China A-share Funds and the "Winner's Curse"

As first half of 2021 came to a close, the China A-share market didn't perform as "expected." Many investors followed the core-holdings and winner-get-stronger playbook that worked well for last two years, but there was a surprised shift towards the small- to mid- cap growth stocks. The ever-changing market landscape made investors feel like they are always half a step behind.

Meanwhile, whenever we do annual or semi-annual reviews, the "champion funds" becomes an ubiquitous buzzword. The top-ranking funds' registration codes almost become the numbers to the next lottery draw: the secret codes to the future wealth! One has to wonder: if an investor uses the short-term performances of the funds as basis for investment decision and rotates to last period's winning funds, how will this strategy compare to the market?

We did an analysis on this exact scenario! Based on 397 equity funds created before 2020, we compared two equity fund investment strategies in the 2011 to 2020 period:

Strategy 1 – "Buy Top": at beginning of each year, buy the top performing fund from last year. For example, in Jan 2011, buy the fund with the highest annual return from 2010. Hold the fund for one year and change to the top performing fund from 2011 at start of 2012. Repeat this until end of 2020.

Strategy 2 – "Buy Bottom": at beginning of each year, buy the worst performing fund from last year. For example, in Jan 2011, buy the fund with the lowest annual return from 2010. Hold the fund for one year and change to the lowest performing fund from 2011 at start of 2012. Repeat this until end of 2020.

Below are the results from our analysis:

YEAR	BUY TOP	BUY BOTTOM
2011	-33.6%	-21.7%
2012	4.5%	1.4%
2013	-8.2%	17.4%
2014	4.6%	32.3%
2015	35.2%	16.7%
2016	-11.9%	-16.8%
2017	24.5%	-11.2%
2018	-23.5%	-29.4%
2019	62.4%	58.6%
2020	63.5%	57.0%
TOTAL RETURN	**101.0%**	**87.4%**
ANNUALIZED RETURN	7.2%	6.5%

Data Source: Wind, Rosefinch; Data Period: 2011.1.1. to 2020.12.31.

There were a few interesting and surprising results. First of all, while the two strategies had a cumulative 101% and 87.4% return over the ten year period, they were still noticeably lower than the 206% return of the Wind Equity Mutual Fund Index over that same period. Secondly, the two opposite strategies actually had surprisingly similar results with one achieving 7.2% return per annum and the other 6.5%. What may have caused such results?

When the "Buy Top" and "Buy Bottom" strategies have similar long-term returns, this means the two types may fundamentally lean towards concentrated positions on single sector or similar style of companies. Maybe the Top Fund caught the opportunity that year and won big, but the probability of replicating the similar extreme outperformance the next year is small. And the Bottom Fund may have just been overweight a sector that's out of favor that year, and not necessarily mean it's a low-quality investor.

In market with shifting preferences, those funds with concentrated bets will have high volatility and their performance may be subject to "mean-reversion". There was a study done by Haitong Securities which found that only 18.55% of those funds ranked in the top 20% in one year can stay in the top 20% the next year. In fact, almost ¼ of these funds fall into the bottom 20% in the next

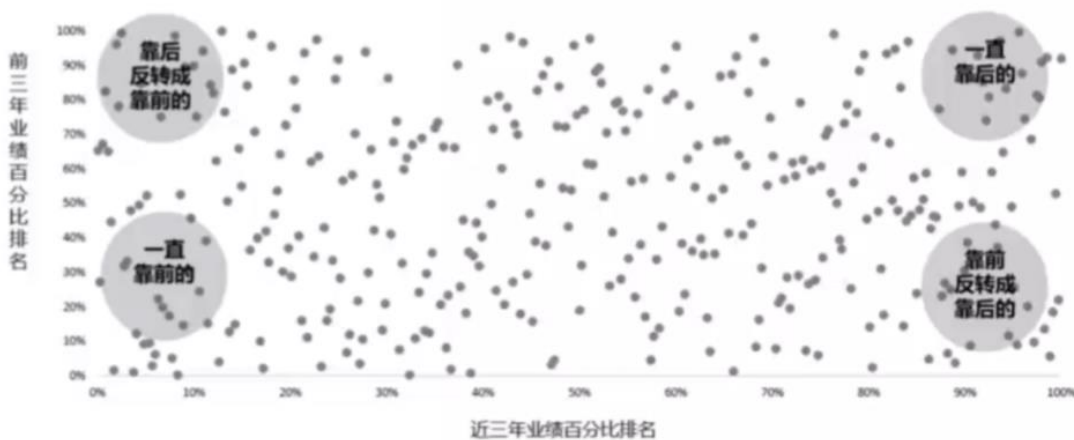
year. In fact, Nobel Laureate Richard Thaler wrote a book on "Winner's Curse", which studied how the winners at auctions tend to lose because the final price is often higher than actual value. Once an

asset is highly sought after, or become the market favorite, it tends to be over-valued. So when you chase it and buy at a high level, the long-term return will become mediocre and potentially negative. For example, there's a super bull stock in A-shares that's gone up 400 times its 2001 IPO price. So if you followed the market hype and bought it in 2008 at 60 times PE, then you'd have suffered many years of doubt and stress… When we look at the holdings of Top Funds, many are the short-term favorite stocks at that time. Being market favorites also means the prices already reflected a lot of high future expectation, thus reducing future return potential. This is the fundamental reason for the mean reversion effect.

Mr Thaler did another analysis in his book "Winner's Curse: Paradoxes and Anomalies of Economic Life." He picked the best 35 stocks and the worst 35 stocks of the NYSE over the last 3-5 years and formed two portfolios: Winners and Losers. He compared the performance of these two portfolios and found that after 3 years, the Losers portfolio will outperform the Winners portfolio. The difference is even more noticeable over 5 years, where the Losers portfolio outperform the market by 30%, and the Winners portfolio underperform the market by 10%. On the one side, because of the emotional bias, the over-reactions to negative news pushed the Losers excessively lower. On the other side, the market over-reacted to positive news and pushed the Winners to over-value territory. Add mean-reversion tendencies on top, and we'll see both over- and under-valued stocks to converge to their long-term intrinsic values.

An over-emphasis on returns may cause investors to start on the wrong foot when choosing funds. According to a recent study from Shanghai Securities, using data from April 2015 to Mar 2021 on 349 Equity-bias Funds, there's no clear correlation between the first three-year return performance and the second three-year performance. This may be due to the shifting market sentiments and changes amongst the funds' PM's.

Scatter Plot of 3 year rankings of 349 funds in Earlier 3 years and Recent 3 years



Data Source: Wind, Shanghai Securities
Data range: X-axis is ranking in recent 3 years from 2018 April to 2021 March; Y-axis is ranking in earlier 3 years from 2015 April to 2018 March. Top left circle is for poor performer who did well; top right circle is for those consistently poor performers; bottom left is for those consistently good performers; bottom right is for good performer who did poorly.

Just like what we read on typical fund risk disclosures: "past performance is not indicative of future performance." In addition to a simple return number, the investor may want to understand the risks behind the returns and whether such performance can be continued? Does the portfolio manager use deep research to invest in the right companies and share their long-term profits, or using frequent trading to chase short term market opportunities? More importantly, does the portfolio manager have a mature investment process to replicate past successes?

We at Rosefinch believe profits will always be the "gravity" to long-term investments. The stock price may be impacted by short-term investors' emotional tendencies and market volatilities, but the company profit will remain a key pillar for the long-term rise of the stock price. We will examine closely the entire industry value chain, and follow the changes in the industry outlook and valuation. We want to identify early opportunities in both upstream and downstream, so we can position for the future profit streams.

Because fundamentally the stocks is a high volatility asset, its risk characteristics means the investment return profile will be non-linear and uneven. It's like a train without an announced departing time: we have to be confident about the ultimate destination, so we won't lose patience and disembark when the train is not moving. From a long-term investor perspective, come rain or shine, the Chinese economy and financial market will continue to steadfastly develop, and our active equity fund will add value to investors over time. For now, we will ignore the distractions from markets' fear, greed and short-term volatilities, and focus on our long-term investment decisions.

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