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Rosefinch Research | 2022 Series # 4

Befriending Volatility

Start of 2022 saw a quick change of style with growth stocks leading the market correction lower. The drop in the first two weeks almost wiped out the whole 2021 gains, leaving a bad taste for the investors. According to Asset Management Association of China (AMAC), you are not alone in feeling the anxiety. AMAC recently conducted a survey that showed over 1/3 of mutual fund investors will feel strong anxiety after losing over -10%. Given this is happening in the beginning of the year, no wonder people are stressed.

In fact, sharp retracements are not unusual: even the best equity funds may see sharp corrections of over -30% in short periods. As of end of 2021, the China equity fund index had retracements of -10% or more in 9 out of 10 years, yet it didn't prevent the index from achieving an impressive annualized +14.6% return for the long-term investors. But if the investors buy-high during euphoria and sell-low under stress, they will end up empty-handed.

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Source: Wind, Rosefinch. Blue bar is annual return on left axis, orange line is max retracement on right axis.

In the world of investing, there's no strategy that wins all the time – even Buffett will admit he can't beat the market every year. But the good investment strategies will usually provide solid returns over a complete cycle. When the growth stocks rally quickly, it also adds risk which can be released during correction phases. We can look at the investment style of investment legend Peter Lynch. Mr. Lynch credited his success in growth stock investment to finding "Tenbagger", or stocks that grow over ten times. When a relatively unknown Peter Lynch took over the $18 million Magellan fund in 1977, no one expected him to generate annualized +29.2% in the next 13 years. By the time Mr. Lynch left Magellan in 1990, the fund had grown to $14 billion, or grew almost 1000 times. **Just like Tenbagger to Lynch, CocaCola to Buffett, or Tesla to Baillie Gifford, investing and staying with star companies of their times allowed these legends to deliver extraordinary returns to investors.**

As the emerging markets poster child, China's A-share market went through tremendous growth in the past 30 years. From the initial 8 stocks in 1990 to over 4600 stocks today, the investable universe grew by over 600 times. The market capitalization of A-shares has increased from 2.8 billion RMB to 90 trillion RMB today, or over 30,000 times. Given such tremendous growth, how many Tenbaggar stocks and Peter Lynch came through? Soochow Securities did a "Tenbaggar" research series focusing on stock performances after the IPO year. In the 20 years since 2000, there were 637 stocks that grew more than 10 times at one point, or 18% of total universe. If we just look at if the stock grew 10 times by 2020, there are only 176 stocks, or 5% of total A-share universe. Soochow Securities filtered further on stocks that's in top 5% in both measures, which resulted in 120 stocks that both achieved high historical performances, and sustained such performances by 2020. The interesting question is: what do we notice about these 120 stocks?

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The first observation is that it takes a long time period to achieve the 10-times performance. When we start tracking at IPO+1 year, on average, it took these stocks 100 months to achieve 10 times growth. 100 months or over 8 years represents at least one bull-bear cycle in the market. The second observation is that there's significant retracement even for the Tenbaggar stocks. During the major stock market corrections in 2008 and 2015, the average retracement for such stocks is over -40%, with many over -50%. Even the road for Tenbaggar is full of twist and turns. **It is important to have a good eye for companies, it's also important to have a steady hand and stay with the position through the market ups and downs.**

Having looked at the Tenbaggar stocks, what about the Peter Lynch's of A-share market? In the same Soochow Securities study, they looked at top 30 stocks that are commonly held by mutual funds, and then selected 25 mutual funds that held these stocks the longest. These mutual funds therefore both identified the stocks and also stayed with the positions for the long-term. These 25 funds had average annualized returns of 19%, thus representing strong industry returns. A closer analysis of these 25 funds revealed that they didn't focus on market timing, but rather maintained high exposures through most periods: they maintained about 85% with very rare major adjustments for most of the period. In addition, the turnover is very low as these fund managers held on to core positions. In 2019, the average position held period for these fund managers is longer than 71% of their peers.

Investment looks easy in rear-view mirror – isn't it just about finding a good company and good fund, then hold on to it? Sounds easy, but it's hard to do. Even when the approach is clear, it still takes discipline and commitment to walk the path of "Tenbaggar" investment. Of course, there are other ways of investing. Hwabao Securities summarized four investment styles, with the "diversified industries w/ less rotation" style the most demanding for stock-selection, but also the most likely to capture Tenbaggars.

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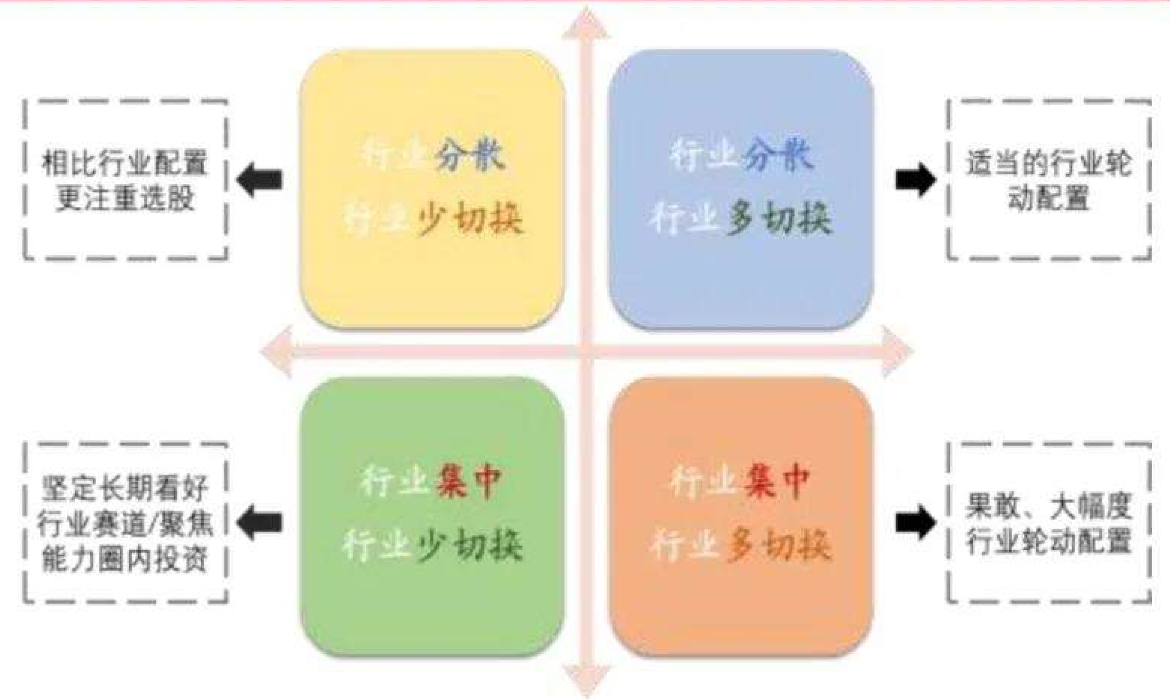

Source: Hwabao Securities. Top left: diversified industries w/ less rotation. Top right: diversified industries w/ more rotation. Bottom left: concentrated industries w/ less rotation. Bottom right: concentrated industries w/ more rotation.

No matter what investment style, one must avoid the "get-rich quick" mentality. Unfortunately, with the information explosion, it's harder to stay calm. The stock prices are dancing daily, portfolio values are bouncing in front of our eyes, there is constant bombardment of the latest "best investment ideas", all of which are baiting us to make high frequency decisions. The most potentially incorrect decisions we make, the less likely we will achieve success in the end. When there's market volatility, risk and opportunity will co-exist. **When the good company's stock price drops, it increases long-term potential returns. Good investors befriend market volatility.**

Peter Lynch said: "A successful stockpicker has the same relationship with a drop in the market as a Minnesotan has with freezing weather. You know it's coming, and you're ready to ride it out, and when your favorite stocks go down with the rest, you jump at the chance to buy more." Li Lu, head of Himalaya Capital Management, said investors should expect slow, gradual, and long-term investment returns. The short-term volatility should not impact our investment style. When you have such approach, you will find the market's volatility and correction can work to your advantage.

Risk and opportunity often travel hand in hand. Both are part of the volatile markets, while various market participants will have different perspectives based on their own capabilities and experiences. The key is how to build deep expertise in specific companies or industries, so that we can accurately evaluate and position for future trends. **Just like in baseball, we don't expect to hit a home-run every time –**

as long as we can hit most of the pitches in our "capability" strike-zone, that will be sufficient for a long-term winning record for our investors.

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