ROSEVALLEY FUNDS

Portfolio Report February 2021

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.

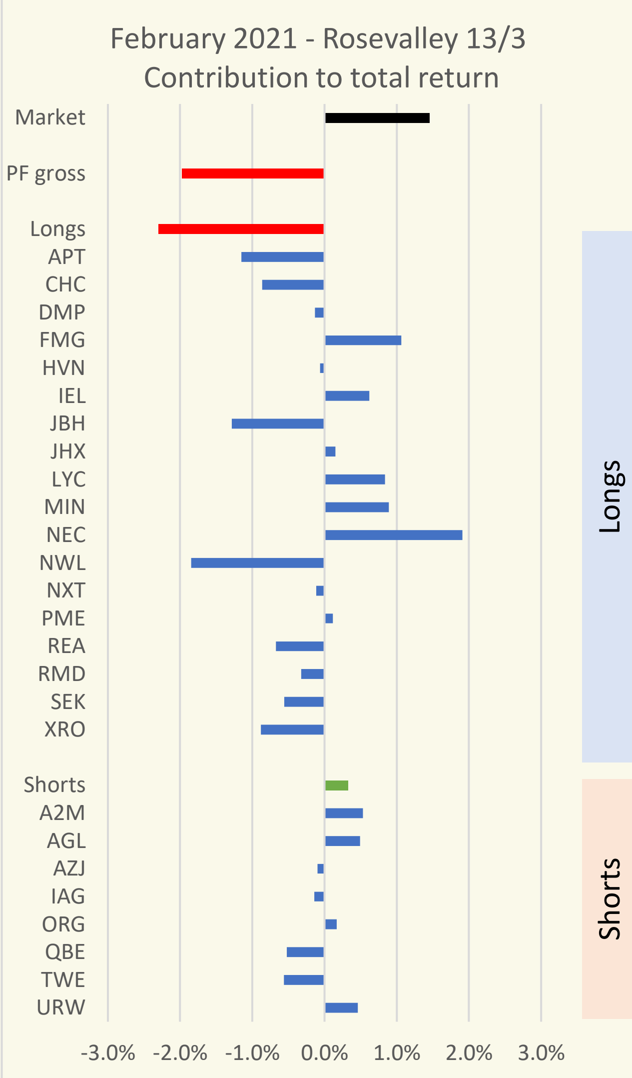
First-time readers of this report, please refer to the blue box at the end for added context and history

Market commentary

February was a positive month for stock markets around the world, mainly driven by optimism about the vaccine rollout – even as Covid-19 cases continued to increase and people were starting to talk about a third wave of the pandemic in some countries.

Total return	
	February 2021
MSCI World	2.5%
S&P 500	2.8%
DJIA	3.2%
FTSE100	1.6%
DAX	2.6%
Hang Seng	2.5%
ASX-200	1.5%
Rosevalley 13/3	-2.0%

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



Source: Factset, Rosevalley

As foreshadowed in our January report, reporting season in Australia was fairly benign. There were few surprises, and those that did occur were mostly positive. Of note were the strong results of the discretionary retailers. While this was not unexpected, it became clear just how strong last year's dynamics of income support and lack of alternatives for spending did help the discretionary retailers.

Looking forward, markets have started to fret about something else entirely: inflation. Or at least, that is what the financial press infers from the recent rise in bond yields. So what is going on here?

Over the past few months, long-term interest rates have been rising around the world. This has been true in the US, the most widely watched market, but in other markets, including Europe and Australia as well (see chart at end of report). As we know, governments and central banks have poured stimulus into their economies at unprecedented rates over the past year or so, and some economists (but by no means all) have been warning that ultimately this must lead to inflation. It is also true that, *if investors expect inflation to rise in the future, they will generally demand higher interest to offset this*. Therefore, to some observers the conclusion is clear: rates are going up, so investors are worried about inflation!

The (financial) press is all over this, and from reading some of the articles you could be forgiven to believe that

Performance as of February 2021								
Portfolio		1 month	3 months	6 months	1 year	Since inception annualized (1 Oct 2018)	Since inception annualized (14 Aug 2018)	Since inception annualized (1 Aug 2018)
Rosevalley 13/3	Gross	-2.0%	7.2%	-2.2%	22.4%	16.2%		
	Net	-2.8%	5.8%	-2.6%	18.6%	13.1%		
Rosevalley 15/5	Gross	-2.0%	6.4%	-4.9%	19.1%		14.4%	
	Net[1]							
Rosevalley 10/0	Gross	-2.8%	5.1%	9.6%	26.4%			19.8%
	Net[2]	-3.4%	2.5%	4.6%	10.5%			6.1%
ASX-200		1.5%	3.0%	11.5%	6.5%	6.7%	6.2%	6.3%

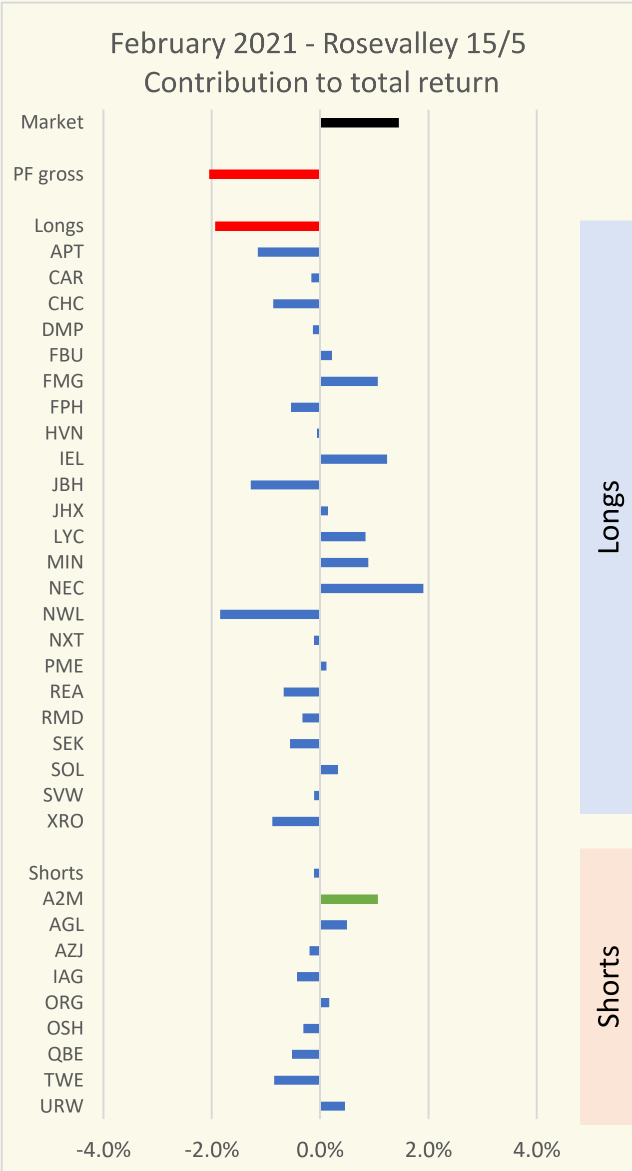
Source: Rosevalley, Factset. Note returns are not audited. [1]Rosevalley 15/5 was not actively traded during the month, so no net numbers are available. [2]Rosevalley 10/0 is traded on a demonstration basis – as a result of its small size commissions are a large proportion of assets, which explains the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

it's a done deal – inflation is just around the corner. However, any statistician worth his/her salt will immediately cry out: "Correlation is not causation!", and they would be right. To us it sounds a bit like "Elephants have four legs – I see a creature with four legs – it must be an elephant". From a Behavioural point of view, we can provide several perspectives: Confirmation Bias (for those who already believe inflation is coming), Availability Heuristic (for those who remember the high-inflation/high-interest-rates 1970s), Cognitive Ease (the story "sounds right"), and surely some others as well. Oh, and for journalists of course it doesn't hurt that this type of story sells well.

From an economic fundamental perspective we see two opposing forces. On the one hand, orthodox wisdom is that an increase in money supply must eventually lead to inflation[1]. On the other hand, it is hard to see inflation in an economy that has plenty of slack in its productive capacity, as most economies currently do. It is this argument that keeps most central banks relaxed about their countries' fiscal and monetary policies.

Here is an alternative explanation: supply and demand (duh!). Could it be that the demand for bonds has recently declined (or stopped growing), just as the supply is increasing? Remember that the central banks tend to buy bonds at shorter maturities, not at longer ones, and it's only the longer-dated bonds that have seen their yields rise. Perhaps investors are re-allocating from bonds to equities, given how well those have done in 2020?

We don't know which of these explanations is right. We just know that the "inflation is coming" explanation is too easy, and other explanations are possible. We will be keeping a close eye on this in the coming months.



Source: Factset, Rosevalley

[1] However, most people who make this argument implicitly assume that the velocity of money doesn't change. It is quite plausible that the velocity of money has decreased recently, and if it goes down further, a further increase in money supply won't lead to inflation.

Portfolio performance

The Rosevalley portfolios were down, underperforming the market by 3.5-4.5%. The main contributor was a long in Nine Entertainment, a media and entertainment company. They hold a significant stake in Domain, an online real estate portal. Strong housing data over the past few months helped this stock. The main detractor was a short in Netwealth, an online wealth-management platform, which reported strong earnings during the month.

Longer term performance

For the 12-month and since-inception timeframes, all Rosevalley portfolios continue to perform very strongly. As a reminder: the expected (as based on the backtest) long-term outperformance after trading costs is around 10% p.a. Size-adjusted, all portfolios are at or above this expected value over a number of time periods and since inception.

Execution

This month the rebalancing trades at the start of the month were favourable, but this was more than offset by an inability to get set in all the shorts – as we have experienced over a number of months. Unfortunately, there is little we can do about this, short of changing brokers. Borrow costs and trading costs were less than modelled. Taken together, the gross-net gap was 82 bps.

Rosevalley 13/3 Execution

	Model	Realized
Gross performance	-1.97%	-1.97%
deviation from model portfolio		-0.96%
difference between trade price and end-of-previous-month price	-0.15%	0.19%
trading costs	-0.26%	-0.08%
borrow costs	-0.12%	0.00%
accrued vs paid dividends		0.04%
Reported net performance	-2.51%	-2.79%

March Portfolio Manager model overrides

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

	13/3	15/5
Longs taken out	MIN, OZL	MIN, BHP
Replaced by	SOL, REA	REA. HVN
Comments	Sector concentration – in both portfolios the next stocks in the list that did not repeat the sector concentration were picked.	

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.

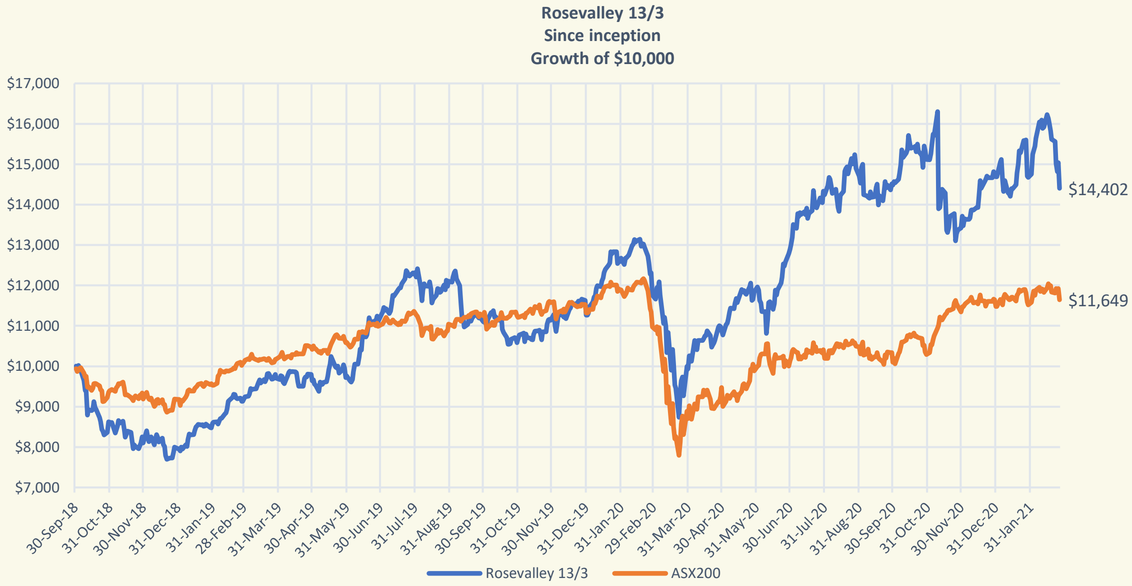
Some context for readers who are less familiar with Rosevalley Funds:

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 March-March 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.



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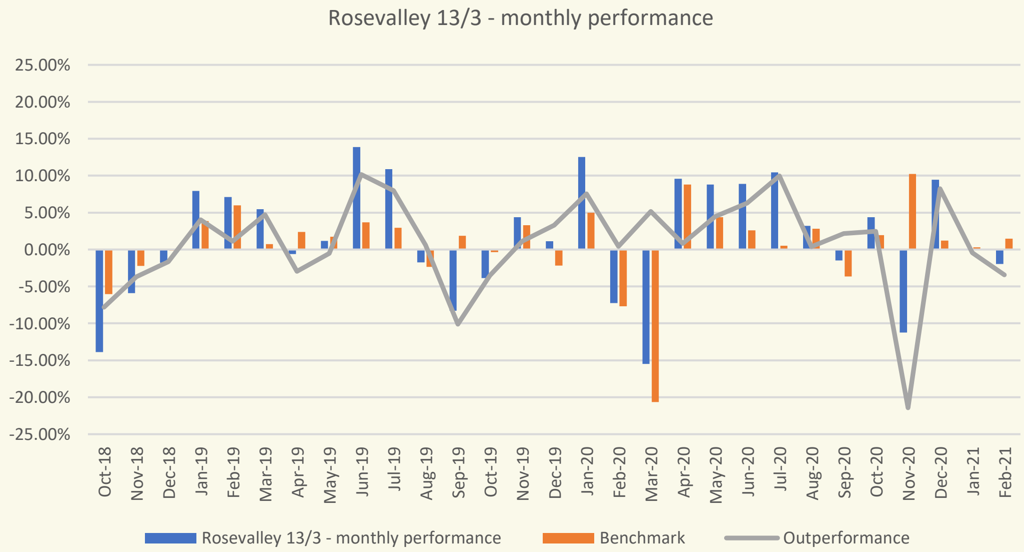

Source: Factset, Rosevalley

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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