ROSEVALLEY FUNDS

# Portfolio Report March 2020

**The Rosevalley Behavioural Finance Funds**

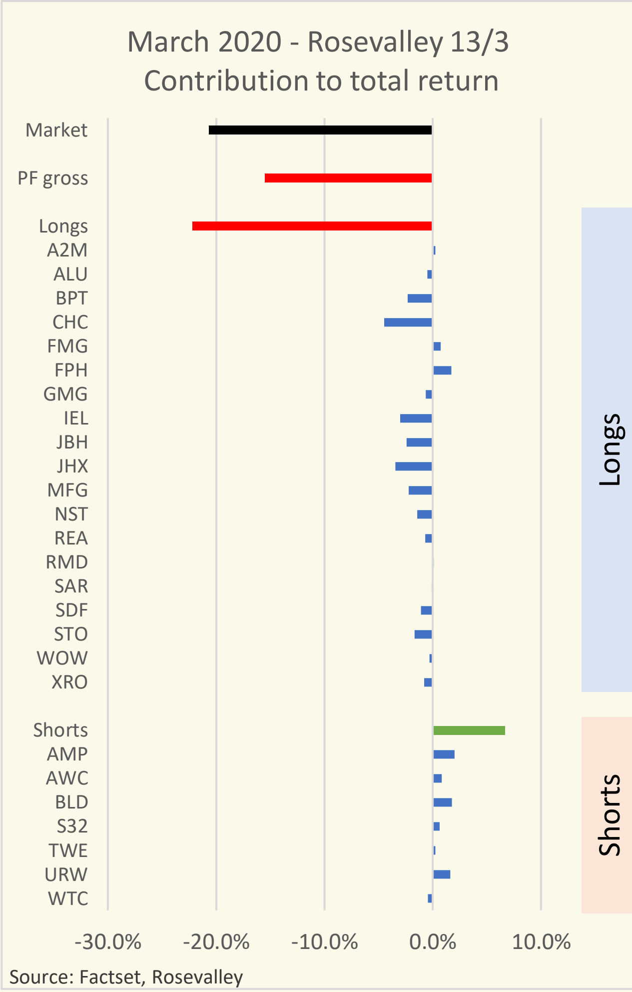
The Rosevalley Behavioural Finance Funds are high-conviction funds that take the theoretical and empirical evidence developed over the past 30 years in Behavioural Finance, and systematically build portfolios from these learnings. The portfolios are constructed on a benchmark-unaware basis, but performance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

*First-time readers of this report, please refer to the blue box at the end for added context and history*

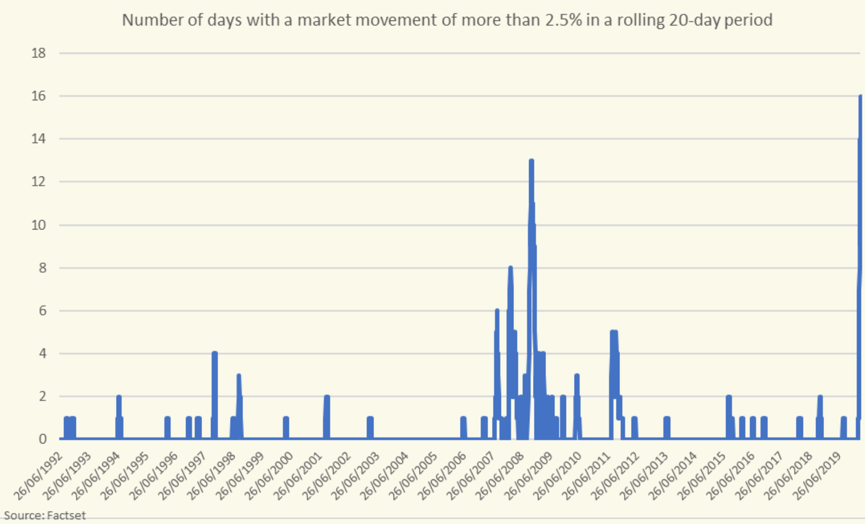
## *Key Events March*

As we write this under social distancing rules, surely the first thing to say is how lucky we are that we ourselves as well as our families are fine. Many are not so lucky, and our hearts go out to them. We wish all readers good health and hope for a speedy end to the current crisis.

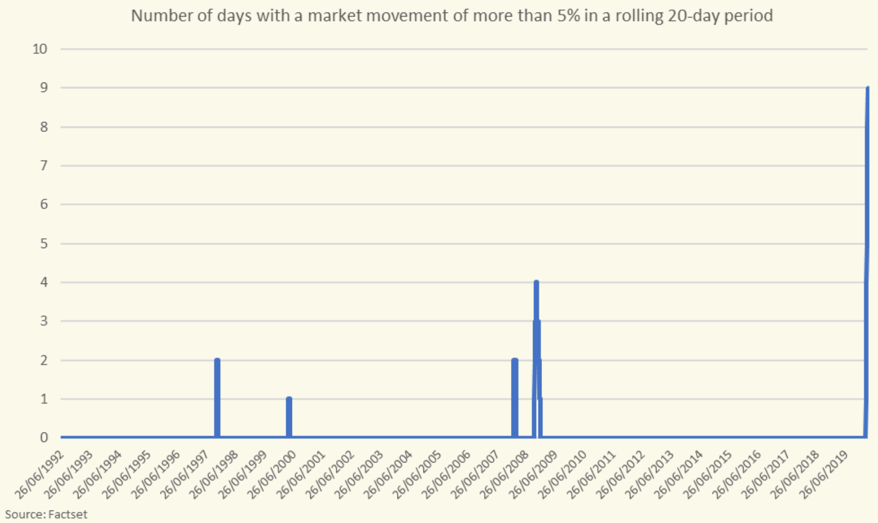
Turning from there to markets, we were struggling for the right opening to describe the markets in March 2020: "Unprecedented"? Seen it too many times in the papers this month... "Wild swings"? Doesn't begin to describe it... "Armageddon"? A tad too dramatic... Maybe with a nod to the Millennial generation: "OMG! OMG!"? A bit cheesy perhaps…




We wrote last month that volatility was what we were expecting for March. It was an easy prediction to make, and honestly, we didn't know how right we would turn out to be! It was a market responding wildly to any bit of news, or indeed no news at all. It is hard to grasp how truly exceptional March was. One way we try to show this is using the two charts below. The first one shows the rolling 20-day total of market moves greater than 2.5% (up or down), since the ASX200 index was constituted in 1992; the second chart shows the same for market moves greater than 5%. Both charts give a good idea of how exceptional the daily moves in March were. Consider this statistic: Inception of the ASX200 index was in May 1992, 18 years ago. Since then there have been over 7,000 trading days. Of those, 20 saw a movement greater than 5%. Of those 20, fully 9 occurred in March 2020!




Our approach, as usual, is looking at these events through a Behavioural Economics/Behavioural Finance prism. Many well-described human traits and biases, e.g. availability heuristic, confirmation bias, framing effect, selective perception – were all on display both in the markets, and in the wider society this month. Consider the example of loo paper hoarding. Why do we do it? Our rational brains know there is no shortage of toilet paper. But what happens when we see other people leave the supermarket with trolleys stacked high with toilet paper? Our brains tell us there is scarcity, and with scarcity comes risk. And we like to avoid risk as much as possible[1].




Likewise, stock markets around the world showed "irrational" behaviour as investors jumped from an end-of-the-world view to there's-light-at-the-end-of-the-tunnel and back, on some days even within one day! Note that this appears to us more proof that markets cannot be described as "efficient": surely the future value of cash flows did not jump up 10% one day and down 10% the next? Investors were really jumping at shadows!

"Investing is simple, but not easy", according to Warren Buffet. Truer words have never been spoken. One of the hard things in investing is resisting the urge to do something all the time – especially in times of crisis. The hardest thing to do, is to do nothing. But doing nothing is usually the right thing to do!

We have seen these forces at work many times and in many places over the course of a long career as a professional investor. And in fact, we feel the same forces tugging at our own brains. This is one of the reasons that the Rosevalley portfolios were designed for a monthly rebalance without intervention in the interim. Yes, the portfolios will show underperformance at times, and we may feel regret for not having done that obvious thing we could have done (but usually only obvious in hindsight) – but the long-term performance will be better for it!

Professor Daniel Kahneman of Princeton University (one of the founding fathers of Behavioural Economics) writes about the Focusing Illusion, which holds that "nothing in life is as important as you think it is while you are thinking about it." We're not sure what he had in mind when he wrote this, but we think it applies here: in the current investment climate, one tends to think about the effects of coronavirus pandemic on share prices, to the exclusion of everything else. A good investor will endeavour to look through the crisis and ask him/herself what else is important in determining the true value of a company. (Of course, the Rosevalley portfolios' success depends exactly on people not doing that!)

Speaking about the Rosevalley funds: at the start of the month we knew we would be watching with interest to find out if people's behaviour would change under the extreme circumstances that the month presented. Or alternatively, whether perhaps margin calls and cash needs would drive investment decision in a different pattern than usual. As it turns out, the portfolios, while down (hard to avoid if fully invested in a market that's down 21%), outperformed the market 500-600 bps. A worthwhile performance that we're very happy with!

Australia's market was at the bottom of the global markets we track for the month. It was interesting to see that, just like in February, Hong Kong was the best market on this list – perhaps there is a glimmer of hope for battered investors that the Australian market might start to do better as soon as the infection numbers have started to decline?

| | **March 2020** |
|---|---|
| MSCI World | -13.1% |
| S&P 500 | -12.4% |
| DJIA | -13.7% |
| FTSE100 | -13.4% |
| DAX | -16.4% |
| Hang Seng | -9.7% |
| ASX200 | -20.7% |
| Source: Factset | |

We thought about including a calendar of pandemic-related events in this report – but quickly realized events have been moving too quickly for this to be practical. The number of travel advisories, travel bans, social distancing rules, business closures, border closures, lockdowns – all in the month of March, was just staggering.

Where to from here? We're sorry to have to say this, but the true answer is: We don't know. We just don't know. But perhaps more importantly, we don't think anyone else knows either. Beware the peddlers of snake oil! There could be a medication available soon (several are in testing phase), or not. Restrictions on movement could be lifted soon, or not. When they do get lifted, lost jobs could quickly be regained, or not. We do have an opinion, and

[1] Note: this is one of many BE-inspired descriptions of the toilet hoarding behaviour. There are other ways to explain it – this article, e.g. describes toilet paper hoarding in terms of the Prisoners Dilemma. The point here is that it is a stark example of behaviour that doesn't make sense when put under a rational microscope.

| Performance as of March 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 | -15.5% | -11.8% | -10.5% | 2.4% | -0.7% | | |
| | Net | -15.7% | -12.5% | -11.4% | -0.1% | -3.6% | | |
| **Rosevalley 15/5** | Gross | -14.4% | -11.5% | -11.6% | -0.3% | | 1.5% | |
| | Net[1] | | | | | | | |
| **Rosevalley 10/0** | Gross | -14.7% | -15.6% | -13.5% | 0.7% | | | 7.6% |
| | Net | -15.3% | -16.9% | -16.0% | -7.7% | | | -10.7% |
| **ASX-200** | | -20.7% | -23.1% | -22.6% | -14.4% | -12.9% | -13.1% | -12.8% |

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.

will share it with you, but be forewarned the confidence in this is very low:

> *We believe the market will bottom in April, and the world economy will pick up later in 2020, which is far faster than many people fear.*

We'll get back to this prediction later in the year and discuss why we got it wrong, or indeed guessed right.

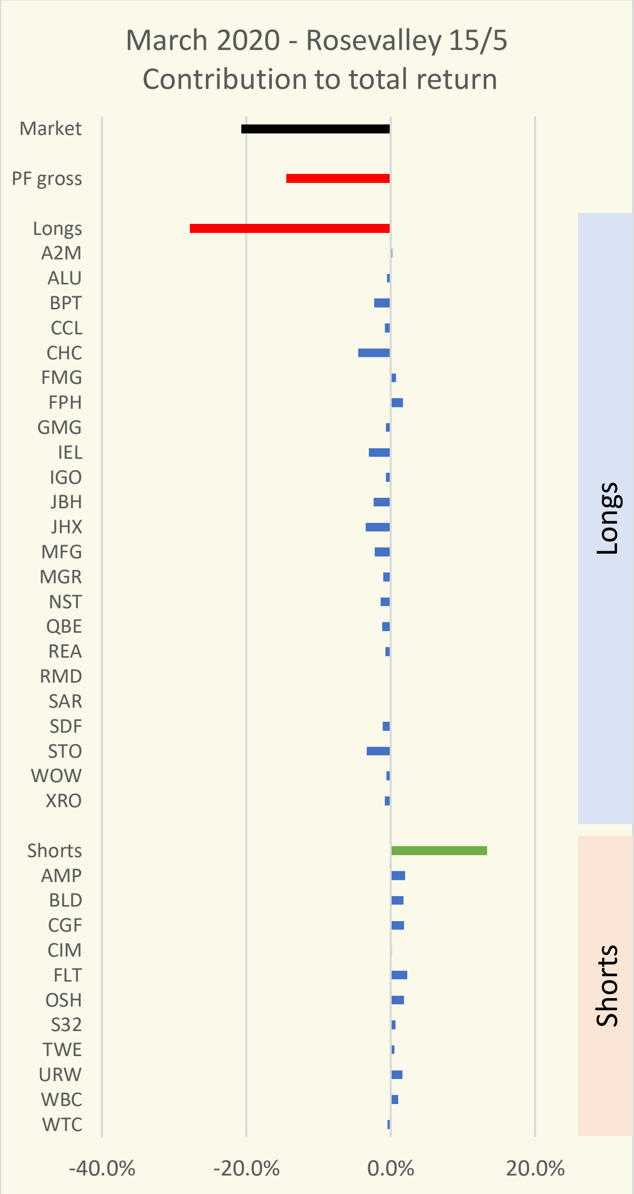
In the meantime, as always, we are not changing our approach. We still believe that even in the chaos of a wide, indiscriminate sell-down, people's behavioural biases stay the same even to the extreme, and the Rosevalley portfolios will continue to take advantage of those.

## *Portfolio performance*

The Rosevalley portfolios had a strong performance this month. While all three portfolios were down, they were down much less than the market. On a gross basis, outperformance ranged from ~500 to ~600 bps across the three portfolios. As would be expected, most longs detracted and most shorts contributed (see contribution charts). Interestingly, however, even Rosevalley 10/0, which is a long-only portfolio, outperformed by 600 bps.

## *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.



Source: Factset, Rosevalley

## *Execution*

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

| | Model | Realized |
|---|---|---|
| Gross performance | -15.49% | -15.49% |
| deviation from model portfolio | | 0.13% |
| difference between trade price and end-of-previous-month price | -0.76% | -0.06% |
| trading costs | -0.22% | -0.07% |
| borrow costs | -0.13% | -0.01% |
| rounding | | -0.23% |
| Net performance | -16.59% | -15.72% |

## *April Portfolio Manager model overrides*

The portfolio for April has no substitutions, which is slightly unusual. In most months, the portfolio manager will make some changes to the model-proposed portfolio based on sector concentration (risk), lack of available shorts (execution), or M&A situations (believed to be not captured by the model). The model proposes that the month of April has a 30% exposure to Health Care stocks. Under normal circumstances this would prompt a substitution to bring this concentration down. However, given the coronavirus crisis, for the time being it was decided that we are quite comfortable with this above-normal exposure to the Health Care sector.

There was another decision that needed to be taken this month. The model has a mechanism for downside protection built in, that gets triggered in the event of a quick market downturn, and the modelled response is to decrease market exposure and hold part of the portfolio in cash. This month was the first time since inception this trigger got activated. The portfolio manager used his discretion and decided not to activate the cash option. This decision was based on the Health Care exposure as mentioned above, plus the perceived risk that the market may bottom out sooner than generally expected.

## *Looking ahead*

In a word, more volatility. Wait, didn't we say that last month? Indeed, we did, and we were right. We expect to be right again for April. Until there are clear signs the pandemic is abating, this is going to be the pattern.

We mentioned the US presidential race a month ago. Do you remember Bernie Sanders was still in the race? Do you recall Super Tuesday? It seems like a lifetime ago. Anyway, with Joe Biden's nomination as good as certain, all eyes are now on how Trump handles the coronavirus crisis, as this will likely greatly influence his chances of re-election. But beware: this works both ways. E.g., if, let's say, a cure is found, and Americans can move around freely by October, Trump's re-election chances will look pretty good at that point.

**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, and the full portfolio holdings for the following month (which no fund manager would normally do) further serve to create the possibility of independent verification.

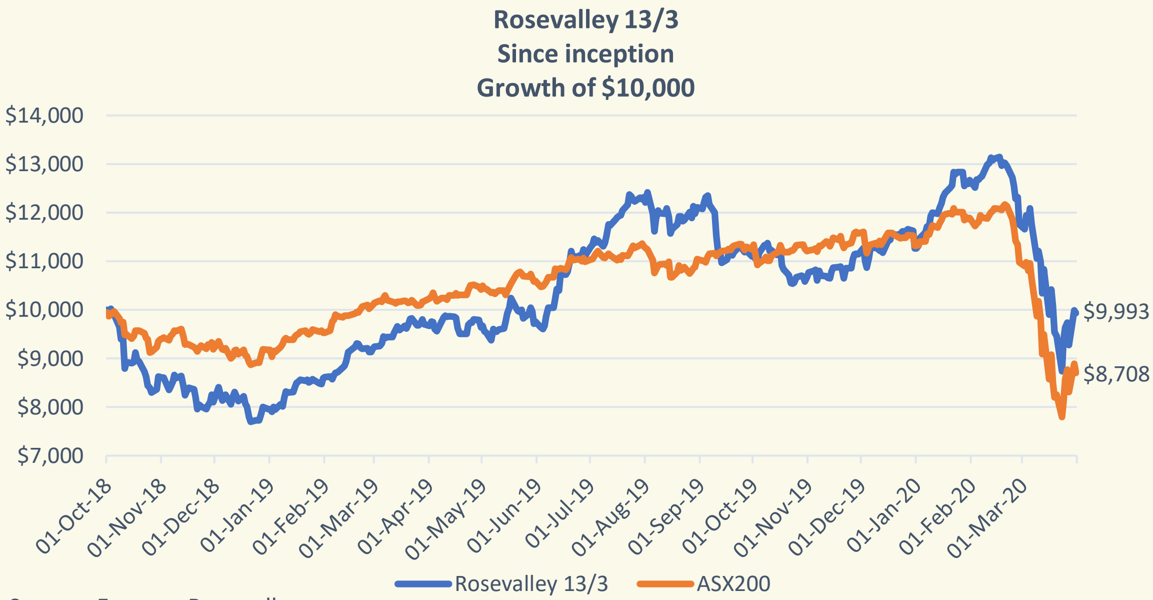
We are currently looking for a sponsor to enable us to continue to build out our track record. We are keen to meet with potential clients interested to sponsor these strategies and /or invest alongside us.

*Some context for readers who are less familiar with Rosevalley Funds:*

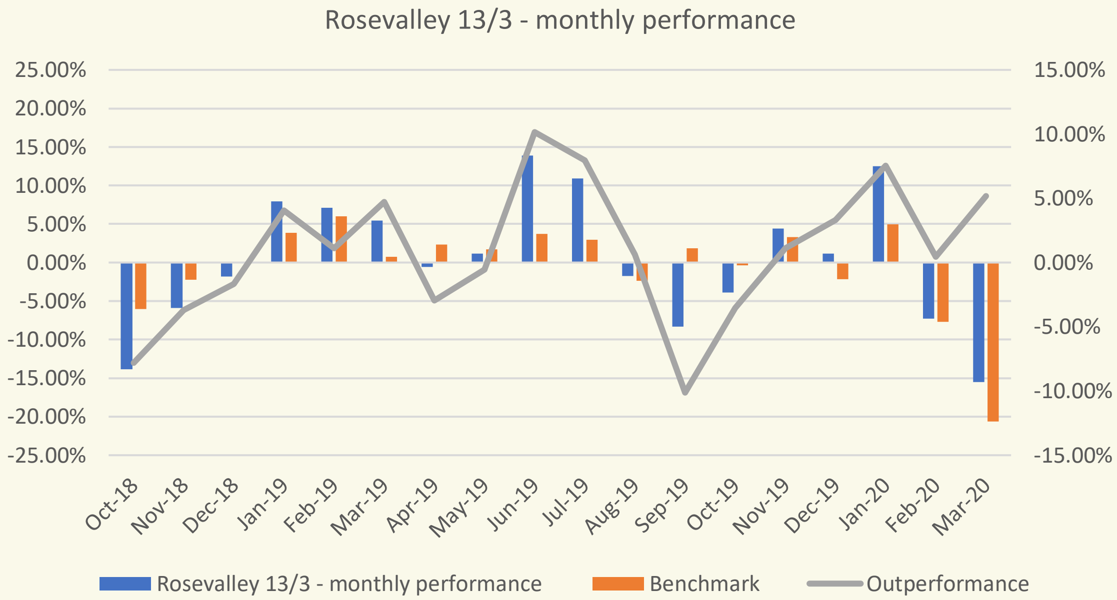
*Rosevalley is a boutique funds manager with a unique approach to portfolio construction. Rosevalley Funds are constructed using the principles of Behavioural Finance (BF). Behavioural Economics and Behavioural Finance were developed over the past 30 years or so through the work of economists like Tversky, Kahnemann, Thaler, Shefrin. The idea behind BF (and the Rosevalley portfolios) is to study human behaviour as it is, not as classical economic theory says it should be (i.e. BF does not believe humans are always rationally maximizing their utility). Rosevalley's portfolio construction algorithms are based on these insights. The model yields a ranking of stocks in order of greatest to smallest upside. Portfolio construction then follows by going long the stocks at the top and short the stocks at the bottom. The flagship product is Rosevalley 13/3, which is a 130/30 fund. We also run a 150/50 (Rosevalley 15/5), and a long-only fund (Rosevalley 10/0). Inception for the three portfolios was during August-October 2018.*

*The portfolios are rebalanced monthly. The Rosevalley team has discretion to make some substitutions, albeit that the bar for those is set high.*

*The monthly report discusses current events, portfolio performance, trade execution, gross-net differences, next month's portfolio, and broader market and macro expectations.*




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.




info@rosevalleyfunds.com
+61-457-807-914
www.rosevalleyfunds.com