ROSEVALLEY FUNDS

Portfolio Report November 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

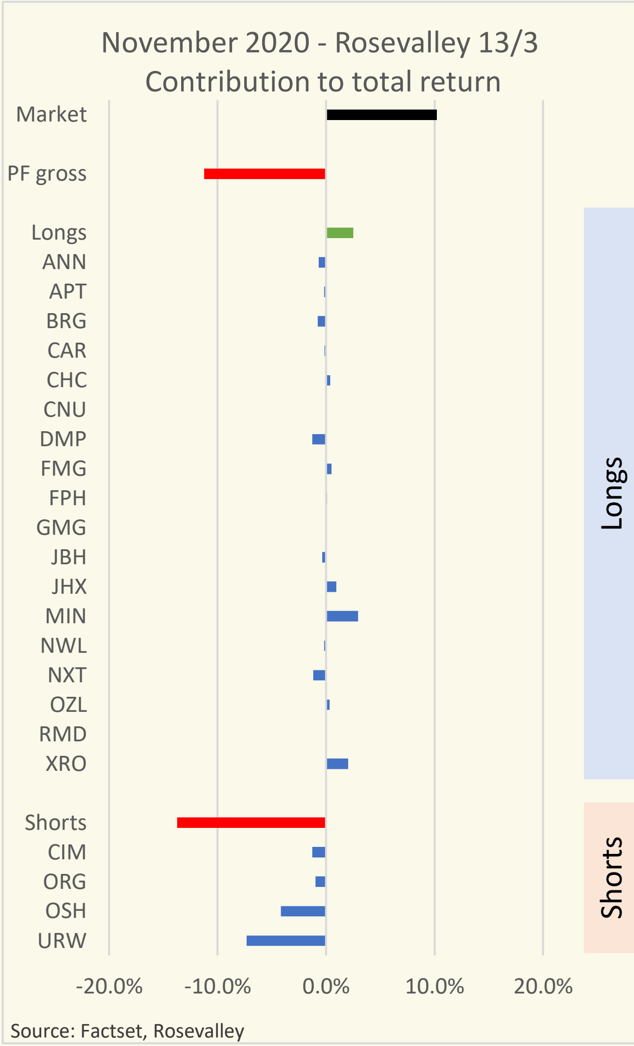
Market commentary

Every portfolio manager has to write a portfolio report like the current one every now and then. This month's portfolio performance was bad in absolute numbers and terrible on a relative basis. The report is going to try and strike a balance: don't be too defensive (*"It was the fault of something really weird happening in the market!"*), and yet make sure our investors keep their confidence in the process and the product without being too flippant (*"Don't worry, we'll make it back in no time!"*). At Rosevalley we believe in our investment approach, and we believe in transparently discussing what happens every month, whether good or bad.

Total return	November 2020
MSCI World	11.8%
S&P 500	10.9%
DJIA	11.8%
FTSE100	12.7%
DAX	15.0%
Hang Seng	9.3%
ASX-200	10.2%
Rosevalley 13/3	-11.2%

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

November was a very strong market for stock markets around the world. Most of the markets we track returned around 10% for the month. The Rosevalley portfolios, on the other hand varied between up 3.6% and down 14.3% - a very disappointing outcome. So what happened? We'll divide the discussion into three parts: Markets, Statistical, and Behavioural.



Markets

The two big events for stock markets around the world were the election of Joe Biden without a majority in the Senate, and the announcement by three different pharmaceutical companies of very positive results in their vaccine development.

We had commented last month on the election outcome (we wrote it after the results were known). The narrative among investors was that a Biden win without a Democrat Senate majority was positive for markets, because it would likely lead to more stimulus, but with a low probability of rolling back some of Trump's tax cuts.

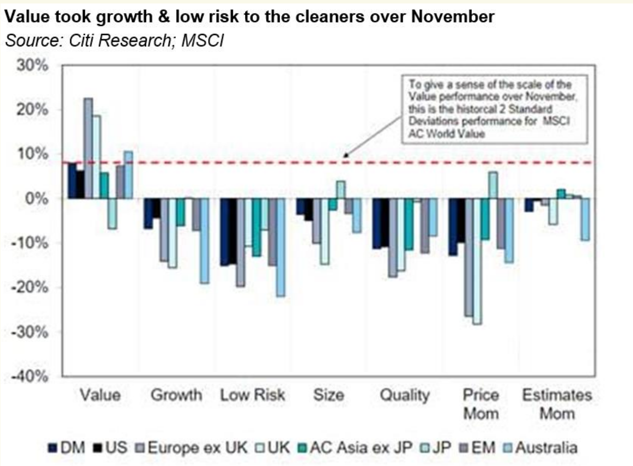
The announcement by Pfizer that the vaccine they currently have in Phase 3 trial showed interim results of 90% efficacy turned out to be a game changer for global markets. Suddenly stocks that had severely underperformed during the year (such as travel stocks,

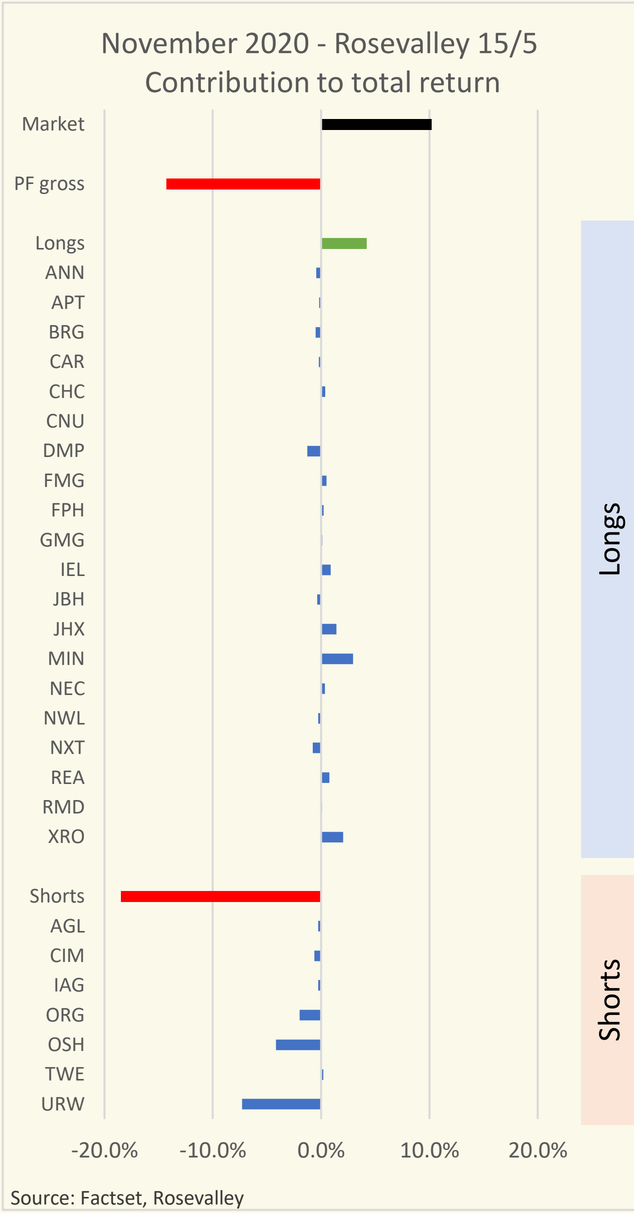
Performance as of November 2020								
Portfolio		1 month	3 months	6 months	1 year	Since inception (1 Oct 2018)	Since inception (14 Aug 2018)	Since inception (1 Aug 2018)
Rosevalley 13/3	Gross	-11.2%	-8.7%	13.3%	20.5%	34.3%		
	Net	-10.2%	-8.0%	13.3%	16.7%	27.3%		
Rosevalley 15/5	Gross	-14.3%	-10.6%	10.4%	17.5%		32.3%	
	Net[1]							
Rosevalley 10/0	Gross	3.6%	4.2%	21.5%	20.7%			51.6%
	Net[2]	2.9%	2.1%	14.9%	6.7%			13.8%
ASX-200		10.2%	8.2%	14.8%	-2.0%	13.4%	13.2%	13.6%

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.

and shopping mall operators) became very attractive again. In contrast, the stocks that had done well on the "work from home" narrative (mainly tech stocks) were seen to be less attractive. As a result, there was a strong rotation from the latter to the former, while at the same time dragging the whole market up.

Commentators in the main have been referring to this rotation as a shift from growth to value. Cue all the stories in the press of the *"return of value investing"*, and the rehashing of stories that appeared over the last decade arguing that *"value wasn't dead"*, but just needed a bit of patience. On one level it's hard to disagree with these comments. The stocks that did well during the month were cheap, and those that didn't, were not. However, we're not sure this month neatly fits in the broader Value vs Growth debate[1], given the unusual nature of the disparate performance of different sectors from February through October. Having said that, the charts that are being produced that show the relative performance of value vs growth do indeed show the most rapid shift from one style to the other ever recorded. See for example this chart from Citi:





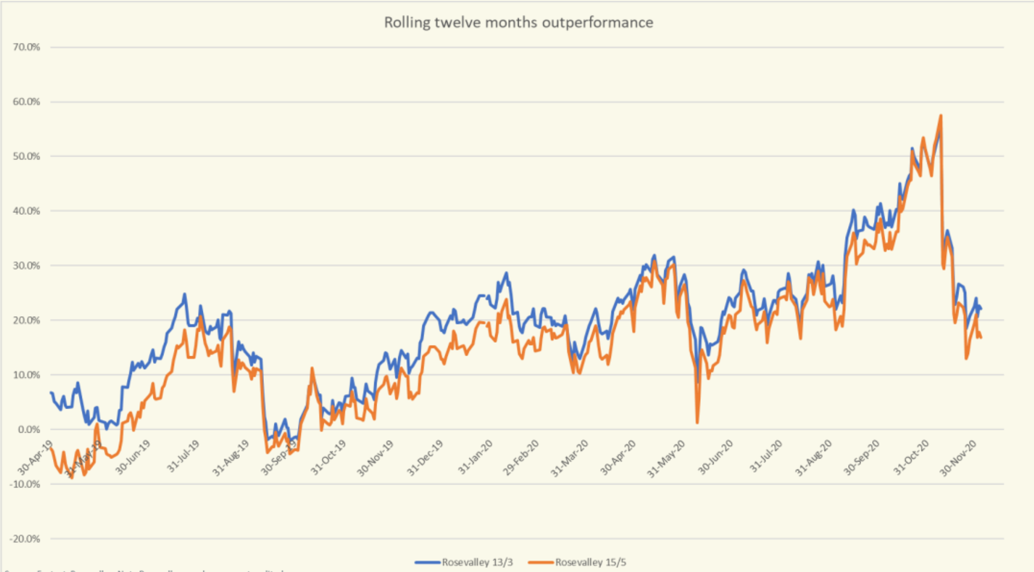
[1] A debate which we are skeptical about anyway, as we have argued in previous newsletters

Portfolio performance

As mentioned above, the portfolios did bad in an absolute sense, and terrible in a relative sense (see table above). The longs eked out a bit of contribution, but the shorts really killed the performance for the month. Like last month, Unibail-Rodamco-Westfield (URW), a REIT with mainly European exposure, was the worst detractor, followed closely by OilSearch (OSH). So what happened, and what context can we put around this?

Statistical

One way to think about this is in purely statistical terms. Let's ask a rhetorical question: In a board game, did you ever roll two double-sixes in a row? How about three times? When that happened, did you stop the game and investigate whether your dice were somehow rigged? The probability of rolling two and three double-sixes in a row is 0.077% and 0.002% respectively; in other words this should occur in 77 and 2 times out of 100,000 turns.



Source: Factset, Rosevalley. Note Rosevalley numbers are not audited

Similarly, with the Rosevalley portfolios, on a statistical basis the November result is one that is simply bound to happen every now and then. The probability of the return we saw for November is 1.2%. Low for sure, but not impossible. It reminds us of a story about professor Fama[2]: On 19 October 1987 the Dow Jones index fell 23% (the day became known as "Black Monday"). Professor Fama had been travelling during the day and had not yet seen or heard the news (this is, of course, pre-internet, mobile or otherwise) when he arrived for his scheduled lecture (after the market closed) in the lecture hall. He was asked by a room full of anxious students what he thought about the market dropping 23% in a single day. After doing some calculations in his head, he answered "You'd expect that to happen once every 612 years"[3].

In addition, we would make the more general point that it is never a good exercise to judge outcomes of statistical processes on one observation. If we look at the rolling-twelve-month performance as at the end of November, the absolute return is at 0.3 standard deviation below expected value and the relative return at 0.3 standard deviation above – a perfectly acceptable result.

All of the above can be summarized, with a nod to Forrest Gump, as: Shit Happens.

Behavioural

While it's easy to roll out some statistics and say there's nothing to worry about, it's hardly satisfactory. Can we point to something specific that happened in November, and tie it to the portfolio construction process in a way that might shed some light on why the performance was disappointing in this month in particular?

We cannot have an answer to this with certainty, because of the simple fact that we cannot ask every individual investor for his/her reasons for buying and selling what they bought and sold during the month. We can, however, postulate a narrative that sounds plausible[4]. Recall that the portfolio construction process is based on the tendency of investors to hold their losers too long and sell their winners too early. With the extraordinarily strong shift in sentiment, and the resultant large movements in shareprices, differentiated by sector, it is not hard to imagine that people would have altered their behaviour during the month somewhat. In other words, where in calmer markets an investor in a loss position would be expected to hold on to the position in the hope of "making it back", during November this same person might have thought *"I really don't know what's happening - better cut my losses"*. If there were enough investors exhibiting this (temporary) shift in behaviour, that could explain the portfolio return for the month.

[2] Professor Fama is a University of Chicago Booth School of Business professor of Finance, and widely recognized as the "father of modern finance. He was instrumental in the development of the Efficient Market Hypothesis.

[3] We can't remember the exact number, but the point is it was multiple hundreds of years.

[4] Of course, as Behavioural investors we are acutely aware that we, like everybody else, are prone to the Narrative Fallacy, and as such the discussion in this paragraph should be read with this in mind.

Longer term performance

We made a reference to the twelve-month rolling performance above. On that basis, all Rosevalley portfolios continue to show very strong absolute and relative performance. In fact, one could argue that the portfolios had "run ahead of themselves" a bit over the past few months!

Execution

This month the rebalancing trades at the start of the month were very slightly favourable. In addition, there was a slight difference from the model portfolio due to a shortage of available borrow in OSH, which helped performance. Taken together, the net return was 97 bps better than the gross return.

Rosevalley 13/3 Execution

	Model	Realized
Gross performance	-11.22%	-11.22%
deviation from model portfolio		0.99%
difference between trade price and end-of-previous-month price	0.05%	0.03%
trading costs	-0.13%	-0.05%
borrow costs	-0.12%	-0.01%
accrued vs paid dividends		0.01%
Reported net performance	-11.42%	-10.25%

December Portfolio Manager model overrides

The portfolios for December have two stock substitutions both for the 13/3 and 15/5 portfolios, all driven by sector concentration concerns – a very similar outcome to the previous month.

The investment committee debated whether to override the model's pick of URW on the short side. The argument for this would be the expected economic recovery now that vaccine deployment is in sight. In the end we decided against this, on the basis that we cannot know whether URW's share price recovery has now mostly happened or not, combined with the fact that we saw November as a bit of an anomalous month, as discussed above.

	13/3	**15/5**
Longs taken out	OZL, BSL	OZL, BSL
Replaced by	CHC, JBH	FPH, CAR
Comments	Sector concentration – in both portfolios the next stocks in the list that did not repeat the sector concentration were picked.	

Looking forward

The big question for investors going forward is *"Has this rotation run its course or is there more to come?"*. Usually we answer this type of questions along the lines of *"We're not sure, but we believe that it won't impact our portfolios performance too much either way"*. In line with the discussion under "Behavioural" above, however, we think the rapid style rotation in November did impact our portfolios, and thus the question is more relevant than usual. Our answer is that we believe that the style rotation has further to run, but that it is unlikely to happen at the same rapid pace that we saw in November. Therefore, we do not believe our portfolios will repeat the November performance as a result. This view also informs the decision not to override the short in URW as discussed above.

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.

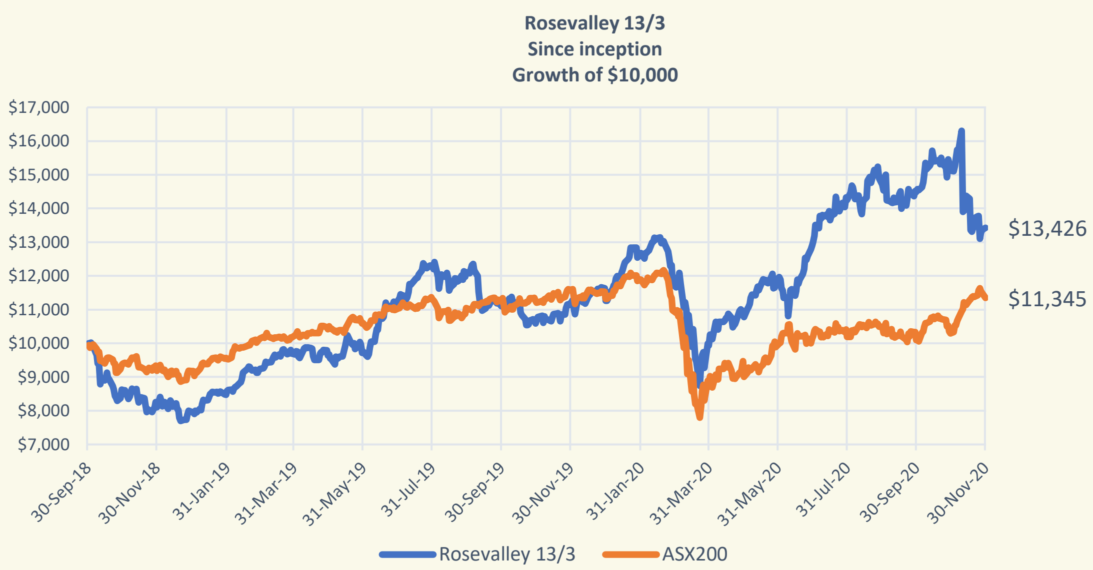
Some context for readers who are less familiar with Rosevalley Funds:

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).

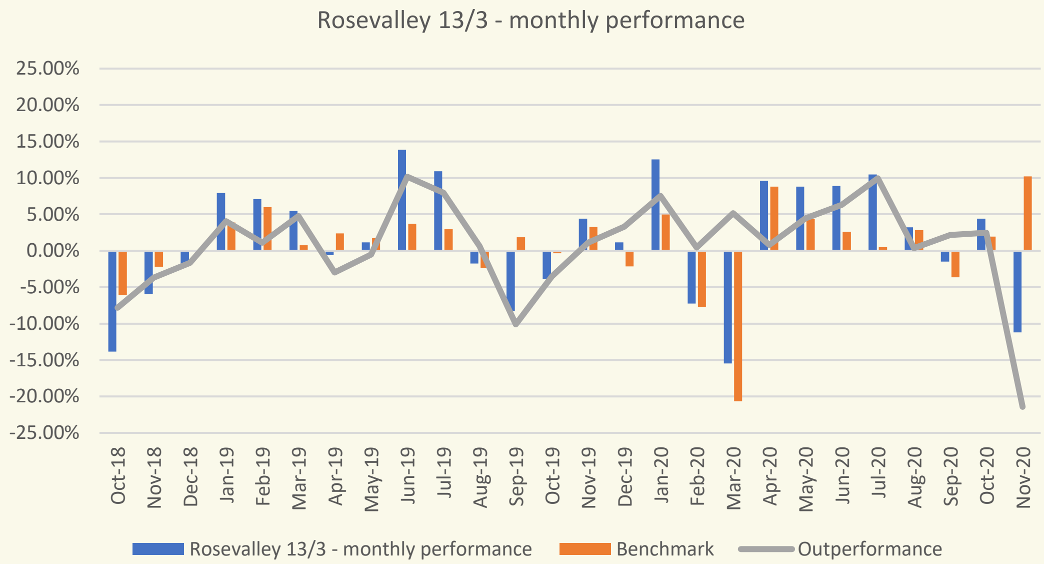
Rosevalley's portfolio construction algorithms are based on these insights. The model yields a ranking of stocks in order of greatest to smallest upside. Portfolio construction then follows by going long the stocks at the top and short the stocks at the bottom. The flagship product is Rosevalley 13/3,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