ROSEVALLEY FUNDS

Portfolio Report February 2020

The Rosevalley Behavioural Finance Funds

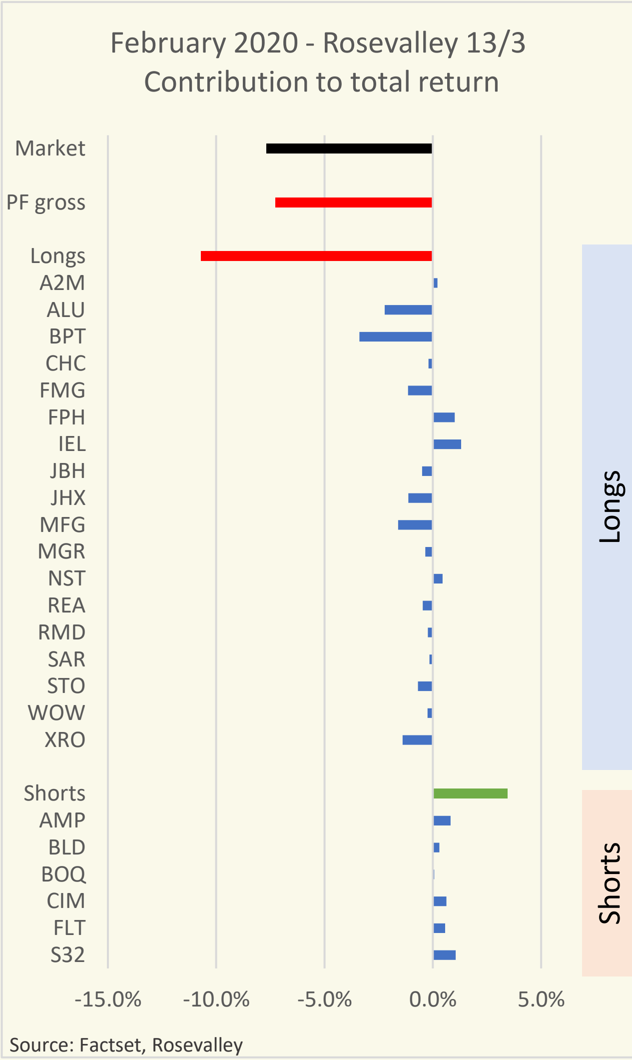
The Rosevalley Behavioural Finance Funds are high-conviction funds that take the theoretical and empirical evidence developed over the past 30 years in Behavioural Finance, and systematically build portfolios from these learnings. The portfolios are constructed on a benchmark-unaware basis, but performance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

Rosevalley is looking for a Sponsor

As most readers are probably aware, the Rosevalley Behavioural Finance Funds are currently run in "Proof of Concept" mode. Of the three portfolios discussed in these monthly newsletters, two (the 15/5 and 10/0) are run with actual money in two different broker accounts, while the third one (the 13/3) is run as a "paper portfolio" with the same broker. The idea is to establish a paper trail that shows the validity of the strategy and that can be independently verified.

The monthly newsletters reflect the purpose of the exercise. The comments on gross vs net, execution, trading costs, etc. reflect the goal of establishing credibility both with regard to the strategy itself and the practical implementation of it. The publication of the full portfolio result of the previous month (which no fund manager would normally do) further serve to create the possibility of independent verification.

We are currently looking for a sponsor to enable us to continue to build out our track record. We are keen to meet with potential clients interested to sponsor these strategies and /or invest alongside us.



Key Events February

Normally, in the February portfolio report we would be talking about reporting season – what companies surprised on the upside and downside, and how the market responded to that. However, February 2020 has proven to be anything but normal! As we discuss below, it was not company earnings that drove markets, but the outbreak of COVID-19.

This was the opening sentence of January's report: *'January 2020 should probably become known as "the month that showed Australian investors just don't care". In spite of seemingly sky-high valuations (more about that later), massive bush fires, Trump's impeachment, the outbreak of the Wuhan coronavirus, and lacklustre markets around the world, the Australian market was up 5%.'*

Perhaps too many investors read the report and agreed! In the last week of February, as the number of people infected with COVID-19 (now the official name for the disease) increased around the world (including, crucially, outside of China), investors decided that they did care after all, and markets sold of sharply. The Australian market was down 7.7% for the month. The Rosevalley portfolios fell as well, with one slightly better and the others slightly worse than the market.

The sell-off fully occurred during the last week of the month:

Performance as of February 2020								
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	-7.3%	5.5%	-2.9%	27.8%	17.5%		
	Net	-7.7%	4.9%	-3.3%	25.0%	14.4%		
Rosevalley 15/5	Gross	-8.2%	4.9%	-6.3%	23.5%		18.6%	
	Net[1]							
Rosevalley 10/0	Gross	-9.8%	0.4%	-2.6%	20.1%			26.1%
	Net	-8.9%	-0.4%	-4.9%	10.5%			6.3%
ASX-200		-7.7%	-5.2%	-0.6%	8.6%	9.7%	9.5%	9.9%

Source: Rosevalley, Factset. Note returns are not audited. [1]Rosevalley 15/5 was not actively traded during the month, so no net numbers are available.

February 2020			
	First three weeks	**Last week**	**Full month**
MSCI World	3.4%	-11.1%	-8.1%
S&P 500	3.6%	-11.4%	-8.2%
DJIA	2.6%	-12.4%	-10.1%
FTSE100	2.0%	-10.8%	-9.0%
DAX	4.6%	-12.4%	-8.4%
Hang Seng	3.8%	-4.0%	-0.4%
ASX200	2.0%	-9.5%	-7.7%

Source: Factset

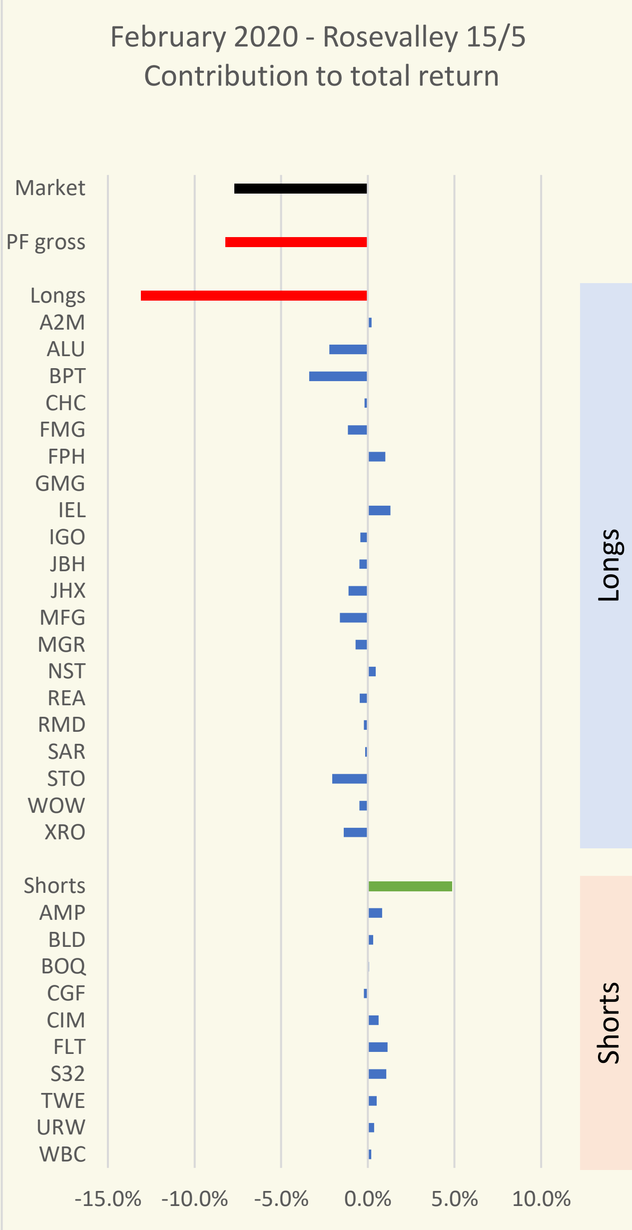
Predictably, the headlines were screaming. “$1.5 trillion dollar wiped off stockmarkets”, “Worst week since the GFC”, “Markets in correction territory”, and so on.

To us, what was surprising was not the sell-off in the last week of the month, but rather the continued positive performance in the first three weeks. Wasn’t it obvious by the end of January that this virus was going to spread all over the world? Particularly after it became clear that people are infectious before they are symptomatic? To us, this is another proof point that markets are not rational (efficient), but rather are driven by emotion, herd mentality, and a host of other biases (as if proof was needed). See here for an interesting article about how our behavioural biases make it hard to respond rationally to an event like the COVID-19 outbreak. The article argues, among other things, that as a result of a trait called “saliency bias”:

> *“First, people tend to underreact before the outbreak of a new infectious disease and overreact when the outbreak occurs: they are complacent before an outbreak and too fearful during an outbreak.”*

We concur – and believe the last week of February was the beginning of the phase of overreacting.

At the current time, investors around the world are asking themselves two main questions:



Source: Factset, Rosevalley

1. When will the outbreak be over?
2. When will markets start to discount the fact that the outbreak is over?

The answers to these questions, of course, are meant to inform the investor of the right time to start buying again. The irony is that investors are not very well equipped to answer the first question. As a result, we can expect some volatility ahead, as markets are likely to respond quite aggressively to relatively minor pieces of news (the next country with a new case, the daily case count going up and down, a promising candidate for a vaccine found, etc., etc.). We are no virologists or epidemiologists, so we are not qualified to answer the first question. As to the second question, we find it very intriguing that Hong Kong was the best performing market among the six listed above, both for the month and for the last week of the month. Is this a tentative suggestion that markets will start to turn as soon as new cases have been on the decline for a couple of weeks?

As always, we are not changing our approach. We believe that even in the chaos of a wide, indiscriminate sell-down people's behavioural biases stay the same, and the Rosevalley portfolios will continue to take advantage of those.

Portfolio performance

The Rosevalley portfolios had a mixed performance, with Rosevalley 13/3 and 15/5 showing a small out- and underperformance respectively, while Rosevalley 10/0 underperformed by a bit over 200 bps. As would be expected, the underperformance came totally from the longs, with Beach and Altium the worst contributors. On the short side the positive contribution was well diversified.

Longer term performance

On a gross basis, all three portfolios continue to be significantly ahead of the benchmark on a 3-month, 1-year and since-inception basis.

Execution

Execution was positive this month, with the realized gross-net gap smaller than modelled.

	Model	Realized
Gross performance	-7.26%	-7.26%
deviation from model portfolio		0.00%
difference between trade price and end-of-previous-month price	-0.40%	-0.31%
trading costs	-0.21%	-0.07%
borrow costs	-0.13%	-0.01%
rounding		-0.02%
Net performance	-8.00%	-7.66%

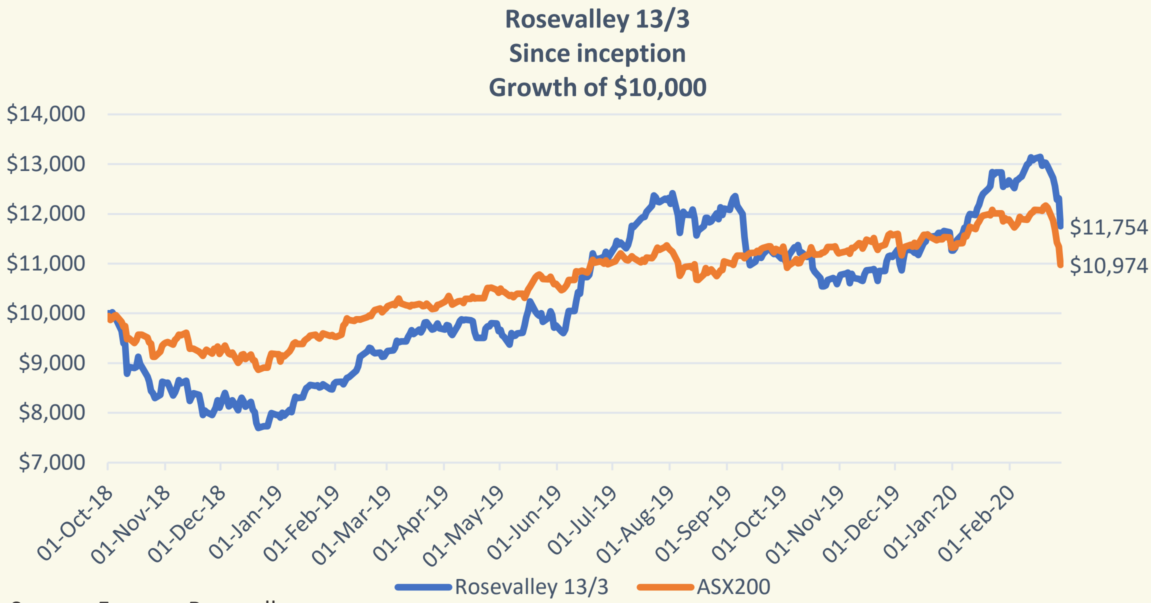
March portfolio – portfolio manager model overrides

The portfolio for March has more substitutions than usual: Rosevalley 13/3 sees 3 longs and 1 short replaced, while Rosevalley 15/5 has 3 longs and 2 shorts replaced:

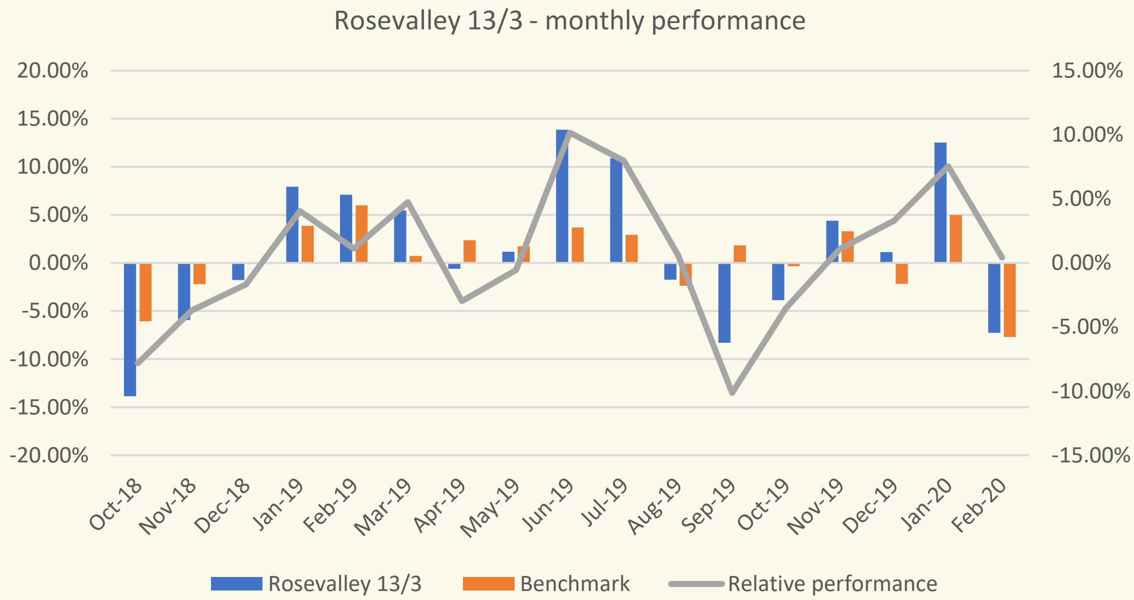
	13/3	15/5
Longs taken out	CSL, NST, SAR	CSL, NST, SAR
Replaced by	GMG, WOW, SDF	SDF, CCL, QBE
Comments	All substitutions were entirely driven by the avoidance of sector concentration.	
Shorts taken out	S32	S32, FLT
Replaced by	WTC	TWE, OSH
Comments	All substitutions were driven by the lack of available shorts.	

Looking ahead

In a word, more volatility. It doesn't take a genius to say that the coronavirus will dominate headlines and market movements over the next month. One interesting thing in this context is how the US presidential race (or, more accurately for the time being, the Democratic nomination race) will influence markets. It seems pretty clear that markets do not favour Bernie Sanders or Elizabeth Warren. It's less clear how ebbs and flows of the other candidates' fortunes might impact markets, or indeed if there is any effect at all, given the overarching concerns around the coronavirus. We'll be watching with great interest!



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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