ROSEVALLEY FUNDS

Portfolio Report May 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

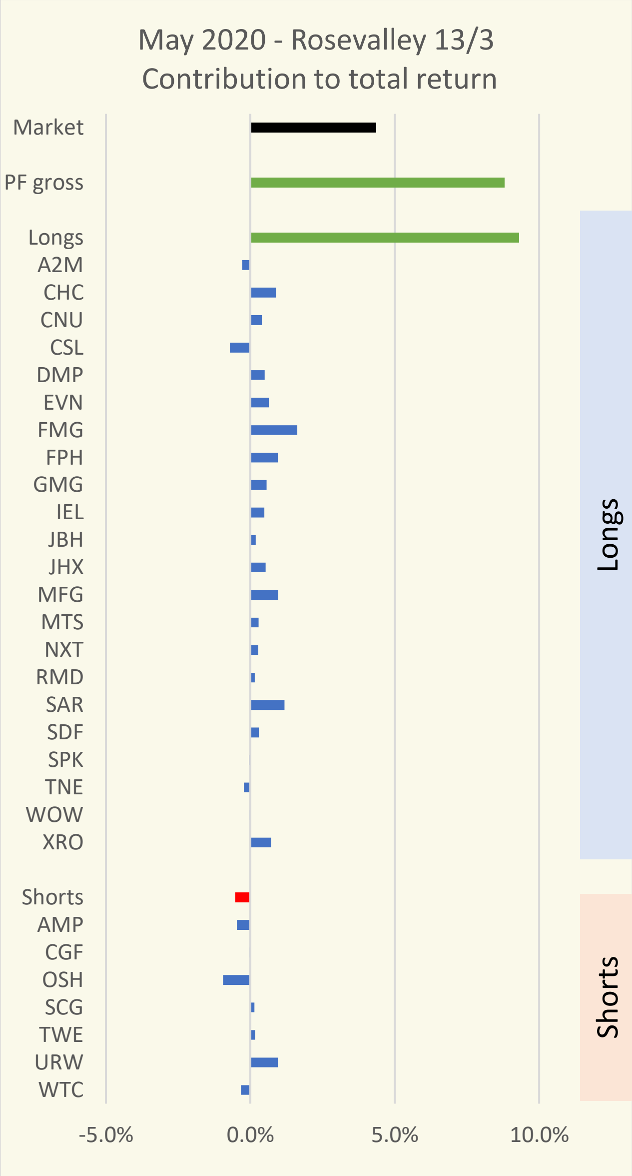
Key Events May

As we are slowly coming out of lockdown, we hope all our readers are safe and healthy. We hope the return to (what will hopefully pass for) more normal times will be rapid and smooth.

During the month, stock markets around the world continued their upwards march, to the surprise of many investors. Of the markets we track, only Hong Kong declined – this clearly in response to renewed unrest after China announced and then approved a new security law that is likely to restrict the freedoms of Hong Kong's inhabitants (and is described by some as the end of Hong Kong's autonomy).

	May 2020
MSCI World	4.5%
S&P 500	4.8%
DJIA	4.3%
FTSE100	3.3%
DAX	6.7%
Hang Seng	-6.8%
ASX200	4.4%

Source: Factset



Source: Factset, Rosevalley

We say "to the surprise of many investors" in reference to the fact that the economic data that came out during the month was not just bad, but bad on a scale that is hard to comprehend. Just to name a few:

- In the US a quarter of the working population has now been stood down or laid off. Second quarter GDP will show the worst quarter-on-quarter contraction in recorded history, and this will likely be true for many countries.
- While China has mostly opened up, its factories are not ramping up production as fast as some had hoped.
- For the first time in decades, China did not publish a targeted GDP growth rate.
- Singapore trade downgraded to an expected 9-12% decline for 2020.
- The Bank of England projected a 14% contraction in GDP for 2020.

It appears the stock market is looking through all of this, and is pricing in a strong recovery with things going back to almost normal within 12-18 months or so. It is hard to

Performance as of May 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	8.8%	0.8%	6.3%	21.4%	18.4%		
	Net	7.3%	-1.1%	3.0%	16.3%	12.3%		
Rosevalley 15/5	Gross	10.1%	1.4%	6.4%	20.3%		20.2%	
	Net[1]							
Rosevalley 10/0	Gross	5.3%	-1.1%	-0.7%	12.6%			24.7%
	Net	2.9%	-6.1%	-7.2%	0.3%			-1.0%
ASX-200		4.4%	-9.9%	-14.6%	-6.7%	-1.1%	-1.4%	-1.0%

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.

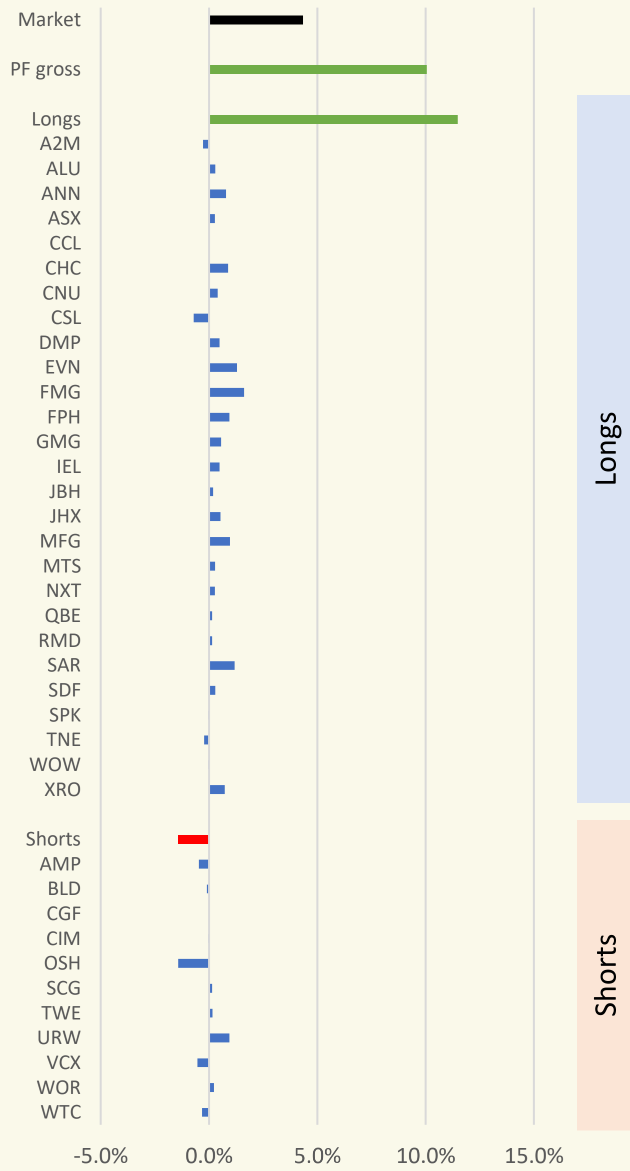
find an economist who would agree with this outlook for economies around the world.

While Australia was not the best performing market in the table above, perhaps it should have been: in spite of what we mentioned above, toward the end of the month it emerged that the economic downturn the economy is going through might be much less severe than feared. The government's JobKeeper program turned out to be covering only 3.5m workers, rather than the expected 6.5 m. This in turn means the risks to the economy when the program runs off in September are much smaller than feared. The market reaction to this news could be seen especially clearly in the sector performance over the last two weeks of the month: the hardest-hit sectors bounced the most (see chart on next page).

We are not the only ones writing about current markets. The co-chairman of Oaktree Capital Management, Howard Marks, writes and publishes memos to clients that are widely followed. In the past month he published two: Uncertainty, and Uncertainty II. We would strongly encourage you to read those (and to subscribe to the memos here). Marks is arguing strongly that the future is unknowable. Not only that, but he also argues that humans are poorly equipped to deal with this state of affairs – a statement that could have come straight from a Behavioural Science textbook[1]: the human mind hates uncertainty, sees patterns where there are none, and craves order and understanding. This explains the proliferation of forecasters in the world: as Marks says (quoted from another source), "Forecasts create the mirage that the future is knowable".

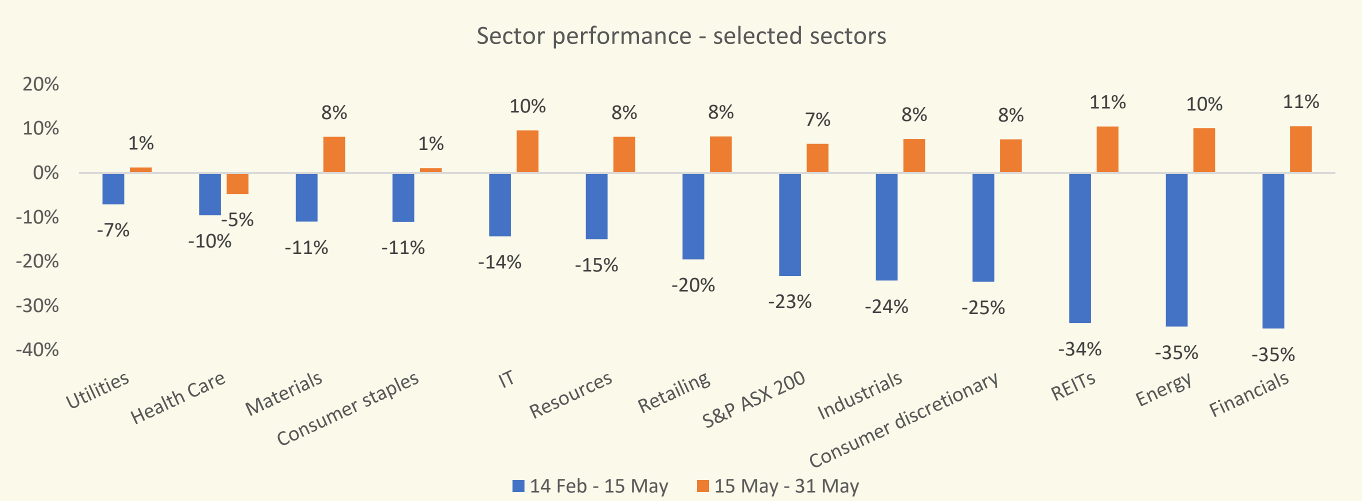
We wholeheartedly agree with Marks on all the points he makes in both memos, and we have made some of these points on these pages before. Which isn't to say we don't have opinions, and don't have our own crack at forecasting the future. We do, however, try our best to keep a healthy dose of skepticism around our own pronouncements. We do differ with Marks in one crucial aspect, though. *We believe there is one thing in the world that is entirely predictable: human behaviour.* This may

May 2020 - Rosevalley 15/5
Contribution to total return



Source: Factset, Rosevalley

[1] Of course, the very fact of us quoting these memos here is Behavioural Science in action itself: the well-known Confirmation Bias, to which we are not immune, leads us to remember (and quote) things we agree with, and forget things that conflict with our pre-existing beliefs. Or, as Paul Simon said in "The Boxer": "A man hears what he wants to hear and disregards the rest" (quote borrowed from Marks' memo).



Source: Factset, Rosevalley

sound counterintuitive: what can be more unpredictable than human behaviour? However, as Behavioural Science teaches us, human behaviour is subject to systematic biases. These are by their very nature predictable. Rosevalley's portfolios therefore are expected to perform both in a hard-to-predict world (as we are currently in), as well as in more normal times.

Portfolio performance

The Rosevalley portfolios did very well this month: on a gross basis they returned 5.3-10%, delivering outperformance of ~100-600 bps. As one would expect, in aggregate the long positions contributed, and the shorts detracted. Positive contributors included:

- The long position in gold miner SAR (up 17.7%), which followed a strong gold price up in spite of this being a "risk-on" month.
- The long position in iron ore miner FMG, which went up 16.2% as the price for iron ore increased on more optimism around the global economy coming out of lockdown, as well as concerns that major Brazilian miner Vale may have production difficulties in light of that country's severe COVID situation.
- The long position in medical device maker Fisher & Paykel (FPH), which went up 9.5% on its positive leverage to the end of the lockdown.
- The short position in URW (down -14.3%), as concerns around commercial real estate values and excessive balance sheet leverage saw investors fleeing this stock.

Negative contributors that stood out were:

- The long position in CSL (down 10.7%), which suffered from a strong rotation from winners into laggards in the last week of the month.
- The short position in OSH (up 14.1%), which rallied strongly on the improved oil price during the month.

Longer term performance

Both on a gross and a net basis, all three portfolios continue to be significantly ahead of the benchmark on a 3-month, 6-month, 1-year and since-inception basis. In fact, during the month we became aware of some information from the Mercer survey of fund manager performance for the quarter and year to April – based on those reports the Rosevalley funds would rank in the top-10 of fund managers in Australia for both time periods.

Execution

The rebalancing trades at the start of the month were done at unfavourable prices, leading to a wider gross-net gap than modelled. This was slightly offset by lower trading and borrowing costs than modelled.

	Model	Realized
Gross performance	8.80%	8.80%
deviation from model portfolio		-0.07%
difference between trade price and end-of-previous-month price	-0.41%	-1.33%
trading costs	-0.39%	-0.09%
borrow costs	-0.12%	-0.01%
prior month dividends		0.05%
Net performance	7.87%	7.34%

June Portfolio Manager model overrides

The portfolios for June have a few substitutions. The model's list again contains four stocks in the materials sector, three of which are gold miners. We have decided to replace the lowest ranked gold miner with the next (non-materials sector) stock on the list. For Rosevalley 15/5 a similar argument applies to the tech sector.

	13/3	15/5
Longs taken out	NST	NST, ALU
Replaced by	NXT	TPM, GMG
Comments	Sector concentration – for 13/3 the next stock in the list was chosen as substitute, while for 15/5 MIN was skipped (sector concentration) and the next two were added.	
Shorts taken out	S32	S32
Replaced by	IPL	CGF
Comments	In both portfolios S32 was taken out due to the lack of availability of shorts. In both portfolios the next one on the list was chosen as a substitute.	

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.

Looking ahead

As Howard Marks alludes to in his memos, making broad macro or market forecasts is currently especially difficult, given the number of never-before-seen forces interacting with each other. Still, our best guess (and that's what it is, a best guess) is as follows: Newsflow over the next 1-2 months will be dominated by stories about economies opening up and progress towards medicines and vaccines. This will keep markets performing, or at least not going back to bear territory. However, over a 6-month time horizon it is likely there will be more newsflow of secondary waves, failed vaccines and economic pain as government support programs come to an end. At that point markets are likely to struggle more. Whether or not there will be a severe downturn will depend on how governments and central banks around the world deal with the unfolding scenarios.

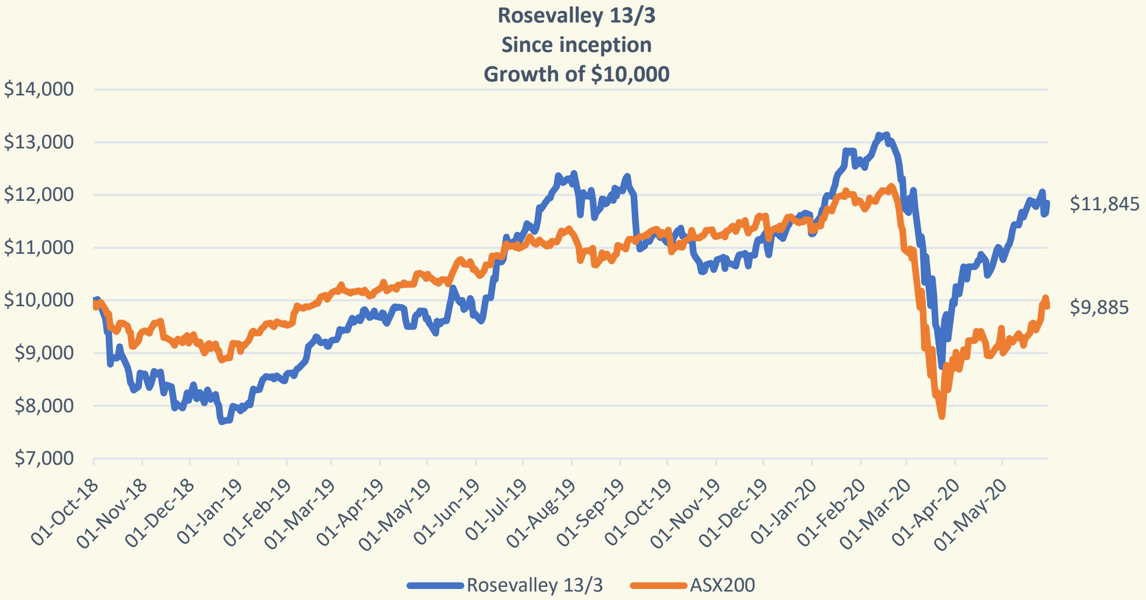
"Hope springs eternal" we said last month. A positive view certainly got rewarded in May. Let's hope it will again in June.

Rosevalley is looking for a Sponsor

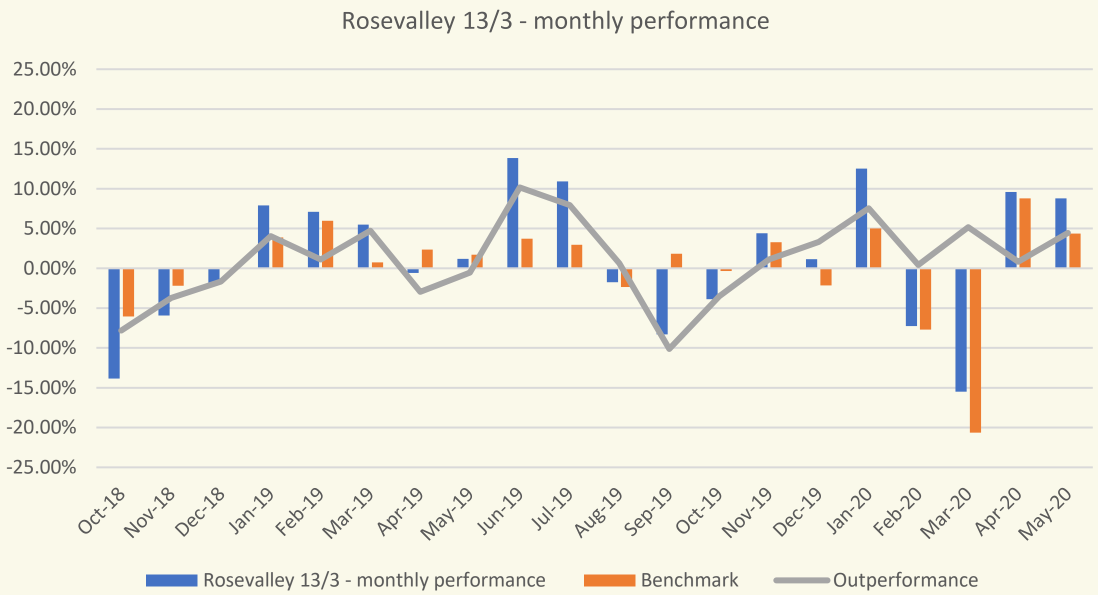
As most readers are probably aware, the Rosevalley Behavioural Finance Funds are currently run in "Proof of Concept" mode. Of the three portfolios discussed in these monthly newsletters, two (the 15/5 and 10/0) are run with actual money in two different broker accounts, while the third one (the 13/3) 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.



Source: Factset, Rosevalley



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