ROSEVALLEY FUNDS

Portfolio Report October 2019

The Rosevalley Behavioural Finance Funds

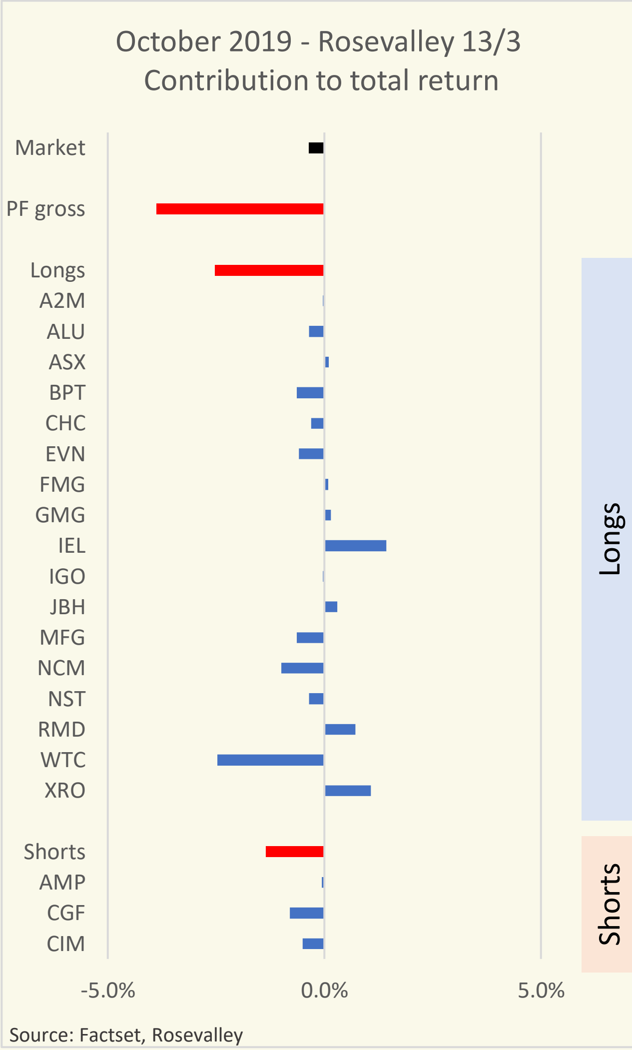
The Rosevalley Behavioural Finance Funds are high-conviction funds that take the theoretical and empirical evidence developed over the past 30 years in Behavioural Finance, and systematically build portfolios from these learnings. The portfolios are constructed on a benchmark-unaware basis, but performance is compared to the ASX-200 accumulation index.

Key Events October

Global markets didn't move much during the month:

	October 2019
MSCI World	1.8%
S&P 500	2.2%
DJIA	0.5%
FTSE100	-1.9%
DAX	3.5%
Hang Seng	3.1%
ASX200	-0.4%

Source: Factset



The Rosevalley portfolios, on the other hand, had a second disappointing month, showing a gross underperformance of 350-450 bps. Unlike the previous month, however, this month the underperformance was driven to a large extent by the sharp fall of Wisetech (WTC), which fell 25% after a short-selling hedge fund published a scathing report on its business, its business practices, and its accounting practices. More about this further down this newsletter.

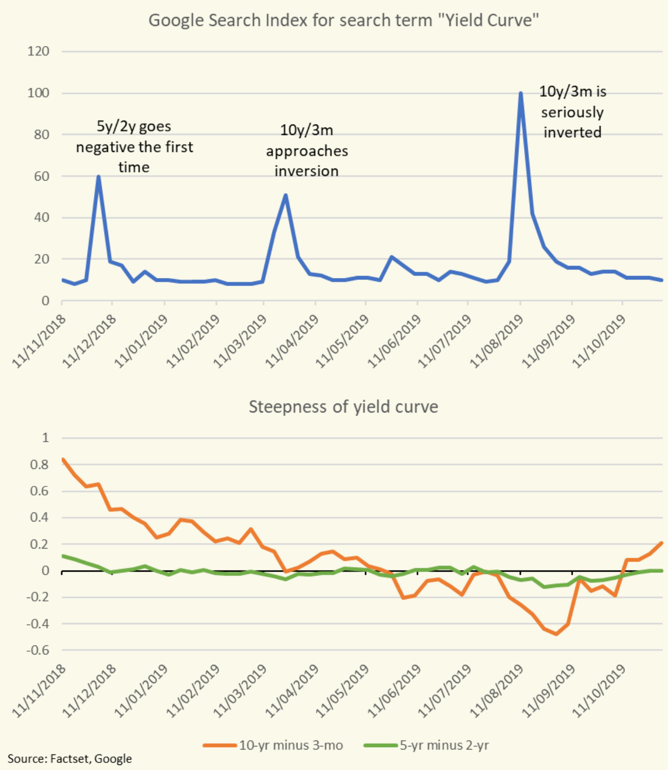
On the geo-political scene, we would highlight the US' withdrawal from Syria as the most noteworthy event. However, from a markets perspective, if one would have expected the oil price to rally, or a flight to safety to result, one would have been wrong. Global markets didn't move much on this news either way.

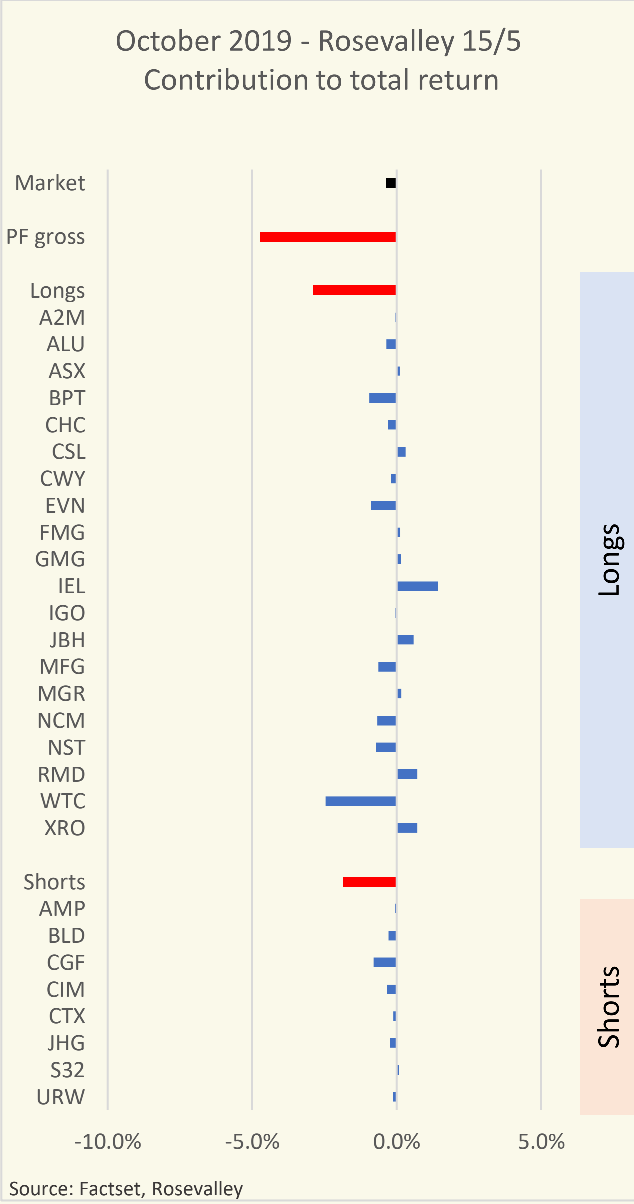
The other event in the US was the start of the impeachment investigation of President Trump. Similarly, while one would perhaps have expected sharp market movements, this didn't really happen.

From a markets perspective the most notable change was somewhat more hidden: the inversion of the yield curve that everybody was talking about a few months ago has completely gone away – and with it the fretting about "the recession that must surely come" (below is a comparison of the yield curve steepness and the frequency of people googling the term). After all, the yield curve has never failed to predict a recession! We didn't really subscribe to this certainty, mainly because we believe that the past decade of unconventional monetary policy has moved interest rates away from their real market values – and therefore the inverted yield curve could not be interpreted as a true market signal about likely future economic developments. Whatever the truth about this, we are certain that investors are not immune to the sentiment, and many will have made portfolio moves based on this thinking, most likely in the same time periods shown on the chart of google searches.

Performance since inception – as of October 2019								
Portfolio		1 month	3 months	6 months	1 year	Since inception (1 Oct 2018)	Since inception (14 Aug 2018)	Since inception (1 Aug 2018)
Rosevalley 13/3	Gross	-3.9%	-13.4%	10.6%	23.9%	6.7%		
	Net	-3.8%	-14.2%	9.8%	22.0%	4.7%		
Rosevalley 15/5	Gross	-4.7%	-14.2%	9.4%	23.2%		9.3%	
	Net	-5.6%	-16.6%	5.8%	15.9%		1.1%	
Rosevalley 10/0	Gross	-4.1%	-10.6%	8.2%	24.1%			19.3%
	Net	-4.3%	-12.5%	3.1%	11.6%			1.8%
ASX-200		-0.4%	-0.9%	7.6%	19.3%	12.1%	11.8%	12.2%

Source: Rosevalley, Factset





Here is what we wrote on Brexit in the June portfolio report:

- *Boris Johnson will be the next UK Prime Minister.*
- *Europe will refuse to re-negotiate the deal they struck earlier with Theresa May.*
- *Johnson will then try to take the UK out on 31 October without a deal.*
- *There will be a revolt in the House of Commons, with enough Conservative MPs joining the opposition in some kind of motion to stop this outcome (something along the lines of a no-confidence motion in conjunction with a ban on a no-deal Brexit).*
- *As a result, new elections will become necessary. Europe will grant another extension, and the Brexit uncertainty will continue for another year.*

Except for the second bullet point, so far we have been right. But as noted before, as students of Behavioural Science, we are very aware that this might be due to luck rather than skill – so we are not yet ready to change careers and become political prognosticators![1]

So what about Wisetech?

On the 17th of October, a US-based hedge fund (called JCal) published a report that claimed (among other things) that Wisetech's revenues and profits are grossly overstated, its accounts are suspect and its auditors aren't paying attention, its products are shoddy, its customers unhappy, and insiders are selling stock. Clearly JCal was short the stock. The shareprice dropped 10% and trading was halted. The company came out with a rebuttal the next day, but the day after that the shareprice fell another 12%. JCal then issued a follow-up report, after which the cycle repeated itself (share price drop, trading halt, company response, further price slide). In both responses, Wisetech categorically stated all of JCal's concerns were false, reiterated guidance, and pointed to the Auditor's opinion, which was unqualified.

It is hard for us to judge the merits of either JCal's or Wisetech's arguments. We read JCal's reports and dialled in to management's investor call. On balance, we would probably side with management, but it is hard to be sure without doing a lot more work.

However, this episode raises an interesting question of market integrity or market manipulation. We are believers in the mechanism of short selling, and the merits of it in providing liquidity to the market, and aiding in price discovery. On the other hand, we note that in the Wisetech case, JCal will have made a lot of money irrespective of whether they are right or not. In other words, if in the coming weeks, months, years, it turns out that their report was indeed, as the company says, completely baseless, this really doesn't matter to JCal – they will celebrate their shorting of the stock and publishing of the report as a great investing success. This surely can't be right, or at the very least it feels not fair.

Inevitably, there are those who call for an end to short-selling. On the other side, there are those who claim what JCal did was no different from what a long investor does when he writes a positive report. We disagree with both arguments. Banning short selling is not the answer, but what JCal did is not the same as writing positive reports – a positive report rarely leads to large losses for small investors.

While it may be hard to implement, it seems to us the answer must be found in existing market manipulation laws. Surely, if it turns out the JCal report was mostly based on shoddy research, or worse, mostly made up, they are guilty of market manipulation? The only "new" regulation to be contemplated that makes sense to us, would be introducing a requirement to publish market-moving reports after-hours and/or require them to be shared with management before publication. However, even if such rules were implemented, one would still be hampered by jurisdictional measures: how could an Australian court prosecute a US-based hedge fund over a report that was published in the US? To completely cover themselves, the front page of their reports even says: "By viewing this material you represent that you are not an Australian resident". Funny how Australians have nevertheless been able to find out about it…

Portfolio performance

The Rosevalley portfolios had a second disappointing month in a row. As mentioned above, the portfolios underperformed by 350-450 bps.

Longer term performance

With the second drawdown in as many months, since inception, on a gross basis Rosevalley 13/3 and 15/5 are now a bit below their benchmark, while Rosevalley 10/0 is still ahead.

Execution

Execution provided another headwind this month: the achieved net performance was 75 bps below the modelled outcome for the Rosevalley 15/5 portfolio, as shown below (the other portfolios showed a similar trend). The main culprits were the inability to exactly replicate the model portfolio, and some unlucky timing on the day of trading.

	Model	Realized
Gross performance	-4.73%	-4.73%
deviation from model portfolio		-0.45%
difference between trade price and end-of-previous-month price	0.23%	0.00%
trading costs	-0.16%	-0.21%
borrow costs	-0.21%	-0.19%
rounding		-0.04%
Net performance	-4.87%	-5.62%

[1] Here is a little joke to illustrate the point: "I can fly", said the man, and he jumped off the roof of the skyscraper. As he was falling down somebody saw him go past the window, and yelled after him: "How is the flying going?". "So far, so good!", the man answered.

November portfolio

The portfolio for November sees one short idea replaced for the 13/3 and one long and one short replaced for the 15/5 portfolio:

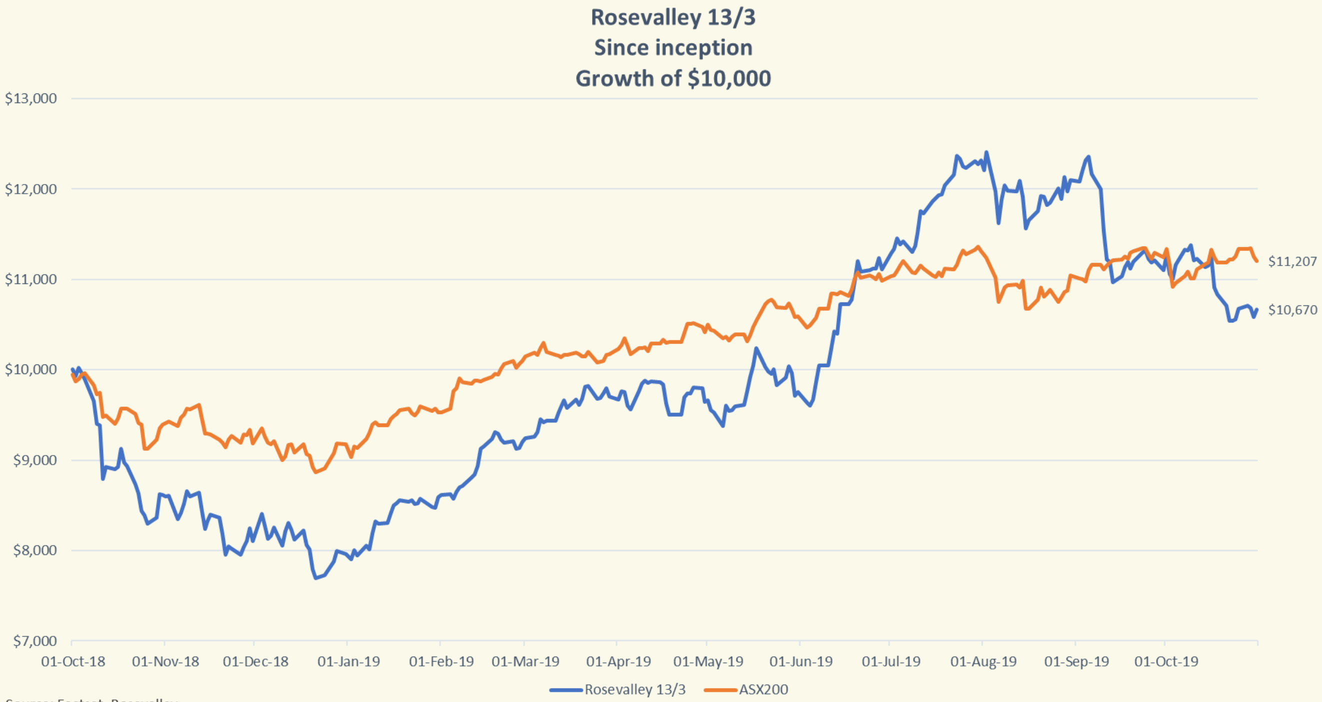
	13/3	15/5
Longs taken out		WTC
Replaced by		GMG
Comments	WTC was taken out because of the uncertainty created due to the short seller report discussed above. The next stock in the list was chosen as replacement.	
Shorts taken out	CYB	CYB
Replaced by	CIM	CGF
Comments	No shorts available in CYB. For both portfolios the next stock in the list was chosen as replacement.	

Looking ahead

For the coming month we expect more of the same things that have dominated over the past half year or so (Fed, interest rates, trade war, Brexit). We can now add impeachment to this list. For Australia, we note that the current bush fires have strongly (re-)ignited the climate change debate, and we expect that over time there may be some impact on the stock market, with fossil fuel exposed stocks likely suffering a long, slow derating.

Investors in the Rosevalley 15/5

Investor 1	4.55%
Investor 2	90.27%
Investor 3	5.17%



Source: Factset, Rosevalley

Rosevalley Funds: The Behavioural Finance Approach

Over the past 30 years Behavioural Finance has emerged as a serious alternative to the Efficient Market Hypothesis. Whereas the Efficient Market Hypothesis starts with the assumption that people (investors) are rational and profit-maximizing, Behavioural Finance builds upon empirical observations of how people actually behave, and goes on to explain securities prices from this principle. Along the development of Behavioural Finance, it has been able to explain many peculiarities that had remained puzzles under the Efficient Market Hypothesis.

Rosevalley Funds portfolios are built around the theoretical and empirical underpinnings of Behavioural Finance, and at heart take advantage of the way human beings behave in the real world.

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