ROSEVALLEY FUNDS

Portfolio Report August 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

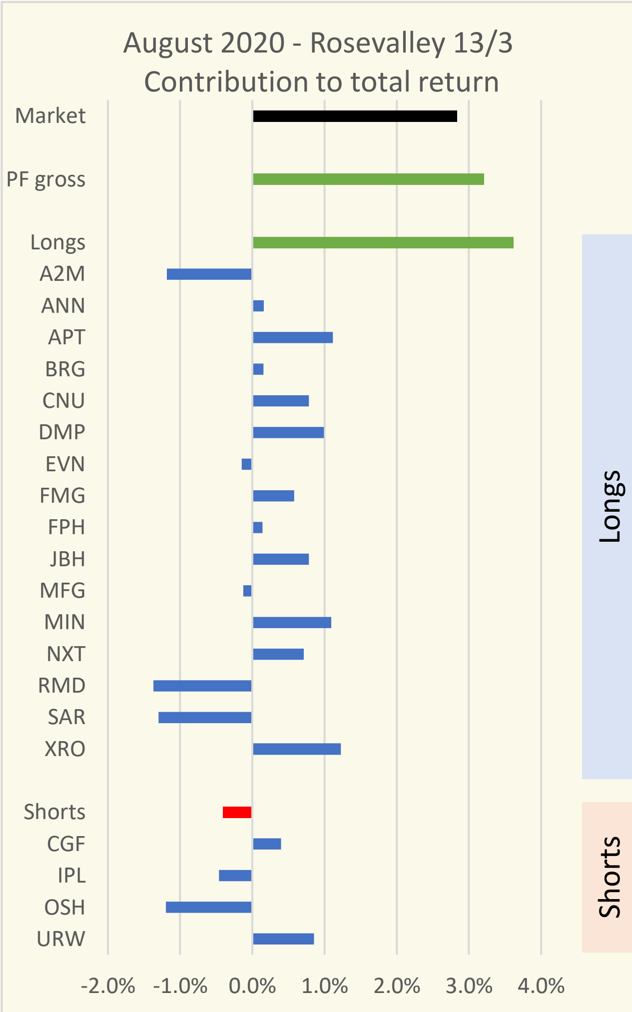
Key Events August

August is reporting season in Australia, with the majority of companies having a fiscal year-end of June 30. Overall, the latest results can be characterised as “in-line”, with around one-third of companies each missing, beating, or being in-line with expectations. It needs to be said that in the lead up to reporting, many companies adjusted their guidance downwards, so that the “in-line with expectations” happened with reference to a diminished expectation compared to a few months ago.

Having said that, the two sectors that performed the best were Materials and Consumer Discretionary. Materials did well because commodity prices have been strong over the first six months of 2020 – in particular iron ore (due to a combination of tight supply with the third biggest producer in the world, Vale in Brazil, placing some of its mines off-line, and strong demand coming from some of China’s stimulus measures). Consumer Discretionary benefited from the government’s stimulus package put in place since the pandemic – most notably JobKeeper and JobSeeker, which put cash in people’s hands.

August also saw the Democratic and Republican conventions in the US. The messages coming out of these were entirely predictable: the Democrats focusing on Trump’s failure to deal with the pandemic, and the Republicans focusing on Biden’s alleged frailty, the strength of the pre-pandemic economy, and law and order. Judging by the polls, some of the Republicans’ messages have been gaining traction, albeit from a statistics point of view it was always more likely that a 10% Trump win probability was going to move up rather than further down.

Stock markets around the world were strong in August, with Australia’s 2.8% in the middle of the pack excluding the US, which was much stronger:



Source: Factset, Rosevalley

Total return	
	August 2020
MSCI World	6.1%
S&P 500	7.2%
DJIA	7.6%
FTSE100	1.8%
DAX	5.1%
Hang Seng	2.4%
XJO	2.8%
Rosevalley 13/3	3.2%

Source: Factset, Rosevalley. Note: The Rosevalley figures are unaudited.

Performance as of August 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	3.2%	24.2%	25.1%	21.5%	47.1%		
	Net	3.2%	23.1%	21.8%	16.9%	38.3%		
Rosevalley 15/5	Gross	1.9%	23.8%	25.5%	17.6%		48.8%	
	Net[1]							
Rosevalley 10/0	Gross	4.2%	16.6%	15.4%	12.4%			45.5%
	Net[2]	3.2%	12.6%	5.6%	-0.2%			11.4%
ASX-200		2.8%	6.0%	-4.5%	-5.1%	4.8%	4.6%	5.0%

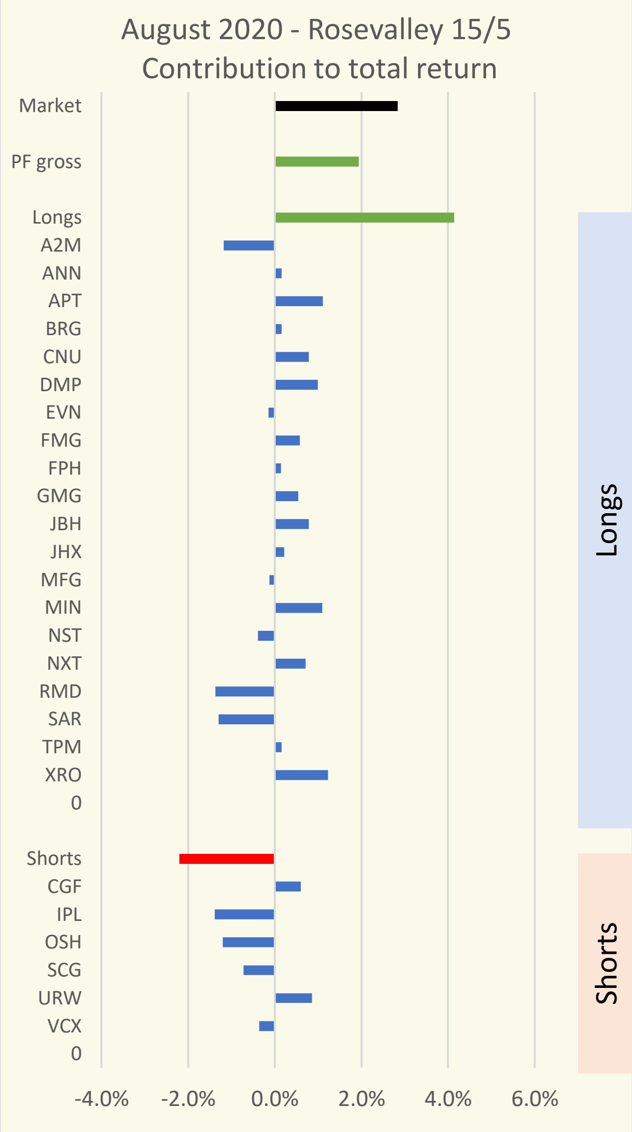
Source: Rosevalley, Factset. Note returns are not audited. [1]Rosevalley 15/5 was not actively traded during the month, so no net numbers are available. [2]Rosevalley 10/0 is traded on a demonstration basis – as a result of its small size commissions are a large proportion of assets, which explains the large gap between gross and net returns.

Portfolio performance

The Rosevalley portfolios had a decent month, with Rosevalley 13/3 and 10/0 outperforming the broader market both on a gross and net basis, while Rosevalley 15/5 slightly underperformed.

For both Rosevalley 13/3 and Rosevalley 15/5 the longs contributed, while the shorts detracted. Positive contribution was broad-based, with 8 stocks contributing around 100 bps each for Rosevalley 13/3.

In line with the results of reporting season, longs in Materials and Discretionary Consumer stocks contributed positively, while the longs in Health Care, Gold, and the shorts in Oil and Chemicals detracted. The notable exception to the reporting season theme was A2 Milk, which reported decent results, but was hurt by comments coming out of China about various potential trade sanctions against Australian companies or products.



Source: Factset, Rosevalley

Longer term performance

Long-term performance continues to look very strong across all time periods for all three portfolios, with realized outperformance running closely in line with the expected 21% gross and 16% net p.a. outperformance.

Execution

The rebalancing trades at the start of the month were done at favourable prices relative to the modelled averages. In addition, both borrow costs and trading costs were lower than modelled, leading to a markedly better net performance than the model would suggest.

	Model	Realized
Gross performance	3.21%	3.21%
deviation from model portfolio		-0.01%
difference between trade price and end-of-previous-month price	-0.69%	0.01%
trading costs	-0.25%	-0.05%
borrow costs	-0.12%	-0.01%
accrued vs paid dividends		0.02%
Reported net performance	2.15%	3.18%

September Portfolio Manager model overrides

The portfolios for September have three and four stock substitutions for the 13/3 and 15/5 portfolios respectively, all driven by sector concentration concerns. For September, the model output is uncharacteristically skewed – for the 15/5 portfolio, IT and Materials would each reach a 50% sector weight before substitutions. There were no substitutes for the shorts.

	13/3	15/5
Longs taken out	APX, CAR, JHX	APX, CAR, JHX, SAR
Replaced by	ANN, GMG, CHC	GMG, IEL, CHC, CWY
Comments	Sector concentration – in both portfolios the next stocks in the list that did not repeat the sector concentration were picked.	

See the appendices for full detail on the list for September.

Looking ahead

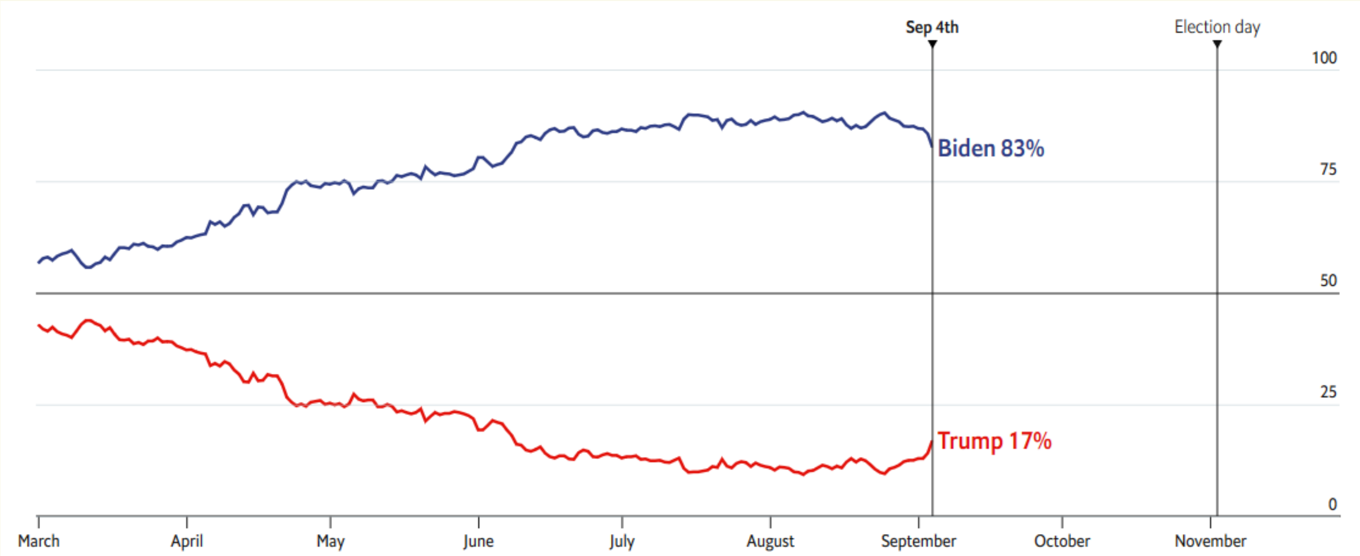
We've noted a marked shift in the political debate in the US: president Trump has (for the time being, anyway), been rather successful at changing the topic of attention away from the pandemic, and towards Law-and-order. We fear (with no apologies for showing our political bias here) that continued success will increase his chances of winning the election. Indeed, as can be seen on the updated version of The Economist's chart on the next page, probabilities have started to move in his favour already. Interestingly, in its latest issue, The Economist is giving Joe Biden advice for the strategy they think he should follow: don't take the bait on the Law-and-order issue, but instead tie the two issues of the pandemic (where the president polls poorly) and the economy (where he polls stronger) together – thus depriving him of his strongest card. But we digress…

How will the stock market move with ebbs and flows of the presidential race? Conventional wisdom is that investors prefer a Trump win – based on the expectation that Biden would be more anti-business (e.g. increase corporate taxes, labour regulation, environmental protection, etc.). This would suggest that the markets should go up when the polls move in favour of Trump, and vice versa. There are also those who argue that causation runs in the opposite way: a strong share market has traditionally gone hand-in-hand with a win for the incumbent (see here), which would suggest that current polls are way off: the current share market performance is predicting a Trump win.

We're not so sure of either point of view. We firmly believe Trump has done more damage to the US and the global economy than Biden ever could or would – albeit his recent tax cuts have provided a short-term boost. On that view, a Biden win doesn't have to be bad for markets at all, at least in the long run. Those of us with clear memories of the race four years ago will remember that conventional wisdom at the time was that Clinton would win, and that, in the unlikely event she wouldn't, share markets would tank. As it happened, she did not win, and share markets did not tank: conventional wisdom had it wrong on both counts.

The other point where we differ from consensus is on the probabilities of a Biden vs Trump win. There is much talk of how pollsters have learned from their errors in 2016. However, our reaction to that is the old adage: every general is preparing his army for the last war, not for the next one. We fear pollsters may be wrong this time for entirely different reasons (we say this without any evidence – but then again, the point of the comment is that there are unknown unknowns, which by definition don't have any evidence).

Having said all that, what keeps us most worried is the increasing likelihood that there will not be a clear winner either way after the election. We are fairly certain that the president is doing all he can to thwart Democrat voters in exercising their right to vote – which gives the Democrats good reason not to accept the results should they lose. At the same time, Trump is making absolutely sure that in case he loses, all his supporters will believe that the election was rigged. Either way it looks like a recipe for great uncertainty in the weeks after November 3rd, with a real possibility of violence in the streets. It is exceedingly sad to see a country that is built on democracy and the rule of law descending into this type of chaos.



Source: The Economist

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 on this website, one (the 10/0) is run with actual money, while one other (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 a track record 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.

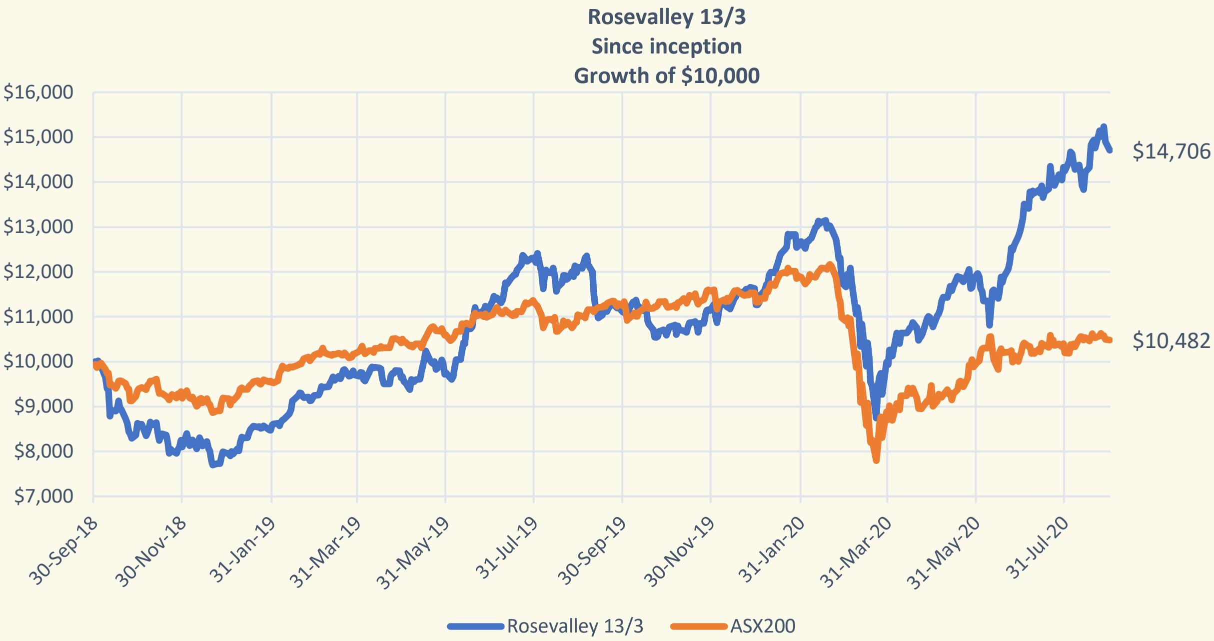
Some context for readers who are less familiar with Rosevalley Funds:

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).

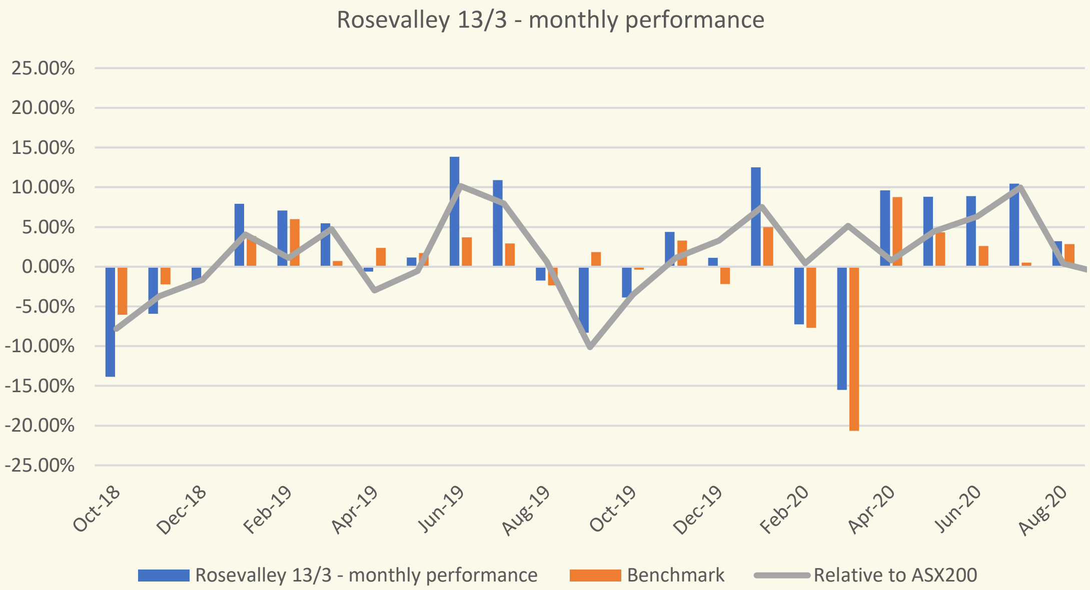
Rosevalley's portfolio construction algorithms are based on these insights. The model yields a ranking of stocks in order of greatest to smallest upside. Portfolio construction then follows by going long the stocks at the top and short the stocks at the bottom. The flagship product is Rosevalley 13/3, 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 September-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



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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