ROSEVALLEY FUNDS

Portfolio Report FY 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.

The year in review

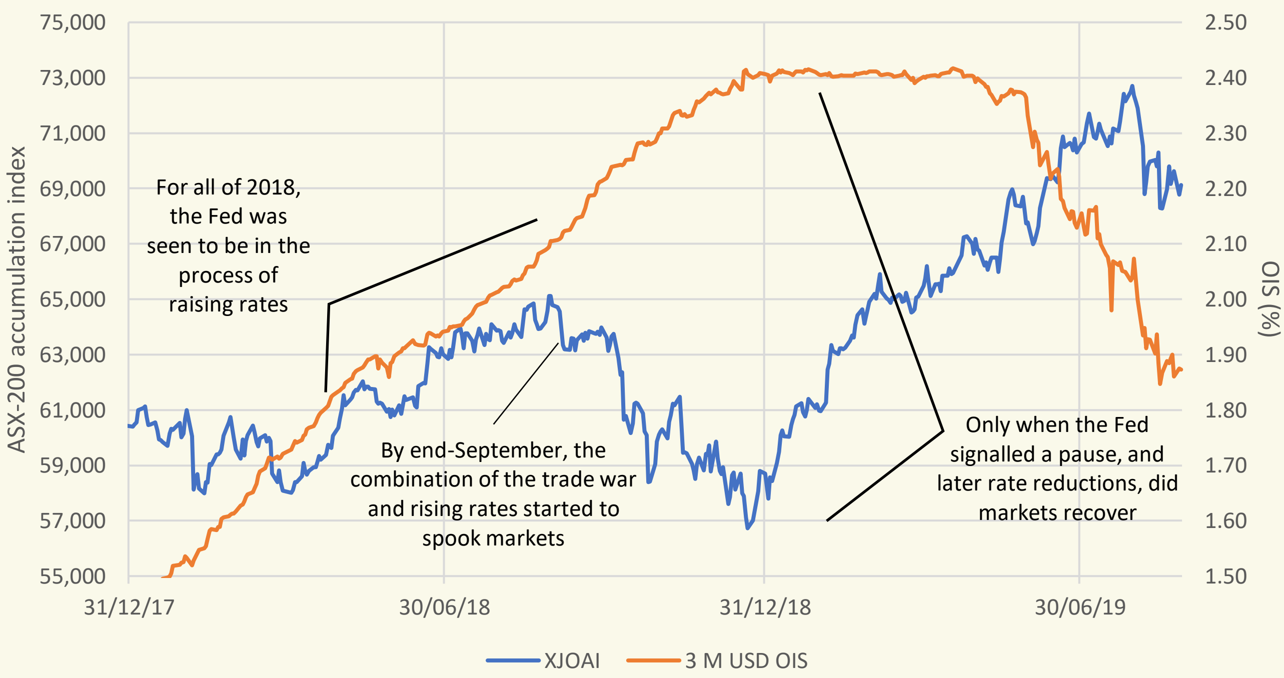
FY2019 (year to 30 June 2019) was a very turbulent year for stockmarkets around the world. The US-China trade war, North Korea, Huawei, Brexit negotiations, Brexit deal, Brexit deal failing (three times), unexpected tweets, another summit with Kim Jung-Un – they all played their part. But if one had to pick one driver that was most influential, it was interest rates. The US Federal Reserve started to raise interest rates in the second half of 2018, which led to a serious market correction in the fourth quarter of the year. Then, in late December 2018, the Fed indicated that it had changed its mind, and was not going to raise rates any further. This was followed up with successive messages of continued restraint, and a developing bias toward lowering rates (which they finally did in late July). See the chart below. Many stockmarkets had their best 6-month period in many years during January-June.

	Jul-Sep	Oct-Dec	Jan-Jun	FY2019
MSCI World	4.8%	-13.5%	15.3%	4.6%
S&P 500	7.7%	-13.5%	18.5%	10.4%
DJIA	9.0%	-11.8%	14.0%	9.6%
FTSE100	-0.7%	-9.6%	13.1%	1.6%
DAX	-0.5%	-13.8%	17.4%	0.8%
Hang Seng	-4.0%	-7.0%	10.4%	-1.4%
ASX200	1.5%	-8.2%	19.7%	11.5%

Source: Factset

For the full year Australia was one of the best-performing markets in the world, if each were measured in their own local currency. When measured in a common currency the US markets did a bit better thanks to the strengthening USD.

ASX-200 vs Fed rate expectations*



* 3 M USD OIS = 3-month overnight index swap rate; this is a measure of what investors think the average overnight rate will be over the next three months. Source: Bloomberg, Factset.

Performance since inception – as of June 2019							
Portfolio		1 month	3 months	6 months	Since inception (1 Oct 2018)	Since inception (14 Aug 2018)	Since inception (1 Aug 2018)
Rosevalley 13/3	Gross	13.9%	14.5%	39.6%	11.1%		
	Net	10.8%	10.9%	28.9%	8.3%		
Rosevalley 15/5	Gross	15.6%	13.5%	39.9%		15.5%	
	Net	15.3%	12.1%	34.9%		10.2%	
Rosevalley 10/0	Gross	9.5%	13.6%	30.4%			21.4%
	Net	7.8%	10.0%	22.7%			6.4%
ASX-200		3.7%	8.0%	19.7%	9.9%	9.6%	10.0%
Source: Rosevalley, Factset							

Portfolio performance

The Rosevalley portfolios ended the year with very strong performance. On a gross basis, all portfolios showed significant absolute performance, as well as outperformance relative to the index. On a net basis, while still strong, performance was negatively impacted by the small size of the portfolios, which drove up average trading costs.

In line with the overall market, there was considerable volatility during the year. The portfolios underperformed in the Oct-Dec 2018 timeframe, but reversed this underperformance during Jan-Jun. On a since-inception basis:

- The flagship portfolio (Rosevalley 13/3) returned 11.1% (gross) since inception on 1/10/18, compared to the ASX-200 9.9%.
- The Rosevalley 15/5 portfolio returned 15.5% (gross) since inception on 14/8/18, compared to the ASX-200 9.6%.
- The Rosevalley 10/0 portfolio returned 21.4% since inception on 1/8/18, compared to the ASX-200 10.0%.

For a discussion on a stock-specific level, we refer to the Rosevalley 13/3 portfolio (see chart on page 4).

- Over the course of the year, 46 stocks made it into the portfolio.
- Of these, 26 had a positive contribution, while 20 detracted from portfolio performance.
- However, the positive contributors contributed on average +1.7%, while the detractors contributed -1.1%.
- There were 7 stocks that contributed more than 2.5%, while there were no stocks that detracted more than -2.5%.
- The largest contributors[1] were:

Stock	Contri-bution	Position	Time held (mo.)
Wisetech (WTC)	7.8%	Long	11
Charter Hall (CHC)	4.8%	Long	8
Northern Star (NST)	4.4%	Long	11
Goodman (GMG)	4.0%	Long	8
AMP (AMP)	3.8%	Short	11
Magellan (MFG)	3.1%	Long	4
A2 Milk (A2M)	3.1%	Long	11
Source: Rosevalley			

  - Wisetech (WTC) is one of the high-flying tech stocks on the ASX, member of the so-called WAAAX[2] group. However, contrary to the other members in this group, WTC is not a young company. It has been around for 25 years. WTC is a global provider of logistics software, claiming to service 19 of the top 20 logistics companies globally. WTC makes money by charging its customers on a 'per use' basis rather than as a subscription model. This means WTC directly benefits as its customers grow their businesses. While it's trading at a very high multiple, earnings have grown at a CAGR of 54% over the past six years.
  - Charter Hall (CHC) is a REIT. Like many REITs in the market, CHC benefited from the decline in interest rates in the second half of the year. In times of low interest rates, yield stocks tend to do well.
  - Northern Star (NST) is a gold miner. Over the year the gold price increased, and many gold miners saw their share price go up as a result.

[1] To clarify: these are contribution numbers, not stock returns, i.e. they are the stock return multiplied by the weight in the portfolio for the duration they were held.

[2] Wisetech, Appen, Altium, Afterpay, Xero

- Goodman (GMG) is another REIT. Like CHC, it benefited from the decline in interest rates and the resulting search for yield.
- AMP (AMP) was once the pre-eminent and dominant asset manager and superannuation provider in the country. However, the company was hard hit when the Royal Commission into the financial industry uncovered many inappropriate (and some fraudulent) practices in the industry in general and in AMP in particular. The company lost its CEO and Chairman in April/May 2018 and has been in crisis mode ever since. The new CEO started in December 2018. We expect it will be a multi-year journey to recover.
- Magellan (MFG) is the most successful listed funds manager in Australia and is mostly focused on international equities. The company has delivered strong investment returns for its clients, but it has also outperformed peers in the area of distribution: it has one of the largest sales forces of any funds manager in the country.
- A2 Milk (A2M) is a producer of milk products. It has been particularly successful in selling baby formula products into the Chinese market. China had seen some food safety scandals with baby food over the past few years, which has led to the situation where most Chinese trust foreign brands more than they trust local brands. A2M has cleverly played into this, and has seen very strong growth as a result.

Execution

To illustrate the difference between gross and net performance, we show a waterfall chart, using the Rosevalley 15/5 portfolio as an example. The sources of difference between gross and net are:

- Weight difference: due to small position size, sometimes the achieved weight differs marginally from the model weight
- Entry/exit price: the difference between achieved trade price and the end-of-the-month that the model uses as the basis for its gross performance calculation
- Trading: brokerage commissions
- Stock borrow cost: the borrow fee and interest costs on the short positions
- Rounding: the residual difference as a result of geometric compounding over time for the above-mentioned differences

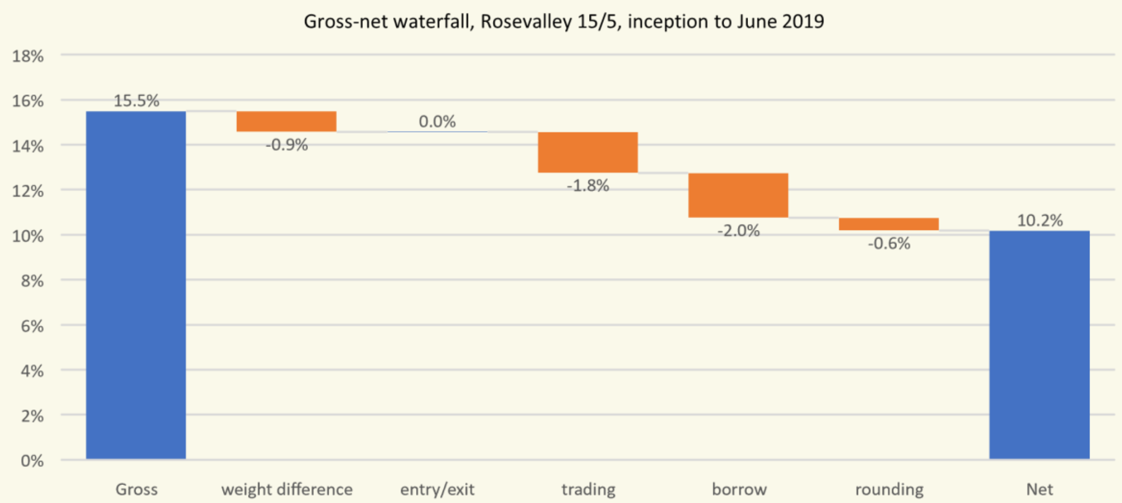
Looking ahead

Looking ahead to the next twelve months, the main thing we foresee is continued volatility. As a statement of what is likely going to happen, we don't think this is particularly insightful, however. Just think of this list: US-China trade war, Brexit, Trump tweets, US election campaign, interest rates, USD strength, Iran, Kashmir, North Korea, Hong Kong protests, Venezuela, populism in Europe. And that's without trying very hard!

Perhaps more interesting is the question of where equity markets will end up in twelve months' time, regardless of the volatility between now and then. We believe the biggest determinant of this question is interest rates and economic growth.

We have commented before on these pages[3] on the bizarre state of affairs markets currently find themselves in: bad economic news = increased probability of interest rate cuts = good news for equities. Consensus expectation is for more rate cuts (both in the US and Australia, as well as in other parts of the world). So does this mean equity markets will continue to scale new highs?

We are of the opinion that over the next year real economic performance will take over from interest rates as the fundamental driver of sharemarkets. However, in a way this just moves the question one step further: will central banks' policy of lowering interest rates succeed in staving off a potential recession? Here we actually are a bit different from the generally accepted view, in that we



Source: Rosevalley

[3] See our portfolio report for June

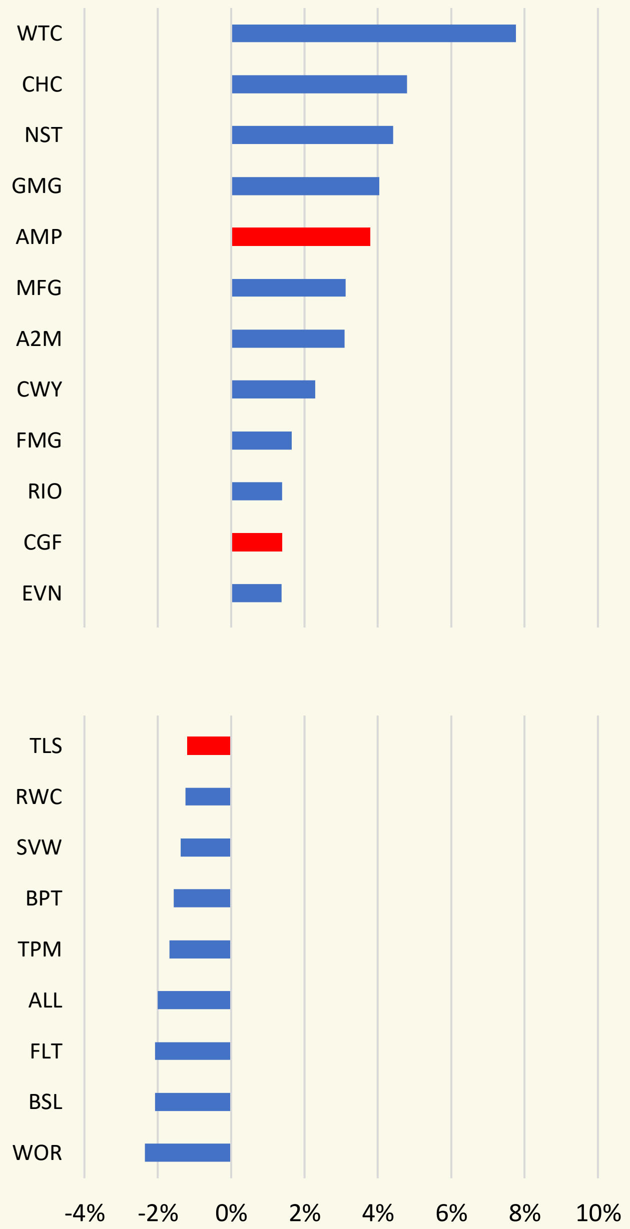
are not convinced that this recession that everybody seems to expect is coming, with or without central bank intervention. We will make just these two points here:

- One of the main arguments for the coming recession seems to be that the current US expansion is now the longest on record, and therefore a "recession is overdue". This argument appears to us to be nonsense, for a number of reasons:
  - As the old adage goes: Expansions don't die of old age, they are killed off, usually by central banks raising rates. Central banks are currently not raising rates, nor are they going to be in the near future.
  - Other countries have had expansions much longer than 10 years (the Netherlands and Australia being the prime examples).
  - While the current expansion is the longest on record, it also the slowest-growing on record – meaning that the total growth from trough to peak where in the past the expansion ended, has not been reached yet (by quite a margin).
- It appears to us that the mood around the world is one of anxiety and carefulness, rather than exuberance. This lack of exuberance suggests to us that the excesses usually present toward the end of the cycle, that lead to the end of the economic expansion, are not present today.

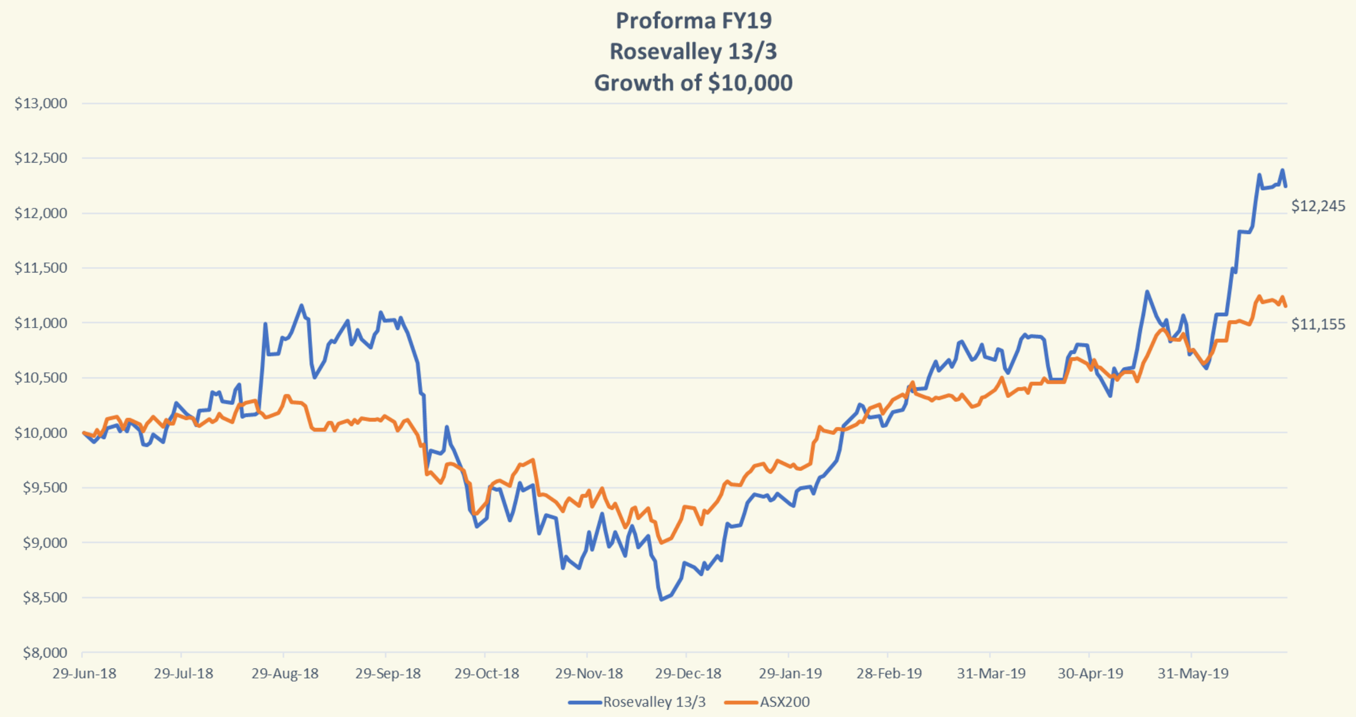
Of course, there are many who would disagree with us, some of whom are more expert and/or experienced than we are. However, many years of investment experience have taught us that economic forecasting is a very inexact science, and that even the best experts get it wrong frequently. More importantly, there is a great deal of the echo chamber effect going around. All of which means that consensus gets things wrong all the time!

Among all the uncertainty in the world, we believe one thing remains unchanged: people's behaviour. Since the Rosevalley portfolios are built to take advantage of how people behave, we are confident that the portfolios will continue to perform well in the coming years.

FY2019 - Contribution by stock, Rosevalley 13/3; top and bottom contributors



Note: shorts in red. Source: 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 hearttake advantage of the way human beings behave in the real world.

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