ROSEVALLEY FUNDS

Portfolio Report September 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 September

September saw a pull-back of markets around the world, with major markets down between 2-4%.

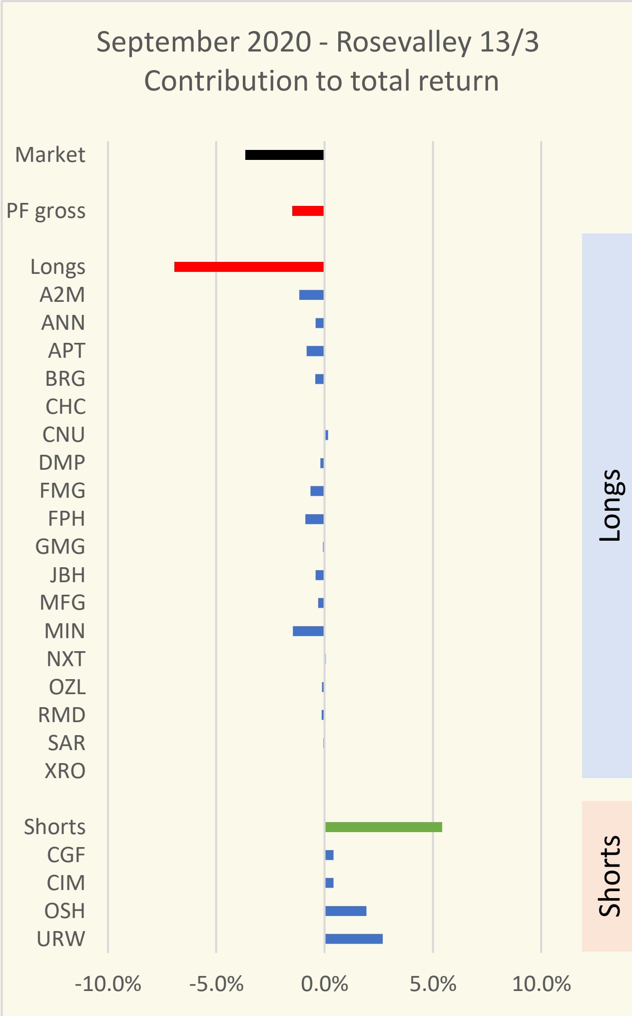
On the whole the markets seemed quite directionless. Positive factors included vaccine hopes, economies around the world opening up, good economic numbers out of China, as well as good job numbers in the US (albeit slowing down relative to June-August). Negative factors included clear second waves of the virus in many countries, with the resulting second round of lockdowns and/or restrictions.

The first Presidential debate took place during the month, but as it happened on the last day of the month it didn't move the market for the month. Early indications suggest there was no clear winner.

In Australia there was the ongoing lockdown in Victoria, and the squabbling between the states about border closures, offset by good infection numbers in NSW, and the anticipation of further stimulus coming in next week's government budget (some of which, such as an extension of the JobKeeper program, are already known).

In a sign that policy makers are worried that loose fiscal and monetary policy is not working its way through the economy as fast or strongly as desired, it was announced that rules subjecting banks to strict checks on customer's ability to repay loans will be eased (a return from the "Lender be careful" of recent years to the more traditional "Borrower beware"). Earlier there had already been an extension to the moratorium on interest payments from 6 months to 10 months. Whether or not this will actually stimulate borrowing and investment is unclear. For now, it seems more likely that it will lead to lower mortgage rates, poorer credit quality and stronger house prices, without a broader impact on the economy.

Stock markets around the world gave up some of their gains from the previous month. Australia was nearer the bottom than the top, but the dispersion was quite small:



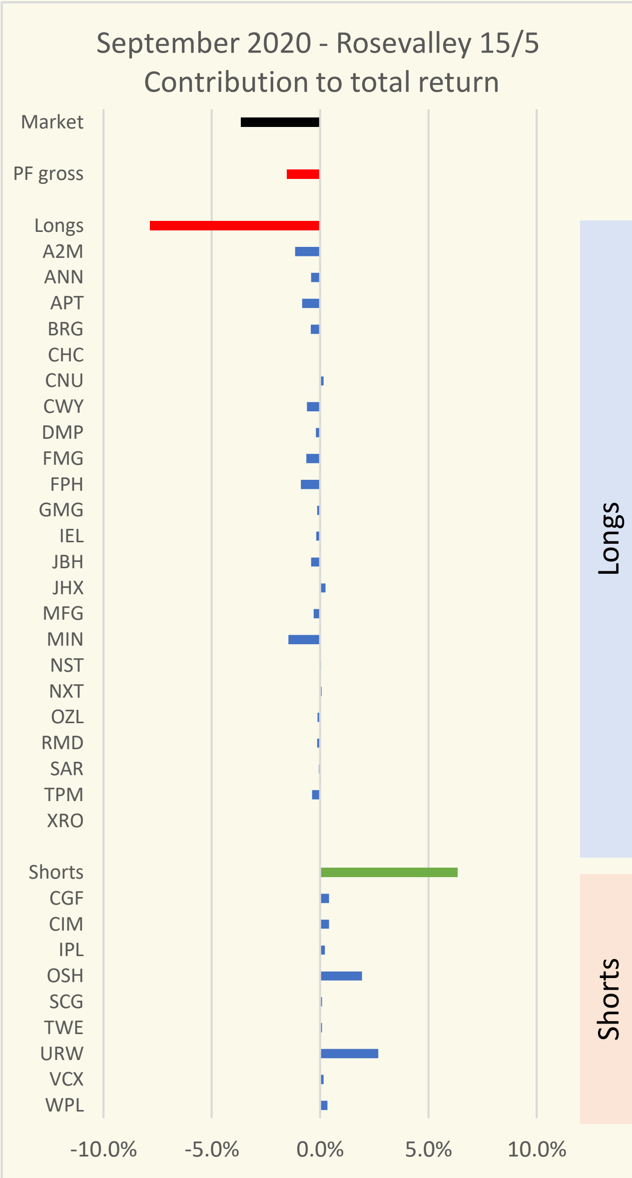
Source: Factset, Rosevalley

Total return	
	September 2020
MSCI World	-3.0%
S&P 500	-3.8%
DJIA	-2.3%
FTSE100	-1.5%
DAX	-1.4%
Hang Seng	-6.8%
ASX-200	-3.7%
Rosevalley 13/3	-1.5%

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

Performance as of September 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	-1.5%	12.3%	45.8%	30.5%	44.9%		
	Net	-1.3%	11.9%	42.6%	25.5%	36.5%		
Rosevalley 15/5	Gross	-1.5%	11.8%	44.4%	27.7%		46.0%	
	Net[1]							
Rosevalley 10/0	Gross	-5.7%	5.2%	27.6%	10.3%			37.2%
	Net[2]	-6.0%	2.6%	17.3%	-1.5%			4.8%
ASX-200		-3.7%	-0.4%	16.0%	-10.2%	1.0%	0.7%	1.1%

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.



Source: Factset, Rosevalley

Portfolio performance

All Rosevalley portfolios were down during the month. However, given where the market traded, this was a decent performance, with Rosevalley 13/3 outperforming the broader market both on a gross and net basis, while Rosevalley 15/5 and 10/0 slightly underperformed.

In the US the market retreat was concentrated in the tech sector, while in Australia it was broad based. This was reflected in the portfolios, with all but a couple of stocks in the portfolio going down, leading to the longs detracting and the shorts contributing. The main standouts were OSH and URW, two shorts that contributed strongly to performance.

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. This month marks the completion of Rosevalley 13/3's second full year of trading. A net performance of 36.5% vs the ASX-200 of 1.0% (an annualized outperformance of 16.3% makes us very proud indeed!

Execution

The rebalancing trades at the start of the month were done at favourable prices relative to the month-end prices; however, the positive variance was not quite as large as the modelled averages. On the plus side, both borrow costs and trading costs were lower than modelled. There was a slight difference from the model portfolio due to a shortage of available borrow in CGF. Taken together, the net return was 20 bps better than the gross return.

Rosevalley 13/3 Execution		
	Model	Realized
Gross performance	-1.49%	-1.49%
deviation from model portfolio		-0.03%
difference between trade price and end-of-previous-month price	1.11%	0.26%
trading costs	-0.30%	-0.05%
borrow costs	-0.12%	-0.01%
accrued vs paid dividends		0.01%
Reported net performance	-0.81%	-1.32%

October Portfolio Manager model overrides

The portfolios for October have three and four stock substitutions for the 13/3 and 15/5 portfolios respectively, all driven by sector concentration concerns. For October, the model output is uncharacteristically skewed – for the 13/3 portfolio, IT and Materials would each reach a 40% sector weight before substitutions. There were no substitutes for the shorts.

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

Looking ahead

This is what we wrote last month:

> *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.*

What a difference "a sniffle" makes! With the president now having tested positive for COVID, it would seem inevitable that the last four weeks of the campaign are going to be dominated by the pandemic. Will this be good or bad for Trump's re-election chances? Will Americans finally realize how bad he has handled this, and opt for his opponent? Or will he get a sympathy vote? Or will he recover quickly and then be able to tell his followers "See, I told you it wasn't a big deal"? We can't really say at this point.

What about the markets' reaction to all of this? We talked about this in last month's newsletter, where we explained where and why we diverge from conventional wisdom. We mentioned that our biggest worry is the possibility of the absence of a clear winner, and the subsequent uncertainty. Last week's presidential debate reaffirmed the reasons for this worry (not that there was any doubt): during the debate president Trump made it quite clear that he will not accept the result unless he wins.

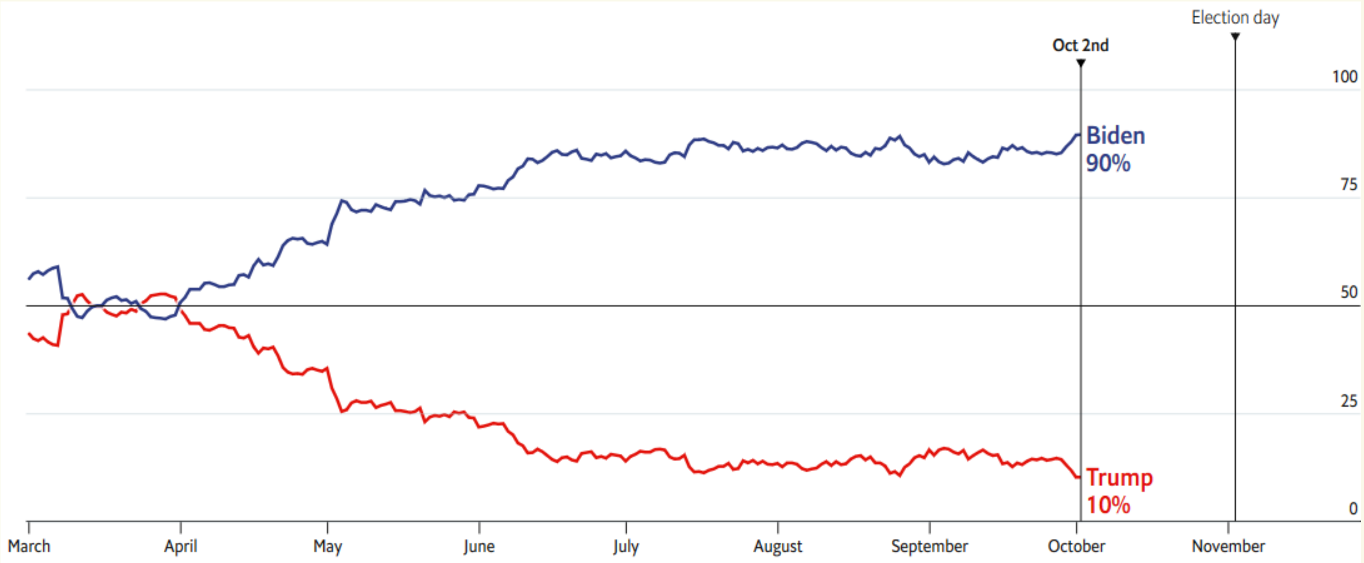
This near-certainty presents us with a dilemma, or perhaps a paradox. It goes as follows: There will be uncertainty after the election. Investors don't like uncertainty, so the market will go down. If investors know today that the market will go down in November, they will reduce their market exposure in anticipation, so the market will have gone down already. But if it has, there is no reason to worry about the market going down in November and no reason to reduce exposure today. Which means the market hasn't gone down yet. But wait, in that case … (return to the start of the argument).

What's going on here? Note that the above paragraph is really just another way of saying "all available information is priced into the market", or "markets are efficient". So for us, as behavioural investors, perhaps there is no paradox here after all. Can human behaviour be such that even a high degree of certainty about future uncertainty does not lead to action today? We could certainly believe this. For example, we could see how the Status Quo bias[1] could lead people to stick with their current portfolio settings until they know more about the election result – even if at that point the thing they know is that they don't know the result!

Of course, it's also possible that our assumptions are simply wrong. Perhaps we are part of a very small minority believing that a period of great uncertainty will follow after the election, and the majority of investors believes there will be a clear winner. We find this hard to believe, but can certainly not argue it's impossible.

Is your head spinning yet? We look forward to writing next month's report – which we will write a few days after the election, at which point we'll likely have a lot more certainty about the uncertainty!

[1] See e.g. https://www.behavioraleconomics.com/resources/mini-encyclopedia-of-be/status-quo-bias/



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.

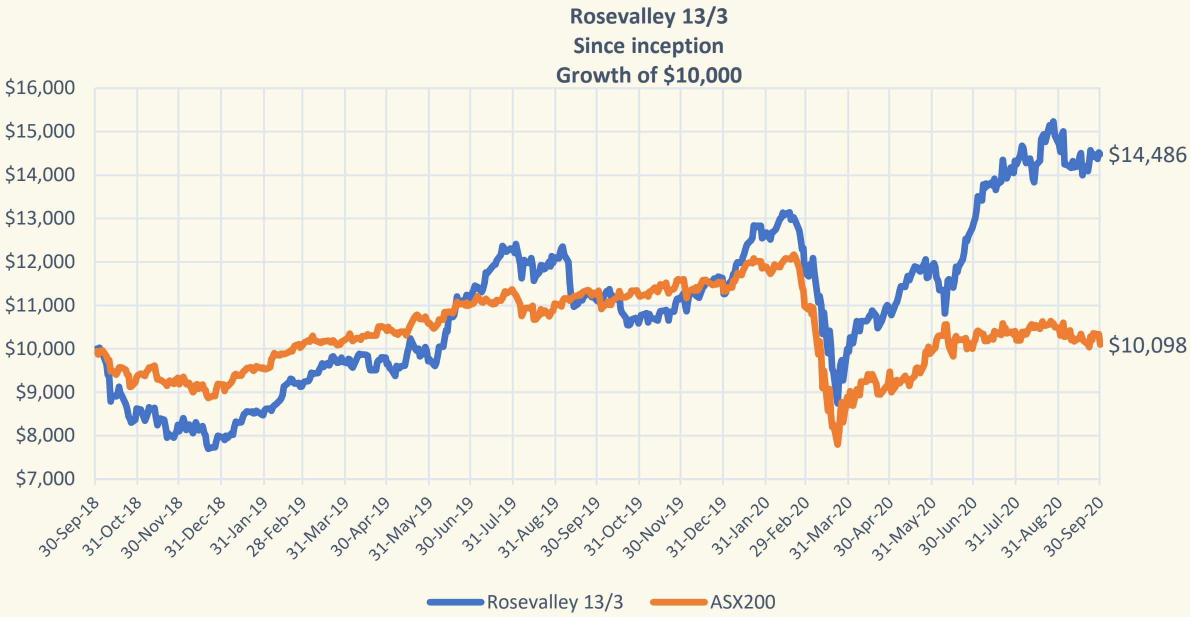
Some context for readers who are less familiar with Rosevalley Funds:

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).

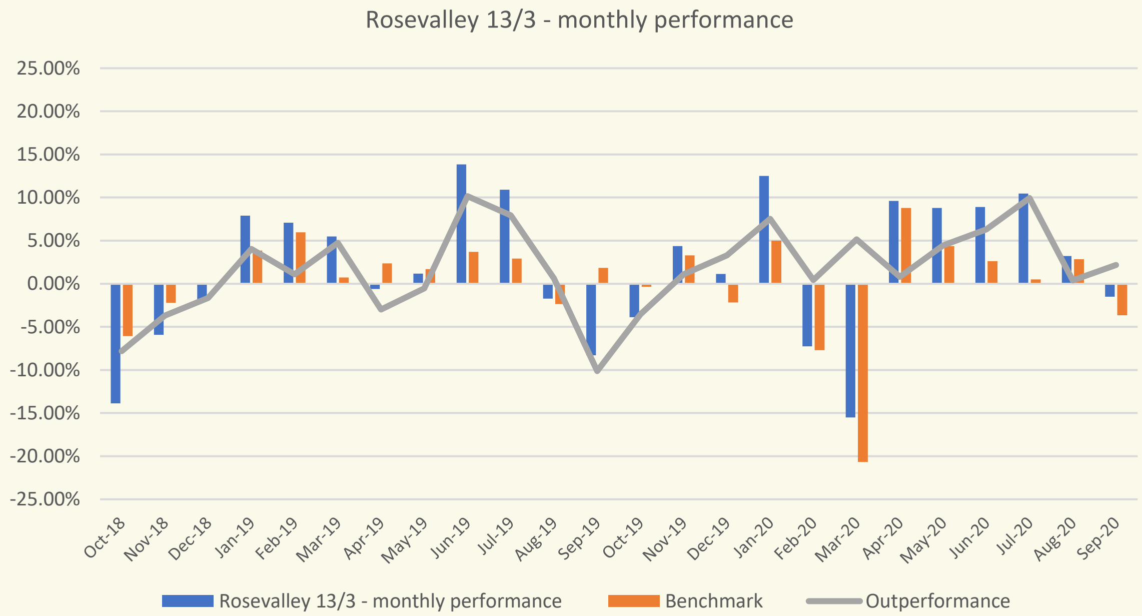
Rosevalley's portfolio construction algorithms are based on these insights. The model yields a ranking of stocks in order of greatest to smallest upside. Portfolio construction then follows by going long the stocks at the top and short the stocks at the bottom. The flagship product is Rosevalley 13/3,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