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Closer to the truth

Structure in uncertainty: balancing risk and expected returns

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At Northstar, we rely on a disciplined and structured process to navigate the complexities of investment management, with a focus on identifying high-quality businesses and purchasing them at favourable valuations. This article explores our approach, illustrating how our framework balances risk and return expectations to generate favourable long-term returns.

Navigating uncertainty is one of the core challenges of investment management. For equity investors, we believe success lies in identifying quality businesses capable of generating sustainable returns above their cost of capital, and paying a fair price for them. At Northstar, we follow a structured investment process designed to identify, evaluate, value, and invest in high quality businesses at favourable prices. This process helps us to balance trade-offs between risk and returns, avoiding excessive exposure to high-risk investments while patiently waiting for the right valuations to invest in exceptional companies.

Process: A framework for success

A structured investment process is essential for consistently navigating uncertainty and delivering favourable long-term returns. Our framework acts as a safeguard against emotional decision-making, behavioural biases and human error, with every investment decision grounded by rigorous research. Our process is built on two key pillars: assessing risk (or quality) and valuation.

We focus on a select universe of proven, high-quality businesses. Each company is evaluated across competitive advantages, industry dynamics, management strength, and sustainability practices, resulting in a risk score that directly determines the maximum position size. Higher quality businesses with fewer risks are eligible for larger allocations, ensuring that the portfolio is consistently skewed toward superior businesses.
The second pillar, valuation, is equally important. A detailed understanding and estimate of what each business is worth and how it compares to other opportunities enables the portfolio to consistently shift toward undervalued opportunities. By remaining disciplined and patient, we aim to enhance portfolio positioning while mitigating risks associated with overpaying.

Together, these pillars result in a portfolio characterised by high-quality, favourably valued businesses. This structured and repeatable process is designed to capitalize on opportunities, while limiting the negative contribution of mistakes, capturing an appropriate balance between risk and expected returns for favourable long-term performance.

Examples: TransDigm and Alibaba

TransDigm: A high-quality compounder

TransDigm illustrates Northstar's focus on identifying and investing in high-quality businesses while exercising valuation discipline. As a leading aerospace company, TransDigm specializes in niche, highly engineered aircraft components, with most of its revenue coming from proprietary and sole-sourced products. These products are critical yet inexpensive for customers, creating high switching costs and strong pricing power. TransDigm further benefits from multi-decade product lifecycles, generating stable, recurring revenue from its high-margin aftermarket products.

TransDigm's dominance is underpinned by regulatory barriers and an existing portfolio of thousands of certified products, making it extremely difficult for competitors to replicate its business. Through disciplined capital allocation and a private equity like approach to M&A, TransDigm continues to extend its lead in lucrative aerospace niches.

TransDigm's strong competitive advantage, favourable industry dynamics, and effective management led to a medium-low risk score, allowing for a maximum position size of 6%. However, the stock consistently traded at a premium to our intrinsic value estimate, reflecting its proven quality and resilience. True to our process, we patiently waited over three years for an opportunity to invest. Our first purchase arose during the COVID sell-off, when fears of declining aerospace demand caused a temporary undervaluation.

Having a long-term perspective and following a structured process allowed for an investment in an exceptional business at an attractive price. While the discount to intrinsic value has not justified a full 6% allocation, the exceptional quality of the business and relatively attractive valuations at times have supported exposures above 3.5%.

Alibaba: Managing risk in an evolving landscape

In contrast to TransDigm, Alibaba illustrates our approach to risk management within an evolving and uncertain environment. When we revisited the investment case in 2022, its long-term prospects as China's leading e-commerce player remained favourable. However, increasing complexity and uncertainty in China raised concerns about both known and unknown risks.

Despite these risks, the investment case remains compelling: Alibaba benefits from unmatched scale, robust network effects, and superior data-driven insights. By attracting top merchants and brands, product quality and authenticity tends to be higher. This quality helps to draw more customers, establish trust, improve retention, and increase basket sizes over time. Its unmatched data advantage enhances advertising campaigns, click through rates, and monetization. In addition, Alibaba continues to diversify into new growth opportunities, including logistics, digital payments, and cloud computing.

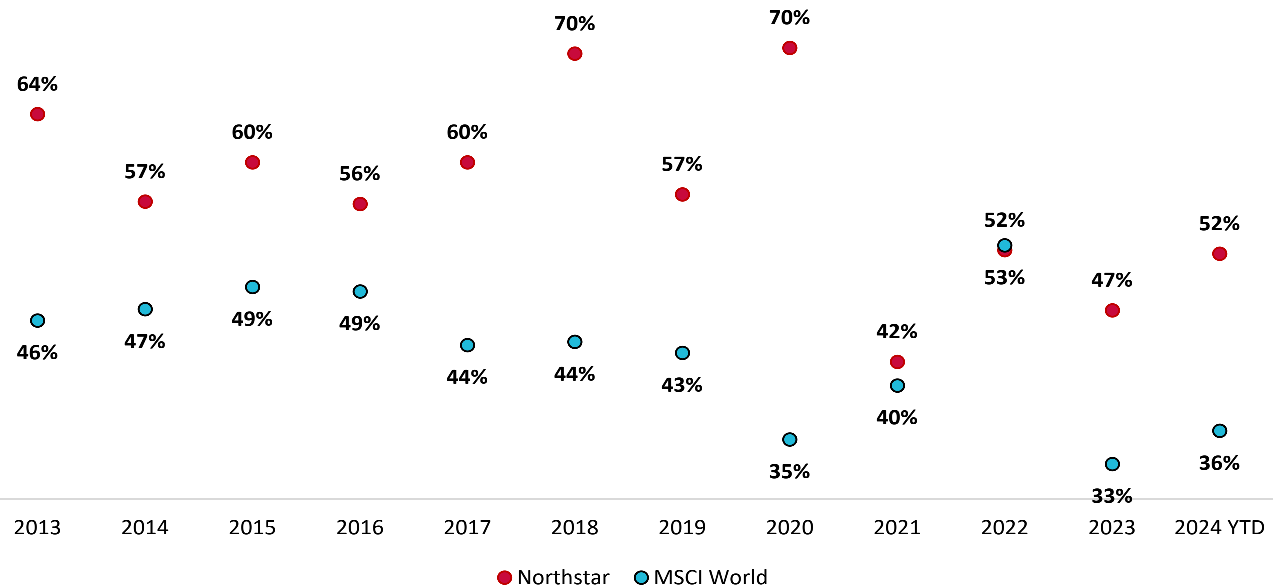
However, several risks became apparent: rising e-commerce competition, increasing regulatory scrutiny, governance concerns, and an uncertain consumption outlook. As a result, Alibaba received a high-risk score, capping exposure to 2% of the portfolio. While its valuation appeared extremely attractive, our disciplined framework prioritized risk management over the allure of potential returns, limiting the impact of subsequent unfavourable performance.

Outcomes: Measuring success

While TransDigm and Alibaba provide two stock specific examples of our process in action, this section considers outcomes at the portfolio level. We consider two metrics: hit rate and win-loss ratio.

Firstly, the hit rate measures the percentage of stocks in the portfolio that outperformed the benchmark, which for us is the MSCI World Index. As shown in the accompanying graph, our focus on high-quality, attractively valued businesses has consistently resulted in strong stock selection relative to the benchmark. It's worth noting that the benchmark's hit rate – representing the percentage of stocks within the index that outperform the index itself – has consistently remained below 50% and has declined in recent years.

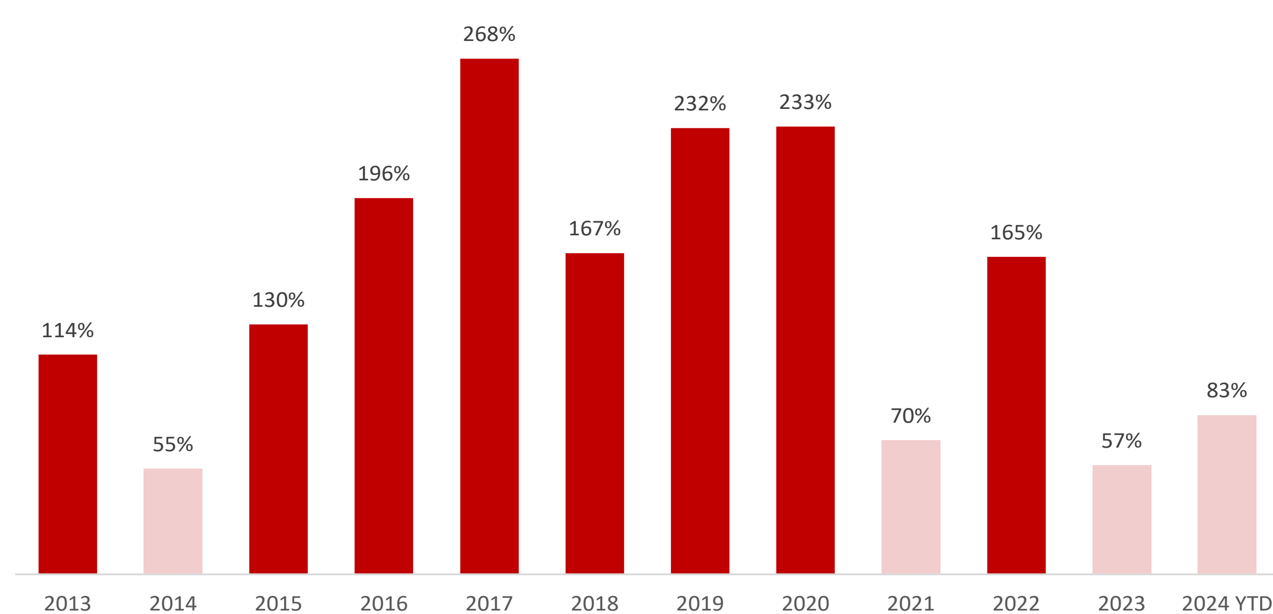
Chart 1: Hit Rate – Northstar Global Equity carve-out versus MSCI World



Sources: S&P Capital IQ, Northstar Asset Management

Secondly, the win-loss ratio evaluates the weighting of outperforming stocks relative to underperforming ones within the portfolio. A value above 100% indicates that larger allocations were made to stocks that outperformed the benchmark. Our disciplined approach to balancing risk and valuation has consistently led to favourable position sizing, as reflected in the consistently strong win-loss ratios over time.

Chart 2: Win-loss ratio – Northstar Global Equity carve-out



Sources: S&P Capital IQ, Northstar Asset Management

Conclusion: An appropriate balance between risk and expected return

Northstar's investment process is designed to navigate the complexities of investment management through a structured and patient approach. By prudently balancing risks and returns, we aim to avoid excessive exposure to high-risk investments while capturing opportunities in high-quality businesses. This structured approach ensures the portfolio remains consistently skewed toward the most attractive risk-adjusted opportunities. Our rigorous framework enables us to identify enduring compounders like TransDigm and effectively manage uncertainty in cases like Alibaba, supporting our commitment to delivering favourable long-term returns.

SA equities: where from here?

Marco Barbieri
Director SA Equity

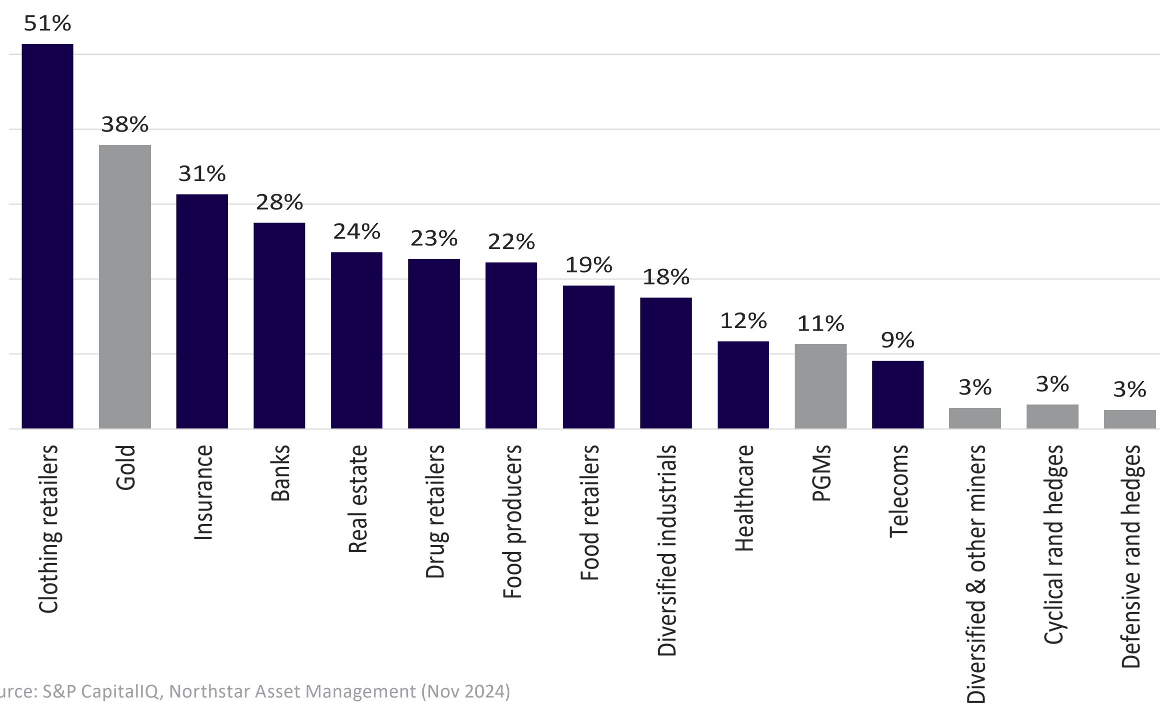
South African equities have rebounded strongly since the May 2024 elections, driven by reforms, improved business confidence, and a stronger rand, with SA-sensitive sectors leading the gains. Despite the recent rally, we believe valuations remain attractive, and the investment case compelling.

Background

Over the past two years, we have emphasised the "South African equity opportunity" despite a challenging macroeconomic environment and various structural bottlenecks in key areas such as rail, ports, and electricity. Eighteen months ago, while most South African-focused investors acknowledged the market's undervaluation, they were primarily concerned with the effects of load-shedding and speculating on how long it would take to resolve. Over the past year, however, several positive catalysts have emerged. The outcome of South Africa's national elections in May and the subsequent formation of a Government of National Unity (GNU) proved to be pivotal, igniting a rally in SA-sensitive assets and sparking a recovery in the rand.

Since the beginning of April 2024, the local equity market (JSE Capped Swix) has surged by 18%, with South African-sensitive sectors significantly outperforming the broader index. As highlighted in the chart below, 9 out of the top 10 best-performing sectors (highlighted in blue) are driven by SA-related factors. These sectors, previously underperformers due to weak growth, have shown marked improvement, coinciding with a stronger rand, which has appreciated approximately 11% against the US dollar during this period. Remarkably, in US dollar terms, SA equities rank as the third-best-performing emerging market year-to-date, trailing only Taiwan and Peru.

Chart 3: SA equities – median sector performance – 01 April to 31 Oct 2024



Source: S&P CapitalIQ, Northstar Asset Management (Nov 2024)

What's changed since the elections? Medium-term growth expectations

From an economic perspective, since May 2024, South Africa has experienced a strong recovery in leading indicators and a significant improvement in business confidence. This recovery is largely attributed to enhanced electricity capacity and the successful transition to a coalition government. Notably, opposition parties have embraced Operation Vulindlela, a joint initiative between the National Treasury and the Presidency aimed at modernising and transforming network industries such as electricity, water, transport, and digital communications.

According to Nedbank (November 2024), successful reforms in electricity, rail, and port freight, combined with improved policy certainty, could elevate South Africa's potential GDP growth to 3.9% by 2027, up from the current 0.9%. While potential and actual growth differ, consensus GDP growth estimates for 2025 and 2026 have also risen to 1.4% and 1.8%, respectively, as economists anticipate improvements in gross fixed capital formation and household consumption to drive growth.

Additionally, credit rating agencies have responded positively. S&P, for example, revised its credit rating outlook for South Africa to "positive" from "neutral" in November 2024, citing the government's commitment to private-sector-friendly infrastructure reforms.

SA stocks: What's priced in?

Although the SA equity rally over the past few months has reduced some of the potential upside, we believe valuations remain attractive and the investment case compelling. While the deep discounts previously embedded in local stocks have moderated to more normalised levels, current prices still do not fully reflect the potential for a cyclical upswing driven by lower interest rates and inflation.

Based on our local equity buy-list, we see double-digit return opportunities across most SA-sensitive sectors, particularly among banks, insurers, retailers, and in the diversified industrial space. Despite an uncertain global macroeconomic backdrop, including slowing Chinese growth and uncertainty surrounding new US foreign policies under Trump, we also see positive medium term prospective returns for local miners and global cyclical stocks at current levels.

How are we positioned and outlook

Northstar's local equity portfolios have benefited from the strong rebound in South Africa-sensitive assets over the past six months. While some volatility is expected as we approach year-end, we remain optimistic about the medium-term outlook for South African cyclicals and select rand-hedge opportunities.

Our approach to portfolio construction is based on a fundamental bottom-up methodology, focusing on detailed risk assessments and stock valuation work. We apply this approach rigorously when allocating capital. Our portfolio's best risk-adjusted opportunities are currently concentrated in the diversified industrial and financial sectors, as well as select opportunities among diversified miners, cyclical rand hedges, and Naspers/ Prosus. We are underweight in local defensives and maintain a gold equity position as insurance.

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