's fixed income process.

NORTHSTAR
ASSET MANAGEMENT

In managing its income funds, Northstar Asset Management aims, as much as possible, to avoid unwanted human bias.

"We strongly try to avoid running on intuition," says director of fixed income, Mark Seymour.

In this regard, the composition of Northstar's local and global income funds is the outcome of a purely systematic process built on fundamental inputs.

"We model all the major components – sovereigns, credit curves and property – through a very process-driven exercise," Seymour explains. "We look at the yield curve, plug in inflation assumptions, repo rate assumptions and fiscal assumptions, and from there build a bear, base and bull case for each."

These valuation models are then run through an optimiser, which delivers the optimal asset allocation mix for meeting the 2% real return targets the funds have set themselves.

“The output from that is purely an expression of what the models are telling us,” Seymour says. “There is no discretion to change those allocations because there is full buy-in to what those outputs are.

“The optimiser tells us exactly how much we should have in cash, floating rate notes, senior bank paper, and across different duration buckets in the nominal bond space. And because all of our effort goes into what we feed into that optimiser, there is no scope for the portfolio manager to try to motivate for any discretion.”

Mark Seymour

The only reasons the actual portfolio would look different to what comes out of the optimiser are therefore purely technical.

“It’s not a perfect world,” Seymour says. “There are some factors like liquidity that could cause us to be slightly different to the optimiser.

“For example, the optimiser might be telling us to have 35% in AT1 paper. But there isn’t that much liquidity in that space and so it might take us time to build up that position.”

The nature of the strategy does however mean that it doesn’t often run into these constraints.

“We try to keep things quite vanilla and not hold too much of anything that has liquidity risk,” says fixed income analyst Sebastian Holzbach. “For example, we had quite a large inflation-linked bond exposure and the latest optimisations have called for a meaningful reduction. Because we can get that exposure through government bonds across the yield curve, they are very liquid and can be executed within one or two days.

“Even with floating-rate paper, the optimiser might point to a large AT1 allocation, but we can get around the liquidity issues there by parking some of that allocation in senior bank FRNs and lately even in government floating-rate bonds. Then, as opportunity arises, we can liquidate some of that to take up our preferred exposure.”

The optimiser is run monthly, but Northstar’s infrastructure does allow it to respond to dislocations that may happen in the interim.

“We are able to turn around single optimisations relatively quickly,” Holzbach says. “Should a crisis unfold we are able to re-run that optimisation and get a quick outcome from the data.

“In the early days, all that optimisation was done within an Excel ecosystem. We’ve since taken that and put it into Python. Before, it would take better part of half a day to run all the data. Now it’s 20 minutes.”

Sebastian Holzbach

In the early days of the business, the fixed income team also ran mandates by committee. However, when Nenegate hit in 2015 Northstar realised that this was not optimal.

“We felt that the decisiveness of our response in that sort of moment where yields spiked dramatically could be improved,” Seymour says. “We decided it would be best to transfer ultimate responsibility to a single portfolio manager.”

Seymour now fills that role for both the Northstar BCI Income Fund and Northstar Global Income Fund. However, he still has the support of a fixed income committee that meets once a week to provide oversight.

“What is vital for our modelling is having reasonable inputs,” Seymour explains. “That is fraught with difficulty. The primary role of the fixed income committee is to test and debate the assumptions we are incorporating, and ensure we are using the best inputs.

“That forum gives us a strong foundation in terms of building conviction that we are using the most reasonable set of data we can in our models. In every meeting, the path of interest rates will come up for scrutiny, we’ll talk about the inflation environment and fiscal risks. Those are the things that to a large degree will dictate the valuations on different bonds.”

Local and Global

This process is identical across both strategies.

“In terms of structure and process, we try to mirror local and global,” Holzbach says. “We build up valuations the same way, using the same factors that drive assets.”

The two strategies also have the same target of a 2% real return after costs. However, the different environments mean that allocations must be managed slightly differently.

“The South African Reserve Bank has run real rates slightly higher than offshore, and it has been easier to earn a real return locally,” Seymour says. “That means that a standard deviation of 3% generally affords us enough risk to achieve our target at a tracking error of around 2%.

“Globally, a 2% real return becomes a lot more difficult to achieve unless we widen that risk budget. In dollar terms, it translates into a 5% standard deviation. So, we do have a slightly different complexion in terms of the asset mix.”