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I’m not a fan of ‘gut instinct’ – top-performing income PM Northstar’s Mark Seymour says the firm’s process is rooted firmly in its portfolio optimisation tool.

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This month the Northstar BCI Income fund will reach its 10-year milestone. Since inception, the fund has returned 7.4% per annum – ahead of its benchmark of 110% of the STeFI call deposit rate and the 7.1% average return from funds in the Asisa South Africa multi-asset income category.

Portfolio manager Mark Seymour told Citywire South Africa that the fund has always been managed in the same way, ‘but the effectiveness of how we’ve done it has continued to improve’.

As one of Northstar’s multi-asset strategies, the fund is run according to the firm’s portfolio optimisation process. That is based off the inputs from Northstar’s fundamental research.

‘Everything we do at Northstar – all our analysis and thinking – goes into a buy list with our return expectations,’ Citywire + rated Seymour said. ‘That is then fed into the optimiser which delivers a recommended mix of asset classes.

‘For this fund, we optimise the portfolio for a standard deviation of 3%. We want to maximise the return for that level of risk, which we believe is prudent and in line with what a low-risk investor needs.’

Seymour (pictured below) added that every analyst at Northstar has a direct line of sight of that buy list and their contributions to it.

'Every analyst puts their valuations into the buy list, and those have return implications,' Seymour said. 'Depending on those numbers, an asset will either be up-weighted or down-weighted.

'It's up to the CIO and portfolio managers to scrutinise the analyst's thinking and the models they have used to make sure they are happy with the numbers. If they aren't, they need to be accountable for not implementing those views as per the buy list.

'This ecosystem of individual accountability fosters collective success by ensuring that each member's responsibility and contributions align towards shared goals, promoting collaboration and unity over personal achievements.'

He added that this also means that the process is not reliant on any one individual, and there is no need for 'star' fund managers.

'I am not a big fan of portfolio managers wanting to bring their "art" or their gut instinct. I want to quantify everything, and then implement.

'I suspect that a lot of fund managers in the industry don't do that because they almost don't want to give their brand away – their "X factor". They literally hold back some of their views and don't put all their thinking into the numbers. Or their views can't be quantified.'

Accountability

However, Seymour believes that with a process like the one at Northstar – where all of your analysis feeds into a tool that has been developed and refined over many years – a portfolio manager should not be overriding the output from the optimiser very often.

'You have the buy list, and you have the optimised portfolios. I believe you track the performance of those, and then the performance of the portfolio, and the portfolio manager has to be accountable for the difference,' he said.

In running the Northstar BCI Income fund, he tries to match the portfolio to what comes out of the optimiser as much as possible. But there may be practical reasons for why this isn't always possible.

'At the moment, for example, the optimiser is calling for higher duration. We are pretty close to what it is saying, but we are holding some corporate bonds linked to the R186 bond at the front end of the curve. It's acting like cash, but it's quite illiquid.

'The optimiser would like us to sell those to take longer duration exposure, but in order to move those bonds we would have to take a capital knock. So, the optimiser is giving us a portfolio in a perfect world with no liquidity constraints and where you don't have to worry about the bid-offer gap. But we do have some practical limitations.'

Credit risk

Seymour added that he is also circumspect about what he will have on the buy list and therefore include in the portfolio.

'A big theme in the fund is that we are light on credit risk. We've only taken bank credit. We are a fixed income team of three, and so we play where our strengths are. That is to be quite flexible in terms of allocating to different points in the curve and managing that duration – taking opportunities in higher-yielding, higher-duration bonds when available, and generating returns in very liquid markets that are priced every day.

'Other funds might have a lot of exposure to sub-debt and credit that is not great quality. A lot of those instruments don't trade every day and their mark-to-market is extremely opaque.'

His fund also does not invest in the debt of state-owned enterprises (SOEs).

'I have been under some pressure to be a little more flexible about my exposures, but I have lived and died by the mantra of buying quality assets at a reasonable price,' he said.

'With SOE paper you just know for a fact that some departments are not operating in a sound financial framework. I would rather not have something go wrong and have to explain why.'

Over the past three years, the Northstar BCI Income Fund has delivered a cumulative 24.8%, ranking it 17th out of 98 funds in the Citywire - Bonds - South African Rand category.