NorthStar
ASSET MANAGEMENT

FIRST AVENUE
INVESTMENT MANAGEMENT

Market Report

QUARTER 3, 2024

Closer to the truth

Myth Busters

Adrian Clayton
Chief Investment Officer/Portfolio Manager (Northstar)

In this article, I explore the phenomenon of overvalued assets and how social media amplifies speculative investment trends. Drawing from historical events like the tulip mania and the dotcom bubble, I illustrate how investors are often lured into these frenzies by influential voices, only to face future losses. Ultimately, one is reminded to focus on long-term, sustainable investments rather than market fads.

....

Do investors make money following talking heads?

A litany of bubbles have burst over the years in markets, these include:

- Tulip mania of 1637.
- South Sea bubble of 1720.
- South African construction stocks before the Soccer World Cup in 2010. In 1999, Murray and Roberts' share price was R2.30, reaching R105 in 2008 and 60c in 2023, the same price it was at in 1976!
- The dotcom – March 2000.
- Sub-prime and the Great Financial Crisis of 2007 where US house prices took 10 years to recover.
- JSE listed property stocks - that collapsed in 2018, reaching 2010 levels before staging a recovery.
- In 2017, the price of Rhodium was $625 oz, by April 2021 it reached $30 000 oz. Fast forward to July 2023, the price hit $4000 oz, not far off where it is today.

Investor outcomes – the bubble bulls versus the bubble bears

In these episodes, big voices proclaimed 'this time is different' causing believers to outnumber disbelievers. Doubters were disarmed by escalating share prices and accompanying narratives.

But, after every one of these modern asset deflations, winners emerge and we must ask, "how did they do it?"

What winners do well, losers do badly?

There are two key features that winners get right. They avoid the bubble through skill, cynicism, research, or experience but endure lengthy periods of underperformance as bubbles take long to inflate but are quick to deflate. And they doubled down on their anti-bubble bet by buying the companies, sectors and asset classes being sold down to fund the hype.

Take the dot-com rage that began in 1995 just after commodity company share prices had peaked. Prior to 1995, Anglo American shares had rallied by 76%, this started in October 1992, and ended in September 1994.

But from September 1994 to April 2000, Anglo American shares did nothing but deliver extreme volatility for their owners. Simultaneously, the Nasdaq rallied 500%.

The tech bubble then eventually burst in March 2000, the Nasdaq fell 75% over the following two years, retreating to 1996 levels. Had long-suffering Anglo shareholders simply held onto their shares from September 1994 to the next big correction which was the Great Financial Crisis (GFC) in November 2007, their returns would have been 800%.

For the same period (September 1994 to November 2007), Nasdaq investors made only 267%, and faced a crisis of confidence, with their capital collapsing by 75% over 24-months.

Not all bubbles are hacks

But not all bubbles are obvious hacks (like tulips were or the South Sea Bubble of 1720 or maybe Bitcoin is today – time will tell), in fact, many initiate their lives as legitimate exciting investments with superior growth prospects.

Take cloud computing and AI, these are long-term growth themes and company share prices should reflect this potential. So too were the early price increases in platinum group metals in 2018, reflecting the introduction of Regulation (EU) 2019/631, European emission standards resulting in higher metal loadings.

It is never enough

But, unfortunately, at some point the pole is set too high, disappointment follows and prices fall. The reset is often sparked by one of two triggers.

The first is that an asset does not deliver its expected growth and becomes an ‘’oh wow’’ moment for the market.

The second is that a point of clarity increases the number of doubters relative to the believers. An example being an analyst report informing investors that to justify the share price of a specific listed electric vehicle manufacturer, the expected annual growth embedded in the share price would require that company to sell one of its cars to every one of the 8.0 billion people on the planet.

And then the great unwind begins!

Be a winner, avoid being a loser

So how do you build your capital, avoid fads, and unearth winners like Anglos of 1995?

Start by analyzing the postmortems of past bubbles to find common features, which include:

- Be cautious of abnormal "returns". These are returning well above equities, the best performing long-term growth asset.
- Lack of cash flow – except for gold, which benefits from two thousand years of history, investments are only worth their cash flow.
- The pain trade by dissenters. Allan Gray almost shut its doors in the late 1990’s as it bet on commodities rather than tech, this put them on the map! Charlie Munger avoided hyped real estate.
- Talking heads – fad evangelists accompany big bubbles.
- If it is too good to be true – it is!

And find which areas of the market are out of fashion?

Based on our bottom-up stock research, at Northstar, we believe that the following areas in markets currently offer long-term opportunities:

- Healthcare stocks.
- Consumer staples – populated by some of the world’s most resilient companies.
- Tech stocks that do not need AI to justify their share prices.
- Certain financials.
- Mid and smaller capitalization companies in the US.
- Oil stocks.
- Emerging markets.

Conclusion

Investing success is not a gift of foresight, but rather an awareness of history.

Super expensive investments carry the burden of expectations, this encumbrance is usually too tough to bear. In contrast, ignored, even maligned assets are often, laden with the highest prospective yield.

Strategic Asset Allocation: A solid foundation, but not without flaws

Mark Seymour
Director Fixed Income

Strategic Asset Allocation (SAA) is a long-term investment strategy that establishes target allocations across different asset classes, such as equities, bonds, and cash, based on an investor's risk tolerance, objectives, and time horizon. While SAA offers a disciplined approach to portfolio construction—diversifying risk and aiming for stable, long-term returns—it is not without its challenges.

One of the key limitations of SAA arises from its reliance on historical data to derive asset class weightings. These weightings may not fully account for future market conditions or structural shifts in economic cycles. Additionally, portfolios can benefit from tactical asset allocation (TAA) and active stock selection, where adjustments are made to capitalize on short-term market opportunities or anomalies, thereby enhancing returns beyond the constraints of a purely strategic framework.

Sharpe Ratio

The Sharpe Ratio measures risk-adjusted returns, enabling investors to evaluate how much excess return they are earning relative to the risk they are taking. The formula is:

$$Sharpe\ Ratio = \frac{(Asset\ Class\ Return - Cash\ Return)}{Standard\ Deviation}$$

A higher Sharpe Ratio signifies better risk-adjusted performance, meaning greater returns for each unit of risk. In the context of SAA, the Sharpe Ratio is crucial for identifying the optimal mix of asset classes. The goal of SAA is to maximize the Sharpe Ratio, resulting in the highest possible return for a given level of risk. By optimizing portfolios according to this ratio, investors can ensure they are selecting allocations that offer the best trade-off between risk and return.

For example, an optimized SAA benchmark may achieve a Sharpe Ratio of 0.46, outperforming any single asset class due to the uncorrelated nature of returns between different assets.

Table 1: Sharpe ratios: Strategic Asset Allocation versus underlying asset classes over different timeframes

Sharpe Ratio	Dec 1959 - Aug 2024	Mar 1969 - Apr 1977	Apr 2003 - Feb 2008
Time period	64 years	8 years	5 years
SAA optimised for the full period	0.46	-0.06	1.26
Cash	0.00	0.00	0.00
Bonds	0.04	-0.88	0.25
Equity	0.33	-0.27	1.83
USD Cash	0.04	0.11	-0.30
Global Bonds	0.11	0.07	-0.04
Global Equity	0.30	-0.11	0.52
Gold	0.14	0.70	0.77
Real return (2% cost)	**4.8%**	**-4.0%**	**16.3%**

Sources: Bloomberg, Iress and Northstar Asset Management

Limitations of SAA

However, one significant limitation of SAA is the low probability that the conditions used to derive an optimal allocation will persist over meaningful shorter timeframes. Typically, historical returns and risk metrics for various asset classes are analysed and optimised to achieve the highest possible Sharpe Ratio. The assumption is that these historical trends will continue into the future. But such assumptions can be flawed.

For example, relying on data from 1980 to 2020—a period marked by declining interest rates—would skew a portfolio toward an excessive weighting in bonds. With the Global Bond Index down 23% from its highs over the past four years, this reliance on historical data would have led to significantly poor returns.

The limitations of SAA are further illustrated in the case of a typical medium- to high-risk client portfolio (see table above). An asset blend that historically delivered a 4.8% real return instead produced a disappointing -4% real return from March 1969 to April 1977, driven largely by poor bond performance. In contrast, the same SAA yielded a 16.3% real return over the five-year period from April 2003 to February 2008, benefiting from a strong equity market. These examples demonstrate that long-term risk and return metrics often do not apply over shorter yet meaningful timeframes, such as the five-year horizon generally recommended to clients in balanced funds. As the examples show, using SAA in isolation may not reliably achieve desired outcomes over periods as long as eight years.

Enhancing accuracy with additional tools

While SAA forms a robust foundation for multi-asset portfolios, it requires additional tools to enhance accuracy and improve outcomes for investors. Markets are not always perfectly efficient, and asset classes or individual securities may at times be mispriced relative to their intrinsic value. These mispricings create opportunities for tactical shifts—adjusting portfolio weightings to go overweight or underweight in specific assets based on forward-looking valuations.

At Northstar, we address this by aggregating the valuations of all analysed assets into three distinct buy lists: Global Equity, Local Equity, and Fixed Income. Each list is carefully optimised to a specific risk level, enabling us to add alpha (market beating returns) through precise stock selection. By applying rigorous risk-return metrics to each list, we make tactical adjustments to asset class weightings, improving the portfolio's ability to outperform its benchmark.

Conclusion

In conclusion, while SAA is a critical component in constructing multi-asset portfolios, the limitations of relying solely on historical data calls for a more dynamic approach. By integrating tactical asset allocation and active stock selection, investors can significantly improve their risk-adjusted returns, ensuring portfolios are not only grounded in a solid strategic foundation but also adaptable to ever-changing market conditions.

Meet The Team

Adam Strydom
Junior Investment Specialist

When did your interest in financial markets start?
My interest in financial markets began at a young age, during my primary school years. It was then that I took my first steps in managing my own money, and quickly became fascinated with budgeting, saving, and investing. I was fortunate to have my father as a mentor in this field, who nurtured my curiosity and shared invaluable lessons about the financial markets. As I grew older, this passion deepened, leading me to pursue financial subjects in high school and take charge of my own share portfolio. I sought every opportunity to gain practical experience, from vacation jobs to further guidance from my father. This journey solidified my commitment to the world of finance.

What did you study and why?
During university, I realized my drive for learning and developing new skills, particularly in understanding human behaviour. I pursued a Bachelor of Commerce, majoring in Investment Management, along with a second major in Psychology (Bachelor of Arts). This unique combination gave me a well-rounded perspective of the finance industry, blending technical expertise with an understanding of the individuals who shape it. To complement my education, I also took coding courses, equipping myself with tools to apply my ideas and knowledge efficiently. Looking ahead, I plan to complete the CFA Level 1 in 2025, continuing my journey to deepen my expertise in finance.

What do you think equips you to do this job properly?
My educational background, paired with my ability to connect with people and understand systems and behaviours, equips me well for my role as an investment specialist. The diverse skills and interests I've cultivated enable me to be a fast learner with strong attention to detail and a focus on efficiency. In a rapidly evolving industry, these traits allow me to adapt and thrive, ensuring I can deliver meaningful results in my role.

What do you love about investing?
I love that investing is far more complex than it initially seems. It's a multifaceted discipline with an endless amount of knowledge to acquire, much of which extends beyond the act of investing itself. This complexity keeps me engaged and excited to continue expanding my expertise.

What do you find the most challenging part of your role to be?
The most challenging aspect of my role, which I find equally rewarding, is continually analysing and improving the processes I'm involved in. By driving greater efficiency, I free up more time for innovation, which ultimately contributes to generating alpha and fostering long-term success.

Why do you think clients will do well at Northstar and First Avenue?
The investment process at Northstar and First Avenue is both rigorous and distinctive, driven by a talented and collaborative team. Our team's synergy and expertise across all stages of asset management ensure a thoughtful and thorough approach to investing, making it a rewarding experience for our clients.

NORTHSTAR

CIS DISCLOSURES

Boutique Collective Investments (RF) (Pty) Ltd ("BCI") is a registered Manager of the Boutique Collective Investments Scheme, approved in terms of the Collective Investments Schemes Control Act, No 45 of 2002 and is a full member of the Association for Savings and Investment SA.

Collective Investment Schemes in securities are generally medium to long term investments. The value of participatory interests may go up or down and past performance is not necessarily an indication of future performance. The Manager does not guarantee the capital or the return of a portfolio. Collective Investments are traded at ruling prices and can engage in borrowing and scrip lending. A schedule of fees, charges and maximum commissions is available on request. BCI reserves the right to close the portfolio to new investors and reopen certain portfolios from time to time in order to manage them more efficiently. Additional information, including application forms, annual or quarterly reports can be obtained from BCI, free of charge. Performance fees will be calculated and accrued on a daily basis based upon the daily outperformance, in excess of the benchmark, multiplied by the share rate and paid over to the manager monthly.

Performance figures quoted for the portfolio is from Morningstar, as at the date of this document for a lump sum investment, using NAV-NAV with income reinvested and do not take any upfront manager's charge into account. Income distributions are declared on the ex-dividend date. Actual investment performance will differ based on the initial fees charge applicable, the actual investment date, the date of reinvestment and dividend withholding tax.

Boutique Collective Investments (RF) Pty Ltd retains full legal responsibility for the third party named portfolio.

Although reasonable steps have been taken to ensure the validity and accuracy of the information in this document, BCI does not accept any responsibility for any claim, damages, loss or expense, however it arises, out of or in connection with the information in this document, whether by a client, investor or intermediary. This document should not be seen as an offer to purchase any specific product and is not to be construed as advice or guidance in any form whatsoever. Investors are encouraged to obtain independent professional investment and taxation advice before investing with or in any of BCI/the Manager's products.

Income funds derive their income from interest-bearing instruments in accordance with Section 100(2) of the Act. The yield is a current yield and is calculated daily.

A feeder fund is a portfolio that invests in a single portfolio of collective investment schemes, which levies its own charges and which could result in a higher fee structure for the feeder fund.

THE FINANCIAL ADVISORY AND INTERMEDIARY SERVICES ACT, 2002

Northstar Asset Management Proprietary Limited is an authorised financial services provider in terms of the Financial Advisory and Intermediary Services Act 2002. All information contained in this document should not be construed, or relied upon, as advice. If you require financial and/or investment advice, please engage the services of an independent financial adviser.

INFORMATION AND CONTENT

The information and content (collectively 'information') accessible in this document are provided by Northstar as general information about the company and its products and services. Northstar does not guarantee the suitability or potential value of any information or particular investment source. Any information in this document is not intended nor does it constitute financial, tax, legal, investment, or other advice. Nothing contained in any service or any other content in this document constitutes a solicitation, recommendation, endorsement or offer by Northstar. Nothing contained in any service or any other content in this document constitutes a solicitation, recommendation, endorsement or offer by Northstar. Illustrations, forecasts or hypothetical data are not guaranteed and are provided for illustrative purposes only; returns or benefits are dependent on the performance of underlying assets or other variable market factors; there are risks involved in buying or selling a financial product; past performances are not necessarily indicative of future performances; and no guarantees are provided.

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

DISCLAIMER

The Management of portfolios is outsourced to Northstar Asset Management (Pty) Ltd, (FSP) Licence No. 601, an Authorised Financial Services Provider under the Financial Advisory and Intermediary Services Act, 2002. This information is not advice, as defined in the Financial Advisory and Intermediary Services Act (No. 37 of 2002). Please be advised that there may be representatives acting under supervision. The manager retains full legal responsibility for the co-named portfolios. Legal Information http://northstar.co.za/page/legal-information/