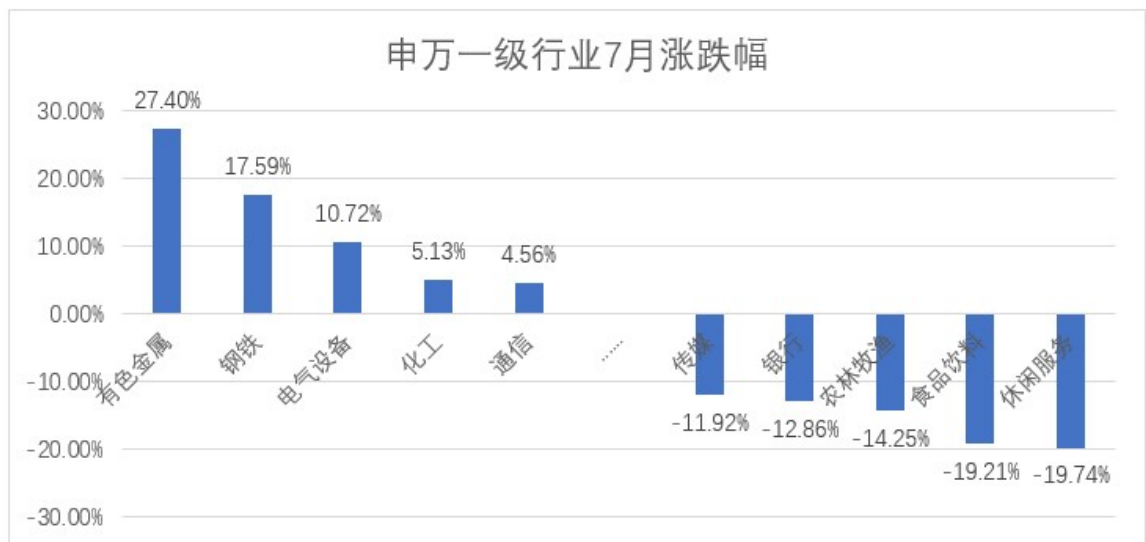


Rosefinch Research | History Repeats Itself

Back in school days, the Chinese teacher taught us: have IT and you will travel far, without IT and you can hardly move. The teacher said “IT” is being righteous. Now I think IT is Lithium battery. There was song by singer Liu Huan that said: if IT is here, the dream is here. By IT, he meant heart; and now, I think IT means semi-conductor, which shares the same pronunciation as “heart” in Chinese. On a more serious note, pain is the source of art and it’s the same source behind these Chinese investment jokes. In July 2021, A-share sectors had huge dispersion – there was a gap of almost 50% between the monthly performance of best vs worst sectors. Amongst ShenWan industries, Food and Beverages retraced almost 20%, while the non-ferrous metal led the way with almost +30% rise.



Source: Wind, Rosefinch

There’s also increased concentration in the transactions. CITIC Securities estimated that the new energy, semi-conductor and energy-related metals took up over 15% of total trading volume which is near the market share of “Maotai index” of leading big caps back in Feb. When market is behaving like this, the stocks’ short-term performance is temporarily disconnected with its fundamentals.

The cycle between “Maotai Index” and “Ningde Index”

Maotai Index or MI was created by Wind in Sep 2020 and stands for the collection of large caps that are leaders of respective industries. The 35 stocks in the index consists of less than 1% of the total number of companies in the Chinese stock market but has market cap of 18 trillion RMB or about 23% of the total market capitalization. This index of market leaders is named after the biggest leader of them all: Maotai.

Ning Index of NI represents the high growth new energy companies who generally have +20% or more forecasted profit growth. The index is named after Ningdeshidai or Contemporary Amperex Technology Co., one of the leading new energy shares with focus on Lithium battery. The index consists of 43 stocks that are the best mid- to large- growing companies in their respective companies.

In the past two years, the market showcased key concepts like “core holdings”, “protective moat”, “business model”, etc. Investors recognized the stability and sustainability of food & beverage or pharmaceutical stocks and paid-up high valuations accordingly. When the government industry policies shifted towards “efficiency and fairness, and develop core technology”, most investors saw new energy vehicles and semi-conductors as the preferred sectors. This increased the risk of over-crowding. Whether it’s the red-hot NI or the cooling MI, high valuation has intrinsic logic from the company development perspective but also requires higher earnings growth justifications. And once the growth logic is proven false, there’s the double whammy from both the growth and valuation discounts.

In 2015’s GEM, the average P/E multiple was over 100 at the peak and took over 3.5 years to find a bottom. It reached a bottom in early 2019 and bounced back 180% since then, but still not back to its 2015 heights. Those investors that got in on the highs lost not just their capital but also their time opportunity.

History often repeats itself. Food and beverages sector had large gains after the pandemic, where the weak earnings growth was ignored as P/E skyrocketed. In 2021 most of these companies went back to historical levels. So, unless there’s strong profitability as base, the mirage built by pure enthusiasm will collapse sooner or later, often unexpectedly.

Choosing between “live for the moment” and “delayed gratification”

Since 2019, with the huge differentiation amongst sector performances, thematic investment becomes a hot topic. There were many multi-billion USD thematic funds set up with clear directions and aggressive positioning. The investors for thematic funds often lack patience, enjoy trading, and believe they can achieve financial independence by deftly and timely switching amongst the favored industries. Unfortunately, it’s tough to build Rome in a single day! The ability to time the market sector rotations proves to be highly elusive, whereas the impulsive decisions are more common during the period of market volatility.

The Accelerating Sector Rotation

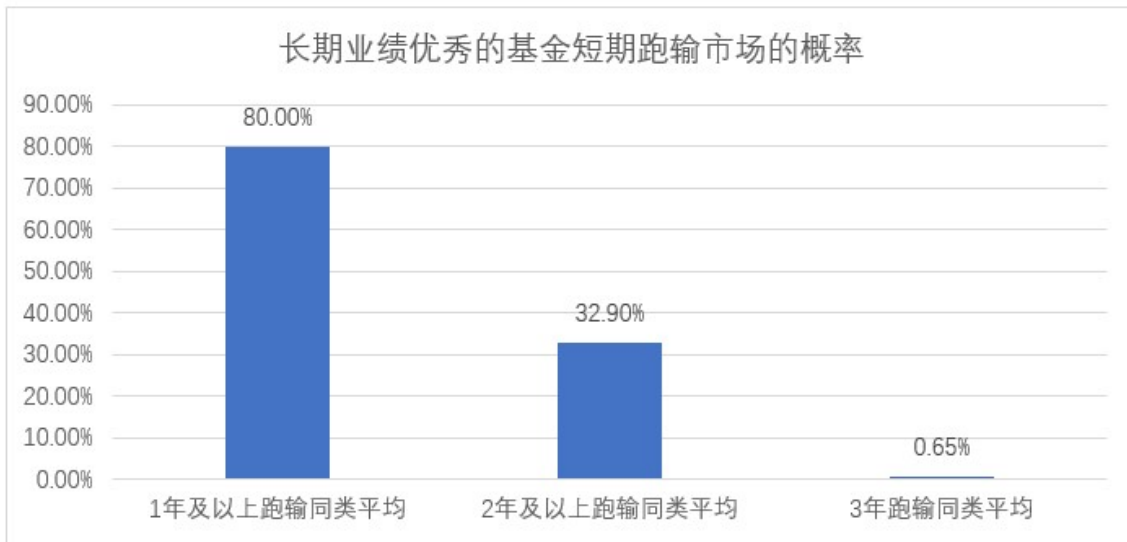
	2021-08-03	2021-08-02	2021-07-30	2021-07-29	2021-07-28	2021-07-27	2021-07-26	2021-07-23	2021-07-22	2021-07-21	2021-07-20
休闲服务(申万)	4.7082	-0.2973	-5.6490	1.8860	-2.0708	-3.0546	-4.7819	-1.8265	-0.9071	-2.8070	0.3028
医药生物(申万)	3.7287	1.5223	-0.8762	2.1460	2.1837	-3.1224	-4.5415	-2.8271	-2.7449	0.9908	0.4611
家用电器(申万)	3.6818	2.8785	0.7209	0.2266	1.0305	-3.4659	-2.5397	-1.9552	-0.0612	-0.8898	-0.6520
建筑材料(申万)	1.6392	5.5312	0.5342	2.3921	-1.0618	-5.5392	-2.4638	-1.2523	0.6074	1.7079	-0.3912
计算机(申万)	1.0865	2.5405	0.7050	2.0212	-2.8637	-1.1662	-2.3174	-2.5133	0.4206	1.7566	-1.1229
食品饮料(申万)	0.9812	4.8032	-4.1372	-0.7355	1.5623	-4.5888	-5.6830	-2.4654	-1.4135	-0.3498	0.2051
交通运输(申万)	0.7705	1.7851	-0.9544	0.6836	-1.0787	-2.9538	-2.0110	-1.9171	0.2750	-0.7324	-0.7212
建筑装饰(申万)	0.6344	1.6629	1.5391	0.7115	-1.5441	-2.7724	-1.1101	0.2911	0.7448	0.3221	0.6070
农林牧渔(申万)	0.5921	3.4039	0.7038	0.9035	-3.0308	-2.6333	-1.4092	-2.1741	-0.3637	-0.5263	-0.0566
综合(申万)	0.4554	2.2277	-0.4363	2.7328	-2.6394	-3.1138	-0.8246	-3.1523	1.7142	1.3075	0.6002
轻工制造(申万)	0.4016	1.1040	-0.4628	1.4747	-0.2223	-3.9236	-2.0094	-2.0225	0.1243	0.3654	-0.1162
纺织服装(申万)	0.3972	1.0568	-0.0206	1.4113	-1.4766	-2.3253	-1.5251	-2.1835	-0.8238	0.2845	-1.3842
非银金融(申万)	0.3744	2.8456	-1.2519	0.8515	-0.5421	-3.1720	-3.7291	-0.0405	1.5969	0.8313	-0.7067
商业贸易(申万)	0.2661	1.5677	0.1343	1.5909	-2.1139	-2.0000	-2.6038	-1.5964	-0.4293	0.5624	-0.0026
房地产(申万)	-0.1675	1.1367	0.0016	0.4581	-0.7837	-3.5828	-4.2250	-0.6520	0.9186	-0.5119	-0.6471
机械设备(申万)	-0.2921	4.0523	0.9502	3.9771	-1.5461	-3.0623	-1.5496	-0.7115	1.5906	1.6043	1.0785
公用事业(申万)	-0.3417	1.3649	2.3197	0.7857	-2.1243	-1.6596	-0.7467	-1.1670	0.5147	0.2662	-0.4805
银行(申万)	-0.5071	1.4989	-1.6296	-0.5350	1.2378	-2.7161	-3.3108	-0.4547	0.6314	-0.8457	-1.3443
化工(申万)	-0.9533	3.3337	-0.6482	3.9602	-1.8185	-3.7138	-1.1146	-1.1126	1.7964	2.3414	0.0510
传媒(申万)	-0.9582	1.3370	-0.1918	1.6877	-0.9143	-2.7953	-3.8380	-2.4176	0.0890	0.3773	-0.1860
通信(申万)	-1.3269	3.2965	1.3255	2.2110	0.0812	1.0806	-2.3397	-1.3668	-0.3822	0.2990	-0.4280
汽车(申万)	-1.7686	5.1879	1.1586	4.1255	-2.4847	-2.6551	-2.8379	1.0703	0.7511	2.4400	0.8055
国防军工(申万)	-1.8419	4.8907	0.1200	4.5118	-5.4869	-1.4977	0.0797	2.1748	-0.2534	1.2794	1.7101
采掘(申万)	-2.3847	-1.0399	1.7767	1.7226	-1.8458	-2.3322	-0.7911	0.0322	1.5169	-0.0596	0.0300
电子(申万)	-3.3849	0.2913	0.4537	4.5724	-2.0689	-1.0378	-0.4804	-1.1889	1.2339	1.9833	1.4913
电气设备(申万)	-3.4211	1.4693	1.0382	6.4813	0.7634	-5.8293	-0.9529	-0.2824	0.8688	4.4967	1.0428
钢铁(申万)	-3.9834	-4.7099	5.6738	3.5918	-2.4575	-4.2553	-1.6865	1.7432	5.3707	2.4115	-1.3411
有色金属(申万)	-5.5411	0.4394	2.4436	5.5375	-3.0548	-4.0262	1.2760	0.5329	2.5791	4.2561	0.4265

Source: Wind, Capital Securities. Above shows daily return of 28 ShenWan industry sectors.

At the end of day, it's a choice between "living for the moment" vs "delayed gratification." Human nature means most people prefer the former, while the latter is the path to long term success. Vanguard's Tidmore and Hon did an analysis in 2020: based on 2600 US mutual funds in the last 25 years, they noticed that amongst those mutual funds that beat the benchmark over time, about 70% of these funds underperform the benchmark over 1-year period about half the time. And 80% of the winning funds will be the bottom quartile amongst their peers for at least one five-year period. This is interesting finding for US funds, will Chinese mutual funds have similar results?

We looked at historical performances of active equity funds in the past 5 years and got similar conclusions to the Vanguard Tidmore & Hon 2020 study. Based on Wind, from 2016 to 2020, there are 155 mutual funds in the top quartile of active equity mutual fund. In these five years, 124 of these 155 had at least one year where they underperformed the group average, or roughly 80%. 51 were behind the group average at least 2 years, or over 30% of the winning funds. There was even one fund that underperformed

the average for 3 out of these 5 years, and still ended up in the top 25% at the end.



Source: Wind, Rosefinch. Data range from 2016.1.1. to 2020.12.31.

How does short term performance fluctuation affect our decision? In Nassim Taleb's book "Antifragile", he mentioned the concept of "signal noise ratio": let's say for every 100 signals you receive, 10 are useful and 90 are noises. As we increase our observation frequency, the signal to noise ratio will go down. For example, when you graph the stock price chart, if you look at the weekly chart, the signal to noise ratio may be 30%. If you look at the daily chart, you get more data, but there's even more noise, and the signal to noise ratio may be only 10%. And if you look at the 5-minute chart, the signal to noise ratio may go down to 5%. It's tough to make the right choice when the signal to noise ratio is low. And even if you can make the right choice half the time, when you increase the decision frequency, the probability of making the right choice over time gets lower as your frequency goes up. To make 3 right decisions in a row, for example, is only 1/8 even if you have a 50/50 chance of being right for each decision. Your risk as a long-term investor, is therefore turning away from a good outperforming fund during its short-term underperformance and missing the chance to be in the top 25% for the long term.

History always repeats itself, and there's nothing new under the sun. In the world of investment, "this time it's different" sounds catchy, but history will repeat itself if human fear and greed remain the key market

drivers. In the current period of wide dispersions, identifying value and staying consistent become even more important.

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