ROSEVALLEY FUNDS

Portfolio Report May 2022

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

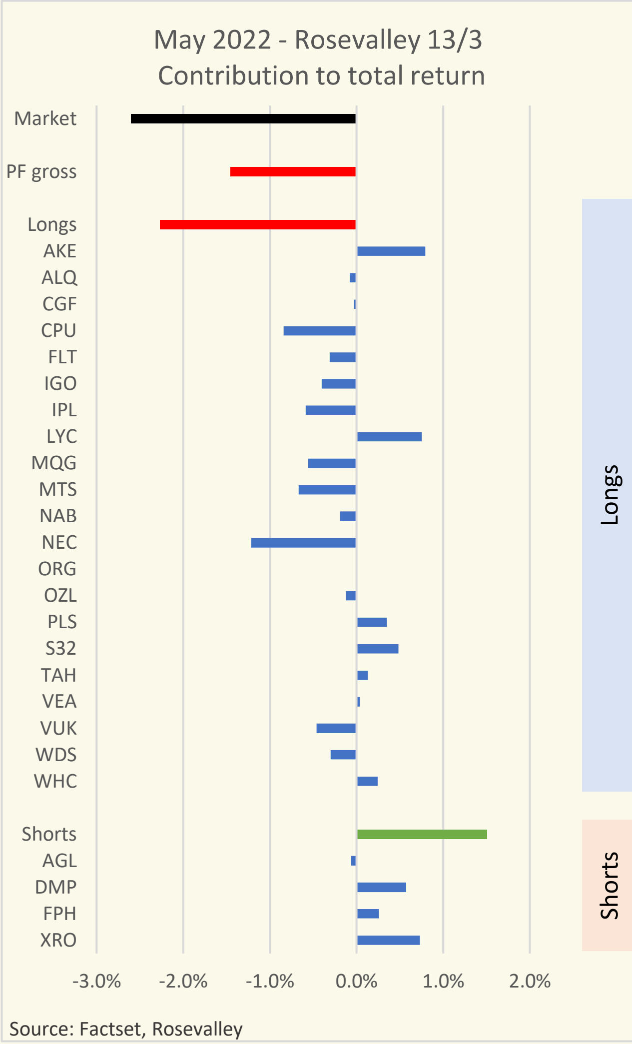
Market commentary

As has happened occasionally in the past, at the time of writing this report (mid-June) it feels like what happened in stockmarkets in the prior month was a lifetime ago. The current environment feels like a full-scale meltdown, making May look in comparison like the good old days. We'll provide some commentary on both, and try to shine our behavioural lens on it.

May

The returns for markets in May were muted, but not bad. Most markets were up 0-2%, with Australia faring worse at -2.6%.

	May 2022
MSCI World	-0.2%
S&P 500	0.2%
DJIA	0.0%
FTSE100	1.1%
DAX	2.1%
Hang Seng	2.2%
ASX-200	-2.6%
Rosevalley 13/3	-0.6%
Rosevalley 10/0	-0.1%



One could argue that May was the month during which the last remnants of the "current inflation is transitory" theory were laid to rest. Certainly central banks around the world behaved this way: the Fed (USA), the BoE (UK). the RBA (Australia) and various other central banks finally started to raise interest rates somewhat aggressively in order to rein in inflation, combining these rate movements with ever increasingly hawkish commentary.

However, even as central banks were finally realizing they had a real inflation problem on their hands that was going to take some serious effort to fix, equity markets were still hoping that central banks could do this fixing relatively easily and with little pain for the economy, leading to flat performance for the month. Rosevalley did alright in May, with small downward moves, but less so than the broader market, thus outperforming the reference ASX-200 index.

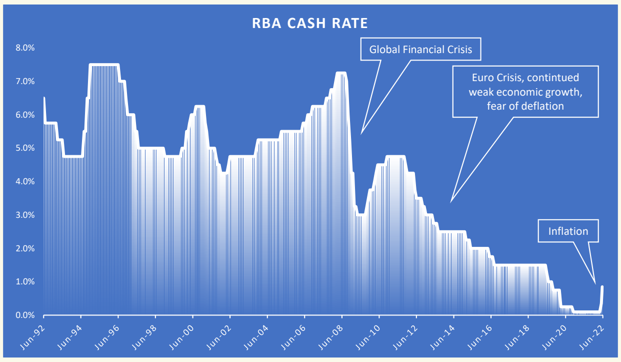
June

This all changed in June, with the published inflation numbers much worse than most forecasters had expected forcing several central banks to respond with more aggressive tightening and commentary. While most central banks raised rates in May by the customary 25 bps (1 bp = 0.01%, so 25 bps = 0.25%), in June they raised by a

Performance as of May 2022								
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	-1.5%	6.6%	-8.3%	4.1%	15.1%		
	Net	-2.1%	5.4%	-9.8%	-0.1%	11.6%		
Rosevalley 15/5	Gross	-0.9%	9.5%	-13.1%	0.8%		13.8%	
	Net[1]							
Rosevalley 10/0	Gross	-0.1%	7.3%	-2.9%	14.9%			18.5%
	Net	-0.2%	6.7%	-3.6%	14.7%			8.4%
ASX-200		-2.6%	3.2%	1.4%	4.8%	8.1%	7.7%	7.7%

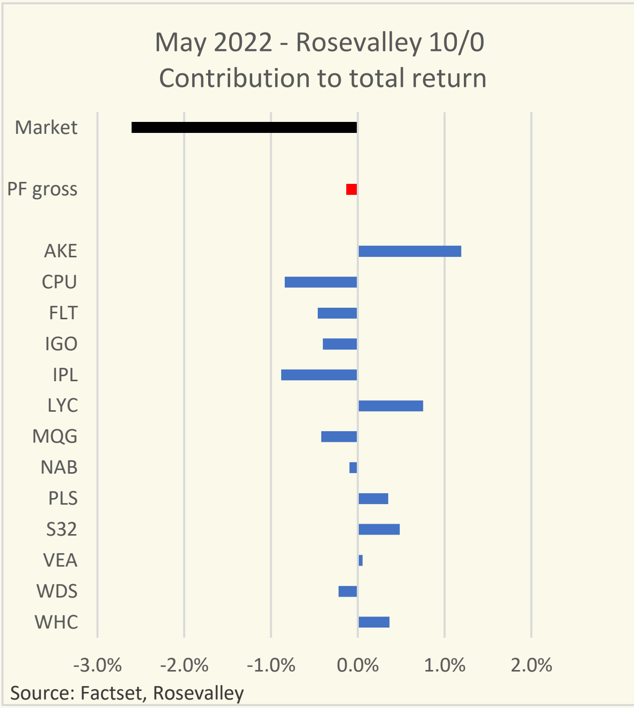
Source: Rosevalley, Factset. Note returns are not audited. [1]Rosevalley 15/5 was not actively traded during the month, so no net numbers are available.

larger amount in response to these worse-than-expected inflation numbers. The Fed raised rates by 75 bps and the RBA did 50 bps. This rapid increase in interest rates is very unusual – in Australia and the US you have to go back to the early 90s to find similarly steep increases in interest rates:



Source: Factset

This time markets reacted strongly. At the time of writing, global markets are down around 10% for June alone, and most have entered what many financial market commentators refer to as "bear-market" territory, which means they are down 20% or more from their most recent highest point.



Time to panic? What else is there to do?[1]

From a behavioural point of view, these times tend to be the most difficult for investors, and the ones where the wrong decisions are made – those that later on prove to be most costly. The chart on the right has an interesting stylized description of the emotions that go through investors' minds, and how these emotions lead investors to end up destroying their returns by buying near the peak and selling near the bottom. The broader point of the chart is that it is extremely hard to "time the market", and the wise strategy is to always stay invested, not just "also" when times are tough, but actually ***especially*** when times are tough.

Figure 1: Investment Process - Roller Coaster of Emotion

[1] Bonus points if you got this reference to the British TV series *Fawlty Towers*. Polly: "Don't panic!" Basil: "What else is there to do?!" See here.

We have spoken in the past about (what we consider) one of the most interesting facts about behavioural science, namely that knowing about behavioural biases does not make you immune to them. This is in contrast to most other areas of human endeavour, where we can learn to do better by having a teacher showing us what we are doing wrong and how we can do better. Behavioural biases don't work that way – you can know them, you can even see them at work in your own behaviour, but you cannot stop yourself. This is why in some areas (like investing) it makes sense to decide on a certain approach or strategy, and then leave it alone – thus making sure your inadequate brain is not going to screw things up for you.

Incidentally, the pattern of decisions by central banks over the past 1-2 years could easily be mapped onto the chart above, thus showing that even the best educated people are not immune to behavioural flaws.

Back to investing. We don't know when markets will recover. Intellectually we can construct an argument and come up with a prediction (which would probably be something like "things will get worse before they get better"), but the truth is, we don't know. Even if indeed things do get worse before they get better, we don't know how and when markets will incorporate this pattern into prices.

As an example, it may very well be that inflation keeps getting worse through to the end of the year, interest rates keep climbing until the end of the year, there is a recession during next year – and yet equity markets bottom out in July. The point is we don't know, and for this reason it is not wise to take one's money out of the market now in the hope to get back in at a later time when the market is lower. History shows that this is a recipe for losing money. Here are some stats (taken from the US market) that illustrate the danger of selling out at times like this:

- *Equities Rally Once Inflation Peaks*—on average, the S&P 500 has risen 12.5% over the subsequent year after inflation has reached a cyclical peak
- *Equities Rally After Fed Hiking Begins*—on average, the S&P 500 has risen 8% over the subsequent year after the Fed initiates a hiking cycle, and 24% (cumulative) over the subsequent three years
- *Peak Fear Is a Catalyst to Buy*—on average, the S&P 500 has risen 27% over the subsequent year after consumer sentiment troughs

Our conclusion is clear: sit tight and realize that downturns are part of long-term investing.

Portfolio performance

The Rosevalley portfolios had a small down month, but outperformed the broader market by between 0.5-2.5%. Rosevalley 13/3 was down 2.1% and Rosevalley 10/0 was down 0.2%.

The two largest contributors were Allkem (AKE) and Lynas (LYC), a lithium miner and rare earth producer respectively. This reflected continued strength in commodity markets. All other longs that contributed were in this space as well. The short positions contributed positively to performance, but outside the miners most long positions detracted. The largest detractor was Nine Entertainment (NEC), which experienced some large earnings downgrades by sell-side analysts.

Longer term performance

Since-inception performance numbers are still strong. However, on a 12-month basis, Rosevalley 13/3 is now on par with the broader market, while Rosevalley 10/0 is still outperforming strongly.

Execution

This month the usual sources of gross-net difference were on par with the modelled expectation: the gross-net gap was -59 bps (vs. an expected -62 bps). There was a small deviation from the theoretical model due to a delisting, but this was offset by lower than modelled trading costs.

Rosevalley 13/3 Execution

	Model	Realized
Gross performance	-1.46%	-1.46%
deviation from model portfolio		-0.30%
difference between trade price and end-of-previous-month price	-0.11%	-0.12%
trading costs	-0.38%	-0.08%
borrow costs	-0.12%	-0.10%
Reported net performance	-2.08%	-2.05%

June Portfolio Manager model overrides

The portfolios for June have one long stock substitution for the 13/3 and 15/5 portfolios driven by concentration concerns: miner Mineral Resources. The substitutes are NAB in Rosevalley 13/3 and CIA in Rosevalley 15/5.

	13/3	15/5
Longs taken out	MIN	MIN
Replaced by	NAB	CIA
Comments	All changes driven by sector concentration considerations.	

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

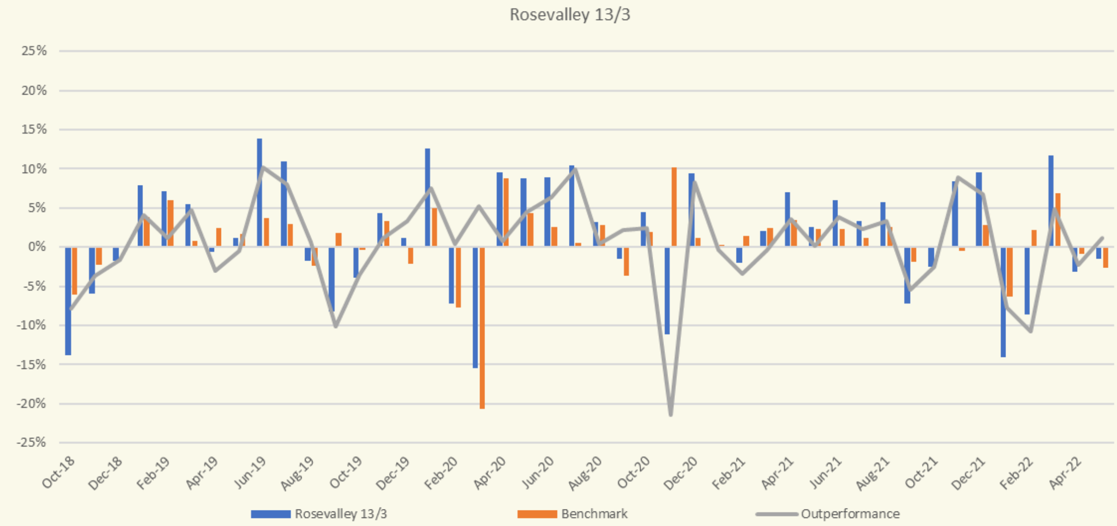
Rosevalley is a boutique funds manager with a unique approach to portfolio construction. Rosevalley Funds are constructed using the principles of Behavioural Finance (BF). Behavioural Economics and Behavioural Finance were developed over the past 30 years or so through the work of economists like Tversky, 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 June-June 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. Note Rosevalley numbers are not audited



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.