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Rosefinch Research | Short-term Noise vs Long-term Trend

Last week saw big drops in core industries like biopharmaceutical (-7.28%) and food & beverage (-9.8%). The Chinese white liquor was always a "slam dunk" to the investors, only it turned into a missed layup. The market though didn't miss a beat and quickly moved from the muted white liquor to other promising sectors. Since 2Q21, the new energy and semi-conductor sectors have rallied significantly. It's partly because of the high growth from promising outlook, and partly because of the over-valuation from excess liquidity jumping onto the bandwagon.

Short term gyrations in stock prices incorporate emotional premium and discount

Tianfeng Securities used turnover rate to track investor sentiment, including the relationship between the hot sectors' turnover rate and the relative movements between these sectors. They analyzed the data from Jan 2018 to July 2021 and found that the peak of hot sectors usually accompanies unusual turnover rates. Take semi-conductor sector as an example, there were a few periods where the 5-day moving average of daily turnover exceeded 8%: April 2018, July 2019, Mar 2020, and July 2020. When the sector turnover rate exceeds certain threshold, the hot sector usually will go through some consolidation. The reason is when short-term market valuation gets too far ahead of the company's profit-growth, it will usually experience some normalization.

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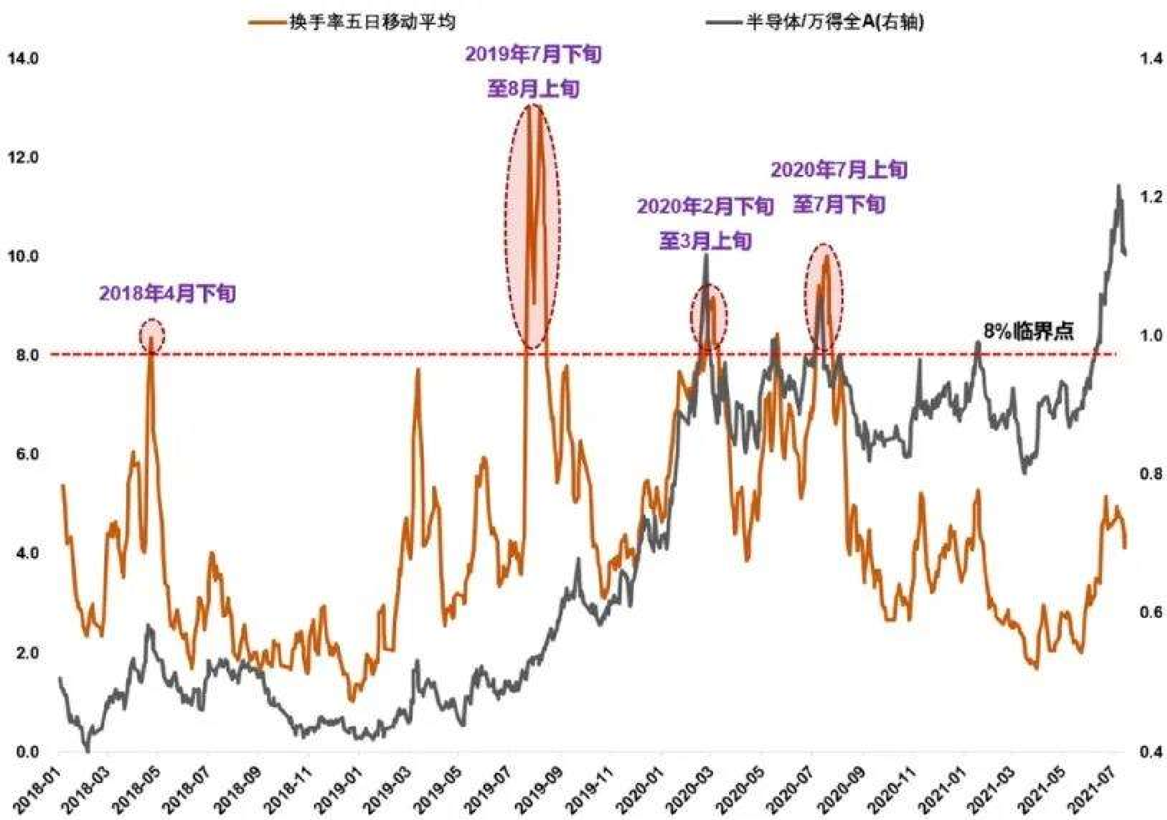
Excess return of semi-conductor vs turnover rate



Data: Wind, Tianfeng Securities, Rosefinch
Orange Line: 5-day moving average of daily turnover rate; Black Line: % of semi-conductor over A-share market

This observation is only one example of impacts from investors' extreme emotions. When driven by human greed and fear, the emotion cycle swings like pendulum – it will stay in reasonable valuation only part of the time, while experience extreme valuations during most of the swing. In fact, most investors' risk preferences swing with the market pendulum. On the one hand, investor will be influenced by the market cycle and become more bullish as market rallies. The net long positions often increase as market goes up. On the other hand, these investors are active market participants and can be an amplifier to push the market towards extreme valuations.

When we look at the market transactions for retail investors, due to delayed access to information, retail investors normally are not buying at the lowest part of the market. Instead, retail inflow normally peaks when the market already had significant rally or when the mutual funds had outstanding performance. These retail investors are entering near the top of the market, thus becoming more susceptible to losses during volatile trading periods. Most of them will in fact throw in the towel when faced with large mark-to-market losses. This is especially the case for very aggressive mutual funds – most retail investors will not have satisfactory returns from such investment. First, these investors normally are late entering the positions and therefore missing the most attractive part of the rally. Second, the high volatility of the A-share market will increase these retail investors' trading frequency. During these rollercoaster emotional swings, the investors' tendency to buy high and sell low further reduces their already limited profit margins.

Shanghai Security Fund Evaluation Center did an analysis recently. They compared two funds with similar returns over three years. Fund A has higher 3y return, while Fund B has lower volatility and smaller drawdown. It turns out Fund B has a higher 3y weighted average return than Fund A. The weighted return takes the fund's return and weigh it by the fund's average AUM during the period. Therefore, if fund AUM is higher due to retail investors chasing the peak and missing the high-performing part of the fund history, then the weighted return will be lower. This weighted return approach is therefore a more accurate measure of retail investors' actual experiences.

基金简称	近三年收益率（%）	波动率（%）	最大回撤（%）	三年加权平均净值利润率（%）	加权平均净值利润率（%）		
					2018	2019	2020
基金 A	168.09	**25.55**	**-31.61**	**117.57**	-28.54	45.31	66.99
基金 B	164.73	**23.52**	**-25.17**	**154.13**	-20.85	43.19	83.38

Data: Wind, Shanghai Securities.
Label from left: name, 3y return, volatility, max drawdown, 3y weighted return, weighted return by year.

Contrary to most investors' impressions, the best investment opportunity arrives when it's darkest. The excessive fear and the most reluctant time to invest are precisely the ingredients for the best long-term investment opportunity.

In fact, those funds that appear to be slow in the short-term may become the great long-term partner for the patient investors. According to Wind, amongst the 623 active equity mutual funds created before 2016, only 27 or 4.3% are in the top half for each of the next 5 years 2016-2020. These 27 funds had an average return of 193% over that 5-year period. Even the lowest of these are in the top 5-year quartile amongst these 623 funds. These funds may not look impressive in Bull markets, but they have better risk control in Bear markets and avoid large drawdowns. Over long term, these funds will keep making new highs.

Investment is both a science and an art. Investors can come up with profit-forecasts using micro-research and forecast models. They can incorporate company developments, monetary policies, and investors' risk preference into the valuation model for the target companies. To the fund managers, profitability and valuation are the two most important aspects of an investment strategy. The responsible managers will always search for the optimal balance between the two. The short-term stock price may

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experience random moves from liquidity flows, but from the long-term perspective, the investment decisions should be based on the deep understanding of the industry's growth and the company's core competitive edge.

Recently there were some large volatile moves in the new energy sector, but we remain extremely bullish in the medium and long-term outlook. 2021 is the first year for China's "3060" initiative. The dual targets of "Carbon-Peak by 2030" and "Carbon-Neutral by 2060" are generating rare growth opportunities for green industries. For the next 10-20 years, there's still plenty of room for sizeable growth in photovoltaic industry. The leading players will have significant edges over cost controls, technological advances, and distribution channels. They have identified their core competitive edge and will maintain a faster-than-average growth rate. With reasonable valuation assumptions, the strong leaders' investment potential is very attractive. What Rosefinch wants is to find these high-quality well-managed companies leading such long-term trends and grow with them.